PINNACOL
ASSURANCE

2012 Annual Report

Making Colorado

A SAFER AND A HEALTHIER PLACE TO WORK

Introduction

Making Colorado **A SAFER AND A HEALTHIER** PLACE TO WORK

Pinnacol Assurance makes Colorado a safer and a healthier place to work. At businesses large and small, from the Eastern Plains to the Front Range, and across the Western Slope, we work hard every day to help our policyholders create healthy workplaces and keep employees safe on the job.

In fact, Pinnacol spends more than 35,000 hours a year keeping Colorado work sites safe, and last year we provided compassionate care to more than 40,000 Coloradans injured at work.

We bring small businesses, in particular, a level of service and resources typically beyond their reach. Our resources include access to our team of 25 safety consultants, proactive safety programs to prevent injuries and a vast library of safety materials.

In recent years, we've taken our commitment to healthy workplaces even further. Through our Health Risk Management pilot program, we help employees and their families live healthier, more active lives. The goal of the program is to prove the link between wellness and fewer employee injuries, reduced workers' compensation insurance costs and greater productivity for Colorado employers. Through our unique partnership with the Colorado School of Public Health, we support and promote workplace wellness training and education.

> "For us, it's not a job, it's a profession. We take a lot of pride in helping ensure the success of a business and protecting an employer's most valuable asset: its employees."
>
> **CLYDE SERNA,** *Safety Consultant*

Beyond the basic necessities of workers' compensation insurance coverage, we enhance the quality of life in Colorado by creating healthier, safer places to work.

A Message From the Interim CEO

Making Colorado **A SAFER AND A HEALTHIER** PLACE TO WORK

Stable. Dependable. Enduring. Committed to Colorado. These are the hallmarks of Pinnacol Assurance.

As the assured source of workers' compensation insurance for Colorado, we don't turn any company away. We remain deeply committed to our mission of protecting Colorado employers and their greatest asset—their employees, as we have for almost 100 years. Pinnacol is the only insurance company solely focused on Colorado workers' comp, so we know this business, and the state, better than anyone else.

2012: Challenge and Change

Despite our enduring mission, Pinnacol lives in a world where the only real constant is change. In 2012, we saw the national workers' comp insurance market continue its downward cycle, with increasing claims, rising medical costs and declining investment income to offset losses.

In response to these market conditions, we're taking proactive steps:

- Applying greater discipline and precision to our underwriting process
- Taking a more focused approach to how we use our financial resources: operationally, promotionally and as corporate citizens
- Dedicating more resources to the management of our investment portfolio, to continue building our financial strength and to offset what we believe will be another challenging year ahead

> "Pinnacol has been a great partner. They've helped us out immensely with the safety, health and welfare of our employees and have made us a much better company."
>
> **RODNEY RICE,** *President and CEO, Hydro Construction*

Over the past year, Pinnacol also experienced change from within. We welcomed new board members, and we redesigned the executive management team. New people are bringing fresh perspectives and innovative ideas to Pinnacol, with the goal of making a good company even better.

Pinnacol will continue to help protect employees—helping to prevent injuries, caring for employees when they do become injured, and getting them back to work as soon as it's safe to do so. We'll also continue to protect the health of businesses—helping to minimize workplace hazards and to manage the inevitable risks that come with operating a business.

Health and Safety Innovation

Beyond our everyday commitments, we live on the forefront of wellness and safety innovation with two distinctive programs:

Health Risk Management, our flagship program for making Colorado a healthier place to work, puts work site wellness within reach for small businesses. Now in its third year, this five-year study touches more than 30,000 lives through 300 participating policyholder companies. Year two results include a 15 percent to 25 percent decline in major risk factors such as obesity, cancer and heart disease, with participants experiencing improvements in nutrition, fitness and productivity.

What we believe, and hope to prove in the next two years, is the direct correlation between work site wellness programs and the reduction of workers' comp injuries and claims costs.

Another way we're making Colorado a healthier place to work is through our multifaceted **partnership with the Colorado School of Public Health**. Together, we're delivering continuing education programs to health and safety professionals, training physicians to fight the opioid prescription epidemic and helping small businesses establish work site wellness programs.

I'm optimistic about Pinnacol's future. We have the right team for the right time in our history. And we're doing the right things, as we've always done, to make Colorado one of the safest and healthiest places to work—for our policyholders, their employees and the state of Colorado.

> "Our goal is to bring wellness to Main Street, Colorado. If we can help that small business owner create a healthier, happier and more productive workforce, we're going to make Colorado a stronger state."
>
> **KAREN CURRAN,** *Director of Health Risk Management*

Year in Review

Making Colorado **A SAFER AND A HEALTHIER** PLACE TO WORK

2012 was another challenging year for Colorado's workers' compensation insurance companies. Claims increased, medical costs rose and investment income declined.

Regardless of the market, Pinnacol Assurance continues to provide assured protection to our policyholders, with competitive rates and differentiating service. To maintain our financial stability and guarantee the payment of claims that may span years or even decades, we're taking action on multiple fronts. We are:

- Managing expenses more tightly
- Carefully stewarding the financial resources entrusted to us, with a more focused approach to how we use them for operational, promotional and corporate citizenship purposes
- Applying more discipline to our underwriting practices
- Focusing on the management of our investment portfolio

At the same time, we pledge to continue doing the things that set us apart and make Colorado a safer and a healthy place to work, no matter the season or cycle—such as delivering outstanding customer service; helping policyholders eliminate workplace hazards and keep their employees safe; and delivering prompt, effective care to workers who do become injured.

> "At our core, we remain customer-focused. What sets us apart is our level of customer service and commitment to the business owners of Colorado."
>
> **MARK ISAKSON,** *Vice President of Underwriting*

Financial Stability:
Earned premium: $426 million

Assets: $1.902 billion

Surplus: More than $616 million

Dividend Distributions:
Returned $37.5 million in general dividends to 89.7 percent of policyholders—our eighth consecutive year of paying dividends

Policyholder Satisfaction and Retention:
Policyholder satisfaction: Averaged 8.8 on a 10-point scale

Policyholder retention: Ninety-two percent of policyholders kept their business with Pinnacol

"We are there to be the strength and security policyholders need to operate their business without worrying what financial risk might arise if an employee gets injured."

MARK ISAKSON, *Vice President of Underwriting*

Financial Performance

Making Colorado **A SAFER AND A HEALTHIER** PLACE TO WORK

As an insurance company, Pinnacol Assurance takes on other businesses' workplace risks and protects them from potential harm—physically and financially. Protecting others, while protecting our own financial strength and stability, requires a smart investment strategy.

Like all insurance companies, Pinnacol relies on our investment returns. In good years, these returns help us grow the business. In difficult times, we rely on investment income to help offset operating losses.

In today's market, which is marked by rising rates and tighter underwriting standards, we've become even more reliant on our investment portfolio. No matter what obstacles we face, Pinnacol must fulfill our commitments to policyholders and injured workers. Current, past and future claims must be paid.

To continue building our financial strength in today's tough market, we're dedicating more attention and resources to the management of our investment portfolio. We recently hired a new chief investment officer who, as part of the executive team, will be responsible for honing our investment strategy and closely monitoring results.

We believe this enhanced focus on investments will bring added security and stability to Pinnacol, its policyholders and their employees across Colorado.

Earned premium: $426 million

Investment portfolio yield: 4.3 percent

Assets: $1.902 billion

Surplus: More than $616 million

General dividends: $37.5 million

Policyholder retention rate: 92 percent

"We work to ensure sufficient cash flow and liquidity so that we can pay claims when our policyholders have injured workers. We also preserve and grow capital so we can be here 50, 75, 100 years from now to honor our promises."

DAVID BOMBERGER, CFA, *Chief Investment Officer*

About Us

Making Colorado **A SAFER AND A HEALTHIER** PLACE TO WORK

Pinnacol Assurance's 600 employees are committed and passionate about what we do—providing assured protection to Colorado employers and their greatest asset—their employees.

Solely focused on workers' compensation insurance for Colorado businesses, we hold a level of expertise that's difficult to match. Best of all, we're based right here in Colorado, with headquarters in Denver and a satellite office in Grand Junction. This allows us to deliver a level of service across the state that's rare in today's world of outsourcing and offshoring. When you call Pinnacol, you experience the prompt, friendly and attentive service that's woven into our culture.

Unlike many of our competitors, that come and go when times are tough, we are a strong, stable and constant presence, ensuring that the promises of workers' comp are there when you need them most:

- The promise to provide assured protection for every Colorado business that comes to us for a workers' compensation policy, no matter its size or risk
- The promise to pay—promptly and reliably—on claims that may last years, decades or even a lifetime, depending on the severity of an injury or illness
- The promise to shield injured workers and employees from financial ruin when bad things happen
- The promise to maintain our own financial strength, so we can continue to deliver on our mission and commitment to our approximately 55,000 policyholders and the state of Colorado

Without workers' compensation coverage, businesses and their employees could be financially ruined by workplace injuries or illnesses. For example, an entrepreneur opens a new restaurant, and an employee slips and hits her head. The associated medical costs or lawsuits could shatter the business and, along with it, that entrepreneur's dreams. The injured worker could face medical bills beyond her means and, perhaps permanently, become unable to support herself and her family.

> "We are there to be the strength and security policyholders need to operate their without worrying what financial risk might arise if an employee gets injured."
>
> **MARK ISAKSON,** *Vice President of Underwriting*

In 1915, Pinnacol put an end to these scenarios in Colorado. And for the next century, we intend to keep our promises by adding safety, health and peace of mind to the mix that already makes Colorado a wonderful place do business.

Leadership

Making Colorado **A SAFER AND A HEALTHIER** PLACE TO WORK

Board of Directors

From left to right: John C. Plotkin, Vice Chair; Patricia L. Peterson; Joshua L. McFarland; Dr. Richard Rivera; Blair E. Richardson, Chair; Jeffrey L. Cummings; Harold L. Logan, Jr.; Howard L. Carver; Joseph A. Hoff

Executive Team

From left to right: David Bomberger, CFA, Chief Investment Officer; Terrence Leve, Vice President, General Counsel and Corporate Secretary; Carole Sumption, Vice President of Corporate Resources; Robert Norris, Vice President of Strategic Development and Chief Information Officer; John Plotkin, Interim CEO; Debra Magures, Vice President of Claims; Jeff Tetrick, Chief Financial Officer; Lori Fox, Vice President of Communications and Public Affairs; Mark Isakson, Vice President of Underwriting

Corporate Citizenship

Making Colorado **A SAFER AND A HEALTHIER** PLACE TO WORK

Pinnacol Assurance is proud of the many ways we support Colorado causes and touch the lives of people in need—from giving the children of injured workers the opportunity for a college education to volunteering an extraordinary number of hours with local nonprofits.

Always seeking to refine and improve what we do, in the year ahead we'll strive to be even more focused in how we use our corporate citizenship resources.

Our corporate citizenship efforts are channeled into two main areas:

Volunteerism

Pinnacol in Action is our employee-run volunteer program that supports Colorado nonprofits.

In 2012, 93 percent of employees spent a total of more than 6,500 hours volunteering in the community:

- Delivered approximately 400 fans for Volunteers of America's Cool Down Colorado campaign
- Collected 100,000 pounds of food for Volunteers of America's Food Drive
- Delivered more than 1,778 meals for Volunteers of America's Meals on Wheels program
- Hosted a *9Health* Fair location and served more than 705 participants

Scholarships

The **Pinnacol Foundation** awards college scholarships to the children of Colorado workers seriously injured or killed on the job—regardless of which insurer handled the parent's claim.

- In 2012, 150 scholarships were awarded, totaling $500,000.
- Since its creation in 2000, the Foundation has distributed over nearly $2.5 million in scholarships, helping hundreds of young people achieve their dreams of a college education.

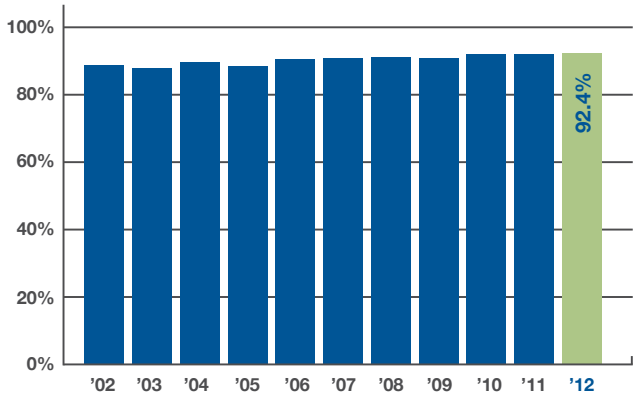
Foundation Board of Directors

David Bomberger, Jeffery L. Cummings, Lori Fox, Peter M. Meersman, Daniel F. O'Neil, John Plotkin, Suzi Stolte, Carole Sumption, Jeff Tetrick, Nonie Rivale Willisch, Sam Winfrey

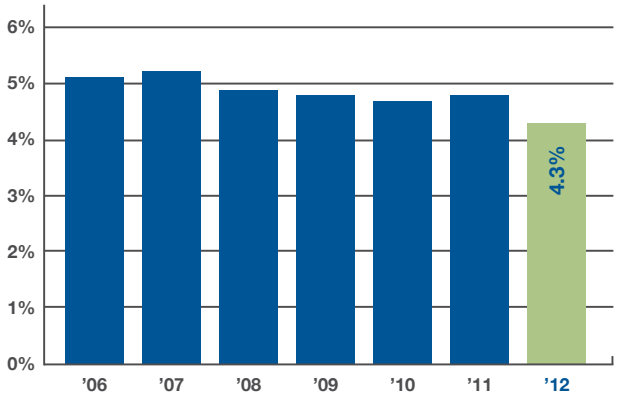
2012 Statistics

Making Colorado **A SAFER AND A HEALTHIER** PLACE TO WORK

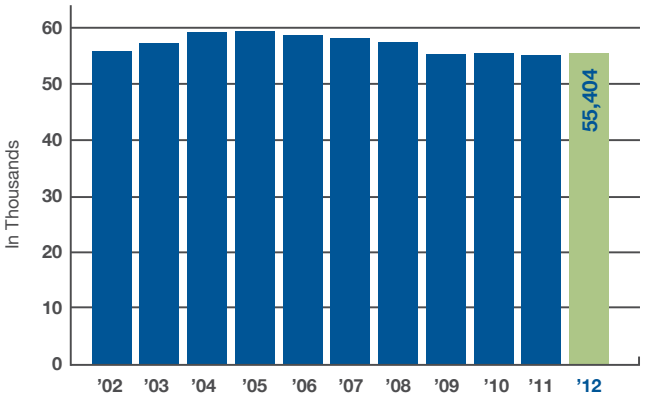
Policyholder Retention Rate
92.4%



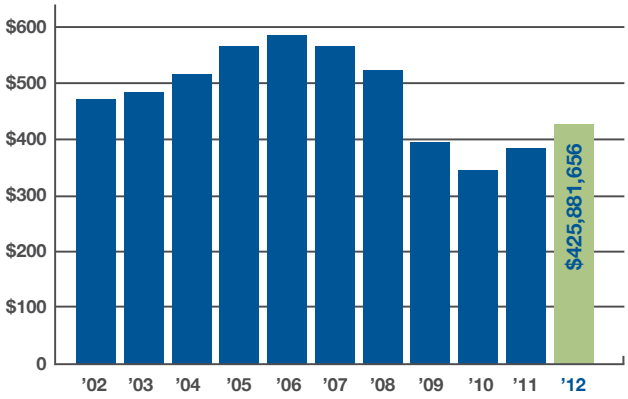
Investment Portfolio Yield
4.3%



Number of Active Policies
55,404



Earned Premium
$425,881,656

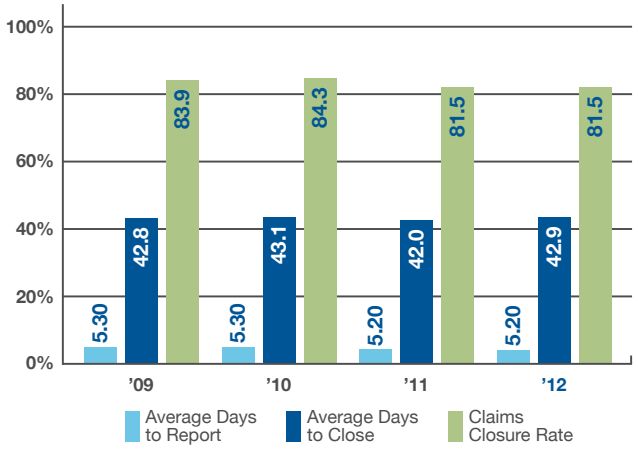


Top 10 Industries Insured by Premium

1	Carpentry Work	$9,052,985
2	Plumbing, Heating and Air Conditioning	$8,694,613
3	Eating Places	$7,876,133
4	Concrete Work	$7,826,861
5	Roofing, Siding and Sheet Metal Work	$7,205,179
6	Building Maintenance Services and NEC	$6,065,026
7	Elementary and Secondary Schools	$6,034,232
8	Excavation Work	$5,761,631
9	Oil and Gas Field Services and NEC	$5,402,738
10	Local Trucking, Without Storage	$5,243,116

Claims

Total New Claims Reported	**44,922**
Total Claims Closed	**46,073**



Top 5 Injury Types

1	Contusion	11,436
2	Strain	9,820
3	Laceration	6,059
4	Sprain	5,614
5	All Other	2,250

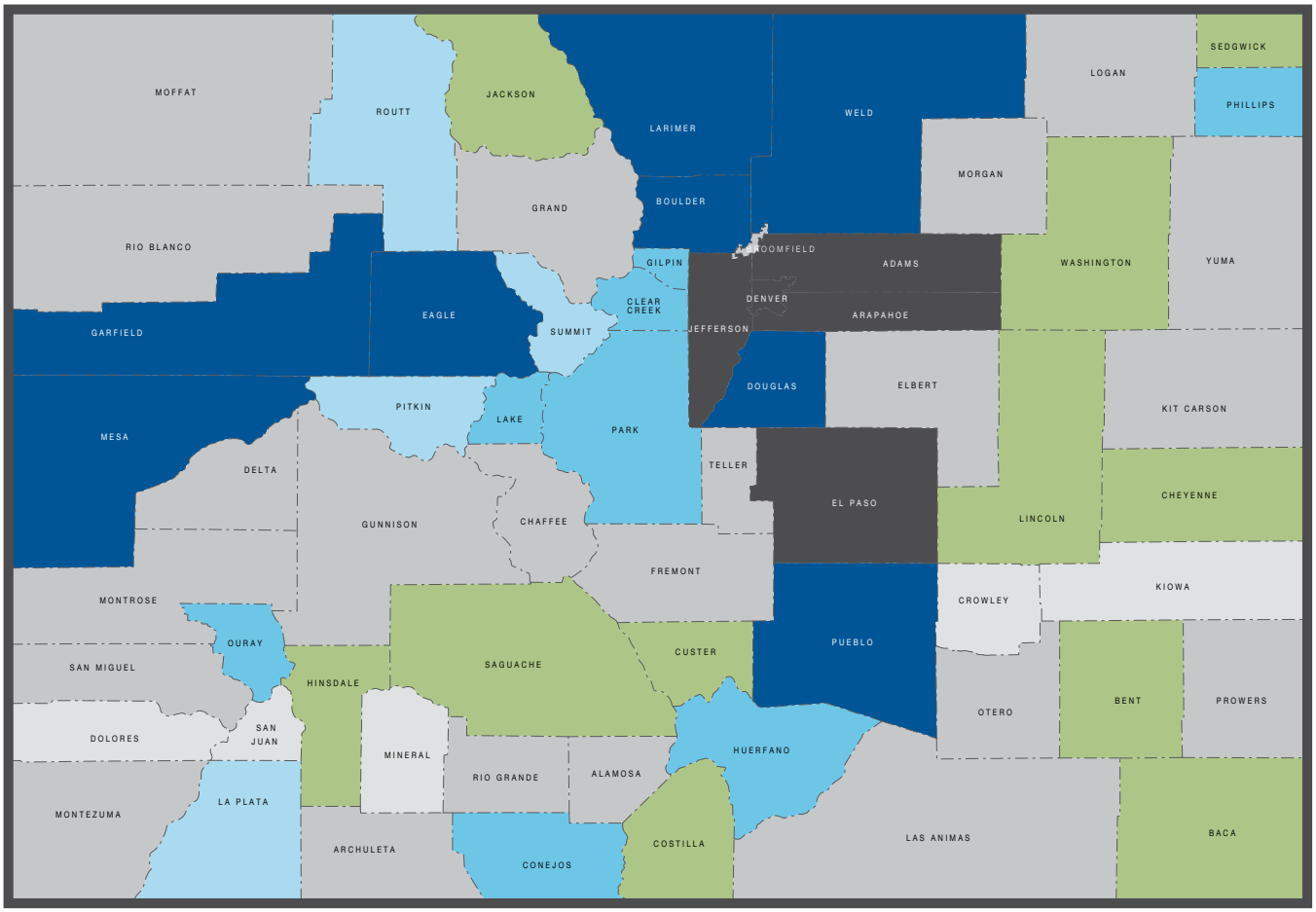
Top 5 Injury Causes

1	Strain–Lifting	3,858
2	Strain or Injury–Misc	3,162
3	Fall–Same Level	2,191
4	Cut–Miscellaneous	2,019
5	Strain or Injury by Twisting	1,904

Top 10 Counties Insured by Premium

		2008	2009	2010	2011	2012
1	Denver	$60,380,295	$51,778,317	$37,001,788	$42,601,236	$49,472,451
2	Adams	$29,991,749	$24,564,978	$43,726,595	$37,267,782	$42,576,417
3	Arapahoe	$41,709,185	$34,087,707	$35,578,997	$30,493,443	$34,728,989
4	El Paso	$36,496,742	$30,862,224	$28,648,522	$28,481,318	$30,914,777
5	Jefferson	$32,229,628	$26,025,663	$12,643,779	$24,781,308	$28,580,047
6	Weld	$26,245,720	$21,626,691	$14,449,542	$22,388,787	$27,254,907
7	Larimer	$24,205,272	$20,214,295	$18,501,550	$18,375,827	$20,378,411
8	Boulder	$20,076,140	$17,300,987	$23,256,293	$17,828,880	$19,158,296
9	Mesa	$18,636,883	$15,033,143	$14,414,362	$14,896,946	$15,026,992
10	Douglas	$14,448,908	$11,203,095	$9,072,071	$10,713,476	$11,940,913

General Dividend by County 2005-2012



$50,000-$200,000	$200,000-$500,000	$500,000-$1,000,000	$1,000,000-$5,000,000	$5,000,000-$10,000,000	$10,000,000-$30,000,000	$30,000,000-$80,000,000

Audited Financials

Making Colorado **A SAFER AND A HEALTHIER** PLACE TO WORK

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

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.

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.

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)
Net cash used in operations	(44,344)	(42,080)
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	399,892	332,083
Cost of investments acquired:		
Bonds	(182,777)	(156,182)
Stocks	(115,145)	(70,604)
Miscellaneous proceeds	(285)	(73)
Total investments acquired	(298,207)	(226,859)
Net cash provided from investments	101,685	105,224
CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES — Cash used in other miscellaneous sources	(7,823)	(35,900)
NET INCREASE IN CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS	49,518	27,244
CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS — Beginning of year	80,053	52,809
CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS— End of year	**$ 129,571**	**$ 80,053**

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	**$ 71,593**	Total	**$ 73,336**

(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	(83,943)	(68,135)
Total Incurred	361,957	359,483
Reductions relating to payments for:		
Current year	135,439	130,948
Prior years	277,898	254,451
Total Paid	413,337	385,399
Balance at December 31	$ 788,778	$ 840,158

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):

	2012	2011
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	31,283	24,613
Ending Balance	$ 350,641	$ 330,649

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):

2012		2011	
Loss Year	**Discount**	**Loss Year**	**Discount**
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	131	2011	600
Total	**$ 159,341**	Total	**$ 154,170**

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
	$ 1,397,763	**$ 185,123**	**$ (632)**	**$ 1,582,254**

	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
	$ 1,476,227	**$ 201,864**	**$ (47)**	**$ 1,678,044**

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.

	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
	$ 1,397,763	**$ 1,582,254**

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):

	Less than 12 months		12 months or greater		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Industrial and miscellaneous	$ 27,220	$ (632)	$ -	$ -	$ 27,220	$ (632)
Total	$ 27,220	$ (632)	$ -	$ -	$ 27,220	$ (632)

The following table provides the length of impairment for those investments in bonds with an unrealized loss as of December 31, 2011 (in thousands):

	Less than 12 months		12 months or greater		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Industrial and miscellaneous	$ 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	**$ 279,836**	**$ 29,855**	**$ -**	**$ 309,691**

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	**$ 278,835**	**$ -**	**$ -**	**$ 278,835**

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):

	2012	2011
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	**$ 126,847**	**$ 117,336**

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 administer 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:

Reinsurer	AM Best Rating
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):

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

** 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 lessor 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 lessor 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 lessor 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	Employee Contribution	AED	SAED	Total Pinnacol 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)

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
Anheuser-Busch Co	Long Term Bond	$ 40,546,869	2.1%
General Electric Co	Long Term Bond & Common Stock	36,679,678	1.9
AT&T Inc	Long Term Bond & Common Stock	36,645,240	1.9
Proctor & Gamble Co	Long Term Bond & Common Stock	30,163,705	1.6
Burlington North Santa Fe	Long Term Bond	29,497,200	1.6
Verizon Global Funding	Long Term Bond & Common Stock	26,621,830	1.4
3M Co	Long Term Bond & Common Stock	24,419,436	1.3
Johnson & Johnson	Long Term Bond & Common Stock	23,720,214	1.2
IBM Corp	Long Term Bond	23,557,236	1.2
Emerson Electric Co	Long Term Bond & Common Stock	22,864,387	1.2

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

NAIC Rating	Amount	Percentage of Total Admitted Assets
Bonds		
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
Preferred Stocks		
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
	$ 1,539,065,293	

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
	$ 98,108,744	

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
		$ 48,417,508	

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
	$ 1,059,785	

9. The following represents the largest unhedged foreign currency 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:	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
		$ 1,059,785	

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

Issuer	NAIC Rating	Amount	Percentage of Total Admitted Assets
Diageo Finance	1FE	$ 20,180,929	1.1%
Weatherford Bermuda	2FE	13,255,336	0.7
Teva Pharmaceutical Fin BV	1FE	9,980,262	0.5
Total Capital	1FE	8,805,050	0.5
BP Capital Markets	1FE	8,798,922	0.5
Statoil ASA	1FE	6,690,663	0.4
Tyco Electronics Group	2FE	6,506,924	0.3
Schlumberger Norge AS	1FE	6,450,875	0.3
Vodafone Group PLC	1FE	3,332,111	0.2
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.

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

Items 14 through 23 are not applicable.

Supplemental Schedule of Investment Information Summary Investment Schedule

As of December 31, 2012

	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
Investment Categories	**Amount**	**Percentage of Gross Investment Holdings**	**Amount**	**Percentage of Total Admitted Assets**
Bonds:				
U.S. Treasury securities	$ 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 motgage-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)

Supplemental Schedule of Investment Information Summary Investment Schedule (continued)

As of December 31, 2012

	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
Investment Categories	**Amount**	**Percentage of Gross Investment Holdings**	**Amount**	**Percentage of Total Admitted Assets**
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.*

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

Distribution December 31, 2012

The electronic version of this report is available on the Web site of the Office of the State Auditor
www.state.co.us/auditor

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303-869-2800

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Report Control Number 2049-12