

# **Tobacco Settlement Endowment Trust Fund**

## *Financial Statements*

June 30, 2011 and 2010  
(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 the permanent fund of the Tobacco Settlement Endowment Trust Fund (the "Fund") as of and for the years ended June 30, 2011 and 2010, 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, 2011 and 2010, and the changes in its financial position 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 the permanent fund of the Fund as of June 30, 2011 and 2010, and the respective changes in financial position thereof for the years then ended in conformity with accounting principles generally accepted in the United States.

Effective July 1, 2010, the Fund implemented Governmental Accounting Standards Board Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* (GASB 54). As more fully discussed in Note 2, the effect of implementing GASB 54 resulted in certain changes to the presentation of fund balances, and certain 2010 fund balances were reclassified to conform to the 2011 presentation.

(Continued)

## **INDEPENDENT AUDITORS' REPORT, CONTINUED**

In accordance with *Government Auditing Standards*, we have also issued our report dated September 28, 2011, 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* and should be considered in assessing the results of our audit.

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.

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

Shawnee, Oklahoma  
September 28, 2011

## **TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

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, 2011 and 2010. The intent of the MD&A is to look at the Fund's financial performance as a whole. It should, therefore, be read in conjunction with the Fund's financial statements and the notes thereto.

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

A Board of Investors was created to manage the investment of the Fund and to annually certify the earnings that are available for program expenditures. A Board of Directors was created to oversee 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 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 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, 2011 and 2010**

**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 2011 and 2010 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>2011</u>	<u>2010</u>
<b>Assets</b>		
Current assets	\$ 128,808,922	83,371,594
Investments, at fair value	591,989,512	497,732,378
Capital assets	<u>60,243</u>	<u>61,024</u>
Total assets	<u>720,858,677</u>	<u>581,164,996</u>
<b>Liabilities</b>		
Current liabilities	13,189,743	9,917,137
Liability under securities lending	45,517,652	44,996,813
Noncurrent liabilities	<u>44,419</u>	<u>34,666</u>
Total liabilities	<u>58,751,814</u>	<u>54,948,616</u>
<b>Net Assets</b>		
Invested in capital assets	60,243	61,024
Restricted for investment	632,837,824	502,043,793
Unrestricted	<u>29,208,796</u>	<u>24,111,563</u>
Total net assets	<u>\$ 662,106,863</u>	<u>526,216,380</u>

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

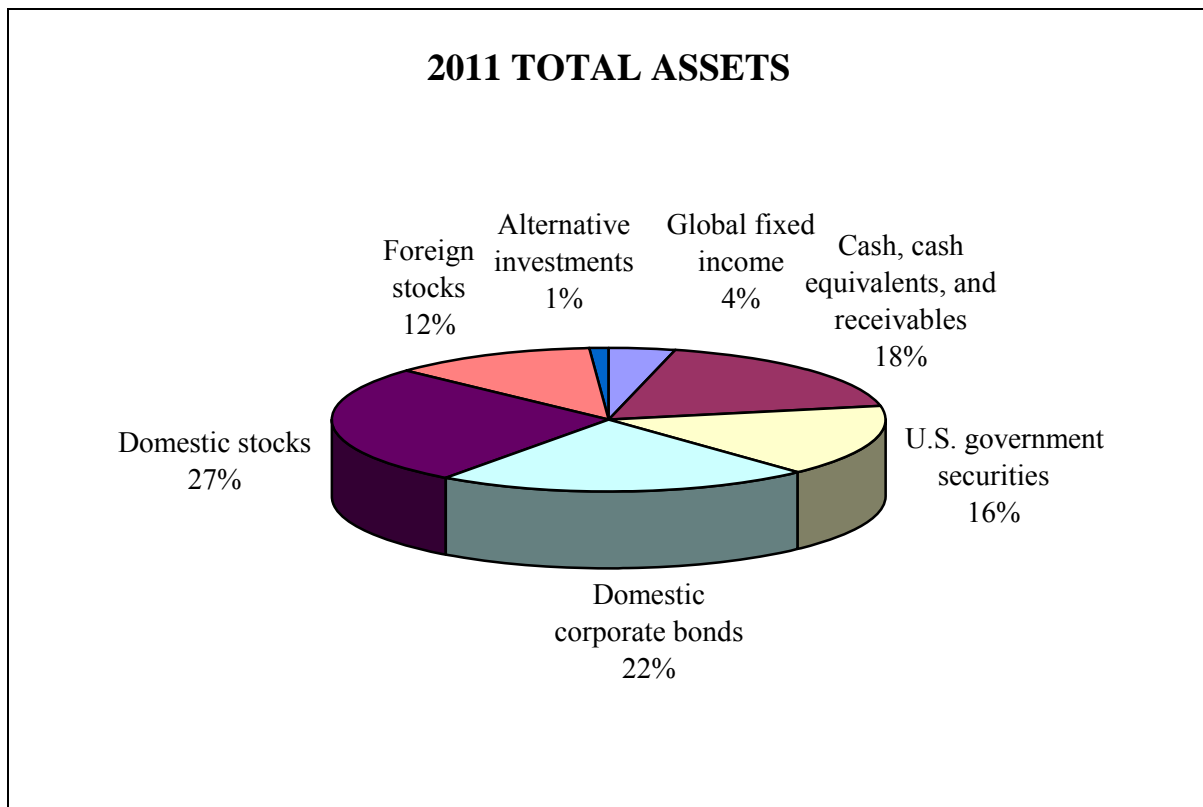
June 30, 2011 and 2010

### FINANCIAL HIGHLIGHTS, CONTINUED

#### Statements of Net Assets, Continued

The Fund's total net assets increased \$135.9 million during the year, as the Fund invested an additional \$56.9 million in settlement receipts, recognized a gain of \$92.5 million as net investment income, and expended \$18.3 million on programs and operations. Total investments increased from \$497.7 million at the beginning of the year to \$591.9 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 \$73.8 million from the net appreciation of the fair value of the portfolio and earned \$18.6 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 \$46 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.



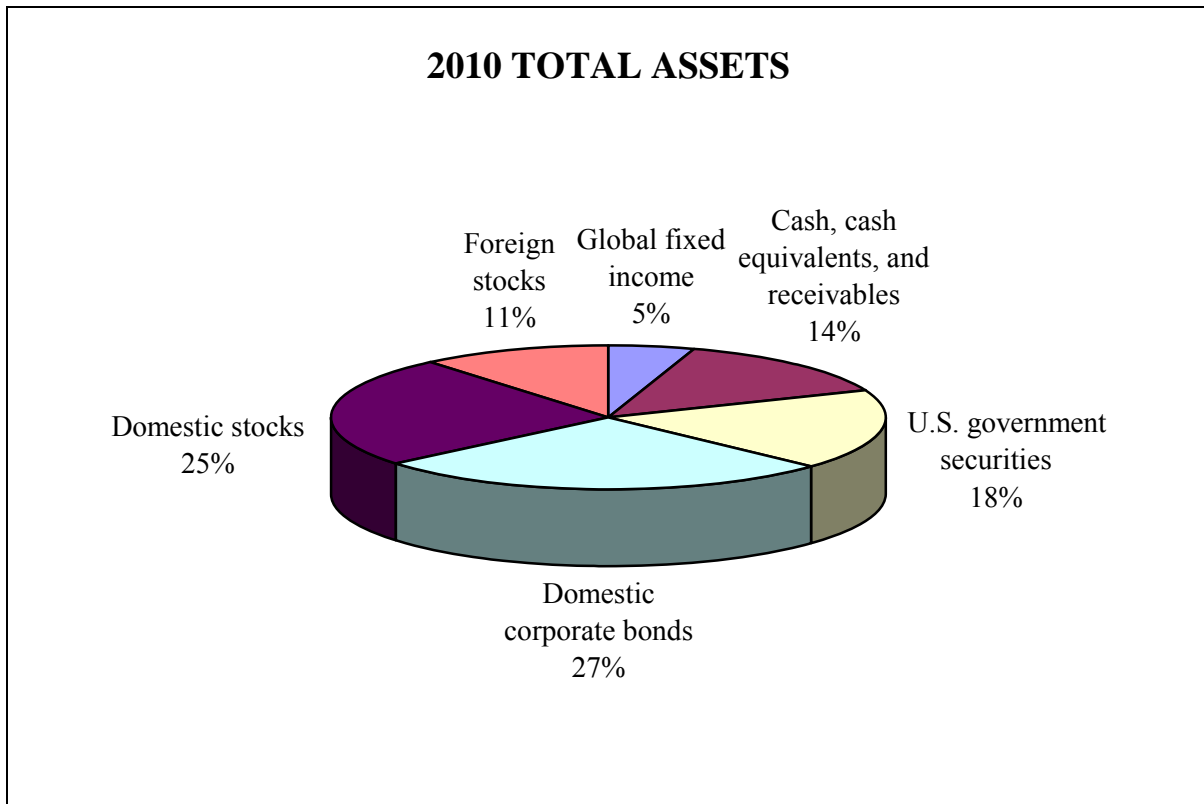
**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

**FINANCIAL HIGHLIGHTS, CONTINUED**

**Statements of Net Assets, Continued**





**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

**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>2011</u>	<u>2010</u>
<b>Investment income:</b>		
Interest and dividend income	\$ 20,833,415	20,002,694
Securities lending income	57,184	84,583
Net appreciation in fair value of investments	<u>73,816,184</u>	<u>34,927,255</u>
Total investment income	94,706,783	55,014,532
Investment expenses	<u>(2,218,818)</u>	<u>(1,907,087)</u>
Net investment income	<u>92,487,965</u>	<u>53,107,445</u>
<b>Other income:</b>		
Contract income	4,759,951	1,551,599
Miscellaneous income	<u>22,877</u>	<u>59,972</u>
Total other income	<u>4,782,828</u>	<u>1,611,571</u>
<b>Expenses:</b>		
Program	17,210,573	16,543,841
Operating	<u>1,124,707</u>	<u>1,030,112</u>
Total expenses	<u>18,335,280</u>	<u>17,573,953</u>
 Increase in net assets before settlement receipts	 78,935,513	 37,145,063
<b>Contribution to fund principal:</b>		
Settlement receipts	<u>56,954,970</u>	<u>60,713,827</u>
Increase in net assets	135,890,483	97,858,890
Net assets, beginning of year	<u>526,216,380</u>	<u>428,357,490</u>
Net assets, end of year	<u>\$ 662,106,863</u>	<u>526,216,380</u>

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

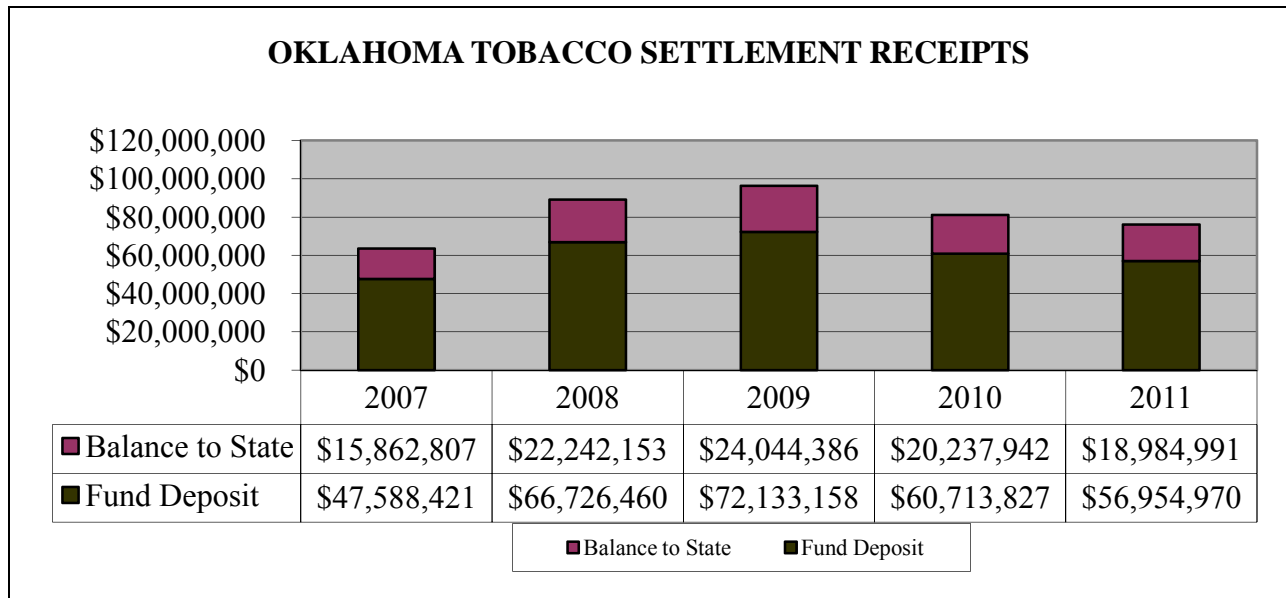
**MANAGEMENT’S DISCUSSION AND ANALYSIS (MD&A), CONTINUED**

**June 30, 2011 and 2010**

**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, 2011 and 2010, 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 \$3,758,857 from 2010.



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 (CDC) 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, 2011 and 2010**

**FINANCIAL HIGHLIGHTS, CONTINUED**

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

Since 1998, increasing numbers of new tobacco manufacturers not participating in the Tobacco 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 calculation has not been received by the settling states and has been deposited in disputed accounts.

	FY-2011				FY-2010			
	<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	\$ 87,572,445	100.00%	65,679,334	100.00%	\$ 89,012,841	100.00%	66,759,631	100.00%
Received	<u>75,939,961</u>	<u>86.72%</u>	<u>56,954,970</u>	<u>86.72%</u>	<u>80,951,769</u>	<u>90.94%</u>	<u>60,713,827</u>	<u>90.94%</u>
Amount Not Received	<u>\$ 11,632,484</u>	<u>13.28%</u>	<u>8,724,364</u>	<u>13.28%</u>	<u>\$ 8,061,072</u>	<u>9.06%</u>	<u>6,045,804</u>	<u>9.06%</u>
	FY-2009				FY-2008			
	<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	\$101,662,042	100.00%	76,246,532	100.00%	\$ 95,207,523	100.00%	71,405,642	100.00%
Received	<u>96,177,544</u>	<u>94.61%</u>	<u>72,133,158</u>	<u>94.61%</u>	<u>88,968,613</u>	<u>93.45%</u>	<u>66,726,460</u>	<u>93.45%</u>
Amount Not Received	<u>\$ 5,484,498</u>	<u>5.39%</u>	<u>4,113,374</u>	<u>5.39%</u>	<u>\$ 6,238,910</u>	<u>6.55%</u>	<u>4,679,182</u>	<u>6.55%</u>

## **TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

#### **FINANCIAL HIGHLIGHTS, CONTINUED**

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

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 FY2011 calculation include various computation interpretations and the completeness or accuracy of data; however, significant disputes involve the application of the nonparticipating manufacturer adjustment. During FY2011, Phillip Morris deposited approximately \$3.9 million into a disputed account disputing their 2008 calculation. These participating manufacturers maintain that they are entitled to withhold, whether by means of offset or otherwise, from their 2011 payment or to place in the disputed payments account the amount attributable to the nonparticipating manufacturer's adjustment for the year disputed. The settling states do not agree with this position, and litigation is pending in this matter.

As settlement receipts were deposited and invested and the portfolio was diversified during the fiscal year ended June 30, 2011, net investment income increased by \$39.4 million. Interest and dividend income increased \$831 thousand, while the net appreciation of investment in the Fund's portfolio increased \$38.9 million. Fees paid to investment managers, consultants, and custodians increased \$312 thousand.

As previously noted, the Fund's principal is restricted for investment purposes only. The earnings 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. Subsequent to June 30, 2011, the Board of Investors received an Attorney General's opinion concerning statutory language in the calculation of earnings (see Note 13). The Board has not acted on this opinion.

The Board of Directors 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. Recently, 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 short-term grants of up to 50% of a project's costs, to organizations proposing innovative and evidence-based approaches to improving health in Oklahoma.

During the fiscal year ended June 30, 2011, the Board of Directors increased program funding by more than \$667 thousand, using a combination of certified earnings, carryover, and income from other state agencies.

## **TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

#### **FINANCIAL HIGHLIGHTS, CONTINUED**

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

During the fiscal years ended June 30, 2010 and 2011, operating expenses increased by \$94,595, from \$1,030,112 to \$1,124,707. Personnel, accounting, and other office-related operating expenses were incurred for a full 12-month period during the fiscal year ended June 30, 2011. Effective July 1, 2010, the Office of the State Treasurer requested, and both Boards approved, that \$100,000 be provided to the State Treasurer as funding for staff support to the Board of Investors for FY2011. 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.

##### **Prevention**

In FY2011, the Board of Directors continued an agreement in the amount of \$5,300,000 with Alere Wellbeing, Inc., provider of the telephone- and web-based Oklahoma Tobacco Helpline (1-800-QUIT-NOW) services to all Oklahomans with a desire to quit tobacco use. The Helpline is collaboratively funded by TSET, the Oklahoma State Department of Health (OSDH), Centers for Disease Control and Prevention (CDC), and the Oklahoma State and Education Employees Group Insurance Board (OSEEGIB). In FY2011 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 first workers were hired in FY2010.

The Board of Directors continued an agreement with the Oklahoma State Department of Health (OSDH) for Helpline services. The agreement included \$400,000 in ARRA funding in FY2011. Total revenue from this contract was \$1,175,000 for 2011 and \$1,551,599 for 2010. These funds are restricted for the purpose of the Helpline.

The Board of Directors entered into a new agreement with the Oklahoma State and Education Employees Group Insurance Board (OSEEGIB) for Helpline services in FY2011. It provides additional Helpline services for HealthChoice insurance beneficiaries. Revenue from this agreement is based on utilization. Although the budget for FY2011 was \$300,000, total revenue from this contract was \$83,448 for FY2011. These funds are restricted for the purpose of the Helpline, evaluation, and an administrative fee.

## TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

June 30, 2011 and 2010

#### FINANCIAL HIGHLIGHTS, CONTINUED

##### Prevention, Continued

In FY2011, the Board of Directors also expanded health communications funding to continue the “*Tobacco Stops With Me*” campaign addressing secondhand smoke and prevention for youth and young adults; a campaign to promote the Helpline to the general public; and development of a “*SoonerQuit for Women*” campaign to specifically encourage Medicaid beneficiaries to utilize the Helpline. The “*SoonerQuit for Women*” campaign is funded through a new agreement with the Oklahoma Health Care Authority, the state’s Medicaid agency, which uses TSET funding as the state share necessary to obtain federal matching funds for development and implementation campaign. The total revenue expected from this agreement in FY2011 is \$300,000. Health Communications funding also supported the launch of the “*5320 / Shape Your Future*” campaign, in collaboration with the OSDH and Governor Fallin, to promote health and reduce obesity and tobacco use among Oklahomans.

During FY2011, 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 FY2011, 51 counties and one tribal nation were served under the comprehensive community grants program.

A Request for Proposals was released in FY2011 to launch a comprehensive community-based program throughout the state to address Oklahoma’s rising obesity rates by increasing physical activity and healthy nutrition. In May 2011, the Board of Directors awarded 15 five-year grants to serve 21 counties beginning July 1, 2011. To prepare for the new initiative, the Board of Directors also entered into agreements with the Oklahoma State Department of Health, Strong and Healthy Oklahoma Division for consultation, technical assistance, and training, as well as the Oklahoma State University Department of Nutrition Sciences for evaluation of the program.

In FY2011, the Board of Directors entered into an agreement with the Oklahoma State Department of Health (OSDH) to provide incentive grants to communities to encourage them to become Certified Healthy Communities. The total amount of the agreement was \$3.5 million to be utilized over the course of three years.

The “Addressing Tobacco in Specific Populations” program was initiated in FY2007 and continued in FY2011. 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. During FY2009, one of those grants was terminated by agreement of both parties. The total budget for the remaining three grantees was \$300,000.

## **TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

#### **FINANCIAL HIGHLIGHTS, CONTINUED**

##### **Prevention, Continued**

The Cessation Systems Initiative (CSI) grantees entered their second full year of grant funding in FY2011. Under the CSI program, the Oklahoma Insurance Department, the Oklahoma Hospital Association, and the Oklahoma Department of Mental Health and Substance Abuse Services work to promote coverage for tobacco dependence treatment among private insurers, to implement a best practice intervention to address tobacco among hospitalized patients, and to infuse tobacco dependence treatment into routine mental health and substance abuse treatment programs.

The Board of Directors continued an agreement in FY2011 with the Oklahoma Department of Mental Health and Substance Abuse Services (ODMHSAS) to partner with the ABLE Commission to check retail tobacco outlets for compliance with the Youth Access to Tobacco Act. The grant focuses on stores near schools or in disadvantaged neighborhoods. Future funding for this initiative is expected to be provided by the Food and Drug Administration (FDA) beginning October 1, 2011.

##### **Research**

In FY2011 the Board of Directors continued funding for the Oklahoma Tobacco Research Center (OTRC), a program of the Peggy and Charles Stephenson Oklahoma Cancer Center. 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. The board's new strategic plan includes expansion of the OTRC into "Phase II" to include the addition of Phase I clinical trials as funding becomes available.

In FY2011 the Board of Directors also continued 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. Under the grant, OCASCR receives \$5.5 million over five and one-half years (FY 2010–FY 2015). The Board's new strategic plan includes expansion of OCASCR to assist in recruiting five new scientists to Oklahoma.

# **TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

### **FINANCIAL HIGHLIGHTS, CONTINUED**

#### **Emerging Opportunities**

The Board of Directors funded its second unsolicited proposal in FY2010. 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.” The new grant, provided to the Oklahoma Health Care Authority, focuses on implementing an evidence-based tobacco treatment intervention in clinical settings that treat pregnant women on Medicaid. The first unsolicited proposal to receive funding in FY2009 was a 3-year program designed to improve fitness and nutrition using an evidence-based program (Coordinated Approach to Child Health—CATCH) in 12 elementary schools in Tulsa County. A special emphasis was placed on serving schools with a higher population of American Indian students from lower income families.



**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

**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 (reserved 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>2011</u>	<u>2010</u>
<b>Assets:</b>		
Cash and cash equivalents	\$ 121,192,268	79,764,153
Interest and dividends receivable	4,098,983	3,602,046
Contract receivable	3,512,090	-
Securities lending receivable	5,581	5,395
Investments at fair value	<u>591,989,512</u>	<u>497,732,378</u>
Total assets	<u>\$ 720,798,434</u>	<u>581,103,972</u>
<b>Liabilities:</b>		
Net payable to brokers	\$ 10,156,258	5,864,604
Accounts payable	3,003,873	4,029,423
Liability under securities lending	<u>45,517,652</u>	<u>44,996,813</u>
Total liabilities	<u>58,677,783</u>	<u>54,890,840</u>
<b>Fund Balances:</b>		
Nonspendable	632,837,824	502,043,793
Assigned	2,928,283	2,416,934
Unassigned	<u>26,354,544</u>	<u>21,752,405</u>
Total fund balances	<u>662,120,651</u>	<u>526,213,132</u>
Total liabilities and fund balances	<u>\$ 720,798,434</u>	<u>581,103,972</u>

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

**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>2011</u>	<u>2010</u>
<b>Revenues:</b>		
Restricted:		
Net appreciation in fair value of investments	\$ 73,816,184	34,927,255
Settlement receipts	56,954,970	60,713,827
Miscellaneous income	22,877	59,972
Total restricted revenues	<u>130,794,031</u>	<u>95,701,054</u>
Interest and dividend income	20,833,415	20,002,694
Securities lending income	57,184	84,583
Contract income	4,759,951	1,551,599
Total revenues	<u>156,444,581</u>	<u>117,339,930</u>
 <b>Expenditures:</b>		
Personnel and administrative	905,730	927,227
Health communication and program promotion	6,142,397	6,040,181
Community programs	4,421,081	5,205,504
Evaluation services	596,887	508,769
Counseling	4,342,659	4,300,734
Research	1,707,549	488,653
Investment management fees	2,218,818	1,907,087
Equipment	13,424	31,879
Other	188,517	74,699
Total expenditures	<u>20,537,062</u>	<u>19,484,733</u>
Net changes in fund balances	135,907,519	97,855,197
Fund balances, beginning of year	<u>526,213,132</u>	<u>428,357,935</u>
Fund balances, end of year	<u>\$ 662,120,651</u>	<u>526,213,132</u>

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2011 and 2010**

**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 Mr. Travis Monroe, Director of Budget and 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>2011</i>	<i>2010</i>
<b>Assets</b>		
Cash and cash equivalents:		
Unrestricted cash	\$ 75,661,221	34,547,652
Restricted cash:		
Securities lending collateral	45,517,652	44,996,813
Contractual	13,395	219,688
Total restricted cash	<u>45,531,047</u>	<u>45,216,501</u>
Total cash and cash equivalents	<u>121,192,268</u>	<u>79,764,153</u>
Receivables:		
Interest and dividends	4,098,983	3,602,046
Contract receivable	3,512,090	-
Securities lending receivable	5,581	5,395
Total receivables	<u>7,616,654</u>	<u>3,607,441</u>
Investments, at fair value:		
U.S. government securities	112,670,635	105,024,165
Foreign government securities	12,418,904	7,376,708
Domestic corporate bonds	156,083,735	155,436,742
Foreign corporate bonds	20,675,354	20,002,809
Domestic stocks	192,144,280	143,979,496
Foreign stocks	90,004,100	65,912,458
Alternative investments	7,992,504	-
Total investments, at fair value	<u>591,989,512</u>	<u>497,732,378</u>
Capital assets, net of accumulated depreciation of \$65,053 and \$39,305 as of June 30, 2011 and 2010, respectively.	<u>60,243</u>	<u>61,024</u>
Total assets	<u>720,858,677</u>	<u>581,164,996</u>

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

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## STATEMENTS OF NET ASSETS, CONTINUED

<i>June 30,</i>	<i>2011</i>	<i>2010</i>
<b>Liabilities</b>		
Net payable to brokers	10,156,257	5,864,604
Accounts payable	3,003,873	4,029,423
Liability under securities lending	45,517,652	44,996,813
Compensated absences:		
Payable within 1 year	29,613	23,110
Payable after 1 year	44,419	34,666
Total liabilities	<u>58,751,814</u>	<u>54,948,616</u>
<b>Net Assets</b>		
Invested in capital assets	60,243	61,024
Restricted for investment	632,837,824	502,043,793
Unrestricted	<u>29,208,796</u>	<u>24,111,563</u>
Total net assets	<u>\$ 662,106,863</u>	<u>526,216,380</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>2011</i>	<i>2010</i>
<b>Expenses:</b>		
Program:		
Health communication and program promotion	\$ 6,142,397	6,040,181
Community programs	4,421,081	5,205,504
Counseling	4,342,659	4,300,734
Evaluation services	596,887	508,769
Research	1,707,549	488,653
Total program expenses	17,210,573	16,543,841
Operating:		
Personnel and administrative	921,986	938,975
Other	176,973	87,772
Depreciation	25,748	3,365
Total operating expenses	1,124,707	1,030,112
Total expenses	18,335,280	17,573,953
<b>Investment income:</b>		
Interest income	15,315,496	15,550,246
Dividend income	5,517,919	4,452,448
Securities lending income	57,184	84,583
Net appreciation in fair value of investments	73,816,184	34,927,255
Total investment income	94,706,783	55,014,532
Investment expenses	(2,218,818)	(1,907,087)
Net investment income	92,487,965	53,107,445
<b>Other income:</b>		
Contract income	4,759,951	1,551,599
Miscellaneous income	22,877	59,972
Total other income	4,782,828	1,611,571
<b>Contribution to fund principal:</b>		
Settlement receipts	56,954,970	60,713,827
Changes in net assets	135,890,483	97,858,890
Net assets, beginning of year	526,216,380	428,357,490
Net assets, end of year	\$ 662,106,863	526,216,380

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

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**BALANCE SHEETS—PERMANENT FUND**

<i>June 30,</i>	<i>2011</i>	<i>2010</i>
<b>Assets</b>		
Cash and cash equivalents:		
Unrestricted cash	\$ 75,661,221	34,547,652
Restricted cash:		
Securities lending collateral	45,517,652	44,996,813
Contractual	13,395	219,688
Total restricted cash	<u>45,531,047</u>	<u>45,216,501</u>
Total cash and cash equivalents	<u>121,192,268</u>	<u>79,764,153</u>
Receivables:		
Interest and dividends	4,098,983	3,602,046
Contract receivable	3,512,090	-
Securities lending receivable	5,581	5,395
Total receivables	<u>7,616,654</u>	<u>3,607,441</u>
Investments, at fair value:		
U.S. government securities	112,670,635	105,024,165
Foreign government securities	12,418,904	7,376,708
Domestic corporate bonds	156,083,735	155,436,742
Foreign corporate bonds	20,675,354	20,002,809
Domestic stocks	192,144,280	143,979,496
Foreign stocks	90,004,100	65,912,458
Alternative investments	7,992,504	-
Total investments, at fair value	<u>591,989,512</u>	<u>497,732,378</u>
Total assets	<u>\$ 720,798,434</u>	<u>581,103,972</u>
<b>Liabilities and Fund Balances</b>		
Liabilities:		
Net payable to brokers	\$ 10,156,258	5,864,604
Accounts payable	3,003,873	4,029,423
Liability under securities lending	45,517,652	44,996,813
Total liabilities	<u>58,677,783</u>	<u>54,890,840</u>
Fund balances:		
Nonspendable	632,837,824	502,043,793
Assigned	2,928,283	2,416,934
Unassigned	26,354,544	21,752,405
Total fund balances	<u>662,120,651</u>	<u>526,213,132</u>
Total liabilities and fund balances	<u>\$ 720,798,434</u>	<u>581,103,972</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>2011</i>	<i>2010</i>
Total fund balances	\$ 662,120,651	526,213,132
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.	60,244	61,024
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>(74,032)</u>	<u>(57,776)</u>
Net assets	<u>\$ 662,106,863</u>	<u>526,216,380</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>2011</i>	<i>2010</i>
<b>Revenues:</b>		
Restricted:		
Net appreciation in fair value of investments	\$ 73,816,184	34,927,255
Settlement receipts	56,954,970	60,713,827
Miscellaneous income	22,877	59,972
Total restricted revenues	<u>130,794,031</u>	<u>95,701,054</u>
Interest income	15,315,496	15,550,246
Dividend income	5,517,919	4,452,448
Securities lending income	57,184	84,583
Contract income	4,759,951	1,551,599
Total revenues	<u>156,444,581</u>	<u>117,339,930</u>
<b>Expenditures:</b>		
Personnel and administrative	905,730	927,227
Health communication and program promotion	6,142,397	6,040,181
Community programs	4,421,081	5,205,504
Evaluation services	596,887	508,769
Counseling	4,342,659	4,300,734
Research	1,707,549	488,653
Investment management fees	2,218,818	1,907,087
Equipment	13,424	31,879
Other	188,517	74,699
Total expenditures	<u>20,537,062</u>	<u>19,484,733</u>
Net changes in fund balances	135,907,519	97,855,197
Fund balances, beginning of year	<u>526,213,132</u>	<u>428,357,935</u>
Fund balances, end of year	<u>\$ 662,120,651</u>	<u>526,213,132</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>2011</i>	<i>2010</i>
Net changes in fund balances	\$ 135,907,519	97,855,197
<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 (less than) greater than depreciation in the current period.</p>	(781)	15,443
<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 amount by which unused compensated absences increased over the amount in the prior year.</p>	<u>(16,255)</u>	<u>(11,750)</u>
<p>Changes in net assets, per statements of activities</p>	<u>\$ 135,890,483</u>	<u>97,858,890</u>

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

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS

June 30, 2011 and 2010

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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 8) may be expended for operations; tobacco prevention and cessation programs; research and treatment efforts in Oklahoma to prevent and combat cancer and other tobacco-related diseases; and other programs to maintain or improve the health of Oklahomans or to enhance health care services provided to Oklahomans, with a particular emphasis on children and senior adults.

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

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

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

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

*Government-Wide Financial Statements*—The statements of net 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

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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 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

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### (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 cash collateral maintained for those securities at June 30 were:

	<u>Fair Value</u>	
	<u>2011</u>	<u>2010</u>
<u>Securities loaned</u>		
U.S. government securities	\$ 1,339,504	2,018,680
U.S. corporate bonds	16,223,799	16,083,236
U.S. equity	<u>27,617,287</u>	<u>26,563,429</u>
Total securities loaned	<u>\$ 45,180,590</u>	<u>44,665,345</u>
Cash collateral maintained for securities loaned	<u>\$ 45,517,652</u>	<u>44,996,813</u>
Percentage of cash collateral to securities loaned as of June 30	<u>100.75%</u>	<u>100.74%</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; however, at June 30, 2011 and 2010, all collateral was presented as cash in U.S. currency. The total value of the collateral held at June 30, 2011 and 2010, was \$337,062 and \$331,468, 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

The cash collateral ratio to securities loaned as of June 30, 2011 and 2010, was below 102% due to a position in a \$1,000,000 unsecured Lehman Brothers note held in the cash collateral pool. The Investment Policy Statement and the executed Securities Lending Agreement and Guaranty require collateral at 102% of the market value of the securities loaned at the time of the transaction. Lehman Brothers filed for bankruptcy protection on September 15, 2008. The loss estimated by BNY Mellon, the securities lending agent, at June 30, 2011, on this security was \$742,500. The security matured on November 24, 2008. The Chairman of the Board of Investors was notified by BNY Mellon shortly after the bankruptcy notice and has negotiated a support agreement in the absorption of realized losses on the Lehman security through the bankruptcy proceedings. BNY Mellon began in January 2009 to accrue its 30% split of securities lending income earned into an escrow account. A 3-year vesting period is required to receive the support. The Fund will be vested in January 2012. The approximate amount accrued in the escrow account at June 30, 2011, was \$133,000. The anticipated total loss at final settlement is not expected to be material and cannot be reasonably estimated at the current time.

Securities lending income included as certified earnings was \$57,184 and \$84,583 for the fiscal years ended June 30, 2011 and 2010, 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

#### 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.

#### Date of Management's Review of Subsequent Events

Management has evaluated subsequent events through September 28, 2011, the date which the financial statements were available to be issued.

### (2) RECLASSIFICATION OF FUND BALANCE

Effective July 1, 2010, the Fund implemented Governmental Accounting Standards Board Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* (GASB 54), which provides guidance to governments to:

- Improve the consistency in reporting fund balance components;
- Enhance fund balance presentation;
- Improve the usefulness of fund balance information; and
- Clarify the definitions of the governmental fund types.

Implementation of GASB 54 resulted in renaming fund balances and reclassifying certain 2010 amounts to conform to the 2011 presentation. The overall effect of implementing GASB 54 upon the Fund's financial reporting was not material to the financial statements of the Fund.

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (3) CASH AND INVESTMENTS

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

	<u>2011</u>	<u>2010</u>
Cash on deposit with the State	\$ 1,016,549	99,216
Foreign currency	830,449	829,969
Contractual restricted cash	13,395	219,688
Collateral from securities lending—restricted cash	45,517,652	44,996,813
Certificates of deposit	6,405,880	4,201,833
Money market mutual fund	<u>67,408,343</u>	<u>29,416,634</u>
	<u>\$ 121,192,268</u>	<u>79,764,153</u>

#### 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 (the “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 \$1,175,000 for 2011 and \$1,551,599 for 2010. As of June 30, 2011 and 2010, there was a restricted cash balance of \$13,395 and \$219,688, respectively, related to the OSDH contract. During the year ended June 30, 2011, the Fund had other contracts with OSDH for over \$3,500,000.

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.

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

See Independent Auditors’ Report.



**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Credit Risk**

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

	<u>2011</u>	
	<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	\$ 10,984	(1)
U.S. Treasury notes	66,472	(1)
Federal Home Loan Mortgage Corp.	4,555	AAA
Federal National Mortgage Corp.	26,916	AAA
Government National Mortgage Association	321	AAA
Other	522	AAA
Other	<u>2,900</u>	A
	<u>112,670</u>	
<b>Corporate bonds (held in U.S. currency):</b>		
Domestic bonds	25,068	A
Domestic bonds	9,965	AA
Domestic bonds	17,616	AAA
Domestic bonds	46,375	B
Domestic bonds	19,685	BA
Domestic bonds	14,222	BAA
Domestic bonds	734	BB
Domestic bonds	466	BBB
Domestic bonds	49	C
Domestic bonds	239	CA
Domestic bonds	12,142	CAA
Domestic bonds	49	CC
Domestic bonds	2,871	CCC
Domestic bonds	479	D
Domestic bonds	<u>6,124</u>	Other
	<u>156,084</u>	

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

	2011	
	<u>Fair Value</u>	
	<i>(Expressed in thousands)</i>	<u>Moody Rating</u>
<b>Foreign corporate bonds (held in U.S. currency):</b>		
Foreign bonds	1,900	A
Foreign bonds	814	AA
Foreign bonds	6,612	B
Foreign bonds	2,094	BA
Foreign bonds	651	BB
Foreign bonds	315	Other
	<u>12,386</u>	
<b>Foreign corporate bonds (held in foreign currency):</b>		
Foreign bonds	1,863	A
Foreign bonds	1,098	AA
Foreign bonds	1,318	B
Foreign bonds	599	BA
Foreign bonds	2,247	BAA
Foreign bonds	123	BB
Foreign bonds	140	BBB
Foreign bonds	20	C
Foreign bonds	683	CAA
Foreign bonds	198	CCC
	<u>8,289</u>	

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Credit Risk, Continued**

	2011	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody Rating</u>
<b>Foreign government bonds (held in U.S. currency):</b>		
Foreign government bonds	244	AA
Foreign government bonds	207	B
Foreign government bonds	223	BA
Foreign government bonds	<u>1,628</u>	BAA
	<u>2,302</u>	
 <b>Foreign government bonds (held in foreign currency):</b>		
Foreign government bonds	916	A
Foreign government bonds	6,046	AAA
Foreign government bonds	2,968	BAA
Foreign government bonds	<u>187</u>	CC
	<u>10,117</u>	
 Total fair value of credit risk	 <u>\$ 301,848</u>	

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

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Credit Risk, Continued**

	2010	
	<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	\$ 5,675	(1)
U.S. Treasury notes	64,066	(1)
Federal Home Loan Bank	355	AAA
Federal Home Loan Mortgage Corp.	7,958	AAA
Federal National Mortgage Corp.	23,793	AAA
Government National Mortgage Association	387	AAA
Other	190	AAA
Other	<u>2,600</u>	A
	<u>105,024</u>	
 <b>Corporate bonds (held in U.S. currency):</b>		
Domestic bonds	33,846	A
Domestic bonds	10,277	AA
Domestic bonds	19,484	AAA
Domestic bonds	41,145	B
Domestic bonds	18,935	BA
Domestic bonds	14,631	BAA
Domestic bonds	1,006	BB
Domestic bonds	212	BBB
Domestic bonds	191	C
Domestic bonds	227	CA
Domestic bonds	11,768	CAA
Domestic bonds	5	CC
Domestic bonds	3,037	CCC
Domestic bonds	61	D
Domestic bonds	<u>612</u>	Other
	<u>155,437</u>	

(Continued)

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(3) CASH AND INVESTMENTS, CONTINUED

Credit Risk, Continued

	2010	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody</u> <u>Rating</u>
<b>Corporate bonds (held in foreign currency):</b>		
Domestic bonds	1,244	A
Domestic bonds	345	AA
Domestic bonds	103	B
Domestic bonds	211	BA
Domestic bonds	38	Other
	<u>1,941</u>	
<b>Foreign corporate bonds (held in U.S. currency):</b>		
Foreign bonds	1,274	A
Foreign bonds	1,878	AA
Foreign bonds	4,824	B
Foreign bonds	922	BA
Foreign bonds	3,420	BAA
Foreign bonds	222	BB
Foreign bonds	234	BBB
Foreign bonds	83	CA
Foreign bonds	587	CAA
Foreign bonds	54	Other
	<u>13,498</u>	

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Credit Risk, Continued**

	2010	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Moody</u> <u>Rating</u>
<b>Foreign corporate bonds (held in foreign currency):</b>		
Foreign bonds	435	A
Foreign bonds	607	AA
Foreign bonds	1,305	B
Foreign bonds	214	BA
Foreign bonds	1,238	BAA
Foreign bonds	110	BB
Foreign bonds	121	BBB
Foreign bonds	62	C
Foreign bonds	319	CAA
Foreign bonds	152	CCC
	<u>4,563</u>	
<b>Foreign government bonds (held in U.S. currency):</b>		
Foreign government bonds	103	AA
Foreign government bonds	665	B
Foreign government bonds	1,681	BA
Foreign government bonds	1,172	BAA
	<u>3,621</u>	
<b>Foreign government bonds (held in foreign currency):</b>		
Foreign government bonds	2,875	AAA
Foreign government bonds	359	BA
Foreign government bonds	522	BAA
	<u>3,756</u>	
Total fair value of credit risk	<u>\$ 287,840</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

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### (3) 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, represented 5% or more of the Fund's net assets at June 30, 2011 or 2010.

#### 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.

	2011	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Effective</u> <u>Duration</u> <u>Years</u>
<b>U.S. government securities (government guaranteed):</b>		
U.S. Treasury bonds	\$ 10,984	17.35
U.S. Treasury notes	66,472	4.49
Government National Mortgage Association	321	3.79
Other	3,422	8.52
<b>Foreign government securities:</b>		
Foreign government bonds (held in U.S. currency)	2,302	6.32
Foreign government bonds (held in foreign currency)	10,117	5.31
<b>Mortgage-backed securities:</b>		
Federal Home Loan Mortgage Corp.	4,555	1.68
Federal National Mortgage Corp.	26,916	5.18
<b>Corporate bonds:</b>		
Domestic bonds (held in U.S. currency)	156,084	4.71
Foreign bonds (held in U.S. currency)	12,386	4.22
Foreign bonds (held in foreign currency)	8,289	4.42
Total fixed income	<u>\$ 301,848</u>	

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Interest Rate Risk, Continued**

	2010	
	<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	\$ 5,675	17.45
U.S. Treasury notes	64,066	4.05
Federal Home Loan Bank	355	7.54
Government National Mortgage Association	387	1.74
Other	2,790	9.42
<b>Foreign government securities:</b>		
Foreign government bonds (held in U.S. currency)	3,621	6.54
Foreign government bonds (held in foreign currency)	3,756	8.48
<b>Mortgage-backed securities:</b>		
Federal Home Loan Mortgage Corp.	7,958	1.22
Federal National Mortgage Corp.	23,793	2.29
<b>Corporate bonds:</b>		
Domestic bonds (held in U.S. currency)	155,437	5.30
Domestic bonds (held in foreign currency)	1,941	5.76
Foreign bonds (held in U.S. currency)	13,498	4.83
Foreign bonds (held in foreign currency)	4,563	3.57
	<u>\$ 287,840</u>	

See Independent Auditors' Report.



**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Foreign Currency Risk**

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

	2011	
	<u>Fair Value</u> (Expressed in thousands)	<u>Type</u>
Foreign currency:		
Argentine peso	\$ 53	Fixed income
Australian dollar	1,094	Equity
Bermuda dollar	842	Fixed income
Brazilian Real	5,613	Equity
Brazilian Real	1,554	Fixed income
Brazilian Real	1	Foreign currency
British pound sterling	13,925	Equity
British pound sterling	3,219	Fixed income
British pound sterling	263	Foreign currency
Canadian dollar	3,502	Equity
Canadian dollar	2,240	Fixed income
Cayman dollar	727	Equity
Cayman dollar	1,222	Fixed income
Columbian peso	258	Fixed income
Euro	29,402	Equity
Euro	18,819	Fixed income
Euro	494	Foreign currency
Hong Kong dollar	7,074	Equity
Israeli shequel	1,205	Equity
Korean Won	3,429	Equity
Malaysian Ringgit	916	Fixed income

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Foreign Currency Risk, Continued**

	2011	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Type</u>
Foreign currency, Continued:		
Malaysian Ringgit	9	Foreign currency
Mexican Nuevo Peso	1,242	Fixed income
Mexican Nuevo Peso	47	Foreign currency
Peruvian Nuevo sol	473	Fixed income
Peruvian Nuevo sol	16	Foreign currency
Russian ruble	1,830	Equity
Russian ruble	708	Fixed income
Singapore dollar	2,227	Equity
South African rand	1,970	Equity
Swedish krona	1,285	Equity
Swiss franc	5,324	Equity
Swiss franc	567	Fixed income
Thai baht	904	Equity
Turkish lira	223	Fixed income
Venezuelan bolivar fuerte	154	Fixed income
Yen	10,493	Equity
	<u>123,324</u>	
Other—securities held in U.S. dollars	<u>605</u>	
	<u>\$ 123,929</u>	

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Foreign Currency Risk, Continued**

	2010	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Type</u>
Foreign currency:		
Argentine peso	\$ 186	Fixed income
Australian dollar	7	Foreign currency
Australian dollar	282	Fixed income
Australian dollar	4,276	Equity
Bermuda dollar	889	Fixed income
Brazilian real	1,471	Fixed income
British pound sterling	359	Foreign currency
British pound sterling	8,892	Equity
British pound sterling	3,551	Fixed income
Canadian dollar	1,597	Fixed income
Canadian dollar	3,532	Equity
Cayman dollar	1,119	Equity
Cayman dollar	1,172	Fixed income
Chilean peso	163	Fixed income
Colombian peso	821	Fixed income
Danish krone	221	Fixed income
Euro	464	Foreign currency
Euro	21,514	Equity
Euro	11,179	Fixed income
Hong Kong dollar	5,926	Equity
Indonesian rupiah	339	Fixed income
Japanese yen	14,456	Equity

(Continued)

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Foreign Currency Risk, Continued**

	2010	
	<u>Fair Value</u> <i>(Expressed in thousands)</i>	<u>Type</u>
Foreign currency, Continued:		
Malaysian ringgit	315	Fixed income
Mexican nuevo peso	816	Fixed income
New Israeli shequel	1,477	Equity
North Korean won	1,141	Equity
Norwegian krone	1,441	Equity
Norwegian krone	48	Fixed income
Peruvian Nuevo sol	18	Fixed income
Qatar rial	369	Fixed income
Russian ruble	891	Fixed income
Singapore dollar	1,449	Equity
South African rand	157	Fixed income
Swedish krona	647	Fixed income
Swiss franc	246	Fixed income
Thai baht	691	Equity
Thai baht	273	Fixed income
Turkish lira	1,056	Fixed income
Venezuelan bolivar fuerte	671	Fixed income
	<u>\$ 94,122</u>	

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (4) DERIVATIVES

Derivative instruments are financial contracts whose values depend on the values of one or more underlying assets, reference rates, or financial indexes. They include futures contracts, swap contracts, options contracts, and forward foreign currency exchange. The Fund's derivatives policy identifies and allows common derivative investments and strategies which are consistent with applicable law and the Investment Policy Statement and requires investment managers to petition for the inclusion of additional derivative instruments and strategies. The guidelines also require investment managers to follow certain controls and documentation and risk management procedures. The Fund enters into these certain derivative instruments primarily to enhance the performance and reduce the volatility of its portfolio. It enters futures contracts to gain or hedge exposure to certain markets and to manage interest rate risk and uses forward foreign exchange contracts primarily to hedge foreign currency exposure. The tables below summarize the various contracts in the portfolio as of June 30, 2011 and 2010. 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

	<u>June 30, 2011</u>		
	<u>2011</u>		
	<u>Expiration</u>	<u>Long/Short</u>	<u>Notional/ Fair Value</u>
	<u>Date</u>		<i>(Expressed in thousands)</i>
U.S. 5-Year Note	September	Short	\$ 11,562
Euro-Bund Future	September	Short	2,729
10-Year Note Future	September	Short	<u>2,569</u>
			<u>\$ 16,860</u>

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(4) DERIVATIVES, CONTINUED**

*Futures Contracts, Continued*

	June 30, 2010		
	2010		
	Expiration	<u>Long/Short</u>	Notional/ <u>Fair Value</u>
	<u>Date</u>		(Expressed in thousands)
U.S. 5-Year Note	September	Short	\$ 947
Long Gilt Future	September	Short	724
Euro-Bobl Future	September	Short	1,777
Euro-Bund Future	September	Short	2,536
10-Year Note Future	September	Short	1,348
U.S. Long Bond	September	Short	<u>383</u>
			<u>\$ 7,715</u>

*Foreign Currency Forward Contracts*

	<u>June 30, 2011</u>	<u>June 30, 2010</u>
	(Expressed in thousands)	
Pending receivable	\$ 30,428	27,274
Pending payable	<u>(30,430)</u>	<u>(26,660)</u>
Foreign currency forward contract (liability) asset	<u>\$ (2)</u>	<u>614</u>

As of June 30, 2011, the foreign currency forward contracts expire in August and September 2011. During the years ended June 30, 2011 and 2010, realized gains on foreign currency contracts were approximately \$93,000 and \$894,000, respectively.

As of June 30, 2011, the Fund had an investment in a foreign currency options contract with a pending receivable of \$18. The foreign currency options contract expires in September 2011.

The Fund invests in mortgage-backed securities, which are reported at fair value in the statements of net assets 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

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### (5) ALTERNATIVE INVESTMENTS

Alternative investments as of June 30, 2011, were with limited partnerships as follows:

<u>Company</u>	<u>Fair Value (Determined using NAV)</u>	<u>Unfunded Commitment</u>	<u>Purpose</u>
FrontPoint Partners L.P.	\$ 3,164,620	11,871,513	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
Medley Opportunity Fund II L.P.	\$ 4,827,884	9,985,932	Investments consist of senior secured direct loans to corporate entities that meet certain criteria.
Total alternative investments	<u>\$ 7,992,504</u>	<u>21,857,445</u>	

Alternative investments are carried at the net asset value (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**

**(6) CAPITAL ASSETS**

The following is a summary of changes in capital assets:

	<u>Balance at June 30, 2010</u>	<u>Additions</u>	<u>Disposals</u>	<u>Balance at June 30, 2011</u>
Depreciable capital assets:				
Office equipment and furnishings	\$ 100,329	24,967	-	125,296
Accumulated depreciation:				
Office equipment and furnishings	<u>(39,305)</u>	<u>(25,748)</u>	<u>-</u>	<u>(65,053)</u>
Net capital assets	<u>\$ 61,024</u>	<u>(781)</u>	<u>-</u>	<u>60,243</u>

	<u>Balance at June 30, 2009</u>	<u>Additions</u>	<u>Disposals</u>	<u>Balance at June 30, 2010</u>
Depreciable capital assets:				
Office equipment and furnishings	\$ 81,521	18,808	-	100,329
Accumulated depreciation:				
Office equipment and furnishings	<u>(35,940)</u>	<u>(3,365)</u>	<u>-</u>	<u>(39,305)</u>
Net capital assets	<u>\$ 45,581</u>	<u>15,443</u>	<u>-</u>	<u>61,024</u>

**(7) CHANGES IN COMPENSATED ABSENCES**

Compensated absence activity was as follows:

	<u>Balance at June 30, 2010</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance at June 30, 2011</u>	<u>Amounts due within 1 year</u>
Compensated absences	<u>\$ 57,776</u>	<u>36,765</u>	<u>(20,509)</u>	<u>74,032</u>	<u>29,613</u>
	<u>Balance at June 30, 2009</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance at June 30, 2010</u>	<u>Amounts due within 1 year</u>
Compensated absences	<u>\$ 46,026</u>	<u>29,002</u>	<u>(17,252)</u>	<u>57,776</u>	<u>23,110</u>

See Independent Auditors' Report.



# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (8) FUND BALANCES

Fund balance refers to the difference between assets and liabilities in the governmental funds balance sheet. Fund balance, as defined in GASB 54, 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 amount of loans and receivables, as well as property acquired for resale and the corpus (principal) of a permanent fund.

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

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

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

- Unassigned Fund Balance: 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 of approved programs and operations, and contractual income less program and operational expenses.*

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

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

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

**(8) FUND BALANCES, CONTINUED**

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

	2011			
	<u>Nonspendable</u>	<u>Assigned</u>	<u>Unassigned</u>	<u>Total</u>
Balance at June 30, 2010	\$ 502,043,793	2,416,934	21,752,405	526,213,132
Settlement receipts	56,954,970	-	-	56,954,970
Net appreciation in fair value of investments	73,816,184	-	-	73,816,184
Miscellaneous income	22,877	-	-	22,877
Contract income	-	-	4,759,951	4,759,951
Expendable earnings	-	-	18,671,781	18,671,781
Program and operating expenses	-	-	(18,318,244)	(18,318,244)
Transfers	-	511,349	(511,349)	-
Balance at June 30, 2011	<u>\$ 632,837,824</u>	<u>2,928,283</u>	<u>26,354,544</u>	<u>662,120,651</u>

Subsequent to June 30, 2011, the Board of Investors certified \$18,917,736.91 of earnings for the 2012 operations; however, the amount certified was prior to completion of the audit and will be adjusted at a later date. The above computation of expendable earnings was done in accordance with present guidelines and interpretations. As further discussed in Note 13, an Attorney General Opinion (No. 2011-11) was issued subsequent to June 30, 2011, which redefines expendable earnings for certification.

	2010			
	<u>Nonspendable</u>	<u>Assigned</u>	<u>Unassigned</u>	<u>Total</u>
Balance at June 30, 2009	\$ 406,342,739	2,201,519	19,813,677	428,357,935
Settlement receipts	60,713,827	-	-	60,713,827
Net appreciation in fair value of investments	34,927,255	-	-	34,927,255
Miscellaneous income	59,972	-	-	59,972
Contract income	-	-	1,551,599	1,551,599
Expendable earnings	-	-	18,180,191	18,180,191
Program and operating expenses	-	-	(17,577,647)	(17,577,647)
Transfers	-	215,415	(215,415)	-
Balance at June 30, 2010	<u>\$ 502,043,793</u>	<u>2,416,934</u>	<u>21,752,405</u>	<u>526,213,132</u>

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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**(9) 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.

**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 2011	
<u>State Employees</u>	<u>The Fund</u>
<u>All Salaries</u>	<u>All Salaries</u>
3.5%	15.5%

Fiscal Year 2010	
<u>State Employees</u>	<u>The Fund</u>
<u>All Salaries</u>	<u>All Salaries</u>
3.5%	15.5%

The Fund’s contributions to the Retirement Plan for the years ended June 30, 2011 and 2010, were \$70,367 and \$63,730, respectively, and were equal to its required contributions for each year.

See Independent Auditors’ Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Deferred Compensation Plan**

The State offers its employees a Deferred Compensation Plan (the “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 Plan is the Board of Trustees of the Oklahoma Public Employees Retirement System (the “Board”).

The 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 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.

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

The 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 Plan is also limited to contributions for years in which the participant was eligible but did not participate in the 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 of up to \$5,000 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 Plan’s provisions.

See Independent Auditors’ Report.

## TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

### NOTES TO FINANCIAL STATEMENTS, CONTINUED

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

##### **Deferred Compensation Plan, Continued**

Effective January 1, 1998, the Board established a Trust and a Trust Fund covering the 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 Plan's participants and their beneficiaries. Prior to the establishment of the Trust, the 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 Plan or to determine that the Trust Fund is adequate to provide the benefits payable pursuant to the Plan.

Further information may be obtained from the Plan's audited financial statements for the years ended June 30, 2011 and 2010. The Fund believes that it has no liabilities with respect to the Plan.

##### **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 that is an active participant in the 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 Plan and is not voluntary.

Upon cessation of contributions to the 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.

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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

#### **Deferred Savings Incentive Plan, Continued**

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

### (11) **OPERATING EXPENSES**

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

Effective July 1, 2010, both Boards have approved that \$100,000 be provided to the Office of the State Treasurer as funding for staff support to the Board of Investors for FY2011. 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.

### (12) **COMMITMENTS AND CONTINGENCIES**

#### **Contracts**

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

#### **Settlement Receipts**

As permitted by the Tobacco Master Settlement Agreement between the State and participating manufacturers, the participating manufacturers have disputed the amount due to the State based on the final calculation and have placed the disputed funds in an escrow account. For the years ended June 30, 2011 and 2010, the Fund's portion of the disputed final calculation was approximately \$8,700,000 and \$6,000,000, respectively. These amounts were deposited in the escrow account for each of the respective years.

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (13) SUBSEQUENT EVENTS

#### Available Earnings

Annual earnings available for expenditure were previously considered to be dividends and interest, less fees to manage the Fund (see Note 8). However, Attorney General Opinion 2011-11, which was issued subsequent to June 30, 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 investments and minus any losses realized by the Fund. As a result, the amount of earnings available for certification may be redefined to include realized gains and losses on the sales of securities. It is expected that future computations of earnings available for certification will be done in compliance with the opinion issued by the Attorney General's Office.

#### Market Fluctuations

Subsequent to June 30, 2011, the United States financial market has had a considerable downward fluctuation. The long-term ratings of U.S. government and federal agencies were lowered from AAA to AA+ by Standard & Poor's rating agency. As the investments of the Fund are at market value, these values have varied considerably and may continue to vary.

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 the permanent fund of the Tobacco Settlement Endowment Trust Fund (the "Fund") as of and for the year ended June 30, 2011, which collectively comprise the Fund's financial statements and have issued our report thereon dated September 28, 2011. 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. In addition, there is a paragraph noting the implementation of GASB 54. 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 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 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.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, 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 28, 2011