PINNACOL ASSURANCE

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

December 31, 2004 and 2003

(With Independent Auditors' Report Thereon)

KPMG LLP
Suite 2700
707 Seventeenth Street
Denver, CO 80202

April 15, 2005

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

We have completed the financial audit of Pinnacol Assurance (Pinnacol) for the year ended December 31, 2004. Our audit was conducted in accordance with auditing standards generally accepted in the United States of America. We were engaged to conduct our audit pursuant to Section 8-45-121(2), C.R.S., which authorizes an annual audit of Pinnacol made by an auditor or firm of auditors, having the specialized knowledge and experience, retained by the state auditor with the consultation and advice of the chief executive officer and the commissioner of insurance. The reports which we have issued as a result of this engagement are set forth in the table of contents which follows.

KPMG LLP

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PINNACOL ASSURANCE

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Other Financial Information and
Comments on Internal Controls and Procedures

Years ended December 31, 2004 and 2003

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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), C.R.S., which authorizes an annual audit of Pinnacol Assurance 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, 2004, 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 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, 2004. The accounting practices used by Pinnacol to prepare the financial statements are in conformity with accounting practices prescribed or permitted by the Division of Insurance of the Department of Regulatory Agencies of the State of Colorado (the Division).

Required Communications to the Legislative Audit Committee

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

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

   In addition, in planning and performing our audit of the financial statements, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. An audit of the financial statements does not include examining the effectiveness of internal control and does not provide assurance on internal control.

2. **Significant Accounting Policies and Alternative Treatments** – There were no changes to significant accounting policies in 2004.

(Continued)

3. **Management Judgments and Accounting 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:

   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 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, 2004, the admitted value of uncollected premiums is estimated to be $45,578,000.

   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 2004, estimated net unbilled audit premiums receivable of $5,738,000 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, 2004, Pinnacol has accrued $1,158,874,000 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 2004 or prior. Pinnacol discounts certain unpaid losses on a tabular basis using a discount rate of 3.5% in 2004 and 2003. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. State law allows Pinnacol the use of a discount factor of up to 6.00%. As approved by the Division and in accordance with the Division's interpretation of the surplus recovery plan filed with the Division in a prior year, Pinnacol discounted its actuarially determined unpaid balances by a factor of 3.75% as of and for the year ended December 31, 2003. As of December 31, 2003, Pinnacol achieved its goal of attaining an acceptable level of surplus as outlined in the surplus recovery plan. Therefore, Pinnacol was no longer permitted to discount actuarially determined balances as of and for the year ended December 31, 2004, and the nontabular discount was eliminated.

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, 2004. There were no audit adjustments.

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 accounting or financial reporting matters that, if not satisfactorily resolved, would have caused us to modify our opinion on the 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 the Company and provide confirmation that we are independent accountants with respect to the Company.

   We are not aware of any additional independence-related relationships between our firm and the Company other than the professional services that have been provided to the Company.

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

Investment Management

Pinnacol has achieved its goal of attaining an acceptable level of surplus as outlined in the state statutes. With the attainment of an acceptable level of surplus, Pinnacol assumed control of the investment portfolio and all investment functions previously handled by the state treasurer as of November 30, 2004. While the Company is not in violation of the investment limitations, the Company's policies and procedures do not delineate investment limitations as required under Section 10-3-228.5, C.R.S. Additionally, supporting documentation for the monthly repurchase and reverse repurchase activity was not retained by Pinnacol.

Summary of Pinnacol's Responses

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

PINNACOL ASSURANCE

Report Summary

Summary of Progress in Implementing Prior Audit Recommendations

The disposition of prior audit recommendations as of April 15, 2005, was:

Implemented	6
Partially implemented	—
Not implemented	—
	6

Disposition of Prior Audit Recommendations

The audit report for the year ended December 31, 2003, included six recommendations. The disposition of these audit recommendations is as follows:

Recommendation	Disposition
1. Pinnacol should review its internal controls in Information Technology related to network security to improve their effectiveness.	Implemented.
2. Pinnacol should reevaluate its system controls with respect to claims reserve authority levels to improve their effectiveness.	Implemented.
3. Pinnacol should enhance its management review process to ensure completeness and accuracy of the information reviewed.	Implemented.
4. Pinnacol should enhance its QIP process by requiring formal follow-up on results to ensure proper corrections are made.	Implemented.
5. Pinnacol should update the Gainsharing Incentive Compensation Plan Design Document for changes made to the plan and review survey comparisons to include base salary and gainsharing compensation.	Implemented in prior years based on information provided subsequent to the issuance of the December 31, 2003, audit report.
6. Pinnacol should submit documentation for the Association Dividend Plan and ensure that final filing with the Colorado Division of Insurance is complete.	Implemented.

PINNACOL ASSURANCE

Recommendation Locator

December 31, 2004

Recommendation locator

Recommendation number	Page number	Recommendation summary	Pinnacol response	Implementation date
1	8	Pinnacol should enhance its investment management process by enhancing documented policies and procedures for administering and recording investment transactions and improving management review procedures.	Agree.	3rd quarter 2005

PINNACOL ASSURANCE

Description of Pinnacol Assurance

December 31, 2004

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

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

Pinnacol is controlled by a nine-member board of directors, which is appointed by the governor with the consent of the senate. The board of directors appoints a chief executive officer. This is in accordance with the applicable statutes of the state, with administration under the direction of a chief executive officer. The state retains no liability on the part of Pinnacol, beyond the amount of any Pinnacol surplus, and no state monies are used for Pinnacol operations. Under Title 8, Article 45, C.R.S., as amended, the state treasurer was the custodian for Pinnacol's cash and invested assets, and after consulting with Pinnacol, the state treasurer made all investing decisions until November 30, 2004. As of November 30, 2004, the custody of Pinnacol's cash and invested assets and all investment-related functions were transferred to the board of directors of Pinnacol.

Policyholders' Surplus

Pinnacol had policyholders' surplus of $365,794,000 and $327,298,000 as of December 31, 2004 and 2003, respectively. The increase in surplus is primarily related to current-year net income. The increase was offset by a decrease in the nontabular discount rate as of January 1, 2004, from 3.75% to 0% as approved by the Division and in accordance with the Division's interpretation of the surplus recovery plan filed with the Division. The decrease resulted in an increase to losses incurred of $85,657,000 in 2004.

In response to Section 8-45-111, C.R.S., management of Pinnacol 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 called for Pinnacol to achieve the "company action level of risk-based capital." Pinnacol has achieved its goal of attaining an acceptable level of surplus as outlined in the state statutes. Pinnacol's surplus level as of December 31, 2003, was verified through an examination conducted by the Division that was completed on November 8, 2004.

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

Investment Management

As of December 31, 2003, Pinnacol had achieved its goal of attaining an acceptable level of surplus as required under the surplus recovery plan filed with the Colorado Division of Insurance (the Division) in 2000. Pinnacol's surplus level as of December 31, 2003, was verified through an examination conducted by the Division which was completed on November 8, 2004. Under Title 8, Article 45, C.R.S., as amended, the state treasurer was the custodian for Pinnacol's cash and invested assets until November 30, 2004. With the attainment of an acceptable level of surplus and verification by the Division, Pinnacol's board of directors assumed control of the investment portfolio and all investment functions previously handled by the state treasurer.

As of December 31, 2004, Pinnacol has cash and invested assets of $1,613,614,000. During a review of Pinnacol's investment process implemented as a result of the transfer on November 30, 2004, we noted the following:

- While the Company is not in violation of the investment limitations, the Company's policies and procedures do not delineate investment limitations as required under Section 10-3-228.5, C.R.S. Additionally, supporting documentation for the monthly repurchase and reverse repurchase activity was not retained by Pinnacol.

Recommendation No. 1

Pinnacol should enhance its investment management process by:

- Enhancing documented policies and procedures for administering and recording investment transactions. These policies and procedures should include sections for 1) monitoring investment limitations per the Colorado statutes; 2) retaining supporting monthly documentation for repurchase and reverse repurchase transactions; and 3) reconciling repurchase and reverse repurchase activity between the involved parties.

Pinnacol Assurance Response

Agree. By the end of the third quarter 2005, Pinnacol will enhance investment policies and procedures to include monitoring of investment limitations, retention of repurchase and reverse repurchase supporting documentation, and the reconciliation of the repurchase and reverse repurchase activity.

KPMG LLP
Suite 2700
707 Seventeenth Street
Denver, CO 80202

Independent Auditors' Report

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

We have audited the accompanying statutory statements of admitted assets, liabilities, and policyholders' surplus of Pinnacol Assurance (the Company) as of December 31, 2004 and 2003, and the related statutory statements of income and changes in policyholders' surplus and cash flows for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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 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 accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between such practices and accounting principles generally accepted in the United States of America 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 of America, the financial position of Pinnacol Assurance as of December 31, 2004 and 2003, 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, 2004 and 2003, and the results of its operations and its cash flows for the years then ended in conformity with accounting practices prescribed or permitted by the Division.

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

KPMG LLP

April 15, 2005

PINNACOL ASSURANCE

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

December 31, 2004 and 2003

(In thousands)

Admitted Assets		**2004**	**2003**
Cash and invested assets:			
Bonds at amortized cost, fair value of $1,346,325 in 2004 and $1,231,032 in 2003 (note 3)	$	1,292,728	1,202,178
Common stock at fair value, cost of $127,372 in 2004 and $89,995 in 2003 (note 3)		140,699	104,498
Real estate at cost, net of accumulated depreciation		23,702	24,488
Cash and cash equivalents		142,925	98,091
Other invested assets		13,560	—
Total cash and invested assets		1,613,614	1,429,255
Uncollected premiums		45,578	48,662
Electronic data processing equipment, at cost, net of accumulated depreciation of $3,239 and $2,073 in 2004 and 2003, respectively		946	1,548
Accrued investment income		13,079	12,746
Total admitted assets	$	1,673,217	1,492,211
Liabilities and Policyholders' Surplus			
Liabilities:			
Reserve for unpaid losses and allocated loss adjustment expenses (note 2)	$	1,121,874	997,505
Reserve for unpaid unallocated loss adjustment expenses (note 2)		37,000	26,924
Total reserve for unpaid losses and loss adjustment expenses		1,158,874	1,024,429
Other liabilities		41,938	38,231
Unearned premiums		95,765	93,203
Credit balances due policyholders		10,846	9,050
Total liabilities		1,307,423	1,164,913
Commitments and contingencies (note 9)			
Policyholders' surplus (note 7)		365,794	327,298
Total liabilities and policyholders' surplus	$	1,673,217	1,492,211

See accompanying notes to statutory financial statements.

PINNACOL ASSURANCE

Statutory Statements of Income and Changes in Policyholders' Surplus

Years ended December 31, 2004 and 2003

(In thousands)

		2004	2003
Underwriting income:			
Premiums earned (note 6)	$	515,471	490,108
Deductions:			
Losses incurred (note 2)		442,213	373,447
Loss adjustment expenses incurred (note 2)		29,151	18,291
Other underwriting expenses incurred		100,738	94,917
Total underwriting deductions		572,102	486,655
Net underwriting gain (loss)		(56,631)	3,453
Investment income:			
Net investment income earned		80,472	77,027
Net realized capital gain		23,331	12,320
Net investment income		103,803	89,347
Other income (loss):			
Provision for uncollectible premiums		(2,245)	(2,556)
Other income		2,656	2,615
Association dividends to policyholders		(8,573)	(5,049)
Net income		39,010	87,810
Change in nonadmitted assets		662	2,059
Change in net unrealized losses in common stock		(1,176)	21,919
Policyholders' surplus at beginning of year		327,298	215,510
Policyholders' surplus at end of year	$	365,794	327,298

See accompanying notes to statutory financial statements.

PINNACOL ASSURANCE

Statutory Statements of Cash Flows

Years ended December 31, 2004 and 2003

(In thousands)

		2004	2003
Cash flows from operations:			
Premiums collected, net of reinsurance	$	521,116	503,735
Losses and loss adjustment expenses paid, net		(336,918)	(291,341)
Underwriting expenses paid		(95,235)	(92,421)
Dividends paid to policyholders		(8,573)	(5,049)
Cash from underwriting		80,390	114,924
Net investment income		76,805	72,925
Net amount withheld or retained for account of others		411	59
Net cash provided by operations		157,606	187,908
Cash flows from investments:			
Proceeds from sale or redemption of investments		393,795	361,719
Purchase of investments		(503,667)	(506,277)
Net cash used for investments		(109,872)	(144,558)
Cash flows from financing and miscellaneous sources:			
Cash applied for (used by) other miscellaneous sources		(2,900)	3,574
Net cash provided by (used for) financing and miscellaneous sources		(2,900)	3,574
Increase in cash on hand and on deposit		44,834	46,924
Cash on hand and on deposit, beginning of year		98,091	51,167
Cash on hand and on deposit, end of year	$	142,925	98,091

See accompanying notes to statutory financial statements.

(1) Nature of Operations and Significant Accounting Policies

(a) Organization

Pinnacol Assurance (Pinnacol) 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.

As of July 1, 2002, Colorado Compensation Insurance Authority's name was officially changed to Pinnacol Assurance with the passage of House Bill 02-1135. With the passage of this bill, Pinnacol is formally acknowledged in state statute as operating as a domestic mutual insurance company, and is a political subdivision of the state of Colorado. This bill also increased the number of board members of Pinnacol to nine members from seven members; clarified that the assets of Pinnacol belong to Pinnacol, and the State has no claim to these assets for any purpose; and authorized the transfer of invested assets of Pinnacol out of the state treasury to the custody of the board of directors of Pinnacol, upon satisfaction of the requirements of the surplus recovery plan. Finally, this bill eliminated the availability to Pinnacol of the provisions of the Government Immunity Act upon the attainment of the required surplus level.

Pinnacol achieved its goal of attaining an acceptable level of surplus as outlined in the state statutes. Pinnacol's surplus level as of December 31, 2003, was verified through an examination conducted by the Colorado Division of Insurance (the Division) that was completed on November 8, 2004. Under the applicable statutes, the state treasurer was the custodian for Pinnacol's cash and invested assets until November 30, 2004, when the custody of cash and invested assets was transferred to the board of directors of Pinnacol. With the attainment of an acceptable level of surplus, Pinnacol's board of directors assumed control of the investment portfolio and all investment related functions previously handled by the state treasurer. In addition, Pinnacol is no longer subject to the provisions of the Government Immunity Act.

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.

(b) Basis of Presentation

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

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

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

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

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

The effects of the foregoing variances from GAAP on the statutory financial statements at December 31, 2004 and 2003, and for the years then ended have been determined and are presented below:

	December 31,	
	2004	**2003**
	(In thousands)	
Statutory policyholders’ surplus	$ 365,794	327,298
Nonadmitted assets	9,836	10,498
Policy acquisition costs	8,812	3,312
Net unrealized gains on bonds	53,597	62,711
GAAP net assets	$ 438,039	403,819
Statutory net income	$ 39,010	87,810
Policy acquisition costs	5,501	481
Change in fair value of investments	(10,291)	(9,579)
GAAP changes in net assets	$ 34,220	78,712

(Continued)

(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 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 (the SVO). 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 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. Pinnacol has elected to use the book value as of January 1, 1994, as the cost for applying the retrospective adjustment method to securities purchased prior to that date. Prepayment assumptions for single-class and multi-class mortgage-backed/asset-backed securities were obtained from Hub Data and Bloomberg. Pinnacol had no negative yield situations requiring a change from the retrospective to prospective method.

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 $816,000 and $820,000 for the years ended December 31, 2004 and 2003, respectively.

(e) Cash and Cash Equivalents

Pinnacol's board of directors assumed control of the investment portfolio and all treasury and investment-related functions previously handled by the state treasurer. The investment portfolio transferred from the state treasurer to Pinnacol's board of directors on November 30, 2004.

As of December 31, 2004, cash and cash equivalents of $142,925,000 include $8,303,000 of cash, $79,883,000 of cash equivalents, and $54,739,000 of short-term investments in bonds. As of December 31, 2003, cash and cash equivalents includes funds held by the state treasury and invested in the state's pooled accounts, as well as amounts held in other bank accounts. In the accompanying statutory balance sheets, Pinnacol has recorded warrants 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 reinsurance agreements of $1,557,000 and $10,167,000 as of December 31, 2004 and 2003, respectively.

(f) Other Invested Assets

Other invested assets of $13,560,000 as of December 31, 2004 are long-term investments in U.S. Treasury notes that are held as collateral for reinsurance agreements and are stated at amortized cost.

(g) Uncollected Premiums

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

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

During 2004 and 2003, Pinnacol recorded a provision or wrote off a total of $2,245,000 and $2,556,000, respectively, in premiums receivable due to the unlikelihood of ultimate collection thereof. These amounts are reflected as provision for uncollectible premiums in the accompanying financial statements.

A significant portion of Pinnacol's premiums receivable balances at December 31, 2004 and 2003 were from companies operating in the construction and services industries in Colorado. The construction industry represents 38% and 44% of premiums receivable balances as of December 31, 2004 and 2003, respectively. The services industry represents 24% of premiums receivable balances as of December 31, 2004 and 2003, with all other individual industries constituting a small fraction of premiums receivable balances.

(h) 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 actuarially and statistically supported aggregate calculations using historical unearned premium data and per policy calculations. For 2004 and 2003, estimated unbilled audit premiums receivable of $5,738,000 and $5,454,000, respectively, are included as uncollected premiums. These estimated receivables have been reduced by 10%, where applicable, to comply with statutory accounting principles.

(i) 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 $1,762,000 and $6,406,000 in 2004 and 2003, respectively. These amounts represent 0.3% and 1.3% of total net premiums written as of 2004 and 2003, 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 calculated as follows:

	December 31, 2004	December 31, 2003
	(In thousands)	
Secured accrued retrospective premium	$ 2,114	11,279
Unsecured amount	59	151
Less: nonadmitted amount (10%)	(6)	(15)
Admitted amount	$ 2,167	11,415

(j) 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 2004 and 2003, such amounts are approximately $10,846,000 and $9,050,000, respectively.

(k) 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, 2004 and 2003 was $946,000 and $1,548,000, respectively. Related depreciation expense of $1,166,000 and $1,164,000 was incurred during 2004 and 2003, respectively.

(l) 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. In accordance with the Manual, these are nonadmitted assets. The net book value of these assets at December 31, 2004 and 2003 was $3,630,000 and $4,228,000, respectively. Related depreciation expense of $791,000 and $765,000 was incurred in 2004 and 2003, respectively.

(m) Other Assets

At December 31, 2004 and 2003 Pinnacol had prepaid assets totaling $1,186,000 and $908,000, respectively. In accordance with the Manual, these are nonadmitted assets.

(n) Discretionary 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 discretionary dividends were declared or paid from surplus in 2004 or 2003.

(o) 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. These dividends are not declared from surplus or recorded as a direct reduction to surplus. Instead, the dividends are recorded as association dividends to policyholders.

(p) Revenue Recognition

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

(q) 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. As permitted by state statute and in accordance with the surplus recovery plan filed with the Division, effective January 1, 2001, Pinnacol discounts unpaid losses and loss adjustment expenses on a nontabular basis at 0% and 3.75% for the years ended December 31, 2004 and 2003, respectively. 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 2004 and 2003. The discount rate used to calculate present value is based on an estimate of expected investment yield and considers the risk of adverse deviation in the future from such yield. State law allows Pinnacol the use of a discount factor of up to 6.00%. As approved by the Division and in accordance with the Division's interpretation of the surplus recovery plan filed with the Division in a prior year, Pinnacol discounted its actuarially determined unpaid balances by a factor of 3.75% as of and for the year ended December 31, 2003. As of December 31, 2003, Pinnacol achieved its goal of attaining an acceptable level of surplus and was no longer permitted to discount actuarially determined balances as of and for the year ended December 31, 2004, and the nontabular discount was eliminated.

(r) 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 twelve-month term of the policies and are reported net of ceded reinsurance.

(s) Subrogation

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

(t) 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).

(u) 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 3.8% in 2004 and 2003), pursuant to Section 8-44-112(1)(a), C.R.S. Such amounts are included in other underwriting expenses incurred.

(v) 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 the CSSDTF. Title 24, Article 51 of the C.R.S., as amended, assigns the authority to establish benefit provisions to the state legislature. 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).

(Continued)

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 the C.R.S., as amended. The contribution rate for members is 8.0% and for Pinnacol is 10.15% (effective July 1, 2003) of covered salary. (From July 2002 through June 2003, the contribution rate for Pinnacol was 10.04%). Beginning with payroll periods ending on or after January 1, 2001, and before June 1, 2004, the employer contribution paid to the CSSDTF were reduced by an employer match on members' voluntary contributions to a defined contribution plan. The match, set by the board of trustees of PERA, is 100% of a member's eligible tax-deferred retirement program contributions limited by a per payroll whole percentage of PERA-includable salary limit (percentage set for January through May 31, 2004, was 1.0%). Any unused defined contribution match money is forwarded to the CSSDTF. With the passage and signing of Senate Bill 04-132, the employer match was suspended on June 1, 2004. Also, a portion of Pinnacol's contribution (1.10% of covered salary January 1, 2004, through June 30, 2004; 1.02% of covered salary July 1, 2004, through December 31, 2004) is allocated for the Health Care Trust Fund. (Prior to July 1, 2004, Pinnacol's contribution rate for the Health Care Trust Fund was 1.1%.) Pinnacol's contributions to CSSDTF for the years ended December 31, 2004, 2003, and 2002 were $2,802,000, $2,435,000, and $2,019,000, respectively, equal to their required contributions for each year.

Pinnacol contributes to the Health Care Trust Fund (HCTF), a cost-sharing multiple-employer postemployment healthcare plan administered by PERA. The HCTF provides a healthcare premium subsidy to PERA participating benefit recipients and their eligible beneficiaries. Title 24, Article 51, Part 12 of the C.R.S., as amended, assigns the authority to establish the HCTF benefit provisions to the state legislature. PERA issues a publicly available annual financial report that includes financial statements and required supplementary information for the HCTF. That report may be obtained by writing to Colorado PERA, 1300 Logan Street, Denver, Colorado 80203 or by calling PERA at 303-832-9550 or 1-800-759-PERA (7372).

Pinnacol is required to contribute at a rate of 1.10% of covered salary from January 1, 2004, through June 30, 2004, and 1.02% from July 1, 2004, through December 30, 2004, for all PERA members as set by statute. No member contributions are required. The contribution requirements for Pinnacol are established under Title 24, Article 51, Part 4 of the C.R.S., as amended. The apportionment of the contribution to the HCTF is established under Title 24, Article 51, Section 208 of the C.R.S., as amended. Pinnacol's contributions to HCTF for the years ended December 31, 2004, 2003, and 2002 were $303,000, $318,000, and $327,000, respectively, equal to their required contributions for each year.

The (CSSDTF) members of Pinnacol may voluntarily contribute to the Voluntary Investment Program (401(k) Plan), an Internal Revenue Code Section 401(k) defined contribution plan administered by PERA. Plan participation is voluntary, and contributions are separate from others made to PERA. Title 24, Article 51, Part 14 of the CRS, as amended, assigns the authority to establish the 401(k) Plan provisions to the state legislature.

The 401(k) Plan is funded by voluntary member contributions up to a maximum limit set by the IRS ($13,000 in 2004). Beginning January 1, 2001, an employer match was legislated that would match 100% of a member's eligible tax-deferred retirement program contributions limited by 1.0% in 2004 (through May 31, 2004) per payroll of the PERA-includable salary. With the passage and signing of

Senate Bill 04-132, the employer match was suspended on June 1, 2004. The contribution requirements for Pinnacol are established under Title 24, Article 51, Section 1402 of the C.R.S., as amended. The 401(k) Plan member contributions from Pinnacol for the year ended December 31, 2004 were $1,742,000. The employer contributions to the 401(k) Plan from Pinnacol for the year ended December 31, 2004 were $102,000.

Pinnacol employees may accrue paid time off based on their length of service subject to certain limitations on the amount which will be paid upon termination. 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 $1,340,000 and $1,432,000 at December 31, 2004 and 2003, respectively, is included in other liabilities in the accompanying financial statements.

(w) Reclassifications

Certain reclassifications have been made to the 2003 statutory financial statements to conform to the 2004 statutory 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 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 and unpaid loss adjustment expenses.

Tabular Discount

Worker's compensation unpaid losses have been discounted on a tabular basis using a discount rate of 3.5% in 2004 and 2003. A tabular discount is calculated with reference to actuarial tables. These tables incorporate an interest rate and, in addition, factor in contingencies such as mortality, remarriage, and inflation rates. The amount of the tabular discount for unpaid losses as of December 31, 2004 and 2003, respectively, is $126,554,000 and $133,483,000. The amount of discount for case reserves at December 31, 2004, is distributed as follows over the years in which the losses were incurred:

	Loss year										
	2004	**2003**	**2002**	**2001**	**2000**	**1999**	**1998**	**1997**	**1996**	**1995**	**Prior**
	(In thousands)										
Amount of Discount Case	$ 9,674	13,202	17,586	11,123	6,360	5,940	5,219	5,727	3,288	4,131	44,304
Amount of Discount Bulk	—	—	—	—	—	—	—	—	—	—	—

Nontabular Discount

As the surplus recovery plan was achieved based on the surplus level as of December 31, 2003, Pinnacol is no longer permitted to record a nontabular discount. Therefore, as of March 31, 2004, Pinnacol increased unpaid losses and allocated loss adjustment expenses and losses incurred by $85,657,000 to eliminate the nontabular discount. The unallocated loss adjustment expense (ULAE) liability was also increased in 2004 by $5,428,000 to eliminate the nontabular discount.

As of December 31, 2003, reserves for workers' compensation claims were discounted on a nontabular basis at 3.75%. A nontabular discount is calculated with reference to an estimated payout pattern and an interest rate without reference to actuarial tables. Colorado statute permitted Pinnacol to discount its loss and loss adjustment expense reserves at rates up to 6%. Pinnacol selected a rate, in keeping with the surplus recovery plan, filed and approved by the Division. The amount of the nontabular discount included in the unpaid losses and allocated loss adjustment expense liability as of December 31, 2003, is $80,272,000. The amount of the nontabular discount included in the ULAE liability as of December 31, 2003, is $5,428,000.

Unpaid Losses and Loss Adjustment Expense

At December 31, 2004, Pinnacol accrued $1,121,874,000 for unpaid losses and allocated loss adjustment expenses. A tabular discount of $126,554,000 (computed at 3.5%) was applied in the actuarial calculation of this liability for unpaid losses and allocated loss adjustment expenses. Reserve credit of approximately $5,900,000 was recorded for high deductibles on unpaid claims at December 31, 2004.

At December 31, 2003, Pinnacol accrued $997,505,000 for unpaid losses and allocated loss adjustment expenses. A discount of $213,755,000 was applied in the actuarial calculation of this liability for unpaid losses and allocated loss adjustment expenses. This discount includes $133,483,000 for the tabular discount (computed at 3.5%), and $80,272,000 for the nontabular discount (computed at 3.75%) as permitted by state statute, and in accordance with the surplus recovery plan filed with the Division. The nontabular discount was permitted by state statute that allows reserves to be discounted at a rate of up to 6%.

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

	2004		2003	
	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	$ 997,505	26,924	897,414	26,899
Additional amounts incurred related to:				
Current year	395,302	21,361	348,074	18,567
Prior years	46,911	7,790	25,373	(276)
Total incurred	442,213	29,151	373,447	18,291
Reductions relating to payments for:				
Current year	101,428	11,659	74,102	11,071
Prior years	216,416	7,416	199,254	7,195
Total paid	317,844	19,075	273,356	18,266
Balance at December 31	$ 1,121,874	37,000	997,505	26,924

As a result of changes in estimates of insured events in prior years, the provision for unpaid losses and allocated loss adjustment expenses increased by $46,911,000 in 2004 and $25,373,000 in 2003. The increase in the reserve for prior-year activity results primarily from the change in the discount rate.

(3) Investments

Estimated fair value of investments in bonds is based on values published by the Securities Valuation Office (SVO) of the NAIC. As of December 31, 2004, these values equal quoted market value prices as provided by Hub Data, an external pricing source, for those or similar investments. However, for certain investments, the SVO does not provide a fair value. For 2004, statutory accounting practices (SAP) changed in that the quoted market value prices as provided by Hub Data may be used as a substitute for the SVO market price. As of December 31, 2003, Pinnacol used the amortized cost of the security as a substitute for fair value per SAP.

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

	2004			
	Amortized cost	**Unrealized gains**	**Unrealized losses**	**Fair value**
	(In thousands)			
U.S. government obligations:				
Nonloan-backed bonds	$ 145,816	12,686	(149)	158,353
Loan-backed bonds	20,157	322	—	20,479
Special revenue:				
Loan-backed bonds	365,301	5,394	(1,693)	369,002
Industrial and miscellaneous:				
Nonloan-backed bonds	587,217	38,580	(2,218)	623,579
Loan-backed bonds	174,237	2,614	(1,939)	174,912
	$ 1,292,728	59,596	(5,999)	1,346,325

	2003			
	Amortized cost	**Unrealized gains**	**Unrealized losses**	**Fair value**
	(In thousands)			
U.S. government obligations:				
Nonloan-backed bonds	$ 155,132	12,278	—	167,410
Loan-backed bonds	3,996	—	—	3,996
Special revenue:				
Loan-backed bonds	262,864	—	—	262,864
Industrial and miscellaneous:				
Nonloan-backed bonds	529,628	17,525	(949)	546,204
Loan-backed bonds	250,558	—	—	250,558
	$ 1,202,178	29,803	(949)	1,231,032

The amortized cost and fair value of investments in debt securities at December 31, 2004, 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.

	Amortized cost	**Fair value**
	(In thousands)	
Due in one year or less	$ 10,002	10,066
Due after one year through five years	164,081	178,361
Due after five years through ten years	410,204	428,767
Due after ten years	708,441	729,131
	$ 1,292,728	1,346,325

(Continued)

Proceeds from sales of investments in bonds during 2004 and 2003 were $290,846,000 and $351,553,000, respectively. Gross gains of $8,402,000 and $12,577,000 and gross losses of $(178,000) and $(257,000) were realized on those sales for 2004 and 2003, 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, 2004:					
Common stocks	$	127,372	13,332	(5)	140,699
December 31, 2003:					
Common stocks	$	89,995	14,503	—	104,498

		Less than 12 months		12 months or greater		Total	
Description of securities		Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
				(In thousands)			
Government obligations	$	—	—	35,956	(149)	35,956	(149)
Special revenue and special assessment obligations		—	—	111,513	(1,692)	111,513	(1,692)
Industrial and miscellaneous		—	—	85,168	(2,218)	85,168	(2,218)
Mortgage-backed securities		—	—	69,978	(1,939)	69,978	(1,939)
Total	$	—	—	302,615	(5,998)	302,615	(5,998)

(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

Municipal 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. If a corporate bond rating for a security falls below BBB-, the security is automatically sold.

(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, 2004 and 2003, are summarized as follows:

		2004	2003
		(In thousands)	
Investment income:			
Corporate and miscellaneous bonds	$	62,636	59,901
U.S. government obligations		10,192	11,478
Cash and other investments		3,513	2,888
Real estate		3,487	3,508
Equity securities		2,770	1,305
Securities lending		469	438
Repurchase/reverse repurchase		42	—
Investment expenses		(2,637)	(2,491)
Net investment income		80,472	77,027
Net realized gains		23,331	12,320
Investment income	$	103,803	89,347

(4) Repurchase/Reverse Repurchase and Securities Lending Transactions

In 2004, Pinnacol entered 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. At December 31, 2004, Pinnacol had outstanding U.S. government securities with fair values of approximately $679,279,000 and a cost of approximately $667,491,000.

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.

In 2003, Pinnacol entered into transactions to lend its securities to a broker-dealer. Pinnacol's custodian lent securities to the broker-dealer in exchange for collateral in the form of U.S. Treasury securities, agency debentures, GNMA, and agency mortgage-backed securities equal to or exceeding 102% of the fair market value of the loaned securities, and corporate securities and money markets equal to or exceeding 105% of the fair market value of the loaned securities. At December 31, 2003, Pinnacol had certain outstanding securities with a fair value of $646,877,000.

The contract with the broker-dealer required the broker-dealer to indemnify Pinnacol if the broker-dealer failed to return the securities or failed to pay Pinnacol for income distributions by the securities' issuers while the securities were on loan. All securities lending transactions could be terminated on demand by either Pinnacol or the broker-dealer.

(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 $27,897,000 and $24,174,000 in 2004 and 2003, respectively.

(6) Reinsurance

Pinnacol purchases catastrophic reinsurance for risks in excess of its retention limits on workers' compensation insurance policies written. Pinnacol has also purchased facultative excess of loss reinsurance for policies related to the Colorado Corn Growers Association with FarmInsure Ltd. Coverage for policies is provided under the following terms:

Period	Reinsurance coverage
Prior to January 1, 2002	Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $6,000,000 per occurrence
January 1, 2002 to April 30, 2002	No catastrophic reinsurance was in place; however, management is not aware of any catastrophes during that time
May 1, 2002 to March 1, 2004	Individual workers' compensation accidents of up to $20,000,000 in excess of retention of $20,000,000 per occurrence
January 1, 2004 to December 31, 2004	Individual Colorado Corn Growers' Association workers' compensation accidents of $250,000 of incurred losses and loss expenses up to an aggregate limit of 67% of gross premiums written
March 1, 2004 to December 31, 2004	Individual workers' compensation accidents of up to $15,000,000 in excess of retention of $5,000,000 per occurrence Individual workers' compensation accidents of up to $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

Effective March 1, 2004, Pinnacol executed a reinsurance contract with Argonaut Insurance Company (a California corporation) for Other States Coverage. 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 reside 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:

		2004	2003
		(In thousands)	
Gross premiums earned	$	516,074	489,946
Premiums ceded		(2,753)	(800)
Premiums assumed		2,150	962
Net premiums earned	$	515,471	490,108
Gross losses incurred	$	468,345	384,544
Losses assumed		3,019	7,194
Net losses incurred	$	471,364	391,738

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, 2004:

Reinsurer	AM best rating
AXIS Specialty Corporation	A
Endurance Specialty Insurance Limited	A
Platinum Underwriters Reinsurance	Au
Renaissance Reinsurance Ltd	A+u
Aspen Insurance UK Ltd.	A
Danish RE Underwrting Agencies Lloyds	NR-4
Danish RE Underwrting Agencies Britian	A
Lloyds Underwriter Syndicate No 2987B	NR
Lloyds Underwriter Syndicate No 2780AD	NR

(7) Policyholders' Surplus

Pinnacol had policyholders' surplus of $365,794,000 and $327,298,000 as of December 31, 2004 and 2003, respectively. Prior to and as of December 31, 2002, surplus was below regulatory levels considered acceptable in the industry. In response to Section 8-45-111, C.R.S., management of Pinnacol had developed, filed, and received approval, effective January 1, 2001, of a Surplus Recovery Plan (the Plan) to strengthen its financial position and attain "a reasonable policyholders' surplus." The Plan 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., the level at which the Division requires a plan for corrective action).

Risk-based capital includes factors that relate to the size of the entity, the perceived risks in the company's business, and also factors relating to the insurance industry in general.

The 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 Division informed of progress toward the goal of "a reasonable level of surplus."

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

The risk-based capital calculation allows a company to compute surplus using discounted tabular reserves, which are indemnity reserves that are calculated using discounts determined with reference to actuarial tables. Nontabular discounted reserves must be adjusted back to get to adjusted capital as defined for risk-based capital purposes. Pinnacol has achieved the "company action level of risk-based capital" as outlined in the Plan, and Pinnacol's surplus is computed using undiscounted reserves as of December 31, 2004. An adjustment of $91,085,000 was recorded in 2004 to eliminate the nontabular discount as a result of achieving the Plan, which increased the total reserve for unpaid losses and loss adjustment expenses and losses and loss adjustment expenses incurred.

As of December 31, 2003, Pinnacol has discounted its unpaid loss and loss adjustment expense reserves in total by approximately $213,755,000. For purposes of calculating risk-based capital only, Pinnacol calculated the tabular discount for certain case-based indemnity reserves of approximately $133,483,000. Accordingly, approximately $85,657,000 of the total discount relates to nontabular reserves which, when adjusted, yields an adjusted surplus of approximately $242,000,000 for risk-based capital purposes.

(8) Uncollected Premiums

At December 31, 2004 and 2003, Pinnacol had admitted assets of $45,578,000 and $48,662,000, 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, 2004 and 2003, Pinnacol had letters of credit for assumptive reinsurance agreements. Pinnacol had a letter of credit with Fireman's Fund Insurance Company for approximately $6,403,000 and $7,888,000 at December 31, 2004 and 2003, respectively. Pinnacol had a letter of credit with Argonaut Insurance Company for $4,812,500 at December 31, 2004. Pinnacol had a letter of credit with Reliance Insurance Company for approximately $902,000 and $1,357,000 at December 31, 2004 and 2003, respectively. These reinsurance agreements allow the companies to draw upon the respective letters of credit at any time to secure any of Pinnacol's obligations under the agreements.

Pinnacol is contingently liable for approximately $66,850,000 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, 2004, 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)
GE Assurance, Virginia	$	41,637
Symetra Financial, Washington		20,688
Metlife, New York		2,690
Allstate, Illinois		1,615
Liberty Life Assurance Company, Massachusetts		220
	$	66,850

(10) Subsequent Events

As Pinnacol has attained an acceptable level of surplus as outlined in the state statutes, the board of directors declared and is planning to pay a general dividend of approximately $55,000,000 in 2005 from surplus to its policyholders with policies in good standing. Pinnacol submitted a General Dividend Allocation rule with the Colorado Division of Insurance in 2003 and subsequently received a "filed" acknowledgement on June 29, 2004. 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, 2004

Pinnacol's total admitted assets as reported on page two of its Annual Statement are $1,673,217,259.

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

Investment category/issuer	Amount	Percentage of total admitted assets
Bonds:		
a. Proctor and Gamble	$ 29,930,981	1.79%
b. Anheuser Busch	24,926,797	1.49%
c. Johnson and Johnson	21,160,799	1.26%
d. Legget and Platt	19,993,668	1.19%
e. Target Corporation	19,952,115	1.19%
f. Standard Credit Card Mstr TR 1994-2A	19,886,940	1.19%
g. Dupont	19,845,865	1.19%
h. General Electric	17,415,307	1.04%
i. First Data Corporation	16,972,887	1.01%
j. American General	16,896,848	1.01%

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	$ 1,227,796,520	73.4%	P/PSF-1	$ —	—
NAIC-2	59,869,098	3.6%	P/PSF-2	—	—
NAIC-3	5,062,754	0.3%	P/PSF-3	—	—
NAIC-4	—	—%	P/PSF-4	—	—
NAIC-5	—	—%	P/PSF-5	—	—
NAIC-6	—	—%	P/PSF-6	—	—
	$ 1,292,728,372			$ —	

3. Assets held in foreign investments are less than 2.5% of Pinnacol's total admitted assets. (none)

4. Assets held in Canadian investments are less than 2.5% of Pinnacol's total assets. (none)

5. Assets held in investments with contractual sales restrictions are less than 2.5% of Pinnacol's total admitted assets. (none)

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 Total Stock Market Index	$ 31,906,525	1.91%
b. Vanguard Index TR Total Stokidx AD	30,348,518	1.81%
c. Vanguard Index TR Total Stock Market	30,341,160	1.81%
d. Vanguard Index TR Total Stock Market Vipers	30,002,526	1.79%
e. T Rowe Price Small Cap	18,099,653	1.08%

7. Assets held in nonaffiliated, privately placed equities are less than 2.5% of Pinnacol's total admitted assets. (none)

8. Assets held in general partnership interests are less than 2.5% of Pinnacol's total admitted assets. (none)

9. Mortgage loans reported in schedule B are less than 2.5% of Pinnacol's total admitted assets. (none)

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 less than 2.5% of Pinnacol's total admitted assets. (none)

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

	Year-end		End of each quarter		
			1st Quarter	2nd Quarter	3rd Quarter
	Amount	Percentage of total admitted assets	Amount (Unaudited)	Amount	Amount
a. Securities lending (do not include assets held as collateral for such transactions)	$ —	—	666,788,000	746,622,445	659,936,751
b. Repurchase agreements	679,279,092	40.6%	—	—	—
c. Reverse repurchase agreements	(679,279,092)	(40.6)%	—	—	—
d. Dollar repurchase agreements	—	—	—	—	—
e. Dollar reverse repurchase agreements	—	—	—	—	—

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

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

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

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

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

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

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Investment Risks Interrogatories

December 31, 2004

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

Investment	Amount	Percentage of total admitted assets
a. Wells Fargo Bank – U.S. Treasury note	$ 13,560,000	0.81%

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Summary Investment Schedule

December 31, 2004

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	$ 112,633,120	6.98%	$ 112,633,120	6.98%
U.S. government agency and corporate obligations (excluding mortgage-backed securities)				
Issued by U.S. government agencies	—	—	—	—
Issued by U.S. government-sponsored agencies	33,182,659	2.06	33,182,659	2.06
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	20,157,207	1.25	20,157,207	1.25
Issued by FNMA and FHLMC	39,410,237	2.44	39,410,237	2.44
Privately issued	—	—	—	—
CMOs and REMICs:				
Issued by FNMA and FHLMC	480,240,745	29.76	480,240,745	29.76
Privately issued and collateralized by MBS issued or guaranteed by GNMA, FMNA, or FHLMC	19,886,940	1.23	19,886,940	1.23
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)	587,217,465	36.39	587,217,465	36.39
Unaffiliated foreign securities	—	—	—	—
Affiliated securities	—	—	—	—

PINNACOL ASSURANCE

Supplemental Schedule of Investment
Information – Summary Investment Schedule

December 31, 2004

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	$ —	—	$ —	—
Preferred stocks:				
Affiliated	—	—	—	—
Unaffiliated	—	—	—	—
Publicly traded equity securities (excluding preferred stocks):				
Affiliated	—	—	—	—
Unaffiliated	140,698,383	8.72	140,698,383	8.72
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	23,702,314	1.47	23,702,314	1.47
Property held for production of income	—	—	—	—
Property issued or guaranteed by GNMA, FMNA,	—	—	—	—
Collateral loans	—	—	—	—
Policy loans	—	—	—	—
Receivables for securities	—	—	—	—
Cash and short-term investments	142,925,359	8.86	142,925,359	8.86
Write-ins for invested assets	13,560,000	0.84	13,560,000	0.84
Total invested assets	$ 1,613,614,429	100.00%	$ 1,613,614,429	100.00%

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

See accompanying independent auditors' report.

KPMG LLP
Suite 2700
707 Seventeenth Street
Denver, CO 80202

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

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

We have audited the statutory financial statements of Pinnacol Assurance (Pinnacol) as of and for the year ended December 31, 2004, and have issued our report thereon dated April 15, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Pinnacol's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable 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 caused by error or fraud 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.

Compliance and Other Matters

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, 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

April 15, 2005

PINNACOL ASSURANCE

Statutory Financial Statements

December 31, 2004

Distribution

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303-869-2800

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