Pinnacol Assurance

Statutory Financial Statements as of and for the
Years Ended December 31, 2009 and 2008,
Supplemental Schedules of Investment Information
as of and for the Year Ended December 31, 2009,
Comments on Internal Controls and Procedures, and
Independent Auditors' Report

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The enclosed report is being distributed to you at this time for your information in accordance with Colorado Revised Statutes (CRS).

SECTION 2-3-103 (2) states in part:

> All reports shall be open to public inspection except for that portion of any report containing recommendations, comments, and any narrative statements which is **released only upon the approval of a majority vote of the committee (emphasis supplied).**

SECTION 2-3-103.7 (1) states in part:

> Any state employee **or other individual acting in an oversight role as a member of a committee, board, or commission** who willfully and knowingly discloses the contents of any report prepared by, or at the direction of, the Office of the State Auditor prior to **the release of such report by a majority vote** of the committee as provided in Section 2-3-103 (2) is guilty of a misdemeanor and, upon conviction thereof, shall be punished by a fine of not more than five hundred dollars (emphasis supplied).

Deloitte & Touche LLP
Suite 3600
555 Seventeenth Street
Denver, CO 80202-3942
USA

Tel: +1 303 292 5400
Fax: +1 303 312-4000
www.deloitte.com

May 21, 2010

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

We have completed the financial audit of Pinnacol Assurance (Pinnacol) for the year ended December 31, 2009. Our audit was conducted 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. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S., which authorizes an annual audit of Pinnacol made by an auditor or firm of auditors, with the specialized knowledge and experience. The reports that we have issued as a result of this engagement are set forth in the table of contents, which follows.

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PINNACOL ASSURANCE

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PINNACOL ASSURANCE

REPORT SUMMARY

Authority and Purpose/Scope of the Audit

This audit was conducted under the authority of Section 8-45-121(2) of the Colorado Revised Statutes (C.R.S.), which authorizes an annual audit of Pinnacol Assurance (Pinnacol or the Company) made by an auditor or firm of auditors, having the specialized knowledge and experience, retained by the State Auditor with the consultation and advice of Pinnacol's Chief Executive Officer and the Commissioner of Insurance. The primary purpose of our engagement was to audit the statutory financial statements of Pinnacol at December 31, 2009, and for the year then ended, 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, and to express an opinion on those financial statements and the supplemental schedules of investment information. The objective of an audit conducted in accordance with such standards is to obtain reasonable, but not absolute, assurance about whether the statutory financial statements are free of material misstatement.

The financial statements of Pinnacol were prepared in accordance with statutory accounting principles prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (hereinafter referred to as statutory financial statements, or financial statements in accordance with statutory accounting principles). Accordingly, they are not designed to present, and do not present, the financial position or results of operations in accordance with accounting principles generally accepted in the United States of America.

We examined, on a test basis, evidence supporting the amounts and disclosures in Pinnacol's financial statements as of December 31, 2009. The accounting practices used by Pinnacol to prepare the financial statements are in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division).

Required Communications to the Legislative Audit Committee

In accordance with auditing standards generally accepted in the United States of America (AU Section 380), and the Statement of Auditing Standards (SAS) No. 114, *The Auditor's Communication with those charged with Governance*, as amended, we must communicate to the Legislative Audit Committee certain matters noted during our audit. The following sets forth these required communications:

Auditor's Responsibility under Professional Standards — The objective of a financial statement audit conducted in accordance with generally accepted auditing standards (GAAS) and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States (GAGAS) is to express an opinion on the fairness of the presentation of the Company's financial statements for the year ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America ("generally accepted accounting principles"), in all material respects. Our responsibilities under GAAS and GAGAS include forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of the Audit Committee, are presented fairly, in all material respects, in conformity with accounting principles prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado. The audit of the financial statements does not relieve management of its responsibilities.

We considered the Company's 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 do not express an opinion on the effectiveness of the Company's internal control over financial reporting. Our consideration of internal control over financial reporting was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses.

1. **Management Judgments and Accounting Estimates —** Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are ordinarily based on knowledge and experience about past and current events and on assumptions about future events. Critical accounting estimates reflected in the Company's 2009 financial statements include the following:

   Bonds and Common Stocks **—** Pinnacol must consider the statutory requirements related to other-than-temporary impairments when determining whether any declines in value are recognized through realized losses in the statutory statement of income or through change in unrealized losses, which is a direct charge to statutory surplus. These statutory requirements for other-than-temporary impairments ("OTTI") require management's judgment and consideration of various characteristics of the investments, the underlying causes of the decline in value, as well as management's intent related to future sales of the securities. The Company recorded $106,000 in other-than-temporary impairments on bonds and $900,000 in other-than-temporary impairments on common stocks and mutual funds for the year ended December 31, 2009.

   Reserve for Unpaid Losses and Loss Adjustment Expenses — Estimating the reserve for unpaid losses and loss adjustment expenses (reserves) of an insurance company is a subjective and judgmental process, particularly for workers' compensation insurance, where the ultimate liability to a claimant may not be known with certainty for a number of years. 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 $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 and prior. Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in 2009. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield.

   Other accounting estimates are as follows:

   Uncollected Premiums — The amount of uncollected premiums, which affects the amount of premium revenue recognized, is estimated using statutory requirements, as well as certain management judgments. Management must determine whether an allowance should be established to provide for all reasonably anticipated uncollectible amounts inherent in the uncollected premiums balance. Factors that are considered in establishing reserves for anticipated uncollectible amounts are collection experience and trends, current overall aging of balances, economic conditions and trends, and evaluations of individual accounts. At December 31, 2009, the admitted value of uncollected premiums as reflected in Pinnacol's financial statements is $27,088,000.

   Earned but Unbilled Premiums Receivable — Pinnacol estimates audit premium adjustments based on prior experience. This prior experience provides actual collection activity, which is then used in establishing estimated premium revenue in the current period related to audit adjustments, subject to current influences such as inflation and other factors. For 2009, net unbilled audit premiums receivable of $0 are included in uncollected premiums.

Association Dividends Payable to Policyholders — Pinnacol has an association dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. Based on the payment pattern for these dividends, management must estimate the future loss ratio for the policyholders in order to determine the accrual recorded at December 31, 2009. For 2009, association dividends payable of $8,000,000 are included in dividends payable to policyholders.

2. **Audit Adjustments and Uncorrected Misstatements** — As discussed in Note 8 of Pinnacol's financial statements, the statutory financial statements included herein contain differences from Pinnacol's Annual Statement as filed with the Division for the year ended December 31, 2009. The differences are due to an audit adjustment of $68,272,000 recorded in the 2008 financial statements to record declines in value of common stock investments as an other-than-temporary impairment charge to net income. These impairments were recorded in the Annual Statement in 2009.

   Our audit of the financial statements was designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. There were no uncorrected misstatements or disclosure items passed identified during our audit. In addition, there were no recorded adjustments as a result of our audits.

3. **Significant Accounting Policies and Alternative Treatments —** The Company's significant accounting policies are set forth in Note 1 to the Company's 2009 statutory financial statements. During the year ended December 31, 2009, there were no significant changes in previously adopted accounting policies or their application, except for the following:

   In 2009, the Company adopted the provisions of SSAP 43R *Loan-backed and Structured Securities,* which changes the calculation of the carrying value of loan-backed securities based on probability of cash flows, changes the evaluation of impairment for loan-backed securities, and expanded the disclosures.

4. **Other Information in Documents Containing Audited Financial Statements** — When audited financial statements are included in documents containing other unaudited information, we read such other information and consider whether it, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, in the financial statements audited by us. We have read the other information in the Company's report, and have inquired as to the methods of measurement and presentation of such information. We did not note any material inconsistencies or obtain knowledge of a material misstatement of fact in the other information.

5. **Disagreements with Management** — We have not had any disagreements with management related to matters that are material to the Company's 2009 financial statements.

6. **Consultation with Other Accountants** — We are not aware of any consultations that management may have had with other accountants about auditing and accounting matters during 2009.

7. **Significant Issues Discussed, or Subject of Correspondence, with Management Prior to Our Retention** — Throughout the year, routine discussions were held, or were the subject of correspondence, with management regarding the application of accounting principles or auditing standards in connection with transactions that have occurred, transactions that are contemplated, or reassessment of current circumstances. In our judgment, such discussions or correspondence were not held in connection with our retention as auditors.

8. **Management Representations** — We have made specific inquiries of the Company's management about the representations embodied in the statutory financial statements. Additionally, we have requested that management provide to us the written representations the Company is required to provide to its independent auditors under GAAS.

9. **Internal Control-Related Matters** — We have identified, and included in the Recommendation Locator and in the Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Statutory Financial Statements in Accordance with *Government Auditing Standards*, certain matters involving the Company's internal control over financial reporting that we consider to be control deficiencies under standards established by the American Institute of Certified Public Accountants.

   The definitions of a deficiency, a material weakness, and a significant deficiency are also set forth within the Findings and Recommendations section below.

10. **Independence** — Our professional standards and other regulatory requirements specify that we communicate to you in writing, at least annually, all independence-related relationships between our firm and Pinnacol and provide confirmation that we are independent accountants with respect to Pinnacol.

    We hereby confirm that as of May 21, 2010, we are independent accountants with respect to Pinnacol under all relevant professional and regulatory standards.

11. **Other Matters** — Deloitte & Touche LLP performed this audit under contract with the Office of the State Auditor and does not discuss accounting or auditing issues with Pinnacol in connection with our retention as auditor.

Summary of Audit Findings

Information Technology General Controls Policies — Pinnacol should improve its information technology general controls by:

1. Expanding and implementing control policies and procedures that require periodic reviews and documentation of user access rights. Actions taken should be properly documented and retained by Pinnacol.

2. Implementing the internal audit recommendation that, "direct write access to the databases housing production and/or sensitive business data should be restricted to appropriate users based on job responsibility." Pinnacol should restrict this access so that non-IT business users do not have elevated or administrative type rights within the database.

Transfer of Policyholder Receivable Data from WCIS to the General Ledger — Pinnacol should investigate the underlying cause of the variance between amounts in the WCIS system and the data uploaded through FTRS to the general ledger in order to ensure policyholder receivable balances are appropriately recorded and reported within the financial statements.

Processing of Structured Settlement Payments through WCIS — Pinnacol should establish a process and thoroughly test any new system to ensure payments are processed correctly prior to implementation. Additionally, Pinnacol should ensure internal controls are designed, implemented, and operating effectively at a sufficient level of detail to prevent incorrect structured settlement payments from being processed and issued through WCIS. Pinnacol should continue to investigate checks which may have been issued in error, as well as underlying causes of such errors within the system, and make adjustments or changes as appropriate.

WCIS Execution of Check Authority Levels — Pinnacol should implement a control or set of controls to detect when claim representatives exceed their check authority level prior to the issuance of multiple checks relating to the same claim. In addition, claim representatives should be required to receive authorization prior to exceeding their check authority level through the issuance of multiple checks which aggregate to an amount exceeding established check authority levels.

Review of Market Values Provided by the Investment Manager — Pinnacol should design and implement a formalized control whereby management reviews the market value of investments provided by the Investment Manager for reasonableness.

Formalization of Key Controls over Other-Than-Temporary Impairment of Investments ("OTTI") — Pinnacol should document a control or set of controls which define the current policy and processes in place related to the evaluation of other-than-temporary impairment of investments.

System Criteria to Track Written Premium — Pinnacol should develop, document and implement a formal process through which they are able to accurately track written premiums.

Summary of Pinnacol's Responses

A summary of the recommendations for the above comments is included in the Recommendation Locator on the next page. The Recommendation Locator also shows Pinnacol's responses to the audit recommendations. A discussion of the audit comments and recommendations is contained in the Finding and Recommendation Section of our report.

PINNACOL ASSURANCE

RECOMMENDATION LOCATOR
DECEMBER 31, 2009

Recommendation Locator

Recommendation Number	Page Number	Recommendation Summary	Pinnacol Response	Implementation Date
1	10	Pinnacol should improve its information technology general controls in the areas of user access rights and access to the databases housing production and/or sensitive business data.	Agree	Fourth quarter 2010
2	11	Pinnacol should investigate the underlying cause of the variance between amounts in the WCIS system and the data uploaded through FTRS to the general ledger in order to ensure policyholder receivable balances are appropriately recorded and reported within the financial statements.	Agree	Fourth quarter 2010
3	11	Pinnacol should establish a process and thoroughly test any new system to ensure payments are processed correctly prior to implementation. Internal controls should be designed, implemented, and operating effectively at a sufficient level of detail to prevent incorrect structured settlement payments from being processed and issued through WCIS.	Agree	Fourth quarter 2010

4	12	Pinnacol should implement a control or set of controls to prevent claim representatives from exceeding their check authority level through the issuance of multiple checks relating to the same claim.	Agree	Third quarter 2010
5	12	Pinnacol should design and implement a formalized control whereby management reviews the market value of investments provided by the Investment Manager for reasonableness.	Agree	Third quarter 2010
6	13	Pinnacol should document a control or set of controls which define the current policy and processes in place related to the evaluation of other-than-temporary impairment of investments.	Agree	Fourth quarter 2010
7	13	Pinnacol should develop, document and implement a formal process through which they are able to accurately track written premiums.	Agree	Fourth quarter 2010

PINNACOL ASSURANCE

DESCRIPTION OF PINNACOL ASSURANCE
DECEMBER 31, 2009

Pinnacol was established as a political subdivision of the State of Colorado under provisions of the Workers' Compensation Act of Colorado (Title 8, Article 45 of the Colorado Revised Statutes, as amended) to operate as a domestic mutual insurance company for the benefit of injured employees and dependents of deceased employees in Colorado. As required under state law, Pinnacol provides an assured source of workers' compensation insurance to Colorado employers. Pinnacol shall not refuse to insure any Colorado employer or cancel any insurance policy due to the risk of loss or amount of premium, except as otherwise provided in Title 8, Article 45, C.R.S., as amended.

Pinnacol is controlled by a nine-member board of directors, which is appointed by the Governor with the consent of the Colorado Senate. The board of directors has control over all monies of Pinnacol and is restricted to use such monies only for the purposes provided in Title 8, Article 45, C.R.S., as amended. The board of directors appoints a chief executive officer who is vested with full power and jurisdiction over the administration of Pinnacol. Pinnacol is not an agency of state government. The state retains no liability on the part of Pinnacol, beyond the amount of any Pinnacol surplus, and no state monies are used for Pinnacol operations. All revenues, monies, and assets of Pinnacol belong solely to Pinnacol. The State of Colorado has no claim to, nor any interest in, such revenues, monies, and assets and shall not borrow, appropriate, or direct payments from such revenues, monies, and assets for any purpose.

Policyholders' Surplus

Pinnacol had policyholders' surplus of $732,527,000 and $698,001,000 as of December 31, 2009 and 2008, respectively. The increase in surplus is primarily related to realized and unrealized gains on bonds and common stocks.

In 2009, Pinnacol issued $122,600,000 in general policyholder dividends to its policyholders in good standing. This is included in Dividends to Policyholders in the statutory statement of income and changes in policyholders' surplus and reduces net income for the year ended December 31, 2009. This accounting treatment is in accordance with statutory accounting practices. See further information at Note 1, General Policyholder Dividends.

Subsequent to December 31, 2010, as discussed in Note 9, the Company declared a general policyholder dividend of $47,500,000. This general dividend was paid in May 2010.

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 and correct misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

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.

We identified the following deficiencies involving the Pinnacol's internal control over financial reporting as of December 31, 2009:

Information Technology General Controls Policies

Internal controls over information technology ("general computer controls") are a key component of internal control over financial reporting. General computer controls are important as they impact the internal controls of all significant automated accounting and business processes of an organization such as Pinnacol. During testing of Pinnacol's information technology general controls and related policies, we noted the following:

1. The Workers Compensation Information System ("WCIS) is Pinnacol's claims processing application. As identified in the 2007 audit (reflected in the report of the predecessor auditor) and in our 2008 audit, Pinnacol's system administrators perform periodic reviews of WCIS's active users and user access rights to identify and remove inappropriate WCIS system access; however, the company's IT security policies do not require documentation of the WCIS reviews. By not documenting these WCIS reviews there is no written evidence that WCIS user access issues, if any, are being identified and resolved.

2. Pinnacol's Internal Audit function reported a number of findings related to the Information Management and Security processes. One specific finding was: *"Internal audit noted that per the Data and Network Services Manager, all users with WCIS access and a static IP address have access to update data directly in the PWCIS database."* Based on our understanding, a change was made in October 2009 to restrict the number of users who have access to update data directly in the PWCIS database. Despite the reduction in the number of business users with

access to the WCIS database, a significant number of business users continue to have direct access to the WCIS database. Direct database access is typically restricted to a very limited number of IT personnel (e.g. Database Administrators) who require such access to perform database production updates, troubleshooting, and database maintenance. A risk exists that business users may modify WCIS data directly in the database rather than through the WCIS application which reduces the integrity of the application and its security functionality. As one example, a user's rights may be restricted to transactions under a set dollar limit within the application; however, a direct database change may be performed that is inconsistent with the application security functionality. Application monitoring reports may not identify changes made directly in the database which increases the possibility for errors in processing WCIS data.

Recommendation #1

Pinnacol should improve its information technology general controls by:

1. Expanding and implementing control policies and procedures that require periodic reviews and documentation of user access rights. Actions taken should be properly documented and retained by Pinnacol.

2. Implementing the internal audit recommendation that, "direct write access to the databases housing production and/or sensitive business data should be restricted to appropriate users based on job responsibility." Pinnacol should restrict this access so that non-IT business users do not have elevated or administrative type rights within the database.

Pinnacol's Response

Agree. A project is underway to implement control policies and procedures that require periodic reviews and documentation of user access rights by December 31, 2010.

The users that have direct access to the database have been defined by job responsibilities and need this access to conduct Pinnacol business. Pinnacol will establish a mitigating control to log all financial transactions, and from this log produce and review reports showing potentially unusual transactions. Target completion date is September 30, 2010.

Transfer of Policyholder Receivable Data from WCIS to the General Ledger

Pinnacol has automated the recording of the monthly change in the policyholder receivable balances to the general ledger through a Financial Transaction Reporting System (FTRS) systematic journal entry. FTRS is an application which reports data directly from WCIS to the general ledger. Policyholder receivable balances per the general ledger are then reconciled to WCIS system detail through a manual reconciliation process. However, in Pinnacol's reconciliation of the general ledger to the system generated detail there is an unexplained amount that is out of balance. This unexplained balance varies month to month and can fluctuate between a debit or credit difference. In the current year the difference in the general ledger balance ranged from $10 thousand to $1.2 million less than the WCIS system detail. Historically the differences have not been material. Through the second quarter of 2009 Pinnacol staff manually recorded an entry to set the general ledger balance equal to system detail in order to adjust for the unreconciled difference. As of year end the difference remains as an unreconciled item. As Pinnacol cannot reconcile between activity recorded to the general ledger and the system detail, the recorded premiums receivable balance may not be accurate.

Recommendation # 2

Pinnacol should investigate the underlying cause of the variance between amounts in the WCIS system and the data uploaded through FTRS to the general ledger in order to ensure policyholder receivable balances are appropriately recorded and reported within the financial statements.

Pinnacol's Response

Agree. Pinnacol will research and document transaction types that flow through FTRS to the policyholder receivable accounts and then compare these to the components within the policy balances report to determine variances. Once the variances are identified, they will be reviewed and appropriate changes will be made to ensure the ledger and report agree and are properly presented within the statutory financial statements. The target completion date for this project is December 31, 2010.

Processing of Structured Settlement Payments through WCIS

During 2009, Pinnacol implemented a new automated process through WCIS to issue structured settlement payments to claimants. Due to the nature and complexity of structured settlement payments, the automated WCIS process did not issue correct payments. For example, when Pinnacol staff modified a structured settlement agreement the changes were not appropriately reflected in the system and required significant manual intervention to produce correct payments. The system programming failures resulted in the issuance of some incorrect payments. Pinnacol staff ran the manual process of issuing structured settlement checks parallel with WCIS; therefore Pinnacol was able to identify certain inaccurate payments but may not have identified all. However Pinnacol was unable to identify the cause of the errors and did not have formal controls which were appropriately designed, implemented and operating effectively at an appropriate level of detail to ensure that the system worked properly prior to implementation. In addition, Pinnacol did not have controls in place at an appropriate level of detail to verify that all checks issued were accurate and appropriately handled.

Recommendation # 3

Pinnacol should establish a process and thoroughly test any new system to ensure payments are processed correctly prior to implementation. Additionally, Pinnacol should ensure internal controls are designed, implemented, and operating effectively at a sufficient level of detail to prevent incorrect structured settlement payments from being processed and issued through WCIS. Pinnacol should continue to investigate checks which may have been issued in error, as well as underlying causes of such errors within the system, and make adjustments or changes as appropriate.

Pinnacol's Response

Agree. A project is underway to identify and resolve the control issues associated with the processing of structured settlements through the automated system implemented in 2009. This project includes a reconciliation of checks issued. The target completion date for this project is December 31, 2010.

WCIS Execution of Check Authority Levels

Pinnacol has implemented check authority levels which are assigned to claims representatives based on employee type. Authority levels for claims representatives are only implemented at the individual check level within WCIS, and not for total payments at the claim level. This provides the opportunity for claims representatives to surpass check authority levels through the issuance of multiple checks for amounts which are individually under their authority level. Pinnacol has quality control processes in place which would likely identify total payments in excess of a claim representative's total authority level. However the excess would be identified subsequent to the issuance of such checks, and Pinnacol does not have a formal process in place to prevent such activity.

Recommendation # 4

Pinnacol should implement a control or set of controls to detect when claim representatives exceed their check authority level prior to the issuance of multiple checks relating to the same claim. In addition, claim representatives should be required to receive authorization prior to exceeding their check authority level through the issuance of multiple checks which aggregate to an amount exceeding established check authority levels.

Pinnacol's Response

Agree. Pinnacol will establish a system check to prevent claim representatives from issuing multiple checks on a single claim during a window of time that exceeds their payment authorization limits. The target completion date for this project is September 30, 2010.

Review of market values provided by the investment manager

In accordance with Statements of Statutory Accounting Principle ("SSAP") No. 26, *Bonds, excluding Loan-backed and Structured Securities*, Pinnacol records bonds with NAIC designations 3 to 6 at the lower of amortized cost or fair value. In accordance with SSAP No. 30, *Investments in Common Stocks*, Pinnacol records common stock at fair value. Investment market values are recorded based on values provided by the asset manager. Pinnacol management does not have a formal process in place to review the reasonableness of investment market values provided to Pinnacol by their investment manager. Therefore, the valuation of investments on Pinnacol's books may not be accurate.

Recommendation # 5

Pinnacol should design and implement a formalized control whereby management reviews the market value of investments provided by the Investment Manager for reasonableness.

Pinnacol's Response.

Agree. Pinnacol will establish a control to review the market value of investments provided by the Asset Manager as of September 30, 2010. It is important to note that Pinnacol's asset manager is subject to a quality assurance review referred to as a SAS 70 Type II review. During this process, an audit firm tests the effectiveness of the asset manager's valuation controls. Pinnacol reviews the SAS 70 report on an annual basis to assure the asset manager's valuation controls are reliable. Pinnacol is not aware of any errors in the valuation of our investments.

Formalization of Key Controls over Other-Than-Temporary Impairment of Investments ("OTTI")

In preparation for control certifications that management of Pinnacol may be required to make in accordance with the Model Audit Rule, Pinnacol implemented the True Integrity Documented Everywhere, "TIDE," initiative to document its internal controls. During 2010, Pinnacol developed a formal other-than-temporary impairments (OTTI) policy to evaluate bonds and stocks and determine amounts to be recorded as other-than-temporary impairments. This OTTI policy has been formally documented and implemented in the current year; however the review process, as defined by the OTTI policy, has not been incorporated into the "TIDE" internal control documentation and processes as a formal control or set of controls.

Recommendation # 6

Pinnacol should document a control or set of controls which define the current policy and processes in place related to the evaluation of other-than-temporary impairment of investments.

Pinnacol's Response.

Agree. Pinnacol will incorporate the OTTI controls into the TIDE internal control documentation by December 31, 2010. Pinnacol is not currently subject to the Model Audit Rule requirements and is performing the TIDE program voluntarily.

System Criteria to Track Written Premium

Written premium is required to be disclosed in Pinnacol's financial statements. Pinnacol calculates written premium as the sum of current year earned premium and current year change in unearned premium, as WCIS is not programmed to track actual written premium. This approach could result in the disclosure of incorrect written premium if the calculation or components within the calculation are inaccurate, as Pinnacol does not have a formal process developed, documented and implemented to track written premium.

Recommendation # 7

Pinnacol should develop, document and implement a formal process through which they are able to accurately track written premiums.

Pinnacol's Response.

Agree. Pinnacol will explore system enhancements to facilitate the accurate reporting of written premium by December 31, 2010.

Disposition of Prior Audit Recommendation

The audit report issued by Deloitte & Touche LLP for the year ended December 31, 2008 included four recommendations. Our observations on the status of these audit recommendations are as follows:

Recommendation	Disposition
Pinnacol should enhance its process of evaluating the technical accounting guidance and evolving practices related to other-than-temporary impairments, as well as documenting its analysis of potential other-than-temporary impairments related to its investments.	Implemented in 2009.
Pinnacol should enhance its information technology controls by expanding and implementing control policies and procedures related to the following:	
a. Periodic reviews of user access rights and actions taken should be properly documented and retained by Pinnacol.	a. Partially Implemented in 2009 - As of December 31, 2009, user access rights for the WCIS application were not periodically reviewed; See Recommendation #1.
b. Monitoring controls should be developed to identify unauthorized changes to the Oracle database underlying the Lawson application.	b. Implemented in 2009.
c. System activity logging and monitoring controls related to the Novell network and the Oracle database underlying the Lawson application should be evaluated to determine which should be enabled. Once enabled, the system administrators should develop and implement procedures for review.	c. Implemented in 2009.
Pinnacol should develop and implement a formal process for reviewing and evaluating the SAS 70 reports for Wells Fargo Trust Operations, Automatic Data Processing, Inc., and Concur Technologies, Inc.	Implemented in 2009.

This process should include Pinnacol's related control environments and the applicable user control considerations.

Recommendation	Disposition
Pinnacol should develop a process for analyzing credit balances within accounts receivable for right of setoff, in order to ensure proper presentation within the statutory financial statements.	Implemented in 2009.

Deloitte.

Deloitte & Touche LLP
Suite 3600
555 Seventeenth Street
Denver, CO 80202-3942
USA

Tel: +1 303 292 5400
Fax: +1 303 312-4000
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance (the "Company") as of December 31, 2009 and 2008, and the related statutory statements of income, changes in policyholders' surplus, and cash flow 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 audits provide a reasonable basis for our opinion.

As more fully described in Note 1 to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, and such practices differ from accounting principles generally accepted in the United States of America. The effects on such financial statements of the differences between the statutory basis of accounting and accounting principles generally accepted in the United States of America are also described in Note 1.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Pinnacol Assurance as of December 31, 2009 and 2008, or the results of its operations or its cash flows for the years then ended.

However, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance as of December 31, 2009 and 2008, and the results of its operations and its cash flows for the year then ended, on the basis of accounting described in Note 1.

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 and regulations 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 and 2008 audits.

Our 2009 audit was conducted for the purpose of forming an opinion on the basic 2009 statutory financial statements taken as a whole. The supplemental schedules of investment information as of and for the year ended December 31, 2009 are presented for purposes of additional analysis and are not a required part of the basic 2009 statutory financial statements. These schedules are the responsibility of the Company's management. Such schedules have been subjected to the auditing procedures applied in our audit of the basic 2009 statutory-basis financial statements. The effects on these schedules of the differences between the statutory basis of accounting and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material. Accordingly, in our opinion, such schedules do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the information shown therein. However, in our opinion, such schedules are fairly stated in all material respects when considered in relation to the basic 2009 statutory financial statements taken as a whole.

Deloitte & Touche LLP

May 21, 2010

STATUTORY STATEMENTS OF ADMITTED ASSETS, LIABILITIES, AND POLICYHOLDERS' SURPLUS
AS OF DECEMBER 31, 2009 AND 2008
(In thousands)

	2009	2008
ADMITTED ASSETS		
CASH AND INVESTED ASSETS:		
Bonds at adjusted carrying value, fair value of $1,706,783 in 2009 and $1,744,613 in 2008 (Note 3)	$1,615,972	$1,692,948
Common stock at fair value, adjusted cost of $212,205 in 2009 and $186,702 in 2008 (Note 3)	268,236	189,062
Real estate at cost — net of accumulated depreciation of $6,332 in 2009 and $5,289 in 2008	21,589	22,343
Cash, cash equivalents and short-term investments	63,556	111,674
Total cash and invested assets	1,969,353	2,016,027
UNCOLLECTED PREMIUMS — Net of allowance	27,088	54,694
ELECTRONIC DATA PROCESSING EQUIPMENT — At cost — net of accumulated depreciation of $4,503 in 2009 $5,272 in 2008	1,898	820
ACCRUED INVESTMENT INCOME	18,328	18,560
TOTAL ADMITTED ASSETS	$2,016,667	$2,090,101
LIABILITIES AND POLICYHOLDERS' SURPLUS		
RESERVE FOR 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 reserve for unpaid losses and loss adjustment expenses	1,149,138	1,223,160
OTHER LIABILITIES	34,663	43,899
UNEARNED PREMIUMS	57,596	70,711
ADVANCE PREMIUMS	14,242	15,357
DIVIDENDS PAYABLE TO POLICYHOLDERS	20,276	29,957
CREDIT BALANCES DUE POLICYHOLDERS	8,225	9,016
Total liabilities	1,284,140	1,392,100
COMMITMENTS AND CONTINGENCIES (Notes 2, 6, 7, and 9)		
POLICYHOLDERS' SURPLUS (Note 6)	732,527	698,001
TOTAL LIABILITIES AND POLICYHOLDERS' SURPLUS	$2,016,667	$2,090,101

See notes to statutory financial statements.

PINNACOL ASSURANCE

STATUTORY STATEMENTS OF INCOME AND CHANGES IN POLICYHOLDERS' SURPLUS FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008 (In thousands)

	2009	2008
UNDERWRITING INCOME:		
Premiums earned (Note 5)	$ 398,502	$ 521,082
Deductions:		
Losses incurred (Note 2 and 5)	255,523	274,076
Loss adjustment expenses incurred (Note 2 and 5)	34,543	66,841
Other underwriting expenses incurred	113,957	124,041
Total underwriting deductions	404,023	464,958
Net underwriting gain (loss)	(5,521)	56,124
INVESTMENT INCOME:		
Net investment income earned	94,402	98,433
Net realized capital gain (loss)	4,773	(56,527)
Total investment income	99,175	41,906
OTHER INCOME (LOSS):		
(Provision) for uncollectible premiums	(1,252)	(2,122)
Other income	1,480	396
Dividends to policyholders	(116,841)	(78,557)
NET (LOSS) INCOME	(22,959)	17,747
CHANGE IN NONADMITTED ASSETS	2,601	(342)
CHANGE IN NET UNREALIZED GAIN (LOSS) ON INVESTMENTS	54,884	(41,806)
CHANGE IN PROVISION FOR REINSURANCE	-	330
POLICYHOLDERS' SURPLUS — Beginning of year	698,001	722,072
POLICYHOLDERS' SURPLUS — End of year	$ 732,527	$ 698,001

See notes to statutory financial statements.

PINNACOL ASSURANCE

STATUTORY STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008
(In thousands)

	2009	2008
CASH FLOWS FROM OPERATIONS:		
Premiums collected — net of reinsurance	$ 415,990	$ 521,808
Losses and loss adjustment expenses paid — net of reinsurance and deductibles	(364,088)	(371,621)
Underwriting expenses paid	(124,652)	(126,385)
Dividends paid to policyholders	(126,523)	(61,943)
Investment income received, net of investment expenses paid	95,199	96,511
Net amount withheld or retained for account of others	228	(1,725)
Net cash provided (used) by operations	(103,846)	56,645
CASH FLOWS FROM INVESTMENTS:		
Proceeds from sale or redemption of investments	311,023	371,859
Purchase of investments	(253,375)	(411,941)
Net cash provided (used) in investments	57,648	(40,082)
CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES — Cash (used) by other miscellaneous sources	(1,920)	(1,588)
NET INCREASE (DECREASE) IN CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS	(48,118)	14,975
CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS — Beginning of year	111,674	96,699
CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS — End of year	$ 63,556	$ 111,674

See notes to statutory financial statements.

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** — The accompanying financial statements of Pinnacol have been prepared in accordance with accounting practices prescribed or permitted by The Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division). Prescribed statutory accounting practices (SAP) are those practices that are incorporated directly or by reference to state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. Colorado has adopted the National Association of Insurance Commissioners' (NAIC) statutory accounting practices, which are codified in the NAIC's *Accounting Practices and Procedures Manual* (the Manual). Therefore, compliance with the Manual is a prescribed accounting practice. In the preparation of the accompanying statutory financial statements, the Company has followed NAIC guidelines and has not utilized any practices which are considered to be permitted practices.

Statutory accounting practices contained in the Manual vary in some respects from accounting principles generally accepted in the United States of America (GAAP). The more significant statutory practices include:

Investments — For SAP, investments in bonds are reported at amortized cost or market value based on their NAIC rating; for GAAP, held-to-maturity investments are recorded at amortized cost and available-for-sale and held-for-trading investments are recorded at fair value. For SAP, common stock is valued based on quotations published by the Securities Valuation Office (SVO) of the NAIC, while under GAAP, common stocks are reported at market value. For SAP, real estate owned and occupied by Pinnacol is included in investments rather than reported as a capital asset as under GAAP.

Policy Acquisition Costs — For SAP the costs of acquiring and renewing business are expensed when incurred. Under GAAP, such costs, to the extent recoverable, are deferred and amortized over the effective period of the related insurance policies.

Nonadmitted Assets — Certain assets designated as "nonadmitted," principally past due premiums receivable, furniture and equipment, and other assets not specifically identified as an admitted asset within the Manual, are excluded from the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus and are charged directly to policyholders' surplus. Under GAAP, such assets are included in the balance sheets at their net realizable value.

The effects of the foregoing variances from GAAP on the statutory financial statements at December 31, 2009 and 2008 and for the years then ended have been determined and are as follows (in thousands):

	2009	2008
Statutory policyholders' surplus	$ 732,527	$ 698,001
Nonadmitted assets	10,645	13,246
Policy acquisition costs — net of amortization	7,339	10,393
Net unrealized gain (loss) on bonds	90,811	51,664
GAAP net assets	$ 841,322	$ 773,304
Statutory net income (loss)	$ (22,959)	$ 17,747
Policy acquisition costs — net of amortization	(3,054)	(815)
Change in fair value of investments	100,652	(82,867)
Other-than-temporary impairments recognized	1,006	68,271
Realized gain on sale of impaired securities	(7,627)	-
Change in provision for reinsurance	-	330
GAAP changes in policyholders' surplus (net assets)	$ 68,018	$ 2,666

(c) **Use of Estimates** — The preparation of statutory financial statements in accordance with accounting practices prescribed by the Division 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 statutory 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 premiums 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) **Investments** — Investments are recorded on the trade date and are carried in accordance with the valuations prescribed by the SVO of the NAIC. Bonds are stated at amortized cost or market value based on their NAIC rating and are adjusted for other-than-temporary declines in fair value.

Common stocks and mutual funds are carried at fair value. Unrealized capital gains on common stocks and mutual funds are reported as a direct adjustment to policyholders' surplus. Common stocks and mutual funds in an unrealized loss position for the years ended December 31, 2009 and 2008 are recorded as other-than-temporarily impaired and are recorded as a realized loss in the statutory statement of income in the period in which they occur.

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. Bonds containing call provisions are amortized to the call or maturity value or date that produces the lowest asset value.

Gains and losses on investments sold are realized in operations and are computed using the specific-identification method.

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. 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.

Real estate includes 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 cost of the building and capitalized improvements is depreciated over an estimated useful life of 30 years using the straight-line method. Depreciation expense was approximately $1,043,000 and $935,000 for the years ended December 31, 2009 and 2008 respectively.

(e) **Cash, Cash Equivalents and Short-Term Investments and Other Invested Assets** — For purposes of the statement of cash flows, cash, cash equivalents and short-term investments include cash on deposit, money market funds, and other investments with maturities of one year or less at the date of acquisition.

As of December 31, 2009, cash, cash equivalents and short-term investments of approximately $63,556,000 include $(11,687,000) of book overdrafts, $0 of cash equivalents, and $75,243,000 of short-term investments. As of December 31, 2008, cash, cash equivalents and short-term investments of approximately $111,674,000 include $(18,189,000) of book overdrafts, $24,989,000 of cash equivalents, and $104,874,000 of short-term investments. In the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus, Pinnacol has recorded checks that have been issued, but not presented for payment, as a reduction of cash and cash equivalents.

(f) **Uncollected Premiums** — Uncollected premiums are reported net of allowances for uncollectible and nonadmitted balances. Certain receivables are not admissible for statutory accounting purposes.

Receivables for canceled policies and billed receivables that have been outstanding for a period exceeding 90 days are not admissible according to the Manual. Pinnacol independently estimates the realizable amounts of premiums receivable and nonadmits uncollectible premiums for the difference between the gross receivable amount and the estimate of the amount to be ultimately realized. Pinnacol also nonadmits receivables for the amount by which nonadmissible receivables, as defined above, exceed the estimate of uncollectible receivables.

During 2009 and 2008, Pinnacol recorded a provision 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 provision for uncollectible premiums in the accompanying statutory statements of income and changes in policyholders' surplus.

A significant portion of Pinnacol's premium 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.

(g) **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, Pinnacol did not show any estimated unbilled audit premium receivable in 2009. 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 $13,350,000, and was included as uncollected premiums on the statutory statement of admitted assets, liabilities, and policyholders' surplus. This estimated receivable was reduced by 10%, where applicable, to comply with the Manual.

(h) **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.

(i) **Electronic Data Processing Equipment** — Electronic data processing equipment is recorded at cost, less accumulated depreciation, and depreciated on a straight-line basis over an estimated useful life of three years. Net book value of these assets at December 31, 2009 and 2008 was approximately $1,898,000 and $820,000, respectively. Related depreciation expense of approximately $927,000 and $1,013,000 was incurred during 2009 and 2008, respectively, and is included in other underwriting expenses incurred in the statements of income and changes in policyholders' surplus.

(j) **Art, Office Furniture and Equipment, and Software** — Art, office furniture and equipment, and software are recorded at cost and depreciated on a straight-line basis. Art and office furniture and equipment are depreciated over an estimated useful life of five years. Software is depreciated over an estimated useful life of three years. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2009 and 2008 was approximately $2,986,000 and $2,800,000, respectively. Related depreciation expense of approximately $1,327,000 and $934,000 was incurred in 2009 and 2008, respectively and is included in other underwriting expenses incurred in the statements of income and changes in policyholders' surplus.

(k) **Other Assets** — At December 31, 2009 and 2008, Pinnacol had prepaid assets and deposits totaling approximately $3,890,000 and $3,186,000, respectively. In accordance with the Manual, these are nonadmitted assets.

(l) **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 of 2009 and 2008, respectively. This is included in dividends to policyholders in the statutory statement of income and changes in policyholders' surplus and reduces net income for the years ended December 31, 2009 and 2008.

(m) **Association Dividend Program** — Pinnacol has an association dividend program whereby 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. For 2009 and 2008, association dividends payable of $8,000,000 and $18,000,000 respectively are included in dividends payable to policyholders. 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 in the statutory statements of income and changes in policyholders' surplus.

(n) **Revenue Recognition** — Premium revenue is recognized using the daily pro rata method over the period the policy is effective.

(o) **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. The reserve for unpaid losses and loss adjustment expenses is estimated by management, which uses an independent third-party actuary to provide estimates 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 reserve for unpaid losses and loss adjustment expenses is adequate. These estimates are continually reviewed and adjusted, as necessary, as experience develops or new information becomes known; such adjustments are included in losses incurred or loss adjustment expenses incurred within the statutory statements of income and changes in policyholders' surplus in the period such information becomes known.

Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in 2009 and 2008. The discount rate used to calculate present value is based on an industry standard rate.

(p) **Unearned Premiums** — Unearned premiums represent amounts either collected or billed and due from policyholders at December 31 but unearned at that date as they pertain to subsequent policy periods. 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 when collections are received.

(r) **Reinsurance** — Ceded reinsurance transactions are accounted for based on estimates of their ultimate cost. Losses incurred, loss adjustment expenses incurred, and the reserve for loss adjustment expenses are reported net of reinsured amounts in accordance with the Manual. Reinsurance premiums are reflected as a reduction of premiums earned (see Note 5).

(s) **Taxes** — As a political subdivision of the State of Colorado, Pinnacol is not subject to Federal or State income taxes under a specific exemption granted under Section 501(c) of the Internal Revenue Code; nor is Pinnacol 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. However, Pinnacol is subject to a surcharge on premiums pursuant to Section 8-44-112(1)(s), C.R.S. The surcharge is based on a rate established annually, approximately 3.618% for 2009 and 3.818% for 2008. Such amounts are included in other underwriting expenses incurred.

(t) Employee Benefits

Defined Benefit Pension Plan through the State of Colorado

Plan Description — All of Pinnacol's 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 PO Box 5800, Denver, Colorado 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 5 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 5 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 5 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 5 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 5 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 (HAS). 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 1 percentage point of salaries contributed by employers for employees hired on or after January 1, 2007.)

Members who are disabled, 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, their eligible children under the age of 18 (23 if a full time student) or their 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 salary, 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. During all of 2009, 1.02 percent of the employees' 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 requires PERA employers to pay an additional .5 percent of salary beginning January 1, 2006, another .5 percent of salary in 2007, and subsequent year increases of .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 employee's 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 year 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 PO Box 5800, Denver, Colorado 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.

Accrued Paid Leave — Pinnacol employees may accrue paid time off based on their length of service subject to certain limitations on the amount that will be paid upon termination or taken in future periods. 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 statutory statements of admitted assets, liabilities and policyholders' surplus.

(u) Application of Recent Statutory Accounting Pronouncements

In September 2009, the NAIC issued Statement of Statutory Accounting Principle No. 43R, "Loan-backed and Structured Securities" (SSAP 43R). SSAP 43R changes the calculation of the carrying value of loan-backed securities based on probability of cash flows. In addition, it changes the standards used to evaluate impairment of a loan-backed security, making it more likely that a security will incur an other-than-temporary impairment. Finally, the required disclosures for loan-backed securities have been expanded. SSAP 43R is effective September 30, 2009. The Company adopted SSAP 43R for its fiscal quarter ended September 30, 2009. The adoption of SSAP 43R did not have an impact on the Company's consolidated financial position or the results of its operations.

In December 2009, the NAIC issued Statement of Statutory Accounting Principle No. 100, "Fair Value Measurements" (SSAP 100). SSAP 100 adopts the majority of FASB Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157), which, effective July 1, 2009, was superseded and replaced by certain provisions of ASC topic 820, "Fair Value Measurements and Disclosures" (ASC topic 820). SSAP 100 changes the valuation methods of assets and liabilities that are required or permitted to be carried at fair value. In addition, SSAP 100 adds disclosure requirements for assets and liabilities carried at fair value. SSAP 100 is effective December 31, 2010 with early adoption permitted for December 31, 2009. The Company adopted SSAP 100 for its fiscal year ended December 31, 2009. The adoption of SSAP 100 did not have a material impact on the Company's consolidated financial position or the results of its operations.

In 2009, the NAIC modified Statement of Statutory Accounting Principle No. 9, "Subsequent Events" (SSAP 9). This modification adopted FASB 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. The modification to SSAP 9 is effective for years ending on or after December 31, 2009. The Company adopted the modifications to SSAP 9 for its fiscal year ended December 31, 2009. The adoption of the modifications to SSAP 9 did not have an impact on the Company's consolidated financial position or the results of its operations.

(v) Reclassification

A reclassification was made in the 2008 statutory statement of admitted assets, liabilities and policyholders' surplus to conform to the 2009 presentation. Advance premiums, which in 2009 are presented separately, were included in unearned premiums in 2008. This reclassification had no effect on previously reported net income, total admitted assets or total policyholders' surplus.

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 net 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 incurred or loss adjustment expenses incurred within the statutory statements of income and changes in policyholders' surplus 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 the time 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 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 workers' compensation payments. Such losses have been discounted on a tabular basis using a discount rate of 3.5% in 2009 and 2008. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield.

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	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	46,160
Total	$ 151,841

Unpaid Losses and Loss Adjustment Expense — 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 in 2009 and 2008 is summarized as follows (in thousands):

	Unpaid Losses and Loss Adjustment Expenses	
	2009	**2008**
Balance — January 1	$1,223,160	$1,253,864
Additional amounts incurred related to:		
Current year	390,369	499,922
Prior years	(100,303)	(159,005)
Total incurred	290,066	340,917
Reductions relating to payments for:		
Current year	115,058	168,403
Prior years	249,030	203,218
Total paid	364,088	371,621
Balance at December 31	$1,149,138	$1,223,160

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 was 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

Estimated fair value of investments in bonds is based on quotations published by the SVO of the NAIC. However, for certain investments, the SVO does not provide a fair market value. For those investments, the quoted market value prices as provided by accepted external pricing vendors may be used as a substitute for the SVO market price. In both 2009 and 2008, Interactive Data Corporation (IDC) and broker quotes were used to obtain fair market values.

The SVO of the NAIC designates ratings of bonds from 1 to 6. Bonds with ratings of 1–2 are stated at amortized cost using the effective interest method. Bonds with ratings of 3–6 require the bond to be carried at the lower of amortized cost or market, with any related unrealized loss reported in policyholders' surplus.

During 2009, Pinnacol had investments in bonds where the SVO designated the bonds at a 3 or higher rating. At December 31, 2009, the fair market value on these bonds was greater than, or equal to, amortized cost, which resulted in a cumulative unrealized loss of $0 and carrying values equal to amortized cost for these bonds. During 2008, Pinnacol had an investment in a bond where the SVO designated the bond at a 5 rating. At December 31, 2008, the fair market value on this bond was lower than amortized cost, which resulted in a cumulative unrealized loss of approximately $1,214,000 of which $158,000 was reported in policyholders' surplus during 2008. During 2009, this bond was sold, resulting in a recovery in policyholders' surplus of approximately $1,214,000.

The book/adjusted carrying value and the fair value of investments in bonds in 2009 and 2008 are summarized as follows (in thousands):

	2009			
	Book/Adjusted Carrying Value	**Gross Unrealized Gains**	**Gross 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	-	-	-	-
	$ 1,615,972	$ 96,037	$ (5,226)	$ 1,706,783

	2008			
	Book/Adjusted Carrying Value	**Gross Unrealized Gains**	**Gross 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	4,985	439	-	5,424
Loan-backed bonds	-	-	-	-
Industrial and miscellaneous:				
Non-loan-backed bonds	945,634	28,363	(30,927)	943,070
Loan-backed bonds	-	-	-	-
	$ 1,692,948	$ 82,592	$ (30,927)	$ 1,744,613

The book/adjusted carrying value and estimated fair value of investments in bonds at December 31, 2009, by contractual maturity, are shown in the following table. 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 the borrower may have the right to call or prepay obligations with or without call or prepayment penalties.

	Book/Adjusted Carrying Value	**Fair value**
	(In thousands)	
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	553,620	577,744
	$ 1,615,972	$ 1,706,783

Proceeds from sales of investments in bonds during 2009 and 2008 were approximately $296,143,000 and $340,802,000, respectively. Realized gains of approximately $10,384,000 and $14,892,000 and realized losses of approximately $4,871,000 and $85,000 were recognized during 2009 and 2008, respectively. Realized losses include approximately $106,000 and $0 in other-than-temporary losses recognized during the years ended December 31, 2009 and 2008, respectively.

Unrealized gains on investments in common stocks and mutual funds are reported directly in policyholders' surplus. Equities in an unrealized loss position are deemed to be other-than-temporarily impaired, with the resulting loss recognized in the statement of income. Other-than-temporary impairments of common stocks and mutual funds result in the establishment of a new, adjusted cost basis for such investments. The original cost, adjusted cost, gross unrealized gains (measured against adjusted cost), and fair value of common stocks and mutual funds are summarized as follows (in thousands):

	Original Cost	Adjusted Cost	Unrealized Gains	Fair value
December 31, 2009	$ 273,750	$ 212,205	$ 56,031	$ 268,236
December 31, 2008	254,973	186,702	2,360	189,062

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

	Less than 12 months		12 months or greater		Total	
Description of Securities	Fair value	Unrealized Losses	Fair value	Unrealized Losses	Fair value	Unrealized Losses
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	12,156	(52)	-	-	12,156	(52)
Total	$ 73,973	$ (4,373)	$ 11,077	$ (853)	$ 85,050	$ (5,226)

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

	Less than 12 months		12 months or greater		Total	
Description of Securities	Fair value	Unrealized Losses	Fair value	Unrealized Losses	Fair value	Unrealized Losses
Industrial and miscellaneous	$255,588	$ (17,702)	$ 70,345	$ (11,802)	$325,933	$ (29,504)
Public utilities	35,213	(719)	8,013	(405)	43,226	(1,124)
Mortgage-backed securities	6,249	(299)	-	-	6,249	(299)
Total	$297,050	$ (18,720)	$ 78,358	$ (12,207)	$375,408	$ (30,927)

There were 6 and 63 bonds in an unrealized loss position as of December 31, 2009 and 2008, respectively.

Impairment of Bonds — The Company writes securities down to fair value that it deems to be other-than-temporarily impaired in the period the securities are deemed to be so impaired. The Company records write-downs as realized capital losses and adjusts the cost basis of the securities accordingly. The Company does not adjust the revised cost basis for subsequent recoveries in value.

The assessment of whether an other-than-temporary impairment has occurred is based upon management's case-by-case evaluation of the underlying reasons for the decline in fair value. Management considers a wide range of factors, as described below, regarding the security issuer and uses its best judgment in evaluating the cause of the decline in its estimated fair value and in assessing the prospects for near-term recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations and future earnings potential of the issuer.

Considerations used by the Company in the impairment evaluation process include, but are not limited to, the following:

- Fair value is significantly below cost.
- The decline in fair value is attributable to specific adverse conditions affecting a particular instrument, its issuer, an industry or geographic area.
- The decline in fair value has existed for an extended period of time.
- A debt security has been downgraded by a credit rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated or scheduled interest payments have not been made.
- The ability and intent to hold investments until recovery, including consideration of the investment manager's discretion to sell securities.

While all available information is taken into account, it is difficult to predict the ultimate recoverable amount from a distressed or impaired security.

Bonds — At December 31, 2009 and 2008, less than 1% and 2%, respectively, of bonds held by the Company were rated non-investment grade. At December 31, 2009 and 2008, the Company had approximately $904,000 and $29,504,000, respectively, of unrealized losses related to its industrial and miscellaneous bonds. The Company does not have any significant concentrations by issuer or by sector. The unrealized losses on the securities are primarily attributable to fluctuations in market interest rates and changes in credit spreads since the securities were acquired.

Loan-Backed-Securities — Loan-backed securities are stated at amortized cost or market value based on their NAIC designation. The prospective method is used to value mortgage-backed securities. Prepayment assumptions for single class and multi-class mortgage-backed/asset-backed securities were obtained from Yield Book and Bloomberg. Pinnacol did not recognize any other-than-temporary impairments on loan-backed securities during the years ended December 31, 2009 or 2008. All loan-backed and structured securities in an unrealized loss position were reviewed to determine whether an other-than-temporary impairment should be recognized. There was one multi-class residential mortgage-backed security in an unrealized loss position as of December 31, 2009 and the Company has not made a decision to sell the security. The Company has evaluated its cash flow requirements and believes that its liquidity is adequate and it will not be required to sell this security before recovery of its cost basis. As of December 31, 2009, this security had been in an unrealized loss position for one month and had unrealized losses of approximately $52,000 and fair value of approximately $12,156,000. The conclusion that this loss is temporary is supported by the length of time the security has been in an unrealized loss position, as well as the dollar amount of the unrealized loss. It is possible the Company could recognize other-than-temporary impairments in the future on this security held at December 31, 2009 if future events, information, and the passage of time, causes it to conclude that declines in fair value are other-than-temporary.

Other-Than-Temporary Impairment — During 2009, Pinnacol recognized approximately $106,000 in other-than-temporary impairments on bonds. The Company did not record other-than-temporary impairments on bonds during the year ended December 31, 2008. During the years ended December 31, 2009 and 2008, the Company recorded other-than-temporary impairments on common stocks and mutual funds in the amounts of approximately $900,000 and $68,272,000, respectively. These impairments relate to market declines in value as of the last day of the year.

Fair Value Measurements — The Company's assets 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 that the Company has the ability to access. Financial assets 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, either directly or indirectly. Level 2 inputs include quoted prices for similar assets in active markets, and inputs other than quoted prices that are observable for the asset, 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.

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.

The following table presents (in thousands) information about the Company's financial assets measured at fair value on a recurring basis for accounting 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:

	Fair Value Measurements - Recurring Basis December 31, 2009			
Assets	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total**
Common stocks and mutual funds	$ 268,236	$ -	$ -	$ 268,236
Total assets	$ 268,236	$ -	$ -	$ 268,236

Certain assets are measured at fair value on a non-recurring basis quarterly or more frequently if events dictate that the carrying value of the asset may not be recovered. These assets include bonds held at fair value with an NAIC rating of 3–6.

Investment Income — Major categories of net 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 bonds	13,180	18,858
Cash and other investments	367	2,068
Real estate	3,866	3,872
Equity securities	4,569	4,102
Repurchase/reverse repurchase	-	583
Investment expenses	(4,315)	(4,179)
Net investment income earned	94,402	98,433
Net realized capital (losses) gains	4,773	(56,527)
Net investment income	$ 99,175	$ 41,906

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 administer 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:

- Layer 1 - Limit of $20,000,000 in excess of retention of $20,000,000 per occurrence
- 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 Company (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 statutory financial statements (in thousands):

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

6. POLICYHOLDERS' SURPLUS

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 on the statutory statements of income and changes in policyholders' surplus and reduces net income for the year ended December 31, 2009.

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

7. COMMITMENTS AND CONTINGENCIES

Lawsuits arise against the Company in the normal course of business. Contingent liabilities arising from litigation and other matters are not considered material in relation to the financial position of the Company.

At December 31, 2009 and 2008, Pinnacol had a letter of credit for the benefit of Argonaut Insurance Company 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 to 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 purchase 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.

8. RECONCILIATION OF ANNUAL STATEMENT TO AUDITED FINANCIAL STATEMENTS

The accompanying statutory financial statements reflect certain adjustments to amounts previously reported in the annual statement filed with the Colorado Division of Insurance. The following reconciles admitted assets, capital and surplus and net income included in the annual statement to the accompanying statutory financial statements as of December 31, 2009 and 2008 (in thousands):

2009	Admitted Assets	Capital and Surplus	Net Income
Total per annual statement	$ 2,016,667	$ 732,527	$ (91,231)
Other-than-temporary impairment adjustment	-	-	68,272
Total per statutory financial statements	$ 2,016,667	$ 732,527	$ (22,959)

2008	Admitted Assets	Capital and Surplus	Net Income
Total per annual statement	$ 2,090,101	$ 698,001	$ 86,019
Other-than-temporary impairment adjustment	-	-	(68,272)
Total per statutory financial statements	$ 2,090,101	$ 698,001	$ 17,747

9. 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 of 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.

Tri-Annual Fiscal Examination - The Division of Insurance has begun its tri-annual financial examination of Pinnacol. This examination covers the fiscal year's ended 2007, 2008 and 2009 and will not be complete prior to the issuance of these financial statements.

PERA Liability - During March of 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 thru May 21, 2010, the date these statutory financial statements were issued.

SUPPLEMENTAL SCHEDULES OF INVESTMENT INFORMATION

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION — INVESTMENT RISKS INTERROGATORIES FOR THE YEARS ENDED DECEMBER 31, 2009

1. Pinnacol's total admitted assets as reported on page two of its Annual Statement are $2,016,667,000.

2. The following are the 10 largest exposures to a single issuer/borrower/investment by investment category, excluding: (i) U.S. government, U.S. government agency securities, and those U.S. government money market funds listed in the Appendix to the *SVO Practices and Procedures Manual* as exempt, (ii) property occupied by Pinnacol, and (iii) policy loans:

	Investment Category/Issuer	Amount	Percentage of Total Admitted Assets
a.	Vanguard	$110,513,159	5.5 %
b.	General Electric Co	48,443,216	2.4
c.	Verizon New Jersey Inc	42,753,568	2.1
d.	IBM	36,029,807	1.8
e.	Diageo Finance BV	33,144,219	1.6
f.	Anheuser-Busch	32,830,060	1.6
g.	Burlington North Sante Fe	32,754,844	1.6
h.	AT&T Inc	32,304,069	1.6
i.	Emerson Electric Co	31,012,263	1.5
j.	Procter & Gamble	28,227,886	1.4

3. Pinnacol's total admitted assets held in bonds by NAIC rating are:

Bonds		
NAIC Rating	Amount	Percentage of Total Admitted Assets
NAIC-1	$1,462,184,223	72.5 %
NAIC-2	213,877,148	10.6
NAIC-3	15,153,567	0.8
NAIC-4	-	0.0
NAIC-5	-	0.0
NAIC-6	-	0.0
	$1,691,214,938	

4. Assets held in foreign investments are less than 2.5% of Pinnacol's total admitted assets.

Items 5 through 10 are not applicable.

11. Assets held in Canadian investments are less than 2.5% of Pinnacol's total admitted assets.

Item 12 is not applicable.

13. The following are the largest equity interests (including investments in the shares of mutual funds, preferred stocks, publicly traded equity securities, and other securities and excluding money market and bond mutual funds listed in the Appendix to the *SVO Purposes and Procedures Manual* as exempt or Class 1):

	Investment Category/Issuer	**Amount**	**Percentage of Total Admitted Assets**
a.	Vanguard	$ 110,513,159	5.5 %
b.	Rainer	22,209,989	1.1
c.	T Rowe Price	21,455,261	1.1
d.	Artio International	21,287,982	1.1
e.	Matthews Asian	17,026,551	0.8
f.	Allianz	8,975,677	0.4
g.	Emerson Electric Co	2,560,473	0.1
h.	Ecolab Inc	2,416,013	0.1
i.	Wells Fargo & Co	2,397,738	0.1
j.	Apple Inc	2,027,242	0.1

Items 14 through 23 are not applicable.

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION — SUMMARY INVESTMENT SCHEDULE AS OF DECEMBER 31, 2009

	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
Investment Categories	**Amount**	**Percentage of Gross Investment Holdings**	**Amount**	**Percentage of Total Admitted Assets**
Bonds:				
U.S. Treasury securities	$ 253,340,327	12.9%	$ 253,340,327	12.9%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
- Issued by U.S. government agencies				
- Issued by U.S. government-sponsored agencies	12,513,499	0.6%	12,513,499	0.6%
Foreign government (including Canada, excluding mortgage-backed securities)	4,986,986	0.2%	4,986,986	0.2%
Securities issued by states, territories, and possessions and their political subdivisions in the U.S.:				
- State, territory, and possessions — general obligations				
- Political subdivisions of states, territories, and possessions — general obligations				
- Revenue and assessment obligations				
- Industrial development and similar obligations				
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
- Guaranteed by GNMA	29,440,628	1.5%	29,440,628	1.5%
- Issued by FNMA and FHLMC	56,932,555	2.9%	56,932,555	2.9%
- All others				
CMOs and REMICs:				
- Issued or guaranteed by GNMA, FNMA, FHLMC or VA	337,952,728	17.2%	337,952,728	17.2%
- Issued by non-US Govt issuers and collateralized by mortgage-backed securities issued by above				
- All other				
Other debt and other fixed income securities (excluding short term):				
- Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	848,367,076	43.1%	848,367,076	43.1%
- Unaffiliated foreign securities	72,438,676	3.7%	72,438,676	3.7%
- Affiliated securities				

(Continued)

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION — SUMMARY INVESTMENT SCHEDULE AS OF DECEMBER 31, 2009

Investment Categories	Gross Investment Holdings* Amount	Gross Investment Holdings* Percentage of Gross Investment Holdings	Admitted Assets as Reported in the Annual Statement Amount	Admitted Assets as Reported in the Annual Statement Percentage of Total Admitted Assets
Equity interests:				
- Investments in mutual funds	$ 200,343,659	10.2%	$ 200,343,659	10.2%
Preferred stocks:				
- Affiliated				
- Unaffiliated				
Publicly traded equity securities (excluding preferred stocks):				
- Affiliated				
- Unaffiliated	67,892,229	3.4%	67,892,229	3.4%
Other equity securities:				
- Affiliated				
- Unaffiliated				
Other equity interests including tangible personal property under lease:				
- Affiliated				
- Unaffiliated				
Mortgage loans:				
- Construction and land development				
- Agricultural				
- Single-family residential properties				
- Multifamily residential properties				
- Commercial loans				
Real estate investments:				
- Property occupied by Company	21,589,010	1.1%	21,589,010	1.1%
- Property held for production of income				
-Property issued or guaranteed by GNMA, FNMA				
Collateral loans				
Policy loans				
Receivables for securities				
Cash, cash equivalents and short-term investments	63,555,802	3.2%	63,555,802	3.2%
Write-ins for invested assets				
TOTAL INVESTED ASSETS	$ 1,969,353,175	100.0%	$ 1,969,353,175	100.0%

* Gross investment holdings as valued in compliance with NAIC *Accounting Practices and Procedures Manual* . (Concluded)

Note: Reinsurance Interrogatories are excluded as they are not applicable.

Deloitte & Touche LLP
Suite 3600
555 Seventeenth Street
Denver, CO 80202-3942
USA

Tel: +1 303 292 5400
Fax: +1 303 312-4000
www.deloitte.com

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 statutory 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. Our report is modified for statutory basis of accounting presentation. 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 statutory 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*.

Although we have included management's written response to our comments in the Findings and Recommendations section above, such responses have not been subjected to the auditing procedures applied in the audit of the statutory financial statements and, accordingly, we do not express an opinion or provide any form of assurance on the appropriateness of the responses or the effectiveness of any corrective actions described therein.

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.

Deloitte & Touche LLP

May 21, 2010

The electronic version of this report is available on the Web site of the
Office of the State Auditor

www.state.co.us/auditor

A bound report may be obtained by calling the
Office of the State Auditor
303-869-2800

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