



PINNACOL ASSURANCE

Statutory-Basis Financial Statements and
Supplemental Schedules of Investment Information

December 31, 2018 and 2017

(With Independent Auditors' Report Thereon)

**LEGISLATIVE AUDIT COMMITTEE
2018 MEMBERS**

Senator Nancy Todd
Chair

Representative Lori Saine
Vice Chair

Representative Rod Bockenfeld
Senator Rhonda Fields
Representative Tracy Kraft-Tharp
Senator Paul Lundeen
Representative Dafna Michaelson Jenet
Senator Jim Smallwood

Office of the State Auditor Staff

Dianne E. Ray
State Auditor

Kerri Hunter
Deputy State Auditor

Crystal Dorsey
Contract Monitor

KPMG LLP
Contract Auditors

An electronic version of this report is available at
www.Colorado.gov/auditor

A bound report may be obtained by calling the
Office of the State Auditor
303.869.2800

Please refer to report number 1810F when
requesting this report

**PINNACOL ASSURANCE
2018 BOARD OF DIRECTORS**

Howard L. Carver
Chair

Fiona E. Arnold
Brad R. Busse
Jeffery L. Cummings
Barbara M. Davis
Mark D. Goodman
Joseph A. Hoff
Geraldine A. Lewis-Jenkins
William N. Lindsay

**PINNACOL ASSURANCE
2017 BOARD OF DIRECTORS**

Howard L. Carver
Chair

Fiona E. Arnold
Brad R. Busse
Jeffery L. Cummings
Barbara M. Davis
Mark D. Goodman
Joseph A. Hoff
Geraldine A. Lewis-Jenkins
William N. Lindsay

PINNACOL ASSURANCE

Table of Contents

	Page(s)
Report Summary	1–2
Description of Pinnacol Assurance	3
Independent Auditors' Report	4–5
Statutory-Basis Financial Statements as of and for the years ended December 31, 2018 and 2017:	
Statutory-Basis Statements of Admitted Assets, Liabilities, and Policyholders' Surplus	6
Statutory-Basis Statements of Operations and Changes in Policyholders' Surplus	7
Statutory-Basis Statements of Cash Flow	8
Notes to Statutory-Basis Financial Statements	9–36
Supplemental Schedules of Investment Information	
Investment Risks Interrogatories	38-40
Summary Investment Schedule	41–42
Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	43–44
Required Communications to Legislative Audit Committee	45–48

PINNACOL ASSURANCE

Report Summary

Authority and Purpose/Scope of the Audit

This audit is conducted under the authority of Section 8-45-121(2) of the Colorado Revised Statutes (C.R.S.), which authorizes the State Auditor to conduct an annual financial audit of Pinnacol Assurance (Pinnacol or the Company) and contract with an auditor or firm of auditors, having the specialized knowledge and experience. The primary purpose of our engagement is to audit the statutory-basis financial statements of Pinnacol as of and for the year ended December 31, 2018, 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 statutory basis 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 basis financial statements are free of material misstatement.

The financial statements of Pinnacol are 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 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 U.S. generally accepted accounting principles.

In the course of our audit, we examined, on a test basis, evidence supporting the amounts and disclosures in Pinnacol's statutory basis financial statements as of and for the year ended December 31, 2018.

Audit Opinion and Report

As we are issuing an opinion on the statutory basis financial statements in conformity with accounting principles prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, we have modified our financial statement opinion to include an adverse opinion on accounting principles generally accepted in the United States of America (GAAP).

We issued a report on Pinnacol's compliance and internal control over financial reporting based on an audit of the financial statements performed in accordance with Government Auditing Standards. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be deficiencies, significant deficiencies, or material weaknesses. 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 significant deficiency is a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Summary of Current Year Findings and Recommendations

There were no reported findings and recommendations resulting from the audit for fiscal year 2018.

PINNACOL ASSURANCE
Report Summary

Summary of Prior Year Findings and Recommendations

There were no reported findings and recommendations resulting from the audit for fiscal year 2017.

PINNACOL ASSURANCE

Description of Pinnacol Assurance

December 31, 2018

Pinnacol Assurance (Pinnacol or the Company) was established as a political subdivision of the State of Colorado (the State) 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 and no State monies are used for Pinnacol operations. All revenue, monies, and assets of Pinnacol belong solely to Pinnacol. The State of Colorado has no claim to, nor any interest in, such revenue, monies, and assets and shall not borrow, appropriate, or direct payments from such revenue, monies, and assets for any purpose.

Cake Insure, Inc. (Cake) was incorporated on September 20, 2017. Cake is a wholly-owned subsidiary of Pinnacol and helps small businesses quote and purchase a workers' compensation insurance policy from Pinnacol. Cake is a digital platform designed to market, underwrite, and service small direct policyholders that are not considered high risk. With the launch of Cake, Pinnacol became subject to Title 10, Article 3, Part 8 of the C.R.S., Insurance Holding Company Systems, which requires additional report filings with the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado. Pinnacol holds 100% of the voting shares ownership in Cake. An "Insurance Holding Company System" is two or more affiliated persons, one or more of which is an insurer.

Policyholders' Surplus

Pinnacol had policyholders' surplus of \$1,290,998,000 and \$1,276,308,000 as of December 31, 2018 and 2017, respectively. The increase in surplus is primarily related to current year net income, offset by the change in unrealized capital gains.



KPMG LLP
Suite 800
1225 17th Street
Denver, CO 80202-5598

Independent Auditors' Report

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

Report on the Financial Statements

We have audited the accompanying financial statements of Pinnacol Assurance, which comprise the statutory statements of admitted assets, liabilities, and policyholders' surplus as of December 31, 2018 and 2017, and the related statutory statements of operations and changes in policyholders' surplus, and cash flow for the years then ended, and the related notes to the statutory financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

As described in Note 1 to the financial statements, the financial statements are prepared by Pinnacol Assurance using statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, which is a basis of accounting other than U.S. generally accepted accounting principles. Accordingly, the financial statements are not intended to be presented in accordance with U.S. generally accepted accounting principles.



The effects on the financial statements of the variances between the statutory accounting practices described in Note 1 and U.S. generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the variances between statutory accounting practices and U.S. generally accepted accounting principles discussed in the Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles paragraph, the financial statements referred to above do not present fairly, in accordance with U.S. generally accepted accounting principles, the financial position of Pinnacol Assurance as of December 31, 2018 and 2017, or the results of its operations or its cash flows for the years then ended.

Opinion on Statutory Basis of Accounting

In our opinion, the 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, 2018 and 2017, and the results of its operations and its cash flow for the years then ended, in accordance with statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado described in Note 1.

Other Matter

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The supplementary information included in the supplemental schedule of investment risks interrogatories and supplemental summary of investment schedule are presented for purposes of additional analysis and are not a required part of the financial statements but is supplementary information required by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated May 22, 2019 on our consideration of Pinnacol Assurance's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Pinnacol Assurance's internal control over financial reporting compliance.

KPMG LLP

Denver, Colorado
May 22, 2019

PINNACOL ASSURANCE

Statutory-Basis Statements of Admitted Assets, Liabilities, and
Policyholders' Surplus

December 31, 2018 and 2017

(In thousands)

Admitted Assets	2018	2017
Cash and invested assets:		
Bonds at adjusted carrying value, fair value of \$2,099,192 in 2018 and \$2,060,910 in 2017 (note 4)	\$ 2,129,597	2,017,524
Preferred stock at adjusted carrying value, fair value of \$7,927 in 2018 and \$8,232 in 2017 (note 4)	7,924	8,158
Common stock at fair value, adjusted cost of \$387,760 in 2018 and \$409,072 in 2017 (note 4)	447,357	544,752
Mortgage loans on real estate (note 4)	15,024	—
Real estate at cost – net of accumulated depreciation of \$17,196 in 2018 and \$15,776 in 2017	15,984	16,854
Cash, cash equivalents, and short-term investments	73,492	76,899
Other invested assets (note 4 and note 9)	92,944	70,490
Receivables for securities sold	1,317	842
Total cash and invested assets	<u>2,783,639</u>	<u>2,735,519</u>
Uncollected premiums	35,689	35,161
Earned but unbilled premiums	32,485	43,610
Funds held by or deposited with reinsurers	2,182	1,792
Electronic data processing equipment – at cost – net of accumulated depreciation of \$8,772 in 2018 and \$8,003 in 2017	495	985
Receivables from subsidiaries and affiliates	172	751
Accrued investment income	17,940	15,893
Total admitted assets	<u>\$ 2,872,602</u>	<u>2,833,711</u>
Liabilities and Policyholders' Surplus		
Reserve for unpaid losses and loss adjustment expenses:		
Reserve for unpaid losses (note 2)	\$ 813,072	815,521
Reserve for unpaid loss adjustment expenses (note 2)	107,496	107,574
Total reserve for unpaid losses and loss adjustment expenses	<u>920,568</u>	<u>923,095</u>
Unearned premiums	83,113	83,431
Advance premiums	11,029	10,786
Dividends payable to policyholders	103,478	78,600
Commissions payable	39,617	39,307
Structured settlement liability (note 3)	386,352	384,790
Payable to subsidiaries and affiliates	58	24
Credit balances due policyholders	8,953	8,566
Payable for securities purchased	4,430	5,183
Other liabilities	24,006	23,621
Total liabilities	<u>1,581,604</u>	<u>1,557,403</u>
Surplus notes (note 7)	100,000	100,000
Special surplus fund for unfunded pension benefits (notes 1 and 7)	407,510	350,883
Unassigned policyholders' surplus (note 7)	783,488	825,425
Total liabilities and policyholders' surplus	<u>\$ 2,872,602</u>	<u>2,833,711</u>

See accompanying notes to statutory-basis financial statements.

PINNACOL ASSURANCE

Statutory-Basis Statements of Operations and Changes in
Policyholders' Surplus

Years ended December 31, 2018 and 2017

(In thousands)

	<u>2018</u>	<u>2017</u>
Underwriting income:		
Premiums earned	\$ 631,755	625,619
Deductions:		
Losses incurred (note 2)	303,206	303,662
Loss adjustment expenses incurred (note 2)	74,775	79,047
Other underwriting expenses incurred	<u>152,720</u>	<u>152,004</u>
Total underwriting deductions	<u>530,701</u>	<u>534,713</u>
Net underwriting gain	<u>101,054</u>	<u>90,906</u>
Investment income:		
Net investment income earned (note 4)	83,380	77,446
Net realized capital gain (note 4)	<u>9,825</u>	<u>17,890</u>
Total investment income	93,205	95,336
Other income (loss):		
Provision for uncollectible premiums	(3,442)	(2,595)
Structured settlement expense (note 3)	(10,828)	(7,908)
Other income	921	856
Dividends to policyholders	<u>(72,355)</u>	<u>(52,430)</u>
Net income	108,555	124,165
Change in nonadmitted assets	538	(1,898)
Change in net unrealized gains on investments	(83,513)	67,692
Correction of an error (note 1x)	(10,890)	—
Policyholders' surplus – beginning of year	<u>1,276,308</u>	<u>1,086,349</u>
Policyholders' surplus – end of year	\$ <u><u>1,290,998</u></u>	\$ <u><u>1,276,308</u></u>

See accompanying notes to statutory-basis financial statements.

PINNACOL ASSURANCE

Statutory-Basis Statements of Cash Flow

Years ended December 31, 2018 and 2017

(In thousands)

	<u>2018</u>	<u>2017</u>
Cash flow from operations:		
Premiums collected – net of reinsurance	\$ 628,256	629,312
Losses and loss adjustment expenses paid – net of reinsurance and deductibles	(380,509)	(395,326)
Other underwriting expenses paid	(153,444)	(141,056)
Dividends paid to policyholders	(47,478)	(48,474)
Investment income received, net of investment expenses paid	84,711	80,757
Miscellaneous proceeds	921	857
Net cash provided by operations	<u>132,457</u>	<u>126,070</u>
Cash flow from investments:		
Proceeds from sale, maturity, or redemption of investments:		
Bonds	392,213	493,543
Stocks	91,469	99,597
Other invested assets	9,245	6,114
Miscellaneous proceeds	—	842
Total proceeds from sale or redemption of investments	<u>492,927</u>	<u>600,096</u>
Cost of investments acquired:		
Bonds	(520,217)	(609,754)
Stocks	(54,746)	(72,400)
Mortgage loans on real estate	(15,024)	—
Other invested assets	(30,506)	(27,802)
Miscellaneous proceeds (applications)	(1,777)	(1,182)
Total investments acquired	<u>(622,270)</u>	<u>(711,138)</u>
Net cash used in investments	<u>(129,343)</u>	<u>(111,042)</u>
Cash flow used in financing and miscellaneous sources:		
Cash used in other miscellaneous sources	<u>(6,521)</u>	<u>(2,927)</u>
Net cash used in financing and miscellaneous sources	<u>(6,521)</u>	<u>(2,927)</u>
Net (decrease) increase in cash, cash equivalents, and short-term investments	(3,407)	12,101
Cash, cash equivalents, and short-term investments – beginning of year	<u>76,899</u>	<u>64,798</u>
Cash, cash equivalents, and short-term investments – end of year	\$ <u><u>73,492</u></u>	\$ <u><u>76,899</u></u>

See accompanying notes to statutory-basis financial statements.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

(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 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.

Cake Insure, Inc. (Cake) was incorporated on September 20, 2017. Cake is a wholly-owned subsidiary of Pinnacol and helps small businesses quote and purchase a workers' compensation insurance policy from Pinnacol.

(b) Basis of Presentation

The accompanying statutory basis 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 basis financial statements, the Company has followed NAIC guidelines and has not utilized any practices 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 differences between SAP and GAAP are as follows:

- Policy acquisition costs, such as commissions, premium surcharges and other expenses directly related to the cost of acquiring new business are expensed as incurred, while under GAAP, they are deferred and amortized over the policy term to provide for proper matching of revenue and expense.
- Investments in debt securities are generally carried at amortized value, while under GAAP, they would be carried at fair value. For GAAP, changes in fair value in bonds go through net investment income.
- Pinnacol's investment in preferred stock of Cake, a subsidiary, is reported at the lower of cost or fair value. Under GAAP, it would be included in the consolidated financial statements and all significant intercompany balances and transactions would be eliminated in consolidation.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

- Short term investments, which include investments with maturities at the time of acquisition of one year or less, are included with cash and cash equivalents in the accompanying statutory basis financial statements, while under GAAP, only investments with maturities at the time of acquisition of three months or less are included with cash and cash equivalents.
- Assets are reported under NAIC SAP at “admitted asset” value and “nonadmitted” assets, or those items not meeting the definition of an asset, are excluded through a charge against policyholders’ surplus, while under GAAP, all assets are reported on the balance sheet, net of any required valuation allowance. Nonadmitted assets at December 31, 2018 and 2017 comprised the following (in thousands):

	2018	2017
Receivables	\$ 16,551	16,894
Fixed assets	280	578
Prepays	2,874	2,771
Total nonadmitted assets	\$ 19,705	20,243

- The reserve for losses and loss adjustment expenses (LAE) is reported net of reinsurance, while under GAAP, the balance sheet reports reinsurance recoverable, including amounts related to losses incurred but not reported, as assets.
- The surplus note is reported as a component of surplus, increasing policyholders’ surplus under NAIC SAP. Under GAAP the surplus note is recorded as long term debt. The related interest expense may not be accrued under NAIC SAP until approved for payment by the commissioner of the state of domicile while under GAAP, the interest expense is recorded as incurred.
- Governmental Accounting Standards Board (GASB) Statement No. 68, *Accounting and Financial Reporting for Pensions*, which is effective for fiscal years ended June 30, 2014 or later, requires employers that are part of a cost sharing multiple employer pension fund to record their portion of the unfunded liability, while under NAIC SAP, the employer must only record the cost of the contribution and any liability for any contributions due and unpaid.
- Governmental Accounting Standards Board (GASB) Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, which is effective for fiscal years ended June 30, 2017, and requires employers that are part of a cost sharing multiple employer OPEB plan to record their portion of the net OPEB liability, while under NAIC SAP, the employer must only record the cost of the contribution and any liability for any contributions due and unpaid.

The effect of the differences between statutory basis of accounting and generally accepted accounting principles, although not reasonably determinable, is presumed to be material. Pinnacol is a political subdivision of the State and as such would follow all applicable Governmental Accounting Standards Board (GASB) pronouncements.

(c) Use of Estimates

The preparation of statutory basis financial statements in accordance with accounting practices prescribed by the Division requires management to make estimates and assumptions that affect the

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the statutory basis financial statements and the reported amounts of revenue and expenses during the reporting period. Significant estimates include the internal structured settlement liability, the reserves for unpaid losses and loss adjustment expenses, the earned but unbilled premiums asset, as well as the allowance for uncollectible premiums, among others. Actual results could differ from those estimates and such differences could be significant.

(d) Investments

Investments are recorded on the trade date. Bonds and preferred stocks are stated at amortized value or fair value, based on their NAIC designation, and are adjusted for other than temporary declines in fair value. Mortgage loans on real estate are carried at the outstanding principal balance, less any allowances for credit losses. Common stocks, mutual funds, and common trust funds are carried at fair value. Other invested assets, including partnerships, are recorded at the underlying audited equity value. For those investments in which the audited financial statements are not available in a timely manner, the unaudited equity value is used. Unrealized capital gains on common stocks, preferred stocks, mutual funds, and common trust funds are reported as a direct adjustment to policyholders' surplus. Common stocks and preferred stocks in an unrealized loss position for both years are recorded as other than temporarily impaired (OTTI) and are recorded as a realized loss in the statutory basis statement of operations in the period in which they occur.

Bond premium or discount is recognized 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 widely accepted models with inputs from major third party data providers. Model assumptions are specific to asset class and collateral type and are regularly evaluated and adjusted where appropriate. The prospective adjustment method is used to value all loan backed securities.

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 \$1,419,000 and \$1,418,000 for the years ended December 31, 2018 and 2017, respectively, and is included in net investment income earned in the statutory basis statements of operations and changes in policyholders' surplus.

(e) Investment in subsidiary

Cake was incorporated on September 20, 2017 as a subsidiary of Pinnacol. Pinnacol purchased 2,000,000 voting shares of preferred stock in Cake on September 28, 2017. Pinnacol's ownership percentage in Cake is 100%.

Pinnacol does not consolidate their financial results with Cake. Pinnacol and Cake issue standalone financial statements that are each independently audited.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

Perpetual preferred stock of Cake is reported at the lower of book value or fair value. Cake preferred shares are not publicly priced. Therefore, the per share cost is being used by Pinnacol for carrying value and fair value for the year in which the preferred stock of Cake was purchased and is confirmed by the NAIC's Securities Valuation Office (SVO).

(f) Cash, Cash Equivalents, and Short-Term Investments

For purposes of the statement of cash flow, 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, 2018, cash, cash equivalents, and short term investments of approximately \$73,492,000 include \$(3,670,000) of book overdrafts, \$67,200,000 of cash equivalents, and \$9,962,000 of short term investments. As of December 31, 2017, cash, cash equivalents, and short term investments of approximately \$76,899,000 include \$(3,095,000) of book overdrafts, \$79,794,000 of cash equivalents, and \$200,000 of short term investments.

(g) Receivables for Securities Sold

As of December 31, 2018 and 2017, receivables for securities sold were approximately \$1,317,000 and \$842,000, respectively. Receivables for securities arise when sales of securities are recorded as of the trade date. A receivable due from the custodian is established when a security has been sold, but the proceeds from the sale have not yet been received. Receivables for securities not received within 15 days from the stated settlement date are nonadmitted. There were no nonadmitted receivables for securities sold in 2018 or 2017.

(h) Uncollected Premiums

Uncollected premiums are reported net of allowances for uncollectible and nonadmitted balances. Certain receivables are not admissible for statutory accounting purposes.

All receivables for canceled policies and billed receivables that relate to balances outstanding for a period exceeding 90 days are not admissible according to the Manual.

Pinnacol independently estimates the realizable amounts of premiums receivable and records an allowance for any uncollectible balances that were not already non-admitted. During 2018 and 2017, Pinnacol recorded a provision of approximately \$3,442,000 and \$2,595,000, 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 basis statements of operations and changes in policyholders' surplus.

A significant portion of Pinnacol's premium receivable balances at December 31, 2018 and 2017 were from companies operating in the construction and services industries in Colorado. The construction industry represents approximately 39% of premiums earned as of December 31, 2018 and 37% as of December 31, 2017. The services industry represents approximately 38% of premiums earned as of December 31, 2018 and 40% as of December 31, 2017, with all other individual industries constituting the remainder of premiums receivable balances.

(i) Earned but Unbilled Premiums

Earned but unbilled premiums represent a receivable or liability for changes in earned premium and audit premiums, which are amounts due from or to policyholders after the respective policy period has

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

expired based on payroll audits performed by Pinnacol. A liability is included as a component of credit balances due policyholders. Such amounts are estimated by Pinnacol based upon internal calculations using historical premium data. Pinnacol recorded a net estimated earned but unbilled premium receivable in 2018 and 2017 of approximately \$32,485,000 and \$43,610,000, respectively.

(j) 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 2018 and 2017, such amounts are approximately \$8,953,000 and \$8,566,000, respectively.

(k) 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, 2018 and 2017 was approximately \$495,000 and \$985,000, respectively. Related depreciation expense of approximately \$769,000 and \$969,000 was incurred during 2018 and 2017, respectively, and is included in LAE and other underwriting expenses incurred in the statutory basis statements of operations and changes in policyholders' surplus.

(l) Office Furniture, Equipment, Software, Art, and Leasehold Improvements

Office furniture, equipment, software, art, and leasehold improvements are recorded at cost and depreciated on a straight line basis. Equipment and software are depreciated over an estimated useful life of three years. Office furniture, art, and automobiles are depreciated over an estimated useful life of five years. Leasehold improvements are depreciated over the shorter of the term of the lease or the useful life. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2018 and 2017 was approximately \$280,000 and \$578,000, respectively. Related depreciation expense of approximately \$240,000 and \$530,000 was incurred in 2018 and 2017, respectively, and is included in LAE and other underwriting expenses incurred in the statutory basis statements of operations and changes in policyholders' surplus.

(m) Safety Group Dividend Program

Pinnacol has a safety group program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. Pinnacol paid out safety group dividends of \$2,717,000 in 2018 and \$2,303,000 in 2017. As of December 31, 2018 and 2017, safety group dividends payable of \$3,289,348 and \$3,651,000, respectively, are included in dividends payable to policyholders. These dividends are not declared from surplus nor are they recorded as a direct reduction to policyholders' surplus. The dividends are recorded as dividends to policyholders in the statutory basis statements of operations and changes in policyholders' surplus.

(n) Individual Loss Control Dividend Program

Pinnacol has an individual loss control dividend (ILCD) program that is designed for policyholders who are committed to effective loss control in their business operations. If the policyholder meets the minimum premium requirements and pays an additional 5% premium charge as a buy in to the plan, the policyholder may receive a reduction of premium based on the policy premium and the loss ratio. Pinnacol paid out ILCDs of \$17,769,000 in 2018 and \$16,483,000 in 2017. As of December 31, 2018 and 2017, ILCDs payable of \$30,061,000, and \$24,882,000, respectively, are included as dividends payable to policyholders in the statutory-basis statements of operations and changes in policyholders' surplus.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

(o) 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 declared general policyholder dividends to its policyholders in good standing of approximately \$70,000,000 in 2018 and \$50,000,000 in 2017. This is included in dividends payable to policyholders.

(p) Reserve for Unpaid Losses and Loss Adjustment Expenses and Structured Settlement Liability

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, 2018 and 2017. 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 basis statements of operations and changes in policyholders' surplus in the period such information becomes known. Subrogation claims (claims against third parties) are recognized as a reduction of losses incurred when collections are received.

Internal structured settlement liabilities represent obligations to claimants and dependents on cases that have been closed by contract. The discounted reserve for internal structured settlements is estimated by management, which uses an independent third party actuary to provide estimates based on these obligations.

(q) Revenue Recognition and Unearned Premiums

For certain policies, earned premium is recorded on an installment basis to match the billing frequency stated in the policyholder contract with a provision for amounts earned but unbilled. Earned premium for all other contracts is recognized using the daily pro rata method over the period the policy is effective.

Unearned premiums represent amounts either collected or billed and due from policyholders at December 31, 2018 and 2017 but unearned at that date as they pertain to subsequent policy periods. Unearned premiums billed, which relate to policy effective dates subsequent to December 31, 2018 are not included in the unearned premiums balance, but are included as advance premium if the related cash is collected. Unearned premiums are computed on a daily pro rata basis over the effective period of the policies.

(r) Premium Deficiency Reserve

A premium deficiency reserve is recognized by recording an additional liability for the deficiency, which results when anticipated future loss, loss adjustment expense, commissions, other acquisition costs and maintenance costs exceed the recorded unearned premium reserve, any future installment premiums on existing policies, and anticipated investment income. The change in this reserve is recorded as a component of other underwriting deductions.

Pinnacol recorded a premium deficiency reserve of \$0 at December 31, 2018 and 2017. Pinnacol considered anticipated investment income at 3.5% when evaluating the premium deficiency reserve for 2018.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

(s) *Multiemployer Pension Plans and Other Postretirement Benefits*

Pinnacol participates in the State Division Trust Fund (SDTF), a cost-sharing multiple-employer defined benefit pension and health care trust fund plan administered by the Public Employees' Retirement Association (PERA). SDTF provides retirement, disability, and survivor benefits. All employees of Pinnacol are members of the SDTF.

As a participant in a multiple-employer pension plan and health care trust fund, Pinnacol recognizes as net pension cost and net postretirement benefit cost the required contribution for the period and as a liability any contributions due and unpaid.

(t) *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. Premiums earned are reported net of reinsurance (note 5).

(u) *Taxes*

As a political subdivision of the State of Colorado, Pinnacol is generally 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. However, Pinnacol is subject to income taxes on any net income that is derived from a trade or business regularly carried on and not in furtherance of the purposes for which it was granted exemption. No income tax provision has been recorded as the net income, if any, from any unrelated trade or business, in the opinion of management, is not material to the financial statements taken as a whole.

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)(a), C.R.S. The surcharge is based on a rate established by the Colorado Department of Labor and Employment Division of Workers' Compensation annually, approximately 1.00% and 1.03% at December 31 2018 and 2017, respectively. Such amounts are included in other underwriting expenses incurred.

(v) *Surplus Note*

Pinnacol issued a \$100,000,000 surplus note on June 25, 2014. Before issuing this debt, the Company obtained approval from the Commissioner of the Division for the transaction and approval to classify the debt as a component of policyholders' surplus.

(w) *Special Surplus Fund for Unfunded Pension Benefits*

Pinnacol participates in a cost sharing multiple-employer defined benefit pension plan administered by PERA. PERA has a net pension liability which represents the unfunded pension benefits. Statutory accounting does not allow Pinnacol's portion of the net pension liability to be recorded as a liability but allows a company to establish a special surplus fund to provide for contingencies. GASB No. 68, *Accounting and Financial Reporting for Pensions* is effective for fiscal years beginning after June 15, 2014. The statement requires cost-sharing employers participating in defined benefit plans to record their proportionate share of the collective net pension liability in their GASB financial statements. PERA provides Pinnacol with the audited schedule of employers' allocations and net pension liability. The total pension liability used to calculate the net pension liability is determined by an actuarial valuation as of December 31, 2016. PERA uses standard update procedures to roll-forward the total pension

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

liability to December 31, 2017. A discount rate of 4.72% is being used. PERA also provides the employer allocation percentage for purposes of calculating Pinnacol's proportionate share of the collective net pension liability.

(x) Immaterial Correction of an Error

During 2018, Pinnacol corrected the methodology in the calculation and reporting of earned but unbilled premiums (EBUB). It was determined that the use of earned premium rather than written premium as the basis for the calculation would result in a more accurate estimate. As of December 31, 2017, surplus was overstated by \$10,890,000 and the receivable for EBUB premiums was overstated by \$10,890,000. The adjustment is immaterial to Pinnacol's surplus as of December 31, 2018 and 2017.

(y) Application of Recent Statutory Accounting Pronouncements

During 2018 there were no substantive revisions to statutory accounting that were applicable to Pinnacol, and therefore, there were no substantive revisions adopted by the Company.

(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 basis statements of operations 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 currently estimated reserves 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.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

Unpaid Losses and Loss Adjustment Expenses

Activity in the liability for unpaid losses and loss adjustment expenses in 2018 and 2017 is summarized as follows (in thousands):

	Unpaid losses and loss adjustment expenses	
	2018	2017
Balance at January 1	\$ 923,095	935,712
Additional amounts incurred related to:		
Current year	431,225	432,960
Prior years	(53,243)	(50,251)
Total incurred	377,982	382,709
Reductions relating to payments for:		
Current year	134,677	131,868
Prior years	245,832	263,458
Total paid	380,509	395,326
Balance at December 31	\$ 920,568	923,095

During the year ended December 31, 2018, the provision for unpaid losses and loss adjustment expenses for insured events of prior years was reduced by \$299,075,000 to \$624,020,000. This reduction includes payments for unpaid losses and loss adjustment expenses of approximately \$245,832,000 and a \$53,243,000 reduction in reserves for prior year unpaid losses and loss adjustment expense. This decrease is generally the result of ongoing analysis of recent loss development trends and better than expected development. Pinnacol's claims 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 initiatives to improve claims handling practices and reduce claims handling expenses when prudent and a reduction of ultimate claim frequency in Colorado. Pinnacol management continually evaluates the estimated 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. At the end of the current year, the amount of reserve credit recorded for high deductibles on unpaid losses was \$2,952,000. Such reduction is collateralized generally with letters of credit for the benefit of Pinnacol. Pinnacol received \$6,989,556 and \$7,133,000 in subrogation as of December 31, 2018 and 2017, respectively. There were no significant changes in methodologies or assumptions used in calculating the reserves.

(3) Internal Structured Settlements

Pinnacol has an internal structured settlement program in which it retains the liability for settlements to claimants rather than purchasing annuities from third parties. This liability has mortality risk and is discounted using a market rate. The internal structured settlement liability is actuarially valued. The internal structured settlement liability is reported as a financing liability separate from unpaid losses and loss adjustment expenses on the statutory-basis statements of admitted assets, liabilities, and policyholders' surplus.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

Activity in the liability for internal structured settlements in 2018 and 2017 is summarized as follows (in thousands):

	2018	2017
Beginning balance	\$ 384,790	378,736
Amounts incurred:		
Change in valuation	10,828	7,908
Amounts paid	(26,166)	(25,377)
New internal structured settlements	16,900	23,523
Ending balance	\$ 386,352	384,790

Pinnacol uses an annuity quote that is based upon an estimated discount rate as a basis for the paid claim amount. As such, the liability should be discounted at a market rate. The discount rate applied to internal structured settlement liabilities is 2.5% at December 31, 2018 and 2017.

The amount of the discount for unpaid internal structured settlements as of December 31, 2018 and 2017 is approximately \$148,736,000 and \$152,555,000, respectively. The discount amounts for internal structured settlement reserves at December 31, 2018 and 2017 are distributed over the years in which the losses were incurred as follows (in thousands):

2018		2017	
Loss year	Discount	Loss year	Discount
Prior	\$ 96,240	Prior	\$ 101,024
2008	9,816	2008	10,336
2009	9,853	2009	10,414
2010	5,113	2010	5,591
2011	6,728	2011	7,149
2012	4,207	2012	4,320
2013	5,331	2013	5,287
2014	6,116	2014	6,019
2015	3,271	2015	1,979
2016	1,484	2016	418
2017	540	2017	18
2018	37		—
Total	\$ 148,736	Total	\$ 152,555

(4) Investments

Estimated fair value of investments in bonds and equities is based on quotations provided by widely accepted third party data providers. In 2018 and 2017, Interactive Data Corporation (IDC), Reuters, and Markit Partners were used to obtain fair market values. Additionally, in 2018 and 2017, the fair value of certain common trust funds were primarily determined by net asset value and common stock warrants were primarily determined by a widely accepted third party vendor, followed by a hierarchy using broker/dealer quotes, Bloomberg, Yield Book analytic model, and a benchmark to index model. Prior month price is used only when information is limited or unavailable.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

(a) Bonds

The Securities Valuation Office (SVO) of the NAIC assigns designations of bonds from 1 to 6. Bonds with designations of 1–2 are stated at amortized value using the interest method. Bonds with designations of 3–6 require the bond to be carried at the lower of amortized value or fair value, with any related unrealized loss reported in policyholders' surplus.

During 2018 and 2017, Pinnacol had investments in long term bonds, which the SVO assigned a 3 or higher designation. Carrying values are equal to the lower of amortized value or fair value for these bonds.

The carrying value and the fair value of investments in long term bonds in 2018 and 2017 are summarized as follows (in thousands). The carrying value includes investment grade bonds that are reported at amortized value and low rated bonds that are reported at the lower of cost or fair value:

	2018			
	Carrying value	Gross unrealized gains	Gross unrealized losses	Fair value
Government obligations:				
Nonloan-backed bonds \$	115,041	2,886	(730)	117,197
Loan-backed bonds	6,253	204	—	6,457
U.S. political subdivisions:				
Nonloan-backed bonds	11,247	384	(46)	11,585
Loan-backed bonds	—	—	—	—
U.S. special revenue:				
Nonloan-backed bonds	49,939	1,543	(505)	50,977
Loan-backed bonds	382,534	550	(9,438)	373,646
Industrial and miscellaneous:				
Nonloan-backed bonds	1,220,548	10,535	(33,777)	1,197,306
Loan-backed bonds	213,588	948	(2,821)	211,715
Hybrid Securities:				
Nonloan-backed bonds	6,704	54	(185)	6,573
Loan-backed bonds	—	—	—	—
Bank Loans:				
Nonloan-backed bonds	123,743	330	(337)	123,736
Loan-backed bonds	—	—	—	—
	\$ 2,129,597	17,434	(47,839)	2,099,192

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

	2017			
	Carrying value	Gross unrealized gains	Gross unrealized losses	Fair value
Government obligations:				
Nonloan-backed bonds \$	103,710	4,115	(487)	107,338
Loan-backed bonds	11,945	500	—	12,445
U.S. political subdivisions:				
Nonloan-backed bonds	11,268	691	(24)	11,935
Loan-backed bonds	—	—	—	—
U.S. special revenue:				
Nonloan-backed bonds	51,227	3,588	(81)	54,734
Loan-backed bonds	349,008	1,168	(2,846)	347,330
Industrial and miscellaneous:				
Nonloan-backed bonds	1,241,051	37,378	(3,848)	1,274,581
Loan-backed bonds	241,708	3,082	(125)	244,665
Hybrid Securities:				
Nonloan-backed bonds	7,607	275	—	7,882
Loan-backed bonds	—	—	—	—
	<u>\$ 2,017,524</u>	<u>50,797</u>	<u>(7,411)</u>	<u>2,060,910</u>

The book/adjusted carrying value and estimated fair value of investments in long term bonds at December 31, 2018, by contractual maturity, are shown in the following table (in thousands). 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.

	2018	
	Book/adjusted carrying value	Fair value
Due in one year or less	\$ 126,822	125,650
Due after one year through five years	703,554	698,065
Due after five years through ten years	884,821	866,314
Due after ten years	414,400	409,163
	<u>\$ 2,129,597</u>	<u>2,099,192</u>

Proceeds from sales of investments in long term bonds during 2018 and 2017 were approximately \$125,208,000 and \$227,717,000, respectively. Realized gains on long term bonds of approximately \$2,270,000 and \$4,885,000 and realized losses of approximately \$(3,001,000) and \$(1,908,000) were recognized during 2018 and 2017, respectively.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

The following table provides the length of impairment for those investments in long term bonds with an unrealized loss as of December 31, 2018 (in thousands):

Description of securities	Less than 12 months		12 months or greater		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. government	\$ 23,712	(206)	56,946	(524)	80,658	(730)
U.S. political subdivisions	—	—	2,411	(46)	2,411	(46)
U.S. special revenue	115,798	(1,831)	226,148	(8,112)	341,946	(9,943)
Industrial and miscellaneous	792,596	(26,184)	285,326	(14,912)	1,077,922	(41,096)
Hybrid securities	6,307	(254)	63	(12)	6,370	(266)
Bank loans	110,858	(5,404)	8,677	(710)	119,535	(6,114)
Total	\$ 1,049,271	(33,879)	579,571	(24,316)	1,628,842	(58,195)

The following table provides the length of impairment for those investments in long term bonds with an unrealized loss as of December 31, 2017 (in thousands):

Description of securities	Less than 12 months		12 months or greater		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
U.S. government	\$ 40,156	(258)	30,741	(229)	70,897	(487)
U.S. political subdivisions	2,453	(24)	—	—	2,453	(24)
U.S. special revenue	183,505	(1,142)	79,568	(1,785)	263,073	(2,927)
Industrial and miscellaneous	277,899	(2,460)	141,478	(3,233)	419,377	(5,693)
Hybrid securities	522	(6)	496	(5)	1,018	(11)
Total	\$ 504,535	(3,890)	252,283	(5,252)	756,818	(9,142)

(b) Loan-Backed and Structured Securities

Loan backed securities are stated at amortized value or fair value based on their NAIC designation. 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 widely accepted models with inputs from major third party data providers. Any loan backed and structured securities in an unrealized loss position were reviewed to determine whether an OTTI should be recognized at year end. At December 31, 2018 and 2017, Pinnacol did not recognize any OTTI on loan backed securities. Loan backed and structured securities in an unrealized loss position as of year-end,

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

stratified based on length of time continuously in these unrealized loss positions, are as follows (in thousands):

	2018	
	Aggregate amount of unrealized loss	Aggregate fair value of securities with unrealized loss
Less than twelve months	\$ 3,863	249,730
Twelve months or longer	8,390	242,482
	<u>\$ 12,253</u>	<u>492,212</u>

(c) Equities

Unrealized gains on investments in common stocks, mutual funds, and common trust funds are reported as a component of policyholders' surplus. For any decline in the fair value of equities which is determined to be other than temporary, the resulting OTTI loss is recognized in the statement of operations. OTTI of common stocks, mutual funds, and common trust 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, mutual funds, and common trust funds are summarized as follows (in thousands):

	Original cost	Adjusted cost	Gross unrealized gains	Fair value
December 31, 2018	\$ 426,489	387,760	59,597	447,357
December 31, 2017	\$ 445,397	409,072	135,680	544,752

The Company is a member of the Federal Home Loan Bank (FHLB) of Topeka. Through its membership, the Company may borrow an amount which is dependent on the market value and risk related to investments that are held at FHLB. The Company has not conducted any borrowings with the FHLB as of December 31, 2018. As a requirement of the membership, Pinnacol owns FHLB Class A and Class B Capital Stock. In 2018, these assets totaled \$500,000 and \$10,000, respectively.

(d) Mortgage Loans on Real Estate

The Company held \$15,024,000 of commercial mortgage loans at December 31, 2018. Mortgage loans on real estate consist entirely of domestic commercial collateralized loans and are carried at their unpaid principal balances adjusted for any unamortized premiums or discounts, origination fees, provision allowances, and foreign currency translations. Interest income is accrued on the unpaid principal balance for all loans, except for loans on non-accrual status. Premiums, discounts, and origination fees are amortized to net investment income using the effective interest method.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

A third-party manager actively manages the Company's mortgage loan portfolio by completing ongoing comprehensive analysis of factors such as debt service coverage ratios, loan-to-value ratios, payment status, default or legal status, collateral property evaluations, and general market conditions. On a quarterly basis, the Company reviews any provided credit quality risk indicators in its internal assessment of loan impairment and credit loss.

Management's periodic evaluation and assessment for mortgage impairments is based on delinquency status, internally derived fair value, as well as credit concern status based on known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the fair value of the underlying collateral, composition of the loan portfolio, current economic conditions, loss experience, and other relevant factors. Risk is mitigated primarily through first lien collateralization, guarantees, loan covenants, and borrower reporting requirements. Since the Company does not hold uncollateralized mortgages, loans are generally not deemed fully uncollectible. Any remaining unrecoverable amounts are written off during the final stage of the foreclosure process.

Loan balances are considered delinquent when payment has not been received based on contractually agreed upon terms. The accrual of interest is discontinued when concerns exist regarding the realization of loan principal or interest. The Company resumes interest accrual on loans when a loan returns to current status or under new terms when loans are restructured or modified.

At December 31, 2018, the Company did not have any troubled, impaired, or delinquent mortgage loans, or any reason to believe payments would be uncollectible on any existing loans.

(e) Other Invested Assets

Investments in partnerships are stated at the underlying audited equity value. For those investments in which the audited financial statements were not available by the March 1, 2019 statutory annual statement filing deadline, the unaudited equity value was used. These assets totaled \$92,944,000 and \$70,490,000 in 2018 and 2017, respectively. The Company has contributed \$83,928,000 in net capital (capital contributions – capital distributions) since investing in partnerships and may be responsible for up to an additional \$116,191,000.

(f) Impairment of Investments

The Company writes securities down to fair value that it deems to be OTTI 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 OTTI 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.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

- 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.
- A change in future expected cash flow has occurred.
- 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.
- The present value of projected cash flows expected to be collected is less than amortized value of loan-backed and structured securities.

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

At December 31, 2018 and 2017, 9.03% and 10.4% of long term bonds held by the Company were rated non-investment grade, respectively. At December 31, 2018 and 2017, the Company had approximately \$58,123,000 and \$9,056,000, respectively, of unrealized losses related to its long term bonds. The unrealized losses on securities are primarily attributable to fluctuations in market interest rates and changes in credit spreads since the securities were acquired.

(g) Other-Than-Temporary Impairment

During 2018 and 2017, the Company recognized \$4,620,000 and \$1,689,000, respectively, in OTTI on long term bonds, \$31,000 and \$8,000, respectively, in OTTI on preferred stock, and \$8,128,000 and \$2,255,000, respectively, in OTTI on common stocks, mutual funds, and common trust funds.

(h) Fair Value Measurements

The Company has categorized its assets and liabilities that are reported on the statutory basis statements of admitted assets, liabilities, and policyholder's surplus at fair value into the three-level fair value hierarchy. The three-level fair value hierarchy is based on the degree of subjectivity inherent in the valuation method by which fair value was determined. The three levels are defined as follows.

- Level 1 – Quoted Prices in Active Markets for Identical Assets and Liabilities: This category, for items measured at fair value on a recurring basis includes common stocks, preferred stocks and money market mutual funds. The estimated fair value of the equity securities within this category are based on quoted prices in active markets and are thus classified as Level 1.
- Level 2 – Significant Other Observable Inputs: This category for items measured at fair value on a recurring basis includes bonds and common stocks which are not exchange traded. The estimated fair values of some of these items were determined by independent pricing services using observable inputs. Others were based on quotes from markets which were not considered actively traded.
- Level 3 – Significant Unobservable Inputs: This category for items measured at fair value includes common stocks, common stock warrants, preferred stocks, and bonds. The estimated fair value of

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

common stock warrants and bonds was determined by internal ratings in the absence of observable inputs.

At the end of each reporting period, the Company evaluates whether or not any event has occurred or circumstances have changed that would cause an instrument to be transferred between Levels 1 and 2. This policy also applies to transfers into or out of Level 3 as stated below. During the current year, no transfers between Level 1 and 2 were required.

The following table represents (in thousands) information about the Company's financial assets measured at fair value in Level 3 as of December 31, 2018.

Assets	Fair value measurements – Level 3 December 31, 2018						Ending balance December 31, 2018
	Beginning balance January 1, 2018	Amortization accretion	Current realized net income	Change in unrealized surplus	Purchases/ Transfers into Level 3	Sales/ Settlements/ Transfers Out of Level 3	
Bonds - bank loans	\$ 2,035	18	(176)	(620)	16,949	(2,654)	15,552
Perpetual preferred stocks	20	—	(9)	—	—	—	11
Common stocks-Industrial and miscellaneous	236	—	(11)	111	374	(66)	644
Total assets	<u>\$ 2,291</u>	<u>18</u>	<u>(196)</u>	<u>(509)</u>	<u>17,323</u>	<u>(2,720)</u>	<u>16,207</u>

The following table represents (in thousands) information about the Company's financial assets measured at fair value in Level 3 as of December 31, 2017.

Assets	Fair value measurements – Level 3 December 31, 2017						Ending balance December 31, 2017
	Beginning balance January 1, 2017	Amortization accretion	Current realized net income	Change in unrealized surplus	Purchases/ Transfers into Level 3	Sales/ Settlements/ Transfers Out of Level 3	
Bonds							
Bank loans	—	56	(190)	163	6,078	(4,072)	2,035
CDOs/CBOs/CLOs	—	—	—	7	1,000	(1,007)	—
All other bonds	2,187	2	(41)	22	27	(2,197)	—
Total bonds	<u>2,187</u>	<u>58</u>	<u>(231)</u>	<u>192</u>	<u>7,105</u>	<u>(7,276)</u>	<u>2,035</u>
Perpetual preferred stocks	—	—	(8)	—	28	—	20
Common stocks-Industrial and miscellaneous	159	—	(45)	86	160	(124)	236
Total assets	<u>\$ 2,346</u>	<u>58</u>	<u>(284)</u>	<u>278</u>	<u>7,293</u>	<u>(7,400)</u>	<u>2,291</u>

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

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, 2018 and 2017, respectively, 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, 2018				
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				
Industrial & miscellaneous	\$ 111,324	—	644	111,968
Common trust funds	—	55,031	—	55,031
Mutual funds	280,358	—	—	280,358
Total common stocks	391,682	55,031	644	447,357
Perpetual preferred stocks	320	—	11	331
Money market mutual funds	67,200	—	—	67,200
Total assets	\$ 459,202	55,031	655	514,888

Fair value measurements – recurring basis				
December 31, 2017				
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				
Industrial & miscellaneous	\$ 131,561	—	236	131,797
Common trust funds	—	79,088	—	79,088
Mutual funds	333,867	—	—	333,867
Total common stocks	465,428	79,088	236	544,752
Perpetual preferred stocks	—	—	20	20
Short-term bonds & cash equivalents	24,000	199	—	24,199
Total assets	\$ 489,428	79,287	256	568,971

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

Certain assets are measured at fair value on a nonrecurring 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 designation of 3–6 and redeemable preferred stocks held at fair value with an NAIC designation of RP3–RP6. There were bonds with these designations where the fair value was less than amortized value, which resulted in an unrealized loss of \$9,221,000 at December 31, 2018 and \$2,984,000 at December 31, 2017.

The following table reflects (in thousands) the fair values and admitted values of all admitted assets and liabilities that are financial instruments excluding those accounted for under the equity method as of December 31, 2018 and 2017, respectively. The fair values are also categorized into the three level fair value hierarchy as described above.

Type of financial instrument	December 31, 2018				
	Fair value	Admitted value	Level 1	Level 2	Level 3
Financial instruments-assets:					
Long-term bonds					
Bank loans	\$ 123,736	123,742	—	104,900	18,836
CDOs/CBOs/CLOs	66,993	68,396	—	65,995	998
Private placements	52,602	54,474	—	—	52,602
All other bonds	<u>1,855,861</u>	<u>1,882,985</u>	<u>—</u>	<u>1,834,518</u>	<u>21,343</u>
Total long-term bonds	<u>2,099,192</u>	<u>2,129,597</u>	<u>—</u>	<u>2,005,413</u>	<u>93,779</u>
Preferred stocks					
Perpetual preferred	331	331	320	—	11
Perpetual preferred-subsidary Cake	7,571	7,571	—	—	7,571
Redeemable preferred	<u>25</u>	<u>22</u>	<u>25</u>	<u>—</u>	<u>—</u>
Total Preferred stocks	<u>7,927</u>	<u>7,924</u>	<u>345</u>	<u>—</u>	<u>7,582</u>
Common stocks					
Industrial & miscellaneous	111,968	111,968	111,324	—	644
Common trust funds	55,031	55,031	—	55,031	—
Mutual funds	<u>280,358</u>	<u>280,358</u>	<u>280,358</u>	<u>—</u>	<u>—</u>
Total Common stocks	<u>447,357</u>	<u>447,357</u>	<u>391,682</u>	<u>55,031</u>	<u>644</u>
Mortgage Loans	<u>15,024</u>	<u>15,024</u>	<u>—</u>	<u>—</u>	<u>15,024</u>
Cash, cash equivalents and short-term investments					
	<u>73,492</u>	<u>73,492</u>	<u>63,530</u>	<u>9,962</u>	<u>—</u>
Other - Affiliated non-collateral loan	<u>4,000</u>	<u>4,000</u>	<u>—</u>	<u>—</u>	<u>4,000</u>
Total assets	<u>\$ 2,646,992</u>	<u>2,677,394</u>	<u>455,557</u>	<u>2,070,406</u>	<u>121,029</u>

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

Type of financial instrument	December 31, 2017				
	Fair value	Admitted value	Level 1	Level 2	Level 3
Financial instruments-assets:					
Long-term bonds					
Bank loans	\$ 135,218	133,626	—	118,496	16,722
CDOs/CBOs/CLOs	35,171	34,900	—	35,171	—
Private placements	29,535	29,232	—	—	29,535
All other bonds	1,860,986	1,819,766	—	1,846,639	14,347
Total long-term bonds	<u>2,060,910</u>	<u>2,017,524</u>	<u>—</u>	<u>2,000,306</u>	<u>60,604</u>
Preferred stocks					
Perpetual preferred	485	422	465	—	20
Perpetual preferred-subsidary Cake	7,571	7,571	—	—	7,571
Redeemable preferred	176	165	176	—	—
Total Preferred stocks	<u>8,232</u>	<u>8,158</u>	<u>641</u>	<u>—</u>	<u>7,591</u>
Common stocks					
Industrial & miscellaneous	131,797	131,797	131,561	—	236
Common trust funds	79,088	79,088	—	79,088	—
Mutual funds	333,867	333,867	333,867	—	—
Total Common stocks	<u>544,752</u>	<u>544,752</u>	<u>465,428</u>	<u>79,088</u>	<u>236</u>
Cash, cash equivalents and short-term investments	<u>76,899</u>	<u>76,899</u>	<u>60,720</u>	<u>16,179</u>	<u>—</u>
Total assets	<u>\$ 2,690,793</u>	<u>2,647,333</u>	<u>526,789</u>	<u>2,095,573</u>	<u>68,431</u>

(i) Investment Income

Major categories of net investment income for the years ended December 31, 2018 and 2017 are summarized as follows (in thousands):

	2018	2017
Investment income:		
Corporate and miscellaneous bonds	\$ 72,771	66,848
U.S. government bonds	2,893	2,736
Cash and other investments	1,314	464
Real estate	5,691	5,983
Other invested assets	2,654	3,237
Mortgage Loans	185	—
Equity securities	15,636	16,081
Surplus note interest expense	(8,625)	(8,625)
Investment expenses	<u>(9,139)</u>	<u>(9,278)</u>
Net investment income earned	<u>83,380</u>	<u>77,446</u>
Net realized capital gain (loss):		
Corporate and miscellaneous bonds	(5,352)	1,294
U.S. government bonds	—	(6)
Equity securities	<u>15,177</u>	<u>16,602</u>
Net realized capital gains	<u>9,825</u>	<u>17,890</u>
Net investment income	<u>\$ 93,205</u>	<u>95,336</u>

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

(5) Reinsurance

Ceded Reinsurance – Pinnacol purchases excess of loss reinsurance with two layers and terrorism coverage. 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
- Terrorism Only – Limit of \$50,000,000 in excess of retention of \$80,000,000 per occurrence

Management is not aware of any loss nor did the Company record any loss great enough to attach to these layers during any of the prior policy periods.

Reinsurance contracts do not relieve Pinnacol of its obligations, and a failure of the reinsurer to honor its obligations could result in losses unreimbursed 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 uses Lloyd's Syndicates as part of its ceded reinsurer program. The Syndicates are generally not rated by AM Best. The remaining reinsurers had the following AM Best ratings at December 31, 2018:

Reinsurer	AM Best Rating
Arch Reinsurance Company	A+
Endurance Specialty Insurance Limited	A+
The Cincinnati Insurance Company	A+
Partner Reinsurance Company Ltd.	A
Lloyd's Syndicate 2003 (Catlin Underwriting Agencies Limited)	A
Lloyd's Syndicate 3000 (Markel Syndicate Management Limited)	A

Assumed Reinsurance – Pinnacol has entered into assumed reinsurance contracts that allow the Company to provide insurance coverage under the workers' compensation provisions of other states for the employees of Colorado companies who work outside of Colorado (Other States Coverage). Effective March 1, 2004, Pinnacol executed a reinsurance contract with Argonaut Insurance Company (a California corporation) for Other States Coverage. The contract was canceled in 2010; however, Pinnacol will continue to pay existing claims in accordance with this reinsurance agreement until these claims are closed or these risks are transferred. As the Company entered into a reinsurance agreement in 2010 with Zurich American Insurance Company, there were no gaps in coverage. This agreement was still in effect as of December 31, 2018. The Other States Coverage contracts are designed as 100% quota share arrangements with Pinnacol acting as the assuming company. Premium revenue is recognized pro rata over the period the policy is effective.

Funds have been placed on deposit as collateral with Argonaut Insurance Company and Zurich American Insurance Company in the amount of \$2,182,000 and \$1,792,000 in 2018 and 2017, respectively.

Pinnacol held unearned premium reserves related to assumed business of \$919,000 and \$811,000 for the years ended December 31, 2018 and 2017, respectively. Pinnacol had loss and loss adjustment expense reserves related to assumed business of \$26,024,000 and \$27,003,000 for the years ended December 31, 2018 and 2017, respectively.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

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

	2018	2017
Direct premiums written	\$ 623,848	620,980
Premiums ceded	(1,325)	(1,336)
Premiums assumed	8,914	8,340
Net premiums written	\$ 631,437	627,984
Direct premiums earned	\$ 624,274	618,554
Premiums ceded	(1,325)	(1,336)
Premiums assumed	8,806	8,401
Net premiums earned	\$ 631,755	625,619
Direct losses incurred	\$ 300,001	300,649
Losses ceded	—	—
Losses assumed	3,205	3,013
Net losses incurred	\$ 303,206	303,662
Direct loss adjustment expenses incurred	\$ 73,108	77,982
Loss adjustment expenses ceded	—	—
Loss adjustment expenses assumed	1,667	1,065
Net loss adjustment expenses incurred	\$ 74,775	79,047

(6) Employee Benefits

(a) *Defined-Benefit Pension Plan through the State of Colorado*

Pensions – Pinnacol participates in the State Division Trust Fund (SDTF), a cost-sharing multiple-employer defined benefit pension fund administered by the Public Employees' Retirement Association of Colorado (PERA). The net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, pension expense, information about the fiduciary net position and additions to/deductions from the fiduciary net position of the SDTF have been determined using the economic resources measurement focus and the accrual basis of accounting. For this purpose, benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms. Investments are reported at fair value.

During the 2018 legislative session, the Colorado General Assembly passed significant pension reform through Senate Bill (SB) 18-200: Concerning Modifications to the Public Employees' Retirement Association Hybrid Defined Benefit Plan Necessary to Eliminate with a High Probability the Unfunded Liability of the Plan Within the Next Thirty Years. Governmental accounting standards require the net pension liability and related amounts of the SDTF for financial reporting purposes be measured using the plan provisions in effect as of the SDTF's measurement date of December 31, 2017. As such, the following disclosures do not include the changes to plan provisions required by SB 18-200.

Plan Description – All Pinnacol employees are provided with pensions through the SDTF-a cost-sharing multiple-employer defined benefit pension plan administered by PERA. Plan benefits are specified in Title 24, Article 51 of the C.R.S., administrative rules set forth at 8 C.C.R. 1502 1, and

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

applicable provisions of the federal Internal Revenue Code. Colorado State law provisions may be amended from time to time by the Colorado General Assembly. PERA issues a publicly available comprehensive annual financial report that can be obtained at <https://www.copera.org/investments/pera-financial-reports>

Benefits provided – PERA provides retirement, disability, and survivor benefits. Retirement benefits are determined by the amount of service credit earned and/or purchased, highest average salary, the benefit structure(s) under which the member retires, the benefit option selected at retirement, and age at retirement. Retirement eligibility is specified in tables set forth at C.R.S. § 24-51-602, 604, 1713, and 1714.

The lifetime retirement benefit for all eligible retiring employees under the PERA benefit structure is the greater of the:

- Highest average salary multiplied by 2.5% and then multiplied by years of service credit.
- The value of the retiring employee's member contribution account plus a 100% match on eligible amounts as of the retirement date. This amount is then annuitized into a monthly benefit based on life expectancy and other actuarial factors.

In all cases the service retirement benefit is limited to 100% of highest average salary and also cannot exceed the maximum benefit allowed by federal Internal Revenue Code.

Members may elect to withdraw their member contribution accounts upon termination of employment with all PERA employers; waiving rights to any lifetime retirement benefits earned. If eligible, the member may receive a match of either 50% or 100% on eligible amounts depending on when contributions were remitted to PERA, the date employment was terminated, whether 5 years of service credit has been obtained and the benefit structure under which contributions were made.

Benefit recipients who elect to receive a lifetime retirement benefit are generally eligible to receive post retirement cost-of-living adjustments (COLAs), referred to as annual increases in the C.R.S. Benefit recipients under the PERA benefit structure who began eligible employment before January 1, 2007 receive an annual increase of 2%, unless PERA has a negative investment year, in which case the annual increase for the next three years is the lesser of 2% or the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) for the prior calendar year. Benefit recipients under the PERA benefit structure who began eligible employment after January 1, 2007 receive an annual increase of the lesser of 2% or the average CPI-W for the prior calendar year, not to exceed 10% of PERA's Annual Increase Reserve (AIR) for the SDTF.

Disability benefits are available for eligible employees once they reach five or more years of service credit and are determined to meet the definition of disability. The disability benefit amount is based on the retirement benefit formula shown above considering a minimum 20 years of service credit, if deemed disabled.

Survivor benefits are determined by several factors, which include the amount of earned service credit, highest average salary of the deceased, the benefit structure(s) under which service credit was obtained, and the qualified survivor(s) who will receive the benefits.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

Contributions – Eligible employees and Pinnacol are required to contribute to the SDTF at a rate set by Colorado statute. The contribution requirements are established under C.R.S. § 24-51-401, *et seq.* Eligible employees are required to contribute 8% of their PERA-includable salary. The employer contribution requirements for Pinnacol are summarized in the table below:

	For the Year Ended 12/31/18	For the Year Ended 12/31/17	For the Year Ended 12/31/16
Employer contribution rate (includes 1.02% allocation to the Health Care Trust Fund – see note 6c) ¹	10.15%	10.15%	10.15%
Amortization Equalization Disbursement (AED) as specified in C.R.S. §24-51-411 ¹	5.00	5.00	4.60
Supplemental Amortization Equalization Disbursement (SAED) as specified in C.R.S., §24-51-411 ¹	5.00	5.00	4.50
Total employer contribution rate ¹	<u>20.15%</u>	<u>20.15%</u>	<u>19.25%</u>

¹Rates are expressed as a percentage of salary as defined in C.R.S. § 24-51-101(42).

Employer contributions are recognized by the SDTF in the period in which the compensation becomes payable to the member and Pinnacol is statutorily committed to pay the contributions to the SDTF. Employer contributions recognized by the SDTF from Pinnacol were \$12,627,000 and \$12,030,000, for the years ended December 31, 2018 and December 31, 2017, respectively. These contributions met the contribution requirement for each year.

(b) Voluntary Tax-Deferred Retirement Plans

Plan Description – Employees of Pinnacol that are also members of the SDTF may voluntarily contribute to the Voluntary Investment Program, an Internal Revenue Code Section 401(k) defined contribution plan administered by PERA. Title 24, Article 51, Part 14 of the C.R.S., as amended, assigns the authority to establish the Plan provisions to the PERA Board of Trustees. PERA issues a publicly available comprehensive annual financial report for the Program. That report can be obtained at <https://www.copera.org/investments/pera-financial-reports>.

Funding Policy – The Voluntary Investment Program is funded by voluntary member contributions up to the maximum limits set by the Internal Revenue Service, as established under Title 24, Article 51, Section 1402 of the C.R.S., as amended. In addition, Pinnacol has agreed to match employee's elective contributions into the PERA 401(k) Plan at 50% up to the first 6% of employees' elected deferrals. Employees are immediately vested in their own contributions, employer contributions and investment earnings. For the years ended December 31, 2018 and 2017, Pinnacol contributed approximately \$1,556,000 and \$1,449,000, respectively, in matching contributions to the PERA 401(k) Plan. Pinnacol also offers a 457 deferred compensation plan.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

(c) Defined Benefit Other Postemployment Benefit (OPEB) Plan

OPEB Plan – Pinnacol participates in the Health Care Trust Fund (HCTF), a cost-sharing multiple-employer defined benefit OPEB plan administered by PERA.

Plan Description – The HCTF is established under Title 24, Article 51, Part 12 of the C.R.S., as amended. Colorado State law provisions may be amended from time to time by the Colorado General Assembly. Title 24, Article 51, Part 12 of the C.R.S., as amended, sets forth a framework that grants authority to the PERA Board to contract, self-insure and authorize disbursements necessary in order to carry out the purposes of the PERACare program, including the administration of the premium subsidies. The HCTF provides a health care premium subsidy to eligible participating PERA benefit recipients and retirees who choose to enroll in one of the PERA health care plans. PERA issues a publicly available comprehensive annual financial report that can be obtained at <https://www.copera.org/investments/pera-financial-reports>.

Funding Policy – Pinnacol is required to contribute at a rate of 1.02% of PERA-includable salary for all PERA members as set by statute. Pinnacol's contribution is included in the contribution rate of 20.15% in Note 6(a). No member contributions are required to the HCTF. The contribution requirements for Pinnacol are established under Title 24, Article 51, Part 4 of the C.R.S., as amended. The apportionment of the contributions to the HCTF is established under Title 24, Article 51, Section 208(1)(f) of the C.R.S., as amended. For the years ending December 31, 2018 and 2017, Pinnacol contributions to the HCTF were approximately \$639,000 and \$609,000, respectively, equal to the required contributions for each year.

(d) Other

Health and Welfare Trust – Effective January 1, 2010, Pinnacol entered into certain self-funded benefit programs with its vendors for healthcare, dental care, and vision care and established a separate legal trust for administrative purposes. In 2018, Pinnacol also entered into a guaranteed cost program with one of its two healthcare vendors. Pinnacol withholds monthly premium from its employee participants' payroll checks and uses these premiums and the employer contribution amounts to fund the trust account. These premiums are used to reimburse medical claims paid by the third party vendors for the self-funded programs or pay premiums to the healthcare vendor for the guaranteed cost program. Employer contributions in 2018 and 2017 were \$6,661,000 and \$7,721,000, respectively.

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 \$2,811,000 and \$2,609,000 at December 31, 2018 and 2017, respectively, is included in other liabilities in the statutory basis statements of admitted assets, liabilities, and policyholders' surplus.

(7) Policyholders' Surplus

Pinnacol declared general policyholder dividends in 2018 of \$70,000,000 and 2017 of \$50,000,000 and subsequently paid them in March 2019 and March 2018. General policyholder dividends are a component of other income.

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 \$180,870,000 for 2018.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

A surplus note in the amount of \$100,000,000 was issued on June 25, 2014, to an unaffiliated third party in exchange for cash. Each payment of principal and interest on the surplus note may be made only with the prior approval of the Division and only to the extent Pinnacol has sufficient policyholders' surplus to make such payment. The interest on the unpaid principal amount of this note will be paid in semiannual installments at the rate of 8.625% per annum. In 2018, \$8,625,000 of interest was paid on the note and recorded as investment expense. The note, which is subordinate to the prior payment of all other liabilities of the Company, will be due and payable twenty years from the issuance date, with an optional pre-payment date in whole or part in fifteen years with no penalty. The surplus note was issued to partially cover Pinnacol's estimated proportionate share of PERA's unfunded liability for vested service of Pinnacol employees and retirees. This liability is not required to be recorded in the statutory basis financial statements as of December 31, 2018, but it reduces the capital adequacy assessments of outside rating agencies, such as A.M. Best. In accordance with the note agreement, Pinnacol may apply the proceeds for general corporate purposes.

The surplus note agreement contains customary affirmative and negative covenants and requires that Pinnacol maintain certain specified ratios and thresholds. Among others, these covenants include maintaining a maximum writing ratio, debt to capitalization ratio and interest coverage ratio. Management believes that at December 31, 2018 Pinnacol is in compliance with such covenants, ratios and thresholds.

The Company participates in a cost-sharing multiple-employer defined benefit pension plan administered by PERA. PERA has a net pension liability which represents the unfunded pension benefits. The funded portion of PERA's total pension liability as of December 31, 2017 is 43.2%. The Company has a special surplus fund to identify its portion of the unfunded pension benefits. Based on information provided by PERA as of June 30, 2018, the Company's special surplus fund for the unfunded pension benefits has increased by \$56,627,000 from \$350,883,000 in 2017 to a new balance of \$407,510,000 for 2018. The discount rate is 4.72%. There are no limitations for using the special surplus fund for policyholders, injured workers or other creditors.

(8) Commitments and Contingencies

The Company has made total commitments of \$116,191,000 to provide additional funds as needed to the following partnerships:

<u>Partnership Name</u>	<u>2018</u>
NB Pinnacol Assurance Fund LP	\$ 90,000,000
Entrust Permal Special Opportunities Fund IV Ltd	7,026,000
Blackstone Tactical Opportunities Fund II LP	5,238,000
North Haven Credit Partners LP	4,842,000
NB Strategic Co-Investment Partners III LP	3,396,000
Warburg Pincus Private Equity XII LP	2,461,000
GCM Grosvenor Opportunistic Credit Fund IV Ltd	1,675,000
Kayne Credit Opportunities Fund LP	1,173,000
Blue Ocean Income Fund LP	380,000
TOTAL	<u>\$ 116,191,000</u>

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.

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

At December 31, 2018 and 2017, Pinnacol had a letter of credit for the benefit of Argonaut Insurance Company under an assumed reinsurance agreement for approximately \$6,297,000 and \$7,468,000, respectively. This reinsurance agreement allows Argonaut Insurance 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 long term bonds and money market securities are amounts held as collateral for the letter of credit of approximately \$10,300,000 and \$13,595,000, compared to a requirement of \$6,297,000 and \$7,468,000, as of December 31, 2018 and 2017, respectively.

At December 31, 2018 and 2017, Pinnacol had a trust for the benefit of Zurich American Insurance Company under an assumed reinsurance agreement. This reinsurance agreement allows Zurich American Insurance Company, the beneficiary, to claim the trust assets at any time to secure any of Pinnacol's obligations under the agreement. Included in long term bonds are amounts held in the trust of approximately \$41,065,000 and \$45,006,000, compared to a requirement of \$39,000,000 as of December 31, 2018 and 2017.

Pinnacol is contingently liable for approximately \$41,270,000 of claims closed by the purchase of annuities from life insurers for structured settlements. Pinnacol has not purchased annuities from life insurers under which the Company is payee, and therefore, no balances are due from such annuity insurers.

Pinnacol is aware of an unfunded net pension liability. If Pinnacol were to partially or fully leave the PERA program, the unfunded net pension liability for the vested service of Pinnacol employees and retirees would become immediately due to PERA. Title 24, Article 51, Section 316 of the C.R.S. requires a company to calculate the reserve transfer necessary when an employer disaffiliates from PERA. The formula to calculate the termination liability differs significantly from the formula used to calculate Pinnacol's share of the unfunded pension obligation under GASB 68. Therefore, the amount of a possible termination liability is unknown but is expected to exceed \$100,000,000. Currently, the possibility of the Company partially or fully leaving the PERA program is remote and would require legislative action.

(9) Related Party Transactions

Pinnacol purchased preferred stock in a non-insurance subsidiary, Cake, for \$10,000,000 on September 28, 2017 in exchange for 2,000,000 preferred shares. In 2017, Cake purchased software and intellectual property from Pinnacol in the amount of \$5,598,000, which exceeded the amount capitalized by Pinnacol by \$2,429,000. Because of common control between Pinnacol and Cake, the excess was recorded as a deemed dividend, reducing the cost basis of Pinnacol's investment in Cake to \$7,571,000. In September 2018, Cake repurchased all outstanding common stock, which increased Pinnacol's voting ownership in Cake from 90% to 100%. There was no change to the 2,000,000 preferred shares owned by Pinnacol.

Effective April 30, 2018, there is a loan agreement between Pinnacol and Cake. Cake, as the borrower, can draw down up to \$4,000,000 over a period of up to two years at an interest rate of LIBOR plus 3.00%. This loan amount was fully funded as of December 31, 2018. Interest is due upon maturity, and there is no pre-payment penalty. This loan is a component of other invested assets.

Under a program administrator agreement approved by the Division, Cake writes policies for Pinnacol through its digital platform that potential policyholders can utilize to receive a quote and bind a policy. Pinnacol makes payments to Cake monthly as policies are generated. During 2018, Pinnacol paid \$385,000 in program administrator fees.

Under a management service agreement approved by the Division, Pinnacol provides certain personnel services to its subsidiary for a set monthly fee and receives reimbursement for costs Cake incurred. During

PINNACOL ASSURANCE

Notes to Statutory-Basis Financial Statements

December 31, 2018 and 2017

2018, Pinnacol received \$5,779,000 in management fees and reimbursed costs from its subsidiary. The management fees offset various expenses in the income statement.

At December 31, 2018 Pinnacol reported \$58,000 due to subsidiary for commissions due Cake as an agent. Pinnacol also reported \$237,000 due from subsidiary, including \$172,000 for management fees and reimbursable expenses under the management service agreement and \$65,000 for accrued loan interest.

There were no transactions with affiliates in amounts that exceeded 0.5% of the total admitted assets of Pinnacol.

(10) Subsequent Events

The Board of Directors declared general dividends on October 31, 2018 in an amount to be approximately \$70,000,000. The final dividend amount of \$70,000,000 was confirmed by the Board in February 2019 and subsequently paid in March 2019.

Subsequent events have been evaluated through May 22, 2019, the date these statutory basis financial statements were available to be issued.

SUPPLEMENTAL SCHEDULES OF INVESTMENT INFORMATION
(See Independent Auditors' Report)

PINNACOL ASSURANCE

Supplemental Schedule of Investment Information
Investment Risks Interrogatories

Year ended December 31, 2018

(In thousands)

1. Pinnacol's total admitted assets as reported on page 2 of its annual statement are: \$ 2,872,602
2. The following are the ten largest exposures to a single issuer/borrower/investment by investment category, excluding: (i) U.S. government securities, U.S. government agency securities, and those U.S. government money market funds listed in the Appendix to the *Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO)* as exempt, (ii) property occupied by Pinnacol, (iii) policy loans, and (iv) asset types that are investment companies (mutual funds) and common trust funds that are diversified within the meaning of the Investment Company Act of 1940 (Section 5(b) (1)).

Issuer	Description of exposure	Amount	Percentage of total admitted assets
2.01 FNMA POOLS	LONG TERM BONDS	\$ 241,498	8.407%
2.02 FHLMC	LONG TERM BONDS, COMMON STOCK	81,554	2.839
2.03 FREDDIE MAC	LONG TERM BONDS, COMMON STOCK	29,447	1.025
2.04 FANNIE MAE	LONG TERM BONDS	17,662	0.615
2.05 GUGGENHEIM PRIVATE DEBT FUND NOTE ISSUER 2.0, LLC	OTHER LONG-TERM ASSETS, LONG TERM BONDS	20,554	0.716
2.06 FGLMC POOLS	LONG TERM BONDS	13,890	0.484
2.07 PETROLEOS MEXICANOS	LONG TERM BONDS, COMMON STOCK	12,238	0.426
2.08 ALPHABET INC	LONG TERM BONDS, COMMON STOCK	11,950	0.416
2.09 WELLS FARGO	LONG TERM BONDS, COMMON STOCK	11,646	0.405
2.10 CAKE INSURE, INC	OTHER LONG-TERM ASSETS, PREFERRED STOCK	11,571	0.403

3. Pinnacol's total admitted assets held in bonds and preferred stocks by NAIC designation are:

NAIC Designation	Amount	Percentage of total admitted assets
Bonds:		
NAIC-1	\$ 1,488,257	51.809%
NAIC-2	462,844	16.112
NAIC-3	81,301	2.830
NAIC-4	89,590	3.119
NAIC-5	16,722	0.582
NAIC-6	845	0.029
Preferred stocks:		
P/RP-1		—
P/RP-2		—
P/RP-3	319	0.011
P/RP-4	23	0.001
P/RP-5	7,571	0.264
P/RP-6	11	0.000
	<u>\$ 2,147,483</u>	

4. Assets held in foreign investments are \$284,057 and assets held in foreign-currency-denominated investments are \$0, which is approximately 9.9% and 0.000% of Pinnacol's total admitted assets, respectively.

5. The following represents aggregate foreign investment exposure categorized by NAIC sovereign designation:

Foreign investment assets		Amount	Percentage of total admitted assets
NAIC Designation			
Countries designated NAIC-1		\$ 244,548	8.513%
Countries designated NAIC-2		32,344	1.126
Countries designated NAIC-3 or below		7,165	0.249
		<u>\$ 284,057</u>	

PINNACOL ASSURANCE
Supplemental Schedule of Investment Information
Investment Risks Interrogatories
Year ended December 31, 2018
(In thousands)

6. The following represents the largest foreign investment exposures by country, categorized by the country's NAIC sovereign designation:

Foreign investment assets			
NAIC Designation	Country	Amount	Percentage of total admitted assets
Countries designated NAIC-1:			
Country 1:	CAYMAN ISLANDS	\$ 66,657	2.320%
Country 2:	AUSTRALIA	31,520	1.097
Countries designated NAIC-2:			
Country 1:	MEXICO	22,533	0.784
Country 2:	INDONESIA	3,503	0.122
Countries designated NAIC-3 or below:			
Country 1:	BRITISH VIRGIN ISLANDS	6,993	0.243
Country 2:	BARBADOS	96	0.003
		<u>\$ 131,302</u>	

7. Aggregate unhedged foreign currency exposure is \$0, which is approximately 0.000% of Pinnacol's total admitted assets.

8. The following represents aggregate unhedged foreign currency exposure categorized by NAIC sovereign designation:

Foreign-Currency-Denominated investment assets			
NAIC Designation	Amount	Percentage of total admitted assets	
Countries designated NAIC-1	\$ —	—%	
Countries designated NAIC-2	—	—	
Countries designated NAIC-3 or below	—	—	
	<u>\$ —</u>		

9. The following represents the largest unhedged foreign currency exposures by country, categorized by the country's NAIC sovereign designation:

Foreign-Currency-Denominated investment assets			
NAIC Designation	Country	Amount	Percentage of total admitted assets
Countries designated NAIC-1:			
Country 1:		\$ —	—%
Country 2:		—	—
Countries designated NAIC-2:			
Country 1:		—	—
Country 2:		—	—
Countries designated NAIC-3 or below:			
Country 1:		—	—
Country 2:		—	—
		<u>\$ —</u>	

10. The following represents the ten largest nonsovereign (i.e., nongovernmental) foreign issues:

Issuer	NAIC Designation	Amount	Percentage of total admitted assets
10.01 PETROLEOS MEXICANOS	2	\$ 12,238	0.426%
10.02 UBS AG STAMFORD CT	1	10,905	0.380
10.03 BNP PARIBAS SA	1	10,766	0.375
10.04 ACTAVIS FUNDING SCS	2	8,803	0.306
10.05 MACQUARIE GROUP LTD	1	8,593	0.299
10.06 JOHNSON CONTROLS INTL PL	2	8,535	0.297
10.07 CREDIT SUISSE GROUP AG	2	8,518	0.297
10.08 SCENTRE GROUP TRUST	1	7,030	0.245
10.09 SINOPEC GRP OVERSEA 2015	1	6,969	0.243
10.10 PETRONAS CAPITAL LTD	1	6,964	0.242

See accompanying independent auditors' report.

PINNACOL ASSURANCE

Supplemental Schedule of Investment Information
Investment Risks Interrogatories

Year ended December 31, 2018

(In thousands)

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

12. Amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions:

12.01 Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets?		Yes []	No [X]
12.02 Aggregate statement value of investments held in investments with contractual sales restrictions	\$	88,944	3.096%
Largest three investments held in investments with contractual sales restrictions:			
12.03 GCM GROSVENOR OPPORTUNISTIC CREDIT FUND IV, LTD	\$	10,139	0.353%
12.04 NB PINNACOL ASSURANCE FUND LP		9,910	0.345
12.05 ENTRUST SPECIAL OPPORTUNITIES FUND III LTD		9,603	0.334

13. The following are the ten 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 Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO) as exempt or Class 1):

Issuer	Amount	Percentage of total admitted assets
13.01 HARDING LOEVNER INTERNATIONAL EQUITY FUND & EMERGING MARKETS FUND	\$ 46,787	1.629%
13.02 BLACKROCK EQUITY INDEX FUND B CTF	39,673	1.381
13.03 WESTWOOD INCOME OPPORTUNITY FUND	37,056	1.290
13.04 VANGUARD INST INDEX FUND	34,558	1.203
13.05 DODGE & COX INTERNATIONAL STOCK FUND	30,202	1.051
13.06 T. ROWE PRICE INSTITUTIONAL SMALL-CAP STOCK FUND	29,185	1.016
13.07 GMO BENCHMARK-FREE ALLOCATION FUND-III	25,560	0.890
13.08 FRANKLIN INTERNATIONAL GROWTH FUND	21,941	0.764
13.09 FIRST EAGLE OVERSEAS FUND	19,916	0.693
13.10 MORGAN STANLEY INSTITUTIONAL FUND	17,641	0.614

Items 14 through 23 are not applicable.

See accompanying independent auditors' report.

PINNACOL ASSURANCE

Supplemental Schedule of Investment Information
Summary Investment Schedule

December 31, 2018

(In thousands)

Investment categories	Gross investment holdings*		Admitted assets as reported in the annual statement	
	Amount	Percentage of gross investment holdings	Amount	Percentage of total admitted assets
Bonds:				
U.S. Treasury securities	\$ 99,068	3.6%	\$ 99,068	3.6%
U.S. government agency obligations (excluding mortgage-backed securities):				
– Issued by U.S. government agencies		—		—
– Issued by U.S. government-sponsored agencies		—		—
Non U.S. government (including Canada, excluding mortgage-backed securities)	15,973	0.6	15,973	0.6
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
– States, territories, and possessions general obligations		—		—
– Political subdivisions of states, territories, and possessions and political general obligations	11,247	0.4	11,247	0.4
– Revenue and assessment obligations	49,939	1.8	49,939	1.8
– Industrial development and similar obligations		—		—
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
– Issued or guaranteed by GNMA	2,546	0.1	2,546	0.1
– Issued or guaranteed by FNMA and FHLMC	349,484	12.6	349,484	12.6
– All other		—		—
CMOs and REMICs:				
– Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	36,757	1.3	36,757	1.3
– Issued by non-U.S. government issuers and collateralized by mortgage-based securities issued by above		—		—
– All other	83,477	3.0	83,477	3.0
Other debt and other fixed income securities (excluding short term):				
– Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	1,187,144	42.6	1,187,144	42.6
– Unaffiliated non-U.S. securities (including Canada)	293,962	10.6	293,962	10.6
– Affiliated securities		—		—
Equity interests:				
– Investments in mutual funds	280,358	10.1	280,358	10.1
Preferred stocks:				
– Affiliated	7,571	0.3	7,571	0.3
– Unaffiliated	353	0.0	353	0.0
Publicly traded equity securities (excluding preferred stocks):				
– Affiliated		—		—
– Unaffiliated	110,891	4.0	110,891	4.0
Other equity securities:				
– Affiliated		—		—
– Unaffiliated	56,108	2.0	56,108	2.0
Other equity interests including tangible personal property under lease:				
– Affiliated		—		—
– Unaffiliated		—		—

PINNACOL ASSURANCE

Supplemental Schedule of Investment Information
Summary Investment Schedule

December 31, 2018

(In thousands)

Investment categories	Gross investment holdings*		Admitted assets as reported in the annual statement	
	Amount	Percentage of gross investment holdings	Amount	Percentage of total admitted assets
Mortgage loans:				
– Construction and land development	\$ —	—%	\$ —	—%
– Agricultural	—	—	—	—
– Single-family residential properties	—	—	—	—
– Multifamily residential properties	8,903	0.3	8,903	0.3
– Commercial loans	6,121	0.2	6,121	0.2
– Mezzanine real estate loans	—	—	—	—
Real estate investments:				
– Property occupied by Company	15,984	0.6	15,984	0.6
– Property held for production of income	—	—	—	—
– Property held for sale	—	—	—	—
Contract loans	—	—	—	—
Derivatives	—	—	—	—
Receivables for securities	1,317	0.0	1,317	0.0
Securities lending	—	—	—	—
Cash, cash equivalents, and short-term investments	73,492	2.6	73,492	2.6
Other invested assets	92,944	3.3	92,944	3.3
Total invested assets	\$ <u>2,783,639</u>	<u>100.0%</u>	\$ <u>2,783,639</u>	<u>100.0%</u>

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

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

See accompanying independent auditors' report.



KPMG LLP
Suite 800
1225 17th Street
Denver, CO 80202-5598

Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

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

We have audited, in accordance with the 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, the financial statements of Pinnacol Assurance, which comprise the statutory statements of admitted assets, liabilities, and policyholders' surplus as of December 31, 2018, and the related statutory statements of operations and changes in policyholders' surplus and cash flow for the year then ended, and the related notes to the statutory financial statements, and have issued our report thereon dated May 22, 2018. Our report on the financial statements includes an adverse opinion on U.S. generally accepted accounting principles because the financial statements are prepared using statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, which is a basis of accounting other than U.S. generally accepted accounting principles. Our report on the financial statements also includes an unmodified opinion on the financial statements in accordance with statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, which is a basis of accounting other than U.S. generally accepted accounting principles.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered Pinnacol Assurance's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Pinnacol Assurance's internal control. Accordingly, we do not express an opinion on the effectiveness of Pinnacol Assurance's internal control.

A deficiency in internal control 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 material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.



Compliance and Other Matters

As part of obtaining reasonable assurance about whether Pinnacol Assurance's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Pinnacol Assurance's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Pinnacol Assurance's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Denver, Colorado
May 22, 2019



KPMG LLP
Suite 800
1225 17th Street
Denver, CO 80202-5598

The Members of the Legislative Audit Committee and
Risk and Audit Committee of the Board of Directors
Pinnacol Assurance
Denver, Colorado

Ladies and Gentlemen:

We have audited the financial statements 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 of Pinnacol Assurance (the Company) as of December 31, 2018 and 2017 and for each of the years then ended, and expect to issue our report thereon under date of May 22, 2019. Under our professional standards, we are providing you with the accompanying information related to the conduct of our audits.

Our Responsibility under Professional Standards

We are responsible for forming and expressing an opinion about whether the financial statements, that have been prepared by management with the oversight of the Pinnacol Assurance Risk and Audit Committee of the Board of Directors (Pinnacol Risk and Audit Committee), are presented fairly, in all material respects, using accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, which practices differ from U.S. generally accepted accounting principles. We have a responsibility to perform our audit of the financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial statement audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. In carrying out this responsibility, we planned and performed the audit to obtain reasonable assurance about whether the financial statements as a whole are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, we are to obtain reasonable, not absolute, assurance that material misstatements are detected. We have no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected. Our audit does not relieve management or the Pinnacol Risk and Audit Committee of their responsibilities.

In addition, in planning and performing our audit of the financial statements, we considered internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances 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 Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

We also have a responsibility to communicate significant matters related to the financial statement audit that are, in our professional judgment, relevant to the responsibilities of the Pinnacol Risk and Audit Committee in overseeing the financial reporting process. We are not required to design procedures for the purpose of identifying other matters to communicate to you.

Other Information in Documents Containing Audited Statutory Financial Statements

Our responsibility for other information in documents containing the Company's financial statements and our auditors' report thereon does not extend beyond the financial information identified in our auditors' report, and we have no obligation to perform any procedures to corroborate other information contained in these documents.



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

Accounting Practices and Alternative Treatments

Significant Accounting Policies

The significant accounting policies used by the Company are described in note 1 to the financial statements.

Unusual Transactions

There have been no unusual transactions that we are aware of that need to be disclosed to you.

Qualitative Aspects of Statutory Accounting Practices

We have discussed with the Pinnacol Assurance Risk and Audit Committee and management our judgments about the quality, not just the acceptability, of the Company's statutory accounting principles as applied in its financial reporting. The discussions generally included such matters as the consistency of the Company's statutory accounting policies and their application, and the understandability and completeness of the Company's financial statements, which include related disclosures.

Management Judgments and Accounting Estimates

The preparation of the financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Those judgments are ordinarily based on knowledge and experience about past and current events and on assumptions about future events. Significant accounting estimates reflected in the Company's 2018 statutory basis financial statements include the following:

Reserve for Unpaid Losses and Loss Adjustment Expenses is based on an analysis of historical paid and incurred claims. To assist management in estimating the liability for unpaid losses and loss adjustment expenses, Pinnacol retains the assistance of an actuarial consulting firm. We evaluated the key factors and assumptions used to develop the reserve for unpaid losses and loss adjustment expenses, including possible management bias in developing the estimate, in determining that the reserve for unpaid losses and loss adjustment expenses is reasonable in relation to the financial statements as a whole.

Structured Settlement Liability is based on mortality risk and is discounted using a market rate. Pinnacol discounts internal structured settlement liabilities on a tabular basis using a discount rate of 2.5% for 2018. The discount rate is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. To assist management in estimating the internal structured settlement liability, Pinnacol retains the assistance of an actuarial consulting firm. We evaluated key factors and assumptions used to develop the structured settlement liability, including possible management bias in developing the estimate, in determining that the structured settlement liability is reasonable in relation to the financial statements as a whole.

Earned but Unbilled Premiums Asset is based on an analysis of internal calculations using historical premium data, including audit premium data. We evaluated key factors and assumptions used to develop the earned but unbilled premiums asset, including possible management bias in developing the estimate, in determining that the earned but unbilled premiums asset is reasonable in relation to the financial statements as a whole.



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

Uncorrected and Corrected Misstatements

Uncorrected Misstatements

In connection with our audit of the Company's financial statements, we have not identified any significant financial statement misstatements that have not been corrected in the Company's books and records as of and for the year ended December 31, 2018 and have communicated that finding to management.

Disagreements with Management

There were no disagreements with management on financial accounting and reporting matters that would have caused a modification of our auditors' reports on the Company's statutory financial statements.

Management's Consultation with Other Accountants

To the best of our knowledge, management has not consulted with or obtained opinions, written or oral, from other independent accountants during the year ended December 31, 2018.

Significant Issues Discussed, or Subject to Correspondence, with Management

Major Issues Discussed with Management prior to Retention

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with the Pinnacol Risk and Audit Committee and management each year prior to our retention by the Legislative Audit Committee as the Company's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

Immaterial Correction of an Error

Management recorded an immaterial correction of an error as described in note 1 to the financial statements. Management identified an error in the methodology used to calculate the earned but unbilled premiums estimate. During 2018, management corrected the methodology by using earned premium rather than written premium as the basis for the calculation. As of December 31, 2017, surplus was overstated by \$10,890,000 and the receivable for EBUB premiums was overstated by \$10,890,000. The adjustment is immaterial to Pinnacol's surplus as of December 31, 2018 and 2017 and was appropriately corrected through surplus in 2018.

Material Written Communications

The following material written communications between management and us have been provided:

1. Internal legal letter
2. Management representation letter

Significant Difficulties Encountered during the Audit

We encountered no significant difficulties in dealing with management in performing our audit.

Independence

We are not aware of any additional relationships between our firm and the Company and persons in a financial reporting oversight role at the Company that may reasonably be thought to bear on independence.



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

Confirmation of Audit Independence

We hereby confirm that as of May 22, 2019, we are independent accountants with respect to the Company under all relevant professional and regulatory standards.

* * * * *

This letter to the Legislative Audit Committee and Pinnacol Risk and Audit Committee of the Board of Directors is intended solely for the information and use of the Legislative Audit Committee, Pinnacol Risk and Audit Committee of the Board of Directors and management and is not intended to be and should not be used by anyone other than these specified parties. However, upon release by the Legislative Audit Committee, the report is a public document.

Very truly yours,

KPMG LLP