KPMG

PINNACOL ASSURANCE

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

December 31, 2006 and 2005

(With Independent Auditors' Report Thereon)

KPMG LLP
Suite 2700
707 Seventeenth Street
Denver, CO 80202

May 21, 2007

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

We have completed the financial audit of Pinnacol Assurance (Pinnacol) for the year ended December 31, 2006. Our audit was conducted in accordance with auditing standards generally accepted in the United States of America. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S., which authorizes an annual audit of Pinnacol made by an auditor or firm of auditors, having the specialized knowledge and experience, retained by the state auditor with the consultation and advice of the chief executive officer and the commissioner of insurance. The reports which we have issued as a result of this engagement are set forth in the table of contents which follows.

KPMG LLP

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Report Summary

Authority and Purpose/Scope of the Audit

This audit was conducted under the authority of Section 8-45-121(2) of the Colorado Revised Statutes (C.R.S.), which authorizes an annual audit of Pinnacol Assurance (Pinnacol or the Company) made by an auditor or firm of auditors, having the specialized knowledge and experience, retained by the state auditor with the consultation and advice of Pinnacol's chief executive officer and the commissioner of insurance. The primary purpose of our engagement was to audit the statutory financial statements of Pinnacol at December 31, 2006, and for the year then ended, in accordance with auditing standards generally accepted in the United States of America and to express an opinion on those financial statements and the notes thereto. The objective of an audit conducted in accordance with such standards is to obtain reasonable, but not absolute, assurance about whether the statutory financial statements are free of material misstatement.

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

We examined, on a test basis, evidence supporting the amounts and disclosures in Pinnacol's financial statements as of December 31, 2006. The accounting practices used by Pinnacol to prepare the financial statements are in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division).

Required Communications to the Legislative Audit Committee

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

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

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

2. **Significant Accounting Policies and Alternative Treatments** – The significant accounting policies used by Pinnacol are described in note 1 to the statutory financial statements. There were no changes to significant accounting policies in 2006.

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

   Uncollected Premiums – The amount of uncollected premiums, which affects the amount of premium revenue recognized, is estimated using statutory requirements, as well as certain management judgments. Management must determine whether an allowance should be established to provide for all reasonably anticipated uncollectible amounts inherent in the uncollected premiums balance. Factors 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, 2006, the admitted value of uncollected premiums is estimated to be $70,652,000.

   Earned but Unbilled Premiums Receivable – Pinnacol estimates audit premium adjustments based on prior experience. This prior experience provides actual collection activity, which is then used in establishing estimated premium revenue in the current period related to audit adjustments, subject to current influences such as inflation and other factors. For 2006, estimated net unbilled audit premiums receivable of $22,950,000 are included in uncollected premiums.

   Unpaid Losses and Loss Adjustment Expenses – Estimating unpaid losses and loss adjustment expenses (reserves) of an insurance company is a subjective and judgmental process, particularly for workers' compensation insurance, where the ultimate liability to a claimant may not be known with certainty for a number of years. To assist management in estimating the liability for unpaid losses and loss adjustment expenses, Pinnacol retains the actuarial consulting services of Milliman U.S.A. At December 31, 2006, Pinnacol has accrued $1,237,421,000 for unpaid losses and loss adjustment expenses as management's best estimate, which management believes to be a reasonable estimate of future amounts to be paid for claims incurred in 2006 or prior. Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in 2006 and 2005. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. State law allows Pinnacol the use of a discount factor of up to 6.00%.

4. **Audit Adjustments and Uncorrected Misstatements** – The statutory financial statements incorporated herein contain no differences with Pinnacol's Annual Statement as filed with the Division for the year ended December 31, 2006. In connection with our audit of the Company's financial statements, we have discussed with management a certain financial statement reclassification that has not been corrected in the Company's books and records as of and for the year ended December 31, 2006. We have reported this statutory statement of cash flows reclassification between investing and financing activities in the amount of $18 million to management on a Summary of Uncorrected Misstatements and have received written representations from management that management believes that the effects of the uncorrected financial statement reclassification are immaterial, both individually and in the aggregate, to the statutory financial statements taken as a whole. As this proposed adjustment is a reclassification, there is no net impact on the statutory statement of cash flows as of December 31, 2006.

(Continued)

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

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

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

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

   We hereby confirm that as of May 21, 2007, we are independent accountants with respect to Pinnacol under all relevant professional and regulatory standards.

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

Summary of Major Audit Findings

Information Technology General Controls Policies

Internal control over information technology is important as it is a component of internal control over financial reporting. Pinnacol's information technology general control policies for physical access to computer facilities, documentation of system access reviews, and segregation of duties conflicts were not always adequate.

Summary of Pinnacol's Responses

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

Summary of Progress in Implementing Prior Audit Recommendations

The disposition of prior audit recommendations as of May 21, 2007 was:

Implemented	2
Partially implemented	—
Not implemented	—
	2

PINNACOL ASSURANCE

Recommendation Locator

December 31, 2006

Recommendation locator

Recommendation number	Page number	Recommendation summary	Pinnacol response	Implementation date
1	8	Pinnacol should enhance its information technology controls policies by expanding policies related to physical access for facilities, documentation of system access reviews, and segregation of duties conflicts.	Agree.	April 2007

PINNACOL ASSURANCE

Description of Pinnacol Assurance

December 31, 2006

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

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

Pinnacol is controlled by a nine-member board of directors, which is appointed by the governor with the consent of the senate. The board of directors appoints a chief executive officer. This is in accordance with the applicable statutes of the state, with administration under the direction of a chief executive officer. The state retains no liability on the part of Pinnacol, beyond the amount of any Pinnacol surplus, and no state monies are used for Pinnacol operations.

In 2006, Pinnacol paid over $56.7 million in general policyholder dividends to its policyholders in good standing. This is included in Dividends to Policyholders on the statutory statement of income and changes in policyholders' surplus and reduces net income for the year ending December 31, 2006. This accounting treatment is in accordance with statutory accounting practices. See further information at note 1(m), General Policyholder Dividends.

Policyholders' Surplus

Pinnacol had policyholders' surplus of $607,473,000 and $471,849,000 as of December 31, 2006 and 2005, respectively. The increase in surplus is primarily related to current-year net income.

Information Technology General Controls Policies

Although the provisions of the federal Sarbanes-Oxley Act, Section 404, are not directly applicable to nonpublic insurance companies, there is a heightened awareness among the industry of the importance of the internal control structure. The National Association of Insurance Commissioners (NAIC) adopted amendments to the model audit rule, including the provision that insurance companies will be required to file a report annually on their assessment of internal control over financial reporting effective beginning with the reporting period ending December 31, 2010 and thereafter. As a result, enhancements to internal controls, including information technology general controls, are becoming common throughout the industry. Internal control over information technology is important as it is a component of internal control over financial reporting.

During a review of a selection of Pinnacol's information technology general controls and related policies, we noted the following:

- The chief executive officer and chief financial officer, who hold financial reporting oversight roles, have physical access to computer facilities that house the financial reporting applications. The effect of allowing those who hold financial reporting oversight roles to physically access computer facilities that house the financial reporting applications is that there is a potential for management override of controls with respect to these applications. Though it does not appear that any management override of controls occurred as a result, such access could give rise to misstatements.
- Pinnacol's system administrators perform periodic reviews of active users and user access rights to identify and remove inappropriate system access; however, no documentation of the reviews exists. The effect of not documenting these reviews is that there is no written evidence that user access issues, if any, are being identified and resolved.
- Several finance personnel have system access to accounts payable modules for creating and maintaining vendors, payment entry, and payment release, which poses segregation of duties conflicts. The risk associated with these conflicts is mitigated, however, by controls over checks, which must be signed by authorized personnel. Though it does not appear that any unauthorized payments were made as a result, such access could give rise to errors or misstatements.
- Six technology liaisons, who are employees who work to bridge the gap between business needs and information technology, as well as 16 other employees, have access to create both policies and claims in the Workers' Compensation Information System (WCIS), thereby creating segregation of duties conflicts between the underwriting and claims functions. The risk associated with these conflicts is mitigated, however, by several controls in the process, which must occur before a claim may be paid. Though it does not appear that any of these employees created both a policy and a claim, such access could give rise to errors or misstatements.

Recommendation No. 1

Pinnacol should enhance its information technology general controls policies by expanding control policies related to physical access for facilities, documentation of system access reviews, and segregation of duties conflicts.

a. Executives with financial reporting oversight roles should not have physical access to computer facilities that house financial reporting applications.

(Continued)

b. Periodic reviews of user access rights performed by system administrators should be properly documented and retained by Pinnacol.

c. Appropriate segregation of duties should be established for accounts payable modules, so that no one employee can create and maintain vendors, enter payments, and release payments in the system.

d. Appropriate segregation of duties should be established for underwriting and claims modules, so that no one employee can create both policies and claims in WCIS.

Pinnacol Response

Agree. Internal control enhancements were implemented in April 2007.

Disposition of Prior Audit Recommendations

The audit report for the year ended December 31, 2005 included two recommendations. The disposition of these audit recommendations is as follows:

Recommendation	Disposition
1. Pinnacol should enhance its information technology general controls by expanding control processes related to network passwords, user IDs, and system access by aligning them with documented policies and procedures and ensuring that regular reviews of such processes are performed.	Implemented.
2. Pinnacol should enhance its controls over the authorization of journal entries by implementing mitigating controls to ensure that intentional or unintentional misstatements that could occur as a result of journal entries being created and posted by the same user do not go undetected.	Implemented.

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Denver, CO 80202

Independent Auditors' Report

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

We have audited the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance (the Company) as of December 31, 2006 and 2005, and the related statutory statements of income and changes in policyholders' surplus and cash flows for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of Pinnacol Assurance as of December 31, 2006 and 2005, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended, in conformity with accounting practices prescribed or permitted by the Division.

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

KPMG LLP

May 21, 2007

PINNACOL ASSURANCE

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

December 31, 2006 and 2005

(In thousands)

Admitted Assets		**2006**	**2005**
Cash and invested assets:			
Bonds at amortized cost, fair value of $1,625,367 in 2006 and $1,549,582 in 2005 (note 3)	$	1,631,197	1,536,708
Common stock at fair value, cost of $186,310 in 2006 and $140,634 in 2005 (note 3)		223,949	159,751
Real estate at cost, net of accumulated depreciation		22,306	22,885
Cash and cash equivalents		44,163	20,954
Other invested assets		—	13,560
Total cash and invested assets		1,921,615	1,753,858
Uncollected premiums, net		70,652	57,985
Electronic data processing equipment, at cost, net of accumulated depreciation of $3,365 and $3,898 in 2006 and 2005, respectively		1,672	992
Accrued investment income		17,066	15,514
Total admitted assets	$	2,011,005	1,828,349
Liabilities and Policyholders' Surplus			
Total reserve for unpaid losses and loss adjustment expenses:			
Reserve for unpaid losses and allocated loss adjustment expenses (note 2)	$	1,199,421	1,167,693
Reserve for unpaid unallocated loss adjustment expenses (note 2)		38,000	38,000
		1,237,421	1,205,693
Other liabilities		43,746	35,793
Unearned premiums		99,864	95,107
Dividends payable to policyholders		13,983	10,046
Credit balances due policyholders		8,518	9,861
Total liabilities		1,403,532	1,356,500
Commitments and contingencies (notes 2, 6, and 9)			
Policyholders' surplus (note 7)		607,473	471,849
Total liabilities and policyholders' surplus	$	2,011,005	1,828,349

See accompanying notes to statutory financial statements.

PINNACOL ASSURANCE

Statutory Statements of Income and Changes in Policyholders' Surplus

Years ended December 31, 2006 and 2005

(In thousands)

		2006	2005
Underwriting income:			
Premiums earned (note 6)	$	588,376	566,470
Deductions:			
Losses incurred (note 2)		359,713	364,274
Loss adjustment expenses incurred (note 2)		24,733	24,021
Other underwriting expenses incurred		115,656	101,818
Total underwriting deductions		500,102	490,113
Net underwriting gain		88,274	76,357
Investment income:			
Net investment income earned		92,776	85,600
Net realized capital gain		4,688	3,508
Net investment income		97,464	89,108
Other income (loss):			
Provision for uncollectible premiums		(5,145)	(2,362)
Other income		2,423	2,683
Dividends to policyholders		(65,694)	(62,290)
Net income		117,322	103,496
Change in nonadmitted assets (increase)		(2,528)	(924)
Change in net unrealized gain in investments		20,830	3,483
Policyholders' surplus at beginning of year		471,849	365,794
Policyholders' surplus at end of year	$	607,473	471,849

See accompanying notes to statutory financial statements.

PINNACOL ASSURANCE

Statutory Statements of Cash Flows

Years ended December 31, 2006 and 2005

(In thousands)

	2006	2005
Cash flows from operations:		
Premiums collected, net of reinsurance	$ 580,466	553,405
Losses and loss adjustment expenses paid, net	(352,718)	(341,476)
Underwriting expenses paid	(109,046)	(98,902)
Dividends paid to policyholders	(61,757)	(62,290)
Cash from underwriting	56,945	50,737
Net investment income	88,600	80,259
Net amount withheld or retained for account of others	(2,722)	321
Net cash provided by operations	142,823	131,317
Cash flows from investments:		
Proceeds from sale or redemption of investments	138,403	167,639
Purchase of investments	(273,784)	(417,494)
Net cash used for investments	(135,381)	(249,855)
Cash flows from financing and miscellaneous sources:		
Cash provided by (used in) other miscellaneous sources	15,767	(3,433)
Net cash provided by (used in) financing and miscellaneous sources	15,767	(3,433)
Increase (decrease) in cash on hand and on deposit	23,209	(121,971)
Cash on hand and on deposit, beginning of year	20,954	142,925
Cash on hand and on deposit, end of year	$ 44,163	20,954

See accompanying notes to statutory financial statements.

(1) Nature of Operations and Significant Accounting Policies

(a) Organization

Pinnacol Assurance (Pinnacol or the Company) was established under provisions of the Workers' Compensation Act of Colorado (Title 8, Article 45 of the Colorado Revised Statutes (C.R.S.), as amended) 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 president, appointed by the board of directors. The state retains no liability on behalf of Pinnacol, and no state monies are used for Pinnacol operations.

As Pinnacol has maintained an acceptable level of surplus, in 2006 and 2005 Pinnacol paid over $56 million and $55 million, respectively, in general policyholder dividends to its policyholders in good standing. An acceptable level of surplus is that which exceeds the Company action level of risk-based capital, which is $149,695,000 for 2006. The board of directors, at its discretion, will determine the amount of policyholder dividends to be declared, if any, based on Pinnacol's overall experience, financial condition, and risk profile.

(b) Basis of Presentation

The accompanying financial statements of Pinnacol have been prepared in accordance with accounting practices prescribed or permitted by The Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division). Prescribed statutory accounting practices are those practices that are incorporated directly or by reference to state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. Colorado has adopted the National Association of Insurance Commissioners' (NAIC) statutory accounting practices, which are codified in the NAIC's Accounting Practices and Procedures Manual (the Manual). Therefore, compliance with the Manual is a prescribed accounting practice.

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

Investments: Investments in bonds and mandatorily redeemable preferred stocks are reported at amortized cost or market value based on their NAIC rating; for GAAP, such fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in operations. Real estate owned and occupied by Pinnacol is included in investments rather than reported as a capital asset as under GAAP.

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

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

The effects of the foregoing variances from GAAP on the statutory financial statements at December 31, 2006 and 2005, and for the years then ended, have been determined and are as follows:

	December 31	
	2006	2005
	(In thousands)	
Statutory policyholders' surplus	$ 607,473	471,849
Nonadmitted assets	13,289	10,761
Policy acquisition costs, net of amortization	9,946	8,409
Net unrealized gain (loss) on bonds	(5,830)	12,874
GAAP net assets	$ 624,878	503,893
Statutory net income	$ 117,322	103,496
Policy acquisition costs, net of amortization	1,537	(403)
Change in fair value of investments	2,126	(37,239)
GAAP changes in net assets	$ 120,985	65,854

(c) Use of Estimates

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

(d) Investments

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

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

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

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

Real estate includes land, the building on the land, and capitalized building improvements used in conducting the Company's business. Land is carried at cost. Building and capitalized building improvements are carried at cost less allowances for depreciation. The cost of the building and capitalized improvements is depreciated over an estimated useful life of 30 years using the straight-line method. Depreciation expense was $839,000 and $821,000 for the years ended December 31, 2006 and 2005, respectively.

(e) Cash and Cash Equivalents and Other Invested Assets

For purposes of the statement of cash flows, cash and cash equivalents 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, 2006, cash and cash equivalents of $44,163,000 include $5,716,000 of cash, $8,929,000 of cash equivalents, and $29,518,000 of short-term investments in bonds. As of December 31, 2005, cash and cash equivalents of $20,954,000 include $10,242,000 of cash, $4,987,000 of cash equivalents, and $5,725,000 of short-term investments in bonds. In the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus, Pinnacol has recorded checks that have been issued, but not presented for payment, as a reduction of cash and cash equivalents. Also included in cash and cash equivalents are amounts held as collateral for assumptive reinsurance agreements of $28,269,000 and $4,836,000 as of December 31, 2006 and 2005, respectively. In addition, $13,560,000 included in other invested assets was held as collateral for assumptive reinsurance agreements in 2005.

(f) Uncollected Premiums

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

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

During 2006 and 2005, Pinnacol recorded a provision, net of recoveries, or wrote off a total of $5,145,000 and $2,362,000, respectively, in premiums receivable due to the unlikelihood of ultimate collection thereof. These amounts are reflected as provision for uncollectible premiums in the accompanying financial statements.

A significant portion of Pinnacol's premiums receivable balances at December 31, 2006 and 2005 were from companies operating in the construction and services industries in Colorado. The construction industry represents 42% and 39% of premiums receivable balances as of December 31, 2006 and 2005, respectively. The services industry represents 23% and 22% of premiums receivable balances as of December 31, 2006 and 2005, respectively, with all other individual industries constituting the remainder of premiums receivable balances.

(g) Earned but Unbilled Premiums

Earned but unbilled premiums represent audit premiums, which are amounts due from policyholders after the respective policy period has expired based on audits performed by Pinnacol. Such amounts are estimated by Pinnacol using internal statistically supported aggregate calculations using historical unearned premium data and per policy calculations. For 2006 and 2005, estimated unbilled audit premiums receivable of $22,950,000 and $13,587,000, respectively, are included as uncollected premiums. These estimated receivables have been reduced by 10%, where applicable, to comply with the Manual.

(h) Retrospectively Rated Contracts

Pinnacol estimates accrued retrospective premium adjustments through the review of each individual retrospectively rated risk, comparing case basis loss development with that anticipated in the policy contract to arrive at the best estimate of return or additional retrospective premium. Pinnacol records accrued retrospective premium as an adjustment to earned premium. Net premiums earned on retrospective workers' compensation policies were $2,228,000 and $2,068,000 in 2006 and 2005, respectively. These amounts represent 0.4% of total net premiums written for both 2006 and 2005, respectively. Ten percent of the amount of accrued retrospective premiums not offset by collateral has been nonadmitted. The total admitted amount of retrospective premium is as follows:

	December 31 2006	December 31 2005
	(In thousands)	
Secured accrued retrospective premium	$ 2,132	2,342
Admitted amount	$ 2,132	2,342

(i) Credit Balances Due Policyholders

Credit balances due policyholders represent excess premiums, which are amounts due to policyholders after the respective policy period has expired based on audits performed by Pinnacol. Such amounts are based on actual results. Generally, credit balances due policyholders are applied to future premium obligations of policyholders. For 2006 and 2005, such amounts are approximately $8,518,000 and $9,861,000, 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, 2006 and 2005 was $1,672,000 and $992,000, respectively. Related depreciation expense of $872,000 and $659,000 was incurred during 2006 and 2005, respectively.

(k) Office Furniture and Equipment

Office furniture and equipment and art are recorded at cost and depreciated on a straight-line basis over an estimated useful life of five years. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2006 and 2005 was $3,529,000 and $3,236,000, respectively. Related depreciation expense of $786,000 and $696,000 was incurred in 2006 and 2005, respectively.

(l) Other Assets

At December 31, 2006 and 2005, Pinnacol had prepaid assets and deposits totaling $1,538,000 and $1,898,000, respectively. In accordance with the Manual, these are nonadmitted assets.

(m) General Policyholder Dividends

The board of directors, at its discretion, determines the amount of general policyholder dividends to be declared based on Pinnacol's overall experience and financial condition. Pinnacol has paid general policyholder dividends to its policyholders in good standing of $56,700,000 and $55,067,000 in May of 2006 and 2005, respectively. This is included in dividends to policyholders in the statutory statement of income and changes in policyholders' surplus and reduces net income for the years ended December 31, 2006 and 2005.

(n) Association Dividend Program

Pinnacol has an association dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. In 2006 and 2005, Pinnacol incurred $8,993,000 and $7,223,000, respectively, of expense related to the association dividend program. These dividends are not declared from surplus nor are they recorded as a direct reduction to surplus. The dividends are considered premium credits and are recorded as dividends to policyholders in the statutory statements of income and changes in policyholders' surplus.

(o) Revenue Recognition

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

(Continued)

(p) Reserve for Unpaid Losses and Loss Adjustment Expenses

The reserve for unpaid losses and loss adjustment expenses represents management's best estimate of ultimate net cost of all reported and unreported losses incurred through December 31. The reserves for unpaid losses and loss adjustment expenses are estimated by management using an independent third-party actuary based on individual case basis valuations and statistical analyses. Those estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes the reserves for unpaid losses and loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted, as necessary, as experience develops or new information becomes known; such adjustments are included in current operations.

Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in 2006 and 2005. The discount rate used to calculate present value is based on an industry standard rate, which is approved by the Division. State law allows Pinnacol the use of a discount factor of up to 6.00%.

(q) Unearned Premiums

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

(r) Subrogation

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

(s) Reinsurance

Ceded reinsurance transactions are accounted for based on estimates of their ultimate cost. Losses, loss adjustment expenses, and the reserves for loss adjustment expenses are reported net of reinsured amounts in accordance with the Manual. Reinsurance premiums are reflected as a reduction of premiums earned (see note 6).

(t) Taxes

As a political subdivision of the State, Pinnacol is not subject to federal or state income taxes under a specific exemption granted under Section 501(c) of the Internal Revenue Code. Additionally, Pinnacol is not subject to a premium tax, pursuant to Section 8-45-117(3), C.R.S. Pinnacol is, however, subject to a surcharge on premiums received, based on a rate established annually (approximately 3.818% in both 2006 and 2005), pursuant to Section 8-44-112(1)(a), C.R.S. Such amounts are included in other underwriting expenses incurred.

(u) Employee Benefits

Defined Benefit Pension Plan

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

Prior to January 1, 2006, state employees and employees of local school districts were members of the combined State and School Division of PERA. On January 1, 2006, that combined division was segregated into a State Division and a separate School Division. Separate actuarial assessments are made for each division.

Employees hired by the state after January 1, 2006, are allowed 60 days to elect to participate in a defined contribution retirement plan administered by the state's Deferred Compensation Committee rather than becoming a member of PERA. If that election is not made, the employee becomes a member of PERA, and the member is allowed another 60 days to elect to participate in a defined contribution plan administered by PERA rather than the defined benefit plan. PERA members electing the defined contribution plan are allowed an irrevocable election between the second and fifth year to use their defined contribution account to purchase service credit and be covered under the defined benefit retirement plan. Employer contributions to both defined contribution plans are the same as the contributions to the PERA defined benefit plan.

Defined benefit plan members vest after five years of service, and if they were hired before July 1, 2005, most are eligible for retirement benefits at age 50 with 30 years of service, at age 60 with 20 years of service, or at age 65 with 5 years of service. Persons hired between July 1, 2005 and December 31, 2006 (except state troopers, plan members, inactive plan members, and retirees) are eligible for retirement benefits at any age with 35 years of service, at age 55 with 30 years of service, at age 60 with 20 years of service, or at age 65 with 5 years of service. Members hired before January 1, 2007 are also eligible for retirement benefits without a reduction for early retirement if they are at least 55 and have a minimum of 5 years of service credit, and their age plus years of service equals 80 or more. State troopers and judges comprise a small percentage of plan members but have higher contribution rates, and state troopers are eligible for retirement benefits at different ages and years of service. Monthly benefits are calculated as a percentage of highest average salary (HAS). HAS is one-twelfth of the average of the highest salaries on which contributions were paid, associated with three periods of 12 consecutive months of service credit.

Members disabled, who have five or more years of service credit, six months of which has been earned since the most recent period of membership, may receive retirement benefits if determined to be permanently disabled. If a member dies before retirement, their spouse or their eligible children under the age of 18 (23 if a full time student) are entitled to a single payment or monthly benefit payments. If there is no eligible spouse, financially dependent parents will receive a survivor's benefit.

Most employees contribute 8.0% of their salary, as defined in Section 24-51-101(42), C.R.S., to an individual account in the plan. From July 1, 2005, to December 31, 2005, the state contributed 10.15% of the employee's salary. From January 1, 2006 through June 30, 2006, the state contributed 10.15% and from July 1, 2006 to December 31, 2006, 10.65% of the employee's salary, plus an additional 0.5% for the Amortization Equalization Disbursement discussed below. During all of Fiscal Year 2005-06, 1.02% of the total contribution was allocated to the Health Care Trust Fund.

At December 31, 2004, the State and School Division of PERA was underfunded with an infinite amortization period, which means that the unfunded actuarially accrued liability would never be fully funded at the current contribution rate. In the 2004 legislative session, the general assembly authorized an Amortization Equalization Disbursement to address the funding shortfall that requires PERA employers to pay an additional 0.5% of salary in 2006, 1.0% of salary in 2007, and subsequent year increases of 0.4% of salary until the additional payment reaches 3.0% in 2012. Salary subject to PERA contribution is gross earnings less any reduction in pay to offset employer contributions to the state sponsored IRC 125 plan established under Section 125 of the Internal Revenue Code. The contribution requirements of plan members and their employers are established, and may be amended, by the general assembly.

Pinnacol's contributions to the Defined Benefit Plan and the Health Care Trust Fund for the fiscal years ended June 30, 2006, 2005, and 2004 were $3,978,000, $3,569,000, and $3,105,000, respectively. These contributions met the contribution requirement for each year.

Voluntary Tax-Deferred Retirement Plans

PERA offers a voluntary 401(k) plan entirely separate from the defined benefit pension plan. The state offers a 457 deferred compensation plan and certain agencies and institutions of the state offer 403(b) or 401(a) plans.

Postretirement Health Care and Life Insurance Benefits

Health Care Program

The PERA Health Care Program (the Program) began covering benefit recipients and qualified dependents on July 1, 1986. This benefit was developed after legislation in 1985 established the Program and the Health Care Fund; the Program was converted to a trust fund in 1999. Under this program, PERA subsidizes a portion of the monthly premium for health care coverage. The benefit recipient pays any remaining amount of that premium through an automatic deduction from the monthly retirement benefit. The premium subsidy was $115 for those with 20 years of service credit ($230 for members under age 65 and not eligible for Medicare), and it was reduced by 5% for each year of service fewer than 20.

The Health Care Trust Fund is maintained by an employer's contribution as discussed above.

Monthly premium costs for participants depend on the health care plan selected, the number of persons covered, Medicare eligibility, and the number of years of service credit. PERA contracts with a major medical indemnity carrier to administer claims for self-insured medical and prescription benefit plans and with several health maintenance organizations providing services within Colorado. As of December 31, 2006, there were 42,433 enrollees in the plan.

Life Insurance Program

Previously, PERA provided its members access to two group decreasing term life insurance plans offered by Prudential Insurance Company and Anthem Life. Effective April 1, 2005, PERA consolidated the two plans, and UnumProvident became the administrator. Members who transition to the new plan may continue coverage into retirement. Premiums are collected by monthly payroll deductions or other means.

Accrued Paid Leave

Pinnacol employees may accrue paid time off based on their length of service subject to certain limitations on the amount that will be paid upon termination or taken in future periods. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The estimated liability for cumulative accrued paid time off of $1,520,000 and $1,321,000 at December 31, 2006 and 2005, respectively, is included in other liabilities in the accompanying statutory financial statements.

(v) Reclassifications

Certain 2005 amounts have been reclassified to conform to the 2006 presentation.

(2) Unpaid Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses (both allocated and unallocated) represent management’s best estimate of the ultimate medical and indemnity net cost of all losses and loss adjustment expenses 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 current operating results.

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

Discounting of Liabilities for Unpaid Losses or Unpaid Loss Adjustment Expenses

Pinnacol discounts its liabilities for unpaid losses for certain long-term scheduled payments. Workers' compensation unpaid losses have been discounted on a tabular basis using a discount rate of 3.5% in 2006 and 2005. A tabular discount is calculated with reference to actuarial tables. These tables incorporate an interest rate and, in addition, factor in contingencies such as mortality, remarriage, and inflation rates. The amount of the tabular discount for unpaid losses as of December 31, 2006 and 2005, respectively, is $142,574,000 and $129,375,000. The amount of discount for case reserves at December 31, 2006, is distributed as follows over the years in which the losses were incurred:

	Loss year										
	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997	Prior
	(In thousands)										
Amount of discount case	$ 12,450	18,949	17,252	13,113	13,985	6,915	4,682	5,098	3,153	4,432	42,545

Unpaid Losses and Loss Adjustment Expense

At December 31, 2006, Pinnacol accrued $1,199,421,000 for unpaid losses and allocated loss adjustment expenses. A tabular discount of $142,574,000 (computed at 3.5%) was applied in the actuarial calculation of this liability for unpaid losses and allocated loss adjustment expenses. Reserve credit of approximately $7,679,000 was recorded for high deductibles on unpaid claims at December 31, 2006.

At December 31, 2005, Pinnacol accrued $1,167,693,000 for unpaid losses and allocated loss adjustment expenses. A tabular discount of $129,375,000 (computed at 3.5%) was applied in the actuarial calculation of this liability for unpaid losses and allocated loss adjustment expenses. Reserve credit of approximately $8,071,000 was recorded for high deductibles on unpaid claims at December 31, 2005.

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

	2006		2005	
	Unpaid losses and allocated loss adjustment expenses	**Unallocated loss adjustment expenses**	**Unpaid losses and allocated loss adjustment expenses**	**Unallocated loss adjustment expenses**
	(In thousands)			
Balance at January 1	$ 1,167,693	38,000	1,121,874	37,000
Additional amounts incurred related to:				
Current year	408,419	40,123	406,819	24,236
Prior years	(48,706)	(15,390)	(42,545)	(215)
Total incurred	359,713	24,733	364,274	24,021
Reductions relating to payments for:				
Current year	93,797	13,885	99,266	14,224
Prior years	234,188	10,848	219,189	8,797
Total paid	327,985	24,733	318,455	23,021
Balance at December 31	$ 1,199,421	38,000	1,167,693	38,000

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and allocated loss adjustment expenses decreased by $48,706,000 in 2006 and $42,545,000 in 2005. The changes are generally the result of ongoing analysis of recent loss development trends and better development efforts. Original estimates are increased or decreased as additional information becomes known regarding individual claims.

(3) Investments

Estimated fair value of investments in bonds is based on values published by the Securities Valuation Office (SVO) of the NAIC. However, for certain investments the SVO does not provide a fair market value. For those investments, the quoted market value prices as provided by accepted external pricing vendors may be used as a substitute for the SVO market price. In both 2006 and 2005, Interactive Data Corporation (IDC) was used to obtain fair market values.

The SVO of the NAIC designates ratings of bonds from 1 to 6. Bonds with ratings of 1–2 are stated at amortized cost using the interest method. Bonds with ratings of 3-6 require the bond to be carried at the lower of amortized cost or market, with any related unrealized loss reported in surplus. During 2006, Pinnacol had an investment in a bond where the SVO designated the bond at a 4 rating; however, the fair market value on this bond is higher than amortized cost, which resulted in a surplus recovery of

$2,308,000. During 2005, this same bond had an SVO designation of a 3 rating and the fair market value was lower than amortized cost, which resulted in an unrealized loss of $2,308,000 that was reported in surplus.

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

	2006			
	Amortized cost	Unrealized gains	Unrealized losses	Fair value
	(In thousands)			
U.S. government obligations:				
Nonloan-backed bonds	$ 436,695	6,604	(5,794)	437,505
Loan-backed bonds	487,008	598	(11,252)	476,354
Special revenue:				
Loan-backed bonds	4,983	—	(44)	4,939
Industrial and miscellaneous:				
Nonloan-backed bonds	702,511	15,320	(11,262)	706,569
Loan-backed bonds	—	—	—	—
	$ 1,631,197	22,522	(28,352)	1,625,367

	2005			
	Amortized cost	Unrealized gains	Unrealized losses	Fair value
	(In thousands)			
U.S. government obligations:				
Nonloan-backed bonds	$ 373,032	8,911	(3,175)	378,768
Loan-backed bonds	450,669	2,432	(8,901)	444,200
Special revenue:				
Loan-backed bonds	59,930	70	(908)	59,092
Industrial and miscellaneous:				
Nonloan-backed bonds	633,091	23,487	(9,188)	647,390
Loan-backed bonds	19,986	146	—	20,132
	$ 1,536,708	35,046	(22,172)	1,549,582

The amortized cost and fair value of investments in debt securities at December 31, 2006, by contractual maturity, are shown in the following table. Contractual maturities may differ from actual maturities because the borrower may have the right to call or prepay obligations with or without call or prepayment penalties.

		Amortized cost	Fair value
		(In thousands)	
Due in one year or less	$	87,435	87,259
Due after one year through five years		348,847	351,366
Due after five years through ten years		554,335	552,978
Due after ten years		640,580	633,764
	$	1,631,197	1,625,367

Proceeds from sales of investments in bonds during 2006 and 2005 were $97,297,000 and $164,359,000, respectively. Gross gains of $260,000 and $3,531,000 and gross losses of $0 and $22,000 were realized on those sales for 2006 and 2005, respectively.

Unrealized gains and losses on investments in common stocks are reported directly in surplus. The gross unrealized gains and losses on and cost and fair value of those investments are summarized as follows:

		Cost	Gross unrealized gains	Gross unrealized losses	Fair value
			(In thousands)		
December 31, 2006:					
Common stocks	$	186,310	39,032	(1,393)	223,949
December 31, 2005:					
Common stocks		140,634	19,117	—	159,751

The following table provides the length of impairment for those investments in bonds with an unrealized loss as of December 31, 2006:

		Less than 12 months		12 months or greater		Total	
Description of securities		**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**
				(In thousands)			
Government obligations	$	37,987	(454)	279,916	(5,340)	317,903	(5,794)
Special revenue and special assessment obligations		4,939	(44)	—	—	4,939	(44)
Industrial and miscellaneous		57,829	(527)	266,556	(10,736)	324,385	(11,263)
Mortgage-backed securities		81,000	(748)	312,704	(10,503)	393,704	(11,251)
Total	$	181,755	(1,773)	859,176	(26,579)	1,040,931	(28,352)

There are 128 securities in an unrealized loss position as of December 31, 2006.

(a) Government Obligations

Any unrealized losses in government securities are due to interest rate fluctuations. Because of the ability to hold to maturity, plus the credit quality of government securities, government obligation unrealized losses are considered temporary.

(b) Special Revenue Obligations

Special revenue obligations are almost always insured, can be held to maturity, and any unrealized losses are typically considered temporary.

(c) Industrial and Miscellaneous Bonds

Investment grade bonds held in the portfolio all have a BBB- rating or higher. All bonds can be held to maturity and any unrealized losses are considered temporary.

(d) Mortgage-Backed Securities

These are securities backed by federal agency status. Any unrealized losses in government securities are due to interest rate fluctuations. Because of the ability to hold to maturity, plus the credit quality of the securities, mortgage-backed securities unrealized losses are considered temporary.

Major categories of net investment income for the years ended December 31, 2006 and 2005 are summarized as follows:

		2006	**2005**
		(In thousands)	
Investment income:			
Corporate and miscellaneous bonds	$	62,658	63,719
U.S. government obligations		20,224	14,541
Cash and other investments		2,434	2,207
Real estate		3,687	3,619
Equity securities		6,247	3,993
Repurchase/reverse repurchase		975	742
Investment expenses		(3,449)	(3,221)
Net investment income		92,776	85,600
Net realized gains		4,688	3,508
Investment income	$	97,464	89,108

(Continued)

(4) Repurchase and Reverse Repurchase Transactions

Pinnacol enters into repurchase and reverse repurchase agreements where the Company agrees to sell securities and simultaneously agrees to repurchase the same or substantially the same securities in the future (reverse repurchase agreement) while also entering into an agreement to purchase securities and simultaneously agrees to resell the same or substantially the same securities in the future (repurchase agreement). The broker-dealer provides securities as collateral equal to or exceeding 105% of the market value of securities transferred into the program. Pinnacol had outstanding U.S. government securities with Trade Principal values of approximately $918,731,000 and $884,739,000 and a cost of approximately $909,496,000 and $871,204,000 as of December 31, 2006 and 2005, respectively.

Pinnacol has no additional credit risk exposure to borrowers. The contract with the broker-dealer requires the broker-dealer to indemnify Pinnacol if the broker-dealer fails to return the securities or fails to pay Pinnacol for income distributions by the securities' issuers while the securities remain in the program. Either Pinnacol or the broker-dealer can terminate all repurchase and reverse repurchase transactions on demand.

(5) Transactions with the State

The state contracts with Pinnacol pursuant to its self-funded insurance program. The state reimburses Pinnacol for all workers' compensation claims and loss adjustment expenses as incurred. Pinnacol accounts for the state contract as an uninsured and partially insured accident and health plan whereby Pinnacol does not record the premium revenue or loss and loss adjustment expenses and related receivables and payables for state workers' compensation costs. Reimbursements billed to the state under this contract were $32,056,000 and $27,506,000 in 2006 and 2005, respectively.

(6) Reinsurance

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

Period	Reinsurance coverage
Prior to January 1, 2002	Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $6,000,000 per occurrence
January 1, 2002 to April 30, 2002	No catastrophic reinsurance was in place.
May 1, 2002 to May 1, 2004	Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $20,000,000 per occurrence
March 1, 2004 to April 30, 2005	Individual workers' compensation accidents of up to $15,000,000 in excess of retention of $5,000,000 per occurrence Individual workers' compensation accidents of up to $40,000,000 in excess of retention of $40,000,000 per occurrence
May 1, 2005 to April 30, 2006	Individual workers' compensation accidents of up to $15,000,000 in excess of retention of $5,000,000 per occurrence; Pinnacol retains 40% within this range of loss Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $20,000,000 per occurrence Individual workers' compensation accidents of up to $40,000,000 in excess of retention of $40,000,000 per occurrence
May 1, 2006 to April 30, 2007	Individual workers' compensation accidents of up to $10,000,000 in excess of retention of $10,000,000 per occurrence Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $20,000,000 per occurrence Individual workers' compensation accidents of up to $40,000,000 in excess of retention of $40,000,000 per occurrence

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

Effective March 1, 2004, Pinnacol executed a reinsurance contract with Argonaut Insurance Company (a California corporation) for Other States Coverage that is in effect as of December 31, 2006. The contract is designed as a 100% quota share arrangement with Pinnacol acting as the assuming company. This allows Pinnacol to provide insurance coverage under the workers' compensation provisions of other states for the employees of Colorado employer companies who work outside of Colorado. Premium revenue is recognized pro rata over the period the policy is effective.

(Continued)

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

		2006	2005
		(In thousands)	
Direct premiums earned	$	582,957	563,454
Premiums ceded		(3,627)	(2,642)
Premiums assumed		9,046	5,658
Net premiums earned	$	588,376	566,470
Direct losses incurred	$	352,222	361,817
Losses ceded		(1,433)	68
Losses assumed		8,924	2,389
Net losses incurred	$	359,713	364,274

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

Pinnacol's reinsurers had the following AM Best ratings at December 31, 2006:

Reinsurer	AM best rating
AXIS Specialty Limited	A
Endurance Specialty Insurance Limited	A-
Renaissance Reinsurance Ltd.	A
Aspen Insurance UK Ltd.	A
Danish RE Underwriting Agencies Lloyds	NR
Catlin Insurance Company Ltd.	A
Odyssey America Reinsurance Corp.	A
Validus Reinsurance Ltd.	A-
Brit Insurance Limited	A

(7) Policyholders' Surplus

Pinnacol had policyholders' surplus of $607,473,000 and $471,849,000 as of December 31, 2006 and 2005, respectively. Prior to and as of December 31, 2002, surplus was below regulatory levels considered acceptable in the industry. In response to Section 8-45-111, C.R.S., management of Pinnacol had developed, filed, and received approval, effective January 1, 2001, of a Surplus Recovery Plan (the Plan) to strengthen its financial position and attain "a reasonable policyholders' surplus." The Plan called for Pinnacol to achieve the "company action level of risk-based capital." Risk-based capital is a regulatory measure of capital adequacy and the "company action level" is the minimum level of risk-based capital required by insurance regulation (i.e., the level at which the Division requires a plan for corrective action). Risk-based capital includes factors that relate to the size of the entity, the perceived risks in the company's business, and also factors relating to the insurance industry in general. The risk-based capital calculation allows a company to compute surplus using discounted tabular reserves, which are indemnity reserves that are calculated using discounts determined with reference to actuarial tables.

The Plan was achieved and Pinnacol has attained an acceptable level of surplus as outlined in the state statutes based on the surplus level as of December 31, 2003. This surplus level was verified through a triennial examination conducted by the Division that was completed on November 8, 2004.

As a result of maintaining an acceptable level of surplus, Pinnacol paid $56,700,000 and $55,067,000 in general policyholder dividends to its policyholders in good standing in 2006 and 2005 respectively. An acceptable level of surplus is that which exceeds the company action level of risk-based capital, which is $149,695,000 for 2006. This is included in dividends to policyholders on the statutory statements of income and changes in policyholders' surplus and reduces net income for the year ending December 31, 2006.

(8) Uncollected Premiums

At December 31, 2006 and 2005, Pinnacol had admitted assets of $70,652,000 and $57,985,000, respectively, representing premiums receivable. Pinnacol routinely assesses the collectibility of these receivables. Based upon Pinnacol's experience, approximately 1% of the earned premium may become uncollectible.

(9) Commitments and Contingencies

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

At December 31, 2006 and 2005, Pinnacol had letters of credit for assumptive reinsurance agreements. Pinnacol had a letter of credit for the benefit of Fireman's Fund Insurance Company for approximately $4,167,000 and $5,454,000 at December 31, 2006 and 2005, respectively. Pinnacol had a letter of credit for the benefit of Argonaut Insurance Company for $19,724,000 and $9,103,000 at December 31, 2006 and 2005, respectively. Pinnacol had a letter of credit for the benefit of Reliance Insurance Company for approximately $902,000 at December 31, 2006 and 2005, respectively. These reinsurance agreements allow the companies to draw upon the respective letters of credit, which are collateralized at 112%, at any time to secure any of Pinnacol's obligations under the agreements. Included in cash, cash equivalents, and other invested assets are amounts held as collateral for letters of credit for reinsurance agreements of $28,269,000 and $18,396,000 as of December 31, 2006 and 2005, respectively.

Pinnacol is contingently liable for approximately $61,366,000 of claims closed by the purchase of annuities from life insurers for structured settlements. No provision has been made for this contingency as management believes that any payments related to this contingency are remote.

At December 31, 2006, the aggregate amount of annuities due from all life insurers equaled the amount of the reserves eliminated when the annuities were purchased and consisted of the following:

Life insurance company and location		**Loss reserves eliminated by annuities**
		(In thousands)
Genworth Financial, Virginia	$	38,040
Symetra Financial, Washington		19,143
Metlife, New York		2,474
Allstate, Illinois		1,491
Liberty Life Assurance Company, Massachusetts		218
	$	61,366

(10) Subsequent Events

As Pinnacol has maintained an acceptable level of surplus, the board of directors held a meeting on April 4, 2007 in which it declared and is planning to pay a general dividend of approximately $60,000,000 in 2007 to its policyholders with policies in good standing. The board of directors, at its discretion, determines the amount of policyholder dividends to be declared based on Pinnacol's overall experience and financial condition.

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Investment Risks Interrogatories

December 31, 2006

Pinnacol's total admitted assets as reported on page two of its Annual Statement are $2,011,005,045.

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

Investment category/issuer	Amount	Percentage of total admitted assets
Bonds:		
a. Vanguard	$ 108,443,163	5.39%
b. General Electric	32,763,997	1.63
c. Proctor and Gamble	29,932,643	1.49
d. Wells Fargo Adv Cash Invest MMKT Inst	28,269,806	1.41
e. Emerson Electric	26,286,471	1.31
f. IBM Corp	25,929,111	1.29
g. Anheuser Busch	24,941,103	1.24
h. Julius Baer	24,544,670	1.22
i. Ford Motor Credit Co	24,475,974	1.22
j. T. Rowe Price Small Cap	22,246,730	1.11

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

Bonds			Preferred stocks		
NAIC rating	Amount	Percentage of total admitted assets	NAIC rating	Amount	Percentage of total admitted assets
NAIC-1	$ 1,615,349,377	80.33%	P/PSF-1	$	
NAIC-2	29,817,797	1.48	P/PSF-2		
NAIC-3	—	—	P/PSF-3		
NAIC-4	24,475,975	1.22	P/PSF-4		
NAIC-5	—	—	P/PSF-5		
NAIC-6	—	—	P/PSF-6		
	$ 1,669,643,149			$ —	

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

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

5. Assets held in investments with contractual sales restrictions are less than 2.5% of Pinnacol's total admitted assets.

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

Investment category/issuer		Amount	Percentage of total admitted assets
a. Vanguard	$	108,443,163	5.39%
b. Julius Baer		24,544,670	1.22
c. T. Rowe Price Small Cap		22,246,730	1.11
d. Rainier		10,827,310	0.54
e. Alliance		10,529,738	0.52
f. Weyerhauser		2,826,000	0.14

7. Assets held in nonaffiliated, privately placed equities are less than 2.5% of Pinnacol's total admitted assets.

8. Assets held in general partnership interests are less than 2.5% of Pinnacol's total admitted assets.

9. Mortgage loans reported in schedule B are less than 2.5% of Pinnacol's total admitted assets.

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

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

		Year-end			End of each quarter		
					1st quarter	2nd quarter	3rd quarter
						(Unaudited)	
		Amount	Percentage of total admitted assets		Amount	Amount	Amount
a. Securities lending (do not include assets held as collateral for such transactions)	$	—	—%	$	—	—	—
b. Repurchase agreements		918,730,998	45.7		889,407,620	858,029,373	929,449,998
c. Reverse repurchase agreements		—	—		—	—	—
d. Dollar repurchase agreements		—	—		—	—	—
e. Dollar reverse repurchase agreements		—	—		—	—	—

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Investment Risks Interrogatories

December 31, 2006

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

	Owned		Written	
	Amount	**Percentage of total admitted assets**	**Amount**	**Percentage of total admitted assets**
a. Hedging	$ —	—%	$ —	—%
b. Income generation	—	—	—	—
c. Other	—	—	—	—

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

	Year-end		End of each quarter		
			1st quarter	**2nd quarter**	**3rd quarter**
				(Unaudited)	
	Amount	**Percentage of total admitted assets**	**Amount**	**Amount**	**Amount**
a. Hedging	$ —	—%	$ —	—	—
b. Income generation	—	—	—	—	—
c. Replications	—	—	—	—	—
d. Other	—	—	—	—	—

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

	Year-end		End of each quarter		
			1st quarter	**2nd quarter**	**3rd quarter**
				(Unaudited)	
	Amount	**Percentage of total admitted assets**	**Amount**	**Amount**	**Amount**
a. Hedging	$ —	—%	$ —	—	—
b. Income generation	—	—	—	—	—
c. Replications	—	—	—	—	—
d. Other	—	—	—	—	—

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Summary Investment Schedule

December 31, 2006

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	$ 414,197,710	21.55%	$ 414,197,710	21.55%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	—	—	—	—
Issued by U.S. government-sponsored agencies	22,497,723	1.17	22,497,723	1.17
Foreign government (including Canada, excluding mortgage-backed securities)	—	—	—	—
Securities issued by states, territories, and possessions and their political subdivisions in the U.S.:				
State, territory, and possessions – general obligations	—	—	—	—
Political subdivisions of states, territories, and possessions – general obligations	—	—	—	—
Revenue and assessment obligations	—	—	—	—
Industrial development and similar obligations	—	—	—	—
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA	14,727,246	0.77	14,727,246	0.77
Issued by FNMA and FHLMC	68,484,794	3.56	68,484,794	3.56
Privately issued	—	—	—	—
CMOs and REMICs:				
Issued by FNMA and FHLMC	—	—	—	—
Privately issued and collateralized by MBS, issued or guaranteed by GNMA, FNMA, or FHLMC	393,615,097	20.48	393,615,097	20.48
All other privately issued	10,180,587	0.53	10,180,587	0.53
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	664,365,578	34.57	664,365,578	34.57
Unaffiliated foreign securities	43,127,772	2.25	43,127,772	2.25
Affiliated securities	—	—	—	—
Equity interests:				
Investments in mutual funds	176,591,611	9.19	176,591,611	9.19
Preferred stocks:				
Affiliated	—	—	—	—
Unaffiliated	—	—	—	—
Publicly traded equity securities (excluding preferred stocks):				
Affiliated	—	—	—	—
Unaffiliated	47,357,656	2.47	47,357,656	2.47

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Summary Investment Schedule

December 31, 2006

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
Other equity securities:				
Affiliated	$ —	—%	$ —	—%
Unaffiliated	—	—	—	—
Other equity interests including tangible personal property under lease:				
Affiliated	—	—	—	—
Unaffiliated	—	—	—	—
Mortgage loans:				
Construction and land development	—	—	—	—
Agricultural	—	—	—	—
Single-family residential properties	—	—	—	—
Multifamily residential properties	—	—	—	—
Commercial loans	—	—	—	—
Real estate investments:				
Property occupied by Company	22,305,573	1.16	22,305,573	1.16
Property held for production of income	—	—	—	—
Property issued or guaranteed by GNMA, FNMA	—	—	—	—
Collateral loans	—	—	—	—
Policy loans	—	—	—	—
Receivables for securities	—	—	—	—
Cash and short-term investments	44,163,085	2.30	44,163,085	2.30
Write-ins for invested assets	—	—	—	—
Total invested assets	$ 1,921,614,432	100.00%	$ 1,921,614,432	100.00%

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

See accompanying independent auditors' report.

KPMG LLP
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Denver, CO 80202

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

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

We have audited the statutory financial statements of Pinnacol Assurance (Pinnacol) as of and for the year ended December 31, 2006, and have issued our report thereon dated May 21, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America.

Internal Control over Financial Reporting

In planning and performing our audit, we considered Pinnacol's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably, such that there is more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

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

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

KPMG LLP

May 21, 2007

PINNACOL ASSURANCE

Statutory Financial Statements

December 31, 2006

Distribution

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www.state.co.us/auditor

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303-869-2800

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