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PINNACOL ASSURANCE

Statutory-Basis Financial Statements and
Supplemental Schedules of Investment Information

December 31, 2016 and 2015

(With Independent Auditors' Report Thereon)

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Report Summary

Authority and Purpose/Scope of the Audit

This audit is conducted under the authority of Section 8 45 121(2) of the Colorado Revised Statutes (C.R.S.), which authorizes the State Auditor to conduct an annual financial audit of Pinnacol Assurance (Pinnacol or the Company) and contract with an auditor or firm of auditors, having the specialized knowledge and experience. The primary purpose of our engagement is to audit the statutory basis financial statements of Pinnacol as of and for the year ended December 31, 2016, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States, and to express an opinion on those statutory basis financial statements and the supplemental schedules of investment information. The objective of an audit conducted in accordance with such standards is to obtain reasonable, but not absolute, assurance about whether the statutory basis financial statements are free of material misstatement.

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

In the course of our audit, we examined, on a test basis, evidence supporting the amounts and disclosures in Pinnacol's statutory basis financial statements as of and for the year ended December 31, 2016.

Audit Opinion and Report

As we are issuing an opinion on the statutory basis financial statements in conformity with accounting principles prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, we have modified our financial statement opinion to include an adverse opinion on accounting principles generally accepted in the United States of America (GAAP).

We issued a report on Pinnacol's compliance and internal control over financial reporting based on an audit of the financial statements performed in accordance with Government Auditing Standards. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be deficiencies, significant deficiencies, or material weaknesses. A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A significant deficiency is a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Summary of Current Year Findings and Recommendations

There were no reported findings and recommendations resulting from the audit for fiscal year 2016.

PINNACOL ASSURANCE

Report Summary

Summary of Prior Year Findings and Recommendations

There were no reported findings and recommendations resulting from the audit for fiscal year 2015.

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

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

Policyholders' Surplus

Pinnacol had policyholders' surplus of $1,086,349,000 and $935,298,000 as of December 31, 2016 and 2015, respectively. The increase in surplus is primarily related to current year net income and unrealized capital gains.

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Suite 800
1225 17th Street
Denver, CO 80202-5598

Independent Auditors' Report

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

Report on the Financial Statements

We have audited the accompanying financial statements of Pinnacol Assurance, which comprise the statutory statements of admitted assets, liabilities, and policyholders' surplus as of December 31, 2016 and 2015, and the related statutory statements of operations and changes in policyholders' surplus, and cash flow for the years then ended, and the related notes to the statutory financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

As described in note 1 to the financial statements, the financial statements are prepared by Pinnacol Assurance using statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, which is a basis of accounting other than U.S. generally accepted accounting principles. Accordingly, the financial statements are not intended to be presented in accordance with U.S. generally accepted accounting principles.

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The effects on the financial statements of the variances between the statutory accounting practices described in note 1 and U.S. generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the variances between statutory accounting principles and U.S. generally accepted accounting principles discussed in the Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles paragraph, the financial statements referred to above do not present fairly, in accordance with U.S. generally accepted accounting principles, the financial position of Pinnacol Assurance as of December 31, 2016 and 2015, or the results of its operations or its cash flow for the years then ended.

Opinion on Statutory Basis of Accounting

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance as of December 31, 2016 and 2015, and the results of its operations and its cash flow for the year then ended, in accordance with statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado described in note 1.

Other Matters

Supplemental Schedule

Our audits were conducted for the purpose of forming an opinion on the financial statements as a whole. The supplementary information included in the supplemental schedule of investment risks interrogatories and supplemental summary investment schedule are presented for purposes of additional analysis and are not a required part of the financial statements but are supplementary information required by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audits of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated May 18, 2017 on our consideration of Pinnacol Assurance's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Pinnacol Assurance's internal control over financial reporting and compliance.

KPMG LLP

Denver, Colorado
May 18, 2017

PINNACOL ASSURANCE

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

December 31, 2016 and 2015

(In thousands)

Admitted Assets		**2016**	**2015**
Cash and invested assets:			
Bonds at adjusted carrying value, fair value of $1,926,469 in 2016 and $1,849,351 in 2015 (note 4)	$	1,902,064	1,833,786
Preferred stock at adjusted carrying value, fair value of $1,114 in 2016 and $555 in 2015 (note 4)		1,094	553
Common stock at fair value, adjusted cost of $426,752 in 2016 and $403,458 in 2015 (note 4)		498,600	447,763
Real estate at cost – net of accumulated depreciation of $14,358 in 2016 and $13,092 in 2015		17,162	16,226
Cash, cash equivalents, and short-term investments		64,798	42,819
Other invested assets (note 4)		45,155	24,417
Receivables for securities sold		770	71
Total cash and invested assets		2,529,643	2,365,635
Uncollected premiums – net of allowance		84,308	79,879
Funds held by or deposited with reinsurers		1,792	1,895
Electronic data processing equipment – at cost – net of accumulated depreciation of $7,034 in 2016 and $5,788 in 2015		1,600	1,762
Accrued investment income		15,516	14,212
Total admitted assets	$	2,632,859	2,463,383
Liabilities and Policyholders' Surplus			
Reserve for unpaid losses and loss adjustment expenses:			
Reserve for unpaid losses (note 2)	$	829,731	834,214
Reserve for unpaid loss adjustment expenses (note 2)		105,981	105,910
Total reserve for unpaid losses and loss adjustment expenses		935,712	940,124
Unearned premiums		81,067	83,514
Advance premiums		10,882	9,771
Dividends payable to policyholders		74,644	51,365
Commissions payable		32,834	33,035
Structured settlement liability (note 3)		378,736	373,371
Credit balances due policyholders		9,416	8,406
Payable for securities purchased		4,340	4,751
Other liabilities		18,879	23,748
Total liabilities		1,546,510	1,528,085
Surplus notes (note 7)		100,000	100,000
Special surplus fund for unfunded pension benefits (notes 1 and 7)		180,271	156,767
Unassigned policyholders' surplus (note 7)		806,078	678,531
Total liabilities and policyholders' surplus	$	2,632,859	2,463,383

See accompanying notes to statutory-basis financial statements.

PINNACOL ASSURANCE

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

Years ended December 31, 2016 and 2015

(In thousands)

		2016	2015
Underwriting income:			
Premiums earned	$	634,640	635,876
Deductions:			
Losses incurred (note 2)		319,696	341,874
Loss adjustment expenses incurred (note 2)		74,618	66,322
Other underwriting expenses incurred		139,968	140,906
Total underwriting deductions		534,282	549,102
Net underwriting gain		100,358	86,774
Investment income:			
Net investment income earned (note 4)		67,189	63,959
Net realized capital gain (loss) (note 4)		15,263	(9,368)
Total investment income		82,452	54,591
Other income (loss):			
Provision for uncollectible premiums		(2,092)	(4,829)
Structured settlement expense (note 3)		(7,720)	(6,180)
Other income		541	625
Dividends to policyholders		(54,094)	(32,410)
Net income		119,445	98,571
Change in nonadmitted assets		(3,687)	(761)
Change in net unrealized losses on investments		35,293	(13,634)
Correction of an error (note 1)		—	3,135
Policyholders' surplus – beginning of year		935,298	847,987
Policyholders' surplus – end of year	$	1,086,349	935,298

See accompanying notes to statutory-basis financial statements.

PINNACOL ASSURANCE

Statutory-Basis Statements of Cash Flow

Years ended December 31, 2016 and 2015

(In thousands)

		2016	2015
Cash flow from operations:			
Premiums collected – net of reinsurance	$	623,428	615,733
Losses and loss adjustment expenses paid – net of reinsurance and deductibles		(398,726)	(397,684)
Other underwriting expenses paid		(142,935)	(133,733)
Dividends paid to policyholders		(30,815)	3,220
Investment income received, net of investment expenses paid		68,584	67,546
Miscellaneous proceeds		541	625
Net cash provided by operations		120,077	155,707
Cash flow from investments:			
Proceeds from sale, maturity, or redemption of investments:			
Bonds		589,720	776,290
Stocks		31,767	32,288
Other invested assets		2,225	1,511
Miscellaneous proceeds		—	4,319
Total proceeds from sale or redemption of investments		623,712	814,408
Cost of investments acquired:			
Bonds		(643,941)	(889,848)
Stocks		(48,709)	(56,644)
Other invested assets		(22,333)	(17,342)
Miscellaneous proceeds (applications)		(3,311)	(3,679)
Total investments acquired		(718,294)	(967,513)
Net cash used in investments		(94,582)	(153,105)
Cash flow from financing and miscellaneous sources:			
Cash used in other miscellaneous sources		(3,516)	839
Net cash provided by financing and miscellaneous sources		(3,516)	839
Net increase (decrease) in cash, cash equivalents, and short-term investments		21,979	3,441
Cash, cash equivalents, and short-term investments – beginning of year		42,819	39,378
Cash, cash equivalents, and short-term investments – end of year	$	64,798	42,819

See accompanying notes to statutory-basis financial statements.

(1) Nature of Operations and Significant Accounting Policies

(a) Organization

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

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

(b) Basis of Presentation

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

Statutory accounting practices contained in the Manual vary in some respects from accounting principles generally accepted in the United States of America (GAAP). The more significant differences between SAP and GAAP are as follows:

- Policy acquisition costs, such as commissions, premium taxes, and other expenses directly related to the cost of acquiring new business are expensed as incurred, while under GAAP, they are deferred and amortized over the policy term to provide for proper matching of revenue and expense.
- Investments in debt securities are generally carried at amortized cost, while under GAAP, they would be carried at fair value. For GAAP, changes in fair value in bonds go through net investment income.
- Short term investments, which include investments with maturities at the time of acquisition of one year or less, are included with cash and cash equivalents in the accompanying statutory basis financial statements, while under GAAP, only investments with maturities at the time of acquisition of three months or less are included with cash and cash equivalents.
- Assets are reported under NAIC SAP at "admitted asset" value and "nonadmitted" assets are excluded through a charge against policyholders' surplus, while under GAAP, all assets are reported on the balance sheet, net of any required valuation allowance. Nonadmitted assets at December 31, 2016 and 2015 comprised the following (in thousands):

		2016	2015
Receivables	$	15,344	12,021
Fixed assets		948	960
Prepaids		2,053	1,677
Total nonadmitted assets	$	18,345	14,658

- The reserve for losses and loss adjustment expenses (LAE) is reported net of reinsurance, while under GAAP, the balance sheet reports reinsurance recoverable, including amounts related to losses incurred but not reported, as assets.
- The surplus note is reported as a component of surplus, increasing policyholders' surplus under NAIC SAP. Under GAAP the surplus note is recorded as long term debt. The related interest expense may not be accrued under NAIC SAP until approved for payment by the commissioner of the state of domicile while under GAAP, the interest expense is recorded as incurred.
- Governmental Accounting Standards Board (GASB) Statement No. 68, *Accounting and Financial Reporting for Pensions*, which is effective for fiscal years ended June 30, 2014 or later, requires employers that are part of a cost sharing multiple employer pension fund to record their portion of the unfunded liability, while under NAIC SAP, the employer must only record the cost of the contribution and any liability for any contributions due and unpaid.

The effect of the differences between statutory basis of accounting and generally accepted accounting principles, although not reasonably determinable, is presumed to be material. Pinnacol is a political subdivision of the State and as such would follow all applicable Governmental Accounting Standards Board (GASB) pronouncements.

(c) Use of Estimates

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

(d) Investments

Investments are recorded on the trade date. Bonds and preferred stocks are stated at amortized cost or fair value, based on their NAIC designation, and are adjusted for other than temporary declines in fair value. Common stocks, mutual funds, and common trust funds are carried at fair value. Other invested assets, including partnerships, are recorded at the underlying audited equity value. For those investments in which the audited financial statements are not available in a timely manner, the unaudited equity value is used. Unrealized capital gains on common stocks, preferred stocks, mutual funds, and common trust funds are reported as a direct adjustment to policyholders' surplus. Common stocks, preferred stocks, mutual funds and common trust funds in an unrealized loss position for the years ended December 31, 2016 and 2015 are recorded as other than temporarily impaired and are recorded as a realized loss in the statutory basis statement of operations in the period in which they occur.

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

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

Prepayment assumptions for purposes of recognition of income and valuing of loan backed bonds and structured securities were obtained from widely accepted models with inputs from major third party data providers. Model assumptions are specific to asset class and collateral type and are regularly evaluated and adjusted where appropriate. The prospective adjustment method is used to value all loan backed securities.

Real estate includes land, the building on the land, and capitalized building improvements used in conducting the Company's business. Land is carried at cost. Building and capitalized building improvements are carried at cost less accumulated depreciation. The cost of the building and capitalized improvements is depreciated over an estimated useful life of 30 years using the straight line method. Depreciation expense was approximately $1,266,000 and $1,140,000 for the years ended December 31, 2016 and 2015, respectively, and is included in net investment income earned in the statutory basis statements of operations and changes in policyholders' surplus.

(e) Cash, Cash Equivalents, and Short-Term Investments

For purposes of the statement of cash flow, cash, cash equivalents, and short term investments include cash on deposit, money market funds, and other investments with maturities of one year or less at the date of acquisition.

As of December 31, 2016, cash, cash equivalents, and short term investments of approximately $64,798,000 include $(11,339,000) of book overdrafts, $19,988,000 of cash equivalents, and $56,149,000 of short term investments. As of December 31, 2015, cash, cash equivalents, and short term investments of approximately $42,819,000 include $(9,268,000) of book overdrafts, $4,000,000 of cash equivalents, and $48,087,000 of short term investments. In the accompanying statutory basis statements of admitted assets, liabilities, and policyholders' surplus, Pinnacol has recorded checks that have been issued, but not presented for payment, as a reduction of cash and cash equivalents.

(f) Receivables for Securities Sold

As of December 31, 2016 and 2015, receivables for securities sold were approximately $770,000 and $71,000, respectively. Receivables for securities arise when sales of securities are recorded as of the trade date. A receivable due from the custodian is established when a security has been sold, but the proceeds from the sale have not yet been received. Receivables for securities not received within 15 days from the settlement date are nonadmitted.

(g) 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 2016 and 2015, Pinnacol recorded a provision of approximately $2,092,000 and $4,829,000, respectively, for premiums receivable due to the unlikelihood of ultimate collection thereof. These amounts are reflected as provision for uncollectible premiums in the accompanying statutory basis statements of operations and changes in policyholders' surplus.

A significant portion of Pinnacol's premium receivable balances at December 31, 2016 and 2015 were from companies operating in the construction and services industries in Colorado. The construction industry represents approximately 36% of premiums earned as of December 31, 2016 and 34% as of December 31, 2015. The services industry represents approximately 40% of premiums earned as of December 31, 2016 and 42% as of December 31, 2015, with all other individual industries constituting the remainder of premiums receivable balances.

(h) Earned but Unbilled Premiums

Earned but unbilled premiums represent a receivable or liability for audit premiums, which are amounts due from or to policyholders after the respective policy period has expired based on payroll audits performed by Pinnacol. A receivable is included as a component of uncollected premiums. A liability is included as a component of credit balances due policyholders. Such amounts are estimated by Pinnacol based upon internal calculations using historical premium data. Based on this analysis, Pinnacol recorded a net estimated audit premiums receivable in 2016 and 2015 of approximately $48,950,000 and $45,390,000, respectively. The increase in the receivable is due to increased covered payroll.

(i) Credit Balances Due Policyholders

Credit balances due policyholders represent excess premiums or are amounts due to policyholders. Generally, credit balances due policyholders are applied to future premium obligations of policyholders. For 2016 and 2015, such amounts are approximately $9,416,000 and $8,406,000, respectively.

(j) Electronic Data Processing Equipment

Electronic data processing equipment is recorded at cost, less accumulated depreciation, and depreciated on a straight line basis over an estimated useful life of three years. Net book value of these assets at December 31, 2016 and 2015 was approximately $1,600,000 and $1,762,000, respectively. Related depreciation expense of approximately $1,246,000 and $833,000 was incurred during 2016 and 2015, respectively, and is included in LAE and other underwriting expenses incurred in the statutory basis statements of operations and changes in policyholders' surplus.

(k) Office Furniture, Equipment, Software, Art, Automobiles , and Leasehold Improvements

Office furniture, equipment, software, art, automobiles, and leasehold improvements are recorded at cost and depreciated on a straight line basis. Equipment, and software are depreciated over an estimated useful life of three years. Office furniture, art, and automobiles are depreciated over an estimated useful life of five years. Leasehold improvements are depreciated over the shorter of the term of the lease or the useful life. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2016 and 2015 was approximately $948,000 and $960,000, respectively. Related depreciation expense of approximately $613,000 and $668,000 was incurred in 2016 and 2015, respectively, and is included in LAE and other underwriting expenses incurred in the statutory basis statements of operations and changes in policyholders' surplus.

(l) Other Assets

At December 31, 2016 and 2015, Pinnacol had prepaid assets and deposits totaling approximately $3,845,000 and $3,573,000, respectively. In accordance with the Manual, funds held by or deposited with reinsurance companies of $1,792,000 and $1,895,000 in 2016 and 2015, respectively are admitted and the remaining amount is nonadmitted.

(m) Safety Group Dividend Program

Pinnacol has a safety group program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. Pinnacol paid out safety group dividends of $3,278,000 in 2016 and $1,941,000 in 2015. As of December 31, 2016 and 2015, safety group dividends payable of $3,500,000, and $2,789,000, respectively, are included in dividends payable to policyholders. These dividends are not declared from surplus nor are they recorded as a direct reduction to policyholders' surplus. The dividends are recorded as dividends to policyholders in the statutory basis statements of operations and changes in policyholders' surplus.

(n) Individual Loss Control Dividend Program

Pinnacol has an individual loss control dividend (ILCD) program that is designed for policyholders who are committed to effective loss control in their business operations. If the policyholder meets the minimum premium requirements and pays an additional 5% premium charge as a buy in to the plan, the policyholder may receive a reduction of premium based on the policy premium and the loss ratio. Pinnacol paid out ILCD of $15,163,000 in 2016 and $12,085,000 in 2015. As of December 31, 2016 and 2015, ILCD payable of $21,093,000, and $18,571,000, respectively, are included as dividends payable to policyholders in the statutory-basis statements of operations and changes in policyholders' surplus.

(o) General Policyholder Dividends

The Board of Directors, at its discretion, determines the amount of general policyholder dividends to be declared, based on Pinnacol's overall experience and financial condition. Pinnacol has declared general policyholder dividends to its policyholders in good standing of $50,000,000 and $30,000,000 in 2016 and 2015, respectively. This is included in dividends payable to policyholders.

(p) Revenue Recognition

For certain policies, earned premium is recorded on an installment basis to match the billing frequency stated in the policyholder contract with a provision for amounts earned but unbilled. Earned premium for all other contracts is recognized using the daily pro rata method over the period the policy is effective.

(q) 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, 2016 and 2015. The reserve for unpaid losses and loss adjustment expenses is estimated by management, which uses an independent third party actuary to provide estimates based on individual case basis valuations and statistical analyses. Those estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes the reserve for unpaid losses and loss adjustment expenses is adequate. These estimates are continually reviewed and adjusted, as necessary, as experience develops or new information becomes known. Such adjustments are included in losses incurred or loss adjustment expenses incurred within the statutory basis statements of operations and changes in policyholders' surplus in the period such information becomes known.

Internal structured settlement liabilities represent obligations to claimants and dependents on cases that have been closed by contract. These obligations are discounted at 2.5% in 2016 and 2015.

(r) Unearned Premiums

Unearned premiums represent amounts either collected or billed and due from policyholders at December 31, 2016 and 2015 but unearned at that date as they pertain to subsequent policy periods. Unearned premiums billed, which relate to policy effective dates subsequent to December 31, 2016 are not included in the unearned premiums balance, but are included as advance premium if the related cash is collected. Unearned premiums are computed on a daily pro rata basis over the effective period of the policies.

(s) Premium Deficiency Reserve

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

Pinnacol recorded a premium deficiency reserve of $0 at December 31, 2016 and 2015. Pinnacol considered anticipated investment income at 3.5% when evaluating the premium deficiency reserve for 2016.

(t) Multiemployer Pension Plans and Other Postretirement Benefits

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

As a participant in a multiemployer pension plan and health care trust fund, Pinnacol recognizes as net pension cost and net postretirement benefit cost the required contribution for the period and as a liability any contributions due and unpaid.

(u) Subrogation

Subrogation claims (claims against third parties) are recognized as a reduction of losses incurred when collections are received. The Company received $6,575,000 and $6,584,000 in subrogation as of December 31, 2016 and 2015, respectively.

(v) Reinsurance

Ceded reinsurance transactions are accounted for based on estimates of their ultimate cost. Losses incurred, loss adjustment expenses incurred, and the reserve for loss adjustment expenses are reported net of reinsured amounts in accordance with the Manual. Premiums earned are reported net of reinsurance (note 5).

(w) Taxes

As a political subdivision of the State of Colorado, Pinnacol is not subject to federal or state income taxes under a specific exemption granted under Section 501(c) of the Internal Revenue Code; nor is Pinnacol subject to property tax or sales and use taxes. Additionally, Pinnacol is not subject to a premium tax pursuant to Section 8 45 117(3), C.R.S. However, Pinnacol is subject to a surcharge on premiums pursuant to Section 8 44 112(1)(s), C.R.S. The surcharge is based on a rate established by the Colorado Department of Labor and Employment Division of Workers' Compensation annually, approximately 0.63% at December 31 2016 and 2015. Such amounts are included in other underwriting expenses incurred.

(x) Surplus Note

Pinnacol issued a $100,000,000 surplus note on June 25, 2014. Before issuing this debt, the Company obtained approval from the Commissioner of the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division) for the transaction and approval to classify the debt as a component of policyholders' surplus. Each payment of principal and interest on the surplus note may be made only with the prior approval of the Commissioner and only to the extent the Company has sufficient policyholders' surplus to make such payment. The interest on the unpaid principal amount of this note will be paid in semiannual installments at the rate of 8.625% per annum. In 2016, $8,625,000 of interest was paid on the note and recorded as investment expense.

(y) Special Surplus Fund for Unfunded Pension Benefits

Pinnacol participates in a cost sharing multiple employer defined benefit pension plan administered by the Public Employees' Retirement Association of Colorado (PERA). PERA has a net pension liability which represents the unfunded pension benefits. Statutory accounting does not allow Pinnacol's portion of the net pension liability to be recorded as a liability but allows a company to establish a special surplus fund to provide for contingencies. GASB No. 68, *Accounting and Financial Reporting for Pensions* is effective for fiscal years beginning after June 15, 2014. The statement requires cost sharing employers participating in defined benefit plans to record their proportionate share of the collective net pension liability in their GASB financial statements. PERA provides Pinnacol with the audited schedule of employers' allocations and net pension liability. This estimated liability is calculated based upon actuarial data valued as of December 31, 2014. PERA uses standard roll forward procedures to then estimate the expected total pension liability as of the measurement date of December 31, 2015. The total pension liability is reduced by the plan's fiduciary net position to obtain the collective net pension liability. A discount rate of 7.5% is being used. PERA also provides the employer allocation percentage for purposes of calculating Pinnacol's proportionate share of the collective net pension liability. The funded portion of PERA's total pension liability as of December 31, 2015 is 56.1%. In 2015, Pinnacol established a special surplus fund to record its portion of the unfunded pension benefits. As of December 31, 2016 and 2015, the special surplus fund for the net pension liability was $180,271,000 and $156,767,000, respectively.

(z) Application of Recent Statutory Accounting Pronouncements

During 2016 there were no substantive revisions to statutory accounting that were applicable to Pinnacol, and therefore, there were no substantive revisions adopted by the Company.

(aa) Immaterial Correction of an Error

During 2015, the Company discovered an error in the accounting estimate for uncollected premiums receivable. In prior years, the aging for installment premiums was based on transaction date and has been changed to due date in accordance with SSAP No. 6. Additionally, the order in which the calculation for nonadmitted aged receivables greater than 90 days due and the calculation for allowance for uncollected premiums have been reversed so that the nonadmitted adjustments are made first and the impairment analysis is performed on the remaining uncollected premium population. Surplus was increased by $3,135,000 in 2015 to correct for this error.

(2) Unpaid Losses and Loss Adjustment Expenses

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

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

Unpaid Losses and Loss Adjustment Expenses

Activity in the liability for unpaid losses and loss adjustment expenses in 2016 and 2015 is summarized as follows (in thousands):

	Unpaid losses and loss adjustment expenses	
	2016	**2015**
Balance at January 1	$ 940,124	929,612
Additional amounts incurred related to:		
Current year	434,309	445,102
Prior years	(39,995)	(36,906)
Total incurred	394,314	408,196
Reductions relating to payments for:		
Current year	127,091	132,407
Prior years	271,635	265,277
Total paid	398,726	397,684
Balance at December 31	$ 935,712	940,124

During the year ended December 31, 2016, approximately $271,635,000 was paid for unpaid losses and loss adjustment expense attributable to insured events of prior years. Reserves for prior years unpaid losses and loss adjustment expense were reduced by $39,995,000 and are now $628,495,000 as a result of re-estimation of unpaid losses and loss adjustment expenses. This decrease is generally the result of ongoing analysis of recent loss development trends and better than expected development. Pinnacol's claims continue the trend of favorable development that has been evident for a number of calendar years. When the actual selected ultimate cost of an accident year's claims is less than the original estimate, favorable development is recorded. This favorable development resulted from initiatives to improve claims handling practices and reduce claims handling expenses when prudent, a reduction of ultimate claim frequency in Colorado, and consistently favorable emergence of defense and cost containment (DCC) expenses throughout the year. Pinnacol management continually evaluates the estimated ultimate cost of all accident years and on a calendar year basis adjusts to the best estimate available, favorable or unfavorable, in the current period. At the end of the current year, the amount of reserve credit recorded for high deductibles on unpaid losses was $3,992,000. Such reduction is collateralized generally with letters of credit for the benefit of Pinnacol.

(3) Internal Structured Settlements

Pinnacol has an internal structured settlement program in which it retains the liability for settlements to claimants rather than purchasing annuities from third parties. This liability has mortality risk and is discounted using a market rate. The discount applied to this liability was 2.5% at December 31, 2016 and 2015. The internal structured settlement liability is actuarially valued. The internal structured settlement liability is reported as a financing liability separate from unpaid losses and loss adjustment expenses on the statutory-basis statements of admitted assets, liabilities, and policyholders' surplus.

Activity in the liability for internal structured settlements in 2016 and 2015 is summarized as follows (in thousands):

		2016	2015
Beginning balance	$	373,371	365,772
Amounts incurred:			
Change in valuation		7,720	6,180
Amounts paid		(24,241)	(22,839)
New internal structured settlements		21,886	24,258
Ending balance	$	378,736	373,371

Pinnacol uses an annuity quote that is based upon an estimated discount rate as a basis for the paid claim amount. As such, the liability should be discounted at a market rate. The discount rate applied to internal structured settlement liabilities is 2.5% at December 31, 2016 and 2015.

The amount of the discount for unpaid internal structured settlements as of December 31, 2016 and 2015 is approximately $154,280,000 and $156,852,000, respectively. The discount amounts for internal structured settlement reserves at December 31, 2016 and 2015 are distributed over the years in which the losses were incurred as follows (in thousands):

2016			2015		
Loss year		Discount	Loss year		Discount
Prior	$	84,446	Prior	$	89,574
2006		13,293	2006		13,928
2007		9,109	2007		9,585
2008		10,888	2008		11,776
2009		11,058	2009		11,704
2010		6,010	2010		6,185
2011		7,153	2011		7,384
2012		4,204	2012		3,167
2013		4,634	2013		2,410
2014		2,319	2014		1,132
2015		1,110	2015		7
2016		56	2016		—
Total	$	154,280	Total	$	156,852

(4) Investments

Estimated fair value of investments in bonds is based on quotations provided by widely accepted third party data providers. In 2016 and 2015, Interactive Data Corporation (IDC), Reuters, and Markit Partners were used to obtain fair market values. Additionally, in 2016 and 2015, the fair value of certain common trust funds were primarily determined by net asset value and warrants were primarily determined by a widely accepted third party vendor, followed by a hierarchy using broker/dealer quotes, Bloomberg, Yield Book analytic model, and a benchmark to index model. Prior month price is used only when information is limited or unavailable.

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

During 2016 and 2015, Pinnacol had investments in long term bonds, which the SVO assigned a 3 or higher designation. At December 31, 2016 and 2015, the fair value on long term bonds was less than amortized cost, which resulted in a cumulative unrealized loss of $1,877,000 and $9,015,000, respectively. Carrying values are equal to the lower of amortized cost or fair value for these bonds.

The carrying value and the fair value of investments in long term bonds in 2016 and 2015 are summarized as follows (in thousands). The carrying value includes investment grade bonds that are reported at amortized cost and low rated bonds that are reported at the lower of cost or fair value:

	2016			
	Carrying value	Gross unrealized gains	Gross unrealized losses	Fair value
Government obligations:				
Nonloan-backed bonds	$ 109,570	4,008	(525)	113,053
Loan-backed bonds	21,223	1,108	—	22,331
U.S. political subdivisions:				
Nonloan-backed bonds	11,288	536	(75)	11,749
Loan-backed bonds	—	—	—	—
U.S. special revenue:				
Nonloan-backed bonds	46,262	1,398	(598)	47,062
Loan-backed bonds	268,406	1,447	(2,580)	267,273
Hybrid Securities:				
Nonloan-backed bonds	5,390	10	(13)	5,387
Loan-backed bonds	—	—	—	—
Industrial and miscellaneous:				
Nonloan-backed bonds	1,201,947	28,284	(12,052)	1,218,179
Loan-backed bonds	237,978	3,719	(262)	241,435
	$ 1,902,064	40,510	(16,105)	1,926,469

	2015			
	Carrying value	**Gross unrealized gains**	**Gross unrealized losses**	**Fair value**
Government obligations:				
Nonloan-backed bonds	$ 80,868	5,706	(157)	86,417
Loan-backed bonds	31,417	1,947	—	33,364
U.S. political subdivisions:				
Nonloan-backed bonds	11,307	142	(88)	11,361
Loan-backed bonds	—	—	—	—
U.S. special revenue:				
Nonloan-backed bonds	37,571	910	(286)	38,195
Loan-backed bonds	235,660	2,257	(522)	237,395
Industrial and miscellaneous:				
Nonloan-backed bonds	1,191,351	20,458	(17,008)	1,194,801
Loan-backed bonds	245,612	2,206	—	247,818
	$ 1,833,786	33,626	(18,061)	1,849,351

The book/adjusted carrying value and estimated fair value of investments in long term bonds at December 31, 2016, by contractual maturity, are shown in the following table (in thousands). Investments such as mortgage backed securities have been allocated based on the original maturity date at issuance. Contractual maturities may differ from actual maturities because the borrower may have the right to call or prepay obligations with or without call or prepayment penalties.

	2016	
	Book/adjusted carrying value	**Fair value**
Due in one year or less	$ 143,012	144,041
Due after one year through five years	714,294	721,534
Due after five years through ten years	763,066	769,511
Due after ten years	281,692	291,383
	$ 1,902,064	1,926,469

Proceeds from sales, redemptions, or maturities of investments in long term bonds during 2016 and 2015 were approximately $589,720,000 and $776,290,000, respectively. Realized gains on long term bonds of approximately $14,628,000 and $26,680,000 and realized losses of approximately $(2,643,000) and $(4,538,000) were recognized during 2016 and 2015, respectively.

In 2016, investments in partnerships are stated at the underlying audited equity value. For those investments in which the audited financial statements were not available by the March 1, 2017 statutory annual statement filing deadline, the unaudited equity value was used. These assets totaled $45,155,000 and $24,417,000 in 2016 and 2015, respectively. The Company has contributed $44,980,000 in capital calls since investing in partnerships and may be responsible for up to an additional $35,140,000.

(Continued)

Unrealized gains on investments in common stocks, mutual funds, and common trust funds are reported as a component of policyholders' surplus. Equities, excluding private equities, in an unrealized loss position are deemed to be other than temporarily impaired, with the resulting loss recognized in the statement of operations. OTTI of common stocks, mutual funds, and common trust funds result in the establishment of a new, adjusted cost basis for such investments. The original cost, adjusted cost, gross unrealized gains (measured against adjusted cost), and fair value of common stocks, mutual funds, and common trust funds are summarized as follows (in thousands):

		Original cost	Adjusted cost	Gross unrealized gains	Fair value
December 31, 2016	$	467,245	426,752	71,848	498,600
December 31, 2015	$	447,068	403,458	44,305	447,763

The following table provides the length of impairment for those investments in long term bonds with an unrealized loss as of December 31, 2016 (in thousands):

		Less than 12 months		12 months or greater		Total	
Description of securities		**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**
U.S. government	$	79,828	(525)	—	—	79,828	(525)
U.S. political subdivisions		2,423	(74)	—	—	2,423	(74)
U.S. special revenue		184,432	(3,178)	—	—	184,432	(3,178)
Hybrid securities		2,000	(13)	—	—	2,000	(13)
Industrial and miscellaneous		438,727	(12,588)	22,614	(1,694)	461,341	(14,282)
Total	$	707,410	(16,378)	22,614	(1,694)	730,024	(18,072)

The following table provides the length of impairment for those investments in long term bonds with an unrealized loss as of December 31, 2015 (in thousands):

		Less than 12 months		12 months or greater		Total	
Description of securities		**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**
U.S. government	$	23,719	(157)	—	—	23,719	(157)
U.S. political subdivisions		2,429	(88)	—	—	2,429	(88)
U.S. special revenue		98,989	(808)	—	—	98,989	(808)
Industrial and miscellaneous		639,838	(24,044)	13,259	(2,026)	653,097	(26,070)
Total	$	764,975	(25,097)	13,259	(2,026)	778,234	(27,123)

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

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

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

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

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

Bonds – At December 31, 2016 and 2015, 10.8% and 9.8% of long term bonds held by the Company were rated noninvestment grade, respectively. At December 31, 2016 and 2015, the Company had approximately $17,935,000 and $26,992,000, respectively, of unrealized losses related to its long term bonds. The Company does not have any significant concentrations by issuer or by sector. The unrealized losses on securities are primarily attributable to fluctuations in market interest rates and changes in credit spreads since the securities were acquired.

Loan-Backed and Structured Securities – Loan backed securities are stated at amortized cost or fair value based on their NAIC designation. The prospective method is used to value mortgage backed securities. Prepayment assumptions for single class and multiclass mortgage backed/asset backed securities were obtained from widely accepted models with inputs from major third party data providers. Any loan backed and structured securities in an unrealized loss position were reviewed to determine whether an OTTI should be recognized at year end. At December 31, 2016 and 2015, Pinnacol recognized OTTI on loan backed securities of approximately $0 and $944,000, respectively. Loan backed and structured securities in an unrealized loss position as of year end, stratified based on length of time continuously in these unrealized loss positions, are as follows (in thousands):

	2016	
	Aggregate amount of unrealized loss	**Aggregate fair value of securities with unrealized loss**
Less than twelve months	$ 2,843	187,843
Twelve months or longer	—	—
	$ 2,843	187,843

Other-Than-Temporary Impairment – During 2016 and 2015, the Company recognized $3,592,000 and $12,339,000, respectively, in OTTI on long term bonds, $1,000 and $7,000, respectively, in OTTI on preferred stock, and $2,234,000 and $25,488,000, respectively, in OTTI on common stocks, mutual funds, and common trust funds.

Fair Value Measurements – The Company has categorized its assets and liabilities that are reported on the statutory basis statements of admitted assets, liabilities, and policyholder's surplus at fair value into the three level fair value hierarchy. The three level fair value hierarchy is based on the degree of subjectivity inherent in the valuation method by which fair value was determined. The three levels are defined as follows.

- Level 1 – Quoted Prices in Active Markets for Identical Assets and Liabilities: This category, for items measured at fair value includes exchange traded preferred and common stocks. The estimated fair value of the equity securities within this category are based on quoted prices in active markets and are thus classified as Level 1.
- Level 2 – Significant Other Observable Inputs: This category for items measured at fair value includes bonds and common stocks which are not exchange traded. The estimated fair values of some of these items were determined by independent pricing services using observable inputs. Others were based on quotes from markets which were not considered actively traded.
- Level 3 – Significant Unobservable Inputs: This category for items measured at fair value includes common stock warrants. The estimated fair value of common stock warrants was determined by internal ratings in the absence of observable inputs.

At the end of each reporting period, the Company evaluates whether or not any event has occurred or circumstances have changed that would cause an instrument to be transferred between Levels 1 and 2. This policy also applies to transfers into or out of Level 3 as stated below. During the current year, no transfers between Level 1 and 2 were required.

The following table represents (in thousands) information about the Company's financial assets measured at fair value in Level 3 as of December 31, 2016.

Assets		Fair value measurements – Level 3 December 31, 2016						
		Beginning balance January 1, 2016	Amortization accretion	Current realized net income	Change in unrealized surplus	Purchases/ Transfers into Level3	Sales/ settlements	Ending balance December 31, 2016
Common stock	$	167	—	(22)	14	17	(17)	159
Bonds		—	1	(9)	(61)	2,289	(33)	2,187
Total assets	$	167	1	(31)	(47)	2,306	(50)	2,346

The following table represents (in thousands) information about the Company's financial assets measured at fair value in Level 3 as of December 31, 2015.

Assets		Fair value measurements – Level 3 December 31, 2015				
		Beginning balance January 1, 2015	Current realized net income	Change in unrealized surplus	Purchases	Ending balance December 31, 2015
Common stock	$	10	(21)	54	124	167
Total assets	$	10	(21)	54	124	167

The following table presents (in thousands) information about the Company's financial assets measured at fair value on a recurring basis for accounting purposes as of December 31, 2016 and 2015, respectively, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

		Fair value measurements – recurring basis December 31, 2016			
Assets		**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**	**Total**
Common stocks	$	124,772		159	124,931
Common trust funds		—	62,000		62,000
Mutual funds		311,669			311,669
Preferred stocks		541	—	—	541
Total assets	$	436,982	62,000	159	499,141

		Fair value measurements – recurring basis December 31, 2015			
Assets		**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**	**Total**
Common stocks, mutual funds, and common trust funds	$	389,529	58,067	167	447,763
Preferred stocks		476	—	—	476
Total assets	$	390,005	58,067	167	448,239

Certain assets are measured at fair value on a nonrecurring basis quarterly or more frequently if events dictate that the carrying value of the asset may not be recovered. These assets include bonds held at fair value with an NAIC designation of 3–6 and redeemable preferred stocks held at fair value with an NAIC designation of RP3 RP6. There were bonds with these designations where the fair value was less than carrying value, which resulted in an unrealized loss of $1,877,000 at December 31, 2016 and $9,015,000 at December 31, 2015.

The Company did not have any significant concentrations by industry or by issuer as of December 31, 2016 or 2015.

The following table reflects (in thousands) the fair values and admitted values of all admitted assets and liabilities that are financial instruments excluding those accounted for under the equity method as of December 31, 2016 and 2015, respectively. The fair values are also categorized into the three level fair value hierarchy as described above.

December 31, 2016

Type of financial instrument		Fair value	Admitted value	Level 1	Level 2	Level 3
Financial instruments-assets:						
Long-term bonds	$	1,926,469	1,902,064	—	1,911,664	14,805
Preferred stocks		1,114	1,094	1,114	—	—
Common stocks		124,931	124,931	124,772	—	159
Common trust funds		62,000	62,000	—	62,000	—
Mutual funds		311,669	311,669	311,669	—	—
Cash, cash equivalents and short-term investments		64,798	64,798	31,846	32,952	—
Total assets	$	2,490,981	2,466,556	469,401	2,006,616	14,964

December 31, 2015

Type of financial instrument		Fair value	Admitted value	Level 1	Level 2	Level 3
Financial instruments-assets:						
Long-term bonds	$	1,849,351	1,833,786	—	1,849,351	
Preferred stocks		555	553	555	—	—
Common stocks, mutual funds, and common trust funds		447,763	447,763	389,529	58,067	167
Cash, cash equivalents and short-term investments		42,820	42,819	33,818	9,002	—
Total assets	$	2,340,489	2,324,921	423,902	1,916,420	167

Investment Income – Major categories of net investment income for the years ended December 31, 2016 and 2015 are summarized as follows (in thousands):

		2016	2015
Investment income:			
Corporate and miscellaneous bonds	$	62,258	60,691
U.S. government bonds		4,283	5,074
Cash and other investments		80	2
Real estate		5,187	5,083
Other invested assets		2,072	905
Equity securities		10,589	9,197
Surplus note interest expense		(8,625)	(8,625)
Investment expenses		(8,655)	(8,368)
Net investment income earned		67,189	63,959
Net realized capital gain (loss):			
Corporate and miscellaneous bonds		7,589	9,803
U.S. government bonds		805	—
Equity securities		6,869	(19,171)
Net realized capital gains		15,263	(9,368)
Net investment income	$	82,452	54,591

(5) Reinsurance

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

- Layer 1 – Limit of $20,000,000 in excess of retention of $20,000,000 per occurrence
- Layer 2 – Limit of $40,000,000 in excess of retention of $40,000,000 per occurrence
- Terrorism Only – Limit of $50,000,000 in excess of retention of $80,000,000 per occurrence

Management is not aware of any loss nor did the Company record any loss great enough to attach to these layers during any of the prior policy periods.

Reinsurance contracts do not relieve Pinnacol of its obligations, and a failure of the reinsurer to honor its obligations could result in losses unreimbursed to Pinnacol. Pinnacol evaluates and monitors the financial condition of its reinsurers to minimize its exposure to loss from reinsurer insolvency. Management of Pinnacol believes its reinsurers are financially sound and will continue to meet their contractual obligations.

(Continued)

Pinnacol uses Lloyd's Syndicates as part of its ceded reinsurer program. The Syndicates are generally not rated by AM Best. The remaining reinsurers had the following AM Best ratings at December 31, 2016:

Reinsurer	AM Best Rating
Arch Reinsurance Company	A+
Partner Reinsurance Company of the U.S.	A
Endurance Assurance Corporation	A
IOA Re, Inc. for and on behalf of Cincinnati Insurance Company	A+
Endurance Specialty Insurance Limited	A
Lloyd's Syndicate 2003 (Catlin Underwriting Agencies Limited)	A
Lloyd's Syndicate 3000 (Markel Syndicate Management Limited)	A

Assumed Reinsurance – Pinnacol has entered into assumed reinsurance contracts that allow the Company to provide insurance coverage under the workers' compensation provisions of other states for the employees of Colorado companies who work outside of Colorado (Other States Coverage). Effective March 1, 2004, Pinnacol executed a reinsurance contract with Argonaut Insurance Company (a California corporation) for Other States Coverage. The contract was canceled in 2010; however, Pinnacol will continue to pay existing claims in accordance with this reinsurance agreement until these claims are closed or these risks are transferred. As the Company entered into a reinsurance agreement in 2010 with Zurich American Insurance Company, there were no gaps in coverage. This agreement was still in effect as of December 31, 2016. The Other States Coverage contracts are designed as 100% quota share arrangements with Pinnacol acting as the assuming company. Premium revenue is recognized pro rata over the period the policy is effective.

Pinnacol held unearned premium reserves related to assumed business of $872,000 and $1,046,000 for the years ended December 31, 2016 and 2015, respectively. Pinnacol had loss and loss adjustment expense reserves related to assumed business of $29,271,000 and $29,213,000 for the years ended December 31, 2016 and 2015, respectively.

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

		2016	2015
Direct premiums written	$	624,536	633,021
Premiums ceded		(1,359)	(1,495)
Premiums assumed		9,015	8,425
Net premiums written	$	632,192	639,951
Direct premiums earned	$	626,809	629,023
Premiums ceded		(1,359)	(1,495)
Premiums assumed		9,190	8,348
Net premiums earned	$	634,640	635,876
Direct losses incurred	$	313,758	334,828
Losses ceded		—	—
Losses assumed		5,938	7,046
Net losses incurred	$	319,696	341,874
Direct loss adjustment expenses incurred	$	73,226	64,931
Loss adjustment expenses ceded		—	—
Loss adjustment expenses assumed		1,392	1,391
Net loss adjustment expenses incurred	$	74,618	66,322

(6) Employee Benefits

(a) Defined-Benefit Pension Plan through the State of Colorado

Pensions – Pinnacol participates in the State Division Trust Fund (SDTF), a cost-sharing multiple-employer defined benefit pension fund administered by the Public Employees' Retirement Association of Colorado ("PERA"). The net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, pension expense, information about the fiduciary net position and additions to/deductions from the fiduciary net position of the SDTF have been determined using the economic resources measurement focus and the accrual basis of accounting. For this purpose, benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms. Investments are reported at fair value.

Plan Description – Plan benefits are specified in Title 24, Article 51 of the Colorado Revised Statutes (C.R.S.), administrative rules set forth at 8 C.C.R. 1502 1, and applicable provisions of the federal Internal Revenue Code. Colorado State law provisions may be amended from time to time by the Colorado General Assembly. PERA issues a publicly available comprehensive annual financial report that can be obtained at www.copera.org/investments/pera-financial-reports.

Benefits provided – PERA provides retirement, disability, and survivor benefits. Retirement benefits are determined by the amount of service credit earned and/or purchased, highest average salary, the benefit structure(s) under which the member retires, the benefit option selected at retirement, and age at retirement. Retirement eligibility is specified in tables set forth at C.R.S. § 24 51 602, 604, 1713, and 1714.

The lifetime retirement benefit for all eligible retiring employees under the PERA Benefit Structure is the greater of the:

- Highest average salary multiplied by 2.5% and then multiplied by years of service credit.
- The value of the retiring employee's member contribution account plus a 100% match on eligible amounts as of the retirement date. This amount is then annuitized into a monthly benefit based on life expectancy and other actuarial factors.

In all cases the service retirement benefit is limited to 100% of highest average salary and also cannot exceed the maximum benefit allowed by federal Internal Revenue Code.

Members may elect to withdraw their member contribution accounts upon termination of employment with all PERA employers; waiving rights to any lifetime retirement benefits earned. If eligible, the member may receive a match of either 50% or 100% on eligible amounts depending on when contributions were remitted to PERA, the date employment was terminated, whether 5 years of service credit has been obtained and the benefit structure under which contributions were made.

Benefit recipients who elect to receive a lifetime retirement benefit are generally eligible to receive post retirement cost of living adjustments (COLAs), referred to as annual increases in the C.R.S. Benefit recipients under the PERA benefit structure who began eligible employment before January 1, 2007 receive an annual increase of 2%, unless PERA has a negative investment year, in which case the annual increase for the next three years is the lesser of 2% or the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI W) for the prior calendar year. Benefit recipients under the PERA benefit structure who began eligible employment after January 1, 2007 receive an annual increase of the lesser of 2% or the average CPI W for the prior calendar year, not to exceed 10% of PERA's Annual Increase Reserve (AIR) for the SDTF.

Disability benefits are available for eligible employees once they reach five or more years of service credit and are determined to meet the definition of disability. The disability benefit amount is based on the retirement benefit formula shown above considering a minimum 20 years of service credit, if deemed disabled.

Survivor benefits are determined by several factors, which include the amount of earned service credit, highest average salary of the deceased, the benefit structure(s) under which service credit was obtained, and the qualified survivor(s) who will receive the benefits.

Contributions – Eligible employees and Pinnacol are required to contribute to the SDTF at a rate set by Colorado statute. The contribution requirements are established under C.R.S. § 24 51 401, et seq. Eligible employees with the exception of State Troopers are required to contribute 8% of their PERA includable salary. The employer contribution requirements for Pinnacol are summarized in the table below:

	For the Year Ended 12/31/14	For the Year Ended 12/31/15	For the Year Ended 12/31/16
Employer contribution rate (includes 1.02% allocation to the Health Care Trust Fund – see note 6c) [1]	10.15%	10.15%	10.15%
Amortization Equalization Disbursement (AED) as specified in C.R.S. §24-51-411 [1]	3.80	4.20	4.60
Supplemental Amortization Equalization Disbursement (SAED) as specified in C.R.S., §24-51-411 [1]	3.50	4.00	4.50
Total employer contribution rate [1]	17.45%	18.35%	19.25%

[1]Rates are expressed as a percentage of salary as defined in C.R.S. § 24-51-101(42).

Employer contributions are recognized in the period in which the compensation becomes payable to the member and Pinnacol is statutorily committed to pay the contributions. Employer contributions to PERA for the years ending December 31, 2016 and 2015 were $10,474,000 and $8,732,000, respectively. These contributions met the contribution requirement for each year.

(b) Voluntary Tax-Deferred Retirement Plans

Employees of Pinnacol that are also members of the SDTF may voluntarily contribute to the Voluntary Investment Program, an Internal Revenue Code Section 401(k) defined contribution plan administered by PERA. Title 24, Article 51, Part 14 of the C.R.S., as amended, assigns the authority to establish the plan provisions to the PERA Board of Trustees. PERA issues a publicly available comprehensive annual financial report for the Program. That report can be obtained at www.copera.org/investments/pera-financial-reports.

Pinnacol matches employee's elective contributions into the PERA 401(k) plan at 50% up to the first 6% of employees' elected deferrals. The matching contribution is immediately vested and available to the employees. During the years ended December 31, 2016 and 2015, Pinnacol contributed approximately $1,358,000 and $1,191,000, respectively, in matching contributions to the 401(k) plan. Pinnacol also offers a 457 deferred compensation plan.

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

Health Care Program – Pinnacol contributed to the Health Care Trust Funds (HCTF), a cost sharing multiple employer healthcare trust administered by PERA. The HCTF benefit provides a health care premium subsidy and health care programs (known as PERACare) to PERA participating benefit recipients and their eligible beneficiaries. Title 24, Article 51, Part 12 of the C.R.S., as amended, establishes the HCTF and sets forth a framework that grants authority to the PERA Board to contact, self insure and authorize disbursements necessary in order to carry out the purposes of the PERACare program, including the administration of health care subsidies. PERA issues a publicly available comprehensive annual financial report that includes financial statements and required supplementary information for the HCTF. That report can be obtained at www.copera.org/investements/pera-financial-reports.

Funding Policy – Pinnacol is required to contribute at a rate of 1.02% of PERA includable 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 contributions to the HCTF is established under Title 24, Article 51, Section 208(1)(f) of the C.R.S., as amended. For the years ending December 31, 2016 and 2015, Pinnacol contributed approximately $555,024 and $485,000, respectively, equal to the required contributions for each year.

(d) Other

Health and Welfare Trust – Effective January 1, 2010, Pinnacol entered into certain self funded benefit programs with its vendors for healthcare, dental care, and vision care and established a separate legal trust for administrative purposes. Pinnacol withholds monthly premium from its employee participants' payroll checks and uses these premiums and the employer contribution amounts to fund the trust account. Medical claims are processed and paid by the third party vendors and subsequently reimbursed by the funds held in the trust. Employer contributions in 2016 and 2015 were $6,197,000 and $5,733,000, respectively.

Accrued Paid Leave – Pinnacol employees may accrue paid time off based on their length of service subject to certain limitations on the amount that will be paid upon termination or taken in future periods. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The estimated liability for cumulative accrued paid time off of approximately $2,274,000 and $1,932,000 at December 31, 2016 and 2015, respectively, is included in other liabilities in the statutory basis statements of admitted assets, liabilities, and policyholders' surplus.

(7) Policyholders' Surplus

Pinnacol declared general policyholder dividends in 2016 and 2015 of $50,000,000 and $30,000,000, respectively, and subsequently paid them in March 2017 and March 2016.

The Division monitors a company's "risk based capital" in assessing the financial strength of an insurance company. Pinnacol's level of surplus exceeds the "company action level" of risk based capital, which is approximately $161,221,000 for 2016.

A surplus note in the amount of $100,000,000 was issued on June 25, 2014, to an unaffiliated third party in exchange for cash. Each payment of principal and interest on the surplus note may be made only with the prior approval of the Commissioner of the Colorado Division of Insurance and only to the extent Pinnacol has sufficient policyholders' surplus to make such payment. The interest on the unpaid principal amount of this note will be paid in semiannual installments at the rate of 8.625% per annum. In 2016, $8,625,000 of interest was paid on the note and recorded as investment expense. The note, which is subordinate to the prior payment of all other liabilities of the Company, will be due and payable twenty years from the issuance date, with an optional pre-payment date in whole or part in fifteen years with no penalty. The surplus note was issued to partially cover Pinnacol's estimated proportionate share of PERA's unfunded liability for vested service of Pinnacol employees and retirees. This liability is not required to be recorded in the statutory basis financial statements as of December 31, 2016, but it reduces the capital adequacy assessments of outside rating agencies, such as A.M. Best. In accordance with the note agreement, Pinnacol may apply the proceeds for general corporate purposes.

(Continued)

Pinnacol participates in a cost sharing multiple employer defined benefit pension plan administered by the Public Employees' Retirement Association of Colorado (PERA). PERA has a net pension liability which represents the unfunded pension benefits. In 2015, Pinnacol established a special surplus fund to record its portion of the unfunded pension benefits. As of December 31, 2016, the special surplus fund amount is $180,271,000. Statutory accounting does not allow Pinnacol's portion of the net pension liability to be recorded as a liability but allows a company to establish a special surplus fund to provide for contingencies. GASB No. 68, *Accounting and Financial Reporting for Pensions* is effective for fiscal years beginning after June 15, 2014. The statement requires cost sharing employers participating in defined benefit plans to record their proportionate share of the collective net pension liability in their GASB financial statements. PERA provides Pinnacol with the audited schedule of employers' allocations and net pension liability. This estimated liability is calculated based upon actuarial data valued as of December 31, 2014. PERA uses standard roll forward procedures to then estimate the expected total pension liability as of the measurement date of December 31, 2015. The total pension liability is reduced by the plan's fiduciary net position to obtain the collective net pension liability. A discount rate of 7.5% is being used. PERA also provides the employer allocation percentage for purposes of calculating Pinnacol's proportionate share of the collective net pension liability. The funded portion of PERA's total pension liability as of December 31, 2015 is 56%.

(8) Commitments and Contingencies

The Company has made total commitments of $35,140,000 to provide additional funds as needed to the following partnerships: Kayne Credit Opportunities Fund LP $2,302,000, North Haven Credit Partners LP $5,494,000, Guggenheim Partners Investment Management, LLC $1,373,000, Blackstone Tactical Opportunities Fund II LP $6,126,000, Entrust Special Opportunities Fund III Ltd $4,651,000, NB Strategic Co-Investment Partners III LP $8,302,000 and Warburg Pincus Private Equity XII LP $6,892,000. The Company has made total commitments of $4,421,000 to provide additional funds as needed to Guggenheim Private Debt Fund Notes A-D Issuer 2.0, LLC.

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

At December 31, 2016 and 2015, Pinnacol had a letter of credit for the benefit of Argonaut Insurance Company under an assumed reinsurance agreement for approximately $10,077,000 and $12,532,000, respectively. This reinsurance agreement allows Argonaut Insurance Company to draw upon the letter of credit, which is 100% collateralized, at any time to secure any of Pinnacol's obligations under the agreement. Included in long term bonds and money market securities are amounts held as collateral for the letter of credit of approximately $23,146,000 and $17,358,000, compared to a requirement of $10,077,000 and $12,532,000, as of December 31, 2016 and 2015, respectively.

Pinnacol had a letter of credit for the benefit of Zurich American Insurance Company under an assumed reinsurance agreement for approximately $37,000,000 as of December 31, 2015. In December 2016, this letter of credit was cancelled and replaced by a trust holding securities with a total book value of $45,442,000 as of December 31, 2016. This reinsurance agreement allows Zurich American Insurance Company, the beneficiary, to claim the trust assets at any time to secure any of Pinnacol's obligations under the agreement. Included in long term bonds are amounts held in the trust of approximately $45,442,000 compared to a requirement of $39,000,000 as of December 31, 2016.

Pinnacol is contingently liable for approximately $49,426,000 of claims closed by the purchase of annuities from life insurers for structured settlements. Pinnacol has not purchased annuities from life insurers under which the Company is payee, and therefore, no balances are due from such annuity insurers.

Pinnacol is aware of an unfunded net pension liability. If Pinnacol were to partially or fully leave the PERA program, the unfunded net pension liability for the vested service of Pinnacol employees and retirees would become immediately due to PERA. Title 24, Article 51, Section 316 of the Colorado Revised Statutes (C.R.S.) requires a company to calculate the reserve transfer necessary when an employer disaffiliates from PERA. The formula to calculate the termination liability differs significantly from the formula used to calculate Pinnacol's share of the unfunded pension obligation under GASB 68. Therefore, the amount of a possible termination liability is unknown but is expected to exceed $100,000,000. Currently, the possibility of the Company partially or fully leaving the PERA program is remote and would require legislative action.

(9) Subsequent Events

The Board of Directors declared general dividends on November 2, 2016 in an amount to be approximately $50,000,000. The final dividend amount of $50,000,000 was confirmed in February 2017 and subsequently paid at the end of March 2017.

Subsequent events have been evaluated through May 18, 2017, the date these statutory basis financial statements were available to be issued.

SUPPLEMENTAL SCHEDULES OF INVESTMENT INFORMATION

(See Independent Auditors’ Report)

PINNACOL ASSURANCE

Supplemental Schedule of Investment Information
Investment Risks Interrogatories

Year ended December 31, 2016

(In thousands)

1. Pinnacol's total admitted assets as reported on page 2 of its annual statement are: $ 2,632,859
2. The following are the ten largest exposures to a single issuer/borrower/investment by investment category, excluding: (i) U.S. government securities, U.S. government agency securities, and those U.S. government money market funds listed in the Appendix to the *Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO)* as exempt, (ii) property occupied by Pinnacol, (iii) policy loans, and (iv) asset types that are investment companies (mutual funds) and common trust funds that are diversified within the meaning of the Investment Company Act of 1940 (Section 5(b) (1)).

	Issuer	Description of exposure		Amount	Percentage of total admitted assets
2.01	FNMA POOLS	LONG–TERM BONDS	$	164,745	6.257%
2.02	FREDDIE MAC GOLD POOLS	LONG–TERM BONDS		39,280	1.492
2.03	FANNIE MAE POOLS	LONG–TERM BONDS		24,524	0.931
2.04	FHLMC POOLS	LONG–TERM BONDS, COMMON STOCK		20,809	0.790
2.05	FGLMC POOLS	LONG–TERM BONDS		19,731	0.749
2.06	GUGGENHEIM PRIVATE DEBT FUND NOTE ISSUER 2.0, LLC	OTHER LONG-TERM ASSETS, LONG–TERM BONDS		14,143	0.537
2.07	CITIGROUP INC	LONG–TERM BONDS, COMMON STOCK, PREFERRED STOCK		11,780	0.447
2.08	JPMORGAN CHASE & CO	LONG–TERM BONDS, COMMON STOCK		11,752	0.446
2.09	KAYNE CREDIT OPPORTUNITIES FUND (QP) LP	OTHER LONG-TERM ASSETS		11,664	0.443
2.10	INTEL CORP	LONG–TERM BONDS, COMMON STOCK		11,511	0.437

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

NAIC Designation		Amount	Percentage of total admitted assets
Bonds:			
NAIC-1	$	1,392,734	52.898%
NAIC-2		341,416	12.968
NAIC-3		79,478	3.019
NAIC-4		101,097	3.840
NAIC-5		19,164	0.728
NAIC-6		1,127	0.043
Preferred stocks:			
P/RP-1		—	—
P/RP-2		541	0.021
P/RP-3		500	0.019
P/RP-4		54	0.002
P/RP-5		—	—
P/RP-6		—	—
	$	1,936,111	

4. Assets held in foreign investments are $201,490 and assets held in foreign-currency-denominated investments are $0, which is approximately 7.653% and 0.000% of Pinnacol's total admitted assets, respectively.

5. The following represents aggregate foreign investment exposure categorized by NAIC sovereign designation:

Foreign investment assets			
NAIC Designation		Amount	Percentage of total admitted assets
Countries designated NAIC-1	$	167,475	6.361%
Countries designated NAIC-2		26,560	1.009
Countries designated NAIC-3 or below		7,455	0.283
	$	201,490	

PINNACOL ASSURANCE

Supplemental Schedule of Investment Information
Investment Risks Interrogatories

Year ended December 31, 2016

(In thousands)

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

Foreign investment assets			
NAIC Designation	**Country**	**Amount**	**Percentage of total admitted assets**
Countries designated NAIC-1:			
Country 1:	AUSTRALIA	$ 26,996	1.025%
Country 2:	IRELAND	18,702	0.710
Countries designated NAIC-2:			
Country 1:	MEXICO	21,033	0.799
Country 2:	INDONESIA	3,504	0.133
Countries designated NAIC-3 or below:			
Country 1:	VIRGIN ISLANDS-BRITISH	6,958	0.264
Country 2:	MARSHALL ISLANDS	497	0.019
		$ 77,690	

7. Aggregate unhedged foreign currency exposure is $0, which is approximately 0.000% of Pinnacol's total admitted assets.

8. The following represents aggregate unhedged foreign currency exposure categorized by NAIC sovereign designation:

Foreign-Currency-Denominated investment assets		
NAIC Designation	**Amount**	**Percentage of total admitted assets**
Countries designated NAIC-1	$	—%
Countries designated NAIC-2		—
Countries designated NAIC-3 or below		—
	$ —	

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

Foreign-Currency-Denominated investment assets			
NAIC Designation	**Country**	**Amount**	**Percentage of total admitted assets**
Countries designated NAIC-1:			
Country 1:		$	—%
Country 2:			—
Countries designated NAIC-2:			
Country 1:			—
Country 2:			—
Countries designated NAIC-3 or below:			
Country 1:			—
Country 2:			—
		$ —	

10 The following represents the ten largest nonsovereign (i.e., nongovernmental) foreign issues:

	Issuer	**NAIC Designation**	**Amount**	**Percentage of total admitted assets**
10	PETROLEOS MEXICANOS	2FE	$ 10,629	0.404%
10	ACTAVIS FUNDING SCS	2FE	10,231	0.389
10	MACQUARIE BANK LTD	1FE	9,999	0.380
10	UBS AG STAMFORD CT	1FE	9,999	0.380
10.1	ING BANK NV	1FE	9,997	0.380
10.1	BNP PARIBAS SA	1FE	9,990	0.379
10.1	JOHNSON CONTROLS INTL PL	2FE	7,961	0.302
10.1	STATOIL ASA-SPON ADR	1FE	7,889	0.300
10.1	TEVA PHARMACEUTICALS NE	2FE	7,508	0.285
10.10	GE CAPITAL INTL FUNDING	1FE	7,242	0.275

PINNACOL ASSURANCE

Supplemental Schedule of Investment Information
Investment Risks Interrogatories

Year ended December 31, 2016

(In thousands)

11. Assets held in Canadian investments are less than 2.5% of Pinnacol's total admitted assets.
12. Pinnacol does not hold any investments with contractual sales restrictions.
13. The following are the ten largest equity interests (including investments in the shares of mutual funds, preferred stocks, publicly traded equity securities, and other securities and excluding money market and bond mutual funds listed in the Appendix to the Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO) as exempt or Class 1):

	Issuer		Amount	Percentage of total admitted assets
13	HARDING LOEVNER INTERNATIONAL EQUITY FUND & EMERGING MARKETS FUND	$	47,408	1.801%
13	WESTWOOD INCOME OPPORTUNITY FUND		46,041	1.749
13	BLACKROCK EQUITY INDEX FUND B CTF		41,661	1.582
13	VANGUARD INST INDEX FUND		35,671	1.355
13.1	DODGE & COX INTERNATIONAL STOCK FUND		33,052	1.255
13.1	T. ROWE PRICE INSTITUTIONAL SMALL-CAP STOCK FUND		28,326	1.076
13.1	FRANKLIN INTERNATIONAL GROWTH FUND		26,372	1.002
13.1	GMO BENCHMARK-FREE ALLOCATION FUND-III		23,889	0.907
13.1	FIRST EAGLE OVERSEAS FUND		21,232	0.806
13.10	WELLINGTON INTERNATIONAL SMALL CAP OPPORTUNITIES CTF		20,338	0.772

14. Assets held in nonaffiliated, privately placed equities is LESS THAN 2.5% of Pinnacol's total admitted assets.

Items 15 through 23 are not applicable.

See accompanying independent auditors' report.

PINNACOL ASSURANCE

Supplemental Schedule of Investment Information
Summary Investment Schedule

December 31, 2016

(In thousands)

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	$ 94,099	3.7%	$ 94,099	3.7%
U.S. government agency obligations (excluding mortgage-backed securities):				
– Issued by U.S. government agencies	—	—	—	—
– Issued by U.S. government-sponsored agencies	—	—	—	—
Non U.S. government (including Canada, excluding mortgage-backed securities)	15,471	0.6	15,471	0.6
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
– States, territories, and possessions general obligations	—	—	—	—
– Political subdivisions of states, territories, and possessions and political general obligations	11,288	0.4	11,288	0.4
– Revenue and assessment obligations	46,262	1.8	46,262	1.8
– Industrial development and similar obligations	—	—	—	—
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
– Issued or guaranteed by GNMA	3,796	0.2	3,796	0.2
– Issued or guaranteed by FNMA and FHLMC	265,142	10.5	265,142	10.5
– All other	—	—	—	—
CMOs and REMICs:				
– Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	20,692	0.8	20,692	0.8
– Issued by non-U.S. government issuers and collateralized by mortgage-based securities issued by above	110,391	4.4	110,391	4.4
– All other	—	—	—	—
Other debt and other fixed income securities (excluding short term):				
– Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	1,129,692	44.7	1,129,692	44.7
– Unaffiliated non-U.S. securities (including Canada)	205,231	8.1	205,231	8.1
– Affiliated securities	—	—	—	—
Equity interests:				
– Investments in mutual funds	311,669	12.3	311,669	12.3
Preferred stocks:				
– Affiliated	—	—	—	—
– Unaffiliated	1,094	0.0	1,094	0.0
Publicly traded equity securities (excluding preferred stocks):				
– Affiliated	—	—	—	—
– Unaffiliated	124,931	4.9	124,931	4.9
Other equity securities:				
– Affiliated	—	—	—	—
– Unaffiliated	62,000	2.5	62,000	2.5
Other equity interests including tangible personal property under lease:				
– Affiliated	—	—	—	—
– Unaffiliated	—	—	—	—

(Continued)

PINNACOL ASSURANCE

Supplemental Schedule of Investment Information
Summary Investment Schedule

December 31, 2016

(In thousands)

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
Mortgage loans:				
– Construction and land development	$ —	—%	$ —	—%
– Agricultural	—	—	—	—
– Single-family residential properties	—	—	—	—
– Multifamily residential properties	—	—	—	—
– Commercial loans	—	—	—	—
– Mezzanine real estate loans	—	—	—	—
Real estate investments:				
– Property occupied by Company	17,162	0.7	17,161	0.7
– Property held for production of income	—	—	—	—
– Property held for sale	—	—	—	—
Contract loans	—	—	—	—
Derivatives	—	—	—	—
Receivables for securities	770	0.0	770	0.0
Securities lending	—	—	—	—
Cash, cash equivalents, and short-term investments	64,798	2.6	64,799	2.6
Other invested assets	45,155	1.8	45,155	1.8
Total invested assets	$ 2,529,643	100.0%	$ 2,529,643	100.0%

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

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

See accompanying independent auditors' report.

KPMG LLP
Suite 800
1225 17th Street
Denver, CO 80202-5598

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

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

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States, the financial statements of Pinnacol Assurance, which comprise the statutory statements of admitted assets, liabilities, and policyholders' surplus as of December 31, 2016, and the related statutory statements of operations and changes in policyholders' surplus, and cash flow for the year then ended, and the related notes to the statutory financial statements, and have issued our report thereon dated May 18, 2017. Our report on the financial statements includes an adverse opinion on U.S. generally accepted accounting principles because the financial statements are prepared using statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, which is a basis of accounting other than U.S. generally accepted accounting principles. Our report on the financial statements also includes an unmodified opinion on the financial statements in accordance with statutory accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, which is a basis of accounting other than U.S. generally accepted accounting principles.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered Pinnacol Assurance's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Pinnacol Assurance's internal control. Accordingly, we do not express an opinion on the effectiveness of Pinnacol Assurance's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

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

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of Pinnacol Assurance's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Pinnacol Assurance's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Denver, Colorado
May 18, 2017

KPMG LLP
Suite 800
1225 17th Street
Denver, CO 80202-5598

May 18, 2017

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

Ladies and Gentlemen:

We have audited the statutory-basis financial statements of Pinnacol Assurance (the Company) as of December 31, 2016 and 2015 and for each of the years then ended, and issued our report thereon dated May 18, 2017. Under our professional standards, we are providing you with the accompanying information related to the conduct of our audits.

Our Responsibility Under Professional Standards

We are responsible for forming and expressing an opinion about whether the financial statements, that have been prepared by management with the oversight of the Pinnacol Assurance Risk and Audit Committee are presented fairly, in all material respects, 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 are the statutory accounting practices (SAP) codified in the NAIC's *Accounting Practices and Procedures Manual*. We have a responsibility to perform our audit of the financial statements in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial statement audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. In carrying out this responsibility, we planned and performed the audit to obtain reasonable assurance about whether the financial statements as a whole are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, we are to obtain reasonable, not absolute, assurance that material misstatements are detected. We have no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected. Our audit does not relieve management or the Pinnacol Assurance Risk and Audit Committee of their responsibilities.

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

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

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

Other Information in Documents Containing Audited Financial Statements

Our responsibility for other information in documents containing the Company's financial statements and our auditors' report thereon does not extend beyond the financial information identified in our auditors' report, and we have no obligation to perform any procedures to corroborate other information contained in these documents. We have, however, read the other information included in the Company's annual report, and no matters came to our attention that cause us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements.

Accounting Practices and Alternative Treatments

Significant Accounting Policies

The significant accounting policies used by the Company are described in note 1 to the statutory-basis financial statements.

Unusual Transactions

On November 2, 2016, the Board of Directors declared a general policyholder dividend to its policyholders in good standing of $50,000,000. The dividend was paid out in March 2017. The Company accounted for the transaction in accordance with SSAP No. 51, *Policyholder Dividend Liability*.

Qualitative Aspects of Accounting Practices

We have discussed with the Risk and Audit Committee and management our judgments about the quality, not just the acceptability, of the Company's accounting principles as applied in its financial reporting. The discussions generally included such matters as the consistency of the Company's accounting policies and their application, and the understandability and completeness of the Company's statutory-basis financial statements, which include related disclosures.

Management Judgments and Accounting Estimates

The preparation of the statutory-basis financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the statutory-basis financial statements and the reported amounts of revenues and expenses during the period. Those judgments are ordinarily based on knowledge and experience about past and current events and on assumptions about future events. Significant accounting estimates reflected in the Company's 2016 statutory basis financial statements include the following:

Bonds and Common Stocks – Pinnacol must consider the statutory requirements related to other than temporary impairments (OTTI) when determining whether any declines in value are recognized through realized losses in the statutory statement of operations or through change in unrealized losses, which is a direct charge to policyholders' surplus. These statutory requirements for other than temporary impairments require management's judgment and consideration of various characteristics of the investments, the underlying causes of the decline in value, as well as management's intent related to future sales of the securities. The Company recorded $5,827,000 in other than temporary impairments on common stocks, mutual funds, and bonds for the year ended December 31, 2016.

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

Reserve for Unpaid Losses and Loss Adjustment Expenses – Estimating the reserve for unpaid losses and loss adjustment expenses (reserves) of an insurance company is a subjective and judgmental process, particularly for workers' compensation insurance, where the ultimate liability to a claimant may not be known with certainty for a number of years. To assist management in estimating the liability for unpaid losses and loss adjustment expenses, Pinnacol retains the assistance of an actuarial consulting firm. At December 31, 2016, Pinnacol has recorded $935,712,000 as reserves for unpaid losses and loss adjustment expenses as management's best estimate, which management believes to be a reasonable estimate of future amounts to be paid for claims incurred in 2016 and in prior years.

Structured Settlement Liability – Pinnacol discounts internal structured settlement liabilities on a tabular basis using a discount rate of 2.5% for 2016. The discount rate is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. To assist management in estimating the internal structured settlement liability, Pinnacol retains the assistance of an actuarial consulting firm. At December 31, 2016, Pinnacol has recorded an internal structured settlement liability of $378,736,000.

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

The premium deficiency reserve as of and for the years ended December 31, 2016 and 2015 was $0. This is due to continued strong underwriting results and estimated future positive results. Pinnacol retains the assistance of an actuarial consulting firm to assist management in estimating the premium deficiency reserve. The premium deficiency reserve evaluation was completed on January 20, 2017 by an independent actuary.

Uncollected Premiums – The amount of uncollected premiums, which affects the amount of premium revenue recognized, is estimated using statutory requirements, as well as certain management judgments. Management must determine whether an allowance should be established to provide for all reasonably anticipated uncollectible amounts inherent in the uncollected premiums balance. Factors that are considered in establishing reserves for anticipated uncollectible amounts are collection experience and trends, current overall aging of balances, economic conditions and trends, and evaluations of individual accounts. At December 31, 2016, the admitted value of uncollected premiums as reflected in Pinnacol's statutory basis financial statements is $84,308,000.

Earned but Unbilled Premiums – Earned but unbilled premiums represent a receivable or liability for audit premiums, which are amounts due from or to policyholders after the respective policy period has expired based on audits performed by Pinnacol. A receivable is included as a component of uncollected premiums. A liability is included as a component of credit balances due policyholders. Such amounts are estimated by Pinnacol based upon internal calculations using historical premium data. Based on this analysis, Pinnacol recorded a net estimated earned but unbilled receivable of approximately $48,950,000 in 2016.

Safety Group Dividends Payable to Policyholders – Pinnacol has a safety group dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. Based on the payment pattern for these dividends, management must estimate the future loss ratio for the eligible policyholders in order to determine the accrual recorded at December 31, 2016. For 2016, safety group dividends payable of $3,500,000 are included in dividends payable to policyholders.

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

Individual Loss Control Dividends Payable to Policyholders – Pinnacol has an individual loss control dividend (ILCD) program that is designed for policyholders who are committed to effective loss control in their business operations. If the policyholder meets the minimum premium requirements and pays an additional 5% premium charge as a buy in to the plan, the policyholder may receive a return of premium based on the policy premium and the loss ratio. For 2016, ILCD payable of $21,093,000 are included in dividends payable to policyholders.

General Policyholder Dividends – The Board of Directors, at its discretion, determines the amount of general policyholder dividends to be declared, based on Pinnacol's overall experience and financial condition. For 2016, a general dividend accrual of $50,000,000 is included in general dividends payable to policyholders.

Agent Loss Control Bonus – Pinnacol offers an agent contingency commission that is based upon each agency's estimated loss ratio. It is calculated as of June 30th for the preceding accident year. For 2016, an agent loss control bonus accrual of $24,000,000 is included in commissions payable.

Uncorrected and Corrected Misstatements

In connection with our audit of the Company's statutory-basis financial statements, we have not identified any significant financial statement misstatements that have not been corrected in the Company's books and records as of and for the year ended December 31, 2016 and have communicated that finding to management.

Disagreements with Management

There were no disagreements with management on financial accounting and reporting matters that would have caused a modification of our auditors' report on the Company's statutory-basis financial statements.

Management's Consultation with Other Accountants

To the best of our knowledge, management has not consulted with or obtained opinions, written or oral, from other independent accountants during the year ended December 31, 2016.

Significant Issues Discussed, or Subject to Correspondence, with Management

Major Issues Discussed with Management Prior to Retention

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with you and management each year prior to our retention by the Company's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

Material Written Communications

The following material written communications between management and us have been provided:

1. Management representation letter

2. Internal legal letter

Significant Difficulties Encountered During the Audit

We encountered no significant difficulties in dealing with management in performing our audit.

Independence

We are not aware of any additional relationships between our firm and the Company and persons in a financial reporting oversight role at the Company that may reasonably be thought to bear on independence.

KPMG

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

Confirmation of Audit Independence

We hereby confirm that as of May 18, 2017, we are independent accountants with respect to the Company under relevant professional and regulatory standards.

* * * * * * *

This letter to the Risk and Audit Committee is intended solely for the information and use of the Risk and Audit Committee and management and is not intended to be and should not be used by anyone other than these specified parties. However, upon release by the Legislative Audit Committee, this report is a public document.

Very truly yours,

KPMG LLP

Denver, Colorado
May 18, 2017