

COLORADO COMPENSATION INSURANCE AUTHORITY  
DBA PINNACOL ASSURANCE  
Audited Statutory-Basis Financial Statements and  
Comments on Internal Controls and Procedures  
Years ended December 31, 1999 and 1998

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CONTAINED IN THIS DOCUMENT

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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)

February 20, 2000

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

We have completed the financial audit of Colorado Compensation Insurance Authority dba Pinnacol Assurance (Pinnacol) for the year ended December 31, 1999. Our audit was conducted in accordance with generally accepted auditing standards. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S. The reports which we have issued as a result of this engagement are set forth in the table of contents which follows. Included in the Auditors' Findings and Recommendations are the responses of the management of Pinnacol.

A stylized signature consisting of a cursive 'M' followed by a square box containing a simple line drawing of a mountain range or a similar abstract shape.

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Colorado Compensation Insurance Authority  
dba Pinnacol Assurance

Audited Statutory-Basis Financial Statements  
and Comments on Internal Controls and Procedures

Years ended December 31, 1999 and 1998

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Colorado Compensation Insurance Authority  
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Audit Report Summary

December 31, 1999

**Authority and Purpose/Scope of the Audit**

**Authority**

The audit was conducted under the authority of Section 8-45-121(2), C.R.S. The primary purpose of our engagement was to audit the statutory-basis financial statements of Pinnacol at December 31, 1999, and for the year then ended, in accordance with generally accepted auditing standards and to express an opinion on those financial statements and the notes thereto. The objective of an audit conducted in accordance with such standards is to obtain reasonable, but not absolute, assurance about whether the statutory-basis 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-basis” financial statements, or 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 generally accepted accounting principles.

Our recommendations with respect to internal accounting and administrative controls as well as other matters are found in the Findings and Recommendations section in this report. In addition, we also evaluated the progress made by Pinnacol in implementing the recommendations resulting from previous audits.

**Scope**

We examined, on a test basis, evidence supporting the amounts and disclosures in Pinnacol’s financial statements as of December 31, 1999. 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 (“Division of Insurance”).

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Audit Report Summary (continued)

December 31, 1999

**Management Judgments and Accounting Estimates**

Generally accepted auditing standards require that the independent accountant communicate to the audit committee or its equivalent, among other items, information regarding accounting estimates which are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. Pinnacol's management has made judgments with respect to certain accounting estimates included in the audited financial statements. The major accounting estimates made by management with respect to the financial statements are summarized below.

Net Realizable Value of Premiums Receivable

Statutory accounting principles require that the premium receivable balances be "equal to gross premium or premium deposits in the course of collection for in-force insurance coverage not more than 90 days past due, less commissions due thereon to agents, not exceeding in the aggregate the company's unearned premium reserve liability." In addition, statutory accounting principles require that a 10% reserve be established on all earned but unbilled premium receivables. These requirements are not subject to management's judgments and estimates.

Premium receivable balances must also be assessed for realizability. In connection therewith, management must determine whether an allowance should be established to provide for all reasonably anticipated losses inherent in the premium receivable balances. Factors which are considered in establishing reserves are: loss experience and trends, current overall aging of balance, economic conditions and trends, and evaluations of individual receivables.

In order for Ernst & Young to satisfy the requirements of generally accepted auditing standards, we performed certain audit procedures and determined that the premium receivable balances were reasonably stated at their net realizable value, subject to the statutory reserve requirements. At December 31, 1999, the net stated value of premiums receivable was estimated to be \$21,484,000.



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Audit Report Summary (continued)

December 31, 1999

Earned but Unbilled Premiums Receivable

Pinnacol estimates audit and retrospective rating adjustments based on prior audit and retrospective premium adjustments, compared with the prior earned premiums for the same policies. This prior year experience is used in projecting estimates for the current period, subject to recent influences such as inflation and other forces. Actuarial techniques must be used to model the prior experience to arrive at the estimates of audit and retrospective premiums. At December 31, 1999, the net unbilled audit premium was estimated to be approximately \$17,781,000, and the net retrospective premium was estimated to be approximately \$1,481,000, which Ernst & Young determined to be reasonable in relation to the financial statements taken as a whole.

Loss and Loss Adjustment Expense

Estimating loss and loss adjustment expense 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 expense, Pinnacol retains the actuarial consulting services of Milliman & Robertson, Inc.

As described in Note 2 of the financial statements, at December 31, 1999 Pinnacol has accrued \$675,375,000 for unpaid loss and loss adjustment expenses, which management believes to be a reasonable estimate of discounted future amounts to be paid for claims incurred in 1999 or prior.

In order for Ernst & Young to satisfy the requirements of generally accepted auditing standards when a specialist has been utilized, an actuary from our staff obtained an understanding of the methods and assumptions used by the specialist to determine whether the findings were suitable to corroborate the representations of management in the financial statements. We concluded that the actuarial methods and assumptions utilized by Milliman & Robertson, Inc. were reasonable given the uncertainties inherent in the environment. Changes occurring during the last several years impact the reasonable range of unpaid losses and loss adjustment expenses and the ultimate selection of the point estimate for reserves in 1999. These changes are: (1) introduction of cost containment and managed care procedures, including encouragement of early reporting of claims; (2) increased use of lump sum and structured settlements; (3) the introduction of the MIRA Loss Reserving System, an expert system that calculates a case-based reserve based on insured worker characteristics, implemented in July 1996; and (4) the increase in provider

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Audit Report Summary (continued)

December 31, 1999

contracting through Pinnacol's preferred provider network, *SelectNet*. These changes tend to adjust the overall characteristics of claims data, which have been taken into account in the actuarial analysis. If the assumptions regarding these changes are too optimistic, the current estimate of reserves will be inadequate.

There is uncertainty with respect to the actuarial process for the following reasons: (1) several significant adjustments have been made to standard actuarial techniques to recognize changes in claim handling and in the state law regarding workers' compensation (if the assumptions regarding these changes are too optimistic, the current estimate of reserves will be inadequate); (2) accurate closing rate information to validate the apparent speed-up in settlements was available for the first time in 1997; and (3) the reserves are discounted, as permitted by Colorado statute, which subjects the general uncertainties associated with projecting reserves to an additional risk of interest rate variability (refer to discussion below relating to statutory discount factor).

Reinsurance

During the year ended December 31, 1998, Pinnacol entered into a 30% quota share reinsurance agreement for losses up to \$50,000 and an excess of loss reinsurance agreement for losses from \$50,000 to \$500,000. Under the terms of these agreements, Pinnacol ceded approximately 22% and 19%, respectively, of the adjusted net earned premiums and received a commission on the ceded premium. To assist management in estimating the amount of premiums receivable and loss and loss adjustment expense, Pinnacol retained the actuarial consulting services of Milliman & Robertson, Inc. In conjunction with Milliman & Robertson, Inc., Pinnacol determined the estimated amount of ceded premiums receivable to be approximately \$12,647,000 in 1998 and the ceded unpaid loss and allocated loss adjustment expense to be approximately \$66,382,000 in 1998.

In 1999, Pinnacol exercised an option to rescind the reinsurance agreement for a \$22,000,000 settlement to be paid to Pinnacol. At the time of the rescission, Pinnacol booked a return of premium, loss payments and ceded commissions. The resulting settlement amount from the contract rescission was used to strengthen reserves for the year ended December 31, 1999.

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Audit Report Summary (continued)

December 31, 1999

Statutory Discount Factor

Another estimate used by Pinnacol in the preparation of its financial statements is the statutory discount factor applied in the determination of the liability for unpaid losses and loss adjustment expenses. 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. State law allows the use of a discount factor of up to 6%; Pinnacol discounted its actuarially determined unpaid balances by a factor of 4.25%, a more conservative discount factor.

**Required Communications to the Legislative Audit Committee**

In accordance with Statement of Auditing Standards (“SAS”) No. 61, *Communication with Audit Committees*, we must communicate to the Audit Committee or its equivalent certain matters noted during our audit. The following sets forth these required communications pursuant to SAS No. 61:

**1. Material errors, material irregularities or possible material illegal acts.**

In connection with our audit, we noted no material errors, irregularities or possible material illegal acts.

**2. Material weaknesses in internal controls.**

In connection with our audit, we noted no matters involving internal control and its operations that we consider to be material weaknesses.

**3. Situations involving the adoption of, or change in, an accounting principle where the application of alternative principles would have a material effect on the financial statements.**

There were no changes in accounting principles in 1999.

**4. Accounting and disclosure decisions with respect to transactions that are unusual in nature and have a material effect on the financial statements.**

As more fully discussed in Note 6 to the financial statements, Pinnacol rescinded both the 30% quota share reinsurance agreement for losses up to \$50,000 and the

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Audit Report Summary (continued)

December 31, 1999

excess of loss reinsurance agreement for losses from \$50,000 to \$500,000. We concur with the recording and disclosure of the resulting transaction.

**5. Accounting and disclosure considerations associated with material contingencies together with the nature and reasonableness of the underlying assumptions and estimates of management.**

We have reviewed, as part of our normal audit procedures, information regarding management's formulation of accounting estimates and have concluded that the estimates are reasonable in the context of the financial statements taken as a whole. See further discussion elsewhere in this Summary and Note 7 to the financial statements in regards to contingencies.

**6. Significant audit adjustments**

There were no significant audit adjustments resulting from our 1999 audit.

**7. The nature of disagreements with management on financial accounting and reporting matters and auditing procedures, whether or not satisfactorily resolved, over any matters that individually or in the aggregate could be significant to the financial statements.**

We had no significant disagreements with management on financial accounting and reporting matters in connection with the 1999 audit. All accounting and reporting matters discussed with management were satisfactorily resolved.

**8. Opinions obtained by management from other independent accountants on the application of accounting principles that would affect the financial statements or the type of opinion that may be rendered on the financial statements.**

We are not aware of any consultations by management with other accountants during 1999 with respect to accounting principles or the type of opinion rendered in connection with our audit.

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Audit Report Summary (continued)

December 31, 1999

**9. Major issues discussed with management in connection with our retention as auditors.**

There were no issues discussed with management relating to the application of accounting principles or auditing standards in connection with our retention as auditors.

**10. Serious difficulties encountered in dealing with management related to the performance of the audit.**

We encountered no difficulties in dealing with management in relation to the performance of the audit.

**Annual Statement**

We have read the annual statement of Pinnacol for the year ended December 31, 1999, which was filed with the Division of Insurance. There were no reconciling differences between amounts reflected in the annual statement and amounts reflected in the audited statutory-basis financial statements contained in this report.

**Auditors' Comments and Recommendations**

This report includes recommendations to improve management and accounting procedures of Pinnacol. Following is a summary of the audit comments discussed in the report:

Pinnacol should:

- Develop formal procedures for analyzing the results of the monitoring of the claim payments by the quality assurance process.
- Establish procedures for communicating product or business process changes.
- Ensure that the bank reconciliations contain only current reconciling items.
- Continue to post the medical payment refunds to the general ledger on a timely basis.
- Maintain adequate documentation of information systems user requests, test results, program changes and approvals.
- Improve segregation of duties regarding information systems development, security administration and operations.
- Implement a process to formally document information systems user access requests.

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Audit Report Summary (continued)

December 31, 1999

- Implement a process to perform and document periodic reviews of user access to Pinnacol information systems.

Management of Pinnacol agrees with all of these recommendations. Responses can be found starting on page 12.

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Audit Report Summary (continued)

December 31, 1999

**Summary of Progress in Implementing Prior Audit Recommendations**

The disposition of prior audit recommendations as of February 20, 2000 was:

Implemented	17
Partially implemented	2
Not implemented	—
Total	<u>19</u>

Additional discussion regarding the status of prior audit recommendations is contained at pages 20 to 21 of this report.

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Recommendation Locator

December 31, 1999

<b>Rec. No.</b>	<b>Page No.</b>	<b>Recommendation Summary</b>	<b>Pinnacol Response</b>	<b>Implementation Date</b>
1	12	Develop formal procedures for analyzing the results of the monitoring of the claim payments by the quality assurance process.	Agree	November 1999
2	14	Establish procedures for communicating product or business process changes.	Agree	May 2000
3	15	Post reconciling items to the general ledger on a timely basis.	Agree	December 1999
4	15	Continue to post medical payment refunds to the general ledger on a timely basis.	Agree	September 1999
5	16	Maintain documentation of all phases of information systems program changes.	Agree	August 2000
6	17	Improve segregation of duties in the information systems environment.	Agree	December 1999
7	18	Formally document information systems user access authorization.	Agree	September 1999
8	19	Perform periodic review of user access to information systems.	Agree	September 2000



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**Description of Colorado Compensation Insurance Authority**

The Colorado Compensation Insurance Authority was established under provisions of the Colorado Compensation Insurance Authority Act (Title 8, Article 45 of the Colorado Revised Statutes, as amended) for the benefit of injured employees and dependents of deceased employees in Colorado. Pinnacol provides an assured source of workers' compensation insurance to all Colorado employers at the lowest possible cost, consistent with maintaining a solvent Colorado Compensation Insurance Authority Fund.

As of September 15, 1999, Colorado Compensation Insurance Authority began doing business as Pinnacol Assurance ("Pinnacol").

Pinnacol is controlled by a governor-appointed, seven-member Board of Directors, in accordance with the applicable statutes of the State, with administration under the direction of a president. 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. Under the applicable statutes, the State Treasurer is the custodian for Pinnacol's cash and invested assets and after consulting with Pinnacol, the State Treasurer makes all investing decisions.

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Findings and Recommendations

**OPERATIONAL AND FINANCIAL ACCOUNTING ENVIRONMENT**

**Maintain the Quality of the Claims Processing Function**

Due to issues noted during the prior auditor's 1995 fieldwork associated with claims processing, the scope of their testing was expanded for the 1995 and subsequent audits. The error rate in 1995 was approximately 8%. During 1996 the error rate decreased slightly to approximately 7%. During 1997, substantial improvements were realized and the error rate decreased to approximately 3%. However, during their 1998 testing, the prior auditors noted a significant increase in the number of claims that were processed with errors. The two basic issues identified in connection with this testing were: 1) incorrect payment amounts and 2) inconsistencies in the documentation included in the claim files. Based on statistical analysis, it was determined that the financial impact of these errors was immaterial; however, an absolute processing error rate of approximately 10% for the first three quarters of 1998 was identified. Pinnacol implemented processing improvements in the fourth quarter of 1998 which decreased the overall error rate for the year to 8%.

Our testing estimated an overall error rate of 2% in 1999. The issues identified included improper calculations of payment amounts or lack of documentation included in the claim files.

During the fourth quarter of 1999, Pinnacol implemented a quality assurance process to monitor the accuracy of claim payments and the adequacy of documentation. As this process was still being developed, Pinnacol had not fully developed the procedures for analyzing and monitoring the results of the testing performed by the quality assurance team. To ensure improvement of the quality assurance process, these procedures should include trends in errors in both documentation and claim payment accuracy, statistical analysis of monetary accuracy of claims, length of time to process the claim and any other criteria that affect the accurate processing of a claim. These procedures should also include communication of results to affected personnel within Pinnacol including training, finance and senior management.

**Recommendation No. 1:**

Pinnacol should develop formal procedures for analyzing the results of the monitoring of the claim payments and documentation by the quality assurance process and use the results to improve the accuracy of the processing of claims. Additional training should be provided to the claims processors to help prevent future improper calculations and improve the documentation in the claim files.

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Findings and Recommendations (continued)

**Pinnacol Response:**

Agree. Pinnacol implemented a Quality Improvement Process (QIP) in November 1999. The QIP is a team-based, self-improvement process whereby the teams determine training needs on a real-time basis through systematic review of active files in each team. Four files per claims representative are reviewed quarterly by each team's respective senior claims representative. The results are summarized in a monthly report illustrating the team's collective strengths and challenge areas. This data is used to establish a Team Development Plan. The Team Development Plan outlines two team strengths and two team challenge areas. The team is assembled to determine ways to maximize claim-handling strengths in addition to creating and implementing strategies to improve challenge areas. Monthly meetings are held to discuss the Team Development Plan and progress. Payment accuracy is an item that is included in the QIP process. In addition to QIP, the Claims Specialists manage a file review process to ensure compliance with business standards. Finally, ongoing training is provided by the Claims Specialists emphasizing the importance of documentation and payment accuracy.

**Establish Procedures for Communicating Product or Business Process Changes**

Pinnacol pays commissions to third parties (e.g., insurance agents or brokers) who sell policies for Pinnacol. When a policy is sold and the policyholder pays their premiums to Pinnacol, the amount of commission owed to the third party is calculated. Once the amount of the commission is calculated, a liability is recorded in the General Ledger. Some of the premiums received are not based upon policies sold by agents or brokers. These premiums are based on policies sold directly by Pinnacol either through a direct call to Pinnacol by the policyholder or through the use of Pinnacol's internet website. When premiums are received on policies not sold by third parties, no commissions are recorded or paid.

During 1999, Pinnacol changed how it was processing the calculation and recording of commissions. Due to this change, a liability was incorrectly recorded for the commissions on premiums not sold by third parties. A liability of \$367,000 was recorded as a payable to Pinnacol. Because the change in the processing of the commission was not effectively communicated to all affected areas, the Finance department was not aware that the incorrect liability had been recorded. Since they are now aware of the change in commission processing, this error has been corrected.

In the normal course of its business, other changes will occur to Pinnacol's business processes and the products that it sells. If Pinnacol does not establish a more effective method for communicating these changes within its organization, these changes could occur and departments within Pinnacol could be affected and be unaware of the changes.

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Findings and Recommendations (continued)

This could result in inaccurate reporting in Pinnacol's financial statements. An appropriate methodology for business process changes includes developing procedures to determine the effect of these changes and for communicating such changes to all affected areas within the Pinnacol organization.

**Recommendation No. 2:**

Pinnacol should implement a methodology that will ensure effective communication of product and business process changes, and ensure that all areas of the organization make the necessary changes to their processes and financial reporting in a timely manner.

**Pinnacol Response:**

Agree. In May of 2000, Pinnacol will implement a multidisciplinary peer review process of all programming changes to ensure that the ramifications of the decisions made have been thoroughly analyzed.

**Post Reconciling Items to the General Ledger on a Timely Basis**

Bank reconciliations as of September 30, 1999 contained old reconciling items and reconciling items that required adjustments to be posted to the general ledger, which had not been made. Several of the reconciling items dated back to 1998, as well as the first quarter of 1999. We also noted several large reconciling items (e.g., \$7,060,000 and \$(8,337,000)) that were outstanding since the first quarter of 1999. Many of these items had been identified by Pinnacol as differences between when certain deposits and the clearing of checks were recorded by Pinnacol versus the State Treasury. Finally, we noted a deposit in transit item dated February 1999 which remained a reconciling item in the September 30, 1999 reconciliation. There was significant improvement in the bank reconciliations at year end and all reconciling items that required adjustment to the general ledger had been posted as of December 31, 1999.

Timely investigation and clearance of reconciling items are essential to an effective control environment and accurate financial records. Reconciliations can effectively locate improper or inaccurate payments.

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Findings and Recommendations (continued)

**Recommendation No. 3:**

Continue to ensure that the bank reconciliations contain only current reconciling items which will make the preparation of the monthly reconciliations a more manageable and efficient process.

**Pinnacol Response:**

Agree. Internal review processes were implemented as of December 1, 1999 to assure that reconciling items are managed on a timely basis.

**Continue to Post Medical Payment Refunds to the General Ledger on a Timely Basis**

Medical payment refunds represent overpayments or improper payments received by medical providers and returned to Pinnacol. When medical payment refunds are received, Pinnacol must identify the original claim payment that the refund relates to. Once identified, Pinnacol reduces the amount of the original claim payment by the amount of the refund. As of September 30, 1999, \$415,000 of medical payment refunds received prior to the third quarter of 1999 were not posted to corresponding claims, thereby not reducing the claim paid amounts in the claim system to reflect the net claim dollars paid. Additionally, the general ledger at September 30, 1999 reflected overstated claims paid by the same amount. We noted through our testing, as of December 31, 1999, that current medical payment refunds are being posted timely and the backlog of old medical payment refunds (i.e., prior to the third quarter of 1999) had been resolved.

**Recommendation No. 4:**

Pinnacol should ensure they continue to post the medical payment refunds to the general ledger on a timely basis.

**Pinnacol Response:**

Agree. This was implemented in September 1999 and we continue to monitor the timeliness of the posting of these refunds.

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Findings and Recommendations (continued)

**OPERATING INFORMATION TECHNOLOGY ENVIRONMENT**

**Program Change Controls**

In today's computer-reliant environment, changes are made to computer programs and systems on a regular and ongoing basis. A sample of ten program changes was reviewed in order to assess the controls surrounding the change process. We found insufficient audit evidence to determine that any of the sampled changes were authorized and approved changes. User requests, acceptance testing and approvals were not documented and maintained for any of the sampled program changes. Controls are necessary to ensure that all of the changes made to systems and applications are properly authorized, tested and approved before they are implemented. These controls help to ensure the integrity of the data provided by these systems and reduce the likelihood of a misappropriation of assets. User involvement is necessary to ensure that all changes correctly and sufficiently meet the user's specifications. Reconciliation of program changes is also necessary to ensure that only authorized changes have been made.

**Recommendation No. 5:**

For program changes, Pinnacol should maintain adequate documentation of the user request, test results, program changes and approvals.

**Pinnacol Response:**

Agree. Pinnacol is in the process of building systems to ensure consistent documentation of program changes including, but not limited to, the original user request, test results and the final approval documentation, as appropriate. The system will be implemented by August 2000.

**Segregation of Duties within the Information Systems Environment**

A basic element of internal control is segregation of duties which ensures that no one person has the ability to affect more than one phase of an operation. A lack of segregation of duties within the Information Systems environment increases the risk that critical application and data files could be altered, modified or processed without proper authorization and approval. The following three segregation of duties issues were evident regarding developers, operations and security:

- The security administrator for Lawson, the general ledger system, has access to the source code as well as the functional responsibility for moving all changes into production. This access allows the same person to make changes and move their own

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Findings and Recommendations (continued)

changes into production. There is no independent review of the change when the same person is responsible for both activities.

- Due to the manner in which card key access has been assigned by security level, personnel without a business need have access to the data center. Access should be limited in order to reduce the opportunity for sabotage, inadvertent errors and to increase the accountability of those responsible for the data center.
- One individual has the functional responsibility for all aspects of the development and program change control for the Financial Transaction Reconciliation System (“FTRS”) used to query database transactions for recording and reconciliation in the Lawson application. As noted above, there is no independence when these activities are performed by the same individual.

**Recommendation No. 6:**

Establish the proper segregation of duties regarding development, security administration and operation functions. We recommend the following:

- Assign the responsibility for security administration to an individual independent of the program change responsibilities within Lawson.
- Modify card key security levels to ensure that only necessary individuals have access to the data center.
- Assign FTRS program migration to an individual independent of the development and security functions.

**Pinnacol Response:**

Agree. The following items were reviewed and implemented during December 1999. The Lawson security administration has been assigned to an individual independent of the program change responsibilities. Also, physical access to Pinnacol secured areas will continue to be reviewed on a routine basis with necessary changes made as appropriate. In addition, the finance office is authorizing the move of data into the data mart after completing quality assurance analysis of the FTRS information.

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Findings and Recommendations (continued)

**User Access Authorization**

Although a procedure has been implemented recently to review users' access to Pinnacol's claims payments system ("WCIS") on a monthly basis, no formal approval documentation is maintained for granting new users specific access, or changing or revoking users' access. Formal documentation procedures have not been established for the authorization of user access. Management cannot be assured that proper functions are assigned, revoked, or proper approvals were obtained for user access. The access granted to every user should be documented with the specific functions necessary to perform their responsibilities listed with the proper approvals.

**Recommendation No. 7:**

Document a formal user access request process. At a minimum, require the use of email to document user management's authorization of which systems, applications and menus (where applicable) a user is to access. Modifications and revocation of access should also be documented and attached to the original access request. Maintain this documentation in the Information Systems Department for future reference.

**Pinnacol Response:**

Agree. This recommendation was implemented in September 1999.

**User Access Privileges**

Currently, access granted within WCIS, the claims and premium system, is not consistently compatible with the users' functional job responsibilities. This access could result in unauthorized or unintentional entries to be made or the inability to effectively perform one's job responsibilities. User access requirements may change as a result of several factors including transfers, terminations, promotions and growth. Therefore, it is important to have the users' access confirmed and recertified on a regular basis.

Pinnacol should perform and document a periodic review of user access on at least an annual basis for all systems, including WCIS. The procedure should require the user's department manager to review and approve the user's access and make any necessary changes to the user's access on a timely basis. This is an effective method of validating that levels of access granted to users are appropriate for their current job responsibilities and to ensure proper segregation of duties within the application. The results of this review should be maintained to support the access levels granted to each user.



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Findings and Recommendations (continued)

**Recommendation No. 8:**

Perform and document a periodic review of users' access on at least an annual basis for all systems.

**Pinnacol Response:**

Agree. We are in the process of developing a security management tool and accompanying procedures to be implemented by September 2000.

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Disposition of Prior Audit Recommendations

Listed below are the recommendations included in the prior audit report dated February 19, 1999, and the disposition or other status of such items as of February 20, 2000.

Recommendation	Comments
1. Improve the quality of the claims processing functions.	Partially implemented. See current year recommendation 1.
2. Reconcile outstanding warrants on a timely basis.	Implemented.
3. Reconcile claim payments between the claims payment system and the general ledger.	Implemented.
4. Implement claims lag cell reconciliation procedures.	Implemented.
5. Design and implement new medical payment system.	Implemented.
6. Manage change in employee culture and implement performance measures.	Implemented.
7. Review year 2000 transaction implications.	Implemented.
8. Improve accuracy of open and closed claim data.	Implemented.
9. Consolidate multiple expenditures to a common medical provider into a single payment.	Implemented.
10. Develop a method to quantify overpaid compensation, dedicate resources to collect overpayments, and investigate whether a claimant is eligible for and/or receiving offsetting disability benefits.	Partially implemented. See current year recommendation 1.
11. Update important general ledger accounts monthly, including changes in the judgmental accounts.	Implemented.
12. Develop and maintain a policies and procedures manual covering the Financial Services Department's Financial and Internal Controls.	Implemented.
13. Effectively use the account payable system to track invoices as received or as known liabilities are incurred.	Implemented.
14. Implement automated edit checks in the medical payment system.	Implemented.

Colorado Compensation Insurance Authority  
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Disposition of Prior Audit Recommendations (continued)

<b>Recommendation</b>	<b>Comments</b>
15. Reduce the level of manual intervention required in the medical payment system.	Implemented.
16. Capture all discounts associated with the preferred provider network.	Implemented.
17. Redesign the close-the-books process to improve the efficiency and effectiveness of closing the books and the finance function itself.	Implemented.
18. Improve access controls to the medical payment and Lawson software systems.	Implemented.
19. Implement the new reporting rules from the NAIC regarding allocated and unallocated loss adjustment expense.	Implemented.

## Report of Independent Auditors

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

We have audited the statutory-basis balance sheet of Colorado Compensation Insurance Authority dba Pinnacol Assurance (“Pinnacol”) as of December 31, 1999, and the related statements of income and changes in policyholders’ surplus (deficit) and cash flow for the year then ended. These financial statements are the responsibility of Pinnacol’s management. Our responsibility is to express an opinion on these financial statements based on our audit. The statutory-basis financial statements of Pinnacol for the year ended December 31, 1998, were audited by other auditors whose report dated February 19, 1999, expressed an unqualified opinion on those statements.

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

As described in Note 1, the accompanying financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (Colorado Division of Insurance), which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the 1999 financial statements referred to above present fairly, in all material respects, the financial position of Pinnacol at December 31, 1999, and the results of its operations and its cash flow for the year then ended, in conformity with accounting practices prescribed or permitted by the Colorado Division of Insurance.

This report is intended solely for the information and use of the Members of the Legislative Audit Committee, the Board of Directors and the 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.



February 20, 2000

Colorado Compensation Insurance Authority  
dba Pinnacle Assurance

Statutory-Basis Balance Sheets

	<b>December 31</b>	
	<b>1999</b>	<b>1998</b>
	<i>(In thousands)</i>	
<b>Admitted assets</b>		
Cash and invested assets:		
Bonds, at amortized cost <i>(Note 3)</i>	\$627,069	\$663,967
Common stock <i>(Note 3)</i>	4,441	–
Cash on hand and on deposit	10,462	18,608
Total cash and invested assets	641,972	682,575
Uncollected premiums, net of allowance for uncollectible and nonadmitted balances of \$11,054 and \$12,219 in 1999 and 1998, respectively	40,746	26,867
Less ceded reinsurance <i>(Note 6)</i>	–	(12,647)
Net premiums receivable	40,746	14,220
Electronic data processing equipment, net of accumulated depreciation of \$11,513 and \$10,365 in 1999 and 1998, respectively	1,329	2,264
Accrued investment income	9,366	9,884
Other assets, net of accumulated depreciation and non-admitted balances of \$3,499 and \$7,629 in 1999 and 1998, respectively <i>(Note 6)</i>	113,895	–
Total admitted assets	\$807,308	\$708,943
<b>Liabilities and policyholders' surplus (deficit)</b>		
Liabilities:		
Unpaid losses and allocated loss adjustment expenses <i>(Note 2)</i>	\$675,375	\$616,555
Unpaid unallocated loss adjustment expenses <i>(Note 2)</i>	23,608	23,608
	698,983	640,163
Premium taxes and other liabilities	31,499	25,801
Unearned premiums	49,532	44,680
Policyholders' deposits	1,594	2,050
Credit balances due policyholders	4,863	3,289
Total liabilities	786,471	715,983
Commitments and contingencies <i>(Note 7)</i>		
Policyholders' surplus (deficit) <i>(Note 2)</i>	20,837	(7,040)
Total liabilities and policyholders' surplus (deficit)	\$807,308	\$708,943

*See accompanying notes.*

Colorado Compensation Insurance Authority  
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Statutory-Basis Statements of Income and  
Changes in Policyholders' Surplus (Deficit)

	<b>Year ended December 31</b>	
	<b>1999</b>	<b>1998</b>
	<i>(In thousands)</i>	
Net premiums earned <i>(Note 6)</i>	\$266,576	\$176,435
Underwriting expenses:		
Losses incurred	215,224	157,500
Loss adjustment expenses incurred	14,712	22,017
Other underwriting expenses incurred	50,456	25,405
Total underwriting expenses	280,392	204,922
Underwriting loss	(13,816)	(28,487)
Net investment income	45,777	52,046
Net realized gain on investments	613	6,674
Provision for uncollectible premiums	(5,546)	(6,577)
Other income	941	598
Net income	27,969	24,254
Increase in nonadmitted assets	(533)	(213)
Change in net unrealized gains in common stock	441	-
Policyholders' deficit at beginning of year	(7,040)	(31,081)
Policyholders' surplus (deficit) at end of year	\$ 20,837	\$ (7,040)

*See accompanying notes.*

Colorado Compensation Insurance Authority  
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Statutory-Basis Statements of Cash Flow

	<b>Year ended December 31</b>	
	<b>1999</b>	<b>1998</b>
	<i>(In thousands)</i>	
<b>Cash flow from operating activities</b>		
Net income	\$ 27,969	\$ 24,254
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation	1,383	2,211
Provision for uncollectible premiums	5,546	6,577
Amortization of bond discount and premium	(1,610)	(2,141)
Net gain on sales of investments	(613)	(6,674)
Other changes in assets and liabilities:		
(Increase) decrease in uncollected premiums	(31,505)	3,991
Decrease in interest receivable	518	1,541
Increase in other assets	(115,230)	(364)
Increase (decrease) in unpaid losses	58,820	(103,845)
Decrease in loss adjustment expense	-	(4,656)
Increase (decrease) in premium taxes and other liabilities	5,698	(3,000)
Increase in unearned premiums	4,852	774
(Decrease) increase in policyholders' deposits	(456)	2,050
Increase (decrease) in credit balance due policyholders	1,574	(1,170)
Total adjustments	(71,023)	(104,706)
Net cash used in operating activities	(43,054)	(80,452)
<b>Cash flow from capital and related financing activities</b>		
Purchase of electronic data processing equipment	(213)	(2,468)
Net cash used for capital and related financing activities	(213)	(2,468)
<b>Cash flow from investing activities</b>		
Proceeds from sale or redemption of bonds	103,150	176,382
Purchase of bonds	(68,029)	(87,133)
Net cash provided by investing activities	35,121	89,249
(Decrease) increase in cash on hand and on deposit	(8,146)	6,329
Cash on hand and on deposit, beginning of year	18,608	12,279
Cash on hand and on deposit, end of year	\$ 10,462	\$ 18,608

*See accompanying notes.*

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements

December 31, 1999

**1. Nature of Operations and Significant Accounting Policies**

**Organization**

The Colorado Compensation Insurance Authority 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) 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.

As of September 15, 1999, Colorado Compensation Insurance Authority began doing business as Pinnacol Assurance ("Pinnacol").

Pinnacol is controlled by a governor-appointed, seven-member Board of Directors, in accordance with the applicable statutes of the State, with administration under the direction of a president. 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. Under the applicable statutes, the State Treasurer is the custodian for Pinnacol's cash and invested assets and, after consulting with Pinnacol, the State Treasurer makes all investing decisions.

The preparation of financial statements of insurance companies requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known which could impact the amounts reported and disclosed herein.

**Basis of Presentation**

The accompanying financial statements of Pinnacol have been prepared in conformity with accounting practices prescribed or permitted by the Colorado Division of Insurance. Such practices vary from generally accepted accounting principles ("GAAP"). The more significant variances from GAAP are as follows:

*Investments:* Investments in bonds and mandatorily redeemable preferred stocks are reported at amortized cost or market value based on their National Association of Insurance Commissioners ("NAIC") rating; for GAAP, such fixed maturity investments would be designated at purchase as held-to-maturity, trading, or available-for-sale.



Colorado Compensation Insurance Authority  
dba Pinnacle Assurance

Notes to Statutory-Basis Financial Statements (continued)

**1. Nature of Operations and Significant Accounting Policies (continued)**

Held-to-maturity fixed investments would be reported at amortized cost, and the remaining fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in operations for those designated as trading and as a separate component of policyholders' equity for those designated as available-for-sale.

*Policy Acquisition Costs:* The costs of acquiring and renewing business are expensed when incurred. Under GAAP, such costs, to the extent recoverable, would be deferred and amortized over the effective period of the related insurance policies.

*Nonadmitted Assets:* Certain assets designated as "nonadmitted," principally past-due agents' balances, a pledged certificate of deposit and furniture and equipment, are excluded from the accompanying balance sheets and are charged directly to policyholders' surplus.

*Reinsurance:* Reserves for losses and loss adjustment expenses and unearned premiums ceded to reinsurers have been reported as reductions of the related reserves rather than as assets as would be required under GAAP.

Commissions allowed by reinsurers on business ceded are reported as income when received rather than being deferred and amortized with deferred policy acquisition costs, as required under GAAP.

*Policyholder Dividends:* Policyholder dividends are recognized when declared rather than over the term of the related policies.

Other significant accounting practices are as follows:

**Investments**

Bonds are principally stated at amortized cost using the interest method.

Prepayment assumptions for purposes of recognition of income and valuing of loan-backed bonds and structured securities were obtained from broker-dealer survey values or internal estimates. These assumptions are consistent with the current interest rate and economic environment. The retrospective method is used to value mortgage-backed securities.

Colorado Compensation Insurance Authority  
dba Pinnacol Assurance

Notes to Statutory-Basis Financial Statements (continued)

**1. Nature of Operations and Significant Accounting Policies (continued)**

Common stocks are reported at market value as determined by the Securities Valuation Office (SVO) of the NAIC.

Realized capital gains and losses are determined using the specific identification basis.

**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 statutory accounting practices. Pinnacol independently estimates the ultimate realizable amounts of premiums receivable and establishes an allowance for uncollectible premiums for the difference between the gross receivable amount and the estimate of the amount to be ultimately realized. Pinnacol also establishes an additional allowance for nonadmitted receivables for the amount by which non-admissible receivables, as defined above, exceed the estimate of uncollectible receivables.

During 1999 and 1998, Pinnacol recorded a provision or wrote off a total of \$5,546,000 and \$6,577,000, respectively, in premiums receivable due to the unlikelihood of ultimate collection thereof. These amounts are reflected as provision for uncollectible premiums in the accompanying financial statements.

A significant portion of Pinnacol's premium receivable balances at December 31, 1999 and 1998 were from companies operating in the construction industry in Colorado.

**Earned but Unbilled Premiums**

Earned but unbilled premiums represent audit and retrospective premiums which are amounts due from policyholders after the respective policy period has expired based either on audits performed by Pinnacol or on the paid loss history of the policyholder. For 1999 and 1998, estimated unbilled audit premiums receivable of \$17,781,000 and \$10,182,000, respectively, and estimated unbilled retrospective premiums of \$1,481,000 and \$2,193,000, respectively, are included as uncollected premiums. These estimated receivables have been reduced by 10% to comply with statutory accounting principles.

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**1. Nature of Operations and Significant Accounting Policies (continued)**

**Electronic Data Processing Equipment**

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

**Office Furniture and Equipment**

Office furniture and equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of five years. For statutory reporting, these are nonadmitted assets. The net book value of these assets at December 31, 1999 and 1998 was \$745,000 and \$333,000, respectively.

**Other Assets**

At December 31, 1999 and 1998, Pinnacol had a \$1,000,000 certificate of deposit pledged as security pursuant to a letter of credit underlying Pinnacol's noncancelable building lease (see Note 7). In accordance with the terms of the lease, the letter of credit would be drawn upon only in the event of Pinnacol's default on its existing lease obligations. The certificate of deposit is reported as a nonadmitted asset.

**Policyholder Dividends**

The Board of Directors, at its discretion, determines the amount of policyholder dividends to be declared, based on Pinnacol's overall experience. No dividends were declared from surplus in 1999 or 1998.

**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.

**Subrogation**

Subrogation claims (claims against third parties) are recognized as a reduction of losses incurred when collections are received.

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**1. Nature of Operations and Significant Accounting Policies (continued)**

**Reinsurance**

Reinsurance premiums are reflected as a reduction of premiums earned (see Note 6).

**Taxes**

As a political subdivision of the State, Pinnacol is not subject to federal or state income taxes under a specific exemption granted under Section 501(c) of the Internal Revenue Code. However, Pinnacol is subject to a premium tax, pursuant to Section 8-45-117(3), C.R.S., which is payable principally to the Subsequent Injury and Major Medical Funds of the Department of Labor and Employment.

**Employee Benefits**

All Pinnacol employees are covered under the contributory retirement plan administered by the Public Employees' Retirement Association of Colorado (PERA). Retirement benefits under this plan are based upon a combination of years of service and salary level prior to retirement. Retirement expense, which is based on salaries paid by Pinnacol, was \$2,177,000 and \$2,098,000 in 1999 and 1998, respectively. PERA also offers a voluntary 401(k) plan entirely separate from the defined benefit plan.

Pinnacol employees may accrue paid time off based on their length of service, subject to certain limitations on the amount which will be paid upon termination. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The estimated liability for cumulative accrued paid time off of \$1,384,000 and \$1,224,000 at December 31, 1999 and 1998, respectively, is included in premium taxes and other liabilities in the accompanying financial statements.

**Permitted Statutory Accounting Practices**

Pinnacol's statutory-basis financial statements are prepared in accordance with accounting practices prescribed or permitted by the Colorado Division of Insurance. Currently, "prescribed" statutory accounting practices are interspersed throughout the state insurance law and regulations, the NAIC's *Accounting Practices and Procedures Manual* and a variety of other NAIC publications. "Permitted" statutory accounting practices encompass all accounting practices that are not prescribed; such practices may

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**1. Nature of Operations and Significant Accounting Policies (continued)**

differ from state to state, may differ from company to company within a state, and may change in the future.

Pinnacol has received written authorization from the Colorado Division of Insurance to present its Statements of Cash Flow in the accompanying financial statements on the indirect method. This is different from the direct method as required by prescribed statutory accounting practices. This difference has no effect on Pinnacol's balance sheets or statements of income and changes in policyholders' surplus (deficit).

**New Accounting Pronouncements**

In 1998, the NAIC adopted codified statutory accounting principles ("Codification") effective January 1, 2001. Codification will likely change, to some extent, prescribed statutory accounting practices and may result in changes to the accounting practices that Pinnacol uses to prepare its statutory-basis financial statements. Codification will require adoption by the various states before it becomes the prescribed statutory basis of accounting for insurance companies domesticated within those states. Accordingly, before Codification becomes effective for Pinnacol, Colorado must adopt Codification as the prescribed basis of accounting on which domestic insurers must report their statutory-basis results to the Division of Insurance. At this time, it is anticipated that Colorado will adopt Codification. Management has not yet determined the impact of Codification to Pinnacol's statutory-basis financial statements.

**Reclassifications**

Certain reclassifications have been made to the prior year statements to conform to the current year presentation.

**2. Unpaid Losses and Loss Adjustment Expenses**

Unpaid losses and loss adjustment expenses (both allocated and unallocated) represent actuarially derived estimates of the ultimate net cost of all losses and loss adjustment expenses which are incurred but unpaid at year end. The reserves for loss and loss adjustment expenses represent the estimated indemnity and medical cost and loss adjustment expenses necessary to cover the ultimate cost of investigating and settling claims. Such estimates are based on individual case estimates for reported claims and

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**2. Unpaid Losses and Loss Adjustment Expenses (continued)**

actuarial estimates for losses which have been incurred but not reported. Any change in probable ultimate liabilities is reflected in current operating results.

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

Due to these factors, among others, the process to estimate loss and loss adjustment 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 and results of operations.

At December 31, 1999, Pinnacol accrued \$675,375,000 for unpaid loss and loss adjustment expenses, which management believes is a reasonable estimate of future amounts to be paid for claims incurred in 1999 or prior. As permitted by state statute, a discount of \$199,739,000 (computed at 4.25%) has been applied in the actuarial calculation of these December 31, 1999 liabilities for unpaid losses and allocated loss adjustment expenses. The state statute allows reserves to be discounted at a rate of up to 6%.

At December 31, 1998, Pinnacol accrued \$616,555,000, net of an adjustment equal to \$58,000,000 for ceded reinsurance. A discount of \$189,792,000 (computed at 4.25%) was applied in the actuarial calculation of this December 31, 1998 liability for unpaid losses and allocated loss adjustment expenses.

Pinnacol's discounted liability for unallocated loss adjustment expenses was \$23,608,000 at December 31, 1999 and 1998, based on actuarial valuation.

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**2. Unpaid Losses and Loss Adjustment Expenses (continued)**

Activity in the liability for unpaid losses and loss adjustment expenses is summarized as follows:

	1999		1998	
	Unpaid Losses and Allocated Loss Adjustment Expenses	Unallocated Loss Adjustment Expenses	Unpaid Losses and Allocated Loss Adjustment Expenses	Unallocated Loss Adjustment Expenses
	<i>(In Thousands)</i>			
Balance at January 1	\$616,555	\$23,608	\$720,400	\$28,264
Additional amounts incurred related to:				
Current year—gross	198,971	10,340	186,737	9,920
Current year—ceded	—	—	(57,505)	—
Net current year	198,971	10,340	129,232	9,920
Prior years	16,423	4,372	30,911	4,195
Total incurred	215,394	14,712	160,143	14,115
Reductions relating to payments for:				
Current year—gross	47,516	8,103	47,606	10,084
Current year—ceded	—	—	(8,877)	—
Net current year	47,516	8,103	38,729	10,084
Prior years	109,058	6,609	225,259	8,687
Total paid	156,574	14,712	263,988	18,771
Balance at December 31	\$675,375	\$23,608	\$616,555	\$23,608

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**2. Unpaid Losses and Loss Adjustment Expenses (continued)**

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and allocated loss adjustment expenses increased by \$16.4 million in 1999. The increase was principally due to the accretion of the prior years' statutory discount.

As reflected in the accompanying financial statements, Pinnacol had a policyholders' surplus of \$20,837,000 and a deficit of \$7,040,000 as of December 31, 1999 and 1998, respectively. This policyholders' deficit arose primarily from adverse developments reported during 1990 and 1989 in the amount of loss reserves required by Pinnacol for prior years' claims which will be paid in the future, and from Pinnacol's related estimate of the most likely amount of losses which will ultimately be paid. Management of Pinnacol is developing a long-range plan to strengthen its financial position and attain a reasonable surplus in response to Section 8-45-111, C.R.S. This plan focuses on reducing Pinnacol's loss ratios through an emphasis on underwriting and a greater internal emphasis on loss control and claims management, employer loss prevention, and cost containment, coupled with maintenance of rate adequacy. Management anticipates that this program will improve operations and increase cash generated from operating activities and will ultimately result in building surplus to an acceptable level.

**3. Investments**

Estimated fair value of investments in bonds is based on values published by the SVO of the NAIC. These values generally represent quoted market value prices for securities traded in the public marketplace or analytically determined values using bid or closing prices for securities not traded in the public marketplace. However, for certain investments, the SVO does not provide a fair value and the Company uses the amortized cost of the security as a substitute for fair value. As of December 31, 1999 and 1998, the fair value of bonds includes \$287,762,000 and \$316,061,000, respectively, of investments that were valued at amortized cost.



Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**3. Investments (continued)**

The amortized cost and the fair value of investments in bonds are summarized as follows:

	1999				1998			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
<i>(In Thousands)</i>								
U.S. Government obligations:								
Non-loan-backed bonds on securities loaned for securities collateral (Note 4)	\$166,532	\$4,610	\$ -	\$171,142	\$190,445	\$20,504	\$ -	\$210,949
Loan-backed bonds	101,010	-	-	101,010	118,630	-	-	118,630
Industrial and miscellaneous:								
Non-loan-backed bonds	226,925	-	(7,044)	219,881	222,623	9,320	(6)	231,937
Loan-backed bonds	132,602	-	-	132,602	132,269	-	-	132,269
	<u>\$627,069</u>	<u>\$4,610</u>	<u>\$(7,044)</u>	<u>\$624,635</u>	<u>\$663,967</u>	<u>\$29,824</u>	<u>\$ (6)</u>	<u>\$693,785</u>

The amortized cost and fair value of investments in debt securities at December 31, 1999, by contractual maturity, are shown below. 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.

	Amortized Cost	Fair Value
<i>(In Thousands)</i>		
Due in one year or less	\$ 5,000	\$ 5,100
Due after one year through five years	112,508	113,777
Due after five years through ten years	265,425	265,359
Due after ten years	244,136	240,399
	<u>\$627,069</u>	<u>\$624,635</u>

Proceeds from sales of investments in bonds during 1999 and 1998 were \$103,150,000 and \$176,382,000, respectively. Gross gains of \$790,000 and \$6,687,000 and gross losses of \$(177,000) and \$(13,000) were realized on those sales for 1999 and 1998, respectively.

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**3. Investments (continued)**

Unrealized gains and losses on investments in common stocks are reported directly in policyholders' surplus and do not affect operations. The gross unrealized gains and losses on, cost and fair value of those investments are summarized as follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	<i>(In Thousands)</i>			
<b>At December 31, 1999</b>				
Common stocks	\$4,000	\$441	\$ –	\$4,441
Total	\$4,000	\$441	\$ –	\$4,441

No investments in common stocks were held at December 31, 1998.

**4. Securities Lending Transactions**

Pinnacol enters into transactions to lend its securities to a broker-dealer. Pinnacol's custodian lends securities to the broker-dealer in exchange for collateral in the form of "A" rated U.S. domestic corporate securities, equal to or exceeding 105% of the fair market value of the loaned securities.

At December 31, 1999 and 1998, Pinnacol had outstanding non-loan-backed U.S. government securities with a fair value of \$171,142,000 and \$210,949,000, respectively. Pinnacol has no additional credit risk exposure to borrowers. The contract with the broker-dealer requires them to indemnify Pinnacol if they fail to return the securities or fail to pay Pinnacol for income distributions by the securities' issuers while the securities are on loan. All securities lending transactions can be terminated on demand by either Pinnacol or the broker-dealer. Pinnacol recognized \$187,000 and \$265,000 of additional investment income during the year ended December 31, 1999 and 1998, respectively, related to securities lending transactions.

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**5. Transactions with the State**

The State contracts with Pinnacol pursuant to its self-funded insurance program. The State reimburses Pinnacol for all workers' compensation claims and loss adjustment expenses as incurred, plus a premium for stop loss coverage. Pinnacol accounts for the State contract as an uninsured and partially insured accident and health plan whereby Pinnacol does not record the premium revenue or loss and loss adjustment expenses and related receivables and payables for State workers' compensation costs. Reimbursements billed to the State under this contract were \$21,395,000 and \$19,862,000 in 1999 and 1998, respectively.

**6. Reinsurance**

In 1998, Pinnacol entered into a 30% quota share reinsurance agreement for losses up to \$50,000 and an excess of loss reinsurance agreement for losses from \$50,000 to \$500,000. Had the reinsurer been unable to meet its obligations under the reinsurance contracts, Pinnacol would have remained liable for amounts ceded to its reinsurer which could have resulted in losses to Pinnacol. Under the terms of the quota share and excess of loss agreements, Pinnacol ceded approximately 22% and 19%, respectively, of the adjusted net earned premiums and received a commission on the ceded premium. In conjunction with an independent actuarial firm, Pinnacol determined the estimated amount of ceded premiums receivable to be approximately \$12,647,000 in 1998 and the ceded unpaid loss and allocated loss adjustment expense to be approximately \$66,382,000 in 1998.

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**6. Reinsurance (continued)**

In 1999, Pinnacol exercised an option to rescind the reinsurance agreement for a \$22,000,000 settlement, of which \$10,191,000 was recorded in 1998. The profit from the contract was used to strengthen reserves for the years ended December 31, 1999 and 1998. At the time of the rescission, Pinnacol booked a return of all amounts paid to or received from the reinsurer since the inception of the reinsurance agreement. The net amount to be returned to Pinnacol, including the \$22,000,000 settlement, equaled \$113,895,000. This is reflected in Other Assets at December 31, 1999 and was received by Pinnacol in early 2000. The impact of the reinsurance agreement and its rescission on the Statements of Income is as follows:

	<b>1999</b>	<b>1998</b>
	<i>(In Thousands)</i>	
Gross premiums earned	\$266,576	\$243,346
Premiums ceded	(79,911)	(66,911)
Premiums rescinded	79,911	-
Net premiums earned	\$266,576	\$176,435
Gross losses incurred	\$215,224	\$213,691
Losses ceded	(67,108)	(66,382)
Profit from reinsurance contract recorded to strengthen unpaid losses	11,809	10,191
Losses rescinded	67,108	-
1998 ceded amount rescinded	10,191	-
Settlement fee	(22,000)	-
Net losses incurred	\$215,224	\$157,500
Gross other underwriting expenses incurred	\$ 50,456	\$ 36,125
Other underwriting expenses ceded	(12,803)	(10,720)
Other underwriting expenses rescinded	12,803	-
Net other underwriting expenses incurred	\$ 50,456	\$ 25,405

Pinnacol also purchases catastrophic reinsurance for risks in excess of its retention limits on workers' compensation insurance policies written. Should the reinsurer be unable to meet its obligations under the reinsurance contract, Pinnacol would remain liable for amounts ceded to its reinsurer. At December 31, 1999 and 1998, Pinnacol had

Colorado Compensation Insurance Authority  
dba Pinnacol Assurance

Notes to Statutory-Basis Financial Statements (continued)

**6. Reinsurance (continued)**

reinsurance coverage for individual workers' compensation accidents of up to \$20 million in excess of its retention of \$6 million per occurrence on 1999 and 1998 accidents. The reinsurance expense associated with this coverage was \$88,000 and \$76,000 in 1999 and 1998, respectively. Pinnacol's management is not aware of any catastrophes that would result in penetration of these limits.

**7. Commitments and Contingencies**

Pinnacol entered into an 11-year, noncancelable operating lease in July 1991. This lease represents Pinnacol's principal commitment. Rent expense associated with this lease was \$1,618,000 and \$1,407,000 in 1999 and 1998, respectively. During 1997, Pinnacol entered into an agreement to sublet one floor of their leased space for approximately \$234,000 per year through the end of Pinnacol's lease.

Future minimum payments, net of the sublease, under this and other operating commitments of Pinnacol are (in thousands):

2000	\$2,103
2001	1,750
2002	1,469
2003	39
2004	2
	<hr/>
	<u>\$5,363</u>

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

Pinnacol is contingently liable for approximately \$68 million of claims closed by the purchases of annuities for structured settlements. No provision has been made for this contingency as management believes that any payments related to this contingency are remote.

Colorado Compensation Insurance Authority  
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Notes to Statutory-Basis Financial Statements (continued)

**7. Commitments and Contingencies (continued)**

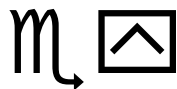
At December 31, 1999, the aggregate amount of annuities due from all life insurers equaled the amount of the reserves eliminated when the annuities were purchased and consisted of the following (in thousands):

<u>Life Insurance Company and Location</u>	<u>Loss Reserves Eliminated by Annuities</u>
GE Assurance, Virginia	\$33,991
SAFECO, Washington	26,137
Transamerica Asset Management, California	3,466
Allstate, Illinois	1,964
Metlife, New York	1,868
Liberty Life Assurance Company, Massachusetts	224
Keyport Life Insurance Company, Rhode Island	174
	<u>\$67,824</u>

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

In planning and performing our audit of the statutory-basis financial statements of Colorado Compensation Insurance Authority dba Pinnacol Assurance (“Pinnacol”) for the year ended December 31, 1999, we considered its internal control to determine our auditing procedures for the purpose of expressing our opinion on Pinnacol’s financial statements and not to provide assurance on its internal control. Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and the use of the Legislative Audit Committee, the Pinnacol Board of Directors, Pinnacol management, 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.



February 20, 2000

Colorado Compensation Insurance Authority  
dba Pinnacol Assurance

Audited Statutory-Basis Financial Statements

December 31, 1999

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