PINNACOL ASSURANCE

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

December 31, 2007 and 2006

(With Independent Auditors' Report Thereon)

KPMG LLP
Suite 2700
707 Seventeenth Street
Denver, CO 80202

May 21, 2008

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, 2007. Our audit was conducted in accordance with auditing standards generally accepted in the United States of America. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S., which authorizes an annual audit of Pinnacol made by an auditor or firm of auditors, having the specialized knowledge and experience, retained by the state auditor with the consultation and advice of the chief executive officer and the commissioner of insurance. The reports that we have issued as a result of this engagement are set forth in the table of contents, which follows.

KPMG LLP

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PINNACOL ASSURANCE

Report Summary

Authority and Purpose/Scope of the Audit

This audit was conducted under the authority of Section 8-45-121(2) of the Colorado Revised Statutes (C.R.S.), which authorizes an annual audit of Pinnacol Assurance (Pinnacol or the Company) made by an auditor or firm of auditors, having the specialized knowledge and experience, retained by the state auditor with the consultation and advice of Pinnacol's chief executive officer and the commissioner of insurance. The primary purpose of our engagement was to audit the statutory financial statements of Pinnacol at December 31, 2007, and for the year then ended, in accordance with auditing standards generally accepted in the United States of America and to express an opinion on those financial statements and the notes thereto. The objective of an audit conducted in accordance with such standards is to obtain reasonable, but not absolute, assurance about whether the statutory financial statements are free of material misstatement.

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

We examined, on a test basis, evidence supporting the amounts and disclosures in Pinnacol's financial statements as of December 31, 2007. The accounting practices used by Pinnacol to prepare the financial statements are in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division).

Required Communications to the Legislative Audit Committee

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

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

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

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

2. **Significant Accounting Policies and Alternative Treatments** – The significant accounting policies used by Pinnacol are described in note 1 to the statutory financial statements. There were no changes to significant accounting policies in 2007.

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

   Uncollected Premiums – The amount of uncollected premiums, which affects the amount of premium revenue recognized, is estimated using statutory requirements, as well as certain management judgments. Management must determine whether an allowance should be established to provide for all reasonably anticipated uncollectible amounts inherent in the uncollected premiums balance. Factors that are considered in establishing reserves for anticipated uncollectible amounts are collection experience and trends, current overall aging of balances, economic conditions and trends, and evaluations of individual accounts. At December 31, 2007, the admitted value of uncollected premiums is estimated to be $64,074,000.

   Earned but Unbilled Premiums Receivable – Pinnacol estimates audit premium adjustments based on prior experience. This prior experience provides actual collection activity, which is then used in establishing estimated premium revenue in the current period related to audit adjustments, subject to current influences such as inflation and other factors. For 2007, estimated net unbilled audit premiums receivable of $20,737,000 are included in uncollected premiums.

   Unpaid Losses and Loss Adjustment Expenses – Estimating unpaid losses and loss adjustment expenses (reserves) of an insurance company is a subjective and judgmental process, particularly for workers' compensation insurance, where the ultimate liability to a claimant may not be known with certainty for a number of years. To assist management in estimating the liability for unpaid losses and loss adjustment expenses, Pinnacol retains the actuarial consulting services of Milliman U.S.A. At December 31, 2007, Pinnacol has accrued $1,253,864,000 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 2007 or prior. Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in 2007. 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.

(Continued)

4. **Audit Adjustments and Uncorrected Misstatements** – The statutory financial statements incorporated herein contain no differences with Pinnacol's Annual Statement as filed with the Division for the year ended December 31, 2007. In connection with our audit of the Company's statutory financial statements, 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, 2007 totaling $252,092, net. We have reported such misstatements to management on a Summary of Audit Differences and have received written representations from management that management believes 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.

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

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

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

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

   We hereby confirm that as of May 21, 2008, we are independent accountants with respect to Pinnacol under all relevant professional and regulatory standards.

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

Summary of Major Audit Findings

Information Technology General Controls Policies

Internal control over information technology is important, as it is a component of internal control over financial reporting. Pinnacol's information technology general control policies for documentation of system access reviews, segregation of duties conflicts, program change management, and communication of system changes were not always adequate.

Importance of the Internal Control Environment

Pinnacol's internal control environment as respects proper segregation of duties over check handling as well as certain corporate governance changes that may further mitigate fraud risks through prevention, detection, or general tone at the top should be enhanced.

Reporting Structure of the Internal Audit Function

Another important aspect of corporate governance is the reporting structure an organization has in place for its internal audit function. In Pinnacol's case, the independence of the internal audit function could be enhanced.

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.

PINNACOL ASSURANCE

Recommendation Locator

December 31, 2007

Recommendation locator

Recommendation number	**Page number**	**Recommendation summary**	**Pinnacol response**	**Implementation date**
1	8	Pinnacol should enhance its information technology controls by expanding control policies and procedures related to documentation of system access reviews, segregation of duties conflicts, program change management, and training.	Agree	Third quarter 2008
2	9	Pinnacol should implement changes with respect to segregation of duties over check handling and should consider corporate governance changes to further mitigate fraud risks and strengthen the overall control environment.	Agree	Continuing and on-going
3	10	Pinnacol should reevaluate the reporting structure of the internal audit function and consider ways to enhance the independence of the function.	Agree	Continuing and on-going

PINNACOL ASSURANCE

Description of Pinnacol Assurance

December 31, 2007

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

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

In 2007, Pinnacol paid over $60.6 million in general policyholder dividends to its policyholders in good standing. This is included in Dividends to Policyholders on the statutory statement of income and changes in policyholders' surplus and reduces net income for the year ending December 31, 2007. This accounting treatment is in accordance with statutory accounting practices. See further information at note 1(m), General Policyholder Dividends.

Policyholders' Surplus

Pinnacol had policyholders' surplus of $722,072,000 and $607,473,000 as of December 31, 2007 and 2006, respectively. The increase in surplus is primarily related to current-year net income.

A control deficiency 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 misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively. The following findings are deemed to be control deficiencies.

Information Technology General Controls Policies

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

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

- As identified in the 2006 audit, Pinnacol’s system administrators perform periodic reviews of active users and user access rights to identify and remove inappropriate system access; however, no documentation of the reviews exists. The effect of not documenting these reviews is that there is no written evidence that user access issues, if any, are being identified and resolved.
- Also as identified in the 2006 audit, seven technology liaisons, who are employees who work to bridge the gap between business needs and information technology, as well as 17 other employees, have access to create both policies and claims in the Workers’ Compensation Information System (WCIS), thereby creating segregation of duties conflicts between the underwriting and claims functions. The risk associated with these conflicts is mitigated, however, by several controls in the process, which must occur before a claim may be paid. Though it does not appear that any of these employees created both a policy and a claim, such access could give rise to errors or misstatements.
- Claims representatives were able to request that claims payment checks be directed back to themselves for special handling (i.e., to hand-deliver to a claimant) through the WCIS system. According to Pinnacol management, a system change was implemented in December 2007 to require that claims payment checks needing special handling be directed to someone other than the claim representative initiating the request to mitigate the risk of fraud. However, this system change was not tested prior to being migrated into production. Later, it was found that the system change was not operating as intended, and certain claims representatives were still able to direct checks back to themselves.

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- Accident dates are entered into the system by claims personnel. When a claimant dies, the accident date in the system must be changed to the date of death for purposes of reporting requirements with the Division of Workers' Compensation. After those reporting requirements are completed, the date of death should be changed back to the accident date so that Pinnacol's actuaries have the correct data for purposes of reserve setting; however these dates were not always being properly changed back by the claims representatives. According to Pinnacol management, a system change was implemented to ensure that the dates were automatically changed back by the system after a short period of time. However, there was no communication of, or training on, this system change for the claims representatives, and in some cases, they were continuing to manually change the dates. Pinnacol's actuaries appropriately considered this issue in determining the reserve estimate; therefore, the effect on the financial statements is insignificant.

Recommendation No. 1

Pinnacol should enhance its information technology general controls by expanding control policies and procedures related to documentation of system access reviews, segregation of duties conflicts, program change management, and training.

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

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

c. All program changes should be properly tested, and issues noted as a result should be resolved, before the changes are migrated into production.

d. All pertinent system changes should be properly communicated to affected personnel, and training, if necessary, should be provided, to ensure that system users are appropriately utilizing the system.

Pinnacol Response

Agree. The recommendation will be implemented by the end of the third quarter of 2008.

Importance of the Internal Control Environment

A Wells Fargo Financial Crimes Investigator notified Pinnacol management of suspicious check cashing activity in Pinnacol's account in April 2007. A concurrent investigation was initiated by Pinnacol management and internal audit. Management's investigation was completed in July 2007, and determined that inappropriate charges and improper check cashings were made by a Pinnacol employee totaling approximately $30,000. The employee is no longer employed by Pinnacol and litigation was pursued.

Internal audit's investigation was finalized in August 2007 and resulted in several internal control recommendations for management's consideration in order to prevent or deter fraud from occurring in the future. Although management agreed with most of internal audit's control recommendations, certain key recommendations were not implemented until the first quarter of 2008. Those recommendations are as follows:

1) Internal controls to prevent the person requesting a check from being able to access it after issuance were not effectively implemented as of December 31, 2007. According to Pinnacol management, these controls were effectively implemented in March 2008.

2) Checks directed to Pinnacol, including those returned due to inaccurate addresses, fatalities, changes in work status, or other matters should be sent directly to the Finance Department. This process will allow checks to be appropriately accounted for and further mitigate the risk of improper handling.

In addition, internal audit recommended that Pinnacol implement certain corporate governance changes that may further mitigate fraud risks through prevention, detection, or general tone at the top. These recommendations include:

- Adopting a corporate fraud policy;
- Enhancing whistle-blowing policies to include protections for employees when reporting suspicious incidents and establishing protocols for incident follow-up and resolution; and
- Training employees annually on:
  - ethics and compliance matters, including fraud indicators;
  - processes in place for reporting such matters and indicators; and
  - protocols for incident follow-up and resolution.

Recommendation No. 2

Pinnacol should consider the corporate governance changes mentioned above to further mitigate fraud risks and continue to strengthen Pinnacol's overall internal control environment.

Pinnacol Response

Agree. Pinnacol has taken this issue very seriously from the initial response through the thorough evaluation of internal controls. All recommendations from the internal audit report have been implemented. Additionally, Pinnacol continues to evaluate our corporate governance environment.

Reporting Structure of the Internal Audit Function

Another important aspect of corporate governance is the reporting structure an organization has in place for its internal audit function. Pinnacol's internal audit currently reports administratively to the Chief Financial Officer (CFO) with open communication lines to the external audit committee chairperson. Under *Government Auditing Standards* issued by the U.S. Comptroller General, in order for an internal audit function to be free from organizational impairments to independence, in addition to having access to those charged with governance, internal audit should be located organizationally outside the line-management function of the unit under audit. In Pinnacol's case, the independence of the internal audit function could be enhanced by having internal audit report administratively to the Chief Executive Officer or another member of senior management that does not have responsibility for overseeing the financial activities of the organization.

(Continued)

Recommendation No. 3

Pinnacol should reevaluate the reporting structure of the internal audit function and consider ways to enhance the independence of this function.

Pinnacol Response

Agree. The Pinnacol audit committee will continue to evaluate the internal audit reporting structure on an annual basis.

Disposition of Prior Audit Recommendation

The audit report for the year ended December 31, 2006 included one recommendation. The disposition of this audit recommendation is as follows:

Recommendation	Disposition
Pinnacol should enhance its information technology controls policies by expanding policies related to physical access for facilities, documentation of system access reviews, and segregation of duties conflicts.	Partially implemented – see Recommendation No. 1 on page 8.

KPMG LLP
Suite 2700
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Denver, CO 80202

Independent Auditors' Report

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

We have audited the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance (the Company) as of December 31, 2007 and 2006, and the related statutory statements of income and changes in policyholders' surplus and cash flows for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of Pinnacol Assurance as of December 31, 2007 and 2006, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended, in conformity with accounting practices prescribed or permitted by the Division.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 21, 2008 on our consideration of the Company's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on 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 audit.

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

KPMG LLP

May 21, 2008

PINNACOL ASSURANCE

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

December 31, 2007 and 2006

(In thousands)

Admitted Assets		2007	2006
Cash and invested assets:			
Bonds at amortized cost, fair value of $1,702,698 in 2007 and $1,625,367 in 2006 (note 3)	$	1,678,243	1,631,197
Common stock at fair value, cost of $218,060 in 2007 and $186,310 in 2006 (note 3)		262,068	223,949
Real estate at cost, net of accumulated depreciation		21,607	22,306
Cash and cash equivalents		96,699	44,163
Total cash and invested assets		2,058,617	1,921,615
Uncollected premiums, net of allowance		64,074	70,652
Electronic data processing equipment, at cost, net of accumulated depreciation of $4,259 and $3,365 in 2007 and 2006, respectively		1,112	1,672
Accrued investment income		17,324	17,066
Total admitted assets	$	2,141,127	2,011,005
Liabilities and Policyholders' Surplus			
Reserve for unpaid losses and loss adjustment expenses:			
Reserve for unpaid losses (note 2)	$	1,042,466	1,040,222
Reserve for unpaid loss adjustment expenses (note 2)		211,398	197,199
Total reserve for unpaid losses and loss adjustment expenses		1,253,864	1,237,421
Other liabilities		48,139	43,746
Unearned premiums		95,549	99,864
Dividends payable to policyholders		13,343	13,983
Credit balances due policyholders		8,160	8,518
Total liabilities		1,419,055	1,403,532
Commitments and contingencies (notes 2, 6, and 9)			
Policyholders' surplus (note 7)		722,072	607,473
Total liabilities and policyholders' surplus	$	2,141,127	2,011,005

See accompanying notes to statutory financial statements.

PINNACOL ASSURANCE

Statutory Statements of Income and Changes in Policyholders' Surplus

Years ended December 31, 2007 and 2006

(In thousands)

	2007	2006
Underwriting income:		
Premiums earned (note 6)	$ 567,284	588,376
Deductions:		
Losses incurred (note 2)	323,743	359,713
Loss adjustment expenses incurred (note 2)	62,647	24,733
Other underwriting expenses incurred	117,107	115,656
Total underwriting deductions	503,497	500,102
Net underwriting gain	63,787	88,274
Investment income:		
Net investment income earned	101,036	92,776
Net realized capital gain	9,396	4,688
Net investment income	110,432	97,464
Other income (loss):		
Recovery (Provision) for uncollectible premiums	2,524	(5,145)
Other income	990	2,423
Dividends to policyholders	(68,503)	(65,694)
Net income	109,230	117,322
Change in nonadmitted assets	385	(2,528)
Change in net unrealized gain in investments	5,314	20,830
Change in provision for reinsurance	(330)	—
Policyholders' surplus at beginning of year	607,473	471,849
Policyholders' surplus at end of year	$ 722,072	607,473

See accompanying notes to statutory financial statements.

PINNACOL ASSURANCE

Statutory Statements of Cash Flows

Years ended December 31, 2007 and 2006

(In thousands)

	2007	2006
Cash flows from operations:		
Premiums collected, net of reinsurance	$ 569,547	580,466
Losses and loss adjustment expenses paid, net	(369,947)	(352,718)
Underwriting expenses paid	(113,071)	(109,046)
Dividends paid to policyholders	(69,143)	(61,757)
Cash from underwriting	17,386	56,945
Net investment income	97,926	88,600
Net amount withheld or retained for account of others	3,514	(2,722)
Net cash provided by operations	118,826	142,823
Cash flows from investments:		
Proceeds from sale or redemption of investments	353,101	138,403
Purchase of investments	(420,705)	(273,784)
Net cash used in investments	(67,604)	(135,381)
Cash flows from financing and miscellaneous sources:		
Cash provided by other miscellaneous sources	1,314	15,767
Net increase in cash on hand and on deposit	52,536	23,209
Cash on hand and on deposit, beginning of year	44,163	20,954
Cash on hand and on deposit, end of year	$ 96,699	44,163

See accompanying notes to statutory financial statements.

(1) Nature of Operations and Significant Accounting Policies

(a) Organization

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

Pinnacol is controlled by a nine-member board of directors, which is appointed by the governor, with the consent of the senate. In accordance with the applicable statutes of the state, the administration of Pinnacol is under the direction of a president, appointed by the board of directors. The state retains no liability on behalf of Pinnacol, and no state monies are used for Pinnacol operations.

As Pinnacol has maintained an acceptable level of surplus, in 2007 and 2006, Pinnacol paid over $60 million and $56 million, respectively, in general policyholder dividends to its policyholders in good standing. An acceptable level of surplus is that which exceeds the Company action level of risk-based capital, which is $159,920,000 for 2007. The board of directors, at its discretion, will determine the amount of policyholder dividends to be declared, if any, based on Pinnacol's overall experience, financial condition, and risk profile.

(b) Basis of Presentation

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

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

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

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

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

The effects of the foregoing variances from GAAP on the statutory financial statements at December 31, 2007 and 2006 and for the years then ended have been determined and are as follows:

	December 31	
	2007	2006
	(In thousands)	
Statutory policyholders' surplus	$ 722,072	607,473
Nonadmitted assets	12,903	13,289
Policy acquisition costs, net of amortization	11,207	9,946
Net unrealized gain (loss) on bonds	24,456	(5,830)
GAAP net assets	$ 770,638	624,878
Statutory net income	$ 109,230	117,322
Policy acquisition costs, net of amortization	1,261	1,537
Change in fair value of investments	35,599	2,126
Change in provision for reinsurance	(330)	—
GAAP changes in net assets	$ 145,760	120,985

(c) Use of Estimates

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

(d) Investments

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

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

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

Prepayment assumptions for purposes of recognition of income and valuing of loan-backed bonds and structured securities were obtained from external broker dealer survey values or internal estimates. These assumptions are consistent with the current interest rate and economic environment. The prospective method is used to value mortgage-backed securities. Prepayment assumptions for single-class and 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 allowances for depreciation. The cost of the building and capitalized improvements is depreciated over an estimated useful life of 30 years using the straight-line method. Depreciation expense was $862,000 and $839,000 for the years ended December 31, 2007 and 2006, respectively.

(e) Cash and Cash Equivalents and Other Invested Assets

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

As of December 31, 2007, cash and cash equivalents of $96,699,000 include $43,938,000 of cash and $52,761,000 of short-term investments in bonds. As of December 31, 2006, cash and cash equivalents of $44,163,000 include $5,716,000 of cash, $8,929,000 of cash equivalents, and $29,518,000 of short-term investments in bonds. In the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus, Pinnacol has recorded checks that have been issued, but not presented for payment, as a reduction of cash and cash equivalents. Also included in cash and cash equivalents are amounts held as collateral for assumptive reinsurance agreements of approximately $42,000,000 and $28,269,000 as of December 31, 2007 and 2006, respectively.

(f) Uncollected Premiums

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

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

During 2007 and 2006, Pinnacol recorded a provision or wrote off a total of $1,293,000 and $5,145,000, respectively, in premiums receivable due to the unlikelihood of ultimate collection thereof. During 2007, Pinnacol reduced the allowance for earned but unbilled premiums by $3,817,000, which resulted in a credit of bad debt expense of $2,524,000. These amounts are reflected as provision for uncollectible premiums in the accompanying financial statements.

A significant portion of Pinnacol's premiums receivable balances at December 31, 2007 and 2006 were from companies operating in the construction and services industries in Colorado. The construction industry represents 38% and 42% of premiums receivable balances as of December 31, 2007 and 2006, respectively. The services industry represents 22% and 23% of premiums receivable balances as of December 31, 2007 and 2006, respectively, with all other individual industries constituting the remainder of premiums receivable balances.

(g) Earned but Unbilled Premiums

Earned but unbilled premiums represent audit premiums, which are amounts due from policyholders after the respective policy period has expired based on audits performed by Pinnacol. Such amounts are estimated by Pinnacol using internal statistically supported aggregate calculations using historical unearned premium data and per policy calculations. For 2007 and 2006, estimated unbilled audit premiums receivable of $20,737,000 and $22,950,000, respectively, are included as uncollected premiums. These estimated receivables have been reduced by 10%, where applicable, to comply with the Manual.

(h) Retrospectively Rated Contracts

Pinnacol estimates accrued retrospective premium adjustments through the review of each individual retrospectively rated risk, comparing case basis loss development with that anticipated in the policy contract to arrive at the best estimate of return or additional retrospective premium. Pinnacol records accrued retrospective premium as an adjustment to earned premium. Net premiums earned on retrospective workers' compensation policies were $2,408,000 and $2,228,000 in 2007 and 2006, respectively. These amounts represent 0.4% of total net premiums written for both 2007 and 2006, respectively. Ten percent of the amount of accrued retrospective premiums not offset by collateral has been nonadmitted. The total admitted amount of retrospective premium is as follows:

		December 31	
		2007	**2006**
		(In thousands)	
Secured accrued retrospective premium	$	2,392	2,132
Admitted amount	$	2,392	2,132

(i) Credit Balances Due Policyholders

Credit balances due policyholders represent excess premiums, which are amounts due to policyholders after the respective policy period has expired based on audits performed by Pinnacol. Such amounts are based on actual results. Generally, credit balances due policyholders are applied to future premium obligations of policyholders. For 2007 and 2006, such amounts are approximately $8,160,000 and $8,518,000, respectively.

(j) Electronic Data Processing Equipment

Electronic data processing equipment is recorded at cost, less accumulated depreciation, and depreciated on a straight-line basis over an estimated useful life of three years. Net book value of these assets at December 31, 2007 and 2006 was $1,112,000 and $1,672,000, respectively. Related depreciation expense of $916,000 and $872,000 was incurred during 2007 and 2006, respectively.

(k) Office Furniture and Equipment

Office furniture and equipment and art are recorded at cost and depreciated on a straight-line basis over an estimated useful life of five years. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2007 and 2006 was $3,127,000 and $3,529,000, respectively. Related depreciation expense of $922,000 and $786,000 was incurred in 2007 and 2006, respectively.

(l) Other Assets

At December 31, 2007 and 2006, Pinnacol had prepaid assets and deposits totaling $1,924,000 and $1,538,000, respectively. In accordance with the Manual, these are nonadmitted assets.

(m) General Policyholder Dividends

The board of directors, at its discretion, determines the amount of general policyholder dividends to be declared based on Pinnacol's overall experience and financial condition. Pinnacol has paid general policyholder dividends to its policyholders in good standing of $60,641,000 and $56,700,000 in May of 2007 and 2006, respectively. This is included in dividends to policyholders in the statutory statement of income and changes in policyholders' surplus and reduces net income for the years ended December 31, 2007 and 2006.

(n) Association Dividend Program

Pinnacol has an association dividend program whereby policyholders who are members of the program are entitled to a dividend based on established criteria. In 2007 and 2006, Pinnacol incurred $7,862,000 and $8,993,000, respectively, of expense related to the association dividend program. These dividends are not declared from surplus nor are they recorded as a direct reduction to surplus. The dividends are considered premium credits and are recorded as dividends to policyholders in the statutory statements of income and changes in policyholders' surplus.

(o) Revenue Recognition

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

(p) Reserve for Unpaid Losses and Loss Adjustment Expenses

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

Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in 2007 and 2006. The discount rate used to calculate present value is based on an industry standard rate.

(q) Unearned Premiums

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

(r) Subrogation

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

(s) Reinsurance

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

(t) Taxes

As a political subdivision of the state, Pinnacol is not subject to federal or state income taxes under a specific exemption granted under Section 501(c) of the Internal Revenue Code. Additionally, Pinnacol is not subject to a premium tax, pursuant to Section 8-45-117(3), C.R.S. Pinnacol is, however, subject to a surcharge on premiums received, based on a rate established annually (approximately 3.818% in both 2007 and 2006), pursuant to Section 8-44-112(1)(a), C.R.S. Such amounts are included in other underwriting expenses incurred.

(u) Employee Benefits

Defined Benefit Pension Plan through the State of Colorado

Plan Description

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

Employees hired by Pinnacol after January 1, 2006, are allowed 60 days to elect to participate in a defined contribution retirement plan administered by the state's Deferred Compensation Committee rather than becoming a member of PERA. If that election is not made, the employee becomes a member of PERA, and the member is allowed 60 days from commencing employment to elect to participate in a defined contribution plan administered by PERA rather than the defined benefit plan.

PERA members electing the defined contribution plan are allowed an irrevocable election between the second and fifth years to use their defined contribution account to purchase service credit and be covered under the defined benefit retirement plan. However, making this election subjects the member to the rules in effect for those hired on or after January 1, 2007, as discussed below. Employer contributions to both defined contribution plans are the same as the contributions to the PERA defined benefit plan.

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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 between July 1, 2005 and December 31, 2006 – 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 – 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.

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 – age 55 with a minimum of 5 years of service credit and age plus years of service equals 85 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 percent times the number of years of service times the highest average salary (HAS). For retirements before January 1, 2009, HAS is calculated as one-twelfth of the average of the highest salaries on which contributions were paid, associated with three periods of 12 consecutive months of service credit and limited to a 15 percent increase between periods. For retirements after January 1, 2009 or persons hired on or after January 1, 2007, more restrictive limits are placed on salary increases between periods used in calculating HAS.

Retiree benefits are increased annually based on their original hire date as follows:

- Hired before July 1, 2005 – 3.5 percent, compounded annually.
- Hired between July 1, 2005 and December 31, 2006 – the lesser of 3 percent or the actual increase in the national Consumer Price Index.
- Hired on or after January 1, 2007 – the lesser of 3 percent or the actual increase in the national Consumer Price Index, limited to a 10 percent 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 percent of the employer contributions for this population.)

Members disabled, who have five or more years of service credit, six months of which have been earned since the most recent period of membership, may receive retirement benefits if determined to be permanently disabled. If a member dies before retirement, their spouse or their eligible children under the age of 18 (23 if a full-time student) 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.

Most employees contribute 8.00% of their salary, as defined in Section 24-51-101(42), C.R.S., to an individual account in the plan. From January 1, 2006 through June 30, 2006, Pinnacol contributed 10.15% and from July 1, 2006 to December 31, 2006, 10.65% of the employee's salary. From January 1, 2007 through December 31, 2007, Pinnacol contributed 11.15% of employee's salary. During all of fiscal year 2006-07, 1.02% of the employee's 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, 2006, the division of PERA in which the state 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 0.5 percent of salary beginning January 1, 2006, an additional 0.5 percent of salary in 2007, and subsequent year increases of 0.4 percent of salary until the additional payment reaches 3.0 percent 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 percent.

Historically, members have been allowed to purchase service credit at reduced rates. However, legislations 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 the programs described above for the fiscal years ended December 31, 2007 and 2006, were $4,100,000 and $3,978,000, respectively. These contributions met the contribution requirement for each year.

Voluntary Tax-Deferred Retirement Plans

PERA offers a voluntary 401(k) plan entirely separate from the defined benefit pension plan. Pinnacol offers a 457 deferred compensation plan. During the year ended December 31, 2007, Pinnacol began matching employee's elective contributions into the PERA 401(k) plan at 50% up to

(Continued)

the first 6% of employees' elected deferrals. The matching contribution is immediately vested and available to the employees. During the year ended December 31, 2007, Pinnacol contributed $307,000 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 to 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, state agencies/institutions are required to contribute 1.02% of gross covered wages to the Health Care Trust Fund. Pinnacol contributed $41,824 and $37,045 as required by statute in fiscal years 2007 and 2006, 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, 2006, there were 42,433 enrolled participants, including spouses and dependents, from all contributors to the plan. At December 31, 2006, the Health Care Trust Fund had an unfunded actuarial accrued liability of $1.0 billion, a funded ratio of 17.2%, and a 37-year amortization period.

Life Insurance Program

During fiscal year 2005-06, PERA provided its members access to a group decreasing team life insurance plan offered by UnumProvident in which 41,101 members participated. Active members may join the UnumProvident Plan and continue coverage into retirements. Premiums are collected by monthly payroll deductions are other means. In addition, PERA maintained coverage for 12,790 members under closed group plans underwritten by Anthem Life, Prudential and New York Life.

Accrued Paid Leave

Pinnacol employees may accrue paid time off based on their length of service subject to certain limitations on the amount that will be paid upon termination or taken in future periods. Paid time off is recorded as an expense and a liability at the time the paid time off is earned. The estimated liability for cumulative accrued paid time off of $1,589,000 and $1,520,000 at December 31, 2007 and 2006, respectively, is included in other liabilities in the accompanying statutory financial statements.

(v) Reclassifications

Certain 2006 amounts have been reclassified to conform to the 2007 presentation.

(2) Unpaid Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expenses (both allocated and unallocated) represent management's best estimate of the ultimate medical and indemnity net cost of all losses and loss adjustment expenses that are incurred but unpaid at year-end. Such estimates are based on individual case estimates for reported claims and actuarial estimates for losses that have been incurred but not reported. Any change in probable ultimate liabilities is reflected in current operating results.

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

Discounting of Liabilities for Unpaid Losses or Unpaid Loss Adjustment Expenses

Pinnacol discounts its liabilities for unpaid losses for certain long-term scheduled payments. Workers' compensation unpaid losses have been discounted on a tabular basis using a discount rate of 3.5% in 2007 and 2006. 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. The amount of the tabular discount for unpaid losses as of December 31, 2007 and 2006, respectively, is $143,333,000 and $142,574,000. The amount of discount for case reserves at December 31, 2007 is distributed as follows over the years in which the losses were incurred:

	Loss year										
	2007	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**	**1998**	**Prior**
	(In thousands)										
Amount of discount	$ 11,096	19,214	14,892	10,917	11,801	11,323	9,025	4,016	4,462	2,910	43,677

Unpaid Losses and Loss Adjustment Expense

At December 31, 2007, Pinnacol accrued $1,253,864,000 for unpaid losses and loss adjustment expenses. A tabular discount of $143,333,000 (computed at 3.5%) was applied in the actuarial calculation of this liability for unpaid losses and loss adjustment expenses. Reserve credit of approximately $13,716,000 was recorded for high deductibles on unpaid claims at December 31, 2007.

At December 31, 2006, Pinnacol accrued $1,237,421,000 for unpaid losses and loss adjustment expenses. A tabular discount of $142,574,000 (computed at 3.5%) was applied in the actuarial calculation of this liability for unpaid losses and loss adjustment expenses. Reserve credit of approximately $7,679,000 was recorded for high deductibles on unpaid claims at December 31, 2006.

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

		2007	2006
		Unpaid losses and loss adjustment expenses	**Unpaid losses and loss adjustment expenses**
		(In thousands)	
Balance at January 1	$	1,237,421	1,205,693
Additional amounts incurred related to:			
Current year		459,594	448,542
Prior years		(73,204)	(64,096)
Total incurred		386,390	384,446
Reductions relating to payments for:			
Current year		117,938	107,682
Prior years		252,009	245,036
Total paid		369,947	352,718
Balance at December 31	$	1,253,864	1,237,421

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and allocated loss adjustment expenses decreased by $73,204,000 in 2007 and $64,096,000 in 2006. The changes are generally the result of ongoing analysis of recent loss development trends and better development efforts. Original estimates are increased or decreased as additional information becomes known regarding individual claims.

(3) Investments

Estimated fair value of investments in bonds is based on values published by the Securities Valuation Office (SVO) of the NAIC. However, for certain investments, the SVO does not provide a fair market value. For those investments, the quoted market value prices as provided by accepted external pricing vendors may be used as a substitute for the SVO market price. In both 2007 and 2006, Interactive Data Corporation (IDC) was used to obtain fair market values.

The SVO of the NAIC designates ratings of bonds from 1 to 6. Bonds with ratings of 1 – 2 are stated at amortized cost using the interest method. Bonds with ratings of 3 – 6 require the bond to be carried at the lower of amortized cost or market, with any related unrealized loss reported in surplus. During 2006, Pinnacol had an investment in a bond where the SVO designated the bond at a 4 rating; however, the fair market value on this bond is higher than amortized cost, which resulted in a surplus recovery of $2,308,000. During 2007, this same bond had an SVO designation of a 4 rating and the fair market value was lower than amortized cost, which resulted in an unrealized loss of $1,056,000 that was reported in surplus.

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

	2007			
	Amortized cost	**Unrealized gains**	**Unrealized losses**	**Fair value**
	(In thousands)			
U.S. government obligations:				
Nonloan-backed bonds	$ 421,324	18,296	—	439,620
Loan-backed bonds	477,313	2,040	(8,173)	471,180
Special revenue:				
Nonloan-backed bonds	4,984	148	—	5,132
Industrial and miscellaneous:				
Nonloan-backed bonds	774,622	19,468	(7,324)	786,766
Loan-backed bonds	—	—	—	—
	$ 1,678,243	39,952	(15,497)	1,702,698

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

The amortized cost and fair value of investments in debt securities at December 31, 2007, by contractual maturity, are shown in the following table. Contractual maturities may differ from actual maturities because the borrower may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized cost	Fair value
	(In thousands)	
Due in one year or less	$ 97,969	98,420
Due after one year through five years	354,648	366,125
Due after five years through ten years	609,549	624,285
Due after ten years	616,077	613,868
	$ 1,678,243	1,702,698

Proceeds from sales of investments in bonds during 2007 and 2006 were $294,391,000 and $97,297,000, respectively. Gross gains of $2,466,000 and $260,000 and gross losses of $829,000 and $0 were realized on those sales for 2007 and 2006, respectively.

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

		Cost	Gross unrealized gains	Gross unrealized losses	Fair value
			(In thousands)		
December 31, 2007:					
Common stocks	$	218,060	46,888	(2,880)	262,068
December 31, 2006:					
Common stocks		186,310	39,032	(1,393)	223,949

The following table provides the length of impairment for those investments in bonds with an unrealized loss as of December 31, 2007:

		Less than 12 months		12 months or greater		Total	
Description of securities		Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
Government obligations	$	—	—	—	—	—	—
Special revenue and special assessment obligations		—	—	—	—	—	—
Industrial and miscellaneous		69,667,482	(972,212)	176,321,134	(5,778,612)	245,988,616	(6,750,824)
Public Utilities		8,090,072	(326,980)	9,667,990	(245,553)	17,758,062	(572,533)
Mortgage-backed securities		48,888,801	(445,211)	239,910,067	(7,728,223)	288,798,868	(8,173,434)
Total	$	126,646,355	(1,744,403)	425,899,191	(13,752,388)	552,545,546	(15,496,791)

There are 74 securities in an unrealized loss position as of December 31, 2007.

(a) Government Obligations

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

(b) Special Revenue Obligations

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

(c) Industrial and Miscellaneous Bonds

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

(d) Mortgage-Backed Securities

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

Major categories of net investment income for the years ended December 31, 2007 and 2006 are summarized as follows:

		2007	2006
		(In thousands)	
Investment income:			
Corporate and miscellaneous bonds	$	66,447	62,658
U.S. government obligations		21,684	20,224
Cash and other investments		3,816	2,434
Real estate		3,882	3,687
Equity securities		8,456	6,247
Repurchase/reverse repurchase		845	975
Investment expenses		(4,094)	(3,449)
Net investment income earned		101,036	92,776
Net realized gains		9,396	4,688
Net investment income	$	110,432	97,464

(4) Repurchase and Reverse Repurchase Transactions

Pinnacol enters into repurchase and reverse repurchase agreements where the Company agrees to sell securities and simultaneously agrees to repurchase the same or substantially the same securities in the future (reverse repurchase agreement) while also entering into an agreement to purchase securities and simultaneously agrees to resell the same or substantially the same securities in the future (repurchase agreement). The broker-dealer provides securities as collateral equal to or exceeding 105% of the market value of securities transferred into the program. Pinnacol had outstanding U.S. government securities with trade principal values of approximately $858,822,000 and $918,731,000 and a cost of approximately $831,718,000 and $909,496,000 as of December 31, 2007 and 2006, respectively.

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

(5) Transactions with the State

The state contracts with Pinnacol pursuant to its self-funded insurance program. The state reimburses Pinnacol for all workers' compensation claims and loss adjustment expenses as incurred. Pinnacol accounts for the state contract as an uninsured and partially insured accident and health plan whereby Pinnacol does not record the premium revenue or loss and loss adjustment expenses and related receivables and payables for state workers' compensation costs. Reimbursements billed to the state under this contract were $31,607,000 and $32,056,000 in 2007 and 2006, respectively.

(6) Reinsurance

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

Period	Reinsurance coverage
May 1, 2005 to April 30, 2006	Individual workers' compensation accidents of up to $15,000,000 in excess of retention of $5,000,000 per occurrence; Pinnacol retains 40% within this range of loss Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $20,000,000 per occurrence Individual workers' compensation accidents of up to $40,000,000 in excess of retention of $40,000,000 per occurrence
May 1, 2006 to April 30, 2007	Individual workers' compensation accidents of up to $10,000,000 in excess of retention of $10,000,000 per occurrence Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $20,000,000 per occurrence Individual workers' compensation accidents of up to $40,000,000 in excess of retention of $40,000,000 per occurrence
May 1, 2007 to April 30, 2008	Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $20,000,000 per occurrence Individual workers' compensation accidents of up to $40,000,000 in excess of retention of $40,000,000 per occurrence

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

Effective March 1, 2004, Pinnacol executed a reinsurance contract with Argonaut Insurance Company (a California corporation) for Other States Coverage that is in effect as of December 31, 2007. The contract is designed as a 100% quota share arrangement with Pinnacol acting as the assuming company. This allows Pinnacol to provide insurance coverage under the workers' compensation provisions of other states for the employees of Colorado employer companies who work outside of Colorado. Premium revenue is recognized pro rata over the period the policy is effective.

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

		2007	2006
		(In thousands)	
Direct premiums earned	$	550,958	582,957
Premiums ceded		(2,464)	(3,627)
Premiums assumed		18,790	9,046
Net premiums earned	$	567,284	588,376
Direct losses incurred	$	310,301	352,222
Losses ceded		(688)	(1,433)
Losses assumed		14,130	8,924
Net losses incurred	$	323,743	359,713

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

Pinnacol’s reinsurers had the following AM Best ratings at December 31, 2007:

Reinsurer	AM best rating
Odyssey America Reinsurance Corp.	A
Catlin Insurance Company Ltd.	A
Aspen Insurance UK Ltd.	A
AXIS Specialty Limited	A
Endurance Specialty Insurance Ltd.	A
Renaissance Reinsurance Ltd.	A+
Validus Reinsurance Ltd.	A-
Brit Insurance Limited	A
Lloyd’s Syndicate 1400	NR
Lloyd’s Syndicate 435	NR
Lloyd’s Syndicate 570	A
Lloyd’s Syndicate 1084	A
Lloyd’s Syndicate 1301	NR
Lloyd’s Syndicate 2987	NR
Lloyd’s Syndicate 4472	NR
Catlin Syndicate 2003	NR
Farm Insure	NR

(7) Policyholders' Surplus

Pinnacol had policyholders' surplus of $722,072,000 and $607,473,000 as of December 31, 2007 and 2006, respectively.

As a result of maintaining an acceptable level of surplus, Pinnacol paid $60,641,000 and $56,700,000 in general policyholder dividends to its policyholders in good standing in 2007 and 2006 respectively. This is included in dividends to policyholders on the statutory statements of income and changes in policyholders' surplus and reduces net income for the year ended December 31, 2007. An acceptable level of surplus is that which exceeds the company action level of risk-based capital, which is $159,920,000 for 2007.

(8) Uncollected Premiums

At December 31, 2007 and 2006, Pinnacol had admitted assets of $64,074,000 and $70,652,000, respectively, representing premiums receivable. Pinnacol routinely assesses the collectibility of these receivables. Based upon Pinnacol's experience, approximately 1% of the earned premium may become uncollectible.

(9) Commitments and Contingencies

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

At December 31, 2007 and 2006, Pinnacol had letters of credit for assumptive reinsurance agreements. Pinnacol had a letter of credit for the benefit of Argonaut Insurance Company for $40,349,000 and $19,724,000 at December 31, 2007 and 2006, respectively. Pinnacol had a letter of credit for the benefit of Fireman's Fund Insurance Company for $0 and $4,167,000 at December 31, 2007 and 2006, respectively. Pinnacol had a letter of credit for the benefit of Reliance Insurance Company for approximately $902,000 at December 31, 2007 and 2006. These reinsurance agreements allow the companies to draw upon the respective letters of credit, which are collateralized at 100%, at any time to secure any of Pinnacol's obligations under the agreements. Included in cash, cash equivalents, and other invested assets are amounts held as collateral for letters of credit for reinsurance agreements of approximately $42,000,000 and $28,269,000 as of December 31, 2007 and 2006, respectively.

Pinnacol is contingently liable for approximately $59,105,000 of claims closed by the purchase of annuities from life insurers for structured settlements. No provision has been made for this contingency as management believes that any payments related to this contingency are remote.

At December 31, 2007, the aggregate amount of annuities due from all life insurers equaled the amount of the reserves eliminated when the annuities were purchased and consisted of the following:

Life insurance company and location		Loss reserves eliminated by annuities
		(In thousands)
Genworth Financial, Virginia	$	36,830
Symetra Financial, Washington		18,196
Metlife, New York		2,426
Allstate, Illinois		1,436
Liberty Life Assurance Company, Massachusetts		217
	$	59,105

(10) Subsequent Events

As Pinnacol has maintained an acceptable level of surplus, the board of directors held a meeting on April 4, 2008 in which it declared and is planning to pay a general dividend of approximately $55,000,000 in 2008 to its policyholders with policies in good standing. The board of directors, at its discretion, determines the amount of policyholder dividends to be declared based on Pinnacol’s overall experience and financial condition.

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Investment Risks Interrogatories

December 31, 2007

Pinnacol's total admitted assets as reported on page two of its Annual Statement are $2,141,126,744.

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

Investment category/issuer	Amount	Percentage of total admitted assets
a. Vanguard	$ 114,459,627	5.3%
b. General Electric	42,712,864	2.0
c. IBM Corp	33,851,717	1.6
d. Proctor and Gamble	33,215,521	1.6
e. Julius Baer	28,582,378	1.3
f. Emerson Electric	26,909,274	1.3
g. Anheuser Busch	24,948,416	1.2
h. Ford Motor Credit Co	23,650,385	1.1
i. Johnson & Johnson	22,294,004	1.0
j. T. Rowe Price Small Cap	21,828,484	1.0

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

Bonds			Preferred stocks		
NAIC rating	Amount	Percentage of total admitted assets	NAIC rating	Amount	Percentage of total admitted assets
NAIC-1	$ 1,591,009,898	74.3%	P/PSF-1	$ —	—%
NAIC-2	63,582,675	3.0	P/PSF-2	—	—
NAIC-3	—	—	P/PSF-3	—	—
NAIC-4	23,650,385	1.1	P/PSF-4	—	—
NAIC-5	—	—	P/PSF-5	—	—
NAIC-6	—	—	P/PSF-6	—	—
	$ 1,678,242,958			$ —	

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

4. Assets held in Canadian investments are not less than 2.5% of Pinnacol's total assets.

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

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

Investment category/issuer		Amount	Percentage of total admitted assets
a. Vanguard	$	114,459,627	5.3%
b. Julius Baer		28,582,378	1.3
c. T. Rowe Price Small Cap		21,828,484	1.0
d. Rainier		19,907,386	0.9
e. Alliance		12,848,867	0.6
f. Apple		2,971,200	0.1

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

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

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

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

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

		Year-end			End of each quarter		
					First quarter	Second quarter	Third quarter
						(Unaudited)	
		Amount	Percentage of total admitted assets		Amount	Amount	Amount
a. Securities lending (do not include assets held as collateral for such transactions)	$	—	—%	$	—	—	—
b. Repurchase agreements		—	—		—	—	—
c. Reverse repurchase agreements		867,142,000	40.5		916,050,998	881,889,998	871,551,000
d. Dollar repurchase agreements		—	—		—	—	—
e. Dollar reverse repurchase agreements		—	—		—	—	—

(Continued)

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

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

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

	Year-end		End of each quarter		
			First quarter	**Second quarter**	**Third quarter**
				(Unaudited)	
	Amount	**Percentage of total admitted assets**	**Amount**	**Amount**	**Amount**
a. Hedging	$ —	—%	$ —	—	—
b. Income generation	—	—	—	—	—
c. Replications	—	—	—	—	—
d. Other	—	—	—	—	—

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

	Year-end		End of each quarter		
			First quarter	**Second quarter**	**Third quarter**
				(Unaudited)	
	Amount	**Percentage of total admitted assets**	**Amount**	**Amount**	**Amount**
a. Hedging	$ —	—%	$ —	—	—
b. Income generation	—	—	—	—	—
c. Replications	—	—	—	—	—
d. Other	—	—	—	—	—

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Summary Investment Schedule

December 31, 2007

Investment categories	Gross investment holdings* Amount	Gross investment holdings* Percentage of gross investment holdings	Admitted assets as reported in the Annual Statement Amount	Admitted assets as reported in the Annual Statement Percentage of total admitted assets
Bonds:				
U.S. Treasury securities	$ 398,825,051	19.37%	$ 398,825,051	19.37%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	—	—	—	—
Issued by U.S. government-sponsored agencies	22,498,547	1.09	22,498,547	1.09
Foreign government (including Canada, excluding mortgage-backed securities)	—	—	—	—
Securities issued by states, territories, and possessions and their political subdivisions in the U.S.:				
State, territory, and possessions – general obligations	—	—	—	—
Political subdivisions of states, territories, and possessions – general obligations	—	—	—	—
Revenue and assessment obligations	—	—	—	—
Industrial development and similar obligations	—	—	—	—
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Guaranteed by GNMA	12,937,244	0.63	12,937,244	0.63
Issued by FNMA and FHLMC	89,675,093	4.36	89,675,093	4.36
Privately issued	—	—	—	—
CMOs and REMICs:				
Issued by FNMA and FHLMC	369,915,846	17.97	369,915,846	17.97
Privately issued and collateralized by MBS, issued or guaranteed by GNMA, FNMA, or FHLMC	—	—	—	—
All other privately issued	4,785,207	0.23	4,785,207	0.23
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	733,476,858	35.63	733,476,858	35.63
Unaffiliated foreign securities	46,129,115	2.24	46,129,115	2.24
Affiliated securities	—	—	—	—
Equity interests:				
Investments in mutual funds	197,626,743	9.60	197,626,743	9.60
Preferred stocks:				
Affiliated	—	—	—	—
Unaffiliated	—	—	—	—
Publicly traded equity securities (excluding preferred stocks):				
Affiliated	—	—	—	—
Unaffiliated	64,441,182	3.13	64,441,182	3.13

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Summary Investment Schedule

December 31, 2007

Investment categories	Gross investment holdings* Amount	Gross investment holdings* Percentage of gross investment holdings	Admitted assets as reported in the Annual Statement Amount	Admitted assets as reported in the Annual Statement Percentage of total admitted assets
Other equity securities:				
Affiliated	$ —	—%	$ —	—%
Unaffiliated	—	—	—	—
Other equity interests including tangible personal property under lease:				
Affiliated	—	—	—	—
Unaffiliated	—	—	—	—
Mortgage loans:				
Construction and land development	—	—	—	—
Agricultural	—	—	—	—
Single-family residential properties	—	—	—	—
Multifamily residential properties	—	—	—	—
Commercial loans	—	—	—	—
Real estate investments:				
Property occupied by Company	21,607,176	1.05	21,607,176	1.05
Property held for production of income	—	—	—	—
Property issued or guaranteed by GNMA, FNMA	—	—	—	—
Collateral loans	—	—	—	—
Policy loans	—	—	—	—
Receivables for securities	—	—	—	—
Cash and short-term investments	96,698,993	4.70	96,698,993	4.70
Write-ins for invested assets	—	—	—	—
Total invested assets	$ 2,058,617,055	100.00%	$ 2,058,617,055	100.00%

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

See accompanying independent auditors' report.

KPMG LLP
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Denver, CO 80202

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

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

We have audited the statutory financial statements of Pinnacol Assurance (Pinnacol) as of and for the year ended December 31, 2007, and have issued our report thereon dated May 21, 2008. Our report is modified for statutory basis of accounting presentation. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States of America.

Internal Control over Financial Reporting

In planning and performing our audit, we considered Pinnacol's internal control over financial reporting 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 entity's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the entity's internal control over financial reporting.

A *control deficiency* 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statement that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be 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 financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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

KPMG LLP

May 21, 2008

PINNACOL ASSURANCE

Distribution

December 31, 2007

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Office of the State Auditor

www.state.co.us/auditor

A bound report may be obtained by calling the
Office of the State Auditor
303-869-2800

Please refer to the Report Control Number below when
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Report Control Number 1916