AMERICAN FINANCIAL GROUP INC
Form 10-Q
November 08, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
Quarterly Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934
For the Quarterly Period Ended September 30, 2013 Commission File No. 1-13653

AMERICAN FINANCIAL GROUP, INC.
Incorporated under the Laws of Ohio IRS Employer I.D. No. 31-1544320
301 East Fourth Street, Cincinnati, Ohio 45202
(513) 579-2121

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

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

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

Large Accelerated Filer þ Accelerated Filer ¨ Non-Accelerated Filer ¨ Smaller Reporting Company ¨

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

As of November 1, 2013, there were 89,365,096 shares of the Registrant’s Common Stock outstanding, excluding 14.9 million shares owned by subsidiaries.

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PART I
ITEM I — FINANCIAL STATEMENTS
AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET (UNAUDITED)
(Dollars in Millions)

	September 30, 2013	December 31, 2012
Assets:		
Cash and cash equivalents	$ 1,331	$ 1,705
Investments:		
Fixed maturities, available for sale at fair value (amortized cost — $24,436 and $22,083)	25,674	24,118
Fixed maturities, trading at fair value	290	321
Equity securities, at fair value (cost — $956 and $778)	1,143	939
Mortgage loans	611	607
Policy loans	240	228
Real estate and other investments	632	531
Total cash and investments	29,921	28,449
Recoverables from reinsurers	3,138	3,750
Prepaid reinsurance premiums	662	471
Agents' balances and premiums receivable	801	636
Deferred policy acquisition costs	867	550
Assets of managed investment entities	2,779	3,225
Other receivables	1,078	539
Variable annuity assets (separate accounts)	629	580
Other assets	887	786
Goodwill	185	185
Total assets	$ 40,947	$ 39,171
Liabilities and Equity:		
Unpaid losses and loss adjustment expenses	$ 6,441	$ 6,845
Unearned premiums	2,047	1,651
Annuity benefits accumulated	19,785	17,609
Life, accident and health reserves	2,011	2,059
Payable to reinsurers	601	475
Liabilities of managed investment entities	2,429	2,892
Long-term debt	913	953
Variable annuity liabilities (separate accounts)	629	580
Other liabilities	1,381	1,359
Total liabilities	36,237	34,423
Shareholders' equity:		
Common Stock, no par value		
— 200,000,000 shares authorized	89	89
— 89,223,607 and 88,979,303 shares outstanding		
Capital surplus	1,109	1,063
Retained earnings:		
Appropriated — managed investment entities	45	75
Unappropriated	2,729	2,520
Accumulated other comprehensive income, net of tax	570	831

Total shareholders’ equity	4,542	4,578
Noncontrolling interests	168	170
Total equity	4,710	4,748
Total liabilities and equity	$ 40,947	$ 39,171

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF EARNINGS (UNAUDITED)
(In Millions, Except Per Share Data)

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Revenues:				
Property and casualty insurance net earned premiums	$949	$848	$2,345	$2,091
Life, accident and health net earned premiums	29	80	87	290
Net investment income	338	326	996	972
Realized gains on:				
Securities (*)	56	85	154	145
Subsidiaries	—	156	—	155
Income (loss) of managed investment entities:				
Investment income	32	31	98	92
Gain (loss) on change in fair value of assets/liabilities	15	(13)	(21)	(63)
Other income	24	25	71	67
Total revenues	1,443	1,538	3,730	3,749
Costs and Expenses:				
Property and casualty insurance:				
Losses and loss adjustment expenses	680	610	1,503	1,317
Commissions and other underwriting expenses	261	254	772	697
Annuity benefits	140	140	394	417
Life, accident and health benefits	42	66	120	238
Annuity and supplemental insurance acquisition expenses	40	46	128	138
Interest charges on borrowed money	18	19	54	57
Expenses of managed investment entities	22	19	68	58
Other expenses	98	99	248	260
Total costs and expenses	1,301	1,253	3,287	3,182
Earnings before income taxes	142	285	443	567
Provision for income taxes	44	74	155	184
Net earnings, including noncontrolling interests	98	211	288	383
Less: Net earnings (loss) attributable to noncontrolling interests	15	(15)	(25)	(55)
Net Earnings Attributable to Shareholders	$83	$226	$313	$438
Earnings Attributable to Shareholders per Common Share:				
Basic	$.94	$2.43	$3.51	$4.58
Diluted	$.92	$2.39	$3.44	$4.50
Average number of Common Shares:				
Basic	89.1	92.9	89.4	95.7
Diluted	91.0	94.6	91.2	97.4
Cash dividends per Common Share	$0.195	$0.175	$0.585	$0.525

(*) Consists of the following:

Realized gains before impairments	$61	$93	$160	$164

Losses on securities with impairment	(5)	(8)	(6)	(20)
Non-credit portion recognized in other comprehensive income (loss)	—	—	—	1
Impairment charges recognized in earnings	(5)	(8)	(6)	(19)
Total realized gains on securities	$56	$85	$154	$145

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AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (UNAUDITED)
(In Millions)

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Net earnings, including noncontrolling interests	$98	$211	$288	$383
Other comprehensive income (loss), net of tax:				
Net unrealized gains (losses) on securities:				
Unrealized holding gains (losses) on securities arising during the period	4	228	(162)	464
Reclassification adjustment for realized gains included in net earnings	(36)	(56)	(99)	(96)
Reclassification adjustment for unrealized gains of subsidiaries sold	—	(18)	—	(18)
Total net unrealized gains (losses) on securities	(32)	154	(261)	350
Foreign currency translation adjustments	3	10	(6)	9
Pension and other postretirement plans adjustments	—	—	—	1
Other comprehensive income (loss), net of tax	(29)	164	(267)	360
Total comprehensive income, net of tax	69	375	21	743
Less: Comprehensive income (loss) attributable to noncontrolling interests	15	(10)	(31)	(47)
Comprehensive income attributable to shareholders	$54	$385	$52	$790

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY (UNAUDITED)
(Dollars in Millions)

	Shareholders' Equity							
	Common Shares	Common Stock and Capital Surplus	Retained Earnings Approp.	Retained Earnings Unapprop.	Accumulated Other Comp Inc. (Loss)	Total	Noncon-trolling Interests	Total Equity
Balance at December 31, 2012	88,979,303	$1,152	$75	$ 2,520	$ 831	$4,578	$170	$4,748
Net earnings	—	—	—	313	—	313	(25)	288
Other comprehensive income	—	—	—	—	(261)	(261)	(6)	(267)
Allocation of losses of managed investment entities	—	—	(30)	—	—	(30)	30	—
Dividends on Common Stock	—	—	—	(52)	—	(52)	—	(52)
Shares issued:								
Exercise of stock options	1,350,551	44	—	—	—	44	—	44
Other benefit plans	376,574	6	—	—	—	6	—	6
Dividend reinvestment plan	10,514	—	—	—	—	—	—	—
Stock-based compensation expense	—	15	—	—	—	15	—	15
Shares acquired and retired	(1,448,156)	(19)	—	(51)	—	(70)	—	(70)
Shares exchanged — benefit plans	(45,179)	—	—	(1)	—	(1)	—	(1)
Other	—	—	—	—	—	—	(1)	(1)
Balance at September 30, 2013	89,223,607	$1,198	$45	$ 2,729	$ 570	$4,542	$168	$4,710
Balance at December 31, 2011	97,846,402	$1,219	$173	$ 2,439	$ 580	$4,411	$146	$4,557
Net earnings	—	—	—	438	—	438	(55)	383
Other comprehensive income	—	—	—	—	352	352	8	360
Allocation of losses of managed investment entities	—	—	(64)	—	—	(64)	64	—
Dividends on Common Stock	—	—	—	(50)	—	(50)	—	(50)
Shares issued:								
Exercise of stock options	1,009,714	27	—	—	—	27	—	27
Other benefit plans	291,610	6	—	—	—	6	—	6
Dividend reinvestment plan	11,697	—	—	—	—	—	—	—
	—	15	—	—	—	15	—	15

Stock-based compensation expense								
Shares acquired and retired	(8,288,776)	(105)	—	(210)	—	(315)	—	(315)
Shares exchanged — benefit plans	(23,685)	—	—	—	—	—	—	—
Other	—	—	—	(40)	(1)	(41)	22	(19)
Balance at September 30, 2012	90,846,962	$1,162	$109	$ 2,577	$ 931	$4,779	$185	$4,964

AMERICAN FINANCIAL GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)
(In Millions)

	Nine months ended September 30, 2013	2012
Operating Activities:		
Net earnings, including noncontrolling interests	$288	$383
Adjustments:		
Depreciation and amortization	110	118
Annuity benefits	394	417
Realized gains on investing activities	(162)	(299)
Net sales of trading securities	20	27
Deferred annuity and life policy acquisition costs	(148)	(177)
Change in:		
Reinsurance and other receivables	(288)	(1,387)
Other assets	(108)	6
Insurance claims and reserves	(7)	1,275
Payable to reinsurers	126	181
Other liabilities	161	(56)
Managed investment entities' assets/liabilities	(23)	(13)
Other operating activities, net	25	12
Net cash provided by operating activities	388	487
Investing Activities:		
Purchases of:		
Fixed maturities	(4,903)	(3,240)
Equity securities	(334)	(231)
Mortgage loans	(100)	(178)
Real estate, property and equipment	(43)	(61)
Proceeds from:		
Maturities and redemptions of fixed maturities	2,356	1,617
Repayments of mortgage loans	97	10
Sales of fixed maturities	257	495
Sales of equity securities	278	235
Sales of subsidiaries	—	302
Cash and cash equivalents of businesses sold	—	(34)
Managed investment entities:		
Purchases of investments	(1,061)	(1,246)
Proceeds from sales and redemptions of investments	1,515	1,429
Other investing activities, net	25	(36)
Net cash used in investing activities	(1,913)	(938)
Financing Activities:		
Annuity receipts	2,852	2,431
Annuity surrenders, benefits and withdrawals	(1,157)	(1,127)
Net transfers from variable annuity assets	25	31
Additional long-term borrowings	—	344

Reductions of long-term debt	(40)	(323)
Issuances of managed investment entities' liabilities	747	456
Retirement of managed investment entities' liabilities	(1,196)	(704)
Issuances of Common Stock	45	27
Repurchases of Common Stock	(70)	(315)
Cash dividends paid on Common Stock	(52)	(50)
Other financing activities, net	(3)	(17)
Net cash provided by financing activities	1,151	753
Net Change in Cash and Cash Equivalents	(374)	302
Cash and cash equivalents at beginning of period	1,705	1,324
Cash and cash equivalents at end of period	$1,331	$1,626

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO NOTES

A. Accounting Policies

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

Certain reclassifications have been made to prior periods to conform to the current year's presentation, primarily the reclassification of investment expenses and real estate income and expenses to net investment income. All significant intercompany balances and transactions have been eliminated. The results of operations of companies since their formation or acquisition are included in the consolidated financial statements. Events or transactions occurring subsequent to September 30, 2013, and prior to the filing date of this Form 10-Q, have been evaluated for potential recognition or disclosure herein.

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

Accounting Standards Adopted in 2013 Effective January 1, 2013, AFG prospectively adopted Accounting Standards Update ("ASU") 2013-02, which requires companies to disclose, in a single location within the financial statements or footnotes, reclassifications out of accumulated other comprehensive income ("AOCI") separately for each component of other comprehensive income. For significant reclassifications, the disclosure is required to include the respective line items in net earnings affected by the reclassification. Disclosures required by the guidance are included in Note K — "Shareholders' Equity." This new disclosure requirement had no impact on AFG's results of operations or financial position.

Fair Value Measurements Accounting standards define fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. The standards establish a hierarchy of valuation techniques based on whether the assumptions that market participants would use in pricing the asset or liability ("inputs") are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect AFG's assumptions about the assumptions market participants would use in pricing the asset or liability. AFG did not have any significant nonrecurring fair value measurements of nonfinancial assets and liabilities in the first nine months of 2013 or 2012.

Investments Fixed maturity and equity securities classified as "available for sale" are reported at fair value with unrealized gains and losses included in AOCI in AFG's Balance Sheet. Fixed maturity and equity securities classified as "trading" are reported at fair value with changes in unrealized holding gains or losses during the period included in net investment income. Mortgage and policy loans are carried primarily at the aggregate unpaid balance.

Premiums and discounts on fixed maturity securities are amortized using the interest method; mortgage-backed securities ("MBS") are amortized over a period based on estimated future principal payments, including prepayments. Prepayment assumptions are reviewed periodically and adjusted to reflect actual prepayments and changes in expectations.

Gains or losses on securities are determined on the specific identification basis. When a decline in the value of a specific investment is considered to be other-than-temporary at the balance sheet date, a provision for impairment is charged to earnings (included in realized gains (losses) on securities) and the cost basis of that investment is reduced. If management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will have to sell the security before recovery of its amortized cost basis, then the other-than-temporary impairment is separated into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income). The credit-related portion of an other-than-temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. Both components are shown in the Statement of Earnings. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge to earnings is recorded to reduce the amortized cost of that security to fair value.

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

Goodwill   Goodwill represents the excess of cost of subsidiaries over AFG's equity in their underlying net assets. Goodwill is not amortized, but is subject to an impairment test at least annually. An entity is not required to complete the quantitative annual goodwill impairment test on a reporting unit if the entity elects to perform a qualitative analysis and determines that it is more likely than not that the reporting unit's fair value exceeds its carrying amount.

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

A subsidiary cedes life insurance policies to a third party on a funds withheld basis whereby the subsidiary retains the assets (securities) associated with the reinsurance contract. Interest is credited to the reinsurer based on the actual investment performance of the retained assets. This reinsurance contract is considered to contain an embedded derivative (that must be adjusted to fair value) because the yield on the payable is based on a specific block of the ceding company's assets, rather than the overall creditworthiness of the ceding company. AFG determined that changes in the fair value of the underlying portfolio of fixed maturity securities is an appropriate measure of the value of the embedded derivative. The securities related to this contract are classified as "trading." The adjustment to fair value on the embedded derivative offsets the investment income recorded on the adjustment to fair value of the related trading portfolio.

Deferred Policy Acquisition Costs ("DPAC")   Policy acquisition costs (principally commissions, premium taxes and certain underwriting and policy issuance costs) directly related to the successful acquisition or renewal of an insurance contract are deferred. DPAC also includes capitalized costs associated with sales inducements offered to fixed annuity policyholders such as enhanced interest rates and premium and persistency bonuses.

For the property and casualty companies, DPAC is limited based upon recoverability without any consideration for anticipated investment income and is charged against income ratably over the terms of the related policies. A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses and unamortized acquisition costs exceed the related unearned premiums. A premium deficiency is first recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability is accrued for the excess deficiency and reported with unpaid losses and loss adjustment expenses.

DPAC related to annuities is deferred to the extent deemed recoverable and amortized, with interest, in relation to the present value of actual and expected gross profits on the policies. Expected gross profits consist principally of estimated future investment margin (estimated future net investment income less interest credited on policyholder funds) and surrender, mortality, and other life and annuity policy charges, less death, annuitization and guaranteed withdrawal benefits in excess of account balances and estimated future policy administration expenses. To the extent that realized gains and losses result in adjustments to the amortization of DPAC related to annuities, such adjustments are reflected as components of realized gains (losses) on securities.

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. See Note A, "Accounting Policies — Life, Accident and Health Reserves" for details on the impact of loss recognition on the accounting for traditional life and health insurance contracts.

DPAC includes the present value of future profits on business in force of annuity and life, accident and health insurance companies acquired ("PVFP"). PVFP represents the portion of the costs to acquire companies that is allocated to the value of the right to receive future cash flows from insurance contracts existing at the date of acquisition. PVFP is amortized with interest in relation to expected gross profits of the acquired policies for annuities and universal life products and in relation to the premium paying period for traditional life and health insurance products.

DPAC and certain other balance sheet amounts related to annuity, long-term care and life businesses are also adjusted, net of tax, for the change in expense that would have been recorded if the unrealized gains (losses) from securities had actually been realized. These adjustments are included in unrealized gains (losses) on marketable securities, a component of AOCI in AFG's Balance Sheet.

Managed Investment Entities   A company is considered the primary beneficiary of, and therefore must consolidate, a variable interest entity ("VIE") based primarily on its ability to direct the activities of the VIE that most significantly impact that entity's economic performance and the obligation to absorb losses of, or receive benefits from, the entity that could potentially be significant to the VIE.

AFG manages, and has investments in, collateralized loan obligations ("CLOs") that are VIEs (see Note H — "Managed Investment Entities"). Both the management fees (payment of which is subordinate to other obligations of the CLOs) and the investments in the CLOs are considered variable interests. AFG has determined that it is the primary beneficiary of the CLOs because (i) its role as asset manager gives it the power to direct the activities that most significantly impact the economic performance of the CLOs and (ii) it has exposure to CLO losses (through its investments in the CLO debt tranches) and the right to receive benefits (through its subordinated management fees and returns on its investments), both of which could potentially be significant to the CLOs.

Because AFG has no right to use the CLO assets and no obligation to pay the CLO liabilities, the assets and liabilities of the CLOs are shown separately in AFG's Balance Sheet (at fair value). AFG has elected the fair value option for reporting on the CLO assets and liabilities to improve the transparency of financial reporting related to the CLOs. The excess of fair value of the CLOs' assets over the fair value of the liabilities is recorded in AFG's Balance Sheet as appropriated retained earnings — managed investment entities, representing amounts that ultimately will inure to the benefit of the CLO debt holders.

The net gain or loss from accounting for the CLO assets and liabilities at fair value is separately presented in AFG's Statement of Earnings. CLO earnings attributable to AFG's shareholders represent the change in fair value of AFG's investments in the CLOs (including distributions) and management fees earned. All other CLO earnings (losses) are not attributable to AFG's shareholders and will ultimately inure to the benefit of the CLO debt holders. As a result, such CLO earnings (losses) are included in net earnings (loss) attributable to noncontrolling interests in AFG's Statement of Earnings and in appropriated retained earnings — managed investment entities in the Balance Sheet. As the CLOs approach maturity (2016 to 2025), it is expected that losses attributable to noncontrolling interests will reduce appropriated retained earnings towards zero as the fair values of the assets and liabilities converge and the CLO assets are used to pay the CLO debt.

At September 30, 2013, assets and liabilities of managed investment entities included $193 million in assets and $147 million in liabilities of a temporary warehousing entity that was established in connection with the formation of a new CLO that is expected to close in the fourth quarter of 2013. Upon closing, all warehoused assets are expected to be transferred to the new CLO and the liabilities will be repaid. At December 31, 2012, assets and liabilities of managed investment entities included $107 million in assets and $87 million in liabilities of a temporary warehousing entity that was established in connection with the formation of a new CLO. All warehoused assets were transferred to that new CLO and the liabilities were repaid when the CLO formation was completed and the CLO issued securities in April 2013.

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

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

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

For certain products, annuity benefits accumulated also includes reserves for accrued persistency and premium bonuses, guaranteed withdrawals and excess benefits expected to be paid on future deaths and annuitizations (“EDAR”). The liability for EDAR is accrued for and modified using assumptions consistent with those used in determining DPAC and DPAC amortization, except that amounts are determined in relation to the present value of total expected assessments. Total expected assessments consist principally of estimated future investment margin, surrender, mortality, and other life and annuity policy charges, and unearned revenues once they are recognized as income.

Annuity benefits accumulated also includes amounts advanced from the Federal Home Loan Bank of Cincinnati.

Unearned Revenue   Certain upfront policy charges on annuities are deferred as unearned revenue (included in other liabilities) and recognized in net earnings using the same assumptions and estimated gross profits used to amortize DPAC.

Life, Accident and Health Reserves   Liabilities for future policy benefits under traditional life, accident and health policies are computed using the net level premium method. Computations are based on the original projections of investment yields, mortality, morbidity and surrenders and include provisions for unfavorable deviations unless a loss recognition event (premium deficiency) occurs. Claim reserves and liabilities established for accident and health claims are modified as necessary to reflect actual experience and developing trends.

For long-duration contracts (such as traditional life and long-term care policies), loss recognition occurs when, based on current expectations as of the measurement date, existing contract liabilities plus the present value of future premiums (including reasonably expected rate increases) are not expected to cover the present value of future claims payments and related settlement and maintenance costs (excluding overhead) as well as unamortized acquisition costs. If a block of business is determined to be in loss recognition, a charge is recorded in earnings in an amount equal to the excess of the present value of expected future claims costs and unamortized acquisition costs over existing reserves plus the present value of expected future premiums (with no provision for adverse deviation). The charge is recorded first to reduce unamortized acquisition costs and then as an additional reserve (if unamortized acquisition costs have been reduced to zero).

In addition, reserves for traditional life and long-term care policies are subject to adjustment for loss recognition charges that would have been recorded if the unrealized gains from securities had actually been realized. This adjustment is included in unrealized gains (losses) on marketable securities, a component of AOCI in AFG's Balance Sheet.

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

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

Premium Recognition   Property and casualty premiums are earned generally over the terms of the policies on a pro rata basis. Unearned premiums represent that portion of premiums written which is applicable to the unexpired terms of policies in force. On reinsurance assumed from other insurance companies or written through various underwriting organizations, unearned premiums are based on information received from such companies and organizations. For traditional life, accident and health products, premiums are recognized as revenue when legally collectible from policyholders. For interest-sensitive life and universal life products, premiums are recorded in a policyholder account, which is reflected as a liability. Revenue is recognized as amounts are assessed against the policyholder account for mortality coverage and contract expenses.

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

Income Taxes   Deferred income taxes are calculated using the liability method. Under this method, deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases and are measured using enacted tax rates. A valuation allowance is established to reduce total deferred tax assets to an amount that will more likely than not be realized.

AFG recognizes the tax benefits of uncertain tax positions only when the position is more likely than not to be sustained under examination by the appropriate taxing authority. Interest and penalties on AFG's reserve for uncertain tax positions are recognized as a component of tax expense.

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

Benefit Plans   AFG provides retirement benefits to qualified employees of participating companies through the AFG 401(k) Retirement and Savings Plan, a defined contribution plan. AFG makes all contributions to the retirement fund portion of the plan and matches a percentage of employee contributions to the savings fund. Company contributions are expensed in the year for which they are declared. AFG and many of its subsidiaries provide health care and life insurance benefits to eligible retirees. AFG also provides postemployment benefits to former or inactive employees (primarily those on disability) who were not deemed retired under other company plans. The projected future cost of providing these benefits is expensed over the period employees earn such benefits.

Earnings Per Share   Although basic earnings per share only considers shares of common stock outstanding during the period, the calculation of diluted earnings per share includes the following adjustments to weighted average common shares related to stock-based compensation plans: third quarter of 2013 and 2012 — 1.9 million and 1.7 million; first nine months of 2013 and 2012 — 1.8 million and 1.7 million, respectively.

AFG's weighted average diluted shares outstanding excludes the following anti-dilutive potential common shares related to stock compensation plans: third quarter of 2013 and 2012 — 1.0 million and 1.9 million; first nine months of 2013 and 2012 — 1.3 million and 1.8 million, respectively. Adjustments to net earnings attributable to shareholders in the calculation of diluted earnings per share were nominal in the 2013 and 2012 periods.

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

B. Acquisitions and Sales of Subsidiaries

Medicare Supplement and Critical Illness Segment In August 2012, AFG completed the sale of its Medicare supplement and critical illness businesses, which included Loyal American Life Insurance Company and four other insurance companies, to Cigna Corporation for $326 million in cash resulting in a pretax gain of $170 million (including fourth quarter 2012 post-closing adjustments, which increased cash proceeds by $19 million and the pretax gain by $15 million). Since the transaction includes the ongoing cessions of certain business to Cigna, the operations sold are not reported as discontinued operations. Summarized Statement of Earnings information for the Medicare supplement and critical illness segment for the third quarter and first nine months of 2012 is shown below (in millions):

	Three months ended September 30, 2012	Nine months ended September 30, 2012
Total revenues	$53	$212
Total costs and expenses	43	184
Earnings before income taxes	$10	$28

During the third quarter of 2012, AFG acquired the outstanding 28% of Marketform, its London-based Lloyd's property and casualty insurance operation that it did not already own for $17 million and sold an additional small annuity company for $7 million.

C. Segments of Operations

AFG manages its business as five segments: (i) Property and casualty insurance, (ii) Annuity, (iii) Run-off long-term care and life, (iv) Medicare supplement and critical illness (sold in August 2012) and (v) Other, which includes holding company costs, and the operations attributable to the noncontrolling interests of the managed investment entities.

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2013	2012	2013	2012
Revenues				
Property and casualty insurance:				
Premiums earned:				
Specialty				
Property and transportation	$517	$487	$1,111	$1,040
Specialty casualty	289	243	825	699
Specialty financial	121	100	350	301
Other specialty	22	18	59	51
Total premiums earned	949	848	2,345	2,091
Net investment income	65	67	196	206
Other income	1	6	10	17
Total property and casualty insurance	1,015	921	2,551	2,314
Annuity:				
Net investment income	259	249	764	722
Other income	17	14	46	39
Total annuity	276	263	810	761
Run-off long-term care and life	50	50	147	146
Medicare supplement and critical illness (a)	—	53	—	212
Other	46	10	68	16
Total revenues before realized gains	1,387	1,297	3,576	3,449
Realized gains on securities	56	85	154	145
Realized gains on subsidiaries	—	156	—	155
Total revenues	$1,443	$1,538	$3,730	$3,749
Earnings Before Income Taxes				
Property and casualty insurance:				
Underwriting:				
Specialty				
Property and transportation	$16	$—	$(5)	$33
Specialty casualty	19	8	70	45
Specialty financial	22	1	50	28
Other specialty	5	7		