

Tobacco Settlement Endowment Trust Fund

Financial Statements

June 30, 2008 and 2007
(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

We have audited the accompanying financial statements of the governmental activities and permanent fund of the Tobacco Settlement Endowment Trust Fund (the "Fund"), as of and for the years ended June 30, 2008 and 2007, which collectively comprise the Fund's basic financial statements as listed in the table of contents. The Fund is a part of the reporting entity of the State of Oklahoma. These financial statements are the responsibility of the Fund's management. 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

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, 2008 and 2007, and the changes in its financial position or, where applicable, its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and permanent fund of the Fund as of June 30, 2008 and 2007, and the respective changes in financial position thereof for the years then ended in conformity with accounting principles generally accepted in the United States.

(Continued)

INDEPENDENT AUDITORS' REPORT, CONTINUED

Our audit was made for the purpose of forming opinions on the financial statements taken as a whole. The required supplementary information contained in the Management's Discussion and Analysis is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 29, 2008, 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

A handwritten signature in cursive script that reads "Finley + Cook, PLLC". The signature is written in black ink and is positioned to the right of the date and location text.

Shawnee, Oklahoma
September 29, 2008

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

June 30, 2008 and 2007

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, 2008 and 2007. 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 dividends and interest, less fees to manage the Fund, 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 Fund operating and program expenditures.

USING THIS ANNUAL REPORT

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

Government-Wide Statements: Government-wide statements include statements of net assets and 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 non-current. 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 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, 2008 and 2007

FINANCIAL HIGHLIGHTS

Statements of Net Assets

The statements of net assets provide an indication of the Fund's financial condition at the end of the 2008 and 2007 fiscal years; the statements report all assets and liabilities using the accrual basis of accounting.

Tobacco Settlement Endowment Trust Fund
Statements of Net Assets

	<u>2008</u>	<u>2007</u>
Assets		
Current assets	\$ 102,173,153	84,230,959
Investments, at fair value	390,291,116	368,883,597
Capital assets	<u>31,605</u>	<u>29,137</u>
Total assets	<u>492,495,874</u>	<u>453,143,693</u>
Liabilities		
Current liabilities	27,838,977	12,170,441
Liability under securities lending	49,067,239	64,673,908
Noncurrent liabilities	<u>27,851</u>	<u>17,657</u>
Total liabilities	<u>76,934,067</u>	<u>76,862,006</u>
Net Assets		
Invested in capital assets	31,605	29,137
Restricted for investment	397,567,206	363,275,447
Unrestricted	<u>17,962,996</u>	<u>12,977,103</u>
Total net assets	<u>\$ 415,561,807</u>	<u>376,281,687</u>

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

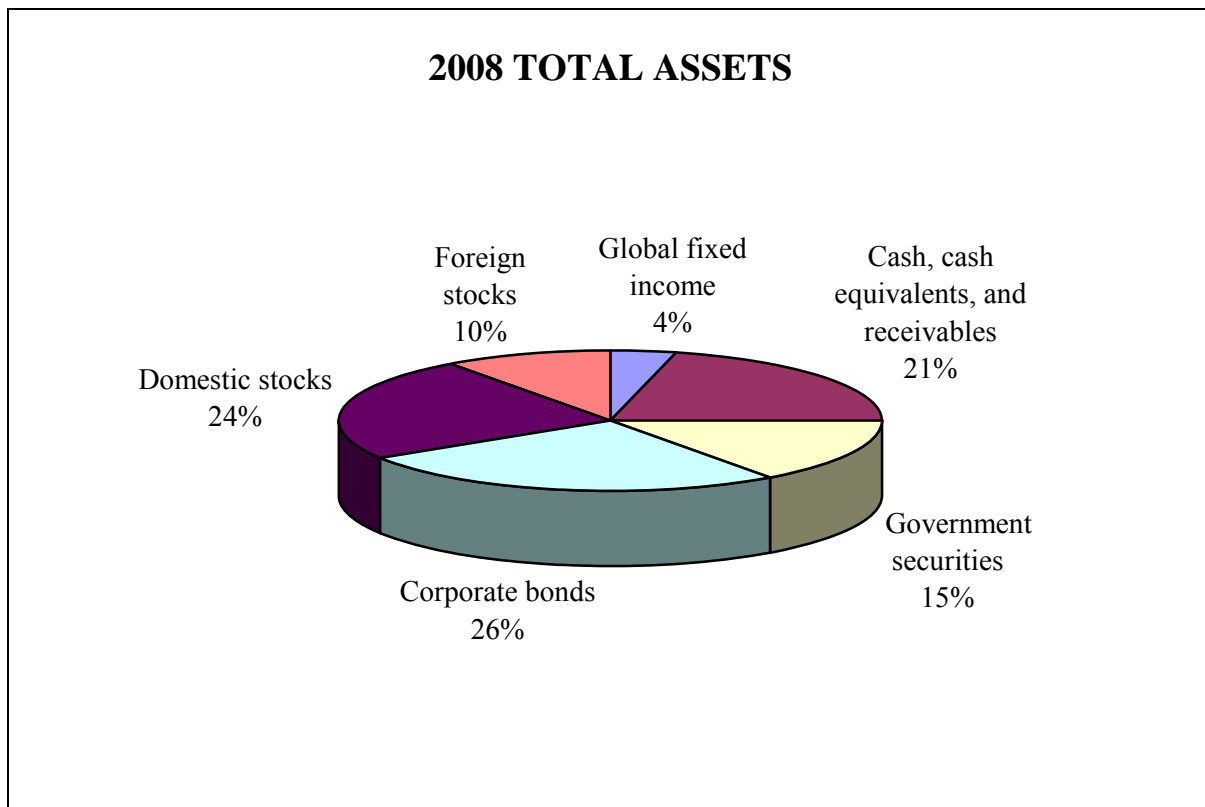
June 30, 2008 and 2007

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Net Assets, Continued

The Fund's total net assets increased \$39.3 million during the year, as the Fund invested an additional \$66.7 million in settlement receipts, recognized a loss of \$16.9 million as net investment income, and expended \$11.8 million on programs and operations. Total investments increased from \$368.9 million at the beginning of the year to \$390.3 million as of year-end, as the Board of Investors invested cash and cash equivalents held at the beginning of the year and additional settlement receipts were deposited during the year. The Fund recognized \$32.5 million from the net depreciation of the fair value of the portfolio and earned \$15.5 million in interest and dividends, net of investment management fees which were certified by the Board of Investors for FY2009 funding. 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 in excess of \$49 million which represents cash collateral presented to the fund by security borrowers through the Board's securities lending effort. Use of this cash is restricted unless the borrowers were to default in the return of the securities borrowed.



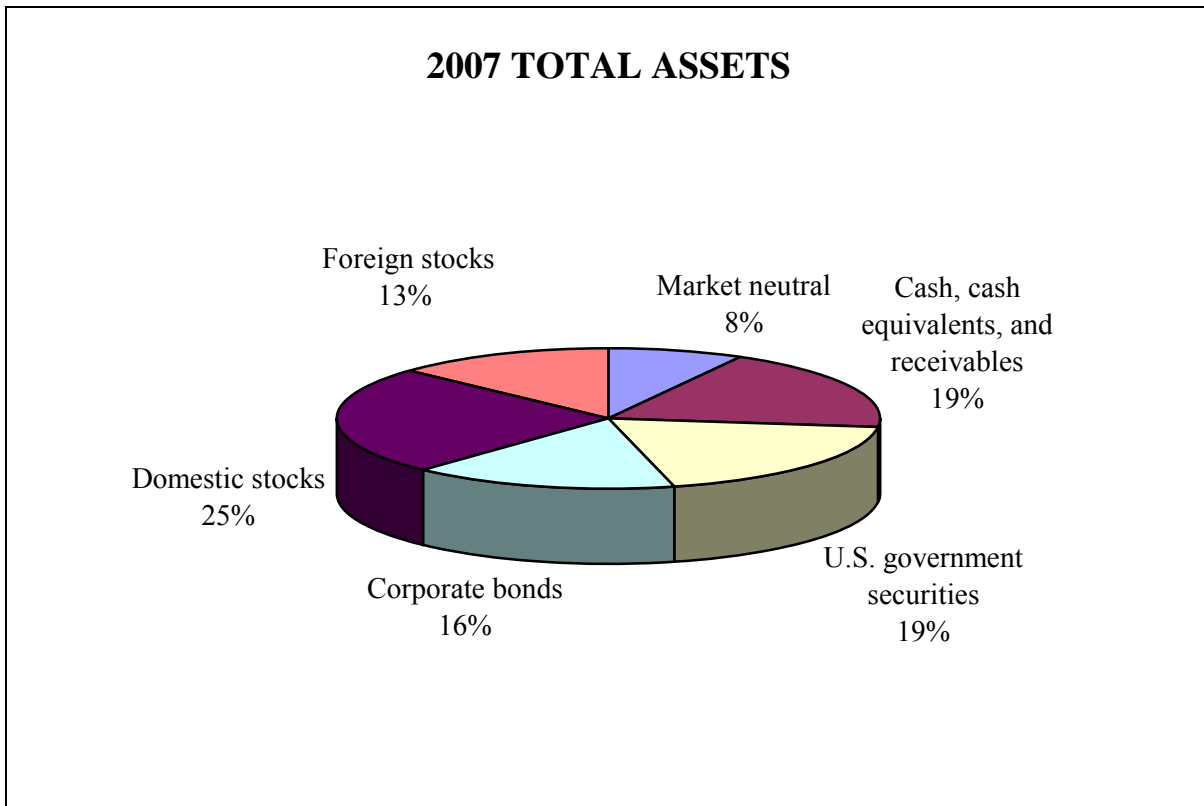
TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2008 and 2007

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Net Assets, Continued



TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2008 and 2007

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>2008</u>	<u>2007</u>
Investment income:		
Interest and dividend income	\$ 16,791,746	11,959,491
Securities lending income	349,284	55,298
Net (depreciation) appreciation in fair value of investments	<u>(32,455,219)</u>	<u>27,993,559</u>
Total investment (loss) income	(15,314,189)	40,008,348
Investment expenses	<u>(1,610,209)</u>	<u>(1,656,271)</u>
Net investment (loss) income	<u>(16,924,398)</u>	<u>38,352,077</u>
Other income:		
Contract income	1,270,452	1,250,000
Miscellaneous income	<u>20,518</u>	<u>670</u>
Total other income	<u>1,290,970</u>	<u>1,250,670</u>
Expenses:		
Program	11,357,363	7,836,614
Operating	<u>455,549</u>	<u>484,989</u>
Total expenses	<u>11,812,912</u>	<u>8,321,603</u>
 (Decrease) increase in net assets before settlement receipts	 (27,446,340)	 31,281,144
Contribution to fund principal:		
Settlement receipts	<u>66,726,460</u>	<u>47,588,421</u>
Increase in net assets	39,280,120	78,869,565
Net assets, beginning of year	<u>376,281,687</u>	<u>297,412,122</u>
Net assets, end of year	<u>\$ 415,561,807</u>	<u>376,281,687</u>

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

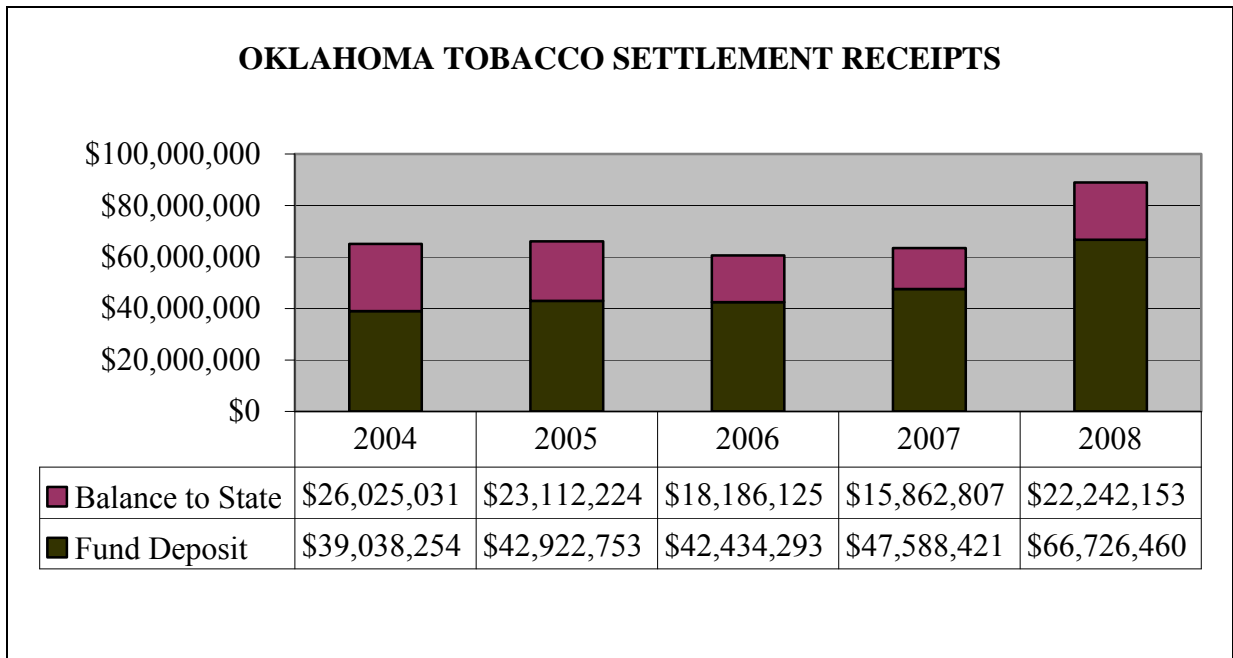
MANAGEMENT’S DISCUSSION AND ANALYSIS (MD&A), CONTINUED

June 30, 2008 and 2007

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, 2008 and 2007, 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 has increased by 5% annually until it reached 75% during the fiscal year ending June 30, 2007, where it remains thereafter. As reflected below, settlement receipts deposited by the Fund increased by \$19,138,039 from 2007.



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.

Previous studies of tobacco consumption reported by the National Association of Attorneys General showed a continued long-term decline in cigarette sales in the United States since the state Attorneys General negotiated the Tobacco Master Settlement Agreement in 1998. A downward trend in consumption was reported through 2005. The Centers for Disease Control and Prevention states that recent research indicates that the more spent on comprehensive tobacco control programs, the greater the reduction in smoking. However, recent surveys indicate that the rate of decline may have stalled in youth and adults, due in large part to the fact that only three states are funding tobacco prevention programs at the minimum levels recommended by the CDC.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2008 and 2007

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

Since 1998, increasing numbers of new tobacco manufacturers, not participating in the Master Settlement Agreement, have entered the market. These new tobacco manufacturers impact the market share of the participating manufacturers and this, in turn, reduces the amount of the settlement payments to the states. As shown below, a significant amount of the payment from the April 15, 2008, calculation was not received by the settling states and has been deposited in disputed accounts.

	FY-2008				FY-2007			
	<u>Final Calculation</u>	<u>%</u>	<u>Deposit to Trust—75%</u>	<u>%</u>	<u>Final Calculation</u>	<u>%</u>	<u>Deposit to Trust—75%</u>	<u>%</u>
Independent Auditor's Oklahoma Final Calculation	\$ 95,207,523	100.00%	71,405,642	100.00%	69,930,243	100.00%	52,447,682	100.00%
Received	<u>88,968,613</u>	<u>93.45%</u>	<u>66,726,460</u>	<u>93.45%</u>	<u>63,451,228</u>	<u>90.74%</u>	<u>47,588,421</u>	<u>90.74%</u>
Amount Not Received	<u>\$ 6,238,910</u>	<u>6.55%</u>	<u>4,679,182</u>	<u>6.55%</u>	<u>6,479,015</u>	<u>9.26%</u>	<u>4,859,261</u>	<u>9.26%</u>
	FY-2006				FY-2005			
	<u>Final Calculation</u>	<u>%</u>	<u>Deposit to Trust—70%</u>	<u>%</u>	<u>Final Calculation</u>	<u>%</u>	<u>Deposit to Trust—65%</u>	<u>%</u>
Independent Auditor's Oklahoma Final Calculation	\$ 68,149,565	100.00%	47,704,695	100.00%	67,174,063	100.00%	43,663,141	100.00%
Received	<u>59,878,586</u>	<u>87.86%</u>	<u>41,915,010</u>	<u>87.86%</u>	<u>65,312,054</u>	<u>97.23%</u>	<u>42,452,853</u>	<u>97.23%</u>
Amount Not Received	<u>\$ 8,270,979</u>	<u>12.14%</u>	<u>5,789,685</u>	<u>12.14%</u>	<u>1,862,009</u>	<u>2.77%</u>	<u>1,210,288</u>	<u>2.77%</u>

A participating manufacturer who disputes the final calculation may pay the disputed amount into the disputed payments accounts to avoid any accrual of interest until the issue is resolved. Noted disputes during the FY2008 calculation include various computation interpretations and completeness or accuracy of data; however, significant disputes involve the application of the non-participating manufacturer adjustment in 2003 and 2004. Subsequent disputes are anticipated for the 2005, 2006, 2007, and probably the 2008 calculation. These participating manufacturers maintain that they are entitled to withhold, whether by means of offset or otherwise, from their 2008 payment or to place in the disputed payments account the amount attributable to the nonparticipating manufacturers adjustment for the year disputed. The settling states do not agree with this position and litigation is pending in this matter.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2008 and 2007

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, 2008, net investment income decreased by \$55.3 million over the \$38.4 million recognized during the 2007 fiscal year. Interest and dividend income increased \$4.8 million while the net appreciation of investment in the Funds' portfolio decreased \$60.4 million. Fees paid to investment managers, consultants, and custodians decreased \$46 thousand.

As previously noted, the Fund's principal is restricted for investment purposes only. The dividend and interest income earned, less the fees spent to manage 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 maintain or improve the health of Oklahomans with a particular emphasis on children and senior adults. The Board of Directors has adopted a strategic plan to maximize the impact of the limited earnings available in the early years by focusing on reducing tobacco use in Oklahoma.

During the fiscal year ended June 30, 2008, the Board of Directors increased program funding by more than \$3.5 million. Counseling Services for fiscal year ended June 30, 2008 was included in program funding. Therefore, Counseling Services reported in fiscal year ended June 30, 2007 was restated to health communication and program promotion. Additional funding was provided for the Oklahoma Tobacco Helpline, a toll-free statewide phone line, 1-800-QUIT-NOW, to meet the growing demand for telephone-based tobacco cessation counseling. The Board of Directors expanded social marketing funding to include a "Tobacco Stops With Me" campaign addressing secondhand smoke and prevention for youth and young adults, and a campaign to promote the Oklahoma Tobacco Helpline and "Become an Ex" web-based cessation program.

During 2008, the Board of Directors also increased 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. The original 16 grantees were joined by 7 new grantees, increasing services from 27 counties and 3 tribal nations to 38 counties and 3 tribal nations.

A new grant program, "Addressing Tobacco in Specific Populations," was initiated in FY2007 and continued in FY2008. Four grantees were awarded funding to plan and implement programs to reduce and prevent tobacco use among the low socioeconomic status, deaf and hard of hearing, college-age, and rural youth populations.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2008 and 2007

FINANCIAL HIGHLIGHTS, CONTINUED

Statements of Activities—Income and Expenses, Continued

In addition, in FY2008 the Board initiated funding for the Oklahoma Tobacco Research Center (OTRC), a program of the OU Cancer Center Institute. The purpose of the OTRC is to reduce the burden of tobacco-related health problems in Oklahoma by stimulating the generation and dissemination of knowledge and the implementation and diffusion of effective practices. Over the course of the 5-year grant, the OTRC is expected to fund research projects and obtain additional research funding from the National Cancer Institute and other federal, state, and private resources.

In FY2008, the Board of Directors continued an agreement with the Oklahoma State Department of Health to provide additional funding to meet the increasing demand for the statewide telephone-based Oklahoma Tobacco Helpline. According to the terms of the contract, OSDH agrees to pay the Board of Directors at the beginning of the contract period up to 31 days of estimated Helpline costs, and reimburse additional Helpline expenses paid out of the beginning deposit throughout the year. Total revenue from this contract was \$1,270,452 for 2008 and \$1,250,000 for 2007. Adjustments to the cash balance are requested by the Board of Directors through pro forma invoices monthly. These funds are restricted for the purpose of the Helpline.

During the fiscal years ended June 30, 2007 and 2008, operating expenses decreased by \$29,440 from \$484,989 to \$455,549. Personnel, accounting, and other office-related operating expenses were incurred for a full 12-month period during the fiscal year ended June 30, 2008. Effective July 1, 2007, the Office of the State Treasurer requested, and both Boards approved, that \$105,000 be provided to the State Treasurer as funding for staff support to the Board of Investors for FY2008. Operating expenses include some staff salaries, travel, and other operating expenses of the Board of Directors and the Board of Investors. During 2007, the maximum amount allowed for operating expenses was changed from \$500,000 to 15% of certified earnings in any fiscal year.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2008 and 2007

FUND HIGHLIGHTS, CONTINUED

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 dividend and interest earnings, less fees to manage the Fund, 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 reserved for investment purposes and balances which are unreserved that are expendable for operations and programs of the Fund.

Tobacco Settlement Endowment Trust Fund **Balance Sheets—Permanent Fund**

	<u>2008</u>	<u>2007</u>
Assets:		
Cash and cash equivalents	\$ 98,936,162	82,087,588
Interest and dividends receivable	3,188,699	2,133,343
Securities lending receivable	27,840	10,028
Contract receivable	20,452	-
Investments at fair value	<u>390,291,116</u>	<u>368,883,597</u>
Total assets	<u>\$ 492,464,269</u>	<u>453,114,556</u>
Liabilities:		
Net payable to brokers	\$ 23,445,497	9,627,408
Accounts payable	4,374,913	2,531,262
Liability under securities lending	<u>49,067,239</u>	<u>64,673,908</u>
Total liabilities	<u>76,887,649</u>	<u>76,832,578</u>
Fund Balances:		
Reserved for investment	397,567,206	363,275,447
Unreserved	<u>18,009,414</u>	<u>13,006,531</u>
Total fund balances	<u>415,576,620</u>	<u>376,281,978</u>
Total liabilities and fund balances	<u>\$ 492,464,269</u>	<u>453,114,556</u>

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2008 and 2007

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>2008</u>	<u>2007</u>
Revenues:		
Restricted:		
Net (depreciation) appreciation in fair value of investments	\$ (32,455,219)	27,993,559
Settlement receipts	66,726,460	47,588,421
Miscellaneous income	20,518	670
Total restricted revenues	<u>34,291,759</u>	<u>75,582,650</u>
Interest and dividend income	16,791,746	11,959,491
Contract income	1,270,452	1,250,000
Securities lending income	349,284	55,298
Total revenues	<u>52,703,241</u>	<u>88,847,439</u>
 Expenditures:		
Personnel and administrative	373,166	423,615
Health communication and program promotion	7,020,909	5,402,347
Community programs	3,443,913	2,160,839
Evaluation services	674,943	273,150
Research	217,598	-
Investment management fees	1,610,209	1,656,271
Equipment	11,901	15,174
Other	55,960	51,390
Total expenditures	<u>13,408,599</u>	<u>9,982,786</u>
Net changes in fund balances	39,294,642	78,864,653
Fund balances, beginning of year	<u>376,281,978</u>	<u>297,417,325</u>
Fund balances, end of year	<u>\$ 415,576,620</u>	<u>376,281,978</u>

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2008 and 2007

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 Dr. James Wilbanks, Director of Revenue & Fiscal Policy, Office of the Oklahoma State Treasurer, 2300 North Lincoln Boulevard, Room 217, Oklahoma City, Oklahoma 73105-4895.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

STATEMENTS OF NET ASSETS

<i>June 30,</i>	<i>2008</i>	<i>2007</i>
Assets		
Cash and cash equivalents:		
Unrestricted cash	\$ 49,868,923	17,413,680
Restricted cash	-	-
Securities lending collateral—restricted cash	49,067,239	64,673,908
Total cash and cash equivalents	<u>98,936,162</u>	<u>82,087,588</u>
Receivables:		
Interest and dividends	3,188,699	2,133,343
Contract receivable	20,452	-
Securities lending receivable	27,840	10,028
Total receivables	<u>3,236,991</u>	<u>2,143,371</u>
Investments, at fair value:		
U.S. government securities	73,330,944	85,855,809
Foreign government securities	3,994,193	-
Domestic corporate bonds	125,962,041	72,889,035
Foreign corporate bonds	19,704,161	2,366,543
Market neutral commingled funds	-	36,687,856
Domestic stocks	119,809,381	112,786,602
Foreign stocks	47,490,396	58,297,752
Total investments, at fair value	<u>390,291,116</u>	<u>368,883,597</u>
Capital assets, net of accumulated depreciation of \$30,662 and \$23,536 as of June 30, 2008 and 2007, respectively.	31,605	29,137
Total assets	<u>492,495,874</u>	<u>453,143,693</u>
Liabilities		
Net payable to brokers	23,445,497	9,627,408
Accounts payable	4,374,913	2,531,262
Liability under securities lending	49,067,239	64,673,908
Compensated absences:		
Payable within 1 year	18,567	11,771
Payable after 1 year	27,851	17,657
Total liabilities	<u>76,934,067</u>	<u>76,862,006</u>
Net Assets		
Invested in capital assets	31,605	29,137
Restricted for investment	397,567,206	363,275,447
Unrestricted	17,962,996	12,977,103
Total net assets	<u>\$ 415,561,807</u>	<u>376,281,687</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>2008</i>	<i>2007</i>
Expenses:		
Program:		
Health communication and program promotion	\$ 7,020,909	5,402,347
Community programs	3,443,913	2,160,839
Evaluation services	674,943	273,150
Research	217,598	-
Depreciation	-	278
Total program expenses	<u>11,357,363</u>	<u>7,836,614</u>
Operating:		
Personnel and administrative	390,156	422,244
Other	58,267	55,536
Depreciation	7,126	7,209
Total operating expenses	<u>455,549</u>	<u>484,989</u>
Total expenses	<u>11,812,912</u>	<u>8,321,603</u>
Investment income:		
Interest income	12,508,145	7,267,466
Dividend income	4,283,601	4,692,025
Securities lending income	349,284	55,298
Net (depreciation) appreciation in fair value of investments	<u>(32,455,219)</u>	<u>27,993,559</u>
Total investment (loss) income	(15,314,189)	40,008,348
Investment expenses	<u>(1,610,209)</u>	<u>(1,656,271)</u>
Net investment (loss) income	<u>(16,924,398)</u>	<u>38,352,077</u>
Other income:		
Contract income	1,270,452	1,250,000
Miscellaneous income	20,518	670
Total other income	<u>1,290,970</u>	<u>1,250,670</u>
Contribution to fund principal:		
Settlement receipts	<u>66,726,460</u>	<u>47,588,421</u>
Changes in net assets	39,280,120	78,869,565
Net assets, beginning of year	<u>376,281,687</u>	<u>297,412,122</u>
Net assets, end of year	<u>\$ 415,561,807</u>	<u>376,281,687</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>2008</i>	<i>2007</i>
Assets		
Cash and cash equivalents:		
Unrestricted cash	\$ 49,868,923	17,413,680
Restricted cash	-	-
Securities lending collateral—restricted cash	<u>49,067,239</u>	<u>64,673,908</u>
Total cash and cash equivalents	<u>98,936,162</u>	<u>82,087,588</u>
Receivables:		
Interest and dividends	3,188,699	2,133,343
Securities lending receivable	27,840	10,028
Contract receivable	<u>20,452</u>	<u>-</u>
Total receivables	<u>3,236,991</u>	<u>2,143,371</u>
Investments, at fair value:		
U.S. government securities	73,330,944	85,855,809
Foreign government securities	3,994,193	-
Domestic corporate bonds	125,962,041	72,889,035
Foreign corporate bonds	19,704,161	2,366,543
Market neutral commingled funds	-	36,687,856
Domestic stocks	119,809,381	112,786,602
Foreign stocks	<u>47,490,396</u>	<u>58,297,752</u>
Total investments, at fair value	<u>390,291,116</u>	<u>368,883,597</u>
Total assets	<u>\$ 492,464,269</u>	<u>453,114,556</u>
Liabilities and Fund Balances		
Liabilities:		
Net payable to brokers	\$ 23,445,497	9,627,408
Accounts payable	4,374,913	2,531,262
Liability under securities lending	<u>49,067,239</u>	<u>64,673,908</u>
Total liabilities	<u>76,887,649</u>	<u>76,832,578</u>
Fund balances:		
Reserved for investment	397,567,206	363,275,447
Unreserved	<u>18,009,414</u>	<u>13,006,531</u>
Total fund balances	<u>415,576,620</u>	<u>376,281,978</u>
Total liabilities and fund balances	<u>\$ 492,464,269</u>	<u>453,114,556</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 ASSETS**

<i>June 30,</i>	<i>2008</i>	<i>2007</i>
Total fund balances	\$ 415,576,620	376,281,978
Amounts reported in the statements of net assets are different because:		
Capital assets used in governmental activities are not financial resources and therefore are not reported in the fund.	31,605	29,137
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>(46,418)</u>	<u>(29,428)</u>
Net assets	<u>\$ 415,561,807</u>	<u>376,281,687</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>2008</i>	<i>2007</i>
Revenues:		
Restricted:		
Net (depreciation) appreciation in fair value of investments	\$ (32,455,219)	27,993,559
Settlement receipts	66,726,460	47,588,421
Miscellaneous income	20,518	670
Total restricted revenues	<u>34,291,759</u>	<u>75,582,650</u>
Interest income	12,508,145	7,267,466
Dividend income	4,283,601	4,692,025
Securities lending income	349,284	55,298
Contract income	<u>1,270,452</u>	<u>1,250,000</u>
Total revenues	<u>52,703,241</u>	<u>88,847,439</u>
Expenditures:		
Personnel and administrative	373,166	423,615
Health communication and program promotion	7,020,909	5,402,347
Community programs	3,443,913	2,160,839
Evaluation services	674,943	273,150
Research	217,598	-
Investment management fees	1,610,209	1,656,271
Equipment	11,901	15,174
Other	<u>55,960</u>	<u>51,390</u>
Total expenditures	<u>13,408,599</u>	<u>9,982,786</u>
Net changes in fund balances	39,294,642	78,864,653
Fund balances, beginning of year	<u>376,281,978</u>	<u>297,417,325</u>
Fund balances, end of year	<u>\$ 415,576,620</u>	<u>376,281,978</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>2008</i>	<i>2007</i>
Net changes in fund balances	\$ 39,294,642	78,864,653
<p>Amounts reported in the statements of activities are different because:</p>		
<p>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 depreciation in the current period.</p>	2,468	3,540
<p>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 cost of compensated absences earned but not used in the current year.</p>	<u>(16,990)</u>	<u>1,372</u>
<p style="padding-left: 40px;">Changes in net assets, per statements of activities</p>	<u>\$ 39,280,120</u>	<u>78,869,565</u>

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

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS

June 30, 2008 and 2007

(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 were 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 dividends and interest, less fees to manage the Fund, are expended for 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

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

See Independent Auditors’ Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

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

Governmental Fund Financial Statements—As a permanent fund, the Fund is reported in the governmental fund financial statements using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Since the Fund predominantly accounts for financial resources, revenue recognition is generally consistent between the accrual and 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 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 the funds invested in an SEC registered money market mutual fund, 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 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 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. Policy requires the securities lending agent to provide indemnification against borrower default, have written agreements with each borrower, not to 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 market values of securities loaned and cash collateral maintained for those securities at June 30 were:

	<u>Market Value</u>	
	<u>2008</u>	<u>2007</u>
U.S. government securities	\$ 13,716,858	31,393,151
U.S. corporate bonds	6,122,996	1,220,401
U.S. equity	<u>27,350,188</u>	<u>30,104,228</u>
	<u>\$ 47,190,042</u>	<u>62,717,780</u>
Cash collateral maintained for securities loaned	<u>\$ 49,067,239</u>	<u>64,673,908</u>

Borrowers were required to deliver and maintain collateral for each loan with a market value equal to 102% of the current market value of the loaned securities. Collateral delivered in non U.S. currency is required to be equal to 105% of the market value of the securities loaned; however, at June 30, 2008 and 2007, all collateral was presented as cash in U.S. currency. The total value of the collateral held at June 30, 2008 and 2007, was \$1,877,197 and \$1,956,128, respectively, more than the current market value of the securities loaned; thus, no credit risk existed at the balance sheet date from these transactions. Collateral was unmatched to the securities loaned with a 1-day maturity. Collateral cannot be used by the Trust except in the event of default.

During fiscal year 2006, securities lending income was not considered certifiable earnings and was included in net assets as restricted for investments. The Fund subsequently determined that securities lending income should be treated as interest income and included it in certifiable earnings. Securities lending income included as certified earnings were \$349,284 and \$55,298 for fiscal year ended June 30, 2008 and 2007, respectively.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, CONTINUED

Capital Assets

Furniture, fixtures, and equipment 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 4- to 12-year periods for computer systems and office furniture and fixtures, respectively.

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.

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 5 to 10 years, 13.33 hours per month for service of 10 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.

The amount of accrued compensated absences considered current was determined based on the amount used during the current year.

Advertising Costs

All costs associated with advertising are expensed as incurred.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS

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

	<u>2008</u>	<u>2007</u>
Cash on deposit with the State	\$ 81,477	142,660
Foreign currency	416,183	-
Collateral from securities lending—restricted cash	49,067,239	64,673,908
Money market mutual fund	<u>49,371,263</u>	<u>17,271,020</u>
	<u>\$ 98,936,162</u>	<u>82,087,588</u>

In excess of \$11 million of cash invested in money market mutual funds will be funded to a new international manager early in fiscal year 2009.

Restricted Cash—Contractual restricted cash represents the net cash balance of funds advanced to the Board of Directors for the reimbursement of the program expenses related to the Oklahoma Tobacco Helpline. According to contract terms, the Oklahoma State Department of Health (OSDH) pays the Board of Directors up to 31 days of estimated Helpline costs at the beginning of the contract. OSDH agrees to reimburse additional Helpline expenses throughout the year funded through monthly pro forma invoicing. Total revenue from this contract was \$1,270,452 for 2008 and \$1,250,000 for 2007. Cash collateral from securities lending activity is identified as restricted cash as it cannot be used by the Trust unless there is default in the return of the securities loaned.

Custodial Credit Risk—Custodial credit risk is the risk that in the event of the failure of 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 counterparty or the counterparty’s trust department but not in the name of the Fund. The investment policy requires that all deposits be invested in a fully collateralized interest-bearing account. Policy also provides that investment collateral be held by a third-party custodian with whom the Fund has a current custodial agreement in the Fund’s name.

See Independent Auditors’ Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(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:

	2008	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody Rating</u>
U.S. government agencies: (Held in U.S. currency)		
U.S. Treasury bonds	\$ 1,292	(1)
U.S. Treasury notes	17,466	(1)
Federal Home Loan Bank	6,876	AAA
Federal Home Loan Mortgage Corp.	9,805	AAA
Federal National Mortgage Corp.	36,006	AAA
Government National Mortgage Association	958	AAA
Other	928	Other
	<u>73,331</u>	
Corporate bonds: (Held in U.S. currency)		
Domestic bonds	6,609	A
Domestic bonds	7,692	AA
Domestic bonds	51,863	AAA
Domestic bonds	29,917	B
Domestic bonds	15,813	BA
Domestic bonds	9,635	BAA
Domestic bonds	332	BBB
Domestic bonds	2,583	CAA
Domestic bonds	1,518	Other
	<u>125,962</u>	
Foreign bonds: (Held in U.S. currency)		
Foreign bonds	1,615	A
Foreign bonds	509	AAA
Foreign bonds	2,272	B
Foreign bonds	2,977	BA
Foreign bonds	1,754	BAA
Foreign bonds	363	Other
	<u>9,490</u>	

(Continued)

See Independent Auditors’ Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

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

Credit Risk—Continued

	2008	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody Rating</u>
Foreign government bonds:		
Foreign government bonds (Held in U.S. currency)	100	B
Foreign government bonds (Held in U.S. currency)	797	BA
Foreign government bonds (Held in U.S. currency)	9	BAA
	<u>906</u>	
Foreign government bonds (Held in foreign currency)	1,576	AAA
Foreign government bonds (Held in foreign currency)	1,512	Other
	<u>3,088</u>	
Foreign bonds (Held in foreign currency)	3,156	A
Foreign bonds (Held in foreign currency)	949	AA
Foreign bonds (Held in foreign currency)	2,629	AAA
Foreign bonds (Held in foreign currency)	1,122	B
Foreign bonds (Held in foreign currency)	600	BA
Foreign bonds (Held in foreign currency)	499	BAA
Foreign bonds (Held in foreign currency)	114	BBB
Foreign bonds (Held in foreign currency)	398	CAA
Foreign bonds (Held in foreign currency)	747	Other
	<u>10,214</u>	
Total fair value of credit risk	<u>\$ 222,991</u>	

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

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS, CONTINUED

Credit Risk—Continued

	2007	
	<u>Fair Value</u>	<u>Moody</u>
	<i>(Expressed in</i>	<u>Rating</u>
	<i>thousands)</i>	
Held in U.S. currency:		
U.S. government agencies:		
U.S. Treasury bonds	\$ 5,492	(1)
U.S. Treasury notes	21,157	(1)
Federal Home Loan Bank	11,090	AAA
Federal Home Loan Mortgage Corp.	20,684	AAA
Federal National Mortgage Corp.	25,989	AAA
Other	1,443	Other
	85,855	
Corporate bonds:		
Domestic bonds	2,695	A
Domestic bonds	1,765	AA
Domestic bonds	31,679	AAA
Domestic bonds	20,308	B
Domestic bonds	13,453	BA
Domestic bonds	2,566	BAA
Domestic bonds	43	BBB
Domestic bonds	207	CAA
Domestic bonds	174	Other
	72,890	
Foreign bonds	501	A
Foreign bonds	313	AAA
Foreign bonds	285	B
Foreign bonds	1,110	BA
Foreign bonds	157	BAA
	2,366	
Total fair value of credit risk	\$ 161,111	

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

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS, CONTINUED

Concentration of Credit Risk—The Fund limits its exposure to concentration 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, represent 5% or more of the Fund’s net assets at June 30, 2008 and 2007.

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

	<u>2008</u>	
	<u>Fair Value</u>	<u>Effective Duration</u>
	<u>Years</u>	
	<i>(Expressed in thousands)</i>	
U.S. government securities (government guaranteed):		
U.S. Treasury bonds	\$ 1,292	10.78
U.S. Treasury notes	17,466	5.22
Federal Home Loan Bank	6,876	2.42
GNMA	958	7.81
Other	928	10.02
Foreign government securities:		
Foreign Government Obl (Held in U.S. currency)	906	9.73
Foreign Government Obl (Held in foreign currency)	3,088	3.32
Mortgage-backed securities:		
Federal Home Loan Mortgage Corp.	9,805	2.17
Federal National Mortgage Corp.	36,006	4.08
Corporate bonds:		
Domestic bonds	125,962	7.49
Foreign bonds (Held in U.S. currency)	9,490	5.94
Foreign bonds (Held in foreign currency)	10,214	5.18
	<u>\$ 222,991</u>	

See Independent Auditors’ Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

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

Interest Rate Risk—Continued

	<u>2007</u>	
	<u>Fair Value</u>	<u>Effective Duration Years</u>
	<i>(Expressed in thousands)</i>	
U.S. government securities		
(government guaranteed):		
U.S. Treasury bonds	\$ 5,492	11.78
U.S. Treasury notes	21,157	6.78
Federal Home Loan Bank	11,090	1.6
GNMA	744	5.34
SLMA	699	4.82
Mortgage-backed securities:		
Federal Home Loan Mortgage Corp.	20,684	3.31
Federal National Mortgage Corp.	25,989	3.47
Corporate bonds:		
Domestic bonds	72,890	6.14
Foreign bonds	<u>2,366</u>	4.4
Total fixed income	<u>\$ 161,111</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 assets through its asset allocation policy. Investment in foreign equities and fixed income is shown by monetary unit to indicate possible foreign currency risk.

	2008	
	<u>Fair Value</u>	<u>Type</u>
	<i>(Expressed in thousands)</i>	
Foreign currency:		
Argentine peso	\$ 163	FX Inc
Australian dollar	11	Foreign currency
Australian dollar	1,204	Equity
Australian dollar	371	FX Inc
Bermuda dollar	101	FX Inc
Brazilian real	565	Equity
Brazilian real	606	FX Inc
British pound sterling	116	Foreign currency
British pound sterling	8,721	Equity
British pound sterling	1,825	FX Inc
Canadian dollar	628	Equity
Canadian dollar	1,401	FX Inc
Cayman dollar	2,574	FX Inc
Chinese renminbi	554	Equity
Colombian peso	150	FX Inc
Danish kroner	604	Equity
Danish kroner	98	FX Inc
Euro	287	Foreign currency
Euro	19,264	Equity
Euro	11,736	FX Inc

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk—Continued

	2008	
	<u>Fair Value</u>	<u>Type</u>
	<i>(Expressed in thousands)</i>	
Foreign currency, continued:		
Hong Kong dollar	826	Equity
Hungarian forint	948	FX Inc
Indian rupee	525	Equity
Indian rupee	324	FX Inc
Japanese yen	3	Foreign currency
Japanese yen	9,941	Equity
Japanese yen	368	FX Inc
Mexican peso	1	Foreign currency
Mexican peso	280	Equity
Mexican peso	565	FX Inc
Norwegian krone	2,050	Equity
Peruvian nuevo sol	41	FX Inc
Russian ruble	544	FX Inc
Singapore dollar	809	Equity
Singapore dollar	310	FX Inc
South African rand	65	FX Inc
Swedish krona	851	Equity
Swedish krona	225	FX Inc
Swiss franc	667	Equity
Thai baht	153	FX Inc
Turkish lira	537	FX Inc
Venequelan bolivar	593	FX Inc
	<u>\$ 71,605</u>	

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk—Continued

	2007	
	<u>Fair Value</u>	<u>Type</u>
	<i>(Expressed in thousands)</i>	
Foreign currency:		
Australian dollar	\$ 1,575	Equity
British pound sterling	12,673	Equity
Canadian dollar	545	Equity
Canadian dollar	393	FX Inc
Cayman dollar	971	FX Inc
Danish kroner	1,029	Equity
Euro	24,975	Equity
Euro	553	FX Inc
Hong Kong dollar	1,013	Equity
Israeli shekel	763	Equity
Japanese yen	9,811	Equity
Korean won	1,038	Equity
Mexican peso	53	Equity
Norwegian krone	1,631	Equity
Singapore dollar	750	Equity
Singapore dollar	450	FX Inc
Swedish krona	1,639	Equity
Swiss franc	802	Equity
	<u>\$ 60,664</u>	

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) FUND BALANCES

Principal funds that are reserved for investment purposes only are composed of settlement receipts and the net appreciation or depreciation in the fair value of invested funds. Annual earnings that are available for expenditure are defined by law as dividends and interest, less fees to manage the Fund, and are recorded as additions to the unreserved fund balance. The Board of Directors manages program and operating expenses that are expended from the unreserved fund balance. Contract revenue is the reimbursement of program expenses related to the Oklahoma Tobacco Helpline and is considered a reduction to unreserved expenses. Operating expenses include salaries, travel, and other operating expenses of the Board of Investors and the Board of Directors. During 2007, the maximum amount allowed for operating expenses was changed from \$500,000 to 15% of certified earnings in any fiscal year. Operating expenses do not include program expenses or investment management expenses. A reconciliation of the reserved and unreserved components of the fund balances is as follows:

	2008		
	<u>Reserved for Investment</u>	<u>Unreserved</u>	<u>Total</u>
Balance, June 30, 2007	\$ 363,275,447	13,006,531	376,281,978
Settlement receipts	66,726,460	-	66,726,460
Net (depreciation) in fair value of investments	(32,455,219)	-	(32,455,219)
Miscellaneous income	20,518	-	20,518
Contract income		1,270,452	1,270,452
Expendable earnings	-	15,530,821	15,530,821
Program and operating expenses	<u>-</u>	<u>(11,798,390)</u>	<u>(11,798,390)</u>
Balances, June 30, 2008	<u>\$ 397,567,206</u>	<u>18,009,414</u>	<u>415,576,620</u>

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**NOTES TO FINANCIAL STATEMENTS, CONTINUED****(2) FUND BALANCES, CONTINUED**

	<u>2007</u>		
	<u>Reserved for Investment</u>	<u>Unreserved</u>	<u>Total</u>
Balance, June 30, 2006	\$ 287,701,209	9,716,116	297,417,325
Settlement receipts	47,588,421	-	47,588,421
Net appreciation in fair value of investments	27,993,559	-	27,993,559
Reclassification or transfer of 2006 securities lending income (see <u>Securities Lending</u> at Note 1)	(8,412)	8,412	-
Miscellaneous income	670	-	670
Contract income	-	1,250,000	1,250,000
Expendable earnings	-	10,358,518	10,358,518
Program and operating expenses	-	(8,326,515)	(8,326,515)
Balances, June 30, 2007	<u>\$ 363,275,447</u>	<u>13,006,531</u>	<u>376,281,978</u>

The Board of Directors has determined that 10% of the unreserved fund balance be designated as a reserve for future periods should annual earnings prove insufficient to cover expenses.

(4) PENSION PLAN**Plan Description**

The Fund contributes to the Oklahoma Public Employees Retirement Plan (the "Plan"), a multiple-employer, cost-sharing public employee retirement plan, which is a defined benefit pension plan administered by the Oklahoma Public Employees Retirement System (OPERS). Benefit provisions are established and can be amended by the State Legislature. The Plan provides retirement, disability, and death benefits. Title 74 of the Oklahoma Statutes, Sections 901 through 943, as amended, provides more complete information about the Plan. OPERS issues a publicly-available financial report that includes financial statements and required supplementary information for the Plan. That report may be obtained by writing to OPERS, P.O. Box 53007, Oklahoma City, Oklahoma 73152, or by calling 1-800-733-9008.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(4) PENSION PLAN, CONTINUED

Funding Policy

The contribution rates for each member category of the Plan are established by and can be amended by the State Legislature and are based on actuarial calculation which is performed to determine the adequacy of contribution rates. The contribution rates applied to each participating State employee's salary for the fiscal year ended June 30, 2008, are listed below:

Contributions	
<u>State Employees'</u>	<u>State Agencies'</u>
<u>All Salaries</u>	<u>All Salaries</u>
3.5%	12.5%

The Fund's contribution of \$40,268, \$28,489, and \$21,228 to the Plan for the years ended June 30, 2008, 2007, and 2006, respectively, was equal to the Fund's established required contribution.

(5) 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.

Effective July 1, 2007, both Boards have approved that \$105,000 be provided to the Office of the State Treasurer as funding for staff support to the Board of Investors for FY2008. During 2007, State statutes were amended and specify that annual operating expenses shall not exceed 15% of certified earnings. Previously, State statutes specified that annual operating expenses could not exceed \$500,000.

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(6) COMMITMENTS AND CONTINGENCIES

Contracts

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

Settlement Receipts

As permitted by the Master Settlement Agreement between the State of Oklahoma and the participating manufacturers, the participating manufacturers have disputed the amount due to the State of Oklahoma based on the final calculation and have placed the disputed funds in an escrow account. For the years ended June 30, 2008 and 2007, the Fund's portion of the disputed final calculation was approximately \$4,700,000 and \$4,900,000, respectively. These amounts were deposited in the escrow account for each of the respective years.

See Independent Auditors' Report.

**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 the financial statements of the governmental activities and permanent fund of the Tobacco Settlement Endowment Trust Fund (the "Fund") as of and for the year ended June 30, 2008, and have issued our report thereon dated September 29, 2008. The Fund is a part of the reporting entity of the State of Oklahoma. Our report includes an explanatory paragraph to emphasize the fact that the financial statements included only that portion of the State of Oklahoma that was attributable to the transactions of the Fund and an explanatory paragraph disclaiming an opinion on required supplementary information. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Fund's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control over financial reporting.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

(Continued)

**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**

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of 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*.

This report is intended solely for the information and use of the management of the Fund, the Oklahoma State Treasurer's Office, and the State of Oklahoma Office of the Auditor and Inspector and is not intended to be and should not be used by anyone other than these specified parties.

Finley + Cook, PLLC

Shawnee, Oklahoma
September 29, 2008