



 Annual Report for 2003



American Financial Group, Inc. (“AFG” or the “Company”) is engaged in property and casualty insurance, focusing on specialized commercial products for businesses, and in the sale of retirement annuities, life and supplemental health insurance products.

*Our property and casualty (“P&C”) operations emphasize underwriting profitability, entrepreneurship and specialization based on a common operating philosophy.*



*Our annuity, life and health businesses focus on developing profitable, innovative products and services to provide customers with more choices in planning for lifestyle security.*



AFG sold 61% of Infinity Property and Casualty Corporation in a February 2003 public offering and its remaining stake in Infinity in December 2003. With the additional capital provided by these sales, AFG is better able to take advantage of its expertise as a niche underwriter during this continuing favorable market and into the future.

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*Please refer to “Forward-Looking Statements” on the inside back cover.*



### ***Play Ball!***

We are proud to have our name displayed prominently on the home of the oldest franchise in professional baseball as the Cincinnati Reds’ Great American Ball Park officially opened its doors in the spring of 2003.

# Financial Highlights

<i>(In millions, except per share data)</i>	2003	2002	2001	2000	1999
<b>Balance Sheet Data:</b>					
Cash and investments	\$13,828	\$13,651	\$12,084	\$11,500	\$11,309
Total assets	20,197	19,505	17,402	16,416	16,054
Long-term debt:					
Parent holding companies	586	648	609	585	493
Subsidiaries	251	297	271	195	240
Shareholders' equity	2,076	1,726	1,498	1,549	1,340
Ratio of debt to total capital(a):					
Parent holding company level	21%	25%	27%	25%	25%
Consolidated	25%	30%	31%	30%	32%
Cash dividends per share	\$0.50	\$0.50	\$1.00	\$1.00	\$1.00
Book value per share	\$28.42	\$24.97	\$21.88	\$22.97	\$22.94
Shares outstanding	73.1	69.1	68.5	67.4	58.4

<b>Summary of Operations:</b>					
Total revenues	\$3,360	\$3,745	\$3,919	\$3,816	\$3,360
Net earnings (loss) – GAAP	\$293.8	\$ 84.6	\$(14.8)	\$(56.0)	\$141.4
After tax income (expense) items included in net earnings (b):					
Special tax benefits (c)	141.5	31.0	—	—	—
Litigation settlements and A&E reserve increase	(23.1)	(19.5)	(44.8)	—	—
World Trade Center loss	—	—	(16.3)	—	—
Net losses from non-financial investee corporations	(3.1)	(9.0)	(16.5)	(91.4)	(17.5)
Realized investment gains (losses)	50.8	(44.7)	(13.1)	2.1	14.0
Discontinued operations (d)	(33.6)	1.4	(19.9)	(0.4)	0.4
Accounting changes and extraordinary items	6.3	(40.4)	(10.0)	(9.1)	(5.5)
Other	(0.8)	—	—	—	—
Net earnings from insurance businesses – Non-GAAP	\$155.8	\$165.8	\$105.8	\$ 42.8	\$150.0
Diluted earnings (loss) per share amounts:					
Net earnings (loss) available to Common Shares – GAAP	\$4.12	\$1.22	\$(0.22)	\$(0.95)	\$2.35
Special tax benefits (c)	2.01	0.44	—	—	—
Litigation settlements and A&E reserve increase	(0.33)	(0.28)	(0.66)	—	—
World Trade Center loss	—	—	(0.24)	—	—
Net losses from non-financial investee corporations	(0.04)	(0.13)	(0.24)	(1.55)	(0.29)
Realized investment gains (losses)	0.73	(0.64)	(0.19)	0.04	0.23
Discontinued operations (d)	(0.48)	0.02	(0.29)	(0.01)	0.01
Accounting changes and extraordinary items	0.09	(0.59)	(0.15)	(0.15)	(0.09)
Other	(0.08)	—	—	—	—
Net earnings from insurance businesses – Non-GAAP	\$2.22	\$2.40	\$1.55	\$0.72	\$2.49

(a) Total capital includes debt, payable to subsidiary trusts, minority interest, and shareholders' equity.

(b) These items are excluded in deriving our "core" earnings from insurance operations for discussion and analytical purposes. Though core earnings is not a generally accepted accounting principles ("GAAP") measure, it is a key performance measure used by analysts and rating agencies.

(c) Reflects tax benefits in 2003 related to AFG's merger with AFC and its basis in Infinity stock. Tax benefits in 2002 relate to the resolution of certain tax matters.

(d) Reflects the results related to Transport Insurance Company which is expected to be sold in 2004.

# To Our Shareholders

The past year was an eventful one for American Financial Group. Some of the events had a direct impact on 2003's results; others will influence our operations and financial strength in years to come. We experienced some successes, and a few disappointments. We will strive to build on the former and learn from the latter.

One of the highlights of 2003 would have to be the sales of our entire ownership of Infinity Property and Casualty Corporation and our direct auto businesses. These sales allow us to refocus our efforts and to establish a firm identity as a specialty commercial insurance company. To help our investors better understand the new business profile, we will generally report the Specialty operations sub-divided into four new business groupings. They are Specialty Property & Transportation, Specialty Casualty, Specialty Financial and California Workers' Compensation.

In a November merger with two holding company subsidiaries, AFG issued 3.3 million common shares and retired voting preferred stock, thereby reducing annual dividends by over \$4 million. The merger also increased book value by \$170 million through elimination of deferred tax liabilities.

## Results of Operations

Net earnings for 2003 were \$293.8 million or \$4.12 per share compared to \$84.6 million or \$1.22 per share in 2002. Results for 2003 include a large deferred tax benefit and greater realized investment gains.

While net earnings increased substantially in 2003, core operating earnings fell short of our goals due primarily to \$50 million of charges for an old property claim arbitration decision and the reduction of estimated future profitability of a block of annuities. Core operating earnings from insurance businesses were \$155.8 million or \$2.22 per share compared to \$165.8 million or \$2.40 per share in 2002. Profitability was also hampered by significant loss development on claims filed in prior years and by the effects of the low interest rate environment on our fixed annuities business, both of which should have less effect on us in 2004 and beyond.

On the bright side, we enjoyed meaningful price increases and a 20% growth in gross written premiums in our Specialty operations. Further, their combined ratio improved to 96% in 2003 from 98.4% in 2002.

## Financial Strength and Investment Quality

Our high quality investment portfolio, with over 93% of its bonds rated investment grade, also had pretax unrealized gains at December 31, 2003, totaling \$575 million, including \$159 million on an investment in Provident Financial Group. Later this year, when Provident is acquired by National City Corporation, we expect to realize that amount plus an additional \$40 million to \$55 million.

In debt offerings completed in 2003 and early 2004, we issued over \$500 million in public debt, with the proceeds used to retire higher coupon trust preferred securities, to repay all of our bank borrowings, and to enhance the capital position of operating subsidiaries. We ended 2003 with a debt to total capital ratio of less than 25% compared to over 30% a year earlier.

In a period marked by insurance company downgrades, both the property and casualty and the life and annuity groups maintained their financial strength ratings from key ratings agencies, including A.M. Best and Standard and Poor's.

## Shareholder Value

Shareholders' equity grew over 20% in 2003 to \$2.1 billion, due primarily to the effects of the holding company mergers mentioned above. Our book value per share increased nearly 14% from 2002 to 2003 and AFG's stock price recently reached a new three-year high.

## 2004 and Beyond

We enter 2004 in solid financial condition and with high expectations. We pledge our best efforts to take advantage of the present day market opportunities. We don't control the economy or the stock market; we do, however, control the basic fundamentals of our own business. Those fundamentals are:

- sound underwriting,
- astute risk selection,
- adequate pricing,
- quality claims handling, and
- clear and open communications among our business leaders.

When we do these things consistently, we generate returns that deliver long-term value to our investors. We also ensure that we will have the financial strength necessary to meet the promises we've made to our policyholders.

Our new business structure supports our vision as a sharply focused specialty insurance group, one that will consistently achieve underwriting profitability and substantial returns on equity. We appreciate the efforts of our employees, agents, officers and fellow board members. This talented team will continue its hard work to build on the many successes of the past year. Thank you for your continued support.

Sincerely,



Carl H. Lindner  
*Chairman of the Board and  
Chief Executive Officer*



Carl H. Lindner III  
*Co-President*



S. Craig Lindner  
*Co-President*

March 31, 2004

# American Financial Group at a Glance

## Segment/Operating Unit

## Description and Developments

### Specialty Property & Casualty Insurance Group (A.M. Best Rating)

Great American Insurance Company (A)  
American Empire Surplus Lines Insurance Company (A)  
Mid-Continent Casualty Company (A)  
National Interstate Insurance Company (A-)  
Republic Indemnity Company of America (A-)

- A highly diversified group of specialized businesses offering a wide range of specialty commercial coverages.
- Focus and specialization are important characteristics of these businesses. Each business line has independent management and operating autonomy.
- These businesses are opportunistic and premium volume for each business line will vary based on current market conditions.
- The Specialty Group's rate increases averaged 20% during 2003 after 27% rate increases in 2002.
- Writes business in all 50 states primarily through independent agents and brokers.
- Continually evaluates expansion in existing markets and opportunities in new specialty niche markets.

### Specialty Group Components:

#### Property and Transportation

Includes physical and damage and liability coverage for buses, trucks and recreational vehicles, inland and ocean marine, agricultural-related products and other property coverages.

#### Specialty Casualty

Includes excess and surplus, general liability, executive and professional liability and customized programs for small to mid-sized businesses.

#### Specialty Financial

Includes risk management insurance programs for lending and leasing institutions, surety and fidelity bonds and foreign credit insurance.

#### California Workers' Compensation

Consists of a subsidiary that writes workers' compensation insurance primarily in the state of California.

#### Other

Includes an internal reinsurance facility and discontinued lines.

- National Interstate, established in 1990, has profitably grown to become the second largest writer in the passenger transportation industry with \$194 million of gross written premium in 2003 for coverage of buses, trucks and recreational vehicles.
- The Inland Marine division has more than doubled its gross written premium since 2000 while maintaining excellent profitability.
- We are the fourth largest writer of crop insurance in the United States and achieved 73% growth in gross written premiums during 2003.
- We are the largest writer of equine mortality insurance in the United States.
- American Empire Surplus Lines, which has experienced 19 consecutive years of underwriting profitability, has developed a niche for coverage of nursing homes.
- We are the sixth largest writer of director and officer liability coverage in the United States for public, private and non-profit companies.
- The Fidelity and Crime operation writes crime insurance for mercantile and financial institutions, including specialized coverage for the armored car and casino industries.

### Annuities, Supplemental Insurance and Life Group (A.M. Best Rating)

Great American Financial Resources, Inc.  
Great American Life Insurance Company (A)  
Annuity Investors Life Insurance Company (A)  
United Teacher Associates Insurance Company (A-)  
Loyal American Life Insurance Company (A)  
Great American Life Assurance Company of Puerto Rico (A)

- Assets of the Company's annuity, supplemental insurance and life operations grew to more than \$10 billion at December 31, 2003.
- Sells traditional tax-deferred annuities primarily to employees of educational and other not-for-profit organizations, as well as the senior market, serving 335,000 clients with nearly \$7 billion of annuity policyholder funds accumulated.
- Sells variable annuities attractive to policyholders seeking an equity-based savings product.
- Markets supplemental health insurance products, including coverage for Medicare supplement, cancer, long-term care and disability.
- Great American Life of Puerto Rico is the largest in-home service life insurance provider in Puerto Rico.

**Segment Data** (dollars in millions)  
for years ended December 31

<i>Specialty Property &amp; Casualty Insurance Group</i>	2003	2002	2001
Gross Written Premiums	\$3,243	\$2,713	\$2,236
Net Written Premiums	\$1,854	\$1,577 <sup>(1)</sup>	\$1,542 <sup>(2)</sup>
Net Earned Premiums	\$1,746	\$1,497	\$1,410
GAAP Ratios:			
Loss & LAE	67.4%	67.5%	68.9% <sup>(3)</sup>
Underwriting Expense	28.5%	30.4%	30.6%
Policyholder Dividends	.1%	.5%	.4%
Combined Ratio	96.0%	98.4%	99.9%

(1) The growth in net written premiums was impacted by reinsurance agreements.

(2) Before a reduction of \$30 million for the unearned premium transfer related to the sale of the Japanese Division.

(3) Excludes the effect (1.8%) of \$25 million of losses attributable to the September 11, 2001 attack.

<i>Specialty Group Components</i>	2003	2002	2001
Gross Written Premiums:			
Property and Transportation	\$1,142	\$ 886	\$ 742
Specialty Casualty	1,413	1,235	859
Specialty Financial	396	332	356
California Workers' Compensation	290	229	243
Other	2	31	36
	\$3,243	\$2,713	\$2,236
Net Written Premiums:			
Property and Transportation	\$ 515	\$ 413	\$ 506
Specialty Casualty	679	609	512
Specialty Financial	302	255	247
California Workers' Compensation	271	219	236
Other	87	81	41 <sup>(1)</sup>
	\$1,854	\$1,577	\$1,542 <sup>(1)</sup>
GAAP Combined Ratio:			
Property and Transportation	87.8%	90.1%	96.7%
Specialty Casualty	98.2%	106.6%	111.5%
Specialty Financial	108.3%	101.4%	80.1%
California Workers' Compensation	92.0%	96.4%	104.8%

(1) Before a reduction of \$30 million for the unearned premium transfer related to the sale of the Japanese Division.

<i>Annuities, Supplemental Insurance and Life Group</i>	2003	2002	2001
Statutory Premiums:			
Annuities:			
Fixed	\$ 740	\$ 769	\$ 513
Variable	122	182	199
Equity-Indexed	7	50	39
Total Annuities	869	1,001	751
Life and Health Premiums	335	313	310
Total Premiums	\$1,204	\$1,314	\$1,061
Gross Investment Income	\$ 517	\$ 532	\$ 508

# Business Summary

In both the Property and Casualty and the Annuity and Life businesses, we sell promises—significant promises—and the foundation of our business is integrity, trustworthiness and respect for others. Success can be defined in many ways, but for us it is ultimately (i) delivering superior solutions for the financial risks and challenges faced by our customers and (ii) generating returns that deliver long-term value to our investors and our employees.

There can be many obstacles in our path, including asbestos and environmental issues, rising loss costs, a litigious climate with many generous jury awards, reduced investment returns and the threat of terrorism. In order to avoid incurring unmanageable losses, we will be more disciplined than ever. Unwavering adherence to our strict fundamentals such as sound underwriting, astute risk selection, adequate pricing, quality claims handling, and clear and open communications is a necessity. Developing strong relationships with our customers and understanding their businesses and their goals are also key.

Proper execution of our strategy begins with the talented, experienced management team we have assembled. They not only make key operating decisions, but also attract and develop the future leaders of our organization, ensuring that our bench is deep and ready. Proper execution will also enable us to be successful and to have the financial strength to continue to meet the promises we make.

## Property and Casualty Insurance Operations

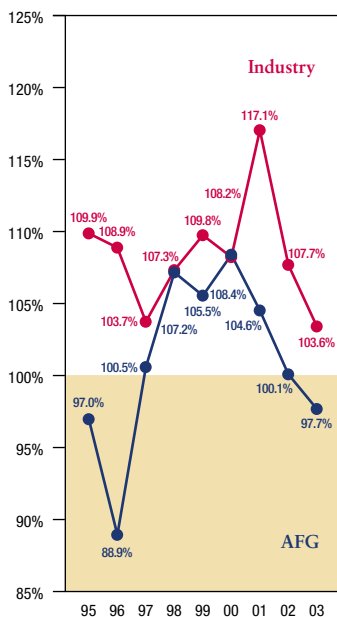
The sale of our remaining interest in Infinity Property and Casualty completed our evolution to a sharply focused specialty insurance group, comprised of multiple business units that operate autonomously but with certain strong central controls and full accountability. This entrepreneurial approach leads to mutual success for the business unit and the company as a whole by allowing individual units to be more opportunistic and to react more quickly to changing market conditions.

Our goal is to earn underwriting profits and our philosophy is to refrain from writing business that is not expected to be profitable even if it is necessary to limit or prevent premium growth to do so. This focus on underwriting performance has enabled our property and casualty group to outperform the industry in 2003 and for seventeen of the last eighteen years; excluding our special A&E charges, for all eighteen years. We believe that our product line diversification and stringent underwriting discipline have contributed to our ability to consistently outperform the industry.

A key strategy of the Specialty Group is to focus on specialized areas where our personnel are experts. Rather than compete in standard commercial lines, we focus on areas in which we believe our knowledge, unique products or distribution provides a significant competitive advantage.

## Specialty Group Profitability vs. Industry (Calendar Year)

Statutory Combined Ratio  
(Total Insurance Losses + Costs)



*Excluding special A&E charges, AFG has outperformed the industry with a lower ratio of losses and costs every year for the last eighteen years.*



We also try to react quickly to take advantage of changing market conditions. We constantly reevaluate conditions in the specialized lines that we write, shifting capital and increasing our attention to those areas we feel provide the best opportunity for attractive returns.

The opportunistic nature of the specialty group may cause premium volumes to vary as capital is reallocated in reaction to changing market conditions. Gross written premiums totaled \$3.2 billion in 2003, an increase of more than \$500 million. Net written premiums increased about \$275 million to \$1.9 billion. The increase in premiums reflects the impact of continuing rate increases and volume growth in most of our businesses—net written premium growth was impacted by a slight increase in reinsurance ceded. Rate increases averaged about 20% during 2003 and are expected to be in the range of 5% to 8% in 2004.

Our combined ratio improved 2.4 points to 96.0% due primarily to rate increases, partially offset by \$16 million in higher prior year development in 2003. On a GAAP basis, the Specialty Group has now generated underwriting profits for nine consecutive quarters.

Through our Specialty Group we offer a wide array of insurance products including, but not limited to, the following major lines of business:

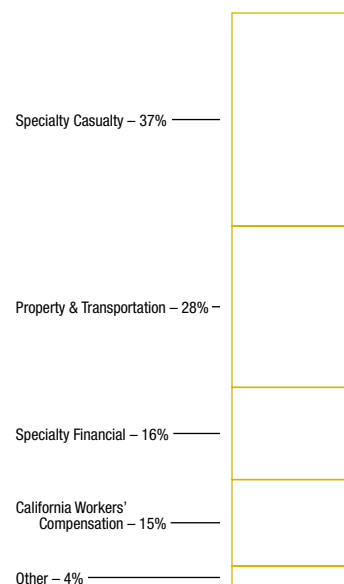
### *Property and Transportation*

- **Inland and Ocean Marine.** Coverage primarily for marine cargo, boat dealers, marina operators/dealers, excursion vessels, builder’s risk, contractor’s equipment, excess property and motor truck cargo.
- **Agricultural-related.** Federally reinsured multi-peril crop (allied lines) insurance covering most perils as well as crop hail, equine mortality and other coverages for full-time operating farms/ranches and agribusiness operations on a nationwide basis.
- **Commercial Automobile.** Customized insurance programs for various transportation operations and a specialized physical damage product for the trucking industry.

### *Specialty Casualty*

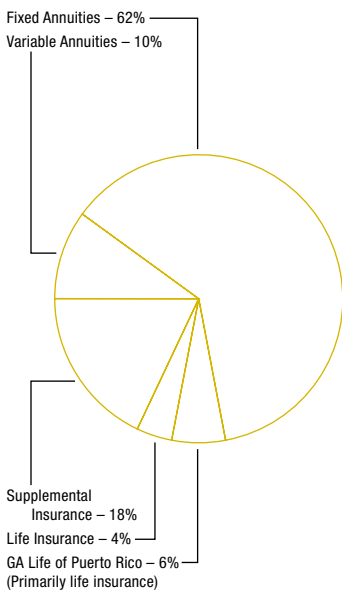
- **Executive and Professional Liability.** Liability coverage for attorneys, architects and engineers, and for directors and officers of businesses and not-for-profit organizations.
- **Umbrella and Excess Liability.** Higher layer liability coverage in excess of primary layers.
- **Excess and Surplus.** Specially designed insurance products for those who can’t find coverage in standard markets.

## Specialty Group 2003 Premium Distribution



*The sale of our remaining interest in Infinity completed our evolution to a sharply focused specialty insurance group.*

**Annuities,  
Supplemental  
Insurance  
and Life Group**  
2003 Premium Distribution



*Through Great American Financial Resources, we offer annuities, supplemental and life insurance products.*

**Specialty Financial**

- **Fidelity and surety bonds.** Fidelity and crime coverage for government, mercantile and financial institutions. Surety coverage for various types of contractors and public and private corporations.
- **Collateral protection.** Coverage for insurance risk management programs for lending and leasing institutions.

**California Workers' Compensation**

- **Workers' Compensation.** Coverage for prescribed benefits payable to employees (principally in California) who are injured on the job.

**Annuities, Supplemental Insurance and Life Group**

Through Great American Financial Resources (GAFRI), we offer annuities, supplemental insurance and life products. While we have diversified our product lines over the last 10 years, we remain committed to those products upon which GAFRI was built. Therefore, we continue strong efforts in the fixed annuity lines of business. In addition, we sell other insurance products in niche markets which are designed to achieve our premium and profitability targets.

Annuities make up the largest product group, accounting for more than three-fourths of GAFRI's premiums and assets. Through Great American Life Insurance Company, we have been marketing tax-deferred annuities since the 1970s and remain a leader in the kindergarten through high school segment of the retirement annuities business. We continue to update our traditional fixed annuity offerings in order to attract quality agents and meet changing market demand. As a result, sales of fixed annuities from this segment climbed for the third straight year. In the non-school segment, sales of fixed annuities fell in 2003 as management maintained its commission and interest crediting discipline during a period of historically low interest rates.

The stock market successes of the 1990s heightened consumer interest in our variable annuity products, including those sold by Annuity Investors Life Insurance Company. Conversely, the continued downward movement in equity markets negatively influenced sales and profitability of these annuities. In 2003, variable annuity premiums totaled \$122 million. Due to the recent rebound in the performance of the stock market, we expect that sales of our variable annuities will begin to increase.

Through United Teacher Associates Insurance Company and Loyal American Life Insurance Company, we sell insurance policies to supplement primary health insurance and other insurance coverage. These products provide for expenses related to critical illness, short-term disability, cancer, intensive care, accidents, hospital stays, and long-term care for individuals and groups. United Teacher Associates' premiums increased nearly 20% in 2003.

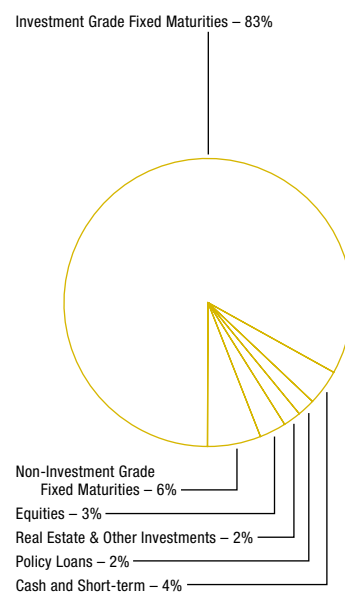
Great American Life Assurance Company of Puerto Rico is the largest in-home service life insurance provider in Puerto Rico. Through this company, we sell life and supplemental health products through a network of company-employed agents and ordinary life, cancer, credit, and group life products through independent agents.

## Investments

Our primary investment objective is to maximize return on an ongoing basis rather than focus on short-term performance. Our talented team of analysts and investment managers has built a high quality investment portfolio that produces a relatively predictable, steady stream of income, mitigating the uncertainties of our insurance operations. Over the years our conservatively invested, low-risk portfolio has generated solid returns and provided asset growth. In 2003, investment income, consisting primarily of interest and dividends received on bonds and stocks held, totaled about \$770 million. This represents a 10% decrease from 2002, reflecting lower average yields on fixed maturity investments partially offset by an increase in average investments. The yield on our fixed maturity portfolio (excluding gains and losses on sales of securities) decreased to 6.2% in 2003 from 7.2% in 2002.

Fixed income securities, primarily investment grade bonds and mortgage-backed securities, account for almost 90% of our total cash and investments. About 93% of our fixed maturities were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies at December 31, 2003. The average life of our fixed maturity investments is less than five years for our property and casualty companies and about seven and one-half years for our life and annuity group, in each case allowing flexibility to react to changes in market conditions. Our fixed income portfolio is also diversified to limit our exposure to any one issuer or industry—the largest investment in securities of any single issuer (other than U.S. Treasury Notes) amounted to less than one percent of total investments at December 31, 2003.

## Investment Portfolio Composition at December 31, 2003



*We have a high quality investment portfolio with over 93% of our bonds rated investment grade.*

Stocks, real estate, policy loans and other investments make up the remainder of our investments. At December 31, 2003, stock investments had an aggregate market value of about \$450 million, more than 75% greater than their cost. Our most significant equity investment is a 15% ownership of Provident Financial Group. In February 2004, Provident announced that it was being acquired by National City Corporation, one of the nation's largest banks. If the transaction is completed, AFG will receive 8.1 million shares of National City in exchange for its investment in Provident. Based on the March 1 price for National City, AFG would recognize an after-tax gain of approximately \$140 million on the sale.

Other investments include a group of classic, turn-of-the-(previous) century, European style hotels in Cincinnati (The Cincinnati), New Orleans (Le Pavillon), and Austin (Driskill); the Chatham Bars Inn on Cape Cod; the Skipjack Cove Yachting Resort on Chesapeake Bay; the Charleston Harbor Resort and Marina; apartment developments in several states; and potentially valuable air rights in New York City. We believe that the market value of these investments is significantly in excess of their carrying value on our balance sheet.



# Financial Review for 2003

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# Selected Financial Data — GAAP

(dollars in millions, except per share data)

	2003	2002	2001	2000	1999
<b>Earnings Statement Data:</b>					
Total Revenues	\$3,360	\$3,745	\$3,919	\$3,816	\$3,360
Operating Earnings Before Income Taxes	301	176	86	110	302
Earnings (Loss) from Continuing Operations	321	124	15	(47)	147
Discontinued Operations (a)	(33)	1	(20)	—	—
Extraordinary Items	—	—	—	—	(2)
Cumulative Effect of Accounting Changes (b)	6	(40)	(10)	(9)	(4)
Net Earnings (Loss)	294	85	(15)	(56)	141
Basic Earnings (Loss) Per Common Share:					
Earnings (Loss) from Continuing Operations	\$4.53	\$1.80	\$ .22	(\$ .79)	\$2.45
Net Earnings (Loss) Available to Common Shares	4.14	1.23	(.22)	(.95)	2.37
Diluted Earnings (Loss) Per Common Share:					
Earnings (Loss) from Continuing Operations	\$4.51	\$1.79	\$ .22	(\$ .79)	\$2.43
Net Earnings (Loss) Available to Common Shares	4.12	1.22	(.22)	(.95)	2.35
Cash Dividends Paid Per Share of Common Stock	\$ .50	\$ .50	\$1.00	\$1.00	\$1.00
Ratio of Earnings to Fixed Charges (c):					
Including Annuity Benefits	1.69	1.36	1.13	1.18	1.71
Excluding Annuity Benefits	3.71	2.40	1.49	1.63	3.36
<b>Balance Sheet Data:</b>					
Total Assets	\$20,197	\$19,505	\$17,402	\$16,416	\$16,054
Long-term Debt:					
Holding Companies	586	648	609	585	493
Subsidiaries	251	297	271	195	240
Minority Interest	188	471	455	508	489
Shareholders' Equity	2,076	1,726	1,498	1,549	1,340

(a) Reflects the results related to Transport Insurance Company which is expected to be sold in 2004.

(b) Reflects the implementation in the following years of accounting changes mandated by recently enacted accounting standards:

2003 – FIN 46 (Consolidation of Variable Interest Entities)

2002 – SFAS #142 (Goodwill and Other Intangibles)

2001 – EITF 99-20 (Asset-backed Securities)

2000 – SFAS #133 (Derivatives)

1999 – SOP 98-5 (Start-up Costs)

(c) Fixed charges are computed on a “total enterprise” basis. For purposes of calculating the ratios, “earnings” have been computed by adding to pretax earnings the fixed charges and the minority interest in earnings of subsidiaries having fixed charges and the undistributed equity in losses of investees. Fixed charges include interest (including or excluding interest credited to annuity policyholders’ accounts as indicated), amortization of debt premium/discount and expense, preferred dividend and distribution requirements of subsidiaries and a portion of rental expense deemed to be representative of the interest factor.

Although the ratio of earnings to fixed charges *excluding* interest on annuities is not required or encouraged to be disclosed under Securities and Exchange Commission rules, some investors and lenders may not consider interest credited to annuity policyholders’ accounts a borrowing cost for an insurance company, and accordingly, believe this ratio is meaningful.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## General

Following is a discussion and analysis of the financial statements and other statistical data that management believes will enhance the understanding of AFG's financial condition and results of operations. This discussion should be read in conjunction with the financial statements beginning on page 28.

## Overview

### *Financial Condition*

AFG strengthened its capital and liquidity during 2003 with shareholders' equity growing by more than \$350 million (20%) to \$2.1 billion. Nearly half of this increase resulted from the elimination of a deferred tax liability following the merger of AFG and two subsidiary holding companies in November. In the merger, AFG issued 3.3 million common shares to retire all \$72 million of voting preferred stock of the subsidiary holding company, American Financial Corporation, thereby reducing annual dividends by over \$4 million.

AFG and its subsidiaries completed several major cash transactions in 2003, including the following:

- AFG received \$186 million on the February initial public offering of 61% of Infinity Property and Casualty, a former subsidiary engaged primarily in nonstandard automobile insurance.
- AFG received \$55 million in July 2003 from Infinity's repayment of a Note.
- AFG sold its remaining interest in Infinity for \$214 million in December.
- AFG issued over \$300 million in public debt in 2003 and repaid nearly \$400 million in bank debt during the year.

In addition, AFG and its subsidiaries issued just over \$200 million in debt during the first quarter of 2004 and used the proceeds primarily to retire higher coupon trust preferred securities.

### *Results of Operations*

Through the operations of its subsidiaries, AFG is engaged primarily in property and casualty insurance and in the sale of retirement annuities, life and supplemental health insurance products. With the sale of Infinity, AFG narrowed the focus of its property and casualty business to its specialized commercial products for businesses.

The property and casualty business is cyclical in nature with periods of high competition resulting in low premium rates, sometimes referred to as a "soft market" or "downturn" followed by periods of reduced competition and higher premium rates, referred to as a "hard market" or "upcycle." The 1990's were a soft market period; prices started to harden in 2000 and accelerated significantly following the terrorist attacks in 2001. Rates have continued to rise into 2004, although the increases have moderated somewhat during the latter part of 2003.

As discussed in the following pages under "Results of Operations," the profitability of AFG's property and casualty business improved during the hard market despite the negative impact of adverse development on prior year claims and lower yields on newly invested funds.

The operating results of AFG's annuity, life and health business were negatively impacted in 2003 by the continued narrowing of spreads in its fixed annuity operations. This spread narrowing was partially offset by improved results in the other annuity, life and health operations.

AFG's net earnings for 2003 were \$294 million (\$4.12 per share). Included in net earnings were the following items, net of tax and minority interest:

- Tax benefits of \$141.5 million related primarily to the elimination of deferred tax reserves in connection with the merger of parent company subsidiaries.
- Net realized gains of \$50.8 million on the sale of securities, subsidiaries and investees.
- Charge of \$28.5 million for an arbitration decision relating to a 1995 property insurance claim.
- Litigation charge of \$23.1 million for a settlement within the California workers' compensation insurance business.
- Impairment provision of \$35.8 million (included in discontinued operations) related to the planned disposal of an inactive property and casualty subsidiary with approximately one-eighth of AFG's total asbestos and environmental liabilities.

# Management's Discussion and Analysis *(continued)*

## Critical Accounting Policies

Significant accounting policies are summarized in Note A to the financial statements. The preparation of financial statements in conformity with generally accepted accounting principles 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 establishment of insurance reserves, especially asbestos and environmental-related reserves, and the determination of "other than temporary" impairment on investments are the two areas where the degree of judgment required to determine amounts recorded in the financial statements make the accounting policies critical. For further discussion of these policies, see "*Liquidity and Capital Resources – Investments*" and "*Liquidity and Capital Resources – Uncertainties*."

## Liquidity and Capital Resources

### Ratios

AFG's debt to total capital ratio (at the parent holding company level) was approximately 21% at December 31, 2003, compared to 25% at December 31, 2002.

AFG's ratio of earnings to fixed charges, including annuity benefits as a fixed charge, was 1.69 for the year ended December 31, 2003. Excluding annuity benefits, this ratio was 3.71 for 2003. Although the ratio excluding interest on annuities is not required or encouraged to be disclosed under Securities and Exchange Commission rules, it is presented because interest credited to annuity policyholder accounts is not always considered a borrowing cost for an insurance company.

The NAIC's model law for risk based capital ("RBC") applies to both life and property and casualty companies. RBC formulas determine the amount of capital that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired. At December 31, 2003, the capital ratios of all AFG insurance companies substantially exceeded the RBC requirements (the lowest capital ratio of any operating AFG subsidiary was 3.7 times its authorized control level RBC; weighted average of all AFG subsidiaries was 5.1 times).

## Sources of Funds

AFG is organized as a holding company with almost all of its operations being conducted by subsidiaries. AFG, however, has continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends, and taxes. Funds to meet these obligations come primarily from dividend and tax payments from its subsidiaries.

Management believes AFG has sufficient resources to meet its liquidity requirements. If funds generated from operations, including dividends and tax payments from subsidiaries, are insufficient to meet fixed charges in any period, AFG would be required to generate cash through borrowings, sales of securities or other assets, or similar transactions.

AFG's bank credit line consists of two facilities: a 364-day revolving facility, extendable annually, for one-third of the total line and a three-year revolving facility for the remaining two-thirds. Amounts borrowed bear interest at rates ranging from 1.25% to 2.25% over LIBOR based on AFG's credit rating. This credit agreement provides ample liquidity and can be used to obtain funds for operating subsidiaries or, if necessary, for the parent companies. About half of the net proceeds from the issuance of Senior Convertible Notes in June 2003 were used to repay borrowings under AFC's bank line. While the credit line provides up to \$280 million of availability, there were no borrowings outstanding at December 31, 2003.

All debentures issued by AFG and GAFRI are rated investment grade by three nationally recognized rating agencies. In February 2004, AFG issued \$115 million in 7-1/8% Debentures due 2034 under a shelf registration statement and called for redemption \$95.5 million in 9-1/8% trust preferred securities. Under a currently effective shelf registration statement, AFG can issue up to an aggregate of \$485 million in additional equity or debt securities. The shelf registration provides AFG with greater flexibility to access the capital markets from time to time as market and other conditions permit.

For statutory accounting purposes, equity securities of non-affiliates are generally carried at market value. At December 31, 2003, AFG's insurance companies owned publicly traded equity securities with a market value of \$451 million. In addition, Great American Insurance Company owns GAFRI common stock with a market value of \$626 million and a statutory carrying value of \$438 million. Decreases in market prices could adversely affect the insurance group's capital, potentially impacting the amount of dividends available or necessitating a capital contribution. Conversely, increases in market prices could have a favorable impact on the group's dividend-paying capability.



Under tax allocation agreements with AFG, its 80%-owned U.S. subsidiaries generally compute tax provisions as if filing separate returns based on book taxable income computed in accordance with generally accepted accounting principles. The resulting provision (or credit) is currently payable to (or receivable from) AFG.

### Contractual Obligations

At December 31, 2003, AFG's material contractual obligations in the next five years and for all years thereafter detailed by type of obligation were as follows (in millions):

Contractual Obligations	Total	Within One Year	2-3 Years	4-5 Years	More than 5 Years
Long-Term Debt	\$ 837.5	\$ 2.0	\$30.7	\$370.3	\$434.5
Payable to					
Subsidiary Trusts	265.5	—	—	—	265.5
Operating Leases	117.5	36.1	47.0	21.1	13.3
<b>Total</b>	<b>\$1,220.5</b>	<b>\$38.1</b>	<b>\$77.7</b>	<b>\$391.4</b>	<b>\$713.3</b>

The AFG Convertible Debentures issued in 2003 are included in the above table at the first put date (2008). AFG's Balance Sheet at December 31, 2003, includes estimated liabilities for claims and benefits payable related to its insurance operations. AFG expects operating cash flows to be sufficient to meet these obligations and also have marketable investments available for sale should the operating cash flows prove to be inadequate.

AFG has no material contractual purchase obligations or other long-term liabilities at December 31, 2003.

### Investments

Approximately two-thirds of AFG's consolidated assets are invested in marketable securities. AFG's investment portfolio at December 31, 2003, contained \$12 billion in "Fixed maturities" classified as available-for-sale and \$455 million in "Other stocks", all carried at market value with unrealized gains and losses reported as a separate component of shareholders' equity on an after-tax basis. At December 31, 2003, AFG had pretax net unrealized gains of \$377.8 million on fixed maturities and \$196.4 million on other stocks. AFG attempts to optimize investment income while building the value of its portfolio, placing emphasis upon long-term performance.

AFG's goal is to maximize return on an ongoing basis rather than focusing on short-term performance.

Fixed income investment funds are generally invested in securities with intermediate-term maturities with an objective of optimizing total return while allowing flexibility to react to changes in market conditions. At December 31, 2003, the average life of AFG's fixed maturities was about 6-1/2 years.

Approximately 93% of the fixed maturities held by AFG were rated "investment grade" (credit rating of AAA to BBB) by nationally recognized rating agencies at December 31, 2003. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated or noninvestment grade. Management believes that the high quality investment portfolio should generate a stable and predictable investment return.

Investments in mortgage backed securities ("MBSs") represented approximately one-fourth of AFG's fixed maturities at December 31, 2003. 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 lower rates. Due to the significant decline in the general level of interest rates in 2002 and 2003, AFG has experienced an increase in the level of prepayments on its MBSs; these prepayments have not been reinvested at interest rates comparable to the rates earned on the prepaid MBSs. Substantially all of AFG's MBSs are investment grade quality, with over 95% rated "AAA" at December 31, 2003.

Summarized information for the unrealized gains and losses recorded in AFG's balance sheet at December 31, 2003, is shown in the following table (dollars in millions). Approximately \$95 million of available-for-sale "Fixed maturities" and \$21 million of "Other stocks" had no unrealized gains or losses at December 31, 2003.

	Securities With Unrealized Gains	Securities With Unrealized Losses
<b>Available-for-sale Fixed Maturities</b>		
Market value of securities	\$8,845	\$3,162
Amortized cost of securities	\$8,395	\$3,234
Gross unrealized gain (loss)	\$ 450	(\$ 72)
Market value as % of amortized cost	105%	98%
Number of security positions	1,575	286
Number individually exceeding \$2 million gain or loss	11	1
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Gas and electric services	\$ 59.7	(\$ 4.3)
Banks, savings and credit institutions	55.5	(1.6)
Mortgage-backed securities	45.7	(45.1)
State and municipal	28.5	(2.2)
Telephone communications	25.1	(0.1)
U.S. government and government agencies	24.4	(5.2)
Air transportation (generally collateralized)	6.9	(5.2)
Percentage rated investment grade	92%	96%
<b>Other Stocks</b>		
Market value of securities	\$ 393	\$ 41
Cost of securities	\$ 196	\$ 42
Gross unrealized gain (loss)	\$ 197	(\$ 1)
Market value as % of cost	201%	98%
Number individually exceeding \$2 million gain or loss	5	—

## Management's Discussion and Analysis *(continued)*

AFG's investment in equity securities of Provident Financial Group, a Cincinnati-based commercial banking and financial services company, represents \$159 million of the \$197 million in unrealized gains on other stocks at December 31, 2003.

The table below sets forth the scheduled maturities of AFG's available-for-sale fixed maturity securities at December 31, 2003, based on their market 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.

Maturity	Securities With Unrealized Gains	Securities With Unrealized Losses
One year or less	3%	—%
After one year through five years	29	10
After five years through ten years	40	16
After ten years	13	9
	85	35
Mortgage-backed securities	15	65
	100%	100%

AFG realized aggregate losses of \$5.3 million during 2003 on \$52.4 million in sales of fixed maturity securities (9 issues; 8 issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2002. Market values of seven of the issues increased an aggregate of \$8.9 million from year-end 2002 to date of sale. The market value of the remaining two securities decreased \$316,000 from year-end 2002 to the sale date.

AFG realized aggregate losses of \$11.1 million during 2002 on \$72.9 million in sales of fixed maturity securities (14 issues; 12 issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2001. Market values of eleven of the securities increased an aggregate of \$8 million from year-end 2001 to date of sale. The market value of one of the securities did not change from year-end 2001 to the date of sale. One of the securities was a Consec bond that decreased in value by \$5 million from year-end 2001 to the date of sale due to the continued decline in Consec's financial condition. The market value of the remaining security decreased \$920,000 from year-end 2001 to the sale date.

Although AFG had the ability to continue holding these investments, its intent to hold them changed due primarily to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular credit or industry, or to modify asset allocation within the portfolio.

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

		Aggregate Market Value	Aggregate Unrealized Gain (Loss)	Market Value as % of Cost Basis
<b>Fixed Maturities</b>				
<b>Securities with unrealized gains:</b>				
Exceeding \$500,000	(290 issues)	\$3,134	\$281	110%
Less than \$500,000	(1,285 issues)	5,711	169	103
		\$8,845	\$450	105%
<b>Securities with unrealized losses:</b>				
Exceeding \$500,000	(43 issues)	\$1,164	(\$ 43)	96%
Less than \$500,000	(243 issues)	1,998	(29)	99
		\$3,162	(\$ 72)	98%

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

		Aggregate Market Value	Aggregate Unrealized Gain (Loss)	Market Value as % of Cost Basis
<b>Fixed Maturities with Unrealized Losses at December 31, 2003</b>				
<b>Investment grade with losses for:</b>				
One year or less	(227 issues)	\$2,953	(\$58)	98%
Greater than one year	(17 issues)	90	(5)	95
		\$3,043	(\$63)	98%
<b>Non-investment grade with losses for:</b>				
One year or less	(15 issues)	\$ 22	(\$ 2)	92%
Greater than one year	(27 issues)	97	(7)	93
		\$ 119	(\$ 9)	93%

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. Factors considered and resources used by management include:

- whether the unrealized loss is credit-driven or a result of changes in market interest rates,
- the extent to which market value is less than cost basis,
- historical operating, balance sheet and cash flow data contained in issuer SEC filings,
- issuer news releases,
- near-term prospects for improvement in the issuer and/or its industry,
- industry research and communications with industry specialists,
- third party research and credit rating reports,
- internally generated financial models and forecasts,

- i) discussions with issuer management, and
- j) ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

Based on its analysis of the factors enumerated above, management believes (i) AFG will recover its cost basis in the securities with unrealized losses and (ii) that AFG has the ability and intent to hold the securities until they mature or recover in value. Should either of these beliefs 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 AFG's liquidity.

Net realized gains (losses) on securities sold and charges for "other than temporary" impairment on securities held were as follows (in millions):

	Net Realized Gains (Losses) on Sales	Charges for Impairment	Other(a)	Total
2003	\$117.1	(\$ 58.4)	\$ 0.2	\$58.9
2002	112.8	(179.4)	(12.4)	(79.0)
2001	89.1	(125.5)(b)	11.6	(24.8)
2000	(1.9)	(27.5)	2.6	(26.8)
1999	37.4	(19.4)	2.1	20.1

- (a) Includes adjustments to carry derivatives at market and to reflect the impact of realized gains and losses on the amortization of deferred policy acquisition costs.
- (b) Does not include \$16.9 million writedown of certain collateralized debt obligations which was recorded as the cumulative effect of an adoption of an accounting change at April 1, 2001.

Increased impairment charges in recent years reflect a rise in corporate defaults in the marketplace resulting from the weakened economy and other factors.

### Uncertainties

As more fully explained in the following paragraphs, management believes that the areas posing the greatest risk of material loss are the adequacy of its insurance reserves and American Premier's contingencies arising out of its former operations.

### Property and Casualty Insurance Reserves

The liability for unpaid losses and loss adjustment expenses ("LAE") was as follows (in millions):

	December 31,	
	2003	2002
Specialty	\$4,105	\$3,712
Personal	243	838
Other lines (including asbestos and environmental)	561	654
	\$4,909	\$5,204

The liabilities 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 periods on direct business written; (b) estimates received from ceding reinsurers and insurance pools and associations; (c) estimates of unreported losses based on past experience; (d) estimates based on experience of expense for investigating and adjusting claims; and (e) the current state of law and coverage litigation. Using these items as well as historical trends adjusted for changes in underwriting standards, policy provisions, product mix and other factors, company actuaries determine a single or "point" estimate which management utilizes in recording its best estimate of the liabilities. Ranges of loss reserves are not developed by company actuaries.

Estimating the liability for unpaid losses and LAE is inherently judgmental and is influenced by factors which are subject to significant variation. Through the use of analytical reserve development techniques, management utilizes items such as the effect of inflation on medical, hospitalization, material, repair and replacement costs, general economic trends and the legal environment.

While current factors and reasonably likely changes in variable factors are considered in estimating the liability for unpaid losses, there is no method or system which can eliminate the risk of actual ultimate results differing from such estimates. As shown in the reserve development table (loss triangle) on page 11 of AFG's 2003 10-K, the original estimates of AFG's liability for losses and loss adjustment expenses, net of reinsurance, over the past 10 years have developed through December 31, 2003, to be deficient (for three years) by as much as 10.4% and redundant (for 7 years) by as much as 7.2% (excluding the effect of special charges for asbestos and environmental exposures). AFG believes this development illustrates the variability in factors considered in estimating its insurance reserves.

Quarterly reviews of unpaid loss and LAE reserves are prepared using standard actuarial techniques. These may include: Case Incurred Development Method; Paid Development Method; Bornhuetter-Ferguson Method; and Incremental Paid LAE to Paid Loss Methods. Generally, data is segmented by major product or coverage within product using countrywide data; however, in some situations data may be reviewed by state or region.

### Asbestos and Environmental-related ("A&E") Reserves

Establishing reserves for A&E claims relating to policies and participations in reinsurance treaties and former operations is subject to uncertainties that are significantly greater than those presented by other types of claims. For this group of claims, traditional actuarial techniques that

## Management's Discussion and Analysis *(continued)*

rely on historical loss development trends cannot be used and a meaningful range of loss cannot be estimated. Case reserves and expense reserves are established by the claims department as specific policies are identified. In addition to the case reserves established for known claims, management establishes additional reserves for claims not yet known or reported and for possible development on known claims. These additional reserves are management's best estimate based on its review of industry trends and other industry information about such claims, with due consideration to individual claim situations like A.P. Green. Estimating ultimate liability for asbestos claims presents a unique and difficult challenge to the insurance industry 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. The casualty insurance industry is engaged in extensive litigation over these coverage and liability issues as the volume and severity of claims against asbestos defendants continue to increase.

While management believes that AFG's reserves for A&E claims are a reasonable estimate of ultimate liability for such claims, actual results may vary materially from the amounts currently recorded due to the difficulty in predicting the number of future claims and the impact of recent bankruptcy filings, and unresolved issues such as whether coverage exists, whether policies are subject to aggregate limits on coverage, whether claims are to be allocated among triggered policies and implicated years, and whether claimants who exhibit no signs of illness will be successful in pursuing their claims.

In February 2003, Great American Insurance Company entered into an agreement for the settlement of asbestos related coverage litigation under insurance policies issued during the 1970's and 1980's to Bigelow-Liptak Corporation and related companies, subsequently known as A.P. Green Industries, Inc. Management believes that this settlement will enhance financial certainty and provides resolution to litigation that represents AFG's largest known asbestos-related claim and the only such claim that management believes to be material.

The settlement is for \$123.5 million (Great American has the option to pay in cash or over time with 5.25% interest), all but \$30 million of which was covered by reserves established prior to September 30, 2002, and anticipated reinsurance recoverables for this matter. As a result, AFG recorded a \$30 million pretax charge (\$19.5 million after tax) in the fourth quarter of 2002. The agreement allows up to 10% of the settlement to be paid in AFG Common Stock.

The settlement has received the approval of the bankruptcy court supervising the reorganization of A.P. Green. It remains subject to the confirmation by the bankruptcy court of a plan of reorganization that includes an injunction prohibiting the assertion against Great American of any present or future asbestos personal injury claims under policies issued to A.P. Green and related companies. This process should be completed in 2004. No assurance can be made that a plan of reorganization will be confirmed; no payments are required until completion of the process. If there is no plan confirmation, the outcome of this litigation will again be subject to the complexities and uncertainties associated with a Chapter 11 proceeding and asbestos coverage litigation.

The payments and reserve balances for asbestos, environmental and other mass torts were as follows (in millions):

	Net Amounts Paid in 2003	Net Reserve Balance 12/31/03
Asbestos	\$23.6	\$278.7
Environmental	15.6	121.2
Other Mass Tort	4.3	23.4
Total	\$43.5	\$423.3

Nearly one-half of AFG's asbestos reserves relate to policies written by AFG subsidiaries. Claims from these policies generally are product oriented claims with only a limited amount of non-product exposures, and are dominated by small to mid-sized commercial entities that are mostly regional policyholders with few national target defendants.

The assumed reinsurance business includes exposures for the periods 1954 to 1983. The asbestos and environmental assumed claims are ceded by various insurance companies under reinsurance treaties. A majority of the individual assumed claims have exposures of less than \$100,000 to AFG. Asbestos losses assumed include some of the industry known manufacturers, distributors and installers. Pollution losses include industry known insured names and sites.

Other mass tort losses include lead, silica and various chemical exposures.

### Exposure to Market Risk

Market risk represents the potential economic loss arising from adverse changes in the fair value of financial instruments. AFG's exposures to market risk relate primarily to its investment portfolio and annuity contracts which are exposed to interest rate risk and, to a lesser extent, equity price risk. To a much lesser extent, AFG's long-term debt is also exposed to interest rate risk.

### Fixed Maturity Portfolio

The fair value of AFG's fixed maturity portfolio is directly impacted by changes in market interest rates. AFG's fixed maturity portfolio is comprised of substantially all fixed rate investments with primarily intermediate-term maturities. This practice allows flexibility in reacting to fluctuations of interest rates. The portfolios of AFG's insurance operations are managed with an attempt to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet policyholder obligations. AFG's life and annuity operations attempt to align the duration of their invested assets to the projected cash flows of policyholder liabilities.

The following table provides information about AFG's "available for sale" fixed maturity investments at December 31, 2003 and 2002, that are sensitive to interest rate risk. The table shows principal cash flows (in millions) and related weighted average interest rates by expected maturity date for each of the five subsequent years and for all years thereafter. Callable bonds and notes are included based on call date or maturity date depending upon which date produces the most conservative yield. Mortgage-backed securities ("MBSs") and sinking fund issues are included based on maturity year adjusted for expected payment patterns. Actual cash flows may differ from those expected.

December 31, 2003		
	Principal Cash Flows	Rate
2004	\$ 647	7.19%
2005	1,120	4.86
2006	947	6.22
2007	778	6.42
2008	1,132	5.98
Thereafter	6,994	5.89
Total	\$11,618	5.94%
Fair Value	\$12,102	

December 31, 2002		
	Principal Cash Flows	Rate
2003	\$ 1,301	10.09%
2004	848	8.31
2005	1,035	7.05
2006	1,135	6.69
2007	1,158	6.12
Thereafter	5,939	6.13
Total	\$11,416	6.88%
Fair Value	\$12,007	

### Equity Price Risk

Equity price risk is the potential economic loss from adverse changes in equity security prices. Although AFG's investment in "Other stocks" is less than 4% of total investments, one-half of "Other stocks" is invested in

Provident Financial Group. In February 2004, Provident announced that it is being acquired by National City Corporation, one of the nation's largest banks. If this transaction is completed, AFG will receive 8.1 million shares (approximately 1%) of National City in exchange for its investment in Provident.

### Annuity Contracts

Substantially all of GAFRI's fixed rate annuity contracts permit GAFRI to change crediting rates (subject to minimum interest rate guarantees of 3% to 4% per annum as determined by applicable law) enabling management to react to changes in market interest rates. Nonetheless, due to the drop in interest rates, GAFRI's spreads have narrowed and will likely continue to narrow through at least 2004. In the fourth quarter of 2003, GAFRI began to issue a portion of new business using a minimum interest guarantee of less than 3% in states where required approvals have been received. Actuarial assumptions used to estimate DPAC and annuity benefits, as well as GAFRI's ability to maintain spread, could be impacted if the current interest rate environment continues for an extended period and causes policyholder behavior to be altered.

Projected payments (in millions) in each of the subsequent five years and for all years thereafter on GAFRI's fixed annuity liabilities at December 31 were as follows.

	First	Second	Third	Fourth	Fifth	Thereafter	Total	Fair Value
2003	\$610	\$710	\$870	\$740	\$690	\$3,355	\$6,975	\$6,781
2002	550	610	740	810	700	3,044	6,454	6,284

Approximately half of GAFRI's fixed annuity liabilities at December 31, 2003, were two-tier in nature in that policyholders can receive a higher amount if they annuitize rather than surrender their policy, even if the surrender charge period has expired. At December 31, 2003, the average stated crediting rate on the inforce block of GAFRI's principal fixed annuity products was approximately 4.1%. The current stated crediting rates (excluding bonus interest) on new sales of GAFRI's products generally range from 2.8% to 3.3%. GAFRI estimates that its effective weighted-average crediting rate on its inforce business over the next five years will approximate 3.8%. This rate reflects actuarial assumptions as to (i) expected investment spread, (ii) deaths, (iii) annuitizations, (iv) surrenders and (v) renewal premiums. Actual experience and changes in actuarial assumptions may result in different effective crediting rates than those above.

GAFRI's equity-indexed fixed annuities provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. GAFRI attempts to mitigate the risk in the equity-based

## Management's Discussion and Analysis *(continued)*

component of these products through the purchase of call options on the appropriate index. GAFRI's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be substantially offset by unrealized and realized gains on the call options purchased by GAFRI. Under SFAS No. 133, both the equity-based component of the annuities and the related call options are considered derivatives and marked to market through current earnings as annuity benefits. Adjusting these derivatives to market value had a net effect of less than 1% of annuity benefits in 2003 and 2002. In 2002, GAFRI chose to suspend new sales of equity-indexed annuities due primarily to lack of volume.

### *Debt and Preferred Securities*

The following table shows scheduled principal payments (in millions) on fixed-rate long-term debt of AFG and its subsidiaries and related weighted average interest rates for each of the subsequent five years and for all years thereafter.

December 31, 2003		
	Scheduled Principal Payments	Rate
2004	*	
2005	\$ 9.9	9.11%
2006	18.6	6.74
2007	75.3	7.13
2008	289.9	4.99
Thereafter	434.5	7.30
Total	\$829.0	6.48%
Fair Value	\$877.8	

(\*) Less than \$2 million.

December 31, 2002		
	Scheduled Principal Payments	Rate
2003	*	
2004	*	
2005	\$ 10.1	9.09%
2006	18.7	6.74
2007	79.9	7.13
Thereafter	429.4	7.14
Total	\$539.8	7.16%
Fair Value	\$504.2	

(\*) Less than \$2 million.

The AFG Convertible Debentures issued in 2003 are included in the above table at the first put date (2008). In December 2003, GAFRI entered into an interest rate swap, effectively converting \$40 million of its 6-7/8% fixed-rate Notes due in 2008 (included in the table above) to a floating rate (about 4.1% at December 31, 2003).

At December 31, 2002, AFG and GAFRI had a total of \$396.6 million outstanding under their variable rate bank lines (2.8% weighted average interest rate at December 31, 2002). No amounts were borrowed under the bank lines at December 31, 2003.

There were \$265 million and \$242 million of subsidiary trust preferred securities with a weighted average interest rate of 8.74% and 9.09% outstanding at December 31, 2003 and 2002, respectively. Although none of these are scheduled for maturity or mandatory redemption during the next five years, approximately \$190 million were redeemed in the first quarter of 2004. Under Financial Accounting Standards Board Interpretation No. 46 ("FIN 46"), which AFG implemented as of December 31, 2003, AFG was required to deconsolidate the wholly-owned subsidiary trusts that issued these securities because they are "variable interest entities" in which AFG is not considered to be the primary beneficiary. These subsidiary trusts were formed to issue the preferred securities and, in turn, purchase a like amount of subordinated debt from their parent company, which provides interest and principal payments to fund the respective trust obligations. Accordingly, at December 31, 2003, the subordinated debt due the trusts is shown as a liability in the Balance Sheet. Prior to that date, the subsidiary trust preferred securities were included in minority interest in the Balance Sheet.

## Results of Operations— Three Years Ended December 31, 2003

### General

The following table shows AFG's net earnings and diluted earnings per share as stated in the Statement of Operations as well as the after-tax effect of other items included in these GAAP measures that are listed below to assist investors in analyzing their impact on the trend in operating results (in millions, except per share amounts):

	2003	2002	2001
<b>Net earnings (loss)</b>	<b>\$293.8</b>	<b>\$84.6</b>	<b>(\$14.8)</b>
After tax income (expense) items included in net earnings:			
Arbitration settlement	(28.5)	—	—
Litigation settlements	(23.1)	(19.5)	—
Special tax benefits	141.5	31.0	—
A&E charge and WTC losses	—	—	(61.1)
Net earnings (losses) from investee corporations	9.1	(9.0)	(16.5)
Realized investment gains (losses)	50.8	(44.7)	(13.1)
Discontinued operations	(33.6)	1.4	(19.9)
Cumulative effect of accounting changes	6.3	(40.4)	(10.0)
<b>Diluted per share amounts:</b>			
<b>Net earnings (loss)</b>	<b>\$4.12</b>	<b>\$1.22</b>	<b>(\$ .22)</b>
Arbitration settlement	(.41)	—	—
Litigation settlements	(.33)	(.28)	—
Special tax benefits	2.01	.44	—
A&E charge and WTC losses	—	—	(.90)
Investee corporations	.13	(.13)	(.24)
Realized investment gains (losses)	.73	(.64)	(.19)
Discontinued operations	(.48)	.02	(.29)
Cumulative effect of accounting changes	.09	(.59)	(.15)

In addition to the effects of items shown in the table above, net earnings increased in 2003 as improved underwriting results more than offset a decline in the fixed annuity operations. Net earnings increased in 2002 primarily due to significantly improved underwriting results and income from the sale of real estate, partially offset by reduced earnings in the annuity and life operations. Net earnings for 2001 include goodwill amortization expense of \$13.7 million (\$.20 per share).

### Property and Casualty Insurance—Underwriting

AFG's property and casualty group has consisted of two major business groups: Specialty and Personal. See Note B, "Acquisitions and Sales of Subsidiaries," to the Financial Statements for a discussion of the sale of nearly all of the Personal group.

The Specialty group includes a highly diversified group of business lines. Some of the more significant areas are inland and ocean marine, California workers' compensation, agricultural-related coverages, executive and professional liability, fidelity and surety bonds, commercial auto, collateral protection, umbrella, and excess and surplus coverages.

The Personal group wrote nonstandard and preferred/standard private passenger auto insurance and, to a lesser extent, homeowners' insurance. Nonstandard automobile insurance covers risks not typically accepted for standard automobile coverage because of the applicant's driving record, type of vehicle, age or other criteria.

To understand the overall profitability of particular lines, the timing of claims payments and the related impact of investment income must be considered. Certain "short-tail" lines of business (primarily property coverages) have quick loss payouts which reduce the time funds are held, thereby limiting investment income earned thereon. On the other hand, "long-tail" lines of business (primarily liability coverages and workers' compensation) have payouts that are either structured over many years or take many years to settle, thereby significantly increasing investment income earned on related premiums received.

Underwriting profitability is measured by the combined ratio which is a sum of the ratios of underwriting losses, loss adjustment expenses, underwriting expenses and policyholder dividends to premiums. When the combined ratio is under 100%, underwriting results are generally considered profitable; when the ratio is over 100%, underwriting results are generally considered unprofitable. The combined ratio does not reflect investment income, other income or federal income taxes.

For certain lines of business and products where the credibility of the range of loss estimates is less certain (primarily many of the various specialty businesses listed above), management believes that it is prudent and appropriate to use conservative assumptions until such time as the data, experience and projections have more credibility, as evidenced by data volume, consistency and maturity of the data. While this practice mitigates the risk of adverse development on this business, it does not eliminate it.

While AFG desires and seeks to earn an underwriting profit on all of its business, it is not always possible to do so. As a result, AFG attempts to expand in the most profitable areas and control growth or even reduce its involvement in the least profitable ones.

Over the last several years, AFG has been realigning its property and casualty business mix and focusing on rate adequacy in order to improve its operating profitability. Management has continued to direct capital in order to take advantage of certain specialty market opportunities. Management believes these actions have been successful and that the current mix of specialty businesses positions the company for solid growth and continuing improved profitability in the foreseeable future.

AFG's combined ratio has been better than the industry average for seventeen of the last eighteen years and excluding AFG's special A&E charges, for all eighteen years. Management believes that AFG's insurance operations have performed better than the industry as a result of product line diversification and stringent underwriting discipline.

Premiums and combined ratios for AFG's property and casualty insurance operations were as follows (dollars in millions):

	2003	2002	2001
<b>Gross Written Premiums (GAAP)</b>			
Specialty:			
Property and Transportation	\$1,142	\$ 886	\$ 742
Specialty Casualty	1,413	1,235	859
Specialty Financial	396	332	356
California Workers' Compensation	290	229	243
Other	2	31	36
Total Specialty	3,243	2,713	2,236
Personal (a)	265	1,222	1,284
	\$3,508	\$3,935	\$3,520
<b>Net Written Premiums (GAAP)</b>			
Specialty:			
Property and Transportation	\$ 515	\$ 413	\$ 506
Specialty Casualty	679	609	512
Specialty Financial	302	255	247
California Workers' Compensation	271	219	236
Other	87	81	41
Total Specialty	1,854	1,577	1,542
Personal (a)	158	837	1,040
	\$2,012	\$2,414	\$2,582
<b>Combined Ratios (GAAP)</b>			
Specialty:			
Property and Transportation	87.8%	90.1%	96.7%
Specialty Casualty	98.2	106.6	111.5
Specialty Financial	108.3	101.4	80.1
California Workers' Compensation	92.0	96.4	104.8
Total Specialty	96.0	98.4	101.7
Personal (a)	103.0	99.8	107.9
Aggregate (including discontinued lines) (b)	98.9%	101.0%	107.5%

(a) Includes the operations of Infinity through the sale date in mid-February 2003 and the direct auto business through its sale at the end of April 2003.

(b) Includes 2.3 points in 2003 for the effect of an arbitration decision relating to a claim arising from a business in runoff, 1.2 points for 2002 relating to the A. P. Green asbestos litigation charge and 3.6 points for 2001 relating to the A&E charge and the attack on the World Trade Center.

As shown in Note P under "Insurance Reserves," AFG's property and casualty operations recorded loss development of \$167 million in 2003, \$171 million in 2002 and \$163 million in 2001 related to prior accident years. Major areas of adverse development were as follows (in millions):

	2003	2002	2001
Property and transportation	\$ 32	\$ 19	\$ 10
Specialty casualty	82	78	48
Personal lines	*	15	*
Arbitration settlement	44	—	—
Asbestos	—	49	108
Other	9	10	(3)
	\$167	\$171	\$163

(\*) Amounts are immaterial and included in Other

The prior year development in Property and transportation related primarily to higher than anticipated frequency of claims in the 1993 through 2001 accident years for the homebuilders' liability business, which is in runoff.

Specialty casualty development includes amounts related to executive liability, other liability and excess casualty runoff. Executive liability development impacted 2001, 2002 and 2003 and resulted primarily from claim severity on directors' and officers' liability policy coverages for 1996 through 2000. Both settlement and defense costs related to shareholder lawsuits have increased beyond estimates. The development in other liability impacted both 2003 and 2002 reflecting an unexpected shift of judicial climate in some previously conservative states. Verdicts, judgments, and settlements have increased. The development in excess casualty runoff during 2002 reflects higher frequency of claims related to the 1999 and 2000 accident years. Excess casualty runoff development in 2001, and to a lesser extent in 2002, was affected by increased severity resulting from a rigorous claims review of case reserves established by former management.

In the personal lines, personal injury and uninsured motorist claims experienced increased severity. During 2002, claims remained open longer and settlement amounts were higher than in previous years.

The arbitration settlement represents a charge in the second quarter of 2003 for an unfavorable decision resulting from Great American's share of a 1995 property fire and business interruption claim. Great American was a 9.5% participant with a number of other companies in the insurance pool that insured the loss during the 1995 coverage year.



Asbestos development was due primarily to a charge of \$30 million for the settlement of asbestos-related coverage in litigation in 2002 and the special \$100 million A&E charge in 2001, which is discussed below. See “*Uncertainties – Asbestos and Environmental-related Reserves*” for additional information about these claims.

### 2001 Special A&E Charge

During the third quarter of 2001, AFG recorded an A&E charge of \$100 million after experiencing an increase in the number and severity of asbestos claims and observing the developments of adverse trends in the property and casualty insurance industry concerning asbestos losses. Of this charge, \$31 million was recorded by Transport Insurance Company, which has been reclassified to discontinued operations. This charge, accompanied by a transfer of \$36 million from excess reserves for other environmental claims, resulted in an increase of \$136 million in asbestos reserves. For a discussion of uncertainties relative to asbestos and environmental claims, see “*Uncertainties – Asbestos and Environmental-related Reserves*”.

### Specialty

The Specialty group’s gross written premiums increased approximately 20% for 2003 compared to 2002, reflecting the impact of continuing rate increases and volume growth in most of its businesses. Specialty rate increases averaged approximately 20% during 2003 and should be in the range of 5% to 8% in 2004. Net written premiums increased 18% in 2003 compared to 2002.

The Specialty group’s combined ratio improved 2.4 points over 2002 reflecting rate increases partially offset by \$16 million in higher prior year development in 2003.

The 29% growth in property and transportation gross written premiums reflects significant volume growth in the federal crop insurance program. In addition, the other property and transportation business experienced rate increases and volume growth in 2003. The 14% increase in gross written premium in specialty casualty primarily relates to rate increases. The 19% increase in specialty financial gross written premiums reflects rate increases as well as volume growth in the fidelity and crime products and certain collateral protection products. The 27% increase in California workers’ compensation relates mostly to rate increases.

The 2.3 point improvement in property and transportation’s combined ratio reflects rate increases, partially offset by \$13 million in additional prior year development in 2003 compared to 2002. Specialty Casualty’s 8.4 point combined ratio improvement is primarily due to rate increases.

The specialty financial combined ratio deterioration of 6.9 points is primarily a result of the decline in results related to the residual value products. Lower used car prices, dealer incentives on new cars and the volume of used cars available from expiring leases contributed to the deterioration in the residual value results. California workers’ compensation combined ratio improved 4.4 points as rate increases and \$10 million of benefit related to recently enacted legislation were partially offset by increased claim costs.

The Specialty group’s gross written premiums increased 21% in 2002 compared to 2001, reflecting the effect of rate increases and the volume growth in certain businesses, partially offset by planned reductions in less profitable lines of business. Specialty rate increases averaged about 27% during 2002. Net written premiums increased 2% in 2002 compared to 2001 as strong growth in gross written premiums was offset by the impact of increased reinsurance coverage in certain lines.

Excluding the effect of the attack on the World Trade Center, the Specialty group’s combined ratio improved 1.5 points for 2002. The improvement reflects strategic changes in the mix of specialty businesses and the impact of rate increases, partially offset by the effects of prior year loss development.

### Personal

The Personal group results represent primarily Infinity’s underwriting results through the public offering in mid-February 2003 and the direct-to-consumer auto business, which was sold in April 2003. AFG’s remaining personal lines business generated about 3% of net written premiums in 2003 and 2002.

The Personal group’s gross written premiums for 2002 decreased about 5% compared to 2001 due primarily to intentional reductions in new business volume in certain non-core markets and through the direct channel, partially offset by the effect of continuing rate increases and volume growth in target markets. Due primarily to rate increases and a reduction in marketing and media cost of the direct business, the Personal group’s combined ratio improved by 8.1 points compared to 2001.

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

The increase in life, accident and health premiums and benefits in 2003 and 2002 reflect the addition of new distribution sources for GAFRI’s supplemental insurance products, partially offset in 2003 by lower sales of life insurance products. In addition, life, accident and health benefits for 2003 and 2002 reflect the effects of adverse mortality in GAFRI’s life insurance operations.

### Investment Income

Changes in investment income reflect fluctuations in market rates and changes in average invested assets. Investment income decreased in 2003 compared to 2002 reflecting lower average yields on fixed maturity investments (due in part to an increase in tax-exempt bonds). Investment income increased in 2002 due primarily to higher average investment in fixed maturity securities, partially offset by lower average yields on those investments.

### Gains (Losses) on Securities

Realized gains (losses) on sales of securities include provisions for other than temporary impairment of securities still held of \$58.4 million in 2003, \$179.4 million in 2002 and \$125.5 million in 2001. Impairment charges in 2003 reflect primarily the downturn in the airline industry and writedowns of certain asset-backed securities. Impairment charges in 2002 and 2001 reflect primarily the downturn in the communications and airline industries and writedowns of certain asset-backed securities.

Realized gains (losses) on securities include losses of \$1.1 million in 2003 and \$11.9 million in 2002, and gains of \$5.2 million in 2001 to adjust the carrying value of AFG's investment in warrants to market value under SFAS No. 133.

### Gains (Losses) on Sales of Subsidiaries and Investees

During 2003, AFG recognized a gain of \$56.5 million on the December 2003 sale of its remaining interest in Infinity which more than offset the \$39.4 million loss it recognized when it sold a 61% interest in Infinity in February 2003. Additional net gains of \$2.7 million were recognized in 2003 on the sale of three small insurance subsidiaries and the settlement of disputed amounts under a contract covering a prior year sale.

In 2002, AFG recognized a \$10.8 million pretax loss on the disposal of its New Jersey private passenger auto business.

In 2001, AFG recognized a \$7.1 million pretax gain on the sale of a small insurance subsidiary. In connection with the sale of the Japanese division in 2001, AFG recognized a \$6.9 million pretax loss and deferred a gain of approximately \$21 million on ceded insurance which is being recognized over the estimated settlement period (weighted average of 4 years) of the ceded claims.

### Gain on Sale of Other Investments

In September 2002, AFG realized a \$9.3 million pretax gain on the sale of its minority ownership in a residential homebuilding company.

### Real Estate Operations

AFG's subsidiaries are engaged in a variety of real estate operations including hotels, apartments, office buildings and recreational facilities; they also own several parcels of land. Revenues and expenses of these operations, including gains and losses on disposal, are included in AFG's statement of operations as shown below (in millions).

	2003	2002	2001
Other income	\$96.5	\$115.0	\$102.6
Other operating and general expenses	73.7	71.7	64.9
Interest charges on borrowed money	2.3	2.6	2.3
Minority interest expense, net	1.9	1.1	3.7

Other income includes net pretax gains on the sale of real estate assets of \$10.3 million in 2003, \$31.0 million in 2002 and \$27.2 million in 2001.

### Other Income

**2003 compared to 2002** Other income increased \$11.0 million (4%) in 2003 compared to 2002 due primarily to increased revenues earned by the Specialty group's growing warranty business and higher fee income in certain other specialty insurance operations, partially offset by the absence of income from Infinity (following its sale in mid-February) and decreased gains on the sale of real estate.

**2002 compared to 2001** Other income increased \$37.3 million (17%) in 2002 due primarily to higher income from real estate operations (including the effect of property sales and a hotel acquired in May 2002), increased fees earned by the Specialty group's new warranty business and higher fee income in certain other specialty insurance operations.

### 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 an additional liability to provide for expected deaths and annuitizations. Changes in crediting rates, actual surrender, death and annuitization experience or modifications in actuarial assumptions can affect this accrual.

The majority of GAFRI's fixed annuity products permit GAFRI to change the crediting rate at any time subject to minimum interest rate guarantees (as determined by applicable law). Approximately half of the annuity benefits accumulated relate to policies that have

a minimum guarantee of 3%; the majority of the balance has a guarantee of 4%. In states where required approvals have been received, GAFRI has begun issuing products with guaranteed minimum crediting rates of less than 3% beginning in the fourth quarter of 2003.

Historically, management has been able to react to changes in market interest rates and maintain a desired interest rate spread. The recent interest rate environment has resulted in a spread compression. Significant changes in projected investment yields could result in charges (or credits) to earnings in the period the projections are modified.

### *Annuity and Life Acquisition Expenses*

Annuity and life acquisition expenses include amortization of annuity and life, accident and health deferred policy acquisition costs (“DPAC”) as well as a portion of commissions on sales of insurance products. Annuity and life acquisition expenses also include amortization of the present value of future profits of businesses acquired.

**2003 compared to 2002** The increase in annuity and life acquisition expenses in 2003 compared to 2002 reflects the continued narrowing of spreads in the fixed annuity operations and an increase in in-force policies, primarily in the annuities and supplemental insurance operations. Included in 2003 were \$15.2 million in DPAC writeoffs related to spread narrowing.

**2002 compared to 2001** The increase in annuity and life acquisition expenses in 2002 compared to 2001 reflects (i) a writeoff of DPAC; (ii) the amortization costs associated with GAFRI’s purchase of MNL in June 2002 and (iii) higher commission expense due to GAFRI’s growth in premiums. Included in 2002 and 2001 were DPAC writeoffs related to variable annuities of \$13.5 million and \$3.0 million, respectively, resulting from the actual performance of the equity markets and a reduction of assumed future returns. Included in 2002 is a DPAC writeoff of \$4 million related primarily to adverse mortality in GAFRI’s life operations. Partially offsetting the DPAC writeoffs in 2002 was a reduction of approximately \$7 million in DPAC amortization on fixed annuities relating to decreases in crediting rates on certain fixed annuity products.

The vast majority of GAFRI’s DPAC asset relates to its fixed annuity, variable annuity and life insurance lines of business. Continued spread compression, decreases in the stock market and adverse mortality could lead to write-offs of DPAC in the future. However, absent significant deterioration in those factors, GAFRI does not anticipate any material write-offs in the foreseeable future.

### *Interest on Borrowed Money*

Changes in interest expense result from fluctuations in market rates as well as changes in borrowings. AFG has generally financed its borrowings on a long-term basis which has resulted in higher current costs.

**2003 compared to 2002** Interest expense decreased in 2003 primarily due to lower average indebtedness and lower interest charges on amounts due reinsurers.

**2002 compared to 2001** Interest expense was virtually unchanged in 2002 as lower average rates on AFG’s variable rate debt were substantially offset by higher average indebtedness and higher average payable to reinsurers balances.

### *Other Operating and General Expenses*

**2003 compared to 2002** Other operating and general expenses for 2003 include a third quarter pretax charge of \$35.5 million related to an agreement to settle a lawsuit alleging antitrust violations by a number of California workers’ compensation insurers including an AFG subsidiary. Excluding this charge, other operating and general expenses decreased 2% in 2003 compared to 2002 as the absence of expenses from Infinity (following its sale in mid-February) offset higher expenses in the Specialty group’s growing warranty business.

**2002 compared to 2001** Other operating and general expenses for 2001 include goodwill amortization of \$13.7 million. Under SFAS No. 142, which was implemented January 1, 2002, goodwill is no longer amortized. Excluding 2001 goodwill amortization, other operating and general expenses increased \$37.7 million (10%) in 2002. Expenses of the Specialty group’s new warranty business, higher expenses in real estate operations (due primarily to the acquisition of a new hotel in May 2002) and higher expenses related to growth in certain other Specialty operations were partially offset by lower charges for environmental reserves related to former operations and lower technology-related expenses.

### *Income Taxes*

The 2003 provision for income taxes includes a benefit of \$136 million related to the AFG/AFC merger for the effect of the elimination of deferred tax liabilities associated with AFC’s holding of AFG stock and reflects \$5.5 million in tax benefits related to AFG’s basis in Infinity stock. The 2002 provision for income taxes includes \$31 million in tax benefits for the reduction of previously accrued amounts due to the resolution of certain tax matters. See Note K to the Financial Statements for more information on the effects of the AFG/AFC merger and an analysis of items affecting AFG’s effective tax rate.

## Investee Corporations

### Infinity Property and Casualty Corporation

AFG's proportionate share (\$12.2 million) of Infinity's earnings is included in equity in net earnings (losses) of investees for the period between the initial sale of 61% of Infinity in February 2003 and AFG's sale of its remaining shares in December 2003.

### Start-up Manufacturing Businesses

Equity in earnings (losses) of investees also includes losses of two start-up manufacturing businesses that were formerly subsidiaries. Equity in net earnings (losses) of investees includes \$3.1 million in 2003 compared to \$3.6 million in 2002 and \$2.9 million in 2001 in losses of one of these businesses. Investee losses in 2002 and 2001 include \$5.4 million and \$13.7 million (including litigation judgments of \$4.7 million), respectively, in losses of the other manufacturing business, which sold substantially all of its assets in December 2002.

## Cumulative Effect of Accounting Changes

Effective December 31, 2003, AFG implemented Interpretation No. 46, "Consolidation of Variable Interest Entities." This interpretation sets forth the requirements for determining the status of entities that do not share economic risk and reward through typical equity ownership, but rather through contractual relationships that distribute economic risks and rewards among various parties. Once an entity is determined to be a VIE, it is required to be consolidated by the primary beneficiary, which is deemed to be the party that is exposed to a majority of the expected losses, or benefits from a majority of the expected residual returns, or both.

See Note A – "Accounting Policies" – "Managed Investment Entity" and "Payable to Subsidiary Trusts." The cumulative effect of implementing FIN 46 was an increase in income of \$6.3 million.

Effective January 1, 2002, AFG implemented Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets", under which goodwill is no longer amortized, but is subject to an impairment test at least annually. The initial impairment testing resulted in a charge of \$40.4 million (net of minority interest and taxes) for the cumulative effect of a change in accounting principle.

In 2001, the cumulative effect of accounting change represents the implementation of a new accounting standard (EITF 99-20) which resulted in a writedown of \$10.0 million (net of minority interest and taxes) of the carrying value of certain collateralized debt obligations as of April 1, 2001.

## Recent Accounting Standards

The following accounting standards have been or may be implemented by AFG. The implementation of these standards is discussed under various subheadings of Note A to the Financial Statements; effects of each are shown in the relevant Notes.

Accounting Standard	Subject of Standard (Year Implemented)	Reference
EITF 99-20	Asset-backed Securities (2001)	"Investments"
SFAS #141	Business Combinations (2001)	"Business Combinations"
SFAS #142	Goodwill and Other Intangibles (2002)	"Goodwill"
SFAS #144	Impairment or Disposal of Long-Lived Assets (2002)	"Discontinued Operations"
SFAS #148	Stock-based Compensation (2002)	"Stock-based Compensation"
FIN 46	Consolidation of Variable Interest Entities (2003)	"Managed Investment Entity"/"Payable to Subsidiary Trust"
SFAS #133 B36	Embedded Derivatives in Reinsurance Contracts (2003)	"Reinsurance"

Other standards issued in recent years did not apply to AFG or had only negligible effects on AFG.

### SOP 03-1

In July 2003, the American Institute of Certified Public Accountants issued Statement of Position ("SOP") 03-1, "Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts." The most significant accounting implications to GAFRI of the SOP are as follows:

(1) changing GAFRI's method for accounting for assets and liabilities related to two-tier annuities and persistency bonuses; (2) amortizing DPAC over the life of deferred annuity contracts excluding the annuitization phase; and (3) establishing an additional liability for guaranteed minimum death benefits for variable annuity contracts.

GAFRI will adopt the SOP effective January 1, 2004. Although interpretation of accounting for certain items covered by the SOP has not been finalized, the effect of initially adopting this SOP is expected to be less than 1% of AFG's equity and will be reported as a cumulative effect of a change in accounting principle in the 2004 results of operations. This effect results primarily from the change in accounting for persistency bonuses. GAFRI does not expect that the final amount will have a material adverse impact on the company.

# Report of Management

The financial information presented in this Annual Report has been prepared by American Financial Group, Inc. and is the responsibility of its management who believes that the financial statements and related notes have been prepared in accordance with generally accepted accounting principles.

The accounting systems and internal controls of the Company have been designed to provide reasonable assurance that the financial records are reliable for preparation of financial statements and that assets are safeguarded against losses from unauthorized use or disposition. These systems and controls are monitored on an ongoing basis.

The Company engages an independent accounting firm to audit its financial statements and express an opinion thereon. The independent auditors have full and free access to all Company records and personnel in conducting their audits. These audits include tests and other procedures as they consider necessary.

Additionally, the Board of Directors, primarily through the Audit Committee, reviews the Company's accounting policies and controls. The independent auditors have full and free access to meet with the Audit Committee, with or without members of management present, to discuss their audit work and any other matters they believe should be brought to the attention of the Committee.

# Report of Independent Auditors

Board of Directors  
American Financial Group, Inc.

We have audited the accompanying consolidated balance sheet of American Financial Group, Inc. and subsidiaries as of December 31, 2003 and 2002, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of American Financial Group, Inc. and subsidiaries at December 31, 2003 and 2002, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States.

As discussed in Notes A and E to the consolidated financial statements, in 2002, the Company implemented Statement of Financial Accounting Standards No. 142, which required a change in the method of accounting for goodwill, and in 2003, the Company implemented FASB interpretation No. 46, which required a change in consolidation policy related to variable interest entities.

Cincinnati, Ohio  
February 12, 2004

*Ernst & Young LLP*

# Consolidated Balance Sheet *(dollars in thousands)*

December 31,	2003	2002
<b>Assets</b>		
Cash and short-term investments	\$ 593,552	\$ 871,103
Investments:		
Fixed maturities:		
Available for sale—at market (amortized cost—\$11,724,181 and \$11,549,710)	12,101,981	12,006,910
Trading—at market	195,390	—
Other stocks—at market (cost—\$258,466 and \$174,645)	454,866	300,445
Policy loans	215,571	214,852
Real estate and other investments	266,435	257,731
Total cash and investments	13,827,795	13,651,041
Recoverables from reinsurers and prepaid reinsurance premiums	3,131,775	2,866,780
Agents' balances and premiums receivable	502,458	708,327
Deferred acquisition costs	851,199	842,070
Other receivables	320,517	307,008
Assets of managed investment entity	424,669	—
Variable annuity assets (separate accounts)	568,434	455,142
Prepaid expenses, deferred charges and other assets	402,081	425,775
Goodwill	168,330	248,683
	<b>\$20,197,258</b>	<b>\$19,504,826</b>
<b>Liabilities and Capital</b>		
Unpaid losses and loss adjustment expenses	\$ 4,909,109	\$ 5,203,831
Unearned premiums	1,594,839	1,847,924
Annuity benefits accumulated	6,974,629	6,453,881
Life, accident and health reserves	1,018,861	902,393
Payable to reinsurers	408,518	508,718
Long-term debt:		
Holding companies	586,051	648,410
Subsidiaries	250,811	296,771
Payable to subsidiary trusts (issuers of preferred securities)	265,472	—
Liabilities of managed investment entity	406,547	—
Variable annuity liabilities (separate accounts)	568,434	455,142
Accounts payable, accrued expenses and other liabilities	950,267	990,884
Total liabilities	17,933,538	17,307,954
Minority interest (including trust-issued preferred securities at December 31, 2002)	187,559	471,024
Shareholders' Equity:		
Common Stock, no par value		
—200,000,000 shares authorized		
—73,056,085 and 69,129,352 shares outstanding	73,056	69,129
Capital surplus	1,035,784	923,042
Retained earnings	664,721	409,777
Unrealized gain on marketable securities, net	302,600	323,900
Total shareholders' equity	2,076,161	1,725,848
	<b>\$20,197,258</b>	<b>\$19,504,826</b>

See notes to consolidated financial statements.

# Consolidated Statement of Operations *(in thousands, except per share data)*

Year Ended December 31,	2003	2002	2001
<b>Income:</b>			
Property and casualty insurance premiums	\$1,909,206	\$2,402,600	\$2,593,938
Life, accident and health premiums	331,887	305,647	280,122
Investment income	773,188	861,503	851,479
Realized gains (losses) on:			
Securities	58,891	(78,968)	(24,776)
Subsidiaries and investees	19,824	(10,769)	170
Other investments	—	9,253	—
Other income	266,647	255,609	218,328
	<b>3,359,643</b>	<b>3,744,875</b>	<b>3,919,261</b>
<b>Costs and Expenses:</b>			
Property and casualty insurance:			
Losses and loss adjustment expenses	1,353,177	1,812,495	2,047,057
Commissions and other underwriting expenses	534,161	614,062	741,026
Annuity benefits	294,940	300,966	294,654
Life, accident and health benefits	250,713	245,271	213,022
Annuity and life acquisition expenses	121,322	114,507	79,297
Interest charges on borrowed money	57,320	60,407	60,744
Other operating and general expenses	447,004	421,344	397,307
	<b>3,058,637</b>	<b>3,569,052</b>	<b>3,833,107</b>
Operating earnings before income taxes	301,006	175,823	86,154
Provision (benefit) for income taxes	(47,454)	17,117	20,471
Net operating earnings	348,460	158,706	65,683
Minority interest expense, net of tax	(36,393)	(26,149)	(34,070)
Equity in net earnings (losses) of investees, net of tax	9,084	(8,990)	(16,550)
Earnings (loss) from continuing operations	321,151	123,567	15,063
Discontinued operations	(33,636)	1,433	(19,863)
Cumulative effect of accounting changes	6,300	(40,360)	(10,040)
<b>Net Earnings (Loss)</b>	<b>\$ 293,815</b>	<b>\$ 84,640</b>	<b>(\$ 14,840)</b>
Premium over stated value paid on redemption of subsidiaries' preferred shares	(4,121)	—	—
Net earnings (loss) available to Common Shares	<b>\$ 289,694</b>	<b>\$ 84,640</b>	<b>(\$ 14,840)</b>
<b>Basic earnings (loss) per Common Share:</b>			
Continuing operations	\$4.53	\$1.80	\$ .22
Discontinued operations	(.48)	.02	(.29)
Cumulative effect of accounting changes	.09	(.59)	(.15)
Net earnings (loss) available to Common Shares	<b>\$4.14</b>	<b>\$1.23</b>	<b>(\$ .22)</b>
<b>Diluted earnings (loss) per Common Share:</b>			
Continuing operations	\$4.51	\$1.79	\$ .22
Discontinued operations	(.48)	.02	(.29)
Cumulative effect of accounting changes	.09	(.59)	(.15)
Net earnings (loss) available to Common Shares	<b>\$4.12</b>	<b>\$1.22</b>	<b>(\$ .22)</b>
<b>Average number of Common Shares:</b>			
Basic	69,937	68,800	67,928
Diluted	70,272	69,203	68,368
Cash dividends per Common Share	\$ .50	\$ .50	\$1.00

See notes to consolidated financial statements.

# Consolidated Statement of Changes in Shareholders' Equity *(dollars in thousands)*

	Common Shares	Common Stock and Capital Surplus	Retained Earnings	Unrealized Gain (Loss) on Securities	Total
<b>Balance at December 31, 2000</b>	67,410,091	\$ 965,654	\$442,276	\$140,600	\$1,548,530
Net earnings (loss)	—	—	(14,840)	—	(14,840)
Change in unrealized	—	—	—	18,700	18,700
Comprehensive income					3,860
Dividends on Common Stock	—	—	(67,874)	—	(67,874)
Shares issued:					
Exercise of stock options	65,335	1,522	—	—	1,522
Dividend reinvestment plan	85,105	1,806	—	—	1,806
Employee stock purchase plan	53,370	1,365	—	—	1,365
Retirement plan contributions	876,877	20,970	—	—	20,970
Deferred compensation distributions	331	9	—	—	9
Directors fees paid in stock	4,044	96	—	—	96
Shares acquired and retired	(3,543)	(51)	(49)	—	(100)
Tax effect of intercompany dividends	—	(6,400)	—	—	(6,400)
Capital transactions of subsidiaries	—	(4,215)	—	—	(4,215)
Other	—	(1,190)	—	—	(1,190)
<b>Balance at December 31, 2001</b>	68,491,610	\$ 979,566	\$359,513	\$159,300	\$1,498,379
Net earnings	—	\$ —	\$ 84,640	\$ —	\$ 84,640
Change in unrealized	—	—	—	164,600	164,600
Comprehensive income					249,240
Dividends on Common Stock	—	—	(34,367)	—	(34,367)
Shares issued:					
Exercise of stock options	28,837	656	—	—	656
Dividend reinvestment plan	298,076	6,616	—	—	6,616
Employee stock purchase plan	45,869	1,143	—	—	1,143
Retirement plan contributions	260,040	6,589	—	—	6,589
Deferred compensation distributions	1,809	45	—	—	45
Directors fees paid in stock	3,904	96	—	—	96
Shares acquired and retired	(793)	(12)	(9)	—	(21)
Tax effect of intercompany dividends	—	(3,200)	—	—	(3,200)
Other	—	672	—	—	672
<b>Balance at December 31, 2002</b>	69,129,352	\$ 992,171	\$409,777	\$323,900	\$1,725,848
Net earnings	—	\$ —	\$293,815	\$ —	\$ 293,815
Change in unrealized	—	—	—	(21,300)	(21,300)
Comprehensive income					272,515
Dividends on Common Stock	—	—	(34,750)	—	(34,750)
Shares issued:					
AFG/AFC merger	3,299,563	75,032	(4,048)	—	70,984
Exercise of stock options	35,000	771	—	—	771
Dividend reinvestment plan	165,428	3,412	—	—	3,412
Employee stock purchase plan	41,940	914	—	—	914
Retirement plan contributions	376,234	7,740	—	—	7,740
Deferred compensation distributions	3,300	71	—	—	71
Directors fees paid in stock	5,272	115	—	—	115
Shares acquired and retired	(4)	—	—	—	—
Elimination of tax effect of prior intercompany dividends	—	34,000	—	—	34,000
Repurchase of trust preferred securities	—	—	(73)	—	(73)
Other	—	(5,386)	—	—	(5,386)
<b>Balance at December 31, 2003</b>	73,056,085	\$1,108,840	\$664,721	\$302,600	\$2,076,161

See notes to consolidated financial statements.



# Consolidated Statement of Cash Flows *(in thousands)*

Year Ended December 31,	2003	2002	2001
<b>Operating Activities:</b>			
Net earnings (loss)	\$ 293,815	\$ 84,640	(\$ 14,840)
Adjustments:			
Cumulative effect of accounting changes	(6,300)	40,360	10,040
Equity in net (earnings) losses of investees	(9,084)	8,990	16,550
Minority interest	16,470	6,096	11,366
Depreciation and amortization	176,857	174,990	126,167
Annuity benefits	294,940	300,966	294,654
Realized (gains) losses on investing activities	(35,633)	49,093	(2,604)
Deferred annuity and life policy acquisition costs	(148,247)	(170,194)	(137,724)
Increase in reinsurance and other receivables	(515,698)	(669,776)	(298,995)
Decrease (increase) in other assets	(85,511)	30,978	(16,211)
Increase in insurance claims and reserves	717,010	703,244	546,522
Increase (decrease) in payable to reinsurers	(21,398)	212,256	154,384
Increase in other liabilities	56,277	39,415	4,558
Other, net	16,002	1,252	28,650
	749,500	812,310	722,517
<b>Investing Activities:</b>			
Purchases of and additional investments in:			
Fixed maturity investments	(8,013,349)	(6,199,022)	(3,827,768)
Equity securities	(147,836)	(16,583)	(9,071)
Subsidiary	—	(48,447)	—
Real estate, property and equipment	(29,699)	(53,639)	(90,111)
Maturities and redemptions of fixed maturity investments	1,833,418	1,807,482	902,820
Sales of:			
Fixed maturity investments	4,745,708	3,566,812	2,468,492
Equity securities	59,987	23,669	15,814
Subsidiaries and investees	461,386	—	40,395
Real estate, property and equipment	16,649	22,417	71,002
Cash and short-term investments of acquired (former) subsidiaries, net	(112,666)	4,684	(134,237)
Collection of receivable from investee	55,000	—	—
Decrease (increase) in other investments	578	27,220	(7,827)
	(1,130,824)	(865,407)	(570,491)
<b>Financing Activities:</b>			
Fixed annuity receipts	788,174	874,470	616,628
Annuity surrenders, benefits and withdrawals	(572,013)	(549,919)	(622,474)
Net transfers from (to) variable annuity assets	966	20,807	(363)
Additional long-term borrowings	337,208	224,560	242,613
Reductions of long-term debt	(454,775)	(159,926)	(143,840)
Issuances of Common Stock	1,516	1,608	2,582
Issuances of trust preferred securities	33,943	—	—
Repurchases of trust preferred securities	(11,322)	—	(75,000)
Subsidiary's issuance of stock in rights offering	10,632	—	—
Cash dividends paid on Common Stock	(31,338)	(27,834)	(66,068)
Other, net	782	(3,739)	(601)
	103,773	380,027	(46,523)
<b>Net Increase (Decrease) in Cash and Short-term Investments</b>	<b>(277,551)</b>	<b>326,930</b>	<b>105,503</b>
Cash and short-term investments at beginning of period	871,103	544,173	438,670
Cash and short-term investments at end of period	\$ 593,552	\$ 871,103	\$ 544,173

See notes to consolidated financial statements.

# Notes to Consolidated Financial Statements

## A. Accounting Policies

### *Basis of Presentation*

The consolidated financial statements include the accounts of American Financial Group, Inc. (“AFG”) and its subsidiaries. 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 in conformity with generally accepted accounting principles 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.

### *Subsidiary Realignment*

Early in 2003, AFG began an analysis of alternatives to simplify its corporate structure and promote easier oversight, analysis and operation of its subsidiaries. As a result, mergers and a recapitalization were consummated. Committees of independent directors conducted the analyses with the counsel of recognized outside experts and approved each of the transactions. AFG merged with two of its subsidiaries, American Financial Corporation (“AFC”) and AFC Holding Company with AFC’s Series J Preferred stock being acquired and retired in exchange for approximately 3.3 million shares of AFG Common Stock (aggregate value of \$75 million). In addition, approximately \$170 million in deferred tax liabilities associated with AFC’s holding of AFG stock were eliminated. As of January 31, 2004, American Premier Underwriters, Inc. (“APU”, a wholly-owned subsidiary) paid an extraordinary dividend consisting of approximately two-thirds of its assets, including insurance subsidiaries, to its immediate parent, APU Holding Company, and retained sufficient assets to enable it to meet its estimated liabilities.

### *Investments*

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

Short-term investments are carried at cost; loans receivable are carried primarily at the aggregate unpaid balance. Premiums and discounts on 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. The most significant determinants of prepayments are the difference between interest rates on the underlying mortgages and current mortgage loan rates and the structure of the security. Other factors affecting prepayments include the size, type and age of underlying mortgages, the geographic location of the mortgaged properties and the creditworthiness of the borrowers. Variations from anticipated prepayments will affect the life and yield of these securities.

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) and the cost basis of that investment is reduced.

### *Derivatives*

Derivatives included in AFG’s Balance Sheet consist primarily of (i) the interest component of certain life reinsurance contracts (included in other liabilities), (ii) an interest rate swap (included in debt), and (iii) 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 current earnings.

In December 2003, Great American Financial Resources, Inc. (“GAFRI”), an 82%-owned subsidiary of AFG, entered into an interest rate swap, effectively converting the interest rate on \$40 million of its 6-7/8% fixed rate Senior Notes to a floating rate based on LIBOR. The swap realigns GAFRI’s mix of floating and fixed rate debt and has been designated a fair value hedge. The terms of the swap match those of the debt; therefore, the swap is considered to be (and is accounted for as) a 100% effective hedge. Both the swap and the hedged debt are adjusted for changes in fair value by offsetting amounts. Accordingly, since the swap is included with long-term debt in the Balance Sheet, the only effect on AFG’s financial statements is that the interest expense on the hedged debt is recorded based on the variable rate.

### *Managed Investment Entity*

The Financial Accounting Standards Board (“FASB”) issued revised Interpretation (“FIN”) No. 46, “Consolidation of Variable Interest Entities” (“VIEs”) in December 2003. FIN 46 sets forth the requirements for consolidating entities that do not share economic risk and reward through typical equity ownership, but rather through contractual relationships that distribute economic risks and rewards among various parties. Once an entity is determined to be a VIE, it is generally required to be consolidated by the primary beneficiary (the party with a majority of either the expected losses or residual rewards or both). Under FIN 46, AFG is considered to be the primary beneficiary of a collateralized debt obligation (“CDO”) in which it owns subordinated notes (considered equity) representing approximately two-thirds of the CDO’s equity (but less than 50% of the voting power) and 5% of the total notes issued by the CDO. Accordingly, AFG implemented FIN 46 effective December 31, 2003; the cumulative difference between accounting for the CDO as an investment and as a consolidated subsidiary at that date is shown in the Statement of Operations as the cumulative effect of an accounting change. Since AFG has no right to use the CDO assets and the CDO liabilities can be extinguished only by using CDO assets, the assets and liabilities of the CDO are shown separate from AFG’s other assets and liabilities in the Consolidated Balance Sheet.

### *Goodwill*

Goodwill represents the excess of cost of subsidiaries over AFG’s equity in their underlying net assets. Through December 31, 2001, goodwill was being amortized over periods of 20 to 40 years. Effective January 1, 2002, AFG implemented Statement of Financial Accounting Standards (“SFAS”) No. 142, under which goodwill is no longer amortized but is subject to an impairment test at least annually. As required under SFAS No. 142, AFG completed the transitional test for goodwill impairment (as of January 1, 2002) in the fourth quarter of 2002. The resulting write-down was reported by restating first quarter 2002 results for the cumulative effect of a change in accounting principle.

### *Insurance*

As discussed under “Reinsurance” below, unpaid losses and loss adjustment expenses and unearned premiums have not been reduced for reinsurance recoverable.

### *Reinsurance*

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policies. AFG’s insurance subsidiaries report as assets (a) the estimated reinsurance recoverable on 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 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. Income on reinsurance assumed is recognized based on reports received from ceding companies.

GAFRI’s subsidiaries cede life insurance policies to a third party on a funds withheld basis where GAFRI retains the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance (including realized gains and losses) of the retained assets. Effective October 1, 2003, GAFRI implemented SFAS No. 133 Implementation Issue B36 (“B36”). Under B36, these reinsurance contracts are considered to contain embedded derivatives (that must be marked to market) 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 changes in the fair value of the underlying portfolios of fixed maturity securities is an appropriate measure of the value of the embedded derivative. As permitted under B36, GAFRI reclassified the securities related to these transactions from “available for sale” to “trading”. The \$16.1 million cumulative effect of marking to market the derivatives embedded in the payables at October 1, 2003, was offset by the initial effect of transferring the related securities from available for sale to trading. Beginning in the fourth quarter of 2003, the mark to market on the embedded derivatives offsets the investment income recorded on the mark to market 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.

## Notes to Consolidated Financial Statements *(continued)*

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 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. 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, net” 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.

### **Annuity and Life Acquisition Expenses**

Annuity and life acquisition expenses on the Statement of Operations consists primarily of amortization of DPAC related to the annuity and life, accident and health businesses. This line item also includes certain marketing and commission costs that are expensed as paid.

### **Unpaid Loss 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 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 and environmental 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 Operations in the period in which determined. In spite of 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 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 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 reports 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.

### **Policyholder Dividends**

Dividends payable to policyholders are included in “Accounts payable, accrued expenses and other liabilities” and represent estimates of amounts payable on participating policies which share in favorable underwriting results. Estimates are accrued during the period in which premiums are earned. Changes in estimates are included in income in the period determined. Policyholder dividends do not become legal liabilities unless and until declared by the boards of directors of the insurance companies.

### *Payable to Subsidiary Trusts (Issuers of Preferred Securities)*

Under FIN 46, AFG is required to deconsolidate three wholly-owned subsidiary trusts because they are “variable interest entities” in which AFG is not considered to be the primary beneficiary. These subsidiary trusts were formed to issue preferred securities and, in turn, purchase a like amount of subordinated debt from their parent company which provides interest and principal payments to fund the respective trust obligations. Accordingly, the subordinated debt due to the trusts is shown as a liability in the Balance Sheet beginning December 31, 2003, and the related interest expense will be shown in the Statement of Operations as “interest on subsidiary trust obligations” beginning in the first quarter of 2004. Prior to these dates, these items were included in the Balance Sheet as minority interest and in the Statement of Operations as minority interest expense. Implementation of FIN 46 with respect to the preferred securities had no effect on earnings.

### *Minority Interest*

For balance sheet purposes, minority interest represents the interests of noncontrolling shareholders in AFG subsidiaries. For income statement purposes, minority interest expense represents those shareholders’ interest in the earnings of AFG subsidiaries. See “Payable to Subsidiary Trusts” above.

### *Income Taxes*

Prior to the AFG/AFC merger in November 2003, AFC filed consolidated federal income tax returns which included all 80%-owned U.S. subsidiaries, except for certain life insurance subsidiaries and their subsidiaries. Because holders of AFC Preferred Stock held in excess of 20% of AFC’s voting rights, AFG (parent) and AFC Holding Company were not eligible to file consolidated returns with AFC, and therefore, filed separately. Following the AFG/AFC merger, AFG will file consolidated federal income tax returns, which will include the companies previously included in the AFC consolidated return.

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.

### *Stock-Based Compensation*

As permitted under SFAS No. 123, “Accounting for Stock-Based Compensation,” AFG accounts for stock options and other stock-based compensation plans using

the intrinsic value based method prescribed by Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees.” Under AFG’s stock option plan, options are granted to officers, directors and key employees at exercise prices equal to the fair value of the shares at the dates of grant. No compensation expense is recognized for stock option grants.

The following table illustrates the effect on net earnings (in thousands) and earnings per share had compensation cost been recognized and determined based on the “fair values” at grant dates consistent with the method prescribed by SFAS No. 123. See Note J “Shareholders’ Equity” for further information on stock options.

For SFAS No. 123 purposes, the “fair value” of \$5.62 per option granted in 2003, \$8.52 in 2002 and \$8.18 in 2001 was calculated using the Black-Scholes option pricing model and the following assumptions: dividend yield of 2%; expected volatility of 30% for 2003 and 2002 and 27% for 2001; risk-free interest rate of 3.6% for 2003, 4.9% for 2002 and 5.3% for 2001; and expected option life of 7.4 years. There is no single reliable method to determine the actual value of options at grant date. Accordingly, actual value of the option grants may be higher or lower than the SFAS No. 123 “fair value”.

	2003	2002	2001
Net earnings (loss), as reported	\$293,815	\$84,640	(\$14,840)
Pro forma stock option expense, net of tax	(6,362)	(5,639)	(5,436)
Adjusted net earnings (loss)	\$287,453	\$79,001	(\$20,276)
Earnings per share (as reported):			
Basic	\$4.14	\$1.23	(\$0.22)
Diluted	\$4.12	\$1.22	(\$0.22)
Earnings per share (adjusted):			
Basic	\$4.05	\$1.15	(\$0.30)
Diluted	\$4.04	\$1.14	(\$0.30)

### *Benefit Plans*

AFG provides retirement benefits to qualified employees of participating companies through the AFG Retirement and Savings Plan, a defined contribution plan. The Company makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. Employees have been permitted to direct the investment of their contributions to independently managed investment funds, while Company contributions have been invested primarily in securities of AFG and affiliates. Employees may direct the investment of a portion of their vested retirement fund account balances (increasing from 87.5% in December 2003 to 100% in April 2004) from securities of AFG and its affiliates to independently managed investment funds. As of December 31, 2003,

## Notes to Consolidated Financial Statements *(continued)*

the Plan owned 11% of AFG's outstanding Common Stock. 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 the employees earn such benefits.

### *Discontinued Operations*

SFAS No. 144, "Accounting For the Impairment or Disposal of Long-Lived Assets," broadens the definition of what constitutes a discontinued operation to include a component of an entity (rather than a segment of a business). A component of an entity may be a reportable segment, a subsidiary or an asset group. Under SFAS No. 144, future operating losses of discontinued entities are no longer recognized before they occur.

### *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 the following dilutive effect of common stock options: 2003 – 335,000 shares; 2002 – 403,000 shares; and 2001 – 440,000 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 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. Acquisitions and Sales of Subsidiaries**

### *Fidelity Excess and Surplus Insurance Company*

In June 2003, AFG sold Fidelity Excess and Surplus Insurance Company, an inactive subsidiary, for \$28.9 million, realizing a pretax gain of \$4.3 million. AFG retained all liability for Fidelity's business related to the period AFG owned the company.

### *Direct automobile insurance business*

In April 2003, AFG sold two of its subsidiaries that market automobile insurance directly to customers for \$32.2 million, realizing a pretax gain of \$3.4 million on the sale. The transaction included the transfer of the right of Great American Insurance Company ("GAI"), an AFG subsidiary, to renew certain of its personal automobile insurance business written on a direct basis in selected markets. Premiums generated by the businesses sold were approximately \$79 million in 2002.

### *Infinity Property and Casualty Corporation*

On December 31, 2002, AFG transferred to Infinity Property and Casualty Corporation ("Infinity", a newly formed subsidiary) subsidiaries involved primarily in the issuance of nonstandard auto policies. Effective January 1, 2003, GAI transferred to Infinity its personal insurance business written through independent agents. In February 2003, AFG sold 61% of Infinity in a public offering for net proceeds of \$186.3 million, realizing a pretax loss of \$39.4 million on the sale. In addition, AFG realized a \$5.5 million tax benefit related to its basis in Infinity stock. In December 2003, AFG sold its remaining share of Infinity for net proceeds of \$214 million, realizing a pretax gain of \$56.5 million on the sale. The businesses transferred generated aggregate net written premiums of approximately \$690 million in 2002.

### *New Jersey private passenger automobile insurance business*

In September 2002, an AFG subsidiary entered into an agreement under which two unrelated entities assumed the subsidiary's obligations to renew its private passenger automobile insurance business written in New Jersey. AFG recognized a \$10.8 million pretax loss on the transaction. As of September 9, 2002, AFG no longer accepts any new private passenger automobile insurance in that state.

### *Manhattan National Life Insurance*

In June 2002, GAFRI paid \$48.5 million for Manhattan National Life Insurance Company ("MNL"), which no longer was writing new business, but had approximately 90,000 policies-in-force (primarily term life). GAFRI has reinsured 90% of this in-force business.

### *Seven Hills Insurance Company*

In July 2001, AFG sold Seven Hills Insurance Company for \$18.4 million, realizing a pretax gain of \$7.1 million. AFG retained all liability for Seven Hills' business related to the period AFG owned the company.

## Japanese division

In December 2000, AFG agreed to sell its Japanese property and casualty division to Mitsui Marine & Fire Insurance Company of America for \$22 million in cash and recorded an estimated \$10.7 million pretax loss. Upon completion of the sale in March 2001, AFG realized an additional pretax loss of \$6.9 million (including post closing adjustments) and deferred a gain of approximately \$21 million on ceded insurance; the deferred gain is being recognized over the estimated settlement period (weighted average of 4 years) of the ceded claims.

## C. Segments of Operations

AFG manages its business as three segments: (i) property and casualty insurance, (ii) annuity, life and supplemental health insurance and (iii) other, which includes holding company assets and costs, and beginning December 31, 2003, the assets and operations of the CDO that AFG manages.

Prior to the sale of its remaining interest in Infinity in the fourth quarter of 2003, AFG separated its property and casualty insurance segment into two components or sub-segments, the Specialty group and the Personal group. The Personal group wrote nonstandard and preferred/standard private passenger auto and other personal insurance coverage. Since AFG has disposed of substantially all of its Personal group business, it has revised its reporting of the Specialty sub-segment into the following components: (i) Property and Transportation which includes inland and ocean marine, agricultural-related business and commercial automobile, (ii) Specialty Casualty which includes executive and professional liability, umbrella and excess liability and excess and surplus, (iii) Specialty Financial which includes fidelity and surety bonds and collateral protection and (iv) California Workers' Compensation. AFG's reportable segments and their components were determined based primarily upon similar economic characteristics, products and services.

AFG's annuity, life and health business markets primarily retirement products as well as life and supplemental health insurance. AFG's businesses operate throughout the United States. In 2003, 2002, and 2001, AFG derived just over 2% of its revenues from the sale of life and supplemental health products in Puerto Rico and just over 1% of its revenues from the sale of property and casualty insurance in Mexico, Canada and Europe.

The following tables (in thousands) show AFG's assets, revenues and operating profit (loss) by significant business segment and sub-segment. Operating profit (loss) represents total revenues less operating expenses.

	2003	2002	2001
<b>Assets</b>			
Property and casualty insurance (a)	\$ 9,230,244	\$ 9,960,769	\$ 8,796,909
Annuities and life	10,177,839	9,349,280	8,370,904
Other	789,175	194,777	233,868
	<b>\$20,197,258</b>	<b>\$19,504,826</b>	<b>\$17,401,681</b>
<b>Revenues (b)</b>			
Property and casualty insurance:			
Premiums earned:			
Specialty			
Property and transportation	\$ 480,597	\$ 419,528	\$ 484,941
Specialty casualty	656,725	572,051	486,508
Specialty financial	262,280	229,415	169,352
California workers' compensation	262,691	213,879	236,533
Other	83,295	62,215	32,163
Personal	163,610	905,246	1,182,651
Other lines	8	266	1,790
	<b>1,909,206</b>	<b>2,402,600</b>	<b>2,593,938</b>
Investment income	252,860	328,593	341,926
Realized gains (losses)	75,193	(52,862)	3,906
Other income	166,071	130,523	108,207
	<b>2,403,330</b>	<b>2,808,854</b>	<b>3,047,977</b>
Annuities, life and health (c)	931,018	897,365	855,733
Other	25,295	38,656	15,551
	<b>\$ 3,359,643</b>	<b>\$ 3,744,875</b>	<b>\$ 3,919,261</b>
<b>Operating Profit (Loss)</b>			
Property and casualty insurance:			
Underwriting:			
Specialty			
Property and transportation	\$ 58,612	\$ 41,336	\$ 16,175
Specialty casualty	11,560	(37,584)	(56,135)
Specialty financial	(21,866)	(3,127)	33,769
California workers' compensation	20,919	7,647	(11,253)
Other	(162)	16,272	(5,830)
Personal	(4,795)	1,339	(93,254)
Other lines (d)	(42,400)	(49,840)	(77,617)
	<b>21,868</b>	<b>(23,957)</b>	<b>(194,145)</b>
Investment and other income (e)	255,891	206,861	293,611
	<b>277,759</b>	<b>182,904</b>	<b>99,466</b>
Annuities, life and health	87,335	61,553	100,864
Other (f)	(64,088)	(68,634)	(114,176)
	<b>\$ 301,006</b>	<b>\$ 175,823</b>	<b>\$ 86,154</b>

(a) Not allocable to sub-segments.

(b) Revenues include sales of products and services as well as other income earned by the respective segments.

(c) Investment income comprises approximately three-fifths of these revenues. Includes impairment charges of \$36.7 million, \$87.5 million and \$51.9 million in 2003, 2002 and 2001, respectively.

(d) Represents development of lines in "run-off" and includes a pretax charge of \$43.8 million in 2003 for an arbitration decision relating to a 1995 property claim from a discontinued business; AFG has ceased underwriting new business in these operations. Includes special charges of \$30 million in 2002 related to the A.P. Green settlement and \$69 million in 2001 related to asbestos and other environmental matters ("A&E").

(e) Includes a 2003 pretax charge of \$35.5 million related to the settlement of litigation.

(f) Includes holding company expenses.

# Notes to Consolidated Financial Statements *(continued)*

## D. Investments

Fixed maturities and other stocks classified as available-for-sale at December 31 consisted of the following (in millions):

	2003				2002			
	Amortized Cost	Market Value	Gross Unrealized Gains Losses		Amortized Cost	Market Value	Gross Unrealized Gains Losses	
Fixed maturities:								
United States Government and government agencies and authorities	\$ 1,392.6	\$ 1,411.8	\$ 24.4	(\$ 5.2)	\$ 1,353.6	\$ 1,402.0	\$ 49.5	(\$ 1.1)
States, municipalities and political subdivisions	943.7	970.0	28.5	(2.2)	584.4	615.2	36.4	(5.6)
Foreign government	146.3	150.0	4.2	(0.5)	163.3	169.9	6.6	—
Public utilities	1,011.4	1,068.8	61.7	(4.3)	1,038.9	1,058.3	43.4	(24.0)
Mortgage-backed securities	3,387.5	3,388.1	45.7	(45.1)	3,106.6	3,232.1	134.6	(9.1)
All other corporate	4,780.5	5,043.0	277.3	(14.8)	5,241.8	5,462.7	312.0	(91.1)
Redeemable preferred stocks	62.2	70.3	8.3	(0.2)	61.1	66.7	7.8	(2.2)
	\$11,724.2	\$12,102.0	\$450.1	(\$ 72.3)	\$11,549.7	\$12,006.9	\$590.3	(\$133.1)
Other stocks	\$ 258.5	\$ 454.9	\$197.5	(\$ 1.1)	\$ 174.6	\$ 300.4	\$130.5	(\$ 4.7)

The following table shows gross unrealized losses on fixed maturities and other stocks by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2003.

	Twelve Months or Less			More Than Twelve Month		
	Unrealized Loss	Market Value	Market as % of Cost	Unrealized Loss	Market Value	Market as % of Cost
Fixed maturities:						
United States Government and government agencies and authorities	(\$ 5.2)	\$ 316.4	98%	(\$ 0.0)	\$ 0.1	94%
States, municipalities and political subdivisions	(0.7)	94.6	99%	(1.5)	31.7	95%
Foreign government	(0.5)	42.6	99%	—	—	—%
Public utilities	(2.9)	80.7	97%	(1.4)	26.6	95%
Mortgage-backed securities	(44.1)	2,039.8	98%	(1.0)	10.9	92%
All other corporate	(6.6)	390.7	98%	(8.2)	117.6	94%
Redeemable preferred stocks	(0.2)	10.5	98%	—	—	—%
	(\$60.2)	\$2,975.3	98%	(\$12.1)	\$186.9	94%
Other stocks	(\$ 0.9)	\$ 36.9	98%	(\$ 0.2)	\$ 3.5	95%

The table below sets forth the scheduled maturities of fixed maturities based on market value as of December 31, 2003. Asset-backed securities and other securities with sinking funds are reported at average maturity. Data based on amortized cost is generally the same. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers. Mortgage-backed securities had an average life of approximately six years at December 31, 2003.

Maturity	
One year or less	2%
After one year through five years	24
After five years through ten years	34
After ten years	12
	72
Mortgage-backed securities	28
	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.

The only investment (other than U.S. Treasury Notes) which exceeds 10% of Shareholders' Equity is an equity investment in Provident Financial Group, Inc., having a market value of \$227 million and \$189 million at December 31, 2003 and 2002, respectively. See Note R – "Subsequent Event".



Realized gains (losses) and changes in unrealized appreciation (depreciation) on fixed maturity and equity security investments are summarized as follows (in thousands):

	Fixed Maturities	Equity Securities	Tax Effects	Total
<b>2003</b>				
Realized – Continuing operations	\$ 51,647	\$ 7,244	(\$ 20,514)	\$ 38,377
Realized – Discontinued operations	1,600	11	(564)	1,047
Change in Unrealized	(79,400)	70,600	3,000	(5,800)
<b>2002</b>				
Realized – Continuing operations	(61,614)	(17,354)	27,594	(51,374)
Realized – Discontinued operations	389	(500)	39	(72)
Change in Unrealized	301,900	(100)	(103,800)	198,000
<b>2001</b>				
Realized – Continuing operations	(15,990)	(8,786)	8,674	(16,102)
Realized – Discontinued operations	675	(39)	(223)	413
Change in Unrealized	139,000	(84,500)	(19,200)	35,300

Gross gains and losses on available-for-sale fixed maturity investment transactions included in the Statement of Cash Flows consisted of the following (in millions):

	2003	2002	2001
Gross Gains	\$152.2	\$155.3	\$108.9
Gross Losses	(\$ 99.0)	(\$216.5)	(\$124.2)

## E. Assets and Liabilities of Managed Investment Entity

AFG has an investment in, and acts as investment manager for, a CDO of which AFG has been determined to be the “primary beneficiary.” Under FIN 46, AFG is required to consolidate the CDO beginning December 31, 2003. The cumulative effect of this change in accounting was an increase in income of \$6.3 million.

Upon formation in 1999, the CDO issued securities in various senior and subordinate classes and the proceeds were invested in primarily floating rate, secured bank loans, and to a lesser extent, high yield bonds, all of which serve as collateral for the securities issued by the CDO. None of the collateral was purchased from AFG. Income from the CDO’s investments is used to service its debt and pay other operating expenses including management fees to AFG. AFG’s investment in this CDO is subordinate to the

senior classes (approximately 92% of the total securities) issued by the CDO. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, AFG’s class would bear losses first.

The assets (substantially all cash and investments carried at market as “trading securities”) of this managed investment entity are separately disclosed in the Consolidated Balance Sheet because they are not available for use to satisfy AFG obligations. Likewise, the CDO liabilities (substantially all debt) are separately disclosed because they represent claims against only the CDO’s assets and not against AFG’s other assets. Accordingly, AFG’s exposure to loss on this investment is limited to its investment (approximately \$11.5 million at December 31, 2003).

Beginning in 2004, the operating results of the CDO will be included in AFG’s Consolidated Statement of Earnings. However, due to the non-recourse nature of the instruments issued by the CDO, any excess losses included in AFG’s results that are not absorbed by AFG’s investment over the life of the CDO would ultimately reverse when the CDO is liquidated. Accordingly, while implementation of FIN 46 will impact the timing of income recognition, it will not impact the overall amount of income recognized over the life of this investment.

AFG is the investment manager and has an investment of \$6.3 million in another CDO (included in fixed maturities) at December 31, 2003, which is not required to be consolidated. This CDO was formed in 2000 and had approximately \$475 million in investments at December 31, 2003.

## F. Goodwill and Other Intangibles

Effective January 1, 2002, goodwill is no longer amortized but is subject to annual impairment testing. AFG completed its initial test in the fourth quarter of 2002 which resulted in a \$40.4 million (\$.59 per share, basic and diluted) impairment charge, net of tax, reported by restating first quarter 2002 results for the cumulative effect of a change in accounting principle. The impairment charge for the annuities and life insurance segment related to a decrease in estimated future earnings based upon lower forecasted new business sales over the next few years. The impairment charge for the personal lines segment related primarily to planned future reductions in new business volume written through the direct channel.

If the goodwill amortization of \$13.7 million (\$.20 per share, basic and diluted) in 2001 had not been expensed, net loss for the period would have been \$1.2 million (\$.02 per share).

## Notes to Consolidated Financial Statements *(continued)*

Changes in the carrying value of goodwill during 2002 and 2003, by reporting segment, are presented in the following table (in thousands):

	Property and Casualty		Annuities and Life	Total
	Specialty	Personal		
Balance December 31, 2001	\$150,999	\$117,391	\$40,404	\$308,794
Goodwill from acquisitions	—	—	1,461	1,461
Transitional impairment charge	—	(39,600)	(21,184)	(60,784)
Other	(788)	—	—	(788)
Balance December 31, 2002	150,211	77,791	20,681	248,683
Goodwill related to businesses sold	—	(77,791)	(645)	(78,436)
Other	—	—	(1,917)	(1,917)
Balance December 31, 2003	\$150,211	\$ —	\$18,119	\$168,330

Included in deferred acquisition costs in AFG's Balance Sheet are \$57.9 million and \$66.8 million at December 31, 2003 and 2002, respectively, representing the present value of future profits ("PVFP") related to acquisitions by AFG's annuity and life business. The PVFP amounts are net of \$65.8 million and \$57.3 million of accumulated amortization. Amortization of the PVFP was \$8.5 million in 2003, \$11.8 million in 2002 and \$9.2 million in 2001. During each of the next five years, the PVFP is expected to decrease at a rate of approximately 14% of the balance at the beginning of each respective year.

### G. Long-Term Debt

Long-term debt consisted of the following at December 31 (in thousands):

	2003	2002
<b>Holding Companies:</b>		
AFG 7-1/8% Senior Debentures due April 2009, less discount of \$1,349 and \$1,552 (imputed rate - 7.2%)	\$301,501	\$301,298
AFG 7-1/8% Senior Debentures due December 2007	75,100	79,600
AFG Senior Convertible Debentures due June 2033 (imputed rate - 4.0%)	189,857	—
Notes payable under bank line American Premier Underwriters, Inc. ("APU") 10-7/8% Subordinated Notes due May 2011, including premium of \$712 and \$777 (imputed rate - 9.6%)	11,433	11,498
Other	8,160	8,014
	<b>\$586,051</b>	<b>\$648,410</b>
<b>Subsidiaries:</b>		
GAFRI 6-7/8% Senior Notes due June 2008	\$100,000	\$100,000
GAFRI 7-1/2% Senior Debentures due November 2033	112,500	—
GAFRI notes payable under bank line	—	148,600
Notes payable secured by real estate	27,063	35,610
Other	11,248	12,561
	<b>\$250,811</b>	<b>\$296,771</b>

At December 31, 2003, sinking fund and other scheduled principal payments on debt for the subsequent five years were as follows (in millions):

	Holding Companies	Subsidiaries	Total
2004	\$ —	\$ 2.0	\$ 2.0
2005	—	11.2	11.2
2006	—	19.5	19.5
2007	80.3	.1	80.4
2008	—	100.1	100.1

In June 2003, AFG issued Senior Convertible Notes due in 2033 at an issue price of 37.153% of the principal amount due at maturity. AFG received \$189.9 million before issue costs of \$4.5 million. Interest is payable semiannually at a rate of 4% of issue price per year through June 2008, after which, interest at 4% annually will be accrued and added to the carrying value of the Notes. In addition, contingent cash interest will be paid if the average market price of a Note for an applicable five-day trading period equals 120% or more of the accreted value. The Notes are redeemable at AFG's option at any time on or after June 2, 2008, at prices ranging from \$371.53 per Note to \$1,000 per Note at maturity. Holders may require AFG to purchase all or a portion of their Notes on five year anniversaries beginning in 2008, at the accreted value. Generally, holders may convert each Note into 11.5016 shares of AFG Common Stock (i) if the average market price of AFG Common Stock to be received upon conversion exceeds 120% of the accreted value, (ii) if the credit rating of the Notes is significantly lowered, or (iii) if AFG calls the Notes for redemption.

In November 2003, GAFRI received approximately \$109 million from the sale of \$112.5 million principal amount of 7-1/2% senior debentures due 2033.

In December 2003, GAFRI entered into an interest rate swap, effectively converting \$40 million of its 6-7/8% fixed-rate Senior Notes to a floating rate of 3-month LIBOR plus 2.906% (about 4.1% at December 31, 2003).

In the first quarter of 2004, AFG issued \$115 million principal amount of 7-1/8% senior debentures due 2034 and GAFRI issued \$86.3 million principal amount of 7-1/4% senior debentures due 2034. Proceeds from both offerings were used to redeem at face value a portion of the outstanding trust preferred securities.

AFG may borrow up to \$280 million under its credit agreement. The line consists of two facilities: a 364-day revolving facility, extendable annually, for one-third of the total line and a three-year revolving facility for the remaining two-thirds with a final maturity in November 2005. Amounts borrowed bear interest at rates ranging

from 1.25% to 2.25% over LIBOR based on AFG's credit rating. In addition, GAFRI has an unsecured credit agreement under which it can borrow up to \$155 million at floating rates based on prime or Eurodollar rates through December 2004.

Cash interest payments of \$48 million, \$47 million and \$51 million were made on long-term debt in 2003, 2002 and 2001, respectively. Interest expense in the Statement of Operations includes interest credited on funds held by AFG's insurance subsidiaries under reinsurance contracts and other similar agreements as follows: 2003 – \$7.8 million; 2002 – \$11.7 million; and 2001 – \$7.1 million.

## H. Payable to Subsidiary Trusts (Issuers of Preferred Securities)

Wholly-owned subsidiary trusts of AFG and GAFRI have issued preferred securities and, in turn, purchased from their parent company a like amount of subordinated debt which provides interest and principal payments to fund the respective trusts' obligations. The preferred securities must be redeemed upon maturity or redemption of the subordinated debt. AFG and GAFRI effectively provide unconditional guarantees of their respective trusts' obligations.

In accordance with FIN 46, variable interest entities that issued preferred securities subsequent to January 31, 2003, are not consolidated for reporting purposes. Beginning December 31, 2003, previously consolidated subsidiary trusts were deconsolidated for reporting purposes under FIN 46. Accordingly, the subordinated debt due the trusts is shown as a liability in AFG's Balance Sheet instead of the preferred securities which were previously reported as minority interest. The preferred securities supported by the payable to subsidiary trusts consisted of the following at December 31, 2003 (in thousands):

Date of Issuance	Issue (Maturity Date)	Amount Outstanding	Optional Redemption Dates
October 1996	AFG 9-1/8% TOPrS (2026)	\$95,459	Currently redeemable
November 1996	GAFRI 9-1/4% TOPrS (2026)	65,013	Currently redeemable
March 1997	GAFRI 8-7/8% Pfd (2027)	70,000	On or after 3/1/2007
May 2003	GAFRI 7.35% Pfd (2033)	20,000	On or after 5/15/2008
May 2003	Variable Rate Pfd (2033)	15,000	On or after 5/23/2008

In May 2003, a GAFRI subsidiary and a 68%-owned subsidiary of GAI issued an aggregate of \$35 million in trust preferred securities maturing in 2033.

The AFG 9-1/8% trust preferred securities and the GAFRI 9-1/4% trust preferred securities were redeemed at face value in the first quarter of 2004.

## I. Minority Interest

Minority interest in AFG's balance sheet is comprised of the following (in thousands):

	2003	2002
Interest of noncontrolling shareholders in subsidiaries' common stock	\$180,937	\$157,207
Managed investment entity	6,622	—
Preferred securities issued by subsidiary trusts (a)	—	241,663
AFC preferred stock	—	72,154
	\$187,559	\$471,024

(a) See Note H – “Payable to Subsidiary Trusts.”

(b) Exchanged for 3.3 million shares of AFG Common Stock in November 2003.

## Minority Interest Expense

Minority interest expense is comprised of (in thousands):

	2003	2002	2001
Interest of noncontrolling shareholders in earnings of subsidiaries	\$16,470	\$6,096	\$11,366
Accrued distributions by consolidated subsidiaries on preferred securities:			
Trust issued securities, net of tax	14,151	14,281	16,932
AFC preferred stock	5,772	5,772	5,772
	\$36,393	\$26,149	\$34,070

## J. Shareholders' Equity

At December 31, 2003, the shares of AFG Common Stock outstanding included 1,361,711 shares held by American Premier, its subsidiary, for possible distribution to certain creditors and other claimants upon proper claim presentation and settlement pursuant to the 1978 plan of reorganization of its predecessor, The Penn Central Corporation. Shares being held for distribution are not eligible to vote, but otherwise are accounted for as issued and outstanding. 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.

In conjunction with the AFG/AFC merger, AFG issued 3.3 million shares of Common Stock in exchange for all of the outstanding shares of AFC Series J preferred stock in November 2003.

The Senior Convertible Notes issued in June 2003 could be converted under certain conditions into 5.9 million shares of AFG Common Stock.

## Notes to Consolidated Financial Statements *(continued)*

### Stock Options

At December 31, 2003, there were 9.7 million shares of AFG Common Stock reserved for issuance under AFG's Stock Option Plan. Options are granted with an exercise price equal to the market price of AFG Common Stock at the date of grant. Options generally become exercisable at the rate of 20% per year commencing one year after grant; those granted to non-employee directors of AFG are fully exercisable upon grant. Options generally expire ten years after the date of grant. Data for AFG's Stock Option Plan is presented below:

	2003		2002		2001	
	Shares	Average Exercise Price	Shares	Average Exercise Price	Shares	Average Exercise Price
Outstanding at beginning of year	6,982,562	\$27.58	6,089,131	\$27.91	6,452,496	\$27.86
Granted	956,250	\$18.54	1,056,750	\$25.78	20,500	\$26.22
Exercised	(35,000)	\$21.12	(28,837)	\$20.80	(65,335)	\$21.39
Forfeited	(188,156)	\$25.02	(134,482)	\$29.41	(318,530)	\$28.16
Outstanding at end of year	7,715,656	\$26.56	6,982,562	\$27.58	6,089,131	\$27.91
Options exercisable at year-end	5,404,330	\$28.51	4,560,210	\$29.01	3,818,305	\$29.23
Options available for grant at year-end	1,942,881		2,710,975		3,633,243	

The following table summarizes information about stock options outstanding at December 31, 2003:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Shares	Average Exercise Price	Average Remaining Life	Shares	Average Exercise Price
\$18.45 – \$20.00	2,626,891	\$19.34	7.4 years	1,147,441	\$19.79
\$20.01 – \$25.00	1,199,225	\$23.94	1.5 "	1,195,225	\$23.95
\$25.01 – \$30.00	1,235,614	\$25.93	7.2 "	536,414	\$26.09
\$30.01 – \$35.00	914,750	\$30.36	2.1 "	912,450	\$30.35
\$35.01 – \$40.00	1,462,676	\$36.81	4.3 "	1,336,300	\$36.91
\$40.01 – \$45.19	276,500	\$42.40	4.2 "	276,500	\$42.40

No compensation cost has been recognized for stock option grants. For information about the SFAS #123 "fair value" of options granted, see Note A – "Accounting Policies—Stock-based Compensation."

### Unrealized Gain (Loss) on Marketable Securities, Net

The change in unrealized gain (loss) on marketable securities included the following (in millions):

	Pretax	Tax Effects	Minority Interest	Net
<b>2003</b>				
Unrealized holding gains on securities arising during the period	\$ 86.5	(\$30.6)	\$ 1.0	\$ 56.9
Adoption of FIN 46	(2.1)	0.8	0.1	(1.2)
Transfer to Trading Securities	(16.1)	5.6	1.9	(8.6)
Realized gains included in net income and unrealized gains of subsidiary sold	(104.5)	36.7	(0.6)	(68.4)
Change in unrealized gain on marketable securities, net	(\$ 36.2)	\$12.5	\$ 2.4	(\$ 21.3)
<b>2002</b>				
Unrealized holding gains on securities arising during the period	\$195.7	(\$66.6)	(\$11.8)	\$117.3
Realized losses included in net income	79.1	(27.7)	(4.1)	47.3
Change in unrealized gain on marketable securities, net	\$274.8	(\$94.3)	(\$15.9)	\$164.6
<b>2001</b>				
Unrealized holding gains (losses) on securities arising during the period	\$ 0.8	(\$ 0.3)	(\$ 4.1)	(\$ 3.6)
Adoption of EITF 99-20	16.9	(6.0)	(0.9)	10.0
Realized losses included in net income and unrealized gains of subsidiary sold	23.6	(8.3)	(3.0)	12.3
Change in unrealized gain on marketable securities, net	\$ 41.3	(\$14.6)	(\$ 8.0)	\$ 18.7

## K. Income Taxes

The following is a reconciliation of income taxes at the statutory rate of 35% and income taxes as shown in the Statement of Operations (in thousands):

	2003	2002	2001
Earnings (loss) before income taxes:			
Operating	\$301,006	\$175,823	\$86,154
Minority interest expense	(44,013)	(33,839)	(43,187)
Equity in net earnings (losses) of investees	13,975	(13,830)	(25,462)
Discontinued operations	(51,795)	2,196	(30,256)
Accounting changes	6,300	(57,716)	(15,948)
<b>Total</b>	<b>\$225,473</b>	<b>\$ 72,634</b>	<b>(\$28,699)</b>
Income taxes at statutory rate	\$ 78,916	\$ 25,422	(\$10,045)
Effect of:			
Adjustment to prior year taxes	(143,500)	(33,192)	(6,317)
Minority interest	7,764	3,058	5,672
Tax exempt interest	(4,970)	(1,367)	(1,233)
Effect of foreign operations	(4,416)	(4,212)	(3,421)
Dividends received deduction	(2,539)	(2,313)	(2,317)
Amortization and writeoff of intangibles	907	3,711	4,526
Nondeductible meals, etc.	770	992	1,381
State income taxes	460	153	781
Losses utilized	—	(3,300)	(1,245)
Tax credits	—	—	(1,243)
Other	(1,734)	(958)	(398)
<b>Total Provision (Credit)</b>	<b>(68,342)</b>	<b>(12,006)</b>	<b>(13,859)</b>
Amounts applicable to:			
Minority interest expense	7,620	7,690	9,117
Equity in net (earnings) losses of investees	(4,891)	4,840	8,912
Discontinued operations	18,159	(763)	10,393
Accounting changes	—	17,356	5,908
Provision (credit) for income taxes as shown on the Statement of Operations	<b>(\$ 47,454)</b>	<b>\$ 17,117</b>	<b>\$20,471</b>

The AFG/AFC merger in November 2003 resulted in the elimination of \$170 million in deferred tax liabilities associated with AFC's holding of AFG stock. Of this amount, \$136 million had previously been recorded through charges to earnings in conjunction with AFC's accounting for AFG's predecessor under the equity method from 1980 through March 1995. The remaining \$34 million had previously been recorded through charges to capital surplus for the tax effect of AFG dividends paid to AFC from April 1995 through the end of 2002, during which time AFG and AFC were in separate tax groups.

Total earnings before income taxes include income subject to tax in foreign jurisdictions of \$21.7 million in 2003, \$17.8 million in 2002 and \$8.3 million in 2001.

The total income tax provision (credit) consists of (in thousands):

	2003	2002	2001
Current taxes:			
Federal	\$ 43,028	\$17,535	\$44,715
Foreign	3,115	2,293	—
State	707	236	1,201
Deferred taxes:			
Federal	(116,338)	(33,762)	(59,042)
Foreign	1,146	1,692	(733)
<b>Total</b>	<b>(\$ 68,342)</b>	<b>(\$12,006)</b>	<b>(\$13,859)</b>

For income tax purposes, AFG and certain members of its consolidated tax group had the following carryforwards available at December 31, 2003 (in millions):

	Expiring	Amount
Operating Loss	2005 – 2009	\$ 4
Operating Loss	2010 – 2019	51
Operating Loss	2020 – 2022	105
Capital Loss	2008	240
Other – Tax Credits		8

## Notes to Consolidated Financial Statements *(continued)*

Deferred income tax assets and liabilities reflect temporary differences between the carrying amounts of assets and liabilities recognized for financial reporting purposes and the amounts recognized for tax purposes. The significant components of deferred tax assets and liabilities included in the Balance Sheet at December 31, were as follows (in millions):

	2003	2002
Deferred tax assets:		
Net operating loss carryforwards	\$ 56.0	\$ 70.4
Capital loss carryforwards	86.0	—
Insurance claims and reserves	263.2	278.6
Other, net	112.8	108.8
	518.0	457.8
Valuation allowance for deferred tax assets	(50.0)	(34.9)
	468.0	422.9
Deferred tax liabilities:		
Deferred acquisition costs	(222.2)	(242.6)
Investment securities	(93.4)	(188.3)
	(315.6)	(430.9)
Net deferred tax asset (liability)	\$152.4	(\$ 8.0)

The gross deferred tax asset has been reduced by a valuation allowance based on an analysis of the likelihood of realization. Factors considered in assessing the need for a valuation allowance include: (i) recent tax returns, which show neither a history of large amounts of taxable income nor cumulative losses in recent years, (ii) opportunities to generate taxable income from sales of appreciated assets, and (iii) the likelihood of generating larger amounts of taxable income in the future. The likelihood of realizing this asset will be reviewed periodically; any adjustments required to the valuation allowance will be made in the period in which the developments on which they are based become known.

Cash payments for income taxes, net of refunds, were \$50.2 million, \$30.0 million and \$6.6 million for 2003, 2002 and 2001, respectively.

## L. Discontinued Operation

In the fourth quarter of 2003, AFG pursued a sale of Transport Insurance Company, an inactive property and casualty subsidiary with only run-off liabilities, including old asbestos and environmental claims. Transport's asbestos and environmental ("A&E") reserves represent approximately 12% of AFG's total A&E reserves. Although an agreement has not been finalized, management expects to complete a sale in 2004. In December, AFG recorded a \$55 million impairment charge to reduce its investment in Transport to estimated fair value, which was determined based on negotiations with potential buyers.

Transport's results are reflected as discontinued for all periods presented in the Statement of Operations; Balance Sheet amounts have not been reclassified. The carrying amount of the major classes of Transport's assets and liabilities and a summary of the discontinued operations follow (in millions):

	2003	2002	2001
<b>Assets:</b>			
Investment in fixed-maturity securities	\$ 70.8	\$ 74.5	
Amounts due from reinsurers and prepaid reinsurance premiums	59.3	62.8	
<b>Liabilities:</b>			
Unpaid losses and loss adjustment expenses	\$111.8	\$117.4	
<b>Operations:</b>			
Revenue	\$ 6.1	\$ 4.7	\$ 4.4
Pretax earnings (loss)	3.2	2.2	(30.3)
Provision (benefit) for income taxes	1.1	0.8	(10.4)
Earnings (loss) from discontinued operations	2.1	1.4	(19.9)
AFG's provision for impairment, net of tax	(35.7)	—	—
Discontinued operations	(\$ 33.6)	\$ 1.4	(\$19.9)

## M. Equity in Net Earnings (Losses) of Investees

From the date of the initial sale of 61% of Infinity in February 2003 through the date of the sale of its remaining interest in Infinity in December 2003, AFG accounted for its ownership interest in Infinity as an investee using the equity method. Equity in Infinity's net earnings during this period was \$12.2 million.

Equity in net earnings (losses) of investees for 2002 and 2001 represents AFG's share of the losses from two start-up manufacturing businesses that were formerly subsidiaries. One of these businesses was sold in December 2002; equity in the net loss of the remaining business was \$3.1 million in 2003.

## N. Commitments and Contingencies

Loss accruals (included in other liabilities) have been recorded for various environmental and occupational injury and disease claims and other contingencies arising out of the railroad operations disposed of by American Premier's predecessor, Penn Central Transportation Company ("PCTC"), prior to its bankruptcy reorganization in 1978 and certain manufacturing operations disposed of by American Premier.

At December 31, 2003, American Premier had liabilities for environmental and personal injury claims aggregating \$74.9 million. The environmental claims consist of a number of proceedings and claims seeking to impose responsibility for hazardous waste remediation costs related to certain sites formerly owned or operated by the railroad and manufacturing operations. Remediation costs are difficult to estimate for a number of reasons, including the number and financial resources of other potentially responsible parties, the range of costs for remediation alternatives, changing technology and the time period over which these matters develop. The personal injury claims include pending and expected claims, primarily by former employees of PCTC, for injury or disease allegedly caused by exposure to excessive noise, asbestos or other substances in the workplace. In December 2001, American Premier recorded a \$12.1 million charge to increase its

environmental reserves due to an increase in expected ultimate claim costs. At December 31, 2003, American Premier had \$8.8 million of offsetting recovery assets (included in other assets) for such environmental and personal injury claims based upon estimates of probable recoveries from insurance carriers.

AFG has accrued approximately \$6.2 million at December 31, 2003, for environmental costs and certain other matters associated with the sales of former operations.

AFG's insurance subsidiaries continue to receive claims related to environmental exposures, asbestos and other mass tort claims. Establishing reserves for these claims is subject to uncertainties that are significantly greater than those presented by other types of claims. The liability for asbestos and environmental reserves at December 31, 2003 and 2002, respectively, was \$515 million and \$572 million; related recoverables from reinsurers (net of allowances for doubtful accounts) at those dates were \$92 million and \$105 million, respectively. These amounts include the reserves (\$70 million) and reinsurance recoverables (\$18 million) of Transport Insurance Company, which AFG expects to sell in 2004.

While management believes AFG has recorded adequate reserves for the items discussed in this note, the outcome is uncertain and could result in liabilities exceeding amounts AFG has currently recorded. Additional amounts could have a material adverse effect on AFG's future results of operations and financial condition.

## O. Quarterly Operating Results (Unaudited)

The operations of certain of AFG's business segments are seasonal in nature. While insurance premiums are recognized on a relatively level basis, claim losses related to adverse weather (snow, hail, hurricanes, tornadoes, etc.) may be seasonal. Quarterly results necessarily rely heavily on estimates. These estimates and certain other factors, such as the nature of investees' operations and discretionary sales of assets, cause the quarterly results not to be necessarily indicative of results for longer periods of time.

## Notes to Consolidated Financial Statements *(continued)*

The following are quarterly results of consolidated operations for the two years ended December 31, 2003 (in millions, except per share amounts).

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total Year
<b>2003</b>					
Revenues	\$839.9	\$776.6	\$848.3	\$894.8	\$3,359.6
Earnings (loss) from:					
Continuing operations	24.8	29.9	41.2	225.2	321.1
Discontinued operations	.3	.6	.4	(34.9)	(33.6)
Cumulative effect of accounting change	—	—	—	6.3	6.3
Net earnings (loss)	25.1	30.5	41.6	196.6	293.8
Basic earnings (loss) per common share:					
Continuing operations	\$.36	\$.43	\$.59	\$3.10	\$4.53
Discontinued operations	—	.01	.01	(.49)	(.48)
Cumulative effect of accounting change	—	—	—	.09	.09
Net earnings (loss) available to Common Shares	\$.36	\$.44	\$.60	\$2.70	\$4.14
Diluted earnings (loss) per common share:					
Continuing operations	\$.36	\$.43	\$.58	\$3.08	\$4.51
Discontinued operations	—	.01	.01	(.49)	(.48)
Cumulative effect of accounting change	—	—	—	.09	.09
Net earnings (loss) available to Common Shares	\$.36	\$.44	\$.59	\$2.68	\$4.12
Average number of Common Shares:					
Basic	69.3	69.6	69.7	71.2	69.9
Diluted	69.4	69.9	70.0	71.7	70.3
<b>2002</b>					
Revenues	\$924.4	\$917.4	\$941.9	\$961.2	\$3,744.9
Earnings (loss) from:					
Continuing operations	42.1	11.5	26.2	43.8	123.6
Discontinued operations	(.3)	.6	.7	.4	1.4
Cumulative effect of accounting change	(40.4)	—	—	—	(40.4)
Net earnings	1.4	12.1	26.9	44.2	84.6
Basic earnings per common share:					
Continuing operations	\$.61	\$.17	\$.38	\$.63	\$1.80
Discontinued operations	—	.01	.01	.01	.02
Cumulative effect of accounting change	(.59)	—	—	—	(.59)
Net earnings available to Common Shares	\$.02	\$.18	\$.39	\$.64	\$1.23
Diluted earnings per common share:					
Continuing operations	\$.61	\$.16	\$.38	\$.63	\$1.79
Discontinued operations	—	.01	.01	.01	.02
Cumulative effect of accounting change	(.59)	—	—	—	(.59)
Net earnings available to Common Shares	\$.02	\$.17	\$.39	\$.64	\$1.22
Average number of Common Shares:					
Basic	68.6	68.7	68.9	69.0	68.8
Diluted	69.0	69.4	69.2	69.3	69.2

Quarterly earnings per share do not add to year-to-date amounts due to changes in shares outstanding.

Results for 2003 include (i) a \$5.5 million first quarter tax benefit related to AFG's investment in Infinity, (ii) a \$43.8 million second quarter charge for an arbitration decision relating to a 1995 property claim, (iii) a \$12.5 million second quarter charge related to the narrowing of spreads on GAFRI's fixed annuities, (iv) a \$35.5 million third quarter charge related to a litigation settlement, (v) a fourth quarter tax benefit of \$136 million related to the elimination of deferred taxes in connection with the AFG/AFC merger, and (vi) a fourth quarter \$55 million charge related to the planned sale of Transport Insurance Company (included in discontinued operations).

Results for 2002 include a \$16 million tax benefit in the first quarter and a \$15 million tax benefit in the fourth quarter resulting from the reduction of previously accrued amounts due to the resolution of certain tax matters. Fourth quarter 2002 results also include a \$30 million charge related to the settlement of asbestos-related litigation.

AFG has realized gains (losses) on sales of subsidiaries in recent years (see Note B). Realized gains (losses) on securities, affiliates and other investments amounted to (in millions):

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total Year
2003	(\$37.7)	\$25.3	\$21.8	\$69.3	\$78.7
2002	(17.4)	(47.7)	(24.9)	9.5	(80.5)



## P. Insurance

Securities owned by insurance subsidiaries having a carrying value of approximately \$900 million at December 31, 2003, were on deposit as required by regulatory authorities.

### Insurance Reserves

The liability for losses and loss adjustment expenses for long-term scheduled payments under certain workers' compensation insurance has been discounted at about 7%, an approximation of long-term investment yields. As a result, the total liability for losses and loss adjustment expenses at December 31, 2003, has been reduced by \$26 million.

The following table provides an analysis of changes in the liability for losses and loss adjustment expenses, net of reinsurance (and grossed up), over the past three years on a GAAP basis (in millions). Adverse development recorded in 2003, 2002 and 2001 in prior year reserves related primarily to charges for asbestos and certain Specialty lines in run-off.

	2003	2002	2001
Balance at beginning of period	\$3,400	\$3,253	\$3,192
Provision for losses and LAE occurring in the current year	1,203	1,664	1,950
Net increase (decrease) in provision for claims of prior years	167	171	163
Total losses and LAE incurred (*)	1,370	1,835	2,113
Payments for losses and LAE of:			
Current year	(389)	(594)	(831)
Prior years	(849)	(1,094)	(1,036)
Total payments	(1,238)	(1,688)	(1,867)
Reserves of businesses sold	(682)	—	(120)
Reclass to unearned premiums	—	—	(65)
Balance at end of period	\$2,850	\$3,400	\$3,253
Add back reinsurance recoverables, net of allowance	2,059	1,804	1,525
Gross unpaid losses and LAE included in the Balance Sheet	\$4,909	\$5,204	\$4,778

(\*) Before amortization of deferred gains on retroactive reinsurance of \$15 million in 2003, \$20 million in 2002 and \$33 million in 2001. Includes losses of Transport Insurance Company which have been reclassified to discontinued operations: 2003 – \$2 million; 2002 – \$2 million; and 2001 – \$33 million.

### Net Investment Income

The following table shows (in millions) investment income earned and investment expenses incurred by AFG's insurance companies.

	2003	2002	2001
Insurance group investment income:			
Fixed maturities	\$753.6	\$849.7	\$838.8
Equity securities	13.1	9.6	8.1
Other	.4	.6	1.1
	767.1	859.9	848.0
Insurance group investment expenses (*)	(39.7)	(40.3)	(36.7)
	\$727.4	\$819.6	\$811.3

(\*) Included primarily in "Other operating and general expenses" in the Statement of Operations.

### Statutory Information

AFG's insurance subsidiaries are required to file financial statements with state insurance regulatory authorities prepared on an accounting basis prescribed or permitted by such authorities (statutory basis). Net earnings and policyholders' surplus on a statutory basis for the insurance subsidiaries were as follows (in millions):

	Net Earnings (Loss)			Policyholders' Surplus	
	2003	2002	2001	2003	2002
Property and casualty companies	\$94	\$116	\$34	\$1,814	\$1,742
Life insurance companies	78	(24)	(25)	549	445

### Reinsurance

In the normal course of business, AFG's insurance subsidiaries cede reinsurance to other companies to diversify risk and limit maximum loss arising from large claims. To the extent that any reinsuring companies are unable to meet obligations under agreements covering reinsurance ceded, AFG's insurance subsidiaries would remain liable. The following table shows (in millions) (i) amounts deducted from property and casualty written and earned premiums in connection with reinsurance ceded, (ii) written and earned premiums included in income for reinsurance assumed and (iii) reinsurance recoveries deducted from losses and loss adjustment expenses.

## Notes to Consolidated Financial Statements *(continued)*

	2003	2002	2001
Direct premiums written	\$3,530	\$4,027	\$3,573
Reinsurance assumed	100	80	94
Reinsurance ceded	(1,618)	(1,693)	(1,114)
Net written premiums	\$2,012	\$2,414	\$2,553 <sup>(*)</sup>
Direct premiums earned	\$3,455	\$3,798	\$3,393
Reinsurance assumed	79	91	92
Reinsurance ceded	(1,625)	(1,486)	(891)
Net earned premiums	\$1,909	\$2,403	\$2,594
Reinsurance recoveries	\$1,124	\$1,142	\$ 773

(\*) Net of \$29.7 million unearned premium transfer related to the sale of the Japanese division.

### Q. Additional Information

Total rental expense for various leases of office space and equipment was \$38 million, \$52 million and \$53 million for 2003, 2002 and 2001, respectively. Sublease rental income related to these leases totaled \$612,000 in 2002 and \$2.4 million in 2001.

Future minimum rentals, related principally to office space, required under operating leases having initial or remaining noncancelable lease terms in excess of one year at December 31, 2003, were as follows: 2004 – \$36 million; 2005 – \$25 million; 2006 – \$22 million; 2007 – \$13 million; 2008 – \$8 million and \$13 million thereafter. In addition, AFG has 99-year land leases (approximately 93 years remaining) at one of its real estate properties. Minimum lease payments under these leases are expected to total approximately \$180,000 in 2004 and are adjusted annually for inflation.

Other operating and general expenses included charges for possible losses on agents' balances, other receivables and other assets in the following amounts: 2003 – \$1.3 million; 2002 – \$2.7 million; and 2001 – \$3.5 million. Losses and loss adjustment expenses included charges for possible losses on reinsurance recoverables of \$4.7 million in 2003 and \$6.6 million in 2002. The aggregate allowance for all such losses amounted to approximately \$84 million and \$89 million at December 31, 2003 and 2002, respectively.

### Unrealized Gain (Loss) on Marketable Securities, Net

In addition to adjusting equity securities and fixed maturity securities classified as "available for sale" to fair value, SFAS 115 requires that certain other balance sheet amounts be adjusted to the extent that unrealized gains and losses from securities would result in adjustments had those gains or losses actually been realized. The components of the Consolidated Balance Sheet caption "Unrealized gain on marketable securities, net" in shareholders' equity are summarized as follows (in millions):

2003	Unadjusted Asset (Liability)	Effect of SFAS 115	Adjusted Asset (Liability)
Fixed maturities – available-for-sale	\$11,724.2	\$377.8	\$12,102.0
Other stocks	258.5	196.4	454.9
Deferred acquisition costs	909.9	(58.7)	851.2
Annuity benefits accumulated	(6,965.7)	(8.9)	(6,974.6)
Pretax unrealized		506.6	
Deferred taxes	327.4	(175.0)	152.4
Minority interest	(158.6)	(29.0)	(187.6)
Unrealized gain		\$302.6	

### 2002

Fixed maturities – available-for-sale	\$11,549.7	\$457.2	\$12,006.9
Other stocks	174.6	125.8	300.4
Deferred acquisition costs	873.1	(31.0)	842.1
Annuity benefits accumulated	(6,444.7)	(9.2)	(6,453.9)
Pretax unrealized		542.8	
Deferred taxes	179.5	(187.5)	(8.0)
Minority interest	(439.6)	(31.4)	(471.0)
Unrealized gain		\$323.9	

### Fair Value of Financial Instruments

The following table presents (in millions) the carrying value and estimated fair value of AFG's financial instruments at December 31.

	2003		2002	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Assets:</b>				
Fixed maturities	\$12,297	\$12,297	\$12,007	\$12,007
Other stocks	455	455	300	300
<b>Liabilities:</b>				
Annuity benefits accumulated	\$ 6,975	\$ 6,781	\$ 6,454	\$ 6,284
Long-term debt:				
Holding companies	586	629	648	624
Subsidiaries	251	257	297	287
Payable to subsidiary trusts	265	271	N/A	N/A
<b>Minority Interest:</b>				
Trust preferred securities	N/A	N/A	\$ 242	\$ 238
AFC preferred stock	\$ —	\$ —	72	54
<b>Shareholders' Equity</b>	<b>\$ 2,076</b>	<b>\$ 1,933</b>	<b>\$ 1,726</b>	<b>\$ 1,595</b>

When available, fair values are based on prices quoted in the most active market for each security. If quoted prices are not available, fair value is estimated based on present values, discounted cash flows, fair value of comparable securities, or similar methods. The fair value of the liability for annuities in the payout phase is assumed to be the present value of the anticipated cash flows, discounted at current interest rates. Fair value of annuities in the accumulation phase is assumed to be the policyholders' cash surrender amount. Fair value of shareholders' equity is based on the quoted market price of AFG's Common Stock.

### *Financial Instruments with Off-Balance-Sheet Risk*

On occasion, AFG and its subsidiaries have entered into financial instrument transactions which may present off-balance-sheet risks of both a credit and market risk nature. These transactions include commitments to fund loans, loan guarantees and commitments to purchase and sell securities or loans. At December 31, 2003, AFG and its subsidiaries had commitments to fund credit facilities and contribute limited partnership capital totaling up to \$15 million.

### *Restrictions on Transfer of Funds and Assets of Subsidiaries*

Payments of dividends, loans and advances by AFG's subsidiaries are subject to various state laws, federal regulations and debt covenants which limit the amount of dividends, loans and advances that can be paid. Under applicable restrictions, the maximum amount of dividends available to AFG in 2004 from its insurance subsidiaries without seeking regulatory clearance is approximately \$181 million. Additional amounts of dividends, loans and advances require regulatory approval.

### *Benefit Plans*

AFG expensed approximately \$20 million in both 2003 and 2002 and \$19 million in 2001 for its retirement and employee savings plans.

### *Transactions With Affiliates*

AFG purchased a \$3.7 million minority interest in a residential homebuilding company from an unrelated party in 1995. At that same time, a brother of AFG's chairman purchased a minority interest in the company for \$825,000. In 2000, that brother and another brother of AFG's chairman acquired the remaining shares from the third parties. In addition, GAFRI had extended a line of credit to this company under which the homebuilder could borrow up to \$8 million at 13%. At December 31, 2001, \$6.4 million was due under the credit line. In September

2002, the homebuilding company was sold to an unrelated party for a gain of \$9.3 million (included in realized gains on other investments) and GAFRI's line of credit was repaid and terminated.

In 2001, an AFG subsidiary purchased a 29% interest in an aircraft for \$1.6 million (fair value as determined by independent third party) from a company owned by a brother of AFG's chairman. The remaining interests in the aircraft are owned by AFG's chairman and his two brothers. Costs of operating the aircraft are being borne proportionately.

In 2000, GAFRI received an \$18.9 million subordinated note in connection with the sale of its minority ownership interest in an ethanol company back to that company. Following the sale, AFG's Chairman beneficially owns 100% of the ethanol company. The note bore interest at 12-1/4% and was repaid as follows: \$6 million in 2001, \$1 million in 2002 and the remaining \$11.9 million in 2003. In December 2003, the ethanol company repaid a GAFRI subsidiary \$4.0 million under a subordinated note that bore interest at 14%. As of the end of 2003, AFG's only remaining interest in the ethanol company is Great American's \$10 million line of credit, under which no amounts have been borrowed.

In connection with the sale of the remaining shares of Infinity in December 2003, AFG paid Infinity \$13.5 million to commute a prior indemnification and cost reimbursement obligation. AFG purchased at fair value \$4.7 million in marketable securities from Infinity during 2003. During 2003, Infinity paid AFG \$9.0 million for rent, information technology, investment, accounting, legal, actuarial and other services. In 2003, Infinity repaid a \$55 million note due to AFG plus \$2.5 million in interest.

During 2003, AFG subsidiaries invested \$20 million in preferred stock and warrants of an unrelated party who utilized the proceeds to repay bank loans, including \$3.4 million in loans and fees to the Provident Bank. AFG's Chairman and members of his immediate family own approximately one-fourth of Provident's parent company; AFG owns 14% of the parent company.

## **R. Subsequent Event (Unaudited)**

In February 2004, Provident announced that it was being acquired by National City Corporation, one of the nation's largest banks. If this transaction is completed, AFG will receive 8.1 million shares (approximately \$290 million market value at March 1, 2004) of National City in exchange for its investment in Provident. Based on the March 1 price for National City, AFG would recognize an after-tax gain of approximately \$140 million on the sale.

# Corporate and Investor Information

## Board of Directors

**Carl H. Lindner** <sup>1\*</sup>

*Chairman of the Board and  
Chief Executive Officer,  
American Financial Group, Inc.*

**Carl H. Lindner III** <sup>1</sup>

*Co-President,  
American Financial Group, Inc.  
President,  
Great American Insurance Company.*

**S. Craig Lindner** <sup>1</sup>

*Co-President,  
American Financial Group, Inc.  
President and Chief Executive Officer,  
Great American Financial  
Resources, Inc.*

**Theodore H. Emmerich** <sup>2\*</sup>

*Retired Managing Partner,  
Ernst & Young LLP,  
certified public accountants,  
Cincinnati, Ohio.*

**James E. Evans**

*Senior Vice President and  
General Counsel,  
American Financial Group, Inc.*

**Terry S. Jacobs** <sup>2, 4</sup>

*Chairman of the Board,  
CEO and Treasurer,  
Regent Communications, Inc.,  
a broadcasting company*

**William R. Martin** <sup>2, 3\*</sup>

*retired Chairman of the Board,  
MB Computing, Inc.,  
a computer software and  
services company.*

**William A. Schutzer** <sup>3, 4</sup>

*Managing Director,  
Lehman Brothers,  
an investment bank*

**William W. Verity** <sup>3, 4\*</sup>

*President, Veritas Asset  
Management, LLC,  
an investment management company*

**Board of Directors Committees:**

1. Executive Committee
  2. Audit Committee
  3. Compensation Committee
  4. Governance Committee
- \* Chairman of Committee

## Corporate Management

**Carl H. Lindner**

*Chairman of the Board and  
Chief Executive Officer*

**S. Craig Lindner**

*Co-President*

**Carl H. Lindner III**

*Co-President*

**James E. Evans**

*Senior Vice President and  
General Counsel*

**Keith A. Jensen**

*Senior Vice President*

**Thomas E. Mischell**

*Senior Vice President – Taxation*

**Fred J. Runk**

*Senior Vice President and Treasurer*

**Kathleen J. Brown**

*Vice President – Taxation*

**Robert E. Dobbs**

*Vice President – Internal Audit*

**Sandra W. Heimann**

*Vice President*

**James C. Kennedy**

*Vice President, Deputy General Counsel  
and Secretary*

**Julie J. Murphy**

*Vice President –  
Chief Information Officer*

**Robert H. Ruffing**

*Vice President and Controller*

**Anne N. Watson**

*Vice President – Investor Relations*

## Corporate Offices

American Financial Group, Inc.  
One East Fourth Street  
Cincinnati, Ohio 45202  
(513) 579-2121

## Annual Shareholders' Meeting

The Annual Shareholders' Meeting is expected to be held at The Cincinnati Hotel in Cincinnati in May 2004. Notices will be mailed to all registered holders of the Company's voting stock.

American Financial Group is an equal opportunity employer.

## Common Stock Market Information

American Financial Group's Common Stock is traded on both the New York Stock Exchange ("NYSE") and the NASDAQ Stock Market, Inc. ("NASDAQ") under the symbol AFG. On March 1, 2004, approximately 13,300 holders of record own our shares.

The following table sets forth the high and low sales prices of AFG's Common Stock as reported on the NYSE Composite Tape.

	High	Low	Dividends Paid
<b>2003</b>			
First Quarter	24.21	18.00	0.125
Second Quarter	23.90	19.27	0.125
Third Quarter	23.77	21.27	0.125
Fourth Quarter	26.70	21.68	0.125
<b>2002</b>			
First Quarter	28.81	22.85	0.125
Second Quarter	30.30	22.51	0.125
Third Quarter	26.30	17.90	0.125
Fourth Quarter	24.80	20.82	0.125

## Dividend Reinvestment Plan

This plan allows registered shareholders of twenty-five or more shares of AFG Common Stock or AFC Preferred Stock to automatically reinvest their dividends towards the purchase (at a 4% discount) of additional AFG common shares. Dividend Reinvestment Plan information and enrollment forms may be obtained from the Company's Transfer Agent.

## Duplicate Mailings

Please call or write the Company if you wish to eliminate any duplicate mailing of this report or other Company materials.

## Forward-Looking Statements

This document contains certain forward-looking statements that are subject to numerous assumptions, risks or uncertainties. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. 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. Examples of such forward-looking statements include statements relating to: expectations concerning market and other conditions and their effect on future premiums, revenues, earnings and investment activities; recoverability of asset values; expected losses and the adequacy of reserves for asbestos, environmental pollution and mass tort claims; rate increases, and improved loss experience.

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

- changes in economic conditions, including interest rates, performance of securities markets, and the availability of capital;
- regulatory actions;
- changes in legal environment;
- tax law changes;
- levels of natural catastrophes, terrorist events, incidents of war and other major losses;
- the ultimate amount of liabilities associated with certain asbestos and environmental-related claims;
- the unpredictability of possible future litigation if certain settlements do not become effective;
- adequacy of insurance reserves;
- trends in mortality and morbidity;
- availability of reinsurance and ability of reinsurers to pay their obligations;
- competitive pressures, including the ability to obtain rate increases; and
- changes in debt and claims paying ratings.

The forward-looking statements herein are made only as of the date of this report. The Company assumes no obligation to publicly update any forward-looking statements.

## Transfer Agent for:

American Financial Group, Inc.;  
American Financial Corporation; and  
American Premier Underwriters, Inc.

c/o Securities Transfer Company  
One East Fourth Street, Suite 1201  
Cincinnati, Ohio 45202  
Telephone: (513) 579-2414  
or (800) 368-3417  
Fax: (513) 287-8270

## Additional Information

Investors or analysts requesting additional information, including copies of the American Financial Group, Inc. Form 10-K as filed with the Securities and Exchange Commission, may contact:

Investor Relations  
American Financial Group, Inc.  
One East Fourth Street  
Cincinnati, Ohio 45202  
(513) 579-6739

SEC filings, news releases, and other information may also be accessed free of charge on American Financial Group's Internet site at: <http://www.amfnl.com>



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