

GREAT AMERICAN FINANCIAL RESOURCES INC  
Form 10-Q  
August 08, 2007

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SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934

For the Quarterly Period Ended  
June 30, 2007

Commission File

No. 1-11632

Incorporated under  
the Laws of Delaware

IRS Employer I.D.

No. 06-1356481

250 East Fifth Street, Cincinnati, Ohio 45202  
(513) 333-5300

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer: Large Accelerated Filer\_\_\_ Accelerated Filer X Non-Accelerated Filer\_\_\_

Indicate by check mark whether the Registrant is a shell company. Yes\_\_\_ No X

As of August 1, 2007, there were 47,774,881 shares of the Registrant's Common Stock outstanding.

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GREAT AMERICAN FINANCIAL RESOURCES, INC.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

PART I

ITEM 1 - FINANCIAL STATEMENTS

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET - (UNAUDITED)

(Dollars in millions)

	June 30, <u>2007</u>	December 31, <u>2006</u>
Assets		
Investments:		
Fixed maturities:		
Available-for-sale - at fair value (amortized cost - \$9,699.9 and \$9,104.3)	\$ 9,535.3	\$ 9,120.5
Trading securities - at fair value	279.8	276.4
Equity securities - at fair value (cost - \$278.8 and \$214.0)	305.6	238.4
Mortgage loans on real estate	189.0	170.6
Real estate	78.0	78.0
Policy loans	269.2	267.1
Cash and cash equivalents	<u>107.7</u>	<u>564.3</u>

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Total cash and investments	10,764.6	10,715.3
Accrued investment income	127.2	124.5
Unamortized insurance acquisition costs	1,015.1	946.1
Reinsurance recoverable	650.5	677.3
Deferred tax benefit on unrealized losses	39.7	-
Other assets	351.0	171.7
Variable annuity assets (separate accounts)	<u>717.2</u>	<u>700.5</u>
	<u>\$13,665.3</u>	<u>\$13,335.4</u>
Liabilities and Stockholders' Equity		
Annuity benefits accumulated	\$ 9,829.1	\$ 9,456.7
Unearned revenue	101.1	104.1
Life, accident and health reserves	1,446.4	1,414.7
Long-term debt	264.1	273.1
Payable to affiliates, net	153.5	133.4
Deferred tax liability on unrealized gains	-	14.0
Accounts payable, accrued expenses and other liabilities	128.4	164.9
Variable annuity liabilities (separate accounts)	<u>717.2</u>	<u>700.5</u>
Total liabilities	12,639.8	12,261.4
Stockholders' Equity:		
Common Stock, \$1 par value		
-100,000,000 shares authorized		
-47,774,881 and 47,569,236 shares outstanding	47.8	47.6
Capital surplus	419.7	416.7
Retained earnings	628.2	583.4
Accumulated other comprehensive income (loss), net	<u>(70.2)</u>	<u>26.3</u>
Total stockholders' equity	<u>1,025.5</u>	<u>1,074.0</u>
	<u>\$13,665.3</u>	<u>\$13,335.4</u>

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

## CONSOLIDATED INCOME STATEMENT - (UNAUDITED)

(In millions, except per share amounts)

	Three months ended		Six months ended	
	<u>June 30,</u>		<u>June 30,</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Revenues:				
Life, accident and health premiums	\$103.4	\$ 75.5	\$210.0	\$152.0
Net investment income	158.0	149.7	316.2	297.6
Realized gains (losses) on:				
Investments	7.7	(8.7)	8.8	(4.6)
Retirement of debt	-	(0.6)	(1.1)	(4.3)
Other income	<u>31.8</u>	<u>21.7</u>	<u>58.9</u>	<u>46.3</u>
	300.9	237.6	592.8	487.0
Costs and Expenses:				
Annuity benefits	90.4	84.0	179.2	166.8
Life, accident and health benefits	85.5	66.6	170.9	130.9
Insurance acquisition expenses	40.7	30.3	85.2	62.3
Interest and debt expenses	5.3	5.7	11.0	11.9
Other expenses	<u>44.3</u>	<u>32.6</u>	<u>82.1</u>	<u>67.2</u>
	<u>266.2</u>	<u>219.2</u>	<u>528.4</u>	<u>439.1</u>

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Operating earnings before income taxes	34.7	18.4	64.4	47.9
Provision for income taxes	<u>11.8</u>	<u>6.3</u>	<u>21.5</u>	<u>16.7</u>
Income from continuing operations	22.9	12.1	42.9	31.2
Discontinued hotel operations, net of tax	-	(0.1)	-	(0.6)
Gain on sale of discontinued hotel, net of tax	<u>1.9</u>	<u>31.6</u>	<u>1.9</u>	<u>31.6</u>
Net Income	<u>\$ 24.8</u>	<u>\$ 43.6</u>	<u>\$ 44.8</u>	<u>\$ 62.2</u>
Basic earnings per common share				
:				
Continuing operations	\$ 0.48	\$ 0.25	\$ 0.90	\$ 0.65
Discontinued hotel operations	-	-	-	(0.01)
Gain on sale of discontinued hotel	<u>0.04</u>	<u>0.67</u>	<u>0.04</u>	<u>0.67</u>
Net income	<u>\$ 0.52</u>	<u>\$ 0.92</u>	<u>0.94</u>	<u>\$ 1.31</u>
Diluted earnings per common share				
:				
Continuing operations	\$ 0.47	\$ 0.25	\$ 0.88	\$ 0.65
Discontinued hotel operations	-	-	-	(0.01)
Gain on sale of discontinued hotel	<u>0.04</u>	<u>0.66</u>	<u>0.04</u>	<u>\$ 0.66</u>
Net income	<u>\$ 0.51</u>	<u>\$ 0.91</u>	<u>\$ 0.92</u>	<u>\$ 1.30</u>
Average number of common shares:				
Basic	47.7	47.4	47.7	47.4
Diluted	48.4	48.0	48.5	48.0

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q  
 GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES  
 CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY - (UNAUDITED)  
 (In millions)

	Six months ended <u>June 30.</u>	
	<u>2007</u>	<u>2006</u>
<b>Common Stock:</b>		
Balance at beginning of period	\$ 47.6	\$ 47.3
Common Stock issued	0.4	0.2
Common Stock retired	<u>(0.2)</u>	<u>(0.1)</u>
)		)
Balance at end of period	<u>\$ 47.8</u>	<u>\$ 47.4</u>
 <b>Capital Surplus:</b>		
Balance at beginning of period	\$416.7	\$409.0
Common Stock issued	6.9	3.1
Common Stock retired	(3.9)	(0.9)
Stock option settlements	(1.6)	-
Agent stock option grants	0.3	0.2
Stock-based compensation expense	<u>1.3</u>	<u>1.0</u>
Balance at end of period	<u>\$419.7</u>	<u>\$412.4</u>
 <b>Retained Earnings:</b>		

Balance at beginning of period	\$583.4	\$489.2
Net income	<u>44.8</u>	<u>62.2</u>
Balance at end of period	<u>\$628.2</u>	<u>\$551.4</u>

Accumulated Other Comprehensive Loss:

Balance at beginning of period	\$ 26.3	\$ 61.2
Change in net unrealized gains (losses) during the period	(99.8)	(179.7)
Change in unrealized pension and other post retirement benefits	<u>3.3</u>	<u>-</u>
Balance at end of period	<u>(\$70.2)</u>	<u>(\$118.5)</u>

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Comprehensive Loss

Net income	\$ 44.8	\$ 62.2
Change in net unrealized gains (losses) during the period	(99.8)	(179.7)
Change in unrealized pension and other post retirement benefits	<u>3.3</u>	<u>-</u>
Comprehensive loss	<u>(\$ 51.7)</u>	<u>(\$117.5)</u>

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS - (UNAUDITED)

(In millions)

Six months ended  
June 30,



	<u>2007</u>	<u>2006</u>
Cash Flows from Operating Activities:		
Net income	\$ 44.8	\$ 62.2
Adjustments:		
Increase in life, accident and health reserves	30.5	21.0
Benefits to annuity policyholders	179.2	166.8
Amortization of insurance acquisition costs	65.2	50.5
Depreciation and amortization	6.5	6.2
Realized (gains) losses on investments	(8.8)	4.6
Gain on sale of discontinued hotel	(2.9)	(48.7)
Realized losses on retirement of debt	1.1	4.3
Net trading portfolio activity	(8.4)	(13.1)
Increase in insurance acquisition costs	(103.2)	(66.9)
Decrease (increase) in reinsurance recoverable	14.4	(4.3)
Increase in other assets	(136.0)	(11.5)
Decrease in other liabilities	(12.9)	(1.1)
Increase in payable to affiliates, net	20.1	26.4
Other, net	<u>(6.7)</u>	<u>(0.9)</u>
	)	)
Net cash provided by operating activities	<u>82.9</u>	<u>195.5</u>
Cash Flows from Investing Activities:		
Purchases of and additional investments in:		
Fixed maturity investments	(1,324.6)	(1,071.5)
Equity securities	(94.4)	(43.4)
Real estate, mortgage loans and other assets	(32.8)	(39.8)
Cash and short-term investments of businesses acquired, net	-	104.8
Proceeds received from sale of Puerto Rican operations, net	-	27.2
Maturities and redemptions of fixed maturity investments	322.9	256.5
Sales of:		
Fixed maturity investments	382.5	735.6
Equity securities	43.3	44.0
Real estate, mortgage loans and other assets	14.1	62.2
Increase in policy loans	<u>(2.1)</u>	<u>(3.9)</u>
	)	)
Net cash provided by (used in) investing activities	<u>(691.1)</u>	<u>71.7</u>

	)	
Cash Flows from Financing Activities:		
Annuity receipts	817.4	515.4
Annuity surrenders, benefits and withdrawals	(691.7)	(592.0)
Net transfers from variable annuity assets	31.9	7.2
Additions to long-term debt	92.0	15.0
Reductions of long-term debt	(102.1)	(82.8)
Issuance of Common Stock	7.2	2.9
Other	<u>(3.1)</u>	<u>(0.8)</u>
	)	)
Net cash provided by (used in) financing activities	<u>151.6</u>	<u>(135.1)</u>
	)	)
Net increase (decrease) in cash and cash equivalents	(456.6)	132.1
Cash and cash equivalents at beginning of period	<u>564.3</u>	<u>154.3</u>
	)	)
Cash and cash equivalents at end of period	<u>\$ 107.7</u>	<u>\$ 286.4</u>

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A. Description of the Company

Great American Financial Resources, Inc. ("GAFRI" or "the Company"), through its subsidiaries, markets fixed, indexed and variable annuities, and various forms of supplemental insurance through independent agents. To a lesser extent, the Company also markets certain of its supplemental insurance products through a captive agency force.

## Acquisition by American Financial Group, Inc.

American Financial Group, Inc. ("AFG") and its subsidiaries owned 81% of GAFRI's Common Stock at August 1, 2007. On May 17, 2007, AFG and GAFRI entered into a definitive merger agreement under which GAFRI would acquire the GAFRI shares which AFG does not currently own at a price of \$24.50 per share in cash, for a total purchase price of approximately \$225 million. GAFRI expects the merger to be completed in September 2007, and will use excess capital plus borrowings from AFG to fund the transaction.

• Accounting Policies

## Basis of Presentation

The accompanying consolidated financial statements for GAFRI and its subsidiaries are unaudited; however, management believes that all adjustments (consisting only of normal recurring accruals unless otherwise disclosed herein) necessary for fair presentation have been made. The results of operations for interim periods are not necessarily indicative of results to be expected for the year. The financial statements have been prepared in accordance with the instructions to Form 10-Q and therefore do not include all information and footnotes necessary to be in conformity with U.S. generally accepted accounting principles ("GAAP").

Certain reclassifications have been made to prior years to conform to the current year's presentation. All significant intercompany balances and transactions have been eliminated. All acquisitions have been treated as purchases. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates.

## Investments

Fixed maturity and equity securities classified as "available-for-sale" are reported at fair value with unrealized gains and losses reported as a separate component of stockholders' equity. Fixed maturity and equity securities classified as "trading" are reported at fair value with changes in unrealized gains or losses during the period included in investment income. Short-term investments are carried at cost; mortgage loans on real estate are carried at the unpaid principal balance adjusted for any unamortized premium or discounts; and policy loans are carried at the aggregate unpaid balance. Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations.

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other than temporary, a provision for impairment is charged to earnings (included in realized gains (losses) on investments) and the cost basis of that investment is reduced.

## Derivatives

Derivatives included in GAFRI's Balance Sheet are recorded at fair value and consist primarily of (i) the interest component of certain life reinsurance contracts (included in other liabilities), (ii) interest rate swaps (included in long-term debt), (iii) the equity-based component of certain annuity products (included in annuity

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

benefits accumulated) and (iv) related call options (included in other assets) designed to be consistent with the characteristics of the liabilities and used to mitigate the risk embedded in those indexed-annuity products. Changes in the fair value of derivatives are included in current earnings.

The terms of the interest rate swaps match those of the debt; therefore, the swaps are considered to be (and are accounted for as) 100% effective fair value hedges. Both the swaps and the hedged debt are adjusted for changes in fair value by offsetting amounts. Accordingly, since the swaps are included with long-term debt in the Balance Sheet, the only effect on GAFRI's financial statements is that the interest expense on the hedged debt is recorded based on the variable rate.

## Goodwill

Goodwill (included in other assets) represents the excess of cost of subsidiaries over GAFRI's equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually.

## Reinsurance

In the normal course of business, GAFRI's insurance subsidiaries cede business to other companies under various reinsurance agreements to diversify risk and limit maximum exposure. These transactions may also provide a source of additional capital and liquidity. GAFRI remains obligated for amounts ceded in the event that the reinsurers do not meet their obligations. GAFRI reviews the financial condition of its reinsurers and monitors the amount of reinsurance it has with each company.

Under certain of these agreements, GAFRI's insurance subsidiaries cede life insurance policies to a third party on a funds withheld basis whereby GAFRI retains the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. These reinsurance contracts are considered to contain embedded derivatives (that must be adjusted to fair value) because the yield on the payables is based on specific blocks of the ceding companies' assets, rather than the overall creditworthiness of the ceding company. GAFRI determined that a change in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. GAFRI classifies the securities related to these transactions as "trading." The adjustment to fair value on the embedded derivatives offsets the investment income recorded on the adjustment to fair value of the related trading portfolios.

## Insurance Acquisition Costs and Expenses

Unamortized insurance acquisition costs consist of deferred policy acquisition costs ("DPAC") and the present value of future profits on business in force ("PVFP") of acquired insurance companies.

Insurance acquisition expenses in the income statement reflect primarily the amortization of DPAC and PVFP. In addition, certain commission costs are expensed as paid and included in insurance acquisition expenses. All other uncapitalized acquisition costs such as marketing and underwriting expenses are included in "Other expenses."

### Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs (principally commissions, advertising, underwriting, policy issuance and sales expenses that vary with and are primarily related to the production of new business) are deferred to the extent that such costs are deemed recoverable. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses.

DPAC related to annuities and universal life insurance products is deferred to the extent deemed recoverable and amortized, with interest, in relation to the present value of actual and expected gross profits on the policies. Expected gross profits consist principally of estimated future investment margin (estimated future net investment income less interest credited on policyholder funds) and surrender, mortality, and other life and variable annuity policy charges, less death and annuitization benefits in excess of account balances and estimated future policy administration expenses.

To the extent that realized gains and losses result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains. DPAC related to annuities is also adjusted, net of tax, for the change in

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

amortization that would have been recorded if the unrealized gains (losses) from securities had actually been realized. This adjustment is included in unrealized gains (losses) on marketable securities, a component of "Accumulated other comprehensive income (loss), net" in the stockholders' equity section of the Balance Sheet.

DPAC related to traditional life and health insurance is amortized over the expected premium paying period of the related policies, in proportion to the ratio of annual premium revenues to total anticipated premium revenues. Such anticipated premium revenues were estimated using the same assumptions used for computing liabilities for future policy benefits.

Life and health insurance contracts are reviewed periodically using actuarial assumptions revised based on actual and anticipated experience, to determine if there is

a potential premium deficiency. If any such deficiency exists, it is recognized by a charge to income and a reduction in unamortized acquisition costs.

Present Value of Future Profits ("PVFP")

Insurance acquisition costs include the PVFP on business in force of acquired insurance companies, which represents the portion of the costs to acquire such companies that is allocated to the value of the right to receive future cash flows from insurance contracts existing at the date of acquisition.

The PVFP is amortized with interest in relation to expected gross profits of the acquired policies for annuities and universal life products and in relation to the premium paying period for traditional life and health insurance products.

Annuity Benefits Accumulated

Annuity receipts and benefit payments are recorded as increases or decreases in "annuity benefits accumulated" rather than as revenue and expense. Increases in this liability for interest credited are charged to expense and decreases for surrender charges are credited to other income.

Reserves for two-tier annuities (annuities with different stated account values depending on whether a policyholder annuitizes, dies or surrenders) are recorded at the lower-tier value plus additional reserves for (i) accrued persistency and premium bonuses; and (ii) excess benefits expected to be paid on future deaths and annuitizations ("EDAR") that require payment of the upper-tier value. The liability for EDAR is accrued for and modified using assumptions consistent with those used in determining DPAC and DPAC amortization, except that accruals are in relation to the present value of total expected assessments. Total expected assessments consist principally of estimated future investment margin, surrender, mortality, and other life and variable annuity policy charges, and unearned revenues once they are recognized as income.

Reserves for traditional single-tier fixed annuities are generally recorded at the stated annuitization value. Reserves for indexed annuities are recorded at a value reflecting the fixed guarantees in the product plus the fair value of the equity participation in the contract.

Unearned Revenue

Policy charges that represent fees for future services are deferred as unearned revenue and recognized as income using the same assumptions and estimated gross profits used to amortize DPAC.

## Life, Accident and Health Reserves

Liabilities for future policy benefits under traditional life, accident and health policies are computed using the net level premium method. Computations are based on the original projections of investment yields, mortality, morbidity and surrenders and include provisions for unfavorable deviations. Reserves established for accident and health claims are modified as necessary to reflect actual experience and developing trends.

The liability for future policy benefits for interest sensitive life and universal life policies is equal to the sum of the accumulated fund balances under such policies.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### Variable Annuity Assets and Liabilities

Separate accounts related to variable annuities represent the fair value of deposits invested in underlying investment funds on which GAFRI earns a fee. Investment funds are selected and may be changed only by the policyholder, who retains investment risk.

GAFRI's variable annuity contracts contain a guaranteed minimum death benefit ("GMDB") to be paid if the policyholder dies before the annuity payout period commences. In periods of declining equity markets, the GMDB may exceed the value of the policyholder's account. A GMDB liability is established for future excess death benefits using assumptions together with a range of reasonably possible scenarios for investment fund performance that are consistent with DPAC capitalization and amortization assumptions.

#### Life, Accident and Health Premiums and Benefits

For traditional life, accident and health products, premiums are recognized as revenue when legally collectible from policyholders. Policy reserves have been established in a manner that allocates policy benefits and expenses on a basis consistent with the recognition of related premiums and generally results in the recognition of profits over the premium paying period of the policies.

For interest sensitive life and universal life products, premiums are recorded in a policyholder account, which is reflected as a liability. Revenue is recognized as amounts are assessed against the policyholder account for mortality coverage and contract expenses. Surrender benefits reduce the account value. Death benefits are expensed when incurred, net of the account value.

#### Payable to Subsidiary Trusts

Two wholly-owned subsidiary trusts were formed to issue preferred securities and, in turn, purchased a like amount of subordinated debt from their parent company. Interest and principal payments from the parent fund the respective trust obligations. GAFRI does not consolidate the trusts because they are "variable interest entities" in which GAFRI is not considered to be the primary beneficiary. Accordingly, the subordinated debt due to the trusts is included in "Long-term debt" in the Balance Sheet and the related interest expense is included in "Interest and debt expenses" in the Income Statement.

## Income Taxes

Under a tax agreement with AFG that became effective in 2006, GAFRI and its subsidiaries in the consolidated tax group generally pay or recover taxes based on each subsidiary's contribution to amounts due under AFG's consolidated return. The tax allocation agreement with AFG has not impacted the recognition of income tax expense and income tax payable in GAFRI's financial statements. If the AFG tax group utilizes any of GAFRI's net operating losses or deductions that originated prior to GAFRI's entering AFG's consolidated tax group, AFG will pay to GAFRI an amount equal to the benefit received.

Deferred income tax assets and liabilities are determined based on differences between financial reporting and tax basis and are measured using enacted tax rates. The Company recognizes deferred tax assets if it is more likely than not that a benefit will be realized. Current and deferred tax assets and liabilities of companies in AFG's consolidated tax group are aggregated with other amounts receivable from or payable to affiliates. Current and deferred tax assets and liabilities of companies not in the consolidated tax group are shown in "Other liabilities" in the Balance Sheet.

Implementation of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109)" ("FIN 48") on January 1, 2007, had no effect on GAFRI's financial position. FIN 48 sets forth criteria for recognition and measurement of tax positions taken or expected to be taken in a tax return. FIN 48 requires that companies recognize the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest, penalties, accounting in interim periods and disclosure. GAFRI's reserve for unrecognized income tax benefits (included in "Payable to affiliates, net" in the Balance Sheet) was approximately \$11 million at January 1, 2007. Recognition of these benefits would reduce GAFRI's effective tax rate. GAFRI does not anticipate significant changes to this reserve within the next twelve months.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### Stock-Based Compensation

All share-based grants are recognized as compensation expense based on their calculated "fair value" at the date of grant over the vesting period. GAFRI uses the Black-Scholes pricing model to measure the fair value of its stock options. See Note I to the Financial Statements - "Stockholders' Equity" for further information on stock options.

#### Benefit Plans

Prior to July 1, 2006, the Company maintained a defined contribution plan that combined a retirement plan and 401(k) plan. Effective that date, the Company's plan was merged with a similar plan sponsored by AFG. As a result, Company employees who meet the eligibility requirements participate in that plan. At the discretion of the GAFRI Board of Directors, GAFRI makes all contributions to the retirement fund portion of the Plan and matches a percentage of employee contributions to the savings fund. Employees are permitted to direct the investment of all contributions to independently managed investment securities as well as funds comprised of GAFRI and AFG securities. Company contributions are expensed in the year for which they are declared.

GAFRI and certain of its subsidiaries provide certain benefits to eligible retirees. The projected future cost of providing these benefits is expensed over the period the employees earn such benefits.

#### Earnings Per Share

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Basic earnings per share is calculated using the weighted-average number of shares of common stock outstanding during the period. The calculation of diluted earnings per share includes the following dilutive effect of common stock options: second quarter and first six months of 2007 - 0.7 million shares and 0.8 million shares, respectively, and second quarter and first six months of 2006 - 0.6 million shares.

### Statement of Cash Flows

For cash flow purposes, "investing activities" are defined as making and collecting loans and acquiring and disposing of debt or equity instruments and property and equipment. "Financing activities" include annuity receipts, benefits and withdrawals and obtaining resources from owners and providing them with a return on their investments. All other activities are considered "operating." Short-term investments having original maturities of three months or less when purchased are considered to be cash equivalents for purposes of the financial statements.

### C. Discontinued Operations

On June 2, 2006, GAFRI sold Chatham Bars Inn, a resort hotel located on Cape Cod, Massachusetts, for \$166 million. In accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets", the operating results and the gain on the sale of the hotel are included in discontinued operations in the Consolidated Income Statement. Discontinued operations for 2007 represent additional gains on operations sold in previous years, primarily the settlement of a contingency associated with the Chatham sale.

In January 2006, GAFRI sold Great American Life Assurance Company of Puerto Rico ("GA-PR") for \$37.5 million in cash, recognizing a pre-tax loss of \$0.5 million. This loss was offset by a like amount of GA-PR earnings recorded prior to the sale. In connection with the sale, GAFRI established a \$7.9 million letter of credit to provide for potential liabilities.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

### D. Acquisitions

On August 7, 2006, GAFRI (parent) acquired all of the outstanding shares of Ceres Group, Inc. During the six months ended June 30, 2007, GAFRI continued to refine the allocation of the purchase price to the individual assets acquired and liabilities assumed based on their estimated fair values. The refinement of the allocation of the purchase price included in the current period balance sheet is based on the best estimates of management and independent appraisers.

In the first quarter of 2006, GALIC acquired, through a reinsurance transaction, the fixed annuity block written by Old Standard Life Insurance Company. As part of the assets received in the reinsurance transaction, GALIC also acquired the stock of Old West Annuity and Life Insurance Company.

GAFRI's financial statements include the results of the above since their acquisition.

### E. Segments of Operations



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GAFRI manages its business as four segments: (i) annuity operations; (ii) supplemental insurance; (iii) life operations; and (iv) corporate and other, which include holding company assets and costs as well as interest and other debt expenses.

Revenue from GAFRI's annuity operations consists primarily of investment income as well as operating revenues from its real estate investments. GAFRI's annuity products are sold through independent agents to employees of primary and secondary educational institutions and in the non-qualified markets. GAFRI is engaged in a variety of real estate operations including hotels and marinas.

GAFRI's supplemental insurance businesses (United Teacher Associates Insurance Company ("UTA"), Loyal American Life Insurance Company, Continental General Insurance Company, Central Reserve Life Insurance Company and Provident American Life and Health Insurance Company primarily offer a variety of Medicare Supplement, long term care and limited benefit policies to supplement primary health insurance and other insurance coverage. These products are offered primarily through independent agents and, to a lesser extent, captive agents.

Traditional term and universal life insurance products had been marketed through national marketing organizations until 2004, when GAFRI suspended new sales of these life insurance products due to inadequate volume and returns. The Company continues to service its in-force block of these policies.

"Corporate and other" consists primarily of GAFRI (parent) and AAG Holding (intermediate holding company) and includes interest expense.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

The following table shows (in millions) GAFRI's revenues and operating profit by significant business segment.

	Three months ended		Six months ended	
	<u>June 30.</u>		<u>June 30.</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
<u>Revenues</u>				
Fixed annuity operations	\$141.4	\$130.6	\$281.2	\$262.2
Variable annuity operations	6.3	6.0	12.3	11.9
Real estate operations	<u>8.5</u>	<u>7.4</u>	<u>14.3</u>	<u>17.7</u>
			(1)	
Total annuity operations	156.2	144.0	307.8	291.8
Supplemental insurance operations	119.1 (2)	79.3	241.4 (2)	158.9
Life operations	17.4	18.2	35.0	36.7
Corporate and other	<u>0.5</u>	<u>5.4</u>	<u>0.9</u>	<u>8.5</u>

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Total operating revenues	293.2	246.9	585.1	495.9
Realized gains (losses)	<u>7.7</u>	<u>(9.3)</u>	<u>7.7</u>	<u>(8.9)</u>
	)		)	
Total revenues per income statement	<u>\$300.9</u>	<u>\$237.6</u>	<u>\$592.8</u>	<u>\$487.0</u>
<u>Operating profit - pre-tax</u>				
Fixed annuity operations	\$ 29.4	\$ 25.9	\$ 56.6	\$ 53.5
Variable annuity operations	1.2	0.6	2.0	1.4
Real estate operations	<u>1.0</u>	<u>0.4</u>	<u>0.7</u>	<u>5.7</u>
			(1)	
Total annuity operations	31.6	26.9	59.3	60.6
Supplemental insurance operations	6.4 (2)	3.9	13.1 (2)	4.2
Life operations	0.5	2.0	2.6	4.1
Corporate and other:				
Interest and other debt expenses	(5.3)	(5.7)	(11.0)	(11.9)
Other	<u>(6.2)</u>	<u>0.6</u>	<u>(7.3)</u>	<u>(0.2)</u>
	)	)	)	)
Pre-tax earnings from continuing operations	27.0	27.7	56.7	56.8
Realized gains (losses)	<u>7.7</u>	<u>(9.3)</u>	<u>7.7</u>	<u>(8.9)</u>
	)	)	)	)
Total operating earnings before income taxes per income statement	<u>\$ 34.7</u>	<u>\$ 18.4</u>	<u>\$ 64.4</u>	<u>\$ 47.9</u>

- 
- Includes \$4.9 million of income resulting from a March 2006 payment received from Palm Beach County, Florida in exchange for the imposition of certain limitations on future development of a marina owned by the Company.
  - Includes results of Ceres Group, Inc., which was acquired by GAFRI in August 2006.
  - Includes \$2.0 million charge related to environmental liabilities associated with certain former manufacturing operations.

F. Goodwill

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Changes in the carrying value of goodwill during the first six months of 2007, by reporting segment, are presented in the following table (in millions):

	<u>Fixed Annuity</u>	<u>Supplemental Insurance</u>	<u>Total</u>
Balance at January 1, 2007	\$6.2	\$ 9.7	\$15.9
Additional goodwill (a)	-	8.8	8.8
Other	<u>(0.1)</u>	-	<u>(0.1)</u>
	)	)	
Balance at June 30, 2007	<u>\$6.1</u>	<u>\$18.5</u>	<u>\$24.6</u>

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(a) Subsidiary purchase accounting refinement related to the Ceres acquisition.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

G. Unamortized Insurance Acquisition Costs

Unamortized insurance acquisition costs consisted of the following (in millions):

	June 30, <u>2007</u>	December 31, <u>2006</u>
Deferred policy acquisition costs ("DPAC")	\$ 784.8	\$742.9
Policyholder sales inducements	133.2	109.4
Unrealized DPAC adjustment	22.0	(1.2)
PVFP	<u>75.1</u>	<u>95.0</u>
	<u>\$1,015.1</u>	<u>\$946.1</u>

The unrealized DPAC adjustment reflects the change in DPAC assuming the unrealized gains or losses on securities had actually been realized. See Note B to the Financial Statements - "Accounting Policies".

In the second quarter of 2007, PVFP was reduced by \$12.3 million due to a refinement of the purchase price allocation for the August 2006 Ceres acquisition. The PVFP amounts in the table above are net of \$78.1 million and \$70.5 million of accumulated amortization at June 30, 2007 and December 31, 2006, respectively. Amortization of the PVFP was \$2.4 million in the second quarter of 2007 and \$7.6 million in the first six months of 2007 compared to \$1.6 million in the second quarter of 2006 and \$3.2 million in the first six months of 2006. The increase in amortization compared to the 2006 periods reflects the acquisition of Ceres, including the effect of higher lapses in the Medicare supplement lines.

H. Long-Term Debt

Long-term debt consisted of the following (in millions):

	June 30, <u>2007</u>	December 31, <u>2006</u>
Direct obligations of GAFRI	\$ 0.8	\$ 0.8
Obligations of AAG Holding (guaranteed by GAFRI):		
7-1/2% Senior Debentures due 2033	112.5	112.5
7-1/4% Senior Debentures due 2034	86.3	86.3
6-7/8% Senior Notes due 2008	28.5	31.5
Bank Credit Facility maturing 2011	<u>16.0</u>	<u>-</u>
	<u>244.1</u>	<u>231.1</u>
Payable to Subsidiary Trusts:		
AAG Holding 8-7/8% Subordinated Debentures due 2027	-	22.0
AAG Holding 7.35% Subordinated Debentures due 2033	<u>20.0</u>	<u>20.0</u>
	<u>20.0</u>	<u>42.0</u>
	<u>\$264.1</u>	<u>\$273.1</u>

To achieve a desired balance between fixed and variable rate debt, GAFRI entered into interest rate swaps, which effectively convert its 6-7/8% Senior Notes to a floating rate of 3-month LIBOR plus 2.9% (effective rate of approximately 8.3% at June 30, 2007 and December 31, 2006). In March 2007, GAFRI repurchased \$3.0 million principal amount of its 6-7/8% Senior Notes for \$3.1 million in cash.

Also in March 2007, GAFRI used funds borrowed under its bank credit facility (discussed below) to redeem its remaining 8-7/8% subordinated debentures due 2027 for \$22.9 million.

In March 2006, the Company replaced its existing \$165 million bank credit agreement with a new \$500 million five-year revolving credit facility shared with AFG. Under terms of the new agreement, GAFRI may borrow up to \$175 million with the ability to borrow up to \$200 million, conditioned on AFG not borrowing in excess of \$300 million. AFG has agreed with GAFRI not to borrow more than \$325 million under the credit facility and has agreed to guarantee amounts borrowed by GAFRI. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating. At June 30, 2007, the interest rate on the credit facility was approximately 6.1%.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

At June 30, 2007, GAFRI had virtually no scheduled principal payments on debt for the next five years other than AAG Holding's Senior Notes due in 2008 and the bank credit facility due in 2011.

#### I. Stockholders' Equity

In the first six months of 2007, GAFRI issued 432,297 shares of Common Stock upon the exercise of stock options. Also in the first six months of 2007, GAFRI granted stock options for 0.6 million shares of Common Stock (at an average price of \$23.76) under GAFRI's stock option plans.

GAFRI uses the Black-Scholes option-pricing model to calculate the "fair value" of its option grants. The fair value of options granted in the first six months of 2007 was \$7.33 per share based on the following assumptions: dividend yield of less than 1%; expected volatility of 20% (due to limited trading volume of GAFRI's common stock, implied volatility of a peer group's publicly traded options used); risk-free interest rate of 4.7%; and expected option life of 6.5 years.

GAFRI's total stock compensation expense was \$0.7 million for the second quarter and \$1.3 million in the first six months of 2007 compared to \$0.6 million and \$1.1 million in the second quarter and first six months of 2006, respectively.

In the first quarter of 2007, GAFRI retired 219,295 shares of common stock which had been purchased in prior years to pre-fund two of the Company's non-qualified benefit plans.

The Company is authorized to issue 25,000,000 shares of Preferred Stock, par value \$1.00 per share.

#### J. Contingencies

Except as discussed in Management's Discussion and Analysis - "Environmental Reserve Charge", there have been no significant changes to the matters discussed and referred to in Note M - "Contingencies" of GAFRI's Annual Report on Form 10-K for 2006.

K. Additional Information

## Statutory Information

Insurance companies are required to file financial statements with state insurance regulatory authorities prepared on an accounting basis prescribed or permitted by such authorities (statutory basis). Certain statutory amounts for GALIC, GAFRI's primary insurance subsidiary, were as follows (in millions):

	June 30, <u>2007</u>	December 31, <u>2006</u>
Capital and surplus	\$653.5	\$643.8
Asset valuation reserve	107.1	88.3
Interest maintenance reserve	-	-
	<u>Six months ended June 30</u>	
	<u>2007</u>	<u>2006</u>
Pre-tax income from operations	\$19.1	\$45.2
Net income	24.1	97.4

The decrease in statutory pre-tax income from operations in the first six months of 2007 compared to the same period in 2006 is due primarily to the impact of (i) higher commissions and costs associated with higher first year statutory premiums; (ii) lower spreads on GALIC's in-force annuity business; and (iii) higher death claims. Net income in 2006 included an after-tax statutory gain on the June 2006 sale of Chatham Bars Inn of approximately \$50 million.

In the first six months of 2007, GALIC paid a \$30 million dividend to GAFRI. The maximum amount of dividends payable by GALIC and Ceres' subsidiaries for the remainder of 2007 without prior regulatory approval is \$91 million and \$19 million, respectively.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

## Variable Annuities

At June 30, 2007, the aggregate guaranteed minimum death benefit value (assuming every policyholder died) on all of GAFRI's variable annuity policies exceeded the fair value of the underlying variable annuities by \$44 million compared to \$59 million at December 31, 2006. Death benefits paid in excess of the variable annuity account balances were \$0.2 million in the first six months of 2007 and 2006.

## Condensed Consolidating Information

GAFRI has guaranteed all of the outstanding debt of its wholly-owned subsidiary, AAG Holding Company, Inc. Condensed (unaudited) consolidating financial statements for GAFRI are as follows:

## CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

<u>JUNE 30, 2007</u>	<u>GAFRI</u>	AAG <u>HOLDING</u>	ALL OTHER <u>SUBS</u>	CONS <u>ENTRIES</u>	<u>CONS</u>
<b>Assets</b>					
Cash and investments	\$ 21.5	\$ -	\$10,743.4	(\$ 0.3)	\$10,764.6
Investment in subsidiaries	956.9	1,185.1	20.3	(2,162.3)	-
Notes receivable from subs	102.4	-	-	(102.4)	-
Unamortized insurance acquisition costs	-	-	1,015.1	-	1,015.1
Other assets	24.9	6.6	1,091.3	45.6	1,168.4
Variable annuity assets (separate accounts)	<u>-</u>	<u>-</u>	<u>717.2</u>	<u>-</u>	<u>717.2</u>
	<u>\$1,105.7</u>	<u>\$1,191.7</u>	<u>\$13,587.3</u>	<u>(\$2,219.4)</u>	<u>\$13,665.3</u>
<b>Liabilities and Stockholders' Equity</b>					
Insurance liabilities	\$ -	\$ -	\$11,382.1	(\$ 5.5)	\$11,376.6
Notes payable to GAFRI	-	102.4	-	(102.4)	-
Other long-term debt	0.8	335.4	-	(72.1)	264.1
Other liabilities	79.4	8.5	199.6	(5.6)	281.9
Variable annuity liabilities (separate accounts)	<u>-</u>	<u>-</u>	<u>717.2</u>	<u>-</u>	<u>717.2</u>
	80.2	446.3	12,298.9	(185.6)	12,639.8
Total stockholders' equity	<u>1,025.5</u>	<u>745.4</u>	<u>1,288.4</u>	<u>(2,033.8)</u>	<u>1,025.5</u>

)

\$1,105.7    \$1,191.7    \$13,587.3    (\$2,219.4)    \$13,665.3

DECEMBER 31, 2006

## Assets

Cash and investments	\$ 16.9	\$ -	\$10,698.8	\$ (0.4)	\$10,715.3
Investment in subsidiaries	1,010.9	1,256.8	24.1	(2,291.8)	-
Notes receivable from subs	102.4	-	-	(102.4)	-
Unamortized insurance acquisition costs	-	-	946.1	-	946.1
Other assets	24.7	5.8	898.4	44.6	973.5
Variable annuity assets (separate accounts)	<u>-</u>	<u>-</u>	<u>700.5</u>	<u>-</u>	<u>700.5</u>
	<u>\$1,154.9</u>	<u>\$1,262.6</u>	<u>\$13,267.9</u>	<u>(\$2,350.0)</u>	<u>\$13,335.4</u>

## Liabilities and Stockholders' Equity

Insurance liabilities	\$ -	\$ -	\$10,980.6	(\$ 5.1)	\$10,975.5
Notes payable to GAFRI	-	102.4	-	(102.4)	-
Other long-term debt	0.8	396.8	-	(124.5)	273.1
Other liabilities	80.1	10.4	227.8	(6.0)	312.3
Variable annuity liabilities (separate accounts)	<u>-</u>	<u>-</u>	<u>700.5</u>	<u>-</u>	<u>700.5</u>
	80.9	509.6	11,908.9	(238.0)	12,261.4
Total stockholders' equity	<u>1,074.0</u>	<u>753.0</u>	<u>1,359.0</u>	<u>(2,112.0)</u>	<u>1,074.0</u>
			)		
	<u>\$1,154.9</u>	<u>\$1,262.6</u>	<u>\$13,267.9</u>	<u>(\$2,350.0)</u>	<u>\$13,335.4</u>



## CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

FOR THE THREE MONTHS ENDED

JUNE 30, 2007

	AAG GAFRI	AAG HOLDING	ALL OTHER SUBS	CONS ENTRIES	CONS CONS
Revenues					
:					
Life, accident and health premiums	\$ -	\$ -	\$103.4	\$ -	\$103.4
Net investment income and other revenue	4.1	-	195.4	(2.0)	197.5
Equity in earnings of subsidiaries	<u>36.7</u>	<u>45.8</u>	<u>-</u>	<u>(82.5)</u>	<u>-</u>
			)		
	40.8	45.8	298.8	(84.5)	300.9
Costs and Expenses:					
Insurance benefits and expenses	-	-	216.6	-	216.6
Interest and debt expenses	0.1	8.9	-	(3.7)	5.3
Other expenses	<u>6.0</u>	<u>0.7</u>	<u>37.6</u>	<u>-</u>	<u>44.3</u>
	<u>6.1</u>	<u>9.6</u>	<u>254.2</u>	<u>(3.7)</u>	<u>266.2</u>
			)		
Earnings before income taxes	34.7	36.2	44.6	(80.8)	34.7
Provision for income taxes	<u>11.8</u>	<u>12.3</u>	<u>15.2</u>	<u>(27.5)</u>	<u>11.8</u>
			)		
Income from continuing operations, net of tax	22.9	23.9	29.4	(53.3)	22.9
Discontinued hotel operations, net of tax	<u>1.9</u>	<u>-</u>	<u>1.9</u>	<u>(1.9)</u>	<u>1.9</u>
			)		
Net income	<u>\$24.8</u>	<u>\$23.9</u>	<u>\$ 31.3</u>	<u>(\$ 55.2)</u>	<u>\$ 24.8</u>

FOR THE SIX MONTHS ENDED  
JUNE 30, 2007

Revenues

:					
Life, accident and health premiums	\$ -	\$ -	\$210.0	\$ -	\$210.0
Net investment income and other revenue	10.0	(3.4)	380.5	(4.3)	382.8
Equity in earnings of subsidiaries	<u>61.1</u>	<u>80.7</u>	<u>-</u>	<u>(141.8)</u>	<u>-</u>
			)		
	71.1	77.3	590.5	(146.1)	592.8

Costs and Expenses:

Insurance benefits and expenses	-	-	435.3	-	435.3
Interest and debt expenses	0.1	19.0	-	(8.1)	11.0
Other expenses	<u>6.6</u>	<u>1.6</u>	<u>73.9</u>	<u>-</u>	<u>82.1</u>
	<u>6.7</u>	<u>20.6</u>	<u>509.2</u>	<u>(8.1)</u>	<u>528.4</u>

Earnings before income taxes	64.4	56.7	81.3	(138.0)	64.4
Provision for income taxes	<u>21.5</u>	<u>19.3</u>	<u>27.8</u>	<u>(47.1)</u>	<u>21.5</u>

Income from continuing operations	42.9	37.4	53.5	(90.9)	42.9
Discontinued hotel operations, net of tax	<u>1.9</u>	<u>-</u>	<u>1.9</u>	<u>(1.9)</u>	<u>1.9</u>

Net income	<u>\$44.8</u>	<u>\$37.4</u>	<u>\$ 55.4</u>	<u>(\$ 92.8)</u>	<u>\$ 44.8</u>
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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

## CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

FOR THE THREE MONTHS ENDED	AAG		ALL OTHER	CONS	
<u>JUNE 30, 2006</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>SUBS</u>	<u>ENTRIES</u>	<u>CONS</u>
Revenues					
:					
Life, accident and health premiums	\$ -	\$ -	\$ 75.5	\$ -	\$ 75.5
Net investment income and other revenue	8.5	(0.3)	158.2	(4.3)	162.1
Equity in earnings of subsidiaries	<u>12.6</u>	<u>73.4</u>	<u>-</u>	<u>(86.0)</u>	<u>-</u>
			)		
	21.1	73.1	233.7	(90.3)	237.6
Costs and Expenses:					
Insurance benefits and expenses	-	-	180.9	-	180.9
Interest and debt expenses	-	10.3	-	(4.6)	5.7
Other expenses	<u>2.7</u>	<u>2.4</u>	<u>27.5</u>	<u>-</u>	<u>32.6</u>
	<u>2.7</u>	<u>12.7</u>	<u>208.4</u>	<u>(4.6)</u>	<u>219.2</u>
			)		
Earnings before income taxes	18.4	60.4	25.3	(85.7)	18.4
Provision for income taxes	<u>6.3</u>	<u>21.2</u>	<u>8.8</u>	<u>(30.0)</u>	<u>6.3</u>
			)		
Income from continuing operations	12.1	39.2	16.5	(55.7)	12.1
Discontinued hotel operations, net of tax	(0.1)	-	(0.1)	0.1	(0.1)
Gain on sale of discontinued hotel, net of tax	<u>31.6</u>	<u>-</u>	<u>31.6</u>	<u>(31.6)</u>	<u>31.6</u>

				)	
Net income	<u>\$43.6</u>	<u>\$39.2</u>	<u>\$ 48.0</u>	<u>(\$ 87.2)</u>	<u>\$ 43.6</u>
FOR THE SIX MONTHS ENDED		AAG	ALL	CONS	
			OTHER		
<u>JUNE 30, 2006</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>SUBS</u>	<u>ENTRIES</u>	<u>CONS</u>
Revenues					
:					
Life, accident and health premiums	\$ -	\$ -	\$152.0	\$ -	\$152.0
Net investment income and other revenue	13.1	(2.1)	332.7	(8.7)	335.0
Equity in earnings of subsidiaries	<u>39.8</u>	<u>113.6</u>	<u>-</u>	<u>(153.4)</u>	<u>-</u>
			)		
	52.9	111.5	484.7	(162.1)	487.0
Costs and Expenses:					
Insurance benefits and expenses	-	-	360.0	-	360.0
Interest and debt expenses	-	20.7	-	(8.8)	11.9
Other expenses	<u>5.0</u>	<u>4.3</u>	<u>57.9</u>	<u>-</u>	<u>67.2</u>
	<u>5.0</u>	<u>25.0</u>	<u>417.9</u>	<u>(8.8)</u>	<u>439.1</u>
			)		
Earnings before income taxes	47.9	86.5	66.8	(153.3)	47.9
Provision for income taxes	<u>16.7</u>	<u>30.4</u>	<u>23.4</u>	<u>(53.8)</u>	<u>16.7</u>
			)		
Income from continuing operations	31.2	56.1	43.4	(99.5)	31.2
Discontinued hotel operations, net of tax	(0.6)	-	(0.6)	0.6	(0.6)

Gain on sale of discontinued hotel, net of tax	<u>31.6</u>	<u>-</u>	<u>31.6</u>	<u>(31.6)</u>	<u>31.6</u>
				)	
Net income	<u>\$62.2</u>	<u>\$56.1</u>	<u>\$ 74.4</u>	<u>(\$130.5)</u>	<u>\$ 62.2</u>

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued  
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

FOR THE SIX MONTHS ENDED	AAG		ALL	CONS	
<u>JUNE 30, 2007</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>OTHER</u>	<u>ENTRIES</u>	<u>CONS</u>
			<u>SUBS</u>		
Cash Flows from Operating Activities:					
Net income	\$ 44.8	\$ 37.4	\$ 55.4	(\$ 92.8)	\$ 44.8
Adjustments:					
Equity in net earnings of subsidiaries and affiliates	(42.3)	(53.0)	-	95.3	-
Increase in life, accident and health reserves	-	-	30.5	-	30.5
Benefits to annuity policyholders	-	-	179.2	-	179.2
Amortization of insurance acquisition costs	-	-	65.2	-	65.2
Depreciation and amortization	1.3	0.9	4.3	-	6.5
Realized (gains) losses on investments	0.1	-	(8.9)	-	(8.8)
Gain on sale of discontinued hotel	-	-	(2.9)	-	(2.9)
Realized (gain) loss on retirement of debt	(1.6)	3.4	0.9	(1.6)	1.1
Net trading portfolio activity	-	-	(8.4)	-	(8.4)
Increase in insurance acquisition costs	-	-	(103.2)	-	(103.2)
Decrease in reinsurance recoverable	-	-	14.4	-	14.4
Decrease (increase) in other assets	(1.4)	1.9	(136.5)	-	(136.0)
Increase (decrease) in other liabilities	0.6	(1.9)	(11.6)	-	(12.9)

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Increase (decrease) in payable to affiliates, net	2.6	(0.8)	18.3	-	20.1
Capital contribution from parent (to subsidiary)	(185.4)	185.4	-	-	-
Dividends from subsidiaries(to parent)	137.3	(107.0)	(30.3)	-	-
Other, net	<u>(4.1)</u>	<u>(4.1)</u>	<u>2.4</u>	<u>(0.9)</u>	<u>(6.7)</u>
	)	)	)	)	)
Net cash provided by (used in) operating activities	<u>(48.1)</u>	<u>62.2</u>	<u>68.8</u>	<u>-</u>	<u>82.9</u>
	)	)	)	)	)
Cash Flows from Investing Activities:					
Purchases of investments and other assets	-	-	(1,469.1)	17.3	(1,451.8)
Maturities and redemptions of fixed maturity investments	32.2	-	346.1	(55.4)	322.9
Sales of investments and other assets	17.3	-	439.9	(17.3)	439.9
Increase in policy loans	<u>-</u>	<u>-</u>	<u>(2.1)</u>	<u>-</u>	<u>(2.1)</u>
		)	)	)	)
Net cash provided by (used in) investing activities	<u>49.5</u>	<u>-</u>	<u>(685.2)</u>	<u>(55.4)</u>	<u>(691.1)</u>
		)	)	)	)
Cash Flows from Financing Activities:					
Annuity receipts	-	-	817.4	-	817.4
Annuity surrenders, benefits and withdrawals	-	-	(691.7)	-	(691.7)
Net transfers from variable annuity assets	-	-	31.9	-	31.9
Additions to long-term debt	-	92.0	-	-	92.0
Reductions of long-term debt	(0.1)	(154.2)	(3.2)	55.4	(102.1)
Issuance of Common Stock	7.2	-	-	-	7.2
Other	<u>(3.1)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(3.1)</u>
	)	)	)	)	)
Net cash provided by (used in) financing activities	<u>4.0</u>	<u>(62.2)</u>	<u>154.4</u>	<u>55.4</u>	<u>151.6</u>
	)	)	)	)	)
Net increase (decrease) in cash and cash equivalents	5.4	-	(462.0)	-	(456.6)
Beginning cash and cash equivalents	<u>2.8</u>	<u>-</u>	<u>561.5</u>	<u>-</u>	<u>564.3</u>

Ending cash and cash equivalents	<u>\$ 8.2</u>	<u>\$ -</u>	<u>\$ 99.5</u>	<u>\$ -</u>	<u>\$ 107.7</u>
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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued  
CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

FOR THE SIX MONTHS ENDED		AAG	ALL OTHER	CONS	
<u>JUNE 30, 2006</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>SUBS</u>	<u>ENTRIES</u>	<u>CONS</u>
Cash Flows from Operating Activities:					
Net income	\$62.2	\$ 56.1	\$ 74.4	(\$130.5)	\$ 62.2
Adjustments:					
Equity in net earnings of subsidiaries and affiliates	(57.3)	(73.7)	-	131.0	-
Increase in life, accident and health reserves	-	-	21.0	-	21.0
Benefits to annuity policyholders	-	-	166.8	-	166.8
Amortization of insurance acquisition costs	-	-	50.5	-	50.5
Depreciation and amortization	2.2	0.8	3.2	-	6.2
Realized losses on investments	1.4	-	3.0	0.2	4.6
Gain on sale of discontinued hotel	-	-	(48.7)	-	(48.7)
Realized loss on retirement of debt	2.2	2.1	-	-	4.3
Net trading portfolio activity	-	-	(13.1)	-	(13.1)
Increase in insurance acquisition costs	-	-	(66.9)	-	(66.9)
Increase in reinsurance recoverable	-	-	(4.3)	-	(4.3)
Increase in other assets	(1.1)	(0.6)	(9.8)	-	(11.5)
Increase (decrease) in other liabilities	(0.2)	0.1	(1.0)	-	(1.1)
Increase in payable to affiliates, net	11.9	1.6	12.9	-	26.4
Capital contribution from parent (to subsidiary)	(30.0)	30.0	-	-	-
Dividends from subsidiaries(to parent)	37.5	(12.4)	(25.1)	-	-
Other, net	<u>1.1</u>	<u>(1.8)</u>	<u>0.5</u>	<u>(0.7)</u>	<u>(0.9)</u>

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	)	)	)		
Net cash provided by operating activities	<u>29.9</u>	<u>2.2</u>	<u>163.4</u>	<u>-</u>	<u>195.5</u>
Cash Flows from Investing Activities:					
Purchases of investments and other assets	-	-	(1,154.7)	-	(1,154.7)
Proceeds received from sale of Puerto Rican operations, net	37.5	-	(10.3)	-	27.2
Maturities and redemptions of fixed maturity investments	1.2	-	255.3	-	256.5
Cash and short-term investments of businesses acquired, net	-	-	104.8	-	104.8
Sales of investments and other assets	5.9	-	835.9	-	841.8
Increase in policy loans	<u>-</u>	<u>-</u>	<u>(3.9)</u>	<u>-</u>	<u>(3.9)</u>
		)	)		
Net cash provided by investing activities	<u>44.6</u>	<u>-</u>	<u>27.1</u>	<u>-</u>	<u>71.7</u>
Cash Flows from Financing Activities:					
Fixed annuity receipts	-	-	515.4	-	515.4
Annuity surrenders, benefits and withdrawals	-	-	(592.0)	-	(592.0)
Net transfers from variable annuity assets	-	-	7.2	-	7.2
Additions to long-term debt	-	15.0	-	-	15.0
Reductions of long-term debt	(65.9)	(16.9)	-	-	(82.8)
Issuance of Common Stock	2.9	-	-	-	2.9
Other	<u>(0.8)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(0.8)</u>
	)	)	)		
Net cash used in financing activities	<u>(63.8)</u>	<u>(1.9)</u>	<u>(69.4)</u>	<u>-</u>	<u>(135.1)</u>
	)	)	)		
Net increase in cash and short-term investments	10.7	0.3	121.1	-	132.1
Beginning cash and short-term investments	<u>7.9</u>	<u>0.3</u>	<u>146.1</u>	<u>-</u>	<u>154.3</u>
Ending cash and short-term investments	<u>\$18.6</u>	<u>\$ 0.6</u>	<u>\$ 267.2</u>	<u>\$ -</u>	<u>\$ 286.4</u>



## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## ITEM 2

## Management's Discussion and Analysis

of Financial Condition and Results of OperationsIndex to MD&A

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## FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. The safe harbor does not apply to statements with respect to the pending transaction with AFG. Some of the forward-looking statements can be identified by the use of forward-looking words such as "anticipates", "believes", "expects", "estimates", "intends", "plans", "seeks", "could", "may", "should", "will" or the negative version of those words or other comparable terminology. Such forward-looking statements relate to: expectations concerning market and other conditions and their effect on future premiums, revenues, earning and investment activities; recoverability of asset values; mortality and the adequacy of reserves for environmental pollution.

Actual results could differ materially from those contained in or implied by such forward-looking statements for a variety of factors including:

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- changes in economic conditions, including interest rates, performance and volatility of securities markets, and the availability of capital;
- trends in persistency, mortality and morbidity;
- regulatory actions;
- changes in regulatory and legal environments;
- tax law changes;
- changes in laws governing retirement savings vehicles;
- cost of environmental clean-up at former manufacturing sites operated by the Company's predecessor;
- availability of reinsurance and ability of reinsurers to pay their obligations;
- results of acquisitions;
- competitive pressures; and
- changes in debt and claims paying ratings.

Forward-looking statements included in this Form 10-Q are made only as of the date of this report and under Section 27A of the Securities Act and Section 21E of the Exchange Act; we do not have any obligation to update any forward-looking statement to reflect subsequent events or circumstances.

### GENERAL

Great American Financial Resources, Inc. ("GAFRI" or "the Company") and its subsidiary, AAG Holding Company, Inc., are organized as holding companies with nearly all of their operations being conducted by their subsidiaries. These companies, however, have continuing expenditures for administrative expenses, corporate services and for the payment of interest and principal on borrowings and stockholder dividends.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### Management's Discussion and Analysis

#### of Financial Condition and Results of Operations - Continued

### OVERVIEW

#### Financial Condition

GAFRI has significantly strengthened its capital and liquidity over the last several years. Since December 31, 2002, stockholders' equity (excluding unrealized gains (losses)) has grown approximately \$430 million (64%) to \$1.1 billion and its debt to capital ratio decreased from more than 36% to 19.1%; in addition, the adjusted capital of GAFRI's largest insurance subsidiary increased nearly \$289 million (59%) to \$774 million.

#### Results of Operations

Through the operations of its insurance subsidiaries, GAFRI is engaged in the sale of retirement annuities and various forms of supplemental insurance products.

GAFRI's net income for the second quarter of 2007 was \$24.8 million (\$0.51 per diluted share) compared to \$43.6 million (\$0.91 per diluted share) for the same period in 2006. GAFRI's net income for the first six months of 2007 was \$44.8 million (\$0.92 per diluted share), compared to \$62.2 million (\$1.30 per diluted share) for the same period in 2006.

GAFRI's net income in the second quarter and first six months of 2006 included an after-tax gain of \$31.6 million (\$0.66 per diluted share) on the sale of a hotel. (See Note C to the Financial Statements) Excluding the impact of the hotel sale, GAFRI's net income in the second quarter and first six months of 2007 increased significantly over the same periods in 2006, reflecting higher realized investment gains and improvements in GAFRI's supplemental insurance and fixed annuity segments, as well as slightly higher earnings in the Company's variable annuity business. These increases were partially offset by higher mortality in the runoff life operations and a \$2 million environmental charge taken in the second quarter of 2007 related to GAFRI's former manufacturing operations.

#### CRITICAL ACCOUNTING POLICIES

Significant accounting policies are described in Note B to the Financial Statements. The preparation of financial statements in conformity with U.S. generally accepted accounting principals ("GAAP") requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future.

Management believes that the following items are the areas where the degree of judgment required to determine amounts recorded in the financial statements make the accounting policies critical:

- The recoverability of unamortized insurance acquisition costs;
- The establishment of insurance reserves;
- The determination of "other than temporary" impairments on investments; and
- Environmental reserves with respect to GAFRI's former manufacturing operations.

For further discussion of these policies, see "Critical Accounting Policies" in GAFRI's 2006 Form 10-K.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### Management's Discussion and Analysis

#### of Financial Condition and Results of Operations - Continued

#### LIQUIDITY AND CAPITAL RESOURCES

##### Ratios

GAFRI's consolidated debt to capital ratio is shown below (dollars in millions). For purposes of this calculation, capital represents the sum of consolidated debt and stockholders' equity (excluding unrealized gains (losses) on fixed maturity securities).

June 30,	<u>December 31,</u>	
<u>2007</u>	<u>2006</u>	<u>2005</u>

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Consolidated Debt	\$ 264	\$ 273	\$ 342
Stockholders' Equity	<u>1,117</u>	<u>1,064</u>	<u>949</u>
Total Capital	<u>\$1,381</u>	<u>\$1,337</u>	<u>\$1,291</u>

Consolidated Debt to Capital	19.1%	20.4%	26.5%
------------------------------	-------	-------	-------

The National Association of Insurance Commissioners' ("NAIC") risk-based capital ("RBC") formula determines the amount of capital that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired. At June 30, 2007, the capital ratio of GAFRI's principal insurance subsidiary was 6.5 times its authorized control level RBC.

### Sources and Uses of Funds

#### Parent Holding Company Liquidity

To pay interest and principal on borrowings and other holding company costs, GAFRI (parent) and AAG Holding use primarily capital distributions from Great American Life Insurance Company ("GALIC") and Ceres Group, Inc., bank borrowings and cash and investments on hand. Capital distributions from GAFRI's insurance subsidiaries are subject to regulatory restrictions relating to statutory surplus and earnings. In the first six months of 2007, GALIC paid a \$30 million dividend to GAFRI. The maximum amount of dividends payable by GALIC and Ceres' subsidiaries for the remainder of 2007 without prior regulatory approval is \$91 million and \$19 million, respectively.

In March 2006, the Company replaced its existing bank credit agreement with a \$500 million five-year credit facility shared with its parent company American Financial Group, Inc. Under terms of the agreement, GAFRI may borrow up to \$175 million with the ability to borrow up to \$200 million, conditioned on AFG not borrowing in excess of \$300 million. At June 30, 2007, GAFRI had borrowings of \$16 million outstanding on the credit agreement, bearing interest at a rate of 6.1%. Under a currently effective shelf registration, GAFRI and AAG Holding can issue up to \$250 million in additional equity or debt securities.

On August 7, 2006, GAFRI (parent) acquired all of the outstanding shares of Ceres Group Inc. for \$204.4 million in cash. To fund the acquisition, GAFRI used cash on hand and borrowings under its bank line. Following the acquisition and the concurrent reinsurance transactions, Ceres distributed \$60 million to GAFRI. GAFRI expects that Ceres' insurance subsidiaries will have the capability to pay up to \$50 million of additional dividends in 2007, subject to regulatory approval.

In March 2007, GAFRI redeemed all of its 8-7/8% trust preferred securities using funds borrowed under the bank credit agreement. See Note H to the Financial Statements - "Long-Term Debt". Also in March 2007, GAFRI repurchased \$3.0 million principal amount of its 6-7/8% Senior Notes for \$3.1 million. In 2006, GAFRI repurchased \$68.5 million principal amount of its 6-7/8% Senior Notes for \$70.8 million.

GAFRI believes that it has sufficient resources to meet its liquidity requirements.

#### Subsidiary Liquidity

The liquidity requirements of GAFRI's insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and expenses, and the payments of dividends and taxes to GAFRI. Historically, cash flows from maturities of bonds held in the investment portfolio, premiums and investment income have exceeded the funds needed to meet these requirements without forcing the sale of investments or requiring contributions from GAFRI. Funds received in excess of cash requirements are generally invested in additional marketable securities. In addition, the insurance subsidiaries generally hold an adequate amount of highly liquid, short-term investments.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### Management's Discussion and Analysis

#### of Financial Condition and Results of Operations - Continued

In GAFRI's annuity business, where profitability is largely dependent on earning a "spread" between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. With declining rates, GAFRI receives some protection due to the ability to lower crediting rates, subject to guaranteed minimums. In a rising interest rate environment, significant protection from withdrawals exists in the form of temporary and permanent surrender charges on GAFRI's annuity products. Annuity surrenders (after surrender fees) totaled approximately \$264 million and \$493 million in the second quarter and first six months of 2007 compared to \$211 million and \$422 million in the comparable 2006 periods. Management believes the increase in surrenders is due to (i) the higher interest rate environment (compared to when certain policies were initially sold); (ii) recent acquisitions of blocks of annuity business; and (iii) policies coming out of their surrender charge periods.

In recent years, the Company's insurance subsidiaries have entered into several reinsurance transactions in connection with (i) the sale of GA-PR; (ii) the acquisition of Ceres and (iii) certain of its life and supplemental insurance operations. These transactions provided additional capital and liquidity and were entered into in the normal course of business in order to exit certain lines, fund acquisitions and transfer risk. The Company may enter into additional reinsurance transactions in the future.

GAFRI believes its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits, operating expenses, dividends and tax payments, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies.

#### Independent Ratings

The Company's principal insurance subsidiaries ("Insurance Companies") are rated by A.M. Best, Fitch and Standard & Poor's. Management believes that the ratings assigned by independent insurance rating agencies are important because agents, potential policyholders and school districts often use a company's rating as an initial screening device in considering annuity products. Management believes that (i) a rating in the "A" category by A.M. Best is necessary to successfully market tax-deferred annuities to public education employees and other not-for-profit groups; and (ii) a rating in the "A" category by at least one rating agency is necessary to successfully compete in other annuity markets. GAFRI's insurance entities also compete in markets other than the sale of tax-deferred annuities. Management believes that these entities can successfully compete in these markets with their current respective ratings listed below.

GAFRI's operations could be materially and adversely affected by ratings downgrades. In connection with recent reviews by independent rating agencies, management indicated that it intends to maintain lower ratios of debt to capital than it has in recent years and intends to maintain the capital of its significant insurance subsidiaries at levels currently indicated by the rating agencies as appropriate for the current ratings. Items that could adversely affect

capital levels include (i) an extended period of low interest rates and a resulting significant narrowing of annuity "spread" (the difference between earnings received by the Company on its investments less the amount credited to policyholders' annuity accounts); (ii) investment impairments; (iii) a sustained decrease in the stock market; (iv) adverse mortality or morbidity; (v) changes in capital levels associated with current rating agency requirements; and (iv) higher than planned dividends paid due to liquidity needs by GAFRI and AAG Holding.

Following are the Company's insurance ratings as of June 30, 2007:

	<u>A.M. Best</u>	<u>Fitch</u>	<u>Standard &amp; Poor's</u>
GALIC*	A (Excellent)	A+ (Strong)	A- (Strong)
AILIC	A (Excellent)	A+ (Strong)	A- (Strong)
Loyal	A (Excellent)	A+ (Strong)	Not rated
UTA	A- (Excellent)	A+ (Strong)	Not rated
CGIC	B++(Good)	A (Strong)	Not rated
CRLIC	B++(Good)	A (Strong)	Not rated

\*GALIC is rated A3 (good financial security) by Moody's.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

GAFRI and GALIC received a "positive" outlook from Moody's. Continental General Insurance Company ("CGIC") and Central Reserve Life Insurance Company ("CRLIC") received positive outlooks from A.M. Best. All of the other ratings carry a "stable" outlook. In evaluating a company, independent rating agencies review such factors as the company's: (i) capital adequacy; (ii) profitability; (iii) leverage and liquidity; (iv) book of business; (v) quality and estimated market value of assets; (vi) adequacy of policy reserves; (vii) experience and competency of management; (viii) operating profile; and (ix) risk management.

Investments

At June 30, 2007, GAFRI's investment portfolio contained \$9.5 billion in "Fixed maturities" classified as available-for-sale, which are carried at fair value with unrealized gains and losses reported as a separate component of stockholders' equity on an after-tax basis. At June 30, 2007, GAFRI had pre-tax net unrealized losses of \$165 million on fixed maturities and net unrealized gains of \$27 million on equity securities.

GAFRI invests primarily in fixed income investments that, including loans and short-term investments, comprised 96% of its investment portfolio at June 30, 2007. GAFRI generally invests in securities having intermediate-term maturities with an objective of optimizing interest yields while maintaining an appropriate relationship of maturities between GAFRI's assets and expected liabilities.

The NAIC assigns quality ratings to publicly traded as well as privately placed securities. At June 30, 2007, approximately 94% of GAFRI's Insurance Companies' fixed maturity portfolio was comprised of investment grade bonds (NAIC rating of "1" or "2"). Management believes that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

At June 30, 2007, the mortgage-backed securities ("MBSs") portfolio represented approximately 30% of the Insurance Companies' investments. MBSs are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of the lower current rates. The market that these securities trade in is highly liquid. Aside from interest rate risk referred to above, GAFRI does not believe a material risk (relative to earnings or liquidity) is inherent in holding such investments.

Approximately 99% of the Insurance Companies' MBSs are rated "AAA". At June 30, 2007, approximately 2% of GAFRI's fixed maturity portfolio was invested in mortgage-backed securities in which the underlying collateral is sub-prime mortgages. At that date, the net unrealized loss on these securities was approximately \$3.0 million. The securities are collateralized by fixed-rate mortgages and have an overall average life of approximately 3 years. None of the securities have been subject to downgrades or "watch listing" by rating agencies. At June 30, 2007, GAFRI had no collateral debt obligations secured by residential mortgages.

Summarized information for the unrealized gains and losses recorded in GAFRI's balance sheet at June 30, 2007, is shown in the following table (dollars in millions). Approximately \$118 million of available-for-sale "Fixed Maturities" and \$10 million of "Equity Securities" had no unrealized gains or losses at June 30, 2007.

<u>Available-for-sale Fixed Maturities</u>	Securities with Unrealized <u>Gains</u>	Securities with Unrealized <u>Losses</u>
Fair value of securities	\$2,201	\$7,216
Amortized cost of securities	\$2,146	\$7,436
Gross unrealized gain (loss)	55	(\$ 220)
Fair value as % of amortized cost	103%	97%
Number of security positions	708	1,080
Number individually exceeding \$2 million gain or loss	-	3
Concentration of gains or (losses) by type or industry (exceeding 5% of unrealized):		
Mortgage-backed securities	\$ 10.3	(\$ 81.9)
Banks, savings and credit institutions	4.7	(46.5)
Gas and electric services	7.6	(14.8)
Insurance companies	4.3	(14.5)
Percentage rated investment grade	87%	97%

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<u>Equity Securities</u>	Securities with Unrealized <u>Gains</u>	Securities with Unrealized <u>Losses</u>
Fair value of securities	\$204	\$ 92
Cost of securities	\$169	\$100
Gross unrealized gain (loss)	\$ 35	(\$ 8)
Fair value as % of cost	121%	92%

The table below sets forth the scheduled maturities of GAFRI's available-for-sale fixed maturity securities at June 30, 2007, based on their fair values. Asset backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

<u>Maturity</u>	Securities with Unrealized <u>Gains</u>	Securities with Unrealized <u>Losses</u>
*	*	*
One year or less	7%	1%
After one year through five years	45	7
After five years through ten years	25	48
After ten years	<u>8</u>	<u>8</u>
Mortgage-backed securities	85 <u>15</u>	64 <u>36</u>
	<u>100</u>	<u>100</u>
	%	%

\*Excludes \$118 million of fixed maturities with no unrealized gains or losses.

When a decline in the value of a specific investment is considered to be "other than temporary," a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are "other than temporary" requires judgment based on subjective as well as objective factors. A listing of factors considered and resources used is contained in the discussion of "Investments" under Management's Discussion and Analysis in GAFRI's 2006 Form 10-K.

The table below (dollars in millions) summarizes the unrealized gains and losses on all securities by dollar amount.



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<u>Fixed Maturities at June 30, 2007</u>	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)	Fair Value as % of Cost Basis
Securities with unrealized gains:			
Exceeding \$500,000 (13 issues)	\$ 113	\$ 9	108.7%
Less than \$500,000 (695 issues)	<u>2,088</u>	<u>46</u>	102.3%
	<u>\$2,201</u>	<u>\$ 55</u>	102.6%
Securities with unrealized losses:			
Exceeding \$500,000 (130 issues)	\$2,596	(\$114)	95.8%
Less than \$500,000 (950 issues)	<u>4,620</u>	<u>(106)</u>	97.8%
	)		
	<u>\$7,216</u>	<u>(\$220)</u>	97.0%
 <u>Equity Securities at June 30, 2007</u>			
Securities with unrealized gains:			
Exceeding \$500,000 (19 issues)	\$112	\$ 29	134.9%
Less than \$500,000 (35 issues)	<u>92</u>	<u>6</u>	107.0%
	<u>\$204</u>	<u>\$ 35</u>	120.7%
Securities with unrealized losses:			
Exceeding \$500,000 (4 issues)	\$ 51	(\$ 6)	89.5%
Less than \$500,000 (22 issues)	<u>41</u>	<u>(2)</u>	95.3%
	)		
	<u>\$ 92</u>	<u>(\$ 8)</u>	92.0%

## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

The following table (dollars in millions) summarizes the unrealized loss for all securities with unrealized losses by issuer quality and length of time those securities have been in an unrealized loss position.

<u>Fixed Maturities with Unrealized Losses at June 30, 2007</u>	<u>Aggregate Fair Value</u>	<u>Aggregate Unrealized Loss</u>	<u>Fair Value as % of Cost Basis</u>
Investment grade with losses for:			
One year or less (482 issues)	\$3,481	(\$ 70)	98.0%
Greater than one year (519 issues)	<u>3,494</u>	<u>(144)</u>	96.0%
	)		
	<u>\$6,975</u>	<u>(\$214)</u>	97.0%
Non-investment grade with losses for:			
One year or less (51 issues)	\$ 134	(\$ 3)	97.8%
Greater than one year (28 issues)	<u>107</u>	<u>(3)</u>	97.3%
	)		
	<u>\$ 241</u>	<u>(\$ 6)</u>	97.6%

Equity Securities with Unrealized

Losses at June 30, 2007

One year or less (23 issues)	\$ 88	(\$ 7)	92.6%
Greater than one year (3 issues)	<u>4</u>	<u>(1)</u>	80.0%
	)		
	<u>\$ 92</u>	<u>(\$ 8)</u>	92.0%

Based on its analysis, management believes that (i) GAFRI will recover its cost basis in the securities with unrealized losses and (ii) GAFRI has the ability and intent to hold the securities until they mature or recover in value. Although GAFRI has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset liability management decisions, market movements, changes in views about appropriate asset allocation, or the desire to offset taxable realized gains. Should GAFRI's ability or intent change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other than temporary impairment could be material to results of operations in a future period. Management believes it is not likely that future impairment charges will have a significant effect on GAFRI's liquidity.

RESULTS OF OPERATIONS

General

As shown in Note E to the Financial Statements - "Segments of Operations", GAFRI's pre-tax earnings from continuing operations decreased \$0.7 million in the second quarter of 2007 compared to the same period in 2006. The decrease reflects a \$2 million environmental charge (see discussion below) taken in the second quarter of 2007 and higher mortality in the runoff life operations, partially offset by improvements in the supplemental insurance and annuity operations segments.

Environmental Reserve Charge

GAFRI recently completed the annual review of its environmental exposures relating to its former manufacturing operations. As a result, GAFRI recorded a \$2 million charge in the second quarter of 2007 relating to revisions in clean up estimates at an existing site. GAFRI's environmental reserves totaled approximately \$15 million at June 30, 2007.

Statutory Annuity Premiums

The following table summarizes GAFRI's statutory annuity sales (in millions):

	Three months ended		Six months ended	
	<u>June 30.</u>		<u>June 30.</u>	
<u>Annuity Premiums</u>	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
403(b) Fixed and Indexed Annuities:				
First Year	\$ 17	\$ 14	\$ 33	\$ 26
Renewal	<u>39</u>	<u>33</u>	<u>74</u>	<u>70</u>
Subtotal	56	47	107	96
Non-403(b) Traditional Fixed Annuities	79	113	150	209
Non-403(b) Indexed Annuities	284	109	518	162
Variable Annuities	<u>20</u>	<u>24</u>	<u>43</u>	<u>48</u>
Total Annuity Premiums	<u>\$439</u>	<u>\$293</u>	<u>\$818</u>	<u>\$515</u>

Statutory annuity premiums in the second quarter and first six months of 2007 were 50% and 59% higher, respectively, than the same 2006 periods due primarily to higher fixed indexed-annuity sales, partially offset by lower sales of traditional fixed annuities in GAFRI's non-403(b) line of business.

Life, Accident and Health Premiums and Benefits

The following table summarizes GAFRI's life, accident and health premiums and benefits as shown in the Consolidated Income Statement (in millions):

	Three months ended		Six months ended	
	<u>June 30.</u>		<u>June 30.</u>	
<u>Premiums</u>	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Supplemental insurance operations				
First year	\$ 16	\$ 9	\$ 29	\$ 19
Renewal	79	58	164	115
Cincinnati life operations (in runoff)	<u>8</u>	<u>9</u>	<u>17</u>	<u>18</u>
	<u>\$103</u>	<u>\$76</u>	<u>\$210</u>	<u>\$152</u>
 <u>Benefits</u>				
Supplemental insurance operations	\$ 72	\$ 56	\$ 145	\$ 109
Cincinnati life operations (in runoff)	<u>14</u>	<u>11</u>	<u>26</u>	<u>22</u>

\$ 86      \$67      \$171      \$131

Ratio of Supplemental benefits to

Supplemental premiums	76%	84%	75%	81%
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GAFRI's supplemental insurance premiums and benefits increased due to the August 2006 Ceres acquisition. The supplemental insurance loss ratio decreased as a result of rate increases, favorable development (not expected to recur) in certain supplemental product lines and the acquisition of Ceres. However, the impact of less than expected new sales and increased lapses in the Medicare supplement line could result in a higher loss ratio than expected.

The Ceres acquisition broadens GAFRI's distribution in both the independent agent and captive agent channels. Prior to the acquisition, GAFRI's supplemental insurance products were sold through relatively few national marketing organizations.

Premiums and benefits of GAFRI's Cincinnati Life operations reflect primarily traditional term and universal life insurance products. In 2004, GAFRI suspended new sales of these insurance products due to inadequate volume and returns.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### Management's Discussion and Analysis

#### of Financial Condition and Results of Operations - Continued

#### Net Investment Income

Net investment income increased \$8.3 million (6%) and \$18.6 million (6%) in the second quarter and first six months of 2007, respectively, compared to the same periods in 2006 due primarily to an increase in average invested assets of approximately \$780 million (8%), partially offset by a lower overall yield on the investment portfolio. The increase in assets reflects internal growth as well as acquisitions. See Note D to the Financial Statements - "Acquisitions".

The yield earned on GAFRI's investment portfolio, excluding real estate investments and realized gains, was approximately 5.9% and 6.1% for the first six months of 2007 and 2006, respectively.

#### Realized Gains (Losses)

##### Investments

Realized gains (losses) on investments included provisions for other than temporary impairment on securities still held as follows: second quarter of 2007 and 2006 - \$1.1 million and \$1.6 million; six months of 2007 and 2006 - \$7.7 million and \$3.0 million, respectively.

##### Retirement of Debt

Loss on retirement of debt in 2007 reflects the redemption of the Company's 8-7/8% subordinated debentures in March 2007 and the repurchase of \$3 million of the Company's 6-7/8% notes.

Loss on retirement of debt in 2006 reflects pre-tax losses on repurchases of \$63.6 million principal amount of the Company's 6-7/8% Senior Notes for \$65.8 million in cash. In addition, in connection with the repurchase, GAFRI paid \$1.9 million to effectively terminate the portion of an interest rate swap that covered the repurchased debt; this amount is included in loss on retirement of debt in the Consolidated Income Statement.

### Other Income

Other income increased \$10.1 million (47%) and \$12.6 million (27%) in the second quarter and first six months of 2007, respectively, compared to the same periods in 2006. The increase reflects higher fee income generated from reinsurance agreements entered into in connection with the Ceres acquisition in August 2006, income earned on company owned life insurance and higher policy fees on annuities. These items were partially offset by a 2006 payment received from Palm Beach County, Florida in exchange for the imposition of certain limitations on future development of a marina owned by the Company.

### Real Estate Operations - Continuing

GAFRI is engaged in a variety of real estate operations including hotels and marinas. Revenues and expenses of these operations are included in GAFRI's Consolidated Income Statement as shown below (in millions).

	Three months ended		Six months ended	
	<u>June 30.</u>		<u>June 30.</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Other income	\$8.5	\$ 7.4	\$14.3	\$17.7(1)
Other expenses:				
Operating expenses	6.1	6.0	11.1	9.9
Depreciation	0.9	0.8	1.7	1.6
Other	0.5	0.2	0.8	0.5

(1) Includes \$4.9 million of income resulting from a March 2006 payment received from Palm Beach County, Florida in exchange for the imposition of certain limitations on future development of a marina owned by the Company.

### Real Estate Operations - Discontinued

On June 2, 2006, GAFRI sold Chatham Bars Inn, a resort hotel located on Cape Cod, Massachusetts, for a price of \$166 million. In the second quarter of 2007, GAFRI received an additional escrow payment in connection with the sale. The operating results and gain on sale of Chatham have been included in discontinued operations in the Consolidated Income Statement.

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Annuity Benefits

Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. On its deferred annuities (annuities in the accumulation phase), GAFRI generally credits interest to policyholders' accounts at their current stated interest rates. Furthermore, for "two-tier" deferred annuities (annuities under which a higher interest amount can be earned if a policy is annuitized rather than surrendered), GAFRI accrues additional reserves for (i) persistency and premium bonuses and (ii) excess benefits expected to be paid on future deaths and annuitizations. Changes in crediting rates, actual surrender, death and annuitization experience or modifications in actuarial assumptions can affect these additional reserves.

Annuity benefits increased \$6.4 million (8%) and \$12.4 million (7%) in the second quarter and first six months of 2007, respectively, compared to the same periods in 2006. This increase reflects higher annuity reserves due to internal growth resulting from higher sales of fixed indexed annuities, partially offset by a lower average crediting rate.

Historically, management has been able to react to changes in market interest rates and maintain a desired interest rate spread. Management believes that significant changes in projected investment yields could result in charges (or credits) to earnings in the period the projections are modified.

Insurance Acquisition Expenses

Insurance acquisition expenses include amortization of deferred policy acquisition costs ("DPAC") as well as a portion of commissions on sales of insurance products. Insurance acquisition expenses also include amortization of the present value of future profits ("PVFP") of businesses acquired. The increase in insurance acquisition expenses in 2007 reflects the growth in the Company's business as well as the August 2006 acquisition of Ceres. Amortization of the PVFP related to the Ceres acquisition was higher than anticipated in the first six months of 2007 as a result of higher lapses in the Medicare supplement lines. Management believes that the higher lapses are due primarily to competition from companies participating in the government subsidized Medicare Advantage program.

Unanticipated spread compression, decreases in the stock market, adverse mortality experience, and higher than expected lapse rates could lead to write-offs of DPAC or PVFP in the future.

Interest and Debt Expenses

The decrease in interest and debt expenses in the second quarter and first six months of 2007 reflects lower average indebtedness in the first half of 2007 compared to the same periods in 2006.

Other Expenses

Other expenses increased \$11.7 million (36%) and \$14.9 million (22%) in the second quarter and first six months of 2007, respectively, compared to the same periods in 2006. The increase reflects the acquisition of Ceres in August 2006 and higher real estate expenses. In addition, the Company recorded a \$2.0 million charge in the second quarter of 2007 relating to its former manufacturing operations. See Management's Discussion and Analysis - "Environmental Reserve Charge".

Income Taxes

GAFRI's effective tax rate in the first six months of 2007 reflects a benefit of \$0.6 million related to adjustments of prior year taxes.

Recent Accounting Standard

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In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," which permits entities to irrevocably elect to report certain financial assets and liabilities (including most insurance contracts) at fair value and recognize the unrealized gains and losses on such items in earnings. SFAS No. 159 is effective January 1, 2008, for calendar year companies. GAFRI is currently evaluating whether it will elect the fair value option for any of its eligible assets or liabilities.

### Item 3

#### Quantitative and Qualitative Disclosure of Market Risk

As of June 30, 2007, there were no material changes to the information provided in Item 7A - "Quantitative and Qualitative Disclosure about Market Risk" in GAFRI's 2006 Form 10-K.

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## GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

### Management's Discussion and Analysis

#### of Financial Condition and Results of Operations - Continued

### Item 4

#### Controls and Procedures

GAFRI's Chief Executive Officer and Chief Financial Officer, with the participation of management, have evaluated GAFRI's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of the end of the period covered by this report. Based on that evaluation, GAFRI's Chief Executive Officer and Chief Financial Officer concluded that these disclosure controls are effective. During the first six months of 2007, there have been no changes in GAFRI's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, GAFRI's internal controls over financial reporting.

## PART II

### OTHER INFORMATION

### Item 6

#### Exhibits

Exhibits:

<u>Number</u>	<u>Exhibit Description</u>
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- 31(a) Certification of the Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
- 31(b) Certification of the Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
- 32 Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 USC Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned duly authorized.

GREAT AMERICAN FINANCIAL RESOURCES, INC.

August 8, 2007

BY:/s/Christopher P. Miliano

Christopher P. Miliano

Chief Financial Officer

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GREAT AMERICAN FINANCIAL RESOURCES, INC.

EXHIBIT 31(a)

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS

I, S. Craig Lindner, the principal executive officer of Great American Financial Resources, Inc., certify that

1. I have reviewed this quarterly report on Form 10-Q of Great American Financial Resources, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board

of directors (or persons performing the equivalent functions):

- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 8, 2007

/s/ S. Craig Lindner

S. Craig Lindner

Chief Executive Officer

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GREAT AMERICAN FINANCIAL RESOURCES, INC.

EXHIBIT 31(b)

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS - CONTINUED

I, Christopher P. Miliano, the principal financial officer of Great American Financial Resources, Inc., certify that

1. I have reviewed this quarterly report on Form 10-Q of Great American Financial Resources, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4.

The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

- (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 8, 2007

/s/ Christopher P. Miliano

Christopher P. Miliano

Chief Financial Officer

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GREAT AMERICAN FINANCIAL RESOURCES, INC.

EXHIBIT 32

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER

Pursuant to 18 USC Section 1350 as adopted pursuant to

Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the filing with the Securities and Exchange Commission of the Quarterly Report of Great American Financial Resources, Inc. (the "Company") on Form 10-Q for the period ended June 30, 2007 (the "Report"), the undersigned officers of the Company, certify, pursuant to Section 18 USC Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of their knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ S. Craig Lindner

S. Craig Lindner

Chief Executive Officer

/s/ Christopher P. Miliano

Christopher P. Miliano

Chief Financial Officer

August 8, 2007

A signed original of this written statement will be retained by the Registrant and furnished to the Securities and Exchange Commission or its staff upon request.

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