PINNACOL ASSURANCE

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

Years ended December 31, 2002 and 2001

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The enclosed report is being distributed to you at this time for your information in accordance with Colorado Revised Statutes ("C.R.S.").

SECTION 2-3-103(2) states in part:

> All reports shall be open to public inspection except for that portion of any report containing recommendations, comments, and any narrative statements, which is **released only upon the approval of a majority vote of the committee.** (emphasis supplied)

SECTION 2-3-103.7(1) states in part:

> Any state employee **or other individual acting in an oversight role as a member of a committee, board, or commission** who willfully and knowingly discloses the contents of any report prepared by, or at the direction of, the Office of the State Auditor prior to **the release of such report by a majority vote** of the committee as provided in Section 2-3-103(2) is guilty of a misdemeanor and, upon conviction thereof, shall be punished by a fine of not more than $500. (emphasis supplied)

COSA-201 04/00

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February 14, 2003

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

We have completed the audit of the statutory-basis financial statements of Pinnacol Assurance ("Pinnacol") for the year ended December 31, 2002. Our audit was conducted in accordance with auditing standards generally accepted in the United States. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S., which requires an annual audit of Pinnacol. The reports which we have issued as a result of this engagement are set forth in the table of contents which follows.

Ernst & Young LLP

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Pinnacol Assurance

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

Years ended December 31, 2002 and 2001

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Pinnacol Assurance

Audit Report Summary

December 31, 2002

Authority and Purpose/Scope of the Audit

This audit was conducted under the authority of Section 8-45-121(2), C.R.S., which requires an annual audit of Pinnacol Assurance. The primary purpose of our engagement was to audit the statutory-basis financial statements of Pinnacol Assurance ("Pinnacol") at December 31, 2002, and for the year then ended, in accordance with auditing standards generally accepted in the United States and to express an opinion on those financial statements and the notes thereto. The objective of an audit conducted in accordance with such standards is to obtain reasonable, but not absolute, assurance about whether the statutory-basis financial statements are free of material misstatement.

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

We examined, on a test basis, evidence supporting the amounts and disclosures in Pinnacol's financial statements as of December 31, 2002. The accounting practices used by Pinnacol to prepare the financial statements are in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado ("Division of Insurance").

Our evaluation of the progress made by Pinnacol in implementing our recommendations with respect to internal accounting and administrative controls resulting from previous audits is found in the Disposition of Prior Audit Recommendations in this report.

Required Communications to the Legislative Audit Committee

In accordance with auditing standards generally accepted in the United States (AU Section 380), and the Statement of Auditing Standards ("SAS") No. 61, *Communication with Audit Committees*, we must communicate to the Audit Committee certain matters noted during our audit. The following sets forth these required communications.

1. **Auditor's Responsibility Under Generally Accepted Auditing Standards—** Our audit was conducted in accordance with auditing standards generally accepted in the United States and was designed to provide reasonable, rather than absolute, assurance that the financial statements are free of material misstatement.

2. **Significant Accounting Policies—**In 2001, Pinnacol changed various accounting policies to be in accordance with the revised National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual*, as adopted by the Colorado Division of Insurance. As a result of these changes, Pinnacol reported a change of accounting principle that increased policyholders' surplus by $5,384,000 as of January 1, 2001, primarily related to the accounting for earned but unbilled premiums. There were no changes to significant accounting policies in 2002.

3. **Management Judgments and Use of Estimates—**Pinnacol's management has made judgments with respect to certain accounting estimates included in the audited financial statements. 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 major accounting estimates are as follows:

   <u>Net Realizable Value of Uncollected Premiums</u>—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 which 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, 2002, the net realizable value of uncollected premiums is estimated to be $53,926,000. The amount at December 31, 2001 was estimated to be $54,345,000.

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 2002 and 2001, estimated net unbilled audit premiums receivable of $22,491,000 and $23,242,000, respectively, are included as uncollected premiums.

Unpaid Losses and Loss Adjustment Expenses—Estimating 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 actuarial consulting services of Milliman U.S.A. At December 31, 2002, Pinnacol has accrued $924,313,000 for unpaid losses and loss adjustment expenses as management's best estimate, which management believes to be a reasonable estimate of discounted future amounts to be paid for claims incurred in 2002 or prior. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. State law allows Pinnacol the use of a discount factor of up to 6.00%; Pinnacol discounted its actuarially determined unpaid balances by a factor of 4.25%, a more conservative discount factor.

4. **Unusual Transactions and Contingencies—**During September 2002, Pinnacol moved into and occupied a new office building. Pinnacol has incurred a total cost of $25,400,000 through 2002 for the purchase of the land and office building. In addition, Pinnacol has an ongoing operating lease for storage space.

5. **Significant Audit Adjustments—**The statutory-basis financial statements incorporated herein contain no differences with Pinnacol's annual statement, as filed with the Colorado Division of Insurance for the year ended December 31, 2002. There were no audit adjustments.

6. **Consultation with Other Accountants—**We are not aware of any instances of management consulting with other accountants regarding auditing and accounting matters during 2002, including the type of opinion rendered in connection with our audit.

7. **Disagreements with Management—**There were no disagreements with management on accounting or financial reporting matters that would have caused us to modify our opinion on the financial statements.

8. **Other Matters**

Ernst & Young performed this audit under contract with the Office of the State Auditor and did not discuss accounting or auditing issues with management in connection with our initial or recurring retention as auditor.

We received excellent cooperation from Pinnacol management and staff throughout the audit.

There were no material errors or irregularities, or possible illegal acts of which we are aware.

We identified no material weaknesses in the system of internal control.

Recommendation Summary

There were no recommendations identified during our audit of the statutory-basis financial statements of Pinnacol at December 31, 2002, and for the year then ended. As discussed below, we did evaluate the progress of implementing prior audit recommendations.

Summary of Progress in Implementing Prior Audit Recommendations

The disposition of prior audit recommendations as of February 14, 2003 was:

Implemented	4
Partially implemented	–
Not implemented	–
	4

Description of Pinnacol Assurance

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

As of July 1, 2002, Pinnacol Assurance's name was officially changed from Colorado Compensation Insurance Authority to Pinnacol Assurance ("Pinnacol"), with the passage of House Bill 02-1135. With the passage of this bill, Pinnacol is formally acknowledged in state statute as operating as a domestic mutual insurance company. This bill also increased the number of board members of Pinnacol to nine members from seven members, clarified that the assets of Pinnacol belong to Pinnacol and the state has no claim to these assets for any purpose, and it authorizes the invested assets of Pinnacol to be transferred out of the state treasury to the custody of the Board of Directors of Pinnacol after the requirements of the surplus recovery plan have been met. Finally, this bill eliminated the availability of the Government Immunity Act upon the attainment of the required surplus level.

Pinnacol is controlled by a nine-member Board of Directors, which is appointed by the Governor, with the consent of the Senate. The Board of Directors appoints a president in accordance with the applicable statutes of the state, and the administration of Pinnacol is under the direction of the president. The state retains no liability on behalf of Pinnacol, and no state monies are used for Pinnacol operations. Under statutes, the State Treasurer is the custodian for Pinnacol's cash and invested assets and, after consulting with Pinnacol, the State Treasurer makes all investing decisions.

Policyholders' Surplus

Pinnacol had policyholders' surplus of $215,510,000 and $143,716,000 as of December 31, 2002 and 2001, respectively. The increase in surplus is primarily related to current year net income. These increases were offset by an increase in nonadmitted assets and the increase in unrealized losses in common stock. The current year-end surplus remains below regulatory levels considered acceptable in the industry.

In response to Section 8-45-111, C.R.S., which required Pinnacol to submit a plan for approval by the commissioner of insurance for the attainment of a reasonable surplus, or, such surplus approved by the commissioner of insurance, management of Pinnacol developed, filed and received approval, effective January 1, 2001, of a long-range plan (the "Plan") to strengthen its financial position and attain "a reasonable policyholders' surplus." The Plan calls for Pinnacol to achieve the "company action level of risk-based capital."

The Plan as filed with and approved by the Colorado Division of Insurance calls for the achievement of a level of risk-based capital, not a specific precise level of statutory surplus. The achievement of the Plan, originally anticipated to take in excess of 10 years, is now expected to be accomplished within the next two to three years.

Note 7 expands on the information detailed above, including the definitions attributable to risk-based capital.

Pinnacol Assurance

Disposition of Prior Audit Recommendations

Listed below are the recommendations included in the prior audit report dated February 15, 2002, and the disposition of such items as of February 14, 2003.

Recommendation	Comments
1. Reconcile and adjust all general ledger account balances on a monthly basis.	Implemented.
2. Reconcile and adjust all cash accounts on a monthly basis.	Implemented.
3. Reconcile the paid losses per the general ledger to the paid loss data utilized by Milliman U.S.A. in developing the unpaid loss reserves.	Implemented.
4. Review the processing of internal structured settlements and make corrections for timing differences to ensure the accuracy of the results of internal structured settlements.	Implemented.

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Report of Independent Auditors

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

We have audited the accompanying statutory-basis balance sheets of Pinnacol Assurance as of December 31, 2002 and 2001, and the related statutory-basis statements of income and changes in policyholders' surplus and cash flow for the years 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 audits.

We conducted our audits in accordance with auditing standards generally accepted in 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 1 to the financial statements, the Company presents its 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 ("Colorado Division of Insurance"), which practices differ from accounting principles generally accepted in the United States. The variances between such practices and accounting principles generally accepted in the United States and the effects on the accompanying financial statements 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 accounting principles generally accepted in the United States, the financial position of Pinnacol Assurance at December 31, 2002 and 2001, or the results of its operations or its cash flow for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pinnacol Assurance at December 31, 2002 and 2001, and the results of its operations and its cash flow for the years then ended in conformity with accounting practices prescribed or permitted by the Colorado Division of Insurance.

As discussed in Note 8 to the financial statements, in 2001 Pinnacol Assurance changed various accounting policies to be in accordance with the revised National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual*, as adopted by the Colorado Division of Insurance.

Ernst + Young LLP

February 14, 2003

Pinnacol Assurance

Statutory-Basis Balance Sheets

(In Thousands)

	December 31, 2002	December 31, 2001
Admitted assets		
Cash and invested assets:		
Bonds *(Note 3)*	$1,053,293	$ 931,009
Common stock *(Note 3)*	59,854	18,927
Real estate	25,204	6,323
Cash on hand and on deposit	51,167	45,519
Other invested assets *(Note 3)*	10,046	7,409
Total cash and invested assets	1,199,564	1,009,187
Uncollected premiums, net of allowance for uncollectible and nonadmitted balances of $16,837 and $15,142 in 2002 and 2001, respectively	53,926	54,345
Electronic data processing equipment, net of accumulated depreciation of $1,889 and $2,837 in 2002 and 2001, respectively	2,468	455
Accrued investment income	13,210	12,621
Total admitted assets	$1,269,168	$1,076,608
Liabilities and policyholders' surplus		
Liabilities:		
Unpaid losses and allocated loss adjustment expenses *(Note 2)*	$ 897,414	$ 795,981
Unpaid unallocated loss adjustment expenses *(Note 2)*	26,899	26,333
Total unpaid losses and loss adjustment expenses	924,313	822,314
Other liabilities	36,343	29,755
Unearned premiums	84,777	75,003
Credit balances due policyholders	8,225	5,820
Total liabilities	1,053,658	932,892
Commitments and contingencies *(Note 9)*		
Policyholders' surplus *(Note 7)*	215,510	143,716
Total liabilities and policyholders' surplus	$1,269,168	$1,076,608

See accompanying notes.

Pinnacol Assurance

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

	Year Ended December 31, 2002	2001
	(In Thousands)	
Premiums earned *(Note 6)*	$470,119	$391,500
Underwriting expenses:		
Losses and loss adjustment expenses incurred	351,502	283,842
Unallocated loss adjustment expenses incurred	16,021	22,405
Other underwriting expenses incurred	92,797	76,159
Total underwriting expenses	460,320	382,406
Underwriting gain	9,799	9,094
Net investment income	74,360	61,604
Net realized gain on investments	2,764	5,892
Provision for uncollectible premiums	(3,628)	(2,610)
Other (loss) income	(333)	1,971
Net income	82,962	75,951
Change in nonadmitted assets	(5,308)	(1,218)
Cumulative effect of changes in accounting principles *(Note 8)*	–	5,384
Change in net unrealized losses in common stock	(5,860)	(968)
Policyholders' surplus at beginning of year	143,716	64,567
Policyholders' surplus at end of year	$215,510	$143,716

See accompanying notes.

Pinnacol Assurance

Statutory-Basis Statements of Cash Flow

	Year Ended December 31, 2002	2001
	(In Thousands)	
Cash from operations		
Premiums collected, net of reinsurance	$480,313	$393,772
Losses and loss adjustment expenses paid, net	(265,524)	(218,656)
Underwriting expenses paid	(81,113)	(72,991)
Cash from underwriting	133,676	102,125
Net investment income	67,447	60,924
Change in net amount withheld or retained for account of others	(3,961)	1,971
Net cash provided by operations	197,162	165,020
Cash from investments		
Proceeds from sale or redemption of investments	227,658	183,717
Purchase of investments	(390,082)	(313,430)
Purchase of real estate	(20,458)	(4,173)
Net cash used for investments	(182,882)	(133,886)
Cash from financing and miscellaneous sources		
Cash applied for other miscellaneous sources	(8,632)	(871)
Net cash used for financing and miscellaneous sources	(8,632)	(871)
Increase in cash on hand and on deposit	5,648	30,263
Cash on hand and on deposit, beginning of year	45,519	15,256
Cash on hand and on deposit, end of year	$ 51,167	$ 45,519

See accompanying notes.

1. Nature of Operations and Significant Accounting Policies

Organization

Pinnacol Assurance was established under provisions of the Workers' Compensation Act of Colorado (Title 8, Article 45 of the Colorado Revised Statutes [C.R.S.], as amended) for the benefit of injured employees and dependents of deceased employees. Pinnacol provides insurance to employers operating within the State of Colorado (the "State") not otherwise insured through private carriers or self-insurance.

As of July 1, 2002, Pinnacol Assurance's name was officially changed from Colorado Compensation Insurance Authority to Pinnacol Assurance ("Pinnacol"), with the passage of House Bill 02-1135. With the passage of this bill, Pinnacol is formally acknowledged in state statute as operating as a domestic mutual insurance company. This bill also increased the number of board members of Pinnacol to nine members from seven members, clarified that the assets of Pinnacol belong to Pinnacol and the state has no claim to these assets for any purpose, and it authorizes the invested assets of Pinnacol to be transferred out of the state treasury to the custody of the Board of Directors of Pinnacol after the requirements of the surplus recovery plan have been met. Finally, this bill eliminated the availability of the Government Immunity Act upon the attainment of the required surplus level.

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 statutes of the state, the administration of Pinnacol is under the direction of the president, appointed by the Board of Directors. The state retains no liability on behalf of Pinnacol, and no state monies are used for Pinnacol operations. Under statutes, the State Treasurer is the custodian for Pinnacol's cash and invested assets and, after consulting with Pinnacol, the State Treasurer makes all investing decisions.

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

Basis of Presentation

The accompanying financial statements of Pinnacol have been prepared in conformity with accounting practices prescribed or permitted by the Colorado Division of Insurance.

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

Such practices vary from accounting principles generally accepted in the United States ("GAAP"). The more significant variances from GAAP are as follows:

Investments: Investments in bonds and mandatorily redeemable preferred stocks are reported at amortized cost or market value based on their National Association of Insurance Commissioners ("NAIC") rating; for GAAP, such fixed maturity investments would be designated at purchase as held-to-maturity, trading, or available-for-sale. Held-to-maturity fixed investments would be reported at amortized cost, and the remaining fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in operations for those designated as trading and as a separate component of equity for those designated as available-for-sale. Real estate owned and occupied by Pinnacol is included in investments at depreciated cost rather than reported as an operating 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 uncollected premiums, furniture and equipment and other assets not specifically identified as an admitted asset within the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual*, are excluded from the accompanying balance sheets and are charged directly to policyholders' surplus. Under GAAP, such assets are included in the balance sheets.

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

The effects of the foregoing variances from GAAP on the statutory-basis financial statements at December 31, 2002 and 2001, and for the years then ended have been determined and are presented below.

	December 31, 2002	December 31, 2001
	(In Thousands)	
Statutory-basis policyholders' surplus	$215,510	$ 143,716
Nonadmitted assets	12,558	7,250
Policy acquisition costs	2,831	2,076
Net unrealized gains on bonds	94,208	37,998
GAAP-basis policyholders' surplus	$325,107	$191,040
Statutory-basis net income	$ 82,962	$ 75,951
Policy acquisition costs	755	336
Earned but unbilled	–	(2,813)
GAAP-basis net income	$ 83,717	$ 73,474

Other significant accounting practices are as follows:

Investments

Bonds are principally stated at amortized cost using the interest method, which provides a consistent yield to maturity.

Prepayment assumptions for purposes of recognition of income and valuing of loan-backed bonds and structured securities were obtained from broker-dealer survey values or internal estimates. These assumptions are consistent with the current interest rate and economic environment. The retrospective method is used to value mortgage-backed securities. Under this method, the income recognized for a reporting period is measured as the difference between the amortized cost of the security at the end of the period and the amortized cost at the beginning of the period, plus any cash received during the period.

Common stocks are reported at market value as determined by the Securities Valuation Office ("SVO") of the NAIC and the related net unrealized gains (losses) are reported as a direct credit (charge) to surplus.

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

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 allowances for 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 $197,000 for the year ended December 31, 2002, as a result of the expenditures for land and building of $25,400,000 through 2002 (Pinnacol moved into and occupied its new office building in September 2002). No depreciation expense was recorded in 2001.

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

Cash on Hand and on Deposit

Cash on hand and on deposit includes funds that are held by the State of Colorado Treasury and invested in the state's pooled accounts, as well as amounts held in other bank accounts. In the accompanying statutory-basis balance sheets, Pinnacol has recorded warrants that have been issued, but not presented for payment, as a reduction of cash on hand and on deposit.

Uncollected Premiums

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

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

During 2002 and 2001, Pinnacol recorded a provision or wrote off a total of $3,628,000 and $2,610,000 respectively, in premiums receivable due to the unlikelihood of ultimate collection thereof. These amounts are reflected as provision for uncollectible premiums in the accompanying financial statements.

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

A significant portion of Pinnacol's premium receivable balances at December 31, 2002 and 2001 were from companies operating in the construction and services industries in Colorado. Recent studies indicate the construction industry represents 31% and 32% of Pinnacol's business in 2002 and 2001, respectively, and the services industry represents 25% and 23%, respectively, of Pinnacol's business in 2002 and 2001, with all other individual industries constituting a small fraction of Pinnacol's business.

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. For 2002 and 2001, estimated unbilled audit premiums receivable of $22,491,000 and $23,242,000, respectively, are included as uncollected premiums. These estimated receivables have been reduced by 10%, where applicable, to comply with statutory accounting principles.

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, 2002 and 2001 was $2,468,000 and $455,000, respectively. Pinnacol purchased new electronic data processing equipment in connection with its move into a new office building.

Office Furniture and Equipment

Office furniture and equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of five years. For statutory reporting, these are nonadmitted assets. The net book value of these assets at December 31, 2002 and 2001 was $4,880,000 and $453,000, respectively. Pinnacol purchased new office furniture and equipment in connection with its move into a new office building.

Other Assets

At December 31, 2002 and 2001, Pinnacol had prepaid assets totaling $751,000 and $773,000. For statutory reporting, these are nonadmitted assets.

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

Policyholder Dividends

The Board of Directors, at its discretion, determines the amount of policyholder dividends to be declared, based on Pinnacol's overall experience. No dividends were declared from surplus in 2002 or 2001.

Revenue Recognition

Premium revenue is recognized pro rata over the period the policy is effective.

Unpaid Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses represents management's best estimate of the ultimate net cost of all reported and unreported losses incurred through December 31. As permitted by state statute and in accordance with the surplus recovery plan filed with the Colorado Division of Insurance, effective January 1, 2001, Pinnacol discounts unpaid losses and loss adjustment expenses at 4.25%. The reserves for unpaid losses and loss adjustment expenses are estimated using 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 reserves for unpaid losses and loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

Unearned Premiums

Unearned premiums represent amounts either collected or billed and due from policyholders at December 31, but unearned at that date as they pertain to subsequent policy periods.

Subrogation

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

Reinsurance

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

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

Taxes

As a political subdivision of the state, Pinnacol is not subject to federal or state income taxes under a specific exemption granted under Section 501(c) of the Internal Revenue Code. 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 (3.8% in 2002), pursuant to Section 8-44-112(1)(a), C.R.S.

Employee Benefits

Pinnacol contributes to the Combined State and School Division Trust Fund ("CSSDTF"), a cost-sharing multiple-employer defined benefit pension plan administered by the Public Employees' Retirement Association of Colorado ("PERA"). CSSDTF provides retirement and disability, annual increases, and death benefits for members or their beneficiaries. All employees of Pinnacol are members of the CSSDTF. Title 24, Article 51 of the Colorado Revised Statutes, as amended, assigns the authority to establish benefit provisions to the State Legislature. PERA issues a publicly available annual financial report that includes financial statements and required supplementary information for CSSDTF. That report may be obtained by writing to PERA of Colorado, 1300 Logan Street, Denver, Colorado 80203 or by calling PERA at 303-832-9550 or 1-800-759-PERA (7372).

Plan members and Pinnacol are required to contribute at a rate set by statute. The contribution requirements of plan members and Pinnacol are established under Title 24, Article 51, Part 4 of the C.R.S., as amended. The contribution rate for members is 8.0% and for Pinnacol is 9.9% (For the entire year of 2002 and the initial six months of 2001 the contribution rate was 9.9% and for the last six months of 2001 the rate was 10.4%) of covered salary. A portion of Pinnacol's contribution (1.1% of covered salary) is allocated for the Health Care Trust Fund. Pinnacol's contributions to CSSDTF for the years ending December 31, 2002 and 2001 were $2,019,000 and $2,414,000, respectively; these amounts are equal to Pinnacol's required contributions for each year.

PERA also offers a voluntary 401(k) plan entirely separate from the defined benefit plan.

Pinnacol employees may accrue paid time off based on their length of service, subject to certain limitations on the amount which will be paid upon termination. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The

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

estimated liability for cumulative accrued paid time off of $1,375,000 and $1,373,000 at December 31, 2002 and 2001, respectively, is included in other liabilities in the accompanying financial statements.

Reclassifications

Certain reclassifications have been made to the 2001 statutory-basis financial statements to conform to the 2002 statutory-basis financial statement presentation. These primarily included the classification of warrants that have been issued but not presented for payment as a reduction of cash on hand and on deposit for both years presented.

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 which 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 current operating results.

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

Due to these factors, among others, the process to estimate loss and loss adjustment reserves at a point in time cannot provide an exact forecast of future payments. Rather, it produces a best estimate of liability as of a certain date. Management believes the reserves currently estimated to be adequate. While the ultimate liability may differ from the current estimate, management does not believe the difference will have a material effect, either adverse or favorable, on Pinnacol's financial position and results of operations.

At December 31, 2002, Pinnacol accrued $897,414,000 for unpaid losses and allocated loss adjustment expenses. As permitted by state statute, and in accordance with the surplus recovery plan filed with the Colorado Division of Insurance, a nontabular discount of $216,121,000 (computed at 4.25%) has been applied in the actuarial

2. Unpaid Losses and Loss Adjustment Expenses (continued)

calculation of these December 31, 2002 liabilities for unpaid losses and allocated loss adjustment expenses. A nontabular discount is calculated with reference to an estimated payout pattern and an interest rate, and without reference to actuarial tables. These tables incorporate an interest rate and in addition, factor in contingencies such as mortality, remarriage and inflation rates. The state statute allows reserves to be discounted at a rate of up to 6%.

At December 31, 2001, Pinnacol accrued $795,981,000 for unpaid losses and allocated loss adjustment expenses. A nontabular discount of $201,635,000 (computed at 4.25%) was applied in the actuarial calculation of this December 31, 2001 liability for unpaid losses and allocated loss adjustment expenses.

Pinnacol's discounted liability for unallocated loss adjustment expenses ("ULAE") was $26,899,000 at December 31, 2002 and $26,333,000 at December 31, 2001. The nontabular discount (computed at 4.25%) for ULAE was $6,100,000 and $6,504,000 at December 31, 2002 and 2001, respectively. ULAE represents the future cost of processing existing claims. Customarily such reserves will approximate 3% to 5% of unpaid losses and allocated loss adjustment expenses. As of December 31, 2002 and 2001, this percentage represented 3.0% and 3.3%, respectively.

2. Unpaid Losses and Loss Adjustment Expenses (continued)

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

	2002		2001	
	Unpaid Losses and Allocated Loss Adjustment Expenses	**Unallocated Loss Adjustment Expenses**	**Unpaid Losses and Allocated Loss Adjustment Expenses**	**Unallocated Loss Adjustment Expenses**
	(In Thousands)			
Balance at January 1	$795,981	$26,333	$708,104	$26,619
Additional amounts incurred related to:				
Current year—gross	349,016	17,409	280,038	20,150
Prior years	2,486	(1,388)	3,804	2,255
Total incurred	351,502	16,021	283,842	22,405
Reductions relating to payments for:				
Current year—gross	89,473	9,490	68,150	13,696
Prior years	160,596	5,965	127,815	8,995
Total paid	250,069	15,455	195,965	22,691
Balance at December 31	$897,414	$26,899	$795,981	$26,333

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and allocated loss adjustment expenses increased by $2,486,000 in 2002 and $3,804,000 in 2001. The increase in the reserve for prior year activity results primarily from the amortization of the discount.

3. Investments

Estimated fair value of investments in bonds is based on values published by the Securities Valuation Office of the NAIC. These values generally represent quoted market value prices for securities traded in the public marketplace or analytically determined values using bid or closing prices for securities not traded in the public marketplace. However, for certain investments, the SVO does not provide a fair value and the Company uses the amortized cost of the security as a substitute for fair value. As of December 31, 2002 and 2001, the fair value of bonds includes $754,014,000 and $525,616,000, respectively, of investments that were valued at amortized cost.

3. Investments (continued)

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

	2002				2001			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
	(In Thousands)							
U.S. Government obligations:								
Nonloan-backed bonds	$ 165,149	$18,069	$ –	$ 183,218	$152,848	$ 6,656	$ (383)	$159,121
Loan-backed bonds	9,804	–	–	9,804	10,389	–	–	10,389
Special revenue:								
Loan-backed bonds	173,460	–	–	173,460	302,100	–	–	302,100
Industrial and miscellaneous:								
Nonloan-backed bonds	655,267	14,959	(64)	670,162	375,710	14,008	(2,057)	387,661
Loan-backed bonds	49,613	–	–	49,613	89,962	–	–	89,962
	$1,053,293	$33,028	$(64)	$1,086,257	$931,009	$20,664	$(2,440)	$949,233

The amortized cost and fair value of investments in debt securities at December 31, 2002, by contractual maturity, are shown below. Contractual maturities may differ from actual maturities because the borrower may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	**Fair Value**
	(In Thousands)	
Due in one year or less	$ 6,779	$ 6,864
Due after one year through five years	127,080	133,394
Due after five years through ten years	395,966	414,038
Due after ten years	523,468	531,961
	$1,053,293	$1,086,257

Proceeds from sales of investments in bonds during 2002 and 2001 were $227,658,000 and $167,880,000 respectively. Gross gains of $9,800,000 and $5,917,000 and gross losses of $(7,036,000) and $(25,000) were realized on those sales for 2002 and 2001, respectively.

3. Investments (continued)

Unrealized gains and losses on investments in common stocks are reported directly in surplus and do not affect net income because the decline in fair value of these investments has been determined to be temporary as of December 31, 2002. The gross unrealized gains and losses on, and cost and fair value of, those investments are summarized as follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(In Thousands)		
At December 31, 2002				
Common stocks	$67,270	$ –	$(7,416)	$59,854
At December 31, 2001				
Common stocks	$20,483	$195	$(1,751)	$18,927

Major categories of net investment income (in thousands) for the years ended December 31, 2002 and 2001 are summarized as follows:

	2002	2001
Investment income		
Corporate and miscellaneous bonds	$59,488	$47,417
U.S. government obligations	12,110	12,911
Cash and other investments	2,085	1,351
Real estate*	873	–
Equity securities	548	197
Securities lending	401	322
Investment expenses	(1,145)	(594)
Net investment income	74,360	61,604
Net realized gains	2,764	5,892
Investment income	$77,124	$67,496

* Includes occupancy of Company-owned property of $873,000 in 2002 and $0 in 2001. Pinnacol charges itself rent expense, which is included in operating expenses incurred, and records investment income for the estimated fair value of rental income on its own office building.

3. Investments (continued)

Other invested assets totaled $10,046,000 and $7,409,000 for the years ended December 31, 2002 and 2001, respectively. These investments are primarily pledged assets in support of letters of credit requirements for Pinnacol's assumed reinsurance contracts.

4. Securities Lending Transactions

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

At December 31, 2002 and 2001, Pinnacol had certain outstanding securities with a fair value of $551,156,000 and $439,126,000, respectively.

Pinnacol has no additional credit risk exposure to borrowers. The contract with the broker-dealer requires them to indemnify Pinnacol if they fail to return the securities or fail to pay Pinnacol for income distributions by the securities' issuers while the securities are on loan. All securities lending transactions can be terminated on demand by either Pinnacol or the broker-dealer. Pinnacol recognized $401,000 and $322,000 of additional investment income during the year ended December 31, 2002 and 2001, respectively, related to securities lending transactions.

5. Transactions with the State

The state contracts with Pinnacol pursuant to its self-funded insurance program. The state reimburses Pinnacol for all workers' compensation claims and loss adjustment expenses as incurred, plus a premium for stop loss coverage. Pinnacol accounts for the state contract as an uninsured and partially insured accident and health plan whereby Pinnacol does not record the premium revenue or loss and loss adjustment expenses and related receivables and payables for state workers' compensation costs. Reimbursements billed to the state under this contract were $23,232,000 and $20,677,000 in 2002 and 2001, respectively.

6. Reinsurance

Pinnacol purchases catastrophic reinsurance for risks in excess of its retention limits on workers' compensation insurance policies written. Should the reinsurer be unable to meet its obligations under the reinsurance contract, Pinnacol would remain liable for amounts ceded to its reinsurer. Prior to January 1, 2002, Pinnacol had reinsurance coverage for individual workers' compensation accidents of up to $20,000,000 in excess of its retention of $6,000,000 per occurrence. No catastrophic reinsurance was in place from January 1, 2002 through April 30, 2002. Effective May 1, 2002, Pinnacol had reinsurance coverage for individual workers compensation accidents of up to $20,000,000 in excess of its retention of $20,000,000 per occurrence. The reinsurance expense associated with this coverage was $358,000 and $101,000 in 2002 and 2001, respectively. Pinnacol's management is not aware of any catastrophes that would result in penetration of these limits.

In order to continue to accommodate the employees of Colorado employer companies that reside outside of Colorado, Pinnacol executed a reinsurance contract with the Fireman's Fund Insurance Company (a California corporation). The contract is designed as a 100% quota share arrangement with Pinnacol acting as the assuming company. The effective date of the contract was September 1, 2001. This replaced an arrangement with Reliance Insurance Company that terminated on August 31, 2001. Claims incurred prior to August 31, 2001 will continue to run out under the Reliance agreement. This contract was terminated December 31, 2002, and management continues to evaluate alternative programs to replace the Fireman's Fund arrangement. Based on the small percentage of this business compared to total earned premium, management does not believe the lack of this accommodation will have a significant impact on the financial condition of Pinnacol.

7. Policyholders' Surplus

Pinnacol had policyholders' surplus of $215,510,000 and $143,716,000 as of December 31, 2002 and 2001, respectively. This is below regulatory levels considered acceptable in the industry. In response to Section 8-45-111, C.R.S., management of Pinnacol has developed, filed and received approval, effective January 1, 2001, of a long-range plan (the "Plan") to strengthen its financial position and attain "a reasonable policyholders' surplus." The Plan calls for Pinnacol to achieve the "company action level of risk-based capital." Risk-based capital is a regulatory measure of capital adequacy and the "company action level" is the minimum level of risk-based capital required by insurance regulation (i.e., the level at which the Division of Insurance requires a plan for corrective action). Risk-based capital includes factors that relate to the size of the entity, the perceived risks in the company's business, and also factors relating to the insurance industry in general.

7. Policyholders' Surplus (continued)

The Plan focuses on five critical areas for the ultimate development of a reasonable level of surplus: (1) expense control, (2) loss cost control, (3) appropriate pricing, (4) investment yield, and (5) leadership. The Plan also includes a periodic reporting process to keep the Colorado Division of Insurance informed of progress toward the goal of "a reasonable level of surplus."

The risk-based capital calculation allows a company to compute surplus using discounted tabular reserves, which are indemnity reserves that are calculated using discounts determined with reference to actuarial tables. Nontabular discounted reserves must be adjusted back to get to adjusted capital, as defined, for risk-based capital purposes. These reserves are calculated with reference to an estimated payout pattern and interest rate, and without reference to actuarial tables. Pinnacol has discounted its reserves by $222,221,000 in total. For purposes of calculating risk-based capital only, Pinnacol calculated the tabular discount for certain case-based indemnity reserves of $121,542,000. Accordingly, $100,679,000 of the total discount relates to nontabular reserves, which when adjusted, yields a surplus of $114,831,000 for risk-based capital purposes. This is below the benchmarks established for risk-based capital. Specifically, the company action level for risk-based capital requires $172,828,000 as of December 31, 2002.

There is no assurance that this is the level of surplus that will be necessary to achieve the Plan. The Plan as filed and approved by the Colorado Division of Insurance calls for the achievement of a level of risk-based capital, not a specific level of statutory surplus. The Plan defines the procedure for reducing the reserve discount rate when certain surplus levels (after discount) are attained. The discount rate will be reduced in one half of a percent increments. Pinnacol's surplus at December 31, 2002, of $215,510,000 meets the surplus requirement defined in the Plan. Accordingly, the reserve discount rate will be reduced during the first quarter of 2003, by 1% (two increments), or $40,913,000, as provided in the Plan.

8. Accounting Changes

Pinnacol prepares its statutory financial statements in conformity with accounting practices prescribed or permitted by the Division of Insurance in the State of Colorado (the "Division"). Effective January 1, 2001, the Division required that insurance companies domiciled in the State of Colorado prepare their statutory-basis financial statements in accordance with the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* subject to any deviations prescribed or permitted by the State of Colorado Insurance Commissioner.

8. Accounting Changes (continued)

Accounting changes adopted to conform to the provisions of the NAIC *Accounting Practices and Procedures Manual* are reported as changes in accounting principles. The cumulative effect of changes in accounting principles is reported as an adjustment to unassigned surplus in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principles had been applied retroactively for all prior periods. As a result of these changes, Pinnacol reported a change of accounting principle that increased policyholders' surplus by $5,384,000 as of January 1, 2001, related to the accounting for earned but unbilled premiums.

9. 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 or the results of operations of Pinnacol.

Pinnacol is contingently liable for approximately $71,199,000 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.

At December 31, 2002, the aggregate amount of annuities due from all life insurers equaled the amount of the reserves eliminated when the annuities were purchased and consisted of the following (in thousands):

Life Insurance Company and Location	Loss Reserves Eliminated by Annuities
GE Assurance, Virginia	$44,276
SAFECO, Washington	22,597
Allstate, Illinois	1,742
Metlife, New York	2,208
Liberty Life Assurance Company, Massachusetts	376
	$71,199

Other Financial Information

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Report of Independent Auditors on Other Financial Information

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

Our audits were conducted for the purpose of forming an opinion on the statutory-basis financial statements taken as a whole. The accompanying supplemental investment disclosure is presented to comply with the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and is not a required part of the statutory-basis financial statements. Such information has been subjected to auditing procedures applied in our audit of the statutory-basis financial statements and, in our opinion, is fairly stated in all material respects in relation to the statutory-basis financial statements taken as a whole.

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

Ernst & Young LLP

February 14, 2003

Pinnacol Assurance

Investment Risks Interrogatories

Pinnacol's total admitted assets as reported on page two of its Annual Statement submitted to the Division of Insurance as of and for the year ended December 31, 2002 is $1,269,167,910.

1. 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 *Securities Valuation Office Practices and Procedures Manual* as exempt, (ii) property occupied by Pinnacol, and (iii) policy loans:

Investment Category/Issuer	Amount	Percentage of Total Admitted Assets
Bonds:		
a. Verizon Wireless	$29,722,834	2.3%
b. IBM Corporation	26,029,781	2.1%
c. Standard Credit Card	24,727,849	1.9%
d. Ford Motor Co.	23,705,523	1.9%
e. General Electric	20,409,645	1.6%
f. Dupont	19,876,952	1.6%
g. Citigroup Inc.	14,977,744	1.2%
h. Target Corporation	14,954,026	1.2%
i. Emerson Electric	14,942,026	1.2%
j. MBNA Master Card TR	14,899,645	1.2%

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

Bonds			Preferred Stocks		
NAIC Rating	Amount	Percentage of Total Admitted Assets	NAIC Rating	Amount	Percentage of Total Admitted Assets
NAIC-1	$ 946,322,500	74.6%	P/PSF-1		
NAIC-2	106,970,898	8.4%	P/PSF-2		
NAIC-3			P/PSF-3		
NAIC-4			P/PSF-4		
NAIC-5			P/PSF-5		
NAIC-6			P/PSF-6		
	$1,053,293,398			(none)	

Pinnacol Assurance

Investment Risks Interrogatories (continued)

3. Assets held in foreign investments are less than 2.5% of Pinnacol's total admitted assets. (none)

4. Assets held in Canadian investments are less than 2.5% of Pinnacol's total assets. (none)

5. Assets held in investments with contractual sales restrictions are less than 2.5% of Pinnacol's total admitted assets. (none)

6. 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 *Securities Valuation Office Practices and Procedures Manual* as exempt or Class 1).

Investment Category/Issuer	**Amount**	**Percentage of Total Admitted Assets**
a. Vanguard Total Stock Market Index	$52,532,083	4.1%
b. T Rowe Price Small Cap	7,321,856	.6%

7. Assets held in nonaffiliated, privately placed equities are less than 2.5% of Pinnacol's total admitted assets. (none)

8. Assets held in general partnership interests are less than 2.5% of Pinnacol's total admitted assets. (none)

9. Mortgage loans reported in Schedule B are less than 2.5% of Pinnacol's total admitted assets. (none)

10. Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in Schedule A are less than 2.5% of Pinnacol's total admitted assets.

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

	At Year End		Unaudited At End of Each Quarter		
			1st Quarter	2nd Quarter	3rd Quarter
	Amount	Percentage of Total Admitted Assets	Amount	Amount	Amount
a. Securities lending (do not include assets held as collateral for such transactions)	$551,156,323	43.4%	$503,612,598	$670,872,573	$512,804,073
b. Repurchase agreements					
c. Reverse repurchase agreements					
d. Dollar repurchase agreements					
e. Dollar reverse repurchase agreements					

12. Warrants not attached to other financial instruments, options, caps, and floors are:

	Owned		Written	
	Amount	Percentage of Total Admitted Assets	Amount	Percentage of Total Admitted Assets
a. Hedging	(none)			
b. Income generation	(none)			
c. Other	(none)			

13. Pinnacol's potential exposure (defined as the amount determined in accordance with the NAIC *Annual Statement Instructions*) for collars, swaps, and forwards as of the following dates:

	At Year End		Unaudited At End of Each Quarter		
			1st Quarter	2nd Quarter	3rd Quarter
	Amount	Percentage of Total Admitted Assets	Amount	Amount	Amount
a. Hedging	(none)				
b. Income generation	(none)				
c. Replications	(none)				
d. Other	(none)				

14. Pinnacol's potential exposure (defined as the amount determined in accordance with the NAIC *Annual Statement Instructions*) for futures contracts as of the following dates:

	At Year End		Unaudited At End of Each Quarter		
			1st Quarter	2nd Quarter	3rd Quarter
	Amount	Percentage of Total Admitted Assets	Amount	Amount	Amount
a. Hedging	(none)				
b. Income generation	(none)				
c. Replications	(none)				
d. Other	(none)				

Pinnacol Assurance

Investment Risks Interrogatories (continued)

15. The 10 largest investments included in the write-ins for invested assets category included on the Summary Investment Schedule are as follows:

Investment	Amount	Percentage of Total Admitted Assets
a. Wells Fargo—Pledge Account	$10,046,162	.8%
b.		
c.		
d.		
e.		
f.		
g.		
h.		
i.		
j.		

These assets are used to support various letters of credit issued by Wells Fargo on behalf of Pinnacol.

Pinnacol Assurance

Summary Investment Schedule

Investment Categories	Gross Investment Holdings* Amount	Gross Investment Holdings* Percentage of Gross Investment Holdings	Admitted Assets as Reported in the Annual Statement Amount	Admitted Assets as Reported in the Annual Statement Percentage of Total Admitted Assets
Bonds:				
U.S. treasury securities	$ 120,186,828	10.02%	$ 120,186,828	10.02%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	44,962,347	3.75%	44,962,347	3.75%
Issued by U.S. government-sponsored agencies				
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	9,804,471	.82%	9,804,471	.82%
Issued by FNMA and FHLMC	6,169,882	.51%	6,169,882	.51%
Privately issued				
CMOs and REMICs:				
Issued by FNMA and FHLMC	347,138,715	28.94%	347,138,715	28.94%
Privately issued and collateralized by MBS issued or guaranteed by GNMA, FMNA, or FHLMC	49,612,692	4.14%	49,612,692	4.14%
All other privately issued				
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	475,418,464	39.63%	475,418,464	39.63%
Unaffiliated foreign securities				
Affiliated securities				

Pinnacol Assurance

Summary Investment Schedule (continued)

Investment Categories	Gross Investment Holdings* Amount	Gross Investment Holdings* Percentage of Gross Investment Holdings	Admitted Assets as Reported in the Annual Statement Amount	Admitted Assets as Reported in the Annual Statement Percentage of Total Admitted Assets
Equity interests:				
Investments in mutual funds	$ 59,853,939	4.99%	$ 59,853,939	4.99%
Preferred stocks:				
Affiliated				
Unaffiliated				
Publicly traded equity securities (excluding preferred stocks):				
Affiliated				
Unaffiliated				
Other equity securities:				
Affiliated				
Unaffiliated				
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	25,203,477	2.10%	25,203,477	2.10%
Property held for production of income				
Property held for sale				
Collateral loans				
Policy loans				
Receivables for securities				
Cash and short-term investments	51,167,335	4.27%	51,167,335	4.27%
Write-ins for invested assets	10,046,162	.84%	10,046,162	.84%
Total invested assets	$1,199,564,312	100%	$1,199,564,312	100%

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

Pinnacol Assurance

Note to Supplemental Investment Risks Interrogatories and Summary Investment Schedule

December 31, 2002

Basis of Presentation

The accompanying interrogatories and schedule presents selected statutory-basis financial data as of December 31, 2002 and for the year then ended for purposes of complying with the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and agrees to or is included in the amounts reported in Pinnacol Assurance's 2002 Statutory Annual Statement as filed with the Colorado Division of Insurance.

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Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of the Financial Statements in Accordance with *Government Auditing Standards*

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

We have audited the statutory-basis financial statements of Pinnacol Assurance ("Pinnacol") as of and for the year ended December 31, 2002, and have issued our report thereon dated February 14, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Pinnacol's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and 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 that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Pinnacol's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

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.

Ernst + Young LLP

February 14, 2003

Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Audited Statutory-Basis Financial Statements

December 31, 2002

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