Colorado Compensation Insurance Authority

dba Pinnacol Assurance

Audited Statutory-Basis Financial Statements and Other Financial Information and Comments on Internal Controls and Procedures

Years ended December 31, 2001 and 2000

February 15, 2002

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

We have completed the financial audit of the Colorado Compensation Insurance Authority dba Pinnacol Assurance ("Pinnacol") for the year ended December 31, 2001. Our audit was conducted in accordance with auditing standards generally accepted in the United States. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S. The reports which we have issued as a result of this engagement are set forth in the table of contents which follows. Included in the Findings and Recommendations are the responses of the management of Pinnacol.

Ernst & Young LLP

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Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Audited Statutory-Basis Financial Statements and Other Financial Information and Comments on Internal Controls and Procedures

Years ended December 31, 2001 and 2000

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Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Audit Report Summary

December 31, 2001

Authority and Purpose/Scope of the Audit

This audit was conducted under the authority of Section 8-45-121(2), C.R.S. The primary purpose of our engagement was to audit the statutory-basis financial statements of Pinnacol at December 31, 2001, and for the year then ended, in accordance with auditing standards generally accepted in the United States 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-basis 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-basis" financial statements, or 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.

We examined, on a test basis, evidence supporting the amounts and disclosures in Pinnacol's financial statements as of December 31, 2001. 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 ("Division of Insurance").

Our recommendations with respect to internal accounting and administrative controls as well as other matters are found in the Findings and Recommendations section in this report. In addition, we also evaluated the progress made by Pinnacol in implementing the recommendations resulting from previous audits.

Required Communications to the Legislative Audit Committee

In accordance with auditing standards generally accepted in the United States (AU Section 380), and the Statement of Auditing Standards ("SAS") No. 61, *Communication with Audit Committees*, 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 Generally Accepted Auditing Standards –** Our audit was conducted in accordance with auditing standards generally accepted in the United States and was designed to provide reasonable, rather than absolute, assurance that the financial statements are free of material misstatement.

2. **Significant Accounting Policies –** In 2001, Pinnacol changed various accounting policies to be in accordance with the revised NAIC *Accounting Practices and Procedures Manual*, as adopted by the Colorado Division of Insurance. As a result of these changes, Pinnacol reported a change of accounting principle that increased policyholders' surplus by $5,384,000 as of January 1, 2001, primarily related to the accounting for earned but unbilled premiums.

   For year-end 2000, Pinnacol elected to record its loss reserves to the midpoint of the reserve range as derived by the actuarial firm of Milliman U.S.A. The election was performed in order to comply early with Pinnacol's filed Surplus Recovery Plan, as submitted to the Colorado Division of Insurance, with an effective date of January 1, 2001.

3. **Management Judgments and Use of Estimates –** Pinnacol's management has made judgments with respect to certain accounting estimates included in the audited financial statements. 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.

   <u>Net Realizable Value of Uncollected Premiums</u> – 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 which 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, 2001, the net realizable value of uncollected premiums is estimated to be $54,345,000. The amount at December 31, 2000 was estimated to be $39,541,000. The increase compared to the prior year results from a change in accounting principle related to earned but unbilled premiums, as well as an increase in uncollected premiums related to the growth in Pinnacol's earned premium.

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 2001 and 2000, estimated net unbilled audit premiums receivable of $23,242,000 and $14,547,000, respectively, are included as 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, 2001, Pinnacol has accrued $822,314,000 for unpaid losses and loss adjustment expenses as management's best estimate, which management believes to be a reasonable estimate of discounted future amounts to be paid for claims incurred in 2001 or prior. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. State law allows the use of a discount factor of up to 6.00%; Pinnacol discounted its actuarially determined unpaid balances by a factor of 4.25%, a more conservative discount factor.

4. **Unusual Transactions and Contingencies –** Pinnacol has ongoing operating leases for building space and storage space. In addition, during the year 2000 Pinnacol executed a contract for the right to acquire 8.5 acres of land located within the Lowry Business Center. Pinnacol has designated this land as the site for its future home office. Pinnacol anticipates a total outlay of $28,000,000 for land, office building, furniture, and fixtures, for the fall of 2002 occupancy.

5. **Significant Audit Adjustments –** The statutory-basis financial statements incorporated herein contain no differences with Pinnacol's amended annual statement, as filed with the Colorado Division of Insurance. However, during the

course of our audit, we identified various adjustments that were recorded by Pinnacol. These adjustments included an increase to unpaid loss reserves by $5.1 million related to out-of-state reserves, and other miscellaneous adjustments that increased surplus by approximately $1.4 million. An adjustment was also recorded by Pinnacol, which related to a posting error for recording the increase to surplus as a result of adopting the provisions of the revised NAIC *Accounting Practices and Procedures Manual*. This adjustment reduced net income by approximately $2.5 million, but had no net impact on surplus. There were additional adjustments to the balance sheet that increased real estate by $1.4 million and decreased uncollected premiums by $1.6 million.

6. **Consultation with Other Accountants –** We are not aware of any instances of management consulting with other accountants regarding auditing and accounting matters during 2001, including the type of opinion rendered in connection with our audit.

7. **Disagreements with Management –** There were no disagreements with management on accounting or financial reporting matters that would have caused us to modify our opinion on the financial statements.

8. **Other Matters**

   Ernst & Young performs 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.

   We received excellent cooperation from Pinnacol management and staff throughout the audit.

   There were no material errors or irregularities, or possible illegal acts of which we are aware.

   We identified no material weaknesses in the system of internal control.

Auditors' Comments and Recommendations

This report includes recommendations to improve management and accounting procedures of Pinnacol. Following is a summary of the audit comments discussed in the report:

Pinnacol should:

- Adjust all general ledger account balances on a monthly basis based on the completed reconciliation procedures.
- Reconcile and adjust all cash accounts on a monthly basis.
- Reconcile paid losses per the general ledger to the paid loss data utilized by Milliman U.S.A. in developing the unpaid loss reserve estimates at least quarterly.
- Review the processing of internal structured settlements and make corrections for timing differences to ensure the accuracy of the results of internal structured settlements.

Summary of Progress in Implementing Prior Audit Recommendations

The disposition of prior audit recommendations as of February 15, 2002 was:

Implemented	4
Partially implemented	1
Not implemented	–
Total	5

Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Recommendation Summary

December 31, 2001

Rec. No.	Recommendation Summary	Pinnacol Response	Implementation Date
1.	Reconcile and adjust all general ledger account balances on a monthly basis.	Agree	May 2002
2.	Reconcile and adjust all cash accounts on a monthly basis.	Agree	March 2002
3.	Reconcile the paid losses per the general ledger to the paid loss data utilized by Milliman U.S.A. in developing the unpaid loss reserves.	Agree	June 2002
4.	Review the processing of internal structured settlements and make corrections for timing differences to ensure the accuracy of the results of internal structured settlements.	Agree	March 2002

Description of Pinnacol Assurance

The Colorado Compensation Insurance Authority was established under provisions of the Colorado Compensation Insurance Authority Act (Title 8, Article 45 of the Colorado Revised Statutes, as amended) for the benefit of injured employees and dependents of deceased employees in Colorado. Pinnacol provides an assured source of workers' compensation insurance to all Colorado employers at the lowest possible cost, consistent with maintaining a solvent Colorado Compensation Insurance Authority Fund.

As of September 15, 1999, Colorado Compensation Insurance Authority began doing business as Pinnacol Assurance ("Pinnacol").

Pinnacol is controlled by a seven-member Board of Directors, which is appointed by the Governor, with the consent of the Senate. The Board of Directors appoints a manager. This is in accordance with the applicable statutes of the State, with administration under the direction of a manager. 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. Under the applicable statutes, the State Treasurer is the custodian for Pinnacol's cash and invested assets and, after consulting with Pinnacol, the State Treasurer makes all investing decisions.

Policyholders' Surplus

Pinnacol had policyholders' surplus of $143,716,000 and $64,567,000 as of December 31, 2001 and 2000, respectively. The increase in surplus is primarily related to current year net income, as well as an increase related to the cumulative effect of changes in accounting principle from the adoption of the revised NAIC *Accounting Practices and Procedures Manual*, effective January 1, 2001. These increases were offset by an increase in nonadmitted assets and the unrealized losses in common stock. The current year-end surplus remains below regulatory levels considered acceptable in the industry.

In response to Section 8-45-111, C.R.S., management of Pinnacol has developed, filed and received approval, effective January 1, 2001, of a long-range plan (the "Plan") to strengthen its financial position and attain "a reasonable policyholders' surplus." The Plan calls for Pinnacol to achieve the "company action level of risk-based capital."

The Plan as filed and approved by the Colorado Division of Insurance calls for the achievement of a level of risk-based capital, not a specific precise level of statutory surplus. The achievement of the Plan is anticipated to take in excess of 10 years.

Note 7 expands on the information detailed above, including the definitions attributable to risk-based capital.

Findings and Recommendations

General Ledger Adjustments Were Not Recorded

Pinnacol's policy is to reconcile general ledger accounts to supporting documentation or subsidiary ledger systems, and adjust for reconciling differences on a monthly basis. We found that although reconciliations were performed, the identified adjustments had not been recorded. We identified audit adjustments of approximately $493,000 to premium taxes and commission accruals, which decreased net income and policyholder surplus. We also identified adjustments to write off miscellaneous unsupported balances related to cancelled checks and a manual loss payment account (a temporary holding account used to record manual claim checks which should be cleared each month-end), which increased net income and policyholder surplus by approximately $243,000. By posting all reconciliation adjustments on a monthly basis, Pinnacol can ensure that its financial statements will appropriately reflect the amounts and nature of financial statement transactions and balances.

Recommendation No. 1:

We recommend that Pinnacol post all identified general ledger variances on a monthly basis in accordance with its reconciliation policy.

Pinnacol Response:

Agree. Effective May 1, 2002, procedures will be implemented to assure the timely reconciliation of all accounts and resolution of recording items.

Timely Cash Account Reconciliations Were Not Completed

During 2001, we found that cash accounts were not being reconciled on a monthly basis in accordance with Pinnacol policy. Pinnacol utilizes approximately four cash accounts, in addition to the funds on deposit with the State Treasury. From these accounts, Pinnacol pays medical and indemnity workers' compensation benefits (approximately $219,000,000), receives policyholder premiums (approximately $394,000,000) and makes general operating disbursements (approximately $62,000,000) as well as various other cash receipts and disbursements in the normal course of business. Pinnacol did complete year-end reconciliations of its cash accounts; however, when we reviewed the completed cash account reconciliations, we identified unsupported variances between the bank balance and the general ledger. This resulted in an accumulation of audit differences that decreased net income and policyholder surplus by approximately $370,000. Timely and complete reconciliation of all cash accounts will ensure that Pinnacol uses accurate financial information for budgeting, planning and operational decisions and that reported financial results are accurate.

Recommendation No. 2:

We recommend that Pinnacol complete monthly reconciliations of all cash accounts and post all identified variances on a monthly basis.

Pinnacol Response:

Agree. Effective March 1, 2002, procedures have been implemented to assure the timely reconciliation of all cash accounts and resolution of recording items on a monthly basis.

Complete Paid Loss Data Was Not Provided to the Actuary

Pinnacol's estimated future unpaid losses are evaluated and estimated by Pinnacol's consulting actuarial firm, Milliman U.S.A. Future unpaid loss estimates are derived using actuarial techniques that utilize historical paid loss data. Pinnacol records the majority of its paid loss data within Workers' Compensation Information System ("WCIS") but it records all paid loss information, which includes paid losses for out-of-state business, in its general ledger.

After we requested that Pinnacol complete a reconciliation of the paid loss data of its general ledger to the information supplied to its actuary, we found that Pinnacol was only providing the paid loss information from its WCIS system to the actuary. Because Pinnacol did not provide complete paid loss data to its actuarial firm, there was an adjustment to estimated unpaid losses and loss adjustment expenses at December 31, 2001 of approximately $5,143,000, discounted ($6,115,000, undiscounted), relating to the out-of-state business. Further, we found that Pinnacol did not provide the out-of-state paid losses to its actuary last year, either. The adjustment related to unpaid losses and loss adjustment expenses at December 31, 2000 was approximately $1,900,000 when discounted ($2,242,000, undiscounted). We found that although out-of-state information was not included in the actuarial data, Pinnacol's estimated future unpaid losses were still within the acceptable range provided by the actuary. If Pinnacol had performed a reconciliation of paid losses provided to the actuary to the amounts recorded in the general ledger, instead of the WCIS system, the estimate for future unpaid losses would be more accurate.

Recommendation No. 3:

We recommend that Pinnacol perform a reconciliation of paid losses per the general ledger to the paid loss data provided to its actuarial firm quarterly. Furthermore, we recommend that Pinnacol begin providing all paid loss data, including paid losses recorded in WCIS and paid losses related to its out-of-state business, to its actuarial firm.

Pinnacol Response:

Agree. Effective June 1, 2002, procedures will be implemented to assure the timely reconciliation of paid loss data per the general ledger to the information provided to Milliman U.S.A., which will include loss data for the out-of-state business.

Adjustments for Timing Differences in the Internal Structured Settlement Accounting Process Were Not Posted

During 2001, Pinnacol began recording internal structured settlements. A structured settlement is an agreement between Pinnacol and the person receiving workers' compensation benefits, which guarantees future, recurring payments for as long as the covered person meets certain requirements. When Pinnacol enters into a structured settlement, Pinnacol writes a check payable to a separate department within Pinnacol and records a paid loss in WCIS to reflect the settlement to facilitate internal management review of these liabilities. Pinnacol also records a structured settlement liability, representing Pinnacol's remaining obligation to the injured person, and a contra income account is charged. When a structured settlement is approved by the Division of Workers' Compensation, Pinnacol reverses the charge to the contra income account.

As of December 31, 2001, we identified certain journal entries that had not been posted to properly record structured settlements that were written near December 31, 2001. This resulted in an adjustment to increase net income and policyholder surplus by approximately $455,000. Reviewing and correcting for any timing differences in the accounting process of internal structured settlements will ensure that Pinnacol's results of operations are accurately stated.

Recommendation No. 4:

We recommend that Pinnacol review the accounting process for all internal structured settlements that are not processed, approved, and completed as of the end of each reporting period, to ensure the accuracy of the results of internal structured settlements.

Pinnacol Response:

Agree. Effective March 1, 2002, procedures have been implemented to review all internal structured settlements that are not processed, approved and completed as of the end of the reporting period, and adjust the financial results as applicable.

Disposition of Prior Audit Recommendations

Listed below are the recommendations included in the prior audit report dated February 20, 2001, and the disposition or other status of such items as of February 15, 2002.

	Recommendation	Comments
1.	Reconcile all general ledger accounts on a timely basis.	Partially implemented; see current year recommendations 1 and 2.
2.	Reconcile policyholder account balances on a timely basis.	Implemented.
3.	Maintain adequate documentation of information systems user requests, test results, program changes and approvals.	Implemented.
4.	Ensure access to the office is properly secured and that only appropriate personnel have access to their respective work areas.	Implemented.
5.	Incorporate a detailed tracking schedule of all fixed asset activity into the general ledger accounting process.	Implemented.

Report of Independent Auditors

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

We have audited the accompanying statutory-basis balance sheets of Colorado Compensation Insurance Authority dba Pinnacol Assurance as of December 31, 2001 and 2000, and the related statutory-basis statements of income and changes in policyholders' surplus and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 in Note 1 to the financial statements, the Company presents its 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 ("Colorado Division of Insurance"), which practices differ from accounting principles generally accepted in the United States. The variances between such practices and accounting principles generally accepted in the United States and the effects on the accompanying financial statements 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 accounting principles generally accepted in the United States, the financial position of Pinnacol Assurance at December 31, 2001 and 2000, or the results of its operations or its cash flow for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pinnacol Assurance at December 31, 2001 and 2000, and the results of its operations and its cash flow for the years then ended in conformity with accounting practices prescribed or permitted by the Colorado Division of Insurance.

As discussed in Note 8 to the financial statements, in 2001 Pinnacol Assurance changed various accounting policies to be in accordance with the revised NAIC *Accounting Practices and Procedures Manual*, as adopted by the Colorado Division of Insurance.

Ernst & Young LLP

February 15, 2002, except for
Note 10, as to which the date is
May 7, 2002

Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Statutory-Basis Balance Sheets
(In thousands)

	December 31, 2001	December 31, 2000
Admitted assets		
Cash and invested assets:		
Bonds *(Note 3)*	$ 931,009	$811,537
Common stock *(Note 3)*	18,927	8,978
Real estate	6,323	20
Cash on hand and on deposit	56,091	15,256
Other invested assets	7,409	–
Total cash and invested assets	1,019,759	835,791
Uncollected premiums, net of allowance for uncollectible and nonadmitted balances of $15,142 and $14,708 in 2001 and 2000, respectively	54,345	39,541
Electronic data processing equipment, net of accumulated depreciation of $2,837 and $2,355 in 2001 and 2000, respectively	455	508
Accrued investment income	12,621	12,534
Other admitted assets	–	750
Total admitted assets	$1,087,180	$889,124
Liabilities and policyholders' surplus		
Liabilities:		
Unpaid losses and allocated loss adjustment expenses *(Note 2)*	$ 795,981	$708,104
Unpaid unallocated loss adjustment expenses *(Note 2)*	26,333	26,619
Total unpaid losses and loss adjustment expenses	822,314	734,723
Other liabilities	40,327	23,499
Unearned premiums	75,003	61,163
Credit balances due policyholders	5,820	5,172
Total liabilities	943,464	824,557
Commitments and contingencies *(Note 9)*		
Policyholders' surplus *(Note 7)*	143,716	64,567
Total liabilities and policyholders' surplus	$1,087,180	$889,124

See accompanying notes.

Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Statutory-Basis Statements of Income and
Changes in Policyholders' Surplus

	Year Ended December 31,	
	2001	**2000**
	(In Thousands)	
Premiums earned *(Note 6)*	$391,500	$306,277
Underwriting expenses:		
Losses incurred	283,842	245,025
Loss adjustment expenses incurred	22,405	15,004
Other underwriting expenses incurred	76,159	57,472
Total underwriting expenses	382,406	317,501
Underwriting gain (loss)	9,094	(11,224)
Net investment income	61,604	54,859
Net realized gain on investments	5,892	861
Provision for uncollectible premiums	(2,610)	(1,698)
Other income	1,971	1,983
Net income	75,951	44,781
Change in nonadmitted assets	(1,218)	(22)
Cumulative effect of changes in accounting principles *(Note 8)*	5,384	–
Change in net unrealized losses in common stock	(968)	(1,029)
Policyholders' surplus at beginning of year	64,567	20,837
Policyholders' surplus at end of year	$143,716	$ 64,567

See accompanying notes.

Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Statutory-Basis Statements of Cash Flow

	Year Ended December 31,	
	2001	**2000**
	(In Thousands)	
Cash from operations		
Premiums collected, net of reinsurance	$393,772	$316,130
Losses and loss adjustment expenses paid, net	(218,656)	(224,289)
Underwriting expenses paid	(62,419)	(65,984)
Cash from underwriting	112,697	25,857
Net investment income	60,924	51,691
Net amount withheld or retained for account of others	1,971	1,983
Net cash provided by operations	175,592	79,531
Cash from investments		
Proceeds from sale or redemption of investments	183,717	95,545
Purchase of investments	(313,430)	(282,737)
Purchase of real estate	(4,173)	(770)
Net cash used for investments	(133,886)	(187,962)
Cash from financing and miscellaneous sources		
Cash provided from reinsurance settlement	–	113,895
Cash applied for other miscellaneous sources	(871)	(670)
Net cash provided by (used for) financing and miscellaneous sources	(871)	113,225
Increase in cash on hand and on deposit	40,835	4,794
Cash on hand and on deposit, beginning of year	15,256	10,462
Cash on hand and on deposit, end of year	$ 56,091	$ 15,256

See accompanying notes.

1. Nature of Operations and Significant Accounting Policies

Organization

The Colorado Compensation Insurance Authority 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. As of September 15, 1999, Colorado Compensation Insurance Authority began doing business as Pinnacol Assurance ("Pinnacol"). 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 seven-member Board of Directors, which is appointed by the Governor, with the consent of Senate. This is in accordance with the applicable statutes of the State, with administration under the direction of a manager. 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. Under the applicable statutes, the State Treasurer is the custodian for Pinnacol's cash and invested assets and, after consulting with Pinnacol, the State Treasurer makes all investing decisions.

The preparation of financial statements of insurance companies requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known which could impact the amounts reported and disclosed herein.

Basis of Presentation

The accompanying financial statements of Pinnacol have been prepared in conformity with accounting practices prescribed or permitted by the Colorado Division of Insurance. Such practices vary from accounting principles generally accepted in the United States ("GAAP").

1. Nature of Operations and Significant Accounting Policies (continued)

The more significant variances from GAAP are as follows:

Investments: Investments in bonds are reported at amortized cost or market value based on their National Association of Insurance Commissioners ("NAIC") rating; for GAAP, such fixed maturity investments would be designated at purchase as held-to-maturity, trading, or available-for-sale. Held-to-maturity fixed investments would be reported at amortized cost, and the remaining fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in operations for those designated as trading and as a separate component of equity for those designated as available-for-sale.

Real estate owned and to be occupied by Pinnacol is included in investments rather than reported as an operating 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 agents' balances, furniture and equipment and other assets not specifically identified as an admitted asset within the *Accounting Practices and Procedures Manual*, are excluded from the accompanying balance sheets and are charged directly to policyholders' surplus. Under GAAP, such assets are included in the balance sheet.

The effects of the foregoing variances from GAAP on the statutory-basis financial statements at December 31, 2001 and 2000, and for the year ended December 31, 2001 have been determined and are presented below.

	December 31,	
	2001	**2000**
	(In Thousands)	
Statutory policyholders' surplus	$143,716	$ 64,567
Nonadmitted assets	7,250	3,522
Policy acquisition costs	2,076	1,740
Net unrealized gains on bonds	37,998	26,805
Earned but unbilled premium	–	10,552
GAAP policyholders' surplus	$191,040	$107,186

1. Nature of Operations and Significant Accounting Policies (continued)

For the year ended December 31, 2001, GAAP net income was less than statutory net income by $2,477,000, consisting of a decrease to income related to recording estimated liabilities associated with earned but unbilled premiums of $2,813,000, offset by an increase of $336,000 related to deferred policy acquisition costs. For the year ended December 31, 2000, GAAP net income exceeded statutory net income by $11,412,000, related to the accounting for earned but unbilled premium and deferred policy acquisition costs.

Other significant accounting practices are as follows:

Investments

Bonds are principally stated at amortized cost using the interest method.

Prepayment assumptions for purposes of recognition of income and valuing of loan-backed bonds and structured securities were obtained from broker-dealer survey values or internal estimates. These assumptions are consistent with the current interest rate and economic environment. The retrospective method is used to value mortgage-backed securities.

Common stocks are reported at market value as determined by the Securities Valuation Office (“SVO”) of the NAIC, and the related net unrealized capital gains (losses) are reported in surplus.

Realized capital gains and losses are determined using the specific identification basis.

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 billed receivables that have been outstanding for a period exceeding 90 days are not admissible according to statutory accounting practices. Pinnacol independently estimates the ultimate realizable amounts of premiums receivable and establishes an allowance for uncollectible premiums for the difference between the gross receivable amount and the estimate of the amount to be ultimately realized.

1. Nature of Operations and Significant Accounting Policies (continued)

Pinnacol also establishes an additional allowance for nonadmitted receivables for the amount by which nonadmissible receivables, as defined above, exceed the estimate of uncollectible receivables.

During 2001 and 2000, Pinnacol recorded a provision or wrote off a total of $2,610,000 and $1,698,000, respectively, in premiums receivable due to the unlikelihood of ultimate collection thereof. These amounts are reflected as provision for uncollectible premiums in the accompanying financial statements.

A significant portion of Pinnacol's premium receivable balances at December 31, 2001 and 2000 were from companies operating in the construction and services industries in Colorado. Recent studies indicate the construction industry represents 32% and 33% of Pinnacol's business in 2001 and 2000, respectively, and the services industry represents 23% of Pinnacol's business in both years, with all other individual industries constituting a small fraction of Pinnacol's business.

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. For 2001 and 2000, estimated unbilled audit premiums receivable of $23,242,000 and $14,547,000, respectively, are included as uncollected premiums. These estimated receivables have been reduced by 10% to comply with statutory accounting principles. The increase in 2001 compared to the prior year relates to Pinnacol's adoption of the revised NAIC *Accounting Practices and Procedures Manual*, effective January 1, 2001.

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, 2001 and 2000 was $455,000 and $508,000, respectively.

1. Nature of Operations and Significant Accounting Policies (continued)

Office Furniture and Equipment

Office furniture and equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of five years. For statutory reporting, these are nonadmitted assets. The net book value of these assets at December 31, 2001 and 2000 was $453,000 and $447,000, respectively.

Other Assets

At December 31, 2001 and 2000, Pinnacol had prepaid assets totaling $773,000 and $1,195,000. For statutory reporting, these are nonadmitted assets.

Policyholder Dividends

The Board of Directors, at its discretion, determines the amount of policyholder dividends to be declared, based on Pinnacol's overall experience. No dividends were declared from policyholders' surplus in 2001 or 2000.

Unearned Premiums

Unearned premiums represent amounts either collected or billed and due from policyholders at December 31, 2001 and 2000, but unearned at that date as they pertain to subsequent policy periods.

Subrogation

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

Reinsurance

Reinsurance premiums are reflected as a reduction of premiums earned (see Note 6).

1. Nature of Operations and Significant Accounting Policies (continued)

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, pursuant to Section 8-44-112(1)(a), C.R.S.

Employee Benefits

Pinnacol contributes to the Combined State and School Division Trust Fund ("CSSDTF"), a cost-sharing multiple-employer defined benefit pension plan administered by the Public Employees' Retirement Association of Colorado ("PERA"). CSSDTF provides retirement and disability, annual increases, and death benefits for members or their beneficiaries. All employees of Pinnacol are members of CSSDTF. Title 24, Article 51 of C.R.S., as amended, assigns the authority to establish benefit provisions to the General Assembly. PERA issues a publicly available annual financial report that includes financial statements and required supplementary information for CSSDTF. That report may be obtained by writing to PERA of Colorado, 1300 Logan Street, Denver, Colorado 80203 or by calling PERA at 303-832-9550 or 1-800-759-PERA (7372).

Plan members and Pinnacol are required to contribute at a rate set by statute. The contribution requirements of plan members and Pinnacol are established under Title 24, Article 51, Part 4 of C.R.S., as amended. The contribution rate for members is 8.0% and for Pinnacol is 9.9% (for the period January 1, 2001 to June 30, 2001, the contribution rate was 10.4%) of covered salary. A portion of Pinnacol's contribution (1.1% of covered salary) is allocated for the Health Care Trust Fund. Pinnacol's contributions to CSSDTF for the years ending December 31, 2001 and 2000 were $2,414,000 and $2,738,000, respectively, equal to their required contributions for each year. PERA also offers a voluntary 401(k) plan entirely separate from the defined benefit plan.

Reclassifications

Certain reclassifications have been made to the 2000 statutory-basis financial statements to conform with the 2001 statutory-basis financial statement 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 which are incurred but unpaid at year-end.

Such estimates are based on individual case estimates for reported claims and actuarial estimates for losses which 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 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.

At December 31, 2001, Pinnacol accrued $795,981,000 for unpaid losses and allocated loss adjustment expenses. As permitted by State statute, a discount of $201,635,000 (computed at 4.25%) has been applied in the actuarial calculation of these December 31, 2001 liabilities for unpaid losses and allocated loss adjustment expenses. The State statute allows reserves to be discounted at a rate of up to 6%.

At December 31, 2000, Pinnacol accrued $708,104,000 for unpaid losses and allocated loss adjustment expenses. A discount of $185,286,000 (computed at 4.25%) was applied in the actuarial calculation of this December 31, 2000 liability for unpaid losses and allocated loss adjustment expenses.

Pinnacol's discounted liability for unallocated loss adjustment expenses ("ULAE") was $26,333,000 and $26,619,000 at December 31, 2001 and 2000, respectively. The discount (computed at 4.25%) for ULAE was $6,504,000 and $6,965,000 at

2. Unpaid Losses and Loss Adjustment Expenses (continued)

December 31, 2001 and 2000, respectively. ULAE represents the future cost of processing existing claims. Customarily such reserves will approximate 3% to 5% of unpaid losses and allocated loss adjustment expenses. As of December 31, 2001 and 2000, this percentage represented 3.3% and 3.8%, respectively.

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

	2001		2000	
	Unpaid Losses and Allocated Loss Adjustment Expenses	**Unallocated Loss Adjustment Expenses**	**Unpaid Losses and Allocated Loss Adjustment Expenses**	**Unallocated Loss Adjustment Expenses**
	(In Thousands)			
Balance at January 1	$708,104	$26,619	$675,375	$23,608
Additional amounts incurred related to:				
Current year	280,038	20,150	224,143	16,035
Prior years	3,804	2,255	21,736	5,582
Total incurred	283,842	22,405	245,879	21,617
Reductions relating to payments for:				
Current year	68,150	13,696	47,447	10,844
Prior years	127,815	8,995	165,703	7,762
Total paid	195,965	22,691	213,150	18,606
Balance at December 31	$795,981	$26,333	$708,104	$26,619

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and allocated loss adjustment expenses was increased by $3,804,000 in 2001 and $21,736,000 in 2000. The increase in the liability for prior year activity results primarily from the amortization of the discount.

3. Investments

Estimated fair value of investments in bonds is based on values published by the SVO of the NAIC. These values generally represent quoted market value prices for securities traded in the public marketplace or analytically determined values using bid or closing prices for securities not traded in the public marketplace.

For certain investments, the SVO does not provide a fair value and the Company uses the amortized cost of the security as a substitute for fair value. As of December 31, 2001 and 2000, the fair value of bonds includes $525,616,000 and $358,945,000, respectively, of investments that were valued at amortized cost.

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

	2001				2000			
	Amortized Cost	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
				(In Thousands)				
U.S. government obligations:								
Non-loan-backed bonds	$152,848	$ 6,656	$ (383)	$159,121	$174,684	$13,814	$ –	$188,498
Loan-backed bonds	10,389	–	–	10,389	14,115	–	–	14,115
Special revenue:								
Loan-backed bonds	302,100	–	–	302,100	171,463	–	–	171,463
Industrial and miscellaneous:								
Non-loan-backed bonds	375,710	14,008	(2,057)	387,661	351,535	3,875	–	355,410
Loan-backed bonds	89,962	–	–	89,962	99,740	–	–	99,740
	$931,009	$20,664	$(2,440)	$949,233	$811,537	$17,689	$ –	$829,226

3. Investments (continued)

The amortized cost and fair value of investments in debt securities at December 31, 2001, by contractual maturity, are shown below. 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.

	December 31, 2001	
	Amortized Cost	Fair Value
	(In Thousands)	
Due in one year or less	$ –	$ –
Due after one year through five years	120,698	125,373
Due after five years through ten years	358,769	368,304
Due after ten years	451,542	455,556
	$931,009	$949,233

Proceeds from sales of investments in bonds during 2001 and 2000 were $167,880,000 and $95,545,000, respectively. Gross gains of $5,916,000 and $1,356,000 and gross losses of $(25,000) and $(495,000) were realized on those sales for 2001 and 2000, respectively.

Unrealized gains and losses on investments in common stocks are reported directly in surplus and do not affect net income. 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)			
At December 31, 2001				
Common stocks	$20,483	$195	$(1,751)	$18,927
At December 31, 2000				
Common stocks	9,566	–	(588)	8,978

3. Investments (continued)

Other invested assets totaled $7,409,000 for the year ended December 31, 2001. These investments are primarily pledged assets in support of letters of credit requirements for Pinnacol's assumed reinsurance contracts.

4. Securities Lending Transactions

Pinnacol enters into transactions to lend its securities to a broker-dealer. Pinnacol's custodian lends securities to the broker-dealer in exchange for collateral in the form of "A" rated U.S. domestic corporate securities, equal to or exceeding 105% of the fair market value of the loaned securities.

At December 31, 2001 and 2000, Pinnacol had certain outstanding securities with a fair value of $439,126,000 and $188,498,000, respectively.

Pinnacol has no additional credit risk exposure to borrowers. The contract with the broker-dealer requires them to indemnify Pinnacol if they fail to return the securities or fail to pay Pinnacol for income distributions by the securities' issuers while the securities are on loan. All securities lending transactions can be terminated on demand by either Pinnacol or the broker-dealer. Pinnacol recognized $322,000 and $209,000 of additional investment income during the year ended December 31, 2001 and 2000, respectively, related to securities lending transactions.

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, plus a premium for stop loss coverage. 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 $20,677,000 and $18,959,000 in 2001 and 2000, respectively.

6. Reinsurance

Prior to January 1, 2002, Pinnacol purchased catastrophic reinsurance for risks in excess of its retention limits on workers' compensation insurance policies written. Should the reinsurer be unable to meet its obligations under the reinsurance contract, Pinnacol would remain liable for amounts ceded to its reinsurer. At December 31, 2001 and 2000, Pinnacol had reinsurance coverage for individual workers' compensation accidents of up to $20,000,000 in excess of its retention of $6,000,000 per occurrence on 2001 and 2000 accidents. The reinsurance expense associated with this coverage was $101,000 and $71,000 in 2001 and 2000, respectively. Pinnacol's management is not aware of any catastrophes that would result in penetration of these limits. This reinsurance contract was not renewed in 2002 (see Note 10).

In order to continue to accommodate the employees of Colorado employer companies that reside outside of Colorado, Pinnacol executed a reinsurance contract with the Fireman's Fund Insurance Company (a California corporation). The contract is designed as a 100% quota share arrangement with Pinnacol acting as the assuming company. The effective date of the contract was September 1, 2000. This replaced an arrangement with Reliance Insurance Company ("Reliance") that terminated on August 31, 2000. Claims incurred prior to August 31, 2000 will continue to run out under the Reliance agreement.

7. Policyholders' Surplus

Pinnacol had policyholders' surplus of $143,716,000 and $64,567,000 as of December 31, 2001 and 2000, respectively. This is below regulatory levels considered acceptable in the industry. In response to Section 8-45-111, C.R.S., management of Pinnacol has developed, filed and received approval, effective January 1, 2001, of a long-range plan (the "Plan") to strengthen its financial position and attain "a reasonable policyholders' surplus." The Plan calls for Pinnacol to achieve the "company action level of risk-based capital." Risk-based capital is a regulatory measure of capital adequacy and the "company action level" is the minimum level of risk-based capital required by insurance regulation (i.e., at the level at which the Division of Insurance takes action). Risk-based capital includes factors that relate to the size of the entity, the perceived risks in the company's business and also factors relating to the insurance industry in general.

7. Policyholders' Surplus (continued)

The Plan focuses on five critical areas for the ultimate development of a reasonable level of surplus: 1) Expense Control, 2) Loss Cost Control, 3) Appropriate Pricing, 4) Investment Yield, and 5) Leadership. The Plan also includes a periodic reporting process to keep the Colorado Division of Insurance informed of progress toward the goal of "a reasonable level of surplus."

The risk-based capital calculation requires that a company's surplus be computed using undiscounted reserves. Pinnacol has discounted its reserves by $208,139,000 in total and this discount must be adjusted back to get to adjusted capital, as defined, which yields a deficit of $63,452,000 for risk-based capital purposes. This is significantly below the benchmarks established for risk-based capital. Specifically, the company action level for risk-based capital requires $168,671,000, as of year-end 2001.

There is no assurance that this is the level of surplus that will be necessary to achieve the Plan. The Plan as filed and approved by the Colorado Division of Insurance calls for the achievement of a level of risk-based capital, not a specific level of statutory surplus. The achievement of the Plan is anticipated to take in excess of 10 years.

8. Accounting Changes

Pinnacol prepares its statutory financial statements in conformity with accounting practices prescribed or permitted by the State of Colorado. Effective January 1, 2001, the State of Colorado required that insurance companies domiciled in the State of Colorado prepare their statutory-basis financial statements in accordance with the NAIC *Accounting Practices and Procedures Manual* subject to any deviations prescribed or permitted by the State of Colorado insurance commissioner.

Accounting changes adopted to conform to the provisions of the NAIC *Accounting Practices and Procedures Manual* are reported as changes in accounting principles. The cumulative effect of changes in accounting principles is reported as an adjustment to unassigned surplus in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principles had been applied retroactively for all prior periods. As a result of these changes, Pinnacol reported a change of accounting principle that increased policyholders' surplus by $5,384,000 as of January 1, 2001, related to the accounting for earned but unbilled premiums.

9. Commitments and Contingencies

Pinnacol entered into an 11-year, noncancelable operating lease in July 1991 for its existing office space. Rent expense associated with this lease was $1,535,000 and $1,579,000 in 2001 and 2000, respectively. During 1997, Pinnacol entered into an agreement to sublet one floor of its leased space for approximately $234,000 per year through the end of Pinnacol's lease.

Future minimum payments, net of the sublease, under these and other operating commitments of Pinnacol are (in thousands):

2002	$1,445
2003	142
2004	74
2005	75
2006 and thereafter	12
Total	$1,748

Effective December 7, 2000, Pinnacol executed a contract with Westfield Development Company, Inc., which provides the right to Pinnacol to acquire approximately 8.5 acres of land located within the Lowry Business Center. This land has been designated by Pinnacol as the site for its future home office, with occupancy anticipated in the fall of 2002.

The terms of the contract provide for a purchase price of approximately $25,000,000, subject to adjustment, which includes both the acquisition of the land and the completion of an office building. It is anticipated an additional $3,000,000 will be required for furniture and fixtures, equating to a total outlay of $28,000,000. Through 2001, Pinnacol has made payments and incurred costs of approximately $6,323,000 for the property, which is included in real estate on the statutory-basis balance sheet.

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 surplus or the results of operations of Pinnacol.

9. Commitments and Contingencies (continued)

Pinnacol is contingently liable for approximately $62,976,000 of claims closed by the purchases of annuities 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, 2001, 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 (in thousands):

Life Insurance Company and Location	**Loss Reserves Eliminated by Annuities**
GE Assurance, Virginia	$34,612
SAFECO, Washington	23,823
Metlife, New York	2,300
Allstate, Illinois	1,857
Liberty Life Assurance Company, Massachusetts	384
	$62,976

10. Subsequent Events

Effective May 1, 2002, Pinnacol purchased catastrophic reinsurance for risks in excess of its retention limits on workers' compensation insurance policies written. Should the reinsurer be unable to meet its obligations under the reinsurance contract, Pinnacol would remain liable for amounts ceded to its reinsurer. With this new coverage, Pinnacol has reinsurance, subject to certain exclusions, for individual workers' compensation accidents of up to $40,000,000 per occurrence in excess of its retention of $20,000,000 per occurrence. Pinnacol's management is not aware of any catastrophes, subsequent to January 1, 2002, that would result in penetration of these limits.

Other Financial Information

Report of Independent Auditors on Other Financial Information

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

Our audits were conducted for the purpose of forming an opinion on the statutory-basis financial statements taken as a whole. The accompanying supplemental investment disclosure is presented to comply with the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and is not a required part of the statutory-basis financial statements. Such information has been subjected to auditing procedures applied in our audit of the statutory-basis financial statements and, in our opinion, is fairly stated in all material respects in relation to the statutory-basis financial statements taken as a whole.

This report is intended solely for the information and use of the Company and state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

Ernst & Young LLP

February 15, 2002

Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Investment Risks Interrogatories

Pinnacol's total admitted assets as reported on page two of its amended Annual Statement is $1,087,179,665.

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

Investment Category/Issuer	Amount	Percentage of Total Admitted Assets
Bonds:		
a. Standard Cr Card	$24,657,607	2.3%
b. Ford Motor Co	23,545,364	2.2%
c. Green Tree	21,970,641	2.0%
d. IBM Corp	21,120,232	1.9%
e. General Electric Cap	20,309,427	1.9%
f. Dupont	19,891,403	1.8%
g. Discover Card	18,490,099	1.7%
h. Cit Group Inc.	14,976,279	1.4%
i. MBNA Mstr Cr Card TR 95-C A	14,863,665	1.4%
j. Electronic Data Systems	14,740,433	1.4%

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	$825,421,154	75.9%	P/PSF-1	$ –	–
NAIC-2	93,531,806	8.6%	P/PSF-2	–	–
NAIC-3	12,055,575	1.1%	P/PSF-3	–	–
NAIC-4	–	–	P/PSF-4	–	–
NAIC-6	–	–	P/PSF-5	–	–
NAIC-6	–	–	P/PSF-6	–	–
	$931,008,535			$ –	

Colorado Compensation Insurance Authority
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Investment Risks Interrogatories (continued)

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

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

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

6. Assets held in equity interests are less than 2.5% of Pinnacol's total admitted assets.

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:

			Unaudited At End of Each Quarter		
	At Year-End		**1st Quarter**	**2nd Quarter**	**3rd Quarter**
	Amount	**Percentage of Total Admitted Assets**	**Amount**	**Amount**	**Amount**
a. Securities lending (do not include assets held as collateral for such transactions)	$483,877,950	44.5%	$404,044,724	$407,037,572	$455,788,917
b. Repurchase agreements	–	–	–	–	–
c. Reverse repurchase agreements	–	–	–	–	–
d. Dollar repurchase agreements	–	–	–	–	–
e. Dollar reverse repurchase agreements	–	–	–	–	–

Investment Risks Interrogatories (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:

	At Year-End		**Unaudited At End of Each Quarter**		
			1st Quarter	**2nd Quarter**	**3rd Quarter**
	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:

	At Year-End		Unaudited At End of Each Quarter		
			1st Quarter	2nd Quarter	3rd Quarter
	Amount	Percentage of Total Admitted Assets	Amount	Amount	Amount
a. Hedging	$ –	–	$ –	$ –	$ –
b. Income generation	–	–	–	–	–
c. Replications	–	–	–	–	–
d. Other	–	–	–	–	–

15. The 10 largest investments included in the write-ins for invested assets category included on the Summary Investment Schedule are as follows:

Investment	Amount	Percentage of Total Admitted Assets
a. Wells Fargo—Pledge Account	$7,409,315	0.7%
b.		
c.		
d.		
e.		
f.		
g.		
h.		
i.		
j.		

Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Summary Investment Schedule

Investment Categories	Gross Investment Holdings* Amount	Percentage of Gross Investment Holdings	Admitted Assets as Reported in the Annual Statement Amount	Percentage of Total Admitted Assets
Bonds:				
U.S. Treasury securities	$ 92,993,736	9.1%	$ 92,993,736	8.6%
U.S. government agency and corporate obligations (excluding mortgage-backed securities):				
Issued by U.S. government agencies	59,855,084	5.9%	59,855,084	5.5%
Issued by U.S. government-sponsored agencies				
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	35,898,141	3.5%	35,898,141	3.3%
Issued by FNMA and FHLMC	24,577,599	2.4%	24,577,599	2.3%
Privately issued				
CMOs and REMICs:				
Issued by FNMA and FHLMC	153,116,313	15.0%	153,116,313	14.1%
Privately issued and collateralized by MBS issued or guaranteed by GNMA, FMNA, or FHLMC	98,895,888	9.7%	98,895,888	9.1%
All other privately issued				
Other debt and other fixed income securities (excluding short term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	465,671,772	45.7%	465,671,772	42.8%
Unaffiliated foreign securities				
Affiliated securities				

Colorado Compensation Insurance Authority
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Summary Investment Schedule (continued)

Investment Categories	Gross Investment Holdings* Amount	Gross Investment Holdings* Percentage of Gross Investment Holdings	Admitted Assets as Reported in the Annual Statement Amount	Admitted Assets as Reported in the Annual Statement Percentage of Total Admitted Assets
Equity interests:				
Investments in mutual funds	$ 18,926,513	1.9%	$ 18,926,513	1.7%
Preferred stocks:				
Affiliated				
Unaffiliated				
Publicly traded equity securities (excluding preferred stocks):				
Affiliated				
Unaffiliated				
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	6,323,332	0.6%	6,323,332	0.6%
Property held for production of income				
Property held for sale				
Collateral loans				
Policy loans				
Receivables for securities				
Cash and short-term investments	56,091,000	5.5%	56,091,000	5.2%
Write-ins for invested assets	7,409,315	0.7%	7,409,315	0.7%
Total invested assets	$1,019,758,693	100.0%	$1,019,758,693	93.8%

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

Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Note to Supplemental Investment Risks Interrogatories
and Summary Investment Schedule

December 31, 2001

Basis of Presentation

The accompanying interrogatories and schedule presents selected statutory-basis financial data as of December 31, 2001 and for the year then ended for purposes of complying with the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* and agrees to or is included in the amounts reported in Pinnacol Assurance's 2001 Statutory Annual Statement as filed with the Colorado Division of Insurance.

Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of the Financial Statement in Accordance with *Government Auditing Standards*

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

We have audited the statutory-basis financial statements of Colorado Compensation Insurance Authority dba Pinnacol Assurance ("Pinnacol") as of and for the year ended December 31, 2001, and have issued our report thereon dated February 15, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Pinnacol's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, 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 that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Pinnacol's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

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.

Ernst + Young LLP

February 15, 2002

Colorado Compensation Insurance Authority
dba Pinnacol Assurance

Audited Statutory-Basis Financial Statements

December 31, 2001

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