

Pinnacol Assurance

Statutory-Basis Financial Statements as of and for the
Years Ended December 31, 2012 and 2011,
Supplemental Schedules of Investment Information
as of and for the Year Ended December 31, 2012,
Comments on Internal Controls and Procedures, and
Independent Auditors' Report



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May 17, 2013

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

We have completed the audit of the statutory-based financial statements of Pinnacol Assurance (Pinnacol) for the year ended December 31, 2012. Our audit was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S., which authorizes the State Auditor to conduct an annual audit of Pinnacol and contract with an auditor or firm of auditors, with the specialized knowledge and experience. The reports that we have issued as a result of this engagement are set forth in the table of contents, which follows.

Deloitte + Touche LLP

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PINNACOL ASSURANCE

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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 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 December 31, 2012, and for the year then ended, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and to express an opinion on those 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 accounting principles generally accepted in the United States of America.

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, 2012.

Required Communications to the Legislative Audit Committee

In accordance with auditing standards generally accepted in the United States of America (AU Section 260 – *The Auditor’s Communication With Those Charged With Governance*), we must communicate to the Legislative Audit Committee certain matters noted during our audit. The following sets forth these required communications:

Auditor’s Responsibility under Professional Standards — The objective of a financial statement audit conducted in accordance with generally accepted auditing standards (GAAS) and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States (GAGAS) is to express an opinion on the fairness of the presentation of the Company’s statutory-basis financial statements as of and for the year ended December 31, 2012, in conformity with accounting principles prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado. The audit of the statutory-basis financial statements does not relieve management of its responsibilities.

The audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether caused by fraud or error. In making those risk assessments, we considered internal control over financial reporting relevant to the Company’s preparation and fair presentation of the financial statements in order to design audit procedures that were appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the Company’s

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

1. **Accounting Estimates** — Accounting estimates are an integral part of the statutory-basis financial statements prepared by management and are based on management's current judgments. Those judgments are ordinarily based on knowledge and experience about past and current events and on assumptions about future events. Significant accounting estimates reflected in the Company's 2012 statutory-basis financial statements include the following:

Bonds and Common Stocks — Pinnacol must consider the statutory requirements related to other-than-temporary impairments when determining whether any declines in value are recognized through realized losses in the statutory statement of operations or through change in unrealized losses, which is a direct charge to policyholders' surplus. These statutory requirements for other-than-temporary impairments ("OTTI") require management's judgment and consideration of various characteristics of the investments, the underlying causes of the decline in value, as well as management's intent related to future sales of the securities. The Company recorded \$1,274,000 in other-than-temporary impairments on common stocks and mutual funds for the year ended December 31, 2012.

Reserve for Unpaid Losses and Loss Adjustment Expenses — Estimating the reserve for unpaid losses and loss adjustment expenses (reserves) of an insurance company is a subjective and judgmental process, particularly for workers' compensation insurance, where the ultimate liability to a claimant may not be known with certainty for a number of years. To assist management in estimating the liability for unpaid losses and loss adjustment expenses, Pinnacol retains the assistance of an actuarial consulting firm. At December 31, 2012, Pinnacol has recorded \$1,139,419,000 for unpaid losses and loss adjustment expenses as management's best estimate, which management believes to be a reasonable estimate of future amounts to be paid for claims incurred in 2012 and in prior years. Pinnacol discounts unpaid losses for certain long-term scheduled workers' compensation payments and discounts internal structured settlement liabilities on a tabular basis using a discount rate of 2.5% for 2012. 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.

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

Pinnacol recorded a premium deficiency reserve of \$20,207,000 as a result of rate reductions and driven by a competitive market and the downturn in the economy in previous years. The premium deficiency reserve evaluation was completed on February 1, 2013 by an independent actuary. Pinnacol considered anticipated investment income at 3.5% when evaluating the premium deficiency reserve for 2012.

Other accounting estimates are as follows:

Uncollected Premiums — The amount of uncollected premiums, which affects the amount of premium revenue recognized, is estimated using statutory requirements, as well as certain management judgments. Management must determine whether an allowance should be established to provide for all reasonably anticipated uncollectible amounts inherent in the uncollected premiums balance. Factors that are considered in establishing reserves for anticipated uncollectible amounts are collection experience and

trends, current overall aging of balances, economic conditions and trends, and evaluations of individual accounts. At December 31, 2012, the admitted value of uncollected premiums as reflected in Pinnacol's statutory-basis financial statements is \$30,480,000.

Earned but Unbilled Premiums — Earned but unbilled premiums represent a receivable or liability for audit premiums, which are amounts due from or to policyholders after the respective policy period has expired based on audits performed by Pinnacol. A receivable is included as a component of uncollected premiums. 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. Based on this analysis, Pinnacol recorded an estimated earned but unbilled receivable of approximately \$9,790,000 in 2012.

Association Dividends Payable to Policyholders — Pinnacol has an association dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. Based on the payment pattern for these dividends, management must estimate the future loss ratio for the eligible policyholders in order to determine the accrual recorded at December 31, 2012. For 2012, association dividends payable of \$2,100,000 are included in dividends payable to policyholders.

2. **Uncorrected Misstatements** — Our audit of the statutory-basis financial statements was designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. There were no uncorrected misstatements or passed disclosure items identified during our audit.
3. **Material Corrected Misstatements** — Our audit of the statutory-basis financial statements was designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. There were no material misstatements that were brought to the attention of management as a result of our audit procedures.
4. **Significant Accounting Policies** — The Company's significant accounting policies are set forth in Note 1 to the Company's 2012 statutory-basis financial statements. During the year ended December 31, 2012, there were no significant changes in previously adopted accounting policies or their application.
5. **Other Information in the Annual Report to Policyholders** — When audited financial statements are included in documents containing other information such as the Company's Annual Report to Policyholders, we read such other information and consider whether it, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, in the statutory-basis financial statements audited by us. We have read the other information in the Company's Annual Report to Policyholders, and have inquired as to the methods of measurement and presentation of such information. We did not note any material inconsistencies or obtain knowledge of a material misstatement of fact in the other information.
6. **Disagreements with Management** — We have not had any disagreements with management related to matters that are material to the Company's 2012 statutory-basis financial statements.
7. **Our Views About Significant Matters that were the Subject of Consultation with Other Accountants** — We are not aware of any consultations that management may have had with other accountants about auditing and accounting matters during 2012.
8. **Significant Issues Discussed, or Subject of Correspondence, with Management Prior to Our Retention** — Throughout the year, routine discussions were held, or were the subject of correspondence, with management regarding the application of accounting principles or auditing standards in connection

with transactions that have occurred, transactions that are contemplated, or reassessment of current circumstances. In our judgment, such discussions or correspondence were not held in connection with our retention as auditors.

9. **Other Significant Findings or Issues Arising from the Audit Discussed, or Subject to Correspondence, with Management** — Throughout the year, routine discussions were held, or were the subject of correspondence, with management. In our judgment, such discussions or correspondence did not involve significant findings or issues requiring communication to the Legislative Audit Committee.
10. **Significant Difficulties Encountered in Performing the Audit** — In our judgment, we received the full cooperation of the Company's management and staff and had unrestricted access to the Company's senior management in the performance of our audit.
11. **Management Representations** — We have made specific inquiries of the Company's management about the representations embodied in the statutory-basis financial statements. Additionally, we have requested that management provide to us the written representations the Company is required to provide to its independent auditors under GAAS.
12. **Other Findings or Issues** — Deloitte & Touche LLP performed this audit under contract with the Office of the State Auditor and did not discuss accounting or auditing issues with Pinnacol in connection with our retention as auditor.
13. **Modifications to the Opinion in the Independent Auditor's 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).
14. **Independence** — Our professional standards and other regulatory requirements specify that we communicate to you in writing, at least annually, all independence-related relationships between our firm and Pinnacol and provide confirmation that we are independent accountants with respect to Pinnacol.

We hereby confirm that as of May 17, 2013, we are independent accountants with respect to Pinnacol under all relevant professional and regulatory standards.

Summary of Audit Findings

No material weaknesses in internal control were discovered during the 2012 audit of the statutory-basis financial statements.

PINNACOL ASSURANCE

DESCRIPTION OF PINNACOL ASSURANCE DECEMBER 31, 2012

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

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

Policyholders’ Surplus

Pinnacol had policyholders’ surplus of \$616,102,000 and \$581,826,000 as of December 31, 2012 and 2011, respectively. The increase in surplus is primarily related to current year net income, and unrealized gains on common stock.

In 2012, Pinnacol paid \$37,453,000 in general policyholder dividends to its policyholders in good standing. This is included in Dividends to Policyholders in the statutory-basis statement of operations and changes in policyholders’ surplus and reduces net income for the year ended December 31, 2012. This accounting treatment is in accordance with statutory accounting practices. See further information at Note 1, General Policyholder Dividends.

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying statutory-basis financial statements of Pinnacol Assurance (the "Company"), which comprise the statutory-basis statements of admitted assets, liabilities and policyholders' surplus as of December 31, 2012 and 2011, and the related statutory-basis statements of operations and changes in policyholders' surplus, and cash flows for the years then ended, and the related notes to the statutory-basis financial statements.

Management's Responsibility for the Statutory-Basis Financial Statements

Management is responsible for the preparation and fair presentation of these statutory-basis financial statements in accordance with the 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 statutory-basis financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statutory-basis financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the statutory-basis financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the statutory-basis financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the statutory-basis 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 Company's internal control.

Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the statutory-basis 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 Accounting Principles Generally Accepted in the United States of America

As described in Note 1 to the statutory-basis financial statements, the statutory-basis financial statements are prepared by Pinnacol Assurance using 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 accounting principles generally accepted in the United States of America, to meet the requirements of the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado.

The effects on the statutory-basis financial statements of the variances between the statutory-basis of accounting described in Note 1 to the statutory-basis financial statements and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Adverse Opinion on Accounting Principles Generally Accepted in the United States of America

In our opinion, because of the significance of the matter described in the Basis for Adverse Opinion on Accounting Principles Generally Accepted in the United States of America paragraph, the statutory-basis financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of Pinnacol Assurance as of December 31, 2012 and 2011, 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 statutory-basis 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, 2012 and 2011, and the results of its operations and its cash flows for the years then ended, in accordance with the accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado as described in Note 1 to the statutory-basis financial statements.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated May 17, 2013, on our consideration of the Company's internal control over financial reporting and our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Company's internal control over financial reporting and compliance.

Report on Supplemental Schedules

Our 2012 audit was conducted for the purpose of forming an opinion on the 2012 statutory-basis financial statements as a whole. The supplemental schedule of investment risk interrogatories and the supplemental summary investment schedule as of and for the year ended December 31, 2012 are presented for purposes of additional analysis and are not a required part of the 2012 statutory-basis

financial statements. These schedules are the responsibility of the Company's management and were derived from and relate directly to the underlying accounting and other records used to prepare the statutory-basis financial statements. Such schedules have been subjected to the auditing procedures applied in our audit of the 2012 statutory-basis financial statements and certain additional procedures, including comparing and reconciling such schedules directly to the underlying accounting and other records used to prepare the statutory-basis financial statements or to the statutory-basis financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, such schedules are fairly stated in all material respects in relation to the 2012 statutory-basis financial statements as a whole.

Deloitte + Touche LLP

May 17, 2013

PINNACOL ASSURANCE

**STATUTORY-BASIS STATEMENTS OF ADMITTED ASSETS, LIABILITIES AND
POLICYHOLDERS' SURPLUS
AS OF DECEMBER 31, 2012 AND 2011
(In thousands)**

| | 2012 | 2011 |
|---|---------------------|---------------------|
| ADMITTED ASSETS | | |
| CASH AND INVESTED ASSETS: | | |
| Bonds at adjusted carrying value, fair value of \$1,582,254 in 2012 and \$1,678,044 in 2011 (Note 3) | \$ 1,397,763 | \$ 1,476,227 |
| Preferred Stock at adjusted carrying value, fair value of \$9 in 2012 and \$0 in 2011 (Note 3) | 9 | - |
| Common stock at fair value, adjusted cost of \$247,185 in 2012 and \$222,468 in 2011 (Note 3) | 309,691 | 278,835 |
| Real estate at cost — net of accumulated depreciation of \$9,693 in 2012 and \$8,557 in 2011 | 19,209 | 20,061 |
| Cash, cash equivalents and short-term investments | 129,571 | 80,053 |
| Total cash and invested assets | 1,856,243 | 1,855,176 |
| UNCOLLECTED PREMIUMS — Net of allowance | 30,480 | 20,909 |
| ELECTRONIC DATA PROCESSING EQUIPMENT — At cost — net of accumulated depreciation of \$3,625 in 2012 and \$3,996 in 2011 | 864 | 1,236 |
| ACCRUED INVESTMENT INCOME | 14,901 | 16,320 |
| TOTAL ADMITTED ASSETS | \$ 1,902,488 | \$ 1,893,641 |
| LIABILITIES AND POLICYHOLDERS' SURPLUS | | |
| RESERVE FOR UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES: | | |
| Reserve for unpaid losses (Note 2) | \$ 1,016,988 | \$ 1,024,637 |
| Reserve for unpaid loss adjustment expenses (Note 2) | 122,431 | 146,170 |
| Total reserve for unpaid losses and loss adjustment expenses | 1,139,419 | 1,170,807 |
| OTHER LIABILITIES | 38,150 | 30,744 |
| UNEARNED PREMIUMS | 62,150 | 56,583 |
| ADVANCE PREMIUMS | 8,931 | 8,894 |
| DIVIDENDS PAYABLE TO POLICYHOLDERS | 12,748 | 11,697 |
| PREMIUM DEFICIENCY RESERVE | 20,207 | 27,095 |
| CREDIT BALANCES DUE POLICYHOLDERS | 4,781 | 5,995 |
| Total liabilities | 1,286,386 | 1,311,815 |
| COMMITMENTS AND CONTINGENCIES (Note 8) | - | - |
| POLICYHOLDERS' SURPLUS (Note 7) | 616,102 | 581,826 |
| TOTAL LIABILITIES AND POLICYHOLDERS' SURPLUS | \$ 1,902,488 | \$ 1,893,641 |

See notes to statutory-basis financial statements.

PINNACOL ASSURANCE

STATUTORY-BASIS STATEMENTS OF OPERATIONS AND CHANGES IN POLICYHOLDERS' SURPLUS FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011 (In thousands)

| | 2012 | 2011 |
|--|------------|------------|
| UNDERWRITING INCOME: | | |
| Premiums earned (Note 5) | \$ 425,882 | \$ 385,795 |
| Deductions: | | |
| Losses incurred (Note 2 and 5) | 326,674 | 309,780 |
| Loss adjustment expenses incurred (Note 2 and 5) | 43,592 | 58,929 |
| Other underwriting expenses incurred | 116,312 | 99,247 |
| Total underwriting deductions | 486,578 | 467,956 |
| Net underwriting loss | (60,696) | (82,161) |
| INVESTMENT INCOME: | | |
| Net investment income earned (Note 3) | 79,841 | 89,110 |
| Net realized capital gain (Note 3) | 47,006 | 28,226 |
| Total investment income | 126,847 | 117,336 |
| OTHER INCOME (LOSS): | | |
| Provision for uncollectible premiums | (385) | (1,770) |
| Other income | 407 | 692 |
| Dividends to policyholders | (38,922) | (40,751) |
| NET INCOME (LOSS) | 27,251 | (6,654) |
| CHANGE IN NONADMITTED ASSETS | 909 | 620 |
| CHANGE IN NET UNREALIZED GAINS ON INVESTMENTS | 6,139 | (29,789) |
| OTHER CHANGES IN POLICYHOLDERS' SURPLUS (Note 1) | (23) | (477) |
| POLICYHOLDERS' SURPLUS — Beginning of year | 581,826 | 618,126 |
| POLICYHOLDERS' SURPLUS — End of year | \$ 616,102 | \$ 581,826 |

See notes to statutory-basis financial statements.

PINNACOL ASSURANCE

STATUTORY-BASIS STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2012 AND 2011 (In thousands)

| | 2012 | 2011 |
|--|------------------|-----------------|
| CASH FLOWS FROM OPERATIONS: | | |
| Premiums collected — net of reinsurance | \$ 421,118 | \$ 387,129 |
| Losses and loss adjustment expenses paid — net of reinsurance and deductibles | (401,658) | (379,757) |
| Underwriting expenses paid | (107,126) | (93,768) |
| Dividends paid to policyholders | (37,871) | (43,627) |
| Investment income received, net of investment expenses paid | 81,171 | 89,020 |
| Net amount withheld or retained for account of others | 22 | (1,077) |
| | <hr/> | <hr/> |
| Net cash used in operations | (44,344) | (42,080) |
| | <hr/> | <hr/> |
| CASH FLOWS FROM INVESTMENTS: | | |
| Proceeds from sale or redemption of investments: | | |
| Bonds | 275,974 | 254,388 |
| Stocks | 123,918 | 77,164 |
| Miscellaneous proceeds | - | 531 |
| Total proceeds from sale or redemption of investments | <hr/> 399,892 | <hr/> 332,083 |
| Cost of investments acquired: | | |
| Bonds | (182,777) | (156,182) |
| Stocks | (115,145) | (70,604) |
| Miscellaneous proceeds | (285) | (73) |
| Total investments acquired | <hr/> (298,207) | <hr/> (226,859) |
| | <hr/> | <hr/> |
| Net cash provided from investments | 101,685 | 105,224 |
| | <hr/> | <hr/> |
| CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES — Cash used in other miscellaneous sources | <hr/> (7,823) | <hr/> (35,900) |
| | <hr/> | <hr/> |
| NET INCREASE IN CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS | 49,518 | 27,244 |
| | <hr/> | <hr/> |
| CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS — Beginning of year | 80,053 | 52,809 |
| | <hr/> | <hr/> |
| CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS — End of year | <hr/> \$ 129,571 | <hr/> \$ 80,053 |
| | <hr/> | <hr/> |

See notes to statutory-basis financial statements.

PINNACOL ASSURANCE

NOTES TO STATUTORY-BASIS FINANCIAL STATEMENTS

DECEMBER 31, 2012 AND 2011

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

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

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

(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 which are considered to be permitted practices.

Statutory accounting practices contained in the Manual vary in some respects from accounting principles generally accepted in the United States of America (GAAP). Pinnacol is a political subdivision of the state and as such would follow all applicable Governmental Accounting Standards Board (GASB) pronouncements. The more significant differences between SAP and GAAP are as follows:

- Policy acquisition costs, such as commissions, premium taxes, 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 cost, while under GAAP, they would be carried at fair value. For GAAP, changes in fair value in bonds go through net investment income;
- Assets are reported under NAIC SAP at "admitted-asset" value and "non-admitted" assets 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;

- 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 effect of the differences between statutory-basis of accounting and generally accepted accounting principles, although not reasonably determinable, is presumed to be material.

(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 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 premium deficiency reserve, internal structured settlements, 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. Reserve for unpaid losses and loss adjustment expenses represent estimates of the ultimate unpaid cost, net of reinsurance, of all losses incurred including losses incurred but not reported. This liability is an estimate and, as such, the ultimate actual liability may vary from the recorded amounts. These liabilities are reviewed periodically and adjustments to the reserve are included in operations in the period such determination is made. Actual results could differ from those estimates and such differences could be significant.

(d) Investments — Investments are recorded on the trade date. Bonds and preferred stocks are stated at amortized cost or fair value, based on their NAIC rating, and are adjusted for other-than-temporary declines in fair value. Common stocks, mutual funds, and common trust funds are carried at fair value. Unrealized capital gains on common stocks, mutual funds, and common trust funds are reported as a direct adjustment to policyholders’ surplus. Common stocks, preferred stocks, mutual funds, and common trust funds in an unrealized loss position for the years ended December 31, 2012 and 2011 are recorded as other-than-temporarily impaired and are recorded as a realized loss in the statutory-basis statement of operations in the period in which they occur.

Amortization of bond premium or discount is calculated using the effective interest method taking into consideration specified interest and principal provisions over the life of the bond. Bonds containing call provisions are amortized to the call or maturity value or date that produces the lowest asset value.

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

Prepayment assumptions for purposes of recognition of income and valuing of loan-backed bonds and structured securities were obtained from widely accepted models with inputs from major third party securities pricing services. These assumptions are consistent with the current interest rate and economic environment. The prospective method is used to value mortgage-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 \$1,137,000 and \$1,128,000 for the years

ended December 31, 2012 and 2011 respectively, and is included in other underwriting expenses incurred in the statutory-basis statements of operations and changes in policyholders' surplus.

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

As of December 31, 2012, cash, cash equivalents and short-term investments of approximately \$129,571,000 include \$(11,723,000) of book overdrafts, \$6,000,000 of cash equivalents, and \$135,294,000 of short-term investments. As of December 31, 2011, cash, cash equivalents and short-term investments of approximately \$80,053,000 include \$(13,155,000) of book overdrafts, \$0 of cash equivalents, and \$93,208,000 of short-term investments. In the accompanying statutory-basis statements of admitted assets, liabilities and policyholders' surplus, Pinnacol has recorded checks that have been issued, but not presented for payment, as a reduction of cash and cash equivalents.

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

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

During 2012 and 2011, Pinnacol recorded a provision of approximately \$385,000 and \$1,770,000, 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, 2012 and 2011 were from companies operating in the construction and services industries in Colorado. The construction industry represents approximately 31% of premiums earned as of December 31, 2012 and 2011. The services industry represents approximately 45% of premiums earned as of December 31, 2012 and 2011, with all other individual industries constituting the remainder of premiums receivable balances.

- (g) Earned But Unbilled Premiums** — Earned but unbilled premiums represent a receivable or liability for audit premiums, which are amounts due from or to policyholders after the respective policy period has expired based on payroll audits performed by Pinnacol. A receivable is included as a component of uncollected premiums. 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. Based on this analysis, Pinnacol recorded an estimated audit receivable in 2012 and 2011 of approximately \$9,790,000 and \$890,000, respectively. The receivable is due to rate increases and increased covered payroll.

- (h) Credit Balances Due Policyholders** — Credit balances due policyholders represent excess premiums or are amounts due to policyholders. Generally, credit balances due policyholders are applied to future premium obligations of policyholders. For 2012 and 2011, such amounts are approximately \$4,781,000 and \$5,995,000, respectively.

- (i) **Electronic Data Processing Equipment** — Electronic data processing equipment is recorded at cost, less accumulated depreciation, and depreciated on a straight-line basis over an estimated useful life of three years. Net book value of these assets at December 31, 2012 and 2011 was approximately \$864,000 and \$1,236,000, respectively. Related depreciation expense of approximately \$370,000 and \$989,000 was incurred during 2012 and 2011, respectively, and is included in other underwriting expenses incurred in the statutory-basis statements of operations and changes in policyholders' surplus.
- (j) **Office Furniture and Equipment and Software** — Office furniture and equipment and software are recorded at cost and depreciated on a straight-line basis. Office furniture and equipment are depreciated over an estimated useful life of five years. Software is depreciated over an estimated useful life of three years. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2012 and 2011 was approximately \$1,056,000 and \$1,781,000, respectively. Related depreciation expense of approximately \$965,000 and \$1,405,000 was incurred in 2012 and 2011, respectively and is included in other underwriting expenses incurred in the statutory-basis statements of operations and changes in policyholders' surplus.
- (k) **Other Assets** — At December 31, 2012 and 2011, Pinnacol had prepaid assets and deposits totaling approximately \$6,271,000 and \$7,193,000, respectively. In accordance with the Manual, these are nonadmitted assets.
- (l) **General Policyholder Dividends** — The board of directors, at its discretion, determines the amount of general policyholder dividends to be declared based on Pinnacol's overall experience and financial condition. Pinnacol paid general policyholder dividends to its policyholders in good standing of approximately \$37,453,000 and \$41,605,000 in May of 2012 and 2011, respectively. This is included in dividends to policyholders in the statutory-basis statements of operations and changes in policyholders' surplus and reduces net income for the years ended December 31, 2012 and 2011.
- (m) **Association Dividend Program** — Pinnacol has an association dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. Pinnacol paid out association dividends of \$1,069,000 and \$1,446,000 in 2012 and 2011, respectively. As of December 31, 2012 and 2011, association dividends payable of \$2,100,000 and \$1,700,000, 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 settled via premium credits and are recorded as dividends to policyholders in the statutory-basis statements of operations and changes in policyholders' surplus.
- (n) **Revenue Recognition** — 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.
- (o) **Reserve for Unpaid Losses and Loss Adjustment Expenses** — The reserve for unpaid losses and loss adjustment expenses represents management's best estimate of ultimate net cost of all reported and unreported losses incurred through December 31, 2012 and 2011. 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.

Certain Workers' Compensation long term case unpaid losses have been discounted on a tabular basis using a discount rate of 2.5% in 2012 and 2011. See Note 9 for discussion of change to tabular discounting effective January 1, 2013.

Internal structured settlement liabilities represent obligations to claimants and dependents on cases that have been closed by contract. These obligations are discounted at 2.5% in 2012 and 2011.

- (p) Unearned Premiums** — Unearned premiums represent amounts either collected or billed and due from policyholders at December 31, 2012 and 2011 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, 2012 are not included in the unearned premiums balance. Unearned premiums are computed on a daily pro rata basis over the 12-month term of the policies.
- (q) 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 \$20,207,000 and \$27,095,000 at December 31, 2012 and 2011 respectively, as a result of rate reductions and driven by a competitive market and the downturn in the economy in previous years. The premium deficiency reserve evaluation was completed on February 1, 2013 by an independent actuary. Pinnacol considered anticipated investment income at 3.5% when evaluating the premium deficiency reserve for 2012.

- (r) Multiemployer Pension Plans and Other Postretirement Benefits** — Pinnacol participates in a cost sharing multiemployer defined benefit pension plan and health care trust fund administered by the Public Employees' Retirement Association (PERA). All employees of Pinnacol are members of the plan and trust fund, and the plan and trust fund provide retirement, disability, health premium subsidies, and death benefits for members or their beneficiaries.

As a participant in a multiemployer 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.

Effective January 1, 2013, SSAP No. 92, *Accounting for Postretirement Benefits Other Than Pensions*, will replace SSAP No. 14 and SSAP No. 102, *Accounting for Pensions*, will replace SSAP No. 89. There will be no material impact to the Company as a result of adopting SSAP No. 92 and 102.

- (s) Division of Insurance Stipulation Order** — In 2010, the Colorado Division of Insurance and Pinnacol entered into a stipulation order where, among other things, Pinnacol agreed to pay \$15,000,000 from surplus to policyholders as a premium credit during 2011 and 2012. This amount was established as a liability in 2010 and is a direct reduction of policyholders' surplus. The liability was paid in full, including an additional \$500,000 for total payments to policyholders of \$15,500,000.

- (t) **Subrogation** — Subrogation claims (claims against third parties) are recognized as a reduction of losses incurred when collections are received. The Company received \$6,349,000 and \$4,025,000 in subrogation as of December 31, 2012 and December 31, 2011, respectively.
- (u) **Reinsurance** — Ceded reinsurance transactions are accounted for based on estimates of their ultimate cost. Losses incurred, loss adjustment expenses incurred, and the reserve for loss adjustment expenses are reported net of reinsured amounts in accordance with the Manual. Reinsurance premiums are reflected as a reduction of premiums earned (see Note 5).
- (v) **Taxes** — As a political subdivision of the State of Colorado, Pinnacol is not subject to Federal or State income taxes under a specific exemption granted under Section 501(c) of the Internal Revenue Code; nor is Pinnacol subject to property tax or sales and use taxes. Additionally, Pinnacol is not subject to a premium tax pursuant to Section 8-45-117(3), C.R.S. However, Pinnacol is subject to a surcharge on premiums pursuant to Section 8-44-112(1)(s), C.R.S. The surcharge is based on a rate established annually, approximately 1.73% for 2012 and 2011. Such amounts are included in other underwriting expenses incurred.
- (w) **Application of Recent Statutory Accounting Pronouncements** — During 2012, 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 AND INTERNAL STRUCTURED SETTLEMENT RESERVES

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 reserves currently estimated to be adequate. While the ultimate liability may differ from the current estimate, management does not believe the difference will have a material effect, either adverse or favorable, on Pinnacol's financial position or results of operations.

Pinnacol also 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 discount applied to this liability was 2.5% at December 31, 2012 and 2011. The internal structured settlement liability is actuarially valued. The internal structured settlement liability is included in unpaid losses and loss adjustment expenses on the statutory-basis statements of admitted assets, liabilities and policyholders' surplus.

(a) Discount of Liabilities for Unpaid Losses:

Pinnacol discounts its liabilities on unpaid losses for certain workers' compensation long-term indemnity payments. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. Such losses have been discounted at a rate of 2.5% in 2012 and 2011.

The amount of tabular discount for case unpaid losses as of December 31, 2012 and December 31, 2011 was \$71,593,000 and \$73,336,000, respectively. The discount on internal structured settlement liabilities is presented in Note 2(c). The amount of discount for case reserves at December 31, 2012 and December 31, 2011 are distributed over the years in which the losses were incurred as follows (in thousands):

| 2012 | | 2011 | |
|------------------|------------------|------------------|------------------|
| Loss Year | Discount | Loss Year | Discount |
| Prior | \$ 11,572 | Prior | \$ 10,924 |
| 2003 | 445 | 2002 | 1,616 |
| 2004 | 1,527 | 2003 | 473 |
| 2005 | 1,139 | 2004 | 1,878 |
| 2006 | 4,892 | 2005 | 1,882 |
| 2007 | 4,548 | 2006 | 5,584 |
| 2008 | 10,815 | 2007 | 7,123 |
| 2009 | 8,557 | 2008 | 14,073 |
| 2010 | 9,773 | 2009 | 11,657 |
| 2011 | 13,130 | 2010 | 10,687 |
| 2012 | 5,195 | 2011 | 7,439 |
| Total | <u>\$ 71,593</u> | Total | <u>\$ 73,336</u> |

(b) Unpaid Losses and Loss Adjustment Expenses:

Activity in the liability for unpaid losses and loss adjustment expenses in 2012 and 2011 is summarized as follows (in thousands):

| | Unpaid Losses and Loss Adjustment Expenses | |
|---|--|-------------------|
| | 2012 | 2011 |
| Balance at January 1 | \$ 840,158 | \$ 866,074 |
| Additional amounts incurred related to: | | |
| Current year | 445,900 | 427,618 |
| Prior years | <u>(83,943)</u> | <u>(68,135)</u> |
| Total Incurred | <u>361,957</u> | <u>359,483</u> |
| Reductions relating to payments for: | | |
| Current year | 135,439 | 130,948 |
| Prior years | <u>277,898</u> | <u>254,451</u> |
| Total Paid | <u>413,337</u> | <u>385,399</u> |
| Balance at December 31 | <u>\$ 788,778</u> | <u>\$ 840,158</u> |

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and loss adjustment expenses decreased by approximately \$83,943,000 and \$68,135,000 in 2012 and 2011, respectively, which is net of a change in discount of approximately (\$1,743,000) and \$3,330,000, respectively. During the year ended December 31, 2012, approximately \$277,898,000 was paid for unpaid losses and loss adjustment expense attributable to insured events of prior years. Reserves for unpaid losses and loss adjustment expense remaining for prior years are now \$478,317,000 as a result of re-estimation of unpaid losses and loss adjustment expenses. This decrease is generally the result of ongoing analysis of recent loss development trends and better than expected development. Pinnacol's claims, for all accident years, continue the trend of favorable development that has been evident for a number of calendar years. When the actual selected ultimate cost of an accident year's claims is less than the original estimate, favorable development is recorded. This favorable development resulted from aggressive claim closure, a reduction of ultimate claim frequency in Colorado, and a reduction of catastrophic losses. Pinnacol management continually evaluates the 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.

(c) Internal Structured Settlements:

Activity in the liability for internal structured settlements in 2012 and 2011 is summarized as follows (in thousands):

| | <u>2012</u> | <u>2011</u> |
|-------------------------------------|-------------------|-------------------|
| Beginning Balance | \$ 330,649 | \$ 315,781 |
| Amounts Incurred: | | |
| Change in Valuation | 8,312 | 9,226 |
| Amounts Paid | (19,603) | (18,971) |
| New Internal Structured Settlements | <u>31,283</u> | <u>24,613</u> |
| Ending Balance | <u>\$ 350,641</u> | <u>\$ 330,649</u> |

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, 2012 and 2011.

The amount of the discount for unpaid internal structured settlements as of December 31, 2012 and 2011 is approximately \$159,341,000 and \$154,170,000 respectively. The amount of discount for internal structured settlement reserves at December 31, 2012 and December 31, 2011 are distributed over the years in which the losses were incurred as follows (in thousands):

| <u>2012</u> | | <u>2011</u> | |
|------------------|-------------------|------------------|-------------------|
| <u>Loss Year</u> | <u>Discount</u> | <u>Loss Year</u> | <u>Discount</u> |
| Prior | \$ 69,880 | Prior | \$ 67,267 |
| 2003 | 12,128 | 2002 | 10,411 |
| 2004 | 7,868 | 2003 | 12,532 |
| 2005 | 13,577 | 2004 | 7,988 |
| 2006 | 16,685 | 2005 | 13,674 |
| 2007 | 10,427 | 2006 | 15,986 |
| 2008 | 12,260 | 2007 | 8,641 |
| 2009 | 10,289 | 2008 | 8,487 |
| 2010 | 3,106 | 2009 | 7,297 |
| 2011 | 2,990 | 2010 | 1,287 |
| 2012 | <u>131</u> | 2011 | <u>600</u> |
| Total | <u>\$ 159,341</u> | Total | <u>\$ 154,170</u> |

3. INVESTMENTS

Estimated fair value of investments in bonds is based on quotations provided by external pricing vendors. In both 2012 and 2011, Interactive Data Corporation (IDC) and Standard and Poor's Security Evaluations (SPSE) were used to obtain fair market values. Additionally, in 2012, the fair value of certain common trust funds is 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.

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

During 2012 and 2011, Pinnacol had investments in bonds which the SVO designated at a 3 or higher rating. At December 31, 2012 and 2011, the fair value on these bonds was greater than, or equal to, amortized cost, which resulted in a cumulative unrealized loss of \$0 and \$0, respectively, and carrying values equal to amortized cost for these bonds.

The book/adjusted carrying value and the fair value of investments in bonds in 2012 and 2011 are summarized as follows (in thousands):

| | 2012 | | | |
|-------------------------------|---|---------------------------------------|--|---------------------|
| | Book/Adjusted Carrying Value | Gross Unrealized Gains | Gross Unrealized Losses | Fair value |
| Government obligations: | | | | |
| Non-loan-backed bonds | \$ 266,861 | \$ 48,754 | \$ - | \$ 315,615 |
| Loan-backed bonds | 134,284 | 9,662 | - | 143,946 |
| Special revenue: | | | | |
| Non-loan-backed bonds | 26,452 | 2,156 | - | 28,608 |
| Loan-backed bonds | 62,934 | 4,080 | - | 67,014 |
| Industrial and miscellaneous: | | | | |
| Non-loan-backed bonds | 907,232 | 120,471 | (632) | 1,027,071 |
| | <u>\$ 1,397,763</u> | <u>\$ 185,123</u> | <u>\$ (632)</u> | <u>\$ 1,582,254</u> |

| | 2011 | | | |
|-------------------------------|---|---------------------------------------|--|---------------------|
| | Book/Adjusted Carrying Value | Gross Unrealized Gains | Gross Unrealized Losses | Fair value |
| Government obligations: | | | | |
| Non-loan-backed bonds | \$ 275,863 | \$ 62,030 | \$ - | \$ 337,893 |
| Loan-backed bonds | 17,054 | 1,887 | - | 18,941 |
| Special revenue: | | | | |
| Non-loan-backed bonds | 11,427 | 108 | - | 11,535 |
| Loan-backed bonds | 275,401 | 20,046 | - | 295,447 |
| Industrial and miscellaneous: | | | | |
| Non-loan-backed bonds | 896,482 | 117,793 | (47) | 1,014,228 |
| | <u>\$ 1,476,227</u> | <u>\$ 201,864</u> | <u>\$ (47)</u> | <u>\$ 1,678,044</u> |

The book/adjusted carrying value and estimated fair value of investments in bonds at December 31, 2012, 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.

| | 2012 | |
|--|---|---------------------|
| | Book/Adjusted Carrying Value | Fair value |
| Due in one year or less | \$ 164,213 | \$ 166,948 |
| Due after one year through five years | 354,249 | 396,245 |
| Due after five years through ten years | 441,698 | 502,920 |
| Due after ten years | 437,603 | 516,141 |
| | <u>\$ 1,397,763</u> | <u>\$ 1,582,254</u> |

Proceeds from sales of investments in bonds during 2012 and 2011 were approximately \$275,974,000 and \$254,388,000, respectively. Realized gains on bonds of approximately \$13,508,000 and \$8,543,000 and realized losses of approximately \$0 and \$149,000 were recognized during 2012 and 2011, respectively.

Unrealized gains on investments in common stocks, mutual funds, and common trust funds are reported as a component of policyholders' surplus. Equities in an unrealized loss position are deemed to be other-than-temporarily impaired, with the resulting loss recognized in the statement of operations. Other-than-temporary impairments 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, 2012 | \$ 277,471 | \$ 247,185 | \$ 62,506 | \$ 309,691 |
| December 31, 2011 | \$ 271,485 | \$ 222,468 | \$ 56,367 | \$ 278,835 |

The following table provides the length of impairment for those investments in bonds with an unrealized loss as of December 31, 2012 (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 |
| Industrial and miscellaneous | \$ 27,220 | \$ (632) | \$ - | \$ - | \$ 27,220 | \$ (632) |
| Total | <u>\$ 27,220</u> | <u>\$ (632)</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 27,220</u> | <u>\$ (632)</u> |

The following table provides the length of impairment for those investments in bonds with an unrealized loss as of December 31, 2011 (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 |
| Industrial and miscellaneous | \$ 1,445 | \$ (47) | \$ - | \$ - | \$ 1,445 | \$ (47) |
| Total | \$ 1,445 | \$ (47) | \$ - | \$ - | \$ 1,445 | \$ (47) |

There were 7 and 1 bonds in an unrealized loss position as of December 31, 2012 and 2011, respectively.

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

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

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

- Fair value is significantly below cost.
- The decline in fair value is attributable to specific adverse conditions affecting a particular instrument, its issuer, an industry or geographic area.
- The decline in fair value has existed for an extended period of time.
- A debt security has been downgraded by a credit rating agency.
- The financial condition of the issuer has deteriorated.
- A change in future expected cash flows 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.

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

Bonds — At December 31, 2012 and 2011, less than 1% of bonds held by the Company were rated non-investment grade. At December 31, 2012 and 2011, the Company had approximately \$632,000 and \$47,000, respectively, of unrealized losses related to its industrial and miscellaneous bonds. The Company does not have any significant concentrations by issuer or by sector. The unrealized losses on securities are primarily attributable to fluctuations in market interest rates and changes in credit spreads since the securities were acquired.

Loan-Backed Securities — Loan-backed securities are stated at amortized cost or fair value based on their NAIC designation. The prospective method is used to value mortgage-backed securities. Prepayment assumptions for single class and multi-class mortgage-backed/asset-backed securities were obtained from 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 other-than-temporary impairment should be recognized at year-end. Pinnacol did not recognize any other-than-temporary impairments on loan-backed securities during the year ended December 31, 2012 and 2011 as there were no loan-backed securities in an unrealized loss position.

Other-Than-Temporary Impairment — During 2012 and 2011, the Company recognized approximately \$0 and \$149,000, respectively, in other-than-temporary impairments on bonds. During 2012 a preferred stock was purchased, and there was no other-than-temporary impairment recorded. During the years ended December 31, 2012 and 2011, the Company recorded other-than-temporary impairments on common stocks, mutual funds, and common trust funds in the amounts of approximately \$1,274,000 and \$4,072,000, respectively. These impairments relate to market declines in value as of the last day of the year.

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 includes exchange-traded preferred and common stocks. 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 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 includes inputs that are unobservable and include situations where there is little, if any, market activity for the asset. The Company has no assets or liabilities measured at fair value in this category.

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 in paragraph 3 below. During the current year, no transfers between Level 1 and 2 were required.

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, 2012 and 2011,

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, 2012**

| 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, mutual funds, and common trust funds | \$ 279,836 | \$ 29,855 | \$ - | \$ 309,691 |
| Total assets | <u>\$ 279,836</u> | <u>\$ 29,855</u> | <u>\$ -</u> | <u>\$ 309,691</u> |

**Fair Value Measurements - Recurring Basis
December 31, 2011**

| Assets | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
|--------------------------------|---|--|--|-------------------|
| Common stocks and mutual funds | \$ 278,835 | \$ - | \$ - | \$ 278,835 |
| Total assets | <u>\$ 278,835</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 278,835</u> |

Certain assets are measured at fair value on a non-recurring basis quarterly or more frequently if events dictate that the carrying value of the asset may not be recovered. These assets include bonds held at fair value with an NAIC rating of 3–6 and redeemable preferred stocks held at fair value with an NAIC rating of RP3-RP6. There were no bonds or preferred stocks with these ratings where the carrying value was less than market value at December 31, 2012 and 2011.

The Company did not have any significant concentrations by industry or by issuer as of December 31, 2012 or 2011.

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, 2012 and 2011, respectively. The fair values are also categorized into the three-level fair value hierarchy as described above.

December 31, 2012

| Type of Financial Instrument | Fair Value | Admitted Value | Level 1 | Level 2 | Level 3 |
|--|---------------------|---------------------|-------------------|---------------------|-------------|
| Financial instruments- assets | | | | | |
| Bonds | \$ 1,582,255 | \$ 1,397,763 | \$ - | \$ 1,582,255 | \$ - |
| Preferred stocks | 9 | 9 | 9 | - | - |
| Common stocks, mutual funds and common trust funds | 309,691 | 309,691 | 279,836 | 29,855 | - |
| Cash equivalents and short-term investments | 141,304 | 141,293 | 85,308 | 55,996 | - |
| Total assets | \$ 2,033,259 | \$ 1,848,756 | \$ 365,153 | \$ 1,668,106 | \$ - |

December 31, 2011

| Type of Financial Instrument | Fair Value | Admitted Value | Level 1 | Level 2 | Level 3 |
|---|---------------------|---------------------|-------------------|---------------------|-------------|
| Financial instruments- assets | | | | | |
| Bonds | \$ 1,678,044 | \$ 1,476,227 | \$ - | \$ 1,678,044 | \$ - |
| Common stocks and mutual funds | 278,835 | 278,835 | 278,835 | - | - |
| Cash equivalents and short-term investments | 93,207 | 93,208 | 91,198 | 2,009 | - |
| Total assets | \$ 2,050,086 | \$ 1,848,270 | \$ 370,033 | \$ 1,680,053 | \$ - |

Investment Income — Major categories of net investment income for the years ended December 31, 2012 and 2011 are summarized as follows (in thousands):

| | <u>2012</u> | <u>2011</u> |
|-----------------------------------|-------------------|-------------------|
| Investment income: | | |
| Corporate and miscellaneous bonds | \$ 54,917 | \$ 68,641 |
| U.S. government bonds | 18,050 | 13,584 |
| Cash and other investments | 38 | 17 |
| Real estate | 3,857 | 3,857 |
| Equity securities | 7,855 | 7,298 |
| Investment expenses | (4,876) | (4,287) |
| Net investment income earned | 79,841 | 89,110 |
| Net realized capital gains | 47,006 | 28,226 |
| Net investment income | <u>\$ 126,847</u> | <u>\$ 117,336</u> |

4. UNINSURED PLANS AND UNINSURED PORTION OF PARTIALLY INSURED PLANS

Pinnacol offered Administrative Services Contract (ASC) Plans until 2011 whereby Pinnacol acted as a third party administrator for all workers' compensation claims under these contracts. All losses and loss adjustment expenses related to claims under these contracts are reimbursed to Pinnacol. Pinnacol does not record premium revenue nor losses and loss adjustment expenses on these plans, but does show the related receivables for these costs. Claims processed and reimbursed under these contracts were approximately \$42,000 and \$19,804,000 in 2012 and 2011, respectively. Net gain (loss) resulting from operations under these contracts were approximately (\$0) and (\$263,000), respectively. Included in these contracts are transactions with the State.

In 2011, Pinnacol terminated the Administrative Services Contract Plans. The Company honored any contracts in force in 2011 but did not renew these contracts, effectively eliminating the program by December 31, 2011.

5. REINSURANCE

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

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

This coverage was in effect during 2012 and 2011. 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 aforementioned policy periods.

Should the reinsurers be unable to meet their obligations under the reinsurance contracts, Pinnacol would remain liable for amounts ceded to its reinsurers. Reinsurance contracts do not relieve Pinnacol of its obligations, and a failure of the reinsurer to honor its obligations could result in losses 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, 2012:

| <u>Reinsurer</u> | <u>AM Best Rating</u> |
|---------------------------------------|-----------------------|
| Aspen Insurance UK Limited | A |
| AXIS Specialty Limited | A |
| Endurance Specialty Insurance Limited | A |
| Validus Reinsurance 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 cancelled 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, 2012. 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.

Pinnacol held unearned premium reserves related to assumed business of \$1,880,000 and \$1,969,000 for the years ended December 31, 2012 and 2011 respectively. Pinnacol had loss and loss adjustment expense reserves related to assumed business of \$28,123,000 and \$29,724,000 for the years ended December 31, 2012 and 2011, respectively.

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

| | <u>2012</u> | <u>2011</u> |
|--|-------------------|-------------------|
| Direct premiums written | \$ 414,982 | \$ 364,238 |
| Premiums ceded | (1,106) | (1,052) |
| Premiums assumed | <u>17,573</u> | <u>19,445</u> |
| Net premiums written | <u>\$ 431,449</u> | <u>\$ 382,631</u> |
| Direct premiums earned | \$ 409,326 | \$ 367,709 |
| Premiums ceded | (1,106) | (1,052) |
| Premiums assumed | <u>17,662</u> | <u>19,138</u> |
| Net premiums earned | <u>\$ 425,882</u> | <u>\$ 385,795</u> |
| Direct losses incurred | \$ 309,286 | \$ 287,648 |
| Losses ceded | - | - |
| Losses assumed | <u>9,077</u> | <u>12,906</u> |
| Net losses incurred * | <u>\$ 318,363</u> | <u>\$ 300,554</u> |
| Direct loss adjustment expenses incurred | \$ 41,271 | \$ 56,496 |
| Loss adjustment expenses ceded | - | - |
| Loss adjustment expenses assumed | <u>2,321</u> | <u>2,433</u> |
| Net loss adjustment expenses incurred | <u>\$ 43,592</u> | <u>\$ 58,929</u> |

* Net losses incurred excludes activity related to the internal structured settlement liability.

6. EMPLOYEE BENEFITS

Defined Benefit Pension Plan through the State of Colorado

Plan Description — All of Pinnacol's employees participate in a defined benefit pension plan. The plan's purpose is to provide income to members and their families at retirement or in case of death or disability. The plan is a cost sharing multiemployer plan administered by the Public Employees' Retirement Association (PERA). PERA was established by state statute in 1931. Responsibility for the

organization and administration of the plan is placed with the Board of Trustees of PERA. Changes to the plan require an actuarial assessment and legislation by the General Assembly. The state plan and other divisions' plans are included in PERA's financial statements, which may be obtained by writing PERA at PO Box 5800, Denver, Colorado 80217, by calling PERA at 1-800-759-PERA (7372), or by visiting www.copera.org.

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

- Hired before July 1, 2005 - age 50 with 30 years of service, age 60 with 20 years of service, or age 65 with 5 years of service.
- Hired on or after July 1, 2005 but before January 1, 2007 – any age with 35 years of service, age 55 with 25 years of service, age 60 with 20 years of service, or age 65 with 5 years of service.
- Hired on or after January 1, 2007 but before January 1, 2011 – any age with 35 years of service, age 55 with 30 years of service, age 60 with 25 years of service, or age 65 with 5 years of service. For employees hired before January 1, 2007, age and service requirements increase to those required for members hired between January 1, 2007 and December 31, 2010 if the member has less than five years of service credit as of January 1, 2011.
- Hired on or after January 1, 2011 but before January 1, 2017 – any age with 35 years of service, age 58 with 30 years of service, age 65 with 5 years of service.
- Hired on or after January 1, 2017 – any age with 35 years of service, age 60 with 30 years of service, or age 65 with 5 years of service.

Members with five years' service credit at January 1, 2011, are also eligible for retirement benefits without a reduction for early retirement based on their original hire date as follows:

- Hired before January 1, 2007 – age 55 and age plus years of service equals 80 or more.
- Hired on or after January 1, 2007 but before January 1, 2011 – age 55 and age plus years of service equals 85 or more. For members hired before January 1, 2007, age plus years of service increase to 85 for members with less than five years of service credit as of January 1, 2011.
- Hired on or after January 1, 2011 but before January 1, 2017 – age 58 and age plus years of service equals 88 or more.
- Hired on or after January 1, 2017 – age 60 plus years of service equals 90.

Members automatically receive the higher of the defined retirement benefit or money purchase benefit at retirement. Defined benefits are calculated as 2.5% times the number of years of service times the highest average salary (HAS). For members eligible to retire as of January 1, 2011, HAS is determined by the highest annual salaries associated with four periods of 12 consecutive months. The lowest of the four periods becomes the base year used as a starting point for a 15% cap on annual salary increases. For members not eligible to retire as of January 1, 2011, more restrictive limits of 8% are placed on salary increases between periods used in calculating HAS.

Prior to January 1, 2011, retiree benefits were increased annually based on their original hire date as follows:

- Hired before July 1, 2005 – 3.5%, compounded annually.
- Hired between July 1, 2005 and December 31, 2006 – the lesser of 3% or the actual increase in the national Consumer Price Index (CPI).

- Hired on or after January 1, 2007 – the lesser of 3% or the actual increase in the national Consumer Price Index, limited to a 10% reduction in a reserve established for cost of living increases related strictly to those hired on or after January 1, 2007. (The reserve is funded by 1 percentage point of salaries contributed by employers for employees hired on or after January 1, 2007.)

In the 2010 legislative session, the general assembly set the current increase as the lesser of 2% or the average of the monthly Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) amounts for the prior calendar year. The 2011 legislation moved the payment date of all increases to July. New rules governing the annual increase amount were effective beginning January 1, 2011.

For January 1, 2011 and beyond, retiree benefits are increased annually based upon the following:

- Hired before January 1, 2007 whose benefit is paid based on retirement prior to January 1, 2011 – 2% per year unless PERA has a negative investment year in which the lesser of 2% or the average monthly CPI-W of the prior year for the next three years if the recipient has been receiving benefits for the last seven months.
- Hired before January 1, 2007 whose benefit is paid based on retirement on or after January 1, 2011 – 2% per year unless PERA has a negative investment year in which the lesser of 2% or the average monthly CPI-W of the prior year for the next three years if the recipient has been receiving benefits for the last twelve months.
- Hired on or after January 1, 2007 – the lesser of 2% or the average monthly CPI-W of the prior year for the next three years if the recipient has been receiving benefits for the last twelve months.

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

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

Most employees contribute 8.0% of their salary, as defined in CRS 24-51-101(42), to an individual account in the plan. Effective July 1, 2010 Senate Bill 10-146 requires members to pay 2.5% additional member contributions through June 30, 2011. Employer contributions for members will be reduced by 2.5%. Senate Bill 11-076 continued these contribution rates through June 30, 2012.

From January 1, 2011, to December 31, 2011, Pinnacol contributed 12.25% of the employee's salary. From January 1, 2012, to June 30, 2012 Pinnacol contributed 13.15% and from July 1, 2012 to December 31, 2012 Pinnacol contributed 15.65% of the employee's salary. During all of 2012, 1.02% of the employees' total salary was allocated to the Health Care Trust Fund.

Per Colorado Revised Statutes, an amortization period of 30 years is deemed actuarially sound. At December 31, 2011, the division of PERA in which Pinnacol participates has a funded ratio of 57.7% and a 56 year amortization period based on current contribution rates. The funded ratio on the market value of assets is lower at 57.6%.

In the 2004 legislative session, the general assembly authorized an Amortization Equalization Disbursement (AED) to address a pension-funding shortfall. The AED requires PERA employers to

pay an additional .5% of salary beginning January 1, 2006, another .5% of salary in 2007, and subsequent year increases of .4% of salary until the additional payment reaches 3.0% in 2012.

In the 2006 legislative session, the general assembly authorized a Supplemental Amortization Equalization Disbursement (SAED) that requires PERA employers to pay an additional one half percentage point of total salaries paid beginning January 1, 2008. The SAED is scheduled to increase by one-half percentage point through 2013 resulting in a cumulative increase of three percentage points. Both the AED and SAED will terminate when funding levels reach 100%.

In the 2010 legislative session, the general assembly extended both the AED and SAED. The AED will continue to increase at a rate of .4% of salary from calendar years 2013 through 2017. The SAED will continue to increase by one-half percentage point from calendar years 2014 through 2017. If the funding ratio reaches 103%, both the AED and the SAED will be reduced by one-half percentage point. Neither the AED nor the SAED may exceed 5%.

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

Pinnacol expects the annual contribution rate, including AED and SAED, to increase as follows from 2013 to 2017:

| Year | Employer | Total Pinnacol | | |
|------|--------------|----------------|-------|--------------|
| | Contribution | AED | SAED | Contribution |
| 2013 | 10.15% | 3.40% | 3.00% | 16.55% |
| 2014 | 10.15% | 3.80% | 3.50% | 17.45% |
| 2015 | 10.15% | 4.20% | 4.00% | 18.35% |
| 2016 | 10.15% | 4.60% | 4.50% | 19.25% |
| 2017 | 10.15% | 5.00% | 5.00% | 20.15% |

Pinnacol’s contributions to PERA for the years ending December 31, 2012 and 2011 were \$6,035,000 and \$5,156,000 respectively. These contributions met the contribution requirement for each year.

Voluntary Tax-Deferred Retirement Plans

PERA offers a voluntary 401(k) plan entirely separate from the defined benefit pension plan. Pinnacol matches employee’s elective contributions into the PERA 401(k) plan at 50% up to the first 6% of employees’ elected deferrals. The matching contribution is immediately vested and available to the employees. During the year ended December 31, 2012 and 2011, Pinnacol contributed approximately \$1,029,000 and \$995,000, respectively, in matching contributions to the 401(k) plan. Pinnacol also offers a 457 deferred compensation plan.

Postretirement Health Care and Life Insurance Benefits through the State of Colorado

Health Care Program — The PERA Health Care Program began covering benefit recipients and qualified dependents on July 1, 1986. This benefit was developed after legislation in 1985 established the program and the Health Care Fund; the program was converted to a trust fund in 1999. The plan is a cost-sharing multiemployer plan under which PERA subsidizes a portion of the monthly premium for health care coverage. The benefits and employer contributions are established in statute and may

be amended by the General Assembly. PERA includes the Health Care Trust Fund in its Comprehensive Annual Financial Report.

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

Employees are not required to contribute to the Health Care Trust Fund, which is maintained by employer's contributions as discussed above. Beginning July 1, 2004, employers are required to contribute 1.02% of gross covered wages to the Health Care Trust Fund. Pinnacol contributed approximately \$430,000 and \$429,000 as required by statute in the years ended December 31, 2012 and 2011, respectively. In each year the amount contributed was 100% of the required contribution.

The Health Care Trust Fund offers two general types of plans: fully-insured plans offered through health care organizations and self-insured plans administered for PERA by third-party vendors. As of December 31, 2011, there were 50,217 enrolled participants, including spouses and dependents, from all contributors to the plan. At December 31, 2011, the Health Care Trust Fund had an unfunded actuarial accrued liability of \$1.43 billion, a funded ratio of 16.5%, and a 49-year amortization period. The actuarial valuation was based on the entry age, level dollar cost method, an 8% investment rate of return, a 4.5% projection of salary increases (assuming a 3.75% inflation rate), a 2.5% initial, 3.5% ultimate annual medical claims increase, 5.68%-7.73% initial, 5.0% ultimate carrier premiums, 4.5% initial, 5.0% ultimate retiree drug subsidy payments, and a level dollar amortization on an open basis over 30 years.

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. Pinnacol withholds monthly premium from its employee participants' payroll checks and uses these premiums and the employer contribution amounts to fund the trust account. Medical claims are processed and paid by the third party vendors and subsequently reimbursed by the funds held in the trust.

Accrued Paid Leave — Pinnacol employees may accrue paid time off based on their length of service subject to certain limitations on the amount that will be paid upon termination or taken in future periods. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The estimated liability for cumulative accrued paid time off of approximately \$1,813,000 and \$1,696,000 at December 31, 2012 and 2011, respectively, is included in other liabilities in the statutory-basis statements of admitted assets, liabilities and policyholders' surplus.

7. POLICYHOLDERS' SURPLUS

Pinnacol paid approximately \$37,453,000 and \$41,605,000 in general policyholder dividends to its policyholders in good standing in 2012 and 2011, respectively. This is included in dividends to policyholders on the statutory-basis statements of operations and changes in policyholders' surplus and reduces net income for the year ended December 31, 2012.

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 \$117,817,000 for 2012.

8. COMMITMENTS AND CONTINGENCIES

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

At December 31, 2012 and 2011, Pinnacol had a letter of credit for the benefit of Argonaut Insurance Company under an assumed reinsurance agreement for approximately \$19,248,000 and \$28,696,000, respectively. In addition, Pinnacol had a letter of credit for the benefit of Zurich American Insurance Company under an assumed reinsurance agreement for approximately \$22,000,000 and \$17,400,000 as of December 31, 2012 and 2011, respectively. These reinsurance agreements allow each reinsurer to draw upon the letter of credit, which is 100% collateralized, at any time to secure any of Pinnacol's obligations under the agreement. Included in fixed maturities are amounts held as collateral for the letter of credit of approximately \$88,845,000 and \$79,551,000, compared to a requirement of \$41,248,000 and \$46,096,000, as of December 31, 2012 and 2011, respectively.

Pinnacol is contingently liable for approximately \$50,936,000 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 liability to PERA which relates to the vested service of Pinnacol employees whose future benefits relate to that service. The variables that impact the determination of the liability are the number of active and inactive members, annual payroll, required contribution rates and the investment returns of PERA. Pinnacol believes the obligation exists if Pinnacol remains part of PERA as these funds will be collected through increased assessments on current and future salaries. The obligation also exists if Pinnacol were to partially or fully leave the PERA program, as the funding would become immediately due to PERA. Section 24-51-316 of the Colorado Statutes requires a company to calculate the reserve transfer necessary when an employer disaffiliates from PERA. Currently, the possibility of the Company partially or fully leaving the PERA program is remote. Pinnacol conducted a study in 2010 to determine the estimated liability if Pinnacol were to disaffiliate from PERA. The results suggest that Pinnacol could have a liability in excess of \$90,000,000. This was calculated with a variety of actuarial assumptions, including a discount rate of 8%. The assumptions used in this study are subject to change and could have a material impact on this estimate. The unfunded liability for vested service of Pinnacol employees and retirees has not been recorded in Pinnacol's statutory-basis financial statements as of December 31, 2012.

9. SUBSEQUENT EVENTS

New Board Members — Four new members were appointed to the Company's Board of Directors on December 20, 2012 with an effective date of January 1, 2013.

CEO Resignation — On January 14, 2013 the Company's Board of Directors accepted the resignation of Ken Ross, the Company's CEO. The Vice Chairman of the Board, John Plotkin, will serve in the role of interim CEO until a permanent replacement has been hired.

Tabular Discount — Effective January 1, 2013, Pinnacol no longer discounts its case reserves on a tabular basis. The change in accounting principle was adopted as SSAP No. 65 permits insurers to discount their tabular reserves; however, it is not required. The accounting change represents a change in the method of applying this principle which differs from the previous method. Estimating case reserves on known claims involves a high degree of subjectivity. Removing the discount assumption, which is based on a projection of future interest rates, eliminates one additional assumption from this significant estimation process. It is more transparent to the users of the statutory-basis financial statements if Pinnacol presents the estimated ultimate cost of settling our claims. The removal of the discount increased unpaid losses and loss adjustment expenses and decreased policyholders' surplus as of January 1, 2013 by \$ 71,593,000.

Subsequent events have been evaluated through May 17, 2013, 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 FOR THE YEARS ENDED DECEMBER 31, 2012

1. Pinnacol's total admitted assets as reported on page two of its Annual Statement are \$1,902,487,585.
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 |
|------------------------------|-------------------------------|---------------|-------------------------------------|
| a. Anheuser-Busch Co | Long Term Bond | \$ 40,546,869 | 2.1 % |
| b. General Electric Co | Long Term Bond & Common Stock | 36,679,678 | 1.9 |
| c. AT&T Inc | Long Term Bond & Common Stock | 36,645,240 | 1.9 |
| d. Proctor & Gamble Co | Long Term Bond & Common Stock | 30,163,705 | 1.6 |
| e. Burlington North Santa Fe | Long Term Bond | 29,497,200 | 1.6 |
| f. Verizon Global Funding | Long Term Bond & Common Stock | 26,621,830 | 1.4 |
| g. 3M Co | Long Term Bond & Common Stock | 24,419,436 | 1.3 |
| h. Johnson & Johnson | Long Term Bond & Common Stock | 23,720,214 | 1.2 |
| i. IBM Corp | Long Term Bond | 23,557,236 | 1.2 |
| j. Emerson Electric Co | Long Term Bond & Common Stock | 22,864,387 | 1.2 |

(Continued)

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

| NAIC Rating | Amount | Percentage of Total Admitted Assets |
|-------------------------|-------------------------|--|
| <u>Bonds</u> | | |
| NAIC-1 | \$ 1,302,514,017 | 68.5 % |
| NAIC-2 | 230,929,984 | 12.1 |
| NAIC-3 | 5,612,792 | 0.3 |
| NAIC-4 | - | 0.0 |
| NAIC-5 | - | 0.0 |
| NAIC-6 | - | 0.0 |
| <u>Preferred Stocks</u> | | |
| P/RP-1 | \$ - | 0.0 % |
| P/RP-2 | 8,500 | 0.0 |
| P/RP-3 | - | 0.0 |
| P/RP-4 | - | 0.0 |
| P/RP-5 | - | 0.0 |
| P/RP-6 | - | 0.0 |
| | <u>\$ 1,539,065,293</u> | |

4. Assets held in foreign investments are \$98,108,744 and assets held in foreign-currency-denominated investments are \$1,059,785 which is approximately 5.2% and 0.1% of Pinnacol's total admitted assets, respectively.
5. The following represents aggregate foreign investment exposure categorized by NAIC sovereign rating:

| Foreign Investment Assets | | |
|----------------------------------|----------------------|--|
| NAIC Rating | Amount | Percentage of Total Admitted Assets |
| Countries rated NAIC-1 | \$ 98,108,744 | 5.2 % |
| Countries rated NAIC-2 | - | 0.0 |
| Countries rated NAIC-3 or below | - | 0.0 |
| | <u>\$ 98,108,744</u> | |

(Continued)

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

| Foreign Investment Assets | | | |
|----------------------------------|----------------|----------------------|--|
| NAIC Rating | Country | Amount | Percentage of Total Admitted Assets |
| Countries rated NAIC-1: | | | |
| Country 1: | United Kingdom | \$ 28,316,873 | 1.5 % |
| Country 2: | Norway | 20,100,635 | 1.1 |
| Countries rated NAIC-2: | | | |
| Country 1: | | - | 0.0 |
| Country 2: | | - | 0.0 |
| Countries rated NAIC-3 or below: | | | |
| Country 1: | | - | 0.0 |
| Country 2: | | - | 0.0 |
| | | <u>\$ 48,417,508</u> | |

7. Aggregate unhedged foreign currency exposure is \$1,059,785 which is approximately 0.1% Pinnacol's total admitted assets.
8. The following represents aggregate unhedged foreign currency exposure categorized by NAIC sovereign rating:

| Foreign-Currency-Denominated Investment Assets | | |
|---|---------------------|--|
| NAIC Rating | Amount | Percentage of Total Admitted Assets |
| Countries rated NAIC-1 | \$ 1,059,785 | 0.1 % |
| Countries rated NAIC-2 | | 0.0 |
| Countries rated NAIC-3 or below | - | 0.0 |
| | <u>\$ 1,059,785</u> | |

(Continued)

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

| Foreign-Currency-Denominated Investment Assets | | | |
|---|----------------|---------------------|--|
| NAIC Rating | Country | Amount | Percentage of Total Admitted Assets |
| Countries rated NAIC-1: | | | |
| Country 1: | Germany | \$ 1,059,785 | 0.1 % |
| Country 2: | | - | 0.0 |
| Countries rated NAIC-2: | | | |
| Country 1: | | - | 0.0 |
| Country 2: | | - | 0.0 |
| Countries rated NAIC-3 or below: | | | |
| Country 1: | | - | 0.0 |
| Country 2: | | - | 0.0 |
| | | <u>\$ 1,059,785</u> | |

10. The following represents the ten largest non-sovereign (i.e. non-governmental) foreign issues:

| Issuer | NAIC Rating | Amount | Percentage of Total Admitted Assets |
|-------------------------------|--------------------|---------------|--|
| a. Diageo Finance | 1FE | \$ 20,180,929 | 1.1 % |
| b. Weatherford Bermuda | 2FE | 13,255,336 | 0.7 |
| c. Teva Pharmaceutical Fin BV | 1FE | 9,980,262 | 0.5 |
| d. Total Capital | 1FE | 8,805,050 | 0.5 |
| e. BP Capital Markets | 1FE | 8,798,922 | 0.5 |
| f. Statoil ASA | 1FE | 6,690,663 | 0.4 |
| g. Tyco Electronics Group | 2FE | 6,506,924 | 0.3 |
| h. Schlumberger Norge AS | 1FE | 6,450,875 | 0.3 |
| i. Vodafone Group PLC | 1FE | 3,332,111 | 0.2 |
| j. Syngenta Finance NV | 1FE | 2,620,792 | 0.1 |

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

12. Pinnacol does not hold any investments with contractual sales restrictions.

(Continued)

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 |
|---------------------------------|---------------|--|
| a. Vanguard Tot Stk Mkt Ind | \$ 51,976,106 | 2.7 % |
| b. T Rowe Price Group Inc | 32,153,474 | 1.7 |
| c. Matthews Asian Growth & Inc | 23,079,986 | 1.2 |
| d. First Eagle Overseas | 21,910,964 | 1.2 |
| e. Scout International Fund | 21,588,154 | 1.1 |
| f. MSCI ACWI Ex USA NP QP CTF | 14,173,970 | 0.7 |
| g. Cadence Mid-Cap Inst | 12,270,224 | 0.6 |
| h. MSCI US Indx NL QP CTF | 11,885,338 | 0.6 |
| i. Vanguard REIT Index Fund-Ins | 11,410,823 | 0.6 |
| j. Exxon Mobil Corp | 4,491,945 | 0.2 |

Items 14 through 23 are not applicable.

(Concluded)

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION SUMMARY INVESTMENT SCHEDULE AS OF DECEMBER 31, 2012

| 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 | \$ 259,049,908 | 14.0% | \$ 259,049,908 | 14.0% |
| U.S. government agency and corporate obligations (excluding mortgage-backed securities): | | | | |
| - Issued by U.S. government agencies | | | | |
| - Issued by U.S. government-sponsored agencies | | | | |
| Foreign government (including Canada, excluding mortgage-backed securities) | 4,992,098 | 0.3% | 4,992,098 | 0.3% |
| Securities issued by states, territories, and possessions and their political subdivisions in the U.S.: | | | | |
| - State, territory, and possessions — general obligations | 2,818,572 | 0.2% | 2,818,572 | 0.2% |
| - Political subdivisions of states, territories, and possessions — general obligations | | | | |
| - Revenue and assessment obligations | 26,451,936 | 1.4% | 26,451,936 | 1.4% |
| - Industrial development and similar obligations | | | | |
| Mortgage-backed securities (includes residential and commercial MBS): | | | | |
| Pass-through securities: | | | | |
| - Guaranteed by GNMA | 12,080,414 | 0.7% | 12,080,414 | 0.7% |
| - Issued by FNMA and FHLMC | 21,536,611 | 1.2% | 21,536,611 | 1.2% |
| - All others | | | | |
| CMOs and REMICs: | | | | |
| - Issued or guaranteed by GNMA, FNMA, FHLMC or VA | 163,601,660 | 8.8% | 163,601,660 | 8.8% |
| - Issued by non-US Govt issuers and collateralized by mortgage-backed securities issued by above | | | | |
| - All other | | | | |
| Other debt and other fixed income securities (excluding short term): | | | | |
| - Unaffiliated domestic securities (includes credit tenant loans rated by the SVO) | 830,891,410 | 44.8% | 830,891,410 | 44.8% |
| - Unaffiliated foreign securities | 76,340,725 | 4.1% | 76,340,725 | 4.1% |
| - Affiliated securities | | | | |

(Continued)

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION SUMMARY INVESTMENT SCHEDULE AS OF DECEMBER 31, 2012

| 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 |
| Equity interests: | | | | |
| - Investments in mutual funds | \$ 174,389,730 | 9.4% | \$ 174,389,730 | 9.4% |
| Preferred stocks: | | | | |
| - Affiliated | | | | |
| - Unaffiliated | 8,500 | 0.0% | 8,500 | 0.0% |
| Publicly traded equity securities (excluding preferred stocks): | | | | |
| - Affiliated | | | | |
| - Unaffiliated | 134,241,631 | 7.2% | 134,241,631 | 7.2% |
| Other equity securities: | | | | |
| - Affiliated | | | | |
| - Unaffiliated | | | | |
| Other equity interests including tangible personal property under lease: | | | | |
| - Affiliated | | | | |
| - Unaffiliated | 1,059,785 | 0.1% | 1,059,785 | 0.1% |
| Mortgage loans: | | | | |
| - Construction and land development | | | | |
| - Agricultural | | | | |
| - Single-family residential properties | | | | |
| - Multifamily residential properties | | | | |
| - Commercial loans | | | | |
| Real estate investments: | | | | |
| - Property occupied by Company | 19,209,404 | 1.0% | 19,209,404 | 1.0% |
| - Property held for production of income | | | | |
| -Property issued or guaranteed by GNMA, FNMA | | | | |
| Collateral loans | | | | |
| Policy loans | | | | |
| Receivables for securities | | | | |
| Cash, cash equivalents and short-term investments | 129,570,878 | 7.0% | 129,570,878 | 7.0% |
| Write-ins for invested assets | | | | |
| TOTAL INVESTED ASSETS | \$ 1,856,243,262 | 100.0% | \$ 1,856,243,262 | 100.0% |

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

(Concluded)

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



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**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 GOVERNMENT AUDITING STANDARDS**

To 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 statutory-basis financial statements of Pinnacol Assurance (Pinnacol) as of and for the year ended December 31, 2012, and the related notes to the statutory-basis financial statements, which collectively comprise Pinnacol's statutory-basis financial statements, and have issued our report thereon dated May 17, 2013. Our report is unmodified for statutory basis of accounting presentation.

Internal Control over Financial Reporting

In planning and performing our audit of the statutory-basis financial statements, we considered Pinnacol'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 opinions on the statutory-basis financial statements, but not for the purpose of expressing an opinion on the effectiveness of Pinnacol's internal control. Accordingly, we do not express an opinion on the effectiveness of Pinnacol'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 a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's statutory-basis 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'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 entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Deloitte + Touche LLP

May 17, 2013

PINNACOL ASSURANCE

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DECEMBER 31, 2012

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