

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**FINANCIAL STATEMENTS  
YEAR ENDED JUNE 30, 2002**



CERTIFIED PUBLIC ACCOUNTANTS

BUSINESS CONSULTANTS

Providence, Rhode Island

## ***INDEPENDENT AUDITOR'S REPORT***

To the Board of Directors  
Tobacco Settlement Financing Corporation

We have audited the accompanying statement of net assets, statement of activities, statement of cash flows, and the individual major fund financial statements of the TOBACCO SETTLEMENT FINANCING CORPORATION (a component unit of the State of Rhode Island) as of and for the period ended June 30, 2002, which collectively comprise the Corporation's basic financial statements. These financial statements are the responsibility of the Corporation's management. 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 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 audit provides a reasonable basis for our opinion.

As discussed in Note 1 to the financial statements, during fiscal year 2002, the Corporation adopted the provisions of Statements No. 34, 37 and 38 of the Governmental Accounting Standards Board.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the TOBACCO SETTLEMENT FINANCING CORPORATION and its individual major funds as of June 30, 2002 and the respective changes in financial position and cash flows thereof for the period then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 17, 2003 on our consideration of the Corporation's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on Pages three through six is not a required part of the financial statements but is supplementary information required by Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit this information and express no opinion thereon.

*Caryer Prescott Clune & Charletta L.L.P.*

March 17, 2003, except for Note 6 which is  
dated May 6, 2003

## **Management's Discussion and Analysis**

This section of the Tobacco Settlement Financing Corporation's (TSFC) annual financial report represents our narrative overview and financial performance analysis for the fiscal year ended June 30, 2002. Please read it in conjunction with the financial statements which follow this section.

The Tobacco Settlement Financing Corporation (TSFC) was created in 2002 as a public corporation, having a distinct legal existence from the State and not constituting a department of state government. The TSFC was created to finance the acquisition from the State of the State's right, title and interest in the State's rights to receive the moneys due under and pursuant to (i) the Master Settlement Agreement, dated November 23, 1998, among the attorneys general of 46 states, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the U.S. Virgin Islands, American Samoa and the Territory of the Northern Marianas and Philip Morris Incorporated, R.J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation and Lorillard Tobacco Company and (ii) the Consent Decree and Final Judgment of the Rhode Island Superior Court for Providence County dated December 17, 1998, as the same has been and may be corrected, amended or modified, in the class action styled State of Rhode Island v. American Tobacco, Inc., et al. (Docket No. 97-3058), including without limitation, the rights of the State to receive the moneys due to it thereunder.

The Corporation issued \$685,390,000 of its Tobacco Settlement Asset-Backed Bonds, Series 2002A ("TSAC Bonds") in June 2002 to finance the costs of acquisition of the right, title and interest to one-hundred percent (100%) of the "state's tobacco receipts", as defined in the Act, after FY 2003.

In accordance with the Act, the TSAC bonds are payable both as to principal and interest solely out of the assets of the Corporation pledged for such purpose; and neither the faith and credit nor the taxing power of the State or any political subdivision thereof is pledged to the payment of the principal of or the interest on the TSAC bonds. The TSAC bonds do not constitute an indebtedness of or a general, legal or "moral" obligation the State or any political subdivision of the State.

## **Financial Highlights**

Management believes the TSFC financial condition is stable. The TSFC's financial position at the end of the first year of operation reflects the anticipated financial position. The following are the key financial highlights:

### *Government-wide perspective-*

- The assets of TSFC exceeded its liabilities at the close of the most recent fiscal year by \$1,311,752 (net assets). All of this amount is available to be used to meet the TSFC's ongoing obligations.

### *Fund perspective-*

- Revenues and other financing sources were \$653,594,241.
- Expenditures and other financing uses were \$545,524,037.
- The excess of revenues and other financial sources exceeded expenditures and other uses by \$108,070,204.

## **Overview of Financial Report**

The TSFC's basic financial statements consists of two components: the Financial Statements and the Notes to the Financial Statements. In addition to the basic financial statements, the report contains Management's Discussion and Analysis (MD&A).

The MD&A serves as an introduction to the basic financial statements and supplementary information. The MD&A represents management examination and analysis of the TSFC's financial condition and performance.

The basic financial statements report information about the TSFC using two perspectives, entity-wide financial statements using the accrual basis and fund financial statements prepared on the modified accrual basis. The entity-wide financial statements include a Statement of Net Assets, a Statement of Activities, and a Statement of Cash Flows while the fund financial statements consist of a Balance Sheet and a Statement of Revenues, Expenditures and Changes in Fund Balance. A Reconciliation of the Statements of Revenues, Expenditures and Changes in Fund to the Statement of Activities is also included in the basic financial statements, as well as Notes to the Financial Statements.

The Statement of Net Assets presents the financial position of the TSFC on the accrual basis of accounting. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the TSFC is improving or deteriorating.

All the current year's revenues and expenses are accounted for in the Statement of Revenues, Expenses, and Changes in Net Assets. This statement is designed to measure the success of the TSFC financial operations over the past year and can be used to determine whether the TSFC will successfully generate sufficient revenues from the Master Settlement Agreement to pay its debt service obligations. This statement will be more meaningful when the operations of the Corporation have fully commenced in succeeding fiscal years.

### Statement of Net Assets

Assets:	
Investments...	\$108,070,204
Rights to future Tobacco Settlement revenue...	544,238,410
Bond issue costs, net...	1,285,627
Total Assets	653,594,241
Liabilities:	
Bonds payable, net...	652,282,489
Total Liabilities...	652,282,489
Net Assets:	
Restricted for debt service...	1,311,752
Unrestricted...	
Total Net Assets...	\$ 1,311,752

Transactions occurring during the fiscal period ended June 30, 2002 were primarily related to the financing and purchase of the rights to future tobacco settlement revenues from the State of Rhode Island. The net assets presented in the Statement of Net Assets as of June 30, 2002 resulted from investment earnings on reserve funds held by the Corporation, and are the only transactions recorded in the Statement of Activities.

#### Long-Term Debt

During fiscal year 2002, the TSFC issued \$685,390,000 of revenue bonds secured by the pledge of revenues from the Master Settlement Agreement. Starting in late March 2003, the TSFC debt, and all other tobacco securitization debts of other jurisdictions, was placed on rating watch by all three major credit rating agencies. Standard & Poor's Rating Services rates the TSFC debt "A", however the bonds were placed on Creditwatch with negative implications on March 26, 2003. The TSFC debt is rated "A3" by Moody's Investor Service, reflecting a downgrade from "A1" announced on March 31, 2003. The bonds are rated "BBB" by Fitch Ratings, reflecting a downgrade from "A+" announced on April 3, 2003 and from "A-" as announced on May 6, 2003. Standard & Poor's Rating Services rates the TSFC debt "A-", reflecting a downgrade from "A" on April 18, 2003. In general, the rating changes reflect the increased vulnerability of tobacco companies to adverse litigation in some jurisdictions. Ratings are subject to change at any time.

For additional information relating to long-term debt, see the notes to the financial statements of this report.

### **Risk Factors and Next Year's Revenues**

TSFC is governed by a five-member Board. The Board has little or no control over the level of revenues which are collected by the Corporation. Risk factors impacting the level of revenues to be received by the TSFC include factors affecting cigarette consumption and the financial liability of the tobacco industry, including litigation risk facing the industry. As described above, the risk of default is monitored by the credit rating agencies. In the event of non-payment of the amounts due and payable under the master settlement which have been purchased by the Corporation, the Attorney General of the State of Rhode Island has pledged to pursue legal remedies to the extent possible to garner amounts due to the Corporation.

### **Requests for Information**

This financial report is designed to provide a general overview of the TSFC finances for all those with an interest in this organization. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to Chairperson, Tobacco Settlement Financial Corporation, c/o State Budget Office, One Capitol Hill, Providence, Rhode Island 02908.

**Tobacco Settlement Financing Corporation**

Statement of Net Assets  
as of June 30, 2002

Assets:

Investments - unrestricted...	\$ 907,873
Investments - restricted...	107,162,331
Rights to future Tobacco Settlement revenue...	544,238,410
Bond issue costs, net...	1,285,627

Total Assets	<u>653,594,241</u>
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Liabilities:

Bonds payable, net of unamortized discount...	652,282,489
Total Liabilities...	<u>652,282,489</u>

Net Assets:

Restricted for debt service...	1,311,752
Unrestricted...	-
Total Net Assets...	<u>\$ 1,311,752</u>

See Notes to Financial Statements.



**Tobacco Settlement Financing Corporation**

Statement of Activities  
for the period June 13, 2002 (inception) through June 30, 2002

Investment income...	<u>\$ 1,311,752</u>
Net increase/(decrease) in Net Assets	1,311,752
Net Assets:	
Beginning of the period...	-
End of the period...	<u><u>\$ 1,311,752</u></u>

See Notes to Financial Statements.

**Tobacco Settlement Financing Corporation**

Statement of Cash Flows  
for the period June 13, 2002 (inception) through June 30, 2002

Cash flows from non-capital financing activities:	
Proceeds from issuance of long-term debt...	<u>\$ 652,282,489</u>
Cash flows from investing activities:	
Purchase of rights to future Tobacco Settlement revenue...	(544,238,410)
Bond issuance costs...	(1,285,627)
Purchase of investments - unrestricted...	(107,162,331)
Purchase of investments - restricted...	(907,873)
Investment earnings...	<u>1,311,752</u>
Net cash used for investing activities...	<u>(652,282,489)</u>
Net increase/(decrease) in cash...	-
Cash, beginning of period...	<u>-</u>
Cash, end of period...	<u><u>\$ -</u></u>
Reconciliation of increase in net assets to net cash provided by/ (used for) operating activities:	
Increase in net assets...	\$ 1,311,752
Investment earnings...	<u>(1,311,752)</u>
Net cash provided by/(used for) operating activities...	<u><u>\$ -</u></u>

See Notes to Financial Statements.

**Tobacco Settlement Financing Corporation**

Balance Sheet, Governmental Funds  
as of June 30, 2002

	<u>General Fund</u>	<u>Debt Service Fund</u>	<u>Total Governmental Funds</u>
Assets:			
Investments...	\$ 907,873	\$ 107,162,331	\$ 108,070,204
Total Assets	<u>\$ 907,873</u>	<u>\$ 107,162,331</u>	<u>\$ 108,070,204</u>
Liabilities and Fund Balances:			
Liabilities:			
Accounts payable...	\$ -	\$ -	\$ -
Total Liabilities	<u>-</u>	<u>-</u>	<u>-</u>
Fund Balances:			
Reserved for debt service...	-	107,162,331	107,162,331
Designated for future expenditure...	907,873		907,873
Total Fund Balances	<u>907,873</u>	<u>107,162,331</u>	<u>108,070,204</u>
Total Liabilities and Fund Balances	<u>\$ 907,873</u>	<u>\$ 107,162,331</u>	<u>\$ 108,070,204</u>

See Notes to Financial Statements.

**Tobacco Settlement Financing Corporation**

Statement of Revenues, Expenditures and Changes in Fund Balances,  
Governmental Funds  
For the period June 13, 2002 (inception) through June 30, 2002

	General Fund	Debt Service Fund	Total Governmental Funds
Revenues:			
Investment income...	\$ -	\$ 1,311,752	\$ 1,311,752
Other Financing Sources:			
Bond proceeds...	685,390,000		685,390,000
Bond discount...	(33,107,511)		(33,107,511)
Operating transfers in...		105,850,579	105,850,579
Total Revenues and Other Financing Sources	<u>652,282,489</u>	<u>107,162,331</u>	<u>759,444,820</u>
Expenditures:			
Current:			
Costs of bond issuance...	1,285,627	-	1,285,627
Purchase of rights to future tobacco settlement revenues from State of Rhode Island...	544,238,410	-	544,238,410
Total Expenditures	<u>545,524,037</u>	<u>-</u>	<u>545,524,037</u>
Other Financing Uses:			
Operating transfers out...	105,850,579	-	105,850,579
Total Expenditures and Other Financing Uses	<u>651,374,616</u>	<u>-</u>	<u>651,374,616</u>
Excess of Revenues and Other Financing Sources Over Expenditures and Other Financing Uses	907,873	107,162,331	108,070,204
Fund Balances:			
Beginning of the period...	-	-	-
End of the period...	<u>\$ 907,873</u>	<u>\$ 107,162,331</u>	<u>108,070,204</u>

Amount reported in the Statement of Net Assets differs because:

Long-term liabilities are not due and payable in the current period and  
therefore are not reported in the funds... (652,282,489)

Long-term assets do not represent currently expendable resources and  
therefore are not reported in the funds... 545,524,037

Net Assets in Statement of Net Assets... \$ 1,311,752

See Notes to Financial Statements.

**Tobacco Settlement Financing Corporation**

Reconciliation of the Statement of Revenues, Expenditures and Changes in Fund Balances  
to the Statement of Activities  
for the period June 13, 2002 (inception) through June 30, 2002

Net change in fund balances for governmental funds \$ 108,070,204

The issuance of long-term debt provides current financial resources to governmental funds. However, the issuance of long-term debt does not have any effect on net assets. (652,282,489)

Governmental funds report outlays for long-term assets as current expenditures. However, in the statement of activities such costs are not reported and are instead capitalized in the Statement of Net Assets. 545,524,037

Change in Net Assets in Statement of Activities \$ 1,311,752

See Notes to Financial Statements.

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002**

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**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Reporting Entity***

The Tobacco Settlement Financing Corporation (the Corporation) was organized on June 13, 2002 as a public corporation by the State of Rhode Island, pursuant to Title 42 of the General Laws, Chapter 133. The Corporation is legally independent and separate from the State and there is no financial accountability between the two entities. The purpose of the Corporation is to purchase Tobacco Settlement Revenues from the State. The Corporation is authorized to issue bonds necessary to provide sufficient funds for carrying out its purpose.

In June 2002, the Corporation issued revenue bonds that are the sole obligation of the Corporation. Accordingly, the State is not liable for any debts issued by the Corporation. Also in June 2002, pursuant to a Purchase and Sale Agreement with the State, the State sold to the Corporation its future rights in the Tobacco Settlement Revenues (TSR's) under the Master Settlement Agreement and the Consent Decree and Final Judgment (the "MSA"). When the Corporation's obligations with the bonds have been fulfilled, the TSR's will revert back to the state.

The Corporation's rights to receive TSR's are expected to produce funding for its obligations.

The TSR payments are dependent on a variety of factors, which include:

- the financial capability of the participating cigarette manufacturers to pay TSR's;
- future cigarette consumption which impacts the TSR payment; and
- future legal and legislative challenges against the tobacco manufacturers and the master settlement agreement that provides for the TSR payments.

The bonds of the Corporation are asset-backed instruments that are secured solely by the tobacco settlement revenues.

The Corporation is a component unit of the State of Rhode Island for financial reporting purposes. Accordingly, the Corporation's financial statements are included in the State of Rhode Island's Annual Financial Report.

In accordance with State reporting requirements, the Corporation has elected not to apply Financial Accounting Standards Board statements and interpretations, Accounting Principles Board opinions, and accounting research bulletins of the Committee on Accounting Procedures issued after November 30, 1989.

***Recently Issued Accounting Standards***

These financial statements include the implementation of GASB No. 34, *Basic Financial Statements, Management's Discussion and Analysis, for State and Local Governments*. This new standard provides for significant changes in terminology and inclusion of a management discussion and analysis as supplementary information and other changes.

The Corporation has implemented GASB No. 37 *Basic Financial Statements – and Management's Discussion and Analysis for State and local Governments: Omnibus*, for the year ended June 30, 2002 which provides expanded language regarding GASB No. 34.

The Corporation has implemented GASB No. 38, *Certain Financial Statement Note Disclosures*, for the year ended June 30, 2002. The adoption of this Statement did not have a significant impact on the Corporation's financial position or results of operations.

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**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002**

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**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Basis of Presentation – Entity-wide Financial Statements***

The Statement of Net Assets displays information on the financial position of the Corporation. The Statement of Activities presents the revenues and expenses of the Corporation for the fiscal period.

The Corporation is treated as a special-purpose government. The entity-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recognized when earned and expenses are recognized when incurred, regardless of the related cash flows.

Net assets comprise the various net earnings from operating and non-operating revenues, and expenses. Net assets are classified in the following two components: restricted for debt service and unrestricted net assets. Restricted for debt service consists of all net assets subject to external restrictions which limit their use to the payment of debt service. Unrestricted consists of all other net assets not included in the above categories.

***Basis of Presentation – Fund Financial Statements***

The fund financial statements provide detailed information for the Corporation's individual funds.

In order to ensure observances of limitations and restrictions placed on the use of resources available to the Corporation, the accounts of the Corporation are maintained in accordance with the principles of "Fund Accounting". This is a procedure by which resources for various purposes are classified for accounting and reporting purposes into funds that are in accordance with activities or objectives specified. Separate accounts are maintained for each fund. Account groups are reporting devices used to account for certain assets and liabilities not recorded directly in the funds.

The Corporation uses the following fund types and account group:

Governmental funds are used to account for the Corporation's general activities, and utilize the flow of current financial resources measurement focus and the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recognized when susceptible to accrual (i.e., when "measurable and available"). "Measurable" means that the amount of the transaction can be determined and "available" means collected within the current period or soon enough thereafter to pay liabilities of the current period. Expenditures are recorded when the related fund liability is incurred, except for unmatured interest on long-term debt which is recognized when due.

Governmental funds include the following fund types:

- General Fund. The Corporation's primary operating fund is the General Fund. It accounts for all financial resources of the Corporation, except those required to be accounted for in another fund.
- Debt Service Fund. The Corporation's accumulation of resources for, and payment of, principal and interest on long-term debt is accounted for in the Debt Service Fund.

Reservations of fund balances represent amounts that are not appropriable or are legally segregated for a specific purpose. Designations of fund balance represent management plans that are subject to change. The financial activities of the Corporation are limited by its enabling legislation and by its revenue bond resolution.

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**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002**

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**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Investments and Purchased Rights to Tobacco Settlement Revenues***

Investments in debt and equity securities are stated at fair value.

As discussed in Note 5, the Corporation purchased State of Rhode Island's rights to future tobacco settlement revenues. The Corporation is accounting for the rights in accordance with the guidance established by the Financial Accounting Standards Board's "Emerging Issues Task Force" in its Consensus 99-20 "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." Specifically, the rights are recorded at cost, and as the future cash flows cannot be reliably estimated for verification, the cost recovery method of accounting will be used to recognize the recovery of the asset. Once the cost is fully recovered, the excess collections from the rights will be recognized as income when received.

***Income Taxes***

The Corporation is exempt from federal and state income taxes.

***Use of Estimates***

Management uses estimates and assumptions in preparing financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and reported revenues and expenses. Actual results could differ from those estimates.

***Amortization of Bond Discount and Issuance Costs***

Bond discounts and issue costs are deferred and amortized over the term of the bonds, using the interest method for discounts and the straight-line method for issue costs. Bond discounts are presented as an adjustment to the face amount of the bonds payable.

***Cash and Cash Equivalents***

Cash represents amounts in demand deposit accounts with financial institutions. Cash equivalents are defined as highly liquid investments with a maturity of three months or less at the time of purchase.

**2. INVESTMENTS**

The table below categorizes the Corporation's investments so as to provide an indication of the level of market risk and credit risk assumed by the Corporation at year end. Market risk is the risk that the market value of an investment, collateral securing the investment or securities underlying a repurchase agreement will decline. Credit risk can be associated with the issuer of a security, with a financial institution holding deposits, or with the custodian of securities or collateral. Category 1 includes insured, registered or securities held by the Corporation or its agent in the Corporation's name. Category 2 includes uninsured and unregistered, with securities held by the counterparty's trust department or agent in the Corporation's name. Category 3 includes uninsured and unregistered with securities held by the counterparty or by its trust department or agent, but not in the Corporation's name.

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**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002**

**2. INVESTMENTS (Continued)**

At June 30, 2002, the investments held by the Corporation were as follows:

<u>Description</u>	<u>Category</u>			<u>Fair Value</u>
	<u>1</u>	<u>2</u>	<u>3</u>	
Commercial paper.....	\$107,161,758			\$107,161,758
Investments not subject to categorization:				
Money Market Mutual Funds.....				908,446
<b>Total</b> .....	<b>\$107,161,758</b>	<b>\$0</b>	<b>\$0</b>	<b>\$108,070,204</b>

**3. LONG-TERM DEBT**

On June 27, 2002 the Corporation issued \$685,390,000 of Tobacco Settlement Asset-Backed Bonds. The bond proceeds were used to purchase the State's future rights in the Tobacco Settlement Revenues (TSR's) under the Master Settlement Agreement and the Consent Decree and Final Judgment (the "MSA"). The bonds bear interest ranging from 5.920% to 6.250% and mature in varying amounts through June 1, 2042. The bonds are subject to early redemption provisions, in whole or in part, at the redemption price of 100% of the principal amount plus accrued interest, without premium. Term Maturities represent the minimum amount of principal that the Corporation must pay as of specific dates. Turbo Maturities represent the requirement contained in the bond indenture to apply 100% of all collections that are in excess of the funding requirements of the indenture to the early redemption of the bonds. The amount of any turbo redemptions made will be credited against the term maturities in ascending chronological order.

Principal and interest payments assuming the Term Maturities schedule are as follows:

<u>Year ending June 30</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2003		\$ 39,184,182	\$ 39,184,182
2004	\$ 640,000	42,234,448	42,874,448
2005	675,000	42,196,560	42,871,560
2006	710,000	42,156,600	42,866,600
2007	750,000	42,114,568	42,864,568
2008 – 2012	32,885,000	206,331,160	239,216,160
2013 – 2017	46,660,000	194,991,880	241,651,880
2018 – 2022	50,465,000	181,033,780	231,498,780
2023 – 2027	73,590,000	163,228,528	236,818,528
2028 – 2032	107,315,000	136,836,086	244,151,086
2033 – 2037	153,795,000	98,280,626	252,075,626
2038 – 2042	217,905,000	42,724,978	260,629,978
<b>Totals</b>	<b>\$ 685,390,000</b>	<b>\$ 1,231,313,396</b>	<b>\$ 1,916,703,396</b>

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**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002**

**3. LONG-TERM DEBT (Continued)**

Principal and interest payments assuming the expected Turbo Maturities schedule are as follows:

<i>Year ending June 30</i>	<i>Principal</i>	<i>Interest</i>	<i>Total</i>
2003		\$ 39,184,182	\$ 39,184,182
2004	\$ 7,425,000	42,234,448	49,659,448
2005	8,720,000	41,794,888	50,514,888
2006	9,885,000	41,278,664	51,163,664
2007	11,125,000	40,693,472	51,818,472
2008 – 2012	139,545,000	184,925,080	324,470,080
2013 – 2017	213,350,000	134,058,662	347,408,662
2018 – 2022	294,680,000	58,281,252	352,961,252
2023 – 2027	660,000	41,250	701,250
2028 – 2032			
2033 – 2037			
2038 – 2042			
<b>Totals</b>	<b>\$ 685,390,000</b>	<b>\$ 582,491,898</b>	<b>\$ 1,267,881,898</b>

The balance due on the Corporation's bonds payable articulates to the reported amount included in the statement of net assets through the following reconciliation:

Outstanding balance on bonds payable...	\$685,390,000
Less: unamortized bond discount...	<u>(33,107,511)</u>
Bonds payable, per statement of net assets...	<u>\$652,282,489</u>

**4. COMMITMENTS AND CONTINGENCIES**

Litigation has been filed against various tobacco manufacturers as well as certain states and public entities. The lawsuits allege, among other claims, that the Master Settlement Agreement (MSA) violates provisions of the U.S. Constitution, state constitutions, federal antitrust and civil rights laws, state consumer protection laws; these actions, if ultimately successful, could result in a determination that the MSA is void or unenforceable. The lawsuits seek to prevent the states from collecting any monies under the MSA, and/or a determination that prevents the tobacco manufacturers from collecting MSA payments through price increases to cigarette consumers. In addition, class action lawsuits have been filed in jurisdictions alleging violations of state Medicaid agreements. To date, no such lawsuits have been successful. The enforcement of the terms of the MSA may continue to be challenged in the future. In the event of an adverse court ruling, the corporation may not have adequate financial resources to service its debt obligations.

**5. VALUATION AND ACCOUNTING FOR PURCHASED INTEREST IN TOBACCO SETTLEMENT REVENUE**

As discussed above, the Corporation has purchased the State of Rhode Island's rights to future Tobacco Settlement Revenues. The consideration transferred to the State for this purchase totaled \$544,238,410, and was paid to the State on June 27, 2002. The Corporation is accounting for these rights in accordance with the guidance established by the Financial Accounting Standards Board's "Emerging Issues Task Force" in its Consensus 99-20 "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." Specifically, the rights are recorded at cost, and as the future cash flows cannot be reliably estimated for verification, the cost recovery method of accounting will be used to recognize the recovery of the asset. Once the cost is fully recovered, the excess collections from the rights will be recognized as income when received.

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**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002**

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**6. SUBSEQUENT EVENTS**

In late March, April and early May 2003, the Corporation's debt obligations, along with all other tobacco securitization debts of other jurisdictions, were placed on rating watch by the three major credit rating agencies. In addition, the ratings assigned to the Corporation's debt obligations were uniformly downgraded by each of the rating agencies. These actions by the agencies reflect the potential result of heightened litigation risks facing cigarette manufacturers, increasing competition from discounted brands, and the expectation of continuing declines in domestic cigarette consumption, as well as other factors.

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CERTIFIED PUBLIC ACCOUNTANTS  
BUSINESS CONSULTANTS

Providence, Rhode Island

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

To the Board of Directors  
Tobacco Settlement Financing Corporation

We have audited the financial statements of the Tobacco Settlement Financing Corporation, as of and for the period ended June 30, 2002, and have issued our report thereon dated March 17, 2003. 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.

Compliance

As part of obtaining reasonable assurance about whether the Tobacco Settlement Financing Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, 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 that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Tobacco Settlement Financing Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Board of Directors, management, the Rhode Island Department of Administration, Rhode Island Auditor General and others within the Organization and is not intended to be and should not be used by anyone other than these specified parties.

*Cayan Prescott Cleve & Chutellari L.L.P.*

March 17, 2003