

Independent Auditors' Report

To the Members of the Legislative Audit Committee and the Board of Directors of Pinnacol Assurance:

We have audited the accompanying balance sheets of Pinnacol Assurance (the "Company") as of December 31, 2009 and 2008, and the related statements of revenue, expenses, and changes in policyholders' surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

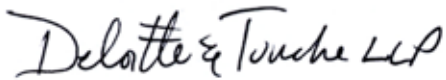
We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2009 and 2008, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Management's Discussion and Analysis listed in the table of contents is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Company's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 21, 2010, on our consideration of the Company's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and

grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our 2009 audit.



May 21, 2010

MANAGEMENT'S DISCUSSION AND ANALYSIS

Pinnacol Assurance (Pinnacol) herein sets forth a narrative overview and analysis of its financial activities for the fiscal years ended December 31, 2009 and 2008. Financial statements for the fiscal years ended December 31, 2008 and 2007, are also provided for comparison.

Overview of the Financial Statements

This overview is an introduction to Pinnacol's financial statements. Pinnacol's financial statements consist of two components: (1) basic financial statements and (2) notes to the basic financial statements.

The balance sheets present information regarding all Pinnacol assets and liabilities, with the difference between the two being reported as policyholders' surplus (net assets).

The statements of revenue, expenses, and changes in policyholders' surplus (net assets) present the financial results of operations for Pinnacol for the three most recent fiscal years. This statement presents information showing how the net assets changed during the three most recent fiscal years. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods. The statement of cash flows details the cash used and provided by the various activities of Pinnacol during the fiscal year. However, this statement does not consider unpaid responsibilities, which have been established by contract or other underlying events during the fiscal year.

The following analyses present three years of comparative condensed financial data.

Analysis of Financial Position

The following is a comparison of the financial position of Pinnacol at December 31, 2009 to 2008 (in thousands):

	2009	2008	Change
ASSETS:			
Cash, investments, and accrued investment income	\$2,056,903	\$2,063,909	\$(7,006)
Capital assets — net (Home Office)	26,472	25,964	508
Uncollected premium	30,857	61,953	(31,096)
Other	<u>11,229</u>	<u>13,578</u>	<u>(2,349)</u>
TOTAL ASSETS	<u>\$2,125,461</u>	<u>\$2,165,404</u>	<u>\$(39,943)</u>
LIABILITIES:			
Reserves for unpaid losses and loss adjustment expenses	\$1,149,138	\$1,223,160	\$(74,022)
Unearned premiums	71,838	86,068	(14,230)
Other	<u>63,163</u>	<u>82,872</u>	<u>(19,709)</u>
TOTAL LIABILITIES	<u>\$1,284,139</u>	<u>\$1,392,100</u>	<u>\$(107,961)</u>
POLICYHOLDERS' SURPLUS (NET ASSETS):			
Invested in capital assets (Home Office)	\$26,472	\$25,964	\$508
Restricted	46,169	50,656	(4,487)
Unrestricted	<u>768,681</u>	<u>696,684</u>	<u>71,997</u>
TOTAL POLICYHOLDERS' SURPLUS (NET ASSETS)	<u>\$841,322</u>	<u>\$773,304</u>	<u>\$68,018</u>

Policyholders' surplus (net assets) has increased by approximately \$68,018,000 from the prior year. See discussion below.

The change in carrying value of Pinnacol's investment portfolio of fixed maturities and equity securities in 2009 was as follows (in thousands):

Carrying value — beginning of the year	\$1,933,675
Purchases — at cost	253,087
Proceeds from sales of investments	(311,024)
Net realized gains (losses)	(1,848)
Net accretion of bonds	477
Change in unrealized gains and losses	<u>100,652</u>
CARRYING VALUE — END OF YEAR	<u>\$1,975,019</u>

The reserve for losses and loss adjustment expenses represents management's best estimate of the ultimate medical and indemnity cost of all losses and loss adjustment expenses, which are incurred but unpaid at year-end, net of reinsurance. To assist management in estimating the liability for unpaid losses and loss adjustment expenses, Pinnacol retains the assistance of an actuarial consulting firm. At December 31, 2009, Pinnacol has accrued approximately \$1,149,138,000 for unpaid losses and loss adjustment expenses as management's best estimate, which management believes to be a reasonable estimate of future amounts to be paid for claims incurred in 2009 or prior. Pinnacol discounted its actuarially determined unpaid balances for certain long-term scheduled payments by a factor of 3.5% (for tabular basis) in 2009, resulting in a discount of \$151,841,000.

The following is a comparison of the financial position of Pinnacol at December 31, 2008 to 2007 (in thousands):

	2008	2007	Change
ASSETS:			
Cash, investments, and accrued investment income	\$2,063,909	\$2,078,789	\$(14,880)
Capital assets — net (Home Office)	25,964	25,846	118
Uncollected premium	61,953	71,926	(9,973)
Other	<u>13,578</u>	<u>13,131</u>	<u>447</u>
TOTAL ASSETS	<u>\$2,165,404</u>	<u>\$2,189,692</u>	<u>\$(24,288)</u>

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	2008	2007	Change
LIABILITIES:			
Reserves for unpaid losses and loss adjustment expenses	\$1,223,160	\$1,253,864	\$(30,704)
Unearned premiums	86,068	95,549	(9,481)
Other	<u>82,872</u>	<u>69,641</u>	<u>13,231</u>
TOTAL LIABILITIES	<u>\$1,392,100</u>	<u>\$1,419,054</u>	<u>\$(26,954)</u>
POLICYHOLDERS' SURPLUS (NET ASSETS):			
Invested in capital assets (Home Office)	\$25,964	\$25,846	\$118
Restricted	50,656	41,252	9,404
Unrestricted	<u>696,684</u>	<u>703,540</u>	<u>(6,856)</u>
TOTAL POLICYHOLDERS' SURPLUS (NET ASSETS)	<u>\$773,304</u>	<u>\$770,638</u>	<u>\$2,666</u>

Policyholders' surplus (net assets) has increased by approximately \$2,666,000 from the prior year. See discussion below.

The change in carrying value of Pinnacol's investment portfolio of fixed maturities and equity securities in 2008 was as follows (in thousands):

Carrying value — beginning of the year	\$1,964,766
Purchases — at cost	410,269
Proceeds from sales of investments	(371,859)
Net realized gains	11,744
Net accretion of bonds	1,623
Change in unrealized gains and losses	<u>(82,868)</u>
CARRYING VALUE — END OF YEAR	<u>\$1,933,675</u>

The reserve for losses and loss adjustment expenses represents management's best estimate of the ultimate medical and indemnity cost of all losses and loss adjustment expenses, which are incurred but unpaid at year-end, net of reinsurance. To assist management in estimating the liability for unpaid losses and loss adjustment expenses, Pinnacol retains the assistance of an actuarial consulting firm. At December 31, 2008, Pinnacol has accrued approximately \$1,223,160,000 for unpaid losses and loss adjustment expenses as management's best estimate, which management believes to be a reasonable estimate of future amounts to be paid for claims incurred in 2008 or prior. Pinnacol discounted its actuarially determined unpaid balances for certain long-term scheduled payments by a factor of 3.5% (for tabular basis) in 2008, resulting in a discount of \$148,184,000.

Results of Operations

The following is a comparison of Pinnacol's results of operations for 2009 to 2008 (in thousands):

	2009 ACTUAL	2008 ACTUAL	CHANGE
OPERATING REVENUES:			
Premium earned	\$398,502	\$521,082	\$(122,580)
Other income	<u>1,480</u>	<u>396</u>	<u>1,084</u>
TOTAL OPERATING REVENUES	<u>399,982</u>	<u>521,478</u>	<u>(121,496)</u>
OPERATING EXPENSES:			
Losses and loss adjustment expenses	290,066	340,917	(50,851)
General and administrative	116,741	124,886	(8,145)
Dividends to policyholders	<u>116,841</u>	<u>78,557</u>	<u>38,284</u>
TOTAL OPERATING EXPENSES	<u>523,648</u>	<u>544,360</u>	<u>(20,712)</u>
OPERATING INCOME	<u>(123,666)</u>	<u>(22,882)</u>	<u>(100,784)</u>
NONOPERATING REVENUE:			
Net investment income	<u>191,684</u>	<u>25,548</u>	<u>166,136</u>
CHANGE IN POLICYHOLDERS' SURPLUS (NET ASSETS)	<u>\$68,018</u>	<u>\$2,666</u>	<u>\$65,352</u>

Operating income was considerably lower in 2009 due to the continued drop in premium rates and high unemployment rates. This was offset by large unrealized gains on Pinnacol's investment portfolio.

Though earned premium decreased from approximately \$521,082,000 of earned premium in 2008 to \$398,502,000 of earned premium in 2009, Pinnacol maintained its role in the market during 2009. Earned premiums decreased by approximately \$122,580,000 when compared to the prior year, primarily due to rate decreases in 2008 and 2009 for policies written thereafter. In addition, high levels of unemployment reduced the number of workers covered under Pinnacol's policies, which also reduced premiums earned.

Incurring losses and loss adjustment expenses were approximately \$290,066,000 and \$340,917,000 for 2009 and 2008, respectively.

The board of directors, at its discretion, determines the amount of general policyholder dividends to be declared based on Pinnacol's overall experience and financial condition. Pinnacol issued general policyholder dividends to policyholders in good standing of approximately \$122,600,000 and \$54,362,000 in 2009 and 2008, respectively.

Net investment income increased from the prior year by approximately \$166,136,000, primarily due to unrealized gains on Pinnacol's investment portfolio. Net realized losses on the sale of investments were approximately \$1,848,000 in 2009, whereas 2008 had net realized gains of \$11,744,000.

The following is a comparison of Pinnacol's results of operations for 2008 to 2007 (in thousands):

	2008 ACTUAL	2007 ACTUAL	CHANGE
OPERATING REVENUES:			
Premium earned	\$521,082	\$567,284	\$(46,202)
Other income	<u>396</u>	<u>990</u>	<u>(594)</u>
TOTAL OPERATING REVENUES	<u>521,478</u>	<u>568,274</u>	<u>(46,796)</u>
OPERATING EXPENSES:			
Losses and loss adjustment expenses	340,917	386,390	(45,473)
General and administrative	124,886	111,884	13,002
Dividends to policyholders	<u>78,557</u>	<u>68,503</u>	<u>10,054</u>
TOTAL OPERATING EXPENSES	<u>544,360</u>	<u>566,777</u>	<u>(22,417)</u>
OPERATING INCOME	<u>(22,882)</u>	<u>1,497</u>	<u>(24,379)</u>
NONOPERATING REVENUE:			
Net investment income	<u>25,548</u>	<u>144,263</u>	<u>(118,715)</u>
CHANGE IN POLICYHOLDERS' SURPLUS (NET ASSETS)	<u>\$2,666</u>	<u>\$145,760</u>	<u>\$(143,094)</u>

Operating income remained strong in 2008; however, this was offset by large unrealized losses on Pinnacol's equity securities.

Pinnacol's book of business decreased from approximately \$567,284,000 of earned premium in 2007 to \$521,082,000 of earned premium in 2008. Pinnacol maintained its role in the market during 2008. Earned premiums decreased by approximately \$46,202,000 when compared to the prior year, primarily due to rate decreases in 2006, 2007 and 2008 for policies written thereafter.

Incurred losses and loss adjustment expenses were approximately \$340,917,000 and \$386,390,000 for 2008 and 2007, respectively.

The board of directors, at its discretion, determines the amount of general policyholder dividends to be declared, based on Pinnacol's overall experience and financial condition. 2005 was the first time Pinnacol paid a general dividend in 23 years. Pinnacol declared general policyholder dividends to policyholders in good standing of approximately \$54,362,000 and \$60,641,000 in 2008 and 2007, respectively.

Net investment income decreased from the prior year by approximately \$118,715,000, primarily due to unrealized losses in Pinnacol's equity securities. Realized gains on the sale of investments were approximately \$11,744,000 in 2008 and \$9,396,000 in 2007.

Economic Factors

The following important economic factors should be considered when evaluating the financial position and operating results of Pinnacol.

Loss and loss adjustment expenses and the corresponding reserves are based on estimates that are subject to inherent variability caused by the nature of the insurance process. The potentially long period of time between the occurrence of an insured event and the final settlement of a claim and the possible effects of changes in the legal, social, and economic environments contribute to this variability. In response to this uncertainty, Pinnacol continually reviews these estimates, obtains independent actuarial studies, and adjusts the estimates as necessary as experience develops or new information becomes known. Such adjustments are made in current operations when such determination is made.

Pinnacol issued general policyholder dividends of \$122,600,000 and \$54,362,000 in 2009 and 2008, respectively, to its policyholders in good standing. This is included in dividends to policyholders on the statement of revenue, expenses and changes in policyholders' surplus (net assets) and reduces net income for the years ending December 31, 2009 and 2008. Pinnacol has paid approximately \$349 million in general policyholder dividends since 2005.

Effective April 7, 2010, the board of directors declared a general dividend of approximately \$47,500,000 to its policyholders with policies in good standing. This general dividend was paid in May 2010.

The investment portfolio is carried at fair value. The fair value of investments is subject to volatility due to market conditions, such as market interest rates. An increase in market interest rates will cause a reduction in the fair value of debt securities already held and impact Pinnacol's financial position by creating unrealized losses. Conversely, a decrease in market interest rates will cause an increase in the fair value of debt securities already held and impact Pinnacol's financial position by creating unrealized gains. Pinnacol adheres to an investment policy and applicable Colorado statutes to maintain a high-quality portfolio.

Pinnacol commenced the discussion of enterprise risk management and what it means to Pinnacol today and into the future at the board and leadership level. The desired outcome of this discussion was twofold. First, a better understanding of risk and the risks that Pinnacol faces at all levels of the organization. Second, a quantification of these risks based upon perceived frequency and severity to assist in the definitions of the appropriate surplus levels to be targeted by Pinnacol for future business plans. The results of this effort indicated that for existing risks, including inflation, market, catastrophic, or economic, the appropriate level of surplus for Pinnacol's risk profile is somewhat less than the surplus recorded at year-end 2009. Based upon this finding, Pinnacol has implemented a series of rate decreases and policyholder dividends to help bring surplus into the levels indicated by the ERM analysis. Each year the board and leadership team are committed to reviewing and updating this process to ensure that the level of surplus is appropriate for the risks faced.

Pinnacol's corporate vision is "To be the best workers' compensation insurance company in the nation." This vision statement was chosen as the critical motivation that will propel Pinnacol's employees to the achievement of the next level of superior results in the areas of customer service, agent partnerships, brand and employee culture.

PINNACOL ASSURANCE BALANCE SHEETS
DECEMBER 31, 2009 AND 2008

(in thousands)

	2009	2008
ASSETS		
INVESTMENTS (NOTE 3):		
Fixed maturities — at fair value (amortized cost: 2009 — \$1,615,972; 2008 — \$1,694,162)	\$1,706,783	\$1,744,613
Equity securities — at fair value (cost: 2009 — \$273,750; 2008 — \$254,973)	268,236	189,062
Short-term investments	14,997	17,901
TOTAL INVESTMENTS	<u>1,990,016</u>	<u>1,951,576</u>
CASH AND CASH EQUIVALENTS	48,559	93,773
CAPITAL ASSETS — Net of accumulated depreciation (Note 9)	26,472	25,964
UNCOLLECTED PREMIUMS RECEIVABLE — Net of allowance for uncollectible balances of \$5,021 for 2009 and \$5,635 for 2008	30,857	61,953
POLICY ACQUISITION COSTS	7,339	10,393
ACCRUED INVESTMENT INCOME	18,328	18,560
PREPAID ASSETS	3,890	3,185
TOTAL	<u>\$2,125,461</u>	<u>\$2,165,404</u>
LIABILITIES AND POLICYHOLDERS' SURPLUS (NET ASSETS)		
UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES:		
Reserve for unpaid losses (Note 2)	\$954,394	\$1,006,494
Reserve for unpaid loss adjustment expenses (Note 2)	194,744	216,666
TOTAL UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES	<u>1,149,138</u>	<u>1,223,160</u>
OTHER LIABILITIES	34,662	43,899
UNEARNED PREMIUMS	71,838	86,068
DIVIDENDS PAYABLE TO POLICYHOLDERS	20,276	29,957
CREDIT BALANCES DUE POLICYHOLDERS	8,225	9,016
TOTAL LIABILITIES	<u>1,284,139</u>	<u>1,392,100</u>
COMMITMENTS AND CONTINGENCIES (NOTES 2, 5, 8, AND 10)		
POLICYHOLDERS' SURPLUS (NET ASSETS):		
Invested in capital assets	26,472	25,964
Restricted	46,169	50,656
Unrestricted	768,681	696,684
TOTAL POLICYHOLDERS' SURPLUS (NET ASSETS)	<u>841,322</u>	<u>773,304</u>
TOTAL	<u>\$2,125,461</u>	<u>\$2,165,404</u>

See notes to basic financial statements.

**STATEMENTS OF REVENUE, EXPENSES,
AND CHANGES IN POLICYHOLDERS'
SURPLUS (NET ASSETS)**

DECEMBER 31, 2009 AND 2008
(in thousands)

	2009	2008
OPERATING REVENUES:		
Premium income	\$398,502	\$521,082
Other income	<u>1,480</u>	<u>396</u>
TOTAL OPERATING REVENUES	<u>399,982</u>	<u>521,478</u>
OPERATING EXPENSES:		
Losses and loss adjustment expenses (Note 2)	290,066	340,917
General and administrative	116,741	124,886
Dividends to policyholders	<u>116,841</u>	<u>78,557</u>
TOTAL OPERATING EXPENSES	<u>523,648</u>	<u>544,360</u>
OPERATING (LOSS)	(123,666)	(22,882)
NONOPERATING REVENUES:		
Net investment income	<u>191,684</u>	<u>25,548</u>
CHANGE IN POLICYHOLDERS' SURPLUS (NET ASSETS)	68,018	2,666
POLICYHOLDERS' SURPLUS (NET ASSETS) — BEGINNING OF YEAR	<u>773,304</u>	<u>770,638</u>
POLICYHOLDERS' SURPLUS (NET ASSETS) — END OF YEAR	<u>\$841,322</u>	<u>\$773,304</u>

See notes to basic financial statements.

STATEMENTS OF CASH FLOWS
DECEMBER 31, 2009 AND 2008

(in thousands)

	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Premiums collected — net of reinsurance	\$412,500	\$521,215
Other income collected	4,970	990
Losses and loss adjustment expenses paid — net of reinsurance and deductibles	(364,088)	(371,621)
General and administrative expenses paid	(121,390)	(126,747)
Dividends paid to policyholders	<u>(126,523)</u>	<u>(61,943)</u>
NET CASH (USED IN) OPERATING ACTIVITIES	<u>(194,531)</u>	<u>(38,106)</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING		
ACTIVITIES — Purchase of capital assets	<u>(3,805)</u>	<u>(3,005)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of investments	(343,018)	(428,029)
Proceeds from sale or redemption of investments	404,017	371,859
Investment income collected	93,519	94,610
Other net investing activities	<u>(1,396)</u>	<u>(255)</u>
NET CASH PROVIDED BY INVESTING ACTIVITIES	<u>153,122</u>	<u>38,185</u>
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(45,214)	(2,926)
CASH AND CASH EQUIVALENTS — BEGINNING OF YEAR	<u>93,773</u>	<u>96,699</u>
CASH AND CASH EQUIVALENTS — END OF YEAR	<u>\$48,559</u>	<u>\$93,773</u>
RECONCILIATION OF NET INCOME TO NET CASH FROM OPERATING ACTIVITIES:		
Operating loss	\$(123,666)	(22,882)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	3,297	2,886
Other changes in assets and liabilities:		
Increase (decrease) in unpaid losses and loss adjustment expenses	(74,022)	(30,704)
Increase (decrease) in unearned premiums	(14,230)	(9,481)
Increase (decrease) in other operating liabilities	(18,917)	12,374
(Increase) decrease in other operating assets	<u>33,007</u>	<u>9,701</u>
NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES	<u>\$(194,531)</u>	<u>\$(38,106)</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION —		
Net increase (decrease) in the fair value	<u>\$100,652</u>	<u>\$(82,868)</u>
<i>See notes to basic financial statements.</i>		

NOTES TO BASIC FINANCIAL STATEMENTS

DECEMBER 31, 2009 AND 2008

1. Nature of Operations and Significant Accounting Policies

(a) Organization — Pinnacol Assurance (Pinnacol or the Company) was established under provisions of the Workers' Compensation Act of Colorado (Title 8, Article 45 of the Colorado Revised Statutes (C.R.S.), as amended), as a political subdivision of the state of Colorado, to operate as a domestic mutual insurance company for the benefit of injured employees and dependents of deceased employees. Pinnacol provides insurance to employers operating within the state of Colorado (the State) not otherwise insured through private carriers or self-insurance.

Pinnacol is controlled by a nine-member board of directors, which is appointed by the governor, with the consent of the Senate. In accordance with the applicable statutes of the state, the administration of Pinnacol is under the direction of a chief executive officer, appointed by the board of directors. Pinnacol is not an agency of the State and the State retains no liability on behalf of Pinnacol, and no state monies are used for Pinnacol operations.

In 2009 and 2008, Pinnacol issued approximately \$122,600,000 and \$54,362,000, respectively, in general policyholder dividends to its policyholders in good standing. The board of directors, at its discretion, determines the amount of policyholder dividends to be declared, if any, based on Pinnacol's overall experience, financial condition, and risk profile.

(b) Basis of Presentation — Pinnacol has no component units using the criteria as set forth in accounting principles generally accepted in the United States of America (GAAP). Pinnacol is a political subdivision of the state and is accounted for as an enterprise fund (a business-type activity). All applicable Governmental Accounting Standards Board (GASB) pronouncements, as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations that do not conflict with or contradict GASB pronouncements in accordance with GASB Statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting, have been implemented by Pinnacol.

The accompanying basic financial statements of Pinnacol have been prepared using the flow of economic resources measurement focus and the accrual method of accounting, in accordance with accounting principles generally accepted in the United States of America (GAAP), which differ from statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division).

The effects of the variances between GAAP and the statutory financial statements at December 31, 2009 and 2008, and for the years then ended have been determined and are presented on the following page (in thousands):

	2009	2008
GAAP policyholders' surplus (net assets)	\$841,322	\$773,304
Nonadmitted assets	(10,645)	(13,246)
Policy acquisition costs	(7,339)	(10,393)
Net unrealized gains on bonds	<u>(90,811)</u>	<u>(51,664)</u>
STATUTORY POLICYHOLDERS' SURPLUS	<u>\$732,527</u>	<u>\$698,001</u>
	2009	2008
GAAP changes in policyholders' surplus (net assets)	\$68,018	\$2,666
Change in fair value of investments	(100,652)	82,868
Policy acquisition costs	3,054	815
Other-than-temporary impairments recognized	(1,006)	(68,272)
Realized gain on sale of impaired securities	7,627	-
Change in provision for reinsurance	-	<u>(330)</u>
STATUTORY NET (LOSS) INCOME	<u>\$(22,959)</u>	<u>\$17,747</u>

(c) Use of Estimates — The preparation of basic financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the basic financial statements, and the reported amounts of revenue and expenses during the reporting period. Significant estimates include the reserves for unpaid losses and loss adjustment expenses, association dividends, the earned but unbilled premium receivable balance included in uncollected premiums, as well as the allowance for uncollectible premiums, among others. Reserve for unpaid losses and loss adjustment expenses represent estimates of the ultimate unpaid cost, net of reinsurance, of all losses incurred, including losses incurred but not reported. This liability is an estimate and as such the ultimate actual liability may vary from the recorded amounts. These liabilities are reviewed periodically and adjustments to the reserve are included in operations in the period such determination is made. Actual results could differ from those estimates and such differences could be significant.

(d) Policyholders' Surplus (Net Assets) — Net assets are classified as follows:

Invested in Capital Assets — This represents the total investment in capital assets related to the Home Office, net of accumulated depreciation. There is no outstanding debt related to these capital assets.

Restricted Net Assets — Restricted net assets include amounts that are held as collateral for reinsurance agreements.

Unrestricted Net Assets — Unrestricted net assets represent resources from the continuing operations of Pinnacol that are not invested in capital assets or restricted as to use by an external third party.

(e) Classification of Revenues and Expenses — Pinnacol has classified revenues and expenses as either operating or nonoperating according to the following criteria:

Operating Revenues and Expenses — Revenues and expenses that result from providing workers' compensation coverages, dividends, claims administration, and loss control and related services for policyholders.

Nonoperating Revenues — Revenues that are not included as operating revenues. Nonoperating revenues include net investment income.

(f) Investments — Pinnacol's investments must comply with Title 10, Article 3, Part 2 of the C.R.S., as amended, which applies to domestic insurance companies. Investments are recorded on trade date. The investment portfolio is carried at estimated fair value.

Amortization of bond premium or discount is calculated using the effective interest method, taking into consideration specified interest and principal provisions over the life of the bond.

Prepayment assumptions for purposes of recognition of income and valuing of loan-backed bonds and structured securities were obtained from external broker-dealer survey values or internal estimates. These assumptions are consistent with the current interest rate and economic environment. The prospective method is used to value mortgage-backed securities. Prepayment assumptions for single-class and multiclass mortgage-backed/asset-backed securities were obtained from Yield Book and Bloomberg.

Realized gains and losses on sales of investments and changes in unrealized gains and losses on investments are reported in net investment income as nonoperating revenues and are computed on the specific-identification basis.

(g) Cash and Cash Equivalents — For purposes of cash flow disclosure, cash and cash equivalents are defined as cash and investments that have original maturities of three months or less from date of purchase. As of December 31, 2009 and 2008, cash and cash equivalents were approximately \$48,559,000 and \$93,773,000, respectively. Pinnacol has recorded cash disbursements that have been issued, but not presented for payment, as a reduction of cash and cash equivalents.

Bank balances up to \$250,000 are insured by the Federal Deposit Insurance Corporation. Remaining balances exceeding \$250,000 fall under the provisions of the Public Deposit Protection Act.

(h) Short Term Investments — Short term investments are securities with original maturities between three months and one year from the date of purchase. Short-term investments are carried at amortized cost, which approximates fair value, in the balance sheets in the amounts of approximately \$14,997,000 and \$17,901,000 for the years ended December 31, 2009 and 2008, respectively.

(i) Capital Assets — Capital assets include real estate, furniture, and equipment. Real estate includes the land, the building on the land, and capitalized building improvements used in conducting the Company's business. Land is carried at cost. Building and capitalized building improvements are carried at cost less accumulated depreciation. The costs of the building and capitalized improvements are depreciated over an estimated useful life of 30 years, using the straight-line method.

Office furniture and equipment and art are recorded at cost and depreciated on a straight-line basis over an estimated useful life of five years.

Electronic data processing equipment and software are recorded at cost and depreciated on a straight-line basis over an estimated useful life of three years.

Refer to Note 9 for a summary of capital asset activity for the years ended December 31, 2009 and 2008.

(j) Uncollected Premium Receivable — Uncollected premium receivable is reported net of allowances for uncollectible balances. Pinnacol independently estimates the ultimate realizable amounts of premiums receivable and establishes an allowance for uncollectible premiums for the difference between the gross receivable amount and the estimate of the amount to be ultimately realized.

During 2009 and 2008, Pinnacol recorded provisions of approximately \$1,252,000 and \$2,122,000, respectively, for premiums receivable due to the unlikelihood of ultimate collection thereof. These amounts are reflected as general and administrative expenses in the accompanying basic financial statements.

A significant portion of Pinnacol's premiums receivable balances at December 31, 2009 and 2008, were from companies operating in the construction and services industries in Colorado. The construction industry represents 33% and 39% of premiums written as of December 31, 2009 and 2008, respectively. The services industry represents 41% and 23% of premiums written as of December 31, 2009 and 2008, respectively, with all other individual industries constituting the remainder of premiums receivable balances.

- (k) Earned but Unbilled Premiums** — Earned but unbilled premiums represent audit premiums, which are amounts due from policyholders after the respective policy period has expired based on audits performed by Pinnacol. Such amounts are estimated by Pinnacol based upon internal statistically supported aggregate calculations using historical unearned premium data and per-policy calculations. Based on this analysis, 2009 estimated unbilled audit premium receivable was brought down to zero. This drop was due to the downturn in the economy and increased unemployment during 2009, which resulted in little or no additional premium due. In 2008 estimated unbilled audit premium receivable was approximately \$14,850,000, and was included as uncollected premiums receivable within the balance sheets.
- (l) Credit Balances Due Policyholders** — Credit balances due policyholders represent excess premiums or are amounts due to policyholders. Generally, credit balances due policyholders are applied to future premium obligations of policyholders. For 2009 and 2008, such amounts are approximately \$8,225,000 and \$9,016,000, respectively.
- (m) Policy Acquisition Costs** — Commissions and other costs that vary with and are directly related to the production of new and renewal business have been deferred. The period of amortization is the effective period of the related insurance policy.
- (n) Reserve for Unpaid Losses and Loss Adjustment Expenses** — The reserve for unpaid losses and loss adjustment expenses represents management's best estimate of ultimate net cost of all reported and unreported losses incurred through December 31. Management estimates the reserve for unpaid losses and loss adjustment expenses with the help of an independent third party actuary. The estimate is based on individual case basis valuations and statistical analyses. Those estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes the reserves for unpaid losses and loss adjustment expenses are adequate. These estimates are continually reviewed and adjusted, as necessary, as experience develops or new information becomes known. Such adjustments are included in losses and loss adjustment expenses within the statement of revenue, expenses, and changes in policyholders' surplus (net assets) in the period such information becomes known.
- Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in both 2009 and 2008. The discount rate used to calculate present value is based on an industry-standard rate.
- (o) Revenue Recognition** — Premium revenue is recognized pro rata over the terms of the related insurance policies and reinsurance contracts.

- (p) Unearned Premiums** — Unearned premiums represent amounts either collected or billed and due from policyholders at December 31, but unearned at that date. Unearned premiums are computed on a pro rata basis over the 12-month term of the policies.
- (q) Subrogation** — Subrogation claims (claims against third parties) are recognized as a reduction of losses incurred upon collection.
- (r) Reinsurance** — Ceded reinsurance transactions are accounted for based on estimates of their ultimate cost. Losses, loss adjustment expenses, and the reserves for loss adjustment expenses are reported gross of reinsured amounts. Reinsurance premiums are reflected as a reduction of premiums earned (see Note 5).
- (s) General Policyholder Dividends** — The board of directors, at its discretion, determines the amount of general policyholder dividends to be declared based on Pinnacol's overall experience and financial condition. Pinnacol has issued general policyholder dividends to its policyholders in good standing of approximately \$122,600,000 and \$54,362,000 in May 2009 and 2008, respectively. This is included in dividends to policyholders on the statement of revenue, expenses, and changes in policyholders' surplus (net assets).
- (t) Association Dividend Program** — Pinnacol has an association dividend program where policyholders who are members of the program are entitled to a dividend based on established criteria. In 2009 Pinnacol reduced the estimate of the future liability for association dividends by \$10,000,000, resulting in a credit of approximately \$5,759,000 in incurred dividend expense. In 2008 Pinnacol incurred approximately \$24,195,000 of expense related to the association dividend program. These dividends are not declared from surplus nor are they recorded as a direct reduction to surplus. The dividends are settled via premium credits and are recorded as dividends to policyholders on the statement of revenue, expenses, and changes in policyholders' surplus (net assets) as an operating expense.
- (u) Taxes** — Pinnacol is not subject to federal or state income taxes, under a specific exemption granted under Section 501(c) of the Internal Revenue Code. As a political subdivision of the state, Pinnacol is not subject to property tax or sales and use taxes. Additionally, Pinnacol is not subject to a premium tax, pursuant to Section 8 45 117(3), C.R.S. Pinnacol is, however, subject to a surcharge on premiums received, based on a rate established annually (approximately 3.618% and 3.818% in 2009 and 2008, respectively), pursuant to Section 8 44 112(1)(a), C.R.S. Such amounts are included in general and administrative expenses.

(v) Employee Benefits**Defined Benefit Pension Plan Through the State of Colorado**

Plan Description — All Pinnacol employees participate in a defined benefit pension plan. The plan's purpose is to provide income to members and their families at retirement or in case of death or disability. The plan is a cost-sharing multiple-employer plan administered by the Public Employees' Retirement Association (PERA). PERA was established by state statute in 1931. Responsibility for the organization and administration of the plan is placed with the Board of Trustees of PERA. Changes to the plan require an actuarial assessment and legislation by the General Assembly. The state plan and other divisions' plans are included in PERA's financial statements, which may be obtained by writing PERA at P.O. Box 5800, Denver, CO 80217; by calling PERA at 1-800-759-PERA (7372); or by visiting www.copera.org.

Defined benefit plan members vest after five years of service and are eligible for full retirement based on their original hire date as follows:

- Hired before July 1, 2005 — age 50 with 30 years of service, age 60 with 20 years of service, or age 65 with five years of service.
- Hired between July 1, 2005, and December 31, 2006 — any age with 35 years of service, age 55 with 30 years of service, age 60 with 20 years of service, or age 65 with five years of service.
- Hired on or after January 1, 2007 — any age with 35 years of service, age 55 with 30 years of service, age 60 with 25 years of service, or age 65 with five years of service.

Members are also eligible for retirement benefits without a reduction for early retirement based on their original hire date as follows:

- Hired before January 1, 2007 — age 55 with a minimum of five years of service credit and age plus years of service equals 80 or more.
- Hired on or after January 1, 2007 — age 55 with a minimum of five years of service credit and age plus years of service equals 85 or more.

Members automatically receive the higher of the defined retirement benefit or money purchase benefit at retirement. Defined benefits are calculated as 2.5 percent times the number of years of service times the highest average salary. For retirements before January 1, 2009, HAS is calculated as one-twelfth of the average of the highest salaries on which contributions were paid, associated with three periods of 12 consecutive months of service credit and limited to a 15 percent increase between periods. For retirements after January 1, 2009, or persons hired on or after January 1, 2007, more restrictive limits are placed on salary increases between periods used in calculating HAS.

Retiree benefits are increased annually based on their original hire date as follows:

- Hired before July 1, 2005 — 3.5 percent, compounded annually.
- Hired between July 1, 2005, and December 31, 2006 — the lesser of 3 percent or the actual increase in the national consumer price index.
- Hired on or after January 1, 2007 — the lesser of 3 percent or the actual increase in the national consumer price index, limited to a 10 percent reduction in a reserve established for cost of living increases related strictly to those hired on or after January 1, 2007. (The reserve is funded by one percentage point of salaries contributed by employers for employees hired on or after January 1, 2007.)

Members who are disabled and who have five or more years of service credit, six months of which has been earned since the most recent period of membership, may receive retirement benefits if determined to be permanently disabled. If a member dies before retirement, his or her eligible children under the age of 18 (23 if a full-time student) or spouse may be entitled to a single payment or monthly benefit payments. If there is no eligible child or spouse, then financially dependent parents, beneficiaries, or the member's estate, may be entitled to a survivor's benefit.

Funding Policy — The contribution requirements of plan members and their employers are established, and may be amended, by the General Assembly. Salary subject to PERA contribution is gross earnings less any reduction in pay to offset employer contributions to the state-sponsored IRC 125 plan established under Section 125 of the Internal Revenue Code.

All employees contribute 8.0 percent of their salaries, as defined in CRS 24-51-101(42), to an individual account in the plan. From January 1, 2008, to December 31, 2008, Pinnacol contributed 12.05 percent of the employee's salary. From January 1, 2009, through December 31, 2009, Pinnacol contributed 12.95 percent. Throughout 2009, 1.02 percent of the employee's total salary was allocated to the Health Care Trust Fund.

Per Colorado Revised Statutes, an amortization period of 30 years is deemed actuarially sound. At December 31, 2008, the division of PERA in which Pinnacol participates was underfunded with an infinite amortization period, which means that the unfunded actuarially accrued liability would never be fully funded at the current contribution rate.

In the 2004 legislative session, the General Assembly authorized an Amortization Equalization Disbursement (AED) to address a pension-funding shortfall. The AED required PERA employers to pay an additional 0.5 percent of salary beginning January 1, 2006 and another 0.5 percent of salary in 2007, and requires subsequent year increases of 0.4 percent of salary until the additional payment reaches 3.0 percent in 2012.

In the 2006 legislative session, the General Assembly authorized a Supplemental Amortization Equalization Disbursement (SAED) that requires PERA employers to pay an additional one-half percentage point of total salaries paid beginning January 1, 2008. The SAED is scheduled to increase by one-half percentage point through 2013, resulting in a cumulative increase of three percentage points. For state employers, each year's one-half-percentage-point increase in the SAED will be deducted from the amount of changes to state employees' salaries, and used by the employer to pay the SAED. Both the AED and SAED will terminate when funding levels reach 100 percent.

Historically, members have been allowed to purchase service credit at reduced rates. However, legislation passed in the 2006 session required that future agreements to purchase service credit be sufficient to fund the related actuarial liability.

Pinnacol's contributions to PERA and/or the state defined contribution plan for the years ending December 31, 2009 and 2008, were \$5,259,000 and \$4,746,000, respectively. These contributions met the contribution requirement for each year.

Voluntary Tax-deferred Retirement Plans

PERA offers a voluntary 401(k) plan entirely separate from the defined benefit pension plan. Pinnacol offers a 457 deferred compensation plan. Pinnacol matches employees' elective contributions into the PERA 401(k) plan at 50% up to the first 6% of employees' elected deferrals. The matching contribution is immediately vested and available to the employees. During the years ended December 31, 2009 and 2008, Pinnacol contributed approximately \$907,000 and \$780,000, respectively, in matching contributions to the 401(k) plan.

Postretirement Health Care and Life Insurance Benefits

Health Care Program — The PERA Health Care Program began covering benefit recipients and qualified dependents on July 1, 1986. This benefit was developed after legislation in 1985 established the program and the Health Care Fund; the program was converted to a trust fund in 1999. The plan is a cost-sharing multiple-employer plan under which PERA subsidizes a portion of the monthly premium for health care coverage. The benefits and employer contributions are established in statute and may be amended by the General Assembly. PERA includes the Health Care Trust Fund in its Comprehensive Annual Financial Report, which may be obtained by writing PERA at P.O. Box 5800, Denver, CO 80217; by calling PERA at 1-800-759-PERA (7372); or by visiting www.copera.org.

After the PERA subsidy, the benefit recipient pays the balance of the premium through an automatic deduction from the monthly retirement benefit. Monthly premium costs for participants depend on the health care plan selected, the PERA subsidy amount, Medicare eligibility, and the number of persons covered. Effective July 1, 2000, the maximum monthly subsidy is \$230 per month for benefit recipients who are under 65 years of age and who are not entitled to Medicare, and \$115 per month for benefit recipients who are 65 years of age or older or who are under 65 years of age and entitled to Medicare. The maximum subsidy is based on the recipient having 20 years of service credit, and is subject to reduction of 5% for each year less than 20 years.

Employees are not required to contribute to the Health Care Trust Fund, which is maintained by employer's contributions as discussed above. Beginning July 1, 2004, employers are required to contribute 1.02% of gross covered wages to the Health Care Trust Fund. Pinnacol contributed approximately \$414,000 and \$402,000 as required by statute in the years ended December 31, 2009 and 2008, respectively. In each year the amount contributed was 100% of the required contribution.

The Health Care Trust Fund offers two general types of plans: fully insured plans offered through health care organizations and self-insured plans administered for PERA by third-party vendors. As of December 31, 2008, there were 45,888 enrolled participants, including spouses and dependents, from all contributors to the plan. At December 31, 2008, the Health Care Trust Fund had an unfunded actuarial accrued liability of \$1.11 billion, a funded ratio of 18.7%, and a 39-year amortization period.

(w) Application of Recent Accounting Pronouncements

In May 2009, the FASB issued Statement of Financial Accounting Standards No. 165, "Subsequent Events" (SFAS No. 165). Effective July 1, 2009, SFAS No. 165 was superseded and replaced by certain provisions of ASC Topic 855, "Subsequent Events" (ASC Topic 855). These provisions of ASC Topic 855 require companies to establish principles and requirements for subsequent events. Specifically, these provisions of ASC Topic 855 require the disclosure of the period after the balance sheet date through which management has evaluated events and transactions that may occur for potential recognition or disclosure in a company's financial statements. In addition, these provisions of ASC Topic 855 provide the circumstances under which the disclosures are required of an entity regarding events and circumstances that have occurred after the balance sheet date but before financial statements are issued or are available to be issued. These provisions of ASC Topic 855 are effective for interim or annual financial periods ending after June 15, 2009. The Company adopted these provisions of ASC Topic 855 for its year ended December 31, 2009, with no effect on the Company's financial position or results of operations.

2. Unpaid Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses (both allocated and unallocated) represent management's best estimate of the ultimate medical and indemnity gross cost of all losses and loss adjustment expenses that are incurred but unpaid at year-end. Such estimates are based on individual case estimates for reported claims and actuarial estimates for losses that have been incurred but not reported. Any change in probable ultimate liabilities is reflected in losses and loss adjustment expenses within the statement of revenue, expenses, and changes in policyholders' surplus (net assets) in the period such determination is made.

The estimated ultimate cost of losses is based on historical patterns and the expected impact of current socioeconomic trends. The ultimate settlement of claims will not be known in many cases for years after the time a policy expires. Court decisions and federal and state legislation between the time a policy is written and associated claims are ultimately settled, among other factors, may dramatically impact the ultimate cost. Due to these factors, among others, the process to estimate loss and loss adjustment expense reserves

at a point in time cannot provide an exact forecast of future payments. Rather, it produces a best estimate of liability as of a certain date. Management believes the reserves currently estimated to be adequate. While the ultimate liability may differ from the current estimate, management does not believe the difference will have a material effect, either adverse or favorable, on Pinnacol's financial position or results of operations.

Discounting of Liabilities for Unpaid Losses — Pinnacol discounts its liabilities for unpaid losses for certain long-term scheduled payments. Workers' compensation unpaid losses have been discounted on a tabular basis using a discount rate of 3.5% in 2009 and 2008. A tabular discount is calculated with reference to actuarial tables. These tables incorporate an interest rate and, in addition, factor in contingencies such as mortality, remarriage, and inflation rates. The amount of the tabular discount for unpaid losses as of December 31, 2009 and 2008, respectively, is approximately \$151,841,000 and \$148,184,000.

The amount of discount for case reserves at December 31, 2009, is distributed as follows over the years in which the losses were incurred (in thousands):

LOSS YEAR	AMOUNT OF DISCOUNT
2009	\$6,092
2008	18,020
2007	14,175
2006	17,304
2005	11,639
2004	8,173
2003	9,066
2002	9,630
2001	8,206
2000	3,376
Prior	<u>46,160</u>
TOTAL	<u>\$151,841</u>

Unpaid Losses and Loss Adjustment Expenses — At December 31, 2009, Pinnacol accrued approximately \$1,149,138,000 for unpaid losses and loss adjustment expenses. A tabular discount of approximately \$151,841,000 (computed at 3.5%) was applied in the actuarial calculation of the liability for unpaid losses. A reserve credit of approximately \$13,702,000 was recorded for high deductibles on unpaid claims at December 31, 2009.

At December 31, 2008, Pinnacol accrued approximately \$1,223,160,000 for unpaid losses and loss adjustment expenses. A tabular discount of approximately \$148,184,000 (computed at 3.5%) was applied in the actuarial calculation of the liability for unpaid losses. A reserve credit of approximately \$16,009,000 was recorded for high deductibles on unpaid claims at December 31, 2008.

Activity in the liability for unpaid losses and loss adjustment expenses for the years ended December 31, 2009 and 2008, is summarized as follows (in thousands):

	UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES	
	2009	2008
BALANCE — JANUARY 1	<u>\$1,223,160</u>	<u>\$1,253,864</u>
Additional amounts incurred related to:		
Current year	390,369	499,922
Prior years	<u>(100,303)</u>	<u>(159,005)</u>
TOTAL INCURRED	<u>290,066</u>	<u>340,917</u>
Reductions relating to payments for:		
Current year	115,058	168,403
Prior years	<u>249,030</u>	<u>203,218</u>
TOTAL PAID	<u>364,088</u>	<u>371,621</u>
BALANCE — DECEMBER 31	<u>\$1,149,138</u>	<u>\$1,223,160</u>

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and allocated loss adjustment expenses decreased by approximately \$100,303,000 and \$159,005,000 in 2009 and 2008, respectively, which is net of accretion of discount of \$3,657,000 and \$4,851,000, respectively. During the year ended December 31, 2009, \$249,030,000 had been paid for unpaid loss and loss adjustment expense attributable to insured events of prior years. Reserves for unpaid loss and loss adjustment expense remaining for prior years are now \$873,827,000 as a result of re-estimation of unpaid losses and loss adjustment expenses. This decrease is generally the result of ongoing analysis of recent loss development trends and better-than-expected development. Pinnacol's claims, for all accident years, continue the trend of favorable development that has been evident for a number of calendar years. When the actual selected ultimate cost of an accident year's claims is less than the original estimate, favorable development is recorded. This favorable development resulted from aggressive claim closure, a reduction of ultimate claim frequency in Colorado, and a reduction of catastrophic losses. Pinnacol management continually evaluates the estimate ultimate cost of all accident years and on a calendar-year basis adjusts to the best estimate available, favorable or unfavorable, in the current period.

3. Investments

The fair value of Pinnacol's fixed maturities is based on quoted market prices for those or similar investments. The amortized cost and fair value of investments in fixed maturities as of December 31, 2009 and 2008, are as follows (in thousands):

2009				
	AMORTIZED COST	UNREALIZED GAINS	UNREALIZED LOSSES	FAIR VALUE
U.S. GOVERNMENT OBLIGATIONS:				
Non-loan-backed bonds	\$265,854	\$14,120	\$(4,270)	\$275,704
Loan-backed bonds	29,440	1,125	-	30,565
SPECIAL REVENUE:				
Non-loan-backed bonds	4,987	372	-	5,359
Loan-backed bonds	394,885	17,599	(52)	412,432
INDUSTRIAL AND MISCELLANEOUS:				
Non-loan-backed bonds	920,806	62,821	(904)	982,723
Loan-backed bonds	-	-	-	-
	<u>\$1,615,972</u>	<u>\$96,037</u>	<u>\$(5,226)</u>	<u>\$1,706,783</u>
2008				
	AMORTIZED COST	UNREALIZED GAINS	UNREALIZED LOSSES	FAIR VALUE
U.S. GOVERNMENT OBLIGATIONS:				
Non-loan-backed bonds	\$263,069	\$43,249	-	\$306,318
Loan-backed bonds	479,260	10,541	-	489,801
SPECIAL REVENUE:				
Non-loan-backed bonds	-	-	-	-
Loan-backed bonds	4,985	439	-	5,424
INDUSTRIAL AND MISCELLANEOUS:				
Non-loan-backed bonds	<u>946,848</u>	<u>28,363</u>	<u>(32,141)</u>	<u>943,070</u>
Loan-backed bonds	-	-	-	-
	<u>\$1,694,162</u>	<u>\$82,592</u>	<u>\$(32,141)</u>	<u>\$1,744,613</u>

The amortized cost and fair value of investments in fixed maturities at December 31, 2009, by contractual maturity, are shown in the following table. Contractual maturities may differ from actual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Investments such as mortgage-backed securities have been allocated based on the original maturity date at issuance (in thousands).

	AMORTIZED COST	FAIR VALUE
Due in one year or less	\$71,275	\$72,417
Due after one year through five years	413,498	443,792
Due after five years through ten years	577,579	612,830
Due after ten years	<u>553,620</u>	<u>577,744</u>
	<u>\$1,615,972</u>	<u>\$1,706,783</u>

Proceeds from sales of investments in fixed maturities during 2009 and 2008 were approximately \$296,143,000 and \$340,802,000, respectively. Gross gains of approximately \$10,384,000 and \$14,892,000 and gross losses of approximately \$4,765,000 and \$85,000 were realized on those sales in 2009 and 2008, respectively.

Disclosures Relating to Credit Risk — Generally, credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by an organization such as Standard & Poor's Corp. (S&P). Pinnacol's investment policy states that all long-term fixed income securities must be rated BBB or higher by S&P at the time of purchase. Presented below is the actual rating by investment type (excluding non-loan-backed investments in U.S. government obligations) for investments in fixed maturities as of December 31, 2009 and 2008, respectively (in thousands).

2009 S&P RATING	CORPORATE BONDS	MORTGAGE-BACKED SECURITIES	ASSET-BACKED SECURITIES	TOTAL
AAA	\$22,311	\$442,998	\$ -	\$465,309
AA+	50,439			50,439
AA	67,497			67,497
AA-	89,983			89,983
A+	99,850			99,850
A	347,410			347,410
A-	76,763			76,763
BBB+	75,048			75,048
BBB	84,822			84,822
BBB-	53,965			53,965
BB+	3,392			3,392
Nonrated	16,601	—	—	16,601
<u>TOTAL</u>	<u>\$988,081</u>	<u>\$442,998</u>	<u>\$ -</u>	<u>\$1,431,079</u>

2008 S&P RATING	CORPORATE BONDS	MORTGAGE-BACKED SECURITIES	ASSET-BACKED SECURITIES	TOTAL
AAA	\$73,263	\$489,801	\$ -	\$563,064
AA+	-			-
AA	78,042			78,042
AA-	54,157			54,157
A+	123,577			123,577
A	*356,704			356,704
A-	93,427			93,427
BBB+	79,028			79,028
BBB	63,188			63,188
BBB-	6,581			6,581
BB+	2,813			2,813
CCC+	<u>23,739</u>	<u>—</u>	<u>—</u>	<u>23,739</u>
<u>TOTAL</u>	<u>\$954,519</u>	<u>\$489,801</u>	<u>\$ -</u>	<u>\$1,444,320</u>

* Includes \$6,025 of short-term corporate bonds.

Disclosures Relating to Interest Rate Risk — Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates. As stated in Pinnacol's investment policy, one of the ways that Pinnacol manages its exposure to interest rate risk is by purchasing a combination of short- and long-term investments and by timing cash flows from maturities so that a portion of the portfolio is maturing, or coming close to maturity, evenly over time as necessary to provide the cash flow and liquidity needed for operations and claim obligations.

Information about the sensitivity of the fair values of Pinnacol's investments to market interest rate fluctuations is provided by the following table that shows the distribution of Pinnacol's investments in fixed maturities by remaining time until the maturity date for 2009 and 2008. Investments such as mortgage-backed securities have been allocated based on the original maturity date at issuance. Contractual maturities may differ from actual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

REMAINING MATURITY 2009 (IN THOUSANDS)					
	12 MONTHS OR LESS	13-24 MONTHS	25-60 MONTHS	MORE THAN 60 MONTHS	TOTAL
U.S. GOVERNMENT OBLIGATIONS	27,267	\$19,310	\$8,463	\$220,663	\$275,703
SPECIAL REVENUE	-	-	-	5,359	5,359
INDUSTRIAL AND MISC.	45,150	61,996	354,022	521,555	982,723
MORTGAGE-BACKED SECURITIES	-	-	-	442,998	442,998
Total	\$72,417	\$81,306	\$362,485	\$1,190,575	\$1,706,783
REMAINING MATURITY 2008 (IN THOUSANDS)					
	12 MONTHS OR LESS	13-24 MONTHS	25-60 MONTHS	MORE THAN 60 MONTHS	TOTAL
U.S. GOVERNMENT OBLIGATIONS	* \$ 11,876	\$28,152	\$28,622	\$249,544	\$318,194
SPECIAL REVENUE	-	-	-	5,424	5,424
INDUSTRIAL AND MISC.	** 82,422	50,370	283,888	532,415	949,095
MORTGAGE-BACKED SECURITIES	11	-	-	489,790	489,801
TOTAL	\$94,309	\$78,522	\$312,510	\$1,277,173	\$1,762,514

* Includes \$11,876 of short-term bonds.
 ** Includes \$6,025 of short-term bonds.

Investments in equity securities are reported at fair value based on quoted market prices. Related unrealized gains and losses are reported directly in nonoperating income. The gross unrealized gains and losses on equity securities, cost, and fair value of those investments are summarized as follows (in thousands):

COMMON STOCKS AND MUTUAL FUNDS	COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
December 31, 2009	<u>\$273,750</u>	<u>\$56,031</u>	<u>\$(61,545)</u>	<u>\$268,236</u>
December 31, 2008	<u>\$254,973</u>	<u>\$2,361</u>	<u>\$(68,272)</u>	<u>\$189,062</u>

The following table provides the length of impairment for those investments with an unrealized loss as of December 31, 2009 (in thousands):

DESCRIPTION OF SECURITIES	LESS THAN 12 MONTHS		12 MONTHS OR GREATER		TOTAL	
	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES
FIXED INCOME:						
Industrial and miscellaneous	\$7,923	\$(51)	\$11,077	\$(853)	\$19,000	\$(904)
Government obligations	53,894	(4,270)	-	-	53,894	(4,270)
Mortgage-backed securities	<u>12,156</u>	<u>(52)</u>	<u>-</u>	<u>-</u>	<u>12,156</u>	<u>(52)</u>
TOTAL FIXED INCOME	<u>73,973</u>	<u>(4,373)</u>	<u>11,077</u>	<u>(853)</u>	<u>85,050</u>	<u>(5,226)</u>
EQUITIES:						
Common stock	7,589	(384)	4,026	(509)	11,615	(893)
Mutual funds	<u>990</u>	<u>(7)</u>	<u>-</u>	<u>-</u>	<u>990</u>	<u>(7)</u>
TOTAL EQUITIES	<u>8,579</u>	<u>(391)</u>	<u>4,026</u>	<u>(509)</u>	<u>12,605</u>	<u>(900)</u>
TOTAL	<u>\$82,552</u>	<u>\$(4,764)</u>	<u>\$15,103</u>	<u>\$(1,362)</u>	<u>\$97,655</u>	<u>\$(6,126)</u>

As of December 31, 2009, unrealized losses consisted of the following number of securities:

DESCRIPTION OF SECURITIES	LESS THAN 12 MONTHS	12 MONTHS OR GREATER	TOTAL
FIXED INCOME:	4	2	6
EQUITIES:	<u>34</u>	<u>7</u>	<u>41</u>
TOTAL	<u>38</u>	<u>9</u>	<u>47</u>

The following table provides the length of impairment for those investments with an unrealized loss as of December 31, 2008 (in thousands):

DESCRIPTION OF SECURITIES	LESS THAN 12 MONTHS		12 MONTHS OR GREATER		TOTAL	
	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES
FIXED INCOME:						
Industrial and miscellaneous	\$255,588	\$(17,702)	\$70,345	\$(11,802)	\$325,933	\$(29,504)
Government obligations	35,213	(719)	8,013	(405)	43,226	(1,124)
Mortgage-backed securities	<u>6,249</u>	<u>(299)</u>	-	-	<u>6,249</u>	<u>(299)</u>
TOTAL FIXED INCOME	297,050	(18,720)	78,358	(12,207)	375,408	(30,927)
EQUITIES:						
Common stock	31,220	(12,743)	5,798	(4,340)	37,018	(17,083)
Mutual funds	<u>111,979</u>	<u>(45,503)</u>	<u>8,069</u>	<u>(5,685)</u>	<u>120,048</u>	<u>(51,188)</u>
TOTAL EQUITIES	143,199	(58,246)	13,867	(10,025)	157,066	(68,271)
TOTAL	<u>\$440,249</u>	<u>\$(76,966)</u>	<u>\$92,225</u>	<u>\$(22,232)</u>	<u>\$532,474</u>	<u>\$(99,198)</u>

As of December 31, 2008, unrealized losses consisted of the following number of securities:

DESCRIPTION OF SECURITIES	LESS THAN 12 MONTHS	12 MONTHS OR GREATER	TOTAL
	FIXED INCOME:	40	13
EQUITIES:	<u>62</u>	<u>24</u>	<u>86</u>
TOTAL	<u>102</u>	<u>37</u>	<u>139</u>

Fair Value Measurements — The Company's assets and liabilities recorded at fair value have been categorized based upon a fair value hierarchy. The levels of the fair value hierarchy are described below.

- Level 1 inputs utilize observable, quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Financial assets and liabilities utilizing Level 1 inputs include actively exchange-traded equity securities.
- Level 2 inputs utilize other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.
- Level 3 inputs are unobservable and include situations where there is little, if any, market activity for the asset or liability.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

The following table presents information about the Company's financial assets measured at fair value on a recurring basis for either accounting or disclosure purposes as of December 31, 2009, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value (in thousands):

FAIR VALUE MEASUREMENTS DECEMBER 31, 2009				
	QUOTED PRICES IN ACTIVE MARKETS FOR IDENTICAL ASSETS (LEVEL 1)	SIGNIFICANT OTHER OBSERVABLE INPUTS (LEVEL 2)	SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)	TOTAL
ASSETS				
Fixed maturities	\$ -	\$1,689,632	\$17,151	\$1,706,783
Equity securities	268,236	-	-	268,236
<u>TOTAL ASSETS</u>	<u>\$268,236</u>	<u>\$1,689,632</u>	<u>\$17,151</u>	<u>\$1,975,019</u>

The following table presents additional information about fixed maturity assets measured at fair value on a recurring basis and for which the Company has utilized Level 3 inputs to determine fair value (in thousands):

RECURRING LEVEL 3 FINANCIAL FIXED MATURITY ASSETS YEAR ENDED DECEMBER 31, 2009	
	FIXED MATURITIES
BALANCE — JANUARY 1, 2009	\$18,073
Realized and unrealized gains and losses:	
Gains (losses) included in income	647
Purchases, issuances and settlements	(1,569)
Transfers in (out) of Level 3	—
BALANCE — DECEMBER 31, 2009	<u>\$17,151</u>
Total gains (losses) for the period included in income attributable to the change in unrealized gains and losses relating to assets held at December 31, 2009	<u>\$647</u>

The Company has no assets or liabilities measured at fair value on a nonrecurring basis as of December 31, 2009.

Investment Income — Major categories of investment income for the years ended December 31, 2009 and 2008, are summarized as follows (in thousands):

	2009	2008
INVESTMENT INCOME:		
Corporate and miscellaneous bonds	\$76,735	\$73,129
U.S. government obligations	13,180	18,858
Cash and other investments	367	2,068
Equity securities	4,569	4,102
Repurchase/reverse repurchase	-	583
Investment expenses	<u>(1,971)</u>	<u>(2,068)</u>
NET INVESTMENT INCOME EARNED	92,880	96,672
NET REALIZED GAINS	(1,848)	11,744
UNREALIZED (LOSSES) GAINS	<u>100,652</u>	<u>(82,868)</u>
NET INVESTMENT INCOME	<u>\$191,684</u>	<u>\$25,548</u>

The company did not have any significant concentrations by industry or by issuer as of December 31, 2009 or 2008.

4. Uninsured Plans and Uninsured Portion of Partially Insured Plans

Pinnacol offers Administrative Services Contract Plans whereby Pinnacol acts as a third-party administrator for all workers' compensation claims under these contracts. All loss and loss adjustment expenses related to claims under these contracts are reimbursed to Pinnacol. Pinnacol does not record premium revenue nor loss and loss adjustment expenses on these plans but does show the related receivables for these costs. Reimbursements billed under these contracts were approximately \$34,294,000 and \$37,171,000 in 2009 and 2008, respectively. Included in these contracts are transactions with the State.

5. Reinsurance

Ceded Reinsurance — Pinnacol purchases excess of loss reinsurance with two layers. The reinsurance coverage for individual workers' compensation accidents was as follows:

- a. Layer 1 — Limit of \$20,000,000 in excess of retention of \$20,000,000 per occurrence.
- b. Layer 2 — Limit of \$40,000,000 in excess of retention of \$40,000,000 per occurrence.

This coverage was in effect at December 31, 2009 and 2008. Management is not aware of any loss great enough to attach to these layers during any of the aforementioned policy periods.

Should the reinsurers be unable to meet their obligations under the reinsurance contracts, Pinnacol would remain liable for amounts ceded to its reinsurers. Reinsurance contracts do not relieve Pinnacol of its obligations, and a failure of the reinsurer to honor its obligations could result in losses to Pinnacol. Pinnacol evaluates and monitors the financial condition of its reinsurers to minimize its exposure to loss from reinsurer insolvency. Management of Pinnacol believes its reinsurers are financially sound and will continue to meet their contractual obligations.

Pinnacol's reinsurers had the following AM Best ratings at December 31, 2009:

REINSURER	AM BEST RATING
AXIS Specialty Limited	A
Endurance Specialty Insurance Ltd.	A
Flagstone Reassurance Suisse SA	A-
Lloyd's Syndicate - FDY #0435	NR
Lloyd's Syndicate - ATR #0570	AS
Lloyd's Syndicate - CSL #1084	AS
Lloyd's Syndicate - BGT #1301	NR
Lloyd's Syndicate - DRE #1400	NR-5
Lloyd's Syndicate - LIB #4472	NR
Validus Reinsurance Ltd.	A-

Assumed Reinsurance — Effective March 1, 2004, Pinnacol executed a reinsurance contract with Argonaut Insurance Co. (a California corporation) for Other States Coverage that is in effect as of December 31, 2009. The contract is designed as a 100% quota share arrangement with Pinnacol acting as the assuming company. This contract allows Pinnacol to provide insurance coverage under the workers' compensation provisions of other states for the employees of Colorado companies who work outside of Colorado. Premium revenue is recognized pro rata over the period the policy is effective.

Pinnacol held unearned premium reserves related to assumed business of \$1,546,000 and \$2,149,000 for the years ended December 31, 2009 and 2008, respectively. Pinnacol had loss and loss adjustment expense reserves related to assumed business of \$28,834,000 and \$30,766,000 for the years ended December 31, 2009 and 2008, respectively.

The following reinsurance activity has been recorded in the accompanying basic financial statements (in thousands):

	2009	2008
Direct premiums written	\$353,824	\$484,459
Premiums ceded	(1,041)	(1,416)
Premiums assumed	<u>17,247</u>	<u>28,559</u>
NET PREMIUMS WRITTEN	<u>\$370,030</u>	<u>\$511,602</u>
Direct premiums earned	\$381,693	\$494,418
Premiums ceded	(1,041)	(1,416)
Premiums assumed	<u>17,850</u>	<u>28,080</u>
NET PREMIUMS EARNED	<u>\$398,502</u>	<u>\$521,082</u>
Direct losses incurred	\$248,298	\$253,626
Losses ceded	-	675
Losses assumed	<u>7,225</u>	<u>19,775</u>
NET LOSSES INCURRED	<u>\$255,523</u>	<u>\$274,076</u>
Direct loss adjustment expenses incurred	\$31,312	\$66,204
Loss adjustment expenses ceded	-	-
Loss adjustment expenses assumed	<u>3,231</u>	<u>637</u>
NET LOSS ADJUSTMENT EXPENSES INCURRED	<u>\$34,543</u>	<u>\$66,841</u>

6. Policyholders' Surplus (Net Assets)

Pinnacol issued approximately \$122,600,000 and \$54,362,000 in general policyholder dividends to its policyholders in good standing in 2009 and 2008, respectively. This is included in dividends to policyholders in the statement of revenue, expenses, and changes in policyholders' surplus (net assets) and reduces net income for the year ending December 31, 2009.

The Division of Insurance monitors a company's "risk-based capital" requirement in assessing the financial strength of an insurance company. Pinnacol's level of statutory-basis policyholders' surplus exceeds the "company action level" of risk-based capital, which is approximately \$115,860,000 for 2009. Pinnacol had statutory basis policyholders' surplus of approximately \$732,527,000 and \$698,001,000 as of December 31, 2009 and 2008, respectively.

7. Compensated Absences for Paid Time Off

Pinnacol employees may accrue paid time off based on their length of service, subject to certain limitations on the amount which will be paid upon termination. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The estimated liability for cumulative accrued paid time off of approximately \$1,574,000 and \$1,684,000 at December 31, 2009 and 2008, respectively, is included in other liabilities in the accompanying financial statements.

8. Commitments and Contingencies

Pinnacol is party to various claims and lawsuits that arise in the normal course of its business. Management of Pinnacol believes that liabilities that may arise due to the resolution of these matters, if any, will not have a material adverse effect on policyholders' surplus or the results of operations and/or liquidity of Pinnacol.

At December 31, 2009 and 2008, Pinnacol had a letter of credit for the benefit of Argonaut Insurance Co. under the assumptive reinsurance agreement for approximately \$46,169,000 and \$50,656,000, respectively. This reinsurance agreement allows the company to draw upon the letter of credit, which is 100% collateralized, at any time to secure any of Pinnacol's obligations under the agreement. Included in fixed maturities are amounts held as collateral for the letter of credit of approximately \$77,433,000 and \$77,414,000, compared with a requirement of \$46,169,000 and \$50,656,000, as of December 31, 2009 and 2008, respectively.

Pinnacol is contingently liable for approximately \$57,153,000 of claims closed by the purchases of annuities from life insurers for structured settlements. No provision has been made for this contingency, as management believes that any payments related to this contingency are remote.

9. Capital Assets

Capital asset activity for the years ended December 31, 2009 and 2008, was as follows (in thousands):

	BALANCE — JAN. 1, 2009	ACQUISITIONS (DISPOSITIONS)	DEPRECIATION	BALANCE — DEC. 31, 2009
LAND, BUILDING, AND IMPROVEMENTS:				
Historical cost	\$27,633	\$289	\$ -	\$27,922
Accumulated depreciation	<u>(5,290)</u>	<u>-</u>	<u>(1,043)</u>	<u>(6,333)</u>
TOTAL	<u>22,343</u>	<u>289</u>	<u>(1,043)</u>	<u>21,589</u>
FURNITURE, FIXTURES, AND ART:				
Historical cost	8,586	(928)	-	7,658
Accumulated depreciation	<u>(5,785)</u>	<u>1,299</u>	<u>(1,011)</u>	<u>(5,497)</u>
TOTAL	<u>2,801</u>	<u>371</u>	<u>(1,011)</u>	<u>2,161</u>
COMPUTER EQUIPMENT:				
Historical cost	6,092	1,449	-	7,541
Accumulated depreciation	<u>(5,272)</u>	<u>1,696</u>	<u>(1,243)</u>	<u>(4,819)</u>
TOTAL	<u>820</u>	<u>3,145</u>	<u>(1,243)</u>	<u>2,722</u>
TOTAL CAPITAL ASSETS — NET	<u>\$25,964</u>	<u>\$3,805</u>	<u>\$(3,297)</u>	<u>\$26,472</u>
	BALANCE — JAN. 1, 2008	ACQUISITIONS (DISPOSITIONS)	DEPRECIATION	BALANCE — DEC. 31, 2008
LAND, BUILDING, AND IMPROVEMENTS:				
Historical cost	\$25,961	\$1,672	\$ -	\$27,633
Accumulated depreciation	<u>(4,354)</u>	<u>-</u>	<u>(936)</u>	<u>(5,290)</u>
TOTAL	<u>21,607</u>	<u>1,672</u>	<u>(936)</u>	<u>22,343</u>
FURNITURE, FIXTURES, AND ART:				
Historical cost	7,974	612	-	8,586
Accumulated depreciation	<u>(4,846)</u>	<u>-</u>	<u>(939)</u>	<u>(5,785)</u>
TOTAL	<u>3,128</u>	<u>612</u>	<u>(939)</u>	<u>2,801</u>
COMPUTER EQUIPMENT:				
Historical cost	5,371	721	-	6,092
Accumulated depreciation	<u>(4,260)</u>	<u>-</u>	<u>(1,012)</u>	<u>(5,272)</u>
TOTAL	<u>1,111</u>	<u>721</u>	<u>(1,012)</u>	<u>820</u>
TOTAL CAPITAL ASSETS — NET	<u>\$25,846</u>	<u>\$3,005</u>	<u>\$(2,887)</u>	<u>\$25,964</u>

10. Subsequent Events

General Dividend Declared — The board of directors held a meeting on April 7, 2010, in which it declared a general dividend of approximately \$47,500,000 to its policyholders with policies in good standing. This general dividend was paid in May 2010. The board of directors, at its discretion, determines the amount of policyholder dividends to be declared based on Pinnacol's overall experience and financial condition.

Performance Audit — During the 2009 Colorado legislative session, SB 09-281 was approved and signed by the governor. An amendment to CRS 8-45-121, SB 09-281 included a performance audit to be conducted and managed by the State Auditor's Office. Extracted from CRS 8-45-121 as enacted:

An annual financial audit and, in 2009, a performance audit of Pinnacol Assurance shall be made as soon as practicable by the state auditor, such audits to include, but not be limited to, executive compensation, premium rate structure, known loss reserves, incurred but not reported losses, and injured workers' claims experience. In conducting such audits, the state auditor may employ a firm of auditors and actuaries, or both, with the necessary specialized knowledge and experience. The cost of such annual audit shall be paid from the operating funds of Pinnacol Assurance. The state auditor shall report his or her findings from such audits, along with any comments and recommendations, to the governor, the general assembly, the executive director of the department of labor and employment, and the commissioner of insurance. The state auditor shall have continuing authority to conduct performance audits of Pinnacol Assurance as the state auditor deems appropriate. The cost of performance audits shall be paid from the operating funds of Pinnacol Assurance.

The 2009 Performance Audit commenced during the third quarter of 2009 and as of the second quarter of 2010 is not yet complete. The audit scope included policy periods going back to 2005.

While the draft results of the Performance Audit have been made available to management, they are confidential and subject to finalization. We expect the report to be released to the public during June 2010. While the results are not expected to impact policyholders' surplus as of December 31, 2009, there is an enhanced risk that the Performance Audit report could carry significant reputational, regulatory and political risk, such that the operations and surplus of Pinnacol could be significantly negatively impacted in future periods.

Triannual Fiscal Examination — The Division of Insurance has begun its triannual financial examination of Pinnacol. This examination covers the fiscal years ended 2007, 2008 and 2009 and will not be complete prior to the issuance of these financial statements.

PERA Liability — During March 2010 Pinnacol was informed that the obligation of Pinnacol for the unfunded portion of the PERA defined benefit plan that all Pinnacol employees — past, present and future — participate in is significantly underfunded as to past service cost. The estimated Pinnacol portion of this underfunding is in excess of \$75 million. In response to PERA's unfunded liability, Colorado enacted legislation during the recently adjourned session, SB 10-01, that provides for additional funding in future periods by increasing the current employer obligation of 13.85% of covered payroll to as much as 20.15% of covered payroll by 2017. As the increases are based upon various actuarial and investment assumptions, there can be no assurance that the 20.15% will be sufficient to fund the entire obligation.

These events have been evaluated through May 21, 2010, the date these financial statements were issued.

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements in Accordance With Government Auditing Standards

To the Members of the Legislative Audit Committee and Pinnacol Assurance Board of Directors:

We have audited the financial statements of Pinnacol Assurance (Pinnacol) as of and for the years ended December 31, 2009 and 2008, and have issued our report thereon dated May 21, 2010. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States of America.

Internal Control Over Financial Reporting

In planning and performing our audits, we considered Pinnacol's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the entity's internal control over financial reporting.

A *deficiency* in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statement that is more than inconsequential will not be prevented or detected by the entity's internal control.

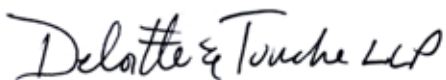
A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Pinnacol's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and the use of the members of the Legislative Audit Committee, the board of directors and management of Pinnacol, and state insurance departments to whose jurisdiction Pinnacol is subject, and is not intended to be and should not be used by anyone other than these specified parties.



May 21, 2010