State of Oregon Department of State Lands Common School Fund

Annual Financial Statements for the Fiscal Year Ended June 30, 2015

Common School Fund

Annual Financial Report

For the Fiscal Year Ended June 30, 2015

Oregon Department of State Lands

An Agency of the State of Oregon

Stephanie Hallock Cummins
Interim Director

Cynthia Wickham
Chief Financial Officer

Report Prepared by:

Vena McCoy, CPA, Fiscal Manager
Star Thomson, CPA

State of Oregon Department of State Lands
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FINANCIAL SECTION

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MERINA
& COMPANY, LLP
Certified Public Accountants and Consultants

CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

PARTNERS
KAMALA K. AUSTIN, CPA • TONYA M. MOFFITT, CPA

INDEPENDENT AUDITOR'S REPORT

State Land Board
Department of State Lands
Salem, Oregon

We have audited the accompanying financial statements of the Common School Fund, a major governmental fund of the State of Oregon, as of and for the year ended June 30, 2015, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America 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 involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Common School Fund as of June 30, 2015, and the changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 1, the financial statements present only the Common School Fund and do not purport to, and do not, present fairly the financial position of the State of Oregon or the Department of State Lands, as of June 30, 2015, the changes in their financial position, or where applicable, their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated November 9, 2015, on our consideration of Common School 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* in considering Common School Fund's internal control over financial reporting and compliance.

Merina & Company

Merina & Company, LLP
West Linn, Oregon
November 9, 2015

BASIC FINANCIAL STATEMENTS

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Balance Sheet

ASSETS		
Cash and Cash Equivalents	$	47,759,998
Investments		1,371,105,457
Custodial Assets		22,334,982
Securities Lending Collateral		65,442,551
Accounts and Interest Receivables (net)		14,486,453
Due from Other Funds		630,555
Advances to Other Funds		300,000
Net Contracts, Notes, and Other Receivables		608,774
Total Assets	$	1,522,668,770
LIABILITIES AND FUND BALANCES		
Liabilities:		
Accounts Payable	$	29,862,345
Obligations Under Securities Lending		65,442,551
Due to Other Funds		760,931
Custodial Liabilities		232,191,378
Total Liabilities		328,257,205
DEFERRED INFLOWS OF RESOURCES		
Unavailable revenue - contracts		608,774
Total Deferred Inflows of Resources		608,774
Fund Balances:		
Restricted by:		
Oregon Constitution		878,427,711
Enabling Legislation		315,375,080
Total Fund Balances		1,193,802,791
Total Liabilities, Deferred Inflows of Resources, and Fund Balances	$	1,522,668,770

The notes to the financial statements are an integral part of this statement.

Statement of Revenues, Expenditures, and Changes in Fund Balances

REVENUES	
Licenses and fees	$ 668,195
Charges for Services	285,083
Rebates and Recoveries	337
Fines, Forfeitures, and Penalties	55,206
Rents and Royalties	5,671,548
Investment Income	54,472,641
Sales	1,196,906
Unclaimed and Escheat Property Revenue	18,213,746
Donations and Grants	100
Other	46,818
Total Revenues	80,610,580
EXPENDITURES	
Personal Services	7,831,923
Services and Supplies	10,205,651
Capital Improvements	539,202
Investment Expenditures	5,092,968
Total Expenditures	23,669,744
Excess (Deficiency) of Revenues Over (Under) Expenditures	56,940,836
OTHER FINANCING SOURCES (USES)	
Transfers From Other Funds	4,354,174
Transfers to Other Funds	(58,844,810)
Insurance Recoveries	2,281,451
Total Other Financing Sources (Uses)	(52,209,185)
Net Change in Fund Balances	4,731,651
Fund Balances - Beginning	1,190,529,038
Prior Period Adjustments	(1,457,898)
Fund Balances - Beginning - As Restated	1,189,071,140
Fund Balances - Ending	$ 1,193,802,791

The notes to the financial statements are an integral part of this statement.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements of the Oregon Department of State Lands' Common School Fund have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB), and the American Institute of Certified Public Accountants (AICPA).

A – THE REPORTING ENTITY

The Department of State Lands (Department) is the administrative agency of the State Land Board handling the day-to-day work of the board in managing the land and other resources dedicated to the Common School Fund. The State Land Board, which consists of the Governor, the Secretary of State and the State Treasurer, is the trustee of the fund as outlined in the Oregon Constitution.

The Common School Fund, a governmental fund, was established at statehood and is intended to generate earnings to distribute to public schools. The Common School Fund accounts for programs that manage state-owned land, including a leasing program that generates annual revenues, for the benefit of the public school system. Estate funds that become the property of the state, unclaimed property, and income derived from unclaimed property are also accounted for in this fund. Statutory and constitutional provisions stipulate that the assets of the fund, including investment income, must be used for common school purposes. The primary funding sources for these programs include investment income, leasing revenues, forest management, unclaimed property receipts, and transfers from other funds.

B – FUND FINANCIAL STATEMENTS

The fund financial statements consist of a balance sheet and a statement of revenues, expenditures and changes in fund balances. The balance sheet is presented as: total assets equal liabilities, deferred inflows of resources, and fund balances. Information for receivables not expected to be collected within one year of the date of the financial statements and payables reported in the financial statements is discussed in Note 4. The statement of revenues, expenditures, and changes in fund balances reports revenues by type and expenditures by function. Other financing sources and other financing uses are reported in the last section of the statement.

C - MEASUREMENT FOCUS, BASIS OF ACCOUNTING AND FINANCIAL STATEMENT PRESENTATION

The Common School Fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized when they are both measurable and available. Revenues are considered to be available when they are collectible within the current year or soon enough thereafter to pay liabilities existing at the end of the year. For this purpose, revenues are considered available, if they are collected within 90 days of the end of the current fiscal year. Expenditures generally are recognized when a liability is incurred, as under accrual accounting.

D – DEPOSITS AND INVESTMENTS

<u>DEPOSITS</u>

Cash deposits not held in a cash management or investment pool are classified as cash and cash equivalents. Cash deposits that are held in a cash management or investment pool are classified as cash and cash equivalents when the pool has the general characteristics of a demand deposit account. Cash and cash equivalents include: cash on hand, cash and investments held by the Office of the State Treasurer in the Oregon Short-Term Fund (OSTF), cash deposits held in demand deposit accounts with custodial banks, and cash deposits of debt proceeds in investment funds held by a trustee.

<u>INVESTMENTS</u>

Investments are reported at fair value with the following exceptions, which are reported using cost-based measures:

- Investments in private equities are reported at cost.
- Investments in the OSTF with remaining maturities of up to 90 days are carried at amortized cost, which approximates fair value. The Department reports these investments as cash and cash equivalents on the balance sheet, but as investments in Note 2.

Changes in the fair value of investments are recognized as investment income (loss) in the current year.

DERIVATIVES

In accordance with State investment policies, the Office of the State Treasurer participates in contracts that have derivative characteristics. Derivative instruments are used to lower the cost of borrowing, to hedge against fluctuations in foreign currency rates, and to manage the overall risk of investment portfolios. The fair value of all derivative instruments within the Common School Fund are reported on the balance sheet as investments, accounts and interest receivable, and accounts and interest payable. The change in fair value for all Common School Fund derivative instruments is reported with investment income on the statement of revenues, expenditures, and changes in fund balances.

E – RECEIVABLES AND PAYABLES

Activities between funds that are representative of lending/borrowing arrangements outstanding at the end of the fiscal year are referred to as "advances to other funds." Receivables consist of revenues earned or accrued in the current period and are shown net of estimated uncollectible amounts. Payables consist of amounts owed to vendors for operational expenditures, other state agencies for services received and investment liabilities outstanding.

F – INTERFUND TRANSACTIONS

Interfund transactions are transactions between the Common School Fund and other funds included in the Oregon Comprehensive Annual Financial Report. Interfund balances (due to/from other funds and advances to/from other funds) result from the time lag between dates that (1) interfund goods and services are provided or reimbursable expenditures/expenses occur, (2) transactions are recorded in the accounting system, and (3) payments between funds are made. Advances to/from other funds are not expected to be repaid within one year. See Note 7 for more on interfund transactions.

G – RESTRICTED ASSETS

Custodial assets are non-cash assets held in trust for third parties in the Unclaimed Property Program.

H – FUND EQUITY

The difference between assets and liabilities plus deferred inflows of resources is labeled "Fund Balance" on the fund financial statements. Fund balance is reported in five components: (1) Nonspendable, (2) Restricted, (3) Committed, (4) Assigned, and (5) Unassigned.

Restricted fund balances are the result of constraints imposed by law through constitutional provisions or enabling legislation or by parties outside the State, such as creditors, grantors, contributors, or laws or regulations of other governments. Common School Fund Balances are all restricted.

For fund balance classification purposes, the Department determines the appropriate classification of each of their detail-level funds based on the resources accounted for in those funds and the constraints on spending those resources. The Department expends resources from the appropriate fund based on each fund's specific spending constraints. Ending fund balances, therefore, are the result of that spending.

NOTE 2 – DEPOSITS AND INVESTMENTS

Common School Fund Investment Portfolio held at Treasury

Investments of the Common School Fund held by the State Treasurer (Treasurer) require the exercise of prudent and reasonable care in the context of the Common School Fund's investment portfolio and as part of an overall investment strategy. The Treasurer is required to diversify investments unless it is not prudent to do so. In addition, the Treasurer must exercise reasonable care to incorporate risk and return objectives suitable to the particular investment fund. The Treasurer has a policy and procedure that addresses objectives and strategies for investments of the Common School Fund.

The Common School Fund's investment policies are governed by statute and the Oregon Investment Council (Council). The Treasurer is the investment officer for the Council and is responsible for the funds on deposit with the Oregon State Treasury (Treasury). The Treasurer works with the State Land Board to ensure implementation of the asset allocation policy that meets the business needs of the Common School Fund. The Council does not make asset allocation changes without considering input from the State Land Board. In accordance with Oregon statutes, the investment funds are invested, and the investments of those funds managed, as a prudent investor would do, exercising reasonable care, skill and caution. The Treasurer is authorized to use demand deposit accounts, fixed income investments, and direct equity investment transactions, although the majority of equity investments are directed by external investment managers under contract with the Council. Investments are managed around a 70 percent equity and a 30 percent fixed income target with a range of plus or minus 5 percent, as detailed below. The Common School Fund's actual asset allocation is monitored monthly relative to established asset allocation policy targets and ranges. A deviation outside of any of the ranges triggers a review and rebalancing back toward the target asset allocation with due consideration given to the liquidity of the investments and transaction costs. Whenever possible, cash flows into and out of the fund are used to rebalance between asset classes. Cash is held only for business operating purposes.

Asset Class	Benchmark	Target Allocation	Range
Domestic Equities	Russell 3000 Index	30%	25% - 35%
International Equities	MSCI ACWI ex-US	30%	25% - 35 %
Private Equity	Russell 3000 + 300 bps	10%	0% -12%
	Total Equities	70%	65% - 75%
US Fixed Income	Barclays Capital Universal Bond Index	30%	25% - 35%
Cash		0%	0% - 3%
Policy Mix	Weighted aggregate of indexes listed above at target allocation	100%	

Common School Fund Participation in the Oregon Short Term Fund Held at Treasury

The Treasurer maintains the Oregon Short-Term Fund (OSTF), a cash and investment pool that is available for use by the Common School Fund. Because the pool operates as a demand deposit account, the Common School Fund portion of the OSTF is classified on the financial statements as cash and cash equivalents. Additional information about the OSTF can be found in the OSTF financial statements at http://www.oregon.gov/treasury/Divisions/Investment/Pages/Oregon-Short-Term-Fund-(OSTF).aspx

Common School Fund Investments Held Outside Treasury

Statutes govern the placement of investments of the Common School Fund held outside Treasury as part of trust agreements or mandatory asset holdings by regulatory agencies. The Common School Fund investment portfolio includes $22,059,982 held outside Treasury and included in the $22,334,982 identified as custodial assets on the balance sheet.

A – DEPOSITS

Custodial Credit Risk for Deposits

The custodial credit risk for deposits is the risk that, in the event of a bank failure, the Department will not be able to recover deposits or collateral securities that are in the possession of an outside party. The Department does not have a formal policy regarding custodial credit risk for deposits. However, banking regulations and Oregon law establish the insurance and collateral requirements for deposit in the OSTF.

Oregon Revised Statutes (ORS) Chapter 295 governs the collateralization of public funds. Bank depositories are required to pledge collateral against any public fund deposits in excess of the deposit insurance amounts. This requirement provides additional protection for public funds in the event of a bank loss. ORS Chapter 295 sets the specific value of the collateral, as well as the types of collateral that are acceptable.

ORS Chapter 295 provides the statutory authority for the Public Funds Collateralization Program (PFCP). The PFCP is an application created by Treasury to facilitate bank depository, custodian, and public official compliance with ORS Chapter 295. Under the PFCP, banks are required to report quarterly to Treasury, providing quarter-end public fund balances in excess of Federal Deposit Insurance Corporation (FDIC) limits. Banks are also required to report their net worth and FDIC Capitalization information. The FDIC assigns each bank a capitalization category quarterly; well capitalized, adequately capitalized or undercapitalized. Based on this information, the bank's minimum collateral required to be pledged with the custodian and the maximum liability in the pool of all banks is calculated for the next quarter. The maximum liability is reported to the bank, Treasury and the custodian.

Barring any exceptions, a bank depository is required to pledge collateral valued at 10 percent or more of the bank's quarter-end public fund deposits if the bank is well capitalized and 110 percent if the bank is adequately capitalized, undercapitalized, or assigned to pledge 110 percent by Treasury.

There are three exceptions to this calculation, and any exceptions are required to be collateralized at 100 percent.

1. A bank may not accept public fund deposits from one depositor in excess of the bank's net worth. If the bank has a drop in net worth that takes it out of compliance, the bank is required to post 100 percent collateral on any amount the depositor has in excess of the bank's net worth while working to eliminate that excess.
2. A bank may not hold aggregate public funds in excess of a percentage of the bank's net worth based on its capitalization category (100 percent for undercapitalized, 150 percent for adequately capitalized, 200 percent for well capitalized) unless approved for a period of 90 days or less by Treasury.
3. A bank may hold in excess of 30 percent of all aggregate public funds reported by all banks holding Oregon public funds, only if the excess is collateralized at 100 percent.

Where interest-bearing balances within the OSTF exceed the FDIC or NCUA amount of $250,000, the balances were covered by collateral held in the PFCP.

As of June 30, 2015 $201,505 in other bank balances of the Common School Fund was held by an investment firm, not covered by the FDIC rules. However the firm is a member of the Securities Investor Protection Corporation which provides protection up to $500,000, of which $250,000 applies to cash credit balances. Consequently the entire bank balance of uninvested Common School Fund deposits was fully insured.

B – Investments

Custodial Credit Risk

Custodial credit risk for investments of the Common School Fund is the risk that, in the event of the failure of the counterparty to a transaction, the State will not be able to recover the value of an investment or collateral securities in the possession of an outside party. The Council has no formal policy regarding the holding of securities by a custodian or counter party. For the year ended June 30. 2015, no investment holdings of the Common School Fund held at Treasury were exposed to custodial credit risk.

At June 30, 2015 the Common School Fund held $21,858,477 in investments outside Treasury. These investments were held with Wedbush, an investment firm. The firm is a member of the Securities Investor Protection Corporation (SIPC) which provides protection up to $500,000 of which a maximum of $250,000 applies to cash credit balances. In addition to the coverage provide by the SIPC, the Firm has purchased from Lloyd's of London an excess SIPC bond that provides additional coverage for up to $25,000,000 in cash and securities for each client, subject to an aggregate loss limit of $100,000,000. The excess SIPC bond, together with SIPC coverage, provides for cash credit balances to each client to a maximum of $1,000,000. This protection will replace client's cash and/or securities that are otherwise unrecoverable. It does not cover clients from losses resulting from the decline in the market value of securities in their accounts. No investment holdings of the Common School Fund held outside Treasury were exposed to custodial credit risk.

Interest Rate Risk

Interest rate risk is the risk (variable in value) borne by an interest bearing asset such as a loan or a bond, due to variability of interest rates. Approximately 30 percent of the Common School Fund's investment portfolio is invested in fixed income securities. Investment policy for fixed income investments of the Common School Fund is to maintain a well-diversified bond portfolio, managed to maximize total return, that reflects the overall characteristics of the Barclays Capital Universal Index Benchmark and to invest opportunistically, using innovative investment approaches within a controlled and defined portfolio allocation.

Credit Risk and Concentration of Credit Risk
Credit risk refers to the risk that a borrower will default on any type of debt by failing to make payments which it is obligated to make. Treasury investment policies for fixed income investments of the Common School Fund maintain an overall portfolio quality of at least "A" or higher; maintain an average bond duration level of plus or minus 20 percent of the Barclays Capital Universal Index. No more than 30 percent of the total fixed income portfolio at market value, may be maintained in securities rated less than Baa3. No more than 10 percent of the total fixed income portfolio, at market value, may be maintained in Rule 144A securities. No more than 25 percent of the fixed income allocation shall be invested in a single industry, or Government Agency. Use of leverage in any fixed income securities is not allowed (excluding use of securities in a securities lending program).

Interest Rate Sensitive Investments
The Common School Fund held approximately $57.9 million in debt instruments backed by pooled mortgages, TBAs (to-be-announced federal agency-issued mortgage pools), collateralized mortgage obligations (CMOs), or fixed-rate mortgages. These securities represent a stream of principal and interest payments from underlying mortgages and consequently, the value of these securities can be volatile as interest rates fluctuate. Assets with these characteristics may also be susceptible to prepayment by the mortgage holders which may result in a decrease in total interest realized. Additionally, the risk of default exits and collateral held may potentially be insufficient to cover the principal due. The Common School Fund also held approximately $8.5 million of asset-backed securities backed primarily by student loan and manufactured housing loan receivables.

The credit rating for the Common School Fund's investments held at Treasury and using the segmented time distribution method at June 30, 2015 follows:

		Investment Maturities (in years)				
Investment Type	Credit Rating[1]	Less than 1	1 to 5	6 to 10	More than 10 or none	Total Market Value
U.S. Treasury Obligations	Exempt	$ 4,250,291	$ 10,920,109	$ 12,052,860	$ 15,834,348	$ 43,057,608
U.S. Treasury Strips	Exempt	-	-	211,256	-	211,256
U.S. Treasury TIPS	Exempt	1,146,537	-	3,639,693	2,948,174	7,734,404
U.S. Federal Agency Debt	AA	-	129,003	-	121,671	250,674
U.S. Federal Agency Mortgages	AAA	-	-	245,786	-	245,786
U.S. Federal Agency Mortgages	Not Rated	5,267,567	89,071	110,176	30,943,452	36,410,266
		10,664,395	11,138,183	16,259,771	49,847,645	87,909,994
Corporate Bonds	AA	-	250,637	884,946	-	1,135,583
	A	392,832	4,862,028	3,720,836	2,759,706	11,735,402
	BBB	721,539	3,959,249	7,691,501	9,221,259	21,593,548
	BB	764,696	71,031	621,348	1,851,222	3,308,297
	B	-	31,204	93,825	64,720	189,749
	CC	-	5,800	-	-	5,800
	CCC	-	-	17,700	-	17,700
		1,879,067	9,179,949	13,030,156	13,896,907	37,986,079
Non-US Government Debt	A	-	2,985	1,502,472	1,481,213	2,986,670
	BBB	-	-	294,330	2,247,089	2,541,419
	BB	416,610	-	453,100	-	869,710
		416,610	2,985	2,249,902	3,728,302	6,397,799

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		Investment Maturities (in years)				
Investment Type	Credit Rating[1]	Less than 1	1 to 5	6 to 10	More than 10 or none	Total Market Value
International Debt Securities	AA	-	-	-	138,316	138,316
	A	91,571	1,077,233	1,192,118	134,944	2,495,866
	BBB	618,322	274,441	1,866,279	1,785,352	4,544,394
	BB	30,128	774,827	2,200,915	164,072	3,169,942
	B	37,350	-	8,855	-	46,205
	Not Rated	-	60,337	-	-	60,337
		777,371	2,186,838	5,268,167	2,222,684	10,455,060
Asset Backed Securities	AAA	488,516	-	-	24,935	513,451
	AA	1,546,003	-	-	-	1,546,003
	A	1,766,819	-	-	-	1,766,819
	BBB	77,020	3,189	-	-	80,209
	BB	1,081,045	-	-	-	1,081,045
	B	328,851	-	-	-	328,851
	CCC	792,048	-	-	-	792,048
	CC	2,104,690	-	-	-	2,104,690
	Not Rated	80,000	-	-	200,300	280,300
		8,264,992	3,189	-	225,235	8,493,416
Collateralized Mortgage	AAA	458,013	-	-	343,915	801,928
	AA	374,425	-	-	824,934	1,199,359
	A	2,144,989	-	-	72,625	2,217,614
	BBB	4,415,342	-	-	-	4,415,342
	BB	1,307,849	-	-	-	1,307,849
	B	4,848,929	-	-	1,008,501	5,857,430
	CCC	1,754,902	-	-	251,986	2,006,888
	CC	1,439,083	-	-	-	1,439,083
	Not Rated	2,020,346	-	-	-	2,020,346
		18,763,878	-	-	2,501,961	21,265,839
Municipals	AAA	211,727	-	-	-	211,727
Mutual Funds, Domestic Fixed	Not Rated	-	-	-	224,198,030	224,198,030
Mutual Funds, International Fixed	Not Rated	-	-	-	8,121,895	8,121,895
Total Debt Investments		$ 40,978,040	$ 22,511,144	$ 36,807,996	$ 304,742,659	$ 405,039,839
Equity - Domestic						302,991,840
Equity - International						336,071,736
Equity - Mutual Funds						190,958,985
Private Equity - Domestic						122,261,717
Real Estate - Domestic						11,138,658
Real Estate - International						2,642,682
						966,065,618
Total Investments						$1,371,105,457

[1] Investments of $43,057,608 in U.S. Treasury obligations, $211,256 in U.S. Treasury Strips, $7,734,404 in U.S. Treasury Inflation Protected Securities (TIPS) , and $5,495,134 in Government National Mortgage Association (GNMA), which are reported within U.S. Federal agency mortgages, are explicitly guaranteed by the U.S. government, and therefore, are exempt from credit risk disclosure requirements.

Investments Held at Treasury

Fixed income securities are classified using final maturity date or next rate reset date, whichever is sooner. Fixed income mutual funds are classified by effective duration, the measurement used by the fund manager.

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. State agencies are required to deposit moneys in state-qualified depositories under Oregon law. Exceptions due to foreign field offices and related circumstances are approved by the Treasurer. International debt securities denominated in U.S. dollars are not subject to currency risk if the investment's obligations will be paid in U.S. dollars. Investment policies for fixed income investments under the management of the Treasurer provides for investments of the Common School Fund in non-dollar denominated securities within a target allocation range of 25 to 35 percent of their portfolio. For investments not under the management of the Treasurer there are no formal policies on foreign currency risk. Deposits and investments exposed to foreign currency risk for the Common School Fund as of June 30, 2015.

	Deposits and Investments (U.S. Dollars)				
Foreign Currency Denominations	Deposits	International Equity Securities	Non-US Government Debt	International Real Estate	Total
Australian Dollar	$ 77,281	$ 7,761,575	$ -	$ 471,853	$ 8,310,709
Brazil Real	-	-	180,299	-	180,299
Canadian Dollar	63,567	12,049,409	-	-	12,112,976
Swiss Franc	44,716	19,393,692	-	-	19,438,408
Danish Krone	2,292	8,115,111	-	-	8,117,403
Euro	170,770	98,847,931	-	668,289	99,686,990
British Pound	114,553	33,838,187	-	496,604	34,449,344
Hong Kong Dollar	48,698	5,016,267	-	549,685	5,614,650
Israeli Shekel	35,589	2,873,965	-	112,154	3,021,708
Japanese Yen	392,714	78,616,022	-	344,097	79,352,833
Mexican Peso	-	-	2,390,307	-	2,390,307
Norwegian Krona	95,445	1,859,057	-	-	1,954,502
New Zealand Dollar	-	71,029	-	-	71,029
Swedish Krona	10,672	12,310,648	-	-	12,321,320
Singapore Dollar	48,978	1,879,847	-	-	1,928,825
Total	$ 1,105,275	$282,632,740	$ 2,570,606	$ 2,642,682	$288,951,303

Investments Held Outside Treasury

Some custodial assets held outside Treasury are not investments. The following table shows the credit rating and segmented time distribution for Investments Held Outside Treasury at June 30, 2015.

		Investment Maturities (in years)			
Investment Type	Credit Rating	Less than 1	1 to 5	6 to 10	Total Market Value
U.S. Agency Securities [1]	AAA	$ -	$ -	$ 6	$ 6
U.S. Treasury Strips [1]	AAA	-	4,669	-	4,669
GNMA [1]	AAA	-	2	-	2
Municipal Bonds [1]	AAA	4,944	4,584	-	9,528
Domestic Mutual Funds-debt [1]	not rated	7,340,314	-	-	7,340,314
		$ 7,345,258	$ 9,255	$ 6	7,354,519
Alternative Equities [1]	N/A				3,998
Domestic Equity Securities [1]	N/A				14,499,960
Total					$ 21,858,477

[1] Some investments (along with certain cash deposits) are reported as part of custodial assets on the balance sheet.

C – Securities Lending

CSF participates in securities lending transactions in accordance with State investment policies. The Oregon State Treasury has, through a Securities Lending Agreement, authorized State Street Bank and Trust Company (State Street) to lend the CSF securities pursuant to a form of loan agreement. Both the State and borrowers maintain the right to terminate all securities lending transactions on demand. There were no significant violations of the provisions of securities lending agreements during the year ended June 30, 2015.

During the year, State Street had the authority to loan short-term, fixed income, and equity securities and to receive as collateral U.S. dollar and foreign currency cash, U.S. government and agency securities, and foreign sovereign debt of Organization of Economic Cooperation and Development countries. Borrowers were required to deliver collateral for each loan equal to not less than 102 percent of the market value of the loaned U.S. securities, international fixed income securities, or 105 percent in the case of international equity. The custodian did not have the ability to pledge or sell collateral securities absent a borrower default, and during the fiscal year the State did impose restrictions on the amount of loans the custodian made on its behalf. The State is fully indemnified against losses due to borrower default by its custodian. There were no losses during the year from the failure of borrowers to return loaned securities and no recoveries of amounts from prior losses.

As of June 30, 2015, the fair value of cash and non-cash collateral received was $68.4 million and invested cash collateral was $64.7 million for CSF. There were no significant violations of the provisions of securities lending agreements during the period of these financial statements.

State Street, as lending agent, has created a fund to reinvest cash collateral received on behalf of the OSTF. CSF receives an allocated portion of this activity based on its deposits in OSTF. As of June 30, 2015, CSF's allocated portion of cash collateral received and invested cash collateral were $0.8 million and $0.8 million, respectively. Securities on loan from the OSTF in total included U.S. Treasury securities (80.38%), U.S. Agency securities (10.33%), and domestic fixed income securities (9.29%).

As permitted under the fund's Declaration of Trust (Declaration), participant purchases and redemptions are transacted at $1 per unit ("constant value") based on the amortized cost of the fund's investments. Accordingly, the securities lending collateral held and the obligation to the lending agent are both stated at constant value on the balance sheet and statement of net position.

The fair value of investments held by the fund is based upon valuations provided by a recognized pricing service. These funds are not registered with the Securities and Exchange Commission, but the custodial agent is subject to the oversight of the Federal Reserve Board and the Massachusetts Commissioner of Banks. No income from the funds was assigned to any other funds.

The maturities of investments made with cash collateral did not generally match the maturities of the securities loaned. Since the securities loaned are callable on demand by either the lender or borrower, the life of the loans at June 30, 2015, is effectively one day. On June 30, 2015, the CSF had no credit risk exposure to borrowers because the amounts the State owes to borrowers exceed the amounts borrowers owe the State. The following table shows the combined balances of the securities on loan, cash and securities collateral received, and investments of cash collateral held.

Securities Lending as of June 30, 2015			
Investment Type	Cash and Securities Collateral Received	Securities on Loan at Fair Value	Investments of Cash Collateral at Fair Value
U.S. Treasury Securities	$ 29,087,580	$ 28,484,939	$ 29,089,034
U.S. Agency Securities	1,334,725	1,306,395	-
Domestic Equity Securities	15,069,514	14,713,359	13,535,370
Domestic Debt Securities	1,161,648	1,138,889	1,882,827
International Equity Securities	21,788,342	20,716,636	20,187,098
	68,441,809	66,360,218	64,694,329
Allocation from Oregon Short Term Fund	1,240,122	1,214,600	751,493
Total	$ 69,681,931	$ 67,574,818	$ 65,445,822

NOTE 3 – DERIVATIVES

Derivatives are financial instruments whose value is derived from underlying assets, reference rates, or indexes. They generally take the form of contracts in which two parties agree to make payments at a later date based on the value of the underlying assets, reference rates, or indexes. The main types of derivatives are futures, forwards, options and swaps.

In the Common School Fund portfolio, forward currency exchange contracts may be used to gain exposure or hedge against the effects of fluctuations in foreign currency exchange rates. A foreign currency exchange contract is a forward contract that is a commitment to purchase or sell a foreign currency at the future date at a negotiated forward rate. Foreign currency forward contracts are privately negotiated contracts with customized terms and are transacted in over-the-counter markets. Risk associated with such contracts includes movement in the value of foreign currencies and the failure of the counter party to perform.

The following table shows the foreign currency exchange contracts within the Common School Fund as of June 30, 2015.

	Currency Forward Contracts		
Currency	**Net Receivables**	**Net Payables**	**Total Exposure**
Australian Dollar	$ 26,721	$ -	$ 26,721
Brazilian Real	2,043	(5,162)	(3,119)
Canadian Dollar	(229,160)	50,466	(178,694)
Swiss Franc	(6,850)	7,195	345
Danish Krone	(88,270)	311	(87,959)
Euro Currency	(14,017)	320,191	306,174
Pound Sterling	588,732	(100,457)	488,275
Hong Kong Dollar	2	(46)	(44)
New Israeli Sheqel	45	(38,048)	(38,003)
Japanese Yen	16,272	(209,672)	(193,400)
Norwegian Krone	(255)	147	(108)
New Zealand Dollar	(527)	4,186	3,659
Swedish Krona	(1,646)	(23,316)	(24,962)
Singapore Dollar	-	(900)	(900)
Total	**$ 293,090**	**$ 4,895**	**$ 297,985**

In the Common School Fund portfolio, rights and warrants are often obtained and held due to existing investments. Rights are the right, but not the obligation, to purchase newly issued equity shares, often in proportion to the number of shares currently owned, in a specified company, at a pre-established price on or within a predetermined date. A warrant provides the holder the right, but not the obligation, to purchase securities from the issuing entity at a specific price and within a certain period. Rights and warrants are privately transacted in over-the-counter markets. Both are subject to general market risk and liquidity risk.

The following table shows the changes in fair value and the fair value of rights and warrants within the Common School Fund as of June 30, 2015.

	Changes in Fair Value [1]		Fair Value at June 30, 2015		
	Classification	**Amount**	**Classification**	**Amount**	**Notional [2]**
Rights	Investment Revenue	$ (93,224)	Common Stock	$ -	$ -
Warrants	Investment Revenue	2,557,007	Long Term Instruments	297,984	147,451,717
Total Fair Value		**$ 2,463,783**		**$ 297,984**	

[1] Excludes futures margin payments

[2] Notional may be a dollar amount or size of underlying for futures and options

The fair value of derivative instruments is reported on the balance sheet as investments, accounts and interest receivables, and accounts payable, and the changes in fair value of derivative instruments are reported on the statement of revenues, expenditures and changes in fund balance as investment income.

NOTE 4 – RECEIVABLES AND PAYABLES

A – RECEIVABLES

The following table disaggregates receivable balances reported in the financial statements as accounts and interest receivable (net) and net contracts. Contracts are not expected to be collected within one year of the date of the financial statements. Receivables reported for governmental activities at June 30, 2015:

Governmental activities	**Total**
General accounts	$ 88,953
Interest	1,778,662
Investment broker receivable	12,618,838
Contracts	654,784
Other Noncurrent Receivables	4,559
Gross receivables	15,145,796
Allowance for doubtful accounts	(50,569)
Total receivables, net	$ 15,095,227

B – PAYABLES

The following table disaggregates accounts payable reported in the financial statements as general accounts payable and broker payable. Payables reported for governmental activities at June 30, 2015:

Governmental activities	**Total**
General accounts payable	$ 3,942,806
Investment broker payable	25,919,539
Total payables	$ 29,862,345

C – CUSTODIAL LIABILITIES

Custodial liabilities consist of unclaimed property held in custody by the Department in perpetuity for the rightful owner as required by ORS 98.302-98.436 and 98.991-98.992. The unclaimed property liability is reported at approximately 39% of the total unclaimed property being held. An annual adjustment is made to this account to reduce the amount reported to the amount actually expected to be paid out based on a history of the account. The total legal liability for the unclaimed property program as of June 30, 2015 was $547,571,081. The accumulated annual adjustment as of June 30, 2015 was $315,379,703.

NOTE 5 – LEASES

A – OPERATING LEASES

The Department has entered into various non-cancelable rental agreements that are accounted for as operating leases because the agreements do not meet the criteria to be classified as capital leases. Operating lease payments are chargeable as rent expense and reported in services and supplies. Rental costs for operating leases for the year ended June 30, 2015, were $112,839. Future minimum rental payments for operating leases in effect as of June 30, 2015:

Year ending June 30,		Payments
2016	$	55,820
2017		1,279
Total future minimum rental payments	$	57,099

B – LEASE RECEIVABLES

The Department receives rental income from land and property leased to non-state entities. For the year ended June 30, 2015, the Department received rental income of $270,646 on leased assets with a carrying value of $1,818,034, net of $123,609 in accumulated depreciation. Future minimum lease revenues for non-cancelable operating leases as of June 30, 2015:

Year ending June 30,		Amount
2016	$	133,486
2017		106,070
2018		76,387
2019		22,606
Total future minimum rental revenues	$	338,549

NOTE 6 – POLLUTION REMEDIATION OBLIGATION

Pollution remediation obligations address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities, including pre-cleanup activities, cleanup activities, government oversight and enforcement-related activities, and post remediation monitoring. Excluded from pollution remediation obligations are obligations for pollution prevention and control activities, fines and penalties, landfill closure and post closure care, and other future remediation activities required upon retirement of an asset.

The Common School Fund recognizes a pollution remediation obligation when it can reasonably estimate the range of expected cash outlays. As of June 30, 2015 the Department is involved in negotiations related to a confidential, non-judicial mediation process that will result in an allocation of costs associated with the investigation and cleanup of contamination in the Portland Harbor Superfund site. There are over 200 parties, private and public, that may eventually bear a share of the costs. It is too early in the Environmental Protection Agency's remedial action process to estimate the total cleanup costs that may be shared by the liable parties and what portion of that, if any, will be assessed against the Common School Fund. The Portland Harbor Superfund site is discussed in greater detail in Note 14.

NOTE 7 – INTERFUND TRANSACTIONS

Interfund balances reported in the financial statements as of June 30, 2015.

	Due from Other Funds		
Due to Other Funds	**General**	**Environmental Management**	**Common School**
Capital Projects	$ -	$ -	$ 1,439
Environmental Management	-	-	759,492
Common School	23,982	606,573	-
Total	$ 23,982	$ 606,573	$ 760,931

	Advances to Other Funds		
Advances from Other Funds			**Common School**
Environmental Management	$ -	$ -	$ 300,000

Interfund balances result from the time lag between the date a transaction for interfund goods and services or reimbursable expenditures is recorded and the date the payment between funds is made. Advances to other funds are not expected to be repaid within one year.

NOTE 8 – RISK FINANCING

The State of Oregon administers property and casualty programs covering State government through its Insurance Fund. The Insurance Fund services claims for: direct physical loss or damage to state property; tort liability claims brought against the State, its officers, employees or agents; workers' compensation; employee dishonesty; and faithful performance coverage for certain positions by law to be covered and other key positions.

As a state agency, the Department participates in the Insurance Fund. The cost of servicing insurance claims and payments is covered by charging an assessment to each entity based on its share of services provided in a prior period. The total statewide coverage assessment is based on independent biennial actuarial forecasts and administrative expenses, less carry-forward or equity in the Insurance fund. For the Common School Fund the amount of claim settlements did not exceed insurance coverage for each of the past three years.

NOTE 9 - COMMITMENTS

Commitments are defined as existing arrangements to enter into future transactions or events, such as contractual obligations with vendors for future purchases or services at specified prices and sometimes at specified quantities. Commitments may also include agreements to make grants and loans.

The Oregon Investment Council has entered into agreements that commit the investment managers for the Common School Fund (CSF), upon request, to additional investment purchases up to a predetermined amount. As of June 30, 2015 the Common School Fund had approximately $101 million in commitments to purchase private equity investments. These amounts are unfunded and are not recorded in the financial statements.

NOTE 10 – RELATED PARTY DISCLOSURES

The Oregon State Treasurer (Treasurer) is a constitutional officer within the executive branch of the state of Oregon, elected by statewide vote. As chief financial officer for the state, the Treasurer heads the Oregon State

Treasury (Treasury). Treasury acts as the central bank for all state agencies and is the largest financial institution in the state. Treasury manages the portfolio of investments for the state's funds, including the Common School Fund.

The State Land Board, which consists of the Governor, Secretary of State and Treasurer, is the trustee of the Common School Fund as outlined in the Oregon Constitution. The Common School Fund's investment policies are governed by statute and the Oregon Investment Council. The Treasurer is the investment officer for the Investment Council. During the year ended June 30, 2015 the Common School Fund paid Treasury $338,580 in fees for the management of the Common School Fund investment portfolio.

NOTE 11– PRIOR PERIOD ADJUSTMENTS

As of June 30, 2015, the beginning fund balance was restated by $1,457,898. An adjustment of $356,924 was made to correct expenditures and revenue that were recognized in the incorrect period. A $1,100,974 adjustment was made to reclassify land reported as other investments in the Common School Fund to a capital asset reported in the State of Oregon Government-wide Financial Statements as required by GASB 34. The land was recorded as an investment prior to the implementation of GASB 34, and therefore, the reclassification reflects a change in accounting principal from a prior period.

NOTE 12– CONTINGENCIES

A – PORTLAND HARBOR SUPERFUND SITE

The Department is involved in negotiations related to a confidential, non-judicial mediation process that will result in an allocation of costs associated with the investigation and cleanup of sediment contamination in the Portland Harbor, a ten-mile stretch of the lower Willamette River area that the U.S. Environmental Protection Agency has listed as a Superfund site under the federal Superfund law (CERCLA). The Department is one of over 200 parties, private companies, and public entities that may eventually be found liable for a share of the costs related to investigation and cleanup of the site.

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PARTNERS
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INDEPENDENT AUDITOR'S 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*

State Land Board
Department of State Lands
Salem, Oregon

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the Balance Sheet and the related Statement of Revenues, Expenditures, and Changes in Fund Balance of the Common School Fund, a major governmental fund of the State of Oregon, as of and for the year ended June 30, 2015, and the related notes to the financial statements, which collectively comprise the Common School Fund's basic financial statements, and have issued our report thereon dated November 9, 2015.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Common School Fund's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Common School Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Common School Fund's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or, significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Common School Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Merina & Company

Merina & Company, LLP
West Linn, Oregon
November 9, 2015