

# **Tobacco Settlement Endowment Trust Fund**

## *Financial Statements*

June 30, 2014 and 2013  
(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 component unit of the State of Oklahoma, as of and for the years ended June 30, 2014 and 2013, 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, 2014 and 2013, 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, 2014 and 2013, 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.

### **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-15 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, 2014, 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.

Shawnee, Oklahoma  
September 29, 2014

DRAFT

## **TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

### **MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)**

**June 30, 2014 and 2013**

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, 2014 and 2013. 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 7) 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, 2014 and 2013

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 28, 2014, meeting, the Board of Investors certified \$52,650,762, reserving \$779,314 for possible audit adjustments. The estimated earnings available for certification for the period ended June 30, 2014, were \$53,430,075.

#### **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, 2014 and 2013

### 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 2014, 2013, and 2012 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>2014</u>	<u>2013</u>	<u>2012</u>
<b>Assets</b>			
Current assets	\$ 138,930,511	162,403,184	79,651,734
Investments, at fair value	923,128,052	789,995,839	672,315,506
Securities lending collateral—non cash	21,992,588	-	-
Capital assets	45,238	42,201	58,589
Total assets	<u>1,084,096,389</u>	<u>952,441,224</u>	<u>752,025,829</u>
<b>Liabilities</b>			
Current liabilities	9,448,427	16,151,201	12,124,274
Liability under securities lending	105,919,077	106,599,991	34,157,133
Noncurrent liabilities	93,459	73,622	62,983
Total liabilities	<u>115,460,963</u>	<u>122,824,814</u>	<u>46,344,390</u>
<b>Net Assets</b>			
Net investment in capital assets	45,238	42,201	58,589
Restricted for investment	845,219,972	729,689,075	613,868,427
Unrestricted	<u>123,370,216</u>	<u>99,885,134</u>	<u>91,754,423</u>
Total net position	<u>\$ 968,635,426</u>	<u>829,616,410</u>	<u>705,681,439</u>

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

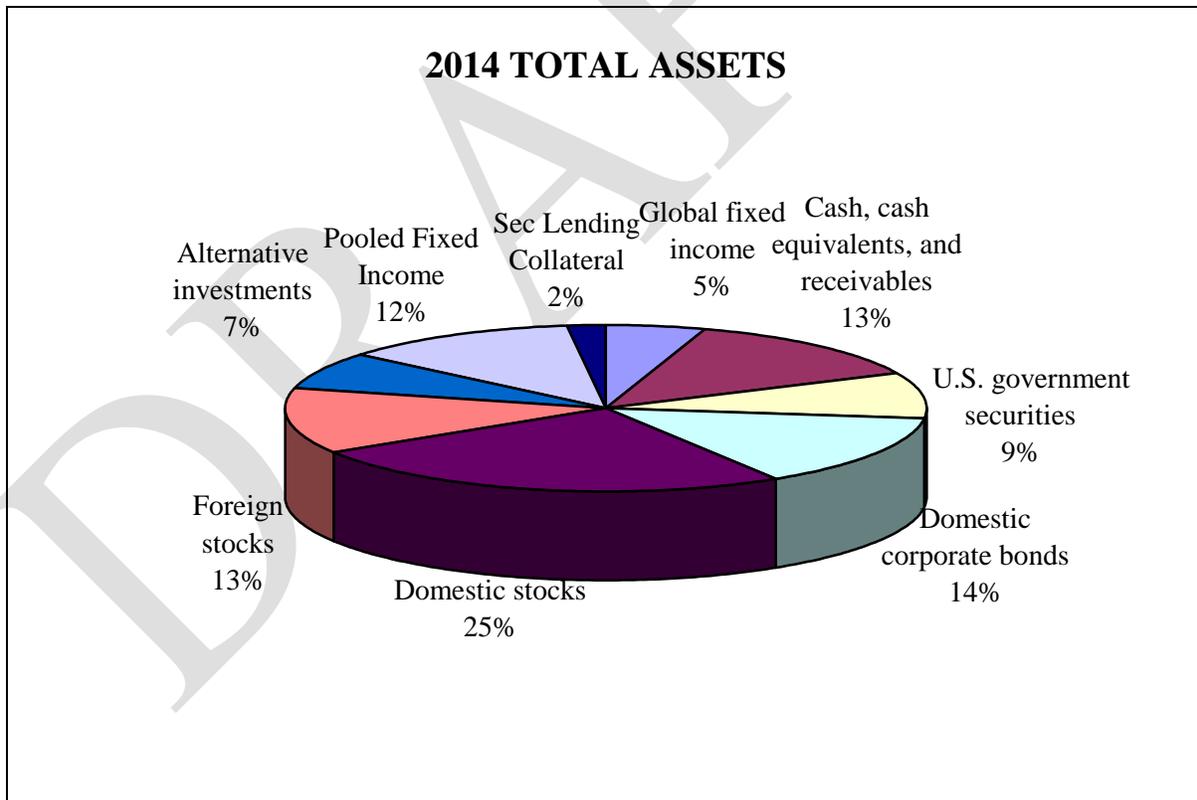
June 30, 2014 and 2013

### FINANCIAL HIGHLIGHTS, CONTINUED

#### Statements of Net Position, Continued

The Fund's total net position increased \$139.0 million during the year, as the Fund invested an additional \$57.9 million in settlement receipts, recognized \$111.0 million as net investment income, and expended \$32.5 million on programs and operations. Total investments increased from \$790.0 million at the beginning of the year to \$923.1 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 \$84.8 million from the net appreciation of the fair value of the portfolio and earned \$26.8 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 \$83.9 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.



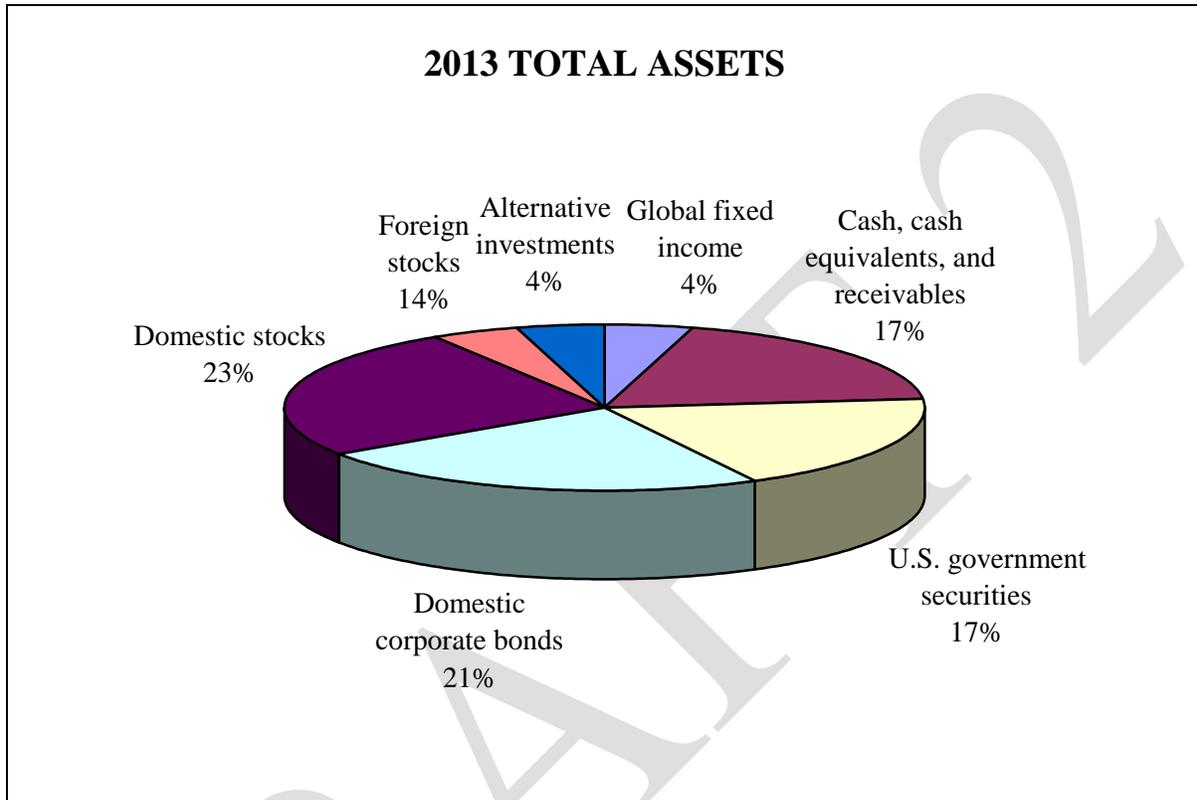
**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2014 and 2013**

**FINANCIAL HIGHLIGHTS, CONTINUED**

**Statements of Net Position, Continued**



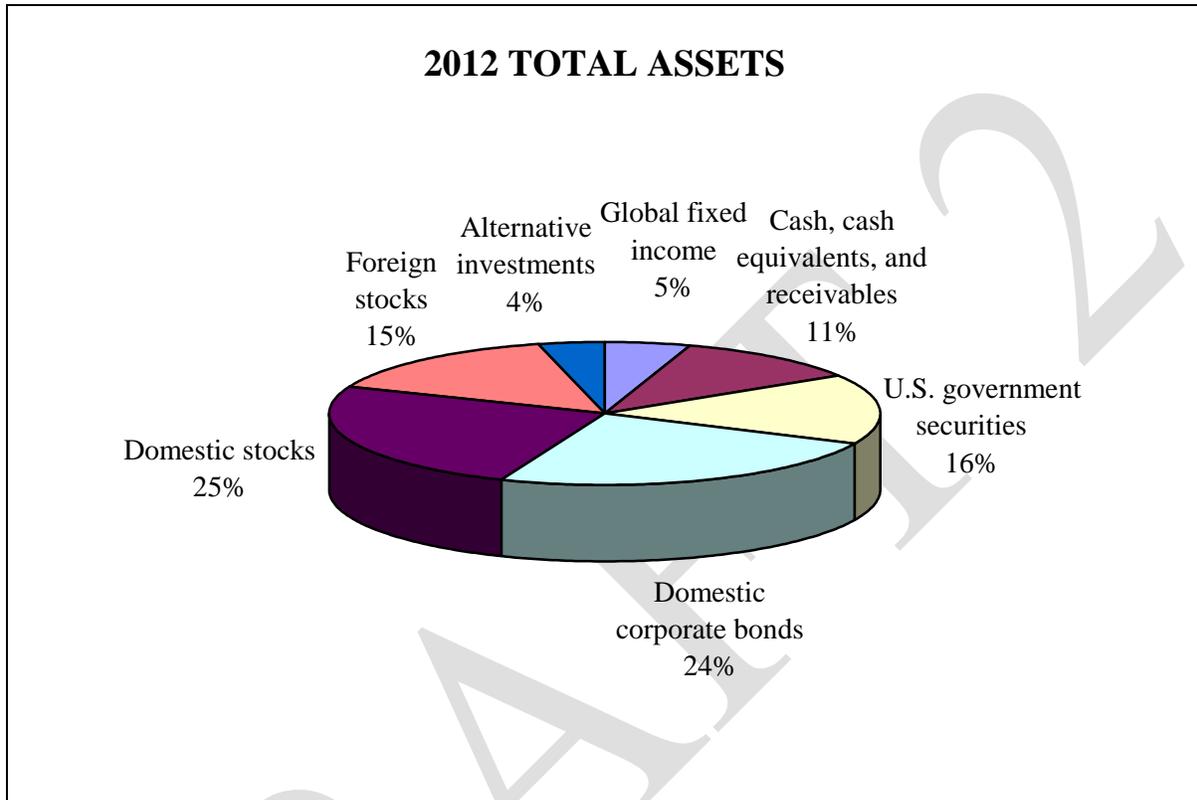
**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2014 and 2013**

**FINANCIAL HIGHLIGHTS, CONTINUED**

**Statements of Net Position, Continued**



**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2014 and 2013**

**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>2014</u>	<u>2013</u>	<u>2012</u>
<b>Investment income:</b>			
Interest and dividend income	\$ 31,968,197	25,867,677	21,098,140
Securities lending income	172,252	84,424	63,106
Net appreciation (depreciation) in fair value of investments:			
Net unrealized gains and losses	57,591,232	30,751,892	(16,818,932)
Net realized gains and losses	26,470,838	16,183,796	7,029,702
	<u>84,062,070</u>	<u>46,935,688</u>	<u>(9,789,230)</u>
Total investment income	116,202,519	72,887,789	11,372,016
Investment expenses	(5,181,212)	(3,846,879)	(2,466,949)
Net investment income	<u>111,021,307</u>	<u>69,040,910</u>	<u>8,905,067</u>
<b>Other income:</b>			
Contract income	2,576,498	2,445,750	6,760,907
Miscellaneous income	52,660	11,451	36,714
Total other income	<u>2,629,158</u>	<u>2,457,201</u>	<u>6,797,621</u>
<b>Expenses:</b>			
Program	31,456,440	30,963,704	28,748,606
Operating	1,062,014	1,656,741	1,442,454
Total expenses	<u>32,518,454</u>	<u>32,620,445</u>	<u>30,191,060</u>
Changes in net position before settlement receipts	81,132,011	38,877,666	(14,488,372)
<b>Contribution to fund principal:</b>			
Settlement receipts	57,887,005	85,057,305	58,062,948
Changes in net position	139,019,016	123,934,971	43,574,576
Net position, beginning of year	<u>829,616,410</u>	<u>705,681,439</u>	<u>662,106,863</u>
Net position, end of year	<u>\$ 968,635,426</u>	<u>829,616,410</u>	<u>705,681,439</u>

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

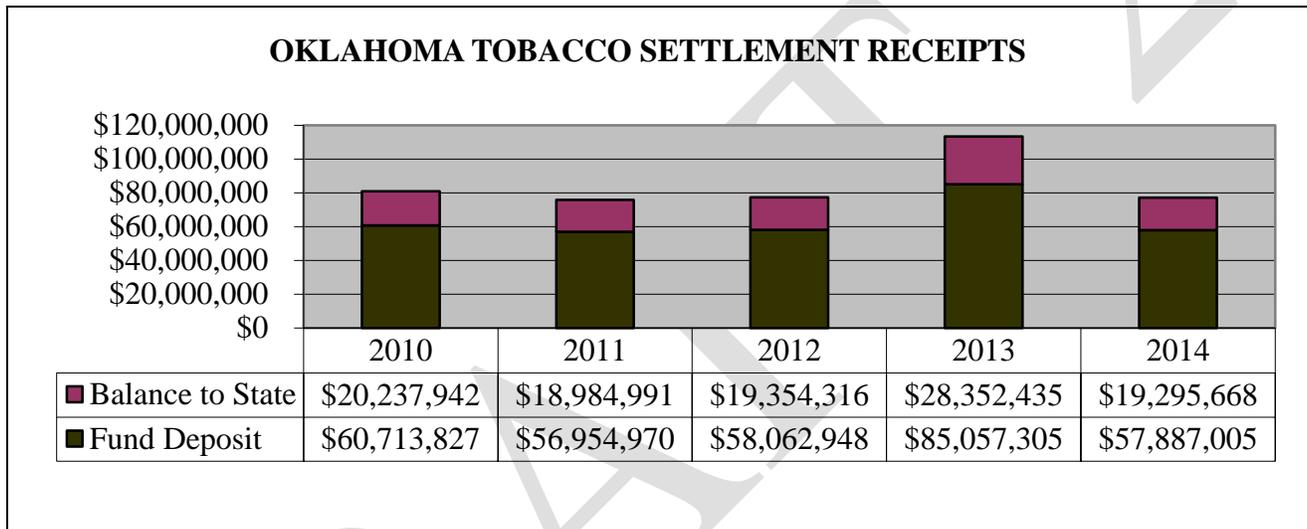
**MANAGEMENT’S DISCUSSION AND ANALYSIS (MD&A), CONTINUED**

**June 30, 2014 and 2013**

**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, 2014 and 2013, 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 \$27,170,300 from 2013.



There is no major change in settlement receipts from 2013. The additional \$27.1 million received in 2013 was due to the settlement of disputed amounts.

The major reason for the increase in settlement receipts over 2012 was the settlement of disputed amounts in April 2013. In prior years, the State had not received all monies, as disputed amounts were not distributed. As discussed in Note 11, this was resolved during 2013. Approximately \$27.1 million of the 2013 increase was due to this dispute being resolved.

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.

## TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2014 and 2013

#### FINANCIAL HIGHLIGHTS, CONTINUED

##### Statements of Activities—Income and Expenses, Continued

As settlement receipts were deposited and invested and the portfolio was diversified during the fiscal year ended June 30, 2014, net investment income increased by \$42.0 million. Interest and dividend income increased \$6.1 million, while the net appreciation of investment in the Fund's portfolio increased \$37.1 million. Fees paid to investment managers, consultants, and custodians increased \$1.3 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.

The Board of Directors adopted a strategic plan to maximize the impact of the limited earnings available in the early years of the agency by focusing on reducing tobacco use in Oklahoma. In 2010, the Board of Directors updated the strategic plan to emphasize three primary areas of funding: Prevention, Research, and Emerging Opportunities. Prevention programs focus on reducing cancer and cardiovascular disease, Oklahoma's leading causes of death, through comprehensive programs addressing the three leading causes of each: tobacco use, physical inactivity, and poor nutrition. Research focuses 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, 2014, the Board of Directors increased program funding by more than \$4.7 million (from \$35,800,628 in FY 13 to \$40,592,962 in FY 14, using a combination of certified earnings, carryover, and income from other state agencies. The administration budget was 3% of certified earnings. By statute, the administration budget is capped at 15% of certified earnings.

##### *Prevention*

In data released in FY 2014, the rate of smoking among Oklahoma adults was at a historic low, and for the first time Oklahoma was ranked 39<sup>th</sup> among states in smoking prevalence. This accomplishment comes after a decade of community based grants, evidence cessation services and constant collaboration to ensure that best practices are used to prevent and reduce tobacco use in Oklahoma.

## TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2014 and 2013

#### FINANCIAL HIGHLIGHTS, CONTINUED

#### Statements of Activities—Income and Expenses, Continued

##### *Prevention, Continued*

In FY 2014, the Board of Directors continued an agreement in the amount of \$5 million with Alere Wellbeing, Inc., provider of the telephone- and web-based Oklahoma Tobacco Helpline (1-800-QUIT NOW or okhelpline.com) services to all Oklahomans with a desire to quit tobacco use. The Helpline is collaboratively funded by the Fund, the Oklahoma State Department of Health (OSDH), Centers for Disease Control and Prevention (CDC), the Oklahoma Employees Group Insurance Division (EGID), and the Oklahoma Health Care Authority (OHCA). In FY 2014, the Oklahoma Tobacco Helpline was ranked No. 1 in the North American Quitline Consortium for reaching tobacco users in need of treatment. In FY 2014, Alere Wellbeing, Inc. also continued to employ Oklahoma workers as “Quit Coaches” to assist tobacco users in 27 states and over 400 commercial clients.

The Board of Directors continued two agreements with state agencies for Helpline services, evaluation, and administrative services. The agreement with the OSDH was for \$750,000 in FY 2014. The agreement with the EGID provides additional Helpline services for HealthChoice insurance beneficiaries. Revenue from this agreement is based on utilization. Total revenue from this agreement was approximately \$65,000 for FY 2014. Funds from these agreements are restricted for the purpose of the Helpline, evaluation, and an administrative fee.

Agreements with the OHCA to offer Helpline services to beneficiaries of the SoonerCare Medicaid plan and Insure Oklahoma participants continued in FY 2014. Revenue from this agreement was \$200,000.

In FY 2014, the Board of Directors continued to invest in best practice health communication plans and continue 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 \$300,000 for each of the last two years (FY 2013 and FY 2012, respectively).

During FY 2014, the Board of Directors also continued funding for comprehensive community-based programs across the state of Oklahoma to implement programs to prevent initiation to tobacco products among youth, to promote quitting among youth and adults, to reduce exposure to secondhand smoke, and to reduce tobacco-related health disparities. Through FY 2014, 50 counties and one tribal nation were served under the comprehensive community grants program.

## TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2014 and 2013

#### FINANCIAL HIGHLIGHTS, CONTINUED

#### Statements of Activities—Income and Expenses, Continued

##### *Prevention, Continued*

In July 2011, 15 five-year “Communities of Excellence in Nutrition and Fitness” grants were awarded to plan interventions to increase physical activity and healthy nutrition within 21 counties. To support the new initiative, the Board of Directors also continued agreements with the Oklahoma State Department of Health, Center for the Advancement of Wellness, to provide training and technical assistance to grantees. In addition, another agreement, with the Oklahoma State University Department of Nutrition Sciences for evaluation of the program, was continued.

In FY 2012, the Board of Directors expanded the agreement with the Oklahoma State Department of Health (OSDH) to provide incentive grants to communities to encourage them to become Certified Healthy Communities. The original agreement provided \$3.5 million to be utilized by the Fund over the course of 3 years. The agreement was expanded in FY 2012 to provide incentive grants to school districts to encourage their school sites to become Certified Healthy Schools. The total of both agreements was \$8.5 million. In FY 2012, 14 communities received grant awards. In FY 2013, 21 communities and 26 school districts received grant awards. In FY 2014, five schools received incentive grant awards and several communities were pursuing grant applications.

Three Health Systems Initiative (HSI) grantees entered their first year of a five year continuation grant beginning FY 2014. Under the HSI program, the Oklahoma Health Care Authority, the Oklahoma Hospital Association, and the Oklahoma Department of Mental Health and Substance Abuse Services work to implement a best practice intervention to address tobacco, nutrition, and physical activity (as appropriate) among hospitalized patients, Medicaid beneficiaries, and to infuse tobacco dependence treatment, nutrition and physical activity into routine mental health and substance abuse treatment programs.

##### *Research*

In FY 2012, the Board of Directors committed \$30.25 million to the Peggy and Charles Stephenson Cancer Center (SCC) to create the TSET Cancer Research Program, expanding access to Phase I Clinical Trials and leveraging additional dollars to recruit scientists as TSET Cancer Research Scholars. In FY 2014, the Stephenson Cancer Center had expanded its Phase I Clinical Trials to include a network of health care providers across the state. Nearly every Oklahoma county was represented in the clinical trial patient census. The FY 2014 budget was \$6.1 million.

The Board of Directors also approved a second five-year agreement to continue the work of the Oklahoma Tobacco Research Center (OTRC) to fund research projects and recruit scientists and TSET Research Scholars to reduce cancer and other tobacco-related diseases in Oklahoma. FY 2014 budget was \$1.4 million.

## TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2014 and 2013

#### FINANCIAL HIGHLIGHTS, CONTINUED

#### Statements of Activities—Income and Expenses, Continued

##### *Research, Continued*

In FY 2012, the Board of Directors also expanded funding for the Oklahoma Center for Adult Stem Cell Research (OCASCR), which was established in FY 2010 with an initial \$500,000 investment. OCASCR is governed by the research directors of the Oklahoma Medical Research Foundation, the University of Oklahoma, and Oklahoma State University, with the Oklahoma Medical Research Foundation serving as the fiscal agent. The original agreement for \$5.5 million over 5½ years was amended to increase the budgets for FY 2012–FY 2015 to \$2 million per year. The FY 2014 budget was \$2.2 million.

##### *Emerging Opportunities*

The “Unsolicited Proposals” program provides an opportunity for organizations to proactively submit a proposal related to any of the program areas listed in the constitutional amendment that created the Fund, instead of reactively applying for funding in response to a “Request for Proposals.” In FY 2014, the Board of Directors funded two new proposals that add to TSET’s investment in promoting physical activity and improved nutrition. TSET funded a 10-year program to institute FitnessGram, a fitness assessment tool, in Oklahoma schools that volunteer to participate in the program. FY 2014 was the first year of the program and schools are expected to implement the program in FY 2015. The Board of Directors also funded a proposal from the Oklahoma City Boathouse Foundation. The agreement with the Oklahoma City Boathouse Foundation seeks to increase awareness and availability of physical activity statewide.

Three unsolicited grants, which were funded in FY 2012, were in the final year of their grants during FY 2014: the Oklahoma after School Network, the Oklahoma State University Dining Services, and the Oklahoma Child Care Association. The grants are designed to create afterschool standards (including tobacco prevention, nutrition, and fitness); menu labeling and improved nutrition among college students; and address tobacco, nutrition, and fitness within child care centers, respectively.

##### *Conference Sponsorships*

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

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2014 and 2013**

**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>2014</u>	<u>2013</u>	<u>2012</u>
<b>Assets:</b>			
Cash and cash equivalents	\$ 134,127,250	158,232,019	75,465,761
Interest and dividends receivable	3,908,317	3,956,231	4,119,127
Contract receivable	862,034	204,424	62,441
Securities lending receivable	32,910	10,510	4,405
Securities lending collateral—non cash	21,992,588	-	-
Investments at fair value	<u>923,128,052</u>	<u>789,995,839</u>	<u>672,315,506</u>
Total assets	<u>\$ 1,084,051,151</u>	<u>952,399,023</u>	<u>751,967,240</u>
<b>Liabilities:</b>			
Net payable to brokers	\$ 3,784,389	6,967,044	1,641,621
Accounts payable	5,601,732	9,135,076	10,440,664
Liability under securities lending	<u>105,919,077</u>	<u>106,599,991</u>	<u>34,157,133</u>
Total liabilities	<u>115,305,198</u>	<u>122,702,111</u>	<u>46,239,418</u>
<b>Fund Balances:</b>			
Nonspendable	845,219,972	729,689,075	613,868,427
Assigned	70,095,906	60,952,331	66,135,396
Unassigned	<u>53,430,075</u>	<u>39,055,506</u>	<u>25,723,999</u>
Total fund balances	<u>968,745,953</u>	<u>829,696,912</u>	<u>705,727,822</u>
Total liabilities and fund balances	<u>\$ 1,084,051,151</u>	<u>952,399,023</u>	<u>751,967,240</u>

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2014 and 2013**

**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>2014</u>	<u>2013</u>	<u>2012</u>
<b>Revenues:</b>			
Restricted:			
Net appreciation (depreciation) in fair value of investments:			
Net unrealized gains and losses	\$ 57,591,232	30,751,892	(16,818,932)
Net realized gains and losses	26,470,838	16,183,796	7,029,702
	<u>84,062,070</u>	<u>46,935,688</u>	<u>(9,789,230)</u>
Settlement receipts	57,887,005	85,057,305	58,062,948
Miscellaneous income	52,660	11,451	36,714
Total restricted revenues	<u>142,001,735</u>	<u>132,004,444</u>	<u>48,310,432</u>
Interest and dividend income	31,968,197	25,867,677	21,098,140
Securities lending income	172,252	84,424	63,106
Contract income	2,576,498	2,445,750	6,760,907
Total revenues	<u>176,718,682</u>	<u>160,402,295</u>	<u>76,232,585</u>
<b>Expenditures:</b>			
Program and grant management support	2,325,960	883,044	1,152,795
Statewide programs	4,943,097	4,694,230	8,395,475
Community programs	6,789,501	6,474,467	7,449,037
Evaluation services	689,175	872,446	5,538,420
Furniture and equipment	28,985	-	794,649
Research	7,217,471	8,758,475	6,571,025
Investment management fees	5,181,212	3,846,879	2,466,949
Health communications	9,491,236	9,161,781	20,422
General operations and administrative expenses	1,003,004	1,741,883	236,642
Total expenditures	<u>37,669,641</u>	<u>36,433,205</u>	<u>32,625,414</u>
Net changes in fund balances	139,049,041	123,969,090	43,607,171
Fund balances, beginning of year	<u>829,696,912</u>	<u>705,727,822</u>	<u>662,120,651</u>
Fund balances, end of year	<u>\$ 968,745,953</u>	<u>829,696,912</u>	<u>705,727,822</u>

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2014 and 2013**

**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.

DRAFT 2

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**STATEMENTS OF NET POSITION**

<i>June 30,</i>	<i>2014</i>	<i>2013</i>
<b>Assets</b>		
Cash and cash equivalents:		
Unrestricted cash	\$ 50,200,761	51,632,028
Restricted cash:		
Securities lending collateral	83,926,489	106,599,991
Total cash and cash equivalents	<u>134,127,250</u>	<u>158,232,019</u>
Receivables:		
Interest and dividends	3,908,317	3,956,231
Contract receivable	862,034	204,424
Securities lending receivable	32,910	10,510
Total receivables	<u>4,803,261</u>	<u>4,171,165</u>
Investments, at fair value:		
U.S. government securities	102,413,878	158,688,335
Foreign government securities	7,323,985	21,253,881
Domestic corporate bonds	153,402,023	199,125,587
Foreign corporate bonds	45,854,937	18,023,855
Domestic stocks	270,304,922	221,105,647
Foreign stocks	141,786,580	130,266,536
Pooled fixed income funds	125,953,066	-
Alternative investments	76,088,661	41,531,998
Total investments, at fair value	<u>923,128,052</u>	<u>789,995,839</u>
Securities lending collateral—non cash	<u>21,992,588</u>	<u>-</u>
Capital assets, net of accumulated depreciation of \$115,022 and \$98,734 as of June 30, 2014 and 2013, respectively.	<u>45,238</u>	<u>42,201</u>
Total assets	<u>1,084,096,389</u>	<u>952,441,224</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>2014</i>	<i>2013</i>
<b>Liabilities</b>		
Net payable to brokers	3,784,389	6,967,044
Accounts payable	5,601,732	9,135,076
Liability under securities lending	105,919,077	106,599,991
Compensated absences:		
Payable within 1 year	62,306	49,081
Payable after 1 year	93,459	73,622
Total liabilities	<u>115,460,963</u>	<u>122,824,814</u>
<b>Net Position</b>		
Net investment in capital assets	45,238	42,201
Restricted for investment	845,219,972	729,689,075
Unrestricted	<u>123,370,216</u>	<u>99,885,134</u>
Total net position	<u>\$ 968,635,426</u>	<u>829,616,410</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>2014</i>	<i>2013</i>
<b>Expenses:</b>		
Program:		
Program and grant management support	\$ 2,325,960	883,044
Statewide programs	4,943,097	4,694,230
Community programs	6,789,501	6,474,467
Evaluation services	689,175	872,446
Health communications	9,491,236	9,161,781
Research	7,217,471	8,758,475
Total program expenses	<u>31,456,440</u>	<u>30,844,443</u>
Operating:		
General operations and administrative expenses	1,045,726	1,759,614
Depreciation	16,288	16,388
Total operating expenses	<u>1,062,014</u>	<u>1,776,002</u>
Total expenses	<u>32,518,454</u>	<u>32,620,445</u>
<b>Investment income:</b>		
Interest income	14,514,737	13,876,853
Dividend income	17,453,460	11,990,824
Securities lending income	172,252	84,424
Net appreciation in fair value of investments:		
Net unrealized gains and losses	57,591,232	30,751,892
Net realized gains and losses	26,470,838	16,183,796
	<u>84,062,070</u>	<u>46,935,688</u>
Total investment income	116,202,519	72,887,789
Investment expenses	<u>(5,181,212)</u>	<u>(3,846,879)</u>
Net investment income	<u>111,021,307</u>	<u>69,040,910</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>2014</i>	<i>2013</i>
<b>Other income:</b>		
Contract income	2,576,498	2,445,750
Miscellaneous income	<u>52,660</u>	<u>11,451</u>
Total other income	<u>2,629,158</u>	<u>2,457,201</u>
Changes in net assets, before settlement receipts	<u>81,132,011</u>	<u>38,877,666</u>
<b>Contribution to fund principal:</b>		
Settlement receipts	<u>57,887,005</u>	<u>85,057,305</u>
Changes in net position	139,019,016	123,934,971
Net position, beginning of year	<u>829,616,410</u>	<u>705,681,439</u>
Net position, end of year	<u>\$ 968,635,426</u>	<u>829,616,410</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>2014</i>	<i>2013</i>
<b>Assets</b>		
Cash and cash equivalents:		
Unrestricted cash	\$ 50,200,761	51,632,028
Restricted cash:		
Securities lending collateral	83,926,489	106,599,991
Total cash and cash equivalents	<u>134,127,250</u>	<u>158,232,019</u>
Receivables:		
Interest and dividends	3,908,317	3,956,231
Contract receivable	862,034	204,424
Securities lending receivable	32,910	10,510
Total receivables	<u>4,803,261</u>	<u>4,171,165</u>
Investments, at fair value:		
U.S. government securities	102,413,878	158,688,335
Foreign government securities	7,323,985	21,253,881
Domestic corporate bonds	153,402,023	199,125,587
Foreign corporate bonds	45,854,937	18,023,855
Domestic stocks	270,304,922	221,105,647
Foreign stocks	141,786,580	130,266,536
Pooled fixed income funds	125,953,066	-
Alternative investments	76,088,661	41,531,998
Total investments, at fair value	<u>923,128,052</u>	<u>789,995,839</u>
Securities lending collateral—non cash	<u>21,992,588</u>	-
Total assets	<u>\$ 1,084,051,151</u>	<u>952,399,023</u>
<b>Liabilities and Fund Balances</b>		
Liabilities:		
Net payable to brokers	\$ 3,784,389	6,967,044
Accounts payable	5,601,732	9,135,076
Liability under securities lending	105,919,077	106,599,991
Total liabilities	<u>115,305,198</u>	<u>122,702,111</u>
Fund balances:		
Nonspendable	845,219,972	729,689,075
Assigned	70,095,906	60,952,331
Unassigned	53,430,075	39,055,506
Total fund balances	<u>968,745,953</u>	<u>829,696,912</u>
Total liabilities and fund balances	<u>\$ 1,084,051,151</u>	<u>952,399,023</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>2014</i>	<i>2013</i>
Total fund balances, per the balance sheets—permanent fund	\$ 968,745,953	829,696,912
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.	45,238	42,201
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	<u>(155,765)</u>	<u>(122,703)</u>
Net position, per the statements of net position	<u>\$ 968,635,426</u>	<u>829,616,410</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>2014</i>	<i>2013</i>
<b>Revenues:</b>		
Restricted:		
Net appreciation in fair value of investments:		
Net unrealized gains and losses	\$ 57,591,232	30,751,892
Net realized gains and losses	26,470,838	16,183,796
	<u>84,062,070</u>	<u>46,935,688</u>
Settlement receipts	57,887,005	85,057,305
Miscellaneous income	52,660	11,451
Total restricted revenues	<u>142,001,735</u>	<u>132,004,444</u>
Interest income	14,514,737	13,876,853
Dividend income	17,453,460	11,990,824
Securities lending income	172,252	84,424
Contract income	2,576,498	2,445,750
Total revenues	<u>176,718,682</u>	<u>160,402,295</u>
<b>Expenditures:</b>		
Program and grant management support	2,325,960	883,044
Statewide programs	4,943,097	4,694,230
Community programs	6,789,501	6,474,467
Evaluation services	689,175	872,446
Furniture and equipment	28,985	-
Research	7,217,471	8,758,475
Investment management fees	5,181,212	3,846,879
Health communications	9,491,236	9,161,781
General operations and administrative expenses	1,003,004	1,741,883
Total expenditures	<u>37,669,641</u>	<u>36,433,205</u>
Net changes in fund balances	139,049,041	123,969,090
Fund balances, beginning of year	<u>829,696,912</u>	<u>705,727,822</u>
Fund balances, end of year	<u>\$ 968,745,953</u>	<u>829,696,912</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>2014</i>	<i>2013</i>
Net changes in fund balances, per the statements of revenues, expenditures, and changes in fund balances—permanent fund	\$ 139,049,041	123,969,090
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.	3,037	(16,388)
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 increased over the amount in the prior year.	<u>(33,062)</u>	<u>(17,731)</u>
Changes in net position, per the statements of activities	<u>\$ 139,019,016</u>	<u>123,934,971</u>

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

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS

June 30, 2014 and 2013

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### (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 7) 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

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### (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

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

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

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

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

#### Investments

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

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

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

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

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

### (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

#### Securities Lending

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

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

	<u>Fair Value</u>	
	<u>2014</u>	<u>2013</u>
Securities loaned:		
U.S. government securities	\$ 25,105,075	21,523,140
U.S. corporate bonds	23,819,539	12,303,773
U.S. equity	52,670,663	70,435,875
Foreign	<u>1,787,590</u>	<u>-</u>
Total securities loaned	<u>\$ 103,382,867</u>	<u>104,262,788</u>
Collateral maintained for securities loaned	<u>\$ 105,919,077</u>	<u>106,599,991</u>
Percentage of collateral to securities loaned as of June 30	<u>102.45%</u>	<u>102.24%</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, 2014, collateral was presented in both cash in U.S. currency, except for one security (EURO), and non-cash securities. The total value of the collateral held at June 30, 2014 and 2013, was \$2,536,210 and \$2,337,203, 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**

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

**Securities Lending, Continued**

At June 30, 2014, cash collateral was \$83,926,489 and non-cash collateral totaled \$21,992,588. Non-cash collateral consisted of the following:

<u>Description</u>	<u>Value</u>
U.S. government debt—Treasuries	\$ 66,453
U.S. government mortgages (i.e., FNMA, GNMA, FMAC)	18,154,108
Foreign securities	<u>3,772,027</u>
	<u>\$ 21,992,588</u>

The collateral ratio to securities loaned as of June 30, 2014 and 2013, was 102.45% and 102.24%, respectively.

Securities lending income included as certified earnings was \$172,252 and \$84,424, respectively, for the fiscal years ended June 30, 2014 and 2013, 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

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### (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.

#### Recent Accounting Pronouncements

In March 2012, GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities* (GASB 65). The objective of GASB 65 is to establish accounting and financial reporting standards that reclassify certain items that were previously reported as assets or liabilities as deferred outflows of resources or deferred inflows of resources; and recognizes certain items that were previously reported as assets or liabilities as outflows of resources or inflows of resources. The provisions of this statement are effective for financial statements for periods beginning after December 15, 2012. Presently, the Fund has no items of deferred outflows of resources or deferred inflows of resources to be reported.

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

#### Recent Accounting Pronouncements, Continued

In March 2012, GASB issued Statement No. 66, *Technical Corrections—2012—An Amendment of GASB Statements No. 10 and No. 62* (GASB 66). GASB 66 improves accounting and financial reporting for a governmental financial reporting entity by resolving conflicting guidance that resulted from the issuance of two pronouncements, Statements No. 54, Fund Balance Reporting and Governmental Fund Type Definitions and No. 62, Codification of Accounting and Financial Reporting Guidance Contained in Pre November 30, 1989, FASB and AICPA Pronouncements. The Fund adopted this statement effective July 1, 2013. The adoption had no significant impact on the financial statements of the Fund.

In June 2012, GASB issued Statement No. 68, *Accounting and Financial Reporting for Pensions* (GASB 68). The primary objective of GASB 68 is to improve accounting and financial reporting by state and local governments for pensions. It also improves information provided by state and local governmental employers about financial support for pensions that is provided by other entities. GASB 68 establishes standards for measuring and recognizing liabilities, deferred outflows of resources, deferred inflows of resources, and expenses/expenditures. This statement is effective for financial statements for periods beginning after June 15, 2014. The Fund has not determined the effects, if any, of implementing GASB 68.

In April 2013, GASB issued Statement No 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees* (GASB 70). GASB 70 will require a government that extends a nonexchange financial guarantee to recognize a liability when qualitative factors and historical data, if any, indicate that it is more likely than not that the government will be required to make a payment on the guarantee. The amount of the liability to be recognized should be the discounted present value of the best estimate of the future outflows expected to be incurred as a result of the guarantee. When there is no best estimate but a range of the estimated future outflows can be established, the amount of the liability to be recognized should be the discounted present value of the minimum amount within the range. A government that has issued an obligation guaranteed in a nonexchange transaction is to report the obligation until legally released as an obligor. This statement also provides additional guidance for intra-entity nonexchange financial guarantees involving blended component units. This statement specifies the information required to be disclosed by governments that extend nonexchange financial guarantees. This statement requires new information to be disclosed by governments that receive nonexchange financial guarantees. The Fund adopted this statement effective July 1, 2013. The adoption had no significant impact on the financial statements of the Fund.

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**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.

**Reclassification of Prior Year Amounts**

Certain 2013 amounts have been reclassified to be comparable with the 2014 presentation.

**Date of Management’s Review of Subsequent Events**

Management has evaluated subsequent events through September 29, 2014, the date which the financial statements were available to be issued, and determined that no subsequent events have occurred which require adjustment to or disclosure in the financial statements.

**(2) CASH AND INVESTMENTS**

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

	<u>2014</u>	<u>2013</u>
Cash on deposit with the State	\$ 9,067,943	12,765,317
Foreign currency	1,191,592	941,751
Collateral from securities lending—restricted cash	83,926,489	106,599,991
Cash and equivalents	17,254,593	8,824,901
Money market mutual fund	<u>22,686,632</u>	<u>29,100,059</u>
	<u>\$ 134,127,250</u>	<u>158,232,019</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**

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**(2) 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.

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See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(2) 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:

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

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(2) CASH AND INVESTMENTS, CONTINUED**

**Credit Risk, Continued**

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

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(2) CASH AND INVESTMENTS, CONTINUED**

**Credit Risk, Continued**

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

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(2) CASH AND INVESTMENTS, CONTINUED**

**Credit Risk, Continued**

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

<sup>(1)</sup> 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**

**(2) CASH AND INVESTMENTS, CONTINUED**

**Credit Risk, Continued**

	2013	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody Rating</u>
<b>U.S. government agencies (held in U.S. currency):</b>		
U.S. Treasury bonds	\$ 78,169	(1)
U.S. Treasury notes	21,089	(1)
U.S. Treasury bills	16,000	(1)
Federal Home Loan Bank	1,962	AA+
Federal Home Loan Mortgage Corp.	3,997	AGY
Federal National Mortgage Corp.	20,896	AGY
Government National Mortgage Association	4,633	AGY
Other	10,271	AGY
Other	827	A2
Other	844	Not Rated
	158,688	
<b>Corporate bonds (held in U.S. currency):</b>		
Domestic bonds	5,415	A1
Domestic bonds	7,902	A2
Domestic bonds	12,369	A3
Domestic bonds	1,088	AA1
Domestic bonds	1,842	AA2
Domestic bonds	5,725	AA3
Domestic bonds	14,851	AAA
Domestic bonds	20,293	B1
Domestic bonds	11,840	B2
Domestic bonds	15,170	B3
Domestic bonds	7,195	BA1
Domestic bonds	8,323	BA2

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

	2013	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody Rating</u>
<b>Corporate bonds (held in U.S. currency), Continued:</b>		
Domestic bonds	21,386	BA3
Domestic bonds	11,824	BAA1
Domestic bonds	13,603	BAA2
Domestic bonds	9,213	BAA3
Domestic bonds	152	C
Domestic bonds	368	CA
Domestic bonds	3,646	CAA1
Domestic bonds	2,707	CAA2
Domestic bonds	4,497	CAA3
Domestic bonds	19,717	Not Rated
	<u>199,126</u>	
<b>Corporate bonds (held in foreign currency):</b>		
Domestic bonds	135	A
Domestic bonds	378	B1
Domestic bonds	136	BAA1
Domestic bonds	857	BAA2
	<u>1,506</u>	
<b>Foreign corporate bonds (held in U.S. currency):</b>		
Foreign bonds	2,655	A2
Foreign bonds	517	B1
Foreign bonds	2,790	B2
Foreign bonds	749	B3
Foreign bonds	739	BA1
Foreign bonds	2,506	BA3
Foreign bonds	934	BAA1
Foreign bonds	269	CA
	<u>11,159</u>	

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

	2013	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody Rating</u>
<b>Foreign corporate bonds (held in foreign currency):</b>		
Foreign bonds	232	A2
Foreign bonds	135	B1
Foreign bonds	1,015	B2
Foreign bonds	139	(P)B2
Foreign bonds	565	B3
Foreign bonds	166	BA2
Foreign bonds	147	BA3
Foreign bonds	263	BAA1
Foreign bonds	172	BAA2
Foreign bonds	373	BAA3
Foreign bonds	19	CA2
Foreign bonds	950	CAA1
Foreign bonds	1,183	Not rated
	<u>5,359</u>	
<b>Foreign government bonds (held in U.S. currency):</b>		
Foreign government bonds	849	B2
Foreign government bonds	850	BAA1
Foreign government bonds	465	BAA3
	<u>2,164</u>	

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(2) CASH AND INVESTMENTS, CONTINUED**

**Credit Risk, Continued**

	2013	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody Rating</u>
<b>Foreign government bonds (held in foreign currency):</b>		
Foreign government bonds	2,125	AA1U
Foreign government bonds	10,056	AAAU
Foreign government bonds	3,778	BAA1
Foreign government bonds	1,041	BAA2
Foreign government bonds	1,611	BAA3
Foreign government bonds	479	Not rated
	<u>19,090</u>	
 Total fair value of credit risk	 <u>\$ 397,092</u>	

<sup>(1)</sup> 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, 2014 or 2013, except for the \$125,953,000 investment in the Pooled Fixed Income Fund at June 30, 2014. 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**

**(2) 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.

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

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS, CONTINUED

Interest Rate Risk, Continued

	2013	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	Effective Duration <u>Years</u>
<b>U.S. government securities (government guaranteed):</b>		
U.S. Treasury bonds	\$ 21,089	18.89
U.S. Treasury notes	78,169	4.64
U.S. Treasury bills	16,000	0.06
Federal Home Loan Bank	1,962	4.51
Federal National Mortgage Association—FHR	609	1.90
Federal National Mortgage Association—FNR	7,150	4.54
Government National Mortgage Association	4,633	7.41
FNA	1,258	1.96
GNR	1,253	3.29
Other	1,672	6.22
<b>Foreign government securities:</b>		
Foreign government bonds (held in U.S. currency)	2,164	5.92
Foreign government bonds (held in foreign currency)	19,090	5.63
<b>Mortgage-backed securities:</b>		
Federal Home Loan Mortgage Corp.	3,997	4.59
Federal National Mortgage Corp.	20,896	5.20
<b>Corporate bonds:</b>		
Domestic bonds (held in U.S. currency)	199,126	3.92
Domestic bonds (held in foreign currency)	1,506	4.62
Foreign bonds (held in U.S. currency)	11,159	3.66
Foreign bonds (held in foreign currency)	5,359	3.88
	<u>\$ 397,092</u>	

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(2) 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.

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

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(2) CASH AND INVESTMENTS, CONTINUED**

**Foreign Currency Risk, Continued**

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

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

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(2) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk, Continued

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

**(2) CASH AND INVESTMENTS, CONTINUED**

**Foreign Currency Risk, Continued**

	2013	
	<u>Fair Value</u> (Expressed in thousands)	<u>Type</u>
Foreign currency:		
Australian dollar	\$ 2,848	Equity
Bermuda dollar	5,760	Equity
Bermuda dollar	805	Fixed income
Brazilian real	1,520	Fixed income
British pound sterling	25,763	Equity
British pound sterling	5,103	Fixed income
British pound sterling	62	Foreign currency
Canadian dollar	8,107	Equity
Canadian dollar	2,343	Fixed income
Cayman dollar	46	Equity
Cayman dollar	304	Fixed income
Euro	35,597	Equity
Euro	21,638	Fixed income
Euro	671	Foreign currency
Hong Kong dollar	4,595	Equity
Indonesian rupiah	2,071	Equity
Israeli new sheqel	2,394	Equity
Japanese yen	16,801	Equity
Jersey	3,740	Equity
Malaysian ringgit	17	Foreign currency

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(2) CASH AND INVESTMENTS, CONTINUED**

**Foreign Currency Risk, Continued**

	2013	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Type</u>
Foreign currency, Continued:		
Mexican nuevo peso	1,702	Equity
Mexican nuevo peso	2,579	Fixed income
Mexican nuevo peso	86	Foreign currency
Netherlands Antillean guilder	1,146	Equity
Norwegian krone	3,888	Equity
Russian ruble	1,739	Equity
Singapore dollar	102	Equity
South Korean won	3,651	Equity
Swedish krona	993	Equity
Swiss franc	6,940	Equity
Thai baht	2,383	Equity
Turkish lira	1,611	Fixed income
South African rand	1,211	Fixed income
South African rand	106	Foreign currency
	<u>\$ 168,322</u>	

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (2) CASH AND INVESTMENTS, CONTINUED

#### Pooled Fixed Income Funds

At June 30, 2014, the pooled fixed income funds consisted of an investment in the Reams Asset Management, Unconstrained Fixed Income Composite (the “Pooled Fixed Income 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, 2014, the average duration of the portfolio of the Pooled Fixed Income Fund was 2.9 years, the average maturity was 1.6 years, the yield to maturity was 0.8%, and the average asset quality was AA2.

At June 30, 2014, the Pooled Fixed Income Fund consisted of:

<u>Fixed Income Securities</u>	<u>Percentage</u>
Corporate	33%
Asset backed	4%
Government related	<1%
Cash & equivalents	8%
Treasury	52%
Mortgage backed	5%

The Fund’s investment in the Pooled Fixed Income Fund was approximately 2% of the total portfolio at June 30, 2014.

See Independent Auditors’ Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(3) 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, 2014 and 2013. 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, 2014		
	<u>Expiration Date</u>	<u>Long/Short</u>	<u>Notional/ Fair Value</u> <i>(Expressed in thousands)</i>
U.S. 10-year note	September 2014	Short	\$ (4,632)
Euro BUND GILT futures	September 2014	Short	(4,428)
Euro BOBL futures	September 2014	Short	(3,333)
			<u>\$ (12,393)</u>

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(3) DERIVATIVES, CONTINUED**

*Futures Contracts, Continued*

	June 30, 2013		
	<u>Expiration Date</u>	<u>Long/Short</u>	<u>Notional/ Fair Value</u> <i>(Expressed in thousands)</i>
U.S. 5-year note	September 2013	Short	\$ (3,389)
U.S. 10-year note	September 2013	Short	(2,405)
Long GILT futures	September 2013	Long	2,037
Euro BOBL futures	September 2013	Long	7,812
U.S. long bond	September 2013	Short	(2,309)
Euro 90-day note	March 2015	Long	21,570
			<u>\$ 23,316</u>

*Foreign Currency Forward Contracts*

	June 30,	
	<u>2014</u>	<u>2013</u>
	<i>(Expressed in thousands)</i>	
Pending receivable	\$ 48,504	39,063
Pending payable	<u>(48,323)</u>	<u>(39,035)</u>
Foreign currency forward contract asset	<u>\$ 181</u>	<u>28</u>

As of June 30, 2014, the foreign currency forward contracts expire in July 2014 and August 2014. During the years ended June 30, 2014 and 2013, realized losses on foreign currency contracts were approximately \$(1,629,000) and \$(388,000), respectively.

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

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(4) ALTERNATIVE INVESTMENTS**

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

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

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(4) ALTERNATIVE INVESTMENTS, CONTINUED**

2013			
<u>Company</u>	<u>Fair Value (Determined using NAV)</u>	<u>Unfunded Commitment</u>	<u>Purpose</u>
SJC Offshore (Frontpoint)	\$ 10,591,460	2,443,410	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
SJC Offshore II (Frontpoint)	1,515,586	13,500,000	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
Medley Opportunity Fund II L.P.	19,245,345	22,037,545	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
AEW Core Property Trust, Inc.	10,179,607	-	Real estate investment trust
Total alternative investments	<u>\$ 41,531,998</u>	<u>37,980,955</u>	

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

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(5) CAPITAL ASSETS**

The following is a summary of changes in capital assets:

	<u>Balance at June 30, 2013</u>	<u>Additions</u>	<u>Disposals</u>	<u>Balance at June 30, 2014</u>
Depreciable capital assets:				
Office equipment and furnishings	\$ 140,935	19,325	-	160,260
Accumulated depreciation:				
Office equipment and furnishings	(98,734)	(16,288)	-	(115,022)
Capital assets, net	<u>\$ 42,201</u>	<u>3,037</u>	<u>-</u>	<u>45,238</u>
	<u>Balance at June 30, 2012</u>	<u>Additions</u>	<u>Disposals</u>	<u>Balance at June 30, 2013</u>
Depreciable capital assets:				
Office equipment and furnishings	\$ 140,935	-	-	140,935
Accumulated depreciation:				
Office equipment and furnishings	(82,346)	(16,388)	-	(98,734)
Capital assets, net	<u>\$ 58,589</u>	<u>(16,388)</u>	<u>-</u>	<u>42,201</u>

**(6) CHANGES IN COMPENSATED ABSENCES**

Compensated absence activity was as follows:

<u>Balance at June 30, 2013</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance at June 30, 2014</u>	<u>Amounts Due Within 1 Year</u>
\$ 122,703	86,652	(53,590)	155,765	62,306
<u>Balance at June 30, 2012</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance at June 30, 2013</u>	<u>Amounts Due Within 1 Year</u>
\$ 104,972	56,894	(39,163)	122,703	49,081

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (7) AVAILABLE EARNINGS AND FUND BALANCES

#### Available Earnings

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

#### 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.*

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (7) AVAILABLE EARNINGS AND FUND BALANCES, CONTINUED

#### Fund Balances, Continued

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

#### Assigned by Board of Directors (Certified)

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

#### 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**

**(7) 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:

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

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(7) AVAILABLE EARNINGS AND FUND BALANCES, CONTINUED**

**Fund Balances, Continued**

	2013				<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, 2012	\$ 613,868,427	42,898,847	23,236,549	25,723,999	705,727,822
Transfer—2012—5% cap	-	(7,620,259)	7,620,259	-	-
Settlement receipts	85,057,305	-	-	-	85,057,305
Net unrealized gains on investments	30,751,892	-	-	-	30,751,892
Miscellaneous income	11,451	-	-	-	11,451
Contract income	-	-	-	2,445,750	2,445,750
Expendable earnings, including net realized gains on investments	-	-	-	38,289,018	38,289,018
Program and operating expenses	-	-	-	(32,586,326)	(32,586,326)
Transfer—estimate of certified earnings for 2013	-	-	(4,416,577)	4,416,577	-
Transfer—estimate of 2013 5% cap	-	(766,488)	-	766,488	-
Balance at June 30, 2013	<u>\$ 729,689,075</u>	<u>34,512,100</u>	<u>26,440,231</u>	<u>39,055,506</u>	<u>829,696,912</u>

The amount of earnings available for certification for the period ended June 30, 2014, was \$53,430,075 which is above 5% of the corpus of the fund.

At their August 28, 2014, meeting, the Board of Investors certified \$52,650,762, 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 2014 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

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### (7) AVAILABLE EARNINGS AND FUND BALANCES, CONTINUED

#### Fund Balances, Continued

The transfers of fund balances during 2014 and 2013 as noted in the above reconciliation are as follows:

#### 2014

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

#### 2013

- In November 2012, the Board of Investors increased its previous certification by \$7,620,259 to equal 5% of the cap.
- The transfer of \$4,416,577 was to adjust the unassigned balance to the estimate of certified earnings at June 30, 2013, before the 5% cap adjustment.
- The \$766,488 is a transfer to estimate the 5% cap adjustment for 2013.

### (8) PENSION PLAN

#### Plan Description

The Fund contributes to the Oklahoma Public Employees Retirement Plan (the "Retirement Plan"), a cost-sharing, multiple-employer public employee retirement system administered by the Oklahoma Public Employees Retirement System (the "System"). The Retirement Plan 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 the Retirement Plan 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 the Retirement Plan. That annual report may be obtained by writing to the Oklahoma Public Employees Retirement System, 5801 N. Broadway Extension, Suite 400, Oklahoma City, Oklahoma 73118 or by calling 1-800-733-9008.

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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**(8) PENSION PLAN, CONTINUED**

**Funding Policy**

Retirement Plan members and the Fund are required to contribute at a rate set by statute. The contribution requirements of Retirement Plan members and the Fund are established and may be amended by the Oklahoma Legislature. The contribution rates are as follows:

Fiscal Year 2014	
<u>State Employees</u>	<u>The Fund</u>
<u>All Salaries</u>	<u>All Salaries</u>
3.5%	16.5%

Fiscal Year 2013	
<u>State Employees</u>	<u>The Fund</u>
<u>All Salaries</u>	<u>All Salaries</u>
3.5%	16.5%

The Fund's contributions to the Retirement Plan for the years ended June 30, 2014, 2013, and 2012, were \$171,427, \$129,208, and \$103,380, respectively, and were equal to its required contributions for each year.

**(9) 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

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#### (9) **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, 2014 and 2013. 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

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#### (9) **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.

#### (10) **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

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### (11) 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

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

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

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

See Independent Auditors' Report.

**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, 2014, 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, 2014. Our report includes an explanatory paragraph disclaiming an opinion on required supplementary information. 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.

Shawnee, Oklahoma  
September 29, 2014