Pinnacol Assurance

Statutory Financial Statements as of and for the Years Ended December 31, 2008 and 2007, Supplemental Schedules of Investment Information as of and for the Year Ended December 31, 2008, Comments on Internal Controls and Procedures, and Independent Auditors' Report

Deloitte.

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May 20, 2009

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

We have completed the financial audit of Pinnacol Assurance (Pinnacol) for the year ended December 31, 2008. Our audit was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S., which authorizes an annual audit of Pinnacol made by an auditor or firm of auditors, having the specialized knowledge and experience, retained by the state auditor with the consultation and advice of the chief executive officer and the commissioner of insurance. The reports that we have issued as a result of this engagement are set forth in the table of contents, which follows.

Deloitte & Touche LLP

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PINNACOL ASSURANCE

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PINNACOL ASSURANCE

REPORT SUMMARY

Authority and Purpose/Scope of the Audit

This audit was conducted under the authority of Section 8-45-121(2) of the Colorado Revised Statutes (C.R.S.), which authorizes an annual audit of Pinnacol Assurance (Pinnacol or the Company) made by an auditor or firm of auditors, having the specialized knowledge and experience, retained by the state auditor with the consultation and advice of Pinnacol's chief executive officer and the commissioner of insurance. The primary purpose of our engagement was to audit the statutory financial statements of Pinnacol at December 31, 2008, and for the year then ended, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and to express an opinion on those financial statements and the supplemental schedules of investment information. The objective of an audit conducted in accordance with such standards is to obtain reasonable, but not absolute, assurance about whether the statutory financial statements are free of material misstatement.

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

We examined, on a test basis, evidence supporting the amounts and disclosures in Pinnacol's financial statements as of December 31, 2008. The accounting practices used by Pinnacol to prepare the financial statements are in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division).

Required Communications to the Legislative Audit Committee

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

1. **Auditor's Responsibility under Professional Standards** — We have a responsibility to conduct our audit of the financial statements in accordance with professional standards. In carrying out this responsibility, we planned and performed the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, we are to obtain reasonable, not absolute, assurance that material misstatements are detected. We have no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected. Our audit does not relieve management or the audit committee of Pinnacol of their responsibilities.

   In addition, in planning and performing our audit of the statutory financial statements, we considered internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Pinnacol's internal control. Accordingly, we do not express an opinion on the effectiveness of Pinnacol's internal control.

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

2. **Significant Accounting Policies and Alternative Treatments** — The significant accounting policies used by Pinnacol are described in Note 1 to the statutory financial statements. There were no changes to significant accounting policies in 2008. However, conditions in the credit markets led to the first significant application of accounting guidance related to other-than-temporary impairments of investments.

3. **Management Judgments and Accounting Estimates** — The preparation of the financial statements requires management of Pinnacol to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. We have reviewed, as part of our normal audit procedures, information regarding management's formulation of accounting estimates and have concluded that the estimates are reasonable in the context of the financial statements taken as a whole. The critical accounting estimates are as follows:

   Bonds and Common Stocks — Pinnacol must consider the statutory requirements related to other-than-temporary impairments when determining whether any declines in value are recognized through realized losses in the statutory statement of income or through change in unrealized losses, which is a direct charge to statutory surplus. These statutory requirements for other-than-temporary impairments ("OTTI") require management's judgment and consideration of various characteristics of the investments, the underlying causes of the decline in value, as well as management's intent related to future sales of the securities. The Company's financial statements reflect OTTI charges to net income based on an audit adjustment of $68,272,000 for OTTI of common stock investments.

   Reserve for Unpaid Losses and Loss Adjustment Expenses — Estimating the reserve for unpaid losses and loss adjustment expenses (reserves) of an insurance company is a subjective and judgmental process, particularly for workers' compensation insurance, where the ultimate liability to a claimant may not be known with certainty for a number of years. To assist management in estimating the liability for unpaid losses and loss adjustment expenses, Pinnacol retains the assistance of an actuarial consulting firm. At December 31, 2008, Pinnacol has accrued $1,223,160,000 for unpaid losses and loss adjustment expenses as management's best estimate, which management believes to be a reasonable estimate of future amounts to be paid for claims incurred in 2008 or prior. Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in 2008. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield.

   Other accounting estimates are as follows:

   Uncollected Premiums — The amount of uncollected premiums, which affects the amount of premium revenue recognized, is estimated using statutory requirements, as well as certain management judgments. Management must determine whether an allowance should be established to provide for all reasonably anticipated uncollectible amounts inherent in the uncollected premiums balance. Factors that are considered in establishing reserves for anticipated uncollectible amounts are collection experience and trends, current overall aging of balances, economic conditions and trends, and evaluations of individual accounts. At December 31, 2008, the admitted value of uncollected premiums as reflected in Pinnacol's financial statements is $54,694,000.

Earned but Unbilled Premiums Receivable — Pinnacol estimates audit premium adjustments based on prior experience. This prior experience provides actual collection activity, which is then used in establishing estimated premium revenue in the current period related to audit adjustments, subject to current influences such as inflation and other factors. For 2008, net unbilled audit premiums receivable of $13,350,000 are included in uncollected premiums.

Association Dividends Payable to Policyholders — Pinnacol has an association dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. Based on the payment pattern for these dividends, management must estimate the future loss ratio for the policyholders in order to determine the accrual recorded at December 31, 2008. For 2008, association dividends payable of $18,000,000 are included in dividends payable to policyholders.

4. **Audit Adjustments and Uncorrected Misstatements** — As discussed in Note 10 of Pinnacol's financial statements the statutory financial statements included herein contain differences from Pinnacol's Annual Statement as filed with the Division for the year ended December 31, 2008. The differences are due to an audit adjustment of $68,272,000 to record declines in value of common stock investments as an other-than-temporary impairment charge to net income; the decline in value was originally accounted for by Pinnacol as a direct charge to surplus. In addition, we have discussed with management certain financial statement misstatements that have not been corrected in the Company's books and records as of and for the year ended December 31, 2008 totaling $7,556,000 impact to net income and statutory surplus. We have reported such misstatements to management on a Summary of Uncorrected Financial Statement Misstatements and have received written representations from management that management believes, and we concur, that the effects of the uncorrected financial statement misstatements are immaterial, both individually and in the aggregate, to the statutory financial statements taken as a whole.

5. **Other Information in Documents Containing Audited Financial Statements** — Our responsibility for other information in documents containing the Company's financial statements and our auditors' report thereon does not extend beyond the financial information identified in our auditors' report, and we have no obligation to perform any procedures to corroborate other information contained in these documents.

6. **Disagreements with Management** — There were no disagreements with management on financial accounting or reporting matters that, if not satisfactorily resolved, would have caused a modification of our auditors' report on the Company's financial statements.

7. **Difficulties Encountered in Performing the Audit** — We encountered no significant difficulties in dealing with management in performing our audit.

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

   We hereby confirm that as of May 20, 2009, we are independent accountants with respect to Pinnacol under all relevant professional and regulatory standards.

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

Summary of Major Audit Findings

Formal Process for Evaluating Other-Than-Temporary Impairments — Pinnacol should enhance its process of evaluating the technical accounting guidance and evolving practices related to other-than-temporary impairments, as well as documenting its analysis of potential other-than-temporary impairments related to its investments.

Information Technology General Controls Policies — Pinnacol's information technology general control policies and practices can be improved in the areas of system access, change management, and monitoring of system changes.

Review of SAS 70 Reports — Pinnacol should develop a formal process for reviewing certain SAS 70 reports for service organizations utilized by the Company.

Right of Setoff within Accounts Receivable — Management should develop a process to analyze credit balances included within the accounts receivable detail to determine whether the right of setoff exists.

Summary of Pinnacol's Responses

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

PINNACOL ASSURANCE

RECOMMENDATION LOCATOR
DECEMBER 31, 2008

Recommendation Locator

Recommendation Number	Page Number	Recommendation Summary	Pinnacol Response	Implementation Date
1	8	Pinnacol should enhance its process of evaluating the technical accounting guidance and evolving practices related to other-than-temporary impairments.	Agree	Third quarter 2009
2	9	Pinnacol should improve information technology general control policies and practices in the areas of system access, change management, and monitoring of system changes.	Agree	Third quarter 2009
3	10	Pinnacol should develop a formal process for reviewing certain SAS 70 reports.	Agree	Third quarter 2009
4	10	Pinnacol should develop a process for analyzing credit balances within accounts receivable for right of setoff.	Agree	Third quarter 2009

DESCRIPTION OF PINNACOL ASSURANCE
DECEMBER 31, 2008

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

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

Policyholders' Surplus

Pinnacol had policyholders' surplus of $698,001,000 and $722,072,000 as of December 31, 2008 and 2007, respectively. The decrease in surplus is primarily related to realized and unrealized losses on bonds and common stocks.

In 2008, Pinnacol declared $54,362,000 in general policyholder dividends to its policyholders in good standing. This is included in Dividends to Policyholders in the statutory statement of income and changes in policyholders' surplus and reduces net income for the year ended December 31, 2008. This accounting treatment is in accordance with statutory accounting practices. See further information at Note 1, General Policyholder Dividends.

Subsequent to December 31, 2008, as discussed in Note 9, the Company has declared additional policyholder dividends of $120,000,000.

A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statement that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

We consider the following matter related to Pinnacol's internal control over financial reporting to be a significant deficiency as of December 31, 2008:

Formal Process for Evaluating Other-Than-Temporary Impairments

As a result of the 2008 declines in value of many of Pinnacol's investments due to the economic downturn, Pinnacol should consider whether there are other-than-temporary impairments (OTTI) to the investments under statutory accounting principles. The NAIC's Emerging Accounting Issues Working Group Interpretation 06-07 *Definition of the Phrase "Other Than Temporary"* (INT 06-07) is the authoritative statutory accounting guidance for OTTI. Statutory accounting principles, as interpreted by INT 06-07, cite a key difference between interest-related declines in value and non-interest related declines. An interest-related impairment is deemed other-than-temporary when an insurance company has the intent to sell an investment as of the reporting date before the anticipated recovery of the cost of the investment. However, for non-interest-related declines, companies are required to consider three factors in deciding whether there is an OTTI:

- the length of time and the extent to which the fair value has been less than cost,
- the financial condition and short term prospects of the issuer, including any specific events that may influence the operations of the issuer, and
- the intent and ability of the company to hold its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in value.

Intent to sell for an interest-related impairment is a different concept than intent and ability to hold an investment until recovery. A company's intent and ability to hold an investment, in the case of non-interest-related declines, could be questioned if the company's investment manager has discretion to buy and sell securities on behalf of the company.

Other-than-temporary impairment decisions represent a significant management judgment that is dependent on consideration of a variety of external and internal factors. During testing of Pinnacol's other-than-temporary impairment analysis, we noted that management does not have a process for formally documenting its evaluation and conclusions of non-interest-related declines where the investment manager has discretion to sell securities. The lack of a formal process for evaluating other-than-temporary impairments resulted in a recorded audit adjustment that reclassified $68,272,000 between net realized capital (loss) gain and change in net unrealized (loss) gain in investments within the statutory statements of income; the audit adjustment did not result in a change in policyholders' surplus for the year ended December 31, 2008.

When performing this evaluation, management should employ a systematic and rational methodology for determining whether an investment is considered other-than-temporarily impaired. This methodology should ensure that all available evidence concerning an investment's decline in fair value is identified and appropriately evaluated in a disciplined manner. Because of the subjective nature of the other-than-temporary impairment evaluation, management should document all factors it considered in reaching its conclusions on whether an investment is other-than-temporarily impaired.

Recommendation #1

Pinnacol should enhance its process of evaluating the technical accounting guidance and evolving practices related to other-than-temporary impairments, as well as documenting its analysis of potential other-than-temporary impairments related to its investments.

Pinnacol's Response

Agree. Management will present an implementation recommendation for approval at the August Investment Committee meeting for operational implementation by end of the third quarter of 2009.

We identified the following other deficiencies involving the Pinnacol's internal control over financial reporting as of December 31, 2008:

Information Technology General Controls Policies

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

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

- Database administrators and system administrators have access to make changes to the Oracle database underlying the Lawson (general ledger) application and there is no mitigating monitoring control, such as monitoring databases changes, to identify unauthorized database changes.

- Monitoring of the Novell network and the Oracle database underlying the Lawson application is not enabled. Pinnacol's system administrators should determine the specific network and database activity that warrants logging and monitoring, and implement reviews of such logs to ensure that the risk of unauthorized activity is mitigated.

Recommendation #2

Pinnacol should enhance its information technology controls by expanding and implementing control policies and procedures related to the following:

a. Periodic reviews of user access rights and actions taken should be properly documented and retained by Pinnacol.

b. Monitoring controls should be developed to identify unauthorized changes to the Oracle database underlying the Lawson application.

c. System activity logging and monitoring controls related to the Novell network and the Oracle database underlying the Lawson application should be evaluated to determine which should be enabled. Once enabled, the system administrators should develop and implement procedures for review.

Pinnacol's Response

Agree. For the first recommendation above, a project has been underway since the end of 2008 to document WCIS reviews and access rights. For the other two recommendations noted above, Data and Network Services will evaluate the recommendations and implement solutions that are determined to be appropriate by end of the third quarter of 2009.

Review of SAS 70 Reports

Currently, management performs a documented review of the SAS 70 related to Conning Asset Management (CAM), Pinnacol's investment manager. However, management does not have a formal process for documenting their review and evaluation of the following SAS 70 reports:

- SAS 70 related to Wells Fargo Trust Operations, which provides the primary investment custody services to Pinnacol.
- SAS 70 related to Automatic Data Processing, Inc., which provides payroll and payroll tax services to Pinnacol.
- SAS 70 related to Concur Technologies, Inc., which provides employee expense management services to Pinnacol.

The review should consider whether exceptions noted by the service auditor impact Pinnacol's related control environments. In addition, management should evaluate whether the applicable user control considerations included within the SAS 70s are appropriately addressed by Pinnacol.

Recommendation #3

Pinnacol should develop and implement a formal process for reviewing and evaluating the SAS 70 reports for Wells Fargo Trust Operations, Automatic Data Processing, Inc., and Concur Technologies, Inc. This process should include Pinnacol's related control environments and the applicable user control considerations.

Pinnacol's Response

Agree. Effective with the third quarter in 2009, management will implement a review and evaluation process for all applicable SAS 70 reports including Pinnacol's related control environment and applicable user controls.

Right of Setoff within Accounts Receivable

Certain credit balances within the accounts receivable detail have been reclassified to a liability account. Others are presented as a reduction to the accounts receivable balance. Management does not have a formal process in place to analyze credit balances included within the accounts receivable detail to determine whether the right of setoff exists. The right of setoff is a reporting entity's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the party owes to the reporting entity against the debt as defined in the Statement of Statutory Accounting Principles (SSAP) No. 64, *Offsetting and Netting of Assets and Liabilities.* Such analysis would allow management to determine whether the right of setoff exists and the amounts should be presented as a reduction to the receivable, or whether the right of setoff does not exist and the amounts should be presented in liabilities.

Recommendation #4

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

Pinnacol's Response

Agree. A process will be developed and implemented for reporting as of the end of third quarter of 2009.

Disposition of Prior Audit Recommendation

The audit report for the year ended December 31, 2007 included three recommendations. The disposition of these audit recommendations is as follows:

Recommendation	Disposition
Pinnacol should enhance its information technology controls by expanding control policies and procedures related to documentation of system access reviews, segregation of duties conflicts, program change management, and training.	Partially implemented in 2008 - The Company addressed the findings related to segregation of duties between the underwriting and claims functions, system changes related to claims representatives directing checks back to themselves, and training on entering accident dates into the system. See Recommendation #2 on page 8 for the portion of the finding related to system access reviews that was not implemented in 2008.
Pinnacol should implement changes with respect to segregation of duties over check handling and should consider corporate governance changes to further mitigate fraud risks and strengthen the overall control environment.	Implemented in 2008.
Pinnacol should reevaluate the reporting structure of the internal audit function and consider ways to enhance the independence of the function.	Implemented in 2008.

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INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying statutory statement of admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance (the "Company") as of December 31, 2008, and the related statutory statements of income, changes in policyholders' surplus, and cash flow for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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

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

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

In accordance with *Government Auditing Standards*, we have also issued our report dated May 20, 2009, on our consideration of the Company's internal control over financial reporting and our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our 2008 audit.

Our 2008 audit was conducted for the purpose of forming an opinion on the basic 2008 statutory financial statements taken as a whole. The supplemental schedules of investment information as of and for the year ended December 31, 2008 are presented for purposes of additional analysis and are not a required part of the basic 2008 statutory financial statements. These schedules are the responsibility of the Company's management. Such schedules have been subjected to the auditing procedures applied in our audit of the basic 2008 statutory-basis financial statements. The effects on these schedules of the differences between the statutory basis of accounting and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material. Accordingly, in our opinion, such schedules do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the information shown therein. However, in our opinion, such schedules are fairly stated in all material respects when considered in relation to the basic 2008 statutory financial statements taken as a whole.

Deloitte & Touche LLP

May 20, 2009

KPMG LLP
Suite 2700
707 Seventeenth Street
Denver, CO 80202

Independent Auditors' Report

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

We have audited the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance (the Company) as of December 31, 2007, and the related statutory statements of income and changes in policyholders' surplus and cash flows for the year then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described more fully in note 1 to the statutory financial statements, the Company prepared these financial statements in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division), which practices differ from U.S. generally accepted accounting principles. The effects on the financial statements of the variances between such practices and U.S. generally accepted accounting principles also are described in note 1.

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of Pinnacol Assurance as of December 31, 2007, or the results of its operations or its cash flows for the year then ended.

Also, in our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance as of December 31, 2007, and the results of its operations and its cash flows for the year then ended, in conformity with accounting practices prescribed or permitted by the Division.

KPMG LLP

May 21, 2008

PINNACOL ASSURANCE

STATUTORY STATEMENTS OF ADMITTED ASSETS, LIABILITIES, AND POLICYHOLDERS' SURPLUS
AS OF DECEMBER 31, 2008 AND 2007
(In thousands)

	2008	2007
ADMITTED ASSETS		
CASH AND INVESTED ASSETS:		
Bonds at adjusted carrying value, fair value of $1,744,613 in 2008 and $1,702,698 in 2007 (Note 3)	$ 1,692,948	$ 1,678,243
Common stock at fair value, cost of $254,973 in 2008 and $218,060 in 2007 (Note 3)	189,062	262,068
Real estate at cost — net of accumulated depreciation of $5,289 in 2008 and $4,354 in 2007	22,343	21,607
Cash, cash equivalents and short-term investments	111,674	96,699
Total cash and invested assets	2,016,027	2,058,617
UNCOLLECTED PREMIUMS — Net of allowance	54,694	64,074
ELECTRONIC DATA PROCESSING EQUIPMENT — At cost — net of accumulated depreciation of $5,272 in 2008 $4,259 in 2007	820	1,112
ACCRUED INVESTMENT INCOME	18,560	17,324
TOTAL ADMITTED ASSETS	$2,090,101	$2,141,127
LIABILITIES AND POLICYHOLDERS' SURPLUS		
RESERVE FOR UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES:		
Reserve for unpaid losses (Note 2)	$ 1,006,494	$ 1,042,466
Reserve for unpaid loss adjustment expenses (Note 2)	216,666	211,398
Total reserve for unpaid losses and loss adjustment expenses	1,223,160	1,253,864
OTHER LIABILITIES	43,899	48,139
UNEARNED PREMIUMS	86,068	95,549
DIVIDENDS PAYABLE TO POLICYHOLDERS	29,957	13,343
CREDIT BALANCES DUE POLICYHOLDERS	9,016	8,160
Total liabilities	1,392,100	1,419,055
COMMITMENTS AND CONTINGENCIES (Notes 2, 6, and 9)		
POLICYHOLDERS' SURPLUS (Note 7)	698,001	722,072
TOTAL LIABILITIES AND POLICYHOLDERS' SURPLUS	$2,090,101	$2,141,127

See notes to statutory financial statements.

PINNACOL ASSURANCE

STATUTORY STATEMENTS OF INCOME AND CHANGES IN POLICYHOLDERS' SURPLUS
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
(In thousands)

	2008	2007
UNDERWRITING INCOME:		
Premiums earned (Note 6)	$ 521,082	$ 567,284
Deductions:		
Losses incurred (Note 2)	274,076	323,743
Loss adjustment expenses incurred (Note 2)	66,841	62,647
Other underwriting expenses incurred	124,041	117,107
Total underwriting deductions	464,958	503,497
Net underwriting gain	56,124	63,787
INVESTMENT INCOME:		
Net investment income earned	98,433	101,036
Net realized capital (loss) gain	(56,527)	9,396
Total investment income	41,906	110,432
OTHER INCOME (LOSS):		
(Provision) recovery for uncollectible premiums	(2,122)	2,524
Other income	396	990
Dividends to policyholders	(78,557)	(68,503)
NET INCOME	17,747	109,230
CHANGE IN NONADMITTED ASSETS	(342)	385
CHANGE IN NET UNREALIZED (LOSS) GAIN IN INVESTMENTS	(41,806)	5,314
CHANGE IN PROVISION FOR REINSURANCE	330	(330)
POLICYHOLDERS' SURPLUS — Beginning of year	722,072	607,473
POLICYHOLDERS' SURPLUS — End of year	$ 698,001	$ 722,072

See notes to statutory financial statements.

PINNACOL ASSURANCE

STATUTORY STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
(In thousands)

	2008	2007
CASH FLOWS FROM OPERATIONS:		
Premiums collected — net of reinsurance	$ 521,808	$ 569,547
Losses and loss adjustment expenses paid — net of reinsurance and deductibles	(371,621)	(369,947)
Underwriting expenses paid	(126,385)	(113,071)
Dividends paid to policyholders	(61,943)	(69,143)
Investment income received, net of investment expenses paid	96,511	97,926
Net amount withheld or retained for account of others	(1,725)	3,514
Net cash provided by operations	56,645	118,826
CASH FLOWS FROM INVESTMENTS:		
Proceeds from sale or redemption of investments	371,859	353,101
Purchase of investments	(411,941)	(420,705)
Net cash used in investments	(40,082)	(67,604)
CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES — Cash provided by other miscellaneous sources	(1,588)	1,314
NET INCREASE IN CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS	14,975	52,536
CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS — Beginning of year	96,699	44,163
CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS — End of year	$ 111,674	$ 96,699

See notes to statutory financial statements.

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

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

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

In 2008 and 2007, Pinnacol declared $54,362,000 and $60,641,000, respectively, in general policyholder dividends to its policyholders in good standing. The board of directors, at its discretion, will determine the amount of policyholder dividends to be declared, if any, based on Pinnacol's overall experience, financial condition, and risk profile.

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

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

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

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

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

The effects of the foregoing variances from GAAP on the statutory financial statements at December 31, 2008 and 2007 and for the years then ended have been determined and are as follows (in thousands):

	2008	2007
Statutory policyholders' surplus	$ 698,001	$ 722,072
Nonadmitted assets	13,246	12,903
Policy acquisition costs — net of amortization	10,393	11,207
Net unrealized gain (loss) on bonds	51,664	24,456
GAAP net assets	$ 773,304	$ 770,638
Statutory net income	$ 17,747	$ 109,230
Policy acquisition costs — net of amortization	(815)	1,261
Change in fair value of investments	(14,596)	35,599
Change in provision for reinsurance	330	(330)
GAAP net income	$ 2,666	$ 145,760

(c) **Use of Estimates** — The preparation of statutory financial statements in accordance with accounting practices prescribed by the Division requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the statutory financial statements and the reported amounts of revenue and expenses during the reporting period. Significant estimates include the reserves for unpaid losses and loss adjustment expenses and the earned but unbilled premiums receivable balance included in uncollected premiums, as well as the allowance for uncollectible premiums among others. Reserve for unpaid losses and loss adjustment expenses represent estimates of the ultimate unpaid cost, net of reinsurance, of all losses incurred, including losses incurred but not reported. The liability is an estimate and, as such, the ultimate actual liability may vary from the recorded amounts. The liabilities are reviewed periodically, and adjustments to the reserve are included in operations in the period such determination is made. Actual results could differ from those estimates, and such differences could be significant.

(d) **Investments** — Investments are recorded on the trade date and are carried in accordance with the valuations prescribed by the SVO of the NAIC. Bonds are stated at amortized cost or market value based on their NAIC rating and are adjusted for other-than-temporary declines in fair value. Common stocks (including shares of mutual funds) are carried at estimated statutory fair value and are adjusted for other-than-temporary declines in fair value. Changes in fair values of stocks are reported as unrealized capital gains (losses) by a direct adjustment to unassigned surplus. Declines in value, determined to be other-than-temporary, are recorded as a realized loss in the statutory statement of income in the period in which they occur.

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

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

Prepayment assumptions for purposes of recognition of income and valuing of loan-backed bonds and structured securities were obtained from external broker dealer survey values. These assumptions are consistent with the current interest rate and economic environment. The prospective method is used to value mortgage-backed securities. Prepayment assumptions for single-class and multiclass mortgage-backed/asset-backed securities were obtained from Yield Book and Bloomberg.

Real estate includes land, the building on the land, and capitalized building improvements used in conducting the Company's business. Land is carried at cost. Building and capitalized building improvements are carried at cost less accumulated depreciation. The cost of the building and capitalized improvements is depreciated over an estimated useful life of 30 years using the straight-line method. Depreciation expense was $935,000 and $862,000 for the years ended December 31, 2008 and 2007 respectively.

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

As of December 31, 2008, cash, cash equivalents and short-term investments of $111,674,000 include $(18,189,000) of book overdrafts, $24,989,000 of cash equivalents, and $104,874,000 of short-term investments. As of December 31, 2007, cash, cash equivalents and short-term investments of $96,699,000 include $43,938,000 of cash, $0 of cash equivalents, and $52,761,000 of short-term investments. In the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus, Pinnacol has recorded checks that have been issued, but not presented for payment, as a reduction of cash and cash equivalents.

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

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

During 2008 and 2007, Pinnacol recorded a provision of $2,122,000 and a recovery of $2,524,000, respectively, for premiums receivable due to the unlikelihood of ultimate collection thereof. During 2007, Pinnacol reduced the allowance for earned but unbilled premiums, which is included within uncollected premiums in the statutory statement of admitted assets, liabilities and policyholders' surplus, by $3,817,000, resulting in a net recovery. These amounts are reflected as (provision) recovery for uncollectible premiums in the accompanying statutory statements of income and changes in policyholders' surplus.

A significant portion of Pinnacol's premiums receivable balances at December 31, 2008 and 2007 were from companies operating in the construction and services industries in Colorado. The construction industry represents 39% and 38% of premiums written as of December 31, 2008 and 2007, respectively. The services industry represents 23% and 22% of premiums written as of December 31, 2008 and 2007, respectively, with all other individual industries constituting the remainder of premiums receivable balances.

(g) **Earned but Unbilled Premiums** — Earned but unbilled premiums represent audit premiums, which are amounts due from policyholders after the respective policy period has expired based on audits performed by Pinnacol. Such amounts are estimated by Pinnacol using internal statistically supported aggregate calculations using historical unearned premium data and per policy calculations. For 2008 and 2007, estimated unbilled audit premiums receivable of $13,350,000 and $20,737,000, respectively, are included as uncollected premiums on the statutory statement of admitted assets, liabilities, and policyholders' surplus. These estimated receivables have been reduced by 10%, where applicable, to comply with the Manual.

(h) **Retrospectively Rated Contracts** — Pinnacol estimates accrued retrospective premium adjustments through the review of each individual retrospectively rated risk, comparing case basis loss development with that anticipated in the policy contract to arrive at the best estimate of return or additional retrospective premium. Pinnacol records accrued retrospective premium as an adjustment to earned premium. Net premiums earned on retrospective workers' compensation policies were $1,897,000 and $2,408,000 in 2008 and 2007, respectively. These amounts represent 0.4% of total net premiums written for both 2008 and 2007. Ten percent of the amount of accrued retrospective premiums not offset by collateral has been nonadmitted.

(i) **Credit Balances Due Policyholders** — Credit balances due policyholders represent excess premiums, which are amounts due to policyholders after the respective policy period has expired based on audits performed by Pinnacol. Such amounts are based on actual results. Generally, credit balances due policyholders are applied to future premium obligations of policyholders. For 2008 and 2007, such amounts are $9,016,000 and $8,160,000, respectively.

(j) **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, 2008 and 2007 was $820,000 and $1,112,000, respectively. Related depreciation expense of $1,013,000 and $916,000 was incurred during 2008 and 2007, respectively, and is included in other underwriting expenses incurred in the statements of income and changes in policyholders' surplus.

(k) **Office Furniture and Equipment** — Office furniture and equipment and art are recorded at cost and depreciated on a straight-line basis over an estimated useful life of five years. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2008 and 2007 was $2,800,000 and $3,127,000, respectively. Related depreciation expense of $934,000 and $922,000 was incurred in 2008 and 2007, respectively and is included in other underwriting expenses incurred in the statements of income and changes in policyholders' surplus.

(l) **Other Assets** — At December 31, 2008 and 2007, Pinnacol had prepaid assets and deposits totaling $3,186,000 and $1,924,000, respectively. In accordance with the Manual, these are nonadmitted assets.

(m) **General Policyholder Dividends** — The board of directors, at its discretion, determines the amount of general policyholder dividends to be declared based on Pinnacol's overall experience and

financial condition. Pinnacol has declared general policyholder dividends to its policyholders in good standing of $54,362,000 and $60,641,000 in May of 2008 and 2007, respectively. This is included in dividends to policyholders in the statutory statement of income and changes in policyholders' surplus and reduces net income for the years ended December 31, 2008 and 2007.

(n) **Association Dividend Program** — Pinnacol has an association dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. In 2008 and 2007, Pinnacol incurred $24,195,000 and $7,862,000, respectively, of expense related to the association dividend program. These dividends are not declared from surplus nor are they recorded as a direct reduction to surplus. The dividends are settled via premium credits and are recorded as dividends to policyholders in the statutory statements of income and changes in policyholders' surplus.

(o) **Revenue Recognition** — Premium revenue is recognized pro rata over the period the policy is effective.

(p) **Reserve for Unpaid Losses and Loss Adjustment Expenses** — The reserve for unpaid losses and loss adjustment expenses represents management's best estimate of ultimate net cost of all reported and unreported losses incurred through December 31. The reserve for unpaid losses and loss adjustment expenses are estimated by management using an independent third-party actuary 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 are adequate. These estimates are continually reviewed and adjusted, as necessary, as experience develops or new information becomes known; such adjustments are included in losses incurred or loss adjustment expenses incurred within the statutory statements of income and changes in policyholders' surplus in the period such information becomes known.

Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in 2008 and 2007. The discount rate used to calculate present value is based on an industry standard rate.

(q) **Unearned Premiums** — Unearned premiums represent amounts either collected or billed and due from policyholders at December 31 but unearned at that date as they pertain to subsequent policy periods. Unearned premiums are computed on a pro rata basis over the 12-month term of the policies.

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

(s) **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 6).

(t) **Taxes** —Pinnacol is not subject to federal or state income taxes under a specific exemption granted under Section 501(c) of the Internal Revenue Code. As a political subdivision of the State, Pinnacol is not 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. Pinnacol is, however, subject to a surcharge on premiums received, based on a rate established annually (approximately 3.818% in both 2008 and 2007), pursuant to Section 8-44-112(1)(a), C.R.S. Such amounts are included in other underwriting expenses incurred.

(u) Employee Benefits

Defined Benefit Pension Plan Through the State of Colorado

Plan Description — Virtually all of Pinnacol's employees participate in a defined benefit pension plan. The plan's purpose is to provide income to members and their families at retirement or in case of death or disability. The plan is a cost-sharing multiple employer plan administered by the Public Employees' Retirement Association (PERA). PERA was established by state statute in 1931. Responsibility for the organization and administration of the plan is placed with the board of trustees of PERA. Changes to the plan require an actuarial assessment and legislation by the general assembly. The state plan and other divisions' plans are included in PERA's financial statements, which may be obtained by writing PERA at PO Box 5800, Denver, Colorado 80217, by calling PERA at 1-800-759-PERA (7372), or by visiting www.copera.org.

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

- Hired before July 1, 2005 — age 50 with 30 years of service, age 60 with 20 years of service, or age 65 with 5 years of service.

- Hired between July 1, 2005 and December 31, 2006 — any age with 35 years of service, age 55 with 30 years of service, age 60 with 20 years of service, or age 65 with 5 years of service.

- Hired on or after January 1, 2007 any age with 35 years of service, age 55 with 30 years of service, age 60 with 25 years of service or age 65 with 5 years of service.

Members are also eligible for retirement benefits without a reduction for early retirement based on their original hire date as follows:

- Hired before January 1, 2007 — age 55 with a minimum of 5 years of service credit and age plus years of service equals 80 or more.

- Hired on or after January 1, 2007 — age 55 with a minimum of 5 years of service credit and age plus years of service equals 85 or more.

Members automatically receive the higher of the defined retirement benefit or money purchase benefit at retirement. Defined benefits are calculated as 2.5 percent times the number of years of service times the highest average salary (HAS). For retirements before January 1, 2009, HAS is calculated as one-twelfth of the average of the highest salaries on which contributions were paid, associated with three periods of 12 consecutive months of service credit and limited to a 15 percent increase between periods. For retirements after January 1, 2009 or persons hired on or after January 1, 2007, more restrictive limits are placed on salary increases between periods used in calculating HAS.

Retiree benefits are increased annually based on their original hire date as follows:

- Hired before July 1, 2005 — 3.5 percent, compounded annually.

- Hired between July 1, 2005 and December 31, 2006 — the lesser of 3 percent or the actual increase in the national Consumer Price Index.

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

Members disabled, who have five or more years of service credit, six months of which have 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 8.00% of their salary, as defined in Section 24-51-101(42), C.R.S., to an individual account in the plan. From January 1, 2008 through December 31, 2008, Pinnacol contributed 12.05% of the employee's salary. From January 1, 2007 through December 31, 2007, Pinnacol contributed 11.15% of employee's salary. During all of 2008, 1.02% of the total contribution 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, 2007, the division of PERA in which the state participates was underfunded with an infinite amortization period, which means that the unfunded actuarially accrued liability would never be fully funded at the current contribution rate.

In the 2004 legislative session, the general assembly authorized an Amortization Equalization Disbursement (AED) to address a pension-funding shortfall. The AED requires PERA employers to pay an additional 0.5 percent of salary beginning January 1, 2006, an additional 0.5 percent of salary in 2007, and subsequent year increases of 0.4 percent of salary until the additional payment reaches 3.0 percent in 2012.

In the 2006 legislative session, the general assembly authorized a Supplemental Amortization Equalization Disbursement (SAED) that requires PERA employers to pay an additional one half percentage point of total salaries paid beginning January 1, 2008. The SAED is scheduled to increase by one half percentage point through 2013 resulting in a cumulative increase of three percentage points. For state employers, each year's one half percentage point increase in the SAED will be deducted from the amount of changes to state employees' salaries, and used by the employer to pay the SAED. Both the AED and SAED will terminate when funding levels reach 100 percent.

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

Pinnacol's contributions to the programs described above for the fiscal years ended December 31, 2008 and 2007, were $4,746,000 and $4,100,000, respectively. These contributions met the contribution requirement for each year.

Voluntary Tax-Deferred Retirement Plans

PERA offers a voluntary 401(k) plan entirely separate from the defined benefit pension plan. Pinnacol offers a 457 deferred compensation plan. During the year ended December 31, 2007, Pinnacol began matching 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, 2008 and 2007, Pinnacol contributed $780,000 and $307,000, respectively, in matching contributions to the 401(k) plan.

Postretirement Health Care and Life Insurance Benefits

Health Care Program — The PERA Health Care Program began covering benefit recipients and qualified dependents on July 1, 1986. This benefit was developed after legislation in 1985 established the program and the Health Care Fund; the program was converted to a trust fund in 1999. The plan is a cost-sharing multiple-employer plan under which PERA subsidizes a portion of the monthly premium for health care coverage. The benefits and employer contributions are established in statute and may be amended by the general assembly. PERA includes the Health Care Trust Fund in its Comprehensive Annual Financial Report, which may be obtained by writing PERA at PO Box 5800, Denver, Colorado 80217, by calling PERA at 1-800-759-PERA (7372), or by visiting www.copera.org.

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

Employees are not required to contribute to the Health Care Trust Fund, which is maintained by employer's contributions as discussed above. Beginning July 1, 2004, employers are required to contribute 1.02% of gross covered wages to the Health Care Trust Fund. Pinnacol contributed $401,726 and $375,023 as required by statute in the years ended December 31, 2008 and 2007, 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, 2007, there were 44,214 enrolled participants, including spouses and dependents, from all contributors to the plan. At December 31, 2007, the Health Care Trust Fund had an unfunded actuarial accrued liability of $1.05 billion, a funded ratio of 19.9%, and a 38-year amortization period.

Accrued Paid Leave — Pinnacol employees may accrue paid time off based on their length of service subject to certain limitations on the amount that will be paid upon termination or taken in future periods. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The estimated liability for cumulative accrued paid time off of $1,684,000 and $1,589,000 at December 31, 2008 and 2007, respectively, is included in other liabilities in the statutory statements of admitted assets, liabilities and policyholders' surplus.

(v) Application of Recent Statutory Accounting Pronouncements

In September 2008, the NAIC issued Statement of Statutory Accounting Principles No. 99, *Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment* (SSAP 99). SSAP 99 establishes statutory accounting principles for the treatment of premium or discount applicable to certain securities subsequent to the recognition of an other-than-temporary impairment. SSAP 99 is effective for years beginning on and after January 1, 2009. The Company is evaluating the impact that the adoption of SSAP 99 will have on its financial position and results of operations.

2. UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES

Unpaid losses and loss adjustment expenses (both allocated and unallocated) represent management's best estimate of the ultimate medical and indemnity net cost of all losses and loss adjustment expenses that are incurred but unpaid at year-end. Such estimates are based on individual case estimates for reported claims and actuarial estimates for losses that have been incurred but not reported. Any change in probable ultimate liabilities is reflected in losses incurred or loss adjustment expenses incurred within the statutory statements of income and changes in policyholders' surplus in the period such determination is made.

The estimated ultimate cost of losses is based on historical patterns and the expected impact of current socioeconomic trends. The ultimate settlement of claims will not be known in many cases for years after the time a policy expires. Court decisions and federal and state legislation between the time a policy is written and the time associated claims are ultimately settled, among other factors, may dramatically impact the ultimate cost. Due to these factors, among others, the process to estimate loss and loss adjustment reserves at a point in time cannot provide an exact forecast of future payments. Rather, it produces a best estimate of liability as of a certain date. Management believes the reserves currently estimated to be adequate. While the ultimate liability may differ from the current estimate, management does not believe the difference will have a material effect, either adverse or favorable, on Pinnacol's financial position or results of operations.

Discounting of Liabilities for Unpaid Losses or Unpaid Loss Adjustment Expenses — Pinnacol discounts its liabilities for unpaid losses for certain long-term scheduled payments. Workers' compensation unpaid losses have been discounted on a tabular basis using a discount rate of 3.5% in 2008 and 2007. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield.

The amount of the tabular discount for unpaid losses as of December 31, 2008 and 2007, respectively, is $148,184,000 and $143,333,000. The amount of discount for case reserves at December 31, 2008 is distributed as follows over the years in which the losses were incurred (in thousands):

Loss Year	**Discount**
2008	$ 9,481
2007	14,762
2006	20,639
2005	11,214
2004	10,420
2003	10,284
2002	9,785
2001	8,563
2000	3,823
1999	4,419
Prior	44,794
Total	$ 148,184

Unpaid Losses and Loss Adjustment Expense — At December 31, 2008, Pinnacol accrued $1,223,160,000 for unpaid losses and loss adjustment expenses. A tabular discount of $148,184,000 (computed at 3.5%) was applied in the actuarial calculation of this liability for unpaid losses and loss adjustment expenses. A reserve credit of approximately $16,009,000 was recorded for high deductibles on unpaid claims at December 31, 2008.

At December 31, 2007, Pinnacol accrued $1,253,864,000 for unpaid losses and loss adjustment expenses. A tabular discount of $143,333,000 (computed at 3.5%) was applied in the actuarial calculation of this liability for unpaid losses and loss adjustment expenses. A reserve credit of approximately $13,716,000 was recorded for high deductibles on unpaid claims at December 31, 2007.

Amounts billed and recoverable for high deductibles on paid claims were $2,841,000 and $2,033,000 as of December 31, 2008 and 2007, respectively. These amounts are fully collateralized.

Activity in the liability for unpaid losses and loss adjustment expenses in 2008 and 2007 is summarized as follows (in thousands):

	Unpaid Losses and Loss Adjustment Expenses	
	2008	2007
Balance — January 1	$ 1,253,864	$ 1,237,421
Additional amounts incurred related to:		
Current year	499,922	459,594
Prior years	(159,005)	(73,204)
Total incurred	340,917	386,390
Reductions relating to payments for:		
Current year	168,403	117,938
Prior years	203,218	252,009
Total paid	371,621	369,947
Balance at December 31	$ 1,223,160	$ 1,253,864

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and allocated loss adjustment expenses decreased by $159,005,000 in 2008 and $73,204,000 in 2007. The changes are generally the result of ongoing analysis of recent loss development trends and better development efforts. Original estimates are increased or decreased as additional information becomes known regarding individual claims. Pinnacol's claims for all accident years continue the trend of favorable development that has been evident for a number of calendar years. When the actual selected ultimate cost of an accident year's claims is less than the original estimate, favorable development is recorded. This favorable development resulted from aggressive claim closure, a reduction of ultimate claim frequency in Colorado, and a reduction of catastrophic losses. Pinnacol management continually evaluates the estimate of ultimate cost of all accident years and, on a calendar year basis, adjusts to the best estimate available, favorable or unfavorable, in the current period.

3. INVESTMENTS

Estimated fair value of investments in bonds is based on quotations published by the SVO of the NAIC. However, for certain investments, the SVO does not provide a fair market value. For those investments, the quoted market value prices as provided by accepted external pricing vendors may be used as a substitute for the SVO market price. In both 2008 and 2007, Interactive Data Corporation (IDC) was used to obtain fair market values.

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

During 2008, Pinnacol had an investment in a bond where the SVO designated the bond at a 5 rating. At December 31, 2008, the fair market value on this bond was lower than amortized cost, which resulted in a cumulative unrealized loss of $1,214,000 of which $158,000 was reported in policyholders' surplus during 2008. During 2007, this same bond had an SVO designation of a 4 rating and the fair market value was lower than amortized cost, which resulted in an unrealized loss of $1,056,000 that was reported in policyholders' surplus.

The book/adjusted carrying value and the fair value of investments in bonds in 2008 and 2007 are summarized as follows (in thousands):

	2008			
	Book/Adjusted Carrying Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair value
U.S. government obligations:				
Nonloan-backed bonds	$ 263,069	$ 43,249	$ -	$ 306,318
Loan-backed bonds	479,260	10,541	-	489,801
Special revenue — nonloan-backed bonds	4,985	439	-	5,424
Industrial and miscellaneous:				
Nonloan-backed bonds	945,634	28,363	(30,927)	943,070
Loan-backed bonds	-	-	-	-
	$ 1,692,948	$ 82,592	$ (30,927)	$ 1,744,613

	2007			
	Book/Adjusted Carrying Value	Gross Unrealized Gains	Gross Unrealized Losses	Fair value
U.S. government obligations:				
Nonloan-backed bonds	$ 421,324	$ 18,296	$ -	$ 439,620
Loan-backed bonds	477,313	2,040	(8,173)	471,180
Special revenue — nonloan-backed bonds	4,984	148	-	5,132
Industrial and miscellaneous:				
Nonloan-backed bonds	774,622	19,468	(7,324)	786,766
Loan-backed bonds	-	-	-	-
	$ 1,678,243	$ 39,952	$ (15,497)	$ 1,702,698

The book/adjusted carrying value and estimated fair value of investments in bonds at December 31, 2008, by contractual maturity, are shown in the following table. Contractual maturities may differ from actual maturities because the borrower may have the right to call or prepay obligations with or without call or prepayment penalties.

	Book/Adjusted Carrying Value	Fair value
	(In thousands)	
Due in one year or less	$ 75,695	$ 76,396
Due after one year through five years	386,916	391,033
Due after five years through ten years	620,143	644,363
Due after ten years	610,194	632,821
	$1,692,948	$1,744,613

Proceeds from sales of investments in bonds during 2008 and 2007 were $340,802,000 and $294,391,000, respectively. Gross gains of $14,892,000 and $2,466,000 and gross losses of $85,000 and $829,000 were realized on those sales for 2008 and 2007, respectively.

Unrealized gains and losses on investments in common stocks are reported directly in policyholders' surplus. Other-than-temporary impairments of common stocks recognized in 2008 resulted in the establishment of a new, adjusted cost basis for such investments. The original cost, adjusted cost, gross unrealized gains and losses, and fair value of those investments are summarized as follows (in thousands):

	Original Cost	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair value
December 31, 2008	$254,973	$186,702	$ 2,360	$ -	$189,062
December 31, 2007	218,060	218,060	46,888	(2,880)	262,068

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

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

The following table provides the length of impairment for those investments in bonds with an unrealized loss as of December 31, 2007:

	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	$ 47,073	$ (972)	$176,321	$ (5,779)	$223,394	$ (6,751)
Public utilities	8,090	(327)	9,668	(246)	17,758	(573)
Mortgage-backed securities	48,889	(445)	239,910	(7,728)	288,799	(8,173)
Total	$104,052	$ (1,744)	$425,899	$(13,753)	$529,951	$ (15,497)

There are 63 and 74 securities in an unrealized loss position as of December 31, 2008 and 2007, respectively.

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

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

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

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

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

Bonds — At December 31, 2008 and 2007, less than 2% of these securities were rated non-investment grade. At December 31, 2008 and 2007, the Company had $29,504 and $6,751, respectively, of unrealized losses related to its industrial and miscellaneous bonds. The Company does not have any significant concentrations by issuer or by sector. The unrealized losses on the securities are primarily attributable to fluctuations in market interest rates and changes in credit spreads since the securities were acquired. These fluctuations, caused by market interest rate changes, have little bearing on whether or not the investment will be ultimately recoverable. At December 31, 2008, the Company does not have the intent to sell the securities before the recovery of the cost of the securities; therefore the Company does not consider these investments to be other-than-temporarily impaired.

Other-Than-Temporary Impairment — The Company did not record other-than-temporary impairments (OTTI) on bonds during the years ended December 31, 2008 and 2007. During the year ended December 31, 2008, the Company recorded OTTI on common stocks in the amounts of $68,272,000. The Company did not record OTTI on common stocks during the year ended December 31, 2007. These impairments primarily relate to declines in value where the Company does not have the ability to hold these securities until the recovery of the cost of the securities due to the discretion provided to the Company's investment manager.

Fair Value Measurements — The Company's assets and liabilities recorded at fair value have been categorized based upon a fair value hierarchy in accordance with Statement of Financial Accounting Standards No. 157 (SFAS 157). The levels of the fair value hierarchy are described below. Level 1, level 2, and level 3 inputs are defined in SFAS 157.

- Level 1 inputs utilize observable, quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Financial assets and liabilities utilizing Level 1 inputs include actively exchange-traded equity securities.

- Level 2 inputs utilize other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

- Level 3 inputs are unobservable and include situations where there is little, if any, market activity for the asset or liability. All of the prices of Level 3 securities were obtained from single broker quotes.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The following table presents information about the Company's financial assets measured at fair value on a recurring basis for accounting purposes as of December 31, 2008 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, 2008			
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	$ 189,062	$ -	$ -	$ 189,062
Total assets	$ 189,062	$ -	$ -	$ 189,062

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. The following table summarizes the assets measured at fair value on a non-recurring basis for accounting purposes as of December 31, 2008 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, 2008			
Assets	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total**
Bonds	$ -	$ 23,740	$ -	$ 23,740
Total assets	$ -	$ 23,740	$ -	$ 23,740

Investment Income — Major categories of net investment income for the years ended December 31, 2008 and 2007 are summarized as follows (in thousands):

	2008	2007
Investment income:		
Corporate and miscellaneous bonds	$ 73,129	$ 66,447
U.S. government obligations	18,858	21,684
Cash and other investments	2,068	3,816
Real estate	3,872	3,882
Equity securities	4,102	8,456
Repurchase/reverse repurchase	583	845
Investment expenses	(4,179)	(4,094)
Net investment income earned	98,433	101,036
Net realized capital (losses) gains	(56,527)	9,396
Net investment income	$ 41,906	$ 110,432

The company did not have any significant concentrations by industry or by issuer as of December 31, 2008.

4. REPURCHASE AND REVERSE REPURCHASE TRANSACTIONS

Pinnacol has entered into repurchase and reverse repurchase agreements where the Company agrees to sell securities and simultaneously agrees to repurchase the same or substantially the same securities in the future (reverse repurchase agreement) while also entering into an agreement to purchase securities and simultaneously agrees to resell the same or substantially the same securities in the future (repurchase agreement). The broker-dealer facilitating the program provides securities as collateral equal to or exceeding 105% of the market value of securities transferred into the program. This agreement was terminated effective July 1, 2008 and all securities were returned to Pinnacol. Pinnacol recognized $583,000 and $845,000 of additional investment income during the years ended December 31, 2008 and 2007, respectively, related to repurchase and reverse repurchase transactions.

Pinnacol had outstanding U.S. government securities with trade principal values of approximately $858,822,000 and a cost of approximately $831,718,000 as of December 31, 2007.

Pinnacol had no additional credit risk exposure to borrowers. The contract with the broker-dealer required the broker-dealer to indemnify Pinnacol if the broker-dealer failed to return the securities or failed to pay Pinnacol for income distributions by the securities' issuers while the securities remained in the program.

5. TRANSACTIONS WITH THE STATE OF COLORADO

The state of Colorado contracts with Pinnacol pursuant to its self-funded insurance program. The state reimburses Pinnacol for all workers' compensation claims and loss adjustment expenses as incurred. Pinnacol accounts for the state contract as an uninsured and partially insured accident and health plan whereby Pinnacol does not record the premium revenue or loss and loss adjustment expenses and related receivables and payables for state workers' compensation costs. Reimbursements billed to the state under this contract were $37,171,000 and $31,607,000 in 2008 and 2007, respectively.

6. REINSURANCE

Pinnacol purchases catastrophic reinsurance for risks in excess of its retention limits on workers compensation insurance policies written. Coverage for policies is provided under the following terms:

Period	Reinsurance coverage
May 1, 2006 to April 30, 2007	Individual workers' compensation accidents of up to $10,000,000 in excess of retention of $10,000,000 per occurrence Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $20,000,000 per occurrence Individual workers' compensation accidents of up to $40,000,000 in excess of retention of $40,000,000 per occurrence
May 1, 2007 to April 30, 2008 and May 1, 2008 to April 30, 2009	Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $20,000,000 per occurrence Individual workers' compensation accidents of up to $40,000,000 in excess of retention of $40,000,000 per occurrence

Management is not aware of any catastrophes during any of the aforementioned policy periods.

Effective March 1, 2004, Pinnacol executed a reinsurance contract with Argonaut Insurance Company (a California corporation) for Other States Coverage that is in effect as of December 31, 2008. The contract is designed as a 100% quota share arrangement with Pinnacol acting as the assuming company. This contract allows Pinnacol to provide insurance coverage under the workers' compensation provisions of other states for the employees of Colorado companies who work outside of Colorado. Premium revenue is recognized pro rata over the period the policy is effective.

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

	2008	2007
Direct premiums written	$484,459	$546,642
Premiums ceded	(1,416)	(2,464)
Premiums assumed	28,559	18,790
Net premiums written	$511,602	$562,968
Direct premiums earned	$494,418	$550,958
Premiums ceded	(1,416)	(2,464)
Premiums assumed	28,080	18,790
Net premiums earned	$521,082	$567,284
Direct losses incurred	$253,626	$310,301
Losses ceded	675	(688)
Losses assumed	19,775	14,130
Net losses incurred	$274,076	$323,743
Direct loss adjustment expenses incurred	$ 66,204	$ 61,919
Loss adjustment expenses ceded	-	-
Loss adjustment expenses assumed	637	728
Net loss adjustment expenses incurred	$ 66,841	$ 62,647

Should the reinsurers be unable to meet their obligations under the reinsurance contracts, Pinnacol would remain liable for amounts ceded to its reinsurers. Reinsurance contracts do not relieve Pinnacol of its obligations, and a failure of the reinsurer to honor its obligations could result in losses to Pinnacol. Pinnacol evaluates and monitors the financial condition of its reinsurers to minimize its exposure to loss from reinsurer insolvency. Management of Pinnacol believes its reinsurers are financially sound and will continue to meet their contractual obligations.

Pinnacol's reinsurers had the following AM Best ratings at December 31, 2008:

Reinsurer	AM Best Rating
Catlin Syndicate #2003	A
AXIS Specialty Limited	A
Endurance Specialty Insurance Ltd.	A
Validus Reinsurance Ltd.	A-
Brit Insurance Limited	A
Lloyd's Syndicate - DRE #1400	NR
Lloyd's Syndicate - FDY #0435	NR
Lloyd's Syndicate - ATR #0570	As
Lloyd's Syndicate - CSL #1084	As
Lloyd's Syndicate - BGT #1301	NR
Lloyd's Syndicate - BRT #2987	NR
Lloyd's Syndicate - LIB #4472	NR
Flagstone Reassurance Suisse SA	A-

7. POLICYHOLDERS' SURPLUS

Pinnacol had policyholders' surplus of $698,001,000 and $722,072,000 as of December 31, 2008 and 2007, respectively.

Pinnacol declared $54,362,000 and $60,641,000 in general policyholder dividends to its policyholders in good standing in 2008 and 2007 respectively. This is included in dividends to policyholders on the statutory statements of income and changes in policyholders' surplus and reduces net income for the year ended December 31, 2008. The Division of Insurance 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 $112,546,000 for 2008.

8. COMMITMENTS AND CONTINGENCIES

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

At December 31, 2008 and 2007, Pinnacol had arranged letters of credit for assumptive reinsurance agreements. Pinnacol had a letter of credit for the benefit of Argonaut Insurance Company for $50,656,000 and $40,349,000, respectively. Pinnacol had a letter of credit for the benefit of Reliance Insurance Company for approximately $0 and $902,000 at December 31, 2008 and 2007, respectively. These reinsurance agreements allow the companies to draw upon the respective letters of credit, which are collateralized at 100%, at any time to secure any of Pinnacol's obligations under the agreements. Included in bonds are amounts held as collateral for letters of credit for reinsurance agreements of approximately $50,656,000 and $42,000,000 as of December 31, 2008 and 2007, respectively.

Pinnacol is contingently liable for approximately $59,506,000 of claims closed by the purchase of annuities from life insurers for structured settlements. No provision has been made for this contingency as management believes that any payments related to this contingency are remote.

9. SUBSEQUENT EVENTS

The board of directors held a meeting on May 6, 2009 in which it declared and is planning to pay a general dividend of approximately $120,000,000 in 2009 to its policyholders with policies in good standing. The board of directors, at its discretion, determines the amount of policyholder dividends to be declared based on Pinnacol's overall experience and financial condition.

10. RECONCILIATION OF ANNUAL STATEMENT TO AUDITED FINANCIAL STATEMENTS

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

	Admitted Assets	Capital and Surplus	Net Income
Total per annual statement	$2,090,100	$698,001	$ 86,019
Other-than-temporary impairment adjustment	-	-	(68,272)
Total per statutory financial statements	$2,090,100	$698,001	$ 17,747

SUPPLEMENTAL SCHEDULES OF INVESTMENT INFORMATION

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION — INVESTMENT RISKS INTERROGATORIES FOR THE YEARS ENDED DECEMBER 31, 2008

1. Pinnacol's total admitted assets as reported on page two of its Annual Statement are $2,090,100,699.

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

Investment Category/Issuer	Amount	Percentage of Total Admitted Assets
a. Vanguard	$ 85,804,448	4.1 %
b. General Electric Co	49,126,255	2.4
c. IMB Intl Group Capital	43,469,489	2.1
d. Verizon New Jersey Inc	42,665,354	2.0
e. Bellsouth Corp	35,810,897	1.7
f. Burlington North Sante Fe	34,322,388	1.6
g. Procter & Gamble Co	33,221,364	1.6
h. Diageo Finance BV	33,133,296	1.6
i. United Technologies Corp	29,472,623	1.4
j. Emerson Electric Co	27,308,364	1.3

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

Bonds		
NAIC Rating	Amount	Percentage of Total Admitted Assets
NAIC-1	$1,499,504,614	71.7 %
NAIC-2	169,703,859	8.1
NAIC-3	-	0.0
NAIC-4	-	0.0
NAIC-5	23,739,715	1.1
NAIC-6	-	0.0
	$1,692,948,188	

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

Items 5 through 10 are not applicable.

11. Assets held in Canadian investments are not less than 2.5% of Pinnacol's total admitted assets.

Item 12 is not applicable.

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

Investment Category/Issuer	**Amount**	**Percentage of Total Admitted Assets**
a. Vanguard	$ 85,804,448	4.1 %
b. Artio International Eqy II-I	17,058,399	0.8
c. Rainer Mid Cap Equity - Inst	16,611,418	0.8
d. T Rowe Price Inst S/C Stock	14,603,295	0.7
e. Allianz CCM Mid Cap FD - Inst	7,140,770	0.3
f. Wells Fargo & Co	2,591,292	0.1
g. Emerson Electric Co	1,745,565	0.1
h. Ecolab Inc	1,631,487	0.1
i. Exxon Mobile Corp	1,596,600	0.1
j. General Electric Co	1,438,560	0.1

Items 15 through 19 are not applicable.

20. Pinnacol's total admitted assets are subject to the following types of agreements as of the following dates:

	Year-End		End of Each Quarter		
		Percentage of Total Admitted Assets	First Quarter	Second Quarter (Unaudited)	Third Quarter
	Amount		Amount	Amount	Amount
a. Securities lending (do not include assets held as collateral for such transactions)	$ -	%	$ -	$ -	$ -
b. Repurchase agreements					
c. Reverse repurchase agreements			861,735,000	771,716,000	
d. Dollar repurchase agreements					
e. Dollar reverse repurchase agreements					

Items 21 through 23 are not applicable.

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION — SUMMARY INVESTMENT SCHEDULE AS OF DECEMBER 31, 2008

Investment Categories	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
	Amount	Percentage of Gross Investment Holdings	Amount	Percentage of Total Admitted Assets
Bonds:				
U.S. Treasury securities	$ 250,555,015	12.428 %	$ 250,555,015	12.428 %
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies				
Issued by U.S. government-sponsored agencies	12,513,668	0.621	12,513,668	0.621
Foreign government (including Canada, excluding mortgage-backed securities)				
Securities issued by states, territories, and possessions and their political subdivisions in the U.S.:				
State, territory, and possessions — general obligations				
Political subdivisions of states, territories, and possessions — general obligations				
Revenue and assessment obligations				
Industrial development and similar obligations				
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA	43,042,264	2.135	43,042,264	2.135
Issued by FNMA and FHLMC	76,339,113	3.787	76,339,113	3.787
Privately issued				
CMOs and REMICs:				
Issued by FNMA and FHLMC	357,771,289	17.746	357,771,289	17.746
Privately issued and collateralized by MBS, issued or guaranteed by GNMA, FNMA, or FHLMC				
All other privately issued	19,573,336	0.971	19,573,336	0.971
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	878,224,425	43.562	878,224,425	43.562
Unaffiliated foreign securities	54,929,079	2.725	54,929,079	2.725
Affiliated securities				

(Continued)

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION — SUMMARY INVESTMENT SCHEDULE AS OF DECEMBER 31, 2007

Investment Categories	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
	Amount	Percentage of Gross Investment Holdings	Amount	Percentage of Total Admitted Assets
Equity interests:				
Investments in mutual funds	$ 142,481,691	7.067 %	$ 142,481,691	7.067 %
Preferred stocks:				
Affiliated				
Unaffiliated				
Publicly traded equity securities (excluding preferred stocks):				
Affiliated				
Unaffiliated				
Other equity securities:				
Affiliated				
Unaffiliated	46,580,478	2.311	46,580,478	2.311
Other equity interests including tangible personal property under lease:				
Affiliated				
Unaffiliated				
Mortgage loans:				
Construction and land development				
Agricultural				
Single-family residential properties				
Multifamily residential properties				
Commercial loans				
Real estate investments:				
Property occupied by Company	22,343,580	1.108	22,343,580	1.108
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	111,673,507	5.539	111,673,507	5.539
Write-ins for invested assets				
TOTAL INVESTED ASSETS	$ 2,016,027,445	100.000 %	$ 2,016,027,445	100.000 %

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

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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 IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

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

We have audited the statutory financial statements of Pinnacol Assurance (Pinnacol) as of and for the year ended December 31, 2008, and have issued our report thereon dated May 20, 2009. Our report is modified for statutory basis of accounting presentation. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America.

Internal Control over Financial Reporting

In planning and performing our audit, we considered Pinnacol's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the entity's internal control over financial reporting.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statement that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiency described in the accompanying schedule of findings and recommendations relating to accounting for other-than-temporary impairments of investments to be a significant deficiency in internal control over financial reporting.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we do not believe that the significant deficiency described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Pinnacol's statutory financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and the use of the members of the Legislative Audit Committee, the board of directors and management of Pinnacol, and state insurance departments to whose jurisdiction Pinnacol is subject, and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

May 20, 2009

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