

GREAT AMERICAN FINANCIAL RESOURCES INC
Form 10-Q
November 08, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

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

For the Quarterly Period Ended
September 30, 2004

Commission File
No. 1-11632

GREAT AMERICAN FINANCIAL RESOURCES, INC.

Incorporated under
the Laws of Delaware

IRS Employer I.D.
No. 06-1356581

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

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

Indicate by check mark whether the Registrant is an accelerated filer. Yes No

As of November 1, 2004, there were 47,055,804 shares of the Registrant's Common Stock outstanding.

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GREAT AMERICAN FINANCIAL RESOURCES, INC.

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Exhibit 31(a)	Certification of the Chief Executive Officer Pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002	E-1
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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

PART I

FINANCIAL INFORMATION

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(Dollars in millions)

	September 30, <u>2004</u>	December 31, <u>2003</u>
Assets		
Investments:		
Fixed maturities:		
Available-for-sale - at market (amortized cost - \$8,304.5 and \$7,568.3)	\$ 8,630.9	\$ 7,845.2
Trading securities - at market	282.9	195.4
Equity securities - at market (cost - \$150.0 and \$45.9)	167.1	83.4
Mortgage loans on real estate	22.6	15.8
Real estate	107.8	79.4
Policy loans	248.7	215.6

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Short-term investments	<u>162.3</u>	<u>143.4</u>
Total investments	9,622.3	8,578.2
Cash	28.0	20.6
Accrued investment income	114.8	100.5
Unamortized insurance acquisition costs, net	698.8	614.2
Reinsurance recoverable	326.3	206.6
Other assets	102.2	105.8
Variable annuity assets (separate accounts)	<u>569.2</u>	<u>568.4</u>
	<u>\$11,461.6</u>	<u>\$10,194.3</u>
Liabilities and Capital		
Annuity benefits accumulated	\$ 8,015.5	\$ 6,974.6
Life, accident and health reserves	1,064.8	1,018.9
Notes payable	300.1	214.0
Payable to subsidiary trusts (issuers of preferred securities)	62.8	155.0
Payable to affiliates, net	115.1	94.2
Deferred taxes on unrealized gains	90.0	84.2
Accounts payable, accrued expenses and other liabilities	209.7	142.5
Variable annuity liabilities (separate accounts)	<u>569.2</u>	<u>568.4</u>
Total liabilities	10,427.2	9,251.8
Stockholders' Equity:		
Common Stock, \$1 par value		
-100,000,000 shares authorized		
-47,054,564 and 46,978,151 shares outstanding	47.1	47.0
Capital surplus	407.0	406.0
Retained earnings	406.2	326.9
Unrealized gains on marketable securities, net	<u>174.1</u>	<u>162.6</u>
Total stockholders' equity	<u>1,034.4</u>	<u>942.5</u>

\$11,461.6 \$10,194.3

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES
CONSOLIDATED INCOME STATEMENT

(In millions, except per share amounts)

	Three months ended		Nine months ended	
	<u>September 30.</u>		<u>September 30.</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Revenues:				
Life, accident and health premiums	\$ 86.0	\$ 83.9	\$263.8	\$246.6
Net investment income	135.4	127.1	394.2	382.2
Realized gains (losses) on:				
Investments	44.3	0.7	48.4	(11.2)
Goodwill impairment	(4.0)	-	(4.0)	-
Retirement of subsidiary trust debt	-	-	(1.3)	-
Other income	<u>34.8</u>	<u>26.9</u>	<u>80.8</u>	<u>65.6</u>
	296.5	238.6	781.9	683.2
Costs and Expenses:				
Annuity benefits	82.5	71.5	228.5	227.2
Life, accident and health benefits	63.9	63.0	199.2	185.4
Insurance acquisition expenses	29.5	27.4	92.3	87.0
Interest on subsidiary trust obligations	1.3	3.2	5.4	9.7
Other interest and debt expenses	5.1	3.0	15.2	8.5
Other expenses	<u>44.0</u>	<u>41.2</u>	<u>122.0</u>	<u>116.3</u>

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	<u>226.3</u>	<u>209.3</u>	<u>662.6</u>	<u>634.1</u>
Operating earnings before income taxes	70.2	29.3	119.3	49.1
Provision for income taxes	<u>22.9</u>	<u>9.4</u>	<u>37.8</u>	<u>13.9</u>
Income before accounting change	47.3	19.9	81.5	35.2
Cumulative effect of accounting change, net of tax	<u>-</u>	<u>-</u>	<u>(2.2)</u>	<u>-</u>
Net Income	<u>\$ 47.3</u>	<u>\$ 19.9</u>	<u>\$ 79.3</u>	<u>\$ 35.2</u>
Basic earnings per common share				
:				
Income before accounting change	\$ 1.00	\$ 0.46	\$ 1.73	\$ 0.82
Accounting change	<u>-</u>	<u>-</u>	<u>(0.05)</u>	<u>-</u>
Net income	<u>\$ 1.00</u>	<u>\$ 0.46</u>	<u>\$ 1.68</u>	<u>\$ 0.82</u>
Diluted earnings per common share				
:				
Income before accounting change	\$ 1.00	\$ 0.46	\$ 1.72	\$ 0.82
Accounting change	<u>-</u>	<u>-</u>	<u>(0.04)</u>	<u>-</u>
Net income	<u>\$ 1.00</u>	<u>\$ 0.46</u>	<u>\$ 1.68</u>	<u>\$ 0.82</u>
Average number of common shares:				
Basic	47.1	43.0	47.1	42.7

Diluted	47.2	43.0	47.3	42.7
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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
 GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES
 CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
 (In millions)

	Nine months ended <u>September 30.</u>	
	<u>2004</u>	<u>2003</u>
Common Stock:		
Balance at beginning of period	\$ 47.0	\$ 42.4
Common Stock issued	<u>0.1</u>	<u>4.5</u>
Balance at end of period	<u>\$ 47.1</u>	<u>\$ 46.9</u>
Capital Surplus:		
Balance at beginning of period	\$406.0	\$347.6
Common Stock issued	1.8	58.2
Common Stock retired	<u>(0.8)</u>	<u>(0.5)</u>
Balance at end of period	<u>\$407.0</u>	<u>\$405.3</u>
Retained Earnings:		
Balance at beginning of period	\$326.9	\$281.9
Net income	<u>79.3</u>	<u>35.2</u>

Balance at end of period	<u>\$406.2</u>	<u>\$317.1</u>
Unrealized Gains, Net:		
Balance at beginning of period	\$162.6	\$180.0
Change during period	<u>11.5</u>	<u>31.2</u>
Balance at end of period	<u>\$174.1</u>	<u>\$211.2</u>
<hr/>		
Comprehensive Income		
Net income	\$ 79.3	\$ 35.2
Other comprehensive income - change in net unrealized gains	<u>11.5</u>	<u>31.2</u>
Comprehensive income	<u>\$ 90.8</u>	<u>\$ 66.4</u>

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS
(In millions)

Nine months ended
September 30,

2004 2003

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Cash Flows from Operating Activities:

Net income	\$ 79.3	\$ 35.2
Adjustments:		
Cumulative effect of accounting change	2.2	-
Increase in life, accident and health reserves	48.0	62.5
Benefits to annuity policyholders	228.5	227.2
Amortization of insurance acquisition costs	68.1	65.7
Depreciation and amortization	19.8	14.6
Realized (gains) losses on investments	(48.4)	11.2
Net trading portfolio activity	(86.0)	0.8
Increase in insurance acquisition costs	(95.0)	(118.8)
Increase in reinsurance recoverable	(19.6)	(33.5)
Decrease (increase) in other assets	(2.1)	19.7
Increase (decrease) in other liabilities	8.1	(10.9)
Increase in payable to affiliates, net	20.2	33.0
Other, net	<u>9.1</u>	<u>9.6</u>
	<u>232.2</u>	<u>316.3</u>

Cash Flows from Investing Activities:

Purchases of and additional investments in:		
Fixed maturity investments	(2,078.0)	(4,059.4)
Equity securities	(62.3)	(12.1)
Real estate, mortgage loans and other assets	(40.8)	(6.9)
Maturities and redemptions of fixed maturity investments	621.4	952.7
Sales of:		
Fixed maturity investments	1,339.2	2,686.9
Equity securities	7.2	19.5
Real estate, mortgage loans and other assets	0.7	3.2
Cash and short-term investments of acquired (former) businesses, net	26.6	-
Increase in policy loans	<u>(2.5)</u>	<u>(0.4)</u>
))
	<u>(188.5)</u>	<u>(416.5)</u>
))

Cash Flows from Financing Activities:

Fixed annuity receipts	524.0	592.8
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Annuity surrenders, benefits and withdrawals	(534.3)	(417.6)
Net transfers from variable annuity assets	2.0	4.1
Additions to notes payable	83.5	8.0
Reductions of notes payable	(0.2)	(66.2)
Issuance of Common Stock	1.9	62.7
Retirement of Common Stock	(0.8)	(0.5)
Issuance of Trust Preferred Securities	-	19.4
Repurchase of Trust Preferred Securities	<u>(93.5)</u>	<u>-</u>
)	
	<u>(17.4)</u>	<u>202.7</u>
)	
Net Increase in cash and short-term investments	26.3	102.5
Beginning cash and short-term investments	<u>164.0</u>	<u>402.2</u>
Ending cash and short-term investments	<u>\$ 190.3</u>	<u>\$ 504.7</u>

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A. Description of the Company

Great American Financial Resources, Inc. ("GAFRI" or "the Company"), through its subsidiaries, markets fixed and variable annuities, and various forms of supplemental insurance and life products through independent agents, payroll deduction plans, financial institutions and in-home sales.

American Financial Group, Inc. ("AFG") and its subsidiaries owned 82% of GAFRI's Common Stock at November 1, 2004.

• Accounting Policies

Basis of Presentation

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

to be in conformity with generally accepted accounting principles.

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

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

Accounting Change

Statement of Position ("SOP") 03-1, "Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts" became effective on January 1, 2004. As discussed in the following policy notes, the SOP changes GAFRI's method of accounting for assets and liabilities related to two-tier annuities and persistency bonuses.

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 stockholders' equity. Fixed maturity securities classified as "trading" are reported at fair value with changes in unrealized gains or losses during the period included in investment income. Short-term investments are carried at cost; mortgage loans on real estate are generally carried at amortized cost; and policy loans are carried 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 differences between interest rates of 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.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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 GAFRI's balance sheet consist primarily of (i) the interest component of certain life reinsurance contracts (included in other liabilities), (ii) interest rate swaps (included in notes payable), (iii) the equity-based component of certain annuity products (included in annuity benefits accumulated) and (iv) related call options (included in other assets) designed to be consistent with the characteristics of the liabilities and used to mitigate the risk embedded in those annuity products. Changes in the fair value of derivatives

are included in current earnings.

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

Reinsurance

In the normal course of business, GAFRI's insurance subsidiaries cede reinsurance to other companies under various coinsurance agreements to diversify risk and limit maximum exposure. These transactions may also provide a source of additional capital and liquidity. GAFRI reviews the financial condition of its reinsurers and monitors the amount of reinsurance it has with each company.

GAFRI's insurance subsidiaries cede life insurance policies to a third party on a funds withheld basis whereby GAFRI retains the assets (securities) associated with the reinsurance contracts. Interest is credited to the reinsurer based on the actual investment performance (including realized gains and losses) of the retained assets. Effective October 1, 2003, the Company implemented Statement of Financial Accounting Standards ("SFAS") No. 133 Implementation Issue B36 ("B36"), "Embedded Derivatives in Reinsurance Contracts." 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 the change 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, the Company reclassified the securities related to these transactions from "available-for-sale" to "trading." The mark to market on the embedded derivatives offsets the investment income recorded on the mark to market of the related trading portfolios.

Insurance Acquisition Costs and Expenses

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

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

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs (principally commissions, advertising, underwriting, policy issuance and sales expenses that vary with and are primarily related to the production of new business) are deferred to the extent that such costs are deemed recoverable. Following the adoption of SOP 03-1, DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses.

DPAC related to annuities and universal life insurance products is deferred to the extent deemed recoverable and amortized, with interest, in relation to the present value of expected gross profits on the policies. These expected gross profits consist principally of estimated future net investment income and surrender, mortality and other life and variable annuity policy charges, less estimated future interest on policyholders' funds, policy administration expenses and death benefits in excess of account values. DPAC is reported net of unearned revenue relating to certain policy charges that represent compensation for future services. These unearned revenues are recognized as income using the same assumptions and factors used to amortize DPAC.

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 on marketable securities, net" in the stockholders' equity section of the Balance Sheet.

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

Life and health insurance contracts are reviewed periodically using actuarial assumptions revised based on actual and anticipated experience, to determine if there is a potential premium deficiency. If any such deficiency exists, it is recognized by a charge to income and a reduction in unamortized acquisition costs.

Present Value of Future Profits ("PVFP")

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

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

Annuity Benefits Accumulated

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

Following the adoption of SOP 03-1, reserves for two-tier annuities (annuities with different stated account values depending on whether a policyholder

annuitizes, dies or surrenders) are now recorded at the lower-tier value plus an additional reserve for accrued persistency and premium bonuses and an additional reserve for excess benefits expected to be paid on future deaths and annuitizations ("EDAR") that require payment of the upper-tier value. The liability for EDAR is accrued for and

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modified using assumptions consistent with those used in determining DPAC and DPAC amortization, except that accruals are in relation to the present value of total expected assessments. Total expected assessments consist primarily of investment margin, surrender charges, and unearned revenues once they are recognized as income.

Prior to the adoption of the SOP, reserves for two-tier annuities were generally recorded at the lower-tier value plus an EDAR reserve.

Reserves for traditional single-tier fixed annuities are generally recorded at the stated annuitization value.

Life, Accident and Health Reserves

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

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

Variable Annuity Assets and Liabilities

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

Variable annuity contracts contain a guaranteed minimum death benefit ("GMDB") to be paid if the policyholder dies before the annuity payout period commences. In periods of declining equity markets, the GMDB may exceed the value of the policyholder's account. A GMDB liability is established for future excess death benefits using assumptions together with a range of reasonably possible scenarios for investment fund performance that are consistent with DPAC capitalization and amortization assumptions. Prior to the adoption of SOP 03-1, death benefits in excess of the variable annuity account balances were expensed when paid.

Life, Accident and Health Premiums and Benefits

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

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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

Payable to Subsidiary Trusts (Issuers of Preferred Securities)

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Under revised Interpretation ("FIN") No. 46, "Consolidation of Variable Interest Entities" ("VIEs") issued by the Financial Accounting Standards Board ("FASB") in December 2003, GAFRI deconsolidated two wholly-owned subsidiary trusts because they are VIEs in which GAFRI 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. Implementation of FIN 46 with respect to the preferred securities had no effect on net earnings.

Income Taxes

GAFRI and Great American Life Insurance Company ("GALIC") have separate tax allocation agreements with American Financial Group, ("AFG"), which designate how tax payments are shared by members of the tax group. In general, both companies compute taxes on a separate return basis. GALIC is obligated to make payments to (or receive benefits from) AFG based on taxable income without regard to temporary differences. If GALIC's taxable income (computed on a statutory accounting basis) exceeds a current period net operating loss of GAFRI, the taxes payable or receivable by GALIC associated with the excess are payable to or receivable from AFG. If the AFG tax group utilizes any of GAFRI's net operating losses or deductions that originated prior to GAFRI's entering AFG's consolidated tax group, AFG will pay to GAFRI an amount equal to the benefit received. The tax allocation agreements with AFG have not impacted the recognition of income tax expense and income tax payable in GAFRI's financial statements.

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

Stock-Based Compensation

As permitted under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," GAFRI 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 GAFRI's employee and director stock option plans, options are granted 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. In March 2004, the FASB issued a proposal that would require GAFRI to recognize the fair value of employee stock options as compensation expense beginning in 2005. In October 2004, the FASB deferred the effective date of its proposed standard to periods beginning after June 15, 2005.

The following table illustrates the effect on net income (in millions) 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.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

For SFAS No. 123 purposes, the "fair value" of \$4.58 per option granted in the first nine months of 2004 and \$4.63 for the first nine months of 2003 was calculated using the Black-Scholes option pricing model and the following assumptions for both periods: expected dividend yield of less than 1%; expected volatility of 20%;

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risk-free interest rate of 3%; and expected option life of 7.5 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."

	<u>Three months ended</u>		<u>Nine months ended</u>	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Net income, as reported	\$47.3	\$19.9	\$79.3	\$35.2
Pro forma stock option expense, net of tax	<u>(0.5)</u>	<u>(0.4)</u>	<u>(1.3)</u>	<u>(1.2)</u>
))))
Adjusted net income	<u>\$46.8</u>	<u>\$19.5</u>	<u>\$78.0</u>	<u>\$34.0</u>
Earnings per share (as reported):				
Basic	\$1.00	\$0.46	\$1.68	\$0.82
Diluted	\$1.00	\$0.46	\$1.68	\$0.82
Earnings per share (adjusted):				
Basic	\$0.99	\$0.45	\$1.66	\$0.80
Diluted	\$0.99	\$0.45	\$1.65	\$0.80

Benefit Plans

GAFRI provides retirement benefits to qualified employees of participating companies through the GAFRI Retirement and Savings Plan, a defined contribution plan. GAFRI makes all contributions to the retirement fund portion of the Plan (at the discretion of the GAFRI Board of Directors) 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. Matching contributions to the savings fund are also invested in accordance with participant elections, while Company contributions to the retirement fund have been invested primarily in GAFRI Common Stock. Company contributions are expensed in the year for which they are declared.

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

Earnings Per Share

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

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following dilutive effect of common stock options (in millions): third quarter and first nine months of 2004 - 0.1 million shares and 0.2 million shares, respectively.

Statement of Cash Flows

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

three months or less when purchased are considered to be cash equivalents for purposes of the financial statements.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

C. Acquisition

On May 17, 2004, GAFRI acquired the fixed annuity block of National Health Insurance Company ("NHIC"). As of September 30, 2004 the block consisted of approximately 32,000 policies with GAAP reserves of approximately \$730 million.

D. Segments of Operations

GAFRI's life and annuity operations include fixed and variable annuity products and traditional life insurance products. GAFRI's annuity products are sold through managing general agents and independent agents to employees of primary and secondary educational institutions, hospitals and in the non-qualified market. Traditional term and universal life insurance products had been marketed through national marketing organizations. In the second quarter of 2004, GAFRI suspended new sales of these life insurance products due to inadequate volume and returns. The Company will continue to service its in-force block of these policies. The Company will also continue to sell life products through its supplemental insurance operations and GA Life of Puerto Rico (see below).

GAFRI's supplemental insurance businesses (United Teacher Associates Insurance Company ("UTA") and Loyal American Life Insurance Company) offer a variety of limited benefit policies to supplement primary health insurance and other insurance coverage. UTA offers its products through independent agents.

GA Life of Puerto Rico ("GAPR") sells in-home life and supplemental health products through a network of company-employed agents. Sales in Puerto Rico accounted for approximately 20% of GAFRI's life, accident and health premiums in the first nine months of 2004 and 2003, respectively.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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Corporate and other consists primarily of GAFRI (parent) and AAG Holding (intermediate holding company). The following table shows GAFRI's revenues and operating profit by significant business segment (in millions):

	Three months ended		Nine months ended	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
<u>Revenues</u>				
Life and annuity products	\$164.3	\$150.7	\$458.7	\$435.1
Supplemental insurance products	70.4	67.1	215.2	196.8
GA Life of Puerto Rico	20.4	19.3	60.8	57.2
Corporate and other	<u>1.1</u>	<u>0.8</u>	<u>4.1</u>	<u>5.3</u>
Total operating revenues	256.2	237.9	738.8	694.4
Realized gains (losses), including goodwill impairment	<u>40.3</u>	<u>0.7</u>	<u>43.1</u>	<u>(11.2)</u>
Total revenues per income statement	<u>\$296.5</u>	<u>\$238.6</u>	<u>\$781.9</u>	<u>\$683.2</u>
<u>Operating profit - pretax</u>				
Life and annuity products	\$ 26.1	\$ 28.7	\$ 71.7	\$ 57.6
Supplemental insurance products	7.1	5.7	19.3	16.8
GA Life of Puerto Rico	5.5	3.0	11.9	9.0
Corporate and other	<u>(8.8)</u>	<u>(8.8)</u>	<u>(26.7)</u>	<u>(23.1)</u>
Pretax earnings from operations	29.9	28.6	76.2	60.3
Realized gains (losses), including goodwill impairment	<u>40.3</u>	<u>0.7</u>	<u>43.1</u>	<u>(11.2)</u>
Total pretax income per income statement	<u>\$ 70.2</u>	<u>\$ 29.3</u>	<u>\$119.3</u>	<u>\$ 49.1</u>

E. Goodwill

Goodwill represents the excess of cost of subsidiaries over GAFRI's equity in their underlying net assets and is included in "Other assets." During the third quarter of 2004, GAFRI recorded a goodwill impairment charge of \$4.0 million related to a wholly-owned insurance agency subsidiary in the life and annuity segment. A review for impairment was prompted by a decrease in estimated future earnings from this agency based on a reduction in forecasted revenues. Fair value of the agency was estimated using the present value of expected future cash flows. After the write-down, goodwill on all segments at September 30, 2004, was \$14.0 million.

F. Unamortized Insurance Acquisition Costs

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

	September 30, <u>2004</u>	December 31, <u>2003</u>
Deferred policy acquisition costs ("DPAC")	\$816.7	\$738.7
Unrealized DPAC adjustment*	(68.3)	(58.7)
Present value of future profits acquired ("PVFP")	70.5	57.9
Unearned revenues	<u>(120.1)</u>	<u>(123.7)</u>
))
	<u>\$698.8</u>	<u>\$614.2</u>

*Reflects the change in DPAC assuming the unrealized gains on securities had actually been realized. (See Note B)

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Included in DPAC at September 30, 2004, are unamortized sales inducements of \$60.8 million. As a result of adopting SOP 03-1, unamortized insurance acquisition costs increased by \$50 million due to required balance sheet reclassifications. Included in PVFP at September 30, 2004 is a preliminary estimate of \$12.1 million relating to the May 2004 acquisition of the fixed annuity business of NHIC. The PVFP amounts in the table above are net of \$71.0 million and \$65.8 million of accumulated amortization at September 30, 2004 and December 31, 2003, respectively. Amortization of the PVFP was \$1.7 million in the third quarter of 2004 and \$5.2 million in the first nine months of 2004 compared to \$1.9 million in the third quarter of 2003 and \$6.2 million in the first nine months of 2003. 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. Notes Payable

Notes payable consisted of the following (in millions):

	September 30, <u>2004</u>	December 31, <u>2003</u>
Direct obligations of GAFRI	\$ 1.3	\$ 1.5
Obligations of AAG Holding (guaranteed by GAFRI):		
6-7/8% Senior Notes due 2008	100.0	100.0
7-1/2% Senior Debentures due 2033	112.5	112.5
7-1/4% Senior Debentures due 2034	<u>86.3</u>	<u>-</u>
 Total	 <u>\$300.1</u>	 <u>\$214.0</u>

In August 2004, AAG Holding replaced its existing bank credit agreement with a \$150 million, unsecured, four-year credit facility. Loans under this agreement will mature on August 28, 2008, (or February 26, 2008, if the Company's senior notes have not been effectively retired). At September 30, 2004, there were no borrowings outstanding under the agreement. Amounts borrowed will bear interest at rates ranging from 1% to 2% over LIBOR based on GAFRI's credit rating.

In the first quarter of 2004, the Company issued \$86.3 million principal amount of 7-1/4%, 30 year Senior Debentures, using the proceeds to redeem its 9-1/4% trust preferred securities at face value and to repurchase a portion of its outstanding 8-7/8% preferred securities. (See Note G)

GAFRI has entered into interest rate swaps, which effectively convert its 6-7/8% Senior Notes to a floating rate of 3-month LIBOR plus 2.9%.

At September 30, 2004, scheduled principal payments on debt for the remainder of 2004 and the subsequent five years were as follows (in millions):

<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
\$0.1	\$0.2	\$0.2	\$0.1	\$100.1	\$0.1

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

Wholly-owned subsidiary trusts of GAFRI have issued preferred securities and, in turn, purchased from their parent company a like amount of subordinated debt that provides interest and principal payments to fund the trusts' obligations. The preferred securities are mandatorily redeemable upon maturity or redemption of the subordinated debt. GAFRI effectively provides an unconditional guarantee of the trusts' obligations.

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

In accordance with revised Interpretation ("FIN") 46, variable interest entities that issued preferred securities subsequent to January 31, 2003, are not consolidated for financial reporting purposes. Beginning December 31, 2003, previously consolidated subsidiary trusts were deconsolidated for financial reporting purposes under FIN 46. Accordingly, the subordinated debt due the trusts is shown as a liability in GAFRI's balance sheet. The preferred securities supported by the payable to subsidiary trusts consisted of the following:

<u>Date of Issuance</u>	<u>Issue (Maturity Date)</u>	<u>Amount Outstanding</u>		<u>Optional Redemption Dates</u>
		<u>9/30/04</u>	<u>12/31/03</u>	
November 1996	9-1/4% TOPrS (2026)	-	\$65,012,500	Redeemed in March 2004
March 1997	8-7/8% Pfd (2027)	\$42,800,000	70,000,000	On or after 3/1/2007
May 2003	7.35% Pfd (2033)	20,000,000	20,000,000	On or after 5/15/2008

In the first quarter of 2004, GAFRI redeemed all of its 9-1/4% trust preferred securities at face value and repurchased \$27.2 million principal amount of its 8-7/8% preferred securities for \$28.5 million in cash, recognizing a pretax charge of \$1.3 million.

I. Stockholders' Equity

At September 30, 2004, there were 5.9 million shares of GAFRI Common Stock reserved for issuance under GAFRI's stock option plans for employees and directors. As of that date, options for 3.5 million shares were outstanding. Under these plans, the exercise price of each option equals the market price of GAFRI Common Stock at the date of grant. Options generally become exercisable at the rate of 20% per year commencing one year after grant. All options expire ten years after the date of grant.

The change in net unrealized gains on marketable securities for the nine months ended September 30 included the following (in millions):

	<u>2004</u>			<u>2003</u>		
	<u>Pretax</u>	<u>Taxes</u>	<u>Net</u>	<u>Pretax</u>	<u>Taxes</u>	<u>Net</u>
Unrealized holding gains on securities arising during the period	\$64.4	(\$22.2)	\$42.2	\$ 36.4	(\$12.5)	\$23.9
Realized (gains) losses on securities	<u>(47.1)</u>	<u>16.4</u>	<u>(30.7)</u>	<u>11.4</u>	<u>(4.1)</u>	<u>7.3</u>
))))))
Change in net unrealized gains on marketable securities	<u>\$17.3</u>	<u>(\$ 5.8)</u>	<u>\$11.5</u>	<u>\$ 47.8</u>	<u>(\$16.6)</u>	<u>\$31.2</u>

In September 2003, GAFRI raised approximately \$60 million through the sale of 4.3 million common shares in a rights offering. In the offering, AFG purchased 3.5 million shares and Carl H. Lindner, the Company's Chairman of the Board, purchased 0.4 million shares.

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

J. Contingencies

There have been no significant changes to the matters discussed and referred to in Note N "Contingencies" of GAFRI's Annual Report on Form 10-K for 2003.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

K. Additional Information

Statutory Information

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

	September 30, <u>2004</u>	December 31, <u>2003</u>
Capital and surplus	\$560.8	\$515.4
Asset valuation reserve	60.6	52.5
Interest maintenance reserve	20.1	21.5
	<u>Nine months ended September 30</u>	
	<u>2004</u>	<u>2003</u>
Pretax income from operations	\$63.6	\$51.9
Net income	51.2	19.6

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Dividends that can be paid by GAFRI's insurance subsidiaries without prior approval of regulatory authorities are subject to restrictions relating to capital and surplus and statutory net income. Based on these restrictions at December 31, 2003, GALIC and GAPR may pay \$56.5 million and \$32.9 million, respectively, in dividends in 2004 without prior approval. In the first nine months of 2004, GALIC paid dividends of \$53.0 million and GAPR paid a dividend of \$1.5 million to GAFRI. A portion of dividends from GAPR may be subject to federal income taxes.

For statutory purposes, the acquisition of the fixed annuity block of business of NHIC was recorded on April 1, 2004 as a reinsurance transaction under which NHIC paid GAFRI a negative ceding commission of \$38 million to assume the block of business.

Variable Annuities

At September 30, 2004 and December 31, 2003, the aggregate guaranteed minimum death benefit value (assuming every policyholder died on those dates) exceeded the market value of the underlying variable annuities by \$139 million and \$142 million, respectively. Death benefits paid in excess of the variable annuity account balances were \$0.9 million and \$1.1 million for the first nine months of 2004 and 2003, respectively.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Condensed Consolidating Information

GAFRI has guaranteed all of the outstanding debt of AAG Holding. Condensed consolidating financial statements for GAFRI are as follows:

CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

	GAFRI	AAG HOLDING	ALL OTHER SUBS	CONS ENTRIES	CONS
<u>SEPTEMBER 30, 2004</u>					
Assets					
Cash and investments	\$ 16.0	\$ -	\$ 9,634.3	\$ -	\$ 9,650.3
Investment in subsidiaries	967.0	1,311.5	10.9	(2,289.4)	-
Notes receivable from AAG Holding	104.4	-	-	(104.4)	-
Unamortized insurance acquisition costs, net	-	-	698.8	-	698.8
Other assets	20.2	8.7	470.5	43.9	543.3
Variable annuity assets (separate accounts)	<u>-</u>	<u>-</u>	<u>569.2</u>	<u>-</u>	<u>569.2</u>
	<u>\$1,107.6</u>	<u>\$1,320.2</u>	<u>\$11,383.7</u>	<u>(\$2,349.9)</u>	<u>\$11,461.6</u>

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Liabilities and Capital

Insurance liabilities	\$ -	\$ -	\$ 9,085.8	(\$ 5.5)	\$ 9,080.3
Notes payable to GAFRI	-	102.4	1.9	(104.3)	-
Other notes payable	1.3	298.8	-	-	300.1
Payable to subsidiary trusts	-	97.9	-	(35.1)	62.8
Other liabilities	71.9	12.2	331.4	(0.7)	414.8
Variable annuity liabilities (separate accounts)	<u>-</u>	<u>-</u>	<u>569.2</u>	<u>-</u>	<u>569.2</u>
	73.2	511.3	9,988.3	(145.6)	10,427.2
Total stockholders' equity	<u>1,034.4</u>	<u>808.9</u>	<u>1,395.4</u>	<u>(2,204.3)</u>	<u>1,034.4</u>
)		
	<u>\$1,107.6</u>	<u>\$1,320.2</u>	<u>\$11,383.7</u>	<u>(\$2,349.9)</u>	<u>\$11,461.6</u>

DECEMBER 31, 2003

Assets

Cash and investments	\$ 0.7	\$ -	\$ 8,599.3	(\$ 1.2)	\$ 8,598.8
Investment in subsidiaries	893.7	1,273.1	15.1	(2,181.9)	-
Notes receivable from AAG Holding	102.8	-	-	(102.8)	-
Unamortized insurance acquisition costs, net	-	-	614.2	-	614.2
Other assets	19.5	4.8	346.6	42.0	412.9
Variable annuity assets (separate accounts)	<u>-</u>	<u>-</u>	<u>568.4</u>	<u>-</u>	<u>568.4</u>
	<u>\$1,016.7</u>	<u>\$1,277.9</u>	<u>\$10,143.6</u>	<u>(\$2,243.9)</u>	<u>\$10,194.3</u>

Liabilities and Capital

Insurance liabilities	\$ -	\$ -	\$ 7,999.2	(\$ 5.7)	\$ 7,993.5
Notes payable to GAFRI	-	102.4	0.4	(102.8)	-
Other notes payable	1.5	212.5	-	-	214.0
Payable to subsidiary trusts	-	175.3	-	(20.3)	155.0
Other liabilities	72.7	18.3	232.7	(2.8)	320.9
Variable annuity liabilities (separate accounts)	<u>-</u>	<u>-</u>	<u>568.4</u>	<u>-</u>	<u>568.4</u>

	74.2	508.5	8,800.7	(131.6)	9,251.8
Total stockholders' equity	<u>942.5</u>	<u>769.4</u>	<u>1,342.9</u>	<u>(2,112.3)</u>	<u>942.5</u>
)		
	<u>\$1,016.7</u>	<u>\$1,277.9</u>	<u>\$10,143.6</u>	<u>(\$2,243.9)</u>	<u>\$10,194.3</u>

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

(In millions)

FOR THE THREE MONTHS ENDED	AAG		ALL	CONS	
<u>SEPTEMBER 30, 2004</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>OTHER</u>	<u>ENTRIES</u>	<u>CONS</u>
			<u>SUBS</u>		
Revenues					
:					
Life, accident and health premiums	\$ -	\$ -	\$ 86.0	\$ -	\$ 86.0
Net investment income and other revenue	7.3	-	206.1	(2.9)	210.5
Equity in earnings of subsidiaries	<u>65.3</u>	<u>70.8</u>	<u>-</u>	<u>(136.1)</u>	<u>-</u>
)		
	72.6	70.8	292.1	(139.0)	296.5
Costs and Expenses:					
Insurance benefits and expenses	-	-	175.9	-	175.9
Interest and debt expenses	-	9.6	-	(3.2)	6.4
Other expenses	<u>2.4</u>	<u>1.7</u>	<u>39.9</u>	<u>-</u>	<u>44.0</u>
)		
	<u>2.4</u>	<u>11.3</u>	<u>215.8</u>	<u>(3.2)</u>	<u>226.3</u>
)		

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Earnings before income taxes	70.2	59.5	76.3	(135.8)	70.2
Provision for income taxes	<u>22.9</u>	<u>21.0</u>	<u>24.9</u>	<u>(45.9)</u>	<u>22.9</u>
)	
Net income	<u>\$47.3</u>	<u>\$38.5</u>	<u>\$ 51.4</u>	<u>(\$ 89.9)</u>	<u>\$ 47.3</u>

FOR THE NINE MONTHS ENDED
SEPTEMBER 30, 2004

Revenues

:					
Life, accident and health premiums	\$ -	\$ -	\$263.8	\$ -	\$263.8
Net investment income and other revenue	17.7	-	509.9	(9.5)	518.1
Equity in earnings of subsidiaries	<u>108.5</u>	<u>131.2</u>	<u>-</u>	<u>(239.7)</u>	<u>-</u>
)	
	126.2	131.2	773.7	(249.2)	781.9

Costs and Expenses:

Insurance benefits and expenses	-	-	520.0	-	520.0
Interest and debt expenses	0.1	30.0	-	(9.5)	20.6
Other expenses	<u>6.8</u>	<u>5.1</u>	<u>110.1</u>	<u>-</u>	<u>122.0</u>
	<u>6.9</u>	<u>35.1</u>	<u>630.1</u>	<u>(9.5)</u>	<u>662.6</u>
)	

Earnings before income taxes	119.3	96.1	143.6	(239.7)	119.3
Provision for income taxes	<u>37.8</u>	<u>33.5</u>	<u>45.7</u>	<u>(79.2)</u>	<u>37.8</u>
)	

Income before accounting change	81.5	62.6	97.9	(160.5)	81.5
Accounting change, net	<u>(2.2)</u>	<u>-</u>	<u>(2.2)</u>	<u>2.2</u>	<u>(2.2)</u>
)	

)))

Net income	<u>\$ 79.3</u>	<u>\$ 62.6</u>	<u>\$ 95.7</u>	<u>(\$158.3)</u>	<u>\$ 79.3</u>
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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

CONDENSED CONSOLIDATING INCOME STATEMENT

(In millions)

FOR THE THREE MONTHS ENDED	AAG	CONS	ALL	CONS		
<u>SEPTEMBER 30, 2003</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>TRUSTS</u>	<u>OTHER</u>	<u>ENTRIES</u>	<u>CONS</u>
				<u>SUBS</u>		
Revenues						
:						
Life, accident and health premiums	\$ -	\$ -	\$ -	\$ 83.9	\$ -	\$ 83.9
Net investment income and other revenue	4.5	-	-	152.6	(2.4)	154.7
Interest income on AAG Holding notes	-	-	3.5	-	(3.5)	-
Equity in earnings of subsidiaries	<u>27.1</u>	<u>35.0</u>	<u>-</u>	<u>-</u>	<u>(62.1)</u>	<u>-</u>
)		
	31.6	35.0	3.5	236.5	(68.0)	238.6
Costs and Expenses:						
Insurance benefits and expenses	-	-	-	161.9	-	161.9
Interest expense (consolidated trusts)	-	3.5	-	-	(3.5)	-
Other interest and debt expenses	-	5.4	-	-	0.8	6.2
Other expenses	<u>2.3</u>	<u>1.9</u>	<u>-</u>	<u>37.1</u>	<u>(0.1)</u>	<u>41.2</u>
)		
	<u>2.3</u>	<u>10.8</u>	<u>-</u>	<u>199.0</u>	<u>(2.8)</u>	<u>209.3</u>
)		

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Earnings before income taxes	29.3	24.2	3.5	37.5	(65.2)	29.3
Provision for income taxes	<u>9.4</u>	<u>8.4</u>	<u>-</u>	<u>12.1</u>	<u>(20.5)</u>	<u>9.4</u>
)	
Net income	<u>\$19.9</u>	<u>\$15.8</u>	<u>\$3.5</u>	<u>\$ 25.4</u>	<u>(\$44.7)</u>	<u>\$ 19.9</u>

FOR THE NINE MONTHS ENDED
SEPTEMBER 30, 2003

Revenues

:						
Life, accident and health premiums	\$ -	\$ -	\$ -	\$246.6	\$ -	\$246.6
Net investment income and other revenue	15.0	-	-	429.9	(8.3)	436.6
Interest income on AAG Holding notes	-	-	10.5	-	(10.5)	-
Equity in earnings of subsidiaries	<u>40.1</u>	<u>63.1</u>	<u>-</u>	<u>-</u>	<u>(103.2)</u>	<u>-</u>
)	
	55.1	63.1	10.5	676.5	(122.0)	683.2

Costs and Expenses:

Insurance benefits and expenses	-	-	-	499.6	-	499.6
Interest expense (consolidated trusts)	-	10.5	-	-	(10.5)	-
Other interest and debt expenses	0.1	15.6	-	-	2.5	18.2
Other expenses	<u>5.9</u>	<u>5.4</u>	<u>-</u>	<u>106.7</u>	<u>(1.7)</u>	<u>116.3</u>
)	
	<u>6.0</u>	<u>31.5</u>	<u>-</u>	<u>606.3</u>	<u>(9.7)</u>	<u>634.1</u>
)	
Earnings before income taxes	49.1	31.6	10.5	70.2	(112.3)	49.1
Provision for income taxes	<u>13.9</u>	<u>10.5</u>	<u>-</u>	<u>20.7</u>	<u>(31.2)</u>	<u>13.9</u>
)	
Net income	<u>\$35.2</u>	<u>\$21.1</u>	<u>\$10.5</u>	<u>\$ 49.5</u>	<u>(\$ 81.1)</u>	<u>\$ 35.2</u>

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

(In millions)

FOR THE NINE MONTHS ENDED	AAG	ALL	CONS		
	HOLDING	OTHER	ENTRIES		
<u>SEPTEMBER 30, 2004</u>	<u>GAFRI</u>	<u>SUBS</u>	<u>ENTRIES</u>		<u>CONS</u>
Cash Flows from Operating Activities:					
Net income	\$ 79.3	\$ 62.6	\$ 95.7	(\$158.3)	\$ 79.3
Adjustments:					
Cumulative effect of accounting change	2.2	-	2.2	(2.2)	2.2
Equity in net earnings of subsidiaries and affiliates	(72.3)	(86.0)	-	158.3	-
Increase in life, accident and health reserves	-	-	48.0	-	48.0
Benefits to annuity policyholders	-	-	228.5	-	228.5
Amortization of insurance acquisition costs	-	-	68.1	-	68.1
Depreciation and amortization	-	2.1	17.7	-	19.8
Realized gains on investments	(0.4)	-	(48.0)	-	(48.4)
Net trading portfolio activity	-	-	(86.0)	-	(86.0)
Increase in insurance acquisition costs	-	-	(95.0)	-	(95.0)
Increase in reinsurance recoverable	-	-	(19.6)	-	(19.6)
Decrease (increase) in other assets	(2.6)	(3.9)	4.4	-	(2.1)
Increase (decrease) in other liabilities	(4.9)	(1.4)	14.4	-	8.1
Increase (decrease) in payable to affiliates, net	4.1	(4.7)	20.8	-	20.2
Capital contribution from parent (to subsidiary)	(119.2)	119.2	-	-	-
Dividends from subsidiaries(to parent)	151.9	(97.4)	(54.5)	-	-
Other, net	<u>(1.2)</u>	<u>1.0</u>	<u>7.1</u>	<u>2.2</u>	<u>9.1</u>
)	<u>36.9</u>	<u>(8.5)</u>	<u>203.8</u>	<u>-</u>	<u>232.2</u>

)

Cash Flows from Investing Activities:

Purchases of investments and other assets	(23.2)	-	(2,186.4)	28.5	(2,181.1)
Maturities and redemptions of fixed maturity investments	-	-	621.4	-	621.4
Sales of investments and other assets	1.0	-	1,356.1	(10.0)	1,347.1
Cash and short-term investments of acquired (former) businesses, net	-	-	26.6	-	26.6
Increase in policy loans	<u>-</u>	<u>-</u>	<u>(2.5)</u>	<u>-</u>	<u>(2.5)</u>
))	
	<u>(22.2)</u>	<u>-</u>	<u>(184.8)</u>	<u>18.5</u>	<u>(188.5)</u>
)))))

Cash Flows from Financing Activities:

Fixed annuity receipts	-	-	524.0	-	524.0
Annuity surrenders, benefits and withdrawals	-	-	(534.3)	-	(534.3)
Net transfers from variable annuity assets	-	-	2.0	-	2.0
Additions to notes payable	-	83.5	-	-	83.5
Reductions of notes payable	(0.2)	-	-	-	(0.2)
Issuance of Common Stock	1.9	-	-	-	1.9
Retirement of Common Stock	(0.8)	-	-	-	(0.8)
Repurchase of Trust Preferred Securities	<u>-</u>	<u>(75.0)</u>	<u>-</u>	<u>(18.5)</u>	<u>(93.5)</u>
)))))
	<u>0.9</u>	<u>8.5</u>	<u>(8.3)</u>	<u>(18.5)</u>	<u>(17.4)</u>
)))))

Net increase in cash and short-term investments

15.6 - 10.7 - 26.3

Beginning cash and short-term investments

0.4 - 163.6 - 164.0

Ending cash and short-term investments

\$ 16.0 \$ - \$ 174.3 \$ - \$ 190.3

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

(In millions)

FOR THE NINE MONTHS ENDED	AAG	CONS	ALL	CONS		
			OTHER	ENTRIES		
<u>SEPTEMBER 30, 2003</u>	<u>GAFRI</u>	<u>HOLDING</u>	<u>TRUSTS</u>	<u>SUBS</u>	<u>ENTRIES</u>	<u>CONS</u>
Cash Flows from Operating Activities:						
Net income	\$35.2	\$21.1	\$10.5	\$ 49.5	(\$81.1)	\$ 35.2
Adjustments:						
Equity in net earnings of subsidiaries and affiliates	(29.4)	(42.4)	-	-	71.8	-
Increase in life, accident and health reserves	-	-	-	62.5	-	62.5
Benefits to annuity policyholders	-	-	-	227.2	-	227.2
Amortization of insurance acquisition costs	-	-	-	65.7	-	65.7
Depreciation and amortization	-	2.6	-	12.0	-	14.6
Realized losses on investments	0.1	-	-	11.1	-	11.2
Net trading portfolio activity	-	-	-	0.8	-	0.8
Increase in insurance acquisition costs	-	-	-	(118.8)	-	(118.8)
Increase in reinsurance recoverable	-	-	-	(33.5)	-	(33.5)
Decrease in other assets	5.5	-	-	14.2	-	19.7
Decrease in other liabilities	(5.9)	-	-	(5.0)	-	(10.9)
Increase in payable to affiliates, net	3.4	-	-	29.6	-	33.0
Capital contribution from parent (to subsidiary)	(95.6)	58.4	-	37.2	-	-
Dividends from subsidiaries (to parent)	28.0	(15.7)	-	(12.3)	-	-
Other, net	<u>0.1</u>	<u>14.6</u>	<u>-</u>	<u>(3.9)</u>	<u>(1.2)</u>	<u>9.6</u>
))		
	<u>(58.6)</u>	<u>38.6</u>	<u>10.5</u>	<u>336.3</u>	<u>(10.5)</u>	<u>316.3</u>
))))))

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Cash Flows from Investing Activities:

Purchases of investments and other assets	-	-	-	(4,078.4)	-	(4,078.4)
Maturities and redemptions of fixed maturity investments	-	-	-	952.7	-	952.7
Sales of investments and other assets	1.2	-	-	2,708.4	-	2,709.6
Decrease in policy loans	<u>-</u>	<u>-</u>	<u>-</u>	<u>(0.4)</u>	<u>-</u>	<u>(0.4)</u>
))	
	<u>1.2</u>	<u>-</u>	<u>-</u>	<u>(417.7)</u>	<u>-</u>	<u>(416.5)</u>
))	

Cash Flows from Financing Activities:

Fixed annuity receipts	-	-	-	592.8	-	592.8
Annuity surrenders, benefits and withdrawals	-	-	-	(417.6)	-	(417.6)
Net transfers from variable annuity assets	-	-	-	4.1	-	4.1
Additions to notes payable	-	8.0	-	-	-	8.0
Reductions of notes payable	(0.2)	(66.0)	-	-	-	(66.2)
Issuance of Common Stock	62.7	-	-	-	-	62.7
Retirement of Common Stock	(0.5)	-	-	-	-	(0.5)
Trust dividend requirements	-	-	(10.5)	-	10.5	-
Issuance of Trust Preferred Securities	<u>-</u>	<u>19.4</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>19.4</u>
	<u>62.0</u>	<u>(38.6)</u>	<u>(10.5)</u>	<u>179.3</u>	<u>10.5</u>	<u>202.7</u>

)

Net increase in cash and short-term investments

Net increase in cash and short-term investments	4.6	-	-	97.9	-	102.5
---	-----	---	---	------	---	-------

Beginning cash and short-term investments	<u>1.9</u>	<u>-</u>	<u>-</u>	<u>400.3</u>	<u>-</u>	<u>402.2</u>
---	------------	----------	----------	--------------	----------	--------------

Ending cash and short-term investments	<u>\$ 6.5</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 498.2</u>	<u>\$ -</u>	<u>\$ 504.7</u>
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Management's Discussion and Analysis

of Financial Condition and Results of OperationsIndex to MD&A

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FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. 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 relate to: expectations concerning market and other conditions and their effect on future premiums, revenues, earning and investment activities; recoverability of asset values; mortality and the adequacy of reserves for environmental pollution.

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

- changes in economic conditions, including interest rates, performance of securities markets, and the availability of capital;
- trends in mortality and morbidity;
- regulatory actions;
- changes in regulatory and legal environments;
- tax law changes;
- availability of reinsurance and ability of reinsurers to pay their obligations;
- competitive pressures; and
- changes in debt and claims paying ratings.

Forward-looking statements included in this Form 10-Q are made only as of the date of this report and under Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934; we do not have any

obligation to update any forward-looking statement to reflect subsequent events or circumstances.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

OVERVIEW

Financial Condition

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

As a result of earnings and certain capital transactions over the last twelve months, GAFRI has significantly strengthened its capital and liquidity. Since year-end 2002, GAFRI's stockholders' equity (excluding unrealized gains on fixed maturity investments) has grown more than \$180 million (27%) while debt has decreased \$30 million (8%).

Acquisition

In May 2004, GAFRI acquired the fixed annuity block of business written by National Health Insurance Company in a reinsurance transaction. In the acquisition, GAFRI was paid a negative ceding commission of \$38 million in addition to the reserves that were assumed.

Results of Operations

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

GAFRI's net income for the third quarter of 2004 was \$47.3 million (\$1.00 per diluted share) compared to \$19.9 million (\$0.46 per diluted share) for the same period in 2003. The increase reflects significantly higher realized gains and improved results in the life and supplemental insurance operations, partially offset by the impact of the continued low interest rate environment on GAFRI's fixed annuity operations.

GAFRI's net income for the first nine months of 2004 was \$79.3 million (\$1.68 per diluted share) compared to \$35.2 million (\$0.82 per diluted share) in the first nine months of 2003. GAFRI's nine month 2004 results reflect significantly higher realized gains and improved operating results in each of the Company's lines of business. These improvements were partially offset by higher interest expense. Results for the 2003 nine months include a pretax charge of \$12.5 million (\$8.1 million after-tax) related to the negative effect of lower investment yields on GAFRI's fixed annuity operations.

GAFRI's 2004 earnings per share amounts reflect the greater number of shares outstanding as a result of the Company's common stock rights offering in September 2003.

CRITICAL ACCOUNTING POLICIES

Significant accounting policies are described in Note B to the financial statements. The preparation of financial statements 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.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Management believes that the establishment of insurance reserves, the determination of "other than temporary" impairments on investments, the recoverability and carrying value of unamortized insurance acquisition costs and environmental reserves of GAFRI's former manufacturing operations, are the areas where the degree of judgement 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 in GAFRI's 2003 Form 10-K "Liquidity and Capital Resources - Uncertainties."

LIQUIDITY AND CAPITAL RESOURCES

Ratios

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

	September 30,	<u>December 31,</u>	
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Consolidated Debt	\$ 363	\$ 369	\$ 393
Stockholders' Equity	<u>872</u>	<u>805</u>	<u>689</u>
Total Capital	<u>\$1,235</u>	<u>\$1,174</u>	<u>\$1,082</u>

Consolidated Debt to Capital	29%	31%	36%
------------------------------	-----	-----	-----

The National Association of Insurance Commissioners' ("NAIC") risk-based capital ("RBC") formula determines the amount of capital that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired. At September 30, 2004, the capital ratio of GAFRI's principal insurance subsidiary was 6.5 times its authorized control level RBC.

Sources and Uses of Funds

To pay interest and principal on borrowings and other holding company costs, GAFRI (parent) and AAG Holding use primarily capital distributions from their directly-owned insurance subsidiaries, (Great American Life Insurance Company ("GALIC") and GA Life of Puerto Rico ("GAPR")), bank borrowings and cash and investments on hand. Capital distributions from GAFRI's insurance subsidiaries are subject to regulatory restrictions relating to statutory surplus and earnings. The maximum amount of dividends payable by GALIC and GAPR in 2004 without prior regulatory approval is \$56.5 million and \$32.9 million, respectively. In the first nine months of 2004, GALIC paid dividends of \$53.0 million and GAPR paid a dividend of \$1.5 million to GAFRI.

In August 2004, the Company replaced its existing credit agreement with a \$150 million credit facility. Loans under this credit facility mature on August 28, 2008 (or in February 2008 if the Company's senior notes due in June 2008 have not been effectively retired). Through November 1, 2004, there have been no borrowings under this new agreement. Amounts borrowed bear interest at rates ranging from 1% to 2% over LIBOR based on GAFRI's credit rating.

Almost 75% of the combined net proceeds from a \$60 million common stock rights offering in September 2003 and a \$112.5 million issuance of 30-year senior debentures in November 2003 were used to repay borrowings under GAFRI's previous bank credit agreement. The remaining proceeds were used to increase insurance subsidiary capital and for general corporate purposes.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

In January 2004, GAFRI raised approximately \$84 million through the issuance of 30-year senior debentures. The majority of the proceeds were used to retire higher costing trust preferred securities. Under a currently effective shelf registration, GAFRI can issue approximately \$50 million in additional equity or debt securities. All debentures issued by GAFRI are rated investment grade by three nationally recognized rating agencies.

In recent years, the Company has entered into several reinsurance transactions in connection with certain of its life and supplemental insurance operations. These transactions provided additional capital and liquidity and were entered into in the normal course of business in order to exit certain lines, fund an acquisition and transfer risk. The Company may enter into additional reinsurance transactions in the future.

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

Independent Ratings

The Company's principal insurance subsidiaries ("Insurance Companies") are rated by A.M. Best, Fitch and Standard & Poor's. Such ratings are generally based on items of concern to policyholders and agents and are not directed toward the protection of investors.

Following are the Company's insurance ratings as of September 30, 2004:

	<u>A.M. Best</u>	<u>Fitch</u>	<u>Standard & Poor's</u>
GALIC*	A (Excellent)	A+ (Strong)	A- (Strong)
AILIC	A (Excellent)	A+ (Strong)	A- (Strong)
Loyal	A (Excellent)	A+ (Strong)	Not rated
UTA	A- (Excellent)	Not rated	Not rated
GAPR	A (Excellent)	Not rated	Not rated

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

All of the above ratings carry a "stable" outlook. In evaluating a company, independent rating agencies review such factors as the company's: (i) capital adequacy; (ii) profitability; (iii) leverage and liquidity; (iv) book of business; (v) quality and estimated market value of assets; (vi) adequacy of policy reserves; (vii) experience and competency of management and (viii) operating profile.

Management believes that the ratings assigned by independent insurance rating agencies are important because agents and potential policyholders often use a company's rating as an initial screening device in considering annuity products. Management believes that (i) a rating in the "A" category by A.M. Best is necessary to successfully market tax-deferred annuities to public education employees and other not-for-profit groups and (ii) a rating in the "A" category by at least one rating agency is necessary to successfully compete in other annuity markets.

GAFRI's insurance entities also compete in markets other than the sale of tax-deferred annuities. Ratings are an important competitive factor; management believes that these entities can successfully compete in these markets with their respective ratings.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

GAFRI's operations could be materially and adversely affected by downgrades. In connection with recent reviews by independent rating agencies, management indicated that it intends to maintain lower ratios of debt to capital than it has in recent years and intends to maintain the capital of its significant insurance subsidiaries at levels currently indicated by the rating agencies as appropriate for the current ratings. Items that could adversely affect capital levels include (i) a sustained decrease in the stock market; (ii) a significant period of low interest rates and a resulting significant narrowing of annuity "spread" (the difference between earnings received by the Company on its investments less the amount credited to policyholders' annuity accounts); (iii) investment impairments; (iv) adverse mortality, and (v) higher than planned dividends paid due to liquidity needs by GAFRI and AAG Holding.

Investments

At September 30, 2004, GAFRI's investment portfolio contained \$8.6 billion in "Fixed maturities" classified as available-for-sale, which are carried at market value with unrealized gains and losses reported as a separate component of stockholders' equity on an after-tax basis. At September 30, 2004, GAFRI had pretax net unrealized gains of \$326 million on fixed maturities and \$17 million on equity securities.

GAFRI invests primarily in fixed income investments that, including loans and short-term investments, comprised 97% of its investment portfolio at September 30, 2004. GAFRI generally invests in securities having intermediate-term maturities with an objective of optimizing interest yields while maintaining an appropriate relationship of maturities between GAFRI's assets and expected liabilities.

The NAIC assigns quality ratings to publicly traded as well as privately placed securities. At September 30, 2004, 94% of GAFRI's fixed maturity portfolio was comprised of investment grade bonds (NAIC rating of "1" or "2"). Management believes that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

At September 30, 2004, GAFRI's mortgage-backed securities ("MBSs") portfolio represented approximately 30% of its investments. MBSs are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of the lower current rates. Due to the significant decline in the general level of interest rates, GAFRI 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. Partly as a result of this, the overall yield on GAFRI's fixed maturity portfolio dropped from 7.0% at January 1, 2003 to 6.1% at September 30, 2004.

More than 95% of GAFRI's MBSs are rated "AAA" with substantially all being investment grade quality. The market in which these securities trade is highly liquid. Aside from interest rate risk referred to above, GAFRI does not believe a material risk (relative to earnings or liquidity) is inherent in holding such investments.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Summarized information for the unrealized gains and losses recorded in GAFRI's balance sheet at September 30, 2004, is shown in the following table (dollars in millions). Approximately \$119 million of available-for-sale "Fixed Maturities" and \$5 million of "Equity Securities" had no unrealized gains or losses at September 30, 2004.

	Securities with Unrealized Gains	Securities with Unrealized Losses
<u>Available-for-sale Fixed Maturities</u>		
Market value of securities	\$6,936	\$1,576

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Amortized cost of securities	\$6,582	\$1,604
Gross unrealized gain (loss)	\$ 354	(\$ 28)
Market value as % of amortized cost	105%	98%
Number of security positions	1,334	179
Number individually exceeding \$2 million gain or loss	7	-
Concentration of gains (losses) by type or industry (exceeding 5% of unrealized):		
Banks, savings and credit institutions	\$ 63.7	(\$ 0.1)
Gas and electric services	47.4	(2.1)
Mortgage-backed securities	35.0	(16.4)
U.S. Government and government agencies	17.1	(2.2)
Percentage rated investment grade	94%	95%

Equity Securities

Market value of securities	\$ 156	\$ 6
Cost of securities	\$ 139	\$ 6
Gross unrealized gain (loss)	\$ 17	\$ -
Market value as % of cost	112%	100%

The table below sets forth the scheduled maturities of GAFRI's available-for-sale fixed maturity securities at September 30, 2004, 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.

<u>Maturity</u>	Securities with Unrealized Gains	Securities with Unrealized Losses
*	*	*
One year or less	2%	1%
After one year through five years	17	5
After five years through ten years	42	11
After ten years	<u>16</u>	<u>12</u>
	77	29
Mortgage-backed securities	<u>23</u>	<u>71</u>
	<u>100</u>	<u>100</u>
	%	%

*Excludes \$119 million of fixed maturities with no unrealized gains or losses.

GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

GAFRI realized aggregate losses of \$1.5 million during the first nine months of 2004 on \$10.9 million in sales of fixed maturity securities (2 issues/issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2003. Market values of both of the issues increased an aggregate of \$1.2 million from December 31 to date of sale.

Although GAFRI 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. None of the securities were sold out of a necessity to raise cash. GAFRI has the ability and intent to hold securities with unrealized losses at September 30, 2004, for a period of time sufficient to allow for a recovery in market value.

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

	Aggregate Market Value	Aggregate Unrealized Gain (Loss)	Market Value as % of Cost Basis
<u>Fixed Maturities at September 30, 2004</u>			
Securities with unrealized gains:			
Exceeding \$500,000 (220 issues):	\$2,473	\$202	108.9%
Less than \$500,000 (1,114 issues):	<u>4,463</u>	<u>152</u>	103.5%
	<u>\$6,936</u>	<u>\$354</u>	105.4%
Securities with unrealized losses:			
Exceeding \$500,000 (15 issues):	\$ 321	(\$ 12)	96.4%
Less than \$500,000 (164 issues):	<u>1,255</u>	<u>(16</u>	98.7%
)		
	<u>\$1,576</u>	<u>(\$ 28)</u>	98.3%

Equity Securities at September 30, 2004

Securities with unrealized gains:

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Exceeding \$500,000 (7 issues):	\$ 101	\$ 13	114.8%
Less than \$500,000 (34 issues):	<u>55</u>	<u>4</u>	107.8%
	<u>\$ 156</u>	<u>\$ 17</u>	112.2%
Securities with unrealized losses:			
	\$ -	\$ -	-
Exceeding \$500,000 (0 issues):	<u>6</u>	<u>-</u>	100.0%
Less than \$500,000 (4 issues):	<u>\$ 6</u>	<u>\$ -</u>	100.0%

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

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

	Aggregate Market <u>Value</u>	Aggregate Unrealized <u>Gain(Loss)</u>	Market Value as % of Cost <u>Basis</u>
Fixed Maturities with Unrealized <u>Losses at September 30, 2004</u>			
Investment grade with losses for:			
One year or less (122 issues)	\$1,108	(\$ 12)	98.9%

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Greater than one year (33 issues)	<u>395</u>	<u>(13)</u>	96.8%
)		
	<u>\$1,503</u>	<u>(\$ 25)</u>	98.4%

Non-investment grade with losses for:

One year or less (14 issues)	\$ 52	(\$ 2)	96.3%
Greater than one year (10 issues)	<u>21</u>	<u>(1)</u>	95.5%
)		
	<u>\$ 73</u>	<u>(\$ 3)</u>	96.1%

Equity Securities with Unrealized

Losses at September 30, 2004

One year or less (4 issues)	\$ 6	\$ -	100.0%
Greater than one year (0 issues)	<u>-</u>	<u>-</u>	-
	<u>\$ 6</u>	<u>\$ -</u>	100.0%

When a decline in the value of a specific investment is considered to be "other than temporary," a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are "other than temporary" requires judgment based on subjective as well as objective factors. A listing of factors considered and resources used is contained in the discussion of "Investments" under Management's Discussion and Analysis in GAFRI's 2003 Form 10-K.

Based on its analysis, management believes that (i) GAFRI will recover its cost basis in the securities with unrealized losses and (ii) GAFRI has the ability and intent to hold the securities until they mature or recover in value. 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 GAFRI's liquidity.

RESULTS OF OPERATIONS

General

Results of operations as shown in the accompanying financial statements are prepared in accordance with generally accepted accounting principles.

Operating earnings before income taxes increased \$40.9 million and \$70.2 million in the third quarter and first nine months of 2004 compared to the same periods in 2003.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

The increase in operating earnings for the third quarter and first nine months of 2004 primarily reflects GAFRI's \$41.5 million gain on its investment in Provident Financial Group related to that company's merger with National City Corporation, lower provisions for impairments on investments as well as improved results in GAFRI's life and supplemental insurance operations. These improved results were partially offset by the impact of the continued low interest rate environment on GAFRI's fixed annuity operations. Results for the 2003 nine months include a pretax charge to earnings of \$12.5 million related to the negative effect of lower investment yields on GAFRI's fixed annuity operations.

Retirement Products

The following table summarizes GAFRI's premiums for its retirement annuities (in millions).

	Three months ended		Nine months ended	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
<u>Annuity Premiums</u>				
Single premium fixed rate annuities	\$138	\$106	\$371	\$434
Flexible premium fixed rate annuities	35	36	130	130
Single premium variable annuities	9	15	26	40
Flexible premium variable annuities	<u>16</u>	<u>16</u>	<u>53</u>	<u>56</u>

\$198 \$173 \$580 \$660

Fixed annuity sales increased in the third quarter of 2004 compared to the same period in 2003 due primarily to an increase in the number of new agencies recruited to sell GAFRI's products. Fixed annuity sales decreased in the first nine months of 2004 compared to the same period in the prior year as the Company continues to maintain discipline in setting its commission and interest rates. This discipline resulted in slowed sales of single premium annuities beginning in the third quarter of 2003. The decrease in sales of variable annuities reflects the Company's decision to offer products with limited features, as well as the performance of the stock market.

Life, Accident and Health Premiums and Benefits

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

	Three months ended <u>September 30,</u>		Nine months ended <u>September 30,</u>	
<u>Premiums</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Supplemental insurance products	\$59	\$56	\$181	\$165
GA Life of Puerto Rico	17	16	52	49
Life products	<u>10</u>	<u>12</u>	<u>31</u>	<u>33</u>
	<u>\$86</u>	<u>\$84</u>	<u>\$264</u>	<u>\$247</u>
 <u>Benefits</u>				
Supplemental insurance products	\$46	\$43	\$140	\$127
GA Life of Puerto Rico	7	9	25	26
Life products	<u>11</u>	<u>11</u>	<u>34</u>	<u>32</u>
	<u>\$64</u>	<u>\$63</u>	<u>\$199</u>	<u>\$185</u>

The increase in premiums and benefits for the supplemental insurance products represents the addition of new distribution sources in 2003.

Beginning in the second quarter of 2004, GALIC's life division stopped issuing life insurance policies due to inadequate volume and returns. GAFRI will continue to service and accept renewal premiums on its in-force block of these policies. The Company will also continue to sell life products through its supplemental insurance operations and

GA Life of Puerto Rico.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Net Investment Income

Net investment income increased \$8.3 million (6%) and \$12.0 million (3%) in the third quarter and first nine months of 2004, respectively, compared to the same periods of 2003. An increase in average invested assets of approximately \$740 million (9%), due primarily to the acquisition of the National Health block of annuities, was partially offset by a lower yield on GAFRI's investment portfolio.

The yield on GAFRI's fixed maturity portfolio was approximately 6.1% at September 30, 2004 compared to approximately 7.0% at January 1, 2003. See "Management's Discussion and Analysis - Investments."

Realized Gains (Losses)

Investments

In July 2004, GAFRI received common and preferred shares equivalent to 1.7 million shares of National City Corporation in exchange for its ownership interest in Provident Financial Group and realized a \$41.5 million pretax gain on the transaction.

Realized gains (losses) on investments included provisions for other than temporary impairment on securities still held as follows: third quarter of 2004 and 2003 - \$2.8 million and \$4.7 million; nine months of 2004 and 2003 - \$10.8 million and \$38.6 million, respectively. Impairment charges in the first nine months of 2003 reflected primarily the downturn in the airline industry and writedowns of certain asset-backed securities.

Goodwill Impairment

Goodwill impairment reflects a third quarter 2004 pretax charge related to a wholly-owned insurance agency subsidiary. (See Note E.)

Retirement of Subsidiary Trust Debt

Loss on retirement of subsidiary trust debt reflects pretax losses on repurchases of \$27.2 million principal amount of the Company's 8-7/8% trust preferred securities in the first quarter of 2004.

Other Income

Other income increased \$7.9 million (29%) and \$15.2 million (23%) in the third quarter and first nine months of 2004 compared to the same periods in 2003 due primarily to (i) increased real estate revenues; (ii) increased surrender fee income on GAFRI's fixed annuity operations (including the National Health block acquired in May 2004); (iii) increased life policy charges and (iv) higher fees earned on GAFRI's variable annuity business due to higher average variable annuity asset balances.

Real Estate Operations

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

	Three months ended		Nine months ended	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Other income	\$20.3	\$16.5	\$38.2	\$33.0
Other expenses	14.3	10.8	31.8	26.6

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Management's Discussion and Analysis

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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 rate annuity products permit GAFRI to change the crediting rate at any time, subject to minimum interest rate guarantees (as determined by applicable law). Approximately one-half of GAFRI's annuity benefits accumulated relate to policies that have a minimum guarantee of 3%; the majority of the balance has a guarantee of 4%. In the fourth quarter of 2003, the Company began issuing products with guaranteed minimum crediting rates of less than 3% in states where required approvals have been received.

Annuity benefits in the third quarter and first nine months of 2004 compared to the same periods in 2003 reflect lower average crediting rates offset by higher annuity balances. Annuity benefits in 2003 include a second quarter charge of \$6.2 million related to the effect of lower investment yields.

Insurance Acquisition Expenses

Insurance acquisition expenses include amortization of DPAC as well as a portion of commissions on sales of insurance products. Insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired.

Included in the first nine months of 2003 is a second quarter DPAC write-off of \$6.3 million related to the negative effect of lower interest rates on GAFRI's fixed annuity operations. Excluding the write-off, insurance acquisition expenses increased \$2.1 million (8%) and \$11.6 million (14%) in the third quarter and first nine months of 2004 compared to the same 2003 periods. These increases relate primarily to higher average balances of unamortized insurance acquisition costs.

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.

Interest on Subsidiary Trust Obligations

The decrease in interest on subsidiary trust obligations in the third quarter and first nine months of 2004 compared to the same periods in 2003 reflects the Company's March 2004 redemption of its 9-1/4% TOPrS and the first quarter 2004 repurchases of \$27.2 million principal amount of its 8-7/8% preferred securities.

Other Interest and Debt Expenses

The increase in other interest and debt expenses in the third quarter and first nine months of 2004 compared to the same periods in 2003 reflects the first quarter 2004 issuance of 7-1/4% Senior Debentures and the paydown of lower interest rate bank debt with proceeds from a 7-1/2% Senior Debenture offering in the fourth quarter of 2003.

Other Expenses

Other expenses increased \$2.8 million (7%) and \$5.7 million (5%) in the third quarter and first nine months of 2004 compared to the same periods in 2003 due primarily to an increase in expenses from real estate operations.

Income Taxes

The provision for income taxes presented reflects the effects of non-taxable foreign operations.

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Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

Cumulative Effect of Accounting Change

In January 2004, GAFRI recorded an after-tax charge of \$2.2 million resulting from the implementation of SOP 03-1. The most significant effect to GAFRI is a change in accounting for assets and liabilities related to two-tier annuities and persistency bonuses. As a result of adopting the SOP, unamortized insurance acquisition costs increased by \$50 million and annuity benefits accumulated increased by \$54 million.

Proposed Standard on Equity

Compensation In March 2004, the FASB issued a proposed accounting standard that, if implemented, would require GAFRI to expense stock option grants beginning in 2005. In October 2004, the FASB delayed the effective date of the proposed standard to periods beginning after June 15, 2005. Currently, GAFRI accounts for stock option grants using the intrinsic value method as permitted under SFAS No. 123. Since options are granted at exercise prices equal to the fair value of the shares at the date of grant, no compensation expense is currently recognized. The effect of using the fair value method that is also permitted under SFAS No. 123 is discussed in Note B to the financial statements.

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Item 3

Quantitative and Qualitative Disclosure of Market Risk

Debt Securities

In January 2004, GAFRI issued Senior Debentures due in 2034 and redeemed all of its outstanding TOPrS and a portion of its 8-7/8% trust preferred securities. See Notes G and H for further discussion. In addition, in 2004 GAFRI entered into interest rate swaps, which effectively convert \$100 million of its senior notes into floating rate debt.

As of September 30, 2004, there were no other material changes to the information provided in GAFRI's Form 10-K for 2003 under the caption "Exposure to Market Risk" in Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 4

Evaluation of Disclosure Controls and Procedures

GAFRI's Chief Executive Officer and Chief Financial Officer, with the participation of management, have evaluated GAFRI's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rule 13a-14c) as of the end of the period covered by this report. Based on the evaluation, they concluded that the controls and procedures are effective. There have been no significant changes in GAFRI's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

PART II

OTHER INFORMATION

Item 2

Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

GAFRI made the following purchases of its \$1 par value common stock during the third quarter:

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid Per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs(a)</u>
<u>2004</u>				
July	43,300	\$14.94	43,300	245,074
August	6,700	\$14.96	6,700	238,374
September	-	-	-	-

(a) In September 1998, GAFRI's Board of Directors authorized the repurchase of 1.5 million shares with no expiration date.

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Item 6

Exhibits and Reports on Form 8-K

- Exhibits:

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

• Reports on Form 8-K:

<u>Date of Report</u>	<u>Items Reported</u>
July 28, 2004	Second Quarter 2004 Earnings Release
October 21, 2004	Third Quarter 2004 Earnings Release

Signature

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

GREAT AMERICAN FINANCIAL RESOURCES, INC.

November 8, 2004

BY: /s/Christopher P. Miliano

Christopher P. Miliano

Chief Financial Officer

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