KPMG

PINNACOL ASSURANCE

Statutory Financial Statements and
Other Financial Information and
Comments on Internal Controls and Procedures

December 31, 2003 and 2002

(With Independent Auditors' Report Thereon)

KPMG LLP
Suite 2700
707 Seventeenth Street
Denver, CO 80202

April 30, 2004

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

We have completed the financial audit of Pinnacol Assurance (Pinnacol) for the year ended December 31, 2003. 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 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 which we have issued as a result of this engagement are set forth in the table of contents which follows.

KPMG LLP

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PINNACOL ASSURANCE

Statutory Financial Statements and
Other Financial Information and
Comments on Internal Controls and Procedures

Years ended December 31, 2003 and 2002

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PINNACOL ASSURANCE

Report Summary

December 31, 2003

Authority and Purpose/Scope of the Audit

This audit was conducted under the authority of Section 8-45-121(2), C.R.S. which authorizes an annual audit of Pinnacol Assurance 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, 2003, 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 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 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, 2003. 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 (AU Section 380), and the Statement of Auditing Standards (SAS) No. 61, *Communication with Audit Committees*, as amended, 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 and Unusual Transactions –** There were no changes to significant accounting policies in 2003.

3. **Management Judgments and Accounting 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:

    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 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, 2003 the admitted value of uncollected premiums is estimated to be $48,662,000.

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 2003 estimated net unbilled audit premiums receivable of $16,869,000 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, 2003 Pinnacol has accrued $1,024,429,161 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 2003 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%. As approved by the Division and in accordance with the Division's interpretation of the surplus recovery plan filed with the Division, Pinnacol discounted its actuarially determined unpaid balances by a factor of 3.75% in 2003 and 4.25% in 2002.

4. **Audit Adjustments and Uncorrected Misstatements** – The statutory financial statements incorporated herein contain no differences with Pinnacol's Annual Statement as filed with the Division for the year ended December 31, 2003. There were no audit adjustments.

5. **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.

6. **Consultation With Other Accountants** – We are not aware of any instances of management consulting with other accountants regarding auditing and accounting matters during 2003, including the type of opinion rendered in connection with our audit.

7. **Other Matters**

KPMG 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.

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

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

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

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Summary of Major Audit Findings

Improvement of Internal Controls in Information Technology

Pinnacol has several computer systems that assist in the day-to-day operations of the Company including the Pinnacol network, Internet firewall, Windows 2000, Cisco Internetwork Operating System, and the Workers' Compensation Information System (WCIS). Information technology assessment or security audits of WCIS and the Pinnacol network, for the purpose of monitoring system access, are not conducted on a regular scheduled basis. Several vulnerabilities in network security were identified in the servers that support key financial systems. Policies and procedures are currently not in place to help ensure network security vulnerabilities (such as the risk of unauthorized intruders) are not introduced into the operational environment. Intrusion detection and detailed auditing mechanisms on the Pinnacol internal network and on key financial systems are limited.

Claims Reserve Authority Levels

Pinnacol's claims representatives are responsible for day-to-day claims operations including setting reserve amounts. Per Company policy, as documented in the Claims Manual, claims reserve authority levels are in place which are based on the experience of the respective claims representatives. However, reserve authority thresholds are not enforced in the WCIS system. The dialogue box that should be generated by WCIS when a threshold is reached that requires additional information and indication of higher-level approval was not functional. When the dialogue box was functional, there were instances where the required information had not been entered by the claims representative.

Improvement of Management Review Controls by Finance Managers

Pinnacol's Finance Department has managers that are responsible for the oversight of the department. The earned but unbilled premium reserve calculation prepared by the internal actuary was reviewed by management; however, when management was asked to explain details regarding the methodology behind the calculation, they were unable to do so. The loss rollforward disclosure prepared by the Finance staff was reviewed by management; however, the information used in the rollforward was inaccurate and did not agree to the underlying supporting documentation such as the loss run, Schedule P of the Annual Statement filed with the Division, and the income statement.

Quality Improvement Process Results and Findings

Pinnacol has a Quality Improvement Process (QIP) in place to ensure the completeness and accuracy of the work performed by individual employees in various departments. Specifically in the Underwriting and Claims areas, policy specialists and claims specialists are responsible for performing four audits per underwriter/claims representative on a quarterly basis. Using predetermined questionnaires, the policy specialists and claims specialists perform the audits by essentially re-performing the work done by the underwriters and claims representatives to ensure their compliance with various requirements as set forth in the questionnaires. However, there is no formal follow-up required with respect to the results/findings of the QIP audits. Therefore, if a significant error is found and recorded by a policy/claims specialist during an audit, there is no formal process to follow up with the respective underwriter/claims representative to ensure that errors or omissions are corrected.

(Continued)

Gainsharing Plan Document

The gainsharing plan is an employee bonus plan that rewards teams for positive results based on quarterly net income and customer satisfaction measures. The gainsharing plan is part of the total compensation package, which includes base salary, variable pay (i.e., gainsharing), and benefits. Pinnacol's management collects salary survey data in order to benchmark the base salaries, for employees that are eligible to participate in the gainsharing plan, and salary and benefits survey data to develop total compensation, but does not compare market data based on a combined compensation including base salary and potential gainsharing. Information pertaining to the gainsharing plan is documented in the Gainsharing Incentive Compensation 2000 Plan Design Document dated December 17, 1999, as well as on Pinnacol's intranet. A payout matrix is established to reflect the desired performance of each team related to the bonuses. Though the payout matrices are updated annually and documented in the Employee Handbook, the Gainsharing Incentive Compensation Plan Design Document is not updated to reflect changes to the plan.

Compliance With Division of Insurance Regulations

Pinnacol's Association Program, of which the Association Dividend Plan is a part, began in 1988 and is designed to promote peer safety and loss control through various employer trade and industry groups. In exchange for specified safety and loss control measures, association membership becomes eligible for a dividend return according to levels set by the Pinnacol Board of Directors. Rate filing requirements were instituted for Pinnacol in 1990. In 1997, prior approval language in Section 10-4-401(3), C.R.S. was implemented, requiring that all rates and rules be subject to prior approval. Based on discussions with and documentation provided by Colorado Division of Insurance (the Division), Pinnacol has not properly filed information about the Association Dividend Plan with the Division in accordance with the above statute and Regulation 5-1-10(C)(2).

Summary of Pinnacol's Responses

A summary of 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 Findings and Recommendations Section of our report.

There were no recommendations in the prior audit report dated February 14, 2003 (issued by Ernst & Young LLP).

PINNACOL ASSURANCE

Recommendation Locator

December 31, 2003

Recommendation Locator

Recommendation number	Page number	Recommendation summary	Pinnacol response	Implementation date
1	7	Pinnacol should review its internal controls in Information Technology related to network security to improve their effectiveness.	Agree	November 30, 2004
2	9	Pinnacol should reevaluate its system controls with respect to claims reserve authority levels to improve their effectiveness.	Agree	July 31, 2004
3	10	Pinnacol should enhance its management review process to ensure completeness and accuracy of the information reviewed.	Agree	April 1, 2004
4	11	Pinnacol should enhance its QIP process by requiring formal follow-up on results to ensure proper corrections are made.	Agree	April 1, 2004
5	12	Pinnacol should update the Gainsharing Incentive Compensation Plan Design Document for changes made to the plan and review survey comparisons to include base salary and gainsharing compensation.	Partially agree	4th Quarter, 2004
6	13	Pinnacol should submit documentation for the Association Dividend Plan and ensure that final filing with the Colorado Division of Insurance is complete.	Agree	June 24, 2004

PINNACOL ASSURANCE

Description of Pinnacol Assurance

December 31, 2003

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. 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.

As of July 1, 2002 Pinnacol Assurance's name was officially changed from Colorado Compensation Insurance Authority to Pinnacol Assurance (Pinnacol).

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 chief executive officer. This is in accordance with the applicable statutes of the state, with administration under the direction of a chief executive officer. 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. Under the applicable 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 $327,298,000 and $215,510,000 as of December 31, 2003 and 2002, respectively. The increase in surplus is primarily related to current year net income, which showed significant improvement due to a favorable loss ratio. A continued reduction in claim frequency helped to reduce the current year loss ratio. The increase was offset by a decrease in the discount rate from 4.25% to 3.75% as approved by the Division and in accordance with the Division's interpretation of the surplus recovery plan filed with the Division. The decrease resulted in an increase to losses incurred of $20,456,000 in 2003. The discount rate is used to calculate the present value of unpaid losses and loss adjustment expenses.

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."

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

Improvement of Internal Controls in Information Technology

Pinnacol had premiums earned of approximately $487 million and losses incurred of approximately $373 million at December 31, 2003. Pinnacol provided workers' compensation insurance to approximately 57,000 policyholders in 2003. Approximately 13,000 claims were open at December 31, 2003. Approximately 50,000 new reported claims were processed by the Workers' Compensation Information System (WCIS) and approximately 52,000 claims were closed by WCIS as of and for the year ended December 31, 2003.

Pinnacol has several computer systems that assist in the day-to-day operations of the Company, including the Pinnacol network, Internet firewall, Windows 2000, Cisco Internetwork Operating System, and WCIS. The Pinnacol network and Internet firewall enable the secure sharing of information throughout Pinnacol and outside of Pinnacol. Operating systems such as Windows 2000 and Cisco Internetwork Operating System enable the use of applications necessary for the Company's operations. WCIS is a system that supports, most importantly, the underwriting and claims processes among others.

During a review of these computer systems we noted the following:

- Information technology assessment or security audits of WCIS and the Pinnacol network for the purpose of monitoring system access are not conducted on a regular scheduled basis. Though it is noted that these assessments have been done in the past (the most recent assessment was done in April 2001), there is no schedule in place to ensure they are done regularly. The potential impact of not conducting these assessments is that vulnerabilities and unauthorized user access may not be identified, and in turn, mitigated.
- A vulnerability mitigation strategy and a pre-operational test environment are not in place. The latest patches (software security fixes) have not been applied to operating systems and applications. Several vulnerabilities (such as the risk of unauthorized intruders) in network security were identified on the servers that support key financial systems. The potential impact of these vulnerabilities is the possibility that financial information may be altered and/or destroyed.
- Policies and procedures are currently not in place to help ensure network security vulnerabilities (such as the risk of unauthorized intruders) are not introduced into the operational environment. The potential impact of a lack of policies and procedures for network security is the possible introduction of vulnerabilities into the production environment that could lead to the destruction or alteration of financial information.
- Intrusion detection and detailed auditing mechanisms are limited on the Pinnacol internal network and on key financial systems. The potential impact of limited intrusion detection and detailed auditing is the possibility that attempts to gain unauthorized access to key financial systems may go undetected.

Recommendation No. 1:

Pinnacol should improve its internal controls in Information Technology through the following:

a. Develop a formal schedule to conduct periodic information technology assessments and security audits at least annually to minimize exposure to internal and external threats that could compromise financial, customer, employee, and/or other sensitive information.

b. Implement a vulnerability mitigation strategy and a pre-operational test environment for all production systems and conduct both internal and external vulnerability/security audits, on a regular schedule, of the Pinnacol network and key systems. Additionally, apply/enable the latest patches (software security fixes) to both operating systems and applications.

c. Develop and disseminate policies that address information security standards for each information system. This should include ensuring that procedures are in place to help system administrators address specific systems (i.e., Windows 2000, Cisco IOS) with respect to security administration.

d. Deploy intrusion detection capabilities that will help protect key financial systems from compromise. Additionally, consider enabling audit capabilities at both the database and operating system level that would detect intrusions.

Pinnacol Assurance Response:

a. Agree. A formal schedule to conduct periodic IT assessments and security audits at least annually will be developed and published by July 31, 2004.

b. Agree. A vulnerability mitigation strategy and pre-operational test environment for production systems will be implemented by August 31, 2004. A regular schedule of internal and external security audits will be developed and published by July 31, 2004. The latest relevant security-oriented patches to key operating systems and applications will be installed by August 31, 2004. To further mitigate risk, an internal firewall will be installed to protect key financial systems. The firewall will be operational by June 30, 2004.

c. Agree. Policies and procedures addressing security standards for each system will be developed and published by September 30, 2004.

d. Agree. Intrusion detection capabilities will be implemented by November 30, 2004. Reasonable auditing capabilities will be enabled at the database and operating system levels by October 31, 2004.

Claims Reserve Authority Levels

The Company establishes reserves for individual claims made for insured workers' compensation incidents. These reserves are set at amounts that estimate the expected claims settlement amounts. The reserve for unpaid losses and loss adjustment expenses was approximately $1 billion as of December 31, 2003.

Pinnacol's claims representatives are responsible for day-to-day claims operations, including setting reserve amounts. Per Company policy, as documented in the Claims Manual, claims reserve authority levels are in place which are based on the experience of the respective claims representatives. If a claims representative tries to set a reserve for a claim in excess of their authority level, the Workers' Compensation Information System (WCIS) should generate a dialogue box indicating that the representative's threshold limit has been reached or exceeded, and additional information, including an indication or approval from a higher-level claims representative, is required.

During a review of these reserve authority levels we noted the following:

- Reserve authority thresholds are not enforced in the WCIS system. The WCIS system allows reserves to be set by claims representatives in excess of their authority limits. The potential impact of not enforcing reserve authority thresholds is that reserves may be set higher than appropriate, or not set high enough, and therefore overstated/understated.

- The dialogue box that should be generated by WCIS when a threshold is reached that requires additional information and indication of higher-level approval was not always functional. Additionally, when the dialogue box generated by WCIS was functional, there were instances where the required information, such as documentation of consultation with a higher-level representative as to the appropriateness of the reserve, had not been entered by the claims representative. The potential impact of a dysfunctional dialogue box is that reserves may be misstated.

Recommendation No. 2:

Pinnacol should reevaluate its system with respect to claims reserve authority levels through the following:

a. The higher-level representative should receive a report indicating that their approval was used to prevent claims representatives from having the capability to enter a higher-level representative's approval without their knowledge.

b. Ensuring the functionality of the dialogue box requiring additional information and higher-level approval.

Pinnacol Assurance Response:

a. Agree. We will implement a report or some other mechanism that notifies people when their approval has been claimed on reserve changes. The report will be implemented by July 31, 2004.

b. Agree. The dialogue box error will be fixed by June 30, 2004.

Improvement of Management Review Controls by Finance Managers

Pinnacol's Finance Department has managers that are responsible for the oversight of the department. Specifically, managers are responsible for reviewing the earned but unbilled premium reserve (which is a reserve for audit premiums due from policyholders after the respective policy period has expired based on audits performed by Pinnacol) calculation performed by Pinnacol's internal actuary for completeness, accuracy, and reasonableness. The reserve for earned but unbilled premium is approximately $17 million as of December 31, 2003. Also, managers are responsible for reviewing financial statement footnote disclosures prepared by Finance staff, particularly the loss rollforward disclosure, for completeness, accuracy and reasonableness. The rollforward of loss reserves includes the prior year loss reserve balance, current year loss expenses, current year loss payments, and the ending current year loss reserve balance.

During a review of the earned but unbilled premium reserve calculation and the loss rollforward disclosure we noted the following:

- The earned but unbilled premium reserve calculation prepared by the internal actuary was reviewed by management; however, when management was asked to explain details regarding the methodology behind the calculation, they were unable to do so. The potential impact of inadequate management review is that financial information could be misstated; however, the earned but unbilled premium reserve recorded by Pinnacol appeared reasonable, and there were no audit adjustments proposed to change the amount recorded.

- The loss rollforward disclosure prepared by the Finance staff was reviewed by management; however, the information used in the rollforward did not agree to the underlying supporting documentation, such as the loss run (which includes individual claim reserves and payments from WCIS), Schedule P of the Annual Statement filed with the Division, the income statement, and the statement of cash flows. For example, total incurred loss and loss adjustment expenses per the loss rollforward typically agree to incurred loss and loss adjustment expenses per the income statement, and total paid loss and loss adjustment expenses per the loss rollforward typically agree to loss payments per the statement of cash flows. Pinnacol's incurred losses and loss adjustment expenses per the loss rollforward differed from the income statement by approximately $3 million, and paid losses and loss adjustment expenses differed from the statement of cash flows by approximately $3 million. The potential impact of inadequate management review is that financial information could be misstated.

Recommendation No. 3:

Pinnacol should enhance its management review process by:

a. Ensuring that management has a thorough understanding of all items being reviewed. By signing off on documentation to indicate review, management should be effectively ensuring that they fully understand, agree with, and approve that documentation.

b. Thoroughly evaluating all information and amounts used by Finance staff by re-performing the work on a test-basis and vouching information back to underlying supporting documentation to ensure completeness and accuracy.

Pinnacol Assurance Response:

a. Agree. We will ensure original work is thoroughly documented, reviewed and understood prior to sign off occurring.

b. Agree. We will evaluate all information and amounts by periodically re-performing computations to ensure the understanding of the computation is accurate.

Quality Improvement Process Results and Findings

Pinnacol has a Quality Improvement Process (QIP) in place to ensure the completeness and accuracy of the work performed by individual employees in various departments. Specifically in the Underwriting and Claims areas, policy specialists and claims specialists are responsible for performing four audits per underwriter/claims representative on a quarterly basis. There are approximately 53 underwriters and 74 claims representatives as of December 31, 2003. Using predetermined questionnaires, the policy specialists and claims specialists perform the audits by essentially re-performing the work done by the underwriters and claims representatives to ensure compliance with various requirements as set forth in the questionnaires. The work of the underwriter/claims representative is then given a percentage score by the policy/claims specialist based on the outcome of the audit. The underwriter/claims representative is provided with the results of the audits and is given the opportunity to discuss the results with the respective specialist to identify ways to improve. Underwriters/claims representatives who score below the tolerable percentage, as defined by their respective team/department, for two quarters and have not shown improvement are subject to disciplinary action as deemed necessary by the respective business director.

(Continued)

During a review of the Underwriting and Claims QIP processes we noted the following:

- There is no formal follow-up required with respect to the specific results/findings of the QIP audits. Therefore, if a significant error is found and recorded by a policy/claims specialist during an audit, there is no formal process to follow up with the respective underwriter/claims representative to ensure that errors or omissions are corrected. The potential impact of not ensuring that errors and omissions are corrected, with respect to Underwriting and Claims, is that premiums, paid claims, and/or reserves may be misstated.

Recommendation No. 4:

Pinnacol should enhance its QIP process by:

- Implementing mandatory follow-up procedures with respect to QIP results and findings to ensure that errors and/or omissions identified by the policy/claims specialists are corrected.

Pinnacol Assurance Response:

Agree. We have implemented a QIP alert system that notifies the team leader in the event of an overall QIP score that is less than 82.5% and/or significant errors that are detected during the audit regardless of the overall score. Examples of significant errors include penalty situations in claim handling and misclassification of SIC code in underwriting. The team leader will ensure that errors and/or omissions identified in the QIP audit are corrected.

Gainsharing Plan Document

The gainsharing plan is an employee incentive plan that rewards teams for positive results based on Pinnacol's quarterly net income and customer satisfaction measures. The program applies to all active, full-time, and part-time employees, except for executives and marketing personnel. The gainsharing incentive is calculated as a percentage of quarterly eligible earnings per employee, with a maximum payout of 20% of eligible earnings. The gainsharing plan was established in 1999 as part of the total compensation package, which includes base salary, variable pay (i.e., gainsharing), and benefits. According to management, Pinnacol sets the midpoints of base salary ranges for employees that are eligible for the gainsharing plan at the 50^{th} percentile of the market using both local and national salary survey data for the insurance industry. The gainsharing plan payout could potentially increase the employee's actual compensation (base salary and gainsharing) by 20%.

For the first three quarters of 2003 Pinnacol paid out approximately $2.9 million in gainsharing awards, and accrued approximately $716 thousand for the fourth quarter, for a total of approximately $3.6 million. This was an average payout of approximately 17.8% of eligible earnings per employee that received a payment during 2003.

The gainsharing plan is a self-funded plan (i.e., the plan is funded by the positive results generated by the teams). Information pertaining to the gainsharing plan is documented in the Gainsharing Incentive Compensation 2000 Plan Design Document (the Document), dated December 17, 1999, as well as Pinnacol's intranet. A payout matrix is established annually for each team to reflect the performance measures related to the calculation of their bonus. The matrix, net income targets, and expense management targets are updated annually in the Employee Handbook.

The purpose of the payout matrix is to quantify the performance measures for each team. For example, business groups (teams comprised of underwriters, claims representatives, etc.) are measured based on a team's revenue in

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excess of expenses as well as key customer performance factors. Support groups (departments such as Finance) are measured based on revenue generators (i.e., number of policyholders, number of claimants, number of accounts payable checks, etc.) as well as customer satisfaction from internal customers (other Pinnacol departments/employees).

During our audit we noted the following:

- Pinnacol's management collects salary survey data in order to benchmark the base salaries for employees that are eligible to participate in the gainsharing plan, and salary and benefits survey data to develop total compensation, but does not compare market data based on a combined compensation including base salary and potential gainsharing.
- Though the payout matrices are updated annually and documented in the Employee Handbook, the Document is not updated annually to reflect changes to the plan. The Document should be updated annually to reflect changes to the payout matrices and any other changes to the gainsharing plan.

Recommendation No. 5:

Pinnacol should improve the gainsharing plan by:

a. Reviewing the survey comparisons with the insurance industry to include base salary, potential gainsharing compensation, and benefits to ensure appropriate pay levels.

b. Improving the documentation with respect to gainsharing by formally updating the Gainsharing Incentive Compensation Plan Design Document for changes made to the plan, including changes to the payout calculations.

Pinnacol Assurance Response:

a. Partially agree. Pinnacol Assurance already complies with audit recommendation (a). In competing with other insurers for employees, we win on the whole package: the combination of base salaries, variable pay and benefits. Pinnacol salaries alone are not enough to attract and retain employees, which limits our ability to compete effectively with our strongest for-profit competitors. We already collect salary (base and variable pay) and benefits survey data and use this in developing our total compensation package. The focus is on the entire package. We want to emphasize that the gainsharing program rewards employees for exceptional performance – not for merely doing the job, but for going "above and beyond" financial and productivity targets. It is pay for performance. The year 2003 was the most successful in Pinnacol Assurance's history and, because of this, the average gainsharing payout was 17.8%. However, if employees don't perform above plan, they receive no payout at all. For example, in the first quarter of 2004, 25% of employees received no bonus. Because of Pinnacol Assurance, and the quality of our employees, Colorado has one of the healthiest workers' compensation systems in the nation.

Auditor's Addendum:

With average gainsharing payouts nearing the maximum of 20%, Pinnacol should review the industry compensation data to ensure that compensation costs are not set at excessive levels.

b. We agree with audit recommendation (b) to update the Gainsharing Incentive Compensation Plan Design Document.

Compliance with Division of Insurance Regulations

Pinnacol's Association Program, of which the Association Dividend Plan is a part, began in 1988 and is designed to promote peer safety and loss control through various employer trade and industry groups. Approximately 68 groups participate in the program as of December 31, 2003. In exchange for specified safety and loss control measures, association membership becomes eligible for a dividend return according to levels set by the Pinnacol Board of Directors.

Rate filing requirements were instituted for Pinnacol in 1990. In 1997, prior approval language in Section 10-4-401(3), C.R.S. was implemented, requiring that all rates and rules be subject to prior approval.

Based on discussions with and documentation provided by Colorado Division of Insurance (the Division), Pinnacol has not properly filed information about the Association Dividend Plan with the Division in accordance with the above statute and Regulation 5-l-10(C)(2).

According to a memorandum addressed to Pinnacol's Agents and Association Executive Directors dated December 8, 2003, Pinnacol's Board of Directors approved a change to the Association Dividend Plan's dividend tables for the 2002-2003 dividend payout that reduced the payout by approximately 35% from previous years. Though the Association Dividend Plan was mentioned in certain filings submitted to the Division, no formal filing specifically discussing the Association Dividend Plan rules has yet been made. Filing No. 113053, which amends the Association Plan's dividend tables, has been made with the Division, but the Division's final review of that filing is pending receipt of a complete filing of the Association Dividend Plan. The impact of not submitting filings to the Division with respect to the Association Dividend Plan is that Pinnacol is not in compliance with Division regulations, intended to ensure reasonableness and protect consumers, and may be subject to fines or penalties once final review of the Association Dividend Plan amendments has been finalized. Based on discussion with the Division, such fines (if any) are not expected to have a material impact on the financial statements taken as a whole. The Division has indicated that any necessary changes to the Plan will not impact the financial statements of Pinnacol as of and for the year ended December 31, 2003, and will be made on a forward-going basis.

Recommendation No. 6:

Pinnacol should submit the proper supporting documentation for the Association Dividend Plan and ensure that final filing with the Division is complete for changes made to the Association Dividend Plan in accordance with Section 10-4-401(3), C.R.S. and Regulation 5-l-10(C)(2).

Pinnacol Assurance Response:

Agree. Pinnacol Assurance has a pending Association Dividend Table submission that was provided to the Division on December 18, 2003. This submission prompted e-mail inquiries from the Division dated May 3, 7, and 14, 2004, and a letter from the Division to Pinnacol Assurance dated May 4, 2004. In response, Pinnacol has provided written responses on June 4, 2004 and June 24, 2004. Pinnacol Assurance and the Division verbally discussed the Association Dividend plan during a conference call on June 23, 2004.

Pinnacol Assurance has historically submitted Association Dividend information to the Division. At this point, the current Association Dividend Tables are pending with the Division.

KPMG LLP
Suite 2700
707 Seventeenth Street
Denver, CO 80202

Independent Auditors' Report

Members of the Legislative Audit Committee and
the 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, 2003, 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. The accompanying statutory statements of Pinnacol Assurance as of December 31, 2002, were audited by other auditors whose report thereon, dated February 14, 2003, expressed an unqualified opinion on the financial statements prepared in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado and an adverse opinion on the financial statements prepared in conformity with accounting principles generally accepted in the United States of America.

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 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 audit provides a reasonable basis for our opinion.

As described 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 accounting principles generally accepted in the United States of America. The variances between such practices and accounting principles generally accepted in the United States of America 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 of America, the financial position of Pinnacol Assurance at December 31, 2003, 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 at December 31, 2003, 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.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included on the supplemental schedules of investment information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

KPMG LLP

April 30, 2004

PINNACOL ASSURANCE

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

December 31, 2003 and 2002

(In thousands)

Admitted Assets		**2003**	**2002**
Cash and invested assets:			
Bonds at amortized cost, fair value of $1,231,032 in 2003 and $1,086,257 in 2002 (note 3)	$	1,202,178	1,053,293
Common stock at fair value, cost of $89,995 in 2003 and $62,270 in 2002 (note 3)		104,498	59,854
Real estate at cost, net of accumulated depreciation		24,488	25,204
Cash on hand and on deposit		98,091	51,167
Other invested assets		—	10,046
Total cash and invested assets		1,429,255	1,199,564
Uncollected premiums		48,662	53,926
Electronic data processing equipment, at cost, net of accumulated depreciation of $2,073 and $1,889 in 2003 and 2002, respectively		1,548	2,468
Accrued investment income		12,746	13,210
Total admitted assets	$	1,492,211	1,269,168
Liabilities and Policyholders' Surplus			
Liabilities:			
Reserve for unpaid losses and allocated loss adjustment expenses (note 2)	$	997,505	897,414
Reserve for unpaid unallocated loss adjustment expenses (note 2)		26,924	26,899
Total reserve for unpaid losses and loss adjustment expenses		1,024,429	924,313
Other liabilities		38,231	36,343
Unearned premiums		93,203	84,777
Credit balances due policyholders		9,050	8,225
Total liabilities		1,164,913	1,053,658
Commitments and contingencies (note 9)			
Policyholders' surplus (note 7)		327,298	215,510
Total liabilities and policyholders' surplus	$	1,492,211	1,269,168

See accompanying notes to statutory financial statements.

PINNACOL ASSURANCE

Statutory Statements of Income and Changes
in Policyholders' Surplus

December 31, 2003 and 2002

(In thousands)

		2003	2002
Underwriting income:			
Premiums earned (note 6)	$	486,922	470,119
Deductions:			
Losses incurred		373,447	351,502
Loss adjustment expenses incurred		18,291	16,021
Other underwriting expenses incurred		94,917	92,797
Total underwriting deductions		486,655	460,320
Net underwriting gain		267	9,799
Investment income:			
Net investment income earned		77,027	74,360
Net realized capital gain		12,320	2,764
Net investment income		89,347	77,124
Other income:			
Provision for uncollectible premiums		(2,556)	(3,628)
Other (loss) income		752	(333)
Net income		87,810	82,962
Change in nonadmitted assets		2,059	(5,308)
Change in net unrealized losses in common stock		21,919	(5,860)
Policyholders' surplus at beginning of year		215,510	143,716
Policyholders' surplus at end of year	$	327,298	215,510

See accompanying notes to statutory financial statements.

PINNACOL ASSURANCE

Statutory Statements of Cash Flows

December 31, 2003 and 2002

(In thousands)

		2003	2002
Cash flows from operations:			
Premiums collected, net of reinsurance	$	500,549	480,313
Losses and loss adjustment expenses paid, net		(291,341)	(265,524)
Underwriting expenses paid		(92,421)	(81,113)
Cash from underwriting		116,787	133,676
Net investment income		72,925	67,447
Net amount withheld or retained for account of others		(1,804)	(3,961)
Net cash provided by operations		187,908	197,162
Cash flows from investments:			
Proceeds from sale or redemption of investments		361,719	227,658
Purchase of investments		(506,277)	(390,082)
Purchase of real estate		—	(20,458)
Net cash used for investments		(144,558)	(182,882)
Cash flows from financing and miscellaneous sources:			
Cash applied for (used by) other miscellaneous sources		3,574	(8,632)
Net cash provided by (used for) financing and miscellaneous sources		3,574	(8,632)
Increase in cash on hand and on deposit		46,924	5,648
Cash on hand and on deposit, beginning of year		51,167	45,519
Cash on hand and on deposit, end of year	$	98,091	51,167

See accompanying notes to statutory financial statements.

(1) Nature of Operations and Significant Accounting Policies

(a) 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, Colorado Compensation Insurance Authority's name was officially changed 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. This is in accordance with the applicable statutes of the state, with administration under the direction of a president. 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. Under the applicable 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.

(b) Basis of Presentation

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

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

Investments: Investments in bonds and mandatorily redeemable preferred stocks are reported at amortized cost or market value based on their NAIC rating; for GAAP, such fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in operations. Real estate owned and occupied by Pinnacol is included in investments 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 premiums receivable, furniture and equipment, and other assets not specifically identified as an admitted asset within the 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 at their net realizable value.

Reinsurance: Reinsurance transactions relating to the balance sheet are reported on a net basis rather than a gross basis.

The effects of the foregoing variances from GAAP on the statutory financial statements at December 31, 2003 and 2002, and for the years then ended have been determined and are presented below:

		December 31	
		2003	**2002**
		(In thousands)	
Statutory policyholders' surplus	$	327,298	215,510
Nonadmitted assets		10,498	12,558
Policy acquisition costs		3,312	2,831
Net unrealized gains on bonds		62,711	94,208
GAAP net assets	$	403,819	325,107
Statutory net income	$	87,810	82,962
Policy acquisition costs		481	755
Change in fair value of investments		(9,579)	50,350
GAAP changes in net assets	$	78,712	134,067

(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 among others. Unpaid losses and loss adjustment expense reserves 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. Actual results could differ from those estimates and such differences could be significant.

(d) Investments

Investments are recorded on trade date and are carried in accordance with the valuations prescribed by the Committee on Valuation of Securities of the NAIC (the SVO). Bonds are stated at amortized cost and are adjusted for other-than-temporary declines in fair value. Stocks are carried at estimated statutory fair value and are adjusted for other-than-temporary declines in fair value. Changes in fair values of stocks and equity funds are reported as unrealized capital gains (losses) by a direct adjustment to unassigned surplus.

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 which 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 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. Pinnacol has elected to use the book value as of January 1, 1994 as the cost for applying the retrospective adjustment method to securities purchased prior to that date. Prepayment assumptions for single class and multi class mortgage-backed/asset-backed securities were obtained from Hub Data and Bloomberg. Pinnacol had no negative yield situations requiring a change from the retrospective to prospective method.

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 $832,000 and $197,000 for the years ended December 31, 2003 and 2002, respectively.

(e) 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 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. Amounts held as collateral for reinsurance agreements were $10,167,000 and $10,046,000 as of December 31, 2003 and 2002, respectively.

(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 2003 and 2002, Pinnacol recorded a provision or wrote off a total of $2,556,000 and $3,628,000, 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.

A significant portion of Pinnacol's premiums receivable balances at December 31, 2003 and 2002 were from companies operating in the construction and services industries in Colorado. Recent studies indicate the construction industry represents 44% and 31% of Pinnacol's business in 2003 and 2002, respectively, and the services industry represents 24% and 25%, respectively, of Pinnacol's business in 2003 and 2002, with all other individual industries constituting a small fraction of Pinnacol's business.

(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 actuarially and statistically supported aggregate calculations using historical unearned premium data and per policy calculations. For 2003 and 2002, estimated unbilled audit premiums receivable of $16,869,000 and $22,491,000, respectively, are included as uncollected premiums. These estimated receivables have been reduced by 10%, where applicable, to comply with statutory accounting principles.

(h) 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 2003 and 2002, such amounts are approximately $9,050,000 and $8,225,000, respectively.

(i) Electronic Data Processing Equipment

Electronic data processing equipment is recorded at cost, less accumulated depreciation, and depreciated on a straight-line basis over an estimated useful life of three years. Net book value of these assets at December 31, 2003 and 2002 was $1,548,000 and $2,468,000, respectively. Related depreciation expense of $1,164,000 and $837,000 was incurred during 2003 and 2002, respectively. Pinnacol wrote off approximately $980,000 in electronic data processing equipment in 2003.

(Continued)

(j) 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. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2003 and 2002 was $4,228,000 and $4,880,000, respectively. Related depreciation expenses of $753,000 and $474,000 was incurred in 2003 and 2002, respectively.

(k) Other Assets

At December 31, 2003 and 2002 Pinnacol had prepaid assets totaling $908,000 and $751,000, respectively. In accordance with the Manual, these are nonadmitted assets.

(l) 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 or paid from surplus in 2003 or 2002.

(m) Association Dividend Program

During 2003 the board of directors approved $6.8 million in dividends payable to Association Program members. These dividends are not declared from surplus or recorded as a direct reduction to surplus. Instead, the dividends payable to Association Program members are considered premium credits and are recorded as a reduction to earned premium.

(n) Revenue Recognition

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

(o) Reserve for Unpaid Losses and Loss Adjustment Expenses

The reserve for unpaid losses and loss adjustment expenses represents management's best estimate of ultimate net cost of all reported and unreported losses incurred through December 31. As permitted by state statute and in accordance with the surplus recovery plan filed with the Division, effective January 1, 2001 Pinnacol discounts unpaid losses and loss adjustment expenses at 3.75% and 4.25% for the years ended December 31, 2003 and 2002, respectively. The reserves 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 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.

(p) 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 twelve-month term of the policies and are reported net of ceded reinsurance.

(Continued)

(q) Subrogation

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

(r) Reinsurance

Ceded reinsurance transactions are accounted for based on estimates of their ultimate cost. Losses, loss adjustment expenses, and the reserves 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).

(s) 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 (approximately 3.8% in 2003 and 2002), pursuant to Section 8-44-112(1)(a). Such amounts are included in other underwriting expenses incurred.

(t) 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 C.R.S., 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 10.15% (effective July 1, 2003) of covered salary (From July 2002 through June 2003 the contribution rate for Pinnacol was 10.04% and for the first six months of 2002 the rate was 9.9% of covered salary). Beginning with payroll periods ending on or after January 1, 2001, the employer contributions paid to the CSSDTF were reduced by an employer match on members' voluntary contributions to a defined contribution plan. The match, set by the Board of Trustees of PERA, is 100% of a member's eligible tax-deferred retirement program contributions limited by a per payroll whole percentage of PERA-includable salary limit (percentage set for 2003 was 2.0%). Any unused deferred contribution match money is forwarded to the CSSDTF. 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 ended December 31, 2003, 2002, and 2001 were $2,435,000, $2,019,000, and $2,414,000, respectively, equal to their required contributions for each year.

Pinnacol contributes to the Health Care Trust Fund (HCTF), a cost-sharing multiple-employer postemployment healthcare plan administered by PERA. The HCTF provides a health care premium subsidy to PERA participating benefit recipients and their eligible beneficiaries. Title 24, Article 51, Part 12 of the C.R.S., as amended, assigns the authority to establish the HCTF benefit provisions to the state legislature. PERA issues a publicly available annual financial report that includes financial statements and required supplementary information for the HCTF. That report may be obtained by writing to Colorado PERA, 1300 Logan Street, Denver, Colorado 80203 or by calling PERA at 303-832-9550 or 1-800-759-PERA (7372).

Pinnacol is required to contribute at a rate of 1.10% of covered salary for all PERA members as set by statute. No member contributions are required. The contribution requirements for Pinnacol are established under Title 24, Article 51, Part 4 of the C.R.S., as amended. The apportionment of the contribution to the HCTF is established under Title 24, Article 51, Section 208 of the C.R.S., as amended. Pinnacol's contributions to HCTF for the years ended December 31, 2003, 2002, and 2001 were $318,000, $327,000, and $338,000, respectively, equal to their required contributions for each year.

The (CSSDTF) members of Pinnacol may voluntarily contribute to the Voluntary Investment Program (401(k) Plan), an Internal Revenue Code Section 401(k) defined contribution plan administered by PERA. Plan participation is voluntary and contributions are separate from others made to PERA. Title 24, Article 51, Part 14 of the CRS, as amended, assigns the authority to establish the 401(k) Plan provisions to the state legislature.

The 401(k) Plan is funded by voluntary member contributions up to a maximum limit set by the IRS ($12,000 in 2003). Beginning January 1, 2001 an employer match was legislated which would match 100% of a member's eligible tax-deferred retirement program contributions limited by 2.0% in 2003 per payroll of the PERA-includable salary. The contribution requirements for Pinnacol are established under Title 24, Article 51, Section 1402 of the C.R.S., as amended. The 401(k) Plan member contributions from Pinnacol for the year ended December 31, 2003, were $1,618,000. The employer contributions to the 401(k) Plan from Pinnacol for the year ended December 31, 2003, were $481,000.

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 estimated liability for cumulative accrued paid time off of $1,432,000 and $1,375,000 at December 31, 2003 and 2002, respectively, is included in other liabilities in the accompanying financial statements.

(u) Reclassifications

Certain reclassifications have been made to the 2002 statutory financial statements to conform to the 2003 statutory financial statement presentation.

(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 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 and 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 and unpaid loss adjustment expenses.

Tabular Discount

Worker's Compensation unpaid losses have been discounted on a tabular basis using a discount rate of 3.5% in 2003 and 2002. A tabular discount is calculated with reference to actuarial tables. These tables incorporate an interest rate and in addition, factor in contingencies such as mortality, remarriage and inflation rates. The amount of the tabular discount for unpaid losses as of December 31, 2003 and December 31, 2002, respectively, is $133,483,000 and $121,542,000. The amount of discount for case reserves at December 31, 2003 is distributed as follows over the years in which the losses were incurred:

Loss year	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994	Prior
					(In thousands)						
Amount of Discount Case	$ 11,918	19,139	14,649	8,552	7,049	6,325	6,490	3,474	4,804	4,353	46,730
Amount of Discount Bulk	—	—	—	—	—	—	—	—	—	—	—

Non-tabular Discount

Some Worker's Compensation claims have been discounted on a non-tabular basis at 3.75%. A non-tabular discount is calculated with reference to an estimated payout pattern and an interest rate, and without reference to actuarial tables. Colorado statute permits Pinnacol to discount its loss and loss adjustment expense reserves at rates up to 6%. Pinnacol selected a rate, in keeping with the Surplus Recovery Plan, filed and approved by the Colorado Division of Insurance. The interest rate used to discount accident years' liabilities on a non-tabular basis has changed from the previous annual statement. The prior interest rate was 4.25%.

The amount of the discount for unpaid losses as of December 31, 2003 and December 31, 2002, respectively, is $80,272,000 and $94,579,000. Pinnacol's discounted liability for unallocated loss adjustment expenses (ULAE) was $26,924,000 at December 31, 2003 and $26,899,000 at December 31, 2002. The non-tabular discount (computed at 3.75% and 4.25% at December 31, 2003 and 2002, respectively) for ULAE was $5,428,000 and $6,100,000 at December 31, 2003 and 2002, respectively. ULAE represents the future cost of processing existing claims. As of December 31, 2003 and 2002, ULAE as a percentage of unpaid loss and allocated loss adjustment expenses represented 2.7% and 3.0%, respectively. The amount of discount at December 31, 2003 for loss, defense and cost containment, and adjusting and other expense is as follows:

Non-tabular discount				
	Case	**Bulk**	**DCC**	**A&O**
	(In thousands)			
$	—	80,272	—	5,428

At December 31, 2003 and 2002, Pinnacol accrued $997,505,000 and $897,414,000, respectively, for unpaid losses and allocated loss adjustment expenses. As permitted by state statute, and in accordance with the surplus recovery plan filed with the Division, a discount of $213,755,000 (computed at 3.75%) and $216,121,000 (computed at 4.25%) for 2003 and 2002, respectively, has been applied in the actuarial calculation of these liabilities for unpaid losses and allocated loss adjustment expenses. The state statute allows reserves to be discounted at a rate of up to 6%.

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

	2003		2002	
	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	$ 897,414	26,899	795,981	26,333
Additional amounts incurred related to:				
Current year – gross	348,074	18,567	349,016	17,409
Prior years	25,373	(276)	2,486	(1,388)
Total incurred	373,447	18,291	351,502	16,021
Reductions relating to payments for:				
Current year – gross	74,102	11,071	89,473	9,490
Prior years	199,254	7,195	160,596	5,965
Total paid	273,356	18,266	250,069	15,455
Balance at December 31	$ 997,505	26,924	897,414	26,899

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 $25,373,000 in 2003 and $2,486,000 in 2002. The increase in the reserve for prior year activity results primarily from the change in the discount rate.

(3) Investments

Estimated fair value of investments in bonds is based on values published by the SVO 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.

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

	2003				2002			
	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	$ 155,132	12,278	—	167,410	165,149	18,069	—	183,218
Loan-backed bonds	3,996	—	—	3,996	9,804	—	—	9,804
Special revenue:								
Loan-backed bonds	262,864	—	—	262,864	173,460	—	—	173,460
Industrial and miscellaneous:								
Nonloan-backed bonds	529,628	17,525	(949)	546,204	655,267	14,959	(64)	670,162
Loan-backed bonds	250,558	—	—	250,558	49,613	—	—	49,613
	$ 1,202,178	29,803	(949)	1,231,032	1,053,293	33,028	(64)	1,086,257

The amortized cost and fair value of investments in debt securities at December 31, 2003 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	$ 15,001	15,858
Due after one year through five years	150,834	157,863
Due after five years through ten years	385,183	398,711
Due after ten years	651,160	658,600
	$ 1,202,178	1,231,032

Proceeds from sales of investments in bonds during 2003 and 2002 were $351,553,000 and $227,658,000 respectively. Gross gains of $12,577,000 and $9,800,000 and gross losses of $(257,000) and $(7,036,000) were realized on those sales for 2003 and 2002, respectively.

Unrealized gains and losses on investments in common stocks are reported directly in surplus. 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)			
December 31, 2003:				
Common stocks	$ 89,995	14,503		104,498
December 31, 2002:				
Common stocks	$ 67,270	—	(7,416)	59,854

Major categories of net investment income for the years ended December 31, 2003 and 2002 are summarized as follows:

		2003	2002
		(In thousands)	
Investment income:			
Corporate and miscellaneous bonds	$	59,901	59,488
U.S. government obligations		11,478	12,110
Cash and other investments		2,888	2,085
Real estate		3,508	873
Equity securities		1,305	548
Securities lending		438	401
Investment expenses		(2,491)	(1,145)
Net investment income		77,027	74,360
Net realized gains		12,320	2,764
Investment income	$	89,347	77,124

(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 U.S. Treasury securities, Agency debentures, GNMA, and Agency mortgage-backed securities equal to or exceeding 102% of the fair market value of the loaned securities, and corporate securities and money markets equal to or exceeding 105% of the fair market value of the loaned securities.

At December 31, 2003 and 2002 Pinnacol had certain outstanding securities with a fair value of $646,877,000 and $551,156,000, respectively.

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 $438,000 and $401,000 of additional investment income during the year ended December 31, 2003 and 2002, 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. 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 $24,174,000 and $23,232,000 in 2003 and 2002, 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 to April 30, 2002 and management is not aware of any catastrophes during that time. 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. This coverage was still in effect as of December 31, 2003. The reinsurance expense associated with this coverage was $800,000 and $358,000 in 2003 and 2002, 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 is 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. Management does not believe the lack of this accommodation will have a significant impact on the financial condition of Pinnacol.

Effective March 1, 2004 Pinnacol executed a reinsurance contract with Argonaut Insurance Company (a California corporation). The contract is designed as a 100% quota share arrangement with Pinnacol acting as the assuming company.

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

		2003	2002
		(In thousands)	
Gross premiums earned	$	486,760	465,554
Premiums ceded		(800)	(358)
Premiums assumed		962	4,923
Net premiums earned	$	486,922	470,119
Gross losses incurred	$	366,253	347,250
Losses assumed		7,194	4,252
Net losses incurred	$	373,447	351,502

(Continued)

Reinsurance contracts do not relieve Pinnacol from 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 rating at December 31, 2003:

Reinsurer	AM Best Rating
AXIS Specialty Corporation	A
Endurance Specialty Insurance Limited	A

(7) Policyholders' Surplus

Pinnacol had policyholders' surplus of $327,298,000 and $215,510,000 as of December 31, 2003 and 2002, respectively. Prior to and as of December 31, 2002 surplus was 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., at the level at which the Division 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. The company action level for risk-based capital requires approximately $166,000,000 as of December 31, 2003.

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 Division 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. Non-tabular discounted reserves must be adjusted back to get to adjusted capital as defined for risk-based capital purposes. Pinnacol has discounted its reserves in total by approximately $214,000,000 as of December 31, 2003. For purposes of calculating risk-based capital only, Pinnacol calculated the tabular discount for certain case-based indemnity reserves of approximately $133,000,000. Accordingly, approximately $86,000,000 of the total discount relates to non-tabular reserves which, when adjusted, yields an adjusted surplus of approximately $242,000,000 for risk-based capital purposes.

The Plan as filed and approved by the Division 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 in one half of a percent increments. Pinnacol's surplus for risk-based capital purposes at December 31, 2003 of $242,000,000 meets the surplus requirement defined in the plan. Accordingly, the non-tabular reserve discount will be eliminated during the first quarter of 2004. The Division is currently performing an examination. Although no assurances can be made, management expects the results of the Division's examination by December 31, 2004.

(Continued)

(8) Uncollected Premiums

At December 31, 2003 and 2002, Pinnacol had admitted assets of $48,662,000 and $53,926,000, respectively, representing premiums receivable. Pinnacol routinely assesses the collectibility of these receivables. Based upon Pinnacol's experience less than 1% of the earned premium may become uncollectible.

(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, the results of operations, and/or liquidity of Pinnacol.

At December 31, 2003 and 2002, Pinnacol had two separate letters of credit related to reinsurance agreements. The first letter of credit for approximately $7,888,000 at December 31, 2003 and 2002 underlies Pinnacol's assumptive reinsurance agreement with Fireman's Fund Insurance Company. The reinsurance agreement allows Fireman's Fund Insurance Company to draw upon the letter of credit at any time to secure any of Pinnacol's obligations under the agreement. The second letter of credit is for approximately $1,357,000 at December 31, 2003 and 2002 and encompasses the assumptive reinsurance agreement made with Reliance Insurance Company.

Pinnacol is contingently liable for approximately $70,851,000 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, 2003 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:

Life insurance company and location		Loss reserves eliminated by annuities
		(In thousands)
GE Assurance, Virginia	$	42,784
SAFECO, Washington		23,462
Allstate, Illinois		1,674
Metlife, New York		2,710
Liberty Life Assurance Company, Massachusetts		221
	$	70,851

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Investment Risks Interrogatories

December 31, 2003

Pinnacol's total admitted assets as reported on page two of its Annual Statement is $1,492,211,393.

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 *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
Bonds:			
a. Verizon Wireless	$	29,679,550	2.0%
b. Anheuser Busch		29,049,401	1.9%
c. General Electric		27,864,584	1.9%
d. IBM Corporation		26,062,567	1.7%
e. Standard Credit Card		24,804,190	1.7%
f. Ford Motor Co.		23,877,652	1.6%
g. Proctor and Gamble		19,952,224	1.3%
h. Target Corporation		19,945,345	1.3%
i. Dupont		19,861,782	1.3%
j. American General		16,884,760	1.1%

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	$	1,132,408,812	75.9%	P/PSF-1	$	—	—
NAIC-2		64,697,424	4.3%	P/PSF-2		—	—
NAIC-3		—		P/PSF-3		—	—
NAIC-4		5,071,505	0.3%	P/PSF-4		—	—
NAIC-5		—		P/PSF-5		—	—
NAIC-6		—		P/PSF-6		—	—
	$	1,202,177,741			$	—	

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)

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Investment Risks Interrogatories

December 31, 2003

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 SVO Purposes and Procedures Manual as exempt or Class 1):

Investment category/issuer	Amount	Percentage of total admitted assets
a. Vanguard Total Stock Market Index	$ 91,983,427	6.2%
b. T Rowe Price Small Cap	12,514,390	0.8%

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 less than 2.5% of Pinnacol's total admitted assets. (none)

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

	Year end		End of each quarter		
			1st Quarter	2nd Quarter	3rd Quarter
	Amount	Percentage of total admitted assets	Amount	Amount (Unaudited)	Amount
a. Securities lending (do not include assets held as collateral for such transactions)	$ 646,877,445	43.4%	591,712,983	613,018,068	653,260,485
b. Repurchase agreements	—	—	—	—	—
c. Reverse repurchase agreements	—	—	—	—	—
d. Dollar repurchase agreements	—	—	—	—	—
e. Dollar reverse repurchase agreements	—	—	—	—	—

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Investment Risks Interrogatories

December 31, 2003

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)		$ (none)	
b. Income generation	(none)		(none)	
c. Other	(none)		(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:

	Year end		End of each quarter		
			1st Quarter	**2nd Quarter**	**3rd Quarter**
	Amount	**Percentage of total admitted assets**	**Amount**	**Amount** (Unaudited)	**Amount**
a. Hedging	$ (none)		$ (none)	(none)	(none)
b. Income generation	(none)		(none)	(none)	(none)
c. Replications	(none)		(none)	(none)	(none)
d. Other	(none)		(none)	(none)	(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:

	Year end		End of each quarter		
			1st Quarter	**2nd Quarter**	**3rd Quarter**
	Amount	**Percentage of total admitted assets**	**Amount**	**Amount** (Unaudited)	**Amount**
a. Hedging	$ (none)		$ (none)	(none)	(none)
b. Income generation	(none)		(none)	(none)	(none)
c. Replications	(none)		(none)	(none)	(none)
d. Other	(none)		(none)	(none)	(none)

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Investment Risks Interrogatories

December 31, 2003

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. (none)	$	(none)	(none)
b. (none)		(none)	(none)
c. (none)		(none)	(none)
d. (none)		(none)	(none)
e. (none)		(none)	(none)
f. (none)		(none)	(none)
g. (none)		(none)	(none)
h. (none)		(none)	(none)
i. (none)		(none)	(none)
j. (none)		(none)	(none)

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Summary Investment Schedule

December 31, 2003

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	$ 114,388,313	8.00%	$ 114,388,313	8.00%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	—	0.00%	—	0.00%
Issued by U.S. government-sponsored agencies	40,743,546	2.85%	40,743,546	2.85%
Foreign government (including Canada, excluding mortgage-backed securities)	—	0.00%	—	0.00%
Securities issued by states, territories, and possessions and their political subdivisions in the U.S.:				
State, territory, and possessions – general obligations	—	0.00%	—	0.00%
Political subdivisions of states, territories, and possessions – general obligations	—	0.00%	—	0.00%
Revenue and assessment obligations	—	0.00%	—	0.00%
Industrial development and similar obligations	—	0.00%	—	0.00%
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA	3,996,022	0.28%	3,996,022	0.28%
Issued by FNMA and FHLMC	2,383,853	0.17%	2,383,853	0.17%
Privately issued	—	0.00%	—	0.00%
CMOs and REMICs:				
Issued by FNMA and FHLMC	471,295,077	32.98%	471,295,077	32.98%
Privately issued and collateralized by MBS issued or guaranteed by GNMA, FMNA, or FHLMC	39,742,615	2.78%	39,742,615	2.78%
All other privately issued	—	0.00%	—	0.00%
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	529,628,315	37.06%	529,628,315	37.06%
Unaffiliated foreign securities	—	0.00%	—	0.00%
Affiliated securities	—	0.00%	—	0.00%

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Summary Investment Schedule

December 31, 2003

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	$ —	0.00%	$ —	0.00%
Preferred stocks:				
Affiliated	—	0.00%	—	0.00%
Unaffiliated	—	0.00%	—	0.00%
Publicly traded equity securities (excluding preferred stocks):				
Affiliated	—	0.00%	—	0.00%
Unaffiliated	104,497,817	7.31%	104,497,817	7.31%
Other equity securities:				
Affiliated	—	0.00%	—	0.00%
Unaffiliated	—	0.00%	—	0.00%
Other equity interests including tangible personal property under lease:				
Affiliated	—	0.00%	—	0.00%
Unaffiliated	—	0.00%	—	0.00%
Mortgage loans:				
Construction and land development	—	0.00%	—	0.00%
Agricultural	—	0.00%	—	0.00%
Single-family residential properties	—	0.00%	—	0.00%
Multifamily residential properties	—	0.00%	—	0.00%
Commercial loans	—	0.00%	—	0.00%
Real estate investments:				
Property occupied by company	24,488,563	1.71%	24,488,563	1.71%
Property held for production of income	—	0.00%	—	0.00%
Property held for sale	—	0.00%	—	0.00%
Collateral loans	—	0.00%	—	0.00%
Policy loans	—	0.00%	—	0.00%
Receivables for securities	—	0.00%	—	0.00%
Cash and short-term investments	98,091,227	6.86%	98,091,227	6.86%
Write-ins for invested assets	—	0.00%	—	0.00%
Total invested assets	$ 1,429,255,348	100.00%	$ 1,429,255,348	100.00%

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

See accompanying independent auditors' report.

KPMG LLP
Suite 2700
707 Seventeenth Street
Denver, CO 80202

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 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, 2003 and have issued our report thereon dated April 30, 2004. 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.

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, 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 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.

KPMG LLP

April 30, 2004

Pinnacol Assurance

Statutory Financial Statements

December 31, 2003

Distribution

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