

GREAT AMERICAN FINANCIAL RESOURCES INC  
Form 10-Q  
May 08, 2006

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SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

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

For the Quarterly Period Ended  
March 31, 2006

Commission File  
No. 1-11632

Incorporated under  
the Laws of Delaware

IRS Employer I.D.  
No. 06-1356481

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

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

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

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

As of May 1, 2006, there were 47,392,148 shares of the Registrant's Common Stock outstanding.

GREAT AMERICAN FINANCIAL RESOURCES, INC.

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

## PART I

## ITEM 1 - FINANCIAL STATEMENTS

## GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEET - (UNAUDITED)

(Dollars in millions)

|  | March 31,<br><u>2006</u> | December 31,<br><u>2005</u> |
|--|--------------------------|-----------------------------|
| Assets   |                          |                             |
| Investments:   |                          |                             |
| Fixed maturities:  |                          |                             |
| Available-for-sale - at fair value<br>(amortized cost - \$8,924.3 and \$8,825.9) | \$ 8,828.4               | \$ 8,930.1                  |
| Trading securities - at fair value   | 279.6                    | 271.9                       |
| Equity securities - at fair value<br>(cost - \$186.2 and \$185.7)                | 201.3                    | 191.4                       |
| Mortgage loans on real estate  | 50.2                     | 38.4                        |
| Real estate  | 115.1                    | 118.3                       |
| Policy loans   | 254.6                    | 258.7                       |
| Short-term investments   | <u>118.2</u>             | <u>132.6</u>                |
| <br>Total investments  | <br>9,847.4              | <br>9,941.4                 |
| Cash   | 10.6                     | 21.7                        |
| Accrued investment income  | 114.0                    | 117.6                       |
| Unamortized insurance acquisition costs  | 855.2                    | 835.9                       |
| Reinsurance recoverable  | 253.4                    | 257.3                       |
| Other assets   | 148.2                    | 104.6                       |
| Variable annuity assets (separate accounts)                                      | <u>673.4</u>             | <u>643.5</u>                |

|  |                       |                       |
|--|-----------------------|-----------------------|
|  | <u>\$11,902.2</u>     | <u>\$11,922.0</u>     |
| Liabilities and Capital                                  |                       |                       |
| Annuity benefits accumulated                             | \$ 8,706.2            | \$ 8,417.3            |
| Unearned revenue   | 117.2                 | 118.2                 |
| Life, accident and health reserves                       | 922.9                 | 1,088.0               |
| Long-term debt   | 286.9                 | 341.8                 |
| Payable to affiliates, net                               | 118.9                 | 119.9                 |
| Deferred taxes on unrealized gains (losses)              | (19.5)                | 31.0                  |
| Accounts payable, accrued expenses and other liabilities | 166.1                 | 155.6                 |
| Variable annuity liabilities (separate accounts)         | <u>673.4</u>          | <u>643.5</u>          |
| <br>   |                       |                       |
| Total liabilities  | 10,972.1              | 10,915.3              |
| Stockholders' Equity:                                    |                       |                       |
| Common Stock, \$1 par value                              |                       |                       |
| -100,000,000 shares authorized                           |                       |                       |
| -47,367,452 and 47,256,092 shares outstanding            | 47.4                  | 47.3                  |
| Capital surplus  | 411.3                 | 409.0                 |
| Retained earnings  | 507.8                 | 489.2                 |
| Unrealized gains(losses) on marketable securities, net   | <u>(36.4)</u>         | <u>61.2</u>           |
|  | )                     |                       |
| Total stockholders' equity                               | <u>930.1</u>          | <u>1,006.7</u>        |
|  | <br><u>\$11,902.2</u> | <br><u>\$11,922.0</u> |

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(In millions, except per share amounts)

|  | Three months ended<br><u>March 31,</u> |                |
|--|--|----------------|
|  | <u>2006</u>                            | <u>2005</u>    |
| Revenues:                              |  |                |
| Life, accident and health premiums     | \$ 76.5                                | \$ 73.6        |
| Net investment income                  | 147.9                                  | 141.0          |
| Realized gains (losses) on:            |  |                |
| Investments                            | 4.1                                    | (0.2)          |
| Retirement of debt                     | (3.7)                                  | -              |
| Other income                           | <u>26.1</u>                            | <u>25.6</u>    |
|  | 250.9                                  | 240.0          |
| Costs and Expenses:                    |  |                |
| Annuity benefits                       | 83.2                                   | 80.7           |
| Life, accident and health benefits     | 63.9                                   | 59.7           |
| Insurance acquisition expenses         | 31.5                                   | 30.4           |
| Interest and debt expenses             | 6.2                                    | 6.8            |
| Other expenses                         | <u>37.4</u>                            | <u>40.7</u>    |
|  | <u>222.2</u>                           | <u>218.3</u>   |
| Operating earnings before income taxes | 28.7                                   | 21.7           |
| Provision for income taxes             | <u>10.1</u>                            | <u>7.5</u>     |
| Income from continuing operations      | 18.6                                   | 14.2           |
| Discontinued operations, net of tax    | <u>-</u>                               | <u>3.6</u>     |
| Net Income                             | <u>\$ 18.6</u>                         | <u>\$ 17.8</u> |

Basic earnings per common share

|                         |  |                |                |
|-------------------------|--|----------------|----------------|
| :                       |  |                |                |
| Continuing operations   |  | \$ 0.39        | \$ 0.30        |
| Discontinued operations |  | <u>-</u>       | <u>0.08</u>    |
| Net income              |  | <u>\$ 0.39</u> | <u>\$ 0.38</u> |

Diluted earnings per common share

|                         |  |                |                |
|-------------------------|--|----------------|----------------|
| :                       |  |                |                |
| Continuing operations   |  | \$ 0.39        | \$ 0.30        |
| Discontinued operations |  | <u>-</u>       | <u>0.08</u>    |
| Net income              |  | <u>\$ 0.39</u> | <u>\$ 0.38</u> |

Average number of common shares:

|         |  |      |      |
|---------|--|------|------|
| Basic   |  | 47.3 | 47.1 |
| Diluted |  | 48.0 | 47.3 |

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY - (UNAUDITED)

(In millions)

Three months ended  
March 31,

2006                      2005

Common Stock:

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|                                |                |                |
|--------------------------------|----------------|----------------|
| Balance at beginning of period | \$ 47.3        | \$ 47.1        |
| Common Stock issued            | 0.1            | -              |
| Common Stock retired           | <u>-</u>       | <u>(0.1)</u>   |
|                                | )              |                |
| Balance at end of period       | <u>\$ 47.4</u> | <u>\$ 47.0</u> |

Capital Surplus:

|                                  |                |                |
|----------------------------------|----------------|----------------|
| Balance at beginning of period   | \$409.0        | \$407.1        |
| Common Stock issued              | 2.0            | 0.2            |
| Common Stock retired             | (0.4)          | (0.6)          |
| Agent stock option grants        | 0.2            | -              |
| Stock-based compensation expense | <u>0.5</u>     | <u>-</u>       |
|                                  | )              |                |
| Balance at end of period         | <u>\$411.3</u> | <u>\$406.7</u> |

Retained Earnings:

|                                |                |                |
|--------------------------------|----------------|----------------|
| Balance at beginning of period | \$489.2        | \$424.0        |
| Net income                     | <u>18.6</u>    | <u>17.8</u>    |
|                                | )              |                |
| Balance at end of period       | <u>\$507.8</u> | <u>\$441.8</u> |

Unrealized Gains (Losses), Net:

|                                |                  |                |
|--------------------------------|------------------|----------------|
| Balance at beginning of period | \$ 61.2          | \$190.9        |
| Change during period           | <u>(97.6)</u>    | <u>(84.9)</u>  |
|                                | )                | )              |
| Balance at end of period       | <u>(\$ 36.4)</u> | <u>\$106.0</u> |

|   |                  |                  |
|---|------------------|------------------|
| Comprehensive Loss  |                  |                  |
| Net income  | \$ 18.6          | \$ 17.8          |
| Other comprehensive income (loss) - change in net<br>unrealized gains (losses) on marketable securities | <u>(97.6)</u>    | <u>(84.9)</u>    |
|   | )                | )                |
| Comprehensive loss  | <u>(\$ 79.0)</u> | <u>(\$ 67.1)</u> |

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

(In millions)

|  | Three months ended<br><u>March 31,</u> |              |
|--|--|--------------|
|  | <u>2006</u>                            | <u>2005</u>  |
| Cash Flows from Operating Activities:          |  |              |
| Net income                                     | \$ 18.6                                | \$ 17.8      |
| Adjustments:                                   |  |              |
| Increase in life, accident and health reserves | 6.2                                    | 22.6         |
| Benefits to annuity policyholders              | 83.2                                   | 80.8         |
| Amortization of insurance acquisition costs    | 24.6                                   | 26.7         |
| Depreciation and amortization                  | 2.1                                    | 8.5          |
| Realized (gains) losses on investments         | (4.1)                                  | 0.6          |
| Realized loss on retirement of debt            | 3.7                                    | -            |
| Net trading portfolio activity                 | (14.1)                                 | 4.9          |
| Increase in insurance acquisition costs        | (27.3)                                 | (33.8)       |
| Decrease (increase) in reinsurance recoverable | 3.5                                    | (3.6)        |
| Increase in other assets                       | (5.8)                                  | (0.3)        |
| Increase (decrease) in other liabilities       | (2.7)                                  | 8.2          |
| Increase in payable to affiliates, net         | 10.1                                   | 4.8          |
| Other, net                                     | <u>(6.0)</u>                           | <u>(1.6)</u> |



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|   |                 |                            |
|---|-----------------|----------------------------|
|   | )               | )                          |
| Net cash provided by operating activities                   |                 | <u>92.0</u> <u>135.6</u>   |
| Cash Flows from Investing Activities:                       |                 |                            |
| Purchases of and additional investments in:                 |                 |                            |
| Fixed maturity investments                                  | (658.1)         | (946.3)                    |
| Equity securities   | (16.0)          | (31.1)                     |
| Real estate, mortgage loans and other assets                | (2.7)           | (0.9)                      |
| Cash and short-term investments of businesses acquired, net | 104.8           | -                          |
| Proceeds received from sale of GAPR, net                    | 27.2            | -                          |
| Maturities and redemptions of fixed maturity investments    | 151.2           | 156.0                      |
| Sales of:   |                 |                            |
| Fixed maturity investments                                  | 364.1           | 584.7                      |
| Equity securities   | 23.9            | 18.2                       |
| Real estate, mortgage loans and other assets                | 15.4            | 0.2                        |
| Increase in policy loans                                    | <u>(0.6)</u>    | <u>(0.1)</u>               |
|   | )               | )                          |
| Net cash provided by (used in) investing activities         |                 | <u>9.2</u> <u>(219.3)</u>  |
|   |                 | )                          |
| Cash Flows from Financing Activities:                       |                 |                            |
| Fixed annuity receipts                                      | 220.3           | 266.5                      |
| Annuity surrenders, benefits and withdrawals                | (294.3)         | (224.3)                    |
| Net transfers from variable annuity assets                  | 4.1             | 0.3                        |
| Additions to long-term debt                                 | 15.0            | -                          |
| Reductions of long-term debt                                | (73.4)          | -                          |
| Issuance of Common Stock                                    | 1.8             | 0.1                        |
| Retirement of Common Stock                                  | <u>(0.2)</u>    | <u>(0.6)</u>               |
|   | )               | )                          |
| Net cash provided by (used in) financing activities         |                 | <u>(126.7)</u> <u>42.0</u> |
|   | )               | )                          |
| Net decrease in cash and short-term investments             | (25.5)          | (41.7)                     |
| Beginning cash and short-term investments                   | <u>154.3</u>    | <u>170.2</u>               |
| Ending cash and short-term investments                      | <u>\$ 128.8</u> | <u>\$ 128.5</u>            |

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 through independent agents.

American Financial Group, Inc. ("AFG") and its subsidiaries owned 81% of GAFRI's Common Stock at May 1, 2006.

B.

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 ("GAAP").

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

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

**Investments**

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

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

## Derivatives

Derivatives included in GAFRI's Balance Sheet consist primarily of (i) the interest component of certain life reinsurance contracts (included in other liabilities), (ii) interest rate swaps (included in long-term debt), (iii) the equity-based component of certain annuity products (included in annuity 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 long-term debt in the Balance Sheet, the only effect on GAFRI's financial statements is that the interest expense on the hedged debt is recorded based on the variable rate.

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

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

## Goodwill

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

## Reinsurance

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

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

## Insurance Acquisition Costs and Expenses

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

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

Deferred Policy Acquisition Costs ("DPAC")

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

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

To the extent that realized gains and losses result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains. DPAC related to annuities is also adjusted, net of tax, for the change in amortization that would have been recorded if the unrealized gains (losses) from securities had actually been realized. This adjustment is included in "unrealized gains (losses) on marketable securities, net" in the 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.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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 payments for traditional life and health insurance products.

Annuity Benefits Accumulated

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

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

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

#### Unearned Revenue

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

#### Life, Accident and Health Reserves

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

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

#### Variable Annuity Assets and Liabilities

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

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

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

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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

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

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

#### Payable to Subsidiary Trusts

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

#### Income Taxes

Until December 31, 2005, GAFRI and its subsidiaries had separate tax allocation agreements with American Financial Group ("AFG") that designated how tax payments were to be shared by members of the tax group. In general, companies computed taxes on a separate return basis without regard to temporary differences. Payments to AFG by GAFRI's insurance subsidiaries were made on a statutory basis.

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

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

#### Stock-Based Compensation

Effective January 1, 2006, GAFRI implemented Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment" using the modified prospective method under which prior year amounts are not restated. Under SFAS No. 123(R), companies must recognize compensation expense for all new share-based awards (including employee stock options), and the nonvested portions of prior awards, based on their calculated "fair value" at the date of grant. Beginning in 2006, all share-based grants are recognized as compensation expense over the vesting period. GAFRI uses the Black-Scholes pricing model to measure the fair value of its stock options.

Prior to the implementation of SFAS No. 123(R), GAFRI accounted for stock options and other stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees." Under this method, no compensation expense for stock option grants was recognized because options are granted at exercise prices equal to the fair value of the shares at the dates of grant. See Note H - "Stockholders' Equity" for further information on stock options, including assumptions used in calculating fair value and pro forma earnings for the 2005 quarter.

## 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 following dilutive effect of common stock options: first quarter of 2006 - 0.7 million shares and first quarter of 2005 - 0.2 million shares.

## Statement of Cash Flows

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

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

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

#### C. Discontinued Operations

In January 2006, GAFRI sold Great American Life Assurance Company of Puerto Rico ("GA-PR") for \$37.5 million in cash to Triple-S Management Corporation, also of Puerto Rico. In connection with the sale, a \$7.5 million letter of credit was established to provide for potential liabilities. Prior to the sale, in December 2005, GA-PR reinsured approximately two-thirds of its in-force business with Triple-S for \$60 million. During 2005, primarily in the fourth quarter, GA-PR paid dividends totaling \$100 million to GAFRI.

GA-PR's results are reflected as discontinued for all periods presented in the Consolidated Income Statement; Balance Sheet amounts have not been reclassified and are only included in the 2005 period. The carrying amount of the major classes of GA-PR's assets and liabilities and a summary of the discontinued operations follow (in millions):

Assets:

12/31/05

|  |                |
|--|----------------|
| Cash and investments                             | \$207.7        |
| Unamortized insurance acquisition costs ("DPAC") | 21.8           |
| Liabilities:                                     |                |
| Insurance reserves                               | \$181.0        |
| Equity excluding unrealized gains                | \$ 39.4        |
| Operations:                                      | <u>3/31/05</u> |
| Premiums   | \$ 18.4        |
| Investment income                                | 2.9            |
| Realized losses                                  | (0.4)          |
| Pre-tax earnings                                 | \$ 3.4         |
| Benefit for income taxes                         | <u>0.2</u>     |
| Net earnings from discontinued operations        | <u>\$ 3.6</u>  |

In January 2006, GAFRI recognized an additional pre-tax loss of \$0.5 million, offsetting a like amount of GA-PR earnings recorded prior to the sale.

D. Acquisition

In January 2006, GALIC acquired, through a reinsurance transaction, the fixed annuity block written by Old Standard Life Insurance Company. As part of the assets received in the reinsurance transaction, GALIC also acquired the stock of Old West Annuity and Life Insurance Company. In total, the transaction resulted in an increase of approximately \$280 million in both annuity benefits accumulated and cash and investments,



including a payment from the seller (negative ceding commission) of approximately \$9 million.

E. Segments of Operations

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

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

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

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 continues to service its in-force block of these policies.

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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

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

|                                   | Three months ended<br><u>March 31,</u> |             |
|-----------------------------------|--|-------------|
|                                   | <u>2006</u>                            | <u>2005</u> |
| <u>Revenues</u>                   |  |             |
| Fixed annuity operations          | \$131.6                                | \$126.8     |
| Variable annuity operations       | 5.9                                    | 5.9         |
| Real estate operations (1)        | <u>11.8</u>                            | <u>11.9</u> |
| <br>                              |  |             |
| Total annuity operations          | 149.3                                  | 144.6       |
| <br>                              |  |             |
| Supplemental insurance operations | 79.6                                   | 74.2        |
| Life operations                   | 18.5                                   | 19.0        |

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|  |                |                |
|--|----------------|----------------|
| Corporate and other  | <u>3.1</u>     | <u>2.4</u>     |
| Total operating revenues   | 250.5          | 240.2          |
| Realized gains (losses)  | <u>0.4</u>     | <u>(0.2)</u>   |
|  | )              |                |
| Total revenues per income statement                                  | <u>\$250.9</u> | <u>\$240.0</u> |
| <br>   |                |                |
| <u>Operating profit - pre-tax</u>                                    |                |                |
| Fixed annuity operations   | \$ 28.1        | \$ 25.0        |
| Variable annuity operations  | 0.8            | 0.8            |
| Real estate operations (1):  |                |                |
| Operating cash flow (1)  | 0.8            | 2.5            |
| Depreciation   | (1.4)          | (1.7)          |
| Other (2)  | <u>4.6</u>     | <u>(1.3)</u>   |
|  | )              |                |
| Total annuity operations   | 32.9           | 25.3           |
| Supplemental insurance operations                                    | 0.3            | 6.6            |
| Life operations  | 2.1            | (1.8)          |
| Corporate and other  | <u>(7.0)</u>   | <u>(8.2)</u>   |
|  | )              |                |
| Pre-tax earnings from continuing operations                          | 28.3           | 21.9           |
| Realized gains (losses)  | <u>0.4</u>     | <u>(0.2)</u>   |
|  | )              |                |
| Total operating earnings before<br>income taxes per income statement | <u>\$ 28.7</u> | <u>\$ 21.7</u> |

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(1) In April 2006, GAFRI announced the sale of Chatham Bars Inn. (See Note K). In October 2005, GAFRI sold the Driskill Hotel in Austin, Texas.

(2) 2006 includes \$4.9 million of income resulting from a payment received from Palm Beach County, Florida in exchange for the imposition of certain limitations on future development of a marina owned by the Company.

F. Unamortized Insurance Acquisition Costs

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

|   | March 31,<br><u>2006</u> | December 31,<br><u>2005</u> |
|---|--------------------------|-----------------------------|
| Deferred policy acquisition costs ("DPAC")        | \$707.4                  | \$726.1                     |
| Sales inducements                                 | 74.6                     | 73.0                        |
| Unrealized DPAC adjustment*                       | 24.3                     | (17.3)                      |
| Present value of future profits acquired ("PVFP") | <u>48.9</u>              | <u>54.1</u>                 |
|   | <u>\$855.2</u>           | <u>\$835.9</u>              |

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

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

The PVFP amounts in the table above are net of \$63.5 million and \$82.5 million of accumulated amortization at March 31, 2006 and December 31, 2005, respectively. The decrease in PVFP reflects the January 2006 sale of GA-PR. Amortization of the PVFP was \$1.6 million in the first quarter of 2006 compared to \$3.7 million in the first quarter of 2005.

G. Long-Term Debt

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

|   | March 31,<br><u>2006</u> | December 31,<br><u>2005</u> |
|---|--------------------------|-----------------------------|
| Direct obligations of GAFRI                       | \$ 0.9                   | \$ 1.0                      |
| Obligations of AAG Holding (guaranteed by GAFRI): |                          |                             |
| 7-1/2% Senior Debentures due 2033                 | 112.5                    | 112.5                       |
| 6-7/8% Senior Notes due 2008                      | 45.2                     | 100.0                       |
| 7-1/4% Senior Debentures due 2034                 | <u>86.3</u>              | <u>86.3</u>                 |

|   |                |                |
|---|----------------|----------------|
|   | <u>244.9</u>   | <u>299.8</u>   |
| Payable to Subsidiary Trusts:                       |                |                |
| AAG Holding 8-7/8% Subordinated Debentures due 2027 | 22.0           | 22.0           |
| AAG Holding 7.35% Subordinated Debentures due 2033  | <u>20.0</u>    | <u>20.0</u>    |
|   | <u>42.0</u>    | <u>42.0</u>    |
|   | <u>\$286.9</u> | <u>\$341.8</u> |

In March 2006, the Company replaced its existing \$165 million bank credit agreement with a new \$500 million five-year revolving credit facility shared with AFG. Under terms of the new agreement, GAFRI may borrow up to \$175 million with the ability to borrow up to \$200 million, conditioned on AFG not borrowing in excess of \$300 million. AFG has agreed with GAFRI not to borrow more than \$325 million under the credit facility and has agreed to guarantee amounts borrowed by GAFRI. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating. No amounts were borrowed under these agreements at March 31, 2006 or December 31, 2005.

To achieve a desired balance between fixed and variable rate debt, GAFRI entered into interest rate swaps which effectively convert its 6-7/8% Senior Notes to a floating rate of 3-month LIBOR plus 2.9% (effective rate of approximately 7.9% and 7.4% at March 31, 2006 and December 31, 2005, respectively).

In the first quarter of 2006, GAFRI repurchased \$54.8 million principal amount of its 6-7/8% Senior Notes for \$56.8 million in cash. In connection with the repurchase, GAFRI paid an additional \$1.6 million to effectively terminate the portion of the interest rate swap that covered the repurchased debt; the cost to terminate the portion of the swap is included in the loss on retirement of debt in the income statement.

At March 31, 2006, GAFRI had virtually no scheduled principal payments on debt for the next five years other than AAG Holding's Senior Notes due in 2008.

#### H. Stockholders' Equity

At March 31, 2006, there were 6.7 million shares of GAFRI Common Stock reserved for issuance under GAFRI's stock option plans. As of that date, options for 3.7 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. Options

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

generally expire ten years after the date of grant. In the first quarter of 2006, 129,593 shares of Common Stock were issued upon the exercise of stock options. In connection with certain of these exercises, 6,568 shares were delivered as payment of the exercise price and these shares were retired. Data for stock options issued under GAFRI's stock option plans is presented below:

|  | <u>Shares</u>    | <u>Average<br/>Exercise<br/>Price</u> | <u>Average<br/>Remaining<br/>Contractual<br/>Term</u> | <u>Aggregate<br/>Intrinsic<br/>Value<br/>(in millions)</u> |
|--|------------------|---------------------------------------|---|--|
| Outstanding at January 1, 2006                   | 3,331,755        | \$17.11                               |   |  |
| Granted  | 558,533          | \$19.35                               |   |  |
| Exercised  | (129,593)        | \$15.30                               |   |  |
| Forfeited/Cancelled                              | <u>(56,925)</u>  | \$19.47                               |   |  |
|  | )                |                                       |   |  |
| Outstanding at March 31, 2006                    | <u>3,703,770</u> | \$17.48                               | 6.2 years   | \$9.9  |
| Options exercisable March 31, 2006               | <u>2,369,910</u> | \$17.70                               | 4.9 years   | \$6.3  |
| Options available for grant at<br>March 31, 2006 | <u>2,990,546</u> |                                       |   |  |

The total intrinsic value of options exercised during the three months ended March 31, 2006 and 2005 was \$670,377 and \$28,955, respectively. During the three months ended March 31, 2006, GAFRI received \$1.8 million from the exercise of stock options. The total tax deductions related to the exercises was \$0.2 million.

GAFRI uses the Black-Scholes option pricing model to calculate the fair value of its option grants. Expected volatility is based on historical volatility (after consideration of other factors). Beginning with grants made in 2006, GAFRI calculates historical volatility using daily prices. GAFRI began using the SEC's simplified method of calculating expected term with its 2006 grants. The fair value of options granted in the first three

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months of 2006 and 2005 was \$6.12 and \$5.28, respectively, based on the following assumptions: dividend yield of less than 1%; expected volatility of 20%; risk-free interest rate of 4.6% in 2006 and 4.3% in 2005; and expected option life of 6.5 years for 2006 and 7.5 years for 2005.

GAFRI's total stock compensation expense for the three months ended March 31, 2006 was \$0.5 million. Related tax benefits totaled \$0.1 million. As of March 31, 2006, there was a total of \$6.5 million of total unrecognized compensation expense related to nonvested stock options granted under GAFRI's plan. That cost is expected to be recognized over a weighted average of 3.6 years.

The following table illustrates the effect on net income (in millions) and earnings per share for the three months ended March 31, 2005, had compensation cost been recognized and determined based on the "fair values" at grant dates consistent with the method used beginning in 2006.

|  | <u>2005</u>   |
|--|---------------|
| Net income, as reported                    | \$17.8        |
| Pro forma stock option expense, net of tax | <u>(0.5)</u>  |
|  | )             |
| Adjusted net income                        | <u>\$17.3</u> |
| Earnings per share (as reported):          |               |
| Basic                                      | \$0.38        |
| Diluted                                    | \$0.38        |
| Earnings per share (adjusted):             |               |
| Basic                                      | \$0.37        |
| Diluted                                    | \$0.37        |

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

I. 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 2005.

J. 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):

|                                | March 31,<br><u>2006</u>           | December 31,<br><u>2005</u> |
|--------------------------------|------------------------------------|-----------------------------|
| Capital and surplus            | \$639.5                            | \$638.0                     |
| Asset valuation reserve        | 92.4                               | 84.6                        |
| Interest maintenance reserve   | 8.6                                | 10.1                        |
|                                | <u>Three months ended March 31</u> |                             |
|                                | <u>2006</u>                        | <u>2005</u>                 |
| Pre-tax income from operations | \$29.2                             | \$16.9                      |
| Net income                     | 34.8                               | 13.2                        |

## Variable Annuities

At March 31, 2006, the aggregate guaranteed minimum death benefit value (assuming every policyholder died on those dates) on all of GAFRI's variable annuity policies exceeded the fair value of the underlying variable annuities by \$75 million compared to \$83 million at December 31, 2005. Death benefits paid in excess of the variable annuity account balances were \$0.1 million and \$0.2 million in the first three months of 2006 and 2005, respectively.

Condensed Consolidating Information

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

CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

| <u>MARCH 31, 2006</u>                            | <u>GAFRI</u>     | <u>AAG<br/>HOLDING</u> | <u>ALL<br/>OTHER<br/>SUBS</u> | <u>CONS<br/>ENTRIES</u> | <u>CONS</u>       |
|--|------------------|------------------------|-------------------------------|-------------------------|-------------------|
| <b>Assets</b>                                    |                  |                        |                               |                         |                   |
| Cash and investments                             | \$ 67.0          | \$ 0.3                 | \$ 9,790.7                    | \$ -                    | \$ 9,858.0        |
| Investment in subsidiaries                       | 814.1            | 1,218.5                | 24.8                          | (2,057.4)               | -                 |
| Notes receivable from subs                       | 104.3            | -                      | -                             | (104.3)                 | -                 |
| Unamortized insurance acquisition costs          | -                | -                      | 855.2                         | -                       | 855.2             |
| Other assets                                     | 24.3             | 7.8                    | 440.3                         | 43.2                    | 515.6             |
| Variable annuity assets (separate accounts)      | <u>-</u>         | <u>-</u>               | <u>673.4</u>                  | <u>-</u>                | <u>673.4</u>      |
|  | <u>\$1,009.7</u> | <u>\$1,226.6</u>       | <u>\$11,784.4</u>             | <u>(\$2,118.5)</u>      | <u>\$11,902.2</u> |
| <b>Liabilities and Capital</b>                   |                  |                        |                               |                         |                   |
| Insurance liabilities                            | \$ -             | \$ -                   | \$ 9,751.3                    | (\$ 5.0)                | \$ 9,746.3        |
| Notes payable to GAFRI                           | -                | 102.4                  | 1.9                           | (104.3)                 | -                 |
| Other long-term debt                             | 1.0              | 396.7                  | -                             | (110.8)                 | 286.9             |
| Other liabilities                                | 78.6             | 2.8                    | 187.9                         | (3.8)                   | 265.5             |
| Variable annuity liabilities (separate accounts) | <u>-</u>         | <u>-</u>               | <u>673.4</u>                  | <u>-</u>                | <u>673.4</u>      |
|  | 79.6             | 501.9                  | 10,614.5                      | (223.9)                 | 10,972.1          |
| Total stockholders' equity                       | <u>930.1</u>     | <u>724.7</u>           | <u>1,169.9</u>                | <u>(1,894.6)</u>        | <u>930.1</u>      |
|  | <u>\$1,009.7</u> | <u>\$1,226.6</u>       | <u>\$11,784.4</u>             | <u>(\$2,118.5)</u>      | <u>\$11,902.2</u> |



DECEMBER 31, 2005

## Assets

|   |                  |                  |                   |                    |                   |
|---|------------------|------------------|-------------------|--------------------|-------------------|
| Cash and investments                        | \$ 64.6          | \$ 0.3           | \$ 9,898.2        | \$ -               | \$ 9,963.1        |
| Investment in subsidiaries                  | 894.2            | 1,312.8          | 24.8              | (2,231.8)          | -                 |
| Notes receivable from subs                  | 104.3            | -                | -                 | (104.3)            | -                 |
| Unamortized insurance acquisition costs     | -                | -                | 835.9             | -                  | 835.9             |
| Other assets                                | 23.4             | 7.3              | 405.1             | 43.7               | 479.5             |
| Variable annuity assets (separate accounts) | <u>-</u>         | <u>-</u>         | <u>643.5</u>      | <u>-</u>           | <u>643.5</u>      |
|   | <u>\$1,086.5</u> | <u>\$1,320.4</u> | <u>\$11,807.5</u> | <u>(\$2,292.4)</u> | <u>\$11,922.0</u> |

## Liabilities and Capital

|  |                  |                  |                   |                    |                   |
|--|------------------|------------------|-------------------|--------------------|-------------------|
| Insurance liabilities                            | \$ -             | \$ -             | \$ 9,628.4        | (\$ 4.9)           | \$ 9,623.5        |
| Notes payable to GAFRI                           | -                | 102.4            | 1.9               | (104.3)            | -                 |
| Other long-term debt                             | 1.0              | 396.7            | -                 | (55.9)             | 341.8             |
| Other liabilities                                | 78.8             | 7.6              | 222.9             | (2.8)              | 306.5             |
| Variable annuity liabilities (separate accounts) | <u>-</u>         | <u>-</u>         | <u>643.5</u>      | <u>-</u>           | <u>643.5</u>      |
|  | 79.8             | 506.7            | 10,496.7          | (167.9)            | 10,915.3          |
| Total stockholders' equity                       | <u>1,006.7</u>   | <u>813.7</u>     | <u>1,310.8</u>    | <u>(2,124.5)</u>   | <u>1,006.7</u>    |
|  | <u>\$1,086.5</u> | <u>\$1,320.4</u> | <u>\$11,807.5</u> | <u>(\$2,292.4)</u> | <u>\$11,922.0</u> |

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

(In millions)

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FOR THE THREE MONTHS ENDED

AAG

ALL  
OTHER

CONS

MARCH 31, 2006

GAFRI

HOLDING

SUBS

ENTRIES

CONS

Revenues

:

|   |             |             |          |               |          |
|---|-------------|-------------|----------|---------------|----------|
| Life, accident and health premiums      | \$ -        | \$ -        | \$ 76.5  | \$ -          | \$ 76.5  |
| Net investment income and other revenue | 4.6         | (1.8)       | 176.0    | (4.4)         | 174.4    |
| Equity in earnings of subsidiaries      | <u>26.4</u> | <u>40.2</u> | <u>-</u> | <u>(66.6)</u> | <u>-</u> |
|   |             |             | )        |               |          |
|   | 31.0        | 38.4        | 252.5    | (71.0)        | 250.9    |

Costs and Expenses:

|                                 |            |             |              |              |              |
|---------------------------------|------------|-------------|--------------|--------------|--------------|
| Insurance benefits and expenses | -          | -           | 178.6        | -            | 178.6        |
| Interest and debt expenses      | -          | 10.4        | -            | (4.2)        | 6.2          |
| Other expenses                  | <u>2.3</u> | <u>1.9</u>  | <u>33.2</u>  | <u>-</u>     | <u>37.4</u>  |
|                                 | <u>2.3</u> | <u>12.3</u> | <u>211.8</u> | <u>(4.2)</u> | <u>222.2</u> |

|                              |             |            |             |               |             |
|------------------------------|-------------|------------|-------------|---------------|-------------|
| Earnings before income taxes | 28.7        | 26.1       | 40.7        | (66.8)        | 28.7        |
| Provision for income taxes   | <u>10.1</u> | <u>9.2</u> | <u>14.3</u> | <u>(23.5)</u> | <u>10.1</u> |

|            |               |               |                |                  |                |
|------------|---------------|---------------|----------------|------------------|----------------|
| Net income | <u>\$18.6</u> | <u>\$16.9</u> | <u>\$ 26.4</u> | <u>(\$ 43.3)</u> | <u>\$ 18.6</u> |
|------------|---------------|---------------|----------------|------------------|----------------|

FOR THE THREE MONTHS ENDED

AAG

ALL  
OTHER

CONS

MARCH 31, 2005

GAFRI

HOLDING

SUBS

ENTRIES

CONS

## Revenues

|   |               |               |                |                  |                |
|---|---------------|---------------|----------------|------------------|----------------|
| :                                       |               |               |                |                  |                |
| Life, accident and health premiums      | \$ -          | \$ -          | \$ 73.6        | \$ -             | \$ 73.6        |
| Net investment income and other revenue | 5.3           | -             | 164.0          | (2.9)            | 166.4          |
| Equity in earnings of subsidiaries      | <u>19.0</u>   | <u>30.2</u>   | <u>-</u>       | <u>(49.2)</u>    | <u>-</u>       |
|   |               |               | )              |                  |                |
|   | 24.3          | 30.2          | 237.6          | (52.1)           | 240.0          |
| Costs and Expenses:                     |               |               |                |                  |                |
| Insurance benefits and expenses         | -             | -             | 170.8          | -                | 170.8          |
| Interest and debt expenses              | -             | 10.0          | -              | (3.2)            | 6.8            |
| Other expenses                          | <u>2.6</u>    | <u>1.4</u>    | <u>36.6</u>    | <u>0.1</u>       | <u>40.7</u>    |
|   | <u>2.6</u>    | <u>11.4</u>   | <u>207.4</u>   | <u>(3.1)</u>     | <u>218.3</u>   |
|   |               |               | )              |                  |                |
| Earnings before income taxes            | 21.7          | 18.8          | 30.2           | (49.0)           | 21.7           |
| Provision for income taxes              | <u>7.5</u>    | <u>6.4</u>    | <u>10.3</u>    | <u>(16.7)</u>    | <u>7.5</u>     |
|   |               |               | )              |                  |                |
| Income from continuing operations       | 14.2          | 12.4          | 19.9           | (32.3)           | 14.2           |
| Discontinued operations, net            | <u>3.6</u>    | <u>-</u>      | <u>3.6</u>     | <u>(3.6)</u>     | <u>3.6</u>     |
|   |               |               | )              |                  |                |
| Net income                              | <u>\$17.8</u> | <u>\$12.4</u> | <u>\$ 23.5</u> | <u>(\$ 35.9)</u> | <u>\$ 17.8</u> |

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

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FOR THE THREE MONTHS ENDED

|   | AAG          | ALL            | CONS         |                |              |
|---|--------------|----------------|--------------|----------------|--------------|
|   |              | OTHER          |              |                |              |
| <u>MARCH 31, 2006</u>                                       | <u>GAFRI</u> | <u>HOLDING</u> | <u>SUBS</u>  | <u>ENTRIES</u> | <u>CONS</u>  |
| Cash Flows from Operating Activities:                       |              |                |              |                |              |
| Net income  | \$18.6       | \$ 16.9        | \$ 26.4      | (\$43.3)       | \$ 18.6      |
| Adjustments:  |              |                |              |                |              |
| Equity in net earnings of subsidiaries and affiliates       | (17.5)       | (26.0)         | -            | 43.5           | -            |
| Increase in life, accident and health reserves              | -            | -              | 6.2          | -              | 6.2          |
| Benefits to annuity policyholders                           | -            | -              | 83.2         | -              | 83.2         |
| Amortization of insurance acquisition costs                 | -            | -              | 24.6         | -              | 24.6         |
| Depreciation and amortization                               | 1.4          | 0.4            | 0.3          | -              | 2.1          |
| Realized (gains) losses on investments                      | 0.5          | -              | (4.8)        | 0.2            | (4.1)        |
| Realized loss on retirement of debt                         | 1.9          | 1.8            | -            | -              | 3.7          |
| Net trading portfolio activity                              | -            | -              | (14.1)       | -              | (14.1)       |
| Increase in insurance acquisition costs                     | -            | -              | (27.3)       | -              | (27.3)       |
| Decrease in reinsurance recoverable                         | -            | -              | 3.5          | -              | 3.5          |
| Increase in other assets                                    | (1.3)        | (0.5)          | (4.0)        | -              | (5.8)        |
| Increase (decrease) in other liabilities                    | 1.0          | 0.1            | (3.8)        | -              | (2.7)        |
| Increase (decrease) in payable to affiliates, net           | 0.9          | (4.9)          | 14.1         | -              | 10.1         |
| Capital contribution from parent (to subsidiary)            | (15.7)       | 15.7           | -            | -              | -            |
| Dividends from subsidiaries(to parent)                      | 26.1         | (1.0)          | (25.1)       | -              | -            |
| Other, net  | <u>0.4</u>   | <u>(1.0)</u>   | <u>(5.0)</u> | <u>(0.4)</u>   | <u>(6.0)</u> |
|   | )            | )              | )            | )              |              |
|   | <u>16.3</u>  | <u>1.5</u>     | <u>74.2</u>  | <u>-</u>       | <u>92.0</u>  |
| Cash Flows from Investing Activities:                       |              |                |              |                |              |
| Purchases of investments and other assets                   | -            | -              | (676.8)      | -              | (676.8)      |
| Proceeds received from sale of GAPR, net                    | 37.5         | -              | (10.3)       | -              | 27.2         |
| Maturities and redemptions of fixed maturity investments    | -            | -              | 151.2        | -              | 151.2        |
| Cash and short-term investments of businesses acquired, net | -            | -              | 104.8        | -              | 104.8        |
| Sales of investments and other assets                       | 1.9          | -              | 401.5        | -              | 403.4        |

|  |               |               |                |             |                |
|--|---------------|---------------|----------------|-------------|----------------|
| Increase in policy loans                                   | —             | —             | <u>(0.6)</u>   | —           | <u>(0.6)</u>   |
|  |               | )             |                | )           |                |
|  | <u>39.4</u>   | —             | <u>(30.2)</u>  | —           | <u>9.2</u>     |
|  |               | )             |                |             |                |
| Cash Flows from Financing Activities:                      |               |               |                |             |                |
| Fixed annuity receipts                                     | -             | -             | 220.3          | -           | 220.3          |
| Annuity surrenders, benefits and withdrawals               | -             | -             | (294.3)        | -           | (294.3)        |
| Net transfers from variable annuity assets                 | -             | -             | 4.1            | -           | 4.1            |
| Additions to long-term debt                                | -             | 15.0          | -              | -           | 15.0           |
| Reductions of long-term debt                               | (56.9)        | (16.5)        | -              | -           | (73.4)         |
| Issuance of Common Stock                                   | 1.8           | -             | -              | -           | 1.8            |
| Retirement of Common Stock                                 | <u>(0.2)</u>  | —             | —              | —           | <u>(0.2)</u>   |
|  |               | )             |                | )           |                |
|  | <u>(55.3)</u> | <u>(1.5)</u>  | <u>(69.9)</u>  | —           | <u>(126.7)</u> |
|  |               | )             |                | )           |                |
| Net increase (decrease) in cash and short-term investments | 0.4           | -             | (25.9)         | -           | (25.5)         |
| Beginning cash and short-term investments                  | <u>7.9</u>    | <u>0.3</u>    | <u>146.1</u>   | —           | <u>154.3</u>   |
| Ending cash and short-term investments                     | <u>\$ 8.3</u> | <u>\$ 0.3</u> | <u>\$120.2</u> | <u>\$ -</u> | <u>\$128.8</u> |

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

(In millions)

| FOR THE THREE MONTHS ENDED | AAG          | ALL         | CONS           |             |
|----------------------------|--------------|-------------|----------------|-------------|
|                            | HOLDING      | OTHER       | ENTRIES        | CONS        |
| <u>MARCH 31, 2005</u>      | <u>GAFRI</u> | <u>SUBS</u> | <u>ENTRIES</u> | <u>CONS</u> |

Cash Flows from Operating Activities:

|   |            |              |              |              |              |
|---|------------|--------------|--------------|--------------|--------------|
| Net income  | \$17.8     | \$12.4       | \$ 23.5      | (\$35.9)     | \$ 17.8      |
| Adjustments:  |            |              |              |              |              |
| Equity in net earnings of subsidiaries and affiliates | (16.1)     | (20.0)       | -            | 36.1         | -            |
| Increase in life, accident and health reserves        | -          | -            | 22.6         | -            | 22.6         |
| Benefits to annuity policyholders                     | -          | -            | 80.8         | -            | 80.8         |
| Amortization of insurance acquisition costs           | -          | -            | 26.7         | -            | 26.7         |
| Depreciation and amortization                         | -          | 0.4          | 8.1          | -            | 8.5          |
| Realized losses on investments                        | -          | -            | 0.6          | -            | 0.6          |
| Net trading portfolio activity                        | -          | -            | 4.9          | -            | 4.9          |
| Increase in insurance acquisition costs               | -          | -            | (33.8)       | -            | (33.8)       |
| Increase in reinsurance recoverable                   | -          | -            | (3.6)        | -            | (3.6)        |
| Decrease (increase) in other assets                   | (2.0)      | (0.5)        | 2.2          | -            | (0.3)        |
| Increase (decrease) in other liabilities              | (1.1)      | (0.5)        | 9.8          | -            | 8.2          |
| Increase (decrease) in payable to affiliates, net     | 0.9        | 11.1         | (7.2)        | -            | 4.8          |
| Capital contribution from parent (to subsidiary)      | (14.7)     | 14.7         | -            | -            | -            |
| Dividends from subsidiaries(to parent)                | 16.6       | (16.6)       | -            | -            | -            |
| Other, net  | <u>-</u>   | <u>(0.7)</u> | <u>(0.7)</u> | <u>(0.2)</u> | <u>(1.6)</u> |
|   | )          | )            | )            | )            |              |
|   | <u>1.4</u> | <u>0.3</u>   | <u>133.9</u> | <u>-</u>     | <u>135.6</u> |

Cash Flows from Investing Activities:

|  |          |          |                |          |                |
|--|----------|----------|----------------|----------|----------------|
| Purchases of investments and other assets                | -        | -        | (978.3)        | -        | (978.3)        |
| Maturities and redemptions of fixed maturity investments | -        | -        | 156.0          | -        | 156.0          |
| Sales of investments and other assets                    | -        | -        | 603.1          | -        | 603.1          |
| Increase in policy loans                                 | <u>-</u> | <u>-</u> | <u>(0.1)</u>   | <u>-</u> | <u>(0.1)</u>   |
|  |          | )        |                | )        |                |
|  | <u>-</u> | <u>-</u> | <u>(219.3)</u> | <u>-</u> | <u>(219.3)</u> |
|  |          | )        |                | )        |                |

Cash Flows from Financing Activities:

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|  |               |               |                |             |                |
|--|---------------|---------------|----------------|-------------|----------------|
| Fixed annuity receipts                                     | -             | -             | 266.5          | -           | 266.5          |
| Annuity surrenders, benefits and withdrawals               | -             | -             | (224.3)        | -           | (224.3)        |
| Net transfers from variable annuity assets                 | -             | -             | 0.3            | -           | 0.3            |
| Issuance of Common Stock                                   | 0.1           | -             | -              | -           | 0.1            |
| Retirement of Common Stock                                 | <u>(0.6)</u>  | <u>-</u>      | <u>-</u>       | <u>-</u>    | <u>(0.6)</u>   |
|  | )             |               |                | )           |                |
|  | <u>(0.5)</u>  | <u>-</u>      | <u>42.5</u>    | <u>-</u>    | <u>42.0</u>    |
|  | )             |               |                |             |                |
| Net increase (decrease) in cash and short-term investments | 0.9           | 0.3           | (42.9)         | -           | (41.7)         |
| Beginning cash and short-term investments                  | <u>1.0</u>    | <u>-</u>      | <u>169.2</u>   | <u>-</u>    | <u>170.2</u>   |
| Ending cash and short-term investments                     | <u>\$ 1.9</u> | <u>\$ 0.3</u> | <u>\$126.3</u> | <u>\$ -</u> | <u>\$128.5</u> |

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GREAT AMERICAN FINANCIAL RESOURCES, INC. 10-Q

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

K. Subsequent Events

On April 19, 2006, GAFRI announced it has signed an agreement to sell Chatham Bars Inn, its resort-hotel property located on Cape Cod, Massachusetts, for a price of \$166 million. The sale, which is subject to customary closing conditions, is expected to close in the second quarter of 2006. GAFRI expects to record a gross gain (after sale expenses) of approximately \$85-\$90 million on the sale. After taxes and after the write-off of certain deferred acquisition costs on annuities associated with the gain recognition, the Company expects to recognize an after-tax gain of approximately \$33-\$36 million (\$0.70-\$0.75 per share). The Company has owned and operated the hotel since 1993.

On May 1, 2006, GAFRI announced it had signed a definitive merger agreement to acquire all of the outstanding shares of Ceres Group, Inc. for \$205 million in cash. Ceres sells health and life insurance products through two primary business segments. Its Senior segment includes Medicare supplement, and other senior health, life and annuity products for Americans age 55 and over. The Medical segment includes major medical health insurance for individuals, families, associations and small businesses. Ceres had approximately \$770 million of assets at December 31, 2005. The transaction, which is expected to be completed in the third quarter of 2006, is subject to the approval of Ceres' stockholders and the Ohio and Nebraska Departments of Insurance and other customary conditions.

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

## ITEM 2

## Management's Discussion and Analysis

of Financial Condition and Results of OperationsIndex to MD&A

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| Forward-Looking Statements      | 21          | Results of Operations | 28          |
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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. 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 persistency, mortality and morbidity;
- regulatory actions;
- changes in regulatory and legal environments;
- tax law changes;
- changes in laws governing retirement savings vehicles;



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- cost of environmental clean-up at former manufacturing sites operated by the Company's predecessor;
- availability of reinsurance and ability of reinsurers to pay their obligations;
- competitive pressures; and
- changes in debt and claims paying ratings.

Forward-looking statements included in this Form 10-Q are made only as of the date of this report and under Section 27A of the Securities Act and Section 21E of the Exchange Act of 1934; we do not have any obligation to update any forward-looking statement to reflect subsequent events or circumstances.

### GENERAL

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

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

### Management's Discussion and Analysis

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

### OVERVIEW

#### Financial Condition

Over the last several years, GAFRI has significantly strengthened its capital and liquidity. Since December 31, 2002, stockholders' equity (excluding unrealized gains and losses on fixed maturities) has grown approximately \$287 million (42%) to \$976 million and its debt to total capital decreased from more than 36% to less than 23%; in addition, the adjusted capital of GAFRI's largest insurance subsidiary increased \$257 million to \$742 million.

#### Results of Operations

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

GAFRI's net income for the first quarter of 2006 was \$18.6 million (\$0.39 per diluted share) compared to \$17.8 million (\$0.38 per diluted share) for the same period in 2005. The improvement reflects higher earnings in GAFRI's fixed annuity and life operations, as well as the investment of the dividends received in 2005 from Great American Life Assurance Company of Puerto Rico ("GA-PR") and proceeds related to the sale of that Company. These improvements were partially offset by lower results in the Company's supplemental lines due primarily to higher expenses, lapses and loss experience.

### 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.

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

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

For further discussion of these policies, see "Critical Accounting Policies" in GAFRI's 2005 Form 10-K.

## LIQUIDITY AND CAPITAL RESOURCES

### Ratios

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

|                              | March 31,      | December 31,   |                |
|------------------------------|----------------|----------------|----------------|
|                              | <u>2006</u>    | <u>2005</u>    | <u>2004</u>    |
| Consolidated Debt            | \$ 287         | \$ 342         | \$ 363         |
| Stockholders' Equity         | <u>976</u>     | <u>949</u>     | <u>895</u>     |
| Total Capital                | <u>\$1,263</u> | <u>\$1,291</u> | <u>\$1,258</u> |
| Consolidated Debt to Capital | 22.7%          | 26.5%          | 28.9%          |

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 March 31, 2006, the capital ratio of GAFRI's principal insurance subsidiary was 7.1 times its authorized control level RBC.

of Financial Condition and Results of Operations - Continued

Sources and Uses of Funds

Parent Holding Company Liquidity

To pay interest and principal on borrowings and other holding company costs, GAFRI (parent) and AAG Holding use primarily capital distributions from Great American Life Insurance Company ("GALIC"), 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 in 2006 without prior regulatory approval is \$148 million. In the first quarter of 2006, GALIC paid a \$30 million dividend to GAFRI.

In March 2006, the Company replaced its existing credit agreement with a new \$500 million five-year credit facility shared with its parent company American Financial Group, Inc. Under terms of the new agreement, GAFRI may borrow up to \$175 million with the ability to borrow up to \$200 million, conditioned on AFG not borrowing in excess of \$300 million. No amounts have been borrowed under this agreement. Amounts borrowed bear interest at rates ranging from 0.5% to 1.25% over LIBOR based on AFG's credit rating; GAFRI's current rate would be 0.6% over LIBOR. Under a currently effective shelf registration, GAFRI and AAG Holding can issue approximately \$250 million in additional equity or debt securities.

At March 31, 2006, GAFRI (parent) had nearly \$70 million of cash and investments on hand. GAFRI believes that it has sufficient resources to meet its liquidity requirements.

Subsidiary Liquidity

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

In GAFRI's annuity business, where profitability is largely dependent on earning a "spread" between invested assets and annuity liabilities, the duration of investments is generally maintained close to that of liabilities. In a rising interest rate environment, significant protection from withdrawals exists in the form of temporary and permanent surrender charges on GAFRI's annuity products. With declining rates, GAFRI receives some protection due to the ability to lower crediting rates, subject to guaranteed minimums.

In recent years, the Company has entered into several reinsurance transactions in connection with (i) the sale of GA-PR and (ii) 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 its insurance subsidiaries maintain sufficient liquidity to pay claims and benefits, operating expenses, dividends and tax payments, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies.

Independent Ratings

The Company's principal insurance subsidiaries ("Insurance Companies") are rated by A.M. Best, Fitch and Standard & Poor's. Management believes that the ratings assigned by independent insurance rating agencies are important because agents, potential policyholders and school districts often use a company's rating as an initial screening device in considering annuity products. Management believes that (i) a rating in the "A" category by A.M. Best is necessary to successfully market tax-deferred annuities to public education employees and other not-for-profit groups; and (ii) a rating in the "A" category by at least one rating agency is necessary to successfully compete in other annuity markets. GAFRI's insurance entities also compete in markets other than the sale of tax-deferred annuities. 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 ratings downgrades. In connection with recent reviews by independent rating agencies, management indicated that it intends to maintain lower ratios of debt to capital than it has in recent years and intends to maintain the capital of its significant insurance subsidiaries at levels currently indicated by the rating agencies as appropriate for the current ratings. Items that could adversely affect capital levels include (i) an extended period of low interest rates and a resulting significant narrowing of annuity "spread" (the difference between earnings received by the Company on its investments less the amount credited to policyholders' annuity accounts); (ii) investment impairments; (iii) a sustained decrease in the stock market; (iv) adverse mortality or morbidity; and (v) higher than planned dividends paid due to liquidity needs by GAFRI and AAG Holding.

Following are the Company's insurance ratings as of March 31, 2006:

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

Investments

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At March 31, 2006, GAFRI's investment portfolio contained \$8.8 billion in "Fixed maturities" classified as available-for-sale, which are carried at fair value with unrealized gains and losses reported as a separate component of stockholders' equity on an after-tax basis. At March 31, 2006, GAFRI had pre-tax net unrealized losses of \$96 million on fixed maturities and net unrealized gains of \$15 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 March 31, 2006. 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 March 31, 2006, 94% of GAFRI's Insurance Companies' fixed maturity portfolio was comprised of investment grade bonds (NAIC rating of "1" or "2"). Management believes that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

At March 31, 2006, the mortgage-backed securities ("MBSs") portfolio represented approximately 30% of the Insurance Companies' investments. MBSs are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of the lower current rates.

More than 95% of the Insurance Companies' 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 March 31, 2006, is shown in the following table (dollars in millions). Approximately \$100 million of available-for-sale "Fixed Maturities" and \$5 million of "Equity Securities" had no unrealized gains or losses at March 31, 2006.

| <u>Available-for-sale Fixed Maturities</u> | Securities<br>with<br>Unrealized<br>Gains | Securities<br>with<br>Unrealized<br>Losses |
|--|---|--|
| Fair value of securities                   | \$2,574                                   | \$6,154                                    |
| Amortized cost of securities               | \$2,485                                   | \$6,339                                    |
| Gross unrealized gain (loss)               | \$ 89                                     | (\$ 185)                                   |
| Fair value as % of amortized cost          | 104%                                      | 97%  |

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|   |         |           |
|---|---------|-----------|
| Number of security positions  | 732     | 872       |
| Number individually exceeding \$2 million gain or loss                                  | 1       | 2         |
| Concentration of gains or (losses) by type or industry<br>(exceeding 5% of unrealized): |         |           |
| Gas and electric services   | \$ 12.6 | (\$ 10.5) |
| Banks, savings and credit institutions  | 9.2     | (22.7)    |
| Mortgage-backed securities  | 8.0     | (87.6)    |
| Percentage rated investment grade   | 86%     | 97%       |

Equity Securities

|                              |       |        |
|------------------------------|-------|--------|
| Fair value of securities     | \$105 | \$91   |
| Cost of securities           | \$ 87 | \$94   |
| Gross unrealized gain (loss) | \$ 18 | (\$ 3) |
| Fair value as % of cost      | 121%  | 97%    |

The table below sets forth the scheduled maturities of GAFRI's available-for-sale fixed maturity securities at March 31, 2006, based on their fair values. Asset backed securities and other securities with sinking funds are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

| <u>Maturity</u>                    | Securities<br>with<br>Unrealized<br><u>Gains</u> | Securities<br>with<br>Unrealized<br><u>Losses</u> |
|------------------------------------|--|---|
| *                                  | *  | *   |
| One year or less                   | 7%   | 1%  |
| After one year through five years  | 34   | 6   |
| After five years through ten years | 36   | 42  |
| After ten years                    | <u>12</u>  | <u>9</u>  |
|                                    | 89   | 58  |
| Mortgage-backed securities         | <u>11</u>  | <u>42</u>   |
|                                    | <u>100</u>                                       | <u>100</u>  |
|                                    | %  | %   |

\*Excludes \$100 million of fixed maturities with no unrealized gains or losses.

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

GAFRI realized aggregate losses of \$5.1 million during the first quarter of 2006 on \$129.3 million in sales of fixed maturity securities (four issues/issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2005. These securities were "AAA" rated mortgage-backed securities that decreased in fair value by an aggregate of \$2.2 million from year-end 2005 to the sale date due to an increase in the general level of interest rates. None of the securities were sold out of a necessity to raise cash.

Although GAFRI has the ability to continue holding its investments with unrealized losses, its intent to hold them may change due to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular issuer or industry, asset/liability management decisions, market movements, changes in views about appropriate asset allocation or the desire to offset taxable realized gains.

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

| <u>Fixed Maturities at March 31, 2006</u>  | Aggregate<br>Fair<br>Value | Aggregate<br>Unrealized<br>Gain (Loss) | Fair<br>Value as<br>% of Cost<br>Basis |
|--|----------------------------|--|--|
| Securities with unrealized gains:          |                            |  |  |
| Exceeding \$500,000 (32 issues):           | \$ 313                     | \$ 26                                  | 109.1%                                 |
| Less than \$500,000 (700 issues):          | <u>2,261</u>               | <u>63</u>                              | 102.9%                                 |
|  | <u>\$2,574</u>             | <u>\$ 89</u>                           | 103.6%                                 |
| Securities with unrealized losses:         |                            |  |  |
| Exceeding \$500,000 (115 issues):          | \$2,190                    | (\$ 97)                                | 95.8%                                  |
| Less than \$500,000 (757 issues):          | <u>3,964</u>               | <u>(88)</u>                            | 97.8%                                  |
|  | <u>\$6,154</u>             | <u>(\$185)</u>                         | 97.1%                                  |
| <br>                                       |                            |  |  |
| <u>Equity Securities at March 31, 2006</u> |                            |  |  |
| Securities with unrealized gains:          |                            |  |  |
| Exceeding \$500,000 (8 issues):            | \$ 51                      | \$13                                   | 134.2%                                 |
| Less than \$500,000 (28 issues):           | <u>54</u>                  | <u>5</u>                               | 110.2%                                 |

|                                    |              |              |        |
|------------------------------------|--------------|--------------|--------|
|                                    | <u>\$105</u> | <u>\$18</u>  | 120.7% |
| Securities with unrealized losses: |              |              |        |
|                                    | \$ 14        | (\$1)        | 93.3%  |
| Exceeding \$500,000 (2 issues):    |              |              |        |
|                                    | <u>77</u>    | <u>(2)</u>   | 97.5%  |
| Less than \$500,000 (14 issues):   | )            |              |        |
|                                    | <u>\$ 91</u> | <u>(\$3)</u> | 96.8%  |

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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.

| <u>Fixed Maturities with Unrealized<br/>Losses at March 31, 2006</u> | <u>Aggregate<br/>Fair<br/>Value</u> | <u>Aggregate<br/>Unrealized<br/>Gain(Loss)</u> | <u>Fair<br/>Value as<br/>% of Cost<br/>Basis</u> |
|--|-------------------------------------|--|--|
| Investment grade with losses for:                                    |                                     |  |  |
| One year or less (724 issues)  | \$5,439                             | (\$153)  | 97.3%  |
| Greater than one year (89 issues)                                    | <u>505</u>                          | <u>(27)</u>                                    | 94.9%  |
|  | )                                   |  |  |
|  | <u>\$5,944</u>                      | <u>(\$180)</u>                                 | 97.1%  |



Non-investment grade with losses for:

|                                   |              |               |       |
|-----------------------------------|--------------|---------------|-------|
| One year or less (43 issues)      | \$166        | (\$ 3)        | 98.2% |
| Greater than one year (16 issues) | <u>44</u>    | <u>(2)</u>    | 95.7% |
|                                   | )            |               |       |
|                                   | <u>\$210</u> | <u>(\$ 5)</u> | 97.7% |

Equity Securities with Unrealized

Losses at March 31, 2006

|                                 |              |               |       |
|---------------------------------|--------------|---------------|-------|
| One year or less (13 issues)    | \$ 43        | (\$ 2)        | 95.6% |
| Greater than one year (3 issue) | <u>48</u>    | <u>(1)</u>    | 98.0% |
|                                 | )            |               |       |
|                                 | <u>\$ 91</u> | <u>(\$ 3)</u> | 96.8% |

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 2005 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.

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

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - Continued

## RESULTS OF OPERATIONS

General

As shown in Footnote E - "Segments of Operations", pre-tax earnings from continuing operations for the first quarter of 2006 increased \$6.4 million compared to the same period in 2005. This improvement reflects higher earnings in the Company's fixed annuity and life operations, as well as the investment of the dividends received in 2005 from GA-PR and proceeds related to the sale of that Company. These improvements were partially offset by lower results in the Company's supplemental lines due primarily to higher expenses, lapses and loss experience.

Annuity Premiums

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

| <u>Annuity Premiums</u>             | Three months ended |              |
|-------------------------------------|--------------------|--------------|
|                                     | <u>March 31,</u>   |              |
|                                     | <u>2006</u>        | <u>2005</u>  |
| 403(b) Fixed and Indexed Annuities: |                    |              |
| First Year                          | \$ 11              | \$ 9         |
| Renewal                             | 34                 | 33           |
| Single Sum                          | <u>26</u>          | <u>16</u>    |
| Subtotal                            | 71                 | 58           |
| Non-403(b) Fixed Annuities          | 81                 | 180          |
| Non-403(b) Indexed Annuities        | 46                 | 1            |
| Variable Annuities                  | <u>24</u>          | <u>26</u>    |
| Total Annuity Premiums              | <u>\$222</u>       | <u>\$265</u> |

GAFRI's non-403(b) fixed annuities in 2005 include approximately \$100 million of fixed annuity premiums from policyholders of an unaffiliated company in rehabilitation who chose to transfer their funds to GAFRI. Excluding the \$100 million, GAFRI's premiums in the first quarter of 2006 were 35% higher than the same period in 2005 due primarily to re-entering the index-annuity market and higher 403(b) annuity sales.

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):

| <u>Premiums</u>                   | Three months ended |             |
|-----------------------------------|--------------------|-------------|
|                                   | <u>March 31,</u>   |             |
|                                   | <u>2006</u>        | <u>2005</u> |
| Supplemental insurance operations | \$67               | \$64        |
| Cincinnati life operations        | <u>9</u>           | <u>10</u>   |
|                                   | <u>\$76</u>        | <u>\$74</u> |
| <br><u>Benefits</u>               |                    |             |
| Supplemental insurance operations | \$53               | \$48        |
| Cincinnati life operations        | <u>11</u>          | <u>12</u>   |
|                                   | <u>\$64</u>        | <u>\$60</u> |

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

## Management's Discussion and Analysis

of Financial Condition and Results of Operations - ContinuedNet Investment Income

Net investment income increased \$6.9 million (5%) in the first quarter of 2006, compared to the same period of 2005 due primarily to an increase in average invested assets of approximately \$459 million (5%). The increase in assets reflects internal growth as well as the acquisition of the block of annuities in January 2006.

The yield on GAFRI's investment portfolio, excluding real estate investments and realized gains, was approximately 6.1% at March 31, 2006 and 6.2% at March 31, 2005.

Realized Gains (Losses)

Investments

Realized gains (losses) on investments included provisions for other than temporary impairment on securities still held of \$1.4 million and \$1.7 million in the first quarter of 2006 and 2005, respectively.

Retirement of Debt

Loss on retirement of debt reflects pre-tax losses on repurchases of \$54.8 million principal amount of the Company's 6-7/8% Senior Notes for \$56.8 million in cash. In addition, in connection with the repurchase, GAFRI paid \$1.6 million to effectively terminate the portion of an interest rate swap that covered the repurchased debt; this amount is included in loss on retirement of debt in the Income Statement.

Other Income

Other income increased \$0.5 million (2%) in the first quarter of 2006 compared to the same period in 2005 reflecting \$4.9 million of income resulting from a payment received from Palm Beach County, Florida in exchange for the imposition of certain limitations on future development of a marina owned by the Company. (See also "Real Estate Operations" below.)

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). The decrease in real estate revenues and expenses is due primarily to the sale of the Driskill Hotel in October 2005.

|                    | <u>2006</u> | <u>Three months ended<br/>March 31,<br/>2005</u> |
|--------------------|-------------|--|
| Other income (1)   | \$11.8      | \$11.9   |
| Other expenses:    |             |  |
| Operating expenses | 6.1         | 9.4  |
| Depreciation       | 1.4         | 1.7  |
| Other              | 0.3         | 1.3  |

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

### Annuity Benefits

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

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

Annuity benefits in the first quarter of 2006 increased \$2.5 million (3%) compared to the same period in 2005. The first quarter comparison reflects an increase in reserves due to new business and an acquisition, offset by lower average crediting rates.

### Insurance Acquisition Expenses

Insurance acquisition expenses includes 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. The increase in insurance acquisition expenses in 2006 reflects the growth in the Company's business.

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 and Debt Expenses

The decrease in interest and debt expenses in the first quarter of 2006 compared to the same period in 2005 reflects the Company's fourth quarter 2005 repurchases of \$20.8 million principal amount of its 8-7/8% preferred securities. Additional decreases relating to the first quarter 2006 repurchases of \$54.8 million of the Company's 6-7/8% Senior Notes were offset by a higher effective interest rate on the Company's floating rate debt.

### Other Expenses

Other expenses decreased \$3.3 million (8%) in the first quarter of 2006 compared to the same period in 2005 reflecting a decrease in expenses from real estate operations due to the sale of the Driskill Hotel in the third quarter of 2005.

### Income Taxes

The effective tax rate on GAFRI's continuing operations approximated 34%-35% in the first quarter of 2006 and 2005.

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## Item 3

### Quantitative and Qualitative Disclosure of Market Risk

As of March 31, 2006, there were no material changes to the information provided in Item 7A - "Quantitative and Qualitative Disclosure about Market Risk" in GAFRI's 2005 Form 10-K.

## Item 4

Controls and Procedures

GAFRI's Chief Executive Officer and Chief Financial Officer, with the participation of management, have evaluated GAFRI's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of March 31, 2006. Based on that evaluation, GAFRI's CEO and CFO concluded that these disclosure controls and procedures were effective. During the first quarter of 2006, there have been no changes in GAFRI's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, GAFRI's internal controls over financial reporting.

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

## PART II

## OTHER INFORMATION

## Item 2

Unregistered Sales of Equity Securities and Use of Proceeds

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

| <u>Period</u> | <u>Total Number<br/>of Shares<br/>Purchased</u> | <u>Average<br/>Price Paid<br/>Per Share</u> | <u>Total Number<br/>of Shares<br/>Purchased as<br/>Part of Publicly<br/>Announced Plans<br/>or Programs</u> | <u>Maximum Number<br/>of Shares<br/>that May<br/>Yet be Purchased<br/>Under the Plans<br/>or Programs(a)</u> |
|---------------|---|---|---|--|
| <u>2006</u>   |   |   |   |  |
| January       | -   | -   | -   | -  |
| February      | -   | -   | -   | -  |
| March         | 12,600  | \$19.15                                     | 12,600  | 1,574,674  |

(a) Represents the remaining shares that may be repurchased under the Plan authorized by GAFRI's Board of Directors in 2005.

Under GAFRI's stockholder-approved Stock Option Plan, 6,568 shares of GAFRI Common Stock were tendered in connection with the exercise of stock options for a total of 9,893 shares in the first quarter of 2006 (5,327 at an average market price of \$22.41 in January; 1,241 at \$23.03 in February; and none in March).

Item 6

Exhibits

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. |

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.

May 5, 2006

BY: /s/Christopher P. Miliano  
Christopher P. Miliano  
Chief Financial Officer