

TOBACCO SETTLEMENT FINANCING CORPORATION

**FINANCIAL STATEMENTS
YEAR ENDED JUNE 30, 2005**

TOBACCO SETTLEMENT FINANCING CORPORATION

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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, 2005, 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, 2005 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 our report dated October 6, 2005 on our consideration of the Corporation's internal control over financial reporting and 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 controls over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on pages three through twelve 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 23 through 25 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.

The supplementary information presented on pages 26 and 27 have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on those presentations.

Prescott Chatelain Fontaine & Williamson, LLP

October 6, 2005

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, 2005. Please read it in conjunction with the financial statements that 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 and in the State's right 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 of 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 were recognized) the liabilities of TSFC exceeded its assets at the close of the 2005 fiscal year by \$572,115,092 (net assets).
- Revenues, consisting of Tobacco Settlement Agreement revenue and investment income, amounted to \$48,740,355.

- Expenses, primarily interest, amounted to \$43,467,365.
- Net assets of the Corporation increased by \$5,272,990 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, 2005</u>	<u>June 30, 2004</u> <u>(as restated)</u>
Current assets	\$75,199,226	\$75,388,685
Other assets	1,443,579	1,482,595
Total assets	76,642,805	76,871,280
<hr/>		
Current liabilities	3,467,441	3,501,234
Long-term debt	645,290,456	650,758,128
Total liabilities	648,757,897	654,259,362
 Net Assets	 \$(572,115,092)	 \$(577,388,082)

Condensed Statements of Activities

	<u>June 30, 2005</u>	<u>June 30, 2004</u> <u>(as restated)</u>
Revenues	\$48,740,355	\$49,807,869
Expenses	43,467,365	43,704,634
Change in Net Assets	\$5,272,990	\$6,103,235

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 2005, the Corporation received \$48.7 million of revenues from TSRs and interest thereon reflecting a decrease of \$1.1 million from FY 2004 revenues of \$49.8 million. This includes an increase of \$0.6 million in TSR's and a decrease of \$1.7 million in investment earnings.

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 2005, the Corporation paid \$6.85 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 2005.

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

The Composition of the Corporation's Board

During Fiscal Year 2005, TSFC was governed by a five-member Board. The Board was comprised of three members appointed by the Governor, one member appointed by the Speaker of the House and one member appointed by the President of the Senate. In July 2005, the composition was changed to include three public members appointed by the Governor subject to Senate confirmation, two members of the State Investment Commission appointed by the Governor who shall give due consideration to the recommendation of the Chair of the State Investment Commission. The three members appointed by the Governor under the previous composition, will continue to serve until such time as they or new members are appointed and/or have received Senate confirmation.

Risk Factors and Next Year's Revenue

The Board has little or no control over the level of revenues that 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 that 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.

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.

In April 2005, the total revenues received by the Corporation as a result of the Tobacco Master Settlement Agreement (MSA) were \$45,315,618. Eleven of the forty-three Subsequent Participating Manufacturers (SPMs) to the MSA paid their MSA payment due April 15, 2005 into an escrow disputed account and nine SPM withheld all or part of their MSA payment due April 1, 2005. However, on October 2005, Rhode Island received a distribution in the amount of \$ 514,707 as a result of some SPMs releasing funds deposited in the escrow dispute account, a back payment by Farmers Tobacco, and the first payment in the General Tobacco settlement. The SPMs asserted that the Independent Auditor's calculation for the MSA payment due April 15, 2005 was incorrect, primarily because it did not contain a Non-Participating Manufacturers (NPM) adjustment. The value of the April 15, 2005 MSA payment in dispute for the Tobacco Settlement Financing Corporation is approximately \$1,366,519. The NPM adjustment would permit the Participating Manufacturers (PM) to reduce their MSA payments if their market share loss exceeds 2% of the original participating manufacturers' 1997 market share, and if the MSA was a significant factor for the PMs' market share loss, and if the PMs prevailed in proving lack of diligent enforcement of the MSA and the escrow statutes. If the NPM adjustment is applied, the payment reduction is based on the percentage of market share lost to NPMs multiplied by three. To maintain their disputed payments, companies must prove first that their lost market share was due to the strictures of the MSA. If an NPM adjustment is applied, it may be satisfied by offsetting any or all Settling States' MSA payments without regard to market share or market loss within the Settling State. The offset is not carried forward to other MSA payments.

In April 2005, the Independent Auditor determined that the PMs' market share loss exceeded 2% of the of the original participating manufacturers' 1997 market share. Rhode Island along with the other Settling States and the PMs have begun a Significant Factors Determination (SFD) proceeding to determine

whether or not the PMs have lost market share due to the MSA. Although no date is set for a final determination of the SFD proceeding, Rhode Island anticipates a SFD determination in 2006.

Pursuant to the MSA, Rhode Island has provided a 30-day notice prior to initiating enforcement proceedings to the SPMs who failed to pay their MSA payments. Rhode Island and the other Settling States entered into negotiations with the SPMs that withheld or deposited their MSA payments into disputed accounts. The negotiations have resulted in some SPMs agreeing to release MSA payments from the disputed escrow accounts to the Settling States. Some SPMs provided a 30-day notice prior to initiating enforcement proceedings seeking to resolve issues of withholding the MSA payments based upon a claim that an NPM adjustment for 2003 should apply. The Settling States have initiated enforcement proceedings against some SPMs for nonpayment of the MSA payment. Rhode Island is working with other Settling States to increase the number of tobacco companies that join the MSA and make MSA payments to Rhode Island and the other Settling States. Rhode Island will continue to vigorously enforce the MSA and related statute.

There continue to be concerns that litigation could threaten the ability of the tobacco companies to pay the amounts owed under the master settlement agreement. Antitrust and constitutional challenges to the MSA are pending in several Settling States, which potentially could affect the legality of the MSA and the MSA payments for Rhode Island. Rhode Island continues to work with the other Settling States to defend these challenges. In addition, the issue whether or not the PMs would seek bankruptcy protection continues to be a concern. Two NPMs have filed for bankruptcy and a PM threatened to seek bankruptcy protection. Philip Morris, a PM, 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.

HCA/Tob/TFSC/9-27-05 mgg rev to MD&A

Tobacco Settlement Financing Corporation

Statement of Net Assets
as of June 30, 2005

Assets:

Investments - unrestricted...	\$ 143,005
Investments - restricted...	74,541,514
Accrued Tobacco Settlement Agreement receipts...	514,707
Bond issue costs, net...	1,443,579

Total Assets 76,642,805

Liabilities:

Accrued interest...	3,467,441
Bonds payable, net of unamortized discount...	645,290,456

Total Liabilities... 648,757,897

Net Assets:

Unrestricted/(deficiency)... (572,115,092)

Total Net Assets... \$ (572,115,092)

See Notes to Financial Statements.

Tobacco Settlement Financing Corporation

Statement of Activities
for the year ended June 30, 2005

Revenues:

Tobacco Settlement Agreement revenue...	\$ 45,831,224
Investment income...	2,909,131
Total revenues...	<u>48,740,355</u>

Expenses:

General and administrative...	65,000
Amortization of bond issue costs...	39,016
Interest expense...	43,363,349
Total expenses...	<u>43,467,365</u>

Net increase in Net Assets 5,272,990

Net Assets/(Deficiency):

Beginning of the year, as restated...	(577,388,082)
End of the year...	<u>\$ (572,115,092)</u>

See Notes to Financial Statements.

Tobacco Settlement Financing Corporation

Statement of Cash Flows
for the year ended June 30, 2005

Cash flows from operating activities:	
Cash received from Tobacco Settlement Agreement...	\$ 45,818,105
Payments to vendors...	(65,000)
	<u>45,753,105</u>
Net cash used for operating activities...	
Cash flows from non-capital financing activities:	
Principal paid on long-term debt...	(6,850,000)
Interest paid on long-term debt...	(42,014,815)
	<u>(48,864,815)</u>
Net cash used for non-capital financing activities...	
Cash flows from investing activities:	
Change in investments - unrestricted...	533,337
Change in investments - restricted...	(330,758)
Investment earnings...	2,909,131
	<u>3,111,710</u>
Net cash provided by investing activities...	
Net increase/(decrease) in cash...	-
Cash, beginning of year...	-
Cash, end of year...	<u>\$ -</u>
Reconciliation of increase in net assets to net cash provided by/ (used for) operating activities:	
Increase in net assets...	\$ 5,272,990
Amortization of bond issue costs...	39,016
Amortization of bond discount...	1,382,327
Change in Accrued Tobacco Settlement Agreement receipts...	(13,120)
Change in Accrued interest...	(33,793)
Interest expense...	42,014,816
Investment earnings...	(2,909,131)
	<u>(2,909,131)</u>
Net cash provided by/(used for) operating activities...	<u>\$ 45,753,105</u>

See Notes to Financial Statements.

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005**

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, 2005**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recently Issued Accounting Standards (Continued)

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.

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.

(CONTINUED)

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Basis of Presentation – Supplemental Information (Fund Financial Statements) (Continued)

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.

Investments

Investments are stated at fair value.

The Corporation's bond indenture and related agreements require that cash and investments be held by the trustee for the benefit of the bond holders. According to the agreements, investments to be held by the trustee are limited to the following:

- United States Treasury Securities
- Demand deposits with banks which are members of the Federal Deposit Insurance Corporation
- Federal Agency or instrumentality bonds
- Certain repurchase agreements
- Certain bankers acceptances
- Shares in certain Investment Companies
- Certain Obligations of any state, or political subdivision, or municipal corporation
- Certain eligible loans
- Investment Agreements approved by the rating agencies
- Commercial paper

(CONTINUED)

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Basis of Presentation – Supplemental Information (Fund Financial Statements) (Continued)

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.

Arbitrage Regulations

Investment income earned by the Corporation is limited by U.S. Treasury regulations. Income earned in excess of allowable amounts will be remitted to the federal government as required by the applicable laws and regulations. The Corporation is required to submit payment of its rebateable arbitrage earnings on the five-year anniversary of the bond issue, and on each succeeding five-year anniversary.

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TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005**

2. INVESTMENTS

At June 30, 2005, the corporation had the following investments:

Description	Maturity	Fair Value
GE Capital Corp commercial paper	December 1, 2005	\$19,694,275
Morgan Stanley commercial paper	December 1, 2005	51,922,166
Wells Fargo Advantage Treasury Plus Money Market	n/a	3,068,078
		\$74,684,519

Concentration of Credit Risk. The corporation does not have a formal policy that limits the amount that may be invested in any one issuer. The investments listed above represent 26.4%, 69.5% and 4.1%, respectively, of the corporation's total investments.

Interest Rate Risk. It is the policy of the corporation to limit the length of its investment maturities in order to manage the exposure to fair value losses arising from increasing interest rates.

Custodial Credit Risk. For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the corporation will not be able to recover the value of its investments that are in the possession of the counterparty. The corporation does not have a formal investment policy for custodial credit risk.

Credit Risk. As of June 30, 2005, the corporation's investment in GE Capital Corp commercial paper was rated A1+ by Standard and Poors and P1 by Moody's. The corporation's investment in Morgan Stanley commercial paper was rated A1 by Standard and Poors and P1 by Moody's. The Wells Fargo Advantage Treasury Plus Money Market is not a rated security, as the fund invests in short-term obligations issued by the U.S. Treasury and also invests in repurchase agreements and other instruments collateralized or secured by U.S. Treasury obligations. The U.S. Treasury does not directly or indirectly insure or guarantee the performance of the fund. Treasury obligations have historically involved minimal risk of loss if held to maturity. However, fluctuations in market interest rates may cause the value of Treasury obligations in the Fund's portfolio to fluctuate.

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, 2005 and 2004 the Corporation utilized \$6,850,000 and \$3,710,000 of excess collections to early redeem an equal amount of outstanding bonds.

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TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005**

3. LONG-TERM DEBT (Continued)

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>
2006		\$ 41,609,295	\$ 41,609,295
2007		41,609,295	41,609,295
2008		41,609,295	41,609,295
2009		41,609,295	41,609,295
2010		41,609,295	41,609,295
2011 – 2015	\$ 25,100,000	203,588,715	228,688,715
2016 – 2020		200,616,875	200,616,875
2021 – 2025	109,770,000	187,444,475	297,214,475
2026 – 2030		167,685,875	167,685,875
2031 – 2035	168,260,000	136,768,100	305,028,100
2036 – 2040		116,156,250	116,156,250
2041 - 2042	371,700,000	46,462,500	418,162,500
Totals	\$ 674,830,000	\$ 1,266,769,265	\$ 1,941,599,265

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, 2005...	<u>(10,560,000)</u>
Outstanding balance of bonds payable...	674,830,000
Less: unamortized bond discount...	<u>(29,539,544)</u>
Bonds payable, per statement of net assets...	<u>\$645,290,456</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.

In April 2005 twenty of the tobacco manufacturers participating in the MSA either withheld all or portions of their payments due, or remitted their payments to an escrow account, disputing the calculations of amounts due under the agreement. These manufacturers assert that the calculations of the April 2005 payments failed to recognize a prescribed adjustment for non-participating manufacturers. The corporation's share of these disputed payments is approximately \$1,366,500. Subsequent to June 30, 2005 the Corporation received \$514,707 of this amount, which has been accrued in these financial statements. Due to uncertainties regarding the ultimate realization of the remaining amount of these disputed payments, they have not been recognized as revenue in the accompanying financial statements. The Corporation and the other affected parties are taking actions prescribed in the MSA to arrive at a resolution of these matters.

(CONTINUED)

TOBACCO SETTLEMENT FINANCING CORPORATION

**NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2005**

5. ADMINISTRATIVE EXPENSES

The State of Rhode Island performs certain accounting, legal, and administrative services on behalf of the Corporation for which it receives no compensation. The values of such services are not material to the Corporation's financial statements, and have not been reflected herein.

6. RISK MANAGEMENT

The Corporation is exposed to various risks of loss related to torts, asset misappropriation, and errors and omissions that could occur in the normal course of operations. The Corporation retains the risk of loss in the event of any judgments against it. As of June 30, 2005, no know asserted or unasserted claims or judgments pending against the Corporation.

Members of the Board and persons acting on the Corporation's behalf, while acting within the scope of their duties or employment, are indemnified against damages pursuant to the Corporation's enabling legislation and state law.

7. RESTRICTED ASSETS

In accordance with the Corporation's revenue bond indenture, investments have been designated as restricted for the following purposes:

Debt Service Reserve Fund	\$51,922,166
Designated for future Debt Service expenditures	22,619,348

The Corporation was in compliance with its Debt Service Reserve requirements as of June 30, 2005.

8. RESTATEMENT

The Corporation's net assets at June 30, 2004 have been restated to reflect the accrual of interest on long-term debt that was unpaid at that date, which was omitted from the previously issued financial statements. The effect of this correction was a reduction of the opening net asset balance in the amount of \$3,501,234. This matter had no effect on the Corporation's cash flows, and all debt service payments have been made on a timely basis and in accordance with the terms of the obligations.

(CONCLUDED)

SUPPLEMENTARY INFORMATION

Tobacco Settlement Financing Corporation

Balance Sheet, Governmental Funds
as of June 30, 2005

	<u>General Fund</u>	<u>Debt Service Fund</u>	<u>Total Governmental Funds</u>
Assets:			
Investments...	\$ 143,005	\$ 74,541,514	\$ 74,684,519
Accrued Tobacco Settlement Agreement receipts...	514,707		514,707
Total Assets	<u>\$ 657,712</u>	<u>\$ 74,541,514</u>	<u>\$ 75,199,226</u>
Liabilities and Fund Balances:			
Liabilities:			
Accounts payable...	\$ -	\$ -	\$ -
Total Liabilities	<u>-</u>	<u>-</u>	<u>-</u>
Fund Balances:			
Reserved for debt service...	-	51,922,166	51,922,166
Designated for future expenditure...	657,712	22,619,348	23,277,060
Total Fund Balances	<u>657,712</u>	<u>74,541,514</u>	<u>75,199,226</u>
Total Liabilities and Fund Balances	<u>\$ 657,712</u>	<u>\$ 74,541,514</u>	<u>\$ 75,199,226</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, 2005

	General Fund	Debt Service Fund	Total Governmental Funds
Revenues:			
Investment income...	\$ 20,453	\$ 2,888,678	\$ 2,909,131
Tobacco Settlement Agreement revenue...	45,831,224	-	45,831,224
Total Revenues	<u>45,851,677</u>	<u>2,888,678</u>	<u>48,740,355</u>
Expenditures:			
Current:			
General and administrative...	65,000	-	65,000
Debt Service: Principal...	-	6,850,000	6,850,000
Debt Service: Interest...	-	42,014,815	42,014,815
Total Expenditures	<u>65,000</u>	<u>48,864,815</u>	<u>48,929,815</u>
Excess of Revenues over/(under) Expenditures	<u>45,786,677</u>	<u>(45,976,137)</u>	<u>(189,460)</u>
Other Financing Sources/(Uses):			
Operating transfers in...	24,145	46,331,039	46,355,184
Operating transfers out...	(46,331,039)	(24,145)	(46,355,184)
Net Other Financing Sources/(Uses)	<u>(46,306,894)</u>	<u>46,306,894</u>	<u>-</u>
Excess of Revenues and Other Financing Sources Over Expenditures and Other Financing Uses	(520,217)	330,757	(189,460)
Fund Balances:			
Beginning of the year...	1,177,929	74,210,757	75,388,686
End of the year...	<u>\$ 657,712</u>	<u>\$ 74,541,514</u>	<u>75,199,226</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... (648,757,897)

Long-term assets do not represent currently expendable resources and therefore are not reported in the funds... 1,443,579

Net Assets in Statement of Net Assets... \$ (572,115,092)

Tobacco Settlement Financing Corporation

Supplemental Calculation of Debt Service Coverage Ratios
for the years ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Beginning balances...	\$ 274,373	\$ -
Revenues:		
Tobacco revenue received...	45,316,517	44,688,862
Investment income...	2,811,755	1,405,877
Transfer from Operating account...	498,989	
Miscellaneous Tobacco Settlement receipts...	501,587	-
Total sources...	<u>49,403,221</u>	<u>46,094,739</u>
Expense reserve...	<u>150,000</u>	<u>150,000</u>
Net Revenue Available for Debt Service...	<u>\$ 49,253,221</u>	<u>\$ 45,944,739</u>
Annual Debt Service:		
Required Principal Payments	\$ -	\$ -
Required Interest Payments	42,014,815	42,234,447
Turbo Principal Payments	6,850,000	3,710,000
Total Annual Debt Service...	<u>\$ 48,864,815</u>	<u>\$ 45,944,447</u>
Coverage Ratio...	<u>1.01</u>	<u>1.00</u>

Tobacco Settlement Financing Corporation

Supplemental Schedule of Actual MSA Receipts Compared to
DRI-WEFA Base Case Projection at Time of Sale

<u>Fiscal Year Ended June 30</u>	<u>DRI-WEFA Base Case Expected MSA Revenue</u>	<u>Actual MSA Revenue Received</u>	<u>Variance</u>
2004	\$ 47,047,106	\$ 45,190,449	\$ (1,856,657)
2005	\$ 47,570,858	\$ 45,316,517	\$ (2,254,341)



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**INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING
AND COMPLIANCE AND OTHER MATTERS 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, 2005, and have issued our report thereon dated October 6, 2005. 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.

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.

Compliance and Other Matters

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 or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the 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.

Pescott Chatellier Fontaine & Wilkinson, LLP

October 6, 2005