

GREAT AMERICAN FINANCIAL RESOURCES INC
Form 10-K
March 28, 2003

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended
December 31, 2002

Commission File
No. 1-11632

GREAT AMERICAN FINANCIAL RESOURCES, INC.

Incorporated under
the Laws of Delaware

IRS Employer I.D.
No. 06-1356481

250 East Fifth Street, Cincinnati, Ohio 45202

(513) 333-5300

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange
on which Registered

Great American Financial Resources, Inc.:
Common Stock, Par Value \$1.00 Per Share

New York

American Annuity Group Capital Trust I (Guaranteed by Registrant):
9-1/4% Trust Originated Preferred Securities

New York

Other Securities for which reports are submitted pursuant to Section 15(d) of the Act:

American Annuity Group Capital Trust II (Guaranteed by Registrant):
8-7/8% Trust Preferred Securities

AAG Holding Company, Inc. (Guaranteed by Registrant):
6-7/8% Senior Notes due June 1, 2008

Securities Registered Pursuant to Section 12(g) of the Act:

None

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and need not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

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

The aggregate market value of the Registrant's Common Stock held by non-affiliates as of the Registrant's most recently completed second fiscal quarter (June 30, 2002) was approximately \$142 million (based upon non-affiliate holdings of 7,367,019 shares and a market price of \$19.30 per share).

As of March 1, 2003, there were 42,468,747 shares of the Registrant's Common Stock outstanding, including 35,059,945 owned by its Parent Company.

Documents Incorporated by Reference:

Proxy Statement for the 2003 Annual Meeting of Stockholders (portions of which are incorporated by reference into Part III hereof).

GREAT AMERICAN FINANCIAL RESOURCES, INC.

INDEX TO ANNUAL REPORT

ON FORM 10-K

Part I

| | <u>Page</u> |
|---|-------------|
| Item 1. Business | |
| Introduction | 1 |
| Annuities | 1 |
| Life Operations | 5 |
| Supplemental Insurance | 5 |
| GA Life of Puerto Rico | 5 |
| Investments | 5 |
| Competition | 7 |
| Regulation | 7 |
| Foreign Operations | 8 |
| Item 2. Properties | 9 |
| Item 3. Legal Proceedings | 9 |
| Item 4. Submission of Matters to a Vote of Security Holders | * |

Part II

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | |
|----------|---|-----|
| Item 5. | Market for Registrant's Common Equity and Related Stockholder Matters | 10 |
| Item 6. | Selected Financial Data | 12 |
| Item 7. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 13 |
| Item 7A. | Quantitative and Qualitative Disclosures about Market Risk | 25 |
| Item 8. | Financial Statements and Supplementary Data | 26 |
| Item 9. | Changes in and Disagreements with Accountants on Accounting and Financial Disclosure | * |
| Part III | | |
| Item 10. | Directors and Executive Officers of the Registrant | 26 |
| Item 11. | Executive Compensation | 26 |
| Item 12. | Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters | 26 |
| Item 13. | Certain Relationships and Related Transactions | 26 |
| Item 14. | Evaluation of Disclosure Controls and Procedures | 26 |
| Part IV | | |
| Item 15. | Exhibits, Financial Statement Schedules, and Reports On Form 8-K | S-1 |

(*) The response to this item is "none".

GREAT AMERICAN FINANCIAL RESOURCES, INC.

FORWARD-LOOKING STATEMENTS

This Form 10-K, chiefly in Items 1, 3, 5, 7 and 8, contains certain forward-looking statements that are subject to numerous assumptions, risks or uncertainties. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Some of the forward-looking statements can be identified by the use of forward-looking words such as "anticipates", "believes", "expects", "estimates", "intends", "plans", "seeks", "could", "may", "should", "will", or the negative version of those words or other comparable terminology. Examples of such forward-looking statements relate to: expectations concerning market and other conditions and their effect on future premiums, revenues, earning and investment activities; recoverability of asset values; mortality; the adequacy of reserves for environmental pollution and expected expense savings resulting from recent initiatives.

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

- changes in economic conditions, including interest rates, performance of securities markets, and the availability of capital;
- trends in mortality and morbidity;
- regulatory actions and changes;

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

- changes in legal environment;
- tax law changes;
- availability of reinsurance;
- competitive pressures; and
- changes in debt and claims paying ratings.

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

PART I

ITEM 1

Business

Introduction

Great American Financial Resources, Inc. ("GAFRI" or "the Company"), which was incorporated as a Delaware corporation in 1987, is an 83%-owned subsidiary of American Financial Group, Inc. ("AFG"). GAFRI is a holding company, which markets retirement products, primarily fixed and variable annuities, and various forms of life and supplemental health insurance through its subsidiaries listed below. GAFRI and its insurance subsidiaries employ approximately 1,000 people in the United States and 600 people (including approximately 450 company-employed agents) in Puerto Rico. SEC filings, news releases and other information may be accessed free of charge through GAFRI's Internet site at: www.gafri.com.

| <u>Subsidiary</u> | <u>Year acquired</u> |
|---|--------------------------|
| Great American Life Insurance Company ("GALIC") | 1992 |
| Annuity Investors Life Insurance Company ("AILIC") | 1994 |
| Loyal American Life Insurance Company ("Loyal") | 1995 |
| Great American Life Assurance Company of Puerto Rico ("GAPR") | 1997 |
| United Teacher Associates Insurance Company ("UTA") | 1999 |
| Manhattan National Life Insurance Company ("MNL") | 2002 |

Acquisitions in recent years have supplemented GAFRI's internal growth as the assets of the holding company and its operating subsidiaries have increased from \$4.5 billion at the end of 1992 to more than \$9.3 billion at the end of 2002. Premiums over the last five years were as follows (in millions):

| | <u>Premiums(1)</u> | | | | |
|------------------------|--------------------|-------------|-------------|-------------|-------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>1999</u> | <u>1998</u> |
| Life and Annuity Group | | | | | |
| Annuity(2) | \$1,000 | \$ 750 | \$ 746 | \$588 | \$521 |
| Life | 66 | 61 | 52 | 42 | 19 |
| Supplemental Insurance | 185 | 194 | 158 | 35 | 37 |
| GA Life of Puerto Rico | <u>63</u> | <u>56</u> | <u>52</u> | <u>49</u> | <u>48</u> |

\$1,314 \$1,061 \$1,008 \$714 \$625

1. Table does not include premiums of subsidiaries or divisions until their first full year following acquisition or formation. All periods exclude premiums of subsidiaries sold.
2. Includes UTA annuities of \$44 million, \$30 million and \$19 million in 2002, 2001 and 2000, respectively.

Annuities

GAFRI's principal products are Flexible Premium Deferred Annuities ("FPDAs") and Single Premium Deferred Annuities ("SPDAs"). Annuities are long-term retirement savings instruments that benefit from income accruing on a tax-deferred basis. The issuer of the annuity collects premiums, credits interest or earnings on the policy and pays out a benefit upon death, surrender or annuitization. FPDAs are characterized by premium payments that are flexible in both amount and timing as determined by the policyholder. SPDAs are issued in exchange for a one-time lump-sum premium payment.

1

The following table (in millions) presents combined financial information of GAFRI's principal annuity operations.

Generally Accepted Accounting Principles ("GAAP") Basis

| | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>1999</u> | <u>1998</u> |
|---------------------------|-------------|-------------|-------------|-------------|-------------|
| Total assets | \$8,014 | \$7,456 | \$7,052 | \$6,657 | \$6,549 |
| Fixed annuity reserves | 6,111 | 5,632 | 5,365 | 5,349 | 5,396 |
| Variable annuity reserves | 455 | 530 | 534 | 354 | 120 |
| Stockholder's equity | 1,139 | 1,023 | 915 | 801 | 862 |

Statutory Accounting Principles Basis

| | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>1999</u> | <u>1998</u> |
|---------------------------------|-------------|-------------|-------------|-------------|-------------|
| Total assets | \$7,319 | \$6,896 | \$6,620 | \$6,493 | \$6,159 |
| Fixed annuity reserves | 6,192 | 5,729 | 5,536 | 5,564 | 5,538 |
| Variable annuity reserves | 455 | 530 | 534 | 354 | 120 |
| Capital and surplus | 419 | 388 | 363 | 404 | 350 |
| Asset valuation reserve(a) | 63 | 79 | 77 | 67 | 63 |
| Interest maintenance reserve(a) | 27 | 11 | 3 | 10 | 21 |

Annuity receipts:

Flexible premium:

| | | | | | |
|------------|------------|------------|------------|------------|------------|
| First year | \$ 60 | \$ 67 | \$ 71 | \$ 55 | \$ 45 |
| Renewal | <u>190</u> | <u>175</u> | <u>156</u> | <u>145</u> | <u>149</u> |
| | 250 | 242 | 227 | 200 | 194 |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | | | |
|------------------------|----------------|---------------|---------------|---------------|---------------|
| Single premium | <u>750</u> | <u>508</u> | <u>519</u> | <u>388</u> | <u>327</u> |
| Total annuity receipts | <u>\$1,000</u> | <u>\$ 750</u> | <u>\$ 746</u> | <u>\$ 588</u> | <u>\$ 521</u> |

(a) Allocation of surplus.

Sales of annuities are affected by many factors, including: (i) competitive annuity products and rates; (ii) the general level of interest rates; (iii) the favorable tax treatment of annuities; (iv) commissions paid to agents; (v) services offered; (vi) ratings from independent insurance rating agencies; (vii) other alternative investments; (viii) performance of the equity markets and (ix) general economic conditions.

Annuity contracts are generally classified as either fixed rate (including equity-indexed) or variable. The following table presents premiums by classification:

| <u>Annuity Premiums</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>1999</u> | <u>1998</u> |
|-------------------------|-------------|-------------|-------------|-------------|-------------|
| Traditional fixed | 77% | 68% | 50% | 55% | 72% |
| Variable | 18 | 27 | 43 | 35 | 17 |
| Equity-indexed | <u>5</u> | <u>5</u> | <u>7</u> | <u>10</u> | <u>11</u> |
| | <u>100</u> | <u>100</u> | <u>100</u> | <u>100</u> | <u>100</u> |
| | % | % | % | % | % |

With a traditional fixed rate annuity, the interest crediting rate is initially set by the issuer and thereafter may be changed from time to time by the issuer subject to any guaranteed minimum interest crediting rates or any guaranteed term in the policy.

2

The Company seeks to maintain a desired spread between the yield on its investment portfolio and the rate it credits to its fixed rate annuities. GAFRI accomplishes this by: (i) offering crediting rates which it has the option to change after any initial guarantee period; (ii) designing annuity products that encourage persistency and (iii) maintaining an appropriate matching of assets and liabilities.

Virtually all new sales of GAFRI's traditional fixed rate annuities offer a minimum interest rate guarantee of 3% or 4% (as determined by applicable law); the majority permit GAFRI to change the crediting rate at any time (subject to the minimum guaranteed interest rates). In determining the frequency and extent of changes in the crediting rate, GAFRI takes into account the economic environment and the relative competitive position of its products. Historically, management has been able to react to changes in market interest rates and maintain a desired interest rate spread. The recent interest rate environment has resulted in a spread compression, which could continue through at least 2003.

In addition to traditional fixed rate annuities, GAFRI offers variable and equity-indexed annuities. Industry sales of such annuities increased substantially in the 1990's as investors sought to obtain the returns available in the equity markets while enjoying the tax-deferred status of annuities. With a variable annuity, the earnings credited to the policy vary based on the investment results of the underlying investment options chosen by the policyholder, generally without any guarantee of principal except in the case of death of the insured annuitant. Premiums directed to the

variable options in policies issued by GAFRI are invested in funds maintained in separate accounts managed by various independent investment managers. GAFRI earns a fee on amounts deposited into variable accounts. Policyholders may also choose to direct all or a portion of their premiums to various fixed rate options, in which case GAFRI earns a spread on amounts deposited. With the downturn in the stock market during the past three years, industrywide sales of variable annuities, including GAFRI sales, have decreased substantially.

An equity-indexed fixed annuity provides policyholders with a crediting rate tied, in part, to the performance of an existing stock market index while protecting them against the related downside risk through a guarantee of principal. GAFRI purchases call options designed to offset substantially all of the increases in the liabilities associated with equity-indexed annuities. In 2002, GAFRI chose to suspend new sales of equity-indexed annuities due primarily to a lack of volume.

In 2002, 2001 and 2000, 16%, 17% and 24%, respectively, of GAFRI's annuity premiums came from California. In 2002, approximately 10% of GAFRI's annuity premiums came from Washington. In 2001, approximately 13% of GAFRI's annuity premiums came from Ohio. No other state accounted for more than 10% of premiums in those years.

The majority of GAFRI's flexible premium annuities are sold in the qualified markets under section 403(b) and 401(k) of the Internal Revenue Code. In the 403(b) market, schools and certain other not-for-profit organizations may allow employees to save for retirement through contributions made on a before-tax basis. In the 401(k) market, both for-profit and not-for-profit organizations may establish qualified retirement plans where employees are eligible to save for retirement through contributions made primarily on a before-tax basis. For federal income tax purposes, before-tax contributions and earnings are not included in the employee's taxable income until amounts are withdrawn.

Sales of GAFRI's fixed rate annuities have increased over the past three years, due in part to the weak stock market environment as well as the development of new products.

3

GAFRI distributes its fixed rate products primarily through a network of 130 managing general agents ("MGAs") who, in turn, direct more than 1,300 actively producing independent agents. The top 15 MGAs accounted for nearly two-thirds of GAFRI's fixed annuity premiums in 2002. No one MGA represented more than 9% of total fixed annuity premiums in 2002. In addition to the independent insurance agent channel, GAFRI also sells its annuity product lines through financial institutions. Sales of annuities from this distribution channel were approximately 6% of total annuity premiums in 2002.

In 2002, GAFRI exited the highly competitive single premium, non-qualified segment of the variable annuity market due primarily to insufficient returns and a lack of critical mass. The Company intends to redesign its variable product and offer it as an ancillary product solely through its 403(b) and 401(k) sales channels. Approximately one-third of GAFRI's variable annuity sales in 2002 were made through the Company's wholly-owned subsidiary, Great American Advisors, Inc. ("GAA"). GAA is a broker/dealer licensed in all 50 states to sell stocks, bonds, options, mutual funds and variable insurance contracts through independent representatives and financial institutions. GAA also acts as the principal underwriter and distributor for the Company's variable annuity products.

GAFRI designs its products with certain provisions to encourage policyholders to maintain their funds with GAFRI for at least five to ten years. Persistency rates reflect the proportion of reserves maintained by the Company and not paid out in the form of surrenders, annuitizations or death benefits. The following table illustrates GALIC's annual persistency rates for its major product groups over the past five years.

Persistency Rates

| <u>Product Group</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>1999</u> | <u>1998</u> |
|----------------------|-------------|-------------|-------------|-------------|-------------|
| Flexible premium | 92% | 90% | 89% | 89% | 88% |
| Single premium | 90 | 88 | 87 | 88 | 87 |

Persistency rates are affected by many of the same factors that affect annuity sales. Although the stock market and interest rate environment affect persistency in the Company's fixed rate annuities, management believes that its persistency rate has benefited from the two-tier design of certain of its products. Two account values are maintained for two-tier annuities - the annuitization (or upper-tier) value and the surrender (or lower-tier) value. The annuitization value is paid upon a policyholder's death or election to annuitize (withdraw funds in a series of periodic payments for at least the minimum number of years specified in the policy). If a lump-sum payment is chosen by the policyholder, the surrender benefit is paid. GALIC's two-tier annuities are particularly attractive to policyholders who intend to accumulate funds to provide retirement income since the annuitization value is accumulated at a more competitive long-term interest rate. At December 31, 2002, two-tier annuities accounted for nearly half of the Company's fixed annuity reserves.

In 2002, more than three-fourths of fixed annuity premiums received were on single-tier policies. After the initial surrender charges have been reduced to zero, single-tier annuities carry one value whether the policy is surrendered or annuitized.

GAFRI is licensed to sell its fixed annuity products in all 50 states; it is licensed to sell its variable products in all states except Vermont. At December 31, 2002, GAFRI had over 305,000 annuity policies in force.

4

Life Operations

In 1997, GALIC began offering traditional term, universal and whole life insurance products through national marketing organizations. In 2002, GALIC's Life Operations had approximately 4,800 agents who sold at least two policies.

On June 28, 2002, GAFRI acquired MNL for \$48.5 million in cash. At December 31, 2002, the Company reinsured 90% of the business in force.

In 2002, the Company issued over \$8.0 billion gross (\$1.9 billion net) face amount of insurance through its life operations; at year-end 2002, this operation had approximately 228,000 policies and \$39 billion gross (\$12 billion net) face amount of insurance in force.

Supplemental Insurance

In 1999, GAFRI acquired UTA. UTA offers a variety of supplemental health products and annuities through independent agents. UTA's principal health products include coverage for Medicare supplement, cancer and long-term care. UTA utilizes endorsements from various state retired teachers associations to sell some of its products.

Loyal American Life Insurance Company offers a variety of supplemental health and life products. The principal products sold by Loyal include cancer, accidental injury, short-term disability, hospital indemnity, universal life and traditional whole life. In 2001, Loyal reinsured a substantial portion of its life insurance business, reduced its operating expenses and redirected its marketing efforts in that line of business. In 2002, Loyal's operations were consolidated with UTA's operations. Together, UTA and Loyal employ more than 200 people in Austin, Texas.

At year-end 2002, GAFRI's operating units writing supplemental insurance products had assets of nearly \$800 million and approximately 354,000 policies with annualized health premiums in force of \$185 million and gross life insurance

in force of \$1.4 billion.

GA Life of Puerto Rico

GAPR sells in-home service life and supplemental health products through a network of company-employed agents. Ordinary life, cancer, credit and group life products are sold through independent agents. GAPR employs over 600 people in Puerto Rico, including 450 company-employed agents.

Investments

Investments comprise almost 90% of the Company's assets (excluding variable annuity assets) and are the principal source of income. Fixed income investments (consisting of fixed maturity investments, policy loans, mortgage loans and short-term investments) comprise 98% of GAFRI's investment portfolio. Risks inherent in connection with fixed income securities include market price volatility and loss upon default. Factors which can affect the market price of these securities include: (i) changes in market interest rates; (ii) creditworthiness of issuers; (iii) the number of market makers and investors and (iv) defaults by major issuers of securities.

5

The Company's investment strategy emphasizes high-quality fixed income securities which management believes should produce a relatively consistent and predictable level of investment income.

The insurance laws of the domiciliary jurisdiction of each of GAFRI's life

insurance subsidiaries govern the types and amounts of investments which are permissible. These rules are designed to ensure the safety and liquidity of the insurers' investment portfolio by placing restrictions on the quality, quantity and diversification of permitted investments.

The NAIC assigns quality ratings to publicly traded as well as privately placed securities. These ratings range from Class 1 (highest quality) to Class 6 (lowest quality). The following table shows the Company's fixed maturity portfolio at market value by NAIC designation (and comparable Standard & Poor's Corporation rating) at December 31, 2002.

| <u>NAIC Rating</u> | <u>Comparable S&P Rating</u> | |
|------------------------|----------------------------------|-----------|
| 1 | AAA, AA, A | 73% |
| 2 | BBB | <u>20</u> |
| | Total investment grade | <u>93</u> |
| 3 | BB | 4 |
| 4 | B | 2 |
| 5 | CCC, CC, C | 1 |
| 6 | D | <u>*</u> |
| | Total non-investment grade | <u>7</u> |

| | |
|------------------------|------------|
| Total fixed maturities | <u>100</u> |
| | % |

* less than 1%

GAFRI's primary investment objective in selecting securities for its fixed maturity portfolio is to optimize interest yields while maintaining an appropriate relationship of maturities between assets and liabilities. The Company invests in bonds that have primarily intermediate-term maturities. This practice provides flexibility to respond to fluctuations in the marketplace.

At December 31, 2002, the average maturity of GAFRI's fixed maturity investments was approximately six and one-half years (including mortgage-backed securities, which had an estimated average life of approximately five and one-fourth years). The table below sets forth the maturities of the Company's fixed maturity investments based on their market value at December 31, 2002.

| | |
|------------------------------------|------------|
| <u>Maturity</u> | |
| One year or less | 6% |
| After one year through five years | 21 |
| After five years through ten years | 28 |
| After ten years | <u>13</u> |
| | 68 |
| Mortgage-backed securities | <u>32</u> |
| | <u>100</u> |
| | % |

6

The following table shows the performance of GAFRI's investment portfolio, excluding real estate investments (dollars in millions).

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--------------------------------------|-------------|-------------|-------------|
| Average cash and investments at cost | \$7,136 | \$6,582 | \$6,423 |
| Gross investment income | 532 | 508 | 498 |
| Realized gains (losses)* | (46) | (52) | 8 |
| Percentage earned: | | | |
| Excluding realized gains (losses) | 7.5% | 7.7% | 7.8% |
| Including realized gains (losses) | 6.8% | 6.9% | 7.9% |

*Includes charges for "other than temporary" impairments of \$97.4 million, \$77.0 million and \$14.3 million in 2002, 2001 and 2000, respectively.

Competition

The Insurance Companies operate in highly competitive markets. They compete with other insurers and financial institutions based on many factors, including: (i) ratings; (ii) financial strength; (iii) reputation; (iv) service to policyholders and agents; (v) product design (including interest rates credited and premium rates charged) and (vi) commissions. Since policies are marketed and distributed primarily through independent agents (except at GAFRI), the Insurance Companies must also compete for agents.

No single insurer dominates the markets in which the Insurance Companies compete. Competitors include: (i) individual insurers and insurance groups; (ii) mutual funds and (iii) other financial institutions. In a broader sense, GAFRI's Insurance Companies compete for retirement savings with a variety of financial institutions offering a full range of financial services. Financial institutions have demonstrated a growing interest in marketing investment and savings products other than traditional deposit accounts.

Regulation

The Insurance Companies are subject to comprehensive regulation under the insurance laws of their states of domicile and the other states in which they operate. These laws, in general, require approval of the particular insurance regulators prior to certain actions such as the payment of dividends in excess of statutory limitations, continuing service arrangements with affiliates and certain other transactions. Regulation and supervision are administered by a state insurance commissioner who has broad statutory powers with respect to granting and revoking licenses, approving forms of insurance contracts and determining types and amounts of business which may be conducted in light of the financial strength and size of the particular company.

The maximum amount of dividends which can be paid in any 12 month period to stockholders by life insurance companies domiciled in the State of Ohio (including GALIC, AILIC and Loyal) without prior approval of the Ohio Insurance Commissioner is the greater of 10% of policyholder surplus or prior year's net income, but only to the extent of earned surplus as of the preceding December 31. Under applicable restrictions, the maximum amount of dividends available to GAFRI in 2003 from GALIC, its principal Ohio domiciled insurance subsidiary, without seeking regulatory clearance, is \$41.9 million.

7

State insurance departments periodically examine the business and accounts of the Insurance Companies and require such companies to submit detailed annual financial statements prepared in accordance with statutory requirements. State insurance laws also regulate the character of each insurance company's investments, reinsurance and security deposits.

The Insurance Companies may be required, under the solvency or guaranty laws of most states in which they do business, to pay assessments (up to certain prescribed limits) to fund policyholder losses or liabilities of insurance companies that become insolvent. These assessments may be deferred or forgiven under most guaranty laws if they would threaten an insurer's financial strength and, in certain instances, may be offset against future premium taxes.

The NAIC is an organization comprised of the chief insurance regulators for each of the 50 states, the District of Columbia and the four U.S. territories. One of its major roles is to develop model laws and regulations affecting insurance company operations and encourage uniform regulation through the adoption of such model laws in all states. As part of the overall insurance regulatory process, the NAIC forms numerous task forces to review, analyze and recommend changes to a variety of areas affecting both the operating and financial aspects of insurance companies.

Many of the Company's other subsidiaries are subject to regulation by various state, federal and other regulatory authorities. Several subsidiaries are insurance agencies and as such are regulated by state insurance departments. Great American Advisors is subject to the rules of the National Association of Securities Dealers, Inc. and the securities laws of the states in which it transacts business. AILIC's variable insurance products are subject to the rules and regulations of the Securities and Exchange Commission and "Blue Sky" laws of the states in which their products are sold.

Foreign Operations

In 1998, GAFRI opened an office in Bangalore, India. Employees located at this office perform computer programming and certain back office functions for the Company's insurance operations. Management believes there are sufficient resources available at domestic locations should there be any interruption in the operations at this office and as a result no materially adverse impact would result from any such interruption.

In 2003, GAFRI entered into an agreement to sell its Indian operation to an unaffiliated third party. The Company will receive a minimum of \$500,000 per year over the next four years based on the amount of business administered by the Indian operation. The Company has also entered into an agreement with the third party to obtain certain services currently provided by this operation for the next five years. The transaction is expected to close in the second quarter of this year and is not expected to have a material impact on the Company or its results.

GAFRI also owns an insurance company in Puerto Rico (see Item 1 - "GA Life of Puerto Rico").

8

ITEM 2

Properties

Location

GAFRI, GALIC and Loyal rent office space in Cincinnati, Ohio totaling approximately 180,000 square feet under leases expiring primarily in 2006 through 2008. Several of the Company's subsidiaries lease marketing and administrative offices in locations throughout the United States.

GAPR rents office space in Puerto Rico totaling approximately 75,000 square feet under leases expiring primarily in 2005.

American Data Source India Private Limited, a software development and administrative services subsidiary of GAFRI, rents space in Bangalore, India totaling approximately 26,000 square feet. The Company has entered into an agreement to sell this subsidiary. (See Item 1 - Foreign Operations)

GAFRI owns a building in Austin, Texas totaling approximately 40,000 square feet, the vast majority of which is used by UTA for its own operations. The remainder of the space is leased to other tenants.

Management believes that its corporate offices are generally well maintained and adequate for the Company's present needs.

GAFRI owns facilities related to its former manufacturing operations totaling approximately 150,000 square feet in North Adams, Massachusetts and 60,000 square feet in Longwood, Florida. The space in these facilities is currently being leased to companies using it for manufacturing and other operations.

ITEM 3

Legal Proceedings

Federal and state laws and regulations, including the Federal Comprehensive Environmental Response, Compensation, and Liability Act and similar state laws, impose liability on the Company, (as the successor to Sprague Technologies, Inc.), for the investigation and clean-up of hazardous substances disposed of or spilled by its former manufacturing operations at facilities still owned by the Company, and facilities transferred in connection with the sales of certain operations, as well as at disposal sites operated by third parties. In addition, the Company has indemnified the purchasers of its former operations for the cost of such activities. At several sites, the Company is conducting clean-up activities of soil and ground water contamination in accordance with consent agreements between the Company and state environmental agencies. The Company has also conducted or is aware of investigations at a number of other locations of its former operations that have disclosed environmental contamination that could cause the Company to incur additional investigative, remedial and legal costs. The Company has also been identified by state and federal regulators as a potentially responsible party at a number of other disposal sites.

Based on the costs incurred by the Company over the past several years and discussions with its independent environmental consultants, management believes that reserves recorded are sufficient in all material respects to satisfy the estimated liabilities. However, the regulatory standards for clean-up are

9

continually evolving and may impose more stringent requirements. In addition, many of the environmental investigations at the Company's former operating locations and third-party sites are still preliminary, and where clean-up plans have been proposed, they have not yet received full approval from the relevant regulatory agencies. Further, the presence of Company-generated wastes at third-party disposal sites exposes the Company to joint and several liability for the potential additional costs of cleaning up wastes generated by others. Accordingly, there can be no assurance that the costs of environmental clean-up for the Company may not be significantly higher in future years, possibly necessitating additional charges.

There are certain other claims involving the Company, including claims relating to the generation, disposal or release into the environment of allegedly hazardous substances. In management's opinion, the outcome of these claims will not, individually or in the aggregate, have a material adverse effect on the Company's financial condition.

UTA was named a defendant in a purported class action lawsuit. (Peggy Berry, et al. v. United Teacher Associates Insurance Company, Travis County District Court, Cause No. GN100461, filed February 11, 2001). The complaint seeks unspecified damages based on the alleged misleading disclosure of UTA's interest crediting practices on its fixed rate annuities. UTA has entered into an agreement to resolve this matter. That settlement is subject to approval of the trial court. The resolution of this matter is not expected to have a material impact on the Company.

GAFRI is subject to other litigation and arbitration in the normal course of business. GAFRI is not a party to any material pending litigation or arbitration.

PART II

ITEM 5

Market for Registrant's Common Equity
and Related Stockholder Matters

GAFRI's Common Stock is listed and traded principally on the New York Stock Exchange ("NYSE") under the symbol GFR. On March 1, 2003, there were approximately 5,200 holders of record of Common Stock. The following table sets forth the range of high and low sales prices for the Common Stock on the NYSE Composite Tape.

| | <u>2002</u> | | <u>2001</u> | |
|----------------|-------------|------------|-------------|------------|
| | <u>High</u> | <u>Low</u> | <u>High</u> | <u>Low</u> |
| First quarter | \$18.85 | \$16.99 | \$19.63 | \$17.90 |
| Second quarter | 20.00 | 16.80 | 18.05 | 16.59 |
| Third quarter | 19.86 | 13.35 | 19.49 | 16.95 |
| Fourth quarter | 17.60 | 14.82 | 19.25 | 17.05 |

The Company paid annual common dividends of \$.10 per share in 2002 and 2001. Although no future dividend policy has been determined, management believes the Company will continue to have the capability to pay similar dividend amounts.

10

At March 1, 2003, approximately 83% of GAFRI's Common Stock was beneficially owned by AFG.

Equity Compensation Plan Information

The following reflects certain information about shares of GAFRI Common Stock authorized for issuance (at December 31, 2002) under equity compensation plans.

Number of securities
 available for future
 issuance under equity

| <u>Equity Compensation Plans</u> | <u>Number of securities to be issued upon exercise of outstanding options</u> | <u>Weighted-average exercise price of outstanding options</u> | <u>compensation plans (excluding securities reflected in column (a))</u> |
|----------------------------------|---|---|--|
| | (a) | (b) | (c) |
| Approved by shareholders | 3,265,185 | \$17.06 | 1,715,777 (1) |
| Not approved by shareholders | 613,118 | \$18.49 | 1,997,583 (2) |

- Includes options exercisable into 0.8 million shares available for issuance under GAFRI's Stock Option Plans for employees and directors, 0.8 million shares issuable under GAFRI's Employee Stock Purchase Plan and 68,400 shares issuable under GAFRI's Non-employee Directors' Compensation Plan.
- Represents shares issuable under the GAFRI Deferred Compensation Plan (0.2 million shares), the Agent Stock Purchase Plan (0.9 million shares), the Agent Stock Option Plan (0.4 million shares) and GAFRI's Bonus Plan (0.5 million shares).

Under the GAFRI Deferred Compensation Plan, certain highly compensated employees of GAFRI and its subsidiaries may defer a portion of their annual salary and/or bonus under the Company's Deferred Compensation Plan. Participants may elect to have the value of deferrals (i) earn a fixed rate of interest set annually by the Board of Directors or a committee thereof, or (ii) fluctuate based on the market value of GAFRI Common Stock, as adjusted to reflect stock splits, distributions, dividends, and a 7-1/2% match to participant deferrals.

Under the Agent Stock Purchase Plan, selected agents are able to utilize commissions earned from the sale of insurance products issued by the Company's subsidiaries to purchase GAFRI Common Stock at 92.5% of the fair market value. The Plan provides that up to 1,000,000 shares of GAFRI Common Stock may be issued.

Under the Agent Stock Option Plan, selected agents are able to earn options to purchase GAFRI Common Stock based on the amount of premium the agents produce from the sale of insurance products issued by the Company's subsidiaries. The options have an exercise price equal to the fair market value of GAFRI Common Stock at the time of grant. The options include vesting provisions based on future premium production. The Plan provides that up to 1,000,000 shares of GAFRI Common Stock may be issued upon the exercise of options.

Under GAFRI's Bonus Plan covering the majority of the Company's officers, participants are required to receive 25% of their annual bonus in the form of GAFRI Common Stock. The Bonus Plan provides for the issuance of up to 500,000 shares of GAFRI Common Stock as partial payment of annual bonuses.

ITEM 6

Selected Financial Data

The following financial data has been summarized from, and should be read in conjunction with, the Company's Consolidated Financial Statements and "Management's Discussion and Analysis of Financial Condition and Results of Operations." The data reflects the acquisitions of MNL in June 2002 and UTA in October 1999, and the sale of the Company's Funeral Insurance Division in September 1998 (in millions, except per share amounts).

| | <u>2002</u> | <u>2001</u> | <u>2000</u> | <u>1999</u> | <u>1998</u> |
|---|----------------|----------------|----------------|----------------|----------------|
| <u>Income Statement Data:</u> | | | | | |
| Total revenues | \$883.2 | \$830.1 | \$824.3 | \$661.5 | \$746.4 |
| Operating earnings before income taxes | \$ 38.9 | \$ 59.9 | \$ 81.1 | \$ 92.0 | \$143.9 |
| Income before extraordinary items and accounting changes | \$ 33.9 | \$ 42.7 | \$ 53.9 | \$ 63.5 | \$ 97.5 |
| Extraordinary items | - | - | - | - | (0.8) |
| Cumulative effect of accounting changes (a) | <u>(17.7)</u> | <u>(5.5)</u> | <u>0.8</u> | <u>(4.7)</u> | <u>-</u> |
| Net income | <u>\$ 16.2</u> | <u>\$ 37.2</u> | <u>\$ 54.7</u> | <u>\$ 58.8</u> | <u>\$ 96.7</u> |
| Basic earnings per common share: | | | | | |
| Income before extraordinary items and accounting changes | \$ 0.80 | \$ 1.01 | \$ 1.27 | \$ 1.50 | \$ 2.27 |
| Extraordinary items | - | - | - | - | (0.02) |
| Accounting changes (a) | <u>(0.42)</u> | <u>(0.13)</u> | <u>0.02</u> | <u>(0.11)</u> | <u>-</u> |
| Net income | <u>\$ 0.38</u> | <u>\$ 0.88</u> | <u>\$ 1.29</u> | <u>\$ 1.39</u> | <u>\$ 2.25</u> |
| Diluted earnings per common share: | | | | | |
| Income before extraordinary items and accounting changes | \$ 0.79 | \$ 1.00 | \$ 1.26 | \$ 1.48 | \$ 2.23 |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | | | |
|--|----------------|----------------|----------------|----------------|----------------|
| Extraordinary items | - | - | - | - | (0.02) |
| Accounting changes (a) | <u>(0.41)</u> | <u>(0.13)</u> | <u>0.02</u> | <u>(0.11)</u> | <u>-</u> |
| |) |) |) |) |) |
| Net income | <u>\$ 0.38</u> | <u>\$ 0.87</u> | <u>\$ 1.28</u> | <u>\$ 1.37</u> | <u>\$ 2.21</u> |
| Cash dividends per common share | \$0.10 | \$0.10 | \$0.10 | \$0.10 | \$0.10 |
| <u>Balance Sheet Data at year-end:</u> | | | | | |
| Total assets | \$9,362.6 | \$8,400.4 | \$7,975.9 | \$7,530.7 | \$7,190.4 |
| Notes payable | 250.3 | 223.0 | 151.9 | 201.3 | 131.0 |
| Mandatorily redeemable preferred securities of subsidiary trusts | 142.9 | 142.9 | 217.9 | 219.6 | 225.0 |
| Net unrealized gains (losses) included in stockholders' equity | 180.0 | 89.8 | 43.9 | (52.9) | 160.1 |
| Total stockholders' equity | 851.9 | 748.8 | 671.7 | 525.7 | 688.7 |

a. Reflects the implementation in the following years of accounting changes mandated by recently enacted accounting standards:

2002 - SFAS #142 (Goodwill and Other Intangibles)

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

2000 - SFAS #133 (Derivatives)

1999 - SOP 98-S (Start-up Costs)

12

ITEM 7

Management's Discussion and Analysis

of Financial Condition and Results of Operations

Please refer to "Forward-Looking Statements" following the index in front of this Form 10-K.

General

Following is a discussion and analysis of the financial statements and other statistical data that management believes will enhance the understanding of the financial condition and results of operations of Great American Financial Resources, Inc. ("GAFRI" or "the Company"). This discussion should be read in conjunction with the financial statements beginning on page F-1.

GAFRI 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.

Critical Accounting Policies

Significant accounting policies are described in Note B to the financial statements. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that can have a significant effect on amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future. Management believes that the establishment of insurance reserves, the determination of "other than temporary" impairments on investments, the recoverability and carrying value of unamortized insurance acquisition costs and environmental reserves of GAFRI's former manufacturing operations are the areas where the degree of judgement required to determine amounts recorded in the financial statements make the accounting policies critical.

Liquidity and Capital Resources

Ratios

GAFRI's consolidated debt to capital ratio was 23% in 2002. For purposes of this calculation, capital represents the sum of consolidated debt, redeemable preferred securities of subsidiary trusts and stockholders' equity (excluding unrealized gains (losses) on marketable securities).

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 December 31, 2002, the capital ratio of GAFRI's principal insurance subsidiary was 5.7 times its authorized control level RBC.

Sources and Uses of Funds

To pay interest and principal on borrowings and other holding company costs, GAFRI (parent) and AAG Holding use primarily capital distributions from their directly-owned insurance subsidiaries, (Great American Life Insurance Company ("GALIC") and GA Life of Puerto Rico ("GAPR")), bank borrowings and cash and investments on hand. Capital distributions from GAFRI's insurance subsidiaries are subject to regulatory restrictions relating to statutory surplus and earnings. The maximum amount of dividends payable by GALIC and GAPR in 2003 without prior regulatory approval is \$41.9 million and \$25.8 million, respectively. In 2002, GALIC paid \$23.0 million in dividends and GAPR paid \$2.5 million in dividends. Also in 2002, GAFRI made capital contributions to GALIC of \$34.0 million.

In the third quarter of 2000, GAFRI paid down approximately \$50 million of its bank credit line. In January 2001, the Company replaced its existing agreement with a \$155 million unsecured credit agreement, which matures at December 31, 2004. In September 2001, GAFRI redeemed its ROPES for \$75 million in cash using bank borrowings. At March 1, 2003, GAFRI had \$6 million available under its bank credit line.

In recent years, the Company has entered into several reinsurance transactions in connection with certain of its life and supplemental health operations. These transactions were entered into both in the normal course of business and as a source of additional capital and liquidity. The Company may enter into additional reinsurance transactions in the future.

At December 31, 2002, GAFRI had \$250 million available under a shelf registration.

Based upon the current level of operations and anticipated growth, GAFRI believes that it will have sufficient resources to meet its liquidity requirements.

Independent

Ratings The Company's principal insurance subsidiaries ("Insurance Companies") are rated by A.M. Best, Fitch and Standard & Poor's. GALIC is rated A3 (good financial security) by Moody's. Such ratings are generally based on items of concern to policyholders and agents and are not directed toward the protection of investors. Following are the Company's ratings as of March 1, 2003:

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

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

Management believes that the ratings assigned by independent insurance rating agencies are important because potential policyholders often use a company's rating as an initial screening device in considering annuity products. Management believes that (i) a rating of "A" by A.M. Best (its third highest rating) 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.

The Company's insurance ratings were recently affirmed by Fitch (with a stable outlook), and affirmed by Moody's (with a negative outlook); its ratings were downgraded by Standard & Poor's (with a negative outlook). GAFRI's operations could be materially and adversely affected by additional downgrades. In connection with recent reviews by independent rating agencies, management indicated that it intends to maintain the capital of its significant insurance subsidiaries at levels currently indicated by the rating agencies as appropriate

14

for the current ratings. Items which could adversely affect capital levels include (i) a sustained decrease in the stock market in 2003 or beyond; (ii) a significant period of low interest rates and a resulting significant narrowing of annuity "spread"; (iii) investment impairments; (iv) a change in statutory reserving requirements for guaranteed minimum death benefits on variable annuities; (v) adverse mortality, and (vi) higher than planned dividends paid due to liquidity needs by GAFRI and AAG Holding.

2002 Acquisition

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

On June 28, 2002, GALIC acquired Manhattan National Life Insurance Company ("MNL") for \$48.5 million in cash. In December 2002, the Company reinsured 90% of the business in force. At December 31, 2002, MNL had statutory assets of approximately \$272 million and statutory capital and surplus of \$45.3 million.

Investments

Insurance laws restrict the types and amounts of investments which are permissible for life insurers. These restrictions are designed to ensure the safety and liquidity of insurers' investment portfolios.

GAFRI invests primarily in fixed income investments which, including loans and short-term investments, comprised 98% of its investment portfolio at December 31, 2002. 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 December 31, 2002, 93% of GAFRI's fixed maturity portfolio was comprised of investment grade bonds (NAIC rating of "1" or "2").

Management believes that a high quality investment portfolio is more likely to generate a stable and predictable investment return.

At December 31, 2002, GAFRI's mortgage-backed securities ("MBSs") portfolio represented approximately one-third of its fixed maturity investments. MBSs are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of the lower current rates. Due to the significant decline in the general level of interest rates in 2002, GAFRI has experienced an increase in the level of prepayments on its MBS portfolio; these prepayments have not been reinvested at interest rates comparable to the rates earned on the prepaid MBSs. Partly as a result of this, the overall yield on GAFRI's fixed maturity portfolio dropped from 7.7% at year end 2001 to 7.0% at year end 2002.

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

15

At December 31, 2002, GAFRI had pretax net unrealized gains of \$287 million on fixed maturities and \$26 million on equity securities. Summarized information for the unrealized gains and losses recorded in GAFRI's balance sheet at December 31, 2002, is shown in the following table (dollars in millions). Approximately \$138 million of "Fixed Maturities" and \$7 million of "Equity Securities" had no unrealized gains or losses at December 31, 2002.

| | Securities with Unrealized <u>Gains</u> | Securities with Unrealized <u>Losses</u> |
|----------------------------|--|---|
| <u>Fixed maturities</u> | | |
| Market value of securities | \$6,239 | \$ 804 |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | |
|---|---------|----------|
| Amortized cost of securities | \$5,872 | \$ 884 |
| Gross unrealized gain or (loss) | \$ 367 | (\$ 80) |
| Market value as % of amortized cost | 106% | 91% |
| Number of security positions | 1,261 | 244 |
| Number individually exceeding \$2 million gain or loss | 11 | 10 |
| Concentration of gains or (losses) by type or industry (exceeding 5% of unrealized): | | |
| Mortgage-backed securities | \$100.9 | (\$ 7.6) |
| Banks | 35.8 | (0.5) |
| U.S. government | 28.5 | (1.1) |
| State and municipal | 19.5 | (2.5) |
| Electric services | 16.2 | (8.6) |
| Asset-backed securities | 10.5 | (8.1) |
| Air transportation (generally collateralized) | 3.6 | (27.7) |
| Percentage rated investment grade | 98% | 67% |

Equity securities

| | | |
|---------------------------------|------|-------|
| Market value of securities | \$64 | \$2 |
| Cost of securities | \$37 | \$3 |
| Gross unrealized gain or (loss) | \$27 | (\$1) |
| Market value as % of cost | 173% | 67% |

GAFRI's investment in equity securities of Provident Financial Group, a Cincinnati-based commercial banking and financial services company, represents \$22 million of the \$27 million in unrealized gains on equity securities at December 31, 2002.

The table below sets forth the scheduled maturities of fixed maturity securities at December 31, 2002, based on their market values. Securities that do not have a single maturity date are reported at average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

| <u>Maturity</u> | Securities with Unrealized Gains | Securities with Unrealized Losses |
|------------------------------------|---|--|
| * | * | * |
| One year or less | 6% | 4% |
| After one year through five years | 19 | 22 |
| After five years through ten years | 29 | 35 |
| After ten years | <u>11</u> | <u>22</u> |
| | 65 | 83 |
| Mortgage-backed securities | <u>35</u> | <u>17</u> |

100
100
%
%

*Excludes \$138 million of fixed maturities with no unrealized gains or losses.

16

GAFRI realized aggregate losses of \$5.1 million during 2002 on \$34.1 million in sales of fixed maturity securities (7 issues/issuers) that had individual unrealized losses greater than \$500,000 at December 31, 2001. Market values of five of the securities increased an aggregate of \$3.4 million from December 31, 2001 to date of sale. One of the securities was a Conseco bond that decreased in value by \$3.1 million from December 31, 2001 to the date of sale due to the continued decline in Conseco's financial condition. The market value of the remaining security did not change from December 31, 2001 to the sale date.

Although GAFRI had the ability to continue holding these investments, its intent to hold them changed due primarily to deterioration in the issuers' creditworthiness, decisions to lessen exposure to a particular credit or industry, or to modify asset allocation within the portfolio. None of the securities were sold out of a necessity to raise cash. GAFRI has the ability and intent to hold securities with unrealized losses at December 31, 2002, for a period of time sufficient to allow for a recovery in market value.

The table below (dollars in millions) summarizes the length of time securities have been in an unrealized gain or loss position at December 31, 2002.

| | <u>Aggregate Market Value</u> | <u>Aggregate Unrealized Gain (Loss)</u> | <u>Market Value as % of Cost Basis</u> |
|---|---------------------------------------|---|--|
| <u>Fixed Maturities</u> | | | |
| Securities with unrealized gains at 12/31/02: | | | |
| Exceeding \$500,000 and for: | | | |
| Less than one year (200 issues) | \$2,293 | \$172 | 108.1% |
| More than one year (36 issues) | 443 | 50 | 112.7 |
| Less than \$500,000 and an unrealized gain for: | | | |
| Less than one year (575 issues) | 2,119 | 75 | 103.7 |
| More than one year (450 issues) | <u>1,384</u> | <u>70</u> | 105.3 |
| | <u>\$6,239</u> | <u>\$367</u> | 106.3% |

Securities with unrealized losses at 12/31/02:

Exceeding \$500,000 and for:

| | | | |
|--------------------------------|--------|---------|-------|
| Less than one year (38 issues) | \$ 197 | (\$ 49) | 80.1% |
|--------------------------------|--------|---------|-------|

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | |
|---|---------------|----------------|-------|
| More than one year (7 issues) | 39 | (10) | 79.6 |
| Less than \$500,000 and an unrealized loss for: | | | |
| Less than one year (148 issues) | 450 | (14) | 97.0 |
| More than one year (51 issues) | <u>118</u> | <u>(7</u> | 94.4 |
| |) | | |
| | <u>\$ 804</u> | <u>(\$ 80)</u> | 91.0% |

Equity Securities

Securities with unrealized gains at 12/31/02:

Exceeding \$500,000 and for:

| | | | |
|---|-------------|-------------|--------|
| Less than one year (3 issues) | \$15 | \$ 4 | 136.4% |
| More than one year (1 issue) | 38 | 22 | 237.5 |
| Less than \$500,000 and an unrealized gain for: | | | |
| Less than one year (8 issues) | 7 | 1 | 116.7 |
| More than one year (2 issues) | <u>4</u> | <u>-</u> | 100.0 |
| | <u>\$64</u> | <u>\$27</u> | 173.0% |

Securities with unrealized losses at 12/31/02:

Exceeding \$500,000 and for:

| | | | |
|-------------------------------|------|------|-----|
| Less than one year (0 issues) | \$ - | \$ - | - % |
| More than one year (0 issues) | - | - | - |

Less than \$500,000 and an unrealized loss for:

| | | | |
|-------------------------------|-------------|---------------|-------|
| Less than one year (3 issues) | 1 | (1) | 50.0 |
| More than one year (1 issue) | <u>1</u> | <u>-</u> | 100.0 |
| | <u>\$ 2</u> | <u>(\$ 1)</u> | 66.7% |

When a decline in the value of a specific investment is considered to be "other than temporary," a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are "other than temporary" requires judgment based on subjective as well as objective factors. Factors considered and resources used by management include:

- a. whether the unrealized loss is credit-driven or a result of changes in market interest rates,
- b. the extent to which market value is less than cost basis,
- c. historical operating, balance sheet and cash flow data contained in issuer SEC filings,
- d. issuer news releases,
- e. near-term prospects for improvement in the issuer and/or its industry,
- f. industry research and communications with industry specialists,
- g. third party research and credit rating reports,
- h. internally generated financial models and forecasts,
- i. discussions with issuer management, and
- j. ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

Based on its analysis of the factors enumerated above, management believes (i) GAFRI will recover its cost basis in the securities with unrealized losses and (ii) that 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. While management believes it is not likely that future impairment charges will have a significant effect on GAFRI's liquidity, impairment charges could have an effect on the Company's ratings.

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

| | Net Realized Gains(Losses) <u>on Sales</u> | Charges for <u>Impairment</u> | <u>Other(a)</u> | <u>Total</u> |
|------|--|----------------------------------|-----------------|--------------|
| 2002 | \$53.1 | (\$97.4) | (\$1.4) | (\$45.7) |
| 2001 | 19.1 | (77.0)(b) | 6.3 | (51.6) |
| 2000 | 21.0 | (14.3) | 1.1 | 7.8 |
| 1999 | (0.6) | (8.6) | 2.1 | (7.1) |
| 1998 | 11.6 | (5.9) | (1.7) | 4.0 |

- a. Includes adjustments to carry derivatives at market and to reflect the impact of realized gains and losses on the amortization of deferred policy acquisition costs.
- b. Does not include an \$8.4 million writedown of certain collateralized debt obligations, which was recorded as the cumulative effect of an adoption of an accounting change at April 1, 2001.

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

Exposure to Market Risk

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

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

The following table provides information about GAFRI's fixed maturity investments at December 31, 2002 and 2001, that are sensitive to interest rate risk. These tables show (dollars in millions) principal cash flows and related weighted-average interest rates by expected maturity date for each of the five subsequent years and for all years thereafter. Callable bonds and notes are included based on call date or maturity date depending upon which date produces the most conservative yield. MBSs and sinking fund issues are included based on maturity year adjusted for expected payment patterns. Actual cash flows may differ from those expected.

| | <u>December 31, 2002</u> | | | <u>December 31, 2001</u> | |
|------------|---------------------------------|-------------|------------|---------------------------------|-------------|
| | <u>Principal Cash Flows</u> | <u>Rate</u> | | <u>Principal Cash Flows</u> | <u>Rate</u> |
| 2003 | \$ 822 | 11.3% | 2002 | \$ 657 | 8.6% |
| 2004 | 548 | 8.5 | 2003 | 886 | 7.8 |
| 2005 | 556 | 7.3 | 2004 | 587 | 8.5 |
| 2006 | 629 | 6.8 | 2005 | 673 | 7.5 |
| 2007 | 653 | 5.8 | 2006 | 613 | 7.2 |
| Thereafter | <u>3,622</u> | 6.3 | Thereafter | <u>2,960</u> | 7.3 |
| Total | <u>\$6,830</u> | 7.2% | Total | <u>\$6,376</u> | 7.6% |
| Fair Value | <u>\$7,181</u> | | Fair Value | <u>\$6,431</u> | |

Annuity Contracts

Substantially all of GAFRI's fixed rate annuity contracts permit GAFRI to change crediting rates (subject to minimum interest rate guarantees of 3% to 4% per annum as determined by applicable law) enabling management to react to changes in market interest rates. Nonetheless, due to the sharp drop in interest rates in 2002, GAFRI's spreads have narrowed and will likely continue to narrow through at least 2003. Actuarial assumptions used to estimate DPAC and Annuity Benefits, as well as GAFRI's ability to maintain spread, could be impacted if the current interest rate environment continues for an extended period and causes policyholder

behavior to be altered.

Projected payments in each of the next five years and for all years thereafter on GAFRI's fixed annuity liabilities at December 31 are as follows (dollars in millions):

| | <u>First</u> | <u>Second</u> | <u>Third</u> | <u>Fourth</u> | <u>Fifth</u> | <u>There after</u> | <u>Total</u> | <u>Fair Value</u> |
|------|--------------|---------------|--------------|---------------|--------------|------------------------|--------------|-----------------------|
| 2002 | \$550 | \$610 | \$740 | \$810 | \$700 | \$3,044 | \$6,454 | \$6,284 |
| 2001 | \$750 | \$680 | \$650 | \$630 | \$610 | \$2,512 | \$5,832 | \$5,659 |

19

Nearly half of GAFRI's fixed annuity liabilities at December 31, 2002, were two-tier in nature in that policyholders can receive a higher amount if they annuitize rather than surrender their policy, even if the surrender charge period has expired. At December 31, 2002, the average stated crediting rate on GAFRI's principal fixed annuity products was approximately 4.3% and current stated crediting rates (excluding bonus interest) on GAFRI's active products generally range from 3.0% to 3.6%. GAFRI estimates that its effective weighted-average crediting rate, on its inforce business over the next five years will approximate 4.3%. This rate reflects actuarial assumptions as to: (i) expected investment spread (ii) deaths; (iii) annuitizations; (iv) surrenders and (v) renewal premiums. Actual experience and changes in actuarial assumptions may result in different effective crediting rates than those above.

GAFRI's equity-indexed fixed annuities provide policyholders with a crediting rate tied, in part, to the performance of an existing stock market index. GAFRI attempts to mitigate the risk in the equity-based component of these products through the purchase of call options on the appropriate index. The Company's strategy is designed so that an increase in the liabilities, due to an increase in the market index, will be substantially offset by unrealized gains on the call options purchased by the Company. Under SFAS No. 133, both the equity-based component of the annuities and the related call options are considered derivatives and marked to market through current earnings as annuity benefits. Adjusting these derivatives to market value had a net effect of less than 1% of annuity benefits in 2002 and 2001. In 2002, GAFRI chose to suspend new sales of equity-indexed annuities due primarily to lack of volume.

Debt and Preferred Securities

The following table shows scheduled principal payments on fixed rate long-term debt of GAFRI and related weighted-average interest rates for the next five years and for all years thereafter (in millions):

| | <u>December 31, 2002</u> | | | <u>December 31, 2001</u> | |
|-------------------|---|-------------|-------------------|---|-------------|
| | <u>Scheduled Principal Payments</u> | <u>Rate</u> | | <u>Scheduled Principal Payments</u> | <u>Rate</u> |
| 2003 through 2007 | * | | 2002 through 2006 | * | |
| Thereafter | <u>\$100.8</u> | 6.9% | Thereafter | <u>\$100.8</u> | 6.9% |
| Total | <u>\$101.7</u> | 6.8% | Total | <u>\$101.9</u> | 6.8% |
| Fair Value | <u>\$ 91.7</u> | | Fair Value | <u>\$ 95.2</u> | |

* Less than \$1 million each year

Under the terms of the Company's bank credit facility entered into in January 2001, GAFRI and its subsidiaries have no variable-rate debt maturing until December 2004. The weighted-average interest rate on GAFRI's variable-rate debt was 2.1% at March 1, 2003, 2.2% at December 31, 2002, and 2.9% at December 31, 2001. There were \$143 million of subsidiary trust preferred securities outstanding at December 31, 2002, and 2001, none of which are scheduled for maturity or mandatory redemption during the next five years; the weighted-average interest rate on these trust securities at December 31, 2002 and 2001 was 9.1%.

20

Results of Operations

General

The comparability of GAFRI's financial statements is affected by the acquisitions of subsidiaries discussed in Note C to its financial statements.

Results of operations as shown in the accompanying financial statements are prepared in accordance with generally accepted accounting principles. Many investors and analysts focus on "core earnings" of companies, setting aside certain items included in net earnings such as realized gains and losses, the cumulative effect of accounting changes and certain other unusual items. Realized gains and losses are excluded from "core earnings" because they are unpredictable and not necessarily indicative of current operating fundamentals. Other items such as the 2000 litigation charges are excluded to assist investors in analyzing their impact on the trend in operating results. Nonetheless, these items are significant components of GAFRI's overall financial results and core earnings should not be considered a substitute for the net income reported in the Consolidated Income Statement as an indication of GAFRI's overall performance. The following table (in millions, except per share amounts) compares the Company's core earnings over the past three years.

| <u>GAFRI (Consolidated):</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---|---------------|---------------|---------------|
| Net operating earnings per income statement | \$33.9 | \$42.7 | \$60.1 |
| Exclude litigation charges, net of tax: | | | |
| Included in annuity benefits | - | - | 9.2 |
| Included in other expenses | - | - | 11.9 |
| Exclude realized losses (gains), net of tax | <u>29.7</u> | <u>33.5</u> | <u>(5.1)</u> |
| | |) | |
| Core net operating earnings | <u>\$63.6</u> | <u>\$76.2</u> | <u>\$76.1</u> |
| | | | |
| <u>Diluted Earnings Per Common Share:</u> | | | |
| Net income per share per income statement | \$0.38 | \$0.87 | \$1.28 |

Exclude, per share:

| | | | |
|---------------------------------------|---------------|---------------|---------------|
| Litigation charges | - | - | 0.50 |
| Realized losses (gains) | 0.70 | 0.78 | (0.12) |
| Equity in results of affiliate | - | - | 0.14 |
| Accounting changes | <u>0.41</u> | <u>0.13</u> | <u>(0.02)</u> |
| | |) | |
| Core net operating earnings per share | <u>\$1.49</u> | <u>\$1.78</u> | <u>\$1.78</u> |

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

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---------------------------------------|----------------|--------------|--------------|
| <u>Annuity Premiums</u> | | | |
| : | | | |
| Single premium fixed rate annuities | \$ 654 | \$401 | \$277 |
| | 165 | 151 | 150 |
| Flexible premium fixed rate annuities | 95 | 107 | 242 |
| Single premium variable annuities | <u>87</u> | <u>92</u> | <u>78</u> |
| Flexible premium variable annuities | | | |
| | <u>\$1,001</u> | <u>\$751</u> | <u>\$747</u> |

Sales of fixed rate annuity products were up 48% and 29% in 2002 and 2001, respectively, and were offset by a decrease in the sale of variable annuities by 8% and 38% over the same periods. Management attributes these trends to the volatile equity and bond markets, the introduction of several new fixed rate products and exiting the "wholesale" (single premium, non-qualified) variable annuity market.

21

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> | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---------------------------------|-------------|-------------|-------------|
| Supplemental insurance products | \$191 | \$190 | \$152 |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | |
|---------------------------------|--------------|--------------|--------------|
| GA Life of Puerto Rico | 61 | 54 | 49 |
| Life products | <u>54</u> | <u>36</u> | <u>29</u> |
| | <u>\$306</u> | <u>\$280</u> | <u>\$230</u> |
| <u>Benefits</u> | | | |
| Supplemental insurance products | \$158 | \$157 | \$128 |
| GA Life of Puerto Rico | 31 | 27 | 24 |
| Life products | <u>56</u> | <u>29</u> | <u>23</u> |
| | <u>\$245</u> | <u>\$213</u> | <u>\$175</u> |

GAFRI continues to experience adverse mortality in GALIC's life division. Further adverse mortality could result in an additional charge to income due to a further reduction in unamortized insurance acquisition costs. (See "MD&A - Insurance Acquisition Expenses")

Life products in 2002 include premiums of \$14 million and benefits of \$19 million related to Manhattan National Life which was acquired in June 2002. The 2001 increase in supplemental insurance premiums and benefits is due primarily to the November 2000 reinsurance of a block of accident and health insurance business.

Net Investment Income

Net investment income increased in 2002 due primarily to higher average invested assets (partially as a result of the MNL acquisition), somewhat offset by lower yields in the portfolio. The yield on GAFRI's fixed maturity portfolio was approximately 7.0% at December 31, 2002 compared to approximately 7.7% at December 31, 2001. (See "MD&A - Investments"). GAFRI expects the yield on its portfolio to further decline through at least 2003.

Net investment income increased in 2001 as a result of higher average invested assets.

Realized Gains (Losses) on Investments

Realized gains (losses) on investments included the following provisions for other than temporary impairment: \$97.4 million, \$77.0 million and \$14.3 million for the years ended 2002, 2001 and 2000, respectively. (See "MD&A - Investments")

Results for 2000 include a pretax gain of \$27.2 million resulting from the sale of GAFRI's investment in a company engaged in the production of ethanol. GAFRI's investment was repurchased by the ethanol company which, following the repurchase, became wholly-owned by GAFRI's Chairman.

Other Income

Other income increased \$4.7 million in 2001 compared to the same period in 2000 due primarily to income from the sale of real estate and, to a lesser extent, increased fees earned on GAFRI's variable annuity and life business. These increases were partially offset by lower annuity policy charges and lower revenues at GAFRI's insurance agency and broker/dealer subsidiaries.

22

Real Estate Operations

GAFRI is engaged in a variety of real estate operations including hotels and marinas; GAFRI also owns various parcels of land. Revenues and expenses of these operations, including gains on disposal, are included in GAFRI's Consolidated Income Statement as shown below (in millions).

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|----------------|-------------|-------------|-------------|
| Other income | \$41.2 | \$46.7 | \$38.3 |
| Other expenses | 34.1 | 30.9 | 32.1 |

Other income included a pretax gain on the sale of real estate assets of \$11.2 million in 2001.

Annuity Benefits

Annuity benefits reflect amounts accrued on annuity policyholders' funds accumulated. The majority of GAFRI's fixed rate annuity products permit GAFRI to change the crediting rate at any time (subject to minimum interest rate guarantees of 3% to 4% per annum). Historically, management has been able to react to changes in market interest rates and maintain a desired interest rate spread. The recent interest rate environment has resulted in a spread compression, which could continue through at least 2003.

On its deferred annuities (annuities in the accumulation phase), GAFRI generally credits interest to policyholders' accounts at their current stated "surrender" interest rates. Furthermore, for "two-tier" deferred annuities (annuities under which a higher interest amount can be earned if a policy is annuitized rather than surrendered), GAFRI accrues an additional liability to provide for expected deaths and annuitizations. Changes in crediting rates, actual surrender, death and annuitization experience or modifications in actuarial assumptions can affect this accrual. In 2002, this accrual was reduced by approximately \$2 million due to (i) decreases in crediting rates on certain fixed annuity products, partially offset by (ii) a modification in projected investment yields. Significant changes in projected investment yields could result in additional benefits or charges to earnings.

Insurance Acquisition Expenses

Insurance acquisition expenses include amortization of deferred policy acquisition costs ("DPAC") as well as a portion of commissions on sales of insurance products. Insurance acquisition expenses also include amortization of the present value of future profits of businesses acquired amounting to \$11.8 million in 2002, \$9.2 million in 2001 and \$10.7 million in 2000.

The increase in insurance acquisition expenses in 2002 reflects (i) a writeoff of DPAC; (ii) the amortization costs associated with GAFRI's purchase of MNL in June 2002 and (iii) higher commission expense due to the Company's growth in premiums. Included in 2002 and 2001 were DPAC writeoffs related to variable annuities of \$13.5 million and \$3.0 million, respectively, resulting from the actual performance of the equity markets and a reduction of assumed future returns. Poor performance in the equity markets could lead to additional DPAC writeoffs or a charge to earnings in order to accrue for guaranteed minimum death benefits included in the variable products. (See "MD&A - Proposed Accounting Standard"). Included in 2002 is a DPAC writeoff of \$4 million related primarily to adverse mortality in the Company's life operations. Partially offsetting the DPAC writeoffs in 2002 was a reduction of approximately \$7 million in DPAC amortization on fixed annuities relating to decreases in crediting rates on certain fixed annuity products. Continued adverse mortality could lead to additional DPAC writeoffs. Significant changes in projected investment yields could result in additional benefits or charges to earnings.

The increase in 2001 is due primarily to (i) increased lapses and increased sales of traditional life insurance by GALIC and (ii) the effect of the equity markets on variable annuity DPAC.

23

Trust Preferred Distribution Requirement

The decrease in trust preferred distribution requirement in 2002 and 2001 reflects the Company's September 2001 redemption of one issue of its trust preferred securities.

Interest and Other Debt Expenses

Higher average borrowings in 2002 were offset by lower interest rates on the Company's bank debt. The decrease in interest and other debt expenses in 2001 compared to 2000 is due primarily to lower average borrowings as well as lower interest rates on these borrowings.

Other Expenses

Other expenses increased in 2002 due to (i) an increase in expenses from real estate operations resulting from the 2002 acquisition of property and (ii) the acquisition of MNL in June 2002. Other expenses decreased 14% in 2001 primarily due to the absence of a litigation charge that was recorded in 2000. (See MD&A - Results of Operations "General").

Income Taxes

The provision for income taxes in all periods presented reflects the effects of non-taxable foreign operations. In 2002 and 2000, the provision for income taxes also reflects reductions of the valuation allowance associated with certain deferred tax assets. (See Note K.)

Equity in Losses of Affiliate

Equity in losses of affiliate in 2000 represents GAFRI's proportionate share of the results of Chiquita Brands International, as well as the writedown in 2000 of GAFRI's investment in Chiquita to market value of approximately \$1 per share. Chiquita reported net losses attributable to common shareholders of \$112 million in 2000.

Cumulative Effect of Accounting Changes

Effective January 1, 2002, GAFRI implemented Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," under which goodwill is no longer amortized, but is subject to an impairment test at least annually. The initial impairment testing resulted in an aftertax charge of \$17.7 million for the cumulative effect of an accounting change. At December 31, 2002, GAFRI had less than \$21 million of unamortized goodwill remaining on its balance sheet.

In 2001, the cumulative effect of accounting change represents the implementation of a new accounting standard (EITF 99-20) which resulted in a writedown of \$8.4 million (\$5.5 million or \$0.13 per share after tax) of the cost basis of certain collateralized debt obligations in the second quarter.

In 2000, GAFRI implemented Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," which requires all derivatives to be recognized in the balance sheet at fair value, and that the initial effect of recognizing derivatives at fair value be reported as a cumulative effect of a change in accounting principle. Accordingly, GAFRI recorded income of \$0.8 million (net of taxes) reflecting the adoption of SFAS No. 133.

24

Recent Accounting Standards

The following accounting standards have been, [or will be] implemented by GAFRI. The implementation of these standards is discussed under various subheadings of Note B to the Financial Statements. Effects of each are shown in the relevant Notes.

Accounting

Year

| <u>Standard</u> | <u>Subject of Standard</u> | <u>Implemented</u> |
|-----------------|--------------------------------|--------------------|
| SFAS #133 | Derivatives | 2000 |
| EITF 99-20 | Asset-backed Securities | 2001 |
| SFAS #141 | Business Combinations | 2001 |
| SFAS #142 | Goodwill and Other Intangibles | 2002 |
| SFAS #148 | Stock-based Compensation | 2002 |

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

Proposed Accounting Standard

GAFRI's variable annuity contracts contain a guaranteed minimum death benefit ("GMDB") (which may exceed the value of the policyholder's account) to be paid if the annuityholder dies before the annuity payout period commences. Payment of any difference between the GMDB and the related account balance is borne by GAFRI and expensed when paid. In periods of declining equity markets, the GMDB difference increases as the variable annuity account value decreases. At December 31, 2002 and 2001, the aggregate GMDB values (assuming every policyholder died on those dates) exceeded the market value of the underlying variable annuities by \$233 million and \$136 million, respectively. Industry practice varies, but GAFRI does not establish GAAP reserves for this mortality risk. If a proposed accounting standard becomes effective, GAFRI would be required to record a liability for the present value of expected GMDB payments. Initial recognition of a GAAP liability (estimated to be less than 4% of the difference between the underlying market value of the variable annuities and the GMDB value) would be accounted for as the cumulative effect of a change in accounting principles. Death benefits paid in excess of the variable annuity account balance were \$1.1 million in 2002.

ITEM 7A

Quantitative and Qualitative Disclosures About Market Risk

The information required by Item 7A is included in Management's Discussion and Analysis of Financial Condition and Results of Operations.

25

ITEM 8

Financial Statements and Supplementary Data

PAGE

Report of Independent Auditors

F-1

Consolidated Balance Sheet:

December 31, 2002 and 2001 F-2

Consolidated Income Statement:

Years Ended December 31, 2002, 2001 and 2000 F-3

Consolidated Statement of Changes in Stockholders' Equity:

Years Ended December 31, 2002, 2001 and 2000 F-4

Consolidated Statement of Cash Flows:

Years Ended December 31, 2002, 2001 and 2000 F-5

Notes to Consolidated Financial Statements F-6

"Selected Quarterly Financial Data" has been included in Note R to the Consolidated Financial Statements.

Please refer to "Forward-Looking Statements" following the index in front of this Form 10-K.

PART III

The information required by the following Items will be included in GAFRI's definitive Proxy Statement for the 2003 Annual Meeting of Stockholders which will be filed with the Securities and Exchange Commission within 120 days of the Company's fiscal year-end and is herein incorporated by reference:

ITEM 10 Directors and Executive Officers of the Registrant

ITEM 11 Executive Compensation

ITEM 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

ITEM 13 Certain Relationships and Related Transactions

Item 14

Evaluation of Disclosure Controls and Procedures

GAFRI's chief executive officer and chief financial officer, with the participation of management, have evaluated GAFRI's disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-14c) as of a date within 90 days prior to filing this report. Based on the evaluation, they concluded that the controls and procedures are effective. There have been no significant changes in GAFRI's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

26

REPORT OF INDEPENDENT AUDITORS

Board of Directors

Great American Financial Resources, Inc.

We have audited the accompanying consolidated balance sheet of Great American Financial Resources, Inc. and subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2002. Our audits also included the financial statement schedules listed in the Index at Item 14(a). These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Great American Financial Resources, Inc. and subsidiaries at December 31, 2002 and 2001, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken

as a whole, present fairly in all material respects the information set forth therein.

As discussed in Notes B and F to the consolidated financial statements, in 2002, the Company implemented Statement of Financial Accounting Standard No. 142, which required a change in the method of accounting for goodwill.

Ernst & Young LLP

Cincinnati, Ohio

February 19, 2003

F-1

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(Dollars in millions)

| | <u>December 31,</u> | |
|--|---------------------|--------------|
| | <u>2002</u> | <u>2001</u> |
| Assets | | |
| Investments: | | |
| Fixed maturities - at market (amortized cost - \$6,894.1 and \$6,302.1) | \$7,181.1 | \$6,431.1 |
| Equity securities - at market (cost - \$47.0 and \$37.8) | 73.5 | 59.0 |
| Mortgage loans on real estate | 18.9 | 24.8 |
| Real estate | 78.6 | 69.4 |
| Policy loans | 214.9 | 211.3 |
| Short-term investments | <u>400.0</u> | <u>131.9</u> |
| Total investments | 7,967.0 | 6,927.5 |
| Cash | 2.2 | 39.0 |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | |
|--|------------------|------------------|
| Accrued investment income | 95.3 | 95.0 |
| Unamortized insurance acquisition costs, net | 591.0 | 556.1 |
| Other assets | 252.0 | 253.2 |
| Variable annuity assets (separate accounts) | <u>455.1</u> | <u>529.6</u> |
| | <u>\$9,362.6</u> | <u>\$8,400.4</u> |
| | | |
| Liabilities and Capital | | |
| Annuity benefits accumulated | \$6,453.9 | \$5,832.1 |
| Life, accident and health reserves | 902.4 | 638.5 |
| Notes payable | 250.3 | 223.0 |
| Payable to affiliates, net | 62.4 | 95.7 |
| Deferred taxes on unrealized gains | 93.3 | 47.2 |
| Accounts payable, accrued expenses and other liabilities | 150.4 | 142.6 |
| Variable annuity liabilities (separate accounts) | <u>455.1</u> | <u>529.6</u> |
| | | |
| Total liabilities | 8,367.8 | 7,508.7 |
| | | |
| Mandatorily redeemable preferred securities of subsidiary trusts | 142.9 | 142.9 |
| | | |
| Stockholders' Equity: | | |
| Common Stock, \$1 par value | | |
| -100,000,000 shares authorized | | |
| -42,456,843 and 42,353,464 shares outstanding | 42.4 | 42.3 |
| Capital surplus | 347.6 | 346.7 |
| Retained earnings | 281.9 | 270.0 |
| Unrealized gains on marketable securities, net | <u>180.0</u> | <u>89.8</u> |
| | | |
| Total stockholders' equity | <u>851.9</u> | <u>748.8</u> |
| | <u>\$9,362.6</u> | <u>\$8,400.4</u> |

See Notes to Consolidated Financial Statements.

F-2

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED INCOME STATEMENT

(In millions, except per share amounts)

| | <u>Year ended December 31,</u> | | |
|---|--------------------------------|--------------|--------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| Revenues: | | | |
| Life, accident and health premiums | \$305.7 | \$280.1 | \$230.4 |
| Net investment income | 527.8 | 506.5 | 495.7 |
| Realized gains (losses) on: | | | |
| Investments | (45.7) | (51.6) | (19.4) |
| Redemption of minority ownership by related party | - | - | 27.2 |
| Other income | <u>95.4</u> | <u>95.1</u> | <u>90.4</u> |
| | 883.2 | 830.1 | 824.3 |
| Costs and Expenses: | | | |
| Annuity benefits | 301.0 | 294.7 | 293.1 |
| Life, accident and health benefits | 245.3 | 213.0 | 175.2 |
| Insurance acquisition expenses | 114.5 | 79.3 | 62.3 |
| Trust preferred distribution requirement | 13.0 | 17.1 | 18.4 |
| Interest and other debt expenses | 10.8 | 10.8 | 13.8 |
| Other expenses | <u>159.7</u> | <u>155.3</u> | <u>180.4</u> |
| | <u>844.3</u> | <u>770.2</u> | <u>743.2</u> |
| Operating earnings before income taxes | 38.9 | 59.9 | 81.1 |
| Provision for income taxes | <u>5.0</u> | <u>17.2</u> | <u>21.0</u> |
| Net operating earnings | 33.9 | 42.7 | 60.1 |

| | | | |
|---|----------------|----------------|----------------|
| Equity in losses of affiliate, net of tax | — | — | <u>(6.2</u> |
| | | |) |
| Income before accounting changes | 33.9 | 42.7 | 53.9 |
| Cumulative effect of accounting changes, net of tax | <u>(17.7</u> | <u>(5.5</u> | <u>0.8</u> |
| |) |) | |
| Net Income | <u>\$ 16.2</u> | <u>\$ 37.2</u> | <u>\$ 54.7</u> |
| Basic earnings per common share: | | | |
| Income before accounting changes | \$0.80 | \$1.01 | \$1.27 |
| Accounting changes | <u>(0.42</u> | <u>(0.13</u> | <u>0.02</u> |
| |) |) | |
| Net income | <u>\$0.38</u> | <u>\$0.88</u> | <u>\$1.29</u> |
| Diluted earnings per common share: | | | |
| Income before accounting changes | \$0.79 | \$1.00 | \$1.26 |
| Accounting changes | <u>(0.41</u> | <u>(0.13</u> | <u>0.02</u> |
| |) |) | |
| Net income | <u>\$0.38</u> | <u>\$0.87</u> | <u>\$1.28</u> |
| Average number of common shares: | | | |
| Basic | 42.4 | 42.3 | 42.3 |
| Diluted | 42.7 | 42.7 | 42.7 |
| Cash dividends per common share | \$0.10 | \$0.10 | \$0.10 |

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(In millions)

| | <u>Year ended December 31,</u> | | |
|-----------------------------------|--------------------------------|----------------|----------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| Common Stock: | | | |
| Balance at beginning of year | \$ 42.3 | \$ 42.3 | \$ 42.4 |
| Common Stock issued | 0.2 | 0.1 | 0.1 |
| Common Stock retired | <u>(0.1)</u> | <u>(0.1)</u> | <u>(0.2)</u> |
| |) |) |) |
| Balance at end of year | <u>\$ 42.4</u> | <u>\$ 42.3</u> | <u>\$ 42.3</u> |
| Capital Surplus: | | | |
| Balance at beginning of year | \$346.7 | \$348.5 | \$349.7 |
| Common Stock issued | 2.4 | 1.3 | 1.0 |
| Common Stock retired | (1.5) | (0.7) | (2.2) |
| Capital transaction of subsidiary | <u>-</u> | <u>(2.4)</u> | <u>-</u> |
| |) |) |) |
| Balance at end of year | <u>\$347.6</u> | <u>\$346.7</u> | <u>\$348.5</u> |
| Retained Earnings: | | | |
| Balance at beginning of year | \$270.0 | \$237.0 | \$186.5 |
| Net income | 16.2 | 37.2 | 54.7 |
| Common dividends declared | <u>(4.3)</u> | <u>(4.2)</u> | <u>(4.2)</u> |
| |) |) |) |
| Balance at end of year | <u>\$281.9</u> | <u>\$270.0</u> | <u>\$237.0</u> |

| | | | |
|--|----------------|----------------|----------------|
| Unrealized Gains (Losses), Net: | | | |
| Balance at beginning of year | \$ 89.8 | \$ 43.9 | (\$ 52.9) |
| Change during year | <u>90.2</u> | <u>45.9</u> | <u>96.8</u> |
| Balance at end of year | <u>\$180.0</u> | <u>\$ 89.8</u> | <u>\$ 43.9</u> |
| Comprehensive Income: | | | |
| Net Income | \$ 16.2 | \$ 37.2 | \$ 54.7 |
| Other comprehensive income - change in net unrealized gains on marketable securities | <u>90.2</u> | <u>45.9</u> | <u>96.8</u> |
| Comprehensive income | <u>\$106.4</u> | <u>\$ 83.1</u> | <u>\$151.5</u> |

See Notes to Consolidated Financial Statements.

F-4

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

(In millions)

| | <u>Year ended December 31,</u> | | |
|---|--------------------------------|-------------|-------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| Cash Flows from Operating Activities: | | | |
| Net income | \$ 16.2 | \$ 37.2 | \$ 54.7 |
| Adjustments: | | | |
| Cumulative effect of accounting changes | 17.7 | 5.5 | (0.8) |
| Equity in losses of affiliate, net of tax | - | - | 6.2 |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | |
|--|-----------------|-----------------|----------------|
| Reductions of notes payable | (0.2) | (16.4) | (59.0) |
| Issuance of Common Stock | 2.6 | 1.4 | 1.1 |
| Retirement of Common Stock | (1.6) | (0.8) | (2.4) |
| Repurchase of trust preferred securities | - | (75.0) | (1.4) |
| Cash dividends paid | <u>(4.3)</u> | <u>(4.2)</u> | <u>(4.2)</u> |
| |) |) |) |
| | <u>369.4</u> | <u>(13.8)</u> | <u>(341.9)</u> |
| |) |) |) |
| Net increase (decrease) in cash and short-term investments | 231.3 | 83.4 | (32.1) |
| Beginning cash and short-term investments | <u>170.9</u> | <u>87.5</u> | <u>119.6</u> |
| Ending cash and short-term investments | <u>\$ 402.2</u> | <u>\$ 170.9</u> | <u>\$ 87.5</u> |

See Notes to Consolidated Financial Statements.

F-5

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO NOTES

| | |
|---|---|
| A. Description of the Company | J. Stockholders' Equity |
| B. Summary of Significant Accounting Policies | K. Income Taxes |
| C. Acquisition | L. Leases |
| D. Segments of Operations | M. Earnings Per Share |
| E. Investments | N. Investment in Affiliate |
| F. Goodwill | O. Contingencies |
| G. Unamortized Insurance Acquisition Costs | P. Statutory Information |
| H. Notes Payable | Q. Additional Information |
| I. Mandatorily Redeemable Preferred Securities of Subsidiary Trusts | R. Quarterly Financial Data (Unaudited) |

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 life and supplemental health insurance through independent agents, payroll

deduction plans, financial institutions and in-home sales.

American Financial Group, Inc. ("AFG") and its subsidiaries owned 83% of GAFRI's Common Stock at December 31, 2002.

B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements include the accounts of GAFRI and its subsidiaries. Certain reclassifications have been made to prior years to conform to the current year's presentation. Acquisitions and sales of subsidiaries have resulted in certain differences in the financial statements and have affected comparability between years. All significant intercompany balances and transactions have been eliminated. All acquisitions have been treated as purchases. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements.

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

Investments

All fixed maturity securities are considered "available for sale" and reported at fair value with unrealized gains and losses reported as a separate component of stockholders' equity. Short-term investments are carried at cost; mortgage loans on real estate are generally carried at amortized cost; policy loans are stated at the aggregate unpaid balance. Premiums and discounts on mortgage-backed securities are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations. The most significant determinants of prepayments are the differences between interest rates of the underlying mortgages and current mortgage loan rates and the structure of the security. Other factors affecting prepayments include the size, type and age of underlying mortgages, the geographic location of the mortgaged properties and the creditworthiness of the borrowers. Variations from anticipated prepayments will affect the life and yield of these securities.

F-6

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other than

temporary, a provision for impairment is charged to earnings and the cost basis of that investment is reduced.

Emerging Issues Task Force Issue No. 99-20 ("EITF 99-20") established a new standard for recognizing interest income and impairment on certain asset-backed investments. Interest income on these investments is recorded at a yield based on projected cash flows. The yield is adjusted prospectively to reflect actual cash flows and changes in projected amounts. Impairment losses on these investments must be recognized when (i) the fair value of the security is less than its cost basis and (ii) there has been an adverse change in the expected cash flows. The new standard became effective on April 1, 2001. Impairment losses at initial application of this rule were recognized as the cumulative effect of an accounting change. Subsequent impairments are recognized as a component of net realized

gains and losses.

Goodwill

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

Reinsurance

In the normal course of business, GAFRI's insurance subsidiaries cede reinsurance to other companies under various coinsurance agreements to diversify risk, limit maximum exposure and provide a source of additional capital and liquidity. Under these agreements, GAFRI pays to the reinsurer a proportionate share of the premiums, less commissions, and the reinsurer is liable for a corresponding part of all benefit payments. A substantial portion of GAFRI's life business is reinsured.

To the extent that any reinsuring companies are unable to meet obligations under agreements covering reinsurance ceded, GAFRI's insurance subsidiaries would remain liable. GAFRI reviews the financial condition of its reinsurers and monitors the amount of reinsurance it has with each company.

Investment in Affiliate

GAFRI's investments in equity securities of companies that are 20% to 50% owned by AFG and its subsidiaries are generally carried at cost, adjusted for a proportionate share of their undistributed earnings or losses.

Due to Chiquita Brands International's announced intention to pursue a plan to restructure its public debt, GAFRI wrote down its investment in Chiquita common stock to market value at December 31, 2000. In 2001, GAFRI suspended accounting for the investment under the equity method due to the restructuring, and reclassified the investment to "equity securities." In a 2002 reorganization of Chiquita, GAFRI's ownership was reduced to less than one-half of 1%.

Insurance Acquisition Costs and Expenses

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

F-7

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Deferred Policy Acquisition Costs ("DPAC")

DPAC (principally commissions, advertising, underwriting, policy issuance and sales expenses that vary with and are primarily related to the production of new business) is deferred to the extent that such costs are deemed recoverable.

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

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

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

Included in insurance acquisition costs are amounts representing the present value of future profits on business in force of acquired insurance companies, which represent 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.

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

Annuity Benefits Accumulated

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

Reserves for two-tier annuities (annuities with different stated account values depending on whether a policyholder annuitizes, dies or surrenders) are generally recorded at the lower-tier value plus an additional reserve for expected deaths and annuitizations ("EDAR") that require payment of the upper-tier value. The liability for EDAR is accrued for and modified using the same assumptions as used in determining DPAC and DPAC amortization.

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

F-8

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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 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.

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 which 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.

Income Taxes

GAFRI and Great American Life Insurance Company ("GALIC") have separate tax allocation agreements with American Financial Corporation ("AFC"), a subsidiary of AFG, which designate how tax payments are shared by members of the tax group. In general, both companies compute taxes on a separate return basis. GALIC is obligated to make payments to (or receive benefits from) AFC based on taxable income without regard to temporary differences. If GALIC's taxable income (computed on a statutory accounting basis) exceeds a current period net operating loss of GAFRI, the taxes payable or receivable by GALIC associated with the excess are payable to or receivable from AFC. If the AFC tax group utilizes any of GAFRI's net operating losses or deductions that originated prior to GAFRI's entering AFC's consolidated tax group, AFC will pay to GAFRI an amount equal to the benefit received. The tax allocation

agreements with AFC have not impacted the recognition of income tax expense and income tax payable in GAFRI's financial statements.

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

Stock-Based Compensation

As permitted under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," GAFRI accounts for stock options and other stock-based compensation plans using the intrinsic value based method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Under GAFRI's stock option plan, options are granted to officers, directors, and key employees at exercise prices equal to the fair value of the shares at the dates of grant. No compensation expense is recognized for stock option grants.

F-9

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

The following table illustrates the effect on net income and earnings per share had compensation cost been recognized and determined for stock option awards based on the fair values at grant dates consistent with the method prescribed by SFAS No. 123. See Note J "Stockholders' Equity" for further information on stock options, including assumptions made in the calculation of proforma stock option expense.

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--|---------------|---------------|---------------|
| Net income, as reported | \$16.2 | \$37.2 | \$54.7 |
| Pro forma stock option expense, net of tax | <u>(1.3)</u> | <u>(2.0)</u> | <u>(2.5)</u> |
| |) |) | |
| Adjusted net income | <u>\$14.9</u> | <u>\$35.2</u> | <u>\$52.2</u> |
| Earnings per share (as reported): | | | |
| Basic | \$0.38 | \$0.88 | \$1.29 |
| Diluted | \$0.38 | \$0.87 | \$1.28 |
| Earning per share (adjusted): | | | |
| Basic | \$0.35 | \$0.83 | \$1.23 |
| Diluted | \$0.35 | \$0.82 | \$1.22 |

Benefit Plans

GAFRI provides retirement benefits to qualified employees of participating companies through the GAFRI Retirement and Savings Plan. Under the retirement fund portion of the Plan,

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

contributions are at the discretion of the GAFRI Board of Directors and are invested primarily in GAFRI securities. Under the savings fund portion of the Plan, GAFRI matches a specific portion of employee contributions. Employees have been permitted to direct the investment of their contributions to independently managed investment funds. Matching contributions to the savings fund portion of the Plan for the year 2002 were invested in accordance with participant elections. Company contributions to the Plan are charged against earnings 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.

Derivatives

Effective October 1, 2000, GAFRI implemented SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," which establishes accounting and reporting standards for derivative instruments (including derivative instruments that are embedded in other contracts) and for hedging activities. Prior year financial statements were not restated. SFAS No. 133 generally requires that derivatives (both assets and liabilities) be recognized in the balance sheet at fair value with changes in fair value included in current income. The cumulative effect of implementing SFAS No. 133, which resulted from the initial recognition of GAFRI's derivatives at fair value, was income of \$0.8 million or \$0.02 per diluted share in 2000.

Derivatives are included in GAFRI's balance sheet and consist primarily of investments in common stock warrants (valued at \$1.2 million and included in equity securities), the equity-based component of certain annuity products (included in annuity benefits accumulated) and related call options (included in other assets) designed to be consistent with the characteristics of the liabilities and used to mitigate the risk imbedded in those annuity products.

Earnings Per Share

Basic earnings per share is calculated using the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per share include the effect of the assumed exercise of dilutive common stock options.

F-10

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

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.

Fair Value of Financial Instruments

Methods and assumptions used in estimating fair values are described in Note Q to the financial statements. These fair values represent point-in-time estimates of value that might not be particularly relevant in predicting GAFRI's future earnings or cash flows.

C. ACQUISITION

On June 28, 2002, GAFRI's principal insurance subsidiary acquired Manhattan National Life Insurance Company ("MNL") from a subsidiary of Consecro, Inc. for \$48.5 million in cash. At December 31, 2002, the Company reinsured 90% of the business in force.

D. SEGMENTS OF OPERATIONS

GAFRI's life and annuity operations offer fixed and variable annuity products and traditional life insurance products. GAFRI's annuity products are sold through managing general agents and independent agents to employees of primary and secondary educational institutions, hospitals and in the non-qualified markets. Traditional term and universal life insurance products are sold through national marketing organizations.

GAFRI's supplemental insurance businesses (United Teacher Associates Insurance Company ("UTA") and Loyal American Life Insurance Company) offer a variety of supplemental health and life products. UTA offers its products through independent agents. At December 31, 2001, Loyal reinsured a substantial portion of its life insurance business and has reduced its marketing efforts in that line of business.

GA Life of Puerto Rico ("GAPR") sells in-home life and supplemental health products through a network of company-employed agents. Sales in Puerto Rico accounted for nearly 20% of GAFRI's life, accident and health premiums in 2002.

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

F-11

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

The following tables show (in millions) GAFRI's assets, revenues and operating profit by significant business segment.

| <u>Assets</u> | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---------------------------------|------------------|------------------|------------------|
| Life and annuity products | \$8,283.5 | \$7,396.1 | \$6,992.3 |
| Supplemental insurance products | 801.4 | 731.5 | 719.6 |
| GA Life of Puerto Rico | 265.3 | 234.0 | 212.2 |
| Corporate and other | <u>12.4</u> | <u>38.8</u> | <u>51.8</u> |
| Total assets per balance sheet | <u>\$9,362.6</u> | <u>\$8,400.4</u> | <u>\$7,975.9</u> |

Revenues

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | |
|--|----------------|----------------|----------------|
| Life and annuity products | \$616.9 | \$574.1 | \$555.5 |
| Supplemental insurance products | 234.6 | 234.0 | 193.3 |
| GA Life of Puerto Rico | 71.6 | 64.3 | 58.7 |
| Corporate and other | <u>5.8</u> | <u>9.3</u> | <u>9.0</u> |
| Total operating revenues | 928.9 | 881.7 | 816.5 |
| Realized gains (losses) | <u>(45.7)</u> | <u>(51.6)</u> | <u>7.8</u> |
| |) |) | |
| Total revenues per income statement | <u>\$883.2</u> | <u>\$830.1</u> | <u>\$824.3</u> |
| | | | |
| <u>Operating profit - pretax</u> | | | |
| Life and annuity products | \$ 96.8 | \$134.2 | \$136.7 |
| Supplemental insurance products | 11.5 | 2.8 | (1.6) |
| GA Life of Puerto Rico | 11.7 | 10.7 | 9.8 |
| Litigation charges (a) | - | - | (32.5) |
| Corporate and other | <u>(35.4)</u> | <u>(36.2)</u> | <u>(39.1)</u> |
| |) |) |) |
| Pretax earnings from operations | 84.6 | 111.5 | 73.3 |
| Realized gains (losses) | <u>(45.7)</u> | <u>(51.6)</u> | <u>7.8</u> |
| |) |) | |
| Total pretax income per income statement | <u>\$ 38.9</u> | <u>\$ 59.9</u> | <u>\$ 81.1</u> |

a. Reflects litigation costs included in other expenses for "Life and annuity products" (\$17.3 million) and "Supplemental insurance products" (\$1.0 million); reflects litigation costs included in annuity benefits for "Life and annuity products" (\$14.2 million).

F-12

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

E. INVESTMENTS

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

Fixed maturity investments at December 31, consisted of the following (in millions):

| | <u>2002</u> | | | |
|--|------------------|------------------|-------------------------|------------------|
| | Amortized | Market | <u>Gross Unrealized</u> | |
| | <u>Cost</u> | <u>Value</u> | <u>Gains</u> | <u>Losses</u> |
| Fixed maturities: | | | | |
| U. S. Government and government agencies and authorities | \$ 742.9 | \$ 770.3 | \$ 28.5 | (\$ 1.1) |
| States, municipalities and political subdivisions | 181.3 | 198.3 | 19.5 | (2.5) |
| Foreign governments | 43.0 | 45.4 | 2.4 | - |
| Public utilities | 573.7 | 583.2 | 23.2 | (13.7) |
| Mortgage-backed securities | 2,245.8 | 2,339.1 | 100.9 | (7.6) |
| All other corporate | 3,086.8 | 3,223.4 | 191.0 | (54.4) |
| Redeemable preferred stocks | <u>20.6</u> | <u>21.4</u> | <u>1.8</u> | <u>(1.0)</u> |
| | |) | | |
| | <u>\$6,894.1</u> | <u>\$7,181.1</u> | <u>\$367.3</u> | <u>(\$ 80.3)</u> |

| | <u>2001</u> | | | |
|--|-------------|--------------|-------------------------|---------------|
| | Amortized | Market | <u>Gross Unrealized</u> | |
| | <u>Cost</u> | <u>Value</u> | <u>Gains</u> | <u>Losses</u> |
| Fixed maturities: | | | | |
| U. S. Government and government agencies and authorities | \$ 457.6 | \$ 467.9 | \$ 11.8 | (\$ 1.5) |
| States, municipalities and political subdivisions | 157.5 | 161.7 | 7.7 | (3.5) |
| Foreign governments | 25.5 | 27.3 | 1.8 | - |
| Public utilities | 373.0 | 377.5 | 7.2 | (2.7) |
| Mortgage-backed securities | 2,014.6 | 2,077.9 | 75.0 | (11.7) |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | | |
|-----------------------------|------------------|------------------|----------------|------------------|
| All other corporate | 3,250.5 | 3,299.5 | 100.4 | (51.4) |
| Redeemable preferred stocks | <u>23.4</u> | <u>19.3</u> | <u>0.4</u> | <u>(4.5)</u> |
| | | |) | |
| | <u>\$6,302.1</u> | <u>\$6,431.1</u> | <u>\$204.3</u> | <u>(\$ 75.3)</u> |

Gross gains and losses on fixed maturity transactions included in GAFRI's Consolidated Statement of Cash Flows consisted of the following (in millions):

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--------------|-------------|-------------|-------------|
| Gross gains | \$74.0 | \$46.3 | \$9.1 |
| Gross losses | (119.2) | (95.8) | (21.9) |

F-13

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

The table below sets forth the scheduled maturities of GAFRI's fixed maturity investments based on market value as of December 31. Asset-backed securities and other securities with sinking funds are reported at average maturity. Data based on amortized cost is generally the same. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers. Mortgage-backed securities had an average life of approximately five and one-fourth years at December 31, 2002 compared to four and one-half years at December 31, 2001.

| <u>Maturity</u> | <u>2002</u> | <u>2001</u> |
|------------------------------------|-------------|-------------|
| One year or less | 6% | 5% |
| After one year through five years | 21 | 22 |
| After five years through ten years | 28 | 25 |
| After ten years | <u>13</u> | <u>16</u> |
| | 68 | 68 |
| Mortgage-backed securities | <u>32</u> | <u>32</u> |
| | <u>100</u> | <u>100</u> |

% %

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

At December 31, 2002, GAFRI had no single investment in excess of 10% of stockholders' equity except for certain investments guaranteed by the U.S. Government or government agencies.

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

| | <u>Fixed</u> <u>Maturities</u> | <u>Equity</u> <u>Securities</u> | <u>Other</u> | <u>Tax</u> <u>Effects</u> | <u>Total</u> |
|----------------------|-----------------------------------|------------------------------------|--------------|------------------------------|--------------|
| <u>2002</u> | | | | | |
| Realized | (\$ 45.2) | (\$ 0.7) | \$0.2 | \$16.0 | (\$ 29.7) |
| Change in unrealized | 158.0 | 5.3 | - | (55.6) | 107.7 |
| <u>2001</u> | | | | | |
| Realized | (\$ 49.5) | (\$ 0.8) | (\$1.3) | \$18.1 | (\$ 33.5) |
| Change in unrealized | 99.9 | (16.2) | - | (29.2) | 54.5 |
| <u>2000</u> | | | | | |
| Realized | (\$ 12.8) | \$20.8 | (\$0.2) | (\$ 2.7) | \$ 5.1 |
| Change in unrealized | 155.6 | 8.7 | - | (56.0) | 108.3 |

F-14

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Major categories of net investment income were as follows (in millions):

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|-----------------------------|--------------|--------------|--------------|
| Fixed maturities* | \$529.5 | \$505.6 | \$491.5 |
| Other | <u>2.8</u> | <u>2.9</u> | <u>6.8</u> |
| Total investment income | 532.3 | 508.5 | 498.3 |
| Investment expenses | <u>(4.5)</u> | <u>(2.0)</u> | <u>(2.6)</u> |

| | | | |
|-----------------------|---|----------------|----------------|
| |) |) |) |
| Net investment income | | <u>\$527.8</u> | <u>\$506.5</u> |
| | | | <u>\$495.7</u> |

* Includes income on fixed maturities, mortgage loans, policy loans and short-term investments.

GAFRI's investment portfolio is managed by a subsidiary of AFG. Investment expenses included investment management charges related to this subsidiary amounting to \$3.3 million in 2002, \$1.4 million in 2001 and \$1.6 million in 2000.

F. GOODWILL

Effective January 1, 2002, goodwill is no longer amortized but is subject to annual impairment testing under a two step process. Under the first step, an entity's net assets are classified by reporting units and compared to their fair value. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. In the second quarter of 2002, GAFRI completed the first step of its transitional impairment test and identified potential impairment of goodwill in its life and annuity and supplemental insurance segments. The second step of the impairment test, measuring the amount of impairment loss, was completed in the fourth quarter with a resulting \$17.7 million after tax (\$0.41 per share) impairment charge reported by restating first quarter 2002 results for the cumulative effect of a change in accounting principle.

If the goodwill amortization of \$1.8 million (\$0.04 per share) in each of the years 2001 and 2000, had not been expensed, net earnings for those periods would have been \$38.8 million (\$0.91 per share) and \$56.3 million (\$1.32 per share), respectively.

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

| | Life and <u>Annuity</u> | Supplemental <u>Insurance</u> | <u>Total</u> |
|--------------------------------|----------------------------|----------------------------------|---------------|
| Balance December 31, 2001 | \$26.9 | \$13.5 | \$40.4 |
| Additions | 1.5 | - | 1.5 |
| Transitional impairment charge | <u>(12.1)</u> | <u>(9.1)</u> | <u>(21.2)</u> |
| |)* |) | |
| Balance December 31, 2002 | <u>\$16.3</u> | <u>\$ 4.4</u> | <u>\$20.7</u> |

* Relates primarily to wholly-owned insurance agency subsidiary.

The impairment charge recorded in 2002 was primarily related to a decrease in estimated future earnings based upon lower forecasted new business sales over the next few years. The fair value was estimated using the expected present value of future cash flows.

F-15

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

G. UNAMORTIZED INSURANCE ACQUISITION COSTS

Unamortized insurance acquisition costs consisted of the following at December 31, (in millions):

| | <u>2002</u> | <u>2001</u> |
|--|----------------|----------------|
| Deferred policy acquisition costs | \$647.8 | \$621.0 |
| Present value of future profits acquired | 66.8 | 71.2 |
| Unearned revenues | <u>(123.6)</u> | <u>(136.1)</u> |
| |) |) |
| | <u>\$591.0</u> | <u>\$556.1</u> |

A progression of GAFRI's present value of future profits acquired ("PVFP") is as follows (in millions):

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---------------------------------------|---------------|---------------|----------------|
| Beginning balance | \$71.2 | \$93.4 | \$115.1 |
| Addition due to acquisitions | 15.2 | - | - |
| Interest accrued | 5.2 | 6.7 | 8.3 |
| Amortization | (17.0) | (15.9) | (19.0) |
| Other (a) | <u>(7.8)</u> | <u>(13.0)</u> | <u>(11.0)</u> |
| |) |) |) |
| | <u>\$66.8</u> | <u>\$71.2</u> | <u>\$ 93.4</u> |
| | | | |
| PVFP gross (original) carrying amount | \$124.1 | \$116.7 | |
| Accumulated amortization | <u>(57.3)</u> | <u>(45.5)</u> | |

))
\$ 66.8 \$ 71.2

a. 2002 amount primarily reflects reinsurance ceding of 90% of Manhattan's life business; 2001 amount primarily reflects reinsurance ceding of 80% of Loyal's life business; 2000 amount relates to purchase accounting adjustment for subsidiary acquired.

The interest accrual rates used range primarily from 5% to 7%. During each of the next five years, the PVFP is expected to decrease at a rate of approximately 13% of the balance at the beginning of each respective year.

H. NOTES PAYABLE

Notes payable consisted of the following at December 31, (in millions):

| | <u>2002</u> | <u>2001</u> |
|---|--------------------|--------------------|
| Direct obligations of GAFRI | \$ 1.7 | \$ 1.9 |
| Obligations of AAG Holding (guaranteed by GAFRI): | | |
| 6-7/8% Senior Notes due 2008 | 100.0 | 100.0 |
| Bank Credit Line | <u>148.6</u> | <u>121.1</u> |
| Total | <u>\$250.3</u> | <u>\$223.0</u> |

In January 2001, AAG Holding replaced its existing bank line with a \$155 million unsecured credit agreement. Loans under the credit agreement mature on December 31, 2004. At December 31, 2002 and 2001, the weighted-average interest rates on amounts borrowed under its credit line were 2.18% and 2.88%, respectively.

At December 31, 2002, scheduled principal payments on debt for the subsequent five years were as follows (in millions):

| <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> |
|-------------|-------------|-------------|-------------|-------------|
| \$0.2 | \$148.8 | \$0.2 | \$0.2 | \$0.1 |

F-16

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Cash interest payments were \$10.2 million in 2002, \$9.9 million in 2001 and \$13.2 million in 2000.

I. MANDATORILY REDEEMABLE PREFERRED SECURITIES OF SUBSIDIARY TRUSTS

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

| <u>Date of Issuance</u> | <u>Issue (Maturity Date)</u> | <u>12/31/02</u> | <u>12/31/01</u> | <u>Optional Redemption Dates</u> |
|-------------------------|------------------------------|-----------------|-----------------|----------------------------------|
| November 1996 | 9-1/4% TOPrS (2026) | \$72,912,500 | \$72,912,500 | Currently redeemable |
| March 1997 | 8-7/8% Pfd (2027) | 70,000,000 | 70,000,000 | On or after 3/1/2007 |

Cash payments with respect to the preferred securities were \$13.0 million and \$18.4 million in 2002 and 2001, respectively.

J. STOCKHOLDERS' EQUITY

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

GAFRI's dividend paying capability is limited by certain customary debt covenants to amounts based on cumulative earnings and losses, debt ratios and other items.

The change in net unrealized gains on marketable securities included the following (in millions):

| | <u>2002</u> | | | <u>2001</u> | | | <u>2000</u> | | |
|--|----------------|-----------------|---------------|---------------|-----------------|---------------|----------------|-----------------|----------------|
| | <u>Pretax</u> | <u>Taxes</u> | <u>Net</u> | <u>Pretax</u> | <u>Taxes</u> | <u>Net</u> | <u>Pretax</u> | <u>Taxes</u> | <u>Net</u> |
| Unrealized holding gains on securities arising during the period | \$ 90.6 | (\$30.1) | \$60.5 | \$12.3 | (\$ 4.2) | \$ 8.1 | \$154.7 | (\$52.6) | \$102.1 |
| Adoption of EITF 99-20 | - | - | - | 8.4 | (2.9) | 5.5 | - | - | - |
| Realized losses (gains) on securities | <u>45.7</u> | <u>(16.0)</u> | <u>29.7</u> | <u>49.8</u> | <u>(17.5)</u> | <u>32.3</u> | <u>(8.1)</u> | <u>2.8</u> | <u>(5.3)</u> |
| |) | | |) | |) | | |) |
| Change in net unrealized gains on marketable securities | <u>\$136.3</u> | <u>(\$46.1)</u> | <u>\$90.2</u> | <u>\$70.5</u> | <u>(\$24.6)</u> | <u>\$45.9</u> | <u>\$146.6</u> | <u>(\$49.8)</u> | <u>\$ 96.8</u> |

At December 31, 2002, there were 4.5 million shares of GAFRI Common Stock reserved for issuance under GAFRI's stock option plans for employees and directors. Under these plans, the exercise price of each option equals the market price of GAFRI Common Stock at the date of grant. Options generally become exercisable at the rate of 20% per year commencing one year after grant. All options expire ten years after the date of grant.

Data for GAFRI's Stock Option Plan is presented below:

| | <u>2002</u> | | <u>2001</u> | | <u>2000</u> | |
|----------------------------------|------------------|---------------------------------------|------------------|---------------------------------------|------------------|---------------------------------------|
| | <u>Shares</u> | <u>Average Exercise Price</u> | <u>Shares</u> | <u>Average Exercise Price</u> | <u>Shares</u> | <u>Average Exercise Price</u> |
| Outstanding at beginning of year | 3,139,159 | \$16.83 | 2,869,462 | \$16.56 | 2,521,115 | \$17.10 |
| Granted | 487,752 | \$17.47 | 576,500 | \$17.96 | 650,000 | \$15.15 |
| Forfeited | (149,200) | \$18.76 | (237,477) | \$17.34 | (236,100) | \$19.32 |
| Exercised | <u>(212,526)</u> | \$13.37 | <u>(69,326)</u> | \$13.51 | <u>(65,553)</u> | \$13.43 |
| | | |) | | | |
| Outstanding at end of year | <u>3,265,185</u> | \$17.06 | <u>3,139,159</u> | \$16.83 | <u>2,869,462</u> | \$16.56 |
| Options exercisable at year-end | 1,952,654 | \$16.72 | 1,821,727 | \$16.03 | 1,454,695 | \$15.83 |

The following table summarizes information about stock options outstanding at December 31, 2002:

| | <u>Options Outstanding</u> | | | <u>Options Exercisable</u> | |
|-------------------|----------------------------|---------------------------------------|---------------------------------------|--------------------------------|---------------------------------------|
| | <u>Shares</u> | <u>Average Exercise Price</u> | <u>Average Remaining Life</u> | <u>Shares</u> | <u>Average Exercise Price</u> |
| \$13.25 - \$15.00 | 1,462,709 | \$13.95 | 5.0 years | 1,182,029 | \$13.71 |
| \$15.01 - \$18.00 | 1,018,299 | \$17.67 | 8.7 years | 120,800 | \$17.79 |
| \$18.01 - \$21.00 | 37,203 | \$19.74 | 6.8 years | 21,041 | \$20.43 |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

\$21.01 - 746,974 \$22.19 5.7 years 628,784 \$22.06
\$24.38

No compensation cost has been recognized for stock option grants. The weighted-average fair value per option granted was \$6.09, \$6.21 and \$5.88 in 2002, 2001 and 2000, respectively.

For SFAS No. 123 purposes, calculations were determined using the Black-Scholes option pricing model and the following assumptions:

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---------------------------|-------------|-------------|-------------|
| Dividend yield | <1% | <1% | <1% |
| Expected volatility | 20% | 20% | 20% |
| Expected life (years) | 7.5 | 7.5 | 7.5 |
| Risk free interest rates: | | | |
| Low | 4.4% | 4.8% | 6.1% |
| High | 5.1% | 5.1% | 6.4% |

F-18

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

K. INCOME TAXES

The following is a reconciliation of income taxes at the statutory rate of 35% and income taxes as shown in the Consolidated Income Statement (in millions).

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---|---------------|---------------|---------------|
| Earnings before income taxes: | | | |
| Operating | \$38.9 | \$59.9 | \$81.1 |
| Equity in losses of affiliate | - | - | (9.5) |
| Cumulative effect of accounting changes | <u>(21.2)</u> | <u>(8.4)</u> | <u>1.2</u> |
| |) |) | |
| Earnings before income taxes | <u>\$17.7</u> | <u>\$51.5</u> | <u>\$72.8</u> |
| Tax computed at statutory rate | \$ 6.2 | \$18.0 | \$25.5 |

| | | | |
|---|---------------|---------------|---------------|
| Effect of: | | | |
| NOL utilization | (3.3) | - | (7.0) |
| Foreign operations | (4.6) | (3.3) | - |
| Goodwill | 3.9 | - | - |
| Other, net | <u>(0.7)</u> | <u>(0.4)</u> | <u>(0.4)</u> |
| |) |) |) |
| Total provision (all current) | 1.5 | 14.3 | 18.1 |
| Amounts applicable to losses of affiliate | - | - | 3.3 |
| Amounts applicable to accounting changes | <u>3.5</u> | <u>2.9</u> | <u>(0.4)</u> |
| | |) | |
| Provision for income tax as shown in | | | |
| Consolidated Income Statement | <u>\$ 5.0</u> | <u>\$17.2</u> | <u>\$21.0</u> |

Included in its consolidated tax provision is tax expense of \$0.4 million and \$3.4 million in 2001 and 2000, respectively, related to GAFRI's operations in Puerto Rico.

The significant components of deferred tax assets and liabilities, excluding the effects of unrealized gains and losses on marketable securities, included in the Consolidated Balance Sheet were as follows (in millions):

| | <u>December 31,</u> | |
|---|---------------------|-------------|
| | <u>2002</u> | <u>2001</u> |
| Deferred tax assets: | | |
| Net operating loss carryforwards | \$4.0 | \$29.2 |
| Accrued expenses | 16.7 | 16.6 |
| Investment securities | 74.2 | 71.2 |
| Policyholder liabilities | 12.7 | 1.4 |
| Capitalized assets | 9.2 | 9.1 |
| Valuation allowance for deferred tax assets | - | (20.4) |
| Deferred tax liabilities: | | |
| Unamortized insurance acquisition costs | (172.3) | (160.4) |

At December 31, 2002, GAFRI had net operating loss carryforwards for federal income tax purposes of approximately \$11 million which are scheduled to expire primarily in 2004 and 2005.

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

L. LEASES

Future minimum lease payments, net of sublease revenues, under operating leases having initial or remaining non-cancelable lease terms in excess of one year at December 31, 2002 are payable as follows: 2003 - \$6.7 million; 2004 - \$7.8 million; 2005 - \$3.8 million; 2006 - \$2.9 million; 2007 - \$1.7 million; 2008 and beyond - \$0.4 million. In addition, GAFRI has 99-year land leases (approximately 94 years remaining) at one of its real estate properties. Minimum lease payments under these leases are expected to be approximately \$90,000 in 2003 and are adjusted annually for inflation.

Rental expense for operating leases, net of sublease revenues, was \$7.0 million in 2002, \$5.5 million in 2001 and \$6.0 million in 2000.

M. EARNINGS PER SHARE

The number of common shares outstanding used in calculating diluted earnings per share in 2002 include 0.3 million shares while 2001 and 2000 include 0.4 million shares, for the effect of the assumed exercise of GAFRI's stock options.

N. INVESTMENT IN AFFILIATE

Prior to Chiquita's March 2002 restructuring, GAFRI owned 2.7 million shares (3% as of December 31, 2001) of Chiquita Common Stock. At that time, AFG and its other subsidiaries owned an additional 28% interest in the common stock of Chiquita. As a result of the restructuring, GAFRI received approximately 19,000 "new" shares in the reorganized company (less than one-half of 1%) plus warrants expiring in 2009 to purchase approximately 318,000 additional shares at \$19.23 per share. Chiquita reported net losses attributable to common shares of \$112 million in 2000.

O. CONTINGENCIES

The Company is continuing its clean-up activities at certain of its former manufacturing operations and third-party sites, in some cases in accordance with consent agreements with federal and state environmental agencies. Changes in regulatory standards and further investigations could affect estimated costs in the future. At December 31, 2002, based on prior costs and discussions with independent environmental consultants, the Company believes the remaining aggregate cost of environmental work at all sites for which it has responsibility will range from \$6.6 million to \$23 million. A significant portion of the known environmental costs are associated with long term remediation and monitoring. It's currently anticipated that such costs will be incurred over the next ten years. Management believes that reserves recorded are sufficient to satisfy the known liabilities and that the ultimate cost will not, individually, or in the aggregate, have a material adverse effect on the financial condition or results of operations of GAFRI.

P. STATUTORY INFORMATION; RESTRICTIONS ON TRANSFERS OF FUNDS AND ASSETS OF
SUBSIDIARIES

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):

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|-------------------------------|-------------|-------------|-------------|
| Capital and surplus | \$418.6 | \$388.4 | \$362.5 |
| Asset valuation reserve | 61.2 | 76.9 | 75.6 |
| Interest maintenance reserve | 26.0 | 11.0 | 3.3 |
| | | | |
| Pretax income from operations | \$ 60.3 | \$131.5 | \$ 78.0 |
| Net income from operations | 46.3 | 97.6 | 55.2 |
| Net income (loss) | (23.6) | 25.2 | 52.1 |

In January 2001, GAFRI's insurance subsidiaries adopted the codification of statutory accounting principles. The cumulative effect of these changes at adoption was not material.

Dividends, which can be paid by GAFRI's insurance subsidiaries without prior approval of regulatory authorities, are subject to restrictions relating to capital and surplus and statutory net income. Based on capital and surplus at December 31, 2002, GALIC and GAFRI may pay \$41.9 million and \$25.8 million, respectively, in dividends in 2003 without prior approval. In 2002, GALIC paid \$23.0 million in dividends and GAFRI paid \$2.5 million in dividends. Also in 2002, GAFRI made capital contributions to GALIC of \$34.0 million.

Securities owned by insurance subsidiaries having a carrying value of \$109 million at December 31, 2002, were on deposit as required by regulatory authorities.

Q. ADDITIONAL INFORMATION

Related Party Transactions

GAFRI had extended a line of credit in 1996 with a company owned by AFG and brothers of GAFRI's Chairman. Under the agreement, this company could borrow up to \$8 million at 13%. At December 31, 2001, \$6.4 million was due under the credit line. In September 2002, the company was sold to a third party and GAFRI's line of credit was repaid and terminated.

In September 2000, GAFRI's minority ownership in a company engaged in the production of ethanol was repurchased by that company for \$7.5 million in cash and \$21.9 million liquidation value of non-voting redeemable preferred stock. GAFRI recorded a pretax gain of \$27.2 million on the transaction. Following the repurchase, GAFRI's Chairman beneficially owned 100% of the ethanol company. In December 2000, the ethanol company retired \$3 million of the preferred stock at liquidation value plus accrued dividends and issued an \$18.9 million subordinated note in exchange for the remaining preferred stock. The outstanding balance of the subordinated note at December 31, 2002, was \$11.9 million. The subordinated note bears interest at 12-1/4% with scheduled repayments through 2005. The ethanol company also owes GAFRI \$4.0 million under a subordinated note bearing interest at 14%.

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Other income includes approximately \$0.4 million in 2001 and approximately \$1 million in 2000, of payments from a subsidiary of AFG for the rental of an office building owned by GALIC. This building was sold in 2001 to an unaffiliated party.

In order to take advantage of operational efficiencies, GAFRI shares certain IT services with AFG. GAFRI made approximately \$3 million and \$7 million in payments to AFG for such services in 2002 and 2001, respectively.

Fair Value of Financial Instruments

The following table shows the carrying value and estimated fair value of GAFRI's financial instruments at December 31 (in millions):

| | 2002 | | 2001 | |
|------------------------------|-------------------|-------------------------|-------------------|-------------------------|
| | Carrying Value | Estimated Fair Value | Carrying Value | Estimated Fair Value |
| <u>Assets</u> | | | | |
| Fixed maturity investments | \$7,181.1 | \$7,181.1 | \$6,431.1 | \$6,431.1 |
| Equity securities | 73.5 | 73.5 | 59.0 | 59.0 |
| <u>Liabilities</u> | | | | |
| Annuity benefits accumulated | \$6,453.9 | \$6,284.4 | \$5,832.1 | \$5,658.6 |
| Notes payable | 250.3 | 240.3 | 223.0 | 216.3 |
| Trust preferred securities | \$ 142.9 | \$ 140.6 | \$ 142.9 | \$ 143.4 |
| Stockholders' equity | \$ 851.9 | \$ 730.3 | \$ 748.8 | \$ 794.1 |

When available, fair values are based on prices quoted in the most active market for each security, including GAFRI Common Stock. If quoted prices are not available, fair value is estimated based on present values, discounted cash flows, fair value of comparable securities or similar methods. The fair value of short-term investments, mortgage loans on real estate and policy loans approximate their carrying value. The fair value of the liability for annuities in the payout phase is assumed to be the present value of the anticipated cash flows, discounted at current interest rates. Fair value of annuities in the accumulation phase is assumed to be the policyholders' cash surrender amount. Fair value of stockholders' equity is based on the quoted market price of GAFRI's Common Stock.

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Unrealized Gains on Marketable Securities, Net

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

| | Unadjusted Asset (Liability) | Effect of SFAS 115 | Adjusted Asset (Liability) |
|--|------------------------------------|-----------------------|----------------------------------|
| <u>2002</u> | | | |
| Fixed maturities | \$6,894.1 | \$287.0 | \$7,181.1 |
| Equity securities | 47.0 | 26.5 | 73.5 |
| Unamortized insurance acquisition costs, net | 622.0 | (31.0) | 591.0 |
| Annuity benefits accumulated | (6,444.7) | (9.2) | (6,453.9) |
| Deferred taxes on unrealized gains | - | <u>(93.3)</u> | (93.3) |
| |) | | |
| Unrealized gains | | <u>\$180.0</u> | |
| <u>2001</u> | | | |
| Fixed maturities | \$6,302.1 | \$129.0 | \$6,431.1 |
| Equity securities | 37.8 | 21.2 | 59.0 |
| Unamortized insurance acquisition costs, net | 565.1 | (9.0) | 556.1 |
| Annuity benefits accumulated | (5,827.9) | (4.2) | (5,832.1) |
| Deferred taxes on unrealized losses | - | <u>(47.2)</u> | (47.2) |
| |) | | |
| Unrealized gains | | <u>\$ 89.8</u> | |

Pension Plan

The Company has a defined benefit pension plan (the "Plan") covering former U.S. employees of its discontinued manufacturing operations. Amounts included in GAFRI's financial statements related to the Plan are immaterial. Pension benefits are based upon past service with the Company and compensation levels. Contributions are made by the Company in amounts necessary to satisfy requirements of ERISA.

F-23

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Accident and Health Reserves

The following table provides an analysis of changes in the liability for unpaid claims included in GAFRI's accident and health reserves over the past three years on a GAAP basis (in millions):

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|---|----------------|----------------|-----------------|
| Balance at beginning of period | \$ 96.6 | \$ 110.2 | \$ 73.9 |
| Provision for benefits occurring in the current year | 134.1 | 134.7 | 103.4 |
| Net increase (decrease) in provision for benefits of prior years (a) | <u>(5.2)</u> | <u>0.9</u> | <u>1.6</u> |
| |) | | |
| Total benefits incurred | 128.9 | 135.6 | 105.0 |
| Payments for losses of: | | | |
| Current year | (90.6) | (91.3) | (52.9) |
| Prior years | <u>(45.6)</u> | <u>(61.3)</u> | <u>(31.1)</u> |
| |) |) | |
| Total payments | (136.2) | (152.6) | (84.0) |
| Reserves of businesses acquired | <u>0.1</u> | <u>3.4</u> | <u>15.3</u> |
| Gross unpaid accident and health claims included in life, accident and health reserves in the Balance Sheet | <u>\$ 89.4</u> | <u>\$ 96.6</u> | <u>\$ 110.2</u> |

a. The decrease in the provision for benefits of prior years for 2002 is due primarily to better than expected results in the medicare supplement line of business.

Reinsurance

The Company has reinsured approximately \$29 billion and \$13 billion in face amount of life insurance as of December 31, 2002 and 2001, respectively. Life premiums ceded were \$61 million, \$49 million and \$43 million for 2002, 2001 and 2000, respectively.

F-24

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

Condensed Consolidating Information

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

CONDENSED CONSOLIDATING BALANCE SHEET

(In millions)

| <u>DECEMBER 31, 2002</u> | <u>GAFRI</u> | <u>AAG HOLDING</u> | <u>TOTAL TRUSTS</u> | <u>ALL OTHER SUBS</u> | <u>CONS ENTRIES</u> | <u>CONS CONS</u> |
|--|----------------|--------------------|---------------------|-----------------------|---------------------|------------------|
| Assets | | | | | | |
| Cash and investments | \$ 3.5 | \$ - | \$ - | \$7,967.3 | (\$ 1.6) | \$7,969.2 |
| Investment in subsidiaries | 801.1 | 1,193.4 | - | 0.9 | (1,995.4) | - |
| Notes receivable from AAG Holding | 102.4 | - | 154.6 | - | (257.0) | - |
| Unamortized insurance acquisition costs, net | - | - | - | 591.0 | - | 591.0 |
| Other assets | 18.3 | 1.4 | 4.7 | 287.9 | 35.0 | 347.3 |
| Variable annuity assets (separate accounts) | <u>-</u> | <u>-</u> | <u>-</u> | <u>455.1</u> | <u>-</u> | <u>455.1</u> |
| | <u>\$925.3</u> | <u>\$1,194.8</u> | <u>\$159.3</u> | <u>\$9,302.2</u> | <u>(\$2,219.0)</u> | <u>\$9,362.6</u> |
| Liabilities and Capital | | | | | | |
| Insurance liabilities | \$ - | \$ - | \$ - | \$7,361.8 | (\$ 5.5) | \$7,356.3 |
| Notes payable to GAFRI | - | 102.4 | - | 0.1 | (102.5) | - |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | | | | |
|---|----------------|------------------|----------------|------------------|--------------------|------------------|
| Notes payable to Trusts | - | 154.6 | - | - | (154.6) | - |
| Other notes payable | 1.7 | 248.6 | - | - | - | 250.3 |
| Other liabilities | 71.7 | 7.4 | 4.7 | 231.3 | (9.0) | 306.1 |
| Variable annuity liabilities (separate accounts) | <u>-</u> | <u>-</u> | <u>-</u> | <u>455.1</u> | <u>-</u> | <u>455.1</u> |
| | 73.4 | 513.0 | 4.7 | 8,048.3 | (271.6) | 8,367.8 |
| Mandatorily redeemable preferred securities of subsidiary trusts | - | - | 150.0 | - | (7.1) | 142.9 |
| Total stockholders' equity | <u>851.9</u> | <u>681.8</u> | <u>4.6</u> | <u>1,253.9</u> | <u>(1,940.3)</u> | <u>851.9</u> |
| | <u>\$925.3</u> | <u>\$1,194.8</u> | <u>\$159.3</u> | <u>\$9,302.2</u> | <u>(\$2,219.0)</u> | <u>\$9,362.6</u> |

DECEMBER 31, 2001

Assets

| | | | | | | |
|---|----------------|------------------|----------------|------------------|--------------------|------------------|
| Cash and investments | \$ 11.4 | \$ - | \$ - | \$6,956.8 | (\$ 1.7) | \$6,966.5 |
| Investment in subsidiaries | 689.1 | 1,080.6 | - | 1.9 | (1,771.6) | - |
| Notes receivable from AAG Holding | 102.4 | - | 154.6 | - | (257.0) | - |
| Unamortized insurance acquisition costs, net | - | - | - | 556.1 | - | 556.1 |
| Other assets | 17.2 | 1.4 | 4.7 | 282.2 | 42.7 | 348.2 |
| Variable annuity assets (separate accounts) | <u>-</u> | <u>-</u> | <u>-</u> | <u>529.6</u> | <u>-</u> | <u>529.6</u> |
| | <u>\$820.1</u> | <u>\$1,082.0</u> | <u>\$159.3</u> | <u>\$8,326.6</u> | <u>(\$1,987.6)</u> | <u>\$8,400.4</u> |

Liabilities and Capital

| | | | | | | |
|-------------------------|------|-------|------|-----------|----------|-----------|
| Insurance liabilities | \$ - | \$ - | \$ - | \$6,475.3 | (\$ 4.7) | \$6,470.6 |
| Notes payable to GAFRI | - | 102.4 | - | 0.1 | (102.5) | - |
| Notes payable to Trusts | - | 154.6 | - | - | (154.6) | - |
| Other notes payable | 1.9 | 221.1 | - | - | - | 223.0 |
| Other liabilities | 69.4 | 10.8 | 4.7 | 209.4 | (8.8) | 285.5 |

| | | | | | | |
|---|----------------|------------------|----------------|------------------|--------------------|------------------|
| Variable annuity liabilities (separate accounts) | <u>-</u> | <u>-</u> | <u>-</u> | <u>529.6</u> | <u>-</u> | <u>529.6</u> |
| | 71.3 | 488.9 | 4.7 | 7,214.4 | (270.6) | 7,508.7 |
| Mandatorily redeemable preferred securities of subsidiary trusts | - | - | 150.0 | - | (7.1) | 142.9 |
| Total stockholders' equity | <u>748.8</u> | <u>593.1</u> | <u>4.6</u> | <u>1,112.2</u> | <u>(1,709.9)</u> | <u>748.8</u> |
| | | | |) | | |
| | <u>\$820.1</u> | <u>\$1,082.0</u> | <u>\$159.3</u> | <u>\$8,326.6</u> | <u>(\$1,987.6)</u> | <u>\$8,400.4</u> |

F-25

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

(In millions)

| YEAR ENDED | AAG | TOTAL | ALL | CONS | | |
|---|----------------------|---------------|--------------|----------------|---------------|----------|
| <u>DECEMBER 31, 2002</u> | <u>GAFRI HOLDING</u> | <u>TRUSTS</u> | <u>OTHER</u> | <u>ENTRIES</u> | <u>CONS</u> | |
| Revenues | | | | | | |
| : | | | | | | |
| Life, accident and health premiums | \$ - | \$ - | \$ - | \$305.7 | \$ - | \$305.7 |
| Net investment income and other revenue | 21.1 | - | - | 575.4 | (19.0) | 577.5 |
| Interest income on AAG Holding notes | - | - | 14.0 | - | (14.0) | - |
| Equity in earnings of subsidiaries | <u>27.4</u> | <u>61.7</u> | <u>-</u> | <u>-</u> | <u>(89.1)</u> | <u>-</u> |
| | | | |) | | |
| | 48.5 | 61.7 | 14.0 | 881.1 | (122.1) | 883.2 |
| Costs and Expenses: | | | | | | |
| Insurance benefits and expenses | - | - | - | 660.8 | - | 660.8 |
| Interest expense on AAG Holding notes | - | 14.0 | - | - | (14.0) | - |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | | | | |
|----------------------------------|---------------|---------------|---------------|----------------|------------------|----------------|
| Other interest and debt expenses | 0.1 | 20.4 | - | - | 3.3 | 23.8 |
| Other expenses | <u>9.5</u> | <u>9.7</u> | <u>-</u> | <u>148.9</u> | <u>(8.4)</u> | <u>159.7</u> |
| | | | |) | | |
| | 9.6 | 44.1 | - | 809.7 | (19.1) | 844.3 |
| Earnings before income taxes | 38.9 | 17.6 | 14.0 | 71.4 | (103.0) | 38.9 |
| Provision for income taxes | <u>5.0</u> | <u>5.5</u> | <u>-</u> | <u>18.3</u> | <u>(23.8)</u> | <u>5.0</u> |
| | | | |) | | |
| Net operating earnings | 33.9 | 12.1 | 14.0 | 53.1 | (79.2) | 33.9 |
| Accounting change, net | <u>(17.7)</u> | <u>-</u> | <u>-</u> | <u>(17.7)</u> | <u>17.7</u> | <u>(17.7)</u> |
| |) | |) | |) | |
| Net income | <u>\$16.2</u> | <u>\$12.1</u> | <u>\$14.0</u> | <u>\$ 35.4</u> | <u>(\$ 61.5)</u> | <u>\$ 16.2</u> |

YEAR ENDED

DECEMBER 31, 2001

Revenues

| | | | | | | |
|---|-------------|-------------|----------|--------------|----------------|--------------|
| : | | | | | | |
| Life, accident and health premiums | \$ - | \$ - | \$ - | \$280.1 | \$ - | \$280.1 |
| Net investment income and other revenue | 25.6 | - | - | 544.6 | (20.2) | 550.0 |
| Interest income on AAG Holding notes | - | - | 18.2 | - | (18.2) | - |
| Equity in earnings of subsidiaries | <u>51.7</u> | <u>89.0</u> | <u>-</u> | <u>-</u> | <u>(140.7)</u> | <u>-</u> |
| | | | |) | | |
| | 77.3 | 89.0 | 18.2 | 824.7 | (179.1) | 830.1 |
| Costs and Expenses: | | | | | | |
| Insurance benefits and expenses | - | - | - | 587.0 | - | 587.0 |
| Interest expense on AAG Holding notes | - | 18.2 | - | - | (18.2) | - |
| Other interest and debt expenses | 0.1 | 20.4 | - | 0.1 | 7.3 | 27.9 |
| Other expenses | <u>17.3</u> | <u>8.8</u> | <u>-</u> | <u>139.0</u> | <u>(9.8)</u> | <u>155.3</u> |
| | | | |) | | |
| | 17.4 | 47.4 | - | 726.1 | (20.7) | 770.2 |

| | | | | | | |
|------------------------------|---------------|---------------|---------------|----------------|------------------|----------------|
| Earnings before income taxes | 59.9 | 41.6 | 18.2 | 98.6 | (158.4) | 59.9 |
| Provision for income taxes | <u>17.2</u> | <u>13.9</u> | <u>-</u> | <u>28.8</u> | <u>(42.7)</u> | <u>17.2</u> |
| | | | |) | | |
| Net operating earnings | 42.7 | 27.7 | 18.2 | 69.8 | (115.7) | 42.7 |
| Accounting change, net | <u>(5.5)</u> | <u>-</u> | <u>-</u> | <u>(5.5)</u> | <u>5.5</u> | <u>(5.5)</u> |
| |) | |) | |) | |
| Net income | <u>\$37.2</u> | <u>\$27.7</u> | <u>\$18.2</u> | <u>\$ 64.3</u> | <u>(\$110.2)</u> | <u>\$ 37.2</u> |

F-26

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

CONDENSED CONSOLIDATING STATEMENT OF OPERATIONS

(In millions)

| YEAR ENDED | AAG | TOTAL | ALL | CONS | | |
|---|-------------|-------------|-----------|-----------|----------------|-----------|
| | GAFRI | HOLDING | TRUSTS | OTHER | ENTRIES | CONS |
| <u>DECEMBER 31, 2000</u> | <u>GA</u> | <u>FR</u> | <u>RI</u> | <u>TR</u> | <u>US</u> | <u>TR</u> |
| Revenues | | | | | | |
| : | | | | | | |
| Life, accident and health premiums | \$ - | \$ - | \$ - | \$230.4 | \$ - | \$230.4 |
| Net investment income and other revenue | 58.9 | - | - | 557.2 | (22.2) | 593.9 |
| Interest income on AAG Holding notes | - | - | 19.6 | - | (19.6) | - |
| Equity in earnings of subsidiaries | <u>41.2</u> | <u>85.7</u> | <u>-</u> | <u>-</u> | <u>(126.9)</u> | <u>-</u> |
| | | | |) | | |
| | 100.1 | 85.7 | 19.6 | 787.6 | (168.7) | 824.3 |
| Costs and Expenses: | | | | | | |
| Insurance benefits and expenses | - | - | - | 530.6 | - | 530.6 |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | | | | |
|---------------------------------------|----------------|---------------|---------------|----------------|------------------|----------------|
| Interest expense on AAG Holding notes | - | 19.6 | - | - | (19.6) | - |
| Other interest and debt expenses | 0.1 | 23.4 | - | 0.1 | 8.6 | 32.2 |
| Other expenses | <u>18.9</u> | <u>13.9</u> | <u>-</u> | <u>159.7</u> | <u>(12.1)</u> | <u>180.4</u> |
| | | | |) | | |
| | 19.0 | 56.9 | - | 690.4 | (23.1) | 743.2 |
| Earnings before income taxes | 81.1 | 28.8 | 19.6 | 97.2 | (145.6) | 81.1 |
| Provision for income taxes | <u>21.0</u> | <u>9.3</u> | <u>-</u> | <u>30.5</u> | <u>(39.8)</u> | <u>21.0</u> |
| | | | |) | | |
| Net operating earnings | 60.1 | 19.5 | 19.6 | 66.7 | (105.8) | 60.1 |
| Equity in losses of affiliate, net | <u>(6.2)</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>(6.2)</u> |
| |) | | | |) | |
| Income before accounting change | 53.9 | 19.5 | 19.6 | 66.7 | (105.8) | 53.9 |
| Accounting change, net | <u>0.8</u> | <u>-</u> | <u>-</u> | <u>0.8</u> | <u>(0.8)</u> | <u>0.8</u> |
| | | | |) | | |
| Net income | <u>\$ 54.7</u> | <u>\$19.5</u> | <u>\$19.6</u> | <u>\$ 67.5</u> | <u>(\$106.6)</u> | <u>\$ 54.7</u> |

F-27

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

YEAR ENDED DECEMBER 31, 2002

(In millions)

| | AAG | TOTAL | ALL | CONS | |
|--|--------------|----------------|---------------|-------------|-------------|
| | | | OTHER | ENTRIES | |
| | <u>GAFRI</u> | <u>HOLDING</u> | <u>TRUSTS</u> | <u>SUBS</u> | <u>CONS</u> |

Cash Flows from Operating Activities:

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | | | | |
|---|--------------|---------------|-------------|----------------|---------------|----------------|
| Net income | \$16.2 | \$12.1 | \$14.0 | \$ 35.4 | (\$ 61.5) | \$ 16.2 |
| Adjustments: | | | | | | |
| Cumulative effect of accounting change | 17.7 | - | - | 17.7 | (17.7) | 17.7 |
| Equity in net earnings of subsidiaries | (29.0) | (42.2) | - | - | 71.2 | - |
| Increase in life, accident and health reserves | - | - | - | 70.0 | - | 70.0 |
| Benefits to annuity policyholders | - | - | - | 301.0 | - | 301.0 |
| Amortization of insurance acquisition costs | - | - | - | 114.5 | - | 114.5 |
| Depreciation and amortization | 0.1 | 0.3 | - | 16.4 | - | 16.8 |
| Realized losses | 0.2 | - | - | 45.5 | - | 45.7 |
| Increase in insurance acquisition costs | - | - | - | (170.2) | - | (170.2) |
| Increase in other assets | (1.0) | - | - | (23.3) | - | (24.3) |
| Increase (decrease) in other liabilities | 5.1 | - | - | (54.3) | - | (49.2) |
| Increase (decrease) in payable to affiliates, net | (2.7) | - | - | (27.1) | - | (29.8) |
| Capital contribution from parent (to subsidiary) | (59.0) | 25.0 | - | 34.0 | - | - |
| Dividends from subsidiaries (to parent) | 47.7 | (22.2) | - | (25.5) | - | - |
| Other, net | <u>0.8</u> | <u>(0.5)</u> | <u>-</u> | <u>11.7</u> | <u>(6.0)</u> | <u>6.0</u> |
| |) | | |) | | |
| | <u>(3.9)</u> | <u>(27.5)</u> | <u>14.0</u> | <u>345.8</u> | <u>(14.0)</u> | <u>314.4</u> |
| |) |) | |) | | |
| Cash Flows from Investing Activities: | | | | | | |
| Purchases of investments and other assets | (0.3) | - | - | (3,904.9) | - | (3,905.2) |
| Maturities and redemptions of fixed investments | 6.4 | - | - | 1,282.9 | - | 1,289.3 |
| Sales of investments and other assets | 2.3 | - | - | 2,200.2 | - | 2,202.5 |
| Purchase of subsidiary | - | - | - | (43.6) | - | (43.6) |
| Decrease in policy loans | <u>-</u> | <u>-</u> | <u>-</u> | <u>4.5</u> | <u>-</u> | <u>4.5</u> |
| | <u>8.4</u> | <u>-</u> | <u>-</u> | <u>(460.9)</u> | <u>-</u> | <u>(452.5)</u> |
| |) |) |) |) |) |) |

Cash Flows from Financing Activities:

| | | | | | | |
|---|---------------|-------------|---------------|-----------------|-------------|-----------------|
| Fixed annuity receipts | - | - | - | 874.5 | - | 874.5 |
| Annuity surrenders, benefits and withdrawals | - | - | - | (549.9) | - | (549.9) |
| Net transfers from variable annuity assets | - | - | - | 20.8 | - | 20.8 |
| Additions to notes payable | - | 27.5 | - | - | - | 27.5 |
| Reductions of notes payable | (0.2) | - | - | - | - | (0.2) |
| Issuance of Common Stock | 2.6 | - | - | - | - | 2.6 |
| Retirement of Common Stock | (1.6) | - | - | - | - | (1.6) |
| Trust dividend requirements | - | - | (14.0) | - | 14.0 | - |
| Cash dividends paid | <u>(4.3)</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>(4.3)</u> |
| |) | | | |) | |
| | <u>(3.5)</u> | <u>27.5</u> | <u>(14.0)</u> | <u>345.4</u> | <u>14.0</u> | <u>369.4</u> |
| |) |) | | | | |
| Net increase in cash and short-term investments | 1.0 | - | - | 230.3 | - | 231.3 |
| Beginning cash and short-term investments | <u>0.9</u> | <u>-</u> | <u>-</u> | <u>170.0</u> | <u>-</u> | <u>170.9</u> |
| Ending cash and short-term investments | <u>\$ 1.9</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 400.3</u> | <u>\$ -</u> | <u>\$ 402.2</u> |

F-28

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

YEAR ENDED DECEMBER 31, 2001

(In millions)

| | AAG | TOTAL | ALL | CONS | |
|--|--------------|----------------|---------------|-------------|-------------|
| | | | OTHER | ENTRIES | |
| | <u>GAFRI</u> | <u>HOLDING</u> | <u>TRUSTS</u> | <u>SUBS</u> | <u>CONS</u> |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

Cash Flows from Operating Activities:

| | | | | | | |
|---|--------------|-------------|-------------|---------------|---------------|---------------|
| Net income | \$ 37.2 | \$ 27.7 | \$18.2 | \$ 64.3 | (\$110.2) | \$ 37.2 |
| Adjustments: | | | | | | |
| Cumulative effect of accounting change | 5.5 | - | - | 5.5 | (5.5) | 5.5 |
| Equity in net earnings of subsidiaries | (37.5) | (60.2) | - | - | 97.7 | - |
| Increase in life, accident and health reserves | - | - | - | 58.0 | - | 58.0 |
| Benefits to annuity policyholders | - | - | - | 294.7 | - | 294.7 |
| Amortization of insurance acquisition costs | - | - | - | 79.3 | - | 79.3 |
| Depreciation and amortization | 0.7 | 4.9 | - | 6.8 | - | 12.4 |
| Realized losses | 3.3 | - | - | 48.3 | - | 51.6 |
| Increase in insurance acquisition costs | - | - | - | (137.7) | - | (137.7) |
| Decrease (increase) in other assets | 9.3 | - | - | (48.1) | - | (38.8) |
| Increase (decrease) in other liabilities | 1.5 | - | - | (11.2) | - | (9.7) |
| Increase (decrease) in payable to affiliates, net | (1.6) | - | - | 15.0 | - | 13.4 |
| Capital contribution from parent (to subsidiary) | (150.6) | 123.1 | - | 27.5 | - | - |
| Dividends from subsidiaries (to parent) | 129.9 | (111.9) | - | (18.0) | - | - |
| Other, net | <u>0.9</u> | <u>18.8</u> | <u>-</u> | <u>(36.8)</u> | <u>1.3</u> | <u>(15.8)</u> |
| | | |) | |) | |
| | <u>(1.4)</u> | <u>2.4</u> | <u>18.2</u> | <u>347.6</u> | <u>(16.7)</u> | <u>350.1</u> |
| |) | | |) | | |

Cash Flows from Investing Activities:

| | | | | | | |
|---|------------|----------|----------|----------------|--------------|----------------|
| Purchases of investments and other assets | (6.4) | - | - | (1,731.4) | - | (1,737.8) |
| Maturities and redemptions of fixed investments | - | - | - | 582.0 | - | 582.0 |
| Sales of investments and other assets | 7.7 | - | - | 893.0 | - | 900.7 |
| Decrease in intercompany notes receivable | 1.5 | - | - | (1.5) | - | - |
| Decrease in policy loans | <u>-</u> | <u>-</u> | <u>-</u> | <u>2.2</u> | <u>-</u> | <u>2.2</u> |
| | <u>2.8</u> | <u>-</u> | <u>-</u> | <u>(254.2)</u> | <u>(1.5)</u> | <u>(252.9)</u> |
| | | |) | |) |) |

Cash Flows from Financing Activities:

| | | | | | | |
|--|---------------|--------------|---------------|-----------------|-------------|-----------------|
| Fixed annuity receipts | - | - | - | 616.6 | - | 616.6 |
| Annuity surrenders, benefits and withdrawals | - | - | - | (622.5) | - | (622.5) |
| Net transfers to variable annuity assets | - | - | - | (0.4) | - | (0.4) |
| Additions to notes payable | 0.1 | 87.4 | - | - | - | 87.5 |
| Reductions of notes payable | (0.2) | (14.8) | - | (1.4) | - | (16.4) |
| Issuance of Common Stock | 1.4 | - | - | - | - | 1.4 |
| Retirement of Common Stock | (0.8) | - | - | - | - | (0.8) |
| Repurchase of trust preferred securities | - | (75.0) | - | - | - | (75.0) |
| Trust dividend requirements | - | - | (18.2) | - | 18.2 | - |
| Cash dividends paid | <u>(4.2)</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>(4.2)</u> |
| |) | | | |) | |
| | <u>(3.7)</u> | <u>(2.4)</u> | <u>(18.2)</u> | <u>(7.7)</u> | <u>18.2</u> | <u>(13.8)</u> |
| |) |) |) | |) | |
| Net increase (decrease) in cash and short-term investments | (2.3) | - | - | 85.7 | - | 83.4 |
| Beginning cash and short-term investments | <u>3.2</u> | <u>-</u> | <u>-</u> | <u>84.3</u> | <u>-</u> | <u>87.5</u> |
| Ending cash and short-term investments | <u>\$ 0.9</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 170.0</u> | <u>\$ -</u> | <u>\$ 170.9</u> |

F-29

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

YEAR ENDED DECEMBER 31, 2000

(In millions)

| | | | |
|-----|-------|--------------|------|
| AAG | TOTAL | ALL OTHER | CONS |
|-----|-------|--------------|------|

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | <u>GAFRI</u> | <u>HOLDING</u> | <u>TRUSTS</u> | <u>SUBS</u> | <u>ENTRIES</u> | <u>CONS</u> |
|--|---------------|----------------|---------------|---------------|----------------|---------------|
| Cash Flows from Operating Activities: | | | | | | |
| Net income | \$ 54.7 | \$ 19.5 | \$19.6 | \$ 67.5 | (\$106.6) | \$ 54.7 |
| Adjustments: | | | | | | |
| Cumulative effect of accounting change | (0.8) | - | - | (0.8) | 0.8 | (0.8) |
| Equity in net (earnings) losses of subsidiaries and affiliates | (18.7) | (59.2) | - | - | 84.1 | 6.2 |
| Increase in life, accident and health reserves | - | - | - | 78.8 | - | 78.8 |
| Benefits to annuity policyholders | - | - | - | 293.1 | - | 293.1 |
| Amortization of insurance acquisition costs | - | - | - | 62.3 | - | 62.3 |
| Depreciation and amortization | 0.9 | 7.8 | - | (2.0) | - | 6.7 |
| Realized (gains) losses (a) | (27.6) | - | - | 19.8 | - | (7.8) |
| Increase in insurance acquisition costs | - | - | - | (146.7) | - | (146.7) |
| Increase in other assets | (5.0) | - | - | (30.0) | - | (35.0) |
| Increase in other liabilities | 3.4 | - | - | 10.1 | - | 13.5 |
| Increase in payable to affiliates, net | 6.7 | - | - | 12.2 | - | 18.9 |
| Capital contribution from parent (to subsidiary) | (103.5) | 96.5 | - | 7.0 | - | - |
| Dividends from subsidiaries (to parent) | 42.6 | (2.6) | - | (40.0) | - | - |
| Other, net | <u>1.0</u> | <u>(62.0)</u> | <u>-</u> | <u>8.3</u> | <u>22.2</u> | <u>(30.5)</u> |
| |) | | |) | | |
| | <u>(46.3)</u> | <u>-</u> | <u>19.6</u> | <u>339.6</u> | <u>-0.5</u> | <u>313.4</u> |
| |) | | | | | |
| Cash Flows from Investing Activities: | | | | | | |
| Purchases of investments and other assets | (2.5) | - | - | (818.1) | - | (820.6) |
| Maturities and redemptions of fixed investments | 0.6 | - | - | 391.8 | - | 392.4 |
| Sales of investments and other assets | 56.3 | - | - | 385.0 | (20.4) | 420.9 |
| Decrease in intercompany notes receivable | (0.3) | - | - | - | 0.3 | - |
| Decrease in policy loans | <u>-</u> | <u>-</u> | <u>-</u> | <u>3.7</u> | <u>-</u> | <u>3.7</u> |
| | <u>54.1</u> | <u>-</u> | <u>-</u> | <u>(37.6)</u> | <u>(20.1)</u> | <u>(3.6)</u> |

| | | | | | | |
|--|---------------|-------------|---------------|----------------|-------------|----------------|
| | | | |) |) |) |
| Cash Flows from Financing Activities: | | | | | | |
| Fixed annuity receipts | - | - | - | 496.8 | - | 496.8 |
| Annuity surrenders, benefits and withdrawals | - | - | - | (731.9) | - | (731.9) |
| Net transfers to variable annuity assets | - | - | - | (50.5) | - | (50.5) |
| Additions to notes payable | 0.1 | - | - | 9.5 | - | 9.6 |
| Reductions of notes payable | (0.3) | - | - | (58.7) | - | (59.0) |
| Issuance of Common Stock | 1.1 | - | - | - | - | 1.1 |
| Retirement of Common Stock | (2.4) | - | - | - | - | (2.4) |
| Repurchase of trust preferred securities | - | - | - | (1.4) | - | (1.4) |
| Trust dividend requirements | - | - | (19.6) | - | 19.6 | - |
| Cash dividends paid | <u>(4.2)</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>(4.2)</u> |
| |) | | | |) | |
| | <u>(5.7)</u> | <u>-</u> | <u>(19.6)</u> | <u>(336.2)</u> | <u>19.6</u> | <u>(341.9)</u> |
| |) |) |) | |) | |
| Net increase (decrease) in cash and short-term investments | 2.1 | - | - | (34.2) | - | (32.1) |
| Beginning cash and short-term investments | <u>1.1</u> | <u>-</u> | <u>-</u> | <u>118.5</u> | <u>-</u> | <u>119.6</u> |
| Ending cash and short-term investments | <u>\$ 3.2</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 84.3</u> | <u>\$ -</u> | <u>\$ 87.5</u> |

(a) Included in the GAFRI column is a (\$27.2) million gain on the redemption of minority ownership by related party.

F-30

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued

R. QUARTERLY FINANCIAL DATA (Unaudited)

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

Quarterly results necessarily rely heavily on estimates. These estimates and certain other factors, such as the seasonal nature of the Company's hotel operations and the discretionary sales of assets, cause the quarterly results not to be necessarily indicative of results for longer periods of time. The following table represents quarterly results of operations for the years ended December 31, 2002 and 2001 (in millions, except per share data).

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Total Year |
|---|------------------|-------------------|------------------|-------------------|----------------|
| <u>2002</u> | | | | | |
| Realized gains (losses) | (\$ 9.6) | (\$ 20.6) | (\$ 21.4) | \$ 5.9 | (\$ 45.7) |
| Total revenues | 213.6 | 204.2 | 221.7 | 243.7 | 883.2 |
| Income before accounting changes | 11.4 | 7.9 | 2.0 | 12.6 | 33.9 |
| Accounting changes | (17.7) | - | - | - | (17.7) |
| Net income (loss) | (6.3) | 7.9 | 2.0 | 12.6 | 16.2 |
| Basic earnings (loss) per common share: | | | | | |
| Income before accounting changes | \$ 0.27 | \$ 0.19 | \$ 0.05 | \$ 0.30 | \$ 0.80 |
| Accounting changes | <u>(0.42)</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>(0.42)</u> |
| Net income (loss) | <u>\$(0.15)</u> | <u>\$ 0.19</u> | <u>\$ 0.05</u> | <u>\$ 0.30</u> | <u>\$ 0.38</u> |
| Diluted earnings (loss) per common share: | | | | | |
| Income before accounting changes | \$ 0.27 | \$ 0.18 | \$ 0.05 | \$ 0.29 | \$ 0.79 |
| Accounting changes | <u>(0.41)</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>(0.41)</u> |
| Net income (loss) | <u>\$(0.14)</u> | <u>\$ 0.18</u> | <u>\$ 0.05</u> | <u>\$ 0.29</u> | <u>\$ 0.38</u> |
| Average common shares outstanding | | | | | |
| Basic | 42.4 | 42.4 | 42.4 | 42.4 | 42.4 |
| Diluted | 42.8 | 42.8 | 42.6 | 42.6 | 42.7 |
| <u>2001</u> | | | | | |
| Realized losses | (\$ 1.8) | (\$ 22.7) | (\$ 1.3) | (\$ 25.8) | (\$ 51.6) |
| Total revenues | 217.0 | 196.6 | 222.3 | 194.2 | 830.1 |
| Income before accounting changes | 17.9 | 5.6 | 18.4 | 0.8 | 42.7 |
| Accounting changes | - | (5.5) | - | - | (5.5) |
| Net income | 17.9 | 0.1 | 18.4 | 0.8 | 37.2 |

Basic earnings (loss) per common share:

| | | | | | |
|----------------------------------|----------------|---------------|----------------|----------------|----------------|
| Income before accounting changes | \$ 0.42 | \$ 0.13 | \$ 0.43 | \$ 0.02 | \$ 1.01 |
| Accounting changes | <u>-</u> | <u>(0.13)</u> | <u>-</u> | <u>-</u> | <u>(0.13)</u> |
| |) | | |) | |
| Net income | <u>\$ 0.42</u> | <u>\$ -</u> | <u>\$ 0.43</u> | <u>\$ 0.02</u> | <u>\$ 0.88</u> |

Diluted earnings (loss) per common share:

| | | | | | |
|----------------------------------|----------------|---------------|----------------|----------------|----------------|
| Income before accounting changes | \$ 0.42 | \$ 0.13 | \$ 0.43 | \$ 0.02 | \$ 1.00 |
| Accounting changes | <u>-</u> | <u>(0.13)</u> | <u>-</u> | <u>-</u> | <u>(0.13)</u> |
| |) | | |) | |
| Net income | <u>\$ 0.42</u> | <u>\$ -</u> | <u>\$ 0.43</u> | <u>\$ 0.02</u> | <u>\$ 0.87</u> |

Average common shares outstanding

| | | | | | |
|---------|------|------|------|------|------|
| Basic | 42.3 | 42.3 | 42.3 | 42.3 | 42.3 |
| Diluted | 42.8 | 42.7 | 42.7 | 42.7 | 42.7 |

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

F-31

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) Documents filed as part of this Report:

1. Financial Statements are Included in Part II, Item 8.
2. Financial Statement Schedules:

Selected Quarterly Financial Data is included in Note R to the Consolidated Financial Statements.

Schedules filed herewith:

For 2002, 2001 and 2000

Page

II - Condensed Financial Information of Registrant S-2

III - Supplementary Insurance Information S-4

All other schedules for which provisions are made in the applicable regulation of the Securities and Exchange Commission have been omitted as they are not applicable, not required, or the information required thereby is set forth in the Financial Statements or the notes thereto.

3. Exhibits - See Exhibit Index on Page E-1.

(b) Report on Form 8-K: None

S-1

GREAT AMERICAN FINANCIAL RESOURCES, INC. - PARENT ONLY

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(In millions)

Condensed Balance Sheet

| | <u>December 31,</u> | |
|------------------------------------|---------------------|----------------|
| | <u>2002</u> | <u>2001</u> |
| Assets | | |
| : | | |
| Investments: | | |
| Fixed maturities - at market | | |
| (amortized cost - \$0.1 and \$8.4) | \$ 0.2 | \$ 8.6 |
| Equity securities - at market | | |
| (cost - \$1.4 and \$2.0) | 1.4 | 1.9 |
| Cash and short-term investments | 1.9 | 0.9 |
| Investment in subsidiaries (a) | 801.1 | 689.1 |
| Note receivable from AAG Holding | 102.4 | 102.4 |
| Other assets | <u>18.3</u> | <u>17.2</u> |
| | <u>\$925.3</u> | <u>\$820.1</u> |

Liabilities and Capital:

| | | |
|--|----------------|----------------|
| Accounts payable, accrued expenses and other liabilities | \$ 36.5 | \$ 31.5 |
| Payables to affiliates | 35.2 | 37.9 |
| Notes payable | 1.7 | 1.9 |
| Stockholders' equity (b) | <u>851.9</u> | <u>748.8</u> |
| | <u>\$925.3</u> | <u>\$820.1</u> |

Condensed Income Statement

| | <u>Year ended December 31,</u> | | |
|--|--------------------------------|-------------|--------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| Revenues: | | | |
| Net investment income and other income | \$21.2 | \$28.9 | \$ 31.3 |
| Realized gains (losses) on investments (c) | (0.1) | (3.3) | 27.6 |
| Equity in undistributed earnings of subsidiaries | 1.9 | 32.8 | (1.4) |
| Capital distributions from subsidiaries | <u>25.5</u> | <u>18.9</u> | <u>42.6</u> |
| | 48.5 | 77.3 | 100.1 |
| Costs and Expenses: | | | |
| Interest and other financing expenses | 0.1 | 0.1 | 0.1 |
| Other expenses | <u>9.5</u> | <u>17.3</u> | <u>18.9</u> |
| | 9.6 | 17.4 | 19.0 |
| Operating earnings before income taxes | 38.9 | 59.9 | 81.1 |
| Provision for income taxes | <u>5.0</u> | <u>17.2</u> | <u>21.0</u> |
| Net operating earnings | 33.9 | 42.7 | 60.1 |
| Equity in losses of affiliate, net of tax | <u>-</u> | <u>-</u> | <u>(6.2)</u> |
| | |) | |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | |
|---|---------------|---------------|----------------|
| Income before accounting changes | 33.9 | 42.7 | 53.9 |
| Cumulative effect of accounting changes, net of tax | <u>(17.7)</u> | <u>(5.5)</u> | <u>0.8</u> |
| |) |) | |
| Net Income | <u>\$16.2</u> | <u>\$37.2</u> | <u>\$ 54.7</u> |

(a) Includes net unrealized gains on marketable securities of \$179.9 million and \$89.7 million in 2002 and 2001, respectively.

(b) Includes net unrealized gains on marketable securities of \$180.0 million and \$89.8 million in 2002 and 2001, respectively.

(c) 2000 amount includes a \$27.2 million gain on the redemption of minority ownership by related party.

S-2

GREAT AMERICAN FINANCIAL RESOURCES, INC. - PARENT ONLY

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF REGISTRANT

(In millions)

Condensed Statement of Cash Flows

| | <u>Year Ended December 31,</u> | | |
|---|--------------------------------|-------------|-------------|
| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
| Cash Flows from Operating Activities: | | | |
| Net income | \$16.2 | \$ 37.2 | \$ 54.7 |
| Adjustments: | | | |
| Cumulative effect of accounting changes | 17.7 | 5.5 | (0.8) |
| Equity in net earnings of subsidiaries | (29.0) | (37.5) | (18.7) |
| Depreciation and amortization | 0.1 | 0.7 | 0.9 |
| Realized (gains) losses (a) | 0.2 | 3.3 | (27.6) |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | |
|--|---------------|---------------|---------------|
| Decrease (increase) in other assets | (1.0) | 9.3 | (5.0) |
| Increase (decrease) in balances with affiliates | (2.7) | (1.6) | 6.7 |
| Increase in other liabilities | 5.1 | 1.5 | 3.4 |
| Capital distributions from subsidiaries | 47.7 | 129.9 | 42.6 |
| Contributions to subsidiaries | (59.0) | (150.6) | (103.5) |
| Other, net | <u>0.8</u> | <u>0.9</u> | <u>1.0</u> |
| | <u>(3.9)</u> | <u>(1.4)</u> | <u>(46.3)</u> |
| |) |) |) |
| Cash Flows from Investing Activities: | | | |
| Purchase of investments | (0.3) | (6.4) | (2.5) |
| Decrease (increase) in intercompany notes receivable | - | 1.5 | (0.3) |
| Maturities and redemptions of fixed maturity investments | 6.4 | - | 0.6 |
| Sales of investments | 2.3 | 7.7 | 35.9 |
| Sale of subsidiaries (b) | <u>-</u> | <u>-</u> | <u>20.4</u> |
| | <u>8.4</u> | <u>2.8</u> | <u>54.1</u> |
| Cash Flows from Financing Activities: | | | |
| Additions to notes payable | - | 0.1 | 0.1 |
| Reductions of notes payable | (0.2) | (0.2) | (0.3) |
| Issuance of Common Stock | 2.6 | 1.4 | 1.1 |
| Retirement of Common Stock | (1.6) | (0.8) | (2.4) |
| Cash dividends paid | <u>(4.3)</u> | <u>(4.2)</u> | <u>(4.2)</u> |
| |) |) |) |
| | <u>(3.5)</u> | <u>(3.7)</u> | <u>(5.7)</u> |
| |) |) |) |
| Net increase (decrease) in cash and short-term investments | 1.0 | (2.3) | 2.1 |
| Beginning cash and short-term investments | <u>0.9</u> | <u>3.2</u> | <u>1.1</u> |
| Ending cash and short-term investments | <u>\$ 1.9</u> | <u>\$ 0.9</u> | <u>\$ 3.2</u> |

- 2000 amount includes a (\$27.2) million gain on the redemption of minority ownership by related party.
- 2000 amount reflects sale of Consolidated Financial Corporation to GALIC.

S-3

GREAT AMERICAN FINANCIAL RESOURCES, INC. AND SUBSIDIARIES

SCHEDULE III - SUPPLEMENTARY INSURANCE INFORMATION

THREE YEARS ENDED DECEMBER 31, 2002

(In millions)

| COLUMN A | COLUMN B | COLUMN C | COLUMN D | COLUMN E | COLUMN F | COLUMN G | COLUMN H | COLUMN I | COLUMN J | COLUMN K | |
|-------------|--|--|-------------------|--|-----------------|-----------------------|--|--|--------------|--------------|-----|
| Segment | Unamortized Insurance Acquisition Costs, Net | Future policy benefits, losses, claims and loss expenses | Unearned Premiums | Other policy claims and benefits payable | Premium Revenue | Net Investment Income | Benefits, claims, losses and settlement expenses | Amortization of insurance acquisition expenses | | | |
| (1) | | | | | | | | | | | |
| <u>2002</u> | | | | | | | | | | | |
| S-4 | Life & Annuity products | \$435 | \$6,659 | \$ 1 | \$15 | \$ 54 | \$474 | \$353 | \$ 68 | \$ 97 | N/A |
| | Supplemental insurance products | 94 | 538 | 2 | 2 | 191 | 38 | 162 | 29 | 31 | N/A |
| | GA Life of Puerto Rico | 62 | 127 | 1 | 11 | 61 | 11 | 31 | 18 | 11 | N/A |
| | Corporate and other | - | - | - | - | - | 5 | - | - | 21 | N/A |
| | Total | <u>\$591</u> | <u>\$7,324</u> | <u>\$ 4</u> | <u>\$28</u> | <u>\$306</u> | <u>\$528</u> | <u>\$546</u> | <u>\$115</u> | <u>\$160</u> | |
| <u>2001</u> | | | | | | | | | | | |
| | Life & Annuity products | \$416 | \$5,835 | \$ 2 | \$12 | \$ 36 | \$451 | \$319 | \$36 | \$ 85 | N/A |

Edgar Filing: GREAT AMERICAN FINANCIAL RESOURCES INC - Form 10-K

| | | | | | | | | | | |
|---------------------------------|--------------|----------------|-------------|-------------|--------------|--------------|--------------|-------------|--------------|-----|
| Supplemental insurance products | 85 | 490 | 2 | - | 190 | 38 | 161 | 27 | 42 | N/A |
| GA Life of Puerto Rico | 55 | 118 | 1 | 11 | 54 | 10 | 28 | 16 | 10 | N/A |
| Corporate and other | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>8</u> | <u>-</u> | <u>-</u> | <u>18</u> | N/A |
| Total | <u>\$556</u> | <u>\$6,443</u> | <u>\$ 5</u> | <u>\$23</u> | <u>\$280</u> | <u>\$507</u> | <u>\$508</u> | <u>\$79</u> | <u>\$155</u> | |
| <u>2000</u> | | | | | | | | | | |
| Life & Annuity products | \$337 | \$5,536 | \$ 1 | \$ 8 | \$ 29 | \$445 | \$313 | \$23 | \$113 | N/A |
| Supplemental insurance products | 102 | 478 | 2 | - | 152 | 34 | 131 | 24 | 41 | N/A |
| GA Life of Puerto Rico | 49 | 108 | 1 | 9 | 49 | 9 | 24 | 15 | 10 | N/A |
| Corporate and other | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>8</u> | <u>-</u> | <u>-</u> | <u>16</u> | N/A |
| Total | <u>\$488</u> | <u>\$6,122</u> | <u>\$ 4</u> | <u>\$17</u> | <u>\$230</u> | <u>\$496</u> | <u>\$468</u> | <u>\$62</u> | <u>\$180</u> | |

1. Allocated by legal entity.

2. Life, accident and health premiums are shown Column F.

GREAT AMERICAN FINANCIAL RESOURCES, INC.

INDEX TO EXHIBITS

| <u>Number</u> | <u>Exhibit Description</u> |
|---------------|--|
| 3.1 | Certificate of Incorporation of Registrant |
| 3.2 | By-laws of Registrant |
| 4 | Registrant has no outstanding debt issues exceeding 10% of the assets of Registrant and consolidated subsidiaries. |

- 10.1 Agreement of Allocation of Payment of Federal Income Taxes ("Great American Financial Resources Tax Allocation Agreement"), dated December 31, 1992, between American Financial Corporation and the Registrant incorporated herein by reference to Exhibit 10.12 to the Registrant's Registration Statement on Form S-2 dated January 7, 1993.
- 10.2 Assignment of Tax Allocation Payments dated December 31, 1992, between American Financial Corporation and the Registrant incorporated herein by reference to Exhibit 10.15 to the Registrant's Registration Statement on Form S-2 dated January 7, 1993.
- 10.3 Agreement for the Allocation of Federal Income Taxes dated May 13, 1974, between American Financial Corporation and Great American Life Insurance Company, as supplemented on January 1, 1987 incorporated herein by reference to Exhibit 10.16 to the Registrant's Registration Statement on Form S-2 dated January 7, 1993.
- 10.4 Investment Services Agreement, dated December 31, 1992, between Great American Life Insurance Company and American Money Management Corporation incorporated herein by reference to Exhibit 10.17 to the Registrant's Registration Statement on Form S-2 dated January 7, 1993.
- 10.5 Common Stock Registration Agreement, dated December 31, 1992, between the Registrant and American Financial Corporation and its wholly-owned subsidiary Great American Insurance Company incorporated herein by reference to Exhibit 10.22 to the Registrant's Registration Statement on Form S-2 dated January 7, 1993.
- 21 Subsidiaries of the Registrant.
- 23 Consent of Independent Auditors.
- 99 Certification of Chief Executive Officer and Chief Financial Officer

E-1

Signatures

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, Great American Financial Resources, Inc. has duly caused this Report to be signed on its behalf by the undersigned, duly authorized.

GREAT AMERICAN FINANCIAL RESOURCES,
INC.

Signed: March 27, 2003

BY: s/CARL H. LINDNER

Carl H. Lindner
Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

| <u>Signature</u> | <u>Capacity</u> | <u>Date</u> |
|---|---|----------------|
| <u>s/CARL H. LINDNER</u> Carl H. Lindner | Chairman of the Board of Directors | March 27, 2003 |
| <u>s/S. CRAIG LINDNER</u> S. Craig Lindner | Director and Chief Executive Officer | March 27, 2003 |
| <u>s/WILLIAM R. MARTIN</u> William R. Martin | Director* | March 27, 2003 |
| <u>s/JOHN T. LAWRENCE, III</u> John T. Lawrence, III | Director* | March 27, 2003 |
| <u>s/RONALD W. TYSOE</u> Ronald W. Tysoe | Director* | March 27, 2003 |
| <u>s/CHRISTOPHER P. MILIANO</u> Christopher P. Miliano | Chief Financial Officer (Principal Accounting Officer) | March 27, 2003 |

* Member of Audit Committee

GREAT AMERICAN FINANCIAL RESOURCES, INC.

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS

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

1. I have reviewed this annual report on Form 10-K of Great American Financial Resources, Inc.,

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

(a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

(b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

(c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

(b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 27, 2003

/s/ S. Craig Lindner
S. Craig Lindner
Chief Executive Officer

SARBANES-OXLEY SECTION 302(a) CERTIFICATIONS - CONTINUED

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

1. I have reviewed this annual report on Form 10-K of Great American Financial Resources, Inc.,
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
 - (c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this

annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 27, 2003

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