AMERICAN FINANCIAL GROUP INC
Form 10-Q
May 11, 2009

UNITED STATES 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
March 31, 2009

Commission File

No. 1-13653

AMERICAN FINANCIAL GROUP, INC.

Incorporated under
the Laws of Ohio

IRS Employer I.D.
No. 31-1544320

One East Fourth Street, Cincinnati, Ohio 45202
(513) 579-2121

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 X No ___

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes ___ No ___

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company:

Large Accelerated Filer _X_ Accelerated Filer ___ Non-Accelerated Filer ___ Smaller Reporting Company ____

Indicate by check mark whether the Registrant is a shell company. Yes ___ No _X_

As of May 1, 2009, there were 115,736,731 shares of the Registrant's Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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PART I

ITEM I - FINANCIAL STATEMENTS

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET (unaudited)

(Dollars In Millions)

	March 31, 2009	December 31, 2008
Assets:		
Cash and cash equivalents	$ 1,315.0	$ 1,264.0
Investments:		
Fixed maturities:		
Available for sale - at fair value		
(amortized cost - $16,263.8 and $15,948.1)	14,308.5	14,079.3
Trading - at fair value	310.7	280.5
Equity securities - at fair value:		
Common stocks (cost - $107.2 and $118.6)	209.6	216.5
Perpetual preferred stocks (cost - $152.4 and $178.4)	88.4	137.1
Mortgage loans	305.4	308.9
Policy loans	280.1	283.6
	317.9	300.6
Real estate and other investments		
Total cash and investments	17,135.6	16,870.5
Recoverables from reinsurers and prepaid		
reinsurance premiums	3,560.0	4,301.7
Agents' balances and premiums receivable	618.3	629.7
Deferred policy acquisition costs	2,410.6	2,343.1

Other receivables	347.2	414.8
Variable annuity assets (separate accounts)	390.7	415.9
Other assets	1,169.5	1,241.6
Goodwill	210.2	210.2
Total Assets	$25,842.1	$26,427.5
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	$ 6,266.4	$ 6,764.2
Unearned premiums	1,678.0	1,697.9
Annuity benefits accumulated	10,689.8	10,652.7
Life, accident and health reserves	1,555.7	1,539.8
Payable to reinsurers	286.0	504.1
Long-term debt	1,058.3	1,029.7
Variable annuity liabilities (separate accounts)	390.7	415.9
Accounts payable, accrued expenses and other liabilities	1,238.4	1,221.6
Total liabilities	23,163.3	23,825.9
Shareholders' Equity:		
Common Stock, no par value		
- 200,000,000 shares authorized		
- 115,721,254 and 115,599,169 shares outstanding	115.7	115.6
Capital surplus	1,239.9	1,235.8
Retained earnings	1,947.8	1,841.6
Accumulated other comprehensive income (loss), net of tax	(740.0)	(703.0)
Total shareholders' equity	2,563.4	2,490.0
Noncontrolling interests	115.4	111.6
Total equity	2,678.8	2,601.6
Total liabilities and equity	$25,842.1	$26,427.5

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF EARNINGS (unaudited)

(In Millions, Except Per Share Data)

	Three months ended March 31, 2009	2008
Income:		
Property and casualty insurance premiums	$ 574.7	$ 635.0
Life, accident and health premiums	109.1	108.7
Investment income	300.2	266.3
Realized gains (losses) on securities (*)	(41.3)	(80.3)
Other income	62.9	72.1
	1,005.6	1,001.8
Costs and Expenses:		
Property and casualty insurance:		
Losses and loss adjustment expenses	271.7	290.9
Commissions and other underwriting expenses	198.7	222.0
Annuity benefits	107.6	104.9
Life, accident and health benefits	91.0	87.4
Annuity and supplemental insurance acquisition expenses	52.1	40.1
Interest charges on borrowed money	16.0	18.7
Other operating and general expenses	100.5	111.8
	837.6	875.8
Operating earnings before income taxes	168.0	126.0
Provision for income taxes	58.3	44.9
Net earnings, including noncontrolling interests	109.7	81.1
Less: Net earnings attributable to noncontrolling interests	(5.9)	(5.1)
Net Earnings Attributable to Shareholders	$ 103.8	$ 76.0

Earnings Attributable to Shareholders per Common Share:		
Basic	$.90	$.67
Diluted	$.88	$.64
Average number of Common Shares:		
Basic	115.7	113.5
Diluted	116.4	117.2
Cash dividends per Common Share	$.13	$.125

(*) Consists of the following:

Realized gains before impairment losses	$ 34.7	$ 21.6
Unrealized losses on securities with impairment charges	(184.4)	(101.9)
Non-credit portion in other comprehensive income	108.4	-
Impairment charges recognized in earnings	(76.0)	(101.9)
Total realized gains(losses) on securities	($ 41.3)	($ 80.3)

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (unaudited)

(Dollars in Millions)

	Shareholders' Equity					
	Common Shares	Common Stock and Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total	Noncon-trolling Interests

Balance at December 31, 2008	115,599,169	$1,351.4	$1,841.6	($703.0)	$2,490.0	$111.6
Cumulative effect of accounting change	-	-	17.5	(17.5)	-	-
Net earnings	-	-	103.8	-	103.8	5.9
Other comprehensive income (loss),						
net of tax:						
Change in unrealized gain (loss)						
on securities	-	-	-	(15.9)	(15.9)	(1.4)
Change in foreign currency translation	-	-	-	(3.8)	(3.8)	(.2)
Change in unrealized pension and other						
postretirement benefits	-	-	-	.2	.2	-
Total comprehensive income				-	84.3	4.3
Dividends on Common Stock	-	-	(15.1)	-	(15.1)	-
Shares issued:						
Benefit plans	116,331	.8	-	-	.8	-
Dividend reinvestment plan	5,754	.1	-	-	.1	-
Other stock-based compensation expense	-	2.7	-	-	2.7	-
Other	-	.6	-	-	.6	(.5)
Balance at March 31, 2009	115,721,254	$1,355.6	$1,947.8	($740.0)	$2,563.4	$ 115.4

Balance at December 31, 2007	113,499,080	$1,300.0	$1,733.5	$12.6	$3,046.1	$99.9
Net earnings	-	-	76.0	-	76.0	5.1
Other comprehensive income (loss),						
net of tax:						
Change in unrealized gain (loss)						

on securities	-	-	-	(70.5)	(70.5)	(2.1)
Change in foreign currency translation	-	-	-	(3.2)	(3.2)	-
Total comprehensive income					2.3	3.0
Dividends on Common Stock	-	-	(14.2)	-	(14.2)	-
Shares issued:						
Exercise of stock options	483,265	9.6	-	-	9.6	-
Dividend reinvestment plan	70,172	1.8	-	-	1.8	-
Other benefit plans	135,149	3.8	-	-	3.8	-
Other stock-based compensation expense	-	2.4	-	-	2.4	-
Shares acquired and retired	(1,003,000)	(11.5)	(14.9)	-	(26.4)	-
Shares tendered in option exercises	(240,325)	(2.7)	(3.5)	-	(6.2)	-
Noncontrolling interest of acquired subsidiary	-	-	-	-	-	18.9
Other	-	.9	-	-	.9	.5
Balance at March 31, 2008	112,944,341	$1,304.3	$1,776.9	($61.1)	$3,020.1	$122.3

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

(In Millions)

	Three months ended March 31,	
	2009	2008

Operating Activities:		
Net earnings, including noncontrolling interests	$ 109.7	$ 81.1
Adjustments:		
Depreciation and amortization	63.2	49.0
Annuity benefits	107.6	104.9
Realized losses on investing activities	41.3	80.0
Net (purchases) sales of trading securities	(35.1)	1.6
Deferred annuity and life policy acquisition costs	(38.4)	(42.5)
Decrease in reinsurance and other receivables	822.9	171.4
Decrease in other assets	62.5	22.6
Decrease in insurance claims and reserves	(501.8)	(35.7)
Decrease in payable to reinsurers	(218.1)	(6.2)
Increase (decrease) in other liabilities	8.1	(65.4)
Other, net	.1	8.9
Net cash provided by operating activities	422.0	369.7
Investing Activities:		
Purchases of and additional investments in:		
Fixed maturity investments	(1,087.9)	(1,823.9)
Equity securities	(.2)	(75.7)
Subsidiaries	(1.5)	(111.8)
Real estate, property and equipment	(11.4)	(12.6)
Maturities and redemptions of fixed maturity investments	380.3	603.9
Sales of:		
Fixed maturity investments	397.1	1,077.9
Equity securities	8.1	75.1
Real estate, property and equipment	.1	4.7
Decrease in securities lending collateral	16.2	4.8
Cash and cash equivalents of businesses acquired	-	90.8
Increase in other investments	(15.0)	(3.9)
Net cash used in investing activities	(314.2)	(170.7)
Financing Activities:		
Annuity receipts	266.1	286.0
Annuity surrenders, benefits and withdrawals	(319.8)	(351.8)
Net transfers from (to) variable annuity assets	(.2)	19.3
Additional long-term borrowings	28.9	270.0
Reductions of long-term debt	(.4)	(216.2)

Decrease in securities lending obligation	(16.2)	(4.8)
Issuances of Common Stock	.4	4.6
Repurchases of Common Stock	-	(26.4)
Cash dividends paid on Common Stock	(15.0)	(12.4)
Other, net	(.6)	.2
Net cash provided by financing activities	(56.8)	(31.5)
Net Increase in Cash and Cash Equivalents	51.0	167.5
Cash and cash equivalents at beginning of period	1,264.0	815.9
Cash and cash equivalents at end of period	$1,315.0	$ 983.4

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO NOTES

A. Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements for American Financial Group, Inc. ("AFG") and 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.

AFG adopted Statement of Financial Accounting Standards ("SFAS") No. 160, "Noncontrolling Interests in Consolidated Financial Statements," on January 1, 2009. As a result, noncontrolling interests in subsidiaries (formerly referred to as minority interest) is reported in the Balance Sheet as a separate component of equity and in the Statement of Earnings as a deduction from net income (instead of as an expense) in deriving net earnings attributable to AFG's shareholders. SFAS No. 160 requires that purchases and sales of equity interests in less than 100%-owned subsidiaries that do not result in a change of control be accounted for as equity transactions and, upon loss of control, requires any interest retained to be recorded at fair value with a gain or loss recognized in earnings. SFAS No. 160 is required to be applied prospectively, except for the provisions related to financial statement presentation of noncontrolling interests, which have been applied retrospectively.

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. 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.

Fair Value Measurements

Effective January 1, 2008, AFG adopted SFAS No. 157, "Fair Value Measurements," with the exception of the application of the statement to nonrecurring fair value measurements of nonfinancial assets and liabilities that was adopted as of January 1, 2009 in accordance with FSP FAS No. 157-2. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standard establishes a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability ("inputs") are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. In the first quarter of 2009, AFG did not have any

significant nonrecurring fair value measurements of nonfinancial assets and liabilities. AFG adopted FSP FAS No. 157-4 as of January 1, 2009. This standard provides guidance on estimating the fair value of an asset or liability when there is no active market and on identifying transactions that are not orderly. The standard did not change the objective of fair value measurements. Adoption of SFAS No. 157 and the FSPs did not have a significant impact on AFG's financial condition or results of operations.

Investments

Fixed maturity and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses included in a separate component of shareholders' equity. Fixed maturity and equity securities classified as "trading" are reported at fair value with changes in unrealized holding gains or losses during the period included in investment income.

Mortgage and policy loans are carried primarily at the aggregate unpaid balance.

Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities ("MBS") 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 at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses)) and the cost basis of that investment is reduced.

In April 2009, the Financial Accounting Standards Board ("FASB") issued FSP FAS No. 115-2, "Recognition and Presentation of Other-Than-Temporary Impairments." Under the guidance, if management can assert that it does not intend to sell an impaired fixed maturity security and it is more likely than not that it will not have to sell the security before recovery of its amortized cost basis, then an entity may separate other than temporary impairments into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income). The credit-related portion of an other than temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are required to be shown in the Statement of Earnings. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge is required to reduce the amortized cost of that security to fair value. AFG adopted this FSP effective January 1, 2009, and recorded a cumulative effect adjustment of $17.5 million to reclassify the non-credit component of previously recognized impairments from retained earnings to accumulated other comprehensive income. Additional disclosures required by the FSP are contained in Note D.

Certain AFG subsidiaries loan fixed maturity and equity securities to other institutions for short periods of time. The borrower is required to provide collateral on which AFG earns investment income, net of a fee to the lending agent. AFG records the collateral held (included in other assets) in its Balance Sheet at fair value. The obligation to return the collateral is included in other liabilities. The securities loaned remain a recorded asset on AFG's Balance Sheet.

Derivatives

Derivatives included in AFG's Balance Sheet are recorded at fair value and consist primarily of (i) components of certain fixed maturity securities (primarily interest-only MBS) and (ii) the equity-based component of certain annuity products (included in annuity benefits accumulated) and related call options (included in other investments) designed to be consistent with the characteristics of the liabilities and used to mitigate the risk embedded in those annuity products. Changes in the fair value of derivatives are included in earnings.

AFG adopted SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities" on January 1, 2009. SFAS No. 161 requires enhanced disclosures about objectives and strategies for using derivatives, how they are accounted for and how the instruments affect the entity's financial statements. See Note E *"Derivatives"* for the related disclosures. Adoption of SFAS No. 161 had no impact on AFG's financial position or results of operations.

Goodwill

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

Reinsurance

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policies. AFG's property and casualty insurance subsidiaries report as assets (a) the estimated reinsurance recoverable on paid and unpaid losses, including an estimate for losses incurred but not reported, and (b) amounts paid to reinsurers applicable to the unexpired terms of policies in force. Payable to reinsurers includes ceded premiums due to reinsurers as well as ceded premiums retained by AFG's property and casualty insurance subsidiaries under contracts to fund ceded losses as they become due. AFG's insurance subsidiaries also assume reinsurance from other companies. Earnings on reinsurance assumed is recognized based on information received from ceding companies.

Certain annuity and supplemental insurance subsidiaries cede life insurance policies to a third party on a funds withheld basis whereby the subsidiaries retain 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. AFG determined that changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The securities related to these transactions are classified 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.

Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs (principally commissions, premium taxes and other marketing and underwriting expenses) related to the production of new business are deferred. For the property and casualty companies, DPAC is limited based upon recoverability without any consideration for anticipated investment income and is charged against income ratably over the terms of the related policies. A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses, unamortized acquisition costs and policy maintenance costs exceed the related unearned premiums. A premium deficiency would first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate

the deficiency. If the premium deficiency was greater than unamortized acquisition costs, a liability would be accrued for the excess deficiency and reported with unpaid losses and loss adjustment expenses.

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. 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 (losses).

DPAC related to annuities is also adjusted, net of tax, for the change in 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 of tax" in the Shareholders' 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.

DPAC includes the present value of future profits on business in force of annuity and supplemental insurance companies acquired ("PVFP"). PVFP represents the portion of the costs to acquire companies that is allocated to the value of the right to receive future cash flows from insurance contracts existing at the date of acquisition. 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.

Unpaid Losses and Loss Adjustment Expenses

The net liabilities stated for unpaid claims and for expenses of investigation and adjustment of unpaid claims are based upon (a) the accumulation of case estimates for losses reported prior to the close of the accounting period on direct business written; (b) estimates received from ceding reinsurers and insurance pools and associations; (c) estimates of unreported losses (including possible development on known claims) based on past experience; (d) estimates based on experience of expenses for investigating and adjusting claims; and (e) the current state of the law and coverage litigation. Establishing reserves for asbestos, environmental and other mass tort claims involves considerably more judgment than other types of claims due to, among other things, inconsistent court decisions, an increase in bankruptcy filings as a result of asbestos-related liabilities, novel theories of coverage, and judicial interpretations that often expand theories of recovery and broaden the scope of coverage.

Loss reserve liabilities are subject to the impact of changes in claim amounts and frequency and other factors. Changes in estimates of the liabilities for losses and loss adjustment expenses are reflected in the Statement of Earnings in the period in which determined. Despite the variability inherent in such estimates, management believes that the liabilities for unpaid losses and loss adjustment expenses are adequate.

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.

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.

Variable Annuity Assets and Liabilities

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

Premium Recognition

Property and casualty premiums are earned generally over the terms of the policies on a pro rata basis. Unearned premiums represent that portion of premiums written which is applicable to the unexpired terms of policies in force. On reinsurance assumed from other insurance companies or written through various underwriting organizations, unearned premiums are based on information received from such companies and organizations. For traditional life, accident and health products, premiums are recognized as revenue when legally collectible from policyholders. 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.

Noncontrolling Interests

For Balance Sheet purposes, noncontrolling interests represents the interests of shareholders other than AFG in consolidated entities. In the Statement of Earnings, net earnings attributable to noncontrolling interests represents such shareholders' interest in the earnings of those entities.

Income Taxes

Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. Deferred tax assets are recognized if it is more likely than not that a benefit will be realized.

AFG records a liability for the inherent uncertainty in quantifying its income tax provisions. Related interest and penalties are recognized as a component of tax expense.

Stock-Based Compensation

All share-based grants are recognized as compensation expense over their vesting periods based on their calculated "fair value" at the date of grant. AFG uses the Black-Scholes pricing model to measure the fair value of employee stock options. See *Note H - "Shareholders' Equity"* for further information on stock options.

Benefit Plans

AFG provides retirement benefits to qualified employees of participating companies through the AFG Retirement and Savings Plan, a defined contribution plan. AFG makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. Company contributions are expensed in the year for which they are declared. AFG and many of its subsidiaries provide health care and life insurance benefits to eligible retirees. AFG also provides postemployment benefits to former or inactive employees (primarily those on disability) who were not deemed retired under other company plans. The projected future cost of providing these benefits is expensed over the period employees earn such benefits.

Earnings Per Share

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 (in millions):

	Three months ended March 31,	
	2009	2008
Adjustments to net earnings attributable to shareholders:		
Dilution of majority-owned subsidiaries	($.1)	($.1)
Assumed issuance of shares under deferred compensation plan	(.9)	(.3)
Adjustments to weighted average common shares:		
Stock-based compensation plans	.7	1.9
Convertible notes	-	1.8

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: first

quarter of 2009 and 2008 - 7.6 million and 3.9 million, respectively.

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 obtaining resources from owners and providing them with a return on their investments, borrowing money and repaying amounts borrowed. Annuity receipts, benefits and withdrawals are also reflected as financing activities. 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.

B. **Segments of Operations** AFG manages its business as three segments: (i) property and casualty insurance, (ii) annuity and supplemental insurance and (iii) other, which includes holding company costs.

AFG reports its property and casualty insurance business in the following Specialty sub-segments: (i) Property and transportation, which includes physical damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages, (ii) Specialty casualty, which includes primarily excess and surplus, general liability, directors and officers liability and customized programs for small to mid-sized businesses, (iii) Specialty financial, which includes risk management insurance programs for lending and leasing institutions, surety and fidelity products and trade credit insurance, and (iv) California workers' compensation. AFG's annuity and supplemental insurance business markets traditional fixed, indexed and variable annuities and a variety of supplemental insurance products. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

The following tables (in millions) show AFG's revenues and operating earnings before income taxes by significant business segment and sub-segment.

	Three months ended March 31,	
	2009	2008
Revenues		
Property and casualty insurance:		
Premiums earned:		
Specialty		
Property and transportation	$ 211.5	$ 236.1
Specialty casualty	171.6	211.8
Specialty financial	130.2	119.6
California workers' compensation	43.6	51.4
Other	17.8	15.9
Other lines	-	.2
	574.7	635.0
Investment income	106.9	100.0
Realized losses	(10.2)	(33.5)
Other	29.9	39.6

	701.3	741.1
Annuity and supplemental insurance:		
Investment income	196.3	168.1
Life, accident and health premiums	109.1	108.7
Realized losses	(31.2)	(43.8)
Other	31.6	29.1
	305.8	262.1
Other	(1.5)	(1.4)
	$1,005.6	$1,001.8

Operating Earnings Before Income Taxes		
Property and casualty insurance:		
Underwriting:		
Specialty		
Property and transportation	$ 48.0	$ 38.7
Specialty casualty	40.3	53.3
Specialty financial	13.5	16.7
California workers' compensation	.2	10.2
Other	3.0	1.2
Other lines	(.7)	2.0
	104.3	122.1
Investment and other operating income	90.6	87.6
Realized losses	(10.2)	(33.5)
	184.7	176.2
Annuity and supplemental insurance:		
Operations	39.3	26.5
Realized losses	(31.2	(43.8

	)	)
	8.1	(17.3)
Other	(24.8	(32.9
	)	)
	$ 168.0	$ 126.0

C.

Fair Value Measurements The framework established in SFAS No. 157 for measuring fair value is based on inputs used in estimating fair value. The three levels of the hierarchy are as follows:

Level 1 - Quoted prices for identical assets or liabilities in active markets (markets in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis).

Level 2 - Quoted prices for similar instruments in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (markets in which there are few transactions, the prices are not current, price quotations vary substantially over time or among market makers, or in which little information is released publicly); and valuations based on other significant inputs that are observable in active markets.

Level 3 - Valuations derived from valuation techniques in which one or more significant inputs are unobservable. The unobservable inputs may include management's own assumptions about the assumptions market participants would use based on the best information available in the circumstances.

AFG's Level 1 financial instruments consist primarily of publicly traded equity securities and highly liquid government bonds for which quoted market prices in active markets are available. AFG's Level 2 financial instruments include separate account assets and liabilities, corporate and municipal fixed maturity securities and mortgage-backed securities ("MBS") priced using observable inputs. Level 2 inputs include benchmark yields, reported trades, corroborated broker/dealer quotes, issuer spreads and benchmark securities. When non-binding broker quotes can be corroborated by comparison to similar securities priced using observable inputs, they are classified as Level 2. AFG's Level 3 is comprised of financial instruments whose fair value is estimated based on non-binding broker quotes or internally developed using significant inputs not based on, or corroborated by, readily available market information.

AFG's management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value. This data is reviewed by internal investment professionals who ensure the fair value is representative of an exit price (consistent with SFAS No. 157).

Assets and liabilities measured at fair value on March 31, 2009, are summarized below (in millions):

	Level 1	Level 2	Level 3	Total
Assets:				
Fixed maturities:				
Available for sale ("AFS")	$ 332	$13,288	$ 689	$14,309
Trading	-	310	1	311
Equity securities:				
Common stocks	59	147	4	210
Perpetual preferred stocks	59	5	24	88
Separate account assets (a)	-	391	-	391
Other investments	-	28	-	28
Other assets	32	31	5	68
Total assets accounted for at fair value	$ 482	$14,200	$ 723	$15,405
Liabilities:				
Derivatives embedded in annuity benefits accumulated	$ -	$ -	$ 86	$ 86

(a) Separate account liabilities equal the fair value for separate account assets.

Approximately 4-1/2% of the total assets measured at fair value were Level 3 assets. Approximately 50% of these assets were MBS whose fair values were determined primarily using non-binding broker quotes; the balance was primarily private placement debt and equity securities whose fair values were determined internally using significant unobservable inputs, including the evaluation of underlying collateral and issuer creditworthiness, as well as certain Level 2 inputs such as comparable yields and multiples on similar publicly traded issues.

Changes in balances of Level 3 financial assets and liabilities during the first quarter of 2009 and 2008 are presented below (in millions). Transfers into (out of) Level 3 are due to a change in the availability of market observable inputs for individual securities and are reflected in the table at fair value as of the date of transfer.

	Fixed Maturities		Equity	Other	Embedded
	AFS	Trading	Securities	Assets	Derivatives
Balance at December 31, 2008	$706	$ 1	$ 44	$ 5	$ 96
Total realized/unrealized gains (losses):					
Included in net income	3	-	(7)	-	(12)
Included in other comprehensive income (loss)	(12)	-	(4)	-	-
Purchases, sales, issuances and settlements	(17)	-	-	-	2
Transfers into (out of) Level 3	9	-	(5)	-	-
Balance at March 31, 2009	$689	$ 1	$ 28	$ 5	$ 86

Balance at December 31, 2007	$527	$11	$56	$5	$155
Total realized/unrealized gains (losses)					
Included in net income	23	(1)	-	(1)	(16)
Included in other comprehensive income (loss)	(2)	-	-	-	-
Purchases, sales, issuances and settlements	117	-	(10)	-	7
Transfers into (out of) Level 3	-	-	-	-	-
Balance at March 31, 2008	$665	$10	$46	$4	$146

D.

Investments Fixed maturities and equity securities classified as available for sale at March 31, 2009, and December 31, 2008, consisted of the following (in millions):

	March 31, 2009				December 31, 2008			
	Amortized	Fair	Gross Unrealized		Amortized	Fair	Gross Unrealized	
	Cost	Value	Gains	Losses	Cost	Value	Gains	Losses
Fixed maturities:								
Direct obligations of the								
United States Government	$ 289	$ 307	$ 18	$ -	$ 298	$ 323	$ 25	$ -
United States Government								
agencies and authorities	216	221	5	-	239	246	7	-
States, municipalities and								
political subdivisions	1,200	1,211	27	(16)	967	965	18	(20)
Foreign government	144	147	3	-	150	155	5	-
Residential MBS	4,733	3,853	42	(922)	4,899	4,046	34	(887)
Commercial MBS	1,116	885	3	(234)	1,089	876	2	(215)
All other corporate	8,518	7,644	79	(953)	8,255	7,422	62	(895)
Redeemable preferred stocks	48	41	1	(8)	51	46	2	(7)
	$16,264	$14,309	$178	($2,133)	$15,948	$14,079	$155	($2,024)
Common stocks	$ 107	$ 210	$119	($ 16)	$ 119	$ 217	$112	($ 14)
Perpetual preferred stocks	$ 152	$ 88	$ -	($ 64)	$ 178	$ 137	$ 2	($ 43)

The non-credit related portion of other than temporary impairment charges are included in other comprehensive income. Such charges taken for securities still owned at March 31 were $193 million for residential MBS and $10 million for corporate bonds.

The following tables show gross unrealized losses (in millions) on fixed maturities and equity securities by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2009 and December 31, 2008.

	Less Than Twelve Months			Twelve Months or More		
	Unrealized Loss	Fair Value	Fair Value as % of Cost	Unrealized Loss	Fair Value	Fair Value as % of Cost
March 31, 2009						
Fixed maturities:						
Direct obligations of the United States Government	$ -	$ 5	100%	$ -	$ -	-%
United States Government agencies and authorities	-	14	99%	-	-	-%
States, municipalities and political subdivisions	(4)	215	98%	(12)	80	86%
Foreign government	-	12	99%	-	-	-%
Residential MBS	(420)	1,489	78%	(502)	1,544	75%
Commercial MBS	(90)	371	81%	(144)	475	77%
All other corporate	(366)	3,237	90%	(587)	1,955	77%
Redeemable preferred stocks	(5)	24	82%	(3)	3	55%
	($ 885)	$5,367	86%	($1,248)	$4,057	77%
Common Stocks	($ 16)	$ 28	63%	$ -	$ -	-%
Perpetual Preferred Stocks	($ 19)	$ 23	55%	($ 45)	$ 44	50%
December 31, 2008						
Fixed maturities:						
United States Government agencies and authorities	$ -	$ 5	99%	$ -	$ 3	100%
States, municipalities and political subdivisions	(15)	187	93%	(5)	41	89%
Foreign government	-	-	-%	-	-	-%
Residential MBS	(567)	2,262	80%	(320)	914	74%

Commercial MBS	(169)	669	80%	(46)	173	79%
All other corporate	(502)	4,361	90%	(393)	1,279	77%
Redeemable preferred stocks	(5)	26	84%	(2)	5	72%
	($1,258)	$7,510	86%	($ 766)	$2,415	76%
Common Stocks	($ 14)	$ 23	62%	$ -	$ -	-%
Perpetual Preferred Stocks	($ 19)	$ 61	76%	($ 24)	$ 35	59%

At March 31, 2009, the gross unrealized losses of $2.1 billion relate to approximately 1,940 fixed maturity securities. Investment grade securities (as determined by nationally recognized rating agencies) represented approximately 79% of the gross unrealized loss and 90% of the fair value. Note that all references to ratings of investment securities held at March 31, 2009, incorporate ratings changes through April 30, 2009. MBS and corporate bonds comprised approximately 87% of the fair value of the available for sale fixed maturity portfolio at March 31, 2009, and 99% of the gross unrealized losses. Gross unrealized losses on these two groups increased significantly during 2008 as widespread deterioration in economic conditions resulted in significantly wider spreads. Approximately 57% of the gross unrealized losses on these two groups at March 31, 2009, included securities that were in an unrealized loss position for more than 12 months.

AFG recognized in earnings approximately $102.8 million in other than temporary impairment charges on securities during the first three months of 2009 including $95.1 million on fixed maturities, primarily relating to corporate bonds and MBS. Management concluded that no additional charges for other than temporary impairment were required based on many factors, including AFG's ability and intent to hold the investments for a period of time sufficient to allow for anticipated recovery of its amortized cost, the length of time and the extent

to which fair value has been below cost, analysis of historical and projected company-specific financial data, the outlook for industry sectors, credit ratings including the fact that 84% of the unrealized losses on AFG's MBS related to investment grade securities, expectations with respect to cash flows from the underlying collateral on MBS, and credit enhancement of certain issues by monoline insurers.

Nearly 74% of the gross unrealized losses on AFG's perpetual preferred stocks relate to investments in banks and credit institutions, 82% of which were investment grade rated. AFG believes these unrealized losses are due primarily to temporary market and sector-related factors and does not consider these securities to be other than temporarily impaired. AFG has the ability and intent to hold these securities until they recover in value.

The following table is a progression of the amount related to credit losses on fixed maturity securities for which a portion of an other than temporary impairment has been recognized in other comprehensive income.

Balance at January 1, 2009	$13.7
Additional credit impairments on:	
Previously impaired securities	-
Securities without prior impairments	46.8
Reductions	-
Balance at March 31, 2009	$60.5

The table below sets forth the scheduled maturities of fixed maturities as of March 31, 2009 (in millions). 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. MBS had an average life of approximately five years at March 31, 2009.

	Amortized	Fair Value	
Maturity	Cost	Amount	%
One year or less	$ 561	$ 560	4%
After one year through five years	5,526	5,143	36
After five years through ten years	3,664	3,278	23
After ten years	664	590	4
	10,415	9,571	67
MBS	5,849	4,738	33
Total	$16,264	$14,309	100 %

Certain risks are inherent in connection with fixed maturity securities, including loss upon default, price volatility in reaction to changes in interest rates, and general market factors and risks associated with reinvestment of proceeds due to prepayments or redemptions in a period of declining interest rates.

Investments in fixed maturity securities of banks and credit institutions represent approximately 12% of AFG's available for sale fixed maturities. There were no investments in individual issuers (other than U.S. Treasury Notes) that exceeded 10% of Shareholders' Equity at March 31, 2009 or December 31, 2008. AFG subsidiaries held collateral for securities on loan of approximately $68 million and $85 million at March 31, 2009 and December 31, 2008, respectively; fair value of securities loaned (plus accrued interest) was approximately $78 million and $94 million at those dates.

Net Unrealized Loss on Marketable Securities

In addition to adjusting equity securities and fixed maturity securities classified as "available for sale" to fair value, GAAP requires that deferred policy acquisition costs related to annuities and certain other balance sheet amounts be adjusted to the extent that unrealized gains and losses from securities would result in adjustments to those balances had the unrealized gains or losses actually been realized. The following table shows the components of the net unrealized loss on securities that is included in Accumulated Other Comprehensive Income (Loss) in AFG's Balance Sheet.

	Pre-tax	Deferred Tax and Amounts Attributable to Noncontrolling Interests	Net
March 31, 2009			
Unrealized gain (loss) on:			
Fixed maturity securities	($1,955.3)	$685.7	($1,269.6)
Equity securities	38.4	(11.9)	26.5
Securities lending collateral	(9.9)	6.6	(3.3)
Deferred policy acquisition costs	844.0	(295.4)	548.6
Annuity benefits and other liabilities	(28.0)	9.8	(18.2)
	($1,110.8)	$ 394.8	($ 716.0)
December 31, 2008			
Unrealized gain (loss) on:			
Fixed maturity securities	($1,868.8)	$655.1	($1,213.7)
Equity securities	56.6	(19.0)	37.6
Securities lending collateral	(10.0)	6.6	(3.4)
Deferred policy acquisition costs	790.2	(276.6)	513.6
Annuity benefits and other liabilities	(25.7)	9.0	(16.7)
	($1,057.7)	$375.1	($ 682.6)

Realized gains (losses) and changes in unrealized appreciation (depreciation) related to fixed maturity and equity security investments are summarized as follows for the three months ended March 31, 2009 and 2008(in millions):

	Fixed Maturities	Equity Securities	Other(*)	Tax Effects	Noncon-trolling Interests	Total
2009						
Realized before impairments	$ 54.9	($ 11.9)	($ 8.3)	($ 12.2)	($ .2)	$ 22.3
Realized - impairments	(95.1)	(7.7)	26.8	26.6	.2	(49.2)
Change in Unrealized	(86.5)	(18.2)	51.6	18.3	1.4	(33.4)
2008						
Realized before impairments	$ 48.1	($ 25.6)	($ .9)	($7.6)	$ -	$14.0
Realized - impairments	(48.3)	(60.8)	7.2	35.7	-	(66.2)
Change in Unrealized	(115.8)	(6.5)	12.2	37.5	2.1	(70.5)

(*) Primarily adjustments to deferred policy acquisition costs related to annuities.

Realized gains includes net gains of $36.1 million in the 2009 quarter and $32.3 million in the 2008 quarter from the mark-to-market of derivative MBS, primarily interest-only securities with interest rates that float inversely with short-term rates. Gross gains and losses (excluding impairment writedowns and mark-to-market of derivatives) on available for sale fixed maturity investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

	2009	2008
Gross Gains	$21.5	$ 23.2
Gross Losses	(4.4)	(4.4)

E.

Derivatives As discussed under *"Derivatives"* in Note A, AFG has derivatives in certain areas of its operations. AFG's derivatives do not qualify for hedge accounting under GAAP; changes in the fair value of derivatives are included in earnings.

Certain securities held in AFG's investment portfolio, primarily interest-only MBS with interest rates that float inversely with short-term rates, are considered to contain embedded derivatives. AFG has elected to measure these securities (in their entirety) at fair value in its financial statements. These investments are part of AFG's overall investment strategy and represent a small component of AFG's overall investment portfolio.

AFG's indexed annuities, which represented 24% of annuity benefits accumulated at March 31, 2009, provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. AFG attempts to mitigate the risk in the index-based component of these products through the purchase of call options on the appropriate index. AFG's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be generally offset by unrealized and realized gains on the call options purchased by AFG. Both the index-based component of the annuities and the related call options are considered derivatives.

As discussed under *"Reinsurance"* in Note A, certain reinsurance contracts in AFG's annuity and supplemental insurance business are considered to contain embedded derivatives.

The following derivatives are included in AFG's Balance Sheet at March 31, 2009 (in millions):

		Fair Value	
Derivative	Balance Sheet Line	Asset	Liability
Derivative MBS	Fixed maturities	$167	$ -
Indexed annuities			
(embedded derivative)	Annuity benefits accumulated	-	86
Equity index call options	Other investments	13	-
Reinsurance contracts			
(embedded derivative)	Other liabilities	-	(23)
		$180	$63

The following table summarizes the earnings impact of recording changes in the fair value of these derivatives for the first quarter of 2009:

Derivative	Statement of Earnings Line	Gain (Loss)
Derivative MBS	Realized gains	$36
Indexed annuities		
(embedded derivative)	Annuity benefits	12
Equity index call options	Annuity benefits	(11)
Reinsurance contracts		
(embedded derivative)	Investment income	3
		$40

Amortizable Intangible Assets Included in deferred policy acquisition costs in AFG's Balance Sheet are $243.7 million and $247.0 million at March 31, 2009, and December 31, 2008, respectively, representing the present value of future profits ("PVFP") related to acquisitions by AFG's annuity and supplemental insurance business. The PVFP amounts include adjustments related to unrealized gains and losses on securities and are net of $126.5 million and $118.5 million of accumulated amortization. Amortization of the PVFP was $8.0 million and $8.7 million during the first three months of 2009 and 2008, respectively.

Included in other assets in AFG's Balance Sheet is $71.7 million at March 31, 2009 and $76.4 million at December 31, 2008, in amortizable intangible assets related to property and casualty insurance acquisitions, primarily the 2008 acquisitions of Marketform and Strategic Comp. These amounts are net of accumulated amortization of $44.2 million and $38.0 million, respectively. Amortization of these intangibles was $6.2 million and $5.2 million for the first three months of 2009 and 2008, respectively.

Long-Term Debt The carrying value of long-term debt consisted of the following (in millions):

	March 31, 2009	December 31, 2008
Direct obligations of AFG:		

7-1/8% Senior Debentures due April 2009	$ 136.1	$136.1
7-1/8% Senior Debentures due February 2034	115.0	115.0
Borrowings under bank credit facility	465.0	465.0
Other	2.9	2.9
	719.0	719.0
Subsidiaries		
:		
Obligations of AAG Holding (guaranteed by AFG):		
7-1/2% Senior Debentures due November 2033	112.5	112.5
7-1/4% Senior Debentures due January 2034	86.3	86.3
Notes payable secured by real estate due 2009 through 2016	66.6	66.9
Secured borrowings	28.9	-
National Interstate bank credit facility	15.0	15.0
American Premier Underwriters 10-7/8% Subordinated Notes due May 2011	7.9	7.9
Other	2.1	2.1
	319.3	290.7
Payable to Subsidiary Trusts:		
AAG Holding Variable Rate Subordinated Debentures due May 2033	20.0	20.0
	$1,058.3	$1,029.7

In April 2009, AFG paid $136.1 million to redeem its outstanding 7-1/8% Senior Notes at maturity. Scheduled principal payments on AFG's remaining debt for the balance of 2009 and the subsequent five years were as follows: 2009 - $6.3 million; 2010 - $8.5 million; 2011 - $481.3 million; 2012 - $23.6 million; 2013 - $3.3 million; and 2014 - $1.6 million.

As shown below (in millions), the majority of AFG's long-term debt is unsecured obligations of the holding company and its subsidiaries:

	March 31, 2009	December 31, 2008
Unsecured obligations	$ 962.8	$ 962.8

Obligations secured by real estate	66.6	66.9
	28.9	-
Other secured borrowings		
	$1,058.3	$1,029.7

AFG can borrow up to $500 million under its revolving credit facility, which expires in March 2011. Amounts borrowed bear interest at rates ranging from .5% to 1.25% (currently .75%) over LIBOR based on AFG's credit rating. At March 31, 2009, AFG had $465 million in borrowings outstanding under the credit facility (interest rate of 2.6% at March 31, 2009).

On March 31, 2009, an AFG subsidiary borrowed $28.9 million at an interest rate of 4.25% over LIBOR. The loan requires principal payments over the next four years.

In July 2008, AFG entered into a 364 day revolving credit facility under which it can borrow up to $120 million at an interest rate of 2.25% over LIBOR. No amounts have been borrowed under this credit facility.

H.

Shareholders' Equity AFG is authorized to issue 12.5 million shares of Voting Preferred Stock and 12.5 million shares of Nonvoting Preferred Stock, each without par value.

Accumulated Other Comprehensive Income (Loss), Net of Tax

Comprehensive income (loss) is defined as all changes in Shareholders' Equity except those arising from transactions with shareholders. Comprehensive income (loss) includes net earnings and other comprehensive income (loss), which consists primarily of changes in net unrealized gains or losses on available for sale securities and foreign currency translation. The progression of the components of accumulated other comprehensive income (loss) follows (in millions):

	Pretax Net Unrealized Gains (Losses) on Securities	Foreign Currency Translation Adjustment	Other (a)	Tax Effects	Noncon-trolling Interests	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2008	($1,057.7)	($13.4)	($10.7)	$373.8	$ 5.0	($703.0)
Cumulative effect of accounting change	(26.9)	-	-	9.4	-	(17.5)
Unrealized holding losses on securities arising during the period	(67.5)	-	-	23.3	1.4	(42.8)

Realized losses included in net earnings	41.3	-	-	(14.4)	-	26.9
Foreign currency translation losses	-	(3.8)	-	-	-	(3.8)
Other	-	-	.3	(.1)	-	.2
Balance at March 31, 2009	($1,110.8)(b)	($17.2)	($10.4)	$392.0	$ 6.4	($740.0)(b)
Balance at December 31, 2007	($ 30.9)	$27.9	$ 4.8	$ 8.3	$ 2.5	$ 12.6
Unrealized holding losses on securities arising during the period	(190.4)	-	-	65.6	2.1	(122.7)
Realized losses included in net earnings	80.3	-	-	(28.1)	-	52.2
Foreign currency translation losses	-	(3.2)	-	-	-	(3.2)
Balance at March 31, 2008	($ 141.0)	$24.7	$ 4.8	$ 45.8	$ 4.6	($ 61.1)

(a) Net unrealized pension and other postretirement plan benefits.
(b) Includes $132.8 million in pretax unrealized losses ($86.3 million net of tax) related to securities for which only the credit portion of an other than temporary impairment has been recorded in earnings.

Stock Incentive Plans

Under AFG's Stock Incentive Plan, employees of AFG and its subsidiaries are eligible to receive equity awards in the form of stock options, stock appreciation rights, restricted stock awards, restricted stock units and stock awards. In the first three months of 2009, AFG issued 79,801 shares of restricted Common Stock and granted stock options for 1.2 million shares of Common Stock (at an average exercise price of $19.10) under the Stock Incentive Plan.

AFG uses the Black-Scholes option pricing model to calculate the "fair value" of its option grants. Expected volatility is based on historical volatility over a period equal to the expected term. The expected term was estimated based on historical exercise patterns and post vesting cancellations. The fair value of options granted during 2009 was $5.85 per share based on the following assumptions: expected dividend yield - 2.7%; expected volatility - 37%; expected term - 7.5 years; risk-free rate - 2.1%.

Total compensation expense related to stock incentive plans of AFG and its subsidiaries was $3.4 million for the first quarter of 2009 compared to $5.1 million for the 2008 quarter. Stock-based compensation expense for the first three months of 2008 includes $2.0 million in first quarter non-deductible stock awards.

- **Contingencies**

There have been no significant changes to the matters discussed and referred to in *Note L - "Contingencies"* of AFG's 2008 Annual Report on Form 10-K.

Condensed Consolidating Information In connection with GAFRI's acquisition of its publicly held common stock in September 2007, AFG has guaranteed all of the outstanding debt of GAFRI and GAFRI's wholly-owned subsidiary, AAG Holding Company, Inc. In addition, GAFRI guarantees AAG Holding's public debt. The AFG and GAFRI guarantees are full and unconditional and joint and several. Condensed consolidating financial statements for AFG are as follows:

CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

March 31, 2009	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
Assets:						
Cash and investments	$ 189.1	$ 19.3	$ .4	$16,929.9	($ 3.1)	$17,135.6
Recoverables from reinsurers and prepaid reinsurance premiums	-	-	-	3,560.0	-	3,560.0
Agents' balances and premiums receivable	-	-	-	618.3	-	618.3
Deferred policy acquisition costs	-	-	-	2,410.6	-	2,410.6
Other assets	20.0	6.3	6.3	1,961.5	123.5	2,117.6
Investment in subsidiaries and affiliates	3,234.5	810.0	898.1	710.9	(5,653.5)	-
Total assets	$3,443.6	$835.6	$904.8	$26,191.2	($5,533.1)	$25,842.1
Liabilities and Equity:						
Unpaid losses, loss adjustment expenses and unearned premiums	$ -	$ -	$ -	$ 7,944.4	$ -	$ 7,944.4
Annuity, life, accident and health benefits and reserves	-	-	-	12,247.2	(1.7)	12,245.5
Long-term debt	719.0	.7	219.3	119.7	(.4)	1,058.3
Other liabilities	161.2	21.1	107.8	1,807.2	(182.2)	1,915.1

	880.2	21.8	327.1	22,118.5	(184.3)	23,163.3
Total shareholders' equity	2,563.4	813.8	577.7	3,957.3	(5,348.8)	2,563.4
Noncontrolling interests	-	-	-	115.4	-	115.4
Total liabilities and equity	$3,443.6	$835.6	$904.8	$26,191.2	($5,533.1)	$25,842.1

December 31, 2008

Assets:						
Cash and investments	$ 188.5	$ 20.4	$ -	$16,663.7	($ 2.1)	$16,870.5
Recoverables from reinsurers and prepaid reinsurance premiums	-	-	-	4,301.7	-	4,301.7
Agents' balances and premiums receivable	-	-	-	629.7	-	629.7
Deferred policy acquisition costs	-	-	-	2,343.1	-	2,343.1
Other assets	11.6	6.0	6.1	2,084.3	174.5	2,282.5
Investment in subsidiaries and affiliates	3,131.6	812.8	900.4	711.8	(5,556.6	-
					)	
Total assets	$3,331.7	$839.2	$906.5	$26,734.3	($5,384.2)	$26,427.5
Liabilities and Equity:						
Unpaid losses, loss adjustment expenses and unearned premiums	$ -	$ -	$ -	$ 8,462.1	$ -	$ 8,462.1
Annuity, life, accident and health benefits and reserves	-	-	-	12,194.2	(1.7)	12,192.5
Long-term debt	719.0	.7	219.4	91.0	(.4)	1,029.7
Other liabilities	122.7	21.8	110.8	1,945.7	(59.4	2,141.6
					)	
	841.7	22.5	330.2	22,693.0	(61.5)	23,825.9
Total shareholders' equity	2,490.0	816.7	576.3	3,929.7	(5,322.7)	2,490.0
Noncontrolling interests	-	-	-	111.6	-	111.6
Total liabilities and equity	$3,331.7	839.2	$906.5	$26,734.3	($5,384.2)	$26,427.5

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AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

CONDENSED CONSOLIDATING STATEMENT OF EARNINGS

(In millions)

FOR THE THREE MONTHS ENDED MARCH 31, 2009	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
Income:						
Property and casualty insurance premiums	$ -	$ -	$ -	$ 574.7	$ -	$ 574.7
Life, accident and health premiums	-	-	-	109.1	-	109.1
Realized gains (losses)	-	-	-	(41.5)	.2	(41.3)
Investment and other income	(3.0)	(2.0)	-	373.8	(5.7)	363.1
Equity in earnings of subsidiaries	179.8	9.3	18.6	-	(207.7)	-
	176.8	7.3	18.6	1,016.1	(213.2)	1,005.6
Costs and Expenses:						
Insurance benefits and expenses	-	-	-	721.1	-	721.1
Interest charges on borrowed money	12.3	-	6.4	3.0	(5.7)	16.0
Other expenses	2.4	4.2	1.1	93.1	(.3)	100.5
	14.7	4.2	7.5	817.2	(6.0)	837.6
Operating earnings before income taxes	162.1	3.1	11.1	198.9	(207.2)	168.0
Provision (credit) for income taxes	58.3	(.6	2.0	68.1	(69.5	58.3

	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
	)			)		
Net earnings, including noncontrolling interests	103.8	3.7	9.1	130.8	(137.7)	109.7
Less: Net earnings attributable to noncontrolling interests	-	-	-	(5.9)	-	(5.9)
Net Earnings Attributable to Shareholders	$103.8	$ 3.7	$ 9.1	$ 124.9	($137.7)	$ 103.8

FOR THE THREE MONTHS ENDED MARCH 31, 2008	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
Income:						
Property and casualty insurance premiums	$ -	$ -	$ -	$ 635.0	$ -	$ 635.0
Life, accident and health premiums	-	-	-	108.7	-	108.7
Realized gains (losses)	(3.0)	-	-	(77.1)	(.2)	(80.3)
Investment and other income	(2.0)	3.5	-	349.1	(12.2)	338.4
Equity in earnings (loss) of subsidiaries	149.6	(22.4)	(13.2)	-	(114.0)	-
	144.6	(18.9)	(13.2)	1,015.7	(126.4)	1,001.8
Costs and Expenses:						
Insurance benefits and expenses	-	-	-	745.3	-	745.3
Interest charges on borrowed money	18.0	-	8.5	4.5	(12.3)	18.7
Other expenses	5.7	3.7	1.2	101.6	(.4)	111.8

	23.7	3.7	9.7	851.4	(12.7)	875.8
Operating earnings (loss) before income taxes	120.9	(22.6)	(22.9)	164.3	(113.7)	126.0
Provision (credit) for income taxes	44.9	(8.0)	(8.4)	57.2	(40.8)	44.9
Net earnings (loss), including noncontrolling interests	76.0	(14.6)	(14.5)	107.1	(72.9)	81.1
Less: Net earnings attributable to noncontrolling interests	-	-	-	(5.1)	-	(5.1)
Net Earnings (Loss) Attributable to Shareholders	$ 76.0	($14.6)	($14.5)	$ 102.0	($ 72.9)	$ 76.0

AMERICAN FINANCIAL GROUP, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

FOR THE THREE MONTHS ENDED MARCH 31, 2009	AFG	GAFRI	AAG Holding	All Other Subs	Consol. Entries	Consolidated
Operating Activities:						
Net earnings (loss), including noncontrolling interests	$103.8	$ 3.7	$ 9.1	$ 130.8	($137.7)	$ 109.7
Adjustments:						
Equity in net (earnings) loss						

of subsidiaries	(115.8)	(8.0)	(14.3)	-	138.1	-
Dividends from subsidiaries	98.5	2.8	-	-	(101.3)	-
Other adjustments, net	(35.8)	2.0	(6.5)	353.0	(.4)	312.3
Net cash provided by (used in) operating activities	50.7	.5	(11.7)	483.8	(101.3)	422.0
Investing Activities:						
Purchase of investments, property and equipment	(3.2)	-	-	(1,096.3)	-	(1,099.5)
Purchase of subsidiaries	-	-	-	(1.5)	-	(1.5)
Capital contributions to subsidiaries	(32.0)	(28.1)	(15.0)	-	75.1	-
Maturities and redemptions of fixed maturity investments	.1	-	-	380.2	-	380.3
Sale of investments, property and equipment	3.0	-	-	402.3	-	405.3
Other, net	-	(.5)	-	1.7	-	1.2
Net cash provided by (used in) investing activities	(32.1)	(28.6)	(15.0)	(313.6)	75.1	(314.2)
Financing Activities:						
Annuity receipts	-	-	-	266.1	-	266.1
Annuity surrenders, benefits and withdrawals	-	-	-	(319.8)	-	(319.8)
Net transfers to variable annuity assets	-	-	-	(.2)	-	(.2)
Additional long-term borrowings	-	-	-	28.9	-	28.9
Reductions of long-term debt	(.1)	-	-	(.3)	-	(.4)
Issuances of Common Stock	.5	-	-	(.1)	-	.4
Capital contribution from parent	-	31.0	27.1	17.0	(75.1)	-
Cash dividends paid	(15.0)	-	-			