Pinnacol Assurance

Statutory Financial Statements as of and for the Years Ended December 31, 2010 and 2009, Supplemental Schedules of Investment Information as of and for the Year Ended December 31, 2010, Comments on Internal Controls and Procedures, and Independent Auditors' Report

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July 28, 2011

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

We have completed the financial audit of Pinnacol Assurance (Pinnacol) for the year ended December 31, 2010. Our audit was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S., which authorizes an annual audit of Pinnacol made by an auditor or firm of auditors, with the specialized knowledge and experience. The reports that we have issued as a result of this engagement are set forth in the table of contents, which follows.

Deloitte + Touche LLP

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PINNACOL ASSURANCE

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PINNACOL ASSURANCE

REPORT SUMMARY

Authority and Purpose/Scope of the Audit

This audit is conducted under the authority of Section 8-45-121(2) of the Colorado Revised Statutes (C.R.S.), which authorizes an annual audit of Pinnacol made by an auditor or firm of auditors, having the specialized knowledge and experience, retained by the State Auditor. The primary purpose of our engagement is to audit the statutory financial statements of Pinnacol as of December 31, 2010, and for the year then ended, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and to express an opinion on those financial statements and the supplemental schedules of investment information. The objective of an audit conducted in accordance with such standards is to obtain reasonable, but not absolute, assurance about whether the statutory financial statements are free of material misstatement.

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

In the course of our audit, we examine, on a test basis, evidence supporting the amounts and disclosures in Pinnacol's statutory financial statements as of December 31, 2010.

Required Communications to the Legislative Audit Committee

In accordance with auditing standards generally accepted in the United States of America (AU Section 380), and the Statement of Auditing Standards (SAS) No. 114, *The Auditor's Communication with those charged with Governance*, as amended, we must communicate to the Legislative Audit Committee certain matters noted during our audit. The following sets forth these required communications:

Auditor's Responsibility under Professional Standards — The objective of a financial statement audit conducted in accordance with generally accepted auditing standards (GAAS) and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States (GAGAS) is to express an opinion on the fairness of the presentation of the Company's financial statements for the year ended December 31, 2010, in conformity with accounting principles prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado. The audit of the financial statements does not relieve management of its responsibilities.

We considered the Company's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we will not express an opinion on the effectiveness of the Company's internal control over financial reporting. Our consideration of internal control over financial reporting is not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses.

1. **Management Judgments and Accounting Estimates —** Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are ordinarily based on knowledge and experience about past and current events and on assumptions about future events. Critical accounting estimates reflected in the Company's 2010 financial statements include the following:

   Bonds and Common Stocks — Pinnacol must consider the statutory requirements related to other-than-temporary impairments when determining whether any declines in value are recognized through realized losses in the statutory statement of operations or through change in unrealized losses, which is a direct charge to statutory surplus. These statutory requirements for other-than-temporary impairments ("OTTI") require management's judgment and consideration of various characteristics of the investments, the underlying causes of the decline in value, as well as management's intent related to future sales of the securities. The Company recorded $252,000 in other-than-temporary impairments on bonds and $231,000 in other-than-temporary impairments on common stocks and mutual funds for the year ended December 31, 2010.

   Reserve for Unpaid Losses and Loss Adjustment Expenses — Estimating the reserve for unpaid losses and loss adjustment expenses (reserves) of an insurance company is a subjective and judgmental process, particularly for workers' compensation insurance, where the ultimate liability to a claimant may not be known with certainty for a number of years. To assist management in estimating the liability for unpaid losses and loss adjustment expenses, Pinnacol retains the assistance of an actuarial consulting firm. At December 31, 2010, Pinnacol has accrued $1,181,855,000 for unpaid losses and loss adjustment expenses as management's best estimate, which management believes to be a reasonable estimate of future amounts to be paid for claims incurred in 2010 and prior. Pinnacol discounts unpaid losses for certain long-term scheduled workers' compensation payments and discounts internal structured settlement liabilities on a tabular basis using a discount rate of 2.5% in 2010. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield.

   Premium Deficiency Reserve — A premium deficiency reserve is recognized by recording an additional liability for the deficiency which results when anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve. The change in this reserve is recorded as a component of underwriting deductions.

   As of December 31, 2010, Pinnacol evaluated the need for a premium deficiency reserve and recorded a liability of $35,344,000 as a result of rate reductions and driven by a competitive market and the downturn in the economy. This evaluation was completed on January 25, 2011. Pinnacol considered anticipated investment income at 3.5% when evaluating the premium deficiency reserve for 2010.

   Other accounting estimates are as follows:

   Uncollected Premiums — The amount of uncollected premiums, which affects the amount of premium revenue recognized, is estimated using statutory requirements, as well as certain management judgments. Management must determine whether an allowance should be established to provide for all reasonably anticipated uncollectible amounts inherent in the uncollected premiums balance. Factors that are considered in establishing reserves for anticipated uncollectible amounts are collection experience and trends, current overall aging of balances, economic conditions and trends, and evaluations of individual accounts. At December 31, 2010, the admitted value of uncollected premiums as reflected in Pinnacol's financial statements is $26,618,000.

Credit balances due policyholders — Pinnacol estimates audit premium adjustments based on prior experience. This prior experience provides actual collection activity, which is then used in establishing estimated premium revenue in the current period related to audit adjustments, subject to current influences such as inflation and other factors. Based on this analysis, Pinnacol recorded an estimated unbilled audit premium liability of approximately $10,000,000 in 2010. The establishment of the liability was due to the downturn in the economy and increased unemployment since 2009 which has resulted in premium refunds. In 2009, Pinnacol did not record any estimated unbilled audit premium liability as a result of this downturn in the economy.

Association Dividends Payable to Policyholders — Pinnacol has an association dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. Based on the payment pattern for these dividends, management must estimate the future loss ratio for the policyholders in order to determine the accrual recorded at December 31, 2010. For 2010, association dividends payable of $4,000,000 are included in dividends payable to policyholders.

Changes in accounting estimates — During the year ended December 31, 2010, there were no significant changes in accounting estimates or in management's judgments relating to such estimates, except for the following:

Change in Discount Rate of Liabilities for Unpaid Losses - Pinnacol discounts its liabilities on unpaid losses for certain long-term scheduled workers' compensation payments. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. Such losses have been discounted at a rate of 2.5% in 2010 and 3.5% in 2009. The decrease was primarily driven by the change in estimated future yields on the investment portfolio, including consideration of decreasing US Treasury rates in the current market. Pinnacol recorded the effect of the change in accounting estimate in accordance with SSAP No. 3, "Accounting Changes and Corrections of Errors". The change in discount rate increased losses incurred by $17,852,000 in the current year.

Change in Discount Rate Used for Estimation of Internal Structured Settlements — In 2010, Pinnacol evaluated the discount rate used for internal structured settlement liabilities and determined the need to adjust the rate to an acceptable current market rate. The Company uses an annuity quote that is based upon an estimated discount rate as a basis for the paid claim amount. As such, the liability should be discounted at a reasonable market rate. As of December 31, 2010, the Company decreased the discount rate applied to internal structured settlement liabilities from 3.5% to 2.5%. The decrease was primarily driven by the change in estimated future yields on the investment portfolio, including consideration of decreasing US Treasury rates in the current market. Pinnacol recorded the effect of the change of an accounting estimate in accordance with SSAP No. 3, "Accounting Changes and Corrections of Errors". The change in estimate resulted in an increase to the liability and an increase in loss incurred in the amount of approximately $37,953,000.

Change in Mortality Table for Estimation of Internal Structured Settlements — Pinnacol changed the mortality table used to estimate liabilities for the internal structured settlements as of December 31, 2010. Mortality risk is the most significant variable in the determination of settlement payments and is evaluated regularly by actuaries. In prior years, the mortality table was based upon lives of disabled people; however, actuarial results show that internal structured settlement recipients often outlive the disabled lives table. As of December 31, 2010, the liabilities of internal structured settlements were valued based upon the US Lives mortality table. The change in accounting estimate impacts the current year statement of operations in accordance with SSAP No. 3 "Accounting Changes and Corrections of Errors". The effect of the change in the discount rate increases the liability and increases loss incurred in the amount of approximately $87,280,000.

Premium Deficiency Reserve — As of December 31, 2010, Pinnacol evaluated the need for a premium deficiency reserve and recorded a liability of $35,344,000 as a result of rate reductions and driven by a competitive market and the downturn in the economy. This represents a change in accounting estimate from a premium deficiency reserve of $0 as of December 31, 2009.

2. **Significant Accounting Policies and Alternative Treatments** — The Company's significant accounting policies are set forth in Note 1 to the Company's 2010 statutory financial statements. During the year ended December 31, 2010, there were no significant changes in previously adopted accounting policies or their application, except for the following:

   Application of Recent Statutory Accounting Pronouncements — The Company adopted Statutory Accounting Principle No. 62R, "Property and Casualty Reinsurance – Revised" (SSAP No. 62R.), which expands the exceptions for retroactive reinsurance to include property/casualty reinsurance run-off agreements that meet specified criteria. SSAP No. 62R is effective January 31, 2010. The adoption of SSAP 62R did not have an impact on the Company's financial position or the results of its operations as it did not enter into any of these agreements in 2010.

   The Company adopted Statutory Accounting Principle No. 5R, "Liabilities, Contingencies and Impairments of Assets" (SSAP No. 5R) and modified SSAP No. 25, "Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties" (SSAP No. 25). SSAP No. 5R adopts, with modification, Financial Accounting Standards Board Interpretation No. (FIN) 45: Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, and interpretation of Financial Accounting Standards Board (FASB) Statement No. 5, 57 and 107 and rescission of FASB Interpretation No. 34. The Company adopted SSAP 5R for its fiscal year ended December 31, 2010. The adoption of SSAP 5R did not have an impact on the Company's financial position or the results of its operations as it has not issued any guarantees.

   The Company adopted Statement on Statutory Accounting Principle No. 16R, "Electronic Data Processing Equipment and Accounting for Software" (SSAP No. 16R). SSAP No. 16R incorporates guidance regarding software that was previously included within other SSAPs. It also adopts, with modification, a nonsubstantive change to ASU 2010-04, "Certain Revenue Arrangements That Include Software Elements". The Company adopted SSAP 16R for its fiscal year ended December 31, 2010. The adoption of SSAP 16R did not have a material impact on the Company's financial position or the results of its operations.

3. **Audit Adjustments and Uncorrected Misstatements** — As discussed in Note 9 of Pinnacol's financial statements, the statutory financial statements included herein contain differences from Pinnacol's Annual Statement as filed with the Division for the year ended December 31, 2009. The differences are due to an audit adjustment of $68,272,000 recorded in the 2008 financial statements to record declines in value of common stock investments as an other-than-temporary impairment charge to net income. These impairments were recorded in the Annual Statement in 2009. There were no differences from Pinnacol's amended Annual Statement as filed with the Division for the year ended December 31, 2010.

   Our audit of the financial statements was designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. We have discussed with management certain financial statement misstatements that have not been corrected in the Company's books and records as of and for the year ended December 31, 2010 totaling $5,968,000, which would decrease the Company's net loss and increase policyholders' surplus. We have reported such misstatements to management on a Summary of Uncorrected Financial Statement Misstatements and have received representations from management that management believes, and we concur, that the effects of the uncorrected financial statement misstatements are immaterial, both individually and in the aggregate, to the statutory financial statements taken as a whole.

4. **Material Corrected Misstatements** — The following material misstatements were brought to the attention of management as a result of our audit procedures and were corrected by management during the current period:

   Management had initially recorded a $76,151,000 increase to its reserves for unpaid losses and loss adjustment expenses as a result of the Company changing its accounting policy to discontinue the practice of discounting certain unpaid losses on a tabular basis. The Company did not justify this change in accounting policy and subsequently decided to continue its policy of discounting and recorded an adjustment of $70,006,000 to decrease its reserves for unpaid losses and loss adjustment expenses to discount its liabilities on unpaid losses for certain long-term scheduled workers' compensation payments at 2.5%.

5. **Other Information in Documents Containing Audited Financial Statements** — When audited financial statements are included in documents containing other unaudited information, we read such other information and consider whether it, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, in the financial statements audited by us. We have read the other information in the Company's report, and have inquired as to the methods of measurement and presentation of such information. We did not note any material inconsistencies or obtain knowledge of a material misstatement of fact in the other information.

6. **Disagreements with Management** — We have not had any disagreements with management related to matters that are material to the Company's 2010 financial statements, except for the application of the Company's adoption of a new accounting policy to discontinue the practice of discounting certain reserves for unpaid losses and loss adjustment expenses as described in item 4 above. We disagreed with management regarding the justification of the change in accounting policy. Management ultimately decided not to change its accounting policy, which resolved the disagreement.

7. **Consultation with Other Accountants** — We are not aware of any consultations that management may have had with other accountants about auditing and accounting matters during 2010.

8. **Significant Issues Discussed, or Subject of Correspondence, with Management Prior to Our Retention** — Throughout the year, routine discussions were held, or were the subject of correspondence, with management regarding the application of accounting principles or auditing standards in connection with transactions that have occurred, transactions that are contemplated, or reassessment of current circumstances. In our judgment, such discussions or correspondence were not held in connection with our retention as auditors.

9. **Significant Difficulties Encountered in Performing the Audit** — In our judgment, we received the full cooperation of the Company's management and staff and had unrestricted access to the Company's senior management in the performance of our audit.

10. **Management Representations** — We have made specific inquiries of the Company's management about the representations embodied in the statutory financial statements. Additionally, we have requested that management provide to us the written representations the Company is required to provide to its independent auditors under GAAS.

11. **Internal Control-Related Matters** — We have identified, and included in the Recommendation Locator and in the Report on Internal Control over Financial Reporting and on Compliance and Other Matters

Based on an Audit of the Statutory Financial Statements in Accordance with *Government Auditing Standards*, certain matters involving the Company's internal control over financial reporting that we consider to be deficiencies in internal control under standards established by the American Institute of Certified Public Accountants.

The definitions of a deficiency in internal control, a material weakness, and a significant deficiency are also set forth within the Findings and Recommendations section below.

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

    We hereby confirm that as of July 28, 2011, we are independent accountants with respect to Pinnacol under all relevant professional and regulatory standards.

13. **Other Matters** — Deloitte & Touche LLP performed this audit under contract with the Office of the State Auditor and does not discuss accounting or auditing issues with Pinnacol in connection with our retention as auditor.

Summary of Audit Findings

Information Technology General Controls Policies — Pinnacol should improve its information technology general controls by:

1) Maintaining documentation to evidence that user access reviews occurred, backups occurred throughout the audit period, and changes and patches are tested prior to their implementation into the production environment. Sufficient supporting evidence for testing of these changes should also be maintained.

2) Update the policies and procedures to include maintaining sufficient evidence of user access reviews and backups occurring throughout the audit period.

Transfer of Policyholder Receivable Data from WCIS to the General Ledger — Pinnacol should investigate the underlying cause of the variance between amounts in the WCIS system and the data uploaded through FTRS to the general ledger in order to ensure policyholder receivable balances are appropriately recorded and reported within the financial statements.

WCIS Execution of Check Authority Levels — Pinnacol should implement a control or set of controls to detect when claim representatives exceed their check authority level prior to the issuance of multiple checks relating to the same claim. In addition, claim representatives should be required to receive authorization prior to exceeding their check authority level through the issuance of multiple checks which aggregate to an amount exceeding established check authority levels.

System Criteria to Track Written Premium — Pinnacol should develop, document and implement a formal process through which they are able to accurately track written premiums.

Timely Review of Account Reconciliations — Pinnacol should review all quarterly account reconciliations timely, prior to quarterly or annual filings.

Routing and Related Documentation of Manual Checks — Pinnacol should maintain more specific documentation of how checks are routed through the Company prior to being mailed or delivered to the claimant.

Calculation of the Return Audit Premium Liability and the Related Impact to Commissions and Taxes, Licenses and Fees — Pinnacol should calculate the liability for return premium in a consistent manner throughout their calculation and should clearly document the rationale for their methodology. Additionally, the Company should record all related journal entries, including the impact to commissions and taxes, licenses and fees.

Review of Data and Assumptions Used by the Company's Third-Party Actuary — Pinnacol should incorporate a detailed review of the appropriateness of the underlying data and assumptions used by the third-party actuary in its actuarial analysis of the premium deficiency reserve.

Summary of Pinnacol's Responses

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

RECOMMENDATION LOCATOR
DECEMBER 31, 2010

Recommendation Locator

Recommendation Number	Page Number	Recommendation Summary	Pinnacol Response	Implementation Date
1	13	Pinnacol should improve its information technology general controls in the areas of user access rights and backups.	Agree	June 2011
2	13	Pinnacol should investigate the underlying cause of the variance between amounts in the WCIS system and the data uploaded through FTRS to the general ledger in order to ensure policyholder receivable balances are appropriately recorded and reported within the financial statements.	Agree	December 2011
3	14	Pinnacol should implement a control or set of controls to prevent claim representatives from exceeding their check authority level through the issuance of multiple checks relating to the same claim.	Agree	March 2011
4	15	Pinnacol should develop, document and implement a formal process through which it is able to accurately track written premiums.	Disagree	None
5	15	Pinnacol should review all quarterly account reconciliations timely, prior to quarterly or annual filings.	Agree	June 2011

6	15	Pinnacol should maintain more specific documentation of how checks are routed through the Company prior to being mailed or delivered to the claimant.	Agree	December 2011
7	16	Pinnacol should calculate the liability for return premium in a consistent manner throughout their calculation and should clearly document the rationale for their methodology. Additionally, the Company should record all related journal entries, including the impact to commissions and taxes, licenses and fees.	Agree	December 2011
8	17	Pinnacol should incorporate a detailed review of the appropriateness of the underlying data and assumptions used by the third-party actuary in its actuarial analysis of the premium deficiency reserve.	Agree	December 2011

PINNACOL ASSURANCE

DESCRIPTION OF PINNACOL ASSURANCE
DECEMBER 31, 2010

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

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

Policyholders' Surplus

Pinnacol had policyholders' surplus of $618,126,000 and $732,527,000 as of December 31, 2010 and 2009, respectively. The decrease in surplus is primarily related to reserve changes and premium deficiency reserves recorded during the year ended December 31, 2010.

Pinnacol discounts its liabilities on unpaid losses for certain long-term scheduled workers' compensation payments. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. Such losses have been discounted at a rate of 2.5% in 2010 and 3.5% in 2009. The decrease was primarily driven by the change in estimated future yields on the investment portfolio, including consideration of decreasing US Treasury rates in the current market. Pinnacol recorded the effect of the change in accounting estimate in accordance with SSAP No. 3, "Accounting Changes and Corrections of Errors". The change in discount rate increased losses incurred by $17,852,000 in the current year.

In 2010, Pinnacol evaluated the discount rate used for internal structured settlement liabilities and determined the need to adjust the rate to an acceptable current market rate. The Company uses an annuity quote that is based upon an estimated discount rate as a basis for the paid claim amount. As such, the liability should be discounted at a reasonable market rate. As of December 31, 2010, the Company decreased the discount rate applied to internal structured settlement liabilities from 3.5% to 2.5%. The decrease was primarily driven by the change in estimated future yields on the investment portfolio, including consideration of decreasing US Treasury rates in the current market. Pinnacol recorded the effect of the change of an accounting estimate in accordance with SSAP No. 3 "Accounting Changes and Corrections of Errors". The change in estimate resulted in an increase to the liability and an increase in loss incurred in the amount of approximately $37,953,000.

Based upon third-party actuarial recommendations in 2010, Pinnacol changed the mortality table used to estimate liabilities for the internal structured settlements as of December 31, 2010. Mortality risk is the most significant variable in the determination of settlement payments and is evaluated regularly by actuaries. In prior years, the mortality table was based upon lives of disabled people; however, actuarial results show that internal structured settlement recipients often outlive the disabled lives table. As of December 31, 2010, the liabilities of internal structured settlements were valued based upon the US Lives mortality table. The change in accounting estimate impacts the current year statement of operations in accordance with SSAP No. 3 “Accounting Changes and Corrections of Errors”. The effect of the change in the discount rate increases the liability and increases loss incurred in the amount of approximately $87,280,000.

Premium Deficiency Reserve — As of December 31, 2010, Pinnacol evaluated the need for a premium deficiency reserve and recorded a liability of $35,344,000 as a result of rate reductions driven by a competitive market and the downturn in the economy. This represents a change in accounting estimate from a premium deficiency reserve of $0 as of December 31, 2009.

These reserve changes are partially offset by an increase in realized capital gains on investments of $16,414,000 and a change in unrealized gains on investments of $30,125,000 for the year ended December 31, 2010.

In 2010, Pinnacol issued $48,226,000 in general policyholder dividends to its policyholders in good standing. This is included in Dividends to Policyholders in the statutory statement of operations and changes in policyholders’ surplus and reduces net income for the year ended December 31, 2010. This accounting treatment is in accordance with statutory accounting practices. See further information at Note 1, General Policyholder Dividends.

Subsequent to December 31, 2010, as discussed in Note 10, the Company declared a general policyholder dividend of $ 41,250,000. This general dividend was paid in May 2011.

A *deficiency* in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's statutory financial statements will not be prevented, or detected and corrected on a timely basis.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

We identified the following deficiencies involving the Pinnacol's internal control over financial reporting as of December 31, 2010. Each of the following is classified as a deficiency in Pinnacol's internal control over financial reporting.

Although we have included management's written response to our comments below, such responses have not been subjected to the auditing procedures applied in our audit and, accordingly, we do not express an opinion or provide any form of assurance on the appropriateness of the responses or the effectiveness of any corrective actions described therein

Information Technology General Controls Policies

Internal controls over information technology general controls (IT general controls) are a key component of internal control over financial reporting. IT general controls are important as they impact the internal controls of all significant automated accounting and business processes of an organization such as Pinnacol. During testing of Pinnacol's IT general controls and related policies, we noted the following:

1. User access reviews at the database level are not performed. This could result in users having inappropriate access over the database, which is a high risk infrastructure layer, where more damage could occur. Similarly, the Company's IT security policies do not require maintaining evidence that user access reviews occurred (i.e. having the reviewer signing and dating the review, etc.) so for the other areas of the infrastructure where reviews are occurring, there is no proof that the reviews actually occurred.

2. Evidence of backups for the Novell network operating system, WCIS (Workers Compensation Information System) database, Lawson general ledger system, and UNIX operating systems is not required to be maintained for a full audit period (one year). By not maintaining evidence of these backups, there is no evidence that the systems are backed up on a periodic basis throughout the year.

3. We did not test the change management process surrounding the Novell and UNIX operating systems, as Pinnacol does not test changes, or patches, in a test environment prior to implementing them into the production area for Novell operating system and although testing is performed on the UNIX operating system prior to implementation, they do not maintain evidence

of such testing. As the patches are not tested, there is a higher risk that these updates could cause issues. Additionally, by not maintaining support for the testing there is no evidence that the changes were tested.

Recommendation #1

Pinnacol should improve its information technology general controls by:

1. Maintaining documentation to evidence that user access reviews occurred, backups occurred throughout the audit period, and changes and patches are tested prior to their implementation into the production environment. Sufficient supporting evidence for testing of these changes should also be maintained.

2. Update the policies and procedures to include maintaining sufficient evidence of user access reviews and backups occurring throughout the audit period.

Pinnacol's Response

Agree. Implementation date: June 2011.

Policies have been updated in the second quarter of 2011 to include maintaining evidence of user access reviews, backups and changes to patches. Documentation will also be maintained for at least a year.

Transfer of Policyholder Receivable Data from WCIS to the General Ledger

Pinnacol has automated the recording of the monthly change in the policyholder receivable balances to the general ledger through a Financial Transaction Reporting System (FTRS) systematic journal entry. FTRS is an application which reports data directly from WCIS to the general ledger. Policyholder receivable balances per the general ledger are then reconciled to WCIS system detail through a manual reconciliation process. However, in Pinnacol's reconciliation there is an unexplained amount that is out of balance between the general ledger and the system generated detail. This unexplained balance varies month to month and can fluctuate between a debit or credit difference. In the current and prior year the difference in the general ledger balance ranged from $1.2 million less that the WCIS system detail, to $1.6 million greater than the WCIS system detail. Historically the differences have not been material. Through the second quarter of 2009 Pinnacol staff manually recorded an entry to set the general ledger balance equal to system detail in order to adjust for the unreconciled difference. As of year end 2010 and 2009, the difference remained as unreconciled items. As Pinnacol cannot reconcile between activity recorded to the general ledger and the system detail, the recorded premiums receivable balance is potentially misstated.

As part of the 2009 audit, we recommended that Pinnacol investigate the underlying causes of the variance between the amounts in the WCIS system and the data uploaded to the general ledger. Pinnacol agreed to research the variances and make appropriate changes to ensure that the general ledger and the WCIS system detail agree. The target completion date was December 31, 2010. At the completion of our audit Pinnacol was still in process of reconciling the difference.

Recommendation # 2

Pinnacol should continue to investigate the underlying cause of the variance between amounts in the WCIS system and the data uploaded through FTRS to the general ledger in order to ensure policyholder receivable balances are appropriately recorded and reported within the financial statements.

Pinnacol's Response

Agree. Implementation date: December 2011.

Significant progress has already been made on this project in 2010 and 2011.

WCIS Execution of Check Authority Levels

Pinnacol has implemented check authority levels which are assigned to claims representatives based on employees' level of authority. Authority levels for claims representatives are only implemented at the individual check level within WCIS, and not for total payments at the claim level. This provides the opportunity for claims representatives to surpass check authority levels through the issuance of multiple checks for amounts which are individually under their authority level. Pinnacol has quality control processes in place which would likely identify total payments in excess of a claim representative's total authority level. However the excess would be identified subsequent to the issuance of such checks, and Pinnacol does not have a formal process in place to prevent such activity.

As part of the 2009 audit, we recommended that Pinnacol establish a system check to prevent claim representatives from issuing multiple checks on a single claim during a window of time that exceeds their payment authorization limits. The target completion date was September 30, 2010. At the completion of our audit Pinnacol was still in process of implementing this system.

Recommendation #3

Pinnacol should implement a control or set of controls to detect when claim representatives exceed their check authority level prior to the issuance of multiple checks relating to the same claim. In addition, claim representatives should be required to receive authorization prior to exceeding their check authority level through the issuance of multiple checks which aggregate to an amount exceeding established check authority levels.

Pinnacol's Response

Agree. Implementation date: March 2011.

Completed in the first quarter of 2011.

System Criteria to Track Written Premium

Written premium is required to be disclosed in Pinnacol's financial statements. Pinnacol calculates written premium as the sum of current year earned premium and current year change in unearned premium, as WCIS is not programmed to track actual written premium. This approach could result in the disclosure of incorrect written premium if the calculation or components within the calculation are inaccurate, as Pinnacol does not have a formal process developed, documented and implemented to track written premium.

As part of the 2009 audit, we recommended that Pinnacol explore system enhancements to facilitate the accurate reporting of written premium. Pinnacol agreed to explore the system enhancements; however, due to system limitations, the Company considered the cost of upgrades to its current system to exceed the benefits provided by a system that would facilitate the tracking of written premium. The Company has documented its process of determining written premium in a memo; however, a risk still exists that disclosure of written premium could be misstated due to the lack of detailed tracking within the system.

Recommendation #4

Pinnacol should develop, document and implement a formal process through which it is able to accurately track written premiums.

Pinnacol's Response.

Disagree. Implementation date: None.

While we agree that system tracking of written premium would be ideal, it is cost-prohibitive. The written premium disclosure would not impact a user's conclusion about the financial stability or performance of Pinnacol. The ability to accurately report earned premium is essential to financial reporting and Pinnacol's systems perform that task with a high level of accuracy. Therefore, Pinnacol does not plan to develop a process to systematically track written premium.

Timely Review of Account Reconciliations

Pinnacol performs monthly account reconciliations. It was discovered in our control testing that reconciliations for 12 accounts were reviewed greater than 60 days after month-end for the specific reconciliation. As the Company is required to file quarterly statements with the Colorado Department of Insurance 45 days after quarter end, and annual statements 60 days after year end, such accounts are not reconciled and reviewed timely to identify and correct errors prior to the filing.

Recommendation #5

Pinnacol should review all quarterly reconciliations timely, prior to the quarterly or annual filings.

Pinnacol's Response

Agree. Implementation date: June 2011.

The reconciliations that Deloitte identified as not reviewed timely contained no material reconciling items and relate to lower risk accounts or transactions. By the end of the second quarter of 2011, Pinnacol will reallocate review assignments and establish a monitoring control to ensure all reconciliations are completed and reviewed prior to filing the statutory statements.

Routing and Related Documentation of Manual Checks

Pinnacol has a control in place which states that checks may never be routed back to the claim representative who requested that check. This control is not operating as designed, which could result in inappropriate segregation of duties. The Company does not consistently maintain sufficient documentation to indicate where the manual checks are routed after the checks are requested by a claims representative. For 6 out of 15 manual checks tested, documentation was not available to evidence the chain of custody of the checks from the time the checks were signed until the time they were mailed. Additionally, based on inquiries of Pinnacol personnel who have access to handle checks once they have been signed, there are instances when checks may be given back to the claims representatives prior to being mailed to a claimant. We did not specifically identify any checks being routed to a claims representative in our selections made; however, a risk exists based on these inquiries performed.

Recommendation #6

Pinnacol should maintain more specific documentation of how checks are routed through the Company prior to being mailed or delivered to the claimant in order to ensure that its control over the routing of checks is operating as designed. We recommend that a signature record be maintained after the checks have been released from the mail room. Additionally, we also recommend that the signature record be maintained electronically on a monthly basis.

Pinnacol's Response

Agree. Implementation date: December 2011.

Pinnacol will review the documentation requirements associated with the check routing procedures and the record retention policy regarding same.

Calculation of the Return Audit Premium Liability and the Related Impact to Commissions and Taxes, Licenses and Fees

Each year Pinnacol estimates the amount of additional premium or premium due back to employers resulting from payroll audited amounts being higher or lower than the amounts used for estimated premiums. For fiscal year 2010, Pinnacol did not use a consistent methodology to calculate the liability for expected returned audit premiums. The recorded balance of this liability was $10 million at December 31, 2010 and is included in credit balances due policyholders in the statutory statements of admitted assets, liabilities and policyholders' surplus. Specifically, the Company used the life to date average percentage of returned premium as a basis for all periods, except for period 5, for which the Company used the prior three-period average. Over the last two years, the Company's experience for final audit premiums has become more volatile than historical experience, and accordingly the Company updated their methodology for estimating final audit premium. However, the rationale for this methodology change was not clearly documented within the Company's analysis. As the determination of return premium is a management estimate, the Company should consider using a variety of methods and estimation processes to perform a sensitivity analysis in order to arrive at a best estimate to record, or to enable recording to the mid-point of the range in accordance with SSAP No. 5R. The lack of a range of outcomes and sensitivity testing could have an impact on surplus or net income. Additionally, as a result of recording a liability for an estimate of return premium, the Company should reduce its accrued commissions payable and taxes licenses and fees payable accordingly. This reduction of accrual was not properly recorded in the Company's general ledger and resulted in an understatement of net income and surplus, which is not significant in magnitude. The adjustments are not reflected in the statutory statements for December 31, 2010.

Recommendation #7

Pinnacol should calculate the liability for return premium in a consistent manner throughout their calculation and should clearly document the rationale for their methodology. The Company should consider developing a range and performing sensitivity analysis in order to arrive at a best estimate to record, or to enable recording to the mid-point of the range in accordance with SSAP No. 5R, to the extent that no amount within the range is more probable than any other. Additionally, the Company should record all related journal entries, including the impact to commissions and taxes, licenses and fees.

Pinnacol's Response

Agree. Implementation date: December 2011.

While the rationale of the methodology change was communicated via e-mail, Pinnacol will ensure that the rationale for the methodology is documented. In addition, while the inconsistency in the calculation did not have a material impact on the balance, Pinnacol agrees that the calculations should be performed consistently. A new process will be developed that will include a range or sensitivity analysis. In addition, Pinnacol will begin booking the impact to commissions and fees.

Review of Data and Assumptions Used by the Company's Third-Party Actuary

Pinnacol currently has controls in place to review the actuarial analysis for reserve balances produced by the third-party actuary. The control consists of the CFO's and Controller's reviews of the deliverable sent from the third-party actuary to the Company. This control was not properly designed during 2010 to require a detailed review of the appropriateness of the underlying data and the third-party actuary's assumptions used in the premium deficiency analysis. This design deficiency resulted in the Company not identifying that the third-party actuary was utilizing the incorrect unearned premium balances (billed and unbilled) in the calculation of the Premium Deficiency Reserve at December 31, 2010.

Recommendation #8

Pinnacol should incorporate a detailed review of the appropriateness of the underlying data and assumptions used by the third-party actuary in its actuarial analysis of the premium deficiency reserve.

Pinnacol's Response

Agree. Implementation date: December 2011.

Pinnacol already has plans to add a detailed review of the underlying data and assumptions used in the calculation during the next actuarial analysis of the premium deficiency reserve.

Disposition of Prior Audit Recommendations

In conjunction with our 2009 audit, Deloitte & Touche LLP prepared our recommendations for improvements related to Pinnacol's control environment. Our observations on the status of these audit recommendations are as follows:

Recommendation	Disposition
2009 Recommendation #1 - Pinnacol should improve its information technology general controls by:	
a. Expanding and implementing control policies and procedures that require periodic reviews and documentation of user access rights. Actions taken should be properly documented and retained by Pinnacol.	a. Partially implemented in 2010 (see recommendation #1).
b. Implementing the internal audit recommendation that, "direct write access to the databases housing production and/or sensitive business data should be restricted to appropriate users based on job responsibility." Pinnacol should restrict this access so that non-IT business users do not have elevated or administrative type rights within the database.	b. Implemented in 2010.
2009 Recommendation #2 - Pinnacol should investigate the underlying cause of the variance between amounts in the WCIS system and the data uploaded through FTRS to the general ledger in order to ensure policyholder receivable balances are appropriately recorded and reported within the financial statements	Not implemented (see recommendation #2).
2009 Recommendation #3 - Pinnacol should establish a process and thoroughly test any new system to ensure payments are processed correctly prior to implementation. Additionally, Pinnacol should ensure internal controls are designed, implemented, and operating effectively at a sufficient level of detail to prevent incorrect structured settlement payments from being processed and issued through WCIS. Pinnacol should continue to investigate checks which may have been issued in error, as well as underlying causes of such errors	Implemented in 2010.

within the system, and make adjustments or changes as appropriate.	
***2009 Recommendation #4* -** Pinnacol should implement a control or set of controls to detect when claim representatives exceed their check authority level prior to the issuance of multiple checks relating to the same claim. In addition, claim representatives should be required to receive authorization prior to exceeding their check authority level through the issuance of multiple checks which aggregate to an amount exceeding established check authority levels.	Not implemented (see recommendation #3).
***2009 Recommendation #5* -** Pinnacol should design and implement a formalized control whereby management reviews the market value of investments provided by the Investment Manager for reasonableness.	Implemented in 2010.
***2009 Recommendation #6* -** Pinnacol should document a control or set of controls which define the current policy and processes in place related to the evaluation of other-than-temporary impairment of investments	Implemented in 2010.
***2009 Recommendation #7* -** Pinnacol should develop, document and implement a formal process through which it is able to accurately track written premiums.	Not implemented (see recommendation #4).

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INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying statutory-basis statements of admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance (the "Company") as of December 31, 2010 and 2009, and the related statutory-basis statements of operations, changes in policyholders' surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As more fully described in Note 1 to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado, and such practices differ from accounting principles generally accepted in the United States of America. The effects on such financial statements of the differences between the statutory basis of accounting and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Pinnacol Assurance as of December 31, 2010 and 2009, or the results of its operations or its cash flows for the years then ended.

However, in our opinion, the statutory-basis financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance as of December 31, 2010 and 2009, and the results of its operations and its cash flows for the year then ended, on the basis of accounting described in Note 1.

In accordance with *Government Auditing Standards*, we have also issued our report dated July 28, 2011, on our consideration of the Company's internal control over financial reporting and our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our 2010 audit.

Our 2010 audit was conducted for the purpose of forming an opinion on the basic 2010 statutory-basis financial statements taken as a whole. The supplemental schedules of investment information as of and for the year ended December 31, 2010 are presented for purposes of additional analysis and are not a required part of the basic 2010 statutory-basis financial statements. These schedules are the responsibility of the Company's management. Such schedules have been subjected to the auditing procedures applied in our audit of the basic 2010 statutory-basis financial statements. The effects on these schedules of the differences between the statutory basis of accounting and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material. Accordingly, in our opinion, such schedules do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the information shown therein. However, in our opinion, such schedules are fairly stated in all material respects when considered in relation to the basic 2010 statutory-basis financial statements taken as a whole.

Deloitte + Touche LLP

July 28, 2011

PINNACOL ASSURANCE

STATUTORY STATEMENTS OF ADMITTED ASSETS, LIABILITIES, AND POLICYHOLDERS' SURPLUS
AS OF DECEMBER 31, 2010 AND 2009
(In thousands)

	2010	2009
ADMITTED ASSETS		
CASH AND INVESTED ASSETS:		
Bonds at adjusted carrying value, fair value of $1,696,381 in 2010 and $1,706,783 in 2009 (Note 3)	$ 1,563,182	$ 1,615,972
Common stock at fair value, adjusted cost of $209,196 in 2010 and $212,205 in 2009 (Note 3)	295,352	268,236
Real estate at cost — net of accumulated depreciation of $7,429 in 2010 and $6,332 in 2009	21,116	21,589
Cash, cash equivalents and short-term investments	52,809	63,556
Receivables for securities sold	532	-
Total cash and invested assets	1,932,991	1,969,353
UNCOLLECTED PREMIUMS — Net of allowance	26,618	27,088
ELECTRONIC DATA PROCESSING EQUIPMENT — At cost — net of accumulated depreciation of $3,007 in 2010 and $4,503 in 2009	1,197	1,898
ACCRUED INVESTMENT INCOME	17,958	18,328
TOTAL ADMITTED ASSETS	$ 1,978,764	$ 2,016,667
LIABILITIES AND POLICYHOLDERS' SURPLUS		
RESERVE FOR UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES:		
Reserve for unpaid losses (Note 2)	$ 1,029,128	$ 954,394
Reserve for unpaid loss adjustment expenses (Note 2)	152,727	194,744
Total reserve for unpaid losses and loss adjustment expenses	1,181,855	1,149,138
OTHER LIABILITIES	42,688	34,663
UNEARNED PREMIUMS	59,746	57,596
ADVANCE PREMIUMS	8,821	14,242
DIVIDENDS PAYABLE TO POLICYHOLDERS	14,572	20,276
PREMIUM DEFICIENCY RESERVE	35,344	-
CREDIT BALANCES DUE POLICYHOLDERS	17,612	8,225
Total liabilities	1,360,638	1,284,140
COMMITMENTS AND CONTINGENCIES (Notes 2, 7, 8, and 10)		
POLICYHOLDERS' SURPLUS (Note 7)	618,126	732,527
TOTAL LIABILITIES AND POLICYHOLDERS' SURPLUS	$ 1,978,764	$ 2,016,667

See notes to statutory financial statements.

PINNACOL ASSURANCE

STATUTORY STATEMENTS OF OPERATIONS AND CHANGES IN POLICYHOLDERS' SURPLUS
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009
(In thousands)

	2010	2009
UNDERWRITING INCOME:		
Premiums earned (Note 5)	$ 344,612	$ 398,502
Deductions:		
Losses incurred (Note 2 and 5)	373,201	255,523
Loss adjustment expenses incurred (Note 2 and 5)	16,136	34,543
Other underwriting expenses incurred	145,518	113,957
Total underwriting deductions	534,855	404,023
Net underwriting loss	(190,243)	(5,521)
INVESTMENT INCOME:		
Net investment income earned	89,496	94,402
Net realized capital gain	21,187	4,773
Total investment income	110,683	99,175
OTHER INCOME (LOSS):		
Provision for uncollectible premiums	(2,330)	(1,252)
Other income	1,134	1,480
Dividends to policyholders	(46,956)	(116,841)
NET LOSS	(127,712)	(22,959)
CHANGE IN NONADMITTED ASSETS	(1,814)	2,601
CHANGE IN NET UNREALIZED GAINS ON INVESTMENTS	30,125	54,884
OTHER CHANGES IN POLICYHOLDERS' SURPLUS (Note 1)	(15,000)	-
POLICYHOLDERS' SURPLUS — Beginning of year	732,527	698,001
POLICYHOLDERS' SURPLUS — End of year	$ 618,126	$ 732,527

See notes to statutory financial statements.

PINNACOL ASSURANCE

STATUTORY STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009
(In thousands)

	2010	2009
CASH FLOWS FROM OPERATIONS:		
Premiums collected — net of reinsurance	$ 339,337	$ 415,990
Losses and loss adjustment expenses paid — net of reinsurance and deductibles	(380,075)	(364,088)
Underwriting expenses paid	(133,570)	(124,652)
Dividends paid to policyholders	(52,659)	(126,523)
Investment income received, net of investment expenses paid	89,377	95,199
Net amount withheld or retained for account of others	(1,196)	228
Net cash used in operations	(138,786)	(103,846)
CASH FLOWS FROM INVESTMENTS:		
Proceeds from sale or redemption of investments	298,728	311,023
Purchase of investments	(221,311)	(253,375)
Net cash provided from investments	77,417	57,648
CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES — Cash provided from (used in) other miscellaneous sources	50,622	(1,920)
NET DECREASE IN CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS	(10,747)	(48,118)
CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS — Beginning of year	63,556	111,674
CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS — End of year	$ 52,809	$ 63,556

See notes to statutory financial statements.

1. NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

- Policy acquisition costs, such as commissions, premium taxes, and other expenses directly related to the cost of acquiring new business are expensed as incurred, while under GAAP, they are deferred and amortized over the policy term to provide for proper matching of revenue and expense;

- Investments in bonds and preferred stocks are generally carried at amortized cost, while under GAAP, they would be classified as available for sale and are carried at fair value;

- Assets are reported under NAIC SAP at "admitted-asset" value and "non-admitted" assets are excluded through a charge against policyholders' surplus, while under GAAP, all assets are reported on the balance sheet, net of any required valuation allowance;

- The reserve for losses and loss adjustment expenses ("LAE") is reported net of reinsurance, while under GAAP, the balance sheet reports reinsurance recoverable, including amounts related to losses incurred but not reported, as assets.

The effect of the differences between statutory basis of accounting and generally accepted accounting principles, although not reasonably determinable, is presumed to be material.

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

(d) **Investments** — Investments are recorded on the trade date. Bonds are stated at amortized cost or market value based on their NAIC rating and are adjusted for other-than-temporary declines in fair value. Common stocks and mutual funds are carried at fair value. Unrealized capital gains on common stocks and mutual funds are reported as a direct adjustment to policyholders' surplus. Common stocks and mutual funds in an unrealized loss position for the years ended December 31, 2010 and 2009 are recorded as other-than-temporarily impaired and are recorded as a realized loss in the statutory statement of operations in the period in which they occur.

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

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

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

Real estate includes land, the building on the land, and capitalized building improvements used in conducting the Company's business. Land is carried at cost. Building and capitalized building improvements are carried at cost less accumulated depreciation. The cost of the building and capitalized improvements is depreciated over an estimated useful life of 30 years using the straight-line method. Depreciation expense was approximately $1,096,000 and $1,043,000 for the years ended December 31, 2010 and 2009 respectively, and is included in other underwriting expenses incurred in the Statutory Statements of Operations and Changes in Policyholders' Surplus.

(e) **Cash, Cash Equivalents and Short-Term Investments and Other Invested Assets** — For purposes of the statement of cash flows, cash, cash equivalents and short-term investments include cash on deposit, money market funds, and other investments with maturities of one year or less at the date of acquisition.

As of December 31, 2010, cash, cash equivalents and short-term investments of approximately $52,809,000 include $(12,309,000) of book overdrafts, $0 of cash equivalents, and $65,118,000 of short-term investments. As of December 31, 2009, cash, cash equivalents and short-term investments of approximately $63,556,000 include $(11,687,000) of book overdrafts, $0 of cash equivalents, and $75,243,000 of short-term investments. In the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus, Pinnacol has recorded checks that have been issued, but not presented for payment, as a reduction of cash and cash equivalents.

(f) **Receivables for Securities Sold -** As of December 31, 2010, receivables for securities sold were approximately $532,000. As of December 31, 2009, receivables for securities sold were $0. Receivables for securities arise when sales of securities are recorded as of the trade date. A receivable due from the broker is established when a security has been sold, but the proceeds from the sale have not yet been received. Receivables for securities not received within 15 days from the settlement date are nonadmitted.

(g) **Uncollected Premiums** — Uncollected premiums are reported net of allowances for uncollectible and nonadmitted balances. Certain receivables are not admissible for statutory accounting purposes.

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

During 2010 and 2009, Pinnacol recorded a provision of approximately $2,330,000 and $1,252,000, respectively, for premiums receivable due to the unlikelihood of ultimate collection thereof. These amounts are reflected as provision for uncollectible premiums in the accompanying statutory statements of operations and changes in policyholders' surplus.

A significant portion of Pinnacol's premium receivable balances at December 31, 2010 and 2009 were from companies operating in the construction and services industries in Colorado. The construction industry represents 32% and 33% of premiums written as of December 31, 2010 and 2009, respectively. The services industry represents 44% and 41% of premiums written as of December 31, 2010 and 2009, respectively, with all other individual industries constituting the remainder of premiums receivable balances.

(h) **Credit Balances Due Policyholders —** Credit balances due policyholders represent excess premiums or are amounts due to policyholders. Generally, credit balances due policyholders are applied to future premium obligations of policyholders. For 2010 and 2009, such amounts are approximately $7,612,000 and $8,225,000, respectively.

Pinnacol also recorded a liability for final audit premiums, which are amounts due to policyholders after the respective policy period has expired based on audits performed by Pinnacol. Such amounts are estimated by Pinnacol based upon internal calculations using historical premium data. Based on this analysis, Pinnacol recorded an estimated audit return premium liability of approximately

$10,000,000 and $0 in 2010 and 2009, respectively. The establishment of the liability was due to the downturn in the economy and covered payroll being less than originally anticipated which has resulted in premium refunds during 2010.

(i) **Electronic Data Processing Equipment** — Electronic data processing equipment is recorded at cost, less accumulated depreciation, and depreciated on a straight-line basis over an estimated useful life of three years. Net book value of these assets at December 31, 2010 and 2009 was approximately $1,197,000 and $1,898,000, respectively. Related depreciation expense of approximately $1,043,000 and $927,000 was incurred during 2010 and 2009, respectively, and is included in other underwriting expenses incurred in the statements of operations and changes in policyholders' surplus.

(j) **Art, Office Furniture and Equipment, and Software** — Art, office furniture and equipment, and software are recorded at cost and depreciated on a straight-line basis. Art, office furniture and equipment are depreciated over an estimated useful life of five years. Software is depreciated over an estimated useful life of three years. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2010 and 2009 was approximately $2,184,000 and $2,986,000, respectively. Related depreciation expense of approximately $1,422,000 and $1,327,000 was incurred in 2010 and 2009, respectively and is included in other underwriting expenses incurred in the statements of operations and changes in policyholders' surplus.

(k) **Other Assets** — At December 31, 2010 and 2009, Pinnacol had prepaid assets and deposits totaling approximately $7,224,000 and $3,890,000, respectively. In accordance with the Manual, these are nonadmitted assets.

(l) **General Policyholder Dividends** — The board of directors, at its discretion, determines the amount of general policyholder dividends to be declared based on Pinnacol's overall experience and financial condition. Pinnacol has paid general policyholder dividends to its policyholders in good standing of approximately $48,226,000 and $122,600,000 in May of 2010 and 2009, respectively. This is included in dividends to policyholders in the statutory statements of operations and changes in policyholders' surplus and reduces net operations for the years ended December 31, 2010 and 2009.

(m) **Association Dividend Program** — Pinnacol has an association dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. In 2010 Pinnacol reduced the estimate of the future liability for association dividends by $4,000,000 resulting in a credit of approximately $4,000,000 in incurred dividend expense. In 2009, Pinnacol reduced the estimate of the future liability for association dividends by $10,000,000 resulting in a credit of approximately $5,759,000 in incurred dividend expense. For 2010 and 2009, association dividends payable of $4,000,000 and $8,000,000, respectively, are included in dividends payable to policyholders. These dividends are not declared from surplus nor are they recorded as a direct reduction to surplus. The dividends are settled via premium credits and are recorded as dividends to policyholders in the statutory statements of operations and changes in policyholders' surplus.

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

(o) **Reserve for Unpaid Losses and Loss Adjustment Expenses** — The reserve for unpaid losses and loss adjustment expenses represents management's best estimate of ultimate net cost of all reported and unreported losses incurred through December 31, 2010 and 2009. The reserve for unpaid losses and loss adjustment expenses is estimated by management, which uses an independent third-party actuary to provide estimates based on individual case basis valuations and statistical analyses. Those estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes the reserve for unpaid losses and loss adjustment expenses is adequate. These estimates are continually reviewed and adjusted, as necessary, as experience develops or new information becomes known; such adjustments are included in losses incurred or loss adjustment expenses incurred within the statutory statements of operations and changes in policyholders' surplus in the period such information becomes known.

Workers' Compensation case unpaid losses have been discounted on a tabular basis using a discount rate of 2.5% in 2010 and 3.5% in 2009.

Internal structured settlement liabilities represent obligations to claimants and dependents on cases that have been closed by contract. These obligations are discounted at 2.5% in 2010 and 3.5% in 2009.

(p) **Unearned Premiums** — Unearned premiums represent amounts either collected or billed and due from policyholders at December 31, 2010 and 2009 but unearned at that date as they pertain to subsequent policy periods. Unearned premiums are computed on a daily pro rata basis over the 12-month term of the policies.

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

As of December 31, 2010, Pinnacol recorded a premium deficiency reserve of $35,344,000 as a result of rate reductions driven by a competitive market and the downturn in the economy. This evaluation was completed on January 25, 2011 by an independent actuary. Pinnacol considered anticipated investment income at 3.5% when evaluating the premium deficiency reserve for 2010. In 2009, management determined that a premium deficiency reserve was not necessary based upon its evaluation.

(r) **Division of Insurance Stipulation -** In 2010, the Colorado Division of Insurance and Pinnacol entered into a stipulation where, among other things, Pinnacol agreed to pay $15 million from surplus to policyholders as a premium credit during 2011. This amount was established as a liability in 2010 and is a direct reduction of policyholders' surplus.

(s) **Subrogation** — Subrogation claims (claims against third parties) are recognized as a reduction of losses incurred when collections are received. The Company received $5,392,000 and $5,746,000 in subrogation as of December 31, 2010 and December 31, 2009, respectively.

(t) **Reinsurance** — Ceded reinsurance transactions are accounted for based on estimates of their ultimate cost. Losses incurred, loss adjustment expenses incurred, and the reserve for loss adjustment expenses are reported net of reinsured amounts in accordance with the Manual. Reinsurance premiums are reflected as a reduction of premiums earned (see Note 5).

(u) **Taxes** — As a political subdivision of the State of Colorado, Pinnacol is not subject to Federal or State income taxes under a specific exemption granted under Section 501(c) of the Internal Revenue Code; nor is Pinnacol subject to property tax or sales and use taxes. Additionally, Pinnacol is not subject to a premium tax pursuant to Section 8-45-117(3), C.R.S. However, Pinnacol is subject to a surcharge on premiums pursuant to Section 8-44-112(1)(s), C.R.S. The surcharge is based on a rate established annually, approximately 1.63% for 2010 and 3.62% for 2009. Such amounts are included in other underwriting expenses incurred.

(v) **Application of Recent Statutory Accounting Pronouncements**

In December 2009, the NAIC issued Statement on Statutory Accounting Principle No. 62R, "Property and Casualty Reinsurance – Revised" (SSAP No. 62R.). This SSAP expands the exceptions for retroactive reinsurance to include property/casualty reinsurance run-off agreements that meet specified criteria. There are several additional criteria, including commissioner approval, financial strength of the nonaffiliated assuming entity, and unlimited transfer of risk, without the ability to cancel the contract. SSAP No. 62R is effective January 31, 2010. The Company adopted SSAP 62R for its fiscal year ended December 31, 2010. The adoption of SSAP 62R did not have an impact on the Company's financial position or the results of its operations as it did not enter into any of these agreements in 2010.

In October 2010, the NAIC issued Statement on Statutory Accounting Principle No. 5R, "Liabilities, Contingencies and Impairments of Assets" (SSAP No. 5R) and modified SSAP No. 25, "Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties" (SSAP No. 25). SSAP No. 5R adopts, with modification, Financial Accounting Standards Board Interpretation No. (FIN) 45: Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, and interpretation of Financial Accounting Standards Board (FASB) Statement No. 5, 57 and 107 and rescission of FASB Interpretation No. 34. The substantive revisions require reporting entities to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, even if the likelihood of having to make payments under the guarantee is remote. Revisions to SSAP No. 25 are nonsubstantive and update the disclosure requirements to complement the revisions made to SSAP No. 5R. The Company adopted SSAP 5R for its fiscal year ended December 31, 2010. The adoption of SSAP 5R did not have an impact on the Company's financial position or the results of its operations as it has not issued any guarantees.

In October 2010, the NAIC issued Statement on Statutory Accounting Principle No. 16R, "Electronic Data Processing Equipment and Accounting for Software" (SSAP No. 16R). SSAP No. 16R incorporates guidance regarding software that was previously included within other SSAPs. It also adopts, with modification, a nonsubstantive change to ASU 2010-04, "Certain Revenue Arrangements That Include Software Elements". Although the revisions are primarily considered placement changes, this item is considered a substantive change, as the adoption resulted in the following SSAPs being superseded: SSAP No. 79, "Depreciation of Nonoperating System Software – an Amendment to SSAP No. 16"; SSAP No. 81, "Software Revenue Recognition"; and SSAP No. 82, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs". The Company adopted SSAP 16R for its fiscal year ended December 31, 2010. The adoption of SSAP 16R did not have a material impact on the Company's financial position or the results of its operations.

2. UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES & INTERNAL STRUCTURED SETTLEMENT RESERVES

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

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

The Company also has an internal structured settlement program in which it retains the liability for settlements to claimants rather than purchasing annuities from third parties. This liability has mortality risk and is discounted using a reasonable market rate. The discount applied to this liability was 2.5% and 3.5% at December 31, 2010 and 2009, respectively. The internal structured settlement liability is actuarially valued on a quarterly basis. The internal structured settlement liability is included in unpaid losses and loss adjustment expenses on the Statements of Admitted Assets, Liabilities, and Policyholders' Surplus.

(a) Discount of Liabilities for Unpaid Losses:

Pinnacol discounts its liabilities on unpaid losses for certain long-term scheduled workers' compensation payments. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. Such losses have been discounted at a rate of 2.5% in 2010 and 3.5% in 2009. The decrease was primarily driven by the change in estimated future yields on the investment portfolio, including consideration of decreasing US Treasury rates in the current market. Pinnacol recorded the effect of the change in accounting estimate in accordance with SSAP No. 3, "Accounting Changes and Corrections of Errors". The change in discount rate increased losses incurred by $17,852,000 in the current year.

The amount of tabular discount for case unpaid losses as of December 31, 2010 and December 31, 2009 was $70,006,000 and $76,151,000, respectively. The discount on internal structured settlement liabilities is presented in Note 2(c). The amount of discount for case reserves at December 31, 2010 is distributed as follows over the years in which the losses were incurred:

Loss Year		Discount
2010	$	5,968
2009		9,654
2008		15,397
2007		9,631
2006		6,786
2005		4,107
2004		2,736
2003		985
2002		1,766
2001		1,800
Prior		11,176
Total	$	70,006

(b) **Unpaid Loss and Loss Adjustment Expenses:**

Activity in the liability for unpaid losses and loss adjustment expenses in 2010 and 2009 is summarized as follows (in thousands). Beginning in 2010, Internal Structured Settlement Reserves are no longer included in the roll-forward and are discussed separately under (c) Internal Structured Settlements below. See reconciliation below.

	Unpaid Losses and Loss Adjustment Expenses			
		2010		**2009**
Balance - January 1	$	968,542 *	$	1,223,160
Additional amounts incurred related to:				
Current year		378,871		390,369
Prior years		(119,093)		(100,303)
Total Incurred		259,778		290,066
Reductions relating to payments for:				
Current year		115,773		115,058
Prior years		246,473		249,030
Total Paid		362,246		364,088
Balance at December 31	$	866,074	$	1,149,138

* Reconciliation of Year End 2009 to Beginning Balance 2010:		
Balance at December 31, 2009	$	1,149,138
Remove Internal Structured Settlements presented in Note 2c		(180,596)

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and loss adjustment expenses decreased by approximately $119,093,000 and $100,303,000 in 2010 and 2009, respectively, which is net of a change in discount of approximately ($6,144,000) and $3,657,000, respectively. Had the discount rate not been changed, 2010 reserves would have been $17,852,000 lower and the net change in discount would have been $11,708,000. During the year ended December 31, 2010, approximately $246,473,000 was paid for unpaid loss and loss adjustment expense attributable to insured events of prior years. Reserves for unpaid loss and loss adjustment expense remaining for prior years are now $602,977,000 as a result of re-estimation of unpaid losses and loss adjustment expenses. This decrease is generally the result of ongoing analysis of recent loss development trends and better than expected development. Pinnacol's claims, for all accident years, continue the trend of favorable development that has been evident for a number of calendar years. When the actual selected ultimate cost of an accident year's claims is less than the original estimate, favorable development is recorded. This favorable development resulted from aggressive claim closure, a reduction of ultimate claim frequency in Colorado, and a reduction of catastrophic losses. Pinnacol management continually evaluates the estimated ultimate cost of all accident years and on a calendar year basis adjusts to the best estimate available, favorable or unfavorable, in the current period.

(c) **Internal Structured Settlements:**

In 2010 Pinnacol changed the mortality table used to estimate liabilities for the internal structured settlements as of December 31, 2010. Mortality risk is the most significant variable in the determination of settlement payments and is evaluated regularly by actuaries. In prior years, the mortality table was based upon lives of disabled people; however, actuarial results show that internal structured settlement recipients often outlive the disabled lives table. As of December 31, 2010, the liabilities of internal structured settlements were valued based upon the US Lives mortality table. The change in accounting estimate impacts the current year operations statement in accordance with SSAP No. 3, "Accounting Changes and Corrections of Errors". The effect of the change in the discount rate increases the liability and increases loss incurred in the amount of approximately $87,280,000.

In 2010, Pinnacol evaluated the discount rate used for internal structured settlement liabilities and determined the need to adjust the rate to an acceptable current market rate. The Company uses an annuity quote that is based upon an estimated discount rate as a basis for the paid claim amount. As such, the liability should be discounted at a reasonable market rate. As of December 31, 2010, the Company decreased the discount rate applied to internal structured settlement liabilities from 3.5% to 2.5%. The decrease was primarily driven by the change in estimated future yields on the investment portfolio , including consideration of decreasing US Treasury rates in the current market. Pinnacol recorded the effect of the change of an accounting estimate in accordance with SSAP No. 3, "Accounting Changes and Corrections of Errors". The change in estimate resulted in an increase to the liability and an increase in loss incurred in the amount of approximately $37,953,000.

During 2010 and 2009, respectively, the total change in the internal structured settlements liability was as follows (in thousands):

	2010	2009 *
Beginning Balance	$ 180,596	$ 167,455
Amounts Incurred:		
Change in Valuation	4,326	5,571
Change in Discount Rate	37,953	-
Change in Mortality Table	87,280	-
Amounts Paid	(17,829)	(16,744)
New Internal Structured Settlements	23,455	24,314
Ending Balance	$ 315,781	$ 180,596

* The 2009 rollforward for the internal structured settlement liability is also included in the unpaid loss and loss adjustment expense rollforward as of December 31, 2009.

The amount of the discount for unpaid internal structured settlements as of December 31, 2010 and 2009, respectively, is approximately $152,743,000 and $75,688,000. The amount of discount for internal structured settlement reserves at December 31, 2010 is distributed as follows over the years in which the losses were incurred (in thousands):

Loss Year	Discount
2010	$ 151
2009	5,704
2008	5,461
2007	7,155
2006	16,795
2005	12,445
2004	9,155
2003	13,239
2002	11,347
2001	16,279
Prior	55,012
Total	$ 152,743

3. INVESTMENTS

Estimated fair value of investments in bonds is based on quotations provided by accepted external pricing vendors. In both 2010 and 2009, Interactive Data Corporation (IDC) and Standard and Poor's Security Evaluations (SPSE) were used to obtain fair market values.

The SVO of the NAIC designates ratings of bonds from 1 to 6. Bonds with ratings of 1–2 are stated at amortized cost using the effective interest method. Bonds with ratings of 3–6 require the bond to be carried at the lower of amortized cost or market, with any related unrealized loss reported in policyholders' surplus.

During 2010 and 2009, Pinnacol had investments in bonds where the SVO designated the bonds at a 3 or higher rating. At December 31, 2010 and 2009, the fair market value on these bonds was greater than, or equal to, amortized cost, which resulted in a cumulative unrealized loss of $0 and $0, respectively, and carrying values equal to amortized cost for these bonds.

The book/adjusted carrying value and the fair value of investments in bonds in 2010 and 2009 are summarized as follows (in thousands):

	2010			
	Book/Adjusted Carrying Value	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair value**
U.S. government obligations:				
Non-loan-backed bonds	$ 285,476	$ 22,383	$ (928)	$ 306,931
Loan-backed bonds	21,493	1,561	-	23,054
Special revenue:				
Loan-backed bonds	338,755	23,829	-	362,584
Industrial and miscellaneous:				
Non-loan-backed bonds	917,458	87,854	(1,500)	1,003,812
	$ 1,563,182	$ 135,627	$ (2,428)	$ 1,696,381

	2009			
	Book/Adjusted Carrying Value	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair value**
U.S. government obligations:				
Non-loan-backed bonds	$ 265,854	$ 14,120	$ (4,270)	$ 275,704
Loan-backed bonds	29,440	1,125	-	30,565
Special revenue:				
Non-loan-backed bonds	4,987	372	-	5,359
Loan-backed bonds	394,885	17,599	(52)	412,432
Industrial and miscellaneous:				
Non-loan-backed bonds	920,806	62,821	(904)	982,723
	$ 1,615,972	$ 96,037	$ (5,226)	$ 1,706,783

The book/adjusted carrying value and estimated fair value of investments in bonds at December 31, 2010, by contractual maturity, are shown in the following table. Investments such as mortgage-backed securities have been allocated based on the original maturity date at issuance. Contractual maturities may differ from actual maturities because the borrower may have the right to call or prepay obligations with or without call or prepayment penalties.

	Book/Adjusted Carrying Value	Fair value
	(In thousands)	
Due in one year or less	$ 57,165	$ 57,795
Due after one year through five years	415,733	451,964
Due after five years through ten years	555,111	611,672
Due after ten years	535,173	574,950
	$1,563,182	$1,696,381

Proceeds from sales of investments in bonds during 2010 and 2009 were approximately $217,110,000 and $296,143,000, respectively. Realized gains on bonds of approximately $3,086,000 and $10,384,000 and realized losses of approximately $252,000 and $4,871,000 were recognized during 2010 and 2009, respectively. Realized losses on bonds include approximately $252,000 and $106,000 in other-than-temporary losses recognized during the years ended December 31, 2010 and 2009, respectively.

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

	Original Cost	Adjusted Cost	Unrealized Gains	Fair value
December 31, 2010	$259,324	$209,196	$86,156	$295,352
December 31, 2009	$273,750	212,205	$56,031	$268,236

The following table provides the length of impairment for those investments in bonds with an unrealized loss as of December 31, 2010 (in thousands):

	Less than 12 months		12 months or greater		Total	
Description of Securities	Fair value	Unrealized Losses	Fair value	Unrealized Losses	Fair value	Unrealized Losses
Industrial and miscellaneous	$ 35,266	$ (1,263)	$ 11,700	$ (237)	$ 46,966	$ (1,500)
Government obligations	2,459	(30)	57,259	(898)	59,718	(928)
Total	$ 37,725	$ (1,293)	$ 68,959	$ (1,135)	$106,684	$ (2,428)

The following table provides the length of impairment for those investments in bonds with an unrealized loss as of December 31, 2009 (in thousands):

Description of Securities	Less than 12 months Fair value	Less than 12 months Unrealized Losses	12 months or greater Fair value	12 months or greater Unrealized Losses	Total Fair value	Total Unrealized Losses
Industrial and miscellaneous	$ 7,923	$ (51)	$ 11,077	$ (853)	$ 19,000	$ (904)
Public utilities	53,894	(4,270)	-	-	53,894	(4,270)
Mortgage-backed securities	12,156	(52)	-	-	12,156	(52)
Total	$ 73,973	$ (4,373)	$ 11,077	$ (853)	$ 85,050	$ (5,226)

There were 16 and 6 bonds in an unrealized loss position as of December 31, 2010 and 2009, respectively.

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

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

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

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

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

Bonds — At December 31, 2010 and 2009, less than 1% and 1%, respectively, of bonds held by the Company were rated non-investment grade. At December 31, 2010 and 2009, the Company had approximately $1,500,000 and $904,000, respectively, of unrealized losses related to its industrial and miscellaneous bonds. The Company does not have any significant concentrations by issuer or by sector. The unrealized losses on the securities are primarily attributable to fluctuations in market interest rates and changes in credit spreads since the securities were acquired.

Loan-Backed-Securities — Loan-backed securities are stated at amortized cost or market value based on their NAIC designation. The prospective method is used to value mortgage-backed securities. Prepayment assumptions for single class and multi-class mortgage-backed/asset-backed securities were obtained from Yield Book and Bloomberg. All loan-backed and structured securities in an unrealized loss position were reviewed to determine whether an other-than-temporary impairment should be recognized. Pinnacol recognized other-than-temporary impairments on loan-backed securities during the year ended December 31, 2010 for approximately $252,000. Pinnacol did not recognize any other-than-temporary impairments on loan-backed securities during the year ended December 31, 2009.

Other-Than-Temporary Impairment — During 2010 and 2009, Pinnacol recognized approximately $252,000 and $106,000, respectively, in other-than-temporary impairments on bonds. During the years ended December 31, 2010 and 2009, the Company recorded other-than-temporary impairments on common stocks and mutual funds in the amounts of approximately $231,000 and $900,000, respectively. These impairments relate to market declines in value as of the last day of the year.

Fair Value Measurements — The Company's assets recorded at fair value have been categorized based upon a fair value hierarchy. The levels of the fair value hierarchy are described below.

- Level 1 inputs utilize observable, quoted prices (unadjusted) in active markets for identical assets that the Company has the ability to access. Financial assets utilizing Level 1 inputs include actively exchange-traded equity securities.

- Level 2 inputs utilize other than quoted prices included in Level 1 that are observable for the asset, either directly or indirectly. Level 2 inputs include quoted prices for similar assets in active markets, and inputs other than quoted prices that are observable for the asset, such as interest rates and yield curves that are observable at commonly quoted intervals.

- Level 3 inputs are unobservable and include situations where there is little, if any, market activity for the asset.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset.

The following table presents (in thousands) information about the Company's financial assets measured at fair value on a recurring basis for accounting purposes as of December 31, 2010 and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

	Fair Value Measurements - Recurring Basis December 31, 2010			
Assets	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Total**
Common stocks and mutual funds	$ 295,352	$ -	$ -	$ 295,352
Total assets	$ 295,352	$ -	$ -	$ 295,352

Certain assets are measured at fair value on a non-recurring basis quarterly or more frequently if events dictate that the carrying value of the asset may not be recovered. These assets include bonds held at fair value with an NAIC rating of 3–6. There were no bonds with these ratings where the carrying value was less than market value at December 31, 2010.

Investment Income — Major categories of net investment income for the years ended December 31, 2010 and 2009 are summarized as follows (in thousands):

	2010	**2009**
Investment income:		
Corporate and miscellaneous bonds	$ 72,387	$ 76,735
U.S. government bonds	12,866	13,180
Cash and other investments	24	367
Real estate	3,864	3,866
Equity securities	4,573	4,569
Investment expenses	(4,218)	(4,315)
Net investment income earned	89,496	94,402
Net realized capital (losses) gains	21,187	4,773
Net investment income	$ 110,683	$ 99,175

The company did not have any significant concentrations by industry or by issuer as of December 31, 2010 or 2009.

4. UNINSURED PLANS AND UNINSURED PORTION OF PARTIALLY INSURED PLANS

Pinnacol offers Administrative Services Contract Plans whereby Pinnacol acts as a third party administer for all workers' compensation claims under these contracts. All loss and loss adjustment expenses related to claims under these contracts are reimbursed to Pinnacol. Pinnacol does not record premium revenue nor loss and loss adjustment expenses on these plans, but does show the related receivables for these costs. Claims processed and reimbursed under these contracts were approximately $37,080,000 and $34,294,000 in 2010 and 2009, respectively. Included in these contracts are transactions with the State.

5. REINSURANCE

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

- Layer 1 - Limit of $20,000,000 in excess of retention of $20,000,000 per occurrence
- Layer 2 - Limit of $40,000,000 in excess of retention of $40,000,000 per occurrence

This coverage was in effect at December 31, 2010 and 2009. Management is not aware of any loss nor did the Company record any loss great enough to attach to these layers during any of the aforementioned policy periods.

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

Pinnacol uses Lloyd's Syndicates as part of its ceded reinsurer program and are generally not rated by AM Best. The remaining reinsurers had the following AM Best ratings at December 31, 2010:

Reinsurer	AM Best Rating
Aspen Insurance UK Limited	A
AXIS Specialty Limited	A
Endurance Specialty Insurance Limited	A
Flagstone Reassurance Suisse SA	A-
Validus Reinsurance Limited	A-

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

Pinnacol held unearned premium reserves related to assumed business of $1,661,000 and $1,546,000 for the years ended December 31, 2010 and 2009 respectively. Pinnacol had loss and loss adjustment expense reserves related to assumed business of $26,300,000 and $28,834,000 for the years ended December 31, 2010 and 2009, respectively.

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

	2010	2009
Direct premiums written	$ 330,531	$ 353,824
Premiums ceded	(1,016)	(1,041)
Premiums assumed	17,247	17,247
Net premiums written	$ 346,762	$ 370,030
Direct premiums earned	$ 328,495	$ 381,693
Premiums ceded	(1,016)	(1,041)
Premiums assumed	17,133	17,850
Net premiums earned	$ 344,612	$ 398,502
Direct losses incurred	$ 234,488	$ 248,298
Losses ceded	-	-
Losses assumed	9,154	7,225
Net losses incurred *	$ 243,642	$ 255,523
Direct loss adjustment expenses incurred	$ 15,704	$ 31,312
Loss adjustment expenses ceded	-	-
Loss adjustment expenses assumed	432	3,231
Net loss adjustment expenses incurred	$ 16,136	$ 34,543

* Net losses incurred for 2010 excludes activity related to the internal structured settlement liability.

6. EMPLOYEE BENEFITS

Defined Benefit Pension Plan through the State of Colorado

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

Defined benefit plan members vest after five years of service and are eligible for full retirement based on their original hire date as follows:

- Hired before July 1, 2005 - age 50 with 30 years of service, age 60 with 20 years of service, or age 65 with 5 years of service.

- Hired on or after July 1, 2005 but before January 1, 2007 – any age with 35 years of service, age 55 with 30 years of service, age 60 with 20 years of service, or age 65 with 5 years of service.

- Hired on or after January 1, 2007 but before January 1, 2011 – any age with 35 years of service, age 55 with 30 years of service, age 60 with 25 years of service, or age 65 with 5 years of service.

- Hired on or after January 1, 2011 – any age with 35 years of service, age 58 with 30 years of service, age 65 with 5 years of service.

Members are also eligible for retirement benefits without a reduction for early retirement based on their original hire date as follows:

- Hired before January 1, 2007 – age 55 with a minimum of 5 years of service credit and age plus years of service equals 80 or more.

- Hired on or after January 1, 2007 but before January 1, 2011 – age 55 with a minimum of 5 years of service credit and age plus years of service equals 85 or more.

- Hired on or after January 1, 2011 – age 58 with a minimum of 5 years of service credit and age plus years of service equals 88 or more.

Members automatically receive the higher of the defined retirement benefit or money purchase benefit at retirement. Defined benefits are calculated as 2.5% times the number of years of service times the highest average salary (HAS). For members eligible to retire as of January 1, 2011,, HAS is determined by the highest annual salaries associated with four periods of 12 consecutive months. The lowest of the four periods becomes the base year used as a starting point for a 15% cap on annual salary increases. For members not eligible to retire as of January 1, 2011, more restrictive limits of 8% are placed on salary increases between periods used in calculating HAS.

Prior to January 1, 2010, retiree benefits were increased annually based on their original hire date as follows:

- Hired before July 1, 2005 – 3.5%, compounded annually.

- Hired between July 1, 2005 and December 31, 2006 – the lesser of 3% or the actual increase in the national Consumer Price Index (CPI).

- Hired on or after January 1, 2007 – the lesser of 3% or the actual increase in the national Consumer Price Index, limited to a 10% reduction in a reserve established for cost of living increases related strictly to those hired on or after January 1, 2007. (The reserve is funded by 1 percentage point of salaries contributed by employers for employees hired on or after January 1, 2007.)

In the 2010 legislative session, the general assembly set the current increase as the lesser of 2% or the average of the monthly CPI amounts for the prior calendar year. The 2009 CPI was negative resulting in a calendar year 2010 increase of 0 %. The 2010 legislation moved the payment date of all increases to July. New rules governing the annual increase amount will be in effect beginning January 1, 2011.

For January 1, 2011 and beyond , retiree benefits are increased annually based upon the following:

- Hired before January 1, 2007 whose benefit is paid based on retirement prior to January 1, 2011 – 2% per year unless PERA has a negative investment year in which the lessor of 2% or the average monthly CPI of the prior year for the next three years if the recipient has been receiving benefits for the last seven months.

- Hired before January 1, 2007 whose benefit is paid based on retirement on or after January 1, 2011 – 2% per year unless PERA has a negative investment year in which the lessor of 2% or the average monthly CPI of the prior year for the next three years if the recipient has been receiving benefits for the last twelve months.

- Hired on or after January 1, 2007 – the lessor of 2% or the average monthly CPI of the prior year for the next three years if the recipient has been receiving benefits for the last twelve months.

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

Funding Policy **-** The contribution requirements of plan members and their employers are established, and may be amended, by the General Assembly. Salary subject to PERA contribution is gross earnings less any reduction in pay to offset employer contributions to the state sponsored IRC 125 plan established under Section 125 of the Internal Revenue Code.

All employees contribute 10.50% of their salary, as defined in CRS 24-51-101(42), to an individual account in the plan. From January 1, 2009, to December 31, 2009, Pinnacol contributed 12.95% of the employee's salary. From January 1, 2010, through June 30, 2010, Pinnacol contributed 13.85%. From July 1, 2010 through December 31, 2010, Pinnacol contributed 11.35%. During all of 2010, 1.02% of the employees' total salary was allocated to the Health Care Trust Fund.

Per Colorado Revised Statutes, an amortization period of 30 years is deemed actuarially sound. At December 31, 2009, the division of PERA in which Pinnacol participates was underfunded with an infinite amortization period, which means that the unfunded actuarially accrued liability would never be fully funded at the current contribution rate.

In the 2004 legislative session, the general assembly authorized an Amortization Equalization Disbursement (AED) to address a pension-funding shortfall. The AED requires PERA employers to pay an additional .5% of salary beginning January 1, 2006, another .5% of salary in 2007, and subsequent year increases of .4% of salary until the additional payment reaches 3.0% in 2012.

In the 2006 legislative session, the general assembly authorized a Supplemental Amortization Equalization Disbursement (SAED) that requires PERA employers to pay an additional one half percentage point of total salaries paid beginning January 1, 2008. The SAED is scheduled to increase by one-half percentage point through 2013 resulting in a cumulative increase of three percentage points. For state employers, each year's one half percentage point increase in the SAED will be deducted from the amount of changes to state employees' salaries, and used by the employer to pay the SAED. Both the AED and SAED will terminate when funding levels reach 100%.

In the 2010 legislative session, the general assembly extended both the AED and SAED. The AED will continue to increase at a rate of .4% of salary from calendar years 2013 through 2017. The SAED will continue to increase by one-half percentage point from calendar years 2014 through 2017. If the funding ratio reaches 103%, both the AED and the SAED will be reduced by one-half percentage point. Neither the AED nor the SAED may exceed 5%.

Pinnacol expects the annual contribution rate, including AED and SAED, to increase as follows from 2011 to 2018:

Year	Employer Contribution	AED	SAED	Total Pinnacol Contribution
2011	7.65%	2.60%	2.00%	12.25%
2012	10.15%	3.00%	2.50%	15.65%
2013	10.15%	3.40%	3.00%	16.55%
2014	10.15%	3.80%	3.50%	17.45%
2015	10.15%	4.20%	4.00%	18.35%
2016	10.15%	4.60%	4.50%	19.25%
2017	10.15%	5.00%	5.00%	20.15%
2018	10.15%	5.00%	5.00%	20.15%

Historically members have been allowed to purchase service credit at reduced rates. However, legislation passed in the 2006 session required that future agreements to purchase service credit be sufficient to fund the related actuarial liability.

Pinnacol's contributions to PERA for the years ending December 31, 2010 and 2009 were $5,118,000 and $5,259,000 respectively. These contributions met the contribution requirement for each year.

In 2010, Pinnacol became aware of an unfunded liability to PERA of approximately $75-$80 million which relates to the vested service of Pinnacol employees whose future benefits relate to that service. The variables that impact the determination of the liability are the number of active and inactive members, annual payroll, required contribution rates and the investment returns of PERA. Pinnacol believes the obligation exists if Pinnacol remains part of PERA as these funds will be collected through increased assessments on current and future salaries. (Refer to Note 8 for further discussion.)

Voluntary Tax-Deferred Retirement Plans

PERA offers a voluntary 401(k) plan entirely separate from the defined benefit pension plan. Pinnacol offers a 457 deferred compensation plan. Pinnacol matches employee's elective contributions into the PERA 401(k) plan at 50% up to the first 6% of employees' elected deferrals. The matching contribution is immediately vested and available to the employees. During the year ended December 31, 2010 and 2009, Pinnacol contributed approximately $970,000 and $907,000, respectively, in matching contributions to the 401(k) plan.

Postretirement Health Care and Life Insurance Benefits

Health Care Program — The PERA Health Care Program began covering benefit recipients and qualified dependents on July 1, 1986. This benefit was developed after legislation in 1985 established the program and the Health Care Fund; the program was converted to a trust fund in 1999. The plan is a cost-sharing multiple-employer plan under which PERA subsidizes a portion of the monthly premium for health care coverage. The benefits and employer contributions are established in statute and may be amended by the General Assembly. PERA includes the Health Care Trust Fund in its Comprehensive Annual Financial Report, which may be obtained by writing PERA at PO Box 5800, Denver, Colorado 80217, by calling PERA at 1-800-759-PERA (7372), or by visiting www.copera.org.

After the PERA subsidy, the benefit recipient pays the balance of the premium through an automatic deduction from the monthly retirement benefit. Monthly premium costs for participants depend on the health care plan selected, the PERA subsidy amount, Medicare eligibility, and the number of persons covered. Effective July 1, 2000, the maximum monthly subsidy is $230 per month for benefit recipients who are under 65 years of age and who are not entitled to Medicare and $115 per month for benefit recipients who are 65 years of age or older or who are under 65 years of age and entitled to Medicare. The maximum subsidy is based on the recipient having 20 years of service credit, and is subject to reduction of 5% for each year less than 20 years.

Employees are not required to contribute to the Health Care Trust Fund, which is maintained by employer's contributions as discussed above. Beginning July 1, 2004, employers are required to contribute 1.02% of gross covered wages to the Health Care Trust Fund. Pinnacol contributed approximately $414,000 and $414,000 as required by statute in the years ended December 31, 2010 and 2009, respectively. In each year the amount contributed was 100% of the required contribution.

The Health Care Trust Fund offers two general types of plans: fully-insured plans offered through health care organizations and self-insured plans administered for PERA by third-party vendors. As of December 31, 2010, there were 46,455 enrolled participants, including spouses and dependents, from all contributors to the plan. At December 31, 2010, the Health Care Trust Fund had an unfunded actuarial accrued liability of $1.40 billion, a funded ratio of 17.5%, and a 42-year amortization period.

Accrued Paid Leave — Pinnacol employees may accrue paid time off based on their length of service subject to certain limitations on the amount that will be paid upon termination or taken in future periods. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The estimated liability for cumulative accrued paid time off of approximately $1,786,000 and $1,574,000 at December 31, 2010 and 2009, respectively, is included in other liabilities in the statutory statements of admitted assets, liabilities and policyholders' surplus.

7. POLICYHOLDERS' SURPLUS

Pinnacol paid approximately $48,226,000 and $122,600,000 in general policyholder dividends to its policyholders in good standing in 2010 and 2009, respectively. This is included in dividends to policyholders on the statutory statements of operations and changes in policyholders' surplus and reduces net operations for the year ended December 31, 2010.

The Division monitors a company's "risk based capital" in assessing the financial strength of an insurance company. Pinnacol's level of surplus exceeds the "company action level" of risk-based capital, which is approximately $106,067,000 for 2010.

8. COMMITMENTS AND CONTINGENCIES

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

At December 31, 2010 and 2009, Pinnacol had a letter of credit for the benefit of Argonaut Insurance Company under the assumptive reinsurance agreement for approximately $39,964,000 and $46,169,000, respectively. In addition, Pinnacol had a letter of credit for the benefit of Zurich American Insurance Company under an assumptive reinsurance agreement for approximately $10,800,000 as of December 31, 2010. These reinsurance agreements allow each reinsurer to draw upon the letter of credit, which is 100% collateralized, at any time to secure any of Pinnacol's obligations under the agreement. Included in fixed maturities are amounts held as collateral for the letter of credit of approximately $79,718,000 and $77,433,000, compared to a requirement of $50,764,000 and $46,169,000, as of December 31, 2010 and 2009, respectively.

Pinnacol is contingently liable for approximately $55,135,000 of claims closed by the purchase of annuities from life insurers for structured settlements. Pinnacol purchased annuities that aggregated more than one percent of surplus from Genworth Life and Annuity Insurance Company of Virginia and Symetra Life Insurance Company of Washington for reserves that approximated $32,392,000 and $15,756,000 as of December 31, 2010. These insurance companies are authorized insurers in the state of Colorado. No provision has been made for this contingency as management believes that any payments related to this contingency are remote.

In 2010, Pinnacol became aware of an unfunded liability to PERA of approximately $75-$80 million which relates to the vested service of Pinnacol employees whose future benefits relate to that service. The variables that impact the determination of the liability are the number of active and inactive members, annual payroll, required contribution rates and the investment returns of PERA. The obligation exists if Pinnacol were to partially or fully leave the PERA program and the funding would become immediately due to PERA. Currently, the possibility of the Company partially or fully leaving the PERA program is remote. In accordance with SSAP No. 5R, "Liabilities, Contingencies and Impairments of Assets", the Company has not recorded this estimated contingency as of December 31, 2010.

9. RECONCILIATION OF ANNUAL STATEMENT TO AUDITED FINANCIAL STATEMENTS

The accompanying statutory financial statements reflect certain adjustments to amounts previously reported in the annual statement filed with the Colorado Division of Insurance. The following reconciles admitted assets, capital and surplus and net income included in the annual statement to the accompanying statutory financial statements as of December 31, 2009 (in thousands):

2009	Admitted Assets	Capital and Surplus	Net Income
Total per annual statement	$ 2,016,667	$ 732,527	$ (91,231)
Other-than-temporary impairment adjustment	-	-	68,272
Total per statutory financial statements	$ 2,016,667	$ 732,527	$ (22,959)

There are no differences in the admitted assets, capital and surplus and net loss as presented in the accompanying statutory-basis financial statements and the amounts as presented in the Company's annual statement (as amended) filed with the Colorado Division of Insurance as of December 31, 2010.

10. SUBSEQUENT EVENTS

General Dividend Declared - The board of directors held a meeting on April 13, 2011 in which it declared a general dividend of approximately $41,250,000 to its policyholders with policies in good standing. This general dividend was paid in May 2011. The board of directors, at its discretion, determines the amount of policyholder dividends to be declared based on Pinnacol's overall experience and financial condition.

Third Party Administration Program - Pinnacol made a decision to terminate its Third Party Administration (TPA) program in 2011. The Administrative Services Contract (ASC) Plan provides an administrative service in which claims are paid on the employer's behalf and subsequently reimbursed by the employer. The Company will honor any contracts in force in 2011 but will not renew these contracts, effectively eliminating the program by December, 31, 2011. The Company does not believe this event will have a material impact on its financial condition.

New Board Members - Three members of the Company's board were replaced after December 31, 2010. It was determined that one board member no longer met the qualifications in the statute to act as a board member and voluntarily resigned. The remaining members were replaced after their terms had expired.

These events have been evaluated through July 28, 2011, the date these statutory financial statements were available to be issued.

SUPPLEMENTAL SCHEDULES OF INVESTMENT INFORMATION

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION — INVESTMENT RISKS INTERROGATORIES FOR THE YEARS ENDED DECEMBER 31, 2010

1. Pinnacol's total admitted assets as reported on page two of its Annual Statement are $1,978,764,000.

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

	Issuer	Description of Exposure	Amount	Percentage of Total Admitted Assets
a.	Vanguard	Mutual fund	$115,393,392	5.8 %
b.	General Electric Co	Bonds & Common stock	46,086,855	2.3
c.	Verizon New Jersey Inc	Bonds & Common stock	43,237,328	2.2
d.	Rainier	Mutual fund	41,204,384	2.1
e.	Anheuser-Busch	Bonds	40,505,096	2.0
f.	Bellsouth Corporation	Bonds & Common stock	35,686,842	1.8
g.	IBM	Bonds	34,787,155	1.8
h.	PacifiCorp	Bonds	34,100,796	1.7
i.	Emerson Electric Co	Bonds & Common stock	30,681,708	1.6
j.	Proctor & Gamble	Bonds & Common stock	28,593,935	1.4

3. Pinnacol's total admitted assets held in bonds by NAIC rating are:

Bonds		
NAIC Rating	Amount	Percentage of Total Admitted Assets
NAIC-1	$1,393,599,907	70.4 %
NAIC-2	222,821,755	11.3
NAIC-3	5,623,540	0.3
NAIC-4	6,254,984	0.3
NAIC-5	-	0.0
NAIC-6	-	0.0
	$1,628,300,186	

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

Items 5 through 10 are not applicable.

(Continued)

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

Item 12 is not applicable.

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

	Issuer	**Amount**	**Percentage of Total Admitted Assets**
a.	Vanguard	$115,393,392	5.8 %
b.	Rainer	41,204,384	2.1
c.	T Rowe Price	27,032,082	1.4
d.	Matthews Asian	20,300,233	1.0
e.	First Eagle Overseas	12,237,501	0.6
f.	Scout International	11,691,052	0.6
g.	Managers Cadence	11,397,274	0.6
h.	Exxon Mobil Corporation	2,222,848	0.1
i.	Emerson Electric Co.	2,214,194	0.1
j.	3M Co.	2,071,200	0.1

Items 14 through 23 are not applicable.

(Concluded)

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION — SUMMARY INVESTMENT SCHEDULE AS OF DECEMBER 31, 2010

Investment Categories	Gross Investment Holdings*		Admitted Assets as Reported in the Annual Statement	
	Amount	Percentage of Gross Investment Holdings	Amount	Percentage of Total Admitted Assets
Bonds:				
U.S. Treasury securities	$ 267,374,093	13.8%	$ 267,374,093	13.8%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
- Issued by U.S. government agencies				
- Issued by U.S. government-sponsored agencies	12,513,329	0.6%	12,513,329	0.6%
Foreign government (including Canada, excluding mortgage-backed securities)	4,988,606	0.3%	4,988,606	0.3%
Securities issued by states, territories, and possessions and their political subdivisions in the U.S.:				
- State, territory, and possessions — general obligations	600,000	0.0%	600,000	0.0%
- Political subdivisions of states, territories, and possessions — general obligations				
- Revenue and assessment obligations				
- Industrial development and similar obligations				
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
- Guaranteed by GNMA	21,492,537	1.1%	21,492,537	1.1%
- Issued by FNMA and FHLMC	43,356,136	2.2%	43,356,136	2.2%
- All others				
CMOs and REMICs:				
- Issued or guaranteed by GNMA, FNMA, FHLMC or VA	295,399,263	15.3%	295,399,263	15.3%
- Issued by non-US Govt issuers and collateralized by motgage-backed securities issued by above				
- All other				
Other debt and other fixed income securities (excluding short term):				
- Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	871,577,414	45.1%	871,577,414	45.1%
- Unaffiliated foreign securities	45,880,890	2.4%	45,880,890	2.4%
- Affiliated securities				

(Continued)

PINNACOL ASSURANCE

SUPPLEMENTAL SCHEDULE OF INVESTMENT INFORMATION — SUMMARY INVESTMENT SCHEDULE AS OF DECEMBER 31, 2010

Investment Categories	Gross Investment Holdings* Amount	Gross Investment Holdings* Percentage of Gross Investment Holdings	Admitted Assets as Reported in the Annual Statement Amount	Admitted Assets as Reported in the Annual Statement Percentage of Total Admitted Assets
Equity interests:				
- Investments in mutual funds	$ 239,255,918	12.4%	$ 239,255,918	12.4%
Preferred stocks:				
- Affiliated				
- Unaffiliated				
Publicly traded equity securities (excluding preferred stocks):				
- Affiliated				
- Unaffiliated	56,096,517	2.9%	56,096,517	2.9%
Other equity securities:				
- Affiliated				
- Unaffiliated				
Other equity interests including tangible personal property under lease:				
- Affiliated				
- Unaffiliated				
Mortgage loans:				
- Construction and land development				
- Agricultural				
- Single-family residential properties				
- Multifamily residential properties				
- Commercial loans				
Real estate investments:				
- Property occupied by Company	21,115,875	1.1%	21,115,875	1.1%
- Property held for production of income				
-Property issued or guaranteed by GNMA, FNMA				
Collateral loans				
Policy loans				
Receivables for securities	530,716	0.0%	530,716	0.0%
Cash, cash equivalents and short-term investments	52,809,441	2.7%	52,809,441	2.7%
Write-ins for invested assets				
TOTAL INVESTED ASSETS	$ 1,932,990,735	100.0%	$ 1,932,990,735	100.0%

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

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

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REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF THE FINANCIAL STATEMENTS IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

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

We have audited the statutory-basis financial statements of Pinnacol Assurance (Pinnacol) as of and for the year ended December 31, 2010, and have issued our report thereon dated July 28, 2011. Our report is modified for statutory basis of accounting presentation. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America.

Internal Control over Financial Reporting

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

A *deficiency* in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Company's statutory-basis financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

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

Although we have included management's written response to our comments in the Findings and Recommendations section above, such responses have not been subjected to the auditing procedures applied in the audit of the statutory-basis financial statements and, accordingly, we do not express an opinion or provide any form of assurance on the appropriateness of the responses or the effectiveness of any corrective actions described therein.

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

Deloitte + Touche LLP

July 28, 2011

PINNACOL ASSURANCE

DISTRIBUTION
DECEMBER 31, 2010

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