

Tobacco Settlement Endowment Trust Fund

Financial Statements

June 30, 2015 and 2014
(With Independent Auditors' Report Thereon)



TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

FINANCIAL STATEMENTS

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INDEPENDENT AUDITORS' REPORT

Board of Directors and
Board of Investors
Tobacco Settlement Endowment Trust Fund

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities and the permanent fund of the Tobacco Settlement Endowment Trust Fund (the "Fund"), which is a part of the State of Oklahoma financial reporting entity, as of and for the years ended June 30, 2015 and 2014, and the related notes to the financial statements, which collectively comprise the Fund's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express opinions on these financial statements based on our audits. We conducted our audits 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

(Continued)

INDEPENDENT AUDITORS' REPORT, CONTINUED

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the permanent fund of the Fund as of June 30, 2015 and 2014, and the respective changes in financial position for the years then ended in accordance with accounting principles generally accepted in the United States.

Emphasis of Matters

Component-Unit-Only Financial Statements

As discussed in Note 1, the financial statements of the Fund, a permanent fund of the State of Oklahoma, are intended to present the financial position and the changes in financial position of only that portion of the governmental activities and governmental funds of the State of Oklahoma that is attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the financial position of the State of Oklahoma as of June 30, 2015 and 2014, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States. Our opinion is not modified with respect to this matter.

Adoption of New Accounting Pronouncements

As discussed in Notes 1 and 2 to the financial statements, in 2015 the Fund adopted new accounting guidance, Statement No. 68 of the Governmental Accounting Standards Board, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27* (GASB 68), and GASB Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date—an amendment of GASB Statement No. 68* (GASB 71). The implementation of GASB 68 and GASB 71 resulted in a cumulative adjustment to restate the beginning net position of the Fund as of July 1, 2014. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States require that the management's discussion and analysis on pages I-1 through I-16 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

(Continued)

INDEPENDENT AUDITORS' REPORT, CONTINUED

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated September 29, 2015, on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Fund's internal control over financial reporting and compliance.

A handwritten signature in black ink that reads "Finley + Cook, PLLC". The signature is written in a cursive, flowing style.

Shawnee, Oklahoma
September 29, 2015

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

June 30, 2015 and 2014

The Management's Discussion and Analysis (MD&A) of the Tobacco Settlement Endowment Trust Fund (the "Fund") provides an overview and overall review of the Fund's financial activities for the fiscal years ended June 30, 2015 and 2014. The intent of the MD&A is to look at the Fund's financial performance as a whole. It should, therefore, be read in conjunction with the Fund's financial statements and the notes thereto.

The Fund was established pursuant to the Constitution of the State of Oklahoma. The Fund's principal was established with funds received by the State of Oklahoma (the "State") on or after July 1, 2001, pursuant to any settlement with or judgment against any tobacco companies. The principal funds are invested, and the earnings (see Note 8) may be expended for operations; tobacco prevention and cessation programs; research and treatment efforts in Oklahoma to prevent and combat cancer and other tobacco-related diseases; and programs to maintain or improve the health of Oklahomans or to enhance health care services provided to Oklahomans, with a particular emphasis on children and senior adults.

A Board of Investors was created to manage the investment of the Fund and to annually certify the earnings that are available for program expenditures. A Board of Directors was created to oversee the Fund's operating and program expenditures.

Through the joint effort of both Boards in 2011, the Board of Investors requested an official Attorney General Opinion regarding conflicting language between Article X of the Constitution and the statutory language in Title 62, Section 2307 in defining earnings available for certification by the Board of Investors. An opinion was issued by the Attorney General on August 31, 2011, stating that earnings for the annual certification by the Board of Investors includes, but is not limited to, interest, dividends, and realized capital gains from investments, minus costs and expenses of the investments, and minus any losses realized by the Fund.

Since this method is reflective of the constitutional language, and the Board of Investors has historically used the definition within the statutory language to certify earnings, additional earnings were certified by the Board of Investors for the year ended June 30, 2011, inclusive of net realized gains. The recalculation according to the Attorney General's opinion resulted in \$36,023,061 being certified by the Board of Investors at their meeting on November 17, 2011.

At this joint meeting of both the Board of Investors and the Board of Directors, there was discussion of a possible action on the earnings previously certified between FY 2001 and FY 2010. It was determined that an additional \$42,898,847 would have been certified during this period had the Board of Investors calculated available earnings under the constitutional language. Upon the request of the Board of Directors, the Board of Investors voted to hold the \$42,898,847 in reserve to be certified when future earnings calculations were below 5% of the corpus of the Fund.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

In consideration of this, the Board of Directors approved the execution of a settlement agreement and release of all claims signed on February 16, 2012. This reserve is to be invested in the same manner as the Fund. According to the agreement, some or all of the reserve funds are to be available for spending when the current year earnings calculation is below 5% of the corpus of the Fund. The certification of reserve funds is limited to the 5% cap, inclusive of the initial calculation based upon the constitutional language. This agreement is in effect until the total amount of the reserve has been certified by the Board of Investors. At their November 14, 2012, meeting, the Board of Investors defined the corpus of the Fund as the custodial market value of the Fund as of June 30, less any previous certified earnings (current year and previous years' certified earnings that remain invested) within the Fund at June 30.

At their August 19, 2015, meeting, the Board of Investors certified \$42,843,669, reserving \$500,000 for possible audit adjustments. The estimated earnings available for certification for the period ended June 30, 2015, were \$43,343,699.

USING THIS ANNUAL REPORT

The basic financial statements presented in the annual report include both government-wide and fund financial statements.

Government-Wide Statements: The government-wide financial statements include the statements of net position and the statements of activities. These statements display information about the Fund as a whole. The government-wide financial statements of the Fund are presented on a full accrual economic resource basis, which includes all assets and liabilities whether current or noncurrent. These statements provide both short-term and long-term information about the Fund's overall financial status.

Fund Statements: The fund financial statements include the governmental fund's balance sheets and the statements of revenues, expenditures, and changes in fund balance. In the fund financial statements, the revenues and expenditures of the Fund are presented using the current financial resources measurement focus and the modified accrual basis of accounting. Under these accounting methods, revenues and assets are recognized when they become both measurable and available, and expenditures and liabilities are recognized when obligations are incurred as a result of the receipt of goods or services.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS

Statements of Net Position

The statements of net position provide an indication of the Fund's financial condition at the end of the 2015, 2014, and 2013 fiscal years; the statements report all assets and liabilities using the accrual basis of accounting.

Tobacco Settlement Endowment Trust Fund **Statements of Net Position**

| | <u>2015</u> | <u>2014</u> | <u>2013</u> |
|---|-----------------------|----------------------|--------------------|
| Assets | | | |
| Current assets | \$ 113,112,524 | 138,930,511 | 162,403,184 |
| Investments, at fair value | 973,596,294 | 923,128,052 | 789,995,839 |
| Securities lending collateral—non-cash | 21,630,365 | 21,992,588 | - |
| Capital assets | <u>42,789</u> | <u>45,238</u> | <u>42,201</u> |
| Total assets | <u>1,108,381,972</u> | <u>1,084,096,389</u> | <u>952,441,224</u> |
| Deferred outflows of resources: | | | |
| Deferred amounts related to the pension | <u>225,753</u> | <u>-</u> | <u>-</u> |
| Liabilities | | | |
| Current liabilities | 13,469,084 | 9,448,427 | 16,151,201 |
| Liability under securities lending | 97,663,938 | 105,919,077 | 106,599,991 |
| Noncurrent liabilities | <u>203,834</u> | <u>93,459</u> | <u>73,622</u> |
| Total liabilities | <u>111,336,856</u> | <u>115,460,963</u> | <u>122,824,814</u> |
| Deferred inflows of resources: | | | |
| Deferred amounts related to the pension | <u>413,472</u> | <u>-</u> | <u>-</u> |
| Net Assets | | | |
| Net investment in capital assets | 42,789 | 45,238 | 42,201 |
| Restricted for investment | 871,615,601 | 845,219,972 | 729,689,075 |
| Unrestricted | <u>125,199,007</u> | <u>123,370,216</u> | <u>99,885,134</u> |
| Total net position | <u>\$ 996,857,397</u> | <u>968,635,426</u> | <u>829,616,410</u> |

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

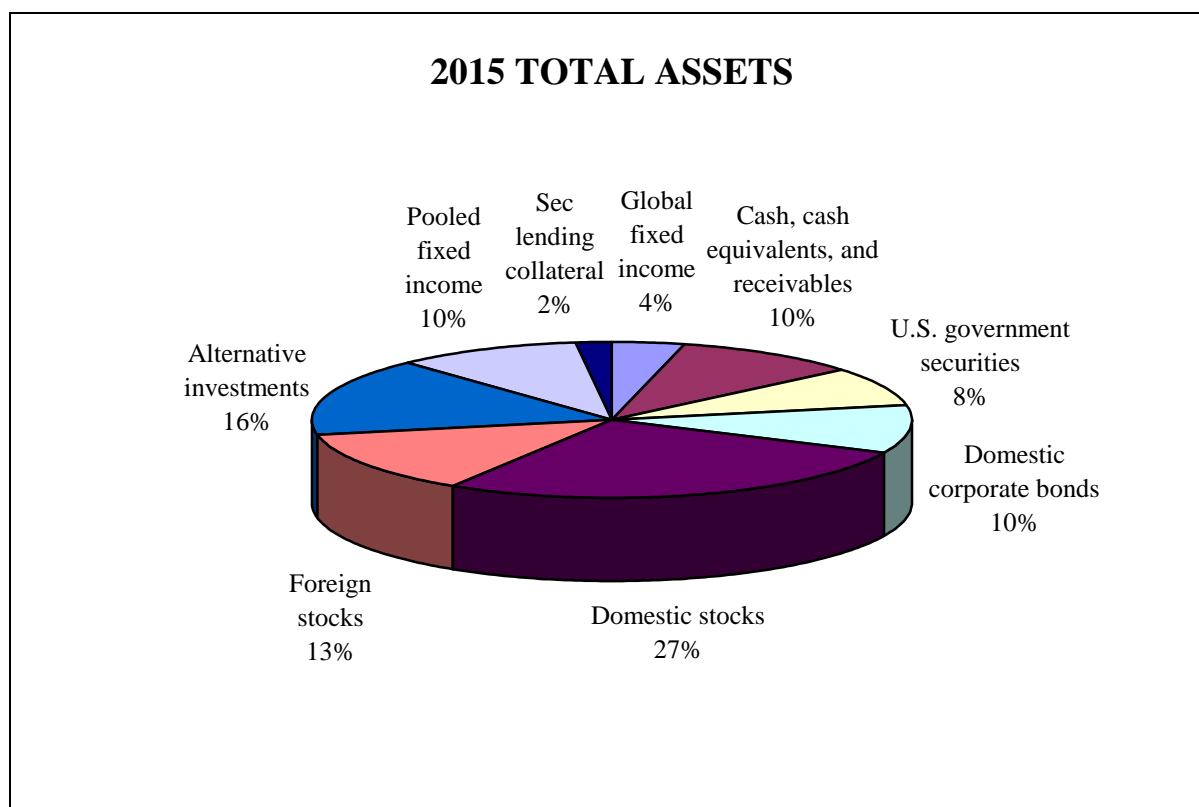
June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Net Position, Continued

The Fund's total net position increased \$28.2 million during the year, as the Fund invested an additional \$57.6 million in settlement receipts, recognized \$14.8 million as net investment income, and expended \$45.4 million on programs and operations. Total investments increased from \$923.1 million at the beginning of the year to \$973.6 million as of year-end, as the Board of Investors invested cash and cash equivalents held at the beginning of the year and additional settlement receipts were deposited during the year. The Fund recognized \$11.7 million from the net depreciation of the fair value of the portfolio and earned \$26.2 million in interest and dividends, net of investment management fees. The Fund's investment policy establishes investment goals and objectives and provides specific investment guidelines for investment managers, including a prohibition from investing in securities issued by companies engaged in the manufacture of tobacco products.

Cash balances also include restricted cash of approximately \$76.0 million, which represents cash collateral presented to the Fund by security borrowers through the Board of Investors' securities lending effort. Use of this cash is restricted unless the borrowers were to default in the return of the securities borrowed.



TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

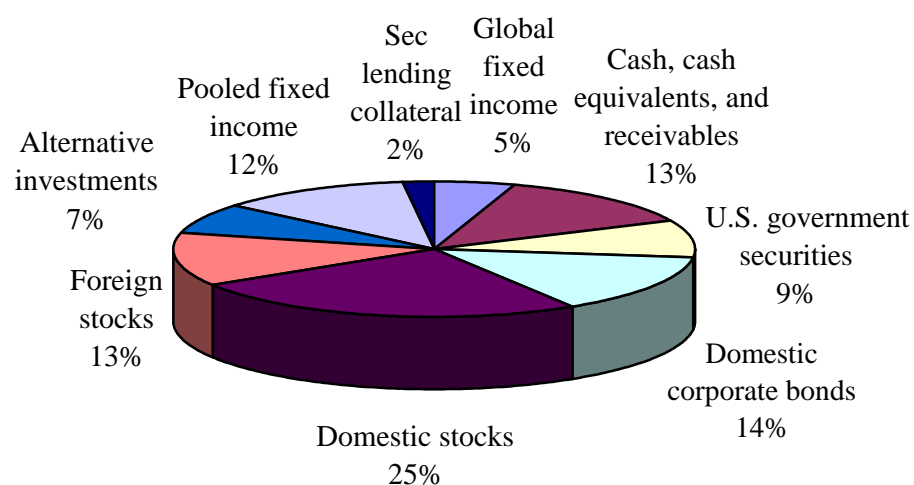
MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Net Position, Continued

2014 TOTAL ASSETS



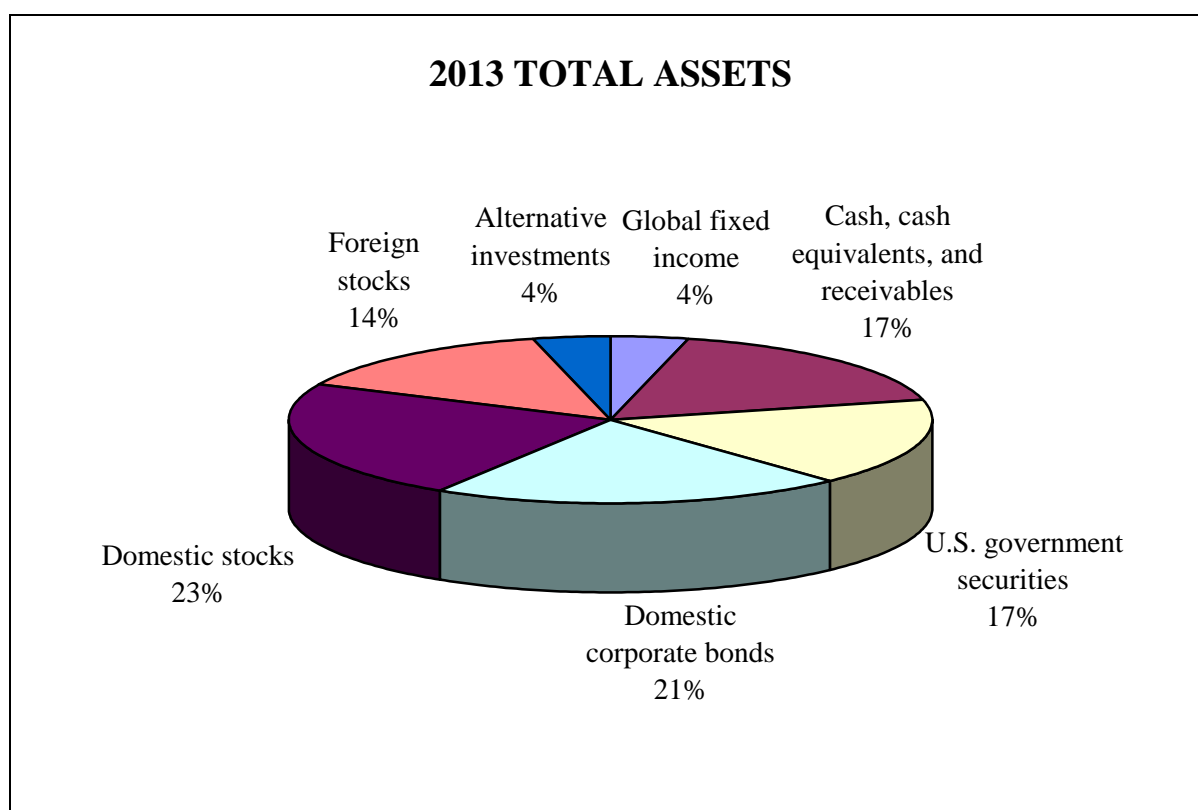
TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Net Position, Continued



TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses

The statements of activities report all of the income and expenses during the time periods indicated.

| Tobacco Settlement Endowment Trust Fund | | | |
|---|-----------------------|--------------------|--------------------|
| <u>Statements of Activities</u> | | | |
| | <u>2015</u> | <u>2014</u> | <u>2013</u> |
| Investment income: | | | |
| Interest and dividend income | \$ 31,019,513 | 31,968,197 | 25,867,677 |
| Securities lending income | 316,161 | 172,252 | 84,424 |
| Net (depreciation) appreciation in fair value of investments: | | | |
| Net unrealized gains and losses | (31,345,113) | 57,591,232 | 30,751,892 |
| Net realized gains and losses | 19,639,273 | 26,470,838 | 16,183,796 |
| | <u>(11,705,840)</u> | <u>84,062,070</u> | <u>46,935,688</u> |
| Total investment income | 19,629,834 | 116,202,519 | 72,887,789 |
| Investment expenses | (4,783,798) | (5,181,212) | (3,846,879) |
| Net investment income | <u>14,846,036</u> | <u>111,021,307</u> | <u>69,040,910</u> |
| Other income: | | | |
| Contract income | 1,546,273 | 2,576,498 | 2,445,750 |
| Miscellaneous income | 95,442 | 52,660 | 11,451 |
| Total other income | <u>1,641,715</u> | <u>2,629,158</u> | <u>2,457,201</u> |
| Expenses: | | | |
| Program | 44,303,328 | 31,456,440 | 30,963,704 |
| Operating | 1,095,816 | 1,062,014 | 1,656,741 |
| Total expenses | <u>45,399,144</u> | <u>32,518,454</u> | <u>32,620,445</u> |
| Changes in net position before settlement receipts | (28,911,393) | 81,132,011 | 38,877,666 |
| Contribution to fund principal: | | | |
| Settlement receipts | 57,645,300 | 57,887,005 | 85,057,305 |
| Changes in net position | <u>28,733,907</u> | <u>139,019,016</u> | <u>123,934,971</u> |
| Net position, beginning of year | 968,635,426 | 829,616,410 | 705,681,439 |
| Cumulative change in net position to adopt GASB 68 and GASB 71 (see Note 2) | (511,936) | - | - |
| Net position, beginning of year, restated | <u>968,123,490</u> | <u>829,616,410</u> | <u>705,681,439</u> |
| Net position, end of year | <u>\$ 996,857,397</u> | <u>968,635,426</u> | <u>829,616,410</u> |

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

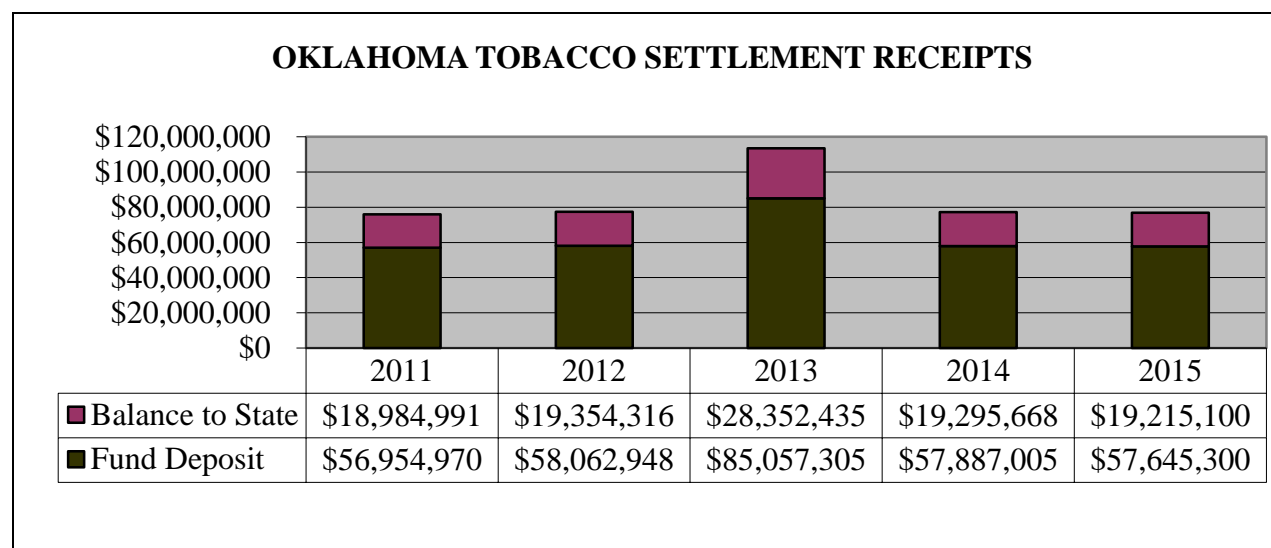
MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Revenues continue to be dominated by settlement receipts which are restricted for investment purposes. During the fiscal years ended June 30, 2015 and 2014, 75% of settlement receipts paid to the State were deposited by the State into the Fund. The percentage of the State's settlement receipts to be received by the Fund increased by 5% annually until it reached 75% during the fiscal year ended June 30, 2007, where it remains. As reflected below, settlement receipts deposited by the Fund decreased by \$241,705 from 2014.



There are no guarantees regarding the State's continued receipt of funds in the settlement of claims against the tobacco companies. The amount received by the State can be attributed to several factors. An independent auditor calculates and determines the amount of all payments based in part on the market share of tobacco consumption.

As settlement receipts were deposited and invested and the portfolio was diversified during the fiscal year ended June 30, 2015, net investment income decreased by \$96.2 million. Interest and dividend income decreased \$948,684, while the net appreciation of investment in the Fund's portfolio decreased \$95.8 million. Fees paid to investment managers, consultants, and custodians decreased \$397,414.

As previously noted, the Fund's principal is restricted for investment purposes only. According to a recent Attorney General's opinion, interest, dividends, and realized capital gains from investments minus costs and expenses of the investments, and minus any losses realized by the Fund may be expended for operations; tobacco use prevention and cessation programs; research and treatment efforts in Oklahoma to prevent and combat cancer and other tobacco-related diseases; and other programs to improve the health and wellbeing of Oklahomans, with a particular emphasis on children and senior adults.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

In the early years of the endowment, the Board of Directors adopted a strategic plan to maximize the impact of the limited earnings available at the time by focusing on preventing and reducing tobacco use in Oklahoma. Tobacco use was Oklahoma's leading cause of preventable death, and it was the reason for the Master Settlement Agreement, which created the funding source for the endowment. While Oklahoma has made great strides in reducing tobacco prevalence and consumption, tobacco use remains Oklahoma's leading cause of preventable death in FY 2015.

In 2010, the Board of Directors updated the strategic plan to emphasize three primary areas of funding: Prevention, Research, and Emerging Opportunities. Prevention programs focus on reducing cancer and cardiovascular disease, Oklahoma's leading causes of death, through comprehensive programs addressing the leading causes of each: tobacco use, physical inactivity, poor nutrition, and obesity. Research programs focus on cancer and tobacco-related diseases. Emerging opportunities are grants to organizations proposing innovative and evidence-based approaches to transform and improve health in Oklahoma. Preference is given to proposals that impact large populations, organizations, or systems, those with multiple funding partners, short-term grants, and those that address the Board of Directors' strategic goals.

During the fiscal year ended June 30, 2015, the Board of Directors increased program funding by more than \$10 million (from \$40,592,962 in FY 2014 to \$50,676,198 in FY 2015), using a combination of certified earnings, carryover, and income from other state agencies. The administration budget was 3% of certified earnings. By statute, the administration budget is capped at 15% of certified earnings.

Prevention

As a result of TSET program investments in tobacco control, smoking prevalence among high school youth dropped from 24% in 2002 to 15.1% in 2013. Smoking prevalence among adults dropped from 26.6% in 2002 to 21.1% in 2014. Additionally per capita cigarette consumption among Oklahoma adults declined 37% from 102 packs per person per year in 2002 to 64.3 packs per person in 2014. These accomplishments come after a decade of community-based grants, evidence-based cessation services, and constant collaboration to ensure that best practices are used to prevent and reduce tobacco use in Oklahoma.

In FY 2015, the Board of Directors continued an agreement in the amount of \$3,850,000 with Alere Wellbeing, Inc., provider of the telephone- and web-based Oklahoma Tobacco Helpline (1-800-QUIT NOW or okhelpline.com) services to all Oklahomans with a desire to quit tobacco use. The Helpline is collaboratively funded by the Fund, the Oklahoma State Department of Health (OSDH), Centers for Disease Control and Prevention (CDC), the Oklahoma Employees Group Insurance Division (EGID), and the Oklahoma Health Care Authority (OHCA).

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Prevention, Continued

In FY 2015, the Oklahoma Tobacco Helpline was ranked among the top five by the North American Quitline Consortium for reaching tobacco users in need of treatment. In FY 2015, Alere Wellbeing, Inc. also continued to employ Oklahoma workers as “Quit Coaches” to assist tobacco users in 28 states and over 750 commercial clients.

In FY 2015 the Board of Directors contracted with the Oklahoma Tobacco Research Center (OTRC) to assume oversight of the Oklahoma Tobacco Helpline, with the goal of transferring all responsibility for the Helpline to the OTRC.

The Board of Directors continued three agreements for reimbursements from state agencies for Helpline services, evaluation, and administrative services. The agreement with the OSDH was for \$750,000 in FY 2015. The agreement with the EGID provides additional Helpline services for HealthChoice insurance beneficiaries. Revenue from this agreement is based on utilization. Total revenue from this agreement was approximately \$100,000 for FY 2015. Agreements with the OHCA to offer Helpline services to beneficiaries of the SoonerCare Medicaid plan and Insure Oklahoma participants continued in FY 2015. Revenue from this agreement was \$150,000. Funds from these agreements are restricted for the purpose of the Helpline and in some cases for Helpline evaluation, and a small administrative fee

In FY 2015, the Board of Directors continued to invest in best practice health communication plans and continued the *Tobacco Stops With Me* and *Shape Your Future* campaigns to encourage Oklahomans to eat better, move more, and be tobacco-free. Media products also promote the Oklahoma Tobacco Helpline to Oklahomans, with a special emphasis on women in the state’s SoonerCare Medicaid program. Through a continuing agreement with the OHCA, federal matching funds for the *SoonerQuit for Women* campaign were \$500,000 and \$300,000 for the last two years (FY 2014 and FY 2013, respectively).

During FY 2015, the Board of Directors also continued funding for the Communities of Excellence grant programs across the state of Oklahoma to address tobacco use and/or obesity prevention in their communities. With goals such as smoke-free policies, and promotion of the Oklahoma Tobacco Helpline, to improving the nutritional value of foods offered in schools and creating shared use agreements to open access to more physical activity options for community members, these grants worked to help Oklahomans eat better, move more, and be tobacco free. In tobacco prevention alone, 53 counties and one tribal nation helped city governments and community organizations adopt over 830 tobacco-free policies in schools, businesses, and city governments, significantly increased the number of smokers making a quit attempt, increased Oklahoma Tobacco Helpline awareness, and increased smoke-free home policies across the state over the past 10 years.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Prevention, Continued

A new comprehensive community-based program was funded by the Board of Directors in May, to reduce silos and combine the community-based work in tobacco control and physical activity and nutrition into one grant program. The TSET Healthy Living Grant Program will focus on reducing and preventing tobacco use and obesity through a comprehensive approach that includes strategic actions and partnerships with businesses, cities and governments, community institutions and organizations and schools. Work on this grant program began in FY 2016, with 50 agencies funded to serve 63 counties.

To support community-based initiatives, the Board of Directors also continued agreements with the Oklahoma State Department of Health, Center for the Advancement of Wellness, to provide training and technical assistance to grantees. In addition, the agreements with the University of Oklahoma College of Public Health and the Oklahoma State University Department of Nutrition Sciences for evaluation of the programs were continued.

In FY 2012, the Board of Directors expanded the agreement with the Oklahoma State Department of Health (OSDH) to provide incentive grants to communities to encourage them to become Certified Healthy Communities. The original agreement provided \$3.5 million to be utilized by the Fund over the course of 3 years. The agreement was expanded in FY 2012 to provide incentive grants to school districts to encourage their school sites to become Certified Healthy Schools. The total of both agreements was \$8.5 million. Between FY 2012 and FY 2015, 45 communities and 53 schools received incentive grant awards. Three Health Systems Initiative (HSI) grantees entered their first year of a 5-year continuation grant beginning FY 2014. Under the HSI program, the Oklahoma Health Care Authority, the Oklahoma Hospital Association, and the Oklahoma Department of Mental Health and Substance Abuse Services work to implement a best practice intervention to address tobacco, nutrition, and physical activity (as appropriate) among hospitalized patients, Medicaid beneficiaries, and to routine mental health and substance abuse treatment programs.

Research

In FY 2012, the Board of Directors committed \$30.25 million over 5 years to the Peggy and Charles Stephenson Cancer Center (SCC) to create the TSET Cancer Research Program, expanding access to Phase I Clinical Trials and leveraging additional dollars to recruit scientists as TSET Cancer Research Scholars. In FY 2014, the Stephenson Cancer Center had expanded its Phase I Clinical Trials to include a network of health care providers across the state. Nearly every county in Oklahoma was represented in the clinical trial patient census, and the TSET Phase I Clinical Trials program is ranked among the top ten in the country. The FY 2015 budget was \$5.96 million.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Research, Continued

The Oklahoma Tobacco Research Center (OTRC) entered its final year in FY 2015, and submitted a continuation application to expand the Center's work in recruiting scientists, funding research projects in population, regulatory, and clinical science, and to inform efforts to prevent and reduce cancer and other tobacco related diseases in Oklahoma. The FY 2015 budget was \$1.5 million.

The Board of Directors also expanded funding for the Oklahoma Center for Adult Stem Cell Research (OCASCR), which was established in FY 2010. The Board of Directors made a commitment of \$5.5 million over 5½ years. OCASCR is governed by the research directors of the Oklahoma Medical Research Foundation, the University of Oklahoma, and Oklahoma State University, with the Oklahoma Medical Research Foundation serving as the fiscal agent. The original agreement was amended in FY 2012 to increase the budget to \$2 million per year, and in FY 2015 the grant was replaced with a new 5-year continuation grant for \$3 million per year, or \$15 million over 5 years. The FY 2015 budget was \$2.75 million.

Emerging Opportunities

The Emerging Opportunities portfolio provides an opportunity for organizations to proactively submit a proposal related to any of the program areas listed in the constitutional amendment that created the Fund, instead of reactively applying for funding in response to a "Request for Proposals." In FY 2014, the Board of Directors funded two new "unsolicited" proposals that add to the Fund's investment in promoting physical activity and improved nutrition. The Fund funded a 5-year program to institute FitnessGram, a fitness assessment tool, in Oklahoma schools that volunteer to participate in the program. In FY 2015, 129 schools were recruited for the program and trained in FY 2015. The Board of Directors also funded a proposal from the Oklahoma City Boathouse Foundation. Through this healthy public-private partnership agreement, the Oklahoma City Boathouse Foundation seeks to increase awareness of and participation in lifetime recreation and availability of physical activity opportunities statewide.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Emerging Opportunities, Continued

In FY 2014 the Board of Directors awarded approximately \$2.6 million over 9 years to the Physician Manpower Training Commission to assist with the Oklahoma Medical Loan Repayment Program, which recruits physicians to practice in medically underserved areas. There are currently 17 physicians practicing across the state as part of the program that also leverages federal health care dollars as 25% of each physician's caseload is comprised of Medicaid beneficiaries. Physicians can earn up to \$160,000 in loan repayment assistance if they practice in a rural area for up to 4 years. When this program is fully matured, 42 physicians will have gone through the program with a total anticipated loan repayment at \$6.72 million, which includes TSET funds and leveraged dollars.

At the end of FY 2015, the Board of Directors awarded \$3.8 million over 6 years to Oklahoma State University for medical residencies for rural and underserved areas of Oklahoma. Oklahoma experiences a severe shortage of primary care physicians and this program will be one step toward addressing that issue. When this program is fully implemented it will graduate, on average, 36 new osteopathic doctors annually.

Conference Sponsorships

In 2010, the Board of Directors established a conference sponsorship process whereby organizations could apply for sponsorship funds for training and conferences that are statewide and address the Board's strategic plan or any area related to the constitutional mission. The FY 2012 and FY 2013 budget for conference sponsorships was \$50,000. In FY 2014, the budget for conference sponsorships was increased to \$75,000 because of an increase in requests and additional partnerships created as part of the Fund's incentive grant programs for schools and communities. In FY 2015, nearly \$70,000 in conference and training grants were provided to organizations across the state.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FUND HIGHLIGHTS

Governmental Fund—Balance Sheets

The Fund is classified as a permanent fund, as the principal funds are restricted by law for investment purposes only. The earnings may be expended for operations; tobacco prevention and cessation programs; research and treatment efforts in Oklahoma to prevent and combat cancer and other tobacco-related diseases; and other programs to maintain or improve the health of Oklahomans or to enhance health care services provided to Oklahomans, with a particular emphasis on children and senior adults. Accordingly, the fund balance at year-end includes balances which are nonspendable (restricted for investment purposes) and balances which are assigned and unassigned that are expendable for operations and programs of the Fund.

Tobacco Settlement Endowment Trust Fund Balance Sheets—Permanent Fund

| | <u>2015</u> | <u>2014</u> | <u>2013</u> |
|--|-------------------------|----------------------|--------------------|
| Assets: | | | |
| Cash and cash equivalents | \$ 110,058,676 | 134,127,250 | 158,232,019 |
| Interest and dividends receivable | 2,962,937 | 3,908,317 | 3,956,231 |
| Contract receivable | 78,753 | 862,034 | 204,424 |
| Securities lending receivable | 12,158 | 32,910 | 10,510 |
| Securities lending collateral—non-cash | 21,630,365 | 21,992,588 | - |
| Investments at fair value | <u>973,596,294</u> | <u>923,128,052</u> | <u>789,995,839</u> |
| Total assets | <u>\$ 1,108,339,183</u> | <u>1,084,051,151</u> | <u>952,399,023</u> |
| Liabilities: | | | |
| Net payable to brokers | 3,491,355 | 3,784,389 | 6,967,044 |
| Accounts payable | 9,916,886 | 5,601,732 | 9,135,076 |
| Liability under securities lending | <u>97,663,938</u> | <u>105,919,077</u> | <u>106,599,991</u> |
| Total liabilities | <u>111,072,179</u> | <u>115,305,198</u> | <u>122,702,111</u> |
| Fund Balances: | | | |
| Nonspendable | 871,615,601 | 845,219,972 | 729,689,075 |
| Assigned | 79,460,253 | 70,095,906 | 60,952,331 |
| Unassigned | <u>46,191,150</u> | <u>53,430,075</u> | <u>39,055,506</u> |
| Total fund balances | <u>997,267,004</u> | <u>968,745,953</u> | <u>829,696,912</u> |
| Total liabilities and fund balances | <u>\$ 1,108,339,183</u> | <u>1,084,051,151</u> | <u>952,399,023</u> |

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

FUND HIGHLIGHTS, CONTINUED

Governmental Fund—Revenues, Expenditures, and Changes in Fund Balances

| | <u>2015</u> | <u>2014</u> | <u>2013</u> |
|---|-----------------------|--------------------|--------------------|
| Revenues: | | | |
| Restricted: | | | |
| Net (depreciation) appreciation in fair value of investments: | | | |
| Net unrealized gains and losses | \$ (31,345,113) | 57,591,232 | 30,751,892 |
| Net realized gains and losses | 19,639,273 | 26,470,838 | 16,183,796 |
| | <u>(11,705,840)</u> | <u>84,062,070</u> | <u>46,935,688</u> |
| Settlement receipts | 57,645,300 | 57,887,005 | 85,057,305 |
| Miscellaneous income | 95,442 | 52,660 | 11,451 |
| Total restricted revenues | <u>46,034,902</u> | <u>142,001,735</u> | <u>132,004,444</u> |
| Interest and dividend income | 31,019,513 | 31,968,197 | 25,867,677 |
| Securities lending income | 316,161 | 172,252 | 84,424 |
| Contract income | 1,546,273 | 2,576,498 | 2,445,750 |
| Total revenues | <u>78,916,849</u> | <u>176,718,682</u> | <u>160,402,295</u> |
| Expenditures: | | | |
| Program and grant management support | 3,190,447 | 2,325,960 | 883,044 |
| Statewide programs | 5,783,327 | 4,943,097 | 4,694,230 |
| Community programs | 9,502,552 | 6,789,501 | 6,474,467 |
| Evaluation services | 1,198,831 | 689,175 | 872,446 |
| Furniture and equipment | 44,275 | 28,985 | - |
| Research | 11,541,727 | 7,217,471 | 8,758,475 |
| Investment management fees | 4,783,798 | 5,181,212 | 3,846,879 |
| Health communications | 13,086,444 | 9,491,236 | 9,161,781 |
| General operations and administrative expenses | 1,264,397 | 1,003,004 | 1,741,883 |
| Total expenditures | <u>50,395,798</u> | <u>37,669,641</u> | <u>36,433,205</u> |
| Net changes in fund balances | 28,521,051 | 139,049,041 | 123,969,090 |
| Fund balances, beginning of year | 968,745,953 | 829,696,912 | 705,727,822 |
| Fund balances, end of year | <u>\$ 997,267,004</u> | <u>968,745,953</u> | <u>829,696,912</u> |

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2015 and 2014

REQUESTS FOR INFORMATION

This financial report is designed to provide a general overview of the Fund's finances for all those with an interest. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to Lisa Murray, Chief Investment Officer, Office of the Oklahoma State Treasurer, 2300 North Lincoln Boulevard, Room 217, Oklahoma City, Oklahoma 73105-4895.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

STATEMENTS OF NET POSITION

| <i>June 30,</i> | <i>2015</i> | <i>2014</i> |
|--|---------------|---------------|
| Assets | | |
| Cash and cash equivalents: | | |
| Unrestricted cash | \$ 34,025,103 | 50,200,761 |
| Restricted cash: | | |
| Securities lending collateral | 76,033,573 | 83,926,489 |
| Total cash and cash equivalents | 110,058,676 | 134,127,250 |
| Receivables: | | |
| Interest and dividends | 2,962,937 | 3,908,317 |
| Contract receivable | 78,753 | 862,034 |
| Securities lending receivable | 12,158 | 32,910 |
| Total receivables | 3,053,848 | 4,803,261 |
| Investments, at fair value: | | |
| U.S. government securities | 93,483,982 | 102,413,878 |
| Foreign government securities | 14,642,531 | 7,323,985 |
| Domestic corporate bonds | 105,326,004 | 153,402,023 |
| Foreign corporate bonds | 35,229,642 | 45,854,937 |
| Domestic stocks | 301,541,692 | 270,304,922 |
| Foreign stocks | 140,411,282 | 141,786,580 |
| Pooled fixed income funds | 110,071,106 | 125,953,066 |
| Alternative investments | 172,890,055 | 76,088,661 |
| Total investments, at fair value | 973,596,294 | 923,128,052 |
| Securities lending collateral—non-cash | 21,630,365 | 21,992,588 |
| Capital assets, net of accumulated depreciation of \$131,929 and \$115,022 as of June 30, 2015 and 2014, respectively. | 42,789 | 45,238 |
| Total assets | 1,108,381,972 | 1,084,096,389 |
| Deferred outflows of resources: | | |
| Deferred amounts related to the pension | 225,753 | - |

(Continued)

See Independent Auditors' Report.
See accompanying notes to financial statements.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

STATEMENTS OF NET POSITION, CONTINUED

| <i>June 30,</i> | <i>2015</i> | <i>2014</i> |
|--|-----------------------|--------------------|
| Liabilities | | |
| Net payable to brokers | 3,491,355 | 3,784,389 |
| Accounts payable | 9,916,886 | 5,601,732 |
| Liability under securities lending | 97,663,938 | 105,919,077 |
| Net pension liability—amount due in more than 1 year | 112,570 | - |
| Compensated absences: | | |
| Payable within 1 year | 60,843 | 62,306 |
| Payable after 1 year | 91,264 | 93,459 |
| Total liabilities | <u>111,336,856</u> | <u>115,460,963</u> |
| Deferred inflows of resources: | | |
| Deferred amounts related to the pension | <u>413,472</u> | <u>-</u> |
| Net Position | | |
| Net investment in capital assets | 42,789 | 45,238 |
| Restricted for investment | 871,615,601 | 845,219,972 |
| Unrestricted | <u>125,199,007</u> | <u>123,370,216</u> |
| Total net position | <u>\$ 996,857,397</u> | <u>968,635,426</u> |

See Independent Auditors' Report.
See accompanying notes to financial statements.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

STATEMENTS OF ACTIVITIES

| <i>Years Ended June 30,</i> | <i>2015</i> | <i>2014</i> |
|---|---------------------|--------------------|
| Expenses: | | |
| Program: | | |
| Program and grant management support | \$ 3,190,447 | 2,325,960 |
| Statewide programs | 5,783,327 | 4,943,097 |
| Community programs | 9,502,552 | 6,789,501 |
| Evaluation services | 1,198,831 | 689,175 |
| Health communications | 13,086,444 | 9,491,236 |
| Research | 11,541,727 | 7,217,471 |
| Total program expenses | <u>44,303,328</u> | <u>31,456,440</u> |
| Operating: | | |
| General operations and administrative expenses | 1,078,909 | 1,045,726 |
| Depreciation | 16,907 | 16,288 |
| Total operating expenses | <u>1,095,816</u> | <u>1,062,014</u> |
| Total expenses | <u>45,399,144</u> | <u>32,518,454</u> |
| Investment income: | | |
| Interest income | 11,784,699 | 14,514,737 |
| Dividend income | 19,234,814 | 17,453,460 |
| Securities lending income | 316,161 | 172,252 |
| Net (depreciation) appreciation in fair value of investments: | | |
| Net unrealized gains and losses | (31,345,113) | 57,591,232 |
| Net realized gains and losses | 19,639,273 | 26,470,838 |
| | <u>(11,705,840)</u> | <u>84,062,070</u> |
| Total investment income | 19,629,834 | 116,202,519 |
| Investment expenses | <u>(4,783,798)</u> | <u>(5,181,212)</u> |
| Net investment income | <u>14,846,036</u> | <u>111,021,307</u> |

(Continued)

See Independent Auditors' Report.
See accompanying notes to financial statements.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

STATEMENTS OF ACTIVITIES, CONTINUED

| <i>Years Ended June 30,</i> | <i>2015</i> | <i>2014</i> |
|---|-----------------------|--------------------|
| Other income: | | |
| Contract income | 1,546,273 | 2,576,498 |
| Miscellaneous income | <u>95,442</u> | <u>52,660</u> |
| Total other income | <u>1,641,715</u> | <u>2,629,158</u> |
| Changes in net position, before settlement receipts | <u>(28,911,393)</u> | <u>81,132,011</u> |
| Contribution to fund principal: | | |
| Settlement receipts | <u>57,645,300</u> | <u>57,887,005</u> |
| Changes in net position | <u>28,733,907</u> | <u>139,019,016</u> |
| Net position, beginning of year | 968,635,426 | 829,616,410 |
| Cumulative change in net position to adopt GASB 68 and GASB 71 (see Note 2) | <u>(511,936)</u> | <u>-</u> |
| Net position, beginning of year, restated | <u>968,123,490</u> | <u>829,616,410</u> |
| Net position, end of year | <u>\$ 996,857,397</u> | <u>968,635,426</u> |

See Independent Auditors' Report.
See accompanying notes to financial statements.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

BALANCE SHEETS—PERMANENT FUND

| <i>June 30,</i> | <i>2015</i> | <i>2014</i> |
|--|-------------------------|----------------------|
| Assets | | |
| Cash and cash equivalents: | | |
| Unrestricted cash | \$ 34,025,103 | 50,200,761 |
| Restricted cash: | | |
| Securities lending collateral | 76,033,573 | 83,926,489 |
| Total cash and cash equivalents | <u>110,058,676</u> | <u>134,127,250</u> |
| Receivables: | | |
| Interest and dividends | 2,962,937 | 3,908,317 |
| Contract receivable | 78,753 | 862,034 |
| Securities lending receivable | 12,158 | 32,910 |
| Total receivables | <u>3,053,848</u> | <u>4,803,261</u> |
| Investments, at fair value: | | |
| U.S. government securities | 93,483,982 | 102,413,878 |
| Foreign government securities | 14,642,531 | 7,323,985 |
| Domestic corporate bonds | 105,326,004 | 153,402,023 |
| Foreign corporate bonds | 35,229,642 | 45,854,937 |
| Domestic stocks | 301,541,692 | 270,304,922 |
| Foreign stocks | 140,411,282 | 141,786,580 |
| Pooled fixed income funds | 110,071,106 | 125,953,066 |
| Alternative investments | 172,890,055 | 76,088,661 |
| Total investments, at fair value | <u>973,596,294</u> | <u>923,128,052</u> |
| Securities lending collateral—non cash | <u>21,630,365</u> | <u>21,992,588</u> |
| Total assets | <u>\$ 1,108,339,183</u> | <u>1,084,051,151</u> |
| Liabilities and Fund Balances | | |
| Liabilities: | | |
| Net payable to brokers | \$ 3,491,355 | 3,784,389 |
| Accounts payable | 9,916,886 | 5,601,732 |
| Liability under securities lending | 97,663,938 | 105,919,077 |
| Total liabilities | <u>111,072,179</u> | <u>115,305,198</u> |
| Fund balances: | | |
| Nonspendable | 871,615,601 | 845,219,972 |
| Assigned | 79,460,253 | 70,095,906 |
| Unassigned | 46,191,150 | 53,430,075 |
| Total fund balances | <u>997,267,004</u> | <u>968,745,953</u> |
| Total liabilities and fund balances | <u>\$ 1,108,339,183</u> | <u>1,084,051,151</u> |

See Independent Auditors' Report.

See accompanying notes to financial statements.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

RECONCILIATION OF THE BALANCE SHEETS—PERMANENT FUND TO THE STATEMENTS OF NET POSITION

| <i>June 30,</i> | <i>2015</i> | <i>2014</i> |
|--|-----------------------|--------------------|
| Total fund balances, per the balance sheets—permanent fund | \$ 997,267,004 | 968,745,953 |
| Amounts reported in the statements of net position are different because: | | |
| Capital assets used in governmental activities are not financial resources and therefore are not reported in the fund. | 42,789 | 45,238 |
| Deferred outflows related to the pension are not financial resources and therefore are not reported in the funds | 225,753 | - |
| Some liabilities are not due and payable in the current period and therefore are not reported in the fund. Those liabilities consist of: | | |
| Compensated absences | (152,107) | (155,765) |
| Net pension liability | (112,570) | - |
| Deferred inflows related to the pension are not due and payable in the current period and therefore are not reported in the funds | (413,472) | - |
| Net position, per the statements of net position | <u>\$ 996,857,397</u> | <u>968,635,426</u> |

See Independent Auditors' Report.
See accompanying notes to financial statements.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

STATEMENTS OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES—PERMANENT FUND

| <i>Years Ended June 30,</i> | <i>2015</i> | <i>2014</i> |
|---|-----------------------|--------------------|
| Revenues: | | |
| Restricted: | | |
| Net (depreciation) appreciation in fair value of investments: | | |
| Net unrealized gains and losses | \$ (31,345,113) | 57,591,232 |
| Net realized gains and losses | 19,639,273 | 26,470,838 |
| | <u>(11,705,840)</u> | <u>84,062,070</u> |
| Settlement receipts | 57,645,300 | 57,887,005 |
| Miscellaneous income | 95,442 | 52,660 |
| Total restricted revenues | <u>46,034,902</u> | <u>142,001,735</u> |
| Interest income | 11,784,699 | 14,514,737 |
| Dividend income | 19,234,814 | 17,453,460 |
| Securities lending income | 316,161 | 172,252 |
| Contract income | 1,546,273 | 2,576,498 |
| Total revenues | <u>78,916,849</u> | <u>176,718,682</u> |
| Expenditures: | | |
| Program and grant management support | 3,190,447 | 2,325,960 |
| Statewide programs | 5,783,327 | 4,943,097 |
| Community programs | 9,502,552 | 6,789,501 |
| Evaluation services | 1,198,831 | 689,175 |
| Furniture and equipment | 44,275 | 28,985 |
| Research | 11,541,727 | 7,217,471 |
| Investment management fees | 4,783,798 | 5,181,212 |
| Health communications | 13,086,444 | 9,491,236 |
| General operations and administrative expenses | 1,264,397 | 1,003,004 |
| Total expenditures | <u>50,395,798</u> | <u>37,669,641</u> |
| Net changes in fund balances | 28,521,051 | 139,049,041 |
| Fund balances, beginning of year | <u>968,745,953</u> | <u>829,696,912</u> |
| Fund balances, end of year | <u>\$ 997,267,004</u> | <u>968,745,953</u> |

See Independent Auditors' Report.

See accompanying notes to financial statements.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

RECONCILIATION OF THE STATEMENTS OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES—PERMANENT FUND TO THE STATEMENTS OF ACTIVITIES

| <i>Years Ended June 30,</i> | <i>2015</i> | <i>2014</i> |
|--|----------------------|--------------------|
| Net changes in fund balances, per the statements of revenues, expenditures, and changes in fund balances—permanent fund | \$ 28,521,051 | 139,049,041 |
| Amounts reported in the statements of activities are different because: | | |
| Governmental funds report capital outlays as expenditures. However, in the statements of activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount by which capital outlays were greater than (less than) depreciation in the current period. | (2,449) | 3,037 |
| Some expenses reported in the statements of activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds. This amount represents the amount by which unused compensated absences decreased (increased) over the amount in the prior year. | 3,658 | (33,062) |
| In the statements of activities, the cost of pension benefits earned net of employee contributions is reported as an element of pension expense. The fund financial statements report pension contributions as expenditures. | <u>211,647</u> | <u>-</u> |
| Changes in net position, per the statements of activities | <u>\$ 28,733,907</u> | <u>139,019,016</u> |

See Independent Auditors' Report.

See accompanying notes to financial statements.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS

June 30, 2015 and 2014

(1) **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Reporting Entity

The Tobacco Settlement Endowment Trust Fund (the “Fund”) was established pursuant to the Constitution of the State of Oklahoma. The Fund principal was established with funds received by the State of Oklahoma (the “State”) on or after July 1, 2001, pursuant to any settlement with or judgment against any tobacco companies. Fifty percent (50%) of all such receipts was deposited into the Fund during the fiscal year ended June 30, 2002. That percentage increased by 5% annually until it reached 75% during the fiscal year ending June 30, 2007, where it remains. However, there are no guarantees regarding the State’s continued receipt of funds in settlement of claims against tobacco companies. The principal funds are invested, and the earnings (see Note 8) may be expended for operations; tobacco prevention and cessation programs; research and treatment efforts in Oklahoma to prevent and combat cancer and other tobacco-related diseases; and other programs to maintain or improve the health of Oklahomans or to enhance health care services provided to Oklahomans, with a particular emphasis on children and senior adults.

Pursuant to the Constitution of the State of Oklahoma, the Board of Investors was created to manage the investment of the principal of the Fund and to annually certify the earnings that are available for program expenditures. The Board of Directors was created to oversee Fund operating and program expenditures. The Fund is a part of the State’s financial reporting entity and is included in the State’s Comprehensive Annual Financial Report as a permanent fund and a governmental entity.

The financial statements of the Fund are intended to present the financial position and changes in financial position of only that portion of the governmental activities and governmental funds of the State that is attributable to the transactions of the Fund, and not those of the entire State.

Basis of Presentation, Measurement Focus, and Basis of Accounting

The financial statements have been prepared in accordance with Governmental Accounting Standards Board Statement No. 34 (GASB 34).

Government-Wide Financial Statements—The statements of net position and the statements of activities are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Investment purchases and sales are recorded as of their trade dates. Settlement receipts are recognized as revenue when they are received by the State and their use is restricted as noted above.

See Independent Auditors’ Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

Basis of Presentation, Measurement Focus, and Basis of Accounting, Continued

Governmental Fund Financial Statements—As a permanent fund, the Fund is reported in the governmental fund financial statements using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Since the Fund predominantly accounts for financial resources, revenue recognition is generally consistent between the accrual and the modified accrual basis of accounting. Settlement receipts are recognized as revenue when they are received by the State and their use is restricted as noted above.

Investment purchases and sales are recorded as of their trade dates. Expenditures generally are recorded when a liability is incurred.

Since the governmental fund financial statements are presented on a different measurement focus and basis of accounting than the government-wide financial statements, reconciliations are presented which briefly explain the adjustments necessary to reconcile the fund and the government-wide presentations.

Investments

The Fund is authorized to invest in eligible investments as approved by the Board of Investors and set forth in its investment policy.

Fund investments are reported at fair value, except for alternative investments (which are reported at net asset value (NAV), which approximates fair value) and SEC-registered money market mutual funds (which are reported as cash equivalents and reported at cost, which approximates fair value). Debt and equity securities are reported at fair value, as determined by the Fund's custodial agent, using pricing services or prices quoted by independent brokers based on the latest reported sales prices at current exchange rates for securities traded on national or international exchanges.

The Fund invests in various traditional financial instruments that fall under the broad definition of derivatives. The Fund's derivatives may include U.S. Treasury strips, collateralized mortgage obligations, asset-backed securities, forward-based derivatives, option-based derivatives, and variable-rate instruments. These investments do not increase investment risk beyond allowable limits specified in the Fund's investment policy.

Net investment income includes net appreciation (depreciation) in the fair value of investments, interest income, dividend income, securities lending income, and investment expenses, which includes investment management and custodial fees and all other significant investment-related costs.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

Securities Lending

The investment policy authorizes the Board of Investors to contract with their custodian to act as their securities lending agent. The policy requires the securities lending agent to provide indemnification against borrower default, have written agreements with each borrower, not loan securities until acceptable collateral is received and monitor that collateral on a daily basis, and review and monitor the approved borrowers to minimize risk.

The fair values of securities loaned and collateral maintained for those securities at June 30 were:

| | <u>Fair Value</u> | |
|---|----------------------|--------------------|
| | <u>2015</u> | <u>2014</u> |
| Securities loaned: | | |
| U.S. government securities | \$ 40,652,839 | 25,105,075 |
| U.S. corporate bonds | 21,915,184 | 23,819,539 |
| U.S. equity | 31,510,717 | 52,670,663 |
| Foreign | <u>1,374,765</u> | <u>1,787,590</u> |
| Total securities loaned | <u>\$ 95,453,505</u> | <u>103,382,867</u> |
| Collateral maintained for securities loaned | <u>\$ 97,663,938</u> | <u>105,919,077</u> |
| Percentage of collateral to securities loaned as of June 30 | <u>102.32%</u> | <u>102.45%</u> |

Borrowers are required to deliver collateral for each loan with a fair value equal to 102% of the current fair value of the loaned securities. Collateral delivered in non-U.S. currency is required to be equal to 105% of the fair value of the securities loaned. At June 30, 2015, collateral was presented in both cash in U.S. currency, except for one security (EURO), and non-cash securities. The total value of the collateral held at June 30, 2015 and 2014, was \$2,210,433 and \$2,536,210, respectively, more than the current fair value of the securities loaned. Cash collateral is invested in a short-term investment pool and is included as an asset on the balance sheet, with an offsetting liability for the return of the collateral.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

Securities Lending, Continued

At June 30, 2015, cash collateral was \$76,033,573 and non-cash collateral totaled \$21,630,365. Non-cash collateral consisted of the following:

| <u>Description</u> | <u>Value</u> |
|--|----------------------|
| U.S. government debt—Treasuries | \$ 15,154,213 |
| U.S. government agencies (i.e., FNMA, GNMA, FMAC) | 4,792,616 |
| Foreign securities | <u>1,683,536</u> |
| | <u>\$ 21,630,365</u> |

Securities lending income included as certified earnings was \$316,161 and \$172,252 for the fiscal years ended June 30, 2015 and 2014, respectively.

Capital Assets

Office equipment and furnishings which have an expected useful life of more than 1 year are recorded as capital assets. Capital assets are recorded at cost when purchased. Depreciation is recorded on capital assets in the government-wide financial statements. Depreciation is calculated on a straight-line basis over a 4- to 12-year period.

No provision for depreciation is recorded in the governmental fund financial statements, as expenditures for capital assets are recorded as period costs when the capital assets are purchased.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

Risks and Uncertainties

The Fund invests in various types of investment securities. Investment securities are exposed to various risks, such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such change could materially affect investment balances, amounts used in the determination of certified earnings and the amounts reported in the financial statements.

Compensated Absences

Employees earn annual vacation leave at the rate of 10 hours per month for the first 5 years of service, 12 hours per month for service of over 5 years to 10 years, 13.33 hours per month for service of over 10 years to 20 years, and 16.67 hours per month for over 20 years of service. Unused annual leave may be accumulated to a maximum of 480 hours. All accrued annual leave is payable upon termination, resignation, retirement, or death. The governmental fund financial statements record expenditures when employees are paid for leave. The government-wide financial statements present the cost of accumulated vacation leave as a liability. The liability is valued based on the current rate of pay.

Advertising Costs

All costs associated with advertising are expensed as incurred.

Pensions

The Fund participates in a cost-sharing, multiple-employer defined benefit pension plan administered by the Oklahoma Public Employees Retirement System. For purposes of measuring the net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense, information about the fiduciary net position of the Fund's participation in the Oklahoma Public Employees Retirement Plan (OPERS) and additions to/deductions from OPERS' fiduciary net position have been determined on the same basis as they are reported by OPERS.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

Recent Accounting Pronouncements

In June 2012, GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27* (GASB 68). The primary objective of GASB 68 is to improve accounting and financial reporting for pensions by state and local governments for pensions. GASB 68 establishes standards for measuring and recognizing liabilities, deferred outflows of resources, deferred inflows of resources, and expenses/expenditures. For defined benefit pensions, GASB 68 identifies the methods and assumptions that should be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service. The Fund adopted this statement effective July 1, 2014. The adoption of GASB 68 resulted in the restatement of beginning net assets of the Fund.

In January 2013, GASB issued Statement No. 69, *Government Combinations and Disposals of Government Operations* (GASB 69). GASB 69 establishes accounting and financial reporting standards related to governmental combinations and disposals of government operations. Generally, governmental combinations include mergers, acquisitions and transfers of operations. This statement improves financial reporting by providing guidance for business combinations in the governmental environment. The Fund adopted this statement July 1, 2014. Presently, the Fund has no items to be reported, and the adoption had no significant impact on the financial statements of the Fund.

In November 2013, GASB issued Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date—an amendment of GASB Statement No. 68* (GASB 71). GASB 71 amends GASB 68 by amending the transition provisions of GASB 68. At transition to GASB 68, employers that could not practically determine all of the deferred inflows and outflows related to pensions were provided guidance that no deferred inflows or outflows should be reported. GASB 71 amends this guidance to provide that a government recognize a beginning deferred outflow of resources for pension contributions made subsequent to the measurement date. GASB 71 will eliminate the source of a potential significant understatement of restated beginning net position and expense in the first year of implementation of GASB 68. The Fund adopted this statement on July 1, 2014, and the prior period financial statements were restated. The adoption of GASB 71 resulted in the restatement of beginning net assets of the Fund.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

Recent Accounting Pronouncements, Continued

In February 2015, GASB issued Statement No. 72, *Fair Value Measurement and Application* (GASB 72). GASB 72 addresses accounting and financial reporting issues related to fair value measurements. The definition of fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. GASB 72 provides guidance for determining a fair value measurement for financial reporting purposes. GASB 72 also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements. The requirements of GASB 72 will enhance comparability of financial statements among governments by requiring measurement of certain assets and liabilities at fair value using a consistent and more detailed definition of fair value and accepted valuation techniques. GASB 72 also will enhance fair value application guidance and related disclosures in order to provide information to financial statement users about the impact of fair value measurements on a government's financial position. GASB 72 is effective for financial statements for periods beginning after June 15, 2015. The Fund will adopt GASB 72 effective July 1, 2015, for the June 30, 2016, reporting year. GASB 72 will require additional and/or revised disclosures in the financial statements.

Annual Budget-to-Actual Comparison

The Fund is not required to prepare an annual budget. Therefore, an annual budget-to-actual comparison as required by GASB 34 is not presented.

Date of Management's Review of Subsequent Events

Management has evaluated subsequent events through September 29, 2015, the date which the financial statements were available to be issued, and determined that no subsequent events have occurred that require adjustment to or disclosure in the financial statements.

(2) RESTATEMENT OF BEGINNING NET POSITION

The beginning net position of the Fund has been restated to effect the implementation of GASB 68 and GASB 71. GASB 68 denotes that during implementation if restatement of all prior years presented is not practical, the cumulative effect of applying GASB 68 should be reported as a restatement of beginning net position for the earliest period restated. As such, the beginning net position as of July 1, 2014, is being restated, as all information needed to restate the year ended June 30, 2014, is not available.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) RESTATEMENT OF BEGINNING NET POSITION, CONTINUED

The cumulative adjustment to the July 1, 2014, beginning net position consists of the following:

| | |
|---|-----------------------|
| Beginning July 1, 2014, net position as previously reported | \$ 968,635,426 |
| Adjustments: | |
| Record the Fund's proportionate share of the net pension liability of OPERS | (683,363) |
| Record the 2014 contributions by the Fund to OPERS as deferred outflows | <u>171,427</u> |
| Net effect of restatement | <u>(511,936)</u> |
| Beginning net position, as restated | <u>\$ 968,123,490</u> |

(3) CASH AND INVESTMENTS

At June 30, cash and cash equivalents were composed of the following:

| | <u>2015</u> | <u>2014</u> |
|--|-----------------------|--------------------|
| Cash on deposit with the State | \$ 8,419,963 | 9,067,943 |
| Foreign currency | 408,790 | 1,191,592 |
| Collateral from securities lending—restricted cash | 76,033,573 | 83,926,489 |
| Cash and equivalents | 7,364,214 | 17,254,593 |
| Money market mutual fund | <u>17,832,136</u> | <u>22,686,633</u> |
| | <u>\$ 110,058,676</u> | <u>134,127,250</u> |

Restricted Cash

Cash collateral from securities lending activity is identified as restricted cash as it cannot be used by the Fund unless there is default in the return of the securities loaned.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Custodial Credit Risk

Custodial credit risk is the risk that in the event of the failure of a counterparty, the Fund will not be able to recover the value of its investments. Deposits are exposed to custodial credit risk if they are uninsured and uncollateralized. Investment securities are exposed to custodial credit risk if they are uninsured, are not registered in the name of the Fund, and are held by the counterparty or the counterparty's trust department but not in the name of the Fund. The investment policy requires that all deposits be invested in a fully collateralized interest-bearing account. Policy also provides that investment collateral be held by a third-party custodian with whom the Fund has a current custodial agreement in the Fund's name.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk

Fixed income securities are subject to credit risk. A bond's credit quality rating is one method of assessing the ability of the issuer to meet its obligation. Exposure to credit risk as of June 30 was as follows:

| | 2015 | |
|--|---------------------------------|---------------------|
| | <u>Fair Value</u> | |
| | <i>(Expressed in thousands)</i> | <u>Moody Rating</u> |
| U.S. government agencies (held in U.S. currency): | | |
| U.S. Treasury bonds | \$ 13,119 | AAA |
| U.S. Treasury notes | 42,646 | AAA |
| Federal Home Loan Bank | 3,893 | AAA |
| Federal Home Loan Mortgage Corp. | 1,967 | AAA |
| Federal National Mortgage Corp. | 7,506 | AAA |
| Government National Mortgage Association | 111 | AAA |
| Other | 22,649 | AAA |
| Other | 790 | A2 |
| Other | 704 | A3 |
| Other | 99 | Aa1 |
| | <u>93,484</u> | |
| Corporate bonds (held in U.S. currency): | | |
| Domestic bonds | 969 | A1 |
| Domestic bonds | 2,312 | A2 |
| Domestic bonds | 3,128 | A3 |
| Domestic bonds | 992 | AA1 |
| Domestic bonds | 1,717 | AA2 |
| Domestic bonds | 2,811 | AA3 |
| Domestic bonds | 2,472 | AAA |
| Domestic bonds | 12,753 | B1 |
| Domestic bonds | 7,870 | B2 |
| Domestic bonds | 7,244 | B3 |
| Domestic bonds | 4,955 | BA1 |
| Domestic bonds | 16,920 | BA2 |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

| | 2015 | |
|--|---------------------------------|---------------------|
| | <u>Fair Value</u> | |
| | <i>(Expressed in thousands)</i> | <u>Moody Rating</u> |
| Corporate bonds (held in U.S. currency), Continued: | | |
| Domestic bonds | 18,018 | BA3 |
| Domestic bonds | 3,116 | BAA1 |
| Domestic bonds | 1,498 | BAA2 |
| Domestic bonds | 1,997 | BAA3 |
| Domestic bonds | 18 | C |
| Domestic bonds | 801 | CA |
| Domestic bonds | 31 | CA2 |
| Domestic bonds | 4,198 | CAA1 |
| Domestic bonds | 2,914 | CAA2 |
| Domestic bonds | 3,236 | CAA3 |
| Domestic bonds | 5,356 | NA/NR |
| | <u>105,326</u> | |
| Foreign corporate bonds (held in U.S. currency): | | |
| Foreign bonds | 206 | A1 |
| Foreign bonds | 217 | A2 |
| Foreign bonds | 1,294 | A3 |
| Foreign bonds | 2,804 | B1 |
| Foreign bonds | 1,995 | B2 |
| Foreign bonds | 2,902 | B3 |
| Foreign bonds | 1,937 | BA1 |
| Foreign bonds | 2,338 | BA2 |
| Foreign bonds | 5,496 | BA3 |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

| | 2015 | |
|--|----------------------|---------------|
| | <u>Fair Value</u> | |
| | <i>(Expressed in</i> | Moody |
| | <i>thousands)</i> | <u>Rating</u> |
| Foreign corporate bonds (held in U.S. currency), Continued: | | |
| Foreign bonds | 1,289 | BAA1 |
| Foreign bonds | 721 | BAA2 |
| Foreign bonds | 3,899 | BAA3 |
| Foreign bonds | 324 | CA |
| Foreign bonds | 505 | CAA1 |
| Foreign bonds | 627 | CAA2 |
| Foreign bonds | 2,795 | NA/NR |
| | <u>29,349</u> | |
| Foreign corporate bonds (held in foreign currency): | | |
| Foreign bonds | 114 | (P)B3 |
| Foreign bonds | 184 | A2 |
| Foreign bonds | 653 | A3 |
| Foreign bonds | 350 | B1 |
| Foreign bonds | 857 | B2 |
| Foreign bonds | 348 | B3 |
| Foreign bonds | 342 | BA1 |
| Foreign bonds | 279 | BA3 |
| Foreign bonds | 367 | BAA1 |
| Foreign bonds | 213 | BAA2 |
| Foreign bonds | 521 | CAA1 |
| Foreign bonds | 1,653 | NR |
| | <u>5,881</u> | |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

| | 2015 | |
|---|-----------------------|---------------|
| | <u>Fair Value</u> | |
| | <i>(Expressed in</i> | Moody |
| | <i>thousands)</i> | <u>Rating</u> |
| Foreign government bonds (held in U.S. currency): | | |
| Foreign government bonds | 649 | B1 |
| Foreign government bonds | 216 | B3 |
| Foreign government bonds | 206 | Ba1 |
| Foreign government bonds | 1,602 | Baa2 |
| Foreign government bonds | 1,672 | Baa3 |
| | <u>4,345</u> | |
| Foreign government bonds (held in foreign currency): | | |
| Foreign government bonds | 1,785 | A3 |
| Foreign government bonds | 2,740 | Aaa |
| Foreign government bonds | 2,570 | Baa2 |
| Foreign government bonds | 3,202 | Baa2u |
| | <u>10,297</u> | |
| Total fair value of credit risk | <u>\$ 248,682</u> | |

⁽¹⁾ Backed by full faith and credit of the U.S. government.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

| | 2014 | |
|--|----------------------|---------------|
| | <u>Fair Value</u> | |
| | <i>(Expressed in</i> | Moody |
| | <i>thousands)</i> | <u>Rating</u> |
| U.S. government agencies (held in U.S. currency): | | |
| U.S. Treasury bonds | \$ 8,540 | AAA |
| U.S. Treasury notes | 63,232 | AAA |
| Federal Home Loan Bank | 7,272 | AAA |
| Federal Home Loan Mortgage Corp. | 2,571 | AAA |
| Federal National Mortgage Corp. | 7,333 | AAA |
| Government National Mortgage Association | 139 | AAA |
| Other | 11,661 | AAA |
| Other | 807 | A2 |
| Other | 743 | A3 |
| Other | 116 | AA1 |
| | <u>102,414</u> | |
| Corporate bonds (held in U.S. currency): | | |
| Domestic bonds | 3,060 | A1 |
| Domestic bonds | 2,679 | A2 |
| Domestic bonds | 4,785 | A3 |
| Domestic bonds | 1,709 | AA1 |
| Domestic bonds | 1,863 | AA2 |
| Domestic bonds | 1,012 | AA3 |
| Domestic bonds | 347 | AAA |
| Domestic bonds | 18,923 | B1 |
| Domestic bonds | 15,379 | B2 |
| Domestic bonds | 14,168 | B3 |
| Domestic bonds | 4,939 | BA1 |
| Domestic bonds | 11,441 | BA2 |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

| | 2014 | |
|--|--|---------------------|
| | <u>Fair Value</u> <i>(Expressed in thousands)</i> | <u>Moody Rating</u> |
| Corporate bonds (held in U.S. currency), Continued: | | |
| Domestic bonds | 20,118 | BA3 |
| Domestic bonds | 5,730 | BAA1 |
| Domestic bonds | 4,542 | BAA2 |
| Domestic bonds | 9,878 | BAA3 |
| Domestic bonds | 338 | C |
| Domestic bonds | 1,263 | CA |
| Domestic bonds | 9,220 | CAA1 |
| Domestic bonds | 6,764 | CAA2 |
| Domestic bonds | 3,606 | CAA3 |
| Domestic bonds | 11,620 | NA |
| Domestic bonds | 18 | DFLT |
| | <u>153,402</u> | |
| Foreign corporate bonds (held in U.S. currency): | | |
| Foreign bonds | 112 | A2 |
| Foreign bonds | 3,683 | B1 |
| Foreign bonds | 2,643 | B2 |
| Foreign bonds | 980 | B3 |
| Foreign bonds | 1,266 | BA2 |
| Foreign bonds | 3,931 | BA3 |
| Foreign bonds | 430 | CA |
| Foreign bonds | 1,436 | CAA1 |
| | <u>14,481</u> | |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

| | 2014 | |
|--|----------------------|---------------|
| | <u>Fair Value</u> | |
| | <i>(Expressed in</i> | Moody |
| | <i>thousands)</i> | <u>Rating</u> |
| Foreign corporate bonds (held in foreign currency): | | |
| Foreign bonds | 169 | PB1 |
| Foreign bonds | 3,758 | A2 |
| Foreign bonds | 764 | A3 |
| Foreign bonds | 2,373 | AA1U |
| Foreign bonds | 10,701 | AAAU |
| Foreign bonds | 598 | B1 |
| Foreign bonds | 1,306 | B2 |
| Foreign bonds | 1,469 | B3 |
| Foreign bonds | 15 | BA1 |
| Foreign bonds | 324 | BA3 |
| Foreign bonds | 3,694 | BAA2 |
| Foreign bonds | 4,415 | BAA2U |
| Foreign bonds | 990 | CAA1 |
| Foreign bonds | 798 | Not rated |
| | <u>31,374</u> | |
| Foreign government bonds (held in U.S. currency): | | |
| Foreign government bonds | 1,373 | BAA1 |
| Foreign government bonds | 693 | BAA3 |
| Foreign government bonds | 1,335 | CAA1 |
| | <u>3,401</u> | |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

| | 2014 | |
|---|--|-------------------------------|
| | <u>Fair Value</u> <i>(Expressed in thousands)</i> | <u>Moody</u> <u>Rating</u> |
| Foreign government bonds (held in foreign currency): | | |
| Foreign government bonds | 2,691 | A3 |
| Foreign government bonds | 636 | BAA1 |
| Foreign government bonds | 596 | BAA3 |
| | <u>3,923</u> | |
| Total fair value of credit risk | <u>\$ 308,995</u> | |

⁽¹⁾ Backed by full faith and credit of the U.S. government.

Concentration of Credit Risk

The Fund limits its exposure to concentrations of credit risk through its investment policy and asset allocation policy. Within asset classes, individual securities are limited to not more than 6% of the investment manager's portfolio; however, securities of one issuer could be represented in more than one asset class. No investments in any one organization, excluding those guaranteed by the U.S. government, represented 5% or more of the Fund's net position at June 30, 2015 or 2014, except for the \$110,071,106 investment in the Pooled Fixed Income Fund at June 30, 2015. While the investment is over 5% of the net position, the Fund has a share of each individual security of the Pooled Fixed Income Fund and no ownership interest in a single security would exceed 5%.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Mortgage-backed securities are highly sensitive to interest rate changes. The investment policy manages interest rate risk by limiting the effective duration of an actively managed fixed-income portfolio. Excluding U.S. government guaranteed securities, effective duration is not to exceed 7 years.

| | 2015 | |
|--|--|---------------------------------------|
| | <u>Fair Value</u> (Expressed in thousands) | Effective Duration <u>Years</u> |
| U.S. government securities (government guaranteed): | | |
| U.S. Treasury bonds | \$ 13,119 | 19.06 |
| U.S. Treasury notes | 42,646 | 4.22 |
| Federal Home Loan Bank | 3,893 | 1.55 |
| Federal National Mortgage Association—FHR | 11,964 | 3.73 |
| Federal National Mortgage Association—FNR | 10,295 | 4.14 |
| Government National Mortgage Association | 111 | 2.62 |
| GNR | 391 | 8.16 |
| Other | 1,594 | 4.44 |
| Foreign government securities: | | |
| Foreign government bonds (held in U.S. currency) | 4,345 | 11.06 |
| Foreign government bonds (held in foreign currency) | 10,296 | 8.61 |
| Mortgage-backed securities: | | |
| Federal Home Loan Mortgage Corp. | 1,967 | 3.84 |
| Federal National Mortgage Corp. | 7,506 | 2.93 |
| Corporate bonds: | | |
| Domestic bonds (held in U.S. currency) | 105,326 | 4.94 |
| Foreign bonds (held in U.S. currency) | 29,349 | 5.75 |
| Foreign bonds (held in foreign currency) | <u>5,880</u> | 3.83 |
| Total fixed income | <u>\$ 248,682</u> | |

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Interest Rate Risk, Continued

| | 2014 | |
|--|--|---------------------------------------|
| | <u>Fair Value</u> <i>(Expressed in thousands)</i> | Effective Duration <u>Years</u> |
| U.S. government securities (government guaranteed): | | |
| U.S. Treasury bonds | \$ 8,540 | 18.76 |
| U.S. Treasury notes | 63,232 | 4.57 |
| Federal Home Loan Bank | 7,272 | 1.94 |
| Federal National Mortgage Association—FHR | 5,291 | 3.29 |
| Federal National Mortgage Association—FNR | 5,776 | 4.78 |
| Government National Mortgage Association | 139 | 2.81 |
| GNR | 594 | 5.90 |
| Other | 1,666 | 5.04 |
| Foreign government securities: | | |
| Foreign government bonds (held in U.S. currency) | 3,401 | 5.61 |
| Foreign government bonds (held in foreign currency) | 3,923 | 7.86 |
| Mortgage-backed securities: | | |
| Federal Home Loan Mortgage Corp. | 2,571 | 4.35 |
| Federal National Mortgage Corp. | 7,333 | 3.59 |
| Corporate bonds: | | |
| Domestic bonds (held in U.S. currency) | 153,402 | 5.26 |
| Foreign bonds (held in U.S. currency) | 14,481 | 4.60 |
| Foreign bonds (held in foreign currency) | 31,374 | 5.44 |
| | | |
| Total fixed income | <u>\$ 308,995</u> | |

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. The investment policy limits foreign equity investments to 10% of total net position through its asset allocation policy. Investment in foreign equities and fixed income is shown by monetary unit to indicate possible foreign currency risk.

| | 2015 | |
|------------------------|----------------------|------------------|
| | <u>Fair Value</u> | |
| | <i>(Expressed in</i> | <u>Type</u> |
| | <i>thousands)</i> | |
| Foreign currency: | | |
| Argentina peso | \$ 77 | Fixed income |
| Australian dollar | 1,800 | Equity |
| Australian dollar | 1,247 | Fixed income |
| Australian dollar | 20 | Foreign currency |
| Bermuda dollar | 3,421 | Equity |
| Bermuda dollar | 1,383 | Fixed income |
| Brazilian real | 3,553 | Equity |
| Brazilian real | 3,190 | Fixed income |
| Brazilian real | 3 | Foreign currency |
| British pound sterling | 24,611 | Equity |
| British pound sterling | 3,785 | Fixed income |
| British pound sterling | 235 | Foreign currency |
| Canadian dollar | 5,534 | Equity |
| Canadian dollar | 2,964 | Fixed income |
| Cayman dollar | 1,769 | Equity |
| Cayman dollar | 2,388 | Fixed income |
| Chilean peso | 407 | Fixed income |
| Colombian peso | 1,829 | Fixed income |
| Croatian kuna | 206 | Fixed income |
| Dominican Peso | 221 | Fixed income |
| Euro | 42,514 | Equity |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk, Continued

| | 2015 | |
|------------------------------|--|------------------|
| | <u>Fair Value</u> (Expressed in thousands) | <u>Type</u> |
| Foreign currency, Continued: | | |
| Euro | 23,365 | Fixed income |
| Euro | 9 | Foreign currency |
| Honduran Lempira | 216 | Fixed income |
| Hong Kong dollar | 5,096 | Equity |
| Indian rupee | 1,398 | Equity |
| Indonesian rupiah | 1,399 | Equity |
| Indonesian rupiah | 2,220 | Fixed income |
| Japanese yen | 21,732 | Equity |
| Japanese yen | 10 | Fixed income |
| Kenyan Shilling | 213 | Fixed income |
| Korean Won | 1,321 | Equity |
| Malaysian ringgit | 15 | Foreign currency |
| Mexican nuevo peso | 1,253 | Equity |
| Mexican nuevo peso | 3,974 | Fixed income |
| Mexican nuevo peso | 117 | Foreign currency |
| Moroccan Dirham | 531 | Fixed income |
| New Israeli sheqel | 2,595 | Equity |
| New Taiwan dollar | 4,182 | Equity |
| Norwegian krone | 4,220 | Equity |
| Peruvian nuevo sol | 285 | Fixed income |
| Philippines Peso | 235 | Fixed income |
| Singapore Dollar | 2,558 | Equity |
| Swiss franc | 9,767 | Equity |
| Thai baht | 1,688 | Equity |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk, Continued

| | 2015 | |
|------------------------------|----------------------|------------------|
| | <u>Fair Value</u> | |
| | <i>(Expressed in</i> | |
| | <i>thousands)</i> | <u>Type</u> |
| Foreign currency, Continued: | | |
| Trinidad and Tobago dollar | 140 | Fixed income |
| Turkish lira | 770 | Fixed income |
| South African rand | 10 | Foreign currency |
| West African franc | 216 | Fixed income |
| | <u>\$ 190,692</u> | |

Securities held in U.S. currency that are traded in foreign markets or are significantly influenced by foreign exchange rates are included in the foreign currency risk shown in the schedule above.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk, Continued

| | 2014 | |
|------------------------|--|------------------|
| | <u>Fair Value</u> <i>(Expressed in thousands)</i> | <u>Type</u> |
| Foreign currency: | | |
| Argentina peso | \$ 110 | Fixed income |
| Australian dollar | 1,859 | Equity |
| Australian dollar | 594 | Fixed income |
| Barbados dollar | 862 | Fixed income |
| Bermuda dollar | 2,170 | Equity |
| Bermuda dollar | 1,720 | Fixed income |
| Bolivar | 1,335 | Fixed income |
| Brazilian real | 3,485 | Equity |
| Brazilian real | 4,425 | Fixed income |
| Brazilian real | 4 | Foreign currency |
| British pound sterling | 23,489 | Equity |
| British pound sterling | 5,974 | Fixed income |
| British pound sterling | 299 | Foreign currency |
| Canadian dollar | 5,776 | Equity |
| Canadian dollar | 2,319 | Fixed income |
| Cayman dollar | 4,856 | Fixed income |
| Chilean peso | 1,189 | Fixed income |
| Chinese yuan | 1,431 | Equity |
| Colombian peso | 2,022 | Fixed income |
| Croatian kuna | 208 | Fixed income |
| Dirham | 315 | Fixed income |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk, Continued

| | 2014 | |
|------------------------------|----------------------|------------------|
| | <u>Fair Value</u> | |
| | <i>(Expressed in</i> | |
| | <i>thousands)</i> | <u>Type</u> |
| Foreign currency, Continued: | | |
| Euro | 41,031 | Equity |
| Euro | 38,027 | Fixed income |
| Euro | 511 | Foreign currency |
| Forint | 1,671 | Fixed income |
| Hong Kong dollar | 4,575 | Equity |
| Indonesian rupiah | 1,788 | Fixed income |
| Indonesian rupiah | 1,478 | Equity |
| Japanese yen | 21,745 | Equity |
| Malaysian ringgit | 18 | Foreign currency |
| Manx Pound | 212 | Fixed income |
| Mexican nuevo peso | 2,683 | Equity |
| Mexican nuevo peso | 5,490 | Fixed income |
| Mexican nuevo peso | 182 | Foreign currency |
| New Israeli sheqel | 2,190 | Equity |
| New Taiwan dollar | 2,364 | Equity |
| Norwegian krone | 214 | Fixed income |
| Norwegian krone | 5,154 | Equity |
| Peruvian nuevo sol | 273 | Fixed income |
| Philippines Peso | 231 | Fixed income |
| Polish zloty | 3,369 | Fixed income |
| Russian ruble | 412 | Fixed income |
| Russian ruble | 1,525 | Equity |
| Singapore dollar | 2,136 | Equity |
| Swedish krona | 1,861 | Equity |
| Swiss franc | 14,452 | Equity |

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk, Continued

| | 2014 | |
|------------------------------|---------------------------------|------------------|
| | <u>Fair Value</u> | <u>Type</u> |
| | <i>(Expressed in thousands)</i> | |
| Foreign currency, Continued: | | |
| Thai baht | 2,450 | Equity |
| Trinidad and Tobago dollar | 150 | Fixed income |
| Turkish lira | 25 | Foreign currency |
| Turkish lira | 1,860 | Fixed income |
| South African rand | 2,007 | Fixed income |
| South African rand | 153 | Foreign currency |
| | <u>\$ 224,679</u> | |

Pooled Fixed Income Funds

The pooled fixed income funds consisted of an investment in the Reams Asset Management, Unconstrained Fixed Income Composite (the “Pooled Fixed Income Fund”), a commingled fund. The Pooled Fixed Income Fund seeks to maximize risk-adjusted total return by systematically pursuing relative value opportunities throughout all sectors of the fixed income market. At June 30, 2015, the average duration of the portfolio of the Pooled Fixed Income Fund was 1.9 years, the average maturity was 2.2 years, the yield to maturity was 1.5%, and the average asset quality was Aa3. At June 30, 2014, the average duration of the portfolio of the Pooled Fixed Income Fund was 2.9 years, the average maturity was 1.6 years, the yield to maturity was 0.8%, and the average asset quality was AA2.

At June 30, the Pooled Fixed Income Fund primarily consisted of:

| | <u>Fixed Income Securities</u> | |
|---------------------------|--------------------------------|-------------|
| | <u>2015</u> | <u>2014</u> |
| Corporate | 41% | 30% |
| Asset-backed | 4% | 4% |
| Government-related | 2% | <1% |
| Cash and cash equivalents | 11% | 8% |
| Treasury | 4% | 52% |
| Mortgage-backed | 3% | 5% |

See Independent Auditors’ Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Pooled Fixed Income Funds, Continued

The Fund's investment in the Pooled Fixed Income Fund was approximately 1.72% of the total portfolio of the Pooled Fixed Income Fund at June 30, 2015.

(4) DERIVATIVES

Derivative instruments are financial contracts whose values depend on the values of one or more underlying assets, reference rates, or financial indexes. They include futures contracts, swap contracts, options contracts, and forward foreign currency exchange. The Fund's derivatives policy identifies and allows common derivative investments and strategies which are consistent with applicable law and the Investment Policy Statement and requires investment managers to petition for the inclusion of additional derivative instruments and strategies. The guidelines also require investment managers to follow certain controls and documentation and risk management procedures. The Fund enters into these certain derivative instruments primarily to enhance the performance and reduce the volatility of its portfolio. It enters futures contracts to gain or hedge exposure to certain markets and to manage interest rate risk and uses forward foreign exchange contracts primarily to hedge foreign currency exposure. The tables below summarize the various contracts in the portfolio as of June 30, 2015 and 2014. The notional values associated with the futures contracts are generally not recorded in the financial statements, as they represent the obligation to purchase the futures contracts. Unrealized gains or losses are recognized daily by the investment manager and have been reflected in the Fund's financial statements. Interest risks associated with these investments are included in the interest rate risk disclosures. The Fund does not anticipate additional significant market risk from the futures or currency contracts.

Futures Contracts

| June 30, 2015 | | | |
|-------------------|----------------------------|-------------------|--|
| | <u>Expiration Date</u> | <u>Long/Short</u> | <u>Notional/ Fair Value</u> <i>(Expressed in thousands)</i> |
| U.S. 10-year note | September 2015 | Short | <u>\$ (1,009)</u> |

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(4) DERIVATIVES, CONTINUED

Futures Contracts, Continued

| | June 30, 2014 | | |
|---------------------------|----------------------------|-------------------|--|
| | <u>Expiration Date</u> | <u>Long/Short</u> | <u>Notional/ Fair Value</u> (Expressed in thousands) |
| U.S. 10-year note | September 2014 | Short | \$ (4,632) |
| Euro BUND GILT futures | September 2014 | Short | (4,428) |
| Euro BOBL futures | September 2014 | Short | (3,333) |
| | | | <u>\$ (12,393)</u> |

Foreign Currency Forward Contracts

| | June 30, | |
|---|--------------------------|-----------------|
| | <u>2015</u> | <u>2014</u> |
| | (Expressed in thousands) | |
| Pending receivable | \$ 29,736 | 48,504 |
| Pending payable | <u>(29,774)</u> | <u>(48,323)</u> |
| Foreign currency forward contracts (liability) asset | <u>\$ (38)</u> | <u>181</u> |

As of June 30, 2015, the foreign currency forward contracts expire in July 2015 and August 2015. During the years ended June 30, 2015 and 2014, realized gains (losses) on foreign currency contracts were approximately \$4,140,060 and \$(1,629,000), respectively.

The Fund invests in mortgage-backed securities, which are reported at fair value in the statements of net position and the balance sheets and are based on the cash flows from interest and principal payments by the underlying mortgages. As a result, they are sensitive to prepayments by mortgagees, which are likely in declining interest rate environments, thereby reducing the values of these securities. The Fund invests in mortgage-backed securities to diversify the portfolio and increase the return while minimizing the extent of risk. Details regarding interest rate risks for these investments are included under the interest rate risk disclosures.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(5) ALTERNATIVE INVESTMENTS

Alternative investments as of June 30 were with limited partnerships as follows:

| | 2015 | | |
|------------------------------------|--|--------------------------------|---|
| <u>Company</u> | <u>Fair Value (Determined using NAV)</u> | <u>Unfunded Commitment</u> | <u>Purpose</u> |
| AEW Core Property Trust, Inc. | \$ 28,034,157 | - | Real estate investment trust. |
| AEW VII | 3,547,632 | 5,601,769 | Real estate investment trust. |
| Medley Opportunity Fund II L.P. | 43,984,381 | 1,332,730 | Investments consist of senior secured direct loans to corporate entities that meet certain criteria. |
| PIMCO All Asset Fund | 44,390,678 | - | Fund invests in other PIMCO funds (A fund of funds). |
| Siguler Guff | 12,493,221 | 22,225,000 | Investments in distressed opportunities in commercial real estate. |
| SJC Offshore (Frontpoint) | 3,908,103 | 2,386,967 | Investments consist of senior secured direct loans to corporate entities that meet certain criteria. |
| SJC Offshore II (Frontpoint) | 6,365,762 | 8,079,655 | Investments consist of senior secured direct loans to corporate entities that meet certain criteria. |
| SJC Onshore | 19,342,065 | 20,345,455 | Investments consist of senior secured direct loans to corporate entities that meet certain criteria. |
| UBS Trumbull | <u>10,824,056</u> | <u>-</u> | Real estate investment trust. |
| Total alternative investments | <u>\$ 172,890,055</u> | <u>59,971,576</u> | |

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(5) ALTERNATIVE INVESTMENTS, CONTINUED

| 2014 | | | |
|------------------------------------|--|--------------------------------|---|
| <u>Company</u> | <u>Fair Value (Determined using NAV)</u> | <u>Unfunded Commitment</u> | <u>Purpose</u> |
| AEW Core Property Trust, Inc. | \$ 11,248,736 | - | Real estate investment trust |
| AEW VII | 3,017,902 | 6,734,981 | Real estate investment trust |
| Medley Opportunity Fund II L.P. | 37,856,714 | 5,876,443 | Investments consist of senior secured direct loans to corporate entities that meet certain criteria. |
| Siguler Guff | 4,639,011 | 15,600,000 | Investments in distressed opportunities in Commercial real estate. |
| SJC Offshore (Frontpoint) | 7,828,986 | 2,386,967 | Investments consist of senior secured direct loans to corporate entities that meet certain criteria. |
| SJC Offshore II (Frontpoint) | 3,840,191 | 11,194,155 | Investments consist of senior secured direct loans to corporate entities that meet certain criteria. |
| SJC Onshore | 7,657,121 | 22,320,652 | Investments consist of senior secured direct loans to corporate entities that meet certain criteria. |
| Total alternative investments | <u>\$ 76,088,661</u> | <u>64,113,198</u> | |

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(5) ALTERNATIVE INVESTMENTS, CONTINUED

Alternative investments are carried at the NAV of the fund as provided by the administrator or general partner. The Fund uses the NAV to determine the fair value for all alternative investments which (a) do not have a readily determinable fair value and (b) prepare their financial statements consistent with the measurement principles of an investment company or have attributes of an investment company. Management evaluates the values provided based on a number of factors, including obtaining an understanding of the fund's underlying investments, strategy, positions, and valuation methodologies, obtaining audited financial statements, obtaining verification of transactions at or near year end, and comparing information provided by the fund administrator or general partner to other available information such as sector data and indexes. Because alternative investments are not readily marketable, their NAV is subject to uncertainty and therefore may differ from the value that would have been used had a ready market for such investments existed. Such a difference could be material. Discretionary redemption of the investment in the limited partnerships by the Fund is not permitted.

(6) CAPITAL ASSETS

The following is a summary of changes in capital assets:

| | Balance at June 30, 2014 | Additions | Disposals | Balance at June 30, 2015 |
|----------------------------------|-----------------------------|----------------|-----------|-----------------------------|
| Depreciable capital assets: | | | | |
| Office equipment and furnishings | \$ 160,260 | 14,458 | - | 174,718 |
| Accumulated depreciation: | | | | |
| Office equipment and furnishings | (115,022) | (16,907) | - | (131,929) |
| Capital assets, net | <u>\$ 45,238</u> | <u>(2,449)</u> | <u>-</u> | <u>42,789</u> |
| | Balance at June 30, 2013 | Additions | Disposals | Balance at June 30, 2014 |
| Depreciable capital assets: | | | | |
| Office equipment and furnishings | \$ 140,935 | 19,325 | - | 160,260 |
| Accumulated depreciation: | | | | |
| Office equipment and furnishings | (98,734) | (16,288) | - | (115,022) |
| Capital assets, net | <u>\$ 42,201</u> | <u>3,037</u> | <u>-</u> | <u>45,238</u> |

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(7) CHANGES IN COMPENSATED ABSENCES

Compensated absence activity was as follows:

| <u>Balance at</u> <u>June 30, 2014</u> | <u>Additions</u> | <u>Reductions</u> | <u>Balance at</u> <u>June 30, 2015</u> | <u>Amounts</u> <u>Due Within</u> <u>1 Year</u> |
|---|------------------|-------------------|---|--|
| \$ <u>155,765</u> | <u>78,079</u> | <u>(81,737)</u> | <u>152,107</u> | <u>60,843</u> |

| <u>Balance at</u> <u>June 30, 2013</u> | <u>Additions</u> | <u>Reductions</u> | <u>Balance at</u> <u>June 30, 2014</u> | <u>Amounts</u> <u>Due Within</u> <u>1 Year</u> |
|---|------------------|-------------------|---|--|
| \$ <u>122,703</u> | <u>86,652</u> | <u>(53,590)</u> | <u>155,765</u> | <u>62,306</u> |

(8) AVAILABLE EARNINGS AND FUND BALANCES

Available Earnings

Annual earnings available for expenditure were previously considered to be dividends and interest, less fees to manage the Fund. However, Attorney General Opinion 2011-11 (AG Opinion 2011-11), which was issued in August 2011, states that earnings are equal to the income generated from the Fund, including but not limited to interest, dividends, and realized capital gains from investments, minus the costs and expenses of investment and minus any losses realized by the Fund. As a result of the AG Opinion 2011-11, the Board of Investors and the Board of Directors reached an agreement in February 2012 that \$42,898,847 of earnings (July 1, 2001, through June 30, 2010) as defined by AG Opinion 2011-11 would be available for certification in addition to any current year earnings in years in which current year earnings to be certified were less than 5% of the corpus of the Fund. The \$42,898,847 was reflected as assigned to be certified earnings. Of this reserve, \$1,041,808 and \$7,620,259 was certified in the November 2013 and in November 2012 board meetings, respectively, to bring the amount in the total certification up to 5% of the corpus, thus reducing the reserve balance to \$34,236,780.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(8) AVAILABLE EARNINGS AND FUND BALANCES, CONTINUED

Fund Balances

Fund balance refers to the difference between assets and liabilities in the governmental funds balance sheet. Fund balance, as defined in GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, as applicable to the Fund, consists of the following three categories:

- Nonspendable Fund Balance: The nonspendable fund balance classification includes amounts that cannot be spent because they are either (a) not in spendable form or (b) legally or contractually required to be maintained intact. This would include items not expected to be converted to cash, including inventories and prepaid amounts. It may also include the long-term amounts of loans and receivables, as well as property acquired for resale and the corpus (principal) of a permanent fund.

Nonspendable amounts are primarily composed of settlement receipts and the net unrealized appreciation or depreciation in the fair value of invested funds.

- Assigned Fund Balance: The assigned fund balance classification reflects amounts that are constrained by the Fund's intent to be used for specific purposes. For purposes of the assigned fund balance, the Fund's Board of Directors and Board of Investors have authority to assign funds for specific purposes.

Assigned by Board of Directors (Certified)

Prior to 2012, the Board of Directors had set aside 10% of the unassigned fund balance as a reserve to be used for future periods should annual earnings prove insufficient for operations. In November 2011, the Board of Directors chose to limit yearly expenditures of certified earnings to no more than 5% of the corpus of the Fund. Each year, any unexpended certified earnings will be added to the reserve of prior year unspent certified earnings. In essence, unexpended amounts will be moved to assigned fund balances for future years' operations. All the unspent amounts have previously been certified by the Board of Investors.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(8) AVAILABLE EARNINGS AND FUND BALANCES, CONTINUED

Fund Balances, Continued

- Assigned Fund Balance, Continued:

Assigned by Board of Investors (Uncertified)

As previously discussed, an additional \$42,898,847 was reserved during 2012 in accordance with an agreement between the Board of Directors and the Board of Investors. According to the agreement, some or all of the reserve funds are to be available for spending when the current year earnings calculation is below 5% of the corpus of the Fund. When future earnings calculations are below 5% of the corpus of the Fund, the reserve will be reduced by the difference and certified for use. The certification of reserve funds is limited to the 5% cap, inclusive of the initial calculation based upon the constitutional language. The agreement will remain in effect until the total amount of the reserve has been certified by the Board of Investors.

- Unassigned Fund Balance: The unassigned fund balance essentially consists of excess funds that have not been classified in the above fund balance categories.

The unassigned fund balance consists of annual earnings that have been certified by the Board of Investors as available for expenditures for approved programs and operations, and contractual income less program and operational expenses.

It is the Fund's policy that expenditures which are incurred for purposes for which both unassigned and assigned fund balances are available, unassigned fund balances are considered to have been spent first.

The Board of Directors manages program and operating expenses that are expended from the assigned and unassigned fund balance. Contract income is the reimbursement of program expenses related to the Helpline and is considered a reduction to unassigned expenses. Operating expenses include salaries, travel, and other operating expenses of the Board of Investors and the Board of Directors. The maximum amount allowed for operating expenses is 15% of certified earnings in any fiscal year. Operating expenses do not include program expenses or investment management expenses.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(8) AVAILABLE EARNINGS AND FUND BALANCES, CONTINUED

Fund Balances, Continued

A reconciliation of the nonspendable, assigned, and unassigned components of the fund balances as of June 30 is as follows:

| | | 2015 | | | |
|---|-----------------------|--------------------|-------------------|-------------------|--------------------|
| | | Assigned | Assigned | | |
| | | Available for | Available for | | |
| | | Expenditure | Expenditure | | |
| | | but | and | | |
| | <u>Nonspendable</u> | <u>Uncertified</u> | <u>Certified</u> | <u>Unassigned</u> | <u>Total</u> |
| Balance at June 30, 2014 | \$ 845,219,972 | 34,236,780 | 35,859,126 | 53,430,075 | 968,745,953 |
| Transfer—2014—5% cap | - | (84,186) | 84,186 | - | - |
| Settlement receipts | 57,645,300 | - | - | - | 57,645,300 |
| Net unrealized losses on investments | (31,345,113) | - | - | - | (31,345,113) |
| Miscellaneous income | 95,442 | - | - | - | 95,442 |
| Contract income | - | - | - | 1,546,273 | 1,546,273 |
| Expendable earnings, including net realized losses on investments | - | - | - | 46,191,149 | 46,191,149 |
| Program and operating expenses | - | - | - | (45,612,000) | (45,612,000) |
| Transfer—estimate of certified earnings for 2015 | - | - | 9,364,347 | (9,364,347) | - |
| Balance at June 30, 2015 | <u>\$ 871,615,601</u> | <u>34,152,594</u> | <u>45,307,659</u> | <u>46,191,150</u> | <u>997,267,004</u> |

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(8) AVAILABLE EARNINGS AND FUND BALANCES, CONTINUED

Fund Balances, Continued

| | 2014 | | | | |
|--|-----------------------|--|--|-------------------|--------------------|
| | | Assigned Available for Expenditure but Uncertified | Assigned Available for Expenditure and Certified | Unassigned | Total |
| | <u>Nonspendable</u> | <u>Uncertified</u> | <u>Certified</u> | <u>Unassigned</u> | <u>Total</u> |
| Balance at June 30, 2013 | \$ 729,689,075 | 34,512,100 | 26,440,231 | 39,055,506 | 829,696,912 |
| Transfer—2013—5% cap | - | (275,320) | 275,320 | - | - |
| Settlement receipts | 57,887,005 | - | - | - | 57,887,005 |
| Net unrealized gains on investments | 57,591,232 | - | - | - | 57,591,232 |
| Miscellaneous income | 52,660 | - | - | - | 52,660 |
| Contract income | - | - | - | 2,576,498 | 2,576,498 |
| Expendable earnings, including net realized gains on investments | - | - | - | 53,430,075 | 53,430,075 |
| Program and operating expenses | - | - | - | (32,488,429) | (32,488,429) |
| Transfer—estimate of certified earnings for 2014 | - | - | 9,143,575 | (9,143,575) | - |
| Balance at June 30, 2014 | <u>\$ 845,219,972</u> | <u>34,236,780</u> | <u>35,859,126</u> | <u>53,430,075</u> | <u>968,745,953</u> |

The amount of earnings available for certification for the period ended June 30, 2015, was \$46,191,149, which is below 5% of the corpus of the fund.

At their August 19, 2015, meeting, the Board of Investors certified \$42,843,669, reserving a portion of the amount available for certification for possible audit adjustments. It is anticipated that the Board of Investors will certify an additional amount at their November 2015 meeting. The Board of Investors has defined the corpus of the Fund as the custodial market value of the Fund as of June 30, less any previous certified earnings (current year and previous years' certified earnings that remain invested) within the Fund at June 30.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(8) AVAILABLE EARNINGS AND FUND BALANCES, CONTINUED

Fund Balances, Continued

The transfers of fund balances during 2015 and 2014 as noted in the above reconciliation are as follows:

2015

- The transfer of \$84,186 was to adjust the certification to equal the 5% cap for 2015.
- The transfer of \$9,364,347 was to adjust the unassigned balance to the estimate of certified earnings at June 30, 2015, before the 5% cap adjustment.

2014

- The transfer of \$275,320 was to adjust the previous 2013 certification to equal the 5% cap for 2013.
- The transfer of \$9,143,575 was to adjust the unassigned balance to the estimate of certified earnings at June 30, 2014, before the 5% cap adjustment.

(9) PENSION PLAN

Plan Description

The Fund contributes to the Oklahoma Public Employees Retirement Plan (OPERS), a cost-sharing, multiple-employer defined benefit public employee retirement plan administered by the Oklahoma Public Employees Retirement System (the "System"). OPERS provides retirement, disability, and death benefits to plan members and beneficiaries. The benefit provisions are established and may be amended by the Oklahoma Legislature. Title 74 of the Oklahoma Statutes, Sections 901–943, as amended, assigns the authority for management and operation of OPERS to the Board of Trustees of the System. The System issues a publicly available annual financial report that includes financial statements and required supplementary information for OPERS. That annual report may be obtained by writing to the Oklahoma Public Employees Retirement System, 5801 N. Broadway Extension, Suite 200, Oklahoma City, Oklahoma 73118 or by calling 1-800-733-9008, or can be obtained at www.opers.ok.gov/websites/opers/images/pdfs/CAFR-2014-OPERS.pdf.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(9) PENSION PLAN, CONTINUED

Benefits Provided

OPERS provides members with full retirement benefits at their specified normal retirement age or, for any person who became a member prior to July 1, 1992, when the sum of the member's age and years of credited service equals or exceeds 80 (Rule of 80), and for any person who became a member after June 30, 1992, when the member's age and years of credited service equals or exceeds 90 (Rule of 90).

Normal retirement date is further qualified to require that all members employed on or after January 1, 1983, must have 6 or more years of full-time equivalent employment with a participating employer before being eligible to receive benefits. Credited service is the sum of participating and prior service. Prior service includes nonparticipating service before January 1, 1975, or the entry date of the employer and active wartime military service.

A member with a minimum of 10 years of participating service may elect early retirement with reduced benefits beginning at age 55 if the participant became a member prior to November 1, 2011, or age 60 if the participant became a member on or after November 1, 2011.

Disability retirement benefits are available for members having 8 years of credited service whose disability status has been certified as being within 1 year of the last day on the job by the Social Security Administration. Disability retirement benefits are determined in the same manner as retirement benefits, but payable immediately without an actuarial reduction.

For state, county, and local agency employees, benefits are determined at 2% of the average annual salary received during the highest 36 months of the last 10 years of participating service, but not to exceed the applicable annual salary cap, multiplied by the number of years of credited service. Members who join OPERS on or after July 1, 2013, will have their salary averaged over the highest 60 months of the last 10 years. Normal retirement age under the Plan is 62 or Rule of 80/90 if the participant became a member prior to November 1, 2011, or age 65 or Rule of 90 if the participant became a member on or after November 1, 2011.

Members who elect to pay the additional contribution rate, which became available in January 2004, will receive benefits using a 2.5% computation factor for each full year the additional contributions are made. In 2004, legislation was enacted to provide an increased benefit to retiring members who were not yet eligible for Medicare. The Medicare Gap benefit option became available to members under age 65 who retired on or after May 1, 2006. Members may elect to receive a temporary increased benefit to cover the cost of health insurance premiums until the member is eligible to receive Medicare. After the member becomes eligible for Medicare, the retirement benefit will be permanently reduced by an actuarially determined amount. The option is irrevocable, must be chosen prior to retirement, and is structured to have a neutral actuarial cost to the plan.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(9) PENSION PLAN, CONTINUED

Benefits Provided, Continued

Members become eligible to vest fully upon termination of employment after attaining 8 years of credited service, or the members' contributions may be withdrawn upon termination of employment.

Upon the death of an active member, the accumulated contributions of the member are paid to the member's named beneficiary(ies) in a single lump sum payment. If a retired member elected a joint annuitant survivor option or an active member was eligible to retire with either reduced or unreduced benefits or eligible to vest the retirement benefit at the time of death, benefits can be paid in monthly payments over the life of the spouse if the spouse so elects.

Benefits are payable to the surviving spouse of an elected official only if the elected official had at least 6 years of participating elected service and was married at least 3 years immediately preceding death. Survivor benefits are terminated upon death of the named survivor and, for elected officials, remarriage of the surviving spouse. Upon the death of a retired member, with no survivor benefits payable, the member's beneficiary(ies) are paid the excess, if any, of the member's accumulated contributions over the sum of all retirement benefit payments made.

Upon the death of a retired member, OPERS will pay a \$5,000 death benefit to the member's beneficiary or estate of the member if there is no living beneficiary. The death benefit will be paid in addition to any excess employee contributions or survivor benefits due to the beneficiary.

Legislation was enacted in 1999 which provided a limited additional benefit for certain terminated members eligible to vest as of July 1, 1998. This limited benefit is payable as an additional \$200 monthly benefit upon the member's retirement up to the total amount of certain excess contributions paid by the participant to OPERS. In April 2001, limited benefit payments began for qualified retired members.

Contributions

The contribution rates for each member category of OPERS are established by the Oklahoma Legislature after recommendation by the Board of Trustees of the System based on an actuarial calculation, which is performed to determine the adequacy of such contribution rates.

Each member participates based on their qualifying gross salary earned, excluding overtime. There is no cap on the qualifying gross salary earned, subject to Internal Revenue Service (IRS) limitations on compensation.

For 2015, 2014, and 2013, *state agency employers* contributed 16.5% on all salary, and *state employees* contributed 3.5% on all salary.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(9) PENSION PLAN, CONTINUED

Contributions, Continued

Members have the option to elect to increase the benefit computation factor for all future service from 2.0% to 2.5%. The election is irrevocable, binding for all future employment under OPERS, and applies only to full years of service. Those who make the election pay the standard contribution rate plus an additional contribution rate, 2.91% which is actuarially determined. The election is available for all state, county, and local government employees, except for elected officials and hazardous duty members.

Contributions to OPERS by the Fund for 2015, 2014, and 2013 were as follows:

| | <u>2015</u> | <u>2014</u> | <u>2013</u> |
|----|----------------|----------------|----------------|
| \$ | <u>219,311</u> | <u>171,427</u> | <u>129,208</u> |

Pension Liabilities, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions

At June 30, 2015, the Fund reported a liability for its proportionate share of the net pension liability. The net pension liability was measured as of June 30, 2014, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of July 1, 2014. The Fund's proportion of the net pension liability was based on the Fund's contributions received by OPERS relative to the total contributions received by OPERS for all participating employers as of June 30, 2014. Based upon this information, the Fund's proportion was 0.061324%.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(9) PENSION PLAN, CONTINUED

Pension Liabilities, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions, Continued

For the year ended June 30, 2015, the Fund recognized pension expense of \$7,664. At June 30, 2015, the Fund reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

| | Deferred Outflows of Resources | Deferred Inflows of Resources |
|---|-----------------------------------|----------------------------------|
| Differences between expected and actual experience | \$ - | 37,269 |
| Changes of assumptions | 6,442 | - |
| Net difference between projected and actual earnings on pension plan investments | - | 376,203 |
| Fund contributions subsequent to the measurement date | <u>219,311</u> | <u>-</u> |
| | <u>\$ 225,753</u> | <u>413,472</u> |

Reported deferred outflows of resources of \$219,311 related to pensions resulting from the Fund's contributions subsequent to the measurement date will be recognized as a decrease of the net pension liability in the year ended June 30, 2016. Any other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

| Years Ended June 30: | |
|----------------------|---------------------|
| 2016 | \$ (85,058) |
| 2017 | (85,058) |
| 2018 | (85,058) |
| 2019 | (76,617) |
| 2020 | <u>(75,239)</u> |
| | <u>\$ (407,030)</u> |

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(9) PENSION PLAN, CONTINUED

Actuarial Methods and Assumptions

The total pension liability was determined on an actuarial valuation prepared as of July 1 2014, using the following actuarial assumptions:

| | |
|---|---|
| Investment return: | 7.5% compounded annually net of investment expense and including inflation |
| Salary increases: | 4.5% to 8.4% per year, including inflation |
| Mortality rates: | Active participants and nondisabled pensioners: RP-2000 Mortality Table projected to 2010 by Scale AA (disabled pensioners set forward 15 years). |
| Annual post-retirement benefit increases: | None |
| Assumed inflation rate: | 3% |
| Payroll growth: | 4.0% per year |
| Actuarial cost method: | Entry age |
| Select period for the termination of employment assumptions | 10 years |

The actuarial assumptions used in the July 1, 2014, valuation are based on the results of the most recent actuarial experience study, which covers the 3-year period ending June 30, 2013. The experience study report is dated May 9, 2014.

The long-term expected rate of return on pension plan investments was determined using a log-normal distribution analysis in which best estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(9) PENSION PLAN, CONTINUED

Actuarial Methods and Assumptions, Continued

The target asset allocation and best estimates of geometric real rates of return for each major asset class as of June 30, 2014, are summarized in the following table:

| <u>Asset Class</u> | <u>Target Asset Allocation</u> | <u>Long-Term Expected Real Rate of Return</u> |
|-----------------------|--------------------------------|---|
| U.S. large cap equity | 38.0% | 5.3% |
| U.S. small cap equity | 6.0% | 5.6% |
| U.S. fixed income | 25.0% | 70.0% |
| International stock | 18.0% | 5.6% |
| Emerging market stock | 6.0% | 6.4% |
| TIPS | 3.5% | 70.0% |
| Rate anticipation | <u>3.5%</u> | 1.5% |
| | <u>100.0%</u> | |

Discount Rate

The discount rate used to measure the total pension liability was 7.50%. The projection of cash flows used to determine the discount rate assumed that contributions from plan members and the employers will be made at the current contribution rate as set out in state statute. Based on those assumptions, OPERS' fiduciary net position was projected through 2113 to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability. The discount rate determined does not use a municipal bond rate.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(9) PENSION PLAN, CONTINUED

Sensitivity of the Net Pension Liability to Changes in the Discount Rate

The following presents the net pension liability of the employer calculated using the discount rate of 7.50%, as well as what the Fund's net pension liability would be if it were calculated using a discount rate that is 1 percentage point lower (6.5%) or 1 percentage point higher (8.5%) than the current rate:

| | 1% Decrease (6.5%) | Current Discount Rate (7.5%) | 1% Increase (8.5%) |
|-------------------------------|-----------------------|---------------------------------|-----------------------|
| Net pension liability (asset) | \$ 700,831 | 112,570 | (387,537) |

Pension Plan Fiduciary Net Position

Detailed information about OPERS' fiduciary net position is available in the separately issued financial report of OPERS which can be located at www.opers.ok.gov.

(10) OKLAHOMA STATE EMPLOYEES DEFERRED COMPENSATION PLAN AND DEFERRED SAVINGS INCENTIVE PLAN

Deferred Compensation Plan

The State offers its employees a Deferred Compensation Plan as authorized by Section 457 of the Internal Revenue Code (IRC), as amended by the Tax Reform Act of 1986, and in accordance with the provisions of Sections 1701 through 1706 of Title 74 of the Oklahoma Statutes.

The supervisory authority for the management and operation of the Deferred Compensation Plan is the Board of Trustees of the Oklahoma Public Employees Retirement System (the "Board").

The Deferred Compensation Plan is available to all State employees, as well as any elected officials receiving a salary from the State. Participants may direct the investment of their contributions in available investment options offered by the Deferred Compensation Plan. The minimum contribution amount is the equivalent of \$25 per month, and participants are immediately 100% vested in their respective accounts. All interest, dividends, and investment fees are allocated to participants' accounts.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(10) OKLAHOMA STATE EMPLOYEES DEFERRED COMPENSATION PLAN AND DEFERRED SAVINGS INCENTIVE PLAN, CONTINUED

Deferred Compensation Plan, Continued

Participants may defer until future years up to the lesser of 100% of their compensation as defined by Deferred Compensation Plan documents or the maximum amount allowed each year as determined by the Internal Revenue Service.

The Deferred Compensation Plan offers a catch-up program to participants, which allows them to defer annually for the 3 years prior to their year of retirement up to twice that plan year's deferral limit. The amount of additional contributions in excess of the normal maximum contributions to the Deferred Compensation Plan is also limited to contributions for years in which the participant was eligible but did not participate in the Deferred Compensation Plan or the difference between contributions made and the maximum allowable level. To be eligible for the catch-up program, the participant must be within 3 years of retirement with no reduced benefits.

Participants age 50 or older may make additional contributions annually subject to certain limits.

Deferred compensation benefits are paid to participants or beneficiaries upon termination, retirement, death, or unforeseeable emergency. Such benefits are based on a participant's account balance and are disbursed in a lump sum or periodic payments at the option of the participant or beneficiaries in accordance with the Deferred Compensation Plan's provisions.

Effective January 1, 1998, the Board established a trust and a trust fund covering the Deferred Compensation Plan's assets, pursuant to federal legislation enacted in 1996, requiring public employers to establish such trusts for plans meeting the requirements of Section 457 of the IRC no later than January 1, 1999. Under the terms of the trust, the corpus or income of the trust fund may be used only for the exclusive benefit of the Deferred Compensation Plan's participants and their beneficiaries. Prior to the establishment of the trust, the Deferred Compensation Plan's assets were subject to the claims of general creditors of the State. The Board acts as trustee of the trust. The participants' accounts are invested in accordance with the investment elections of the participants. The Board is accountable for all deferred compensation received, but has no duty to require any compensation to be deferred or to determine that the amounts received comply with the Deferred Compensation Plan or to determine that the trust fund is adequate to provide the benefits payable pursuant to the Deferred Compensation Plan.

Further information may be obtained from the Deferred Compensation Plan's audited financial statements for the years ended June 30, 2015 and 2014. The Fund believes that it has no liabilities with respect to the Deferred Compensation Plan.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(10) **OKLAHOMA STATE EMPLOYEES DEFERRED COMPENSATION PLAN AND DEFERRED SAVINGS INCENTIVE PLAN, CONTINUED**

Deferred Savings Incentive Plan

Effective January 1, 1998, the State established the Oklahoma State Employees Deferred Savings Incentive Plan (the "Savings Incentive Plan") as a money purchase pension plan pursuant to IRC Section 401(a). The Savings Incentive Plan and its related trust are intended to meet the requirements of IRC Sections 401(a) and 501(a).

Any qualified participant who is a State employee who is an active participant in the Deferred Compensation Plan is eligible for a contribution of the amount determined by Oklahoma Legislature, currently the equivalent of \$25 per month. Participation in the Savings Incentive Plan is automatic in the month of participation in the Deferred Compensation Plan and is not voluntary.

Upon cessation of contributions to the Deferred Compensation Plan, termination of employment with the State, retirement, or death, a participant will no longer be eligible for contributions from the State into the Savings Incentive Plan. Participants are at all times 100% vested in their Savings Incentive Plan account. Participant contributions are not required or permitted. Qualified participants may make rollover contributions to the Savings Incentive Plan, provided such rollover contributions meet applicable requirements of the IRC. Plan participants may direct the investment of the contributions in available investment options offered by the Savings Incentive Plan. All interest, dividends, and investment fees are allocated to the participants' accounts.

Savings Incentive Plan benefits are paid to participants or beneficiaries upon termination, retirement, or death. Such benefits are based on a participant's account balance and are disbursed in a lump sum or periodic payments or may be rolled over to a qualified plan at the option of the participant or beneficiaries.

(11) **OPERATING EXPENSES**

The State constitutional amendment creating the Fund also provides for the payment of authorized administrative expenses of the Office of the State Treasurer and the Board of Directors. State statutes further specify that the State Treasurer shall provide any necessary staff support to the Board of Investors and may request funding for the cost of up to two full-time equivalent employees.

During 2007, State statutes were amended and specify that annual operating expenses shall not exceed 15% of certified earnings.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(12) COMMITMENTS AND CONTINGENCIES

Contracts

The Fund has entered into various contracts to assist in its program operations. The contracts are generally for a commitment of 1 year with options to renew.

Settlement Receipts

As a result of the 2013 NPM Adjustment Arbitration Settlement, the State received additional tobacco settlement receipts in FY 2013 and it will also receive additional funds in the future because, as part of the settlement, there will be no withholding from the State's Master Settlement Agreement (MSA) payment, which is expected to increase the State's future annual payments by an estimated additional \$8 million to \$10 million.

The original dispute involved the diligent enforcement of the provisions within the MSA that required the State to adopt a Qualifying Statute. Participating manufacturers contended the State did not diligently enforce the provisions of its Qualifying Statute during calendar year 2003 and every year thereafter. While the provisions of the Qualifying Statute to be enforced appear relatively simple on the surface, enforcement proved to be a complex and difficult undertaking. An additional complication was the MSA's silence as to what was required for diligent enforcement.

As part of the settlement, the State agreed to take on additional responsibilities, many of which it was already performing. Major requirements of the settlement are that the State must enforce its Complementary Statute against contraband tobacco products and pay a per-stick amount for cigarette sales which have been taxed and stamped. Enforcement of the settlement is expected to require some State statutory changes.

See Independent Auditors' Report.

**SUPPLEMENTARY INFORMATION REQUIRED BY
GOVERNMENTAL ACCOUNTING STANDARDS BOARD
STATEMENTS NO. 68 AND 71**

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**SCHEDULE OF THE FUND'S PROPORTIONATE SHARE OF
THE NET PENSION LIABILITY****Oklahoma Public Employees Retirement Plan****Current Fiscal Year**

| | <u>2015</u> |
|---|-------------|
| Fund's proportion of the net pension liability | 0.06132439% |
| Fund's proportional share of the net pension liability | \$ 112,570 |
| Fund's covered-employee payroll | 1,038,952 |
| Fund's proportionate share of the net pension liability as a percentage of its covered payroll | 10.83% |
| OPERS' fiduciary net position as a percentage of the total pension liability | 97.90% |

* The amounts presented for each fiscal year were determined as of
June 30th of the prior year.

Only the current fiscal year is presented because 10-year data is not readily available.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**SCHEDULE OF THE FUND'S CONTRIBUTIONS
Oklahoma Public Employees Retirement Plan****Last 5 Fiscal Years**

| | <u>2015</u> | <u>2014</u> | <u>2013</u> | <u>2012</u> | <u>2011</u> |
|---|----------------|----------------|----------------|----------------|---------------|
| Contractually required contribution | \$ 219,311 | 171,427 | 129,208 | 103,380 | 70,367 |
| Contributions in relation to the contractually required contributions | <u>219,311</u> | <u>171,427</u> | <u>129,208</u> | <u>103,380</u> | <u>70,367</u> |
| Contribution deficiency (excess) | <u>\$ -</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| Fund's covered-employee payroll | \$ 1,329,158 | 1,038,952 | 783,079 | 626,545 | 453,981 |
| Contributions as a percentage of covered-employee payroll | 16.50% | 16.50% | 16.50% | 16.50% | 15.50% |

Only the last 5 fiscal years are presented because 10-year data is not readily available.

See Independent Auditors' Report.



**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN
ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

Board of Directors and
Board of Investors
Tobacco Settlement Endowment Trust Fund

We have audited, in accordance with the 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, the financial statements of the governmental activities and the permanent fund of the Tobacco Settlement Endowment Trust Fund (the "Fund"), which is a part of the State of Oklahoma financial reporting entity, as of and for the year ended June 30, 2015, and the related notes to the financial statements, which collectively comprise the Fund's basic financial statements, and have issued our report thereon dated September 29, 2015. Our report includes an explanatory paragraph disclaiming an opinion on required supplementary information. Our report also includes an explanatory paragraph noting the adoption of Governmental Accounting Standards Board's Statements No. 68 and 71 by the Fund, requiring the restatement of beginning net position. In addition, our report also includes an explanatory paragraph to emphasize the fact that the financial statements include only that portion of the State of Oklahoma that is attributable to transactions of the Fund.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Fund's internal control over financial reporting ("internal control") to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

(Continued)

**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN
ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*, CONTINUED**

Internal Control Over Financial Reporting, Continued

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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*.

Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Fund's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Fund's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Finley + Cook, PLLC

Shawnee, Oklahoma
September 29, 2015