

# **Tobacco Settlement Endowment Trust Fund**

## *Financial Statements*

June 30, 2007 and 2006  
(With Independent Auditors' Report Thereon)



# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## FINANCIAL STATEMENTS

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## **INDEPENDENT AUDITORS' REPORT**

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

We have audited the accompanying financial statements of the governmental activities and permanent fund of the Tobacco Settlement Endowment Trust Fund (the "Fund"), as of and for the years ended June 30, 2007 and 2006, 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 changes in financial position of only that portion of the governmental activities and governmental funds of the State of Oklahoma that are 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, 2007 and 2006, and the changes in the State of Oklahoma's 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 financial position of the governmental activities and permanent fund of the Fund as of June 30, 2007 and 2006, and the respective changes in financial position thereof for the years then ended in conformity with accounting principles generally accepted in the United States.

(Continued)

**INDEPENDENT AUDITORS' REPORT, CONTINUED**

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

In accordance with *Government Auditing Standards*, we have also issued a report dated September 21, 2007, on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

Shawnee, Oklahoma  
September 21, 2007

# **TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2007 and 2006**

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, 2007 and 2006. The intent of the MD&A is to look at the Fund's financial performance as a whole. It should, therefore, be read in conjunction with the Fund's financial statements and the notes thereto.

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

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

### **USING THIS ANNUAL REPORT**

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

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

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

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2007 and 2006**

**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 2007 and 2006 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>2007</u>	<u>2006</u>
<b>Assets</b>		
Current assets	\$ 84,230,959	64,060,896
Investments, at fair value	368,883,597	266,618,097
Capital assets	29,137	25,596
Total assets	<u>453,143,693</u>	<u>330,704,589</u>
<b>Liabilities</b>		
Current liabilities	12,170,441	2,906,150
Liability under securities lending	64,673,908	30,367,838
Noncurrent liabilities	17,657	18,479
Total liabilities	<u>76,862,006</u>	<u>33,292,467</u>
<b>Net Assets</b>		
Invested in capital assets	29,137	25,596
Restricted for investment	363,275,447	287,701,209
Unrestricted	12,977,103	9,685,317
Total net assets	<u>\$ 376,281,687</u>	<u>297,412,122</u>

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

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

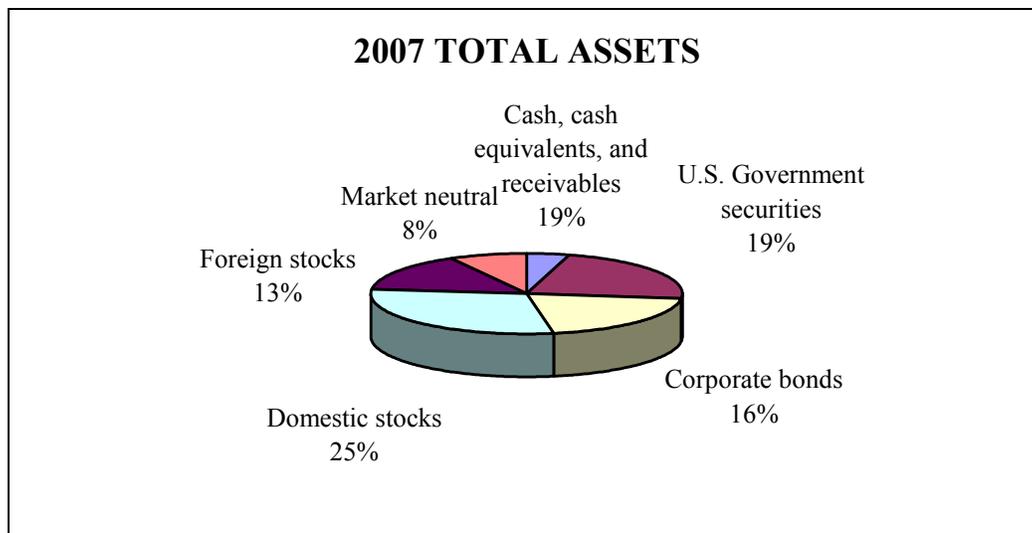
June 30, 2007 and 2006

### FINANCIAL HIGHLIGHTS, CONTINUED

#### Statements of Net Assets, Continued

The Fund's total net assets increased \$78.9 million during the year, as the Fund invested an additional \$47.6 million in settlement receipts, recognized an additional \$38.4 million as net investment income, and expended \$8.3 million on programs and operations. Total investments increased from \$266.6 million at the beginning of the year to \$368.9 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 \$28 million from the net appreciation of the fair value of the portfolio and earned \$10.4 million in interest and dividends, net of investment management fees which were certified by the Board of Investors for FY2008 funding. The Fund's investment policy establishes investment goals and objectives and provides specific investment guidelines for investment managers, including a prohibition from investing in securities issued by companies engaged in the manufacture of tobacco products.

Cash balances also include restricted cash in excess of \$64 million which represents cash collateral presented to the fund by security borrowers through the Board's securities lending effort. Use of this cash is restricted unless the borrowers were to default in the return of the securities borrowed.



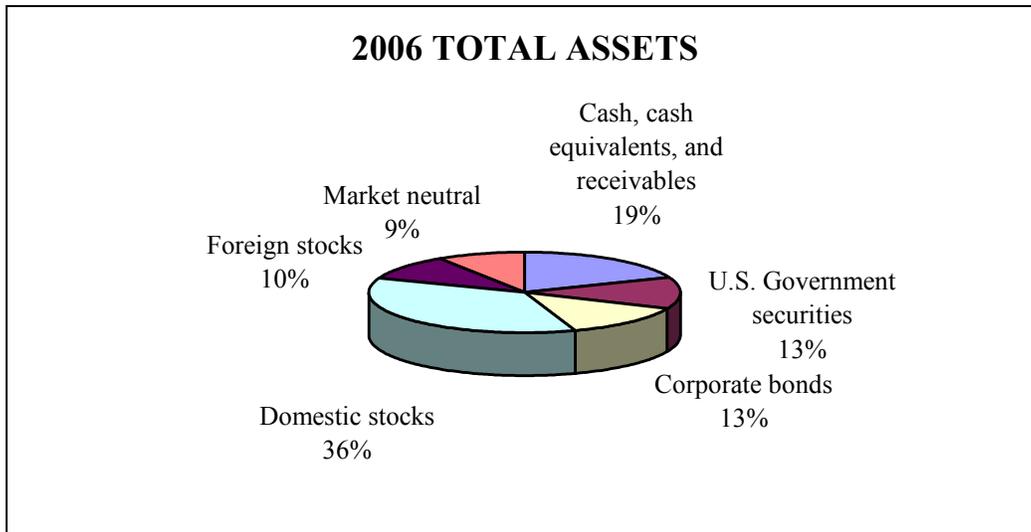
**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2007 and 2006**

**FINANCIAL HIGHLIGHTS, CONTINUED**

**Statements of Net Assets, Continued**



**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2007 and 2006**

**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>2007</u>	<u>2006</u>
<b>Investment income:</b>		
Interest and dividend income	\$ 11,959,491	8,461,166
Securities lending income	55,298	8,412
Net appreciation in fair value of investments	<u>27,993,559</u>	<u>7,737,441</u>
Total investment income	40,008,348	16,207,019
Investment expenses	<u>(1,656,271)</u>	<u>(1,617,784)</u>
Net investment income	<u>38,352,077</u>	<u>14,589,235</u>
 <b>Other income:</b>		
Contract income	1,250,000	1,250,000
Miscellaneous income	<u>670</u>	<u>-</u>
Total other income	<u>1,250,670</u>	<u>1,250,000</u>
 <b>Expenses:</b>		
Program	7,836,614	5,775,871
Operating	<u>484,989</u>	<u>487,652</u>
Total expenses	<u>8,321,603</u>	<u>6,263,523</u>
 Increase in net assets before settlement receipts	 31,281,144	 9,575,712
 <b>Contribution to fund principal:</b>		
Settlement receipts	<u>47,588,421</u>	<u>42,434,293</u>
Increase in net assets	78,869,565	52,010,005
 Net assets, beginning of year	 <u>297,412,122</u>	 <u>245,402,117</u>
 Net assets, end of year	 <u>\$ 376,281,687</u>	 <u>297,412,122</u>

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

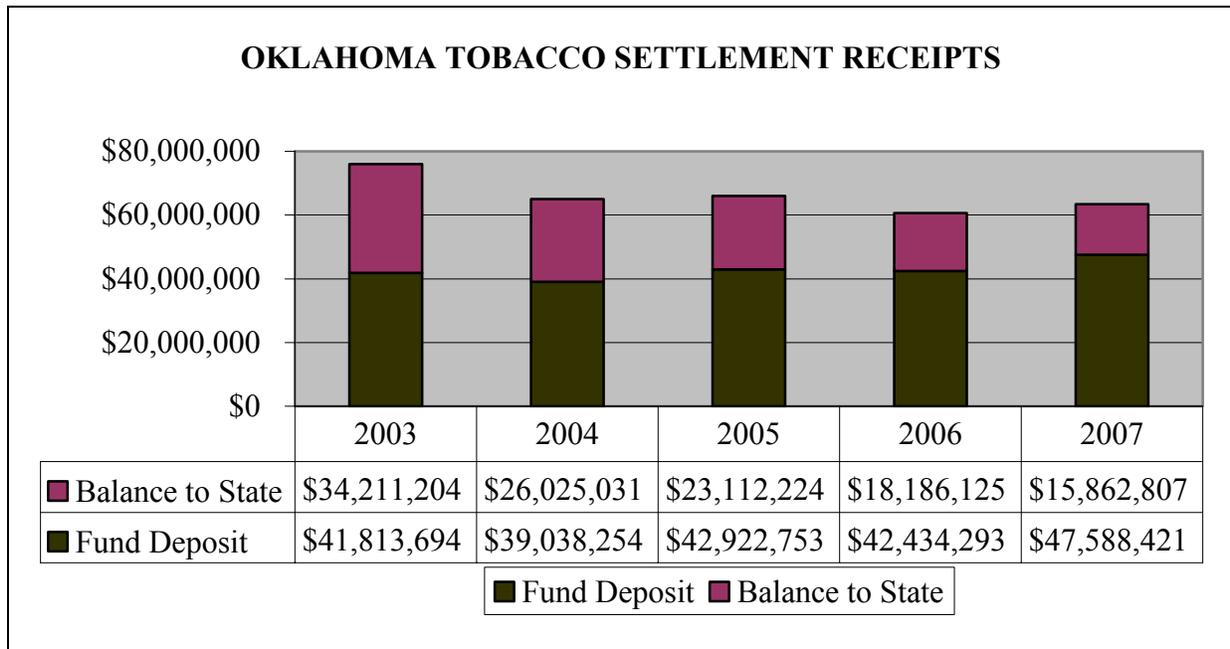
**MANAGEMENT’S DISCUSSION AND ANALYSIS (MD&A), CONTINUED**

**June 30, 2007 and 2006**

**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, 2007 and 2006, 75% and 70%, respectively, of settlement receipts paid to the State were deposited by the State into the Fund. The percentage of the State’s settlement receipts to be received by the Fund has increased by 5% annually until it reached 75% during the fiscal year ending June 30, 2007, where it remains thereafter. As reflected below, settlement receipts deposited by the Fund increased by \$5,154,128 from 2006.



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

Previous studies of tobacco consumption reported by the National Association of Attorneys General showed a continued long-term decline in cigarette sales in the United States since the state Attorneys General negotiated the Tobacco Master Settlement Agreement in 1998. A downward trend in consumption was reported through 2005. The Centers for Disease Control and Prevention states that recent research indicates that the more spent on comprehensive tobacco control programs, the greater the reduction in smoking. However, recent surveys indicate that the rate of decline may have stalled in youth and adults, due in large part to the fact that only three states are funding tobacco prevention programs at the minimum levels recommended by the CDC. In FY2007, funding for Oklahoma’s tobacco prevention programs was just over half the minimum amount recommended by the CDC.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2007 and 2006**

**FINANCIAL HIGHLIGHTS, CONTINUED**

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

Since 1998, increasing numbers of new tobacco manufacturers, not participating in the Master Settlement Agreement, have entered the market. These new tobacco manufacturers impact the market share of the participating manufacturers and this, in turn, reduces the amount of the settlement payments to the states. As shown below, a significant amount of the payment from the April 15, 2007, calculation was not received by the settling states and has been deposited in disputed accounts.

	FY-2007				FY-2006			
	<u>Final Calculation</u>	%	<u>Deposit to Trust—75%</u>	%	<u>Final Calculation</u>	%	<u>Deposit to Trust—70%</u>	%
Independent Auditor's Oklahoma Final Calculation	\$ 69,930,243	100.0%	52,447,682	100.0%	68,058,917	100.0%	47,641,242	100.0%
Received	<u>63,451,228</u>	<u>90.7%</u>	<u>47,588,421</u>	<u>90.7%</u>	<u>60,620,418</u>	<u>89.1%</u>	<u>42,434,293</u>	<u>89.1%</u>
Amount Not Received	<u>\$ 6,479,015</u>	<u>9.3%</u>	<u>4,859,261</u>	<u>9.3%</u>	<u>7,438,499</u>	<u>10.9%</u>	<u>5,206,949</u>	<u>10.9%</u>

A participating manufacturer who disputes the final calculation may pay the disputed amount into the disputed payments accounts to avoid any accrual of interest until the issue is resolved. Noted disputes during the FY2007 calculation include various computation interpretations and completeness or accuracy of data; however, significant disputes involve the application of the non-participating manufacturer adjustment in 2003 and 2004. Subsequent disputes are anticipated for the 2005, 2006, and probably the 2007 calculation. These participating manufacturers maintain that they are entitled to withhold, whether by means of offset or otherwise, from their 2007 payment or to place in the disputed payments account the amount attributable to the nonparticipating manufacturers adjustment for the year disputed. The settling states do not agree with this position and litigation is pending in this matter.

As settlement receipts were deposited and invested and the portfolio was diversified during the fiscal year ended June 30, 2007, net investment income increased by \$23.8 million over the \$14.6 million recognized during the 2006 fiscal year. Interest and dividend income increased \$3.5 million while the net appreciation of investment in the Funds' portfolio increased \$20.3 million. Fees paid to investment managers, consultants, and custodians increased \$38.5 thousand.

## **TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2007 and 2006**

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

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

As previously noted, the Fund's principal is restricted for investment purposes only. The dividend and interest income earned, less the fees spent to manage the Fund, may be expended for operations, tobacco use prevention and cessation programs, research and treatment efforts in Oklahoma to prevent and combat cancer and other tobacco-related diseases, and other programs to maintain or improve the health of Oklahomans with a particular emphasis on children and senior adults. The Board of Directors has adopted a strategic plan to maximize the impact of the limited earnings available in the early years by focusing on reducing tobacco use in Oklahoma.

During the fiscal year ended June 30, 2007, the Board of Directors increased program funding by more than \$2 million. Additional funding was provided to meet the growing demand for the Oklahoma Tobacco Helpline, a toll-free statewide phone line, 1-800-QUIT-NOW, to meet the growing demand for telephone-based tobacco cessation counseling. The Board of Directors continued to fund a youth prevention counter-marketing campaign. FY2007 campaigns included ads to educate youth on the hazardous ingredients contained in tobacco products and the harmful effects of secondhand smoke.

During 2007, the Board of Directors also increased funding for 16 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. These 16 grantees provide services in 25 counties and three tribal nations.

A new grant program, "Addressing Tobacco in Specific Populations," was initiated in FY2007. 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.

In FY2007, the Board of Directors continued an agreement with the Oklahoma State Department of Health to provide additional funding to meet the increasing demand for the statewide telephone-based Oklahoma Tobacco Helpline. According to the terms of the contract, OSDH agrees to pay the Board of Directors at the beginning of the contract period up to 31 days of estimated Helpline costs, and reimburse additional Helpline expenses paid out of the beginning deposit throughout the year. Total revenue from this contract was \$1,250,000 for 2007 and 2006. Adjustments to the cash balance are requested by the Board of Directors through pro forma invoices monthly. These funds are restricted for the purpose of the Helpline.

During the fiscal years ended June 30, 2006 and 2007, operating expenses decreased by \$2,663 from \$487,652 to \$484,989. Personnel, accounting, and other office-related operating expenses initiated during the 2006 fiscal year were incurred for a full 12-month period during the fiscal year ended June 30, 2007. Effective July 1, 2006, the Office of the State Treasurer requested, and both Boards approved, that \$114,000 be provided to the State Treasurer as funding for staff support to the Board of Investors for FY2007. Operating expenses includes salaries, travel, and other operating expenses of the Board of Directors and the Board of Investors. During 2007, the maximum amount allowed for operating expenses was changed from \$500,000 to 15% of certified earnings in any fiscal year.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2007 and 2006**

**FUND HIGHLIGHTS, CONTINUED**

**Governmental Fund—Balance Sheets**

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

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

	<u>2007</u>	<u>2006</u>
<b>Assets:</b>		
Cash and cash equivalents	\$ 82,087,588	60,824,847
Interest and dividends receivable	2,133,343	1,401,206
Securities lending receivable	10,028	3,550
Net receivable from brokers	-	1,831,293
Investments at fair value	<u>368,883,597</u>	<u>266,618,097</u>
Total assets	<u>\$ 453,114,556</u>	<u>330,678,993</u>
<b>Liabilities:</b>		
Net payable to brokers	\$ 9,627,408	-
Accounts payable	2,531,262	2,893,830
Liability under securities lending	<u>64,673,908</u>	<u>30,367,838</u>
Total liabilities	<u>76,832,578</u>	<u>33,261,668</u>
<b>Fund Balances:</b>		
Reserved for investment	363,275,447	287,701,209
Unreserved	<u>13,006,531</u>	<u>9,716,116</u>
Total fund balances	<u>376,281,978</u>	<u>297,417,325</u>
Total liabilities and fund balances	<u>\$ 453,114,556</u>	<u>330,678,993</u>

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2007 and 2006**

**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>2007</u>	<u>2006</u>
<b>Revenues:</b>		
Restricted:		
Net appreciation in fair value of investments	\$ 27,993,559	7,737,441
Settlement receipts	47,588,421	42,434,293
Miscellaneous income	670	-
Total restricted revenues	<u>75,582,650</u>	<u>50,171,734</u>
Interest and dividend income	11,959,491	8,461,166
Contract income	1,250,000	1,250,000
Securities lending income	55,298	8,412
Total revenues	<u>88,847,439</u>	<u>59,891,312</u>
<b>Expenditures:</b>		
Personnel and administrative	423,615	426,245
Counseling services	3,454,732	2,793,937
Health communication and program promotion	1,947,615	1,368,462
Community programs	2,160,839	1,273,017
Evaluation services	273,150	339,899
Investment management fees	1,656,271	1,617,784
Equipment	15,174	4,686
Other	51,390	46,673
Total expenditures	<u>9,982,786</u>	<u>7,870,703</u>
Net changes in fund balances	78,864,653	52,020,609
Fund balances, beginning of year	<u>297,417,325</u>	<u>245,396,716</u>
Fund balances, end of year	<u>\$ 376,281,978</u>	<u>297,417,325</u>

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

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

**June 30, 2007 and 2006**

**REQUESTS FOR INFORMATION**

This financial report is designed to provide a general overview of the Fund's finances for all those with an interest. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to Dr. James Wilbanks, Director of Revenue & Fiscal Policy, Office of the Oklahoma State Treasurer, 2300 North Lincoln Boulevard, Room 217, Oklahoma City, Oklahoma 73105-4895.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**STATEMENTS OF NET ASSETS**

<i>June 30,</i>	<i>2007</i>	<i>2006</i>
<b>Assets</b>		
Cash and cash equivalents:		
Unrestricted cash	\$ 17,413,680	30,207,008
Restricted cash	-	250,001
Securities lending collateral—restricted cash	64,673,908	30,367,838
Total cash and cash equivalents	<u>82,087,588</u>	<u>60,824,847</u>
Receivables:		
Interest and dividends	2,133,343	1,401,206
Net receivable from brokers	-	1,831,293
Securities lending receivable	10,028	3,550
Total receivables	<u>2,143,371</u>	<u>3,236,049</u>
Investments, at fair value:		
U.S. Government securities	85,855,809	41,682,352
Domestic corporate bonds	72,889,035	43,543,212
Foreign corporate bonds	2,366,543	3,972,063
Market neutral commingled funds	36,687,856	30,887,662
Domestic stocks	112,786,602	115,949,897
Foreign stocks	58,297,752	30,582,911
Total investments, at fair value	<u>368,883,597</u>	<u>266,618,097</u>
Capital assets, net of accumulated depreciation of \$23,536 and \$16,049 as of June 30, 2007 and 2006, respectively.	29,137	25,596
Total assets	<u>453,143,693</u>	<u>330,704,589</u>
<b>Liabilities</b>		
Net payable to brokers	9,627,408	-
Accounts payable	2,531,262	2,893,830
Liability under securities lending	64,673,908	30,367,838
Compensated absences:		
Payable within 1 year	11,771	12,320
Payable after 1 year	17,657	18,479
Total liabilities	<u>76,862,006</u>	<u>33,292,467</u>
<b>Net Assets</b>		
Invested in capital assets	29,137	25,596
Restricted for investment	363,275,447	287,701,209
Unrestricted	12,977,103	9,685,317
Total net assets	<u>\$ 376,281,687</u>	<u>297,412,122</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>2007</i>	<i>2006</i>
<b>Expenses:</b>		
Program:		
Counseling services	\$ 3,454,732	2,793,937
Health communication and program promotion	1,947,615	1,368,462
Community programs	2,160,839	1,273,017
Evaluation services	273,150	339,899
Depreciation	278	556
Total program expenses	<u>7,836,614</u>	<u>5,775,871</u>
Operating:		
Personnel and administrative	422,244	431,099
Other	55,536	49,628
Depreciation	7,209	6,925
Total operating expenses	<u>484,989</u>	<u>487,652</u>
Total expenses	<u>8,321,603</u>	<u>6,263,523</u>
<b>Investment income:</b>		
Interest income	7,267,466	5,353,583
Dividend income	4,692,025	3,107,583
Securities lending income	55,298	8,412
Net appreciation in fair value of investments	27,993,559	7,737,441
Total investment income	40,008,348	16,207,019
Investment expenses	(1,656,271)	(1,617,784)
Net investment income	<u>38,352,077</u>	<u>14,589,235</u>
<b>Other income:</b>		
Contract income	1,250,000	1,250,000
Miscellaneous income	670	-
Total other income	<u>1,250,670</u>	<u>1,250,000</u>
<b>Contribution to fund principal:</b>		
Settlement receipts	47,588,421	42,434,293
Changes in net assets	78,869,565	52,010,005
Net assets, beginning of year	<u>297,412,122</u>	<u>245,402,117</u>
Net assets, end of year	<u>\$ 376,281,687</u>	<u>297,412,122</u>

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

## TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

### BALANCE SHEETS—PERMANENT FUND

<i>June 30,</i>	<i>2007</i>	<i>2006</i>
<b>Assets</b>		
Cash and cash equivalents:		
Unrestricted cash	\$ 17,413,680	30,207,008
Restricted cash	-	250,001
Securities lending collateral—restricted cash	64,673,908	30,367,838
Total cash and cash equivalents	<u>82,087,588</u>	<u>60,824,847</u>
Receivables:		
Interest and dividends	2,133,343	1,401,206
Securities lending receivable	10,028	3,550
Net receivable from brokers	-	1,831,293
Total receivables	<u>2,143,371</u>	<u>3,236,049</u>
Investments, at fair value:		
U.S. Government securities	85,855,809	41,682,352
Domestic corporate bonds	72,889,035	43,543,212
Foreign corporate bonds	2,366,543	3,972,063
Market neutral commingled funds	36,687,856	30,887,662
Domestic stocks	112,786,602	115,949,897
Foreign stocks	58,297,752	30,582,911
Total investments, at fair value	<u>368,883,597</u>	<u>266,618,097</u>
Total assets	<u>\$ 453,114,556</u>	<u>330,678,993</u>
<b>Liabilities and Fund Balances</b>		
Liabilities:		
Net payable to brokers	\$ 9,627,408	-
Accounts payable	2,531,262	2,893,830
Liability under securities lending	64,673,908	30,367,838
Total liabilities	<u>76,832,578</u>	<u>33,261,668</u>
Fund balances:		
Reserved for investment	363,275,447	287,701,209
Unreserved	13,006,531	9,716,116
Total fund balances	<u>376,281,978</u>	<u>297,417,325</u>
Total liabilities and fund balances	<u>\$ 453,114,556</u>	<u>330,678,993</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>2007</i>	<i>2006</i>
Total fund balances	\$ 376,281,978	297,417,325
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.	29,137	25,596
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>(29,428)</u>	<u>(30,799)</u>
Net assets	<u>\$ 376,281,687</u>	<u>297,412,122</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>2007</i>	<i>2006</i>
<b>Revenues:</b>		
Restricted:		
Net appreciation in fair value of investments	\$ 27,993,559	7,737,441
Settlement receipts	47,588,421	42,434,293
Miscellaneous income	670	-
Total restricted revenues	<u>75,582,650</u>	<u>50,171,734</u>
Interest income	7,267,466	5,353,583
Dividend income	4,692,025	3,107,583
Securities lending income	55,298	8,412
Contract income	<u>1,250,000</u>	<u>1,250,000</u>
Total revenues	<u>88,847,439</u>	<u>59,891,312</u>
<b>Expenditures:</b>		
Personnel and administrative	423,615	426,245
Counseling services	3,454,732	2,793,937
Health communication and program promotion	1,947,615	1,368,462
Community programs	2,160,839	1,273,017
Evaluation services	273,150	339,899
Investment management fees	1,656,271	1,617,784
Equipment	15,174	4,686
Other	51,390	46,673
Total expenditures	<u>9,982,786</u>	<u>7,870,703</u>
Net changes in fund balances	78,864,653	52,020,609
Fund balances, beginning of year	<u>297,417,325</u>	<u>245,396,716</u>
Fund balances, end of year	<u>\$ 376,281,978</u>	<u>297,417,325</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>2007</i>	<i>2006</i>
Net changes in fund balances	\$ 78,864,653	52,020,609
<p>Amounts reported in the statements of activities are different because:</p>		
<p>Governmental funds report capital outlays as expenditures. However, in the statements of activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount by which capital outlays were greater than (less than) depreciation in the current period.</p>	3,540	(5,750)
<p>Some expenses reported in the statements of activities do not require the use of current financial resources and therefore are not reported as expenditures in governmental funds. This amount represents the cost of compensated absences earned but not used in the current year.</p>	<u>1,372</u>	<u>(4,854)</u>
<p>Changes in net assets, per statements of activities</p>	<u>\$ 78,869,565</u>	<u>52,010,005</u>

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

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS

June 30, 2007 and 2006

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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 were deposited into the Fund during the fiscal year ended June 30, 2002. That percentage increased by 5% annually until it reached 75% during the fiscal year ending June 30, 2007, where it remains thereafter. However, there are no guarantees regarding the State’s continued receipt of funds in settlement of claims against tobacco companies. The principal funds are invested and the dividends and interest, less fees to manage the Fund, are expended for tobacco prevention and cessation programs; research and treatment efforts in Oklahoma to prevent and combat cancer and other tobacco-related diseases; and other programs to maintain or improve the health of Oklahomans or to enhance health care services provided to Oklahomans, with a particular emphasis on children and senior adults.

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

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

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

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

See Independent Auditors’ Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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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 government-wide presentations.

#### Investments

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

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

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

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

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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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. Policy requires the securities lending agent to provide indemnification against borrower default, have written agreements with each borrower, not to loan securities until acceptable collateral is received and monitor that collateral on a daily basis, and review and monitor the approved borrowers to minimize risk.

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

	<u>Market Value</u>	
	<u>2007</u>	<u>2006</u>
U.S. Government securities	\$ 31,393,151	10,552,532
U.S. corporate bonds	1,220,401	2,330,785
Foreign corporate bonds	-	147,469
U.S. equity	30,104,228	16,061,723
Foreign equity	-	555,034
	<u>\$ 62,717,780</u>	<u>29,647,543</u>
Cash collateral maintained for securities loaned	<u>\$ 64,673,908</u>	<u>30,367,838</u>

Borrowers were required to deliver and maintain collateral for each loan with a market value equal to 102% of the current market value of the loaned securities. Collateral delivered in non U.S. currency is required to be equal to 105% of the market value of the securities loaned; however, at June 30, 2007 and 2006, all collateral was presented as cash in U.S. currency. The total value of the collateral held at June 30, 2007 and 2006, was \$ 1,956,128 and \$720,295, respectively, more than the current market value of the securities loaned; thus, no credit risk existed at the balance sheet date from these transactions. Collateral was unmatched to the securities loaned with a one-day maturity. Collateral cannot be used by the Trust except in the event of default.

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

During fiscal year 2006, securities lending income was not considered certifiable earnings and was included in net assets as restricted for investments. The Fund subsequently determined that securities lending income should be treated as interest income and included in certifiable earnings. Therefore, securities lending income received for fiscal year 2006 in the amount of \$8,412 has been transferred from net assets restricted for investment to unrestricted net assets.

#### Capital Assets

Furniture, fixtures, and equipment which have an expected useful life of more than 1 year are recorded as capital assets. Capital assets are recorded at cost when purchased. Depreciation is recorded on capital assets in the government-wide financial statements. Depreciation is calculated on a straight-line basis over 4- to 12-year periods for computer systems and office furniture and fixtures, respectively.

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

#### Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### Compensated Absences

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

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, Continued**

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

**Advertising Costs**

All costs associated with advertising are expensed as incurred.

**(2) CASH AND INVESTMENTS**

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

	<u>2007</u>	<u>2006</u>
Cash on deposit with the State	\$ 142,660	11,579
Contractual restricted cash	-	250,001
Collateral from securities lending—restricted cash	64,673,908	30,367,838
Money market mutual fund	<u>17,271,020</u>	<u>30,195,429</u>
	<u>\$ 82,087,588</u>	<u>60,824,847</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. 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 \$1,250,000 for 2007 and 2006. Cash collateral from securities lending activity is identified as restricted cash as it cannot be used by the Trust unless there is default in the return of the securities loaned.

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

See Independent Auditors’ Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

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

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

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

See Independent Auditors’ Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Credit Risk**—Continued

	2006	
	<u>Fair Value</u>	<u>Moody</u>
	<i>(Expressed in thousands)</i>	<u>Rating</u>
<b>U.S. Government agencies:</b>		
U.S. Treasury bonds	\$ 5,231	(1)
U.S. Treasury notes	11,836	(1)
Federal Home Loan Bank	3,066	AAA
Federal Home Loan Mortgage Corp.	8,250	AAA
Federal National Mortgage Corp.	12,306	AAA
Other	993	Other
	41,682	
<b>Corporate bonds:</b>		
Domestic bonds	2,546	A
Domestic bonds	1,912	AA
Domestic bonds	9,434	AAA
Domestic bonds	12,661	B
Domestic bonds	12,769	BA
Domestic bonds	3,703	BAA
Domestic bonds	44	BBB
Domestic bonds	398	CAA
Domestic bonds	76	Other
	43,543	
Foreign bonds	521	A
Foreign bonds	270	AA
Foreign bonds	845	AAA
Foreign bonds	1,048	B
Foreign bonds	1,168	BA
Foreign bonds	120	BAA
	3,972	
Total fair value of credit risk	\$ 89,197	

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

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Concentration of Credit Risk**—The Fund limits its exposure to concentration of credit risk through its investment policy and asset allocation policy. Within asset classes, individual securities are limited to not more than 6% of the investment manager’s portfolio; however, securities of one issuer could be represented in more than one asset class. No investments in any one organization, excluding those guaranteed by the U.S. Government, represent 5% or more of the Fund’s net assets at June 30, 2007 and 2006.

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

	<u>2007</u>	
	<u>Fair Value</u>	<u>Effective Duration</u>
	<u>Years</u>	
	<i>(Expressed in thousands)</i>	
<b>U.S. Government securities</b>		
<b>(government guaranteed):</b>		
U.S. Treasury bonds	\$ 5,492	11.78
U.S. Treasury notes	21,157	6.78
Federal Home Loan Bank	11,090	1.6
GNMA	744	5.34
SLMA	699	4.82
<b>Mortgage-backed securities:</b>		
Federal Home Loan Mortgage Corp.	20,684	3.31
Federal National Mortgage Corp.	25,989	3.47
<b>Corporate bonds:</b>		
Domestic bonds	72,890	6.14
Foreign bonds	2,366	4.4
	<u>161,111</u>	
Total fixed income	<u>\$ 161,111</u>	

See Independent Auditors’ Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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

**Interest Rate Risk**—Continued

	<u>2006</u>	
	<u>Fair Value</u>	<u>Effective Duration Years</u>
	<i>(Expressed in thousands)</i>	
<b>U.S. Government securities</b>		
<b>(government guaranteed):</b>		
U.S. Treasury bonds	\$ 5,231	12.94
U.S. Treasury notes	11,836	5.35
Federal Home Loan Bank	3,066	3.1
GNMA	211	16.66
SLMA	782	3.87
<b>Mortgage-backed securities:</b>		
Federal Home Loan Mortgage Corp.	8,250	3.18
Federal National Mortgage Corp.	12,306	3.05
<b>Corporate bonds:</b>		
Domestic bonds	43,543	6.35
Foreign bonds	<u>3,972</u>	5.64
Total fixed income	<u>\$ 89,197</u>	

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS, CONTINUED

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

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

See Independent Auditors' Report.

TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

NOTES TO FINANCIAL STATEMENTS, CONTINUED

(2) CASH AND INVESTMENTS, CONTINUED

Foreign Currency Risk—Continued

	2006	
	<u>Fair Value</u>	<u>Type</u>
	<i>(Expressed in thousands)</i>	
<b>Foreign currency:</b>		
Australian dollar	\$ 533	Equity
Bermuda dollar	200	FX Inc
British pound sterling	5,128	Equity
British pound sterling	127	FX Inc
Canadian dollar	503	Equity
Canadian dollar	1,299	FX Inc
Cayman dollar	287	FX Inc
Danish kroner	716	Equity
Egyptian pound	227	FX Inc
Euro	12,495	Equity
Euro	893	FX Inc
Hong Kong dollar	877	Equity
Israeli shekel	1,990	Equity
Israeli shekel	303	FX Inc
Japanese yen	5,376	Equity
Korean won	314	Equity
Mexican peso	82	FX Inc
New Taiwan dollar	277	Equity
New Zealand dollar	299	Equity
Norwegian krone	432	Equity
Singapore dollar	413	Equity
Singapore dollar	554	FX Inc
South Korean won	130	Equity
Swedish krona	263	Equity
Swiss franc	837	Equity
	<u>\$ 34,555</u>	

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (3) FUND BALANCES

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

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

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (3) FUND BALANCES, CONTINUED

	2006		
	Reserved for <u>Investment</u>	<u>Unreserved</u>	<u>Total</u>
Balance, June 30, 2005	\$ 237,521,063	7,875,653	245,396,716
Settlement receipts	42,434,293	-	42,434,293
Net appreciation in fair value of investments	7,737,441	-	7,737,441
Securities lending income, reclassified in 2007	8,412	-	8,412
Contract income	-	1,250,000	1,250,000
Expendable earnings	-	6,843,382	6,843,382
Program and operating expenses	-	(6,252,919)	(6,252,919)
	<u>\$ 287,701,209</u>	<u>9,716,116</u>	<u>297,417,325</u>
Balances, June 30, 2006	<u>\$ 287,701,209</u>	<u>9,716,116</u>	<u>297,417,325</u>

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

### (4) PENSION PLAN

#### Plan Description

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

See Independent Auditors' Report.

**TOBACCO SETTLEMENT ENDOWMENT TRUST FUND**

**NOTES TO FINANCIAL STATEMENTS, CONTINUED**

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**(4) PENSION PLAN, CONTINUED**

**Funding Policy**

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

	State Employees' Contributions		State Agencies' Contributions	
	<u>First \$25,000</u>	<u>Above \$25,000</u>	<u>All Salaries</u>	<u>All Salaries</u>
2007	-	-	3.5%	12.5%
2006	3.0%	3.5%	-	11.5%

The Fund's contribution of \$28,489, \$21,228, and \$16,088 to the Plan for the years ended June 30, 2007, 2006, and 2005, respectively, was equal to the Fund's established required contribution.

**(5) OPERATING EXPENSES**

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

Effective July 1, 2006, both Boards have approved that \$114,000 be provided to the Office of the State Treasurer as funding for staff support to the Board of Investors for FY2007. During 2007, State statutes were amended and specify that annual operating expenses shall not exceed 15% of certified earnings. Previously, State statutes specified that annual operating expenses could not exceed \$500,000.

See Independent Auditors' Report.

# TOBACCO SETTLEMENT ENDOWMENT TRUST FUND

## NOTES TO FINANCIAL STATEMENTS, CONTINUED

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### (6) COMMITMENTS AND CONTINGENCIES

#### Contracts

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

#### Settlement Receipts

As permitted by the Master Settlement Agreement between the State of Oklahoma and the participating manufacturers, the participating manufacturers have disputed the amount due to the State of Oklahoma based on the final calculation and have placed the disputed funds in an escrow account. For the years ended June 30, 2007 and 2006, the Fund's portion of the disputed final calculation was approximately \$4,900,000 and \$5,200,000, respectively. These amounts were deposited in the escrow account for each of the respective years.

See Independent Auditors' Report.

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

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

We have audited the financial statements of the governmental activities and permanent fund of the Tobacco Settlement Endowment Trust Fund (the "Fund") as of and for the year ended June 30, 2007, and have issued our report thereon dated September 21, 2007. The Fund is a part of the reporting entity of the State of Oklahoma. Our report includes an explanatory paragraph to emphasize the fact that the financial statements included only that portion of the State of Oklahoma that was attributable to the transactions of the Fund and an explanatory paragraph disclaiming an opinion on required supplementary information. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

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

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

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

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

(Continued)

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING 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.

Shawnee, Oklahoma  
September 21, 2007