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CAKE INSURE, INC. A SUBSIDIARY OF PINNACOL ASSURANCE

AUGUST 2018

PERFORMANCE AUDIT

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DIANNE E. RAY, CPA

STATE AUDITOR

July 25, 2018

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of Pinnacol Assurance (Pinnacol) and Cake Insure, Inc., (Cake Insure), a subsidiary of Pinnacol. The audit was conducted pursuant to Section 8-45-121(2), C.R.S., which authorizes the State Auditor to conduct an audit of Pinnacol as the State Auditor deems appropriate. The report presents our findings, conclusions, and recommendations, and the responses of Pinnacol and Cake Insure.

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CONTENTS

REPORT HIGHLIGHTS

CAKE INSURE, INC. A SUBSIDIARY OF PINNACOL ASSURANCE

PERFORMANCE AUDIT, AUGUST 2018

PINNACOL ASSURANCE
CAKE INSURE, INC.

CONCERN

Pinnacol Assurance lacks written policies and procedures for tracking of expenses and aligning the estimated costs with actual costs related to services it provides to its subsidiary, Cake Insure, Inc. Without following consistent procedures, it is difficult for Pinnacol to determine whether it is over- or undercharging Cake Insure, Inc., for the costs of services.

KEY FACTS AND FINDINGS

- In November 2016 Pinnacol Assurance (Pinnacol) created a new internal division named Destiny. Destiny was created to develop a digital platform that would allow Pinnacol to offer insurance to the small business market in a quick and easy format. The development of the digital platform began in January 2017 and was completed in September 2017.

- As work continued on the digital platform, Pinnacol management began exploring the idea of creating a separate for-profit subsidiary for Destiny operations. Although Destiny and the digital platform could have remained within Pinnacol as a separate division, Pinnacol management determined that operating as a separate wholly-owned subsidiary with outside investors would be more beneficial to the company.

- In September 2017, Pinnacol created a for-profit subsidiary named Cake Insure, Inc., (Cake Insure). Cake Insure was created to market, sell, and service workers' compensation insurance for small business policies with less than $10,000 in annual premiums that are not considered to be high risk.

- Cake Insure is not an insurance company and all policies sold by Cake Insure are carried by Pinnacol. Cake Insure was initially rolled-out in October 2017 and fully launched by January 2018.

- Cake Insure pays Pinnacol a monthly fee for providing management services. Pinnacol staff estimated the monthly fee based on a cost calculation of employees' predicted time for providing services; however, Pinnacol did not require employees to track the actual time they spent providing services to Cake Insure. Since Pinnacol has not established written policies and procedures for the calculation of the monthly fee, or performed a detailed review of its cost calculation, it cannot determine if it is adequately recovering its costs. Any gains or losses from the services could have financial reporting or tax obligations for Pinnacol and Cake Insure.

BACKGROUND

- Pinnacol Assurance is a political subdivision of the State that serves to ensure that Colorado employers have access to workers' compensation insurance coverage and the means to cover the cost of compensating injured workers and their dependents.

- As a quasi-governmental entity, Pinnacol is unique from other workers compensation entities in that statutes indicate that it is to operate like a mutual insurance company, yet it has the benefit of being exempt from certain state and federal taxes under the Internal Revenue Service.

- Pursuant to statute, Pinnacol is not allowed to provide any other type of insurance except workers compensation, and cannot own or operate another insurance company. Pinnacol may sell services and may enter into agreements with public or private entities for the purpose of carrying out its duties and functions.

KEY RECOMMENDATIONS

- Establish and implement written policies and procedures for calculating the monthly fee charged to Cake Insure.
- Require employees to track actual time worked on Cake Insure.
- Recalculate the fees charged to Cake Insure during Calendar Year 2017 and adjust the fees, as appropriate, to ensure that the fees align with the cost of services provided to Cake Insure during the year.

CHAPTER 1
OVERVIEW

In 1915, Colorado enacted workers' compensation laws and created the State Compensation Insurance Fund (Fund) to ensure that employers had access to workers' compensation insurance coverage and the means to cover the cost of compensating injured workers and their dependents. The Fund was overseen by the Industrial Commission of Colorado until 1968 when it was placed as an agency of the State within the Department of Labor and Employment. In 1987, the General Assembly enacted legislation that transitioned the Fund to a political subdivision of the State and changed its name to the State Compensation Insurance Authority (State Authority). In 2002, the State Authority was officially named Pinnacol Assurance (Pinnacol) under the provisions of the Colorado Workers' Compensation Act (Act) (Title 8, Article 45 of the Colorado Revised Statutes, as amended).

Pinnacol is a political subdivision of the State that serves to ensure that Colorado employers have access to workers' compensation insurance coverage and the means to cover the cost of compensating injured workers and their dependents. In Colorado, the majority of employers are required by law to carry a workers' compensation insurance policy for their employees. Workers' compensation insurance pays for medical costs associated with work-related injuries and, when necessary, provides indemnity (lost wage) benefits to injured workers, and death benefits to dependent widows and children.

Some employers have difficulty purchasing workers' compensation insurance in the private market due to the inherent risk of their business. In order to make sure that these high-risk employers have access to the insurance they need, states have established workers' compensation insurance authorities that are "insurers of last resort." Pinnacol is the State's insurer of last resort, meaning that it cannot 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 statute [Section 8-45-101(5)(f), C.R.S.]. Some examples of appropriate reasons for canceling or rejecting a policy include policies that are fraudulent, policies that have been materially misrepresented, and policies with premiums that have not been paid [Section 8-44-110, C.R.S.].

EXHIBIT 1.1 shows, based on the most recent premium market share data, that Pinnacol is Colorado's largest workers' compensation insurance carrier.

EXHIBIT 1.1. COLORADO WORKERS' COMPENSATION INSURANCE MARKET SHARE[1]
CALENDAR YEARS 2014 THROUGH 2016

INSURER	2014	2015	2016
Pinnacol Assurance	59.8%	59.9%	58.6%
Travelers Insurance Company	5.4%	5.6%	5.6%
Zurich American Insurance Company	4.2%	4.2%	3.4%
Indemnity Insurance Company Of North America	2.1%	3.4%	3.4%
Others, combined[2]	28.5%	26.9%	29.0%

SOURCE: Office of the State Auditor analysis of data provided by the Colorado Division of Insurance.
[1]Measured as a percentage of total premiums charged to all employers in the insured market. This does not include employers who are self-insured.
[2]An average of 316 insurers other than those listed provided workers' compensation coverage in Colorado between 2014 and 2016, each with less than 1.2 percent of the market in 2016.

PINNACOL ADMINISTRATION

As required by the Act, Pinnacol is governed by a nine-member Board of Directors (Pinnacol Board) that is appointed by the Governor with the consent of the Senate. The members of the Pinnacol Board serve 5-year terms. The Pinnacol Board must be composed of the following types of members:

- Four employers who obtain workers' compensation insurance from Pinnacol, including one farmer or rancher.
- Three employees of employers who obtain workers' compensation insurance from Pinnacol.
- One member who is experienced in managing and operating insurance companies, but does not have any business interest that competes with Pinnacol.
- One member who is experienced in finance or investments, but is not an employer insured through Pinnacol [Section 8-45-101(2)(a), C.R.S.].

The Pinnacol Board appoints the Chief Executive Officer who administers Pinnacol. As of the end of Calendar Year 2017, Pinnacol had 634 full-time equivalent staff. Pinnacol employees are not subject to the State's human resource requirements and rules, such as pay scales and leave accruals; however, because Pinnacol is a political subdivision, Pinnacol's employees do participate in the State's retirement program, the Public Employees' Retirement Association (PERA) [Section 8-45-101(8), C.R.S.].

Like other workers' compensation insurers in Colorado, Pinnacol is subject to oversight by two state agencies: (1) the Division of Insurance, within the Department of Regulatory Agencies; and (2) the Division of Workers' Compensation, within the Department of Labor and Employment. The Division of Insurance monitors the financial condition of the insurance industry by conducting periodic examinations of all Colorado insurers, reviewing each insurer's risk based capital (surplus) to ensure the capital meets regulatory requirements, and reviewing the rate-setting procedures and data used by workers' compensation insurers to calculate premiums. Examinations can result in enforcement action, such as a cease and desist order, the revocation of a license, or civil penalties. The Division of Workers' Compensation is responsible for the administration of the workers' compensation system in Colorado. They periodically audit all workers' compensation insurers to monitor their compliance with the Act. These audits analyze claim practices and assess compliance with the Act. Insurers who are not compliant with the Act may have fines imposed upon them.

Under the Act, the Pinnacol Board is vested with the responsibility to establish Pinnacol's workers' compensation rates and premiums. These workers' compensation rates must "not [be] excessive, inadequate, or unfairly discriminatory" [Section 8-45-101(5)(e), C.R.S.]. Earned premiums paid by policyholders contribute to Pinnacol's policyholders' surplus. In accordance with state statute, the Pinnacol Board is responsible for determining the amount of policyholders' surplus to set aside in order to ensure Pinnacol has sufficient reserves to pay any unpaid claims [Section 8-45-111, C.R.S.]. EXHIBIT 1.2 shows the Pinnacol policyholders' surplus from 2012 to 2017, which rose 107 percent during that time, as well as the amount of premiums earned and dividends declared to policyholders.

EXHIBIT 1.2. PINNACOL POLICYHOLDERS' SURPLUS, PREMIUMS EARNED, AND DIVIDENDS DECLARED (IN THOUSANDS)

POLICYHOLDER'S SURPLUS	2012	2013	2014	2015	2016	2017
Unfunded Pension Benefits	$0	$0	$0	$156,767	$180,271	$350,883
Surplus Notes	$0	$0	$100,000	$100,000	$100,000	$100,000
Unassigned	$616,102	$625,560	$747,987	$678,531	$806,078	$825,425
Total Policyholder's Surplus	$616,102	$625,560	$847,987	$935,298	$1,086,349	$1,276,308
Premiums Earned	$425,882	$479,719	$569,319	$635,876	$634,640	$625,619
Dividends Declared	$37,453	$0	$0	$30,000	$50,000	$50,000

SOURCE: Pinnacol Assurance Audited Statutory-Basis Financial Statements and Supplemental Schedules of Investment Information, Years Ended December 31, 2012, through 2016. Unaudited Pinnacol Assurance Statutory-Basis Financial Statements and Supplemental Schedules of Investment Information, Year Ended December 31, 2017.

The Pinnacol Board has overall fiduciary responsibility for the operations of Pinnacol, including:

- Developing and approving an annual budget.

- Establishing general policies and procedures for the operation and administration of Pinnacol.

- Reviewing and recommending legislation pertaining to workers' compensation.

- Controlling Pinnacol's investments.

- Issuing dividends to policyholders from the policyholders' surplus.

As a quasi-governmental entity, Pinnacol is unique from other workers compensation entities. Pinnacol's enabling statutes indicate that Pinnacol is to operate like a mutual insurance company. As a workers' compensation organization created and organized by the State, Pinnacol has the benefit of being exempt from certain state and federal taxes under the Internal Revenue Service (IRS) Code Section 501(c)(27)(B).

Pinnacol is exempt from the federal income tax because it meets each of the following Internal Revenue Code criteria [IRC 501(c)(27)(B)]:

- Created and initially funded by the State
- Prohibited from dissolution

- Provides workers' compensation insurance exclusively
- Is the State's insurer of last resort
- Is governed by a Board of Directors that includes a majority of members appointed by the Governor

Because of this exemption, Pinnacol is also exempt from state income taxes. EXHIBIT 1.3 summarizes a comparison of Pinnacol and other Colorado insurers' tax exemptions.

EXHIBIT 1.3. PINNACOL AND ALL OTHER COLORADO INSURANCE PROVIDERS TAX EXEMPTIONS

	PINNACOL ASSURANCE	ALL OTHER COLORADO INSURANCE PROVIDERS
Federal Income Tax	X	
State Corporate Income Taxes	X	X
State Insurance Premium Tax	X	
Property Tax	X	
State and Use Tax	X	

SOURCE: Internal Revenue Code 501(c)(27)(B) and Sections 39-22-112, 39-26-704, 39-3-105, and 10-3-209 C.R.S.

CAKE INSURE, INC.

In September 2017, Pinnacol created a for-profit subsidiary named Cake Insure, Inc., (Cake Insure). Cake Insure was created to market, sell, and service workers' compensation insurance for small business policies with less than $10,000 in annual premiums that are not considered to be high risk. Cake Insure uses a digital platform to more quickly and conveniently allow small business employers to obtain policies for workers' compensation insurance. Cake Insure is not an insurance company. Cake Insure quotes and sells policies on behalf of Pinnacol, meaning that Cake Insure evaluates the risk of potential policies and determines if they should accept the policy, while Pinnacol holds the liability for the policy and any future claims. Cake Insure was initially rolled-out in October 2017 and fully launched by January 2018.

Cake Insure Articles of Incorporation authorized 10 million shares of common stock and 10 million shares of convertible preferred stock. Pinnacol Board initially approved a $10 million investment in Cake

Insure for 2 million shares of convertible preferred shares. Certain Pinnacol executives were also issued 222,222 shares of common stock. After both issuances, Pinnacol held 90 percent ownership of the entity and Pinnacol executives held the remaining 10 percent ownership. As a majority-owned subsidiary of Pinnacol, Cake Insure is staffed exclusively by Pinnacol employees. At the inception of the Cake Insure project, Pinnacol management reassigned certain Pinnacol employees to the project and later hired two employees from outside the organization to staff the project. As of May 2018, Cake Insure had 19 full-time employees and two temporary staff. All staff are Pinnacol employees and, as such, they are paid by Pinnacol, receive the same benefits as Pinnacol employees, and are required to follow all Pinnacol policies and procedures. Cake Insure and its employees operate in a separate office from Pinnacol.

Cake Insure earns revenue from Pinnacol in the form of program administration fees in exchange for providing marketing, quoting, and selling of small workers' compensation policies. From September 20, 2017, (inception) through March 31, 2018, Cake Insure received approximately $43,500 in service fee revenue from Pinnacol and $15,300 in investment income. EXHIBIT 1.4 shows Cake Insure's total revenues and expenses from inception through December 31, 2017, January 2018, February 2018, and March 2018 respectively.

EXHIBIT 1.4. CAKE INSURE REVENUES, EXPENSES, AND NET LOSSES SEPTEMBER 2017 THROUGH MARCH 2018

	SEPTEMBER 20, 2017 (INCEPTION)	INCEPTION -DECEMBER 31, 2017	JANUARY 2018	FEBRUARY 2018	MARCH 2018	TOTAL
TOTAL REVENUES	$0	$14,170	$10,362	$14,389	$19,924	$58,845
TOTAL EXPENSES	$0	$2,033,782	$434,323	$630,795	$685,612	$3,784,512
NET LOSS	$0	$(2,019,612)	$(423,961)	$(616,406)	$(665,688)	$(3,725,667)

SOURCE: Cake Insure, Inc., and Subsidiary Consolidated Financial Statements and Independent Auditors' Report December 31, 2017, and Cake Insure, Inc., Unaudited Financial Statements as of January 31, 2018, February 28, 2018, and March 31, 2018.

AUDIT PURPOSE, SCOPE, AND METHODOLOGY

We conducted this performance audit pursuant to Section 8-45-121(2), C.R.S., which authorizes the State Auditor to conduct a performance audit of Pinnacol as deemed appropriate. Audit work was performed from March 2018 through July 2018. We appreciate the cooperation and assistance provided by the management and staff of Pinnacol and Cake Insure during this audit.

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate audit evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objectives.

The key objectives of the audit were to understand Cake Insure and its (1) formation, (2) structure, (3) relationship with Pinnacol, and (4) future. The scope of the audit did not include a review of Pinnacol's business that does not relate to Cake Insure.

To accomplish our audit objectives, we performed the following audit work:

- Reviewed relevant state and federal laws.
- Reviewed relevant policies and procedures for Pinnacol and Cake Insure.
- Interviewed Pinnacol and Cake Insure staff and executives.
- Collected and reviewed Pinnacol and Cake Insure financial information.

- Obtained testimony and documentation related to the formation of Cake Insure.

- Reviewed contracts and agreements between Pinnacol and Cake Insure, including any related cost estimates.

- Reviewed transactions between Pinnacol and Cake Insure related to the formation and ongoing operations of Cake Insure.

- Identified the roles and responsibilities of Pinnacol and Cake Insure staff.

- Obtained and reviewed the financial model developed by Pinnacol for Cake Insure.

We relied on the following nonstatistical samples to support our audit:

- A random sample of 1 month of Cake Insure's accounts payable and accounts receivable reconciliations performed from October 2017 through March 2018 to test internal controls over Cake Insure's accounting practices.

- A random sample of 1 month of Cake Insure's financial statements prepared from October 2017 through March 2018 to test if the financial statements were reconciled to general ledger information.

- A random sample of 1 month of Cake Insure's commission and flat fee calculations prepared from October 2017 through March 2018 to test if commissions and flat fees were prepared within policy.

The results of our testing using these samples were not intended to be projected to the entire population. Rather, the samples were chosen to provide sufficient coverage of those areas that were significant to the objectives of this audit. We planned our audit work to assess the effectiveness of those internal controls that were significant to our audit objectives. Our conclusions on the effectiveness of those controls, as well as specific details about the audit work supporting our findings, conclusions, and recommendations, are described in the remainder of this report.

A draft of this report was reviewed by Pinnacol and Cake Insure. We have incorporated Pinnacol and Cake Insure's comments into the report where relevant. The written response to the recommendation and the related implementation dates are the sole responsibility of Pinnacol and Cake Insure.

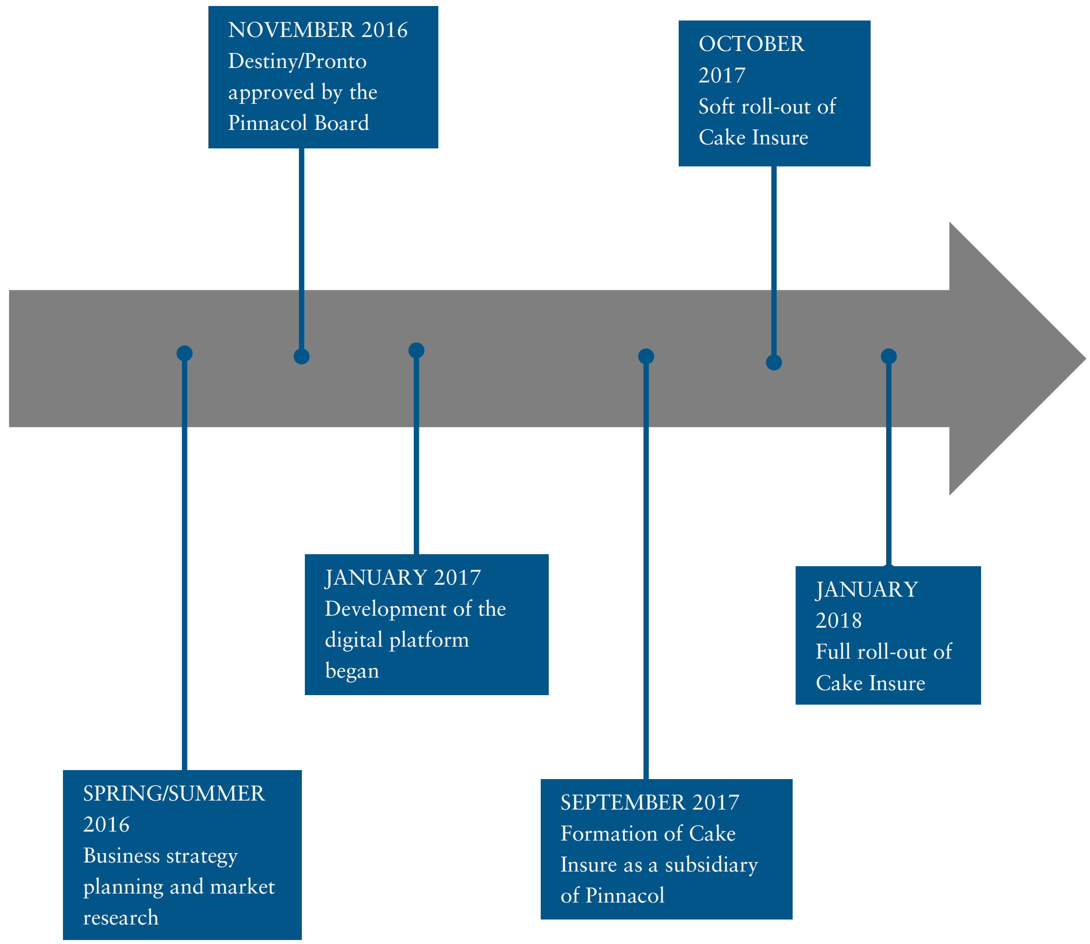
CHAPTER 2

CAKE INSURE, INC.

In November 2016 Pinnacol created a new internal division named Destiny. Destiny was created to develop a digital platform that would allow Pinnacol to offer insurance to the small business market in a quick and easy format. The development of the digital platform began in January 2017 and was completed in September 2017. Destiny and the digital platform later formed the Cake Insure, Inc., (Cake Insure) entity.

EXHIBIT 2.1 illustrates the timeline for the development and formation of Cake Insure Inc.

EXHIBIT 2.1. FORMATION OF CAKE INSURE TIMELINE



SOURCE: Auditor analysis based on interviews with Cake Insure and Pinnacol staff.

DEVELOPMENT OF DIGITAL PLATFORM

The primary purpose of Destiny was to develop a digital platform that would allow customers to quickly obtain a quote for and purchase a workers' compensation insurance policy online. All employees working on the digital platform worked in a separate building and were required to sign nondisclosure agreements to maintain the secrecy of the project from other Pinnacol employees and anyone outside Pinnacol. Destiny staff began building the digital platform, Pronto, in January 2017, and development of Pronto was completed in September 2017. The new Pronto platform allows customers to enter their business information online and get an insurance quote in minutes. Additionally, the platform houses customer information and provides a portal for policyholders to get proof of insurance, make payments, and make changes to their policy. Pinnacol management determined that Pronto was best developed through Destiny because they wanted the project to operate similar to a start-up company, where employees are able to focus 100 percent of their efforts on the project.

According to Pinnacol management, the Pronto digital platform was developed to (1) create a quick and easy customer experience to better meet the expectations and needs of small business owners, (2) cut costs through efficiencies and economies of scale, and (3) remain competitive in the current market. Pinnacol management explained that they saw other businesses pursuing similar initiatives nationally and in Colorado and decided that Pronto was necessary to meet changing customer expectations. The platform was specifically developed for smaller low-risk policies with annual policyholder premiums totaling less than $10,000. Pinnacol management explained that this threshold was a natural breakpoint because, by terms of Pinnacol's filing with the Colorado Division of Insurance, policies of $10,000 and above require more extensive underwriting than those under that threshold.

There are three ways that customers can obtain a policy through Pinnacol: (1) through an agent, (2) directly from Pinnacol, and (3) directly from Cake Insure. EXHIBIT 2.2 illustrates how policies with annual premiums totaling less than $10,000 were referred to Pinnacol as of Calendar Year 2017.

EXHIBIT 2.2. REFERRAL SOURCE FOR PINNACOL'S POLICIES WITH ANNUAL POLICYHOLDER PREMIUM TOTALING LESS THAN $10,000
CALENDAR YEAR 2017

	AGENTS	DIRECT THROUGH PINNACOL	DIRECT THROUGH CAKE INSURE	TOTAL
Policy Count	31,329	12,424	561	44,314
Total Premium	$95,910,816	$27,542,420	$791,572	$124,244,808

SOURCE: Auditor analysis of Pinnacol's policyholders under $10,000 in annual premium as of December 31, 2017.

Small business policies made up approximately 79 percent of Pinnacol's total policy count but represented only 21 percent of premiums for the Calendar Year Ended December 31, 2017. Approximately 29 percent of these small dollar policies were brought directly to Pinnacol by small business owners or by Cake Insure. The remaining 71 percent of the policies were referred to Pinnacol through agents. According to Pinnacol, the commissions Pinnacol paid to agents for these small policies totaled $7.8 million for the Calendar Year Ended December 31, 2017. Pinnacol said that the policyholders brought by agents would not have been expected to go through Cake Insure because Cake Insure only places direct business, not agent business. In addition, Pinnacol would have incurred the commission costs whether Cake Insure existed or not if the policyholder chose to work with an agent. According to Pinnacol management, the Cake Insure focus is not to reduce the commissions paid for agent represented business, but to bring in new business.

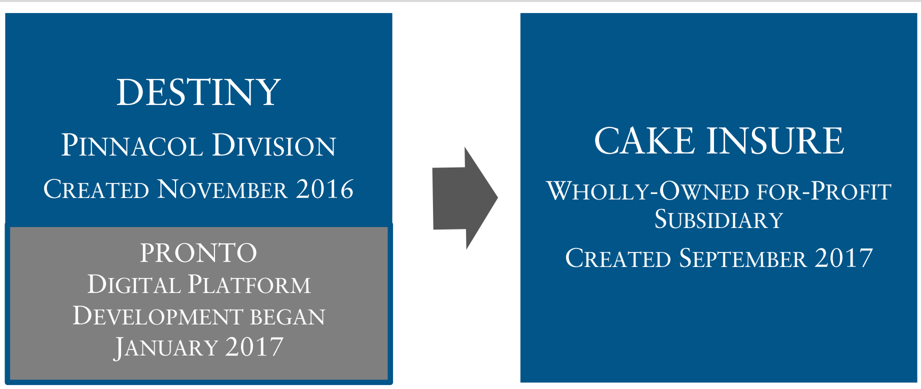
The audit team could not identify the full cost of development or independently confirm the $5.1 million Pinnacol reported as the approximate development costs of Destiny, which includes the platform Pronto. While the audit team attempted to identify the Destiny development costs by reviewing general ledger data, performing interviews with Pinnacol accounting staff, and reviewing transactions in Pinnacol's accounting system, we noted that the $5.1 million reported cost did not include all Cake Insure legal fees paid by Pinnacol because expenses related to Destiny were not initially tracked separately from Pinnacol's other legal fees. Additionally, it is not Pinnacol's practice to track employee time on projects or across departments. Therefore, the reported total also does not include staff time for Pinnacol employees not assigned to Destiny.

As work continued on Pronto, Pinnacol management began exploring the idea of creating a separate for-profit subsidiary for Destiny operations. Although Destiny and Pronto could have remained in Pinnacol as a division, Pinnacol determined that a subsidiary would be more beneficial in two ways: (1) it would open up more opportunity for outside investment and (2) it would reduce Pinnacol's liability and protect Pinnacol policyholders. Specifically, Pinnacol intended to form the subsidiary as a separate C-Corporation, meaning that owners of the subsidiary (Pinnacol) would not be personally liable for any of the subsidiary's activities. A C-Corporation is a legal entity that is taxed separately from its owners under subchapter C of the Internal Revenue Code (Code). This would in effect protect Pinnacol (and Pinnacol's policyholder's surplus) from the subsidiary's operations. Forming the subsidiary as a C-Corporation would also allow for more outside investment, as the subsidiary would be able to issue stock in exchange for investment in the company.

FORMATION OF CAKE INSURE

In September 2017, work on the Destiny project was complete and the Pinnacol Board approved the formation of a private subsidiary named Cake Insure, Inc., (Cake Insure). EXHIBIT 2.3 illustrates the relationship between Destiny, Pronto, and Cake Insure.

EXHIBIT 2.3. PRONTO, DESTINY, AND CAKE INSURE RELATIONSHIP



SOURCE: Auditor analysis of testimony from Pinnacol and Cake Insure staff.

The Articles of Incorporation for Cake Insure authorized 10 million shares of common stock and 10 million shares of convertible preferred stock. With the Pinnacol Board's approval, Pinnacol provided an initial capital investment of $10 million to purchase 2 million shares of Cake Insure preferred stock at a par value of $5 per share. As of May 2018, Cake Insure had 10 million shares of preferred stock authorized, with 2 million shares issued and outstanding. Each preferred share has the following rights and preferences:

- Each share of preferred stock has one vote with regard to all matters submitted to the holders of the stock for approval.

- At any time upon the election of the holder, each share of preferred stock can be converted to one share of common stock.

- Each share of preferred stock has a preference upon dissolution, liquidation, or deemed liquidation of Cake Insure, to receive an amount equal to the issuance price plus an accrued dividend of 5 percent per annum from the date of issuance. As of May 2018, the estimated liquidation preference for the preferred stock is $10,336,000.

Management identified six Pinnacol employees who were a large part of the Pronto project, and issued bonuses that were specifically meant to purchase shares of Cake Insure. The six employees purchased 222,222 shares of common stock at a par value of $0.50 per share. Each share of common stock has one vote with regard to all matters submitted to holders of the stock for approval. In addition, each share of common stock is subordinate to the preferred stock of the company, and the common stock issued to the six employees is subject to a right of first refusal agreement. A right of first refusal agreement was included as part of the employees' stock purchase agreement, and allows Cake Insure the ability to purchase any issued shares back from the employee before they are able to sell or dispose of the shares to a third party. According to Cake Insure management, the right of refusal was a special circumstance with the employees who bought stock, and Cake Insure has no intention of issuing a right of refusal agreement for other common stock issuances. In total, the bonuses used to purchase the common stock, all associated taxes, and related issuance expenses totaled $162,998. Three of the six employees awarded stock currently sit on the Cake Insure Board of Directors (Cake Board). As of May 2018, Cake Insure had 10 million shares of common stock authorized, with 222,222 shares issued and outstanding. At that time Pinnacol held a 90 percent majority interest in Cake Insure, and the six Pinnacol executive employees held the remaining 10 percent.

As part of the formation of Cake Insure, Pinnacol sold all Destiny assets, including the intellectual property of the Pronto project and all program source code and system configuration data to Cake Insure for $5.6 million. Of that amount, $3.2 million was capitalized as a software asset and $2.4 million was considered a deemed dividend to preferred shareholders. Accounting guidance allows for the capitalization of certain costs related to software developed for internal use. Pinnacol management determined the Pronto software to be for internal use as Cake Insure is a subsidiary of Pinnacol. The remaining $2.4 million in costs represented expenses incurred by Pinnacol with the formation of Cake Insure. These expenses included start-up, branding, and trademark costs prior to the formation of Cake Insure that could not be capitalized because the sale of intellectual property was between entities under common control. Cake Insure management issued a deemed dividend to preferred shareholders (Pinnacol) as reimbursement for these expenses. Pinnacol and Cake Insure management also at that time signed a software license agreement, which granted Pinnacol a royalty-free, non-transferable and non-assignable license to use the intellectual property owned by Cake Insure exclusively in the State of Colorado.

FUTURE GOALS AND PROJECTIONS OF CAKE INSURE

According to the business plan approved by Pinnacol's Board in November 2016, Pinnacol's initial $7.8 million capital investment in Cake Insure and later the $2.2 million additional capital investment approved in September 2017 were intended to finance the development of the platform and fund operations through March 2018. In February 2018 the Pinnacol Board began discussions on how best to continue funding the project. Management's internal financials estimated that Cake Insure would have enough cash to operate through May of 2018 without a cash infusion. The Pinnacol Board voted to loan additional funds to Cake Insure, and on April 30, 2018, Pinnacol issued a $4 million loan to the company. The loan may be drawn down in incremental amounts of not less than $100,000. The loan matures on the earlier of (1) April 30, 2020, or (2) the date which Pinnacol no longer owns at least 50 percent of the equity of Cake Insure. The loan bears interest on any outstanding principal at the London Inter-bank Offered Rate (LIBOR) which is, as of May 31, 2018, 2.72 percent, plus 3 percent annually. Interest on the loan is payable upon maturity, and there is no pre-payment penalty.

Cake Insure management estimates that the loan will be sufficient to fund Cake Insure's operations through Calendar Year 2018. As of that time, management hopes to have raised additional capital from outside investors. According to Pinnacol management, if external capital is not available, management intends to seek additional investment from Pinnacol until financing is secured. Although Pinnacol management is currently committed to the Cake Insure business model and willing to provide additional financial support if necessary, its commitment to future funding is not legally binding.

CAKE INSURE INVESTORS

According to Pinnacol management, in order to defray costs and diversify risk, they are seeking to secure two investors or partnerships in Cake Insure from other state compensation insurance funds similar to Pinnacol by the end of 2018. A state compensation insurance fund is a workers' compensation fund designed to write workers' compensation insurance in a single state. Some of these companies operate as private insurance companies and some operate as agencies of their respective state governments. The investment and/or partnership would allow Cake Insure to market, quote, and sell policies on behalf of the state compensation insurance funds in other states. Management maintains that finding insurance companies that operate in other states to invest in Cake Insure and the Pronto software will enable insurance companies to improve service and efficiency in the states in which they operate. As previously mentioned, Cake Insure granted Pinnacol a royalty-free, nontransferable and non-assignable license to use its intellectual property. These terms were specific between Cake Insure and Pinnacol, and it is unclear if the same terms will be granted to future investors. Management is looking for investors that align with their long-term strategic vision for the company, are interested in a long-term commitment to Cake Insure, and have experience in the insurance industry. Pinnacol management stated that they have had interest from potential partners and investors. As of the end of our audit, Cake Insure had not secured outside investors.

If Cake Insure secures outside investors, the company could potentially have to separate from Pinnacol operations. As noted in CHAPTER 1, all employees that currently work on Cake Insure are Pinnacol employees. If Cake Insure had to separate from Pinnacol, all of those employees would have to leave Pinnacol employment and become Cake Insure employees. Any employee that leaves Pinnacol employment would no longer be eligible for PERA benefits. Cake Insure management plans to supplement the loss of PERA by offering a competitive employee benefit plan, but any details for future retirement plans are tentative and have not been finalized.

Cake Insure staff stated that if they do not secure outside investors, Pinnacol could continue to fund Cake Insure through additional debt or equity financing. Pinnacol could also absorb Cake Insure back into Pinnacol as a division. According to Cake Insure management, operating as a separate subsidiary is an increase of approximately $100,000 a year over operating as a Pinnacol division. The increase in costs is due to leasing space for the Cake Insure subsidiary and performing required financial audits of Cake Insure. By reviewing the lease agreement and audit costs, the audit team was able to substantiate this estimate.

CAKE INSURE FINANCIAL MODELS

Pinnacol management developed financial models of Cake Insure's projected operations in the fall of 2017. These models are based on Pinnacol management's estimate of future revenues, expenses, and profit of Cake Insure through 2022. Pinnacol management has presented the financial models to its Board and communicated the key assumptions used in the calculations. Management actively reviews these models as part of their normal review of operations, so the models are modified as goals and circumstances change.

There are four financial models: (1) Colorado-only Model, (2) Base Model, (3) Aggressive Case Model, and (4) Conservative Case Model. These models are based on various assumptions on market penetration into other states, future revenues and expenses, and various business operation scenarios. The models were developed for Pinnacol management's use, but are also used to attract outside investors to Cake Insure. Any potential investors who request this information are asked to sign a non-disclosure agreement.

Users of the Cake Insure models have the ability to adjust the calculations for various assumptions and scenarios, including:

- Changing the commission structure to a variety of single commission and variable commissions, with and without fees attached to each policy referred.

- Using its platform to provide distribution and policy management services to third-party carriers in up to 12 other states by 2022.

- Using its platform to provide distribution and policy management services to third-party carriers in other lines of insurance, with such use to be in place by 2019.

- Selling use of the Pronto platform as licensing sales.

- Increasing the $10,000 premium limit on policies accepted by the company.

Although there are four financial models, management primarily relies on the Colorado-only Model and Base Model as the assumptions used in those models are the most realistic. Because of the confidential nature of the information included in these models, we will not include any identifying financial information or assumptions in this report. The following assumptions were included in Cake Insure's Colorado-only and Base Model projections:

- Cake Insure will obtain business from out of State (Base Model only).
- Cake Insure will sell other lines of insurance.
- Cake Insure will sell software licenses to other insurance carriers.
- Cake Insure will increase the current $10,000 premium limit on policies accepted.

COLORADO-ONLY MODEL

The Colorado-only Model assumes that Cake Insure will only operate in Colorado. It allows the user to project operations if Cake Insure started selling or quoting other lines of insurance and licensing use of the Pronto software.

Under this model, management has calculated that Cake Insure will start making a profit in 2020. EXHIBIT 2.4 illustrates the percentage increases in net pre-tax income projections for the Colorado-only Model for Calendar Years 2019 through 2022.

EXHIBIT 2.4. PROJECTED PERCENTAGE INCREASE IN NET PRE-TAX INCOME FROM PRIOR YEAR FOR CAKE INSURE COLORADO-ONLY MODEL

	2019	2020	2021	2022
Percentage Increase from the Prior Year	85%	266%	180%	46%

SOURCE: Auditor analysis of the Cake Insure Financial Model provided by Cake Insure.

EXHIBIT 2.5 illustrates the percentage increases for the revenue components of the Colorado-only Model's projection for Calendar Years 2019 through 2022.

EXHIBIT 2.5. PROJECTED PERCENTAGE INCREASE IN REVENUE FROM PRIOR YEAR FOR CAKE INSURE COLORADO-ONLY MODEL				
	2019	2020	2021	2022
Commission Revenue Percentage Increase from Prior Year	643%	143%	48%	20%
Commission Revenue from Other Insurance Lines Percentage Increase from Prior Year	0%	306%	110%	56%
Software Sales Percentage Increase from Prior Year	23%	19%	16%	14%
Total Revenue Percentage Increase from Prior Year	344%	140%	56%	28%
SOURCE: Auditor analysis of the Cake Insure Financial Model provided by Cake Insure.				

BASE MODEL

The Base Model expands on the Colorado-only model, assuming that Cake Insure would be able to operate in other states. Under this model, management has calculated that Cake Insure will start making a profit in 2021.

EXHIBIT 2.6 illustrates the percentage increases (decreases) in net pre-tax income for the Base Model's projection for Calendar Years 2019 through 2022.

EXHIBIT 2.6. PROJECTED PERCENTAGE INCREASE (DECREASE) IN NET PRE-TAX INCOME FOR CAKE INSURE BASE MODEL				
	2019	2020	2021	2022
Percentage Increase (Decrease) from the Prior Year	(1%)	68%	369%	178%
SOURCE: Auditor analysis of the Cake Insure Financial Model provided by Cake Insure.				

EXHIBIT 2.7 illustrates the percentage increases for the revenue components of the Base Model's projection for Calendar Years 2019 through 2022.

EXHIBIT 2.7. PROJECTED PERCENTAGE INCREASE IN REVENUE FROM PRIOR YEAR FOR CAKE INSURE BASE MODEL

	2019	2020	2021	2022
Commission Revenue Increase (Decrease) from Prior Year	937%	235%	88%	47%
Commission Revenue from Other Insurance Lines Increase (Decrease) from Prior Year	0%	454%	164%	88%
Software Sales Increase (Decrease) from Prior Year	22%	18%	15%	13%
Total Revenue Increase (Decrease) from Prior Year	505%	233%	97%	55%

SOURCE: Auditor analysis of the Cake Insure Financial Model provided by Cake Insure.

AGGRESSIVE CASE MODEL

The Aggressive Case Model assumes that there will be a higher rate of market penetration into new markets, such as out of state, and that Cake Insure will underwrite other lines of insurance. The Aggressive Case Model also assumes there will be higher research and development costs as a result of the higher market penetration rate.

CONSERVATIVE CASE MODEL

The Conservative Case Model assumes that there will be a lower rate of market penetration into new markets, such as out of state, and that Cake Insure will be used to quote and sell other lines of insurance. The Conservative Case Model also assumes that there will be less research and development costs as a result of the lower market penetration rate.

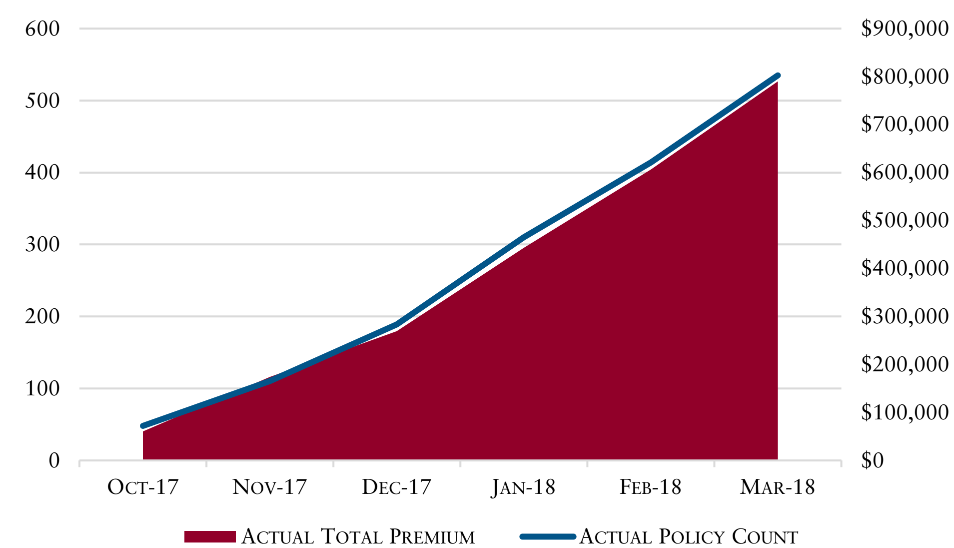
As of June 2018, Cake Insure had not obtained outside investors, expanded business out of state, quoted, or sold other lines of insurance or software licensing, or increased the premium limit on policyholders accepted. Because these models rely heavily on these assumptions and scenarios, the audit team could not conclude whether the models and future projections are currently reasonable.

RELATIONSHIP BETWEEN CAKE INSURE AND PINNACOL

Pinnacol and Cake Insure operate under a Program Administrator Agreement (Program Agreement), which defines the revenue and fee structure for Cake Insure. Under the Program Agreement, Cake Insure earns both a flat fee and direct commissions for providing these services for Pinnacol. The flat fee is a non-refundable $200 charge for each policy referred to Pinnacol that is intended to cover Cake Insure's administrative costs for the policy referral. Cake Insure's direct commissions are calculated as a percentage of each policy premium referred to Pinnacol—a 12 percent commission on all policies sold directly by the company through its website, and a 5 percent commission on all policies that are referred to the company from Pinnacol. Flat fee and commission revenues are recognized by Cake Insure over the life of the policy.

EXHIBIT 2.8 illustrates Cake Insure's actual policy count and premiums from October 2017 when it began selling policies through March 2018.

EXHIBIT 2.8. CAKE INSURE ACTUAL POLICY COUNT AND TOTAL PREMIUMS
OCTOBER 2017 THROUGH MARCH 2018



SOURCE: Actual policy counts and total premiums provided by Cake Insure.

For the 6-month period of October 2017 through March 2018, Cake Insure reported $43,538 in flat and commission fees revenue. Cake Insure reported $32,419 in flat and commission fees receivable from Pinnacol as of March 2018.

Cake Insure and Pinnacol also operate under a Master Service Agreement (Master Agreement). Under the Master Agreement, Cake Insure must pay a fee to Pinnacol for (1) the amount of time Pinnacol employees spend providing financial, legal, human resources, marketing, and other overhead-type activities for Cake Insure; (2) the costs incurred by Pinnacol for Cake Insure's full-time employees; and (3) any costs incurred by Pinnacol for payments to vendors providing goods or services to Cake Insure. Cake Insure must also reimburse Pinnacol for any out-of-pocket costs related to consultants, external legal counsel, contractors, and vendors providing goods and services to Cake Insure.

Pinnacol is also to provide Cake Insure the following financial services in accordance with the Master Agreement:

- Reconciliations of all financial statement accounts, including accounts payable, accounts receivable, and bank account reconciliations.

- Calculation of the fees and commissions owed to Cake Insure from Pinnacol.

- Preparation of monthly financial statements.

- All reconciliations are performed and approved by the Pinnacol staff assigned to work on Cake Insure. The financial statements are also prepared and approved by Pinnacol staff and then subsequently sent to Cake Insure management for final review and approval.

As noted above, as part of the Master Agreement, Cake Insure must reimburse Pinnacol for the cost of the services provided by Pinnacol employees. As of May 2018, there were a total of 21 employees working at Cake Insure. Nine of these were Pinnacol employees at the time they began working on Cake Insure. The remaining 12 employees were outside hires that were brought on by Pinnacol to exclusively work on Cake Insure. The Cake Insure employees are divided into three different teams:

- Marketing team. This team is in charge of promoting and marketing Cake Insure's services.

- Client care team. This team follows up with policyholders to obtain missing information and to address any questions they might have. This team also communicates with Pinnacol about any claims that customers may have. Additionally, this team refers customers to Pinnacol if Cake Insure is unable to underwrite their policy. Examples for referrals are (1) the policy exceeds $10,000, (2) the policy is complicated, or (3) the business has outstanding bad debt with Pinnacol.

- Development team. This team is in charge of maintaining and developing the Pronto platform and related services.

Cake Insure and Pinnacol have established a set of internal controls to ensure segregation of duties between both entities. Pinnacol accountants track all of Cake Insure's expenses, including salary costs, vendor invoices, and travel reimbursements, in Concur, a software used for expense tracking. Both Pinnacol and Cake Insure management are required to review and approve all expenses; once approved, the expense is uploaded to the Pinnacol general ledger. On the 15th of each month, a Pinnacol employee will produce reports providing details of all of Cake Insure's direct expense transactions, the allocation of salary costs attributed to Cake Insure, and Master Agreement fees for the previous month, and will use those documents to calculate the company's total monthly expenses. The amount is then billed to Cake Insure. Cake Insure's monthly financial statements are prepared by Pinnacol employees and reviewed by both Pinnacol and Cake Insure management.

TAX IMPLICATIONS

The existing Parent/Subsidiary relationship between Pinnacol and Cake Insure could have tax implications. While Pinnacol is tax-exempt from federal, state, property, and sales and use tax, Cake Insure is not. Exempt organizations such as Pinnacol are subject to taxes on any net "unrelated business income." IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*, defines unrelated business income as any "income from a trade or business regularly conducted by an exempt organization and not substantially related to the performance by the organization of its exempt purpose or function." As discussed further below, in Pinnacol's case, this could include any non-dividend income paid by Cake Insure to Pinnacol in excess of certain limits.

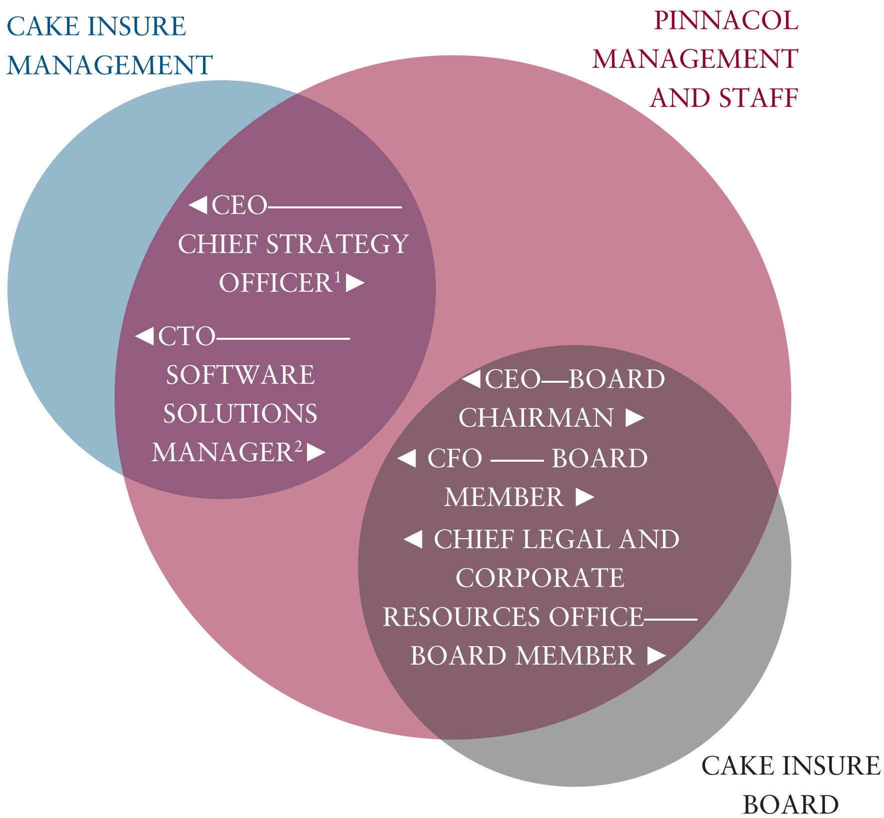
Although unrelated business income is generally taxable, there are some exclusions to the rules. Any dividends paid from Cake Insure to Pinnacol would be excluded from unrelated business income under Section 512 of the Code. As of December 31, 2017, Cake Insure was running a net-loss on operations, meaning that there were no dividends paid to Pinnacol as a result of net income. The deemed dividend included in the purchase was not a result of net income. Based on projections provided by management, Cake Insure is not expected to pay dividends to Pinnacol in 2018.

The Parent/Subsidiary relationship between Pinnacol and Cake Insure means both entities are under common control. Section 482 of the Code, and the regulations that fall under it, requires that taxpayers clearly reflect income attributable to transactions between controlled entities to prevent the evasion of taxes. According to federal regulation [26 CFR 1.482-1], transactions between controlled entities may be considered at "arm's length" if the results of the transaction are consistent with the results that would have been realized if unrelated parties had engaged in the same transaction under the same circumstances. In general, any non-dividend transaction between Pinnacol and Cake Insure that in other situations would not be taxed must be completed at arms-length so that there is no avoidance of taxes. If the circumstances suggest that the transaction was structured and a payment from Cake Insure to Pinnacol was made in excess of the arm's length amount, this excess amount could be taxed as unrelated business income for Pinnacol.

As it relates to Pinnacol and Cake Insure, additional guidance regarding arm's length transactions may be found under Section 482 of the Code. One scenario discussed in 26 CFR 1.482-2 involves loans from a parent to its subsidiary. If the loan contains an interest rate in excess of the arm's length standard, the excess amount of interest on that loan could be taxed as unrelated business income. Another scenario described in 26 CFR 1.482-9 deals with a Parent company that provides services to its Subsidiary, similar to the existing Master Services Agreement that Pinnacol and Cake Insure have in place. Under 26 CFR 1.482-9, payments in excess of the arm's length standard could be subject to the tax on unrelated business income. Therefore, Pinnacol should be analyzing the Master Agreement to ensure that all fees are structured and paid at arm's length.

There are other considerations management needs to take into account to ensure all transactions are conducted at arm's length, including separating the corporate structure of Cake Insure from Pinnacol. As described previously, Pinnacol is involved in the day-to-day operations of Cake Insure. For example, Cake Insure currently only has Pinnacol employees working on its operations and other Pinnacol employees dedicate a portion of their time to work on Cake Insure under the Master Agreement. Further, Cake Insure executives are Pinnacol executives, and Pinnacol executives sit on the Cake Insure Board. Cake Insure and Pinnacol do not currently perform an arms-length analysis for transactions between the two entities, although management has represented that all transactions are appropriate. EXHIBIT 2.9 illustrates the relationship between Pinnacol, Cake Insure management, and the Cake Insure Board.

EXHIBIT 2.9. CAKE INSURE AND PINNACOL RELATIONSHIP



SOURCE: Auditor analysis of Cake Insure and Pinnacol's organizational chart.
[1] Individual did not retain their title as Chief Strategy Officer when Cake became a subsidiary.
[2] Individual did not retain their title as Software Solutions Manager when Cake became a subsidiary.

MASTER SERVICE AGREEMENT FEES

As previously stated, Cake Insure entered into the Master Agreement with Pinnacol. The original Master Agreement began September 20, 2017, which was then superseded by another version of the Master Agreement on October 9, 2017. Under the Master Agreement, Cake Insure was required to pay Pinnacol a monthly fee to provide management services to Cake Insure. The Master Agreement was effective for October 2017 through March 2018, at which time the parties could extend the Master Agreement if requested. An extension was granted in April 2018, and the Master Agreement now continues on a month-to-month basis. The monthly service fee was intended to cover the cost of the services Pinnacol provided to Cake Insure, including payroll and out-of-pocket costs incurred by Pinnacol.

The current monthly fee for the Master Agreement is $30,500. In total, Cake Insure paid Pinnacol $356,463 for services rendered from September 20, 2017, to May 31, 2018.

WHAT WAS THE PURPOSE OF THE AUDIT WORK AND WHAT WORK WAS PERFORMED?

The purpose of our audit work was to review Pinnacol's calculation of the Master Agreement's monthly fee to determine if its methodology was reasonable for the services being provided, and to determine if there was a basis for the amount charged. We interviewed Pinnacol management and staff about the methodology used for the calculation and asked for copies of any policies and procedures related to the calculation.

HOW WERE THE RESULTS OF THE AUDIT MEASURED?

According to Pinnacol management and staff, the goal of the Master Agreement was for Pinnacol to break even on the costs of services provided to Cake Insure. In order to calculate the estimated fee in the Master Agreement, Pinnacol performed the following:

- Identified 10 full-time Pinnacol employees who would provide most of the services noted in the Master Agreement for Cake Insure.

- Identified additional human resource employees who would provide certain additional services noted in the Master Agreement for Cake Insure.

- Instructed all Pinnacol employees providing services to Cake Insure to estimate the amount of time it would take to provide the services noted in the Master Agreement. The employee estimates ranged from 5 to 60 percent of the employees' time.

Pinnacol used the employee time estimates to calculate the expected salary and benefit costs for providing services to Cake Insure. This estimate was then used to determine the monthly fee noted in the Master Agreement.

WHAT PROBLEMS DID THE AUDIT WORK IDENTIFY?

We identified issues with the calculation of the monthly fee in the Master Agreement. Specifically, Pinnacol management estimated the change in costs when some employee changes took place during the term of the Master Agreement, instead of recalculating the costs to determine what impact those changes made. The initial calculation was performed prior to the effective date of the Master Agreement, and was calculated using payroll information for the specific employees that management intended to use on the project. However, Pinnacol did not use all of the intended employees, and one employee's time was later substituted by time from two other employees. The monthly fee was initially set at $44,900, but was reduced to $35,300 for April and May 2018, and $30,500 in June 2018 based on a reduction in Pinnacol's marketing staff's time once certain work was completed.

WHY DID THESE PROBLEMS OCCUR?

Pinnacol has not established written policies and procedures for the calculation of the monthly fee in the Master Agreement. Additionally, Pinnacol has not required each employee providing services to Cake Insure to track actual time spent providing services for Cake Insure in order to align actual costs with estimated costs used to calculate the monthly service fee. Finally, Pinnacol management has not performed a detailed review of its cost calculation since the Master Agreement was implemented, which does not allow them to determine the monthly fee needed to meet management's goal of breaking even on the costs of services provided to Cake Insure.

WHY DOES THE PROBLEM MATTER?

Without adequate policies and procedures, Pinnacol cannot determine whether it is adequately recovering its costs for services provided to Cake Insure, or if it is over- or undercharging Cake Insure. Furthermore, any gains or losses resulting from the provision of such services could have financial reporting or tax obligations for both Pinnacol and Cake Insure. In addition, management has previously shared Cake Insure financial information with potential investors. If the operating costs of Cake Insure are not being accurately tracked, the information management is distributing may not reflect the true costs.

RECOMMENDATION 1

Pinnacol Assurance should ensure the monthly fee contained in the Master Service Agreement (Agreement) with Cake Insure, Inc., (Cake Insure) is appropriate by:

A Establishing and implementing written policies and procedures for calculating the monthly fee charged to Cake Insure.

B Requiring employees to track actual time worked on Cake Insure.

C Recalculating the fees charged to Cake Insure during Calendar Year 2017 and adjusting the fees, as appropriate, to ensure that the fees align with the cost of services provided to Cake Insure during the year. This should include revising the current Agreement as needed in order to meet management's goal of breaking even on the costs of services provided to Cake Insure.

RESPONSE

PINNACOL ASSURANCE

A AGREE. IMPLEMENTATION DATE: JULY 31, 2018.

We do have procedures for calculating the monthly fee charged to Cake Insure, but those procedures have not been documented. Pinnacol did not establish such written policies and procedures at the inception of Cake Insure because the basis of and process for calculating the monthly fee charged to Cake Insure was, essentially, a pilot. Pinnacol needed to first determine if the approach it was testing made sense before memorializing it in policy and procedure.

The monthly fee is reported in an invoice that has three components: the shared services flat fee, salaries and benefits for employees assigned to Cake Insure, and Cake Insure direct expenses. The shared services flat fee does not change unless the contract changes. The other two components are taken from Pinnacol's general ledger detail each month. We agree that written policies and procedures are a beneficial enhancement to our internal control environment. We will also ask our internal auditor, EY, to include a review of these policies and procedures in their previously scheduled internal audit of Cake Insure later in 2018.

B AGREE. IMPLEMENTATION DATE: JULY 31, 2018.

We agree that regular reviews of Pinnacol's costs to provide those shared services will help ensure that Cake Insure's future expenses are materially accurate. We believe a twice-monthly estimate, similar to our timesheet timeline, by the Pinnacol staff who regularly perform services on Cake Insure's behalf would allow us to better track the cost of the services provided to Cake Insure without adding significant overhead.

Pinnacol will implement a review process by July 31, 2018. The process will include revising the flat fee when there are material changes in the estimated cost. We will also ask our internal auditor, EY, to include a review of this process in their previously scheduled internal audit of Cake Insure later in 2018.

C AGREE. IMPLEMENTATION DATE: JULY 31, 2018.

We will review the estimated cost of shared services provided to Cake Insure from September 2017 to June 2018. If there are any material differences, we will work with Cake Insure to adjust the fee. Our initial indication is that Pinnacol's cost to provide these services is $66 per month less than expected. We will have a final assessment by July 31, 2018. We will also ask our internal auditor, EY, to include a review of this process in their previously scheduled internal audit of Cake Insure later in 2018.

LEGISLATIVE INTENT

Pinnacol was created as a political subdivision of the State [Section 8-45-101(1), C.R.S.]. As such, Pinnacol receives both state and federal tax benefits that are not available to other workers' compensation insurers, as discussed in CHAPTER 1. Accordingly, Pinnacol must comply with some requirements that apply to all domestic insurance companies, and some requirements unique only to Pinnacol due to its public purpose and political subdivision status.

In addition, in the same enabling statutes, Pinnacol is directed to "operate as a domestic mutual insurance company," with a few exceptions. Pinnacol is charged with providing workers' compensation insurance to any Colorado employer (as the "insurer of last resort") with exceptions defined in statutes, but is not allowed to "provide any other type of insurance or to provide insurance to employers that are not Colorado employers" [Section 8-45-101(5)(f), C.R.S.]. However, it is allowed to sell services that it develops pursuant to its statutes [Section 8-45-101(7), C.R.S.]. Pinnacol also "may enter into cooperative arrangements with any public or private entity for the purpose of carrying out its powers, duties, and functions" [Section 8-45-101(11), C.R.S.]; however, it may "not acquire or control any other insurer" [Section 8-45-117(10), C.R.S.]. As discussed in CHAPTER 2, Pinnacol initially created the digital platform and separate division within Pinnacol before transferring both to the separate subsidiary, Cake Insure. Pinnacol could have chosen to maintain the digital platform and division within Pinnacol, in alignment with these specific enabling statutes, without invoking the expanded authority of a domestic insurer. This would have alleviated the need for strict accounting for "arms-length transactions" and various tax considerations discussed in CHAPTER 2.

Operating as a domestic insurer, Pinnacol is allowed to "organize or acquire one or more subsidiaries" engaged in statutorily defined activities [Section 10-3-802(1), C.R.S.]. The defined activities for Pinnacol would have to align with its specific statutory authority. However by creating Cake Insure, as Pinnacol explained, (1) it would open up more opportunity for outside investment and expertise, and (2) it would reduce Pinnacol's liability and protect Pinnacol policyholders. Pinnacol has consulted with numerous attorneys and tax specialists on the creation of Cake Insure. The resulting opinions indicate that Pinnacol is within its statutory authority to create, own, and operate Cake Insure.

To better understand the General Assembly's intent for Pinnacol, we reviewed Pinnacol's recent legislative history. In 2009 the Legislature created an Interim Committee to Study Issues Related to Pinnacol Assurance, including a review of the structural options for Pinnacol. The Committee recognized three structural options: (1) restore Pinnacol as a state agency, (2) maintain the current status as a quasi-governmental entity, and (3) make Pinnacol a completely private enterprise. However, the Committee did not make a recommendation or propose legislation related to Pinnacol's structure.

More recently, during Calendar Years 2011 and 2012, Pinnacol management began to research privatization in an attempt to restructure the company and further align it with its private competitors. During that time, Governor Hickenlooper appointed a state task force to determine if privatization was beneficial for Pinnacol and the State. The task force faced opposition from members of the General Assembly and business owners and the issue was eventually dropped. Later in the spring of 2016, Pinnacol pursued legislation, this time in an effort to establish a wholly-owned, for-profit subsidiary to provide workers compensation insurance outside of Colorado. In the face of opposition, the Pinnacol board voted unanimously to stop pursuing that legislation.

Since Cake Insure appears to be within Pinnacol's statutory authority, and considering the various legislative directions Pinnacol has previously pursued, is Cake Insure the type of entity the General Assembly intended, combining the selling of services with a for-profit subsidiary seeking outside investors?

This is a matter for policymakers to consider, and therefore, we issue no recommendation in this section.