

Tobacco Settlement Endowment Trust Fund

Financial Statements

June 30, 2016 and 2015
(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, 2016 and 2015, 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, 2016 and 2015, 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, 2016 and 2015, 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 Note 1 to the financial statements, in 2016 the Fund adopted new accounting guidance, Statement No. 72 of the Governmental Accounting Standards Board, *Fair Value Measurement and Application* (GASB 72). The implementation of GASB 72 resulted in revised disclosures related to the financial statements. 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 and the schedule of the Fund's proportionate share of the net pension liability and schedule of the Fund's contributions on pages 60 and 61, respectively, 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, 2016, 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, 2016

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

June 30, 2016 and 2015

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, 2016 and 2015. 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, 2016 and 2015

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 24, 2016, meeting, the Board of Investors certified \$26,330,290, reserving \$500,000 for possible audit adjustments. The estimated earnings available for certification for the period ended June 30, 2016, were \$26,830,290.

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, 2016 and 2015

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 2016, 2015, and 2014 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>2016</u>	<u>2015</u>	<u>2014</u>
Assets			
Current assets	\$ 121,256,739	113,112,524	138,930,511
Investments, at fair value	1,001,295,395	973,596,294	923,128,052
Securities lending collateral—non-cash	39,803,195	21,630,365	21,992,588
Capital assets	<u>58,520</u>	<u>42,789</u>	<u>45,238</u>
Total assets	<u>1,162,413,849</u>	<u>1,108,381,972</u>	<u>1,084,096,389</u>
Deferred outflows of resources:			
Deferred amounts related to the pension	<u>532,465</u>	<u>225,753</u>	<u>-</u>
Liabilities			
Current liabilities	21,019,502	13,469,084	9,448,427
Liability under securities lending	122,292,462	97,663,938	105,919,077
Noncurrent liabilities	<u>368,870</u>	<u>203,834</u>	<u>93,459</u>
Total liabilities	<u>143,680,834</u>	<u>111,336,856</u>	<u>115,460,963</u>
Deferred inflows of resources:			
Deferred amounts related to the pension	<u>376,012</u>	<u>413,472</u>	<u>-</u>
Net Assets			
Net investment in capital assets	58,520	42,789	45,238
Restricted for investment	914,652,652	871,615,601	845,219,972
Unrestricted	<u>104,178,296</u>	<u>125,199,007</u>	<u>123,370,216</u>
Total net position	<u>\$ 1,018,889,468</u>	<u>996,857,397</u>	<u>968,635,426</u>

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

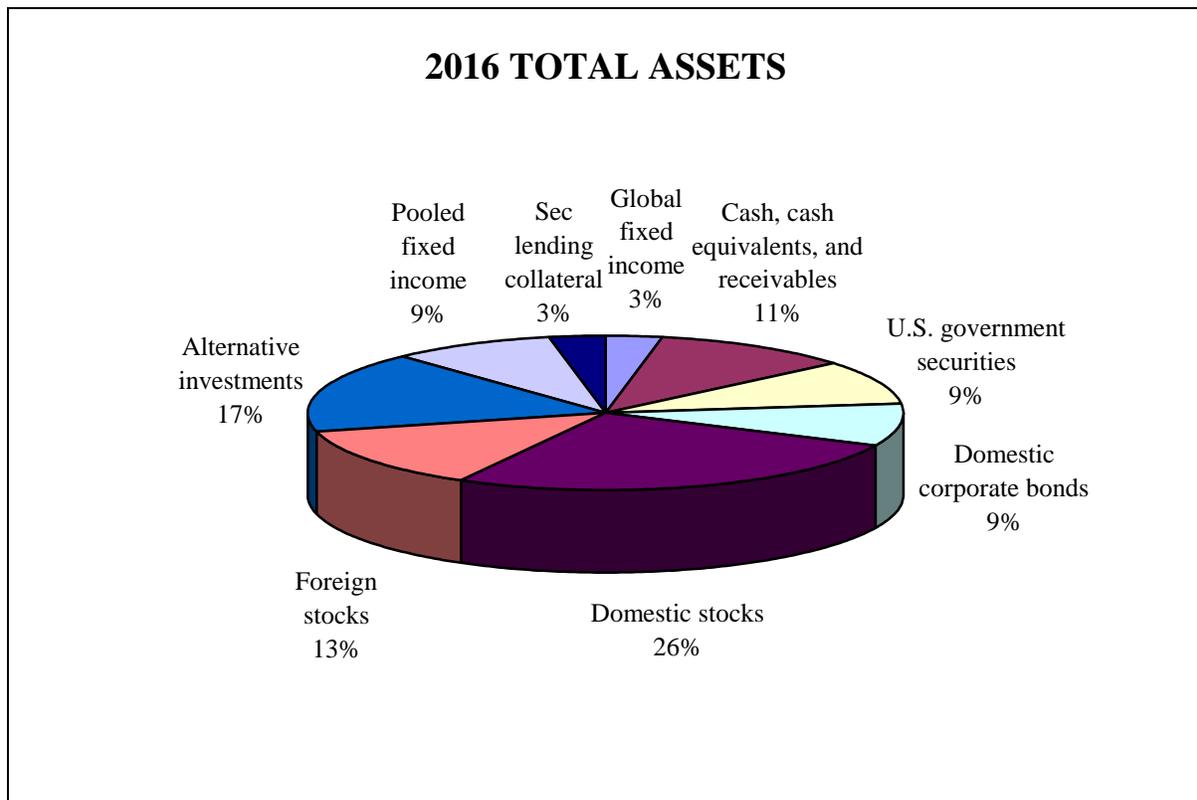
June 30, 2016 and 2015

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Net Position, Continued

The Fund's total net position increased \$22.03 million during the year, as the Fund invested an additional \$57 million in settlement receipts, recognized \$13.1 million as net investment income, and expended \$50.1 million on programs and operations. Total investments increased from \$973.6 million at the beginning of the year to \$1,001.3 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 \$15.2 million from the net depreciation of the fair value of the portfolio and earned \$28.2 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 \$82.5 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.



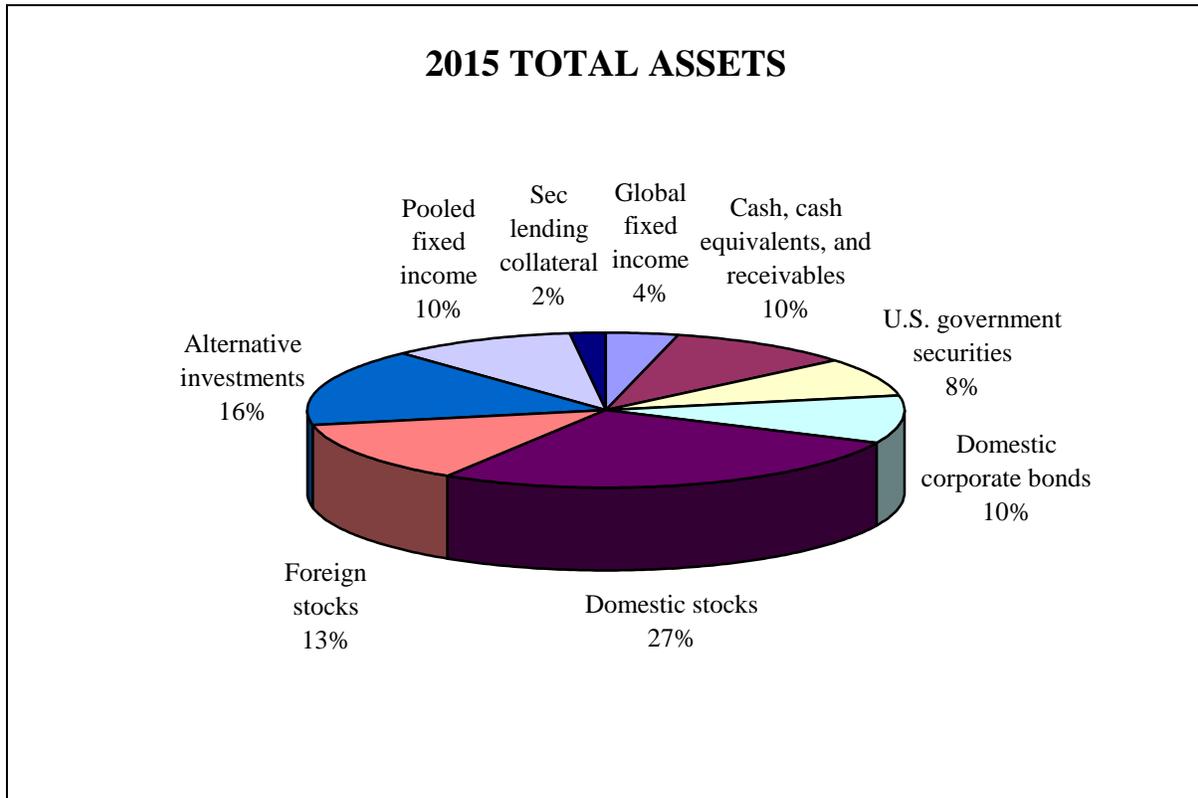
TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Net Position, Continued



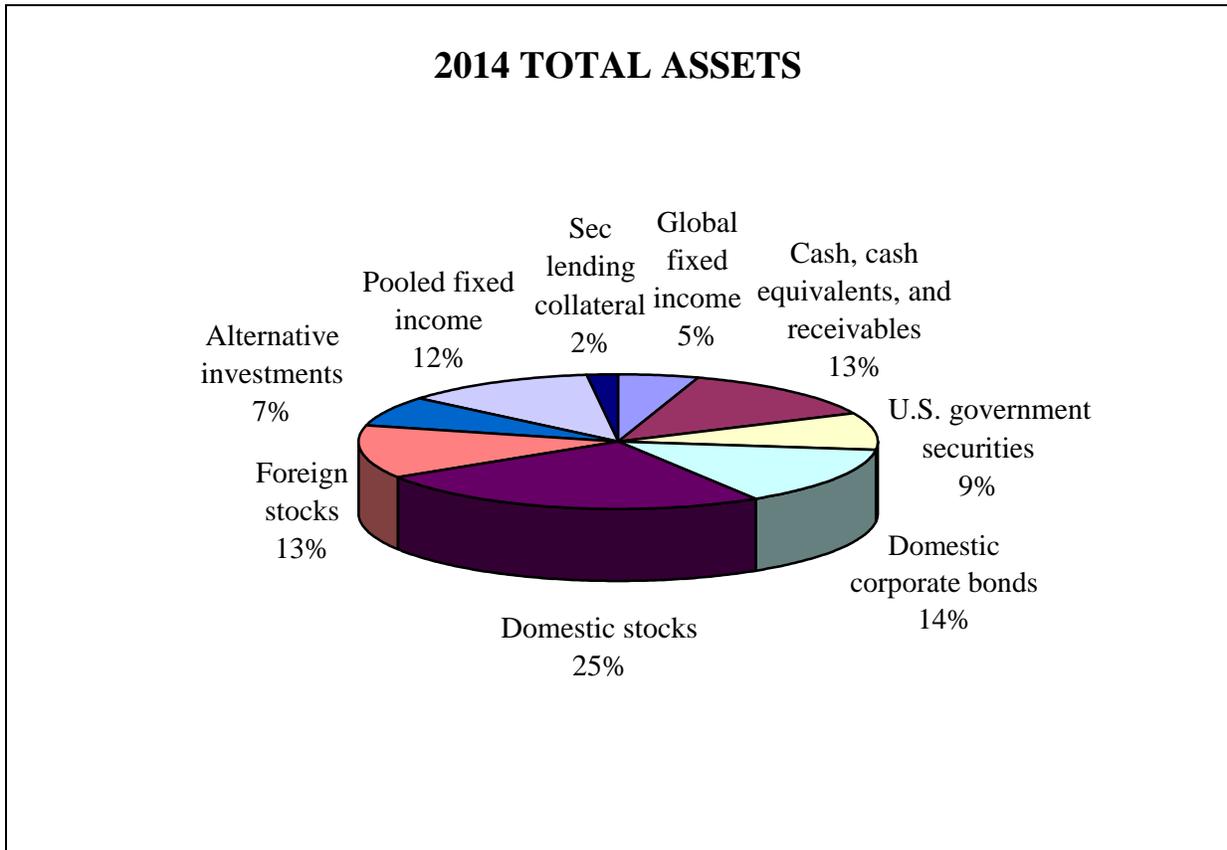
TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Net Position, Continued



TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

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
Statements of Activities

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Investment income:			
Interest and dividend income	\$ 34,158,974	31,019,513	31,968,197
Securities lending income	212,847	316,161	172,252
Net (depreciation) appreciation in fair value of investments:			
Net unrealized gains and losses	(14,027,159)	(31,345,113)	57,591,232
Net realized gains and losses	<u>(1,204,386)</u>	<u>19,639,273</u>	<u>26,470,838</u>
	<u>(15,231,545)</u>	<u>(11,705,840)</u>	<u>84,062,070</u>
Total investment income	19,140,276	19,629,834	116,202,519
Investment expenses	<u>(6,007,660)</u>	<u>(4,783,798)</u>	<u>(5,181,212)</u>
Net investment income	<u>13,132,616</u>	<u>14,846,036</u>	<u>111,021,307</u>
Other income:			
Contract income	1,745,641	1,546,273	2,576,498
Miscellaneous income	<u>57,237</u>	<u>95,442</u>	<u>52,660</u>
Total other income	<u>1,802,878</u>	<u>1,641,715</u>	<u>2,629,158</u>
Expenses:			
Program	48,426,413	44,303,328	31,456,440
Operating	<u>1,483,983</u>	<u>1,095,816</u>	<u>1,062,014</u>
Total expenses	<u>49,910,396</u>	<u>45,399,144</u>	<u>32,518,454</u>
Changes in net position before settlement receipts	(34,974,902)	(28,911,393)	81,132,011
Contribution to fund principal:			
Settlement receipts	<u>57,006,973</u>	<u>57,645,300</u>	<u>57,887,005</u>
Changes in net position	<u>22,032,071</u>	<u>28,733,907</u>	<u>139,019,016</u>
Net position, beginning of year	996,857,397	968,635,426	829,616,410
Cumulative change in net position to adopt GASB 68 and GASB 71 (see Note 2)	<u>-</u>	<u>(511,936)</u>	<u>-</u>
Net position, beginning of year, restated in 2015	<u>996,857,397</u>	<u>968,123,490</u>	<u>829,616,410</u>
Net position, end of year	<u>\$ 1,018,889,468</u>	<u>996,857,397</u>	<u>968,635,426</u>

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

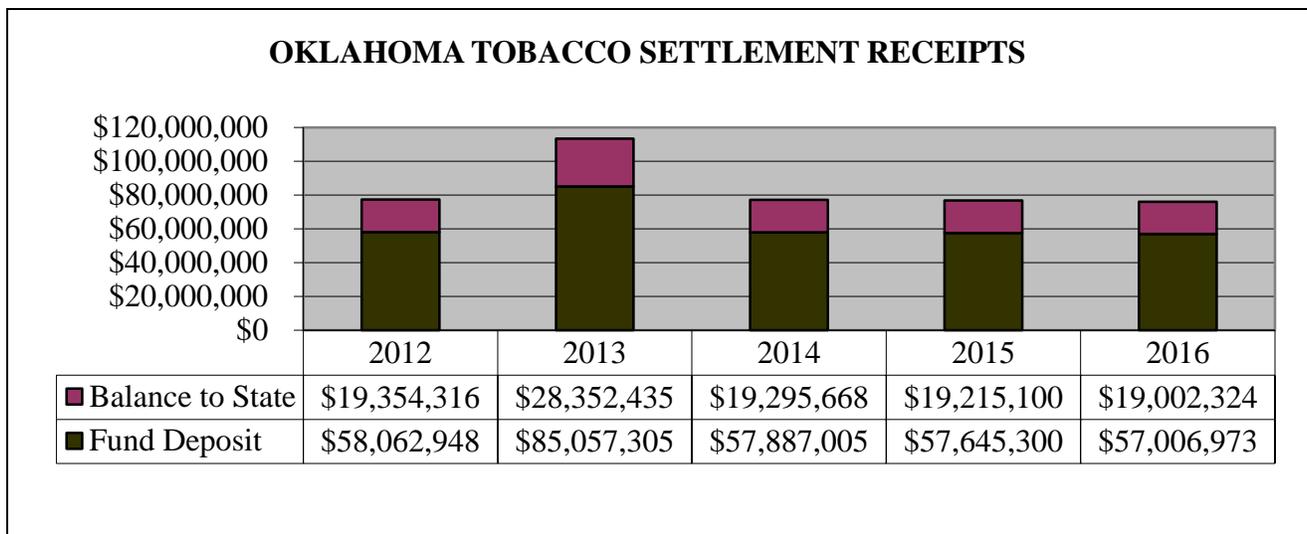
MANAGEMENT’S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2016 and 2015

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, 2016 and 2015, 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 \$638,327 from 2015.



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, 2016, net investment income decreased by \$1.7 million. Interest and dividend income increased \$3.1 million, while the net appreciation of investment in the Fund’s portfolio decreased \$3.5 million. Fees paid to investment managers, consultants, and custodians increased \$1.2 million.

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, 2016 and 2015

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 that 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 16.

Since FY 10, the Board of Directors has updated its annual 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, 2016, the Board of Directors decreased program funding by more than \$660,000 (from \$50,676,198 in FY 15 to \$50,014,201 in FY16), using a combination of certified earnings, carryover, and matching funds from the Oklahoma Health Care Authority, after a decline in annual earnings from the TSET endowment. The administration budget was 4% of certified earnings. By statute, the administration budget is capped at 15% of certified earnings.

When originally adopted, the Board of Directors "Allocation of Earnings and Reserve Fund" policy limited yearly expenditures of certified funds to no more than 5% of the corpus of the trust fund. It also established a reserve fund of up to two years' expenses by holding back 10% of certified earnings annually. In January 2016, the Board of Directors amended its "Allocation of Earnings and Reserve Fund" policy to establish a *target spending limit* as "the average of the preceding three years' certified earnings, plus expected lapse (for example, if the expected lapse is 10% then the targeted spending limit equals three year average certified earnings, divided by 0.9)." In addition the policy was further amended to continue the reserve fund by holding back the excess of certified earnings over the target spending limit until the level of two years' expenses is obtained. The same process is used to replenish the reserve when needed. Each year, any unexpended certified earnings shall be added to this reserve. The balance of the reserve fund as of June 30, 2016, was approximately \$35,000,000.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Prevention

As a result of TSET investments in tobacco control, smoking prevalence among high school youth dropped 37%, from 24% in 2002 to 15.1% in 2013. Smoking prevalence among adults dropped 21% 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 62.6 packs per person in 2015. These accomplishments come after a decade of community-based grants, health communication interventions, evidence-based health system change and cessation services, and constant collaboration to ensure that best practices are used to prevent and reduce tobacco use in Oklahoma.

In FY 16, the Board of Directors outsourced administration and programmatic oversight of the Oklahoma Tobacco Helpline to the Oklahoma Tobacco Research Center, a program of the Stephenson Cancer Center. The OTRC has subsequently maintained an agreement with Alere Wellbeing, Inc. to provide the telephone coaching/web/email/text services of the Oklahoma Tobacco Helpline. At the same time Alere Wellbeing, Inc. was purchased by Optum, however no services have changed as a result of the purchase. 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).

In FY 16, 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 16, Optum also continued to employ Oklahoma workers as “Quit Coaches” to assist tobacco users in 26 states (and Guam) and over 750 commercial clients.

The Board of Directors ended three agreements for reimbursements from state agencies (Oklahoma State Department of Health, Oklahoma HealthCare Authority, and Oklahoma Employees Group Insurance Division) for Helpline services, evaluation, and administrative services in FY 16, as those agreements transferred to the Oklahoma Tobacco Research Center when the Helpline oversight moved to the OTRC for FY 16.

In FY 16, the Board of Directors continued to invest in best practice health communication interventions 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 \$422,713 and \$500,000 for the last two years (FY 15 and FY 16, respectively).

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Prevention, Continued

The long-standing Communities of Excellence program, a comprehensive community-based effort, ended June 30, 15. In its place, the board launched the TSET Healthy Living program, a new community-based program to address and integrate the issues of tobacco use and obesity prevention, promoting good nutrition, physical activity, and tobacco-free living, across the business, community organizations, city governments and schools within each community. The TSET Healthy Living program grants were awarded to 50 lead agencies to serve 63 of Oklahoma's 77 counties, or 94 percent of the state's population.

To support community-based initiatives, the Board of Directors also continued an agreement with the Oklahoma State Department of Health, Center for the Advancement of Wellness, to provide training, consultation, and technical assistance to grantees. In addition, an agreement with the University of Oklahoma, College of Public Health and the Oklahoma State University Department of Nutrition Sciences (together known as the University Partnership for Applied Evaluation and Research or UPAER) for evaluation of the programs was continued.

In FY 12, 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 implement policies and practices that promote prevention and wellness in the areas of tobacco use, physical inactivity, poor nutrition, mental health and substance abuse, and access to health services. City governments and schools that become "Certified Healthy" by the Oklahoma State Department of Health are eligible to apply for TSET Healthy Communities incentive grants or TSET healthy schools incentive grants. 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 12 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 12 and FY 16, 56 communities, 69 school districts, and 21 school sites received incentive grant awards. The balance of the \$8.5 million, after expenses and awards, is \$4,803,535, which can be used in future years until the funds are exhausted.

Three Health Systems Initiative (HSI) grantees entered their second year of a five-year continuation grant beginning FY 14. 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 best practice interventions to address tobacco, nutrition, and physical activity (as appropriate) among patients in inpatient hospitals or outpatient care in a hospital affiliated clinic, Medicaid beneficiaries, and within routine mental health and substance abuse treatment inpatient and outpatient programs.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Research

The Peggy and Charles Stephenson Cancer Center (SCC) entered its fourth year of a five year grant, which began in FY 12, when the Board of Directors committed \$30.25 million over five years. The grant created a 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 16, the SCC 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 three in the country for the number of patients enrolled in Phase I clinical trials. The FY 16 budget was \$5.5 million.

The Oklahoma Tobacco Research Center (OTRC), a program of the Stephenson Cancer Center, was funded for a new, five-year grant cycle beginning FY 16. This continuation application was funded in an effort to expand the OTRC'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 16 budget was \$3.16 million.

The Oklahoma Center for Adult Stem Cell Research (OCASCR), which was established in FY 10, entered the second year of a five-year continuation grant to advance regenerative medicine through the use of adult stem cells. 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. In FY 15 the Board of Directors committed up to \$3 million per year or \$15 million over five years. The FY 16 budget was \$3 million.

Emerging Opportunities

TSET's Emerging Opportunities portfolio provides a channel 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."

A new grant to the Oklahoma State University – Center for Health Sciences was made beginning FY 16, to expand medical residencies for rural and underserved areas of Oklahoma. Oklahoma experiences a severe shortage of primary care physicians and this \$3.8 million, six-year program is one step toward addressing that issue. When this program is fully implemented it will graduate, on average, 36 new osteopathic doctors annually.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Emerging Opportunities, Continued

In FY 16, the grant to the Physician Manpower Training Commission (PMTTC) was renewed for the fourth year of a five year grant. The grant to PMTC helps to fund the Oklahoma Medical Loan Repayment Program, which recruits physicians to practice in rural and medically underserved areas. There are currently 33 physicians practicing across the state as part of the program that 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 four 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 during the 6-year period, which includes TSET funds and leveraged dollars.

In FY 16, the Board of Directors renewed grants to the Oklahoma State Department of Health for the second year of a five-year program to implement FitnessGram (an evidence-based, standardized fitness assessment tool) in elementary schools throughout Oklahoma, on a voluntary basis. In FY 16, the program halted recruitment of additional schools due to technical difficulties in the online data collection system. The OSDH has been working to address the issues, and by the end of FY 16, most of the issues have been resolved.

The Oklahoma City Boathouse Foundation grant was renewed for the second year of a three year grant. Through this 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.

Conference Sponsorships

In FY 10, 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 16 budget for conference sponsorships was \$75,000. Twelve conference and training grants totaling \$38,520 were awarded in FY 16. The grant category was frozen midyear by the Board of Directors to accommodate a decrease in program spending.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

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>2016</u>	<u>2015</u>	<u>2014</u>
Assets:			
Cash and cash equivalents	\$ 116,663,252	110,058,676	134,127,250
Interest and dividends receivable	3,479,330	2,962,937	3,908,317
Contract receivable	1,091,373	78,753	862,034
Securities lending receivable	22,784	12,158	32,910
Securities lending collateral—non-cash	39,803,195	21,630,365	21,992,588
Investments at fair value	<u>1,001,295,395</u>	<u>973,596,294</u>	<u>923,128,052</u>
Total assets	<u>\$ 1,162,355,329</u>	<u>1,108,339,183</u>	<u>1,084,051,151</u>
Liabilities:			
Net payable to brokers	\$ 12,384,335	3,491,355	3,784,389
Accounts payable	8,569,548	9,916,886	5,601,732
Liability under securities lending	<u>122,292,461</u>	<u>97,663,938</u>	<u>105,919,077</u>
Total liabilities	<u>143,246,344</u>	<u>111,072,179</u>	<u>115,305,198</u>
Fund Balances:			
Nonspendable	914,652,652	871,615,601	845,219,972
Assigned	77,296,558	79,460,253	70,095,906
Unassigned	<u>27,159,775</u>	<u>46,191,150</u>	<u>53,430,075</u>
Total fund balances	<u>1,019,108,985</u>	<u>997,267,004</u>	<u>968,745,953</u>
Total liabilities and fund balances	<u>\$ 1,162,355,329</u>	<u>1,108,339,183</u>	<u>1,084,051,151</u>

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

FUND HIGHLIGHTS, CONTINUED

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

Tobacco Settlement Endowment Trust Fund
Revenues, Expenditures, and Changes in Fund Balances—Permanent Fund

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Revenues:			
Restricted:			
Net (depreciation) appreciation in fair value of investments:			
Net unrealized gains and losses	\$ (14,027,159)	(31,345,113)	57,591,232
Net realized gains and losses	(1,204,386)	19,639,273	26,470,838
	<u>(15,231,545)</u>	<u>(11,705,840)</u>	<u>84,062,070</u>
Settlement receipts	57,006,973	57,645,300	57,887,005
Miscellaneous income	57,237	95,442	52,660
Total restricted revenues	<u>41,832,665</u>	<u>46,034,902</u>	<u>142,001,735</u>
Interest and dividend income	34,158,974	31,019,513	31,968,197
Securities lending income	212,847	316,161	172,252
Contract income	1,745,641	1,546,273	2,576,498
Total revenues	<u>77,950,127</u>	<u>78,916,849</u>	<u>176,718,682</u>
Expenditures:			
Program and grant management support	3,293,917	3,190,447	2,325,960
Statewide programs	6,712,285	5,783,327	4,943,097
Community programs	11,795,132	9,502,552	6,789,501
Evaluation services	1,368,503	1,198,831	689,175
Furniture and equipment	43,783	44,275	28,985
Research	10,599,515	11,541,727	7,217,471
Investment management fees	6,007,660	4,783,798	5,181,212
Health communications	14,657,061	13,086,444	9,491,236
General operations and administrative expenses	<u>1,630,290</u>	<u>1,264,397</u>	<u>1,003,004</u>
Total expenditures	<u>56,108,146</u>	<u>50,395,798</u>	<u>37,669,641</u>
Net changes in fund balances	21,841,981	28,521,051	139,049,041
Fund balances, beginning of year	<u>997,267,004</u>	<u>968,745,953</u>	<u>829,696,912</u>
Fund balances, end of year	<u>\$ 1,019,108,985</u>	<u>997,267,004</u>	<u>968,745,953</u>

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2016 and 2015

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>2016</i>	<i>2015</i>
Assets		
Cash and cash equivalents:		
Unrestricted cash	\$ 34,173,986	34,025,103
Restricted cash:		
Securities lending collateral	82,489,266	76,033,573
Total cash and cash equivalents	<u>116,663,252</u>	<u>110,058,676</u>
Receivables:		
Interest and dividends	3,479,330	2,962,937
Contract receivable	1,091,373	78,753
Securities lending receivable	22,784	12,158
Total receivables	<u>4,593,487</u>	<u>3,053,848</u>
Investments, at fair value:		
U.S. government securities	104,958,482	93,483,982
Foreign government securities	9,120,908	14,642,531
Domestic corporate bonds	107,744,720	105,326,004
Foreign corporate bonds	28,230,161	35,229,642
Domestic stocks	302,613,827	301,541,692
Foreign stocks	150,304,822	140,411,282
Pooled fixed income funds	102,755,140	110,071,106
Alternative investments	195,567,335	172,890,055
Total investments, at fair value	<u>1,001,295,395</u>	<u>973,596,294</u>
Securities lending collateral—non-cash	<u>39,803,195</u>	<u>21,630,365</u>
Capital assets, net of accumulated depreciation of \$149,690 and \$131,929 as of June 30, 2015 and 2014, respectively.	<u>58,520</u>	<u>42,789</u>
Total assets	<u>1,162,413,849</u>	<u>1,108,381,972</u>
Deferred outflows of resources:		
Deferred amounts related to the pension	<u>532,465</u>	<u>225,753</u>

(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>2016</i>	<i>2015</i>
Liabilities		
Net payable to brokers	12,384,335	3,491,355
Accounts payable	8,569,548	9,916,886
Liability under securities lending	122,292,461	97,663,938
Net pension liability—amount due in more than 1 year	270,441	112,570
Compensated absences:		
Payable within 1 year	65,620	60,843
Payable after 1 year	98,429	91,264
Total liabilities	<u>143,680,834</u>	<u>111,336,856</u>
Deferred inflows of resources:		
Deferred amounts related to the pension	<u>376,012</u>	<u>413,472</u>
Net Position		
Net investment in capital assets	58,520	42,789
Restricted for investment	914,652,652	871,615,601
Unrestricted	<u>104,178,296</u>	<u>125,199,007</u>
Total net position	<u>\$ 1,018,889,468</u>	<u>996,857,397</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>2016</i>	<i>2015</i>
Expenses:		
Program:		
Program and grant management support	\$ 3,293,917	3,190,447
Statewide programs	6,712,285	5,783,327
Community programs	11,795,132	9,502,552
Evaluation services	1,368,503	1,198,831
Health communications	14,657,061	13,086,444
Research	10,599,515	11,541,727
Total program expenses	<u>48,426,413</u>	<u>44,303,328</u>
Operating:		
General operations and administrative expenses	1,466,222	1,078,909
Depreciation	17,761	16,907
Total operating expenses	<u>1,483,983</u>	<u>1,095,816</u>
Total expenses	<u>49,910,396</u>	<u>45,399,144</u>
Investment income:		
Interest income	12,788,435	11,784,699
Dividend income	21,370,539	19,234,814
Securities lending income	212,847	316,161
Net (depreciation) appreciation in fair value of investments:		
Net unrealized gains and losses	(14,027,159)	(31,345,113)
Net realized gains and losses	(1,204,386)	19,639,273
	<u>(15,231,545)</u>	<u>(11,705,840)</u>
Total investment income	19,140,276	19,629,834
Investment expenses	(6,007,660)	(4,783,798)
Net investment income	<u>13,132,616</u>	<u>14,846,036</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>2016</i>	<i>2015</i>
Other income:		
Contract income	1,745,641	1,546,273
Miscellaneous income	57,237	95,442
Total other income	<u>1,802,878</u>	<u>1,641,715</u>
Changes in net position, before settlement receipts	<u>(34,974,902)</u>	<u>(28,911,393)</u>
Contribution to fund principal:		
Settlement receipts	<u>57,006,973</u>	<u>57,645,300</u>
Changes in net position	<u>22,032,071</u>	<u>28,733,907</u>
Net position, beginning of year	996,857,397	968,635,426
Cumulative change in net position to adopt GASB 68 and GASB 71 (see Note 2)	<u>-</u>	<u>(511,936)</u>
Net position, beginning of year, restated in 2015	<u>996,857,397</u>	<u>968,123,490</u>
Net position, end of year	<u>\$ 1,018,889,468</u>	<u>996,857,397</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>2016</i>	<i>2015</i>
Assets		
Cash and cash equivalents:		
Unrestricted cash	\$ 34,173,986	34,025,103
Restricted cash:		
Securities lending collateral	<u>82,489,266</u>	<u>76,033,573</u>
Total cash and cash equivalents	<u>116,663,252</u>	<u>110,058,676</u>
Receivables:		
Interest and dividends	3,479,330	2,962,937
Contract receivable	1,091,373	78,753
Securities lending receivable	<u>22,784</u>	<u>12,158</u>
Total receivables	<u>4,593,487</u>	<u>3,053,848</u>
Investments, at fair value:		
U.S. government securities	104,958,482	93,483,982
Foreign government securities	9,120,908	14,642,531
Domestic corporate bonds	107,744,720	105,326,004
Foreign corporate bonds	28,230,161	35,229,642
Domestic stocks	302,613,827	301,541,692
Foreign stocks	150,304,822	140,411,282
Pooled fixed income funds	102,755,140	110,071,106
Alternative investments	<u>195,567,335</u>	<u>172,890,055</u>
Total investments, at fair value	<u>1,001,295,395</u>	<u>973,596,294</u>
Securities lending collateral—non cash	<u>39,803,195</u>	<u>21,630,365</u>
Total assets	<u>\$ 1,162,355,329</u>	<u>1,108,339,183</u>
Liabilities and Fund Balances		
Liabilities:		
Net payable to brokers	12,384,335	3,491,355
Accounts payable	8,569,548	9,916,886
Liability under securities lending	<u>122,292,461</u>	<u>97,663,938</u>
Total liabilities	<u>143,246,344</u>	<u>111,072,179</u>
Fund balances:		
Nonspendable	914,652,652	871,615,601
Assigned	77,296,558	79,460,253
Unassigned	<u>27,159,775</u>	<u>46,191,150</u>
Total fund balances	<u>1,019,108,985</u>	<u>997,267,004</u>
Total liabilities and fund balances	<u>\$ 1,162,355,329</u>	<u>1,108,339,183</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>2016</i>	<i>2015</i>
Total fund balances, per the balance sheets—permanent fund	\$ 1,019,108,985	997,267,004
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.	58,520	42,789
Deferred outflows related to the pension are not financial resources and therefore are not reported in the funds.	532,465	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	(164,049)	(152,107)
Net pension liability	(270,441)	(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.	<u>(376,012)</u>	<u>(413,472)</u>
Net position, per the statements of net position	<u>\$ 1,018,889,468</u>	<u>996,857,397</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>2016</i>	<i>2015</i>
Revenues:		
Restricted:		
Net (depreciation) appreciation in fair value of investments:		
Net unrealized gains and losses	\$ (14,027,159)	(31,345,113)
Net realized gains and losses	<u>(1,204,386)</u>	<u>19,639,273</u>
	<u>(15,231,545)</u>	<u>(11,705,840)</u>
Settlement receipts	57,006,973	57,645,300
Miscellaneous income	<u>57,237</u>	<u>95,442</u>
Total restricted revenues	<u>41,832,665</u>	<u>46,034,902</u>
Interest income	12,788,435	11,784,699
Dividend income	21,370,539	19,234,814
Securities lending income	212,847	316,161
Contract income	<u>1,745,641</u>	<u>1,546,273</u>
Total revenues	<u>77,950,127</u>	<u>78,916,849</u>
Expenditures:		
Program and grant management support	3,293,917	3,190,447
Statewide programs	6,712,285	5,783,327
Community programs	11,795,132	9,502,552
Evaluation services	1,368,503	1,198,831
Furniture and equipment	43,783	44,275
Research	10,599,515	11,541,727
Investment management fees	6,007,660	4,783,798
Health communications	14,657,061	13,086,444
General operations and administrative expenses	<u>1,630,290</u>	<u>1,264,397</u>
Total expenditures	<u>56,108,146</u>	<u>50,395,798</u>
Net changes in fund balances	21,841,981	28,521,051
Fund balances, beginning of year	<u>997,267,004</u>	<u>968,745,953</u>
Fund balances, end of year	<u>\$ 1,019,108,985</u>	<u>997,267,004</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>2016</i>	<i>2015</i>
Net changes in fund balances, per the statements of revenues, expenditures, and changes in fund balances—permanent fund	\$ 21,841,981	28,521,051
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.	15,731	(2,449)
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.	(11,942)	3,658
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>186,301</u>	<u>211,647</u>
Changes in net position, per the statements of activities	<u>\$ 22,032,071</u>	<u>28,733,907</u>

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

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

(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.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

Investments, Continued

Generally accepted accounting principles establish a fair value hierarchy for the determination and measurement of fair value. This hierarchy is based on the type of valuation inputs needed to measure the fair value of an asset. The hierarchy generally is as follows:

1. Level 1—Unadjusted quoted prices in active markets for identical assets.
2. Level 2—Quoted prices for similar assets, or inputs that are observable or other forms of market corroborated inputs.
3. Level 3—Pricing based on best available information, including primarily unobservable inputs and assumptions market participants would use in pricing the asset.

In addition to the above three levels, if an investment does not have a readily determined fair value, the investment can be measured using (NAV) per share (or its equivalent). Investments valued at NAV are categorized as NAV and not listed as level 1, 2, or 3.

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>2016</u>	<u>2015</u>
Securities loaned:		
U.S. government securities	\$ 18,185,464	40,652,839
U.S. corporate bonds	27,840,682	21,915,184
U.S. equity	73,049,661	31,510,717
Foreign	<u>252,687</u>	<u>1,374,765</u>
Total securities loaned	<u>\$ 119,328,494</u>	<u>95,453,505</u>
Collateral maintained for securities loaned	<u>\$ 122,292,461</u>	<u>97,663,938</u>
Percentage of collateral to securities loaned as of June 30	<u>102.48%</u>	<u>102.32%</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 (U.S. currency - except for one security (EURO)), and non-cash securities. The total value of the collateral held at June 30, 2016 and 2015, was \$2,963,967 and \$2,210,433, 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, 2016, cash collateral was \$82,489,266 and non-cash collateral totaled \$39,803,195. Non-cash collateral consisted of the following:

<u>Description</u>	<u>Value</u>
U.S. government debt—Treasuries	\$ 26,848,852
U.S. government agencies (i.e., FNMA, GNMA, FMAC)	11,143,420
Foreign securities	<u>1,810,923</u>
	<u>\$ 39,803,195</u>

Securities lending income included as certified earnings was \$212,847 and \$316,161 for the fiscal years ended June 30, 2016 and 2015, 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 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. The Fund adopted this statement on July 1, 2015. Adoption of this statement resulted in presentation changes to the financial statements and revised disclosures related to the financial statements.

In June 2015, GASB issued Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments* (GASB 76). GASB 76 identifies accounting sources used to prepare state and local government financial statements in conformity with GAAP, and established a GAAP hierarchy of these resources. This Statement improves financial reporting by raising the category of GAAP Implementation Guides in the GAAP hierarchy, by emphasizing the importance of analogies to authoritative literature when an accounting event is not specified in authoritative GAAP, and by requiring the consideration of consistency with GASB Concept Statements when evaluating accounting treatments in non-authoritative GAAP. The Fund adopted this statement on July 1, 2015. The adoption had no significant impact on the Fund's financial statements.

In December 2015, GASB issued Statement No. 79, *Certain Investment Pools and Pool Participants* (GASB 79). GASB 79 establishes criteria for an external investment pool to qualify for making the election to measure all of its investments at amortized cost for financial reporting purposes. Specific criteria address (1) the way the external investment pool transacts with participants; (2) requirements for portfolio maturity, quality, diversification, and liquidity; and (3) calculation and requirements of a shadow price. The Fund adopted this statement on July 1, 2015. The adoption of this Statement had no significant impact on the financial statements.

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 January 2016, GASB issued Statement No. 80, *Blending Requirements for Certain Component Units* (GASB 80). GASB 80 amends blending requirements for the financial statements of component units to include criteria requiring blending of a component unit organized as a not-for-profit corporation in which the primary government is the sole corporate member. The Fund will adopt GASB 80 effective July 1, 2016, for the June 30, 2017, reporting year. The Fund does not expect GASB 80 to have a significant impact on the financial statements.

In March 2016, GASB issued Statement No. 81, *Irrevocable Split-Interest Agreements* (GASB 81). GASB 81 provides recognition and measurement guidance for situations in which a government is one of the beneficiaries of an irrevocable split-interest agreement. Irrevocable split-interest agreements are a type of giving by a donor to provide resources to two or more beneficiaries, including governments. GASB 81 provides the recognition and reporting requirements applicable when a government is one of the parties to such an agreement. The Fund will adopt GASB 81 effective July 1, 2017, for the June 30, 2018, reporting year. The Fund does not expect GASB 81 to have a significant impact on 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, 2016, 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 2015 BEGINNING NET POSITION

The beginning net position of the Fund as of July 1, 2014, was 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 2015 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>2016</u>	<u>2015</u>
Cash on deposit with the State	\$ 7,014,844	8,419,963
Foreign currency	918,758	408,790
Collateral from securities lending—restricted cash	82,489,266	76,033,573
Cash and equivalents	12,957,701	7,364,214
Money market mutual fund	<u>13,282,683</u>	<u>17,832,136</u>
	<u>\$ 116,663,252</u>	<u>110,058,676</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:

	2016	
	<u>Fair Value</u>	<u>Moody</u>
	<i>(Expressed in</i>	<u>Rating</u>
	<i>thousands)</i>	
U.S. government agencies (held in U.S. currency):		
U.S. Treasury bonds	\$ 16,000	AAA
U.S. Treasury notes	51,896	AAA
Federal Home Loan Mortgage Corp.	5,795	AAA
Federal National Mortgage Corp.	1,424	AAA
Government National Mortgage Association	89	AAA
Other	28,180	AAA
Other	88	Aa1
Other	766	A2
Other	721	A3
	104,959	
Corporate bonds (held in U.S. currency):		
Domestic bonds	389	(P)BA2
Domestic bonds	230	A1
Domestic bonds	2,331	A2
Domestic bonds	2,756	A3
Domestic bonds	1,560	AA1
Domestic bonds	1,648	AA2
Domestic bonds	2,088	AA3
Domestic bonds	1,160	AAA
Domestic bonds	13,591	B1
Domestic bonds	6,181	B2
Domestic bonds	6,404	B3
Domestic bonds	9,346	BA1
Domestic bonds	12,004	BA2

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

	2016	
	<u>Fair Value</u>	
	<i>(Expressed in thousands)</i>	<u>Moody Rating</u>
Corporate bonds (held in U.S. currency), Continued:		
Domestic bonds	22,713	BA3
Domestic bonds	2,562	BAA1
Domestic bonds	1,395	BAA2
Domestic bonds	5,246	BAA3
Domestic bonds	91	C
Domestic bonds	1,145	CA
Domestic bonds	3,640	CAA1
Domestic bonds	2,915	CAA2
Domestic bonds	2,791	CAA3
Domestic bonds	13	DFLT
Domestic bonds	5,545	NA/NR
	<u>107,744</u>	
Foreign corporate bonds (held in U.S. currency):		
Foreign bonds	274	A1
Foreign bonds	2,061	B1
Foreign bonds	2,360	B2
Foreign bonds	2,856	B3
Foreign bonds	1,931	BA1
Foreign bonds	2,561	BA2
Foreign bonds	2,455	BA3

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

	2016	
	<u>Fair Value</u>	
	<i>(Expressed in thousands)</i>	<u>Moody Rating</u>
Foreign corporate bonds (held in U.S. currency), Continued:		
Foreign bonds	290	BAA1
Foreign bonds	1,414	BAA2
Foreign bonds	1,941	BAA3
Foreign bonds	352	CA
Foreign bonds	978	CAA1
Foreign bonds	685	CAA2
Foreign bonds	2,192	NA/NR
	<u>22,350</u>	
Foreign corporate bonds (held in foreign currency):		
Foreign bonds	128	(P)BA3
Foreign bonds	444	A3
Foreign bonds	1,153	B1
Foreign bonds	1,301	B2
Foreign bonds	746	B3
Foreign bonds	278	BA1
Foreign bonds	421	BA2
Foreign bonds	473	BA3
Foreign bonds	65	BAA3
Foreign bonds	230	CAA1
Foreign bonds	641	NR
	<u>5,880</u>	

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

	2016	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody</u> <u>Rating</u>
Foreign government bonds (held in U.S. currency):		
Foreign government bonds	194	B1
Foreign government bonds	741	B3
Foreign government bonds	442	Ba2
Foreign government bonds	216	Ba3
Foreign government bonds	1,173	Baa2
Foreign government bonds	1,326	Baa3
	<u>4,092</u>	
Foreign government bonds (held in foreign currency):		
Foreign government bonds	1,545	A3
Foreign government bonds	214	B1
Foreign government bonds	218	B2
Foreign government bonds	424	Ba1
Foreign government bonds	2,623	Ba2
Foreign government bonds	5	Baa2
	<u>5,029</u>	
Total fair value of credit risk	<u>\$ 250,054</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

	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 thousands)</i>	<u>Moody 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> (Expressed in thousands)	<u>Moody</u> <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	<u>1,672</u>	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	<u>3,202</u>	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.

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, 2016 or 2015, except for \$102,755,139 and \$110,071,106 invested in the Pooled Fixed Income Fund at June 30, 2016 and 2015, respectively. 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.

	<u>2016</u>	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	Effective Duration <u>Years</u>
U.S. government securities (government guaranteed):		
U.S. Treasury bonds	\$ 16,000	20.62
U.S. Treasury notes	51,896	4.12
Federal National Mortgage Association—FHR	13,515	3.06
Federal National Mortgage Association—FNR	14,266	3.07
Government National Mortgage Association	89	1.38
GNR	399	7.42
Other	1,575	3.01
Foreign government securities:		
Foreign government bonds (held in U.S. currency)	4,092	20.97
Foreign government bonds (held in foreign currency)	5,029	12.71
Mortgage-backed securities:		
Federal Home Loan Mortgage Corp.	5,795	1.53
Federal National Mortgage Corp.	1,424	1.95
Corporate bonds:		
Domestic bonds (held in U.S. currency)	107,744	4.94
Foreign bonds (held in U.S. currency)	22,350	4.95
Foreign bonds (held in foreign currency)	5,880	3.60
	<u>\$ 250,054</u>	

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Interest Rate Risk, Continued

	2015	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	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)	5,880	3.83
	<u>\$ 248,682</u>	
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

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.

	2016	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Type</u>
Foreign currency:		
Argentina peso	\$ 944	Fixed income
Armenian Dram	214	Fixed income
Australian dollar	2,972	Equity
Australian dollar	499	Fixed income
Australian dollar	112	Foreign currency
Bermuda dollar	4,255	Equity
Bermuda dollar	1,204	Fixed income
Brazilian real	4,949	Equity
Brazilian real	3,065	Fixed income
Brazilian real	142	Foreign currency
British pound sterling	21,924	Equity
British pound sterling	6,383	Fixed income
British pound sterling	371	Foreign currency
Canadian dollar	6,701	Equity
Canadian dollar	3,063	Fixed income
Cayman dollar	6,817	Equity
Cayman dollar	1,679	Fixed income
CFA Franc Bceao	216	Fixed income
Colombian peso	1,265	Fixed income
Euro	36,204	Equity
Euro	12,774	Fixed income
Euro	40	Foreign currency
Hong Kong dollar	6,679	Equity
Hong Kong dollar	35	Foreign currency
Indian rupee	2,003	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

	2016	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Type</u>
Foreign currency, Continued:		
Indonesian rupiah	1,548	Equity
Indonesian rupiah	1,326	Fixed income
Japanese yen	23,546	Equity
Kenyan Shilling	194	Fixed income
Lempira	218	Fixed income
Mexican nuevo peso	2,465	Fixed income
Mexican nuevo peso	219	Foreign currency
Moroccan Dirham	543	Fixed income
Netherlands Antillian Guilder	331	Fixed income
New Israeli sheqel	8,002	Equity
New Taiwan dollar	4,031	Equity
Norwegian krone	3,882	Equity
Peruvian nuevo sol	290	Fixed income
Philippines Peso	254	Fixed income
Russian Ruble	424	Fixed income
South Korean Won	1,461	Equity
Swedish Krona	2,254	Equity
Swiss franc	11,145	Equity
Thai baht	1,932	Equity
	<u>\$ 188,575</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

	2015	
	<u>Fair Value</u> (Expressed in thousands)	<u>Type</u>
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> <i>(Expressed in thousands)</i>	<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 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>	

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, 2016, the average duration of the portfolio of the Pooled Fixed Income Fund was (0.02) years, the average maturity was 2.6 years, the yield to maturity was 1.7%, and the average asset quality was Aa2. 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, the Pooled Fixed Income Fund primarily consisted of:

	<u>Fixed Income Securities</u>	
	<u>2016</u>	<u>2015</u>
Corporate	25%	38%
Asset-backed	3%	4%
Government-related	3%	2%
Cash and cash equivalents	15%	11%
Treasury	46%	40%
Mortgage-backed	8%	3%
Non-US dollar	0%	2%

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 1.62% and 1.72% of the total portfolio of the Pooled Fixed Income Fund at June 30, 2016 and 2015, respectively.

Investments Measured at Fair Value

TSET categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. TSET has the following recurring fair value measurements as of June 30:

	Amounts Measured at Fair Value	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>June 30, 2016</i>				
<u>Investments Measured at Fair Value</u>				
U.S. government securities	\$ 104,958,482	72,248,849	32,709,633	-
Foreign government securities	9,120,908	-	9,120,908	-
Domestic corporate bonds	107,744,720	-	106,373,603	1,371,117
Foreign corporate bonds	28,230,161	-	28,230,161	-
Domestic stocks	302,613,827	298,201,123	4,412,704	-
Foreign stocks	150,304,822	147,185,353	-	3,119,469
Pooled fixed income funds	102,755,140	-	-	102,755,140
Alternative investments	44,413,382	44,413,382	-	-
	<u>850,141,442</u>	<u>562,048,707</u>	<u>180,847,009</u>	<u>107,245,726</u>
Alternative investments measured at NAV:				
Core real estate	81,712,253			
Non-real estate	69,441,700			
	<u>151,153,953</u>			
Total investments at fair value	<u>\$ 1,001,295,395</u>	<u>562,048,707</u>	<u>180,847,009</u>	<u>107,245,726</u>

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Investments Measured at Fair Value, Continued

		Fair Value Measurements at		
		Reporting Date Using		
		Quoted Prices	Significant	Significant
		in Active	Other	Unobservable
		Markets for	Observable	Inputs
		Identical	Inputs	Inputs
		Assets	(Level 2)	(Level 3)
	Amounts	(Level 1)		
	Measured at			
	Fair Value			
<i>June 30, 2015</i>				
<u>Investments Measured at Fair Value</u>				
U.S. government securities	\$ 93,483,982	64,078,568	29,405,414	-
Foreign government securities	14,642,531	-	14,642,531	-
Domestic corporate bonds	105,326,004	525,150	104,800,854	-
Foreign corporate bonds	35,229,642	-	35,229,642	-
Domestic stocks	301,541,692	301,503,100	38,592	-
Foreign stocks	140,411,282	136,886,324	-	3,524,958
Pooled fixed income funds	110,071,106	-	-	110,071,106
Alternative investments	44,390,678	44,390,678	-	-
	<u>845,096,917</u>	<u>547,383,820</u>	<u>184,117,033</u>	<u>113,596,064</u>
Alternative investments measured at NAV:				
Core real estate	54,899,066			
Non-real estate	73,600,311			
	<u>128,499,377</u>			
Total investments at fair value	<u>\$ 973,596,294</u>	<u>547,383,820</u>	<u>184,117,033</u>	<u>113,596,064</u>

Debt and equity securities and alternative investments in Level 1 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. Debt and equity securities classified in Level 2 of the fair value hierarchy are inputs, other than quoted prices included within Level 1, which are observable either directly or indirectly.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Investments Measured at Fair Value, Continued

Alternative investments that are not classified as Level 1 investments are carried at the NAV of the fund as provided by the administrator or general partner as these investments do not have a readily determinable fair value. 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) a proportionate share of the net assets is attributed to member units or an ownership interest in partners' capital. 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.

Fair Value of Private Equity—The Fund participates in a number of private equity partnerships as a limited partner. Private equity investments are structured to be operated by a general partner, usually highly experienced in the specific focus of the partnership, who calls for investments from the limited partners when a suitable investment opportunity arises. As such, investments in private equity can generally never be redeemed, but instead participate in distributions from the partnership as liquidation of the underlying assets are realized.

The Fund's private equity (PE) investments have a long investment horizon of 5 to 10 years, are not liquid, and the Fund generally holds this type of investment to maturity. Depending on the type of holdings within a given partnership, the investment horizon can be extended if the general partner deems the remaining investments in the fund still hold significant future value and a majority of limited partners concur. The Fund's PE general partners typically make fair value determinations on the investments in each of their respective funds quarterly using a variety of pricing techniques including, but not limited to, observable transaction values for similar investments, third-party bids, appraisals of both properties and businesses, and public market capitalization of similar or like businesses. Each PE fund then calculates the fair value of the Fund's ownership of the partners' capital on a quarterly basis. Although most PE interests are marketable in a secondary market, the Fund generally does not sell its interests early at values less than its interest in the partnership.

Additional information on alternative investments are described in Note 5.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(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, 2016 and 2015. 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, 2016		
	<u>Expiration Date</u>	<u>Long/Short</u>	<u>Notional/ Fair Value</u> <i>(Expressed in thousands)</i>
U.S. 10-year note	September 2016	Short	\$ (7,713)
U.S. 5-year note	September 2016	Short	\$ 10,383
Euro BVX1 30-year bond	September 2016	Short	\$ (218)
U.S. long bond	September 2016	Short	\$ 345
U.S. Ultra bond	September 2016	Short	\$ (4,473)

	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	\$ (1,009)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(4) DERIVATIVES, CONTINUED

Foreign Currency Forward Contracts

	June 30,	
	<u>2016</u>	<u>2015</u>
	<i>(Expressed in thousands)</i>	
Pending receivable	\$ 19,094	29,736
Pending payable	<u>(19,060)</u>	<u>(29,774)</u>
Foreign currency forward contracts (liability) asset	\$ <u>34</u>	<u>(38)</u>

As of June 30, 2016, the foreign currency forward contracts expire in July 2016, August 2016, and September 2016. During the years ended June 30, 2016 and 2015, realized (losses) gains on foreign currency contracts were approximately \$(88,220) and \$4,140,060, 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 including limited partnerships as follows:

2016			
<u>Company</u>	<u>Fair Value</u>	<u>Unfunded Commitment</u>	<u>Purpose</u>
<u>Real Estate</u>			
AEW Core Property Trust, Inc.	\$ 30,975,622	-	Real estate investment trust.
AEW VII	5,266,660	4,178,759	Real estate investment trust.
Siguler Guff	23,293,136	12,302,500	Investments in distressed opportunities in commercial real estate.
UBS Trumbull	<u>22,176,835</u>	-	Real estate investment trust.
	<u>81,712,253</u>	<u>16,481,259</u>	
<u>Fund of Funds</u>			
PIMCO All Asset Fund	<u>44,413,382</u>	-	Fund invests in other PIMCO funds (A fund of funds).
<u>Other</u>			
Medley Opportunity Fund II L.P.	37,287,841	1,332,729	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
SJC Offshore (Frontpoint)	3,019,585	2,292,987	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
SJC Offshore II (Frontpoint)	8,996,660	2,600,213	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
SJC Onshore	<u>20,137,614</u>	<u>3,021,315</u>	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
	<u>69,441,700</u>	<u>9,247,244</u>	
Total alternative investments	<u>\$ 195,567,335</u>	<u>25,728,503</u>	

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(5) ALTERNATIVE INVESTMENTS, CONTINUED

2015			
<u>Company</u>	<u>Fair Value</u>	<u>Unfunded Commitment</u>	<u>Purpose</u>
<u>Real estate</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.
Siguler Guff	12,493,221	22,225,000	Investments in distressed opportunities in commercial real estate.
UBS Trumbull	<u>10,824,056</u>	<u>-</u>	Real estate investment trust.
	<u>54,899,066</u>	<u>27,826,769</u>	
<u>Fund of Funds</u>			
PIMCO All Asset Fund	<u>44,390,678</u>	<u>-</u>	Fund invests in other PIMCO funds (A fund of funds).
<u>Other</u>			
SJC Offshore (Frontpoint)	3,908,103	2,386,967	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
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.
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	<u>19,342,065</u>	<u>20,345,455</u>	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
	<u>73,600,311</u>	<u>32,144,807</u>	
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

(6) CAPITAL ASSETS

The following is a summary of changes in capital assets:

	<u>Balance at June 30, 2015</u>	<u>Additions</u>	<u>Disposals</u>	<u>Balance at June 30, 2016</u>
Depreciable capital assets:				
Office equipment and furnishings	\$ 174,718	33,492	-	208,210
Accumulated depreciation:				
Office equipment and furnishings	<u>(131,929)</u>	<u>(17,761)</u>	<u>-</u>	<u>(149,690)</u>
Capital assets, net	<u>\$ 42,789</u>	<u>15,731</u>	<u>-</u>	<u>58,520</u>

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

(7) CHANGES IN COMPENSATED ABSENCES

Compensated absence activity was as follows:

<u>Balance at June 30, 2015</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance at June 30, 2016</u>	<u>Amounts Due Within 1 Year</u>
<u>\$ 152,107</u>	<u>97,931</u>	<u>(85,989)</u>	<u>164,049</u>	<u>65,620</u>

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

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(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, \$84,186, \$1,041,808, and \$7,620,259 was certified in the November 2015, 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 \$34,152,594.

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.

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 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.

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.

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 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.

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

	2016				<u>Total</u>
	<u>Nonspendable</u>	Assigned Available for Expenditure but <u>Uncertified</u>	Assigned Available for Expenditure and <u>Certified</u>	<u>Unassigned</u>	
Balance at June 30, 2015	\$ 871,615,601	34,152,594	45,307,659	46,191,150	997,267,004
Estimated Transfer—2016— 5% cap	-	(22,537,652)	22,537,652	-	-
Settlement receipts	57,006,973	-	-	-	57,006,973
Net unrealized losses on investments	(14,027,159)	-	-	-	(14,027,159)
Miscellaneous income	57,237	-	-	-	57,237
Contract income	-	-	-	1,745,642	1,745,642
Expendable earnings, including net realized losses on investments	-	-	-	27,159,775	27,159,775
Program and operating expenses	-	-	-	(50,100,487)	(50,100,487)
Transfer—estimate of certified earnings for 2016	-	-	(2,163,695)	2,163,695	-
Balance at June 30, 2016	<u>\$ 914,652,652</u>	<u>11,614,942</u>	<u>65,681,616</u>	<u>27,159,775</u>	<u>1,019,108,985</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

	2015				
	<u>Nonspendable</u>	<u>Assigned Available for Expenditure but Uncertified</u>	<u>Assigned Available for Expenditure and 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—2015—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>

The amount of earnings available for certification for the period ended June 30, 2016, was \$27,159,775, which is below 5% of the corpus of the fund.

At their August 24, 2016, meeting, the Board of Investors certified \$26,330,290, 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 2016 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 2016 and 2015 as noted in the above reconciliation are as follows:

2016

- The transfer of \$22,537,652 was to adjust the certification to equal the 5% cap for 2016.
- The transfer of \$2,449,638 was to adjust the unassigned balance to the estimate of certified earnings at June 30, 2016, before the 5% cap adjustment.

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.

(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 2016, 2015, and 2014, *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 2016, 2015, and 2014 were as follows:

	<u>2016</u>	<u>2015</u>	<u>2014</u>
\$	<u>226,292</u>	<u>219,311</u>	<u>171,427</u>

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

At June 30, 2016, the Fund reported a liability for its proportionate share of the net pension liability. The net pension liability was measured as of June 30, 2015, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of July 1, 2015. 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, 2015. Based upon this information, the Fund's proportion was .07518864%.

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, 2016, the Fund recognized pension expense of \$38,991. At June 30, 2016, the Fund reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Differences between expected and actual experience	\$ -	30,070
Changes of assumptions	4,207	-
Proportionate changes	79,698	-
Net difference between projected and actual earnings on pension plan investments	223,268	345,942
Fund contributions subsequent to the measurement date	<u>225,292</u>	<u>-</u>
	<u>\$ 532,465</u>	<u>376,012</u>

Reported deferred outflows of resources of \$225,292 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, 2017. 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:	
2017	\$ (42,101)
2018	(26,912)
2019	(55,642)
2020	<u>55,816</u>
	<u>\$ (68,839)</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, 2015, 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, 2015, 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:

Asset Class	Target Asset Allocation	Long-Term Expected Real Rate of Return
U.S. large cap equity	38.0%	5.3%
U.S. small cap equity	6.0%	5.6%
U.S. fixed income	25.0%	0.7%
International stock	18.0%	5.6%
Emerging market stock	6.0%	6.4%
TIPS	3.5%	0.7%
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 2114 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 <u>(6.5%)</u>	Current Discount Rate <u>(7.5%)</u>	1% Increase <u>(8.5%)</u>
Net pension liability (asset)	\$ <u>1,007,734</u>	<u>270,441</u>	<u>(356,374)</u>

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, 2016 and 2015. 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 part of the 2013 NPM Adjustment Arbitration 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. Once the agreement has been finalized, the State may 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.

See Independent Auditors' Report.

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

TOBACCO SETTLEMENT ENDOWMENT TRUST

**SCHEDULE OF THE FUND'S PROPORTIONATE SHARE OF
THE NET PENSION LIABILITY
Oklahoma Public Employees Retirement Plan**

Last 2 Fiscal Years

	<u>2016</u> *	<u>2015</u> *
Fund's proportion of the net pension liability	0.07518864%	0.06132439%
Fund's proportional share of the net pension liability	\$ 270,441	112,570
Fund's covered payroll	1,329,158	1,038,952
Fund's proportionate share of the net pension liability as a percentage of its covered payroll	18.09%	10.83%
OPERS' fiduciary net position as a percentage of the total pension liability	96.00%	97.90%

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

Only the last 2 fiscal years are 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 6 Fiscal Years

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>
Contractually required contribution	\$ 225,292	219,311	171,427	129,208	103,380	70,367
Contributions in relation to the contractually required contribution	<u>225,292</u>	<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>	<u>-</u>
Fund's covered payroll	\$ 1,365,406	1,329,158	1,038,952	783,079	626,545	453,981
Contributions as a percentage of covered payroll	16.50%	16.50%	16.50%	16.50%	16.50%	15.50%

Only the last 6 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, 2016, 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, 2016. 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. 72 by the Fund. 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, 2016