

TOBACCO SETTLEMENT FINANCING CORPORATION

**FINANCIAL STATEMENTS
YEAR ENDED JUNE 30, 2004**

TOBACCO SETTLEMENT FINANCING CORPORATION

TABLE OF CONTENTS

Independent Auditor's Report...	1 – 2
Management's Discussion and Analysis...	3 – 7
Basic Financial Statements:	
Statement of Net Assets...	8
Statement of Activities...	9
Statement of Cash Flows...	10
Notes to Financial Statements...	11 – 16
Supplementary Information:	
Balance Sheet, Governmental Funds...	17
Statement of Revenues, Expenditures, Other Financing Sources and Uses and Changes in Fund Balances, Governmental Funds...	18
Reconciliation of the Statement of Revenues, Expenditures, Other Financing Sources and Uses and Changes in Fund Balances to the Statement of Activities...	19
Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards...	20 – 21



PRESCOTT·CHATELLIER
FONTAINE·WILKINSON·LLP
CERTIFIED PUBLIC ACCOUNTANTS
BUSINESS & FINANCIAL ADVISORS

Two Charles Street, Providence, RI 02904
401 421 2710 telephone 401 274 5230 facsimile
www.yourcpafirm.com

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Tobacco Settlement Financing Corporation

We have audited the accompanying basic financial statements of the TOBACCO SETTLEMENT FINANCING CORPORATION (a component unit of the State of Rhode Island) as of and for the year ended June 30, 2004, as listed in the foregoing table of contents. 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the TOBACCO SETTLEMENT FINANCING CORPORATION as of June 30, 2004 and the respective changes in financial position and cash flows thereof for the year 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 September 29, 2004 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.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information presented on pages 16 through 18 is presented for purposes of additional analysis and to provide information for presentation of the Corporation's financial statements in the State of Rhode Island's Comprehensive Annual Financial Report, and is not a required part of the Corporation's basic financial statements. Such information, has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly presented in all material respects in relation to the basic financial statements taken as a whole.

Prescott Chatelain Fontaine & Wilkinson, LLP

September 29, 2004

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, 2004. 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 December 31, 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 following are the key financial highlights from the financial statements:

- Due to the balance of the bonds outstanding exceeding the assets recognized (no future revenues are recognized) the liabilities of TSFC exceeded its assets at the close of the 2004 fiscal year by \$573,886,848 (net assets).
- Revenues, consisting of Tobacco Settlement Agreement revenue and investment income, amounted to \$49,807,869.
- Expenses, primarily interest, amounted to \$43,738,634.
- Net assets of the Corporation increased by \$6,069,235 during the fiscal year.

Overview of Annual Financial Report

The TSFC's basic financial statements consist of two components: the Financial Statements and the Notes to the Financial Statements. In addition to the basic financial statements, the report contains other supplemental information and 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's examination and analysis of the TSFC's financial condition and performance.

The basic financial statements report information about the TSFC using an accrual accounting method. The basic financial statements include a Statement of Net Assets; Statement of Activities, a Statement of Cash Flows, and 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 of the current year's revenues and expenses are accounted for in the Statement of Activities. This statement measures the success of the TSFC's financial operations over the past year and can be used to determine whether the TSFC will successfully garner sufficient revenues from the Master Settlement Agreement to pay debt service obligations.

Condensed Statements of Net Assets

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Current assets	\$75,388,685	\$72,205,935
Other assets	1,482,595	1,521,611
Total assets	76,871,280	73,727,546
Current liabilities	-	600,672
Long-term debt	650,758,128	653,082,957
Total liabilities	650,758,128	653,683,629
Net Assets	\$(573,886,848)	\$(579,956,083)

Condensed Statements of Activities

	<u>June 30, 2004</u>	<u>June 30, 2003</u>
Revenues	\$49,807,869	\$3,026,264
Expenses	43,738,634	40,055,689
Change in Net Assets	\$6,069,235	\$(37,029,425)

The corporation purchased the State's rights to the TSRs beginning with TSRs received after December 31, 2003. Therefore, the corporation issued bonds in an amount sufficient to cover the purchase price; a required debt service reserve; and scheduled interest payments until such date as the corporation obtained the rights to the TSRs. During the fiscal year ended June 30, 2003 the corporation utilized \$37,029,425 of designated cash reserves to fund a portion of the \$39,184,181 in aggregate interest payments made on its outstanding bonds.

During fiscal year 2004, the Corporation received \$49.8 million of revenues from TSRs and interest thereon. In August 2004, the Corporation received revenues from a settlement with Vibo, a cigarette manufacturer that decided to join the Master Settlement Agreement (MSA). Since the original settlement between the 46 states and the tobacco industry, more than 40 companies have joined the MSA. Vibo represented the largest remaining non-participating manufacturer. Vibo represents approximately 76% of Rhode Island's sales from non-participating manufacturers. Rhode Island's first payment of \$501,587 represented interest on prior obligations based on 2000-2003 cigarette sales by Vibo. Future payments under the settlement will consist of an annual payment due on April 15th and a "prior obligations" payment due on August 30th. In April 2005, TSFC expects to receive approximately \$500,000 for Vibo's cigarette sales for the period July 1, 2004 through December 31, 2004. On August 30th 2005, the TSFC expects to receive all accrued interest plus 1% of the principal amount associated with Vibo's prior cigarette sales. In subsequent years, Vibo will make its annual payment on April 15th for the prior calendar years' cigarette sales, and on August 30th, Vibo will make an escalating payment on its prior obligations.

The Corporation paid \$42.2 million in interest on long term bonds and paid \$3.7 million in principal on long term debt pursuant to the turbo redemption provisions of the Trust Indenture relating to the Tobacco

Settlement Asset-Backed Bonds, Series 2002A ("TSAC Bonds") issued in June 2002. The Corporation did not issue any additional debt.

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, were placed on rating watch by all three major credit rating agencies. The TSFC debt is rated "Baa3" by Moody's Investors Service, reflecting a downgrade from "Baa2" announced on April 21, 2004. The bonds were previously downgraded by Moody's from A1 to A3 on March 31, 2003, and from A3 to Baa2 on June 2, 2003. The bonds are rated "BBB" by Fitch Ratings, reflecting a downgrade from "A-" announced on May 6, 2003. The bonds were previously downgraded by Fitch from "A+" to "A-" on April 3, 2003. Standard & Poor's Rating Services rates the TSFC debt "BBB", reflecting a downgrade from "A-" on August 28, 2003. The bonds had been downgraded from "A" to "A-" on April 18, 2003 by Standard & Poor's. In general, the rating changes reflect the increased vulnerability of tobacco companies to adverse litigation in some jurisdictions, and concerns about litigation relating to the model statutes enacted by the various states. Ratings are subject to change at any time.

During fiscal year 2004, the Corporation paid \$3.7 million in principal on long term debt pursuant to the turbo redemption provisions of the Trust Indenture relating to its outstanding bonds. The amount of principal determined by the Trustee to be subject to the "turbo" redemption was based upon actual cash available in June 2004. Additional bonds will be subject to turbo redemption in December 2004, again based upon available cash. The Corporation did not issue any additional debt.

For additional information relating to capital assets or 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 any 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 assigned to 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.

As described above, additional TSRs are expected to be received from Vibo, a non-participating manufacturer that has joined the Master Settlement Agreement. However, states have collected less TSRs than originally expected due to a decline in cigarette volume, due possibly to higher than expected state excise taxes, which have increased significantly in many jurisdictions. The adjustment for inflation has offset the volume adjustment, but it has not outweighed it to date.

There continue to be concerns about litigation which could threaten the ability of the tobacco companies to pay the amounts owed under the master settlement agreement. Last year, for example Philip Morris had warned states that it might be unable to make its April 2004 settlement payment because of an Illinois lawsuit, which had the potential to push the company into bankruptcy. In a more recent development, the

US Justice Department is asking tobacco companies for \$280 billion as repayment for allegedly defrauding and misleading the public about the health risks of cigarette smoking.

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, 2004

Assets:

Investments - unrestricted...	\$ 676,342
Investments - restricted...	74,210,756
Accrued Tobacco Settlement Agreement receipts...	501,587
Bond issue costs, net...	1,482,595

Total Assets	<u>76,871,280</u>
--------------	-------------------

Liabilities:

Bonds payable, net of unamortized discount...	650,758,128
---	-------------

Total Liabilities...	<u>650,758,128</u>
----------------------	--------------------

Net Assets:

Unrestricted/(deficiency)...	(573,886,848)
------------------------------	---------------

Total Net Assets...	<u>\$ (573,886,848)</u>
---------------------	-------------------------

See Notes to Financial Statements.

Tobacco Settlement Financing Corporation

Statement of Activities
for the year ended June 30, 2004

Revenues:

Tobacco Settlement Agreement revenue...	\$ 45,190,449
Investment income...	4,617,420
Total revenues...	<u>49,807,869</u>

Expenses:

General and administrative...	80,000
Amortization of bond issue costs...	39,016
Interest expense...	43,619,618
Total expenses...	<u>43,738,634</u>

Net increase in Net Assets 6,069,235

Net Assets/(Deficiency):

Beginning of the year...	(579,956,083)
End of the year...	<u>\$ (573,886,848)</u>

See Notes to Financial Statements.

Tobacco Settlement Financing Corporation

Statement of Cash Flows
for the year ended June 30, 2004

Cash flows from operating activities:

Cash received from Tobacco Settlement Agreement...	\$ 45,142,524
Payments to vendors...	(80,000)
Payments of Settlement Agreement receipts to State...	(453,662)
Net cash used for operating activities...	<u>44,608,862</u>

Cash flows from non-capital financing activities:

Principal paid on long-term debt...	(3,710,000)
Interest paid on long-term debt...	(42,234,447)
Net cash used for non-capital financing activities...	<u>(45,944,447)</u>

Cash flows from investing activities:

Change in investments - unrestricted...	(75,315)
Change in investments - restricted...	(3,206,520)
Investment earnings...	4,617,420
Net cash provided by investing activities...	<u>1,335,585</u>

Net increase/(decrease) in cash... -

Cash, beginning of year... -

Cash, end of year... \$ -

Reconciliation of increase in net assets to net cash provided by/
(used for) operating activities:

Increase in net assets...	\$ 6,069,235
Amortization of bond issue costs...	39,016
Amortization of bond discount...	1,385,171
Change in Accrued Tobacco Settlement Agreement receipts...	(501,587)
Interest expense...	42,234,447
Investment earnings...	(4,617,420)

Net cash provided by/(used for) operating activities... \$ 44,608,862

See Notes to Financial Statements.

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004**

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

In 2004 the Governmental Accounting Standards Board issued a Technical Bulletin titled: *Tobacco Settlement Recognition and Financial Reporting Entity Issues*. This Technical Bulletin was issued to provide guidance on recording and presenting Tobacco Settlement transactions and determining if separate entities created to purchase a settling government's interest in future settlement revenues should be considered component units of that government. The Corporation elected to adopt the applicable provisions of this Technical Bulletin in its 2003 financial statements.

(CONTINUED)

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004**

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 – Supplemental Information (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:

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.

(CONTINUED)

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Investments

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

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.

(CONTINUED)

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004**

2. INVESTMENTS (Continued)

At June 30, 2004, 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.....	\$72,761,043			\$72,761,043
Investments not subject to categorization:				
Money Market Mutual Funds.....				2,126,055
Total	\$72,761,043	\$0	\$0	\$74,887,098

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. The bond indenture contains "Turbo Maturity" provisions, whereby the Corporation is required to apply 100% of all collections that are in excess of the then current 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. During the year ended June 30, 2004 the Corporation utilized \$3,710,000 of excess collections to early redeem an equal amount of outstanding bonds.

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

<i>Year ending June 30</i>	<i>Principal</i>	<i>Interest</i>	<i>Total</i>
2005		\$ 42,014,815	\$ 42,014,815
2006		42,014,815	42,014,815
2007		42,014,815	42,014,815
2008		42,014,815	42,014,815
2009		42,014,815	42,014,815
2010 – 2014	\$ 31,950,000	206,291,195	238,241,195
2015 – 2019		200,616,875	200,616,875
2020 – 2024	109,770,000	194,030,675	303,800,675
2025 – 2029		167,685,875	167,685,875
2030 – 2034	168,260,000	147,074,025	315,334,025
2035 – 2039		116,156,250	116,156,250
2040 – 2042	371,700,000	69,693,750	441,393,750
Totals	\$ 681,680,000	\$ 1,311,622,720	\$ 1,993,302,720

(CONTINUED)

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004**

3. LONG-TERM DEBT (Continued)

The balance due on the Corporation's bonds payable reconciles to the reported amount included in the statement of net assets as follows:

Original Bond principal...	\$685,390,000
Less: "Turbo Redemptions" through June 30, 2004...	(3,710,000)
Outstanding balance of bonds payable...	681,680,000
Less: unamortized bond discount...	<u>(30,921,872)</u>
Bonds payable, per statement of net assets...	<u>\$650,758,128</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. ACCOUNTING FOR PURCHASED INTEREST IN TOBACCO SETTLEMENT REVENUE

In accordance with the guidance provided in the Governmental Accounting Standards Board Technical Bulletin, the corporation has changed its method of accounting for its purchased interest in future Settlement Agreement receipts for the fiscal year ended June 30, 2003. The guidance concludes that neither an asset nor revenue from the Settlement Agreement should be recorded until the domestic sale of cigarettes occurs. Under this current guidance, transactions related to the Settlement Agreement will be recognized on the accrual basis, consistent with the timing of the domestic sale of cigarettes and the resulting Settlement Agreement payments required to be made by the participating cigarette manufacturers.

(CONTINUED)

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2004**

6. SUBSEQUENT EVENTS

On August 27, 2004 the Corporation received \$501,587 in Settlement Agreement receipts, attributable to transactions occurring prior to June 30, 2004. Accordingly, this amount has been recognized in the Statement of Net Assets as "Accrued TSA receipts".

(CONCLUDED)

SUPPLEMENTARY INFORMATION

Tobacco Settlement Financing Corporation

Balance Sheet, Governmental Funds
as of June 30, 2004

	<u>General Fund</u>	<u>Debt Service Fund</u>	<u>Total Governmental Funds</u>
Assets:			
Investments...	\$ 676,342	\$ 74,210,756	\$ 74,887,098
Accrued Tobacco Settlement Agreement receipts...	501,587		501,587
Total Assets	<u>\$ 1,177,929</u>	<u>\$ 74,210,756</u>	<u>\$ 75,388,685</u>
Liabilities and Fund Balances:			
Liabilities:			
Accounts payable...	\$ -	\$ -	\$ -
Total Liabilities	<u>-</u>	<u>-</u>	<u>-</u>
Fund Balances:			
Reserved for debt service...	-	52,314,561	52,314,561
Designated for future expenditure...	1,177,929	21,896,195	23,074,124
Total Fund Balances	<u>1,177,929</u>	<u>74,210,756</u>	<u>75,388,685</u>
Total Liabilities and Fund Balances	<u>\$ 1,177,929</u>	<u>\$ 74,210,756</u>	<u>\$ 75,388,685</u>

Tobacco Settlement Financing Corporation

Statement of Revenues, Expenditures, Other Financing Sources and Uses and Changes in Fund Balances,
Governmental Funds
For the year ended June 30, 2004

	General Fund	Debt Service Fund	Total Governmental Funds
Revenues:			
Investment income...	\$ 6,938	\$ 4,610,482	\$ 4,617,420
Tobacco Settlement Agreement revenue...	45,644,111	-	45,644,111
Total Revenues	<u>45,651,049</u>	<u>4,610,482</u>	<u>50,261,531</u>
Expenditures:			
Current:			
General and administrative...	80,000	-	80,000
Debt Service: Principal...	-	3,710,000	3,710,000
Debt Service: Interest...	-	42,234,447	42,234,447
Total Expenditures	<u>80,000</u>	<u>45,944,447</u>	<u>46,024,447</u>
Excess of Revenues over/(under) Expenditures	<u>45,571,049</u>	<u>(41,333,965)</u>	<u>4,237,084</u>
Other Financing Sources/(Uses):			
Operating transfers...	(44,540,485)	44,540,485	-
Transfer of Settlement Agreement receipts to State...	(453,662)	-	(453,662)
Net Other Financing Sources/(Uses)	<u>(44,994,147)</u>	<u>44,540,485</u>	<u>(453,662)</u>
Excess of Revenues and Other Financing Sources Over Expenditures and Other Financing Uses	576,902	3,206,520	3,783,422
Fund Balances:			
Beginning of the year...	601,027	71,004,236	71,605,263
End of the year...	<u>\$ 1,177,929</u>	<u>\$ 74,210,756</u>	<u>75,388,685</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... (650,758,128)

Long-term assets do not represent currently expendable resources and therefore are not reported in the funds... 1,482,595

Net Assets in Statement of Net Assets... \$ (573,886,848)

Tobacco Settlement Financing Corporation

Reconciliation of the Statement of Revenues, Expenditures, Other Financing Sources and Uses
and Changes in Fund Balances to the Statement of Activities
for the year ended June 30, 2004

Net change in fund balances for governmental funds	\$ 3,783,422
 Bond discounts are not recorded in governmental funds as the net proceeds of bond issues are recorded as current revenue. In the Statement of Activities these amounts are recorded and amortized as a component of interest expense over the life of the bond.	 (1,385,171)
 Governmental funds report outlays for debt service as current expenditures. However, in the statement of activities such costs are not reported and are instead recorded as reductions of the outstanding debt.	 3,710,000
 Amortization of bond issue costs is not recorded in governmental funds, as such outlays are recorded as current expenditures. In the Statement of Net Assets these costs are recorded and amortized over the term of the bond.	 (39,016)
 Change in Net Assets in Statement of Activities	 <u>\$ 6,069,235</u>



PRESCOTT·CHATELLIER
FONTAINE·WILKINSON·LLP
CERTIFIED PUBLIC ACCOUNTANTS
BUSINESS & FINANCIAL ADVISORS

Two Charles Street, Providence, RI 02904
401 421 2710 telephone 401 274 5230 facsimile
www.yourcpafirm.com

**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 year ended June 30, 2004, and have issued our report thereon dated September 29, 2004. 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.

Ruscott Chatelain Fontaine & Willenison, LLP

September 29, 2004