Pinnacol Assurance

Performance Audit
May 2010

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STATE OF COLORADO

Sally Symanski, CPA
State Auditor

OFFICE OF THE STATE AUDITOR
303.869.2800
FAX 303.869.3060

Legislative Services Building
200 East 14th Avenue
Denver, Colorado 80203-2211

May 13, 2010

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of Pinnacol Assurance. The audit was conducted pursuant to Section 8-45-121(2), C.R.S., which required the State Auditor to conduct a performance audit of Pinnacol Assurance in 2009. The report presents our findings, conclusions, and recommendations, and the responses of Pinnacol Assurance and the Pinnacol Board of Directors.

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Glossary of Terms and Abbreviations

AASCIF – American Association of State Compensation Insurance Funds. AASCIF is an association of workers' compensation insurers from 27 different states plus 10 workers' compensation boards in Canada.

Board – Pinnacol Assurance Board of Directors. A nine-member Board of Directors appointed by the Governor and confirmed by the Senate to serve five year terms. The Board consists of four employers that are insured by Pinnacol, including one farmer or rancher; three employees of employers that are insured by Pinnacol; one individual who is experienced in managing and operating insurance companies but does not have any business interest that competes with Pinnacol; and one individual who is experienced in finance or investments but is not an employer insured by Pinnacol.

CEO – Chief Executive Officer.

CHFA – Colorado Housing and Finance Authority. A Colorado political subdivision that provides education, technical expertise, and fixed rate financing for homeowners and small businesses.

Colorado Authority – The Colorado Compensation Insurance Authority. The Colorado state fund that existed as a political subdivision between 1990 and 2002, prior to the establishment of Pinnacol Assurance.

Combined Ratio – The percentage of each insurance premium dollar spent on claims and expenses.

Division of Insurance – Located within the Department of Regulatory Agencies. Regulates the insurance industry and assists consumers and other stakeholders with insurance issues. Referred to as "Division" in Chapter 3.

Division of Workers' Compensation – Located within the Department of Labor and Employment. Responsible for administering the Colorado Workers' Compensation Act [Articles 40 through 47 of Title 8, C.R.S.]. Referred to as the "Division" in Chapter 4.

Executive Performance Plan – Pinnacol's formula-based bonus program which is designed to motivate and reward executives for their annual performance against defined objectives.

Gainsharing – Pinnacol's bonus program which is designed to incentivize extraordinary non-executive employee performance.

LCM – Loss Cost Multiplier. Rating factor that reflects the insurer's expense component of the premium, as well as differences in expected loss costs for employers covered by the insurer from the overall state average loss costs.

Losses – The amount the insurance carrier is required to pay towards an injured worker's claim.

NAIC – National Association of Insurance Commissioners**.** Comprises state insurance regulators and provides a forum for the development of uniform policy across the states. The NAIC has developed a risk-based capital (RBC) system, as described under "RBC" below, to help workers' compensation insurers and regulators ensure adequate surplus levels are maintained. In accordance with Colorado insurance regulations, workers' compensation insurers doing business in Colorado use NAIC's RBC system to determine whether their surplus levels are adequate.

NCCI – National Council on Compensation Insurance. Designated by the Commissioner of Insurance as Colorado's rating organization for workers' compensation insurance, NCCI collects workers' compensation data from individual insurers, including Pinnacol, and analyzes industry trends to prepare recommended workers' compensation insurance rate factors.

Office of Administrative Courts – Located within the Department of Personnel and Administration. Conducts administrative hearings for a number of state agencies, including the Division of Workers' Compensation.

PERA – Public Employees' Retirement Association. Provides retirement and related benefits to employees of participating public employers in the State of Colorado, such as state government and some political subdivisions, including Pinnacol Assurance.

RBC – Risk-Based Capital. The NAIC has developed a risk-based capital (RBC) system that has two main components: an RBC formula that establishes a hypothetical minimum capital (surplus) standard and an RBC model law that grants authority to state insurance regulators to take specific actions based on an insurer's level of surplus relative to the standard.

RTD – Regional Transportation District. A political subdivision statutorily charged with developing, maintaining, and operating a mass transportation system within the Denver metropolitan area**.**

SCIF – State Compensation Insurance Fund. Colorado's first state fund, established by the General Assembly in 1915. The SCIF was a state agency within the Department of Labor and Employment was created to ensure Colorado employers had access to workers' compensation insurance.

State Authority – State Compensation Insurance Authority. The Colorado state fund that existed from 1987 to 1990. The State Authority replaced the SCIF and was a political subdivision not under the jurisdiction of any state agency.

State Fund – A state workers' compensation insurance fund. State funds were generally established to provide workers' compensation insurance because no private market existed for this type of insurance when workers' compensation laws were first enacted. Many state funds, including Pinnacol, serve as the state "insurer of last resort," meaning they must provide insurance coverage to any employer in good standing, regardless of risk or company size.

Pinnacol Assurance
Performance Audit
May 2010

Purpose and Scope

This audit was conducted pursuant to Section 8-45-121(2), C.R.S., (Senate Bill 09-281), which requires the State Auditor to conduct a performance audit of Pinnacol Assurance (Pinnacol) in 2009. We reviewed the areas required by the statute, including (1) executive compensation, (2) the premium rate structure, (3) loss reserves, and (4) injured workers' claims experience. We reviewed Pinnacol's policies and practices for determining executive compensation and the bonus programs for both executive and non-executive staff. We engaged Regulatory Consultants, Inc. (RCI), a firm with specialists having actuarial and workers' compensation insurance expertise, to review claims processing, rate-setting and premiums, loss reserves, and policyholders' surplus. In addition, we reviewed Pinnacol's controls over travel and entertainment expenses. We performed audit work from June 2009 through May 2010. At the end of the audit, we obtained a management representation letter from Pinnacol stating that, to the best of its knowledge, it had provided us with all data and documentation relevant to the audit.

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

Overview

Pinnacol, a political subdivision governed by a nine-member, Governor-appointed Board of Directors, serves as Colorado's workers' compensation insurance fund. Pinnacol is the State's "insurer of last resort," meaning that Pinnacol must provide insurance coverage to employers that have difficulty purchasing it privately. Pinnacol had about 55,000 workers' compensation policies in effect in 2009. Between 2007 and 2009 Pinnacol held more than a 50 percent share in Colorado's workers' compensation insurance market (measured as a percentage of all workers' compensation insurance premiums charged). Based on this measure of market share, Pinnacol has been Colorado's largest workers' compensation insurer since at least 1996.

In 2009 Pinnacol collected about $399 million in premiums and paid about $256 million for claims. Like other workers' compensation insurers, Pinnacol is required to maintain an adequate reserve for unpaid losses and set aside additional funds as a policyholders' surplus. At the end of 2009 Pinnacol held about $733 million in policyholders' surplus.

For further information on this report, contact the Office of the State Auditor at 303.869.2800.

Pinnacol is subject to oversight by the Colorado Division of Workers' Compensation within the Department of Labor and Employment, and the Colorado Division of Insurance within the Department of Regulatory Agencies. Pinnacol is exempt from federal and state corporate income taxes, the state insurance premium tax, state sales and use taxes, and property taxes. Pinnacol is subject to a surcharge on workers' compensation insurance premiums received.

Key Findings

Compensation

We compared the combined salaries, bonuses, and perquisites Pinnacol paid its chief executive officer (CEO) to those of similar workers' compensation insurers in other states, other large Colorado political subdivisions, and private insurers that offer workers' compensation coverage to Colorado employers. While we found that Pinnacol's executive compensation was generally at the high end of the range among the entities we reviewed, we did not find evidence that Pinnacol's executive compensation was necessarily unreasonable in comparison to other organizations. We found that Pinnacol paid its CEO significant bonuses relative to the other organizations.

We conducted detailed audit work on Pinnacol's two executive bonus programs and a non-executive gainsharing program. Overall, we found that Pinnacol's executive and non-executive staff have repeatedly received bonuses at maximum levels for many years. We identified the following problems:

- **Executive Performance Plan (Plan) Targets.** Pinnacol's Board regularly set certain Plan targets below the prior years' actual results between 2002 and 2008 which allowed Pinnacol executives to receive maximum level bonuses under the Plan almost every year over this period. Under the Plan, each executive may earn a bonus equal to a percentage of his or her total annual salary, ranging up to a maximum of 52.5 percent for the CEO. Pinnacol has not fully documented the rationale for setting Plan targets or implemented a standardized, documented process to evaluate whether the targets are achieving the Plan's intended purpose. Pinnacol paid more than $1.9 million in Plan bonuses during 2007 through 2009.

- **Executive Discretionary Bonus Program.** Pinnacol has not clearly distinguished the discretionary bonus program from the Plan or coordinated the timing of the two types of bonus awards to help prevent duplication. We found one example where an executive received a bonus under both programs for similar accomplishments. Pinnacol established its executive discretionary bonus program to reward "extraordinary performance" and "special projects." Between 2007 and 2009, Pinnacol executives were awarded 15 discretionary bonuses totaling $172,700.

- **Gainsharing for Non-Executives.** Similar to the Plan, Pinnacol set gainsharing net income targets below the prior years' actual net income in every quarter of 2009, and non-executive staff were awarded the maximum bonuses possible—20 percent of salary—56 percent of the time during 2008 and 2009. The gainsharing program rewards non-executive staff on a quarterly basis for achieving "extraordinary" performance. These bonus results indicate that Pinnacol may set gainsharing targets too low. Further, Pinnacol has not fully documented the rationale for setting program targets. Pinnacol paid employees over $11.4 million in gainsharing bonuses for 2008 and 2009.

We also noted that, as of September 2009, all Pinnacol executive staff have agreements with the Pinnacol Board that would take effect in the event of a change in control, such as Pinnacol becoming an agency of state government. The agreements maintain each executive's salary, benefits, and Executive Performance Plan bonuses at designated levels for up to two years after a change in control, or provide additional payouts upon termination for specified reasons. Based on 2009 data, if the agreements were triggered and all executives were terminated without cause or for "good reason" as defined in the agreements, we estimate Pinnacol's exposure would be more than $4.3 million.

Premiums, Reserves, and Surplus

Under statute, the Pinnacol Board is responsible for establishing workers' compensation rates and premiums, setting aside reserves to cover claims, and maintaining an adequate surplus. Statute requires that workers' compensation insurance rates "not be excessive, inadequate, or unfairly discriminatory." Since 1996 Pinnacol has assigned all policies to a tier which affects the premium paid by the policyholder. Pinnacol currently has six tiers (labeled Non-Standard, Standard, Standard Plus, Preferred, Preferred Plus, and Superior) and selects different loss cost multipliers (LCMs) for each tier. Pinnacol establishes individual loss cost multipliers (LCMs) for each tier to reflect the insurer's expenses and differences in expected loss costs. Setting the LCMs is an important step in calculating an employer's final premium.

Statute requires insurers to file all rating factors used to determine premiums with the Division of Insurance before being used. RCI, the specialists with which we contracted, reviewed Pinnacol's rate-setting processes for 2006 through 2009 and found weaknesses that raise concerns about whether Pinnacol's rates may be excessive, inadequate, or unfairly discriminatory, as follows:

- **Rate Setting.** Pinnacol's LCMs may generate rates that are unfairly discriminatory among employers. Pinnacol's method of selecting Loss Cost Multipliers (LCMs) for its tiers appears to overcharge employers with policies in the Standard and Non-Standard tiers relative to employers in the Preferred and Superior tiers. In addition, for 2006 through 2010, Pinnacol used information containing inaccuracies and unsubstantiated assumptions to calculate indicated LCMs and to select final LCMs. The number and significance of the problems indicate a lack of adequate controls over the rate-setting process.

- **Schedule Rating Eligibility.** Pinnacol's method of determining an employer's eligibility for Schedule Rating may not be fair to all employers. Schedule Rating adjustments are one type of increase or decrease an insurer may make to an employer's premium based on evaluation of certain risk factors. Pinnacol uses a method to determine if policies are eligible for Schedule Rating that tends to negatively affect employers in the higher-risk, Non-Standard tier.

- **Rate Filings.** Pinnacol used some rating information for 2006 through 2010 that was not filed with the Division of Insurance as required under state law and other rating information that was filed in an incomplete form.

RCI also reviewed Pinnacol's reserves and surplus for 2006 through 2009. RCI found that Pinnacol recorded reserves at a conservative level over this period but concluded that Pinnacol's reserves were within reasonable bounds. RCI also concluded that Pinnacol's surplus was adequate to meet its obligations. Pinnacol is a single-line, single state, workers' compensation insurer that serves as the insurer of last resort for Colorado. As such, Pinnacol's surplus is subject to more risk than other insurers, increasing the difficulty of estimating total payouts on complex claims and the importance of having an adequate surplus. However, as of the end of 2009, Pinnacol's surplus continues to exceed a range established by the Board to help manage the surplus level.

Injured Workers' Claims Experience

When a workers' compensation claim is reported, Pinnacol, like other insurers, must determine whether the claim should be admitted and paid against the employer's insurance policy. Pinnacol processes some claims automatically (generally lower-cost medical-only claims) and assigns other claims (generally higher-dollar claims and those that involve payments for lost wages) to claims representatives for processing. We found two areas in which Pinnacol could make improvements.

- **Claims Handling.** For 5 of a sample of 60 claims (8 percent) tested, RCI found that Pinnacol was not in compliance with statutes and rules established by the Division of Workers' Compensation related to timeliness of claim filing, notifications to injured workers, and sufficiency of documentation for claim admission/denial.

- **Injured Worker Surveys.** Pinnacol does not use the results of its injured worker surveys as a component of the Executive Performance Plan or gainsharing program. In contrast, Pinnacol does use the results of customer satisfaction surveys of policyholders as a factor in the bonus programs.

Travel and Entertainment

For some Pinnacol employees and Board members, traveling for business and entertaining business partners are routine responsibilities. In 2009 Pinnacol paid about $1.5 million for travel and entertainment expenses through reimbursements to employees and Board members and through charges to company credit cards issued to individual staff. We found weaknesses in Pinnacol's policies and controls over travel and entertainment expenses, as well as over third-party payments made on behalf of Pinnacol personnel and Board members.

- **Travel and Entertainment Expenses.** We found that 45 of the sample of 60 travel and entertainment expenses Pinnacol approved for staff and Board members did not comply with one or more of Pinnacol's own travel and entertainment expense policies. The routine reimbursement of expenses that violate Pinnacol's expense policies renders the policies virtually meaningless as controls over spending on travel and entertainment. Additionally, Pinnacol has not established firm limits on lodging and non-business meal expenses.

- **Gifts and Expenses Paid by Third Parties for Pinnacol.** All of Pinnacol's executives and about half of the Board members received gifts and/or travel and entertainment expenses paid by third parties between January 1, 2008, and September 30, 2009. The expenses included, for example, two Pinnacol executives attending conferences at a total estimated cost to a third party of about $12,000. We could not determine the total amount of such expenses for executives and Board members because Pinnacol's policies do not clearly define, or require tracking of, gifts or third-party expenses that employees and Board members must disclose.

Our recommendations and the responses of Pinnacol Assurance and the Pinnacol Board can be found in the Recommendation Locator and in the body of this report.

RECOMMENDATION LOCATOR
Agency Addressed: Pinnacol Assurance

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
1	33	Ensure the Executive Performance Plan is structured to promote and reward superior performance by (a) fully documenting the method and rationales for setting targets, (b) developing a standardized evaluation process, and (c) obtaining professional expertise to develop a method for setting performance targets as appropriate.	Agree	December 2010
2	35	Develop written policies and procedures for the Executive Performance Plan that (a) describe the data sources and methods to determine net income and combined ratio results for the Plan and calculate bonuses, (b) require a thorough, standardized, and documented review of all data and calculations prior to payment, and (c) establish a mechanism to recover any bonus payments made in error.	Agree	December 2010
3	38	Reevaluate whether the discretionary bonus program is in the best interests of Pinnacol Assurance and its policyholders. If the program is retained, create a written policy that (a) clearly indicates the program's purpose as distinct from the Executive Performance Plan, (b) includes criteria that define "extraordinary" performance and "special projects," (c) coordinates the timing of different executive bonuses to minimize duplication, (d) requires the CEO to report all discretionary bonuses to the Board in advance, and (e) documents the dollar limits for the program.	Agree	December 2010
4	42	Strengthen the gainsharing program by (a) evaluating the target-setting process to ensure the program meets its philosophy of paying bonuses for extraordinary performance, and (b) documenting clear and reasonable objectives and rationales for the program, including all critical elements of the program.	Agree	December 2010
5	50	Further research and refine the methods used to select loss cost multipliers. Select and apply loss cost multipliers that are based on indicated differences in expected losses and expenses among tiers, giving full consideration to all other rating adjustments.	Partially Agree	December 2010
6	54	Improve the method used to determine indicated tier LCMs by (a) implementing a comprehensive review of all data, calculations, and material assumptions for accuracy, consistency, and reasonableness, and (b) considering the use of a qualified actuary to assist in setting rates.	Agree	December 2010

RECOMMENDATION LOCATOR
Agency Addressed: Pinnacol Assurance

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
7	57	Ensure that the method used to determine eligibility for the Schedule Rating Plan complies with all applicable statutes by (a) reevaluating the use of the Standard tier LCM to determine eligibility and the effect of the method on employer premiums, and (b) filing all rating information with the Division of Insurance before using the information to determine premiums.	Agree	December 2010
8	61	Improve rate filings submitted to the Division of Insurance by (a) reevaluating the Schedule Rating Plan to eliminate factors that duplicate the employer's experience rating, (b) filing any changes to the Schedule Rating Plan before applying them, and (c) ensuring submitted filings are complete and accurate.	Partially Agree	December 2010
9	70	Apply the surplus policy, including annually evaluating the surplus collar, adjusting the collar as appropriate, and managing rates and dividends to bring the surplus to a level within the collar.	Agree	Implemented and Ongoing
10	77	Continue training and other efforts to ensure that staff are handling claims appropriately and to reduce errors and violations in processing claims.	Agree	Implemented and Ongoing
11	79	Consider expanding the use of the injured worker surveys by setting targets and including the results as a component of the Executive Performance Plan and gainsharing programs.	Agree	December 2010
12	85	Adhere to established policies over travel and entertainment expenses by (a) establishing a meaningful review process to enforce all policy requirements and disciplining managers that do not uphold policies, and (b) implementing a policy that requires an independent review of Board member and CEO travel and entertainment expenses.	Agree	December 2010
13	88	Strengthen controls over lodging and non-business meal expenses by establishing clear "not to exceed" spending guidelines in the expense policies and requiring employees and Board members to follow the guidelines.	Agree	December 2010

RECOMMENDATION LOCATOR
Agency Addressed: Pinnacol Assurance

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
14	91	Strengthen employee and Board business ethics and conflict of interest policies by defining the type and dollar value of gifts, benefits, or expenses paid by Pinnacol's business partners that employees and Board members must disclose.	Agree	December 2010

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Overview of Pinnacol Assurance

Chapter 1

According to statute, Colorado's workers' compensation system is intended "... to assure the quick and efficient delivery of disability and medical benefits to injured workers at a reasonable cost to employers without the necessity of litigation" [Section 8-40-102(1), C.R.S.]. Colorado enacted workers' compensation laws in 1915 in response to the increase in work-related injuries caused by the mechanization of the Industrial Revolution. Before workers' compensation laws were established, injured workers faced uncertain results in court that could take years to resolve. This legal process was costly for the worker and the employer, and did not always provide beneficial results. Today, workers' compensation generally pays for the 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.

Like most states, Colorado now requires nearly all employers to carry workers' compensation insurance. However, at the time Colorado first enacted workers' compensation laws in 1915 no private market existed for this type of insurance. To ensure employers had access to coverage, the General Assembly established the State Compensation Insurance Fund (SCIF) as an agency within the Department of Labor and Employment. Since 1915, the State's workers' compensation insurance fund (state fund), has evolved from a state agency to a political subdivision named Pinnacol Assurance (Pinnacol) which is required to operate as a domestic mutual insurance company, except as otherwise provided by law [Section 8-45-101(1), C.R.S.].

Like many other state funds, Pinnacol serves as the State's "insurer of last resort." This means Pinnacol must provide insurance coverage to employers that have difficulty purchasing it privately. By doing so, Pinnacol helps the State ensure that all Colorado employers can cover the cost of compensating injured workers and their dependents. Statute specifically prohibits Colorado's state fund from denying coverage to any Colorado employer "due to the risk of loss or amount of premium" [Section 8-45-101(5), et seq., C.R.S.]. Pinnacol had a total of about 55,000 policies in effect in 2009. Pinnacol does not track the number of the employers it serves as the insurer of last resort.

Operations and Administration

Colorado's first state fund, the SCIF, operated as a state agency under the Department of Labor and Employment between 1915 and 1987. In 1987 the

General Assembly enacted legislation under which the state fund became the State Compensation Insurance Authority (State Authority), a political subdivision not under the jurisdiction of any state agency. Like many other state funds, the State Authority was governed by a Board of Directors whose members were appointed by the Governor. In 1990, the State Authority's name was changed to the Colorado Compensation Insurance Authority (Colorado Authority), and the number of Board members was increased from five to seven. In 2002, the number of Board members was increased to nine, and the Colorado Authority officially became Pinnacol Assurance.

Pinnacol reports that as of March 2010 it employed 12 executive and 599 non-executive staff. As employees of a political subdivision, Pinnacol's employees are not subject to state personnel rules. However, statute stipulates that Pinnacol's employees participate in the State's retirement program, the Public Employees' Retirement Association (PERA).

The members of Pinnacol's Board of Directors (Board) are appointed by the Governor with the approval of the Senate. As required by statute, the Board consists of four employers who obtain workers' compensation insurance from Pinnacol, including one farmer or rancher; three employees of employers who obtain insurance from Pinnacol; one individual who is experienced in managing and operating insurance companies but does not have any business interest that competes with Pinnacol; and one individual who is experienced in finance or investments but is not an employer insured through Pinnacol. All Board members serve terms of five years. Board meetings are open to the public under state law.

Statute [Section 8-45-101, et seq., C.R.S.] assigns the Board a variety of responsibilities, including:

- Developing and approving an annual budget;
- Appointing the chief executive officer of Pinnacol;
- Establishing general policies and procedures for the operation of Pinnacol;
- Promulgating policies and procedures that establish the basis by which employer premiums are determined;
- Reviewing and recommending legislation pertaining to workers' compensation;
- Implementing policies and procedures to contain medical care costs related to workers' compensation;
- Controlling and using all moneys collected by Pinnacol to provide workers' compensation insurance to Colorado employers; and
- Issuing dividends to policyholders from Pinnacol's surplus funds.

The Board has overall fiduciary responsibility for the operation of Pinnacol. Statute states that custody, and the responsibility for the investment, of Pinnacol's funds will be transferred from the State Treasurer to the Board once Pinnacol attains a “reasonable surplus” [Section 8-45-117(6), C.R.S.]. Pinnacol attained a reasonable surplus in 2003 during its third year of operating under a 10-year surplus recovery plan. House Bill 97-1180 required Pinnacol to develop the surplus recovery plan to address the troubled financial condition Pinnacol had faced for more than 20 years. Pursuant to the bill, Pinnacol designed the plan and received approval from the Commissioner of Insurance for the plan in 2000. As a result of attaining a reasonable surplus in 2003, control of Pinnacol’s investments was transferred from the State Treasurer to Pinnacol’s Board. In addition, as of that time, Pinnacol no longer qualifies for governmental immunity under state law [Section 8-45-101(12), C.R.S.].

In 2002 Pinnacol’s statute was amended to require Pinnacol to “operate as a domestic mutual insurance company except as otherwise provided by law” [Section 8-45-101(1), C.R.S]. Domestic mutual insurers are owned by their policyholders and are governed by boards elected by the policyholders. Although Pinnacol is not owned by its policyholders, and its policyholders do not elect its Board, Pinnacol does pay dividends to its policyholders.

Like other workers’ compensation insurers in Colorado, Pinnacol is subject to oversight by two state agencies:

- **The Colorado Division of Insurance** within the Department of Regulatory Agencies carries out a number of responsibilities relating to monitoring the financial condition of the insurance industry. These responsibilities include conducting periodic examinations of all Colorado insurers, reviewing each insurer’s risk based capital (surplus) to ensure the capital meets the requirements of Colorado Insurance Regulation 3-1-11, and reviewing the rate-setting procedures and data used by workers’ compensation insurers to calculate premiums. We discuss the role of the Division of Insurance related to Pinnacol in Chapter 3.

- **The Colorado Division of Workers' Compensation** within the Colorado Department of Labor and Employment conducts periodic audits of all workers’ compensation insurers to monitor their compliance with the Colorado Workers’ Compensation Act. These audits cover categories the Division has determined are important to proper claims adjusting, such as timely and accurate compensation payments. We discuss the Division of Workers’ Compensations’ role and its audits of Pinnacol in Chapter 4.

Workers’ Compensation Insurance Market

Currently, 26 states have state funds. State funds generally fall into two categories: exclusive and competitive. Typically, states with exclusive funds require employers either to purchase workers' compensation insurance from the state fund or to self-insure. States with competitive funds generally allow employers to purchase coverage from either the state fund or competing private carriers, or to self-insure. Pinnacol is one of 21 competitive state funds. States without state funds rely on the private market to provide workers' compensation coverage but have various mechanisms to assist employers who cannot obtain workers' compensation insurance through the private market.

Pinnacol is a significant presence in the Colorado workers' compensation market. Between 2007 and 2009 Pinnacol held more than a 50 percent market share, measured as a percent of all workers' compensation insurance premiums charged. The following table shows Pinnacol's place in Colorado's insured workers' compensation market during these years.

Table 1
Colorado Workers' Compensation Insurance Market Share[1]
Calendar Years 2007 through 2009

Insurer	2007	2008	2009
Pinnacol	**57.4%**	**57.4%**	**53.4%**
National Union Fire Insurance Co. of Pittsburgh, PA[2]	0.7%	1.1%	2.8%
Zurich American Insurance Company[2]	3.4%	2.4%	2.5%
Liberty Insurance Corporation[2]	3.5%	2.0%	2.0%
Others, combined [3]	35.0%	37.1%	39.3%

Source: Office of the State Auditor analysis of data provided by the Colorado Divisions of Insurance, Workers' Compensation, and Unemployment Insurance, and Pinnacol Assurance.

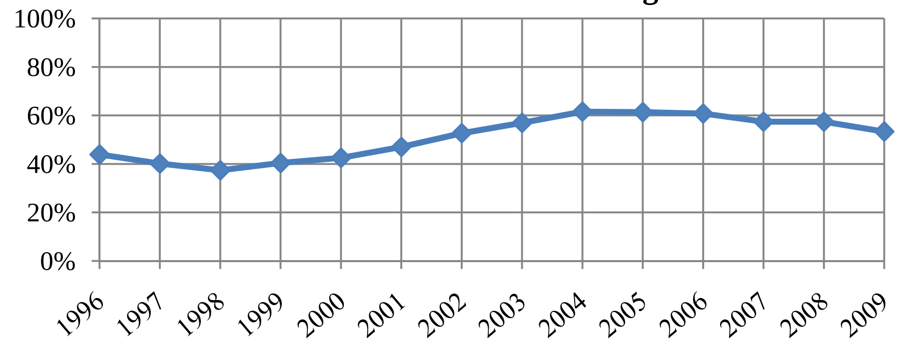
[1] Measured as a percent of total premiums charged to all employers in the insured market. This does not include employers that are self-insured.

[2] These companies held the largest market shares in Colorado, following Pinnacol, in 2009.

[3] An average of 215 other insurers provided workers' compensation coverage in Colorado between 2007 and 2009, each with less than about 2.0 percent of the market in 2009.

Based on premium market share, Pinnacol has been Colorado's largest workers' compensation insurance carrier since at least 1996. As the chart below illustrates, Pinnacol's market share grew consistently between 1998 and 2004. Although Pinnacol's market share has dropped in recent years, it is still the state's largest workers' compensation insurer by a significant margin.

Pinnacol Market Share 1996 through 2009



Source: Office of the State Auditor analysis of information provided by the Colorado Division of Insurance.

Note: Market share is measured as a percent of total workers' compensation premiums charged to all insured employers.

Financial Information

Most of Pinnacol's revenue comes from insurance premiums and the majority of its expenses are to pay workers' compensation claims (losses). The following table shows the average number of new claims filed with Pinnacol and the average number of existing claims Pinnacol closed each month from January 2007 through August 2009.

Table 2
Monthly Average of Claims Activity
2007 through 2009[1]

Year	Average Count of Newly Filed	Average Count of Closed
2007	5,001	4,947
2008	4,647	4,465
2009[1]	3,924	3,035

Source: Regulatory Consultants, Inc. analysis of data provided by Pinnacol Assurance.

[1] The data for 2009 are for the first eight months of the calendar year.

Additionally, as shown in Table 3 below, between 2005 and 2009 the amount Pinnacol collected in premiums decreased from about $566 million to about $399 million, or 30 percent. During the same period, Pinnacol's payments on claims decreased from about $364 million to about $256 million, also about 30 percent. Table 3 details Pinnacol's revenue, expenses, and distributions between 2005 and 2009, and the resulting changes in policyholders' surplus. We discuss the surplus further in Chapter 3.

Table 3
Pinnacol Assurance
Revenue, Expenses, and Policyholders' Surplus
Calendar Years 2005 through 2009
(in Thousands)

	2005	2006	2007	2008	2009	Change 2005-2009
Surplus–Beginning of Year	**$365,794**	**$471,849**	**$607,473**	**$722,072**	**$698,001**	**91%**
Revenue						
Premiums Earned	$566,470	$588,376	$567,284	$521,082	$398,502	(30%)
Investment & Other Income[1]	$89,429	$94,742	$113,946	$40,180	$99,403	11%
Total Revenue	**$655,899**	**$683,118**	**$681,230**	**$561,262**	**$497,905**	**(24%)**
Expenses & Distributions						
Claims[2]	$364,274	$359,713	$323,743	$274,076	$255,523	(30%)
Operating & Administration[3]	$125,839	$140,389	$179,754	$190,882	$148,500	18%
Total Expenses & Distributions	**$490,113**	**$500,102**	**$503,497**	**$464,958**	**$404,023**	**(18%)**
Net Income Before Dividends	**$165,786**	**$183,016**	**$177,733**	**$96,304**	**$93,882**	**(43%)**
Policyholders' Dividends[4]	$62,290	$65,694	$68,503	$78,557	$116,841	88%
Net Income After Dividends	**$103,496**	**$117,322**	**$109,230**	**$17,747**	**($22,959)**	**(122%)**
Other Changes in Assets[5]	$2,559	$18,302	$5,369	($41,818)	$57,485	2,146%
Surplus–End of Year	**$471,849**	**$607,473**	**$722,072**	**$698,001**	**$732,527**	**55%**

Source: Statutory Financial Statements for Pinnacol Assurance, 2005 through 2009, audited by Pinnacol's independent external auditor. For 2008 and 2009, there are timing differences for some items between these financial statements and the annual statements filed with the Division of Insurance.

[1] Investments include bonds, preferred stocks, and real estate. Investment income excludes unrealized gains/losses.

[2] Claims are reflected in the financial statements as "losses."

[3] Includes all administrative costs, as well as costs for litigation, cost containment, and investigations.

[4] Includes general dividends and Association dividends. Association dividends are available to policyholders that participate in the Association Dividend program, which promotes safety efforts by policyholders. Policyholders receive Association dividends through premium credits.

[5] Includes increases/decreases in non-admitted assets under the statutory basis of accounting (assets that cannot be used to pay for claims or that are otherwise encumbered), provision for reinsurance, and unrealized gains/losses on investments.

Pinnacol is required by statute to maintain an adequate amount of funds in reserve for unpaid losses; this reserve is recorded as a liability on Pinnacol's financial statements. In addition, Pinnacol is required by statute to set aside additional funds as a policyholder surplus [Section 8-45-111, C.R.S.]. Each year Pinnacol files information regarding its surplus with the Division of Insurance as part of its required annual statement filing. The Division of Insurance conducts quarterly and annual reviews of Pinnacol's annual statements to ensure that the minimum requirements are being met. Additionally, once every three years the Division conducts an on-site financial examination of Pinnacol which includes verifying the accuracy of the annual statements Pinnacol filed with the Division.

Tax Obligations

Pinnacol's legal and organizational characteristics dictate its tax obligations. Like other state workers' compensation funds, Pinnacol is exempt from the federal income tax because it meets each of the following Internal Revenue Code (IRC) 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; and
- 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 corporate income taxes. All other insurers in Colorado are exempt from state corporate income taxes because they pay the state insurance premium tax. However, under state law, Pinnacol does not pay the state premium tax. Finally, Pinnacol's status as a political subdivision exempts it from state sales and use taxes, and property taxes.

All workers' compensation insurers in Colorado, including Pinnacol, are subject to a surcharge on premiums received. This surcharge is based on a rate established annually by the Division of Workers' Compensation; the rate was approximately 3.8 percent in 2007 and 2008, and about 3.6 percent in 2009. Insurers pay the surcharge to offset the cost of the Division's administration of Colorado's workers' compensation system and to fund the Major Medical and Subsequent Injury Funds within the Department of Labor and Employment.

Audit Scope

This audit was conducted pursuant to Section 8-45-121(2), C.R.S., which requires the State Auditor to conduct a performance audit of Pinnacol Assurance in 2009. We reviewed the areas required by statute, which states that the audit shall include, but not necessarily be limited to, the following:

- **Executive Compensation.** We reviewed data on Pinnacol's executive compensation packages, as well as comparable market data on executive compensation paid by other insurance carriers, both public and private. Chapter 2 discusses these comparisons, as well as the bonus programs Pinnacol has established for both executive and non-executive staff.

- **Premium Rate Structure and Loss Reserves.** We engaged a contractor with actuarial and workers' compensation insurance expertise to conduct work related to rates and premiums, loss reserves (including incurred but not reported losses), and policyholders' surplus. Chapter 3 discusses Pinnacol's methods for determining policyholder insurance rates and premiums and for establishing reserves to pay losses. Chapter 3 also discusses Pinnacol's policyholders' surplus and related policies.

- **Injured Workers' Claims Experience.** We reviewed Pinnacol's policies and interviewed Pinnacol staff about the process for handling claims. We engaged a contractor with expertise in workers' compensation to test a sample of claims for compliance with applicable statutes, regulations, and Pinnacol policies. Our audit did not include a qualitative review of Pinnacol's claims handling practices. As such, we did not examine issues such as the appropriateness of: (1) decisions regarding medical treatment for injured workers, (2) determinations of temporary or permanent disability of injured workers, or (3) the use of medical specialists in the handling of claims. Chapter 4 discusses Pinnacol's processes for claims handling and obtaining and using input from injured workers.

In addition, we reviewed and tested Pinnacol's controls over travel and entertainment because this is commonly a high-risk area with respect to potential misuse of funds. Chapter 5 discusses the results of our review of Pinnacol's policies and practices in this area.

During our audit, we interviewed Pinnacol Board members, management, and staff regarding Pinnacol's practices related to compensation, rate setting, reserves and surplus, and claims handling. We gathered information from the Division of Workers' Compensation regarding its responsibilities relative to workers' compensation insurers, including Pinnacol. Further, we interviewed staff of the Division of Insurance regarding its oversight of the rate-setting process for workers' compensation insurers, and Pinnacol in particular.

We gathered information from national organizations such as the National Association of Insurance Commissioners (NAIC), which comprises state insurance regulators and assists in uniform supervision of insurance carriers, in part by establishing standards related to minimum insurance surplus levels. We contacted the National Council on Compensation Insurance (NCCI), Colorado's designated rating organization, which collects workers' compensation data from individual insurers, including Pinnacol, and recommends workers' compensation insurance rules and rate factors.

Finally, we collected information from Pinnacol's executive compensation consultant and from three state funds with similar attributes as Pinnacol to identify practices and trends in other comparable workers' compensation state funds. We selected these three funds because, like Pinnacol, they are insurers of last resort, were created by their legislatures, and are quasi-governmental entities. Pinnacol also uses these funds for comparison purposes.

Compensation

Chapter 2

The fundamental goal of any well-designed employee compensation package is to attract, retain, and motivate high-quality employees who will contribute to achieving an organization's core objectives. For an organization that has a public mission, such as Pinnacol, another important goal is for the design of the compensation strategy to be able to withstand stakeholder scrutiny. The compensation paid to Pinnacol's executive and non-executive staff has been a matter of public concern in recent years.

Designing an executive compensation package that accomplishes both of the goals noted above is a critical function of the Pinnacol Board. To help it meet this responsibility, the Board established a Compensation Committee (Committee) which is composed of the Board Chair and four other Board members. The Committee is charged with establishing Pinnacol's executive compensation philosophy, approving the terms of employment and all compensation for the chief executive officer (CEO), approving the goals of the Executive Performance Plan (Plan), and reviewing the outcomes of the Plan. The Board as a whole must approve all of the Committee's recommendations. The Board also periodically hires a compensation consultant to provide compensation data about Pinnacol's competitors and comparable state funds, and to make recommendations on the structure of the executive compensation program. Pinnacol hired such a consultant in each of the years we reviewed, 2006 through 2009.

Pinnacol offers a range of executive and non-executive compensation packages. All staff receive a package that includes salary, insurance coverage (health, dental, life, and short-term/long-term disability), and retirement benefits through the Colorado Public Employees' Retirement Association (PERA). Pinnacol also offers 401(k) and 457 deferred compensation plans to executive and non-executive employees. Pinnacol matches employee contributions to the 401(k) plan at a rate of 50 percent up to the first 6 percent of employee-elected contributions. Pinnacol does not make contributions to the 457 plan. The CEO and vice presidents also receive perquisites that include car allowances and health benefits such as payments for physical exams or health club memberships. Finally, Pinnacol has established bonus programs for both executive and non-executive staff. In 2009, Pinnacol paid a total of about $54 million in employee compensation, including bonuses and benefits.

We reviewed Pinnacol's executive and non-executive compensation philosophies as well as its policies and procedures for executing those philosophies through the establishment of total compensation for executives and incentive compensation for non-executives. We also reviewed reports prepared by the compensation consultants Pinnacol has hired to review its executive compensation and non-executive bonus programs. We identified best practices used by other public and private sector entities in designing executive compensation packages. Finally, we compared the salaries, bonuses, and perquisites paid to Pinnacol's executive staff to those paid by a sample of other insurers and selected Colorado political subdivisions. While we found that Pinnacol's executive compensation generally was at the high end of the range among the entities we reviewed, we did not find evidence that Pinnacol's executive compensation was necessarily unreasonable in comparison to these other organizations. However, we did find that Pinnacol's executives and non-executive staff have repeatedly received bonuses at maximum levels for many years. As a result, we question whether Pinnacol's bonus programs promote superior or extraordinary performance as intended. Our executive compensation comparisons and the concerns we identified with Pinnacol's bonus programs are discussed in this chapter.

Executive Compensation Comparisons

Pinnacol's executive compensation philosophy places heavy emphasis on the establishment of competitive compensation packages. The philosophy specifically states that the fixed components of total executive compensation, such as salary, will be set at a competitive level to allow "Pinnacol to attract, motivate and retain the quality and quantity of executives needed to fulfill its commitments to its stakeholders." The compensation philosophy further states that bonus and incentive compensation "shall be designed so that the target amount of compensation will be above the competitive market when superior performance is achieved as compared to the business plan and peer organizations."

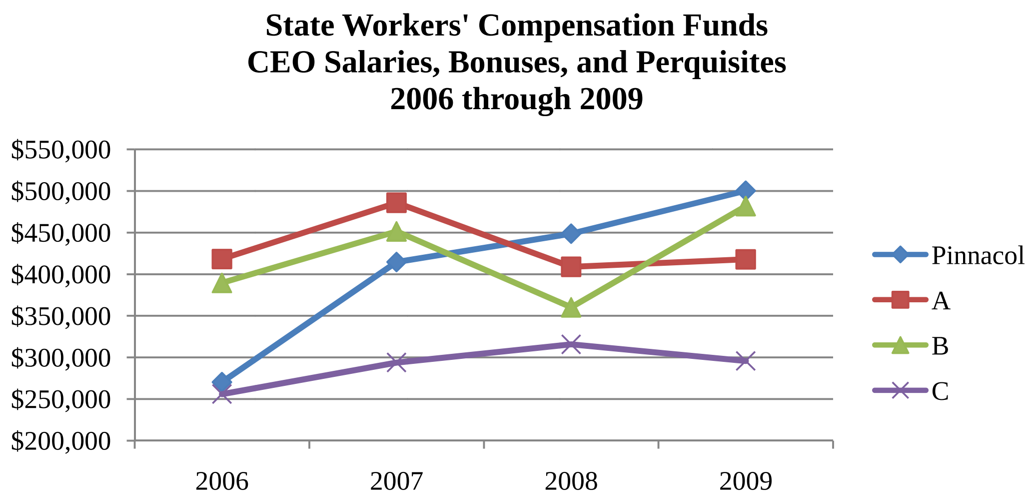
With respect to executive compensation, Pinnacol defines its competitive market as including insurance, healthcare, and financial services organizations of comparable size, and similar state funds within the American Association of State Compensation Insurance Funds (AASCIF). AASCIF is an association of workers' compensation insurers from 27 different states and 10 workers' compensation boards in Canada. Pinnacol is a member of AASCIF.

We compared the combined salaries, bonuses, and perquisites paid by Pinnacol to its executive staff between 2006 and 2009 to that paid by three groups of organizations: (1) three workers' compensation state funds in the western United States that are part of AASCIF Group A (described below), (2) three other large Colorado political subdivisions, and (3) six private insurers that compete with

Pinnacol. We primarily focused on the compensation of Pinnacol's CEO for these comparisons. In conducting these comparisons, we noted that Pinnacol's executive compensation has grown more consistently than compensation at the other state funds and that Pinnacol paid larger bonuses to its executives than the other political subdivisions. We did not conclude on the comparison with the six private workers' compensation insurers because we believe these comparisons provide limited value due to the differences in the size and nature of the organizations. This comparison is included for informational purposes.

Comparison with AASCIF Group A Funds. Pinnacol's compensation consultant defines Pinnacol as an AASCIF "Group A" state fund. Group A state funds are competitive funds, are not state agencies, and have their CEO's compensation set by the fund's Board. Pinnacol's compensation consultant provided data to Pinnacol regarding the compensation paid by Group A state funds in each of the years we reviewed (2006 through 2009). Pinnacol relied on this information to assess the competitiveness of its executive compensation packages and to guide compensation decisions.

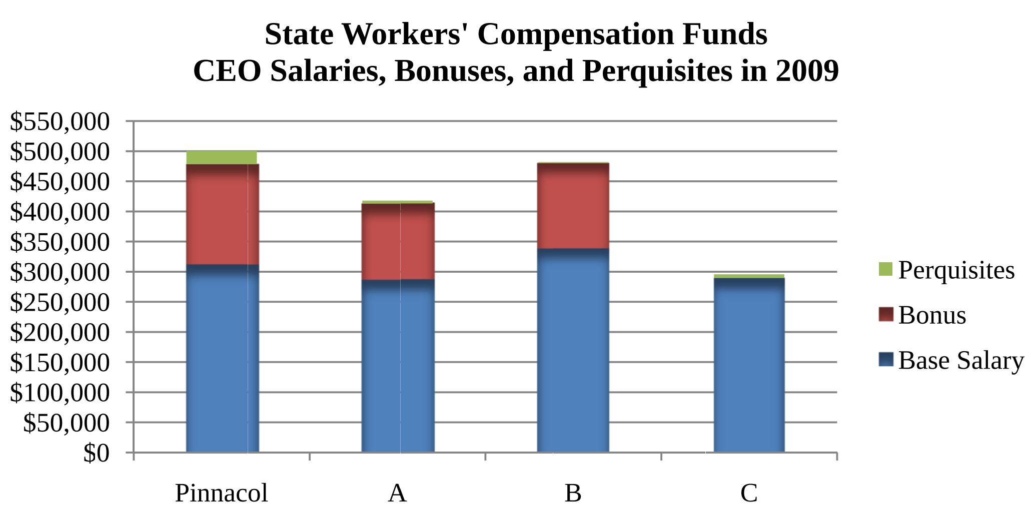
Because of Pinnacol's reliance on AASCIF data for benchmarking purposes, we compared the compensation Pinnacol paid to its CEO to that paid by three other AASCIF Group A state funds to their CEOs. As shown in the following chart, the sum of the salary, bonuses, and perquisites earned by each of the CEOs between 2006 and 2009 varied significantly from year to year. However, Pinnacol's CEO was the only one in our sample whose total salary, bonuses, and perquisites grew each year between. Further, the bonuses earned by Pinnacol's CEO grew steadily, from about 28 percent of his combined salary, bonuses, and perquisites in 2007 to about 34 percent in 2009. We did not compare 2006 to 2009 because Pinnacol's CEO was only eligible to receive a partial year bonus in 2006 based on his hire date in the fall of 2005. Unlike Pinnacol's CEO, the CEOs of the other state funds either took a reduction in pay or earned a smaller performance bonus in at least one of the years in our comparison.



Source: Office of the State Auditor analysis of data provided by Pinnacol Assurance and the state funds or insurance departments of three western states that are included in AASCIF Group A.

Note: The bonus paid to Pinnacol's CEO in 2006 was based on a partial year because the CEO was hired in 2005.

We looked more closely at each of these compensation components (salary, bonuses, and perquisites) for Pinnacol and the three state funds in our comparison for 2009. As mentioned earlier, we found the bonus earned by Pinnacol's CEO in 2009 represented about 34 percent of his total salary, bonuses, and perquisites. On the other hand, the bonuses earned by the other CEOs ranged from zero for state fund C to about 30 percent for state funds A and B. The following chart shows the breakdown of salaries, bonuses, and perquisites for 2009.



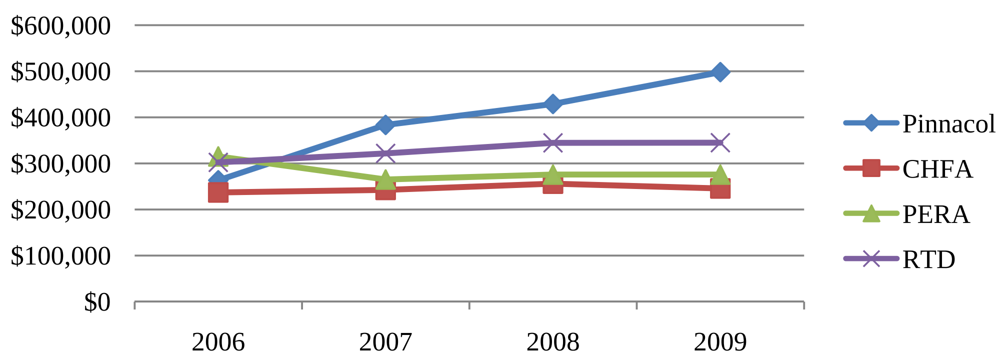
Source: Office of the State Auditor analysis of data from Pinnacol Assurance and other state funds.

Note: The CEO of state fund C did not receive a bonus in 2009.

Comparison with Colorado Political Subdivisions. We compared Pinnacol's CEO salary, bonuses, and perquisites to those of the CEOs of three large Colorado political subdivisions: the Regional Transportation District (RTD), the Colorado Housing and Finance Authority (CHFA), and the Public Employees' Retirement Association (PERA). Like Pinnacol, these entities were created by the General Assembly, are tax-exempt in some form, and have a public mission. Pinnacol, CHFA, and PERA have some or all of their Board members appointed by the Governor. In addition, the employees of these three political subdivisions participate in the PERA retirement program. In contrast, all RTD Board members are elected, and RTD employees participate in RTD's own retirement program. According to Pinnacol, it does not compete with these political subdivisions for executive staff and therefore does not use these entities for comparative purposes.

As shown in the following table, the combined salaries, bonuses, and perquisites paid to Pinnacol's CEO grew steadily between 2006 and 2009. The growth in compensation was primarily due to large bonuses earned by Pinnacol's CEO.

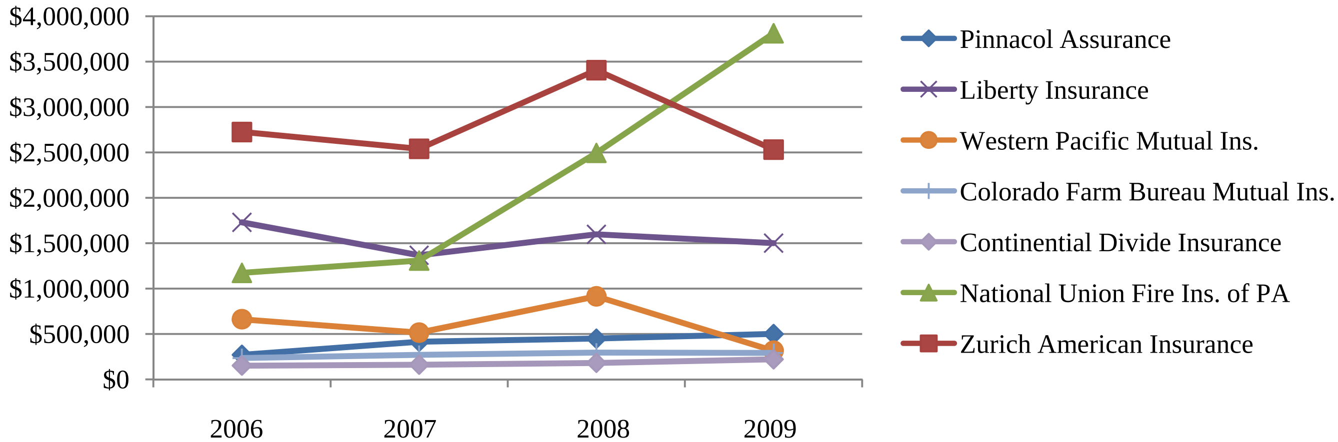
Political Subdivisions
CEO Salaries, Bonuses, and Perquisites
2006 through 2009



Source: Office of the State Auditor analysis of data provided by the Colorado Housing and Finance Authority (CHFA), the Public Employees' Retirement Association (PERA), and the Regional Transportation District (RTD). For a comprehensive discussion of the compensation of RTD's CEO, please see *Executive Compensation Practices, Regional Transportation District* Performance Audit (March 2010.)

Comparison with Other Insurers. As noted in Pinnacol's executive compensation philosophy, Pinnacol compares its financial performance and compensation against other insurance, healthcare, and financial services organizations. We compared the salaries, bonuses, and perquisites earned by Pinnacol's CEO with those earned by the CEOs of three small insurers domiciled in Colorado and three large multi-state, multi-line insurers not domiciled in Colorado that offer workers' compensation insurance to Colorado employers. We found the combined salary, bonuses, and perquisites earned by Pinnacol's CEO was comparable to that earned by the CEOs of the small workers' compensation insurers domiciled in Colorado. With respect to the CEOs of the three large insurers not domiciled in Colorado, Pinnacol's CEO earned significantly less. This is not surprising because the three multi-line companies are significantly larger and more complex than Pinnacol. We made these comparisons because Pinnacol competes with these organizations for business and executive talent in Colorado. However, we believe these comparisons provide limited value due to the differences in the size and nature of the organizations.

Pinnacol and Competitors
CEO Salaries, Bonuses, and Perquisites
2006 through 2009



Source: Office of the State Auditor analysis of data provided by the Division of Insurance.
Note: Zurich American, Liberty, and National Union Fire insurance companies are multi-line, multi-state insurers. Western Pacific Mutual, Colorado Farm Bureau Mutual, and Continental Divide are all smaller insurers domiciled in Colorado.

A tally of the compensation Pinnacol paid its CEO between 2007 and 2009 is included in Appendix A of this report. Pinnacol represented that Appendix A fully and accurately discloses all compensation and benefits Pinnacol has paid to, or on behalf of, the CEO for 2007 through 2009. Further, Pinnacol represented that, over this period, it did not make contributions to any additional retirement plans (other than listed in Appendix A) on behalf of the CEO, purchase additional service credits in PERA for the CEO, or allow the CEO to accrue additional amounts of Paid Time Off over the 16.67 hours he is authorized to accrue on a monthly basis.

In addition, we reviewed similar compensation information for the vice presidents at Pinnacol and at the three state funds and three political subdivisions mentioned above. As with the CEO compensation, on average Pinnacol's vice presidents received higher salaries, bonuses, and perquisites than the vice presidents at the state funds and Colorado political subdivisions in our sample. These higher compensation levels were again due to significantly larger bonuses. For example, the average bonus paid to Pinnacol's vice presidents in 2009 was about $102,000. This amount is about 76 percent higher than the next largest average bonus paid to the vice presidents of any of the state funds in our sample. The average annual bonuses paid to vice presidents by each of the other three state funds ranged from $1,000 to $58,000.

Finally, in September 2009 Pinnacol's Board approved change in control agreements for all executive staff. The stated purpose of these agreements is to maintain operating stability by fostering management continuity in the event of a change in control. The agreements specify that any of the following types of events constitute a change in control: (1) the Legislature makes Pinnacol an agency of state government; (2) 40 percent or more of Pinnacol's assets are sold or transferred without the Board's consent; (3) at least three-fourths of Pinnacol's Board members are replaced within a 12 month period; or (4) any merger, consolidation, dissolution, or other change occurs without the Board's consent in which Pinnacol is not the surviving entity or is no longer independent.

The agreements provide two types of benefits to executive staff. First, Pinnacol must maintain each executive's salary, benefits, and Executive Performance Plan bonus at designated levels for up to two years after a change in control occurs. Second, if a change in control occurs and an executive is terminated without cause, or is terminated for "good reason" (including constructive termination), the executive will receive an enhanced severance package that varies based on the executive's level. Specifically, the CEO's severance benefit includes 2.5 years of salary and bonuses; the vice presidents' benefits include 1.75 years of salary and bonuses; and the associate vice presidents' benefits include 1 year of salary and benefits. According to Pinnacol's compensation consultant, these agreements are uncommon among state funds. While the change in control agreements were not activated during our audit, if circumstances changed and the agreements were triggered, Pinnacol's executives would receive a significant lump sum of additional compensation. Based on 2009 salaries and bonuses, if a change in control resulted in all the executives being terminated without cause or for "good reason" (i.e., their jobs were moved out of state), we estimate Pinnacol's exposure would be more than $4.3 million.

Based on the large impact bonuses currently have on Pinnacol's executive compensation, we conducted a detailed review of Pinnacol's two executive bonus programs: the Executive Performance Plan (Plan) and the discretionary bonus program. Each bonus program and the concerns we identified are described below.

Executive Performance Plan

According to its policy, Pinnacol established the Plan, a formula-based bonus program, to motivate and reward executives for their performance against defined Pinnacol-wide and individual goals. In addition, Pinnacol's executive compensation philosophy stipulates that bonuses will be paid when "superior performance" is achieved compared to the business plan and peer organizations. Under the Plan, executives can earn varying bonus amounts in addition to their base salary. Bonus amounts are calculated as a percentage of an executive's total annual salary and range from a maximum of 37.5 percent for the associate vice presidents up to a maximum of 52.5 percent for the CEO. Over the past three years (2007, 2008, and 2009) Pinnacol paid more than $1.9 million in Plan bonuses.

The two primary types of goals included in the Plan formula are Pinnacol-wide (referred to as corporate) and individual/business unit goals. The weight given to the corporate and individual/business unit goals varies according to an executive's level in the organization. Prior to 2009, individual/business unit goals were not included in the CEO's bonus. Executives work with their supervisors and Pinnacol's human resources department to develop individual/business unit goals tailored to their job duties.

Pinnacol's Board established three core measures within the corporate goal to measure executive performance: net income, combined ratio (the percentage of each premium dollar Pinnacol spends on claims and expenses), and customer service ratings by policyholders. Net income results are the primary trigger for Plan bonuses; Pinnacol must reach the net income threshold (minimum) target for Plan bonuses to be paid. The weights assigned to the three core measures are as follows:

Net income	35%
Combined ratio	35%
+ Customer service	30%
= Total Corporate Goal	100%

Pinnacol's Board sets the targets for the net income and combined ratio measures based on recommendations from the Compensation Committee, using information from Pinnacol's annual business plan. The business plan, which contains projections of revenue and expenses for the following calendar year, is prepared by Pinnacol staff and is approved by the Board, generally around December. Targets for the customer service measure are set by the Compensation Committee based on information provided by Pinnacol's survey consultant regarding industry best practices such as those found in the American Customer Satisfaction Index.

The survey used to measure policyholder satisfaction was created by Pinnacol's survey consultant and is administered by Pinnacol staff on an annual basis.

We reviewed the Plan results from 2000 through 2009 and found that Pinnacol's executives received maximum level bonuses almost every year. To determine how the Pinnacol Board sets the net income and combined ratio targets with respect to its philosophy to reward superior performance, we conducted a detailed review of the structure of the Plan between 2006 and 2009. Specifically, we reviewed the bonuses earned by Pinnacol's executives, Board and Compensation Committee minutes, and reports written by Pinnacol's compensation consultant. On the basis of these reviews, we found that between 2002 and 2008 the Board regularly set the net income and combined ratio targets below the prior years' actual results. However, we could not determine whether the Board used a sound, systematic methodology to set these targets because the Board and Pinnacol provided very limited documentation of the target-setting method used during this period. We discuss our concerns regarding the bonus targets and the lack of documentation in the following two sections.

Bonus Targets

In line with best practices, the Board's Compensation Committee annually sets threshold (minimum), commendable (mid-range), and maximum performance targets for each of the Plan's three core measures. As the following chart shows, we found that Pinnacol's executives achieved the maximum bonus level for each core measure in three of the last four years, or at a rate of 75 percent.

Table 4
Executive Performance Plan Maximum Targets and Actual Results
2006 through 2009 (in Millions)

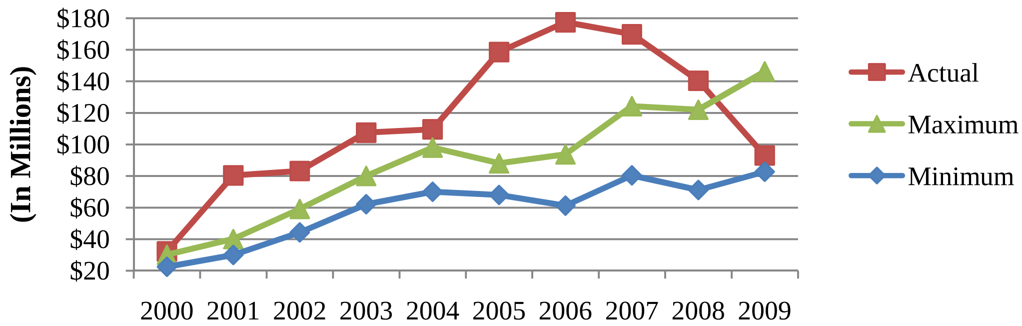
	2006	**2007**	**2008**	**2009**
Net Income Actual	$178	$170	$140	$93
Net Income Maximum Target	$94	$124	$122	$146
Actual Performance Met Maximum Target?	Yes	Yes	Yes	No[1]
Combined Ratio Actual[2]	86.9%	87.5%	89.6%	100.3%
Combined Ratio Maximum Target	98.5%	91.1%	99.8%	93.6%
Actual Performance Met Maximum Target?	Yes	Yes	Yes	No[2]
Customer Service Actual	8.8	8.7	8.8	8.8
Customer Service Maximum Target	8.5	8.8	8.8	8.8
Actual Performance Met Maximum Target?	Yes	No[3]	Yes	Yes

Source: Office of the State Auditor analysis of data provided by Pinnacol Assurance.
[1] The Combined Ratio and Net Income targets were reached at the minimum level in 2009.
[2] For the Combined Ratio measure, the goal is to minimize the ratio, which represents the proportion of premiums earned that is spent for claims and expenses.
[3] The Customer Service target was reached at the mid-range level in 2007.

While we were unable to determine the Board's methodology for setting targets, we did determine that the Board set net income and combined ratio targets well below the prior year's actual results each year between 2002 and 2008. For example, as shown in Table 4 above, although Pinnacol's actual net income in 2007 was about $170 million, the Board set the net income maximum target for 2008 at $122 million, or less than three-quarters of the 2007 actual net income. Pinnacol actually earned about $140 million in net income in 2008, which triggered maximum level bonuses for this measure.

The following graph compares the minimum and maximum net income targets set by the Board for calendar years 2000 through 2009 to Pinnacol's actual net income in these years. By setting current-year targets below prior-year actual results, the Board allowed executives to earn the maximum bonus each year, even when Pinnacol's net income grew very little, as in 2002 and 2004, or declined, as in 2007 and 2008.

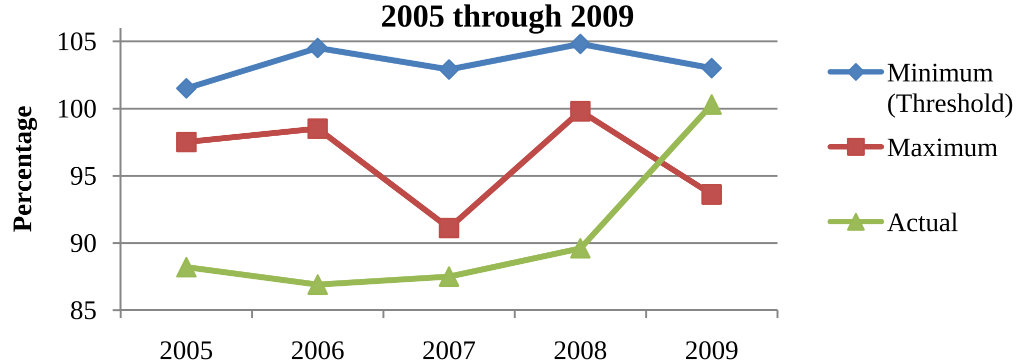
Net Income[1]
Plan Targets and Actual Results
2000 through 2009



Source: Office of the State Auditor analysis of data provided by Pinnacol Assurance.
[1] Actual net income for the Plan excludes payments to policyholders through a return of premium program.

The Board added the combined ratio measure to the Plan in 2005. The goal is to minimize the combined ratio, which represents the proportion of premiums earned that is spent for claims and expenses. For each year since 2005, the Board has set targets for this measure at a level that does not appear to require executives to stretch Pinnacol's performance to earn a maximum level bonus. For example, as shown in the chart below, the Board set the 2008 maximum target at 99.8 percent despite the fact that the actual combined ratio from 2007 was 87.5 percent. This means that Pinnacol limited its expenses in 2007 to 87.5 percent of premiums earned, but for 2008, all executives received the maximum bonus for the measure while expenses increased to 89.6 percent of premiums. Similar to the results for net income, Pinnacol's executives earned the maximum combined ratio bonuses every year from 2005 through 2008.

Combined Ratio[1]
Plan Targets and Actual Results
2005 through 2009



Source: Office of the State Auditor analysis of data provided by Pinnacol Assurance.
[1] For the Combined Ratio measure, the goal is to minimize the ratio, which represents the proportion of premiums earned that is spent for claims and expenses.

In 2009, for the first time in nearly a decade, Pinnacol executives did not earn maximum level bonuses for net income and combined ratio. Rather, in 2009, executives earned bonuses for these measures that were between the minimum and mid-range targets, which still resulted in bonus payouts. For example, the CEO's Plan bonus in 2009 was about $123,000, an amount equivalent to about 39 percent of his base salary.

As noted above, the Board uses information from Pinnacol's annual business plan to assist it in establishing net income and combined ratio targets for the Plan. According to Pinnacol, staff and Board members consider factors such as anticipated rate decreases, payroll fluctuations, unemployment, estimated reserves, and investment earnings to establish and approve the financial projections included in the business plan. These projections include net income and combined ratio. Regardless of the impact that these factors have on the projected net income and combined ratio, we question whether setting Plan targets substantially below prior year actual results, or the trend of executives reaching the maximum targets in each year between 2002 and 2008, demonstrate the philosophy of stretching performance to superior levels.

Both the Board and its compensation consultant have expressed concerns that the Plan targets may not promote superior performance. In response to Board concerns regarding the fact that Pinnacol's executives had repeatedly earned maximum level bonuses since 2000, the compensation consultant reviewed the Plan in 2006. The consultant concluded that the design of the Plan was "fundamentally sound" but noted concerns about whether the Plan performance targets were established using the probability theory that this and other consultants had advised the Board to use. According to this theory, targets should be set according to the following guidelines: executives should have an 80- to

90- percent likelihood of reaching the minimum target; a 50- to 60- percent likelihood of reaching the mid-range target; and a 20-percent likelihood of reaching the maximum target. The consultant further stated, “when at or near maximum level of performance is achieved year after year, we question whether the levels of performance set are ’soft’.” The consultant strongly recommended that the Board focus its attention on: (1) assessing the business planning process, (2) evaluating the degree of stretch in the business plan objectives, and (3) using the probability theory within the Plan.

Although we did not conduct a comprehensive evaluation of Pinnacol’s business planning process, we did find that Pinnacol’s actual net income and combined ratio results consistently surpassed business plan projections during the years we reviewed by significant amounts. For example, actual net income exceeded planned net income each year between 2004 and 2009 by a range of about 48 percent to about 177 percent. While these results could indicate “superior” performance by Pinnacol’s executives or weaknesses in the business planning process, they could also indicate that the Plan’s performance targets were not set according to best practices. The Board indicated that it used a new method to set the net income and combined ratio targets for 2009. However, as discussed in the next section, we could not fully review the new method due to incomplete documentation. Setting performance targets can be a complex process; in the future, the Board should work with a compensation expert to help ensure that targets are established which appropriately reflect Pinnacol’s philosophy of rewarding “superior performance.”

Target-Setting Documentation

To determine how the Board set the performance targets for the Plan, we requested documentation from Pinnacol demonstrating the methodology. We identified problems with Pinnacol’s documentation of the target-setting method. First, neither Pinnacol nor the Board provided documentation of the Plan target-setting process for 2006 through 2008, aside from limited information in Compensation Committee minutes.

Second, although Pinnacol did provide some documentation of a new method used to set the net income and combined ratio targets for 2009, the documentation did not clearly explain the rationale used to set each target. The documentation explained the rationale used to establish the maximum net income target, which was set at $146.3 million, or about $6 million (4 percent) above the 2008 actual net income. The documentation also showed the calculations of all the net income and combined ratio targets but did not explain the rationale for the minimum and mid-range net income targets or any of the three combined ratio targets. For example, the minimum net income target was set 57.7 percent below the maximum net income target for 2009, but there was no written explanation of why the minimum target was set at this level.

The lack of documentation for 2006 through 2008 and the incomplete documentation for 2009 impeded our ability to evaluate the reasonableness of the target-setting process. In particular, for 2009 we could not determine whether the change to the methodology or the decline in Pinnacol's financial performance (Pinnacol's premium revenue was about $123 million less in 2009 than in 2008) contributed more significantly to the reduced bonuses for 2009. In addition, we could not determine if the Board has implemented the probability theory approach recommended by Pinnacol's consultants in the past.

Maintaining comprehensive documentation of the methodology for setting Plan targets is important to help ensure that targets reflect Pinnacol's philosophy of rewarding superior performance, to promote consistency of the targets over time, and to provide a mechanism through which Pinnacol can gather information regarding potential problems in the design of the program.

Finally, although we did not conduct an in-depth review of the customer service targets and results, we also found that the process for setting these targets is not documented. Further, the maximum targets for this bonus component were met 75 percent of the time between 2006 and 2009, as shown in Table 4. This raises similar concerns to those we have discussed regarding the net income and combined ratio targets. In other words, the high rate at which the customer service targets have been met may indicate that the targets are being set too low.

Method to Evaluate Targets

We reviewed Board and Compensation Committee minutes between 2006 and 2009, and interviewed Board members regarding the evaluation of the Plan. During the period we reviewed, we found no evidence that the Board has a mechanism to evaluate whether the method used to set the targets should be changed. Compensation Committee members we spoke with indicated that they consider past results when setting the Plan targets each year. However, there is no documented process to guide this evaluation and limited evidence of how the Committee has used results to influence its target setting. According to Pinnacol's compensation consultant, "[I]f performance goals are not set appropriately, there can be negative consequences . . . . If executives are consistently and easily achieving the performance targets, executives are being sent the wrong message that superior performance is not required to receive an incentive payout." Developing and maintaining an incentive program that promotes superior performance requires a sound methodology, including a feedback mechanism to identify when adjustments to the method must be made.

Without a systematic and documented process for the Committee to follow in setting annual Plan targets, and a mechanism to evaluate the method used to set the targets, there is a risk that the process will be subjective and inconsistent over time and fail to accomplish its intent of motivating executives to stretch. In addition, written policies and procedures can serve as a tool for new Board members and Pinnacol executives to understand how the process operates.

To strengthen the Plan, the Board should establish a documented, systematic method to set net income and combined ratio targets that limit the probability of executives reaching the maximum targets and promote improved performance from year to year. Furthermore, the Board should document the target-setting methodology and develop and document the mechanism that will be used to evaluate Plan targets. The evaluation of the Plan targets should occur after bonuses are paid to ensure the Board has complete information about the performance of the program. Bonuses are generally paid in April each year based on the prior year's performance. Finally, the Board should continue to use a compensation consultant to assist in the development and application of its target-setting methodology.

Recommendation No. 1:

The Board of Directors should work with Pinnacol Assurance management to ensure the Executive Performance Plan is structured to promote and reward superior performance by:

a. Fully documenting the methodology for setting all targets, the rationales for the methodology, and how it should be applied. The documentation should clearly reflect how the Board has defined superior performance and how the target-setting methodology supports that definition.

b. Developing and documenting a standardized evaluation mechanism that includes reviewing the targets against actual results annually. The evaluation should be used to determine the extent to which the program's intent of rewarding superior performance is being accomplished and to modify the program's structure and goals as needed.

c. Obtaining professional expertise regarding the development and application of a methodology for setting performance targets as appropriate.

Pinnacol Board of Directors and Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

a. The Board establishes Executive Performance Plan targets. Prior to 2009, Plan targets were set by reviewing the company's annual business plan goals and utilizing the probability theory recommended by compensation consultants. In 2009, the Board changed its methodology for setting Plan targets to an established formula that also factors in past performance. The 2009 Plan maximum net income target was set at 230 percent of the 2009 business plan goal. The Board Compensation Committee documented this methodology for setting Plan targets in 2009 and used the same methodology for establishing 2010 Plan targets. The Board will expand its documentation to define how the target-setting methodology supports superior performance.

b. A standardized evaluation process, developed and implemented in 2009, is already in place. The Board Compensation Committee evaluated the process used in 2009 at the February 17, 2010 Compensation Committee meeting and recommended the same methodology for 2010 which was approved at the March 10, 2010 Board meeting. The Board Compensation Committee will document this annual evaluation in meeting minutes.

c. This process is already in place. For the past several years, the Board has retained the Hay Group to provide professional executive compensation expertise.

Controls over Payment of Plan Bonuses

Pinnacol has a fiduciary responsibility to ensure that payment of all Plan bonuses is accurate and based on reliable data. To determine the adequacy of the controls Pinnacol has in place over the payment of bonuses, we reviewed Pinnacol's Plan policy which describes guidelines for the program such as eligibility and award criteria, and we verified the calculation of Plan bonuses paid between 2006 and 2009. We noted two areas in which Pinnacol could improve controls over the payments.

First, Pinnacol does not have controls to ensure that the net income and combined ratio results are calculated accurately and consistently from year to year or to detect and correct errors in determining bonuses. Specifically, in 2006 and 2007 Pinnacol used a different method to calculate the combined ratios than in prior or subsequent years; in 2008 Pinnacol used a different method to calculate net income for the Plan than in prior or subsequent years. According to Pinnacol, the use of different calculation methods in these years was an error. These errors were relatively small and did not affect the Plan bonuses in these years. In addition, due to a typographical error in calculating bonuses, Pinnacol underpaid one vice president by $900 in 2008. According to Pinnacol, the vice president was compensated for the underpayment in 2010. Pinnacol does not have a documented process for determining net income or combined ratio results for the Plan or calculating bonuses based on the results. In addition, although Pinnacol indicated that the calculation of Plan results and bonuses is reviewed by someone other than the person who prepares them, this process is not documented. Without a documented process to guide preparers and reviewers that describes the source of data and method to be used to calculate results and bonuses, there is a risk that errors could occur that would affect bonus payments in the future.

Second, Pinnacol does not have a mechanism to recoup bonuses paid in error. Even with improved controls, errors in the calculation of bonuses could occur. Pinnacol should establish policies and procedures for determining the results and bonuses for the Plan and to recover any incorrect overpayments.

Recommendation No. 2:

The Board of Directors should work with Pinnacol Assurance management to improve Pinnacol's controls over awards paid under the Executive Performance Plan by developing and implementing written policies and procedures that:

a. Describe the sources of data and methods for determining net income and combined ratio results for the Plan as well as for calculating bonuses.

b. Require a thorough, standardized, and documented review of all data and calculations related to determining bonuses prior to payment.

c. Establish a mechanism for recovering any bonus payments made in error.

Pinnacol Board of Directors and Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

a. The methodology used to calculate net income and combined ratio was documented by the Controller in 2010 for the 2009 bonuses. This methodology was provided to the Compensation Committee and the Board for their review. In the future, Pinnacol will use a consistent methodology to calculate net income and combined ratio and will continue to report the methodology to the Board and Compensation Committee. Bonus calculations have been documented for many years.

b. The Controller already reviews all data and calculations performed by Human Resources prior to payment. For the 2009 bonuses, this review was documented. This recommendation has already been implemented.

c. Though no overpayments have been made in the past, the Board and Pinnacol Assurance agree to investigate the possibility of implementing a mechanism for recovering any bonus payments made in error.

Executive Discretionary Bonus Program

In addition to the Executive Performance Plan, Pinnacol established a discretionary bonus program for its executives, effective in 2007. According to Board minutes, the purpose of the program is to reward the executive team for "extraordinary performance above and beyond" normal job duties and for "special projects."

In each of the past three years (2007, 2008, and 2009) the Board has designated an amount not to exceed $180,000 for discretionary bonuses. The CEO has the authority to award discretionary bonuses of up to $10,000 to each assistant vice president and $25,000 to each vice president each year. The Board retained authority to award the CEO a discretionary bonus of up to $30,000 each year. The Board does not approve the discretionary bonuses awarded by the CEO, and discretionary bonuses may be given at any time during the year. Between 2007 and 2009, the CEO awarded a total of 14 discretionary bonuses totaling $162,700. Over the same period, the Board awarded one discretionary bonus to the CEO for $10,000.

We interviewed Board members, reviewed Board and Compensation Committee minutes, and reviewed all of the discretionary bonuses awarded between 2007 and 2009, as well as the written rationale prepared by the CEO and/or Board for each award. We also compared the rationale for each discretionary bonus with the personal goals established for each executive under the Executive Performance

Plan in each of these years. On the basis of these reviews, we identified three weaknesses in the discretionary bonus program.

First, Pinnacol does not have a written policy for the discretionary bonus program that describes its purpose and critical elements. For example, we found that the terms “extraordinary performance” and “special projects” have not been defined, creating a risk of rewarding ordinary, rather than extraordinary, performance and of duplication between the Plan and the discretionary bonus program. We found one example of possible duplication between the bonus programs. Specifically, one Pinnacol executive received a Plan bonus of about $3,900 in 2008 for accomplishing an individual Plan goal related to developing a new vision and values program and providing related training. That same year, the CEO also awarded the executive a discretionary bonus of $13,600. One of the three justifications for the discretionary bonus was that the executive had developed the training program for the new vision and values program described in the Plan goal.

Second, the Board and CEO may award discretionary bonuses at any time during the year. Pinnacol’s compensation consultant advised the Compensation Committee that, in state funds that have both formula bonus programs (such as the Plan) and discretionary bonus programs, discretionary bonuses are generally awarded after the formula bonuses. This approach can help prevent duplicate awards for the same performance.

Third, we found that until December 2008 the Board did not require the CEO to report any information regarding the discretionary bonuses he awarded. In 2008 the Board did ask the CEO to explain the discretionary bonuses he had awarded in 2007 and 2008. The Board also began requiring the CEO to inform the Board of all proposed discretionary awards in advance. This review is a good oversight mechanism for the Board. However, this requirement is not formally documented in policy.

According to Pinnacol’s compensation consultant, it is uncommon for state funds that, like Pinnacol, are members of AASCIF to have both discretionary and formula bonus programs. Considering this, and the weaknesses we found, the Pinnacol Board should reevaluate whether a discretionary bonus program is in the best interests of Pinnacol and its policyholders. If the Board determines that there is a need for the program in addition to the Plan, the Board should implement adequate controls to prevent discretionary bonuses from being given for the same accomplishments that are rewarded through the Plan or for carrying out regularly assigned job duties. The Board should develop a written policy for the discretionary bonus program that:

- Clearly indicates how its purpose is distinct from the purpose of the Plan.

- Includes criteria that define "extraordinary" performance and "special projects" in such a way that they are distinct from the achievements the Plan rewards. The criteria should also be designed to recognize only accomplishments that are not part of an executive's normally assigned duties.

- Coordinates the timing of Plan bonuses and discretionary bonuses to help ensure they are not duplicative.

- Documents the requirement for the CEO to report all discretionary bonuses to the Board for review before the bonuses are paid.

The policy should also document the dollar limits the Board has established for the program.

Although Pinnacol is not subject to State Personnel Rules, it could look to these as a model for developing and documenting its discretionary bonus program. State Personnel Rules require state agencies that participate in the State's discretionary bonus program to document award criteria and dollar limits.

Recommendation No. 3:

The Pinnacol Board of Directors should reevaluate whether the discretionary bonus program is in the best interests of Pinnacol Assurance and its policyholders. If the Board chooses to retain the program, it should work with Pinnacol Assurance management to strengthen the discretionary bonus program by creating a written policy that:

a. Clearly indicates the program's purpose and how it is distinct from the purpose of the Executive Performance Plan.

b. Includes criteria that define "extraordinary" performance and "special projects" in such a way that they are distinct from the achievements the Plan rewards and do not include normally assigned duties.

c. Coordinates the timing of Executive Performance Plan bonuses and discretionary bonuses to prevent duplication.

d. Includes the requirement that the CEO report all discretionary bonuses to the Board for review before the bonuses are paid.

e. Documents the dollar limits the Board has established for the program.

Pinnacol Board of Directors and Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

a. The Board agrees to provide additional documentation as described in the recommendation.

b. The Board agrees to provide additional documentation as described in the recommendation.

c. The Board agrees to review the timing of discretionary bonuses.

d. In 2009, the Board formally made it a requirement for the CEO to report all discretionary bonuses to the Board for review prior to bonuses being paid. This recommendation has already been implemented.

e. Dollar limits were set with the inception of the plan and have remained unchanged. This recommendation has already been implemented.

Gainsharing for Non-Executives

Pinnacol has a gainsharing program for non-executive employees to incentivize performance. According to Pinnacol's gainsharing program manual, this program is designed to foster "profit and financial stability" by rewarding "extraordinary performance that is above and beyond expectations." Each quarter, non-executive employees can earn, in addition to their base salary, a bonus of up to 20 percent of their quarterly salary in gainsharing awards. Pinnacol paid employees more than $11.4 million in total gainsharing awards for 2008 and 2009, and about $42.5 million since the program's implementation in 1999.

Since the program's inception, Pinnacol has based gainsharing bonuses on the collective performance of teams of employees rather than on individual achievements. Virtually all Pinnacol employees are assigned to one of two types of teams: a business team that directly handles claims or a corporate team that serves as expert support for business teams. Pinnacol measures the performance of employees for gainsharing by using two types of performance measures at the team level and two types of measures of the collective performance of Pinnacol as a whole.

These gainsharing program measures evaluate both the financial and non-financial performance of non-executive staff. The program measures financial results through net income targets and general employee performance through performance goals at. Pinnacol's executive team works with a gainsharing task force, made up of the human resources administrator and other managerial staff, to set quarterly targets and goals at both the Pinnacol-wide and individual team levels at the beginning of each year. These are described in detail below:

- **Pinnacol-wide Net Income Targets.** Employees on both business and corporate teams earn this portion of the gainsharing bonus if Pinnacol earns more net income than was forecast in the business plan. For example, for the first quarter of 2009 business team employees were eligible to receive a gainsharing bonus equal to 1 percent of their quarterly salary if Pinnacol's quarterly net income reached about $15.6 million. Business team employees could have earned up to 5 percent of their quarterly salary if Pinnacol's quarterly net income reached about $20.1 million. Employees on corporate teams can earn up to 7.5 percent of their quarterly salary as a gainsharing bonus for this measure.

- **Pinnacol-wide Performance Goals.** Used only for corporate teams, these performance measures focus on customer satisfaction and are intended to align the work of the corporate teams with that of the business teams. For example, one Pinnacol performance goal for corporate teams measures policyholder satisfaction, using quarterly results from a policyholder survey. Employees on corporate teams can earn up to 5 percent of their quarterly salary as a gainsharing bonus for this measure.

- **Team Net Income Targets.** Used only for business teams because corporate teams do not directly generate net income. Similar to the Pinnacol-wide net income measure, a range of team targets is set based on team financial plans which derive from Pinnacol's business plan. Employees on business teams can earn up to 10 percent of their quarterly salary as a gainsharing bonus for this measure.

- **Team Performance Goals.** These goals measure the performance of each business and corporate team. Some team goals apply to every team, such as staying within an established team budget, while other team goals are geared to the unique work the team performs. For example, the legal team is measured on the number of consultations it provides each quarter to claims representatives. Employees on business teams can earn up to 7.5 percent of their quarterly salary as a gainsharing bonus for this measure; on corporate teams, up to 10 percent.

Pinnacol has used net income targets and performance goals to award gainsharing bonuses to staff since the program was implemented in 1999. However, in 2009 the Pinnacol executive team changed the allocation formula it uses to calculate total gainsharing bonuses. We therefore focused our review on the 2009 gainsharing model. We reviewed the gainsharing targets and goals Pinnacol set in 2009 and the payout results for the 27 teams that existed in both 2008 and 2009. (Pinnacol reorganized its staff early in 2009 and now has 30 teams.) We identified two concerns with the measures Pinnacol used to award gainsharing bonuses.

Targets and goals may be too low. We found two indicators that the gainsharing targets and goals may be set too low to effectively accomplish the program's stated purpose of rewarding "extraordinary" performance. First, we analyzed bonuses for the 27 teams that existed during 2008 and 2009 and found that, during this eight-quarter period, teams received the maximum bonus award possible—20 percent of salary—56 percent of the time. On average, employees earned overall bonuses equal to 19 percent of their salary in 2008 and 15 percent of their salary in 2009. Further, data from Pinnacol shows that the yearly averages for gainsharing bonuses have exceeded 15 percent of salary in 8 of the 11 years the program has been in place. Second, as with the Plan, Pinnacol sets gainsharing net income targets below actual performance for the prior year. We compared the Pinnacol net income targets for the four quarters of 2009 with the actual net income Pinnacol earned in each corresponding quarter in 2008. We found that, in every quarter, Pinnacol set the 2009 targets at 31 to 64 percent of the actual net income for the corresponding quarter in the prior year. For example, for employees to receive a bonus based on Pinnacol's net income in the first quarter of 2009, Pinnacol had to earn approximately $15.6 million in net income that quarter. However, Pinnacol's actual net income for the corresponding first quarter of 2008 was more than $24.4 million.

Pinnacol reduced the rates it charged policyholders by about 10 percent between 2008 and 2009, leading to a projected decline in net income. Pinnacol indicated that it set gainsharing targets low for 2009 to reflect that forecast. However, as noted below, because Pinnacol does not document the rationale behind the gainsharing target-setting process, we could not determine how the targets were set. In fact, the trend data we received from Pinnacol, showing yearly averages for gainsharing bonuses that exceeded 15 percent of salary in 8 of the 11 years the program has been in place, suggests that gainsharing bonuses have been high historically.

Lack of written procedures. Overall, Pinnacol does not document many of the rationales underlying the gainsharing program. Notably, Pinnacol does not define what is meant by "extraordinary performance" for the gainsharing program or how it determines the specific quarterly targets it sets for employees as a basis for their gainsharing bonuses. As such, it is unclear how Pinnacol determines appropriate targets that reward extraordinary performance. In 2006 Pinnacol hired an outside consultant to review the design and operation of the gainsharing program, but the review did not include an analysis of the target-setting process or financial outcomes of the program. Despite these exclusions, the consultant noted that Pinnacol's employees were concerned that Pinnacol was "consistently exceeding financial targets by large percentages," which caused the employees to question the "integrity of the [gainsharing program's] results."

To strengthen the gainsharing program, Pinnacol should assess the target-setting process and document the critical elements of the program. In particular, Pinnacol should assess whether it has set targets and goals that reflect the program's purpose of rewarding extraordinary performance.

Recommendation No. 4:

Pinnacol Assurance should strengthen the gainsharing program by:

a. Evaluating its target-setting process to ensure the program is meeting its philosophy of paying bonuses only for extraordinary performance.

b. Documenting clear and reasonable objectives and rationales for the program, including all critical elements.

Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

Pinnacol agrees with the recommendations.

Premiums, Reserves, and Surplus

Chapter 3

Statutes assign responsibility to the Pinnacol Board for establishing workers' compensation rates and premiums, setting aside reserves to cover claims, and maintaining a surplus. Statutes require that the Board determine premiums "on a basis that shall be fair, equitable, and just among . . . employers" and set rates such that they provide reserves and produce a reasonable surplus [Sections 8-45-103(1), 105(1), and 107, C.R.S.].

Insurers establish reserves for losses, or claims payments, and the associated costs for managing incurred claims that will be paid in the future. Reserves are particularly important in workers' compensation cases because claims payments on behalf of injured workers may be made over many years. In addition, having a reasonable surplus of funds is a sign of an insurer's financial strength and security. Both reserves and surplus are discussed in detail later in the chapter.

We contracted with Regulatory Consultants, Inc. (RCI) to review Pinnacol's processes for setting rates, establishing reserves, and managing its surplus. RCI is a national firm with 15 years of experience in providing insurance examination and consulting services. The RCI team assigned to this review has extensive experience in the workers' compensation area. The comments in this chapter were prepared by RCI, except for the final finding regarding management of the surplus, which was prepared by the Office of the State Auditor.

Rates and Premiums

Workers' compensation insurers are ultimately responsible for ensuring that their premiums comply with all applicable statutes and regulations and are not excessive, inadequate, or unfairly discriminatory. However, the Division of Insurance (Division), under the direction of the Commissioner of Insurance (Commissioner), has the following authority over workers' compensation insurance rates:

- The Commissioner licenses and designates an insurance rating organization to establish certain factors and rules for use in setting workers' compensation insurance rates in Colorado [Section 10-4-408, C.R.S.]. The Commissioner has designated the National Council on Compensation Insurance (NCCI) as Colorado's rating organization for workers' compensation insurance. NCCI is the designated rating agency for 34 states. NCCI collects workers' compensation data from individual insurers, including Pinnacol, and analyzes industry trends to prepare recommended workers' compensation insurance rules and rate factors, such as loss costs and experience modification factors, as defined in Table 5. The Commissioner holds a hearing to discuss NCCI's recommended loss costs and considers testimony from interested parties before approving the final loss costs for use by workers' compensation insurers doing business in Colorado each year.

- The Commissioner has authority to review rate filings from insurers for compliance with applicable statutes and regulations, which require, in part, that insurance rates not be excessive, inadequate, or unfairly discriminatory. Under statute and insurance regulations, insurers are required to file all rating information with the Division before use [Sections 10-4-401(3)(b), C.R.S., and Colorado Insurance Regulation 5-1-10(5)(A).]. This type of rate regulation is generally known as "file and use." If the Commissioner has good cause to believe that any rating information does not comply with applicable statutes and regulations and the insurer is unwilling to modify the rating information to be in compliance, the Commissioner has the authority to hold a public hearing. If, after the public hearing, the rating information is still found to be in violation, the Commissioner could impose sanctions and restrictions, such as prohibiting further use of the rating information and requiring the insurer to refund any excess premium, plus interest, to policyholders [Section 10-4-418(3) and (4), C.R.S.].

The following table explains some of the common terms related to workers' compensation rates and premiums that will be used throughout this chapter.

Table 5
Terms Used in Setting Rates for Workers' Compensation Insurance

	Term	Definition	Who Determines	Who Reviews/Approves	How Applied by Insurer
1	Loss Cost	Claims cost component of the insurance premium, stated as a cost per $100 of employer payroll. Set by work classification, such as carpentry, clerical, and sales. Specific to Colorado.	NCCI[1] uses data reported by Colorado workers' compensation insurers to determine recommended loss costs, by work classification, that are filed with the Division.	Division reviews NCCI's recommended loss costs. The Commissioner holds a hearing before approving final loss costs.	Applied as the first step in calculating manual premium (see Table 7). Used by all workers' compensation insurers in Colorado.
2	Loss Cost Multiplier (LCM)	Rating factor that reflects the insurer's expenses as well as differences in expected loss costs for employers covered by the insurer from the overall State average loss costs.	Set by each insurer, including Pinnacol, and filed with the Division.	Division reviews but does not approve or deny.[2]	Applied to each policy (see Table 7). For Pinnacol, the LCM varies based on the tier in which the policy is issued.
3	Manual Premium	Initial premium amount calculated before any discounts or other adjustments are applied.	NCCI establishes the premium calculation method.	NCCI files the calculation method with the Division. The Division reviews but does not approve or deny.[2]	Calculated for each policy (see Table 7).
4	Experience Modification Factor	Factor based on historical losses (claims payments) and payroll of each employer.	NCCI determines for Colorado employers that qualify based on the subject premium (see Table 7).	Division reviews NCCI's methodology of calculating the experience modification factors, but does not approve or deny.[2]	Applied to all policies that qualify if the employer has sufficient years of loss history to evaluate.
5	Schedule Rating Plan	A plan that establishes a range of discounts or surcharges that an insurer may apply to an insurance premium to reflect the risks specific to that employer.	NCCI establishes a Schedule Rating Plan for Colorado but insurers may file and use a different plan if they choose.	Division reviews the NCCI Schedule Rating Plan and any Plan filed by an insurer that is different from the NCCI Plan. The Division does not approve or deny.[2]	Applied to each policy with a manual premium above a threshold set by NCCI or the insurer (see Table 7).
6	Loss Adjustment Expenses (LAE)	Specific expenses of managing claims, such as salaries of claims representatives, costs to investigate claims, and legal fees. Included in loss costs and LCMs.	Set by each insurer, including Pinnacol, and filed with the Division as a component of the loss cost or LCM.	LAE factors are included in rate filings for loss costs and LCMs. Commissioner approves loss costs and reviews filed LCMs, but does not approve or deny the LCMs.	Used by NCCI in determining loss costs and by insurers in determining their LCMs.

Source: Information provided by the Division of Insurance.
[1]The National Council on Compensation Insurance (NCCI) is Colorado's designated rating organization for workers' compensation insurance. NCCI prepares recommended workers' compensation insurance rules and rate factors.
[2]If, upon review, the Division finds that any of the filed LCMs, manual premium calculations, method used to determine experience modification factors, or Schedule Rating Plan, would result in rates that are excessive, inadequate, or unfairly discriminatory, the Division would require the LCMs, calculations, method, or Plan to be modified appropriately.

Determining the premium for a workers' compensation policy is a multi-step process. In addition to the NCCI loss costs approved by the Commissioner, insurers establish loss cost multipliers (LCMs) as defined in Table 5 above, and apply a variety of adjustments to calculate a final annual premium for each policy.

Since 1996, Pinnacol has assigned all policies to a tier based on an evaluation of specific risk factors. Pinnacol currently has six tiers and evaluates the tier each policy should be assigned to when the policy is first issued and upon renewal. Generally speaking, employers that have high risk factors are assigned to the Non-Standard tier while those with low risk factors are assigned to the Standard-Plus through Superior tiers. Employers with average risk are placed in the Standard tier. Pinnacol establishes individual LCMs for each tier, with the Superior tier having the most favorable LCM (i.e., employers are charged the lowest rates) and the Non-Standard tier having the least favorable LCM, as shown in the following table.

Table 6
Pinnacol Tiers and Associated Loss Cost Multipliers
For Rates Effective in 2009 and 2010[1]

Tier	**Non-Standard**	**Standard**	**Standard Plus**	**Preferred**	**Preferred Plus**	**Superior**
Loss Cost Multiplier (LCM)	1.55	1.30	1.21	1.15	1.08	0.97

Source: Information provided by Pinnacol Assurance.
[1]As of the end of the review, Pinnacol had not filed new LCMs with the Division of Insurance for 2010. Therefore, the LCMs effective in 2009 are also in effect for 2010.

The process of selecting LCMs involves performing various calculations, making estimates, and considering information such as general economic trends and projections of changes in claims filing and losses. Thus, Pinnacol uses judgment in the selection of its LCMs, as permitted by statute [Section 10-4-403(2)(a)(I), C.R.S.]. As part of this process, Pinnacol calculates what are referred to as "indicated" LCMs using historical data such as premium and loss amounts. Pinnacol uses the indicated LCMs, along with the estimates, assumptions, and other related information, to ultimately select LCMs for each tier.

The following table shows an example of how loss costs, LCMs, and other rating factors are applied in calculating a premium.

Table 7
Example of Workers' Compensation Premium Calculation for Pinnacol Assurance

Step 1: Calculate Manual Premium

Work Classification	Estimated Payroll[1]	(A) Payroll/ $100	(B) Loss Cost	(C) Loss Cost Multiplier (LCM)[2]	Premium (A)x(B)x(C)
Residential Carpentry	$1,136,800	$11,368.00	11.02	1.55	$194,177
Outside Sales	$45,000	$450.00	0.38	1.55	$265
Clerical	$139,900	$1,399.00	0.24	1.55	$520
Manual Premium (described in Table 5)					**$194,962**

Step 2: Calculate Premium Adjustments and Total Annual Premium

Rating Element	Description of Rating Element	Application for Example	Change in Premium
Adjustments for items such as employer cancelling the policy mid-term. Set by NCCI.		NA	$0
= Subject Premium			**$194,962**
+ Experience Modification Factor (described in Table 5)		0.53	$103,330
= Modified Premium			**$298,292**
Schedule Rating Plan Adjustment (described in Table 5)		- 3%	($8,949)
Adjustments for various items, such as discounts for employers with cost containment programs. Some factors set by NCCI and some by Pinnacol.		- 5%	($14,467)
= Standard Premium (discussed later in chapter)			**$274,876**
- Premium Discount (discussed later in chapter)		- 12.1%	($33,260)
Adjustments for various items, including discounts for employers electing a higher deductible and surcharges for certain industries or risks (e.g., terrorism or natural disaster). Some factors set by NCCI and some by state or federal law.		3.75% of total payroll/$100	$496
+ Annual Policy Fee–charged by Pinnacol for each policy.		$165	$165
= Total Annual Premium			**$242,277**

Source: Analysis of information provided by the Division of Insurance and Pinnacol Assurance.
[1] Payroll for an employer is estimated at the beginning of the policy period for purposes of calculating the insurance premium.
[2] Pinnacol has different LCMs for each tier. The calculation of manual premium for a given policy uses the LCM for the tier to which the policy is assigned. In this example, the LCM for the Non-Standard tier is used.

RCI reviewed Pinnacol's rate-setting processes, the rate filings submitted to the Division of Insurance for 2006 through 2009, and Pinnacol's documentation related to the rates. RCI also recalculated premiums for a sample of Pinnacol policies, as discussed in more detail later in the chapter. On the basis of its review and recalculations, RCI identified problems with Pinnacol's rate-setting method and its filing of rating information with the Division. These problems raise concerns about whether Pinnacol's rates are fair, adequate, and not excessive. These problems are discussed in the following sections.

Rating Adjustments

Statute states that workers' compensation insurance rates "shall not be excessive, inadequate, or unfairly discriminatory" [Section 10-4-403(1), C.R.S.]. The statute goes on to state, ". . . unfair discrimination exists if, after allowing for practical limitations, **price differentials fail to reflect equitably the differences in expected losses and expenses."** [Emphasis added]. Determination of whether rates are excessive, inadequate, or unfairly discriminatory is ascertained by reviewing the rate filings and rate setting practices of the individual insurer, not comparing the rate filings and practices with those of other insurers.

In reviewing Pinnacol's rate-setting processes, RCI found that Pinnacol's method of selecting LCMs for the tiers appears to overcharge employers in the Standard and Non-Standard tiers relative to employers in the Preferred and Superior tiers. In other words, Pinnacol's method of selecting the tier LCMs leads to employers in the Standard and Non-Standard tiers tending to subsidize employers in the Preferred and Superior tiers. This subsidization may result from the duplicative or compounding effect of other premium discounts and surcharges applied by Pinnacol. In RCI's opinion, the subsidization suggests that the LCMs Pinnacol uses may generate rates that are unfairly discriminatory among employers.

In practice, the effect of Pinnacol's selected tier LCMs on premiums should not duplicate the effect of premium discounts or surcharges provided by the experience modification factor or Schedule Rating Plan. The experience modification factor and Schedule Rating Plan are described in Table 5. With respect to Pinnacol, some potential for overlap among rating factors exists. This is because Pinnacol's process for selecting LCMs, NCCI's determination of experience modification factors, and some of Pinnacol's Schedule Rating factors all consider an employer's historical loss experience. If an employer's historical loss experience is favorable (actual losses were lower than expected losses), the LCM for the tier, the experience modification factor, and Schedule Rating adjustments may each provide for a lower premium. Thus, an employer may receive three discounts that may overlap because they are all based, in part, on the employer's loss experience. For example, Pinnacol may expect an employer to have losses and expenses that are 15 percent lower than the average Pinnacol insured employer. If the LCM and experience modification factors each provide a 10 percent discount to that employer, then the combined impact of these two discounts will exceed the 15 percent discount indicated by the employer's expected losses and expenses. The reverse is also true; if an employer's historical loss experience is unfavorable (actual losses were higher than expected) the tier LCM, the experience modification factor, and the Schedule Rating adjustment could all generate increases in an employer's premium.

RCI reviewed Pinnacol's LCMs and analyzed data on case-incurred losses and earned premiums for 2006 through 2009 to calculate loss ratios (losses divided by premiums) for each tier, and for Pinnacol as a whole. RCI found that Pinnacol's premiums for policies in higher-risk tiers appear to subsidize policies in lower-risk tiers in 2006 through 2008. The subsidization is suggested by the differences in loss ratios among tiers relative to Pinnacol as a whole. If the final premiums derived using the tier LCMs, experience modification factors, and Schedule Rating adjustments did *not* include some overlap, we would expect the loss ratios to be approximately equal for all tiers. In other words, if the loss ratios were approximately the same across all the tiers, this would indicate that they equitably reflect differences in expected losses and expenses among employers. Instead, as shown in Table 8 below, for 2006 through 2008, policies in the Non-Standard, Standard, and Standard-Plus tiers have loss ratios that are less than the loss ratio for Pinnacol as a whole while policies in the Preferred, Preferred-Plus, and Superior tiers have loss ratios greater than for Pinnacol as a whole. For example, for 2008, the loss ratio for the Standard tier is 62.8 percent but the loss ratio for Pinnacol as a whole is 64.7 percent. This indicates that the premiums for policies in higher-risk tiers have higher premiums than they should, and therefore lower loss ratios. At the same time, the loss ratio for the Superior tier is 66.1 percent compared to the loss ratio of 64.7 percent for Pinnacol as a whole.

The loss ratios for 2009 are more balanced among tiers. However, the data used to calculate these ratios are immature. Since many of the 2009 policies were still in force as of April 30, 2010, it may be too early to obtain an accurate assessment of total premiums and claims for this policy year.

Table 8
Loss Ratios for Pinnacol Tiers
2006 Through 2009

Policy Year	Non-Standard	Standard	Standard Plus	Preferred	Preferred Plus	Superior	Pinnacol as a Whole
2006	51.8%	51.4%	54.8%	59.4%	62.6%	66.6%	56.5%
2007	50.3%	52.7%	50.2%	65.0%	65.0%	58.3%	57.7%
2008	55.9%	62.8%	62.7%	65.0%	72.2%	66.1%	64.7%
2009	58.4%	57.6%	61.4%	64.5%	54.8%	51.4%	58.2%

Source: RCI analysis of case-incurred losses evaluated as of 4/30/10 and earned premiums, including all tier pricing and other rating adjustments, provided by Pinnacol Assurance.

RCI conducted some statistical analyses of the loss ratios in the table above for 2006 through 2008. The probability that the differences between the loss ratios for the Preferred, Preferred Plus, and Superior tiers relative to those for the Non-Standard, Standard, and Standard-Plus tiers are due only to random fluctuation is extremely small. These findings suggest that Pinnacol's selected tier LCM differentials resulted in unfair discrimination among policyholders in 2006 through 2008. As discussed in the next section, RCI identified a number of concerns with the rate setting process, some of which affected 2009 LCMs by tier. In part due to these concerns, and because the 2009 data are not mature, RCI could not determine whether the improvement in the loss ratios for 2009 was the result of changes in how Pinnacol selected its LCMs.

Pinnacol began using its tiering structure in 1996 and has filed rating information related to the structure and the tier LCMs with the Division of Insurance. Pinnacol noted that the Division of Insurance has not raised concerns regarding the tier LCMs. Nonetheless, RCI's analysis indicates a need for additional analysis. Pinnacol and the Board should further research and refine the methods used to derive the LCMs. Specifically, the Pinnacol Board should select LCMs based on indicated differences in expected losses and expenses among tiers, giving full consideration to all other anticipated rating adjustments.

Recommendation No. 5:

The Board of Directors should work with Pinnacol Assurance management to further research and refine the methods used to select the loss cost multipliers. The Board and Pinnacol should select and apply loss cost multipliers that are based on indicated differences in expected losses and expenses among tiers, giving full consideration to all other anticipated rating adjustments.

Pinnacol Board of Directors and Pinnacol Assurance Response:

Partially agree. Implementation date: December 31, 2010.

Pinnacol and the Board of Directors will continue to evaluate and exercise prudent consideration in the selection of each individual tier change based on indications for the determination of our ultimate loss cost multipliers. This process includes but is not limited to: maintaining our intent of complying with Colorado Insurance Law, utilizing allowable judgment, properly acknowledging Colorado Division of Insurance oversight and loss cost rate orders, our past and prospective loss experience, Colorado marketplace conditions, valid rating adjustments, potential changes to our underwriting model, and expense provisions. Hence, our goal of striving to ensure that our rates are not excessive, inadequate, or unfairly discriminatory is unchanged.

Pinnacol does not believe that this audit process validated any Colorado Insurance Law concerns with our rating process that were material or that would have ultimately had an impact on our "filed" rates.

Auditor's Addendum:

The audit identified evidence that indicates Pinnacol's rate setting practices result in higher-risk employers paying premiums that subsidize the premiums charged to lower-risk employers. This is not an issue of "materiality"; this is an issue of fairness in rate-setting and could be discriminatory under state law. Pinnacol should address this concern.

Rate Setting

RCI's review of Pinnacol's rate-setting process revealed a number of inaccuracies and unsubstantiated assumptions in the information Pinnacol used to calculate indicated LCMs and select final LCMs for each tier for 2006 through 2010. The effect of these inaccuracies and assumptions may be offsetting to a certain extent. It is not possible to quantify the final effect on the LCMs, because the selection of the LCMs involves judgment on the part of Pinnacol management. However, the number and significance of the problems indicate a lack of adequate controls over the rate-setting process. Examples of the problems are discussed below.

- **Inaccurate Premium and Loss Data.** In calculating the indicated LCMs, Pinnacol uses historical data on losses (claims payments) and premiums for all the employers in each tier as well as for all employers insured by Pinnacol as a whole. RCI found that for the 2009 LCMs, Pinnacol used inaccurate premium and loss data for each tier, which ultimately contributed to the indicated LCMs being understated. As a result, Pinnacol may have selected final LCMs for each tier that were understated, which could cause rates to be lower than they would be if accurate data had been used. Pinnacol indicated that the use of incorrect data was an error and that the final selected LCMs were not based on the incorrect indications.

- **Incorrect Estimate of Ultimate Losses.** One estimate Pinnacol uses to help it select the LCMs for the tiers is the amount of projected "ultimate losses" on claims. The "ultimate loss" is the projected total of the payments that will be made for incurred claims. In estimating ultimate losses related to LCMs in the 2008 rate filing, Pinnacol used incorrect data, which resulted in an underestimate of the ultimate losses. RCI compared Pinnacol's estimated ultimate losses, as indicated in the rate filing, to estimates of ultimate losses prepared by Pinnacol's actuary as part of the actuary's quarterly reserve studies. RCI found that while the estimates in the 2006 and 2007 rate filings were roughly equivalent to the estimates in the corresponding reserve studies, this was not the case in the

2008 rate filing. Due in large part to the use of incorrect data, Pinnacol's estimated ultimate losses in the 2008 rate filing were approximately 25 percent less than in the 2008 reserve study. Underestimating ultimate losses may have caused Pinnacol to select LCMs that were understated. Pinnacol indicated that the use of incorrect data was an error. In hindsight, Pinnacol asserted that correction of this error would have had no impact on the rating decision for the year in question.

- **Profit Assumptions.** The LCMs should be selected so that the premiums cover anticipated losses and loss adjustment expenses (LAE), operating expenses, and a reasonable profit. RCI found unexplained changes in Pinnacol's assumed profit provisions for 2006 through 2009. Profit provisions are stated as a percentage of premium. The selected profit provision includes profits and investment income. In Pinnacol's case, the inclusion of investment income resulted in an overall negative profit provision for most years. According to data Pinnacol provided to RCI, Pinnacol selected the following profit provisions for the years under review:

Table 9
Pinnacol Implied Profit Provisions
2006 through 2009

Filing Effective Year	2006	2007	2008	2009
Implied Profit Provision	-3.0%	-9.5%	0.0%	-9.0%

Source: RCI analysis of data provided by Pinnacol Assurance.

These changes to the profit provision from year to year represent a significant shift in assumptions. However, Pinnacol did not provide RCI with documentation that fully substantiated the implied profit provisions shown in the table or the investment income assumptions.

Colorado Insurance Regulation 5-1-10(5)(A) states that a "workers' compensation filing must identify the amount or percentage of the provision for profit . . . and how this provision is added to the final rate." The same regulation also requires insurers to complete standardized rate filing forms, which include a section where the assumed profit should be shown. In the filings submitted to the Division for all four of these years, Pinnacol left the section of the filing where the assumed profit should be recorded blank, implying a zero profit each year.

- **Variable Expense Assumptions.** An estimated variable expense ratio (the ratio of variable expenses to premiums) is used in calculating the indicated LCMs. The standardized rate filing forms include a section where the insurer breaks down its expenses into fixed and variable components. RCI questions the reasonableness of Pinnacol's determinations of fixed and variable expenses by tier. The breakdown of expenses into the fixed and variable components requires a thorough review of expense accounting and some judgment. While Pinnacol's total expense provision was identical for each of the six tiers, the variable expense ratios were not consistent across the tiers. For example, in its rate filing for 2008, Pinnacol determined that about 6 percent of the expenses for the Superior tier were variable but more than 93 percent of the expenses for the Non-Standard tier were variable. These are the same types of expenses for all tiers, so it is reasonable to expect the variable expense ratios to be consistent across all tiers. Pinnacol did not provide data to RCI to substantiate the differences between the fixed and variable expense ratios and indicated that these assumptions were made judgmentally. These assumptions regarding different variable expense ratios among the tiers incorporate an additional level of judgment into the calculation of the indicated LCMs where no judgment is required. The impact of this judgment is to increase the difference in the final LCMs among tiers.

Pinnacol stated that it considers the effect of these errors and assumptions to be immaterial to the final LCMs, so it does not plan to recalculate the indicated LCMs or modify its assumptions as a basis for selecting different LCMs. RCI found that, although the effect of many of the specific problems it identified is material to the indicated LCMs, it is not clear that the final selected LCMs were unreasonable. However, the number of problems and the magnitude of the errors are concerning in that they indicate that Pinnacol does not exercise due care and lacks controls over the rate-setting process. Inadequate controls increase the risk that significant errors could occur in the process without being detected or corrected.

During the review, it came to RCI's attention that Pinnacol does not have an actuary participating in the rate-setting process. One way Pinnacol and the Board could improve controls over rate-setting would be to seek the assistance of an actuary. RCI believes that a number of the issues it identified, particularly the use of inaccurate premium and loss data and the use of inaccurate data to project ultimate losses, would have been readily recognized if reviewed by an actuary. In RCI's experience, it is common for an insurer of Pinnacol's size to have an actuary involved in the rate-setting process.

Overall, Pinnacol should improve the methods used to determine the indicated tier LCMs to improve the accuracy of the rate-setting process.

Recommendation No. 6:

The Board of Directors and Pinnacol Assurance should improve the method used to determine the indicated tier LCMs by:

a. Implementing a comprehensive review process for all data, calculations, and material assumptions used in the process for accuracy, consistency, and reasonableness.

b. Considering the use of a qualified actuary to assist in setting rates.

Pinnacol Board of Directors and Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

a. Pinnacol and the Board will conduct research and develop a viable review process. Such review process will determine if any changes are needed.

b. Pinnacol management will continue to evaluate the merits of using a qualified actuary to assist in setting rates and implement any needed changes.

Determining Schedule Rating Eligibility

Insurers use Schedule Rating Plans (Plans) to reduce or increase an employer's premium based on employer-specific risk factors, such as those shown in Table 11, later in this chapter. The risk factors are established by NCCI if the insurer uses the NCCI Plan, or by the insurer if the insurer files its own Plan. Plans are applied to policies with premiums above a specified threshold. To determine the amount of any Plan adjustment, the insurer evaluates eligible employers on the specified factors. Colorado insurance regulations allow for a maximum adjustment under a Schedule Rating Plan of plus or minus 25 percent of the modified premium (shown in Table 7).

Pinnacol submitted a filing to the Division in September 2000 indicating that it would apply its Plan to policies with a $10,000 manual premium or more. According to NCCI, manual premium is determined by multiplying the NCCI loss cost for each work classification code by the Loss Cost Multiplier (LCM) for each

$100 of payroll and summing the results for all work classifications for the employer. This calculation is shown in Step 1 of Table 7.

RCI reviewed Pinnacol's Schedule Rating Plan filings submitted to the Division and analyzed data on all 250,685 of Pinnacol's policies that had effective dates between January 1, 2005, and December 31, 2008. RCI found that Pinnacol calculates manual premium in one way to determine the final annual premium on a policy but in a different way to determine a policy's eligibility for Schedule Rating. Specifically, to determine the total annual premium on a policy, Pinnacol follows the NCCI formula described in the previous paragraph, using the specific LCM for the tier in which the policy is issued (see the final line in Table 7). However, to determine a policy's eligibility for Schedule Rating, Pinnacol calculates the manual premium using the LCM of the Standard tier, regardless of the tier in which the policy is issued. As discussed below, RCI identified three concerns with Pinnacol's method of determining whether a policy is eligible for Schedule Rating. These concerns raise questions as to whether Pinnacol's method for determining eligibility for Schedule Rating complies with statutory requirements that rates not be excessive, inadequate, or unfairly discriminatory.

First, RCI found that none of the Schedule Rating Plan filings submitted to the Division between 1995 and 2008 specifically stated that Pinnacol determined eligibility using a manual premium that was calculated differently than the NCCI formula. Pinnacol filed information on its Plan with the Division in 1995, 1996, 1998, and 2000. The 1995, 1996, and 1998 filings did not make any reference to the use of the Standard tier LCM to determine Plan eligibility. The 2000 filing, which increased the threshold for applying the Plan to the $10,000 manual premium, stated, "This change primarily affects Standard tier customers . . . ." The filing does not clearly state that the Standard tier LCM would be used to determine eligibility for all policies. Statutes require that all rating information be filed with the Division before use.

Second, RCI found that Pinnacol's method of determining eligibility for Schedule Rating makes some policies eligible for Schedule Rating that would not otherwise be, if eligibility were based on the manual premium calculated using the NCCI formula. RCI analyzed the estimated manual premiums as of the policy issue date, using the LCM in which the policy was issued, for the 250,685 Pinnacol policies in effect between January 1, 2005, and December 31, 2008. This analysis indicates that Pinnacol's method of determining eligibility for Schedule Rating increased the number of policies eligible for adjustments under the Plan by about 4,600. Further, the analysis indicates that Pinnacol's method of determining eligibility for Schedule Rating appears to benefit employers in the Superior, Preferred Plus, Preferred, and Standard Plus tiers, making more of them eligible for premium decreases while at the same time making more employers in the Non-Standard tier subject to premium increases, as shown in the following table. For example, 242 policies in the Superior tier experienced decreases in their final premiums, while only 42 experienced increases. On the other hand, only 6 policies in the Non-Standard tier experienced decreases in their final premiums, but 24 experienced premium increases.

Table 10
Effect on Policies[1] of Determining Eligibility for Schedule Rating Using the Standard Tier LCM

Tier	Policies with Reduced Final Premiums		Policies with Increased Final Premiums		Net Adjustment
	Number	Decrease	Number	Increase	
Superior	242	($76,477)	42	$10,458	($66,019)
Preferred Plus	834	($249,988)	210	$47,542	($202,446)
Preferred	1,078	($320,309)	433	$138,929	($181,380)
Standard Plus	259	($80,243)	120	$42,390	($37,853)
Non-Standard	6	($1,368)	24	$13,072	$11,704
Total	**2,419**	**($728,385)**	**829**	**$252,391**	**($475,994)**

Source: RCI analysis of data provided by Pinnacol Assurance.
[1]In addition to the policies listed above, all of which experienced adjustments to their premiums based on the Schedule Rating Plan, another 1,364 policies across the tiers were evaluated for Schedule Rating but did not experience adjustments to their final premiums based on Pinnacol's assessment of the risks.

Third, RCI found that Pinnacol's method of determining eligibility for Schedule Rating makes some policies ineligible for Schedule Rating adjustments that otherwise would be eligible. RCI's analysis identified 546 policies that were not eligible for Schedule Rating adjustments because their manual premiums, calculated using the Standard tier LCM in accordance with Pinnacol's practice, were below the $10,000 threshold. However, these policies would have met the threshold and been eligible for Schedule Rating if Pinnacol had calculated their manual premiums using the LCM for the tier in which the policies were issued. The 546 policies included 341 in the Non-Standard tier, 104 in the Standard Plus tier, 62 in the Preferred tier, 29 in the Preferred Plus tier, and 10 in the Superior tier. In other words, Pinnacol did not consider these policies for Schedule Rating adjustments because Pinnacol determined them ineligible for the Plan.

The Division of Insurance conducted a market conduct exam in 1998 when Colorado's state fund was known as the Colorado Compensation Insurance Authority. The exam report references the Authority's underwriting manual, which stated, in part, "Always determine the manual premium [to determine Schedule Rating eligibility] using the Standard tier rate." At the time of the exam, the Authority had three tiers. Pinnacol has stated that "any concerns regarding this practice [of determining eligibility for Schedule Rating using the Standard tier LCM for all policies] would have been raised . . . in . . . the examination report." The report does not raise a concern regarding the method. However, the report does state, "Failure to . . . criticize specific [insurer] practices does not constitute acceptance by the Colorado Division of Insurance of such practices."

In other words, the fact that the report did not criticize Pinnacol's method does not necessarily indicate that the methodology was acceptable to the Division.

In December 2009 Pinnacol submitted its Schedule Rating Plan to the Division. The filing stated, "a policy must generate $10,000 in premium to qualify for schedule rating. To ensure consistent and non-discriminatory treatment of all policyholders, the eligibility is determined at manual premium standard tier rates." The filing contained no additional language to explain how the use of the Standard tier LCM to determine Schedule Rating eligibility for all policies is "non-discriminatory."

The Pinnacol Board should work with Pinnacol management to reevaluate the use of the Standard tier LCM to determine whether policies are eligible for Schedule Rating adjustments. The evaluation should focus on ensuring that this method of determining eligibility complies with statutory requirements that rates not be excessive, inadequate, or unfairly discriminatory. Pinnacol should also ensure that it files all rating information with the Division of Insurance before using the information to determine premiums.

Recommendation No. 7:

The Pinnacol Board should work with Pinnacol Assurance management to ensure that the method used to determine eligibility for the Schedule Rating Plan is in compliance with all applicable statutes by:

a. Reevaluating the use of the Standard tier LCM to determine whether policies are eligible for Schedule Rating adjustments and the effect of the methodology on employer premiums.

b. Filing all rating information with the Division of Insurance before using the information to determine premiums.

Pinnacol Board of Directors and Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

a. Pinnacol management will continue our on-going regulatory dialogue with the Colorado Division of Insurance to determine an appropriate outcome to this issue by ensuring our method used to determine eligibility for the Schedule Rating Plan remains compliant with Colorado Insurance Law and does not adversely impact our policyholders. The result(s) of such dialogue will be communicated to the Board for its consideration. This audit has validated that our consistent process has increased schedule rating eligibility by approximately 2 percent of our policyholders over a four-year period (January 1, 2005 – December 31, 2008) resulting in schedule rating net premium reductions equaling $475,994. As such, we will continue to research this issue and implement any needed changes.

Auditor's Addendum:

The audit demonstrated that Pinnacol's method of determining eligibility for Schedule Rating is potentially discriminatory because employers in the Non-Standard tier were disproportionately affected by premium increases while employers in the other tiers disproportionately received premium reductions. This is not a validation of Pinnacol's process. As of the end of our audit, the Division had notified Pinnacol that issues with its December 2009 filing need to be resolved before the filing can be found to comply with applicable laws and regulations. The Division specifically stated that it is unclear how Pinnacol's process results in non-discriminatory treatment of policyholders and requested that Pinnacol justify that its Schedule Rating Plan results in rates that are not excessive, inadequate, or unfairly discriminatory.

b. Pinnacol management will review our process of filing all rating information with the Division of Insurance with the intention of ensuring we are in compliance with all statutes and our filings are complete and accurate. The results of this review will be communicated to the Board.

Rate Filings

Statutes and regulations require workers' compensation insurers to file all rating information with the Division of Insurance before using the information to determine premiums [Sections 10-4-401(3)(b), C.R.S., and Colorado Insurance Regulations 5-1-10 and 5-1-11]. The Commissioner of Insurance has the authority to review all rate filings for compliance with applicable statutes and regulations, including the statutory requirement that rates not be excessive, inadequate, or unfairly discriminatory. If the Commissioner has good cause to believe that any rating information does not comply with the statutes and regulations, and if after a public hearing the rating information is found to be in violation, the Commissioner can prohibit the insurer from using the rating information or impose other sanctions.

RCI reviewed the rate filings Pinnacol submitted to the Division for rates effective in 2006 through 2010 and Pinnacol's documentation related to the rates. RCI also recalculated the premiums for a sample of 104 policies for compliance with the filed rating information. RCI selected its sample from the 250,685 new and renewal policies in effect between January 1, 2005, and December 31, 2008; these policies had premiums totaling more than $2.1 billion. RCI randomly selected five unique policy numbers from each of Pinnacol's six tiers and reviewed each policy issuance and renewal. Sixteen of the policies were not in effect for all years reviewed (i.e., some were new policies at some point during the four-year period and others were not renewed for all years), resulting in the final sample of 104 policies. On the basis of these reviews and recalculations, RCI found that Pinnacol has used some rating information that was not filed with the Division and used other rating information that was filed in an incomplete form, as discussed below.

Unfiled Rating Information

Pinnacol has been using the Schedule Rating Plan risk factors and adjustment percentages shown in Table 11 below, since December 2002.

Table 11
Pinnacol's Schedule Rating Plan (Effective December 2002)

Risk Factor	Adjustment Range
Management (includes consideration of the employer's cooperation/compliance with requests from Pinnacol for underwriting, auditing, loss control, and claims information)	+/- 10%
Loss Control (includes consideration of whether the employer has and uses a return to work plan and a written safety program, has a functioning safety committee and cost containment program, and management's attitude toward and involvement in safety efforts)	+/- 10%
Exposures (includes consideration of items such as how the employer's turnover compares to industry averages, the condition of machinery, employee training on safety, and the use of screening tools such as drug testing and background checks)	+/- 10%
Loss History (includes consideration of trends in the employer's claims frequency and loss ratio)	+/- 4%
Financial History (includes consideration of the number of policy delinquency notices issued to the employer by Pinnacol and the number of times Pinnacol has reinstated the employer's policy)	+/- 4%
Maximum Adjustment to Modified Premium	+/- 25%

Source: Schedule Rating Plan provided by Pinnacol Assurance.

RCI found that Pinnacol did not file the risk factors and percentages in its Schedule Rating Plan with the Division until December 2009, seven years after it began using the risk factors. When rating information is used without being filed with the Division, the Commissioner has no opportunity review the information to help protect employers from excessive, inadequate, or unfairly discriminatory rates.

RCI identified a specific concern with the Loss History risk factor in the Plan, which is based on two components: the employer's loss frequency (the frequency of filing claims) and loss ratio (losses divided by premium). RCI found there is a potential that the Loss History risk factor will lead to adjustments that are also reflected in the experience modification adjustment. This is because both loss frequency and losses are also considered in NCCI's determination of experience modification factors. NCCI rules state that a Schedule Rating Plan ". . . adjusts premium based on . . . employer-specific factors . . . **that are not otherwise reflected in the employer's experience [modifier]**" [emphasis added]. Because the Commissioner of Insurance has designated NCCI as Colorado's rating agency for workers' compensation insurance, all insurers doing business in Colorado must comply with NCCI rating rules.

RCI found that over the period reviewed (January 1, 2005, through December 31, 2008) Pinnacol evaluated about 46,310 policies for Schedule Rating using the rating factors in Table 11, which had not been filed with the Division. Although the Schedule Rating adjustments Pinnacol applied to these policies reduced total premium by only about 4 percent, the adjustments were applied to approximately 75 percent of Pinnacol's total final premiums for the period. Pinnacol's use of these unfiled risk factors violates Section 10-4-401(3)(b), C.R.S., which requires workers' compensation insurers to file all rating data, and Colorado Insurance Regulation 5-1-11(3)(J), which states, in part, "Each insurer . . . shall file its . . . [Schedule Rating Plan] . . . **prior to implementation** with the Division of Insurance" [emphasis added]. Pinnacol indicated that the failure to file the Schedule Rating risk factors was an oversight.

Incomplete Filing

RCI found other problems with Pinnacol's filing of a Premium Discount Table with the Division that was effective beginning January 1, 2007. The Premium Discount Table provides for discounts that increase as the policy premium increases. The purpose of the discounts is to reflect the fact that many of the costs associated with issuing policies are fixed and do not increase with higher premium amounts. Premium discounts are calculated on a policy's standard premium (shown in Table 7). Pinnacol's filed Premium Discount Table included two sections, each of which provided a different level of detail on the discounts.

RCI identified two problems with Pinnacol's filed Premium Discount Table. First, there were inconsistencies within the table; some of the discounts shown in one section of the table conflicted with the discounts shown in the other section.

As a result, the table is unclear with respect to which discounts Pinnacol intended to apply to some premium ranges. Second, the table was incomplete; it appears that a page of the filing was erroneously excluded, omitting detailed discount information for some premium ranges. Although these problems do not appear to have contributed to inadequate, excessive, or unfairly discriminatory rates, they indicate a lack of controls over the filings Pinnacol submitted to the Division.

The filing of all rating information is required by statute to allow the Division of Insurance to review rates to help ensure they are not excessive, inadequate, or unfairly discriminatory. When Pinnacol files incomplete and conflicting information, it hinders the Division's ability to accomplish this purpose.

After RCI brought these filing issues to Pinnacol's attention, Pinnacol submitted filings to the Division. Pinnacol submitted one filing in November 2009 that addressed both the inconsistencies and the omission in the Premium Discount Table. The 2009 filing indicates an effective date of January 1, 2007. However, according to Division of Insurance officials, insurers are not permitted to file rating information with retroactive effective dates. Pinnacol submitted a second filing in December 2009 that contained the risk factors in its Schedule Rating Plan.

Recommendation No. 8:

Pinnacol Assurance should improve its rate filings submitted to the Division of Insurance by:

a. Reevaluating its Schedule Rating Plan to eliminate factors that duplicate the employer's experience rating.

b. Ensuring it files any changes to its Schedule Rating Plan before applying the changes.

c. Ensuring it submits filings that are complete and accurate.

Pinnacol Assurance Response:

Partially agree. Implementation date: December 31, 2010.

a. Pinnacol management will continue our on-going regulatory dialogue with the Colorado Division of Insurance to determine an appropriate outcome to this issue by ensuring our Schedule Rating Plan factors remain compliant with Colorado Insurance Law while not adversely impacting our policyholders. At this point, Pinnacol does not believe that this audit process validated that our schedule rating factors duplicate the employer's experience rating.

Auditor's Addendum:

The audit identified potential duplication between Pinnacol's Schedule Rating risk factors and NCCI's experience modification factor. This is a violation of NCCI rules and affects policyholder premiums. Further, Pinnacol has used the Schedule Rating risk factors for seven years without filing them with the Division of Insurance, as required by law.

b. As previously stated in our response to Recommendation No. 7b, Pinnacol will review our process of filing all rating information (including changes to the Schedule Rating Plan) with the Division of Insurance with the intention of ensuring we are in compliance with all statutes and our filings are complete and accurate.

c. As previously stated in our response to Recommendation Nos. 7b and 8b, Pinnacol will review our process of filing all rating information with the Division of Insurance with the intention of ensuring we are in compliance with all statutes and our filings are complete and accurate.

Reserves

Insurers establish reserves for future payments on already incurred claims. Loss reserves typically include three estimates of projected payments—one for known claims, one for unknown claims (referred to as Incurred But Not Reported, or IBNR claims), and one for the costs of managing claims. The costs of managing claims, which include expenses such as the salaries of claims representatives, legal fees, and administrative expenses that are incurred specifically for managing claims, are commonly referred to as Loss Adjustment Expenses (LAE). The following table shows Pinnacol's year-end reserves for losses and LAE for the period 2006 through 2009.

Table 12
Pinnacol Assurance Reserves for Unpaid Losses and LAE
December 31, 2006 through December 31, 2009
(in Millions)

	2006	**2007**	**2008**	**2009**	**Change 2006 to 2009**
Reserve for Losses	$1,040	$1,043	$1,006	$954	(8.3%)
Reserve for LAE	$197	$211	$217	$195	(1.0%)
Combined Reserves	**$1,237**	**$1,254**	**$1,223**	**$1,149**	**(7.1%)**

Source: Pinnacol Assurance's Statutory Audited Financial Statements for 2006 through 2009.

Pinnacol uses an outside actuary to perform quarterly analyses of its loss and LAE reserves and to prepare recommended year-end reserve amounts. RCI reviewed the actuary's quarterly reserve studies and the projections that generated Pinnacol's estimated reserves for 2006 through the first half of 2009. In each of these years, Pinnacol recorded year-end reserves at the actuary's central estimate, which represents the actuary's best estimate of what reserves should be. The actuary also provides low and high reserve estimates representing a range of 10 percent below and 10 percent above the central estimate, respectively. RCI found the actuary's methodology and assumptions to be actuarially sound and reasonable and the associated calculations to be accurate. The actuary used a comprehensive and standard methodology comparable to methods and assumptions applied by other insurers in the industry.

Over the period RCI reviewed, Pinnacol's actual loss and LAE payments have been lower than the amounts reflected in recorded reserves. RCI performed a hindsight analysis of reserves, which provides insight on the accuracy of the reserving process. For example, using information on actual claims payments and LAE as of December 31, 2006, 2007, and 2008, it is possible to develop new estimates that provide an indication of the accuracy of the original estimates. The following table provides one-year hindsight estimates (using actual claims payments and LAE as of one year after the original estimate) and estimates based on all the claims payments and LAE paid as of December 31, 2008. This analysis indicates that Pinnacol has recorded its reserves at a conservative level over this period, meaning at a higher level than might have been necessary according to hindsight review. However, RCI concluded based on its experience that Pinnacol's reserves are within reasonable bounds.

Table 13
Hindsight Analysis of Pinnacol's Net Loss and LAE Reserves
(in Millions)

Calendar Year	Loss and LAE Reserves Recorded	Loss and LAE Reserves Estimated One Year Later	Recorded Reserves (Over)/Under Estimate from One Year Later	Loss and LAE Reserves Estimated at 12/31/08	Recorded Reserves (Over)/Under Estimate at 12/31/08
2005	$1,206	$1,152	($ 54)	$ 991	($215)
2006	$1,237	$1,159	($ 78)	$1,041	($196)
2007	$1,254	$1,100	($154)	$1,100	($154)

Source: RCI analysis of data from Pinnacol Assurance's annual financial statements filed with the Division of Insurance in 2005 through 2008.

As noted above, a portion of the reserves reflect estimates of payments for unknown claims, which are generally referred to as Incurred But Not Reported (IBNR). The estimate of IBNR losses is based on an actuarial assessment of known claims, projections for unreported claims, and expected reserves for re-opened claims. Between 2005 and 2009, Pinnacol's IBNR reserves represented between 56 and 59 percent of total loss and LAE reserves as recorded in the financial statements each year. The ratios are consistent over this period, indicating a stable reserving philosophy.

To establish case reserves for an individual claim, Pinnacol estimates the total payments the claim will incur at the time the claim is filed. Pinnacol uses an automated reserving system to assist in setting the case reserves. Claims representatives consider a variety of factors to select a reserve code that reflects the "seriousness" of the claim. The factors include the type of injury, the potential for temporary or permanent disability, and the type and extent of treatment typically needed for the type of injury. The automated system then computes estimated indemnity and medical payment amounts to be reserved based on the selected reserve code. Pinnacol claims representatives monitor case reserves on an ongoing basis. Case reserves may be adjusted throughout the life of a claim as payments on the claim are made and changes related to the claim occur, such as a significant modification to the claimant's treatment plan or if an expected temporary disability becomes permanent. RCI reviewed Pinnacol's method for establishing case reserves for individual claims and did not identify any concerns with the method.

During the period RCI reviewed, Pinnacol booked its reserves net of tabular discount. Tabular discount reflects the time value of money for those claims with fixed and reasonably determinable payments. Pinnacol used a discount rate of 3.5 percent for all years RCI reviewed. The total amount of tabular discount has steadily increased from approximately $129 million at December 31, 2005 to $148 million at December 31, 2008. Discounted reserves represent the present value of expected future payments on incurred claims and assume investment returns at a rate equal to the discount rate. As such, the valuation of a discounted reserve is somewhat more at risk than an undiscounted reserve because the discounted reserves are subject to investment risk.

Division of Insurance Oversight

The Colorado Division of Insurance provides some oversight of Pinnacol's reserves. First, Pinnacol, like all other workers' compensation insurers doing business in Colorado, is required to file an annual statement of actuarial opinion with the Division of Insurance and annual financial statements that contain information on reserves, actual claims payments, and LAE. The annual statement of actuarial opinion provides the opinion of the insurer's actuary regarding the reserves recorded in the annual statements. The Division reviews the annual statements for reasonableness in areas such as the loss and LAE reserves and the consistency of loss ratios and earned premiums from year to year. The Division also reviews the actuarial opinions and will question the insurer regarding any items that raise concerns, such as significant changes in reserves over time.

Second, the Division conducts financial examinations of all insurers on a regular basis. The Division examines Pinnacol every three years. In the most recently completed exam, which was for the period ending December 31, 2006, the Division did not identify concerns with Pinnacol's overall loss and LAE reserve amounts. However, the Division did recommend that Pinnacol correct its classification of certain costs associated with claims. Specifically, Pinnacol had included some costs related to handling claims in its reserve for losses, rather than in the reserve for LAE. The Division is currently conducting its financial examination of Pinnacol for the period ended December 31, 2009.

Workers' compensation is traditionally a volatile and cyclical line of business. Projected claims costs are subject to relatively wide variance due to the long payout period. The industry tends to move through multi-year cycles of relative profitability followed by extended periods of adverse financial results. The uncertainty regarding rating and reserving is amplified for Pinnacol as a single-product, single-state insurer. This is because Pinnacol cannot spread its risks across multiple lines of business or states. For these reasons, it is appropriate for Pinnacol to establish reserves at conservative levels. In RCI's opinion, Pinnacol's recorded loss and LAE reserves have been consistently set at a reasonably conservative level throughout the period reviewed.

Surplus

Statute requires the Pinnacol Board to maintain a reasonable surplus, as determined in statute, or as approved by the Commissioner of Insurance [Section

8-45-107, C.R.S.]. In accordance with Colorado insurance regulations, workers' compensation insurers doing business in Colorado use the National Association of Insurance Commission's (NAIC's) risk-based capital system to determine whether their surplus levels are adequate. The NAIC was created by state insurance regulators in 1871 and provides a forum for the development of uniform policy across the states when uniformity is appropriate. When the NAIC identifies a situation or policy that could benefit from a national standard, it drafts a new model law or regulation, or an amendment to an existing law or regulation, for the consideration of state regulators. The NAIC has established a risk-based capital (RBC) system that has two main components, as follows:

- A risk-based capital formula that establishes a hypothetical minimum capital (surplus) level (referred to as the "authorized control level") that is compared to an insurer's actual surplus. The RBC formula includes factors that relate to the size of the insurer and the perceived risks in the insurer's business and the industry in general. The RBC level resulting from the formula is intended to be a minimum regulatory capital standard and does not necessarily indicate the full amount of surplus an insurer would want to hold to meet its safety and competitive objectives. In other words, for financial stability, an insurer would most likely want to hold a greater surplus than the minimum.

- A risk-based capital model law that grants automatic authority to the state insurance regulator to take specific actions based on an insurer's level of surplus relative to the authorized control level. In Colorado, such actions are codified in Colorado Insurance Regulation 3-1-11, as discussed below.

The RBC ratios and model law are intended to create a safety net for insurers and the employers they serve, as well as to provide a basis for regulatory authority and remedial actions. Each state determines whether or not to adopt and implement NAIC standards and model laws or regulations.

Colorado Insurance Regulation 3-1-11 adopts the NAIC model law and standards for surplus levels. The regulation also establishes requirements for insurers to report their RBC ratios to the Division and provides for corrective and regulatory measures to be taken by the Commissioner in situations when an insurer's surplus falls below the standards. The regulation states that an excess surplus over the NAIC minimum level "is desirable in the business of insurance . . . and helps to secure an insurer . . . against various risks inherent in, or affecting, the business of insurance."

The Colorado Division of Insurance reviews Pinnacol's reported surplus each quarter and conducts financial examinations of the surplus every three years. Pinnacol experienced financial difficulties throughout the 1980s and 1990s and had a $7 million surplus deficit at the end of 1998. House Bill 97-1180 required Pinnacol to develop a surplus recovery plan to address its troubled financial condition. Pursuant to the bill, Pinnacol designed a plan that was approved by the Commissioner of Insurance in 2000. Under the plan, Pinnacol intended to strengthen its financial position and attain a surplus of $250 million by 2010. Pinnacol had achieved this surplus goal by December 31, 2003. The surplus has grown significantly since that time, reaching about $733 million as of December 31, 2009. Due to the growth in the surplus, Pinnacol began issuing general dividends to policyholders in 2005 and has continued paying general dividends each year. The following table shows Pinnacol's year-end surplus and general dividends paid for 2005 through 2009.

Table 14
Pinnacol Surplus and General Dividends
2005 through 2009 (in Millions)

	2005	2006	2007	2008	2009
Surplus as of December 31	$472	$607	$722	$698	$733
General Policyholder Dividends Based on Surplus at the End of the Prior Year[1]	$57	$61	$54	$123	$47.5[2]

Source: Pinnacol Assurance's audited financial statements and annual statements filed with the Division of Insurance for 2005 through 2009.

[1] General dividends are typically paid in the spring, based on the surplus at the end of the previous calendar year. The dividends are shown above in the year they were earned, i.e., the year before they were paid. For example, Pinnacol paid about $123 million in general dividends in the spring of 2009 based on the surplus at December 31, 2008.

[2] Pinnacol announced general dividends of about $47.5 million to be paid in 2010 based on the surplus at December 31, 2009.

Pinnacol benchmarks its performance with respect to surplus against a number of other workers' compensation insurers, including six other state funds that are also single-line workers' compensation insurers, one private workers' compensation insurer, and three private insurance companies that provide multiple lines of insurance. The table below shows Pinnacol's surplus, dividends, and RBC ratio compared to these other insurers in 2009.

Table 15
Workers' Compensation Insurance Providers
Comparison of Dividends, Surplus, and Risk-Based Capital for 2009
(in Thousands)

Insurer	Dividends Issued	End of Year Surplus	RBC Ratio[1]
Pinnacol Assurance	**$116,841[2]**	**$732,527**	**1265%**
LWCC (Louisiana)	$15,000	$633,469	2129%
Texas Mutual	$93,114	$1,313,671	1181%
Missouri Mutual	$0	$154,350	1157%
WCF (Utah)	$9,844	$562,971	1072%
Beacon Mutual (Rhode Island)	$2,062	$152,498	970%
BrickStreet Mutual (West Virginia)[3]	$0	$394,634	898%
Accident Fund Co.[4]	$22,491	$689,923	856%
Amerisure[4]	$5,139	$191,519	710%
FCCI[4]	$0	$427,390	703%
IWIF (Maryland)	$2,037	$287,550	487%

Source: Office of the State Auditor analysis of each insurer's 2009 annual statements.
[1] The NAIC has developed a risk-based capital (RBC) formula that establishes a minimum regulatory surplus standard that does not necessarily indicate the full amount of surplus an insurer would want to hold to meet its safety and competitive objectives. The RBC Ratio indicates the percentage by which the insurer's surplus exceeds this minimum standard.
[2] Includes general dividends of about $123 million and Association dividends of about ($5.8 million). Policyholders may opt to participate in the Association Dividend program, which promotes safety efforts by policyholders. Policyholders receive Association dividends through premium credits. The negative Association dividend amount in 2009 reflects an over-accrual of Association dividends at the end of 2008 that was reversed in 2009.
[3] BrickStreet Mutual is a private, mutual insurance company that serves as West Virginia's insurer of last resort.
[4] These are private insurance companies offering other lines of insurance in addition to workers' compensation.

RCI concluded that Pinnacol's surplus is adequate to meet its obligations. As noted above, Pinnacol is a single-line, single state, workers' compensation insurer that is mandated to serve as the insurer of last resort. As such, Pinnacol's surplus is subject to more risk than other insurers because Pinnacol cannot spread its risk across multiple states or to another line of business. In addition, as the insurer of last resort, Pinnacol is required to insure high-risk employers that other workers' compensation insurers may not accept. Further, workers' compensation claims are often paid over a very long period, which increases the difficulty of estimating the total payouts on more complex claims and therefore the importance of having an adequate surplus.

Pinnacol's Surplus Policy

The Pinnacol Board developed a surplus policy in 2006 to help guide its management of Pinnacol's surplus. The policy states, "Based upon peer analysis, regulatory requirements, and risk adjusted modeling, the appropriate statutory surplus for Pinnacol is a range of $400 to $500 million . . . ." According to the policy, the appropriate surplus range will be reviewed annually and adjusted as needed. The policy generally refers to this range as a "surplus collar." The Board established the surplus collar based on consideration of a variety of factors, including the minimum surplus determined through the NAIC's risk-based capital formula, risks associated with terrorism and catastrophic losses, and current and anticipated future economic and political factors. The surplus policy identifies two primary methods of controlling the level of surplus: (1) payment of dividends to policyholders, and (2) reduction of premiums. The policy indicates that these methods are intended to be used over a time horizon of several years.

We reviewed Pinnacol's year-end surplus amounts, the general dividends Pinnacol paid from the year-end surplus amounts, and the surplus collar in place for 2007 through 2009. As the following table shows, Pinnacol has moved the surplus, after payment of general dividends, closer to the range established by the collar over these years.

Table 16
Pinnacol Year-End Surplus, General Dividends, and Surplus Collar
2007 through 2009 (in Millions)

	2007	**2008**	**2009**
Surplus as of December 31	$722	$698	$733
General Policyholder Dividends Paid Based on Surplus at the End of the Prior Year[1]	$54	$123	$47.5[2]
Surplus After General Dividends	**$668**	**$575**	**$685.5**
Surplus Collar	$400 - $500	$450 - $600	$450 - $600
Difference Between Surplus After General Dividends and Upper End of Surplus Collar	$168	($25)	$85.5

Source: Office of the State Auditor analysis of data from Pinnacol Assurance's audited financial statements and annual statements filed with the Division of Insurance for 2007 through 2009, and data provided by Pinnacol Assurance.

[1]General dividends are typically distributed in the spring, based on the surplus as of the end of the previous calendar year. The dividend amounts are shown in the year before they were paid. For example, Pinnacol distributed about $123 million in general dividends in the spring of 2009 based on the surplus as of December 31, 2008.

[2]Pinnacol announced general dividends of about $47.5 million to be paid in 2010.

As shown in Table 14, Pinnacol's year-end surplus grew about 55 percent between 2005 and 2009. In addition, as shown in Table 15, Pinnacol's RBC ratio is among the highest of the insurers Pinnacol uses to benchmark its own performance. Further, Pinnacol noted in its Management's Discussion and Analysis within its 2009 Basic Financial Statements that "the appropriate level of surplus for Pinnacol's risk profile is somewhat less than the surplus recorded at year end 2009." As such, establishing and following a policy to proactively manage the level of Pinnacol's surplus is important for the Board in carrying out its fiduciary responsibilities. The Board should continue to work with Pinnacol management to annually assess the surplus level and the appropriate amount of surplus.

Recommendation No. 9:

The Board of Directors should continue to work with Pinnacol Assurance management to apply the surplus policy, including annually evaluating the surplus collar, adjusting the collar as appropriate, and managing rates and dividends to bring the surplus to a level within the collar.

Pinnacol Board of Directors and Pinnacol Assurance Response:

Agree. Implementation date: Implemented and ongoing.

The Board and Pinnacol management will continue to apply the surplus policy, including evaluating and adjusting the surplus collar and managing rates and dividends on a multi-year timeframe, to bring the surplus to a level indicated by the collar.

Injured Workers' Claims Experience

Chapter 4

Pinnacol's stated mission is to "provide assured protection to Colorado employers and their greatest asset—their employees." This requires that Pinnacol ensure that injured workers receive prompt medical attention and necessary follow-up care. According to its policies, Pinnacol's employees are responsible for ensuring that all claims payments are "necessary and proper." Pinnacol specifically states, "We best serve as stewards when we reduce uncertainty by investigating and denying questionable claims, promptly paying compensable claims, and communicating information to our policyholders and workers about issues that affect their interests."

To meet these goals, Pinnacol has organized its staff around its fundamental function, administering the claims of injured workers. Most of Pinnacol's staff are assigned to work on one of two types of teams: business or corporate. Each business team handles the claims of the policyholders assigned to that team; policyholders are assigned to teams based on policy size and geographic location within the state. Each business team is composed of claims representatives, nurses, underwriters, and other staff as needed. The corporate teams provide support to the business teams. Each corporate team has specialized responsibilities, such as providing legal or medical advice on individual claims or processing provider billings. In 2009 Pinnacol processed about 48,000 claims for injuries that occurred that year and paid about $256 million for open claims.

As a workers' compensation insurer operating in Colorado, Pinnacol must follow the claims handling guidelines and procedures that are established in the Colorado Workers' Compensation Act (Act) [Section 8-40-401, et seq., C.R.S.] and the Workers' Compensation Rules of Procedure (Rules). The Rules are promulgated by the Division of Workers' Compensation (Division) in the Department of Labor and Employment. The Act was established to ensure "the quick and efficient delivery" of benefits to injured workers at a "reasonable cost to employers, without the necessity of any litigation" [Section 8-40-102(1), C.R.S.]. Statute charges the Division with enforcement and administration of the Act [Section 8-47-101(2), C.R.S.]. The Division conducts audits of the claims filed by each workers' compensation insurer approximately every two years, at the Division's discretion, and tests for compliance in categories the Division has determined are important to proper claims adjusting. These categories include: timely reporting of claims, timely and accurate compensation payments, timely medical benefit payment or denial of payment, and timely and properly supported termination of temporary disability benefits. Insurers who knowingly or repeatedly violate the Act are subject to fines as determined by the Division [Section 8-43-304(1.5), C.R.S.].

The Division also acts as a resource for injured workers and employers regarding their rights and the claims process. If an injured worker disagrees with the insurer or medical provider about his or her medical care, the injured worker can file a petition with the Division requesting either a change in physician or an independent medical examination by a provider selected by the Division. An injured worker can also file a petition with the Division to reopen a closed claim on the grounds of a mistake or change in condition. Additionally, in instances where an injured worker and the insurer or medical provider cannot reach an agreement, the Office of Administrative Courts within the Department of Personnel and Administration can hold a hearing to resolve the dispute.

Section 8-45-121(2), C.R.S., requires that this audit review the "injured worker's claims experience." To address this requirement, we reviewed Pinnacol's processes and controls for handling claims and tested a sample of claims for compliance with applicable statutes, rules, and policies. We contracted with Regulatory Consultants, Inc. (RCI), a national firm with 15 years of experience in providing insurance examination and consulting services, including extensive experience in workers' compensation. In addition, we reviewed Pinnacol's surveys of injured workers. The scope of our audit did not include a detailed review of Pinnacol's claims software system or Pinnacol's internal compliance and excellence reviews. This audit also did not evaluate the appropriateness of medical treatments or determinations of disability and medical improvement.

Our testing found that Pinnacol could further improve its handling of claims and expand its use of injured worker survey results. We discuss these issues in the following sections.

Claims Handling Process

Section 8-43-102(1)(a), C.R.S., requires employees who are injured at work to report the injury to their employer within four working days of the incident. The employer, in turn, is required to report the injury to its workers' compensation insurer as a claim against the employer's policy. Workers' compensation Rules require insurers, including Pinnacol, to report the following types of claims to the Division within 10 days of receiving notification of the claim:

- Claims that will be denied
- Claims for specified occupational diseases
- Claims involving fatalities

- Claims involving lost time from work of more than three shifts, or days (referred to as “indemnity claims”)

Insurers do not have to report claims to the Division if the claims do not fall within one of these categories. For example, an insurer does not have to report a claim for a minor injury that does not lead to time off work when the insurer does not deny that claim.

Like other workers’ compensation insurers, Pinnacol must determine whether a claim is compensable once it has been reported, regardless of claim type. Compensable claims are those for which Pinnacol admits liability and will pay against the employer’s insurance policy. In general, claims are compensable under the workers’ compensation system when an employee who is covered under a valid workers’ compensation insurance policy is injured at work while performing a job duty.

To determine compensability, Pinnacol categorizes claims into two types: those that will be assigned a claims representative for processing, and those that will be processed automatically. Pinnacol assigns to a claims representative all indemnity claims, more complex medical-only claims, and any claim that must be filed with the Division. The claims representative is responsible for processing the claim in accordance with the Colorado Workers’ Compensation Act (Act), the Workers’ Compensation Rules of Procedure (Rules), and Pinnacol’s claims handling manual. Claims representatives are responsible for claims assigned to them throughout the life of the claim. Pinnacol received about 48,000 new claims in 2009; of these, about 30,000 claims (63 percent) were processed by a claims representative.

Claims that are processed automatically are not assigned to a claims representative for processing and are generally medical-only (not indemnity) claims that are expected to be for relatively low amounts. Pinnacol’s claims software system is programmed with the claims handling requirements found in the Act and Rules. This system can process claims automatically if Pinnacol receives all required information at the time the claim is reported. In 2009 Pinnacol processed about 37 percent of the new claims it received automatically (about 18,000 of 48,000 claims).

Claims representatives are charged with making timely decisions about the compensability of each claim, coordinating with the injured worker’s medical service provider, monitoring treatment according to a treatment plan created by the provider, authorizing or denying medical services based on the treatment plan, and developing a closure plan for the claim based on the treatment plan. The closure plan is intended to “facilitate the creation of strategies to close claims as quickly as possible while being fiscally responsible and compliant with regulatory requirements." In addition, Pinnacol instructs claims representatives to consider settlement at various points during the life of a claim, such as each time they review a claim file and each time they consult with a manager, claims specialist, staff legal counsel, or outside legal counsel about the claim.

Generally, Pinnacol can close a claim for one of three reasons: the claim has been denied, the claim has been settled, or the injured worker has reached maximum medical improvement. Maximum medical improvement, determined by the injured worker's provider, defines the point at which the worker's condition cannot be improved any further or when treatment options have been exhausted and no major medical change can be expected in the worker's condition. Pinnacol's liability for a claim does not necessarily end when a claim is closed. For example, in the case of some severe injuries, injured workers' claims will be closed because workers have reached maximum medical improvement but they will continue to receive permanent total disability benefits for the rest of their lives.

Controls over Claims Handling

To ensure that Pinnacol appropriately manages claims and pays only those that are compensable, Pinnacol's claims handling manual states that claims representatives, in part, must:

- Conduct initial investigative work on the claim (e.g., determine if lost work time is related to the work injury).
- Determine if an investigation of the legitimacy of the claim is needed.
- Determine if factors exist that could reduce the amount to be paid on the claim (e.g., the employee willfully failed to use safety devices or follow the employer's safety rules).

Claims representatives are responsible for keeping all parties involved with the claim informed of the claim's status throughout the process. This responsibility includes providing injured workers and their employers with copies of all documents pertaining to the claim, informing injured workers about the providers from which they can receive care, and informing all parties about when the claim will be closed.

Additionally, claims representatives are responsible for monitoring the treatment decisions made by physicians, with the assistance of Pinnacol's medical staff. If a claims representative determines a medical provider is not providing appropriate treatment, the claims representative must formally dispute the treatment through the Division's established processes; Pinnacol cannot deny or restrict treatment without Division approval. The Act stipulates that all insurers, including Pinnacol, must provide medical treatment that is reasonably needed to cure or relieve the injured worker from the effects of the injury [Section 8-43-501(1), C.R.S.]. Additionally, statute states that an injured worker's physician must use the Medical Treatment Guidelines and Utilization Standards developed by the Division [Section 8-42-101(3)(b), C.R.S.].

According to Pinnacol personnel, the following additional systems and structures are in place to help ensure that claims are handled appropriately.

- **Training and team organization.** Pinnacol states that it provides all claims representatives with ongoing training and access to expert assistance, including both Pinnacol medical staff and outside medical specialists. Further, each claims representative is limited to handling only claims specifically assigned to him or her based on the representative's experience and knowledge. Pinnacol indicates that the team structure is also intended to help ensure claims are handled appropriately. For example, nurses on the team sit next to claims representatives, which keeps everyone aware of all of the details of each claim, including contacts with all involved parties. Additionally, managers are responsible for monitoring their teams' work through daily reports. For example, managers monitor whether claims representatives are using resources like the medical team as often as Pinnacol's policies require.

- **Reviews.** Pinnacol's policies state that Pinnacol conducts two types of internal reviews: (1) compliance reviews, designed to mirror the Division's biannual audit; and (2) excellence reviews, designed to "capture everything else" that the Division does not monitor, including, in part, the appropriateness of medical decisions, treatment, and reserve amounts (estimated total cost of the claim). Each quarter, a team of Pinnacol specialists conducts both types of reviews for a sample of approved and denied claims to determine whether claims are being handled appropriately and in compliance with statutes, Rules, and Pinnacol's policies. The team includes claims specialists who review claims determinations and nursing specialists who review the medical recommendations of all medical staff. Pinnacol has established policies and procedures for the specialists to follow for both types of reviews to ensure that the review processes are standardized. Both types of reviews are conducted quarterly, and Pinnacol uses a method of random sampling to ensure recently filed claims from each claims representative's caseload are chosen for review. The results of the reviews are used to guide staff individually and to provide training that will address deficient practices. In 2008 Pinnacol claims representatives were responsible for processing about 35,000 of the nearly 56,000 claims filed with Pinnacol that year.

Pinnacol conducted 1,490 compliance reviews and 1,172 excellence reviews in 2008, examining about 7.6 percent of the claims the representatives were responsible for that year.

- **Automated claims system.** In addition to processing claims that are not processed manually by a claims representative, Pinnacol's automated system guides claims representatives to the appropriate, standardized compensability determination for assigned claims. The system contains a variety of edits that control how a claim is processed. For example, the automated system will allow claims representatives to send claims to the Division only if the electronic claims file includes the required closure plan and reserve amount. The system also prompts claims representatives to enter any missing data and automatically determines an admission or denial of liability, based on the data entered by the claims representative.

Claims Testing

Between January 1, 2007, and August 31, 2009, there were about 147,200 claims reported to Pinnacol. Pinnacol's actions with respect to these claims are detailed in the table below.

Table 17
Claims with a Date of Injury Between
January 1, 2007 and August 31, 2009

Type of Claim	Number of Claims
Division[1] Notification Required	
Admitted	21,361
Denied	6,812
Settled (Mutual Agreement)	4,624
Settled (Court Order)	223
Sub-Total Division Notification Required	**33,020**
Division Notification Not Required	**114,141**
Total	**147,161**

Source: RCI analysis of data provided by Pinnacol Assurance.
[1]Division of Workers' Compensation.

As the table shows, for the time period analyzed by RCI, the majority of Pinnacol's claims were not required to be reported to the Division (114,141 of the 147,161 total claims, or about 78 percent).

RCI tested a sample of 60 closed claims to assess Pinnacol's compliance with statutes and Rules regarding the timeliness of filing with the Division, the timeliness of notifying the injured worker of the status of his or her claim, and the sufficiency of supporting documentation for the admission or denial of the claim.

The sample was selected to include claims that Pinnacol had accepted, denied, settled with an attorney, and settled without an attorney. The contractor found violations in five claims (about 8 percent), as follows:

- For 4 of the 60 claims, Pinnacol did not notify the Division within 10 days of receiving notice of the claim, which was a violation of workers' compensation Rules. Pinnacol notified the Division between 12 and 23 days after receiving notification of the claim.

- For one claim, Pinnacol did not file the statement of liability or contest within 20 days of first notifying the Division of the injury, which was a violation of workers' compensation Rules. Pinnacol filed the statement of liability or contest 106 days after first notifying the Division of the injury.

As mentioned earlier, the Division conducts audits of all Colorado workers' compensation insurers approximately every two years to determine if claims are being managed in accordance with statutes and Rules. We reviewed the results of the Division's most recently completed audit which tested a sample of 440 Pinnacol claims with injury dates between June 2008 and May 2009. The Division found that Pinnacol's compliance ranged from 91 percent to 100 percent across the nine categories tested. The Division considers a compliance rate of 90 percent or more on each individual compliance category to be acceptable.

Similar to issues discussed in Chapter 3 regarding rate setting and rate filings, the 5 errors RCI found in its testing of 60 claims reveals an opportunity for Pinnacol to strengthen its controls. Pinnacol should continue its efforts to improve claims handling to ensure compliance with requirements and to better serve policyholders and injured workers.

Recommendation No. 10:

Pinnacol Assurance should continue its training and other efforts to ensure that staff are handling claims appropriately and to reduce errors and violations in processing claims.

Pinnacol Assurance Response:

Agree. Implementation date: Implemented and ongoing.

Pinnacol agrees with Recommendation No. 10 and remains committed to continuing training and other efforts to handle claims appropriately. The compliance results from the Division of Workers' Compensation Claims audits clearly demonstrate that Pinnacol's results improved in each category from 2007 to 2009.

Injured Worker Surveys

Another method Pinnacol uses to evaluate claims handling is to seek feedback from injured workers through an annual survey. Pinnacol's survey consultant created the survey tool Pinnacol uses to collect information from injured workers regarding their satisfaction with claims handling. In most years, Pinnacol distributes the survey to injured workers by mail. However, in 2009 Pinnacol hired a survey administration company to conduct the survey by phone. The survey administration company administered the survey to a random sample of 600 injured workers with indemnity claims for injuries that occurred between July 2008 and June 2009. The survey industry generally considers phone surveys to produce the most accurate results. However, the administration of phone surveys can be cost-prohibitive. As such, Pinnacol follows best practices in conducting phone surveys every few years to verify the accuracy of, and establish benchmarks for, the mail surveys conducted in other years. In years in which Pinnacol conducts a mail survey, it sends the survey to most injured workers with indemnity claims.

The survey tool designed by Pinnacol's consultant includes questions such as whether Pinnacol staff and the medical provider(s) explained the benefits the injured worker was receiving, answered all the injured worker's questions, and generally treated the injured worker with respect and courtesy. Injured workers are asked to rate their satisfaction in each area on a scale from 1 (not at all satisfied, or poor service) to 10 (very satisfied, or excellent service). Based on these ratings, a numerical score is calculated that reflects the ratings provided by all respondents for the year. Pinnacol administered the injured worker survey each year between 2001 and 2009, except 2008. In 2008 Pinnacol had intended to administer the survey online but realized that many injured workers had not provided email addresses to Pinnacol. According to Pinnacol staff, this realization occurred too late to administer a survey that year. The table below shows the average overall injured worker survey ratings between 2005 and 2009.

Table 18
Injured Workers' Overall Satisfaction Ratings
Survey[1] Results for 2005 through 2009

Year	2005	2006	2007	2008	2009
Rating	7.1	8.1	8.1	N/A[2]	7.8

Source: Data provided by Pinnacol Assurance.
[1]Pinnacol sent mail surveys to most injured workers with indemnity claims in 2005, 2006, and 2007. In 2009, Pinnacol contacted a random sample of 600 injured workers with indemnity claims for a phone survey.
[2]Pinnacol did not conduct a survey in 2008.

Pinnacol reported that it uses the injured worker survey results to improve operations. For example, in 2007 Pinnacol changed correspondence provided to injured workers that describes injured workers' benefits, rights, and the claims process. Pinnacol reported that this change was based on results from the survey that indicated injured workers were dissatisfied with their understanding of their benefits and rights and some aspects of the claims process.

As stated above, Pinnacol's mission is to "provide assured protection to Colorado employers and their greatest asset—their employees." Based on this mission statement, Pinnacol should consider incorporating the injured worker survey results into the Executive Performance Plan and gainsharing bonus programs, which are discussed in Chapter 2. Currently, the only measure of satisfaction incorporated into either of Pinnacol's bonus programs is that of its policyholders. By setting targets and adding the results of the injured worker survey as a performance measure for both bonus programs, Pinnacol will strengthen the alignment of its bonus programs to its mission statement and ensure its employees have incentives to focus on the needs of both policyholders and injured workers.

Recommendation No. 11:

Pinnacol Assurance should consider expanding the use of the injured worker surveys by setting targets and including the results as a component of the Executive Performance Plan and gainsharing programs.

Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

The Board and Pinnacol agree to evaluate the injured worker survey process and internal uses. Neither the Board nor Pinnacol can commit to include survey results in the Executive Performance Plan and gainsharing metrics until an analysis is completed. In addition, Senate Bill 10-13 and

Division of Workers' Compensation Rules of Procedure Rule 5, 5-14 regarding surveys will impact the survey process. At the time of the response, Senate Bill 13 has not been signed into law and Rule 5-14 is only proposed. Pinnacol will study the issue.

Travel and Entertainment

Chapter 5

Statute states that Pinnacol shall operate as a domestic mutual insurer except as otherwise provided by law [Section 8-45-101(1), C.R.S.]. As such, Pinnacol has a responsibility to its policyholders to ensure effective stewardship and accountability for the premiums they pay to Pinnacol. According to its 2007 business plan, Pinnacol attributes its success in capturing and maintaining the majority of Colorado's workers' compensation insurance market to "a commitment to excellence." In pursuit of this commitment, Pinnacol requires all of its employees to uphold its core values, including accountability and integrity. In its mission statement, Pinnacol states that it holds itself to the highest standards of performance in a variety of areas, including financial results, operational efficiency, and workplace practices. To meet these standards, Pinnacol further requires each employee to serve as a "good steward" of Pinnacol's resources.

Effective internal controls are critical to creating and maintaining an environment of accountability and good stewardship. Internal controls serve to maximize efficiency; minimize waste, errors, and fraud; and ensure that management's objectives are met. According to Generally Accepted Government Auditing Standards, government entities are responsible for establishing internal controls that provide reasonable assurance over the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control systems should include: an environment within the organization that reinforces and encourages compliance with standards, policies, and other requirements; policies and procedures that ensure management directives are carried out; and regular monitoring of all components in the control system.

We examined Pinnacol's policies and related controls over travel and entertainment expenses, as well as third-party payments made on behalf of Pinnacol personnel and Board members. We identified weaknesses in Pinnacol's policies and controls that prevent Pinnacol from ensuring that policies are followed, policyholder dollars are properly managed, and conflicts of interest are avoided. First, we reviewed Pinnacol's travel and entertainment expense policies and a sample of expenses. We found that Pinnacol failed to enforce its own travel and entertainment expense policies for 75 percent of the sample we tested. We also found Pinnacol has not placed meaningful limits on lodging and non-business meal expenses. Second, we reviewed gifts and expenses paid for by Pinnacol's business partners on behalf of Pinnacol staff and Board members. We found

Pinnacol's policies do not require staff or Board members to track or report gifts or expenses paid for on their behalf by business partners. Procedures are not in place to ensure travel and entertainment expense policies are carried out or to monitor compliance with these policies on a regular basis. This chapter discusses the concerns we identified with Pinnacol's controls in these areas.

Oversight of Travel and Entertainment Expenses

For some Pinnacol employees and Board members, traveling and entertaining business partners, such as agents who sell Pinnacol policies, are routine responsibilities. Statute requires the Board to establish general policies and procedures for the operation and administration of Pinnacol and to control and administer all moneys in accordance with Pinnacol's purpose [Section 8-45-101, C.R.S.]. In 2009 Pinnacol paid about $1.5 million for travel and entertainment expenses through reimbursements to employees and Board members and through company credit cards issued to individual staff. To control these expenses, Pinnacol has policies to address the types of allowable expenses that will be reimbursed to employees and Board members or that can be charged to Pinnacol credit cards as business expenses. The stated purpose of these policies is to ensure that expenses are reasonable and consistent. Additionally, Pinnacol requires employees and Board members to submit travel and entertainment expenses using an electronic, standardized expense report to a manager for review and approval. Pinnacol's policies require managers to review each expense on the report for accuracy and general policy compliance.

In addition to reviewing Pinnacol's policies and procedures for travel and entertainment expenses, we tested a sample of 60 expenses incurred by 25 executive and non-executive staff and 8 Board members between June and November 2009. We tested expenses in five categories: lodging, airfare, business meals (meals for Pinnacol staff or Board members that involved a business discussion), non-business meals (personal meals for Pinnacol staff or Board members while traveling for business that did not involve a business discussion), and entertainment (meals or other activities that include Pinnacol staff and/or Board members and Pinnacol business partners that included a business discussion). Our sample of expenses totaled about $16,300, or about 3 percent of the total $498,800 incurred by employees and Board members in these categories during the six-month period we reviewed. We found exceptions in 45 of the 60 expenses tested (75 percent); 28 of the expenses contained multiple exceptions. The expenses with exceptions totaled about $15,600, or about 96 percent of the $16,300 tested. The exceptions are described below.

Unallowable expenses. Of the 60 expenses we reviewed, four violated Pinnacol's policies on allowable expenses. Three of the four violated Pinnacol's policy that prohibits payment for alcohol purchases unless a business partner is being entertained. These three alcohol purchases, totaling $303, lacked documentation to demonstrate they were incurred when a business partner was present. The fourth expense violated Pinnacol's policy prohibiting reimbursement of ". . . snacks, or other meals outside of breakfast, lunch, or dinner." This expense involved reimbursement of $291 for two non-business meal expenses incurred by a group of Pinnacol employees in one evening, about one and a half hours apart. Reimbursing both meal expenses appears to violate the policy, which prohibits reimbursement of a snack or other meal in addition to dinner. Additionally, the employee did not submit itemized receipts for either meal expense.

No proof of payment. Pinnacol's policies require a credit card receipt or other proof of payment for lodging and meal expenses over $50. Of the 11 lodging expenses in our sample, three over $50 did not have proof of payment. These expenses totaled $3,370 of the $9,194 in lodging expenses we tested. In addition, of the 28 meal expenses in our sample, three totaling $262 did not include a credit card receipt or other proof of payment. It is critical to have credit card receipts or other proof of payment to demonstrate that expenses have been paid by the person requesting reimbursement. This helps to ensure that Pinnacol is only reimbursing staff and Board members for actual business expenses incurred.

Missing evidence of prior approval or expense justification. Pinnacol's policies require employees and Board members to obtain prior approval from the CEO for any out-of-state travel. Of the 11 lodging expenses we reviewed, six totaling about $6,200 were for out-of-state travel. None of these six expenses were supported by evidence of prior approval from the CEO. Pinnacol's policies further require prior approval from a manager and written justification for lodging expenses that are "greater than the normal prevailing rate in the area." Pinnacol's policies suggest that employees use federal guidelines to determine prevailing rates for lodging expenses. Of the 11 lodging expenses reviewed, nine totaling about $8,300 were paid at higher than the prevailing rates but did not include evidence of prior approval or justification. For example, one expense for lodging in Colorado Springs exceeded $500 per night; the prevailing rate for this area was $88 per night. Finally, Pinnacol's policies do not allow spouses of Pinnacol staff or Board members to incur travel expenses without a documented "bona fide business purpose" and evidence of prior approval. Our sample included three non-business expenses for Board members totaling $435 that included the Board members' spouses. Pinnacol reimbursed these expenses without evidence of a business purpose or prior approval.

No itemized receipts. Pinnacol's policies require itemized receipts, detailing the cost of each item included in the expense, for all travel and entertainment expenses over $50. Of the 60 expenses in our sample, 43 were for amounts over $50 and therefore should have had itemized receipts. We found that 19 of these expenses (44 percent) did not have itemized receipts. The expenses lacking itemized receipts included one non-business, out-of-state meal costing $117 for a Board member and one three-night lodging expense for a Pinnacol employee costing $1,500. Without itemized receipts, Pinnacol cannot confirm whether expenses are allowable under its policies.

No attendee and business topic information. Pinnacol's policies require documentation of (1) the names and titles of all attendees and (2) the business topic discussed during business meals or while entertaining business partners. In our sample of 60 expenses, 32 should have included the names and titles of all attendees and the business topic discussed. However, we found that 29 of the 32 expenses (91 percent), totaling about $3,130, were missing at least one of the two required pieces of information. Nineteen of the 32 expenses (59 percent) did not have adequate information to identify all attendees. Although the expense documentation included some attendee information, such as the first or last names of attendees, none of the 19 included full names and company information, as required by policy. Ten of the 32 expenses (31 percent) did not have the business discussion information. Finally, seven (22 percent) lacked adequate documentation of both the attendees and the business topic. Without adequate information about who was in attendance and what was discussed, Pinnacol lacks assurance that these expenses were for appropriate business activities.

Erroneous coding. Pinnacol's policies require employees and Board members to use Pinnacol's standardized financial codes when reporting all travel and entertainment expenses. We found six expenses totaling about $220 in our sample of 60 that were miscoded, and two additional expenses totaling about $2,400 that were not broken out into all the appropriate financial categories. For example, some meal expenses were coded as lodging, and some non-business meals were coded as entertainment expenses. As a result, Pinnacol is not accurately tracking and accounting for travel and entertainment expenses.

Pinnacol's policy specifically requires managerial review and approval for all travel and entertainment expenses. Although we confirmed that all of the expenses in our sample had been reviewed and approved prior to payment, the high rate of policy violations we found indicates that managerial review has not served as an effective control. Rather, the routine reimbursement of expenses that violate Pinnacol's travel and entertainment expense policies renders these policies virtually meaningless as controls over employee and Board member spending. In response to our expense testing results, Pinnacol's management stated that its managers have ultimate authority for determining which expenses are acceptable.

In addition to the absence of any meaningful review of travel and entertainment expenses, we also found that Pinnacol's process does not ensure an independent review because, in some instances, a subordinate is reviewing and approving expenses incurred by an individual who is higher in the organization. Specifically, we found that Pinnacol's practice is for the CEO to review and approve Board member expenses, even though the Board is responsible for hiring, overseeing, and determining compensation for the CEO. In addition, a Pinnacol vice president reviews and approves the CEO's expenses. To strengthen controls over Board member and CEO expenses, Pinnacol should establish policies to require the Board or a designated Board member to review the expenses of the CEO and require the Board chair to review the expenses of Board members.

In 2007, Pinnacol's internal auditor reviewed Pinnacol's expense policies and tested a sample of expenses. The internal auditor found many of the same policy violations identified in our audit and recommended that Pinnacol enforce its policies. Our review shows that Pinnacol still lacks fundamental controls over travel and entertainment expenses. Further, the practice of allowing individual managers to subjectively determine appropriate spending and authorizing subordinates to review and approve the expenses of higher level staff or Board members significantly reduces the value of both the policies and the review process.

In our opinion, the fact that 75 percent of the sample we tested contained violations of the travel and entertainment expense policies borders on abuse under Government Auditing Standards. Abuse is defined as behavior that is deficient or improper when compared with behavior that a prudent person would consider a reasonable and necessary business practice given the facts and circumstances. Pinnacol is responsible for establishing a sound system of internal controls over travel and entertainment expenses that eliminates subjectivity, holds all employees accountable to the same standards, and encourages good stewardship of policyholder funds. Pinnacol should adhere to its policies, require adequate documentation and expense justifications, and prohibit unallowable expenses. Pinnacol should also establish a meaningful review process that ensures policies are followed. To further encourage good stewardship of policyholder funds, Pinnacol should prevent conflicts of interest by establishing a policy requiring that all expenses for Board members and top management be reviewed and approved by an individual at a higher or at least equal level in the organization.

Recommendation No. 12:

Pinnacol Assurance and the Board of Directors should adhere to established policies over employee and Board travel and entertainment expenses and improve policies where necessary by:

a. Establishing a meaningful review process that enforces all policy requirements such as those for proper receipts, documentation, prior approval and justification, and allowable expense provisions. Managers that do not uphold policies should be subject to disciplinary action.

b. Establishing and implementing a policy that requires an independent review of Board member and CEO travel and entertainment expenses, such as by requiring the Board or a designated Board member to review for approval the expenses of the CEO and requiring the Board Chair to review for approval the expenses of Board members.

Pinnacol Board of Directors and Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

a. Pinnacol will review and revise the travel and entertainment expense policy to make sure that it accurately reflects all of the requirements for reimbursement. After the revised policy is issued and communicated to employees, all managers will be responsible for fully enforcing the policy.

b. The Board will evaluate a policy designating the Board member(s) responsible for reviewing the expenses of the CEO and of Board members.

Spending Guidelines

In addition to the pervasive weaknesses in oversight of travel and entertainment spending, we found that Pinnacol has not established firm limits or adequate guidance regarding the reasonableness of expenses for lodging and non-business meals.

First, Pinnacol's policies state that lodging expenses should be "moderate"; if these expenses are "greater than the normal prevailing rate in the area," then the traveler must obtain prior approval for them and justify the higher lodging cost in the expense report. Pinnacol's policies recommend, but do not require, that employees use federal guidelines to assist in determining "moderate" lodging costs. The federal guidelines establish maximum daily allowances for federal employees' travel. These allowances vary depending on the cost of living in the destination city.

Second, Pinnacol's policies state that non-business meal expenses while traveling for business are to be "reasonable." Specifically, the policies note that employees should try not to exceed $10 for breakfast or lunch and $16 for dinner on non-business meals. The policies also say that Pinnacol will take into consideration the cost of living in different geographic areas and again note the federal guidelines, which give daily rather than per-meal rates, as a reference.

Although Pinnacol references the federal guidelines in its policy, in practice Pinnacol does not require employees and Board members to follow the guidelines. As noted above, Pinnacol states that the managers reviewing and approving travel expenses are responsible for determining what is "moderate" or "reasonable." While reviewing expenses incurred by staff and Board members between June and November 2009, we identified a number of lodging and non-business meal expenses that appeared to be excessive and could have been reduced if Pinnacol established and followed clear spending guidelines and "not to exceed" limits. Specifically, we found:

- In nine of the eleven lodging expenses in our sample, the nightly rate was higher than the rate listed in the federal guidelines by between $37 and $421 per night. The nine expenses totaled about $8,300. For one in-state expense, hotel charges exceeded $500 per night, compared to the $88 per night rate that federal guidelines cited for the area. For one out-of-state lodging expense, hotel charges exceeded $350 per night, while $121 was the listed federal guideline for the area.

- In six of the ten non-business meal expenses in our sample, the meal charges were higher than Pinnacol's individual meal guidelines by about $6 to $44 per person, per meal. These six non-business meal expenses, totaling about $740, exceeded Pinnacol's guidelines of $10 for breakfast or lunch and $16 for dinner by a total of almost $500.

By not placing meaningful limits on lodging and non-business meal expenses, Pinnacol fails to communicate to employees the importance of limiting their expenses. As we noted in the previous section, in no instance was the higher charge justified or explained in expense reports. Pinnacol spent about $352,000 on lodging and $33,000 on non-business meal expenses in 2009. Pinnacol could realize cost savings by enforcing reasonable spending guidelines and implementing clear "not to exceed" limits for expenses.

Pinnacol reports that it plans to remove all references to the federal guidelines from the written expense policies, as no guidelines or limits are used in practice. Rather than removing the guidelines from expense policies, Pinnacol should strengthen its controls over lodging and meal expenses by using the federal guidelines in daily practice or establishing other clear guidelines as it deems appropriate. The federal guidelines are a good model because they are determined after extensive review of average hotel and restaurant prices throughout the year for individual cities. If Pinnacol implements a limit that falls within the federal allowances, it may be able to substantially reduce its travel costs.

Recommendation No. 13:

Pinnacol Assurance should strengthen its controls over lodging and non-business meal expenses by establishing clear "not to exceed" spending guidelines on these expenses in its expense policies and requiring employees and Board members to follow the guidelines.

Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

As part of the travel and expense policy review mentioned in the response to Recommendation No. 12, Pinnacol will evaluate enhancing the guidelines on lodging and meal spending. Any decisions made will be incorporated into the revised policy.

Expenses Paid by Third Parties

To conduct its business, Pinnacol must interact with a variety of business partners. On occasion, these interactions involve Pinnacol's business partners paying for travel or entertainment for Pinnacol staff and Board members. While Pinnacol does not directly pay for gifts received from and expenses paid by its business partners, Pinnacol's business partners likely build these costs into the fees they charge to Pinnacol. As such, it is critical for Pinnacol to have internal controls that ensure inappropriate expenses or gifts are not accepted, transparency is maintained, and conflicts of interest do not arise, either in appearance or in fact.

The Pinnacol Board and Pinnacol management have each adopted a "Business Ethics and Conflict of Interest" policy. These polices respectively govern the Board and Pinnacol staff and address, to some extent, the acceptance of gifts. The Board policy states, in part, "Conflicts of interest may . . . arise when a [B]oard member, or members of his or her family, receives improper personal benefits as a result of his or her position as a member of the [B]oard." The policy requires any Board member who is aware of real or apparent conflicts of interest to immediately report them to the Board Governance and Ethics Committee. This committee is responsible for determining whether a conflict of interest may exist and disclosing this information to the Board for action, as necessary. The policy does not provide any detailed guidance regarding what would be considered "improper personal benefits" that need to be disclosed.

The Business Ethics and Conflict of Interest policy applicable to officers and employees of Pinnacol states:

> No employee or officer shall knowingly become involved in a conflict of interest without proper reporting and authorization . . . . Such conflict of interest shall include, but is not limited to acceptance, directly or indirectly, of payments, [or] services . . . from a supplier, contractor, subcontractor, customer, or other entity with whom Pinnacol does business. The foregoing shall be deemed to include gifts, trips, entertainment, or other favors of more than nominal value . . . ."

This policy requires that "[a]ny employee who is aware of facts which might involve the slightest possibility or appearance of a conflict of interest shall immediately report, in writing, such details to his or her team leader."

We reviewed these policies and information from Pinnacol executives, Board members, and a sample of 15 of Pinnacol's business partners regarding hospitality, gift, and entertainment expenses paid on behalf of Pinnacol between January 1, 2008, and September 30, 2009. According to the information reported to us, all of Pinnacol's executives and about half the Board members received some amount of business travel, meals, and/or entertainment paid for by a business partner during this period. Some of these expenses were for sizeable amounts. For example, one of Pinnacol's business partners paid for two executives to attend conferences in 2008 and 2009 at Pebble Beach, California, and Tucker's Point, Bermuda, respectively. The business partner estimated that each trip cost about $3,000 per person.

In addition, although most of the expenses reported to us by Pinnacol's executives, Board members, and business partners did not include a dollar value, based on our research we estimate that the costs for some of the entertainment expenses in our sample, such as a round of golf on a course in Colorado Springs and indoor skydiving experiences, could range from about $30 to $230 per person. However, neither we nor Pinnacol can certify that all expenses accepted during the period we reviewed were reported because Pinnacol does not require executives or Board members to track expenses that are made on their behalf by business partners. Without a tracking requirement, the executives and Board members generally had to rely on their personal notes and memories to determine what they had accepted.

Our review of Pinnacol's Business Ethics and Conflict of Interest policies and the information regarding gifts identified two concerns. First, the Board's policy does not define the types or dollar value of gifts or benefit that must be disclosed to the Board Governance and Ethics Committee.

Second, the employee policy does not define the amount of any gift that would be considered to be of more than "nominal value." Without a definition of this term, employees must judge for themselves whether a gift or an expense paid for by a business partner may be accepted without disclosure. Because neither the Board nor the employee policy clearly defines the gifts or benefits that must be disclosed, Pinnacol cannot ensure expenses incurred by business partners, such as those we reviewed, are appropriate and do not create a real or apparent conflict of interest.

We identified two sources that could provide guidance to Pinnacol and its Board in strengthening the policies regarding the disclosure of gifts. First, the Public Employees' Retirement Association (PERA) is, like Pinnacol, a political subdivision of the State. PERA has clear guidelines regarding the disclosure of gifts and has defined the value that must be reported. Specifically, PERA requires that its employees and Board members annually disclose non-consumable gifts valued at more than $100 that other employees or Board members did not receive, and entertainment, meals, tickets, or recreational or cultural activities reasonably valued at $100 or more.

Second, in August 2001 the Council of the International Federation of Accountants (Council) issued a study that made recommendations and provided guidance to help public governing bodies develop practices to ensure they operate effectively, efficiently, and transparently. The study reviewed information on governance practices in the public sector to try to identify best practices. In the study, the Council recommended that organizations serving the public interest should define the types of "normal and reasonable" hospitality, gifts, or entertainment their employees and Board members may accept and require that employees and Board members keep a full record of such items accepted above a defined minimum limit.

Pinnacol could use PERA's policies and the recommendations of the Council as guidelines for clarifying the disclosure requirements of its own policies. Pinnacol and the Board should define the dollar value of any gifts or benefits accepted by employees or Board members that must be disclosed to help ensure transparency and prevent the occurrence and appearance of conflicts of interest.

Recommendation No. 14:

Pinnacol Assurance and the Board of Directors should strengthen employee and Board Business Ethics and Conflict of Interest policies by defining the type and dollar value of gifts, benefits, or expenses paid by Pinnacol's business partners, that employees and Board members must disclose.

Pinnacol Board of Directors and Pinnacol Assurance Response:

Agree. Implementation date: December 31, 2010.

Pinnacol and the Board will research possible policy enhancements and implement changes.

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Appendix

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Appendix A

W-2 Earnings and Employer Contributions for the CEO of Pinnacol Assurance from 2007 through 2009

The following table shows W-2 earnings and employer contributions paid by Pinnacol to, or on behalf of, its CEO from 2007 through 2009, broken down by W-2 earnings, retirement, and insurance.

W-2 Earnings and Employer Contributions Pinnacol Assurance CEO 2007 through 2009			
	2007	**2008**	**2009**
W-2 Earnings			
Base Salary	$268,750	$297,500	$311,000
Executive Performance Plan (EPP) Bonus	$114,750	$131,545	$157,500
Discretionary Bonus	$0	$0	$10,000
Car Allowance	$7,200	$9,400	$9,600
Health Club Allowance	$0	$1,079	$1,033
Taxable Moving	$24,049	$0	$0
Employment contract provision to assist with out-of-state dependent medical coverage not covered in Pinnacol health plan	$0	$9,289	$9,013
Gift Reporting	$0	$0	$2,240
Total W-2 Earnings	*$414,749*	*$448,813*	*$500,386*
Retirement (Employer Contributions)			
PERA	$25,277	$27,715	$31,728
401(K)	$3,375	$10,250	$10,905
Medicare	$5,981	$6,561	$7,210
Total Retirement Contributions	*$34,633*	*$44,526*	*$49,843*
Insurance (Employer Contributions)			
Health and Dental	$8,936	$11,130	$12,419
Life and Disability	$811	$811	$811
Total Insurance Contributions	*$9,747*	*$11,941*	*$13,230*
Total W-2 Earnings and Employer Contributions	**$459,129**	**$505,280**	**$563,459**
Source: Data provided by Pinnacol Assurance.			

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