

**TOBACCO SETTLEMENT**  
**FINANCING CORPORATION**

**FINANCIAL STATEMENTS**  
**YEAR ENDED JUNE 30, 2011**

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**TABLE OF CONTENTS**

Report of Independent Auditors...	1 – 2
Management’s Discussion and Analysis...	3 – 17
Financial Statements:	
Statement of Net Assets...	18
Statement of Activities...	19
Statement of Cash Flows...	20
Balance Sheet, Governmental Funds...	21
Statement of Revenues, Expenditures, Other Financing Sources and Uses and Changes in Fund Balances, Governmental Funds...	22
Reconciliation of the Statement of Revenues, Expenditures, Other Financing Sources and Uses and Changes in Fund Balances to the Statement of Activities...	23
Notes to Financial Statements...	24 – 32
Supplementary Information:	
Calculation of Debt Service Coverage Ratios...	33
Schedule of Actual MSA Receipts Compared to Base Case Projection at Time of Sale...	34
Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards...	35 – 36

## **REPORT OF INDEPENDENT AUDITORS**

To the Board of Directors  
Tobacco Settlement Financing Corporation

We have audited the accompanying financial statements of the governmental activities and each governmental fund of the Tobacco Settlement Financing Corporation (a component unit of the State of Rhode Island) (the Corporation) as of and for the year ended June 30, 2011, as listed in the table of contents. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express opinions 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 opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each governmental fund of the Tobacco Settlement Financing Corporation as of June 30, 2011 and the respective changes in financial position and, where applicable, 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 September 29, 2011 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.

Needham  
Boston  
Concord  
Taunton

The Management's Discussion and Analysis on pages 3 through 17 is not a required part of the financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. 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 the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the basic financial statements that collectively comprise the Tobacco Settlement Financing Corporation's basic financial statements. The Calculation of Debt Service Coverage Ratios and Schedule of Actual MSA Receipts Compared to Base Case Projection at Time of Sale on pages 33 and 34 have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

*Blawie PC*

Providence, Rhode Island  
September 29, 2011

## **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, 2011. Please read it in conjunction with the financial statements that follow this section. It should also be noted that while attempts have been made to disclose all pertinent risk factors, it is difficult to capture all current litigation and other proceedings relating to the Master Settlement Agreement, and the reader should not rely upon management's discussion contained herein when making investment decisions.

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 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 June 2007, the Corporation issued \$197,005,742 of its Tobacco Settlement Asset-Backed Bonds, Series 2007 A, B and C which are structurally subordinate to the payment in full of the 2002 Series A Bonds. The Trustee is entitled to receive the "Residual" tobacco settlement revenues pledged to pay the 2007 Series A, B and C Bonds upon full payment of the 2002 Series A Bonds.

In accordance with the Act, the 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 bonds. The 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**

Future revenues continue to be threatened by factors discussed under "Risk Factors and Next Year's Revenue".

The following are the key financial highlights from the financial statements:

- Due to the balance of the bonds outstanding exceeding the assets recognized (no receivables for future revenues were recognized) the liabilities of TSFC exceeded its assets at the close of the 2011 fiscal year by \$753,739,129 (net assets).
- Revenues, consisting of Tobacco Settlement Agreement revenue and investment income, amounted to \$50,166,288.

### **Financial Highlights (continued)**

- Expenses, primarily interest expense, amounted to \$53,533,427.
- Net assets of the Corporation decreased by \$3,367,139 during the fiscal year.
- The Corporation had \$12,570,000 in Turbo Redemptions 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 the accrual basis of accounting. 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.

**Overview of Annual Financial Report (continued)**

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, 2011</u>	<u>June 30, 2010</u>
Current assets	\$71,800,603	\$72,061,390
Other assets	<u>2,122,144</u>	<u>\$2,186,133</u>
Total assets	<u>\$73,922,747</u>	<u>\$72,247,523</u>
Current liabilities	3,085,741	3,148,590
Long-term debt	<u>824,576,135</u>	<u>821,470,923</u>
Total liabilities	<u>827,661,876</u>	<u>824,619,513</u>
Net Assets (Deficiency)	<u>\$(753,739,129)</u>	<u>\$(750,371,990)</u>



**Overview of Annual Financial Report (continued)**

**Condensed Statements of Activities**

	<u>June 30, 2011</u>	<u>June 30, 2010</u>
Revenues	\$ 50,166,288	\$ 52,030,107
Expenses	<u>53,533,427</u>	<u>53,394,368</u>
Change in Net Assets	<u>\$ (3,367,139)</u>	<u>\$ (1,364,261)</u>

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 2011, the Corporation received \$50.2 million of revenues from TSRs and interest thereon reflecting a decrease of \$1.8 million from FY 2010 revenues of \$52.0 million. This reflects a decrease of \$2.8 million in TSR's and an increase of \$1.0 million in interest earnings.

The Corporation incurred \$52.0 million in interest on long term bonds and paid \$12.6 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.

### **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 2002 Series A Bonds are rated "Baa1", "Ba1", and "B1" by Moody's Investors Service for the 2023, 2032, and 2042 maturities, respectively, reflecting rating changes announced on September 8, 2011. The 2002 Series A Bonds were previously downgraded to "Baa3" on April 21, 2004 and were previously downgraded by Moody's from A1 to A3 on March 31, 2003, and from A3 to Baa2 on June 2, 2003. The 2002 Series A Bonds are rated "BBB+" by Fitch Ratings, reflecting an upgrade from "BBB" announced on January 28, 2008. The Series 2002 A Bonds were previously downgraded by Fitch from "A+" to "A-" on April 3, 2003, and from A- to BBB on May 6, 2003. Standard & Poor's Rating Services rates the TSFC 2002 Series A debt "BBB," reflecting a downgrade from "A-" on August 28, 2003. The 2002 Series A Bonds had been downgraded from "A" to "A-" on April 18, 2003 by Standard & Poor's.

In June 2007, the TSFC issued \$197,005,742 bonds, which included \$176,974,412 Series 2007 A Bonds, \$17,336,217 Series 2007 B Bonds and \$2,695,112 Series 2007 C Bonds. The Series C Bonds were unrated. Standard & Poor's Rating Services rates the TSFC 2007 Series A debt "B", reflecting a downgrade from "BB" on November 11, 2010. The 2007 Series A debt was previously downgraded to "BB" on September 11, 2009. Standard & Poor's Rating Services rates the 2007 Series B debt "B-", reflecting a downgrade from "BB-" on November 11, 2010. The 2007 Series B debt was previously downgraded to "BB-" on September 11, 2009.

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 2011, the Corporation paid \$12.6 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 2011.

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. In 2007, the Governor made appointments of two members who are members of the State Investment Commission. Two 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 possibly impacting the level of revenues to be received by the TSFC are beyond the control of the Corporation and include, but are not limited to, cigarette consumption, financial viability of the Participating Manufacturers and the liability of the tobacco 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 Agreement that have been assigned to the Corporation, the State of

Rhode Island has pledged to pursue legal remedies to the extent possible to obtain amounts due pursuant to the Master Settlement Agreement and payable to the Corporation.

Many adjustments are included in the calculation of a MSA Payment, such as a volume adjustment, cost of living adjustment and Non-Participating Manufacturer (NPM) adjustment. An NPM adjustment would permit the Participating Manufacturers (PM) to reduce their MSA payments provided that the PMs' market share loss exceeds 2% of the original participating manufacturers' 1997 market share, that the MSA was a significant factor for the PMs' market share loss, and that the states did not enact a Model Escrow Statute included in the MSA and diligently enforce it and the MSA. If the NPM adjustment is applied, the payment reduction is based on the percentage of market share lost to NPMs multiplied by three and allocated to states that did not diligently enforce the MSA and the escrow statute, up to the amount of the allocable share. The offset is not carried forward to other MSA payments.

States have collected less TSRs than originally expected due to a decline in cigarette volume attributable to many factors, including, but not limited, to the Master Settlement Agreement and higher excise taxes, both state and federal. 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 SPMs withheld all or part of their MSA payment due April 1, 2005. On or about October 4, 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 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 is \$1,366,519.

In April 2005, the Independent Auditor determined that the PMs experienced a 2003 market share loss exceeding 2% of the of the Original Participating Manufacturers' 1997 market share. Rhode Island along with the other Settling States and the PMs initiated a Significant Factors Determination (SFD) proceeding to determine whether or not the MSA was a significant fact in the PM's market share loss greater than 2%. The Settling States and the PMs selected an economic firm, The Brattle Group, to conduct the analysis and determine whether or not the MSA was a significant factor in the PMs' loss of market share. Rhode Island along with the other Settling States and the PMs engaged experts, presented data and briefed legal issues to the selected economic firm, The Brattle Group.

On March 27, 2006, The Brattle Group made its final determination that the MSA was a significant factor contributing to the market share loss for calendar year 2003. In a statement dated March 28, 2006, the co-chairs of the National Association of Attorney General's Tobacco Committee, stated, among other things, that the Settling States believe it would not be appropriate for a PM to withhold any portion of the April 2006 Annual Payment. According to the statement, the Settling States believed that the PMs must still prove to a court that the Settling States have not enacted the Model Statute and diligently enforced it and they also believed that every Settling State will be found to have diligently enforced its Model Statute in 2003. It has been reported, however, that the general counsel of Reynolds Tobacco has stated that he believes that not all states were diligently enforcing their Model Statutes.

It has been reported that on March 31, 2006, Philip Morris made its full \$3.4 billion payment, even though it believes that sum should eventually be reduced to reflect its market share loss due in the MSA, and it intends to continue to negotiate with the Settling States' Attorneys General for a reduction of its payment. It has been further reported that Lorillard paid approximately \$558 million of its 2006 Annual MSA Payment on March 31, 2006 to the Settling Sates and deposited the balance of the 2006 MSA Annual Payment, \$108 million, into the Disputed Payments Account pending final non-appealable resolution of the 2003 NPM Adjustment. Additionally, it has been reported that Reynolds American paid approximately \$ 1.3 billion of its Annual MSA Payment for 2006 to Settling States and deposited \$647 million in the Disputed Payment Account pending resolution of the 2003 NPM Adjustment. According to

the co-chairs of the NAAG Tobacco Committee in a statement released on April 18, 2006, the Annual Payments paid by Lorillard and Reynolds American to the Settling States constitute about 82% of the amount that was due. The three SPMs from who the largest payments were due made substantial payments. One of the three SPMs paid a portion of its payment to the Disputed Payments Account and the other two SPMs each withheld a portion of the payment due.

In April 2006, the Independent Auditor calculated that the PMs' payment for the MSA payment due April 15, 2006 should be \$6,568,524,930. The PMs paid the Settling States \$5,754,873,468 for the Annual MSA payment due April 15, 2006. The total revenues received by the Corporation as a result of the MSA were \$41,545,702. The value of the April 15, 2006 MSA payment in dispute to Rhode Island is approximately \$5,858,290, which includes PMs that either withheld or deposited into Disputed Escrow Accounts \$39,579,991 related to the 2003 NPM Adjustment.

To obtain the full MSA payment due April 15, 2006, Rhode Island issued a 30 day notice of intent to initiate proceedings to the PMs, pursuant to the MSA. On April 18, 2006, the co-chairs of the NAAG Tobacco Committee restated that the Settling States believe that no NPM Adjustment would be found to apply and, thus, the Settling States are entitled to receive the full payment due under the MSA. They stated that each Settling State has enacted a Model Statute, that all states believe they have diligently enforced their Model Statute and that they will ultimately receive the money in dispute. Since that date, more than 30 Settling States have filed suit in their respective state courts against one or more of the PMs to obtain the entire 2006 MSA Payment and or the PMs sued the state to compel arbitration.

In October 2006, the OPMs and some SPMs moved to compel Rhode Island to arbitrate the 2003 NPM Adjustment. Rhode Island argued that the issue of whether or not a state diligently enforced the Qualifying Statute should be determined by the state MSA court rather than nationwide arbitration. In 2007, the Rhode Island Superior Court held that the issue of diligent enforcement is integral to the 2003 NPM Adjustment and the 2003 NPM Adjustment should be decided in arbitration for consistency.

Rhode Island moved for reconsideration, which the Rhode Island Superior Court denied. Rhode Island appealed the Rhode Island Superior Court decision and sought a stay of it. The Supreme Court of Rhode Island remanded the case to Rhode Island Superior Court to determine if a stay should be granted. The Rhode Island Superior Court denied the motion for a stay. While the appeal was pending before the Supreme Court of Rhode Island, the PMs and 46 states entered into an Agreement Regarding Arbitration whereby the states agreed to arbitration and the PMs agreed to release some money from the 2003 NPM Adjustment disputed account, cap damages by a 20% reduction on an award of damages from the states, and other benefits for the states.

The nationwide arbitration of the 2003 NPM Adjustment and related matters was scheduled to commence in September 2009, at which time the parties were to name one arbitrator each. The two party arbitrators would then select the third arbitrator. The three-member panel will then set a schedule for the matter. The arbitrators are required by the MSA to be retired federal judges. The States and the PMs developed arbitration procedures and processes to govern the arbitration and would submit them to the arbitration panel. By June 30, 2010, the three member arbitration panel was selected. The arbitration began with a phone conference in July 2010 followed by an in-person hearing day. It is expected that arbitration process will continue for a significant amount of time.

The PMs and the Settling States have submitted Statements of Claim to the arbitration panel. The Settling have submitted brief concerning preliminary issues for the arbitration panel to decide, including the 2003 Settlement Agreements concerning Brown & Williamson. The Settling States assert that, in June 2003, the OPMs unconditionally released the Settling States from all claims that they may have with respect to cigarettes sold or shipped from 1999 through 2002. The OPMs and the Settling States had entered into agreements that resolved a variety of disputes relating to cigarette sales and MSA payments from 1999 through 2002. The Settling States maintain that since an NPM Adjustment for 2003 would be based upon cigarettes sold or shipped in 2002, the release in June 2003 agreements bars the OPMs from claiming an NPM Adjustment for 2003. The PMs have filed counter actions claiming that they are entitled to a 2003 NPM Adjustment. At this time, litigation is underway as to the determination of

whether a 2003 NPM adjustment should be applied to the MSA payment. As previously noted, any Settling State that adopts, maintains and diligently enforces its Qualifying Statute is not subject to the NPM Adjustment.

The State of Rhode Island has adopted the Model Statute (which is a Qualifying Statute under the MSA). "Diligent Enforcement" is not defined in the MSA. Furthermore, no provision of the MSA attempts to define what activities, if undertaken by a Settling State, would constitute diligent enforcement. As noted above, the Rhode Island Attorney General's Office has stated that the State has been and is diligently enforcing its Model Statute. Furthermore, the MSA does not explicitly state which party bears the burden of proving or disproving whether a Settling State has diligently enforced its Qualifying Statute or whether any diligent enforcement dispute would be resolved in state courts or through arbitration.

Future NPM Adjustment claims for Settling States remain possible for calendar years 2004, 2005, and all future years. The Brattle Group has been engaged as the Firm to determine whether or not the MSA was a significant factor for the PMs loss of market share in 2004. Rhode Island prepared for a Significant Factors Determination Proceeding concerning market share loss. The economic firm determined that the MSA was a significant factor for the PMs' market share loss greater than 2% in 2004 and 2005. For a significant factor determination for year 2006, the PMs and the Settling States selected a different economic firm; however, the significant factor determination was the same that the MSA was a significant factor in the market share loss of the PMs greater than 2% of the PMs' market share from 1997. For the significant factor for years 2007 through 2009, the PMs and the Settling States agreed to instruct the Independent Auditor that the MSA was a significant factor for the PMs' loss of market share greater than 2% of the PMs' 1997 market share. The Settling States agreed to provide the PMs with data for years 2007 through 2009. The OPMs agreed to pay \$15 million over three years to the "Antitrust/Consumer Protection Tobacco Enforcement Fund" established pursuant to MSA § VIII

In 2007, participating manufacturers withheld or deposited in a disputed payments account \$759,901,725 of which approximately \$5.4 million would be allocated to Rhode Island.



In April 2008, participating manufacturers paid the Settling States \$7,022,663,940 and withheld or deposited in a disputed payments account \$536,189,064. Rhode Island received an MSA payment in the amount of \$53,246,221.

The Independent Auditor calculated that the MSA payment due April 15, 2009 was \$7,577,256,366. On April 15 and 17, 2009, the participating manufacturers paid the Settling States \$7,050,630,533 for 2009 and \$56,037,366 for earlier years. The participating manufacturers paid \$110,179,682 into the Disputed Payments Account on account of the NPM Adjustment. The participating manufacturers withheld \$412,698,683 on account of the NPM Adjustment, \$3,333,328 on account of the "Net vs. Gross" dispute, and \$418,888 was defaulted on by Daughters and Ryan (the only PM to default this year). Rhode Island received an MSA payment in the amount of \$58,018,809, including \$3,866,745 for joining the Agreement Regarding Arbitration.

The Independent Auditor calculated that the MSA payment due April 15, 2010 was \$7,068,272,985. On April 15 and 17, 2010, the participating manufacturers paid the Settling States \$6,381,050,380 for 2009 and \$12,309,983 for earlier years. The participating manufacturers paid \$576,112,050 into the Disputed Payments Account on account of the NPM Adjustment. The participating manufacturers withheld \$ 21,083,728 on account of the NPM Adjustment, \$ 3,116,080 on account of other basis, and \$86,943,059 was defaulted on by General Tobacco (the only PM to default this year). Rhode Island received an MSA payment in the amount of \$48,620,448.

The Independent Auditor calculated that the MSA payment due April 15, 2011 was \$6,957,627,854. On April 15 and 19, 2011, the participating manufacturers paid the Settling States \$6,029,481,330 for 2010 and \$5,978,580 for earlier years. The participating manufacturers paid \$881,449,597 into the Disputed Payments Account on account of the NPM Adjustment. The participating manufacturers withheld \$20,686,101 on account of the NPM Adjustment, \$3,288,831 on account of the Liggett Group LLC "Liggett" "Net vs. Gross" dispute ( note that on August 19, 2011, Liggett was put on notice of the States' intent to initiation an arbitration to resolve this dispute), and \$22,723,650 was

defaulted upon (mainly by Farmers and General Tobacco). Rhode Island received an MSA payment in the amount of \$45,812,109.

Although a Settling State that diligently enforces its Qualifying Statute is not subject to the NPM Adjustment, many procedural uncertainties, as described above, still remain regarding the resolution of a dispute regarding NPM Adjustment. In addition, the resolution of the substance of such disputes could take years. A decision by the PMs to pay the amount of a claimed NPM Adjustment into the Disputed Payments Account or to withhold payment of such an amount pending the resolution of the dispute would have a material adverse effect on the amounts of TSRs available to the Corporation to make Turbo Redemptions and other payments on the bonds during such period. Should a PM be determined with finality to be entitled to an NPM Adjustment in a future year, the operation of the NPM Adjustment would also have a material adverse effect on the amounts of TSRs available to the Corporation to make Turbo Redemptions and other payments on the bonds.

Rhode Island is working, independently and 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 statutes.

There continue to be concerns that litigation could threaten the ability of the tobacco companies to pay the amounts owed under the MSA, including but not limited to, bankruptcy. 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. A number of PMs have filed for bankruptcy; however, Rhode Island and the other Settling States are pursuing claims in the bankruptcy courts.

### **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 Financing 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, 2011

**Assets:**

Current assets:

Cash and cash equivalents...	\$	158,509
Investments - restricted...		<u>71,642,094</u>
Total current assets		<u>71,800,603</u>

Noncurrent assets:

Bond issue costs, net...		<u>2,122,144</u>
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Total Assets	\$	<u>73,922,747</u>
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**Liabilities:**

Current liabilities:

Accrued interest...	\$	<u>3,085,741</u>
Total current liabilities		<u>3,085,741</u>

Noncurrent liabilities:

Bonds payable, net of unamortized discount...		<u>824,576,135</u>
Total noncurrent liabilities		<u>824,576,135</u>

Total Liabilities...		<u>827,661,876</u>
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**Net Assets:**

Restricted for debt service		71,644,963
Unrestricted/(deficiency)...		<u>(825,384,092)</u>

Total Net Assets...	\$	<u>(753,739,129)</u>
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See Notes to Financial Statements.

**Tobacco Settlement Financing Corporation**

Statement of Activities  
for the year ended June 30, 2011

Revenues:	
Tobacco Settlement Agreement revenue...	\$ 45,812,110
Investment income...	4,354,178
Total revenues...	<u>50,166,288</u>
Expenses:	
General and administrative...	74,000
Amortization of bond issue and discount costs...	1,398,614
Interest expense...	<u>52,060,813</u>
Total expenses...	<u>53,533,427</u>
Net decrease in Net Assets	(3,367,139)
Net Assets/(Deficiency):	
Beginning of the year...	(750,371,990)
End of the year...	<u>\$ (753,739,129)</u>

See Notes to Financial Statements.

**Tobacco Settlement Financing Corporation**

Statement of Cash Flows  
for the year ended June 30, 2011

Cash flows from operating activities:	
Cash received from Tobacco Settlement Agreement...	\$ 45,812,110
Payments to vendors...	(74,000)
Net cash provided by operating activities...	<u>45,738,110</u>
Cash flows from non-capital financing activities:	
Principal paid on long-term debt...	(12,570,000)
Interest paid on long-term debt...	(37,783,075)
Net cash used for non-capital financing activities...	<u>(50,353,075)</u>
Cash flows from investing activities:	
Change in investments - restricted...	(1,643,275)
Investment earnings...	4,354,178
Net cash provided by investing activities...	<u>2,710,903</u>
Net increase/(decrease) in cash...	(1,904,062)
Cash, beginning of year...	<u>2,062,571</u>
Cash, end of year...	<u>\$ 158,509</u>
Reconciliation of increase in net assets to net cash provided by/(used for) operating activities:	
Decrease in net assets...	\$ (3,367,139)
Amortization of bond issue costs...	63,989
Amortization of bond discount...	1,334,625
Change in Accrued interest...	(62,850)
Interest expense...	37,783,075
Accretion of interest on capital appreciation bonds...	14,340,588
Investment earnings...	(4,354,178)
Net cash provided by/(used for) operating activities...	<u>\$ 45,738,110</u>

See Notes to Financial Statements.

**Tobacco Settlement Financing Corporation**

Balance Sheet, Governmental Funds  
as of June 30, 2011

	<u>General Fund</u>	<u>Debt Service Fund</u>	<u>Total Governmental Funds</u>
<b>Assets:</b>			
Cash and cash equivalents...	\$ 155,640	\$ 2,869	\$ 158,509
Investments...	-	71,642,094	71,642,094
<b>Total Assets</b>	<u>\$ 155,640</u>	<u>\$ 71,644,963</u>	<u>\$ 71,800,603</u>
<b>Liabilities and Fund Balances:</b>			
<b>Liabilities:</b>			
Accounts payable...	\$ -	\$ -	\$ -
<b>Total Liabilities</b>	<u>-</u>	<u>-</u>	<u>-</u>
<b>Fund Balances:</b>			
Restricted for debt service...	-	71,644,963	71,644,963
Assigned for future expenditures...	155,640		155,640
<b>Total Fund Balances</b>	<u>155,640</u>	<u>71,644,963</u>	<u>71,800,603</u>
<b>Total Liabilities and Fund Balances</b>	<u>\$ 155,640</u>	<u>\$ 71,644,963</u>	<u>\$ 71,800,603</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, 2011

	General Fund	Debt Service Fund	Total Governmental Funds
<b>Revenues:</b>			
Investment income...	\$ 62	\$ 4,354,116	\$ 4,354,178
Tobacco Settlement Agreement revenue...	45,812,110		45,812,110
Total Revenues	<u>45,812,172</u>	<u>4,354,116</u>	<u>50,166,288</u>
<b>Expenditures:</b>			
<b>Current:</b>			
General and administrative...	74,000		74,000
Debt Service: Principal...		12,570,000	12,570,000
Debt Service: Interest...		37,783,075	37,783,075
Total Expenditures	<u>74,000</u>	<u>50,353,075</u>	<u>50,427,075</u>
Excess of Revenues over/(under) Expenditures	<u>45,738,172</u>	<u>(45,998,959)</u>	<u>(260,787)</u>
<b>Other Financing Sources/(Uses):</b>			
Operating transfers in...	99	45,748,355	45,748,454
Operating transfers out...	(45,748,355)	(99)	(45,748,454)
Net Other Financing Sources/(Uses)	<u>(45,748,256)</u>	<u>45,748,256</u>	<u>-</u>
Excess of Revenues and Other Financing Sources Over/Under Expenditures and Other Financing Uses	(10,084)	(250,703)	(260,787)
<b>Fund Balances:</b>			
Beginning of the year...	165,724	71,895,666	72,061,390
End of the year...	<u>\$ 155,640</u>	<u>\$ 71,644,963</u>	<u>71,800,603</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...	(827,661,876)
Long-term assets do not represent currently expendable resources and therefore are not reported in the funds...	2,122,144
Net Assets in Statement of Net Assets...	<u>\$ (753,739,129)</u>



**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, 2011

Net change in fund balances for governmental funds	\$ (260,787)
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.	(1,334,625)
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.	12,570,000
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.	(63,989)
Accretion of interest on capital appreciation bonds are not recorded in governmental funds. However, in the statement of activities these amounts are included in interest expense paid to bondholders.	(14,340,588)
Governmental funds report outlays for interest expense when the payment is due. However, in the statement of activities these amounts are accrued ratably over the term of the reporting period.	62,850
Change in Net Assets in Statement of Activities	<u>\$ (3,367,139)</u>

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2011**

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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 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, and again in June 2007, 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 and 2007, pursuant to Purchase and Sale Agreements 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.

These financial statements were prepared in accordance with accounting principles generally accepted in the United States of America, as prescribed by the Governmental Accounting Standards Board. 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.

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. This guidance concluded 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, 2011**

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

***Recently Issued Accounting Standards***

- ✓ GASB Statement No. 54 – Fund Balance Reporting and Governmental Fund Type Definitions, effective for the Corporation's fiscal year ending June 30, 2011. The adoption of this Statement did not have an impact on the Corporation's financial position or results in operation.
- ✓ GASB Statement No. 59 – Financial Instruments Omnibus, effective for the Corporation's fiscal year ending June 30, 2011. The adoption of this Statement did not have an impact on the Corporation's financial position or results in operation.

The Corporation will adopt the following new accounting pronouncement in future years:

- ✓ GASB Statement No. 60 – Accounting and Financial Reporting for Service Concession Arrangement, effective for the Corporation's fiscal year ending June 30, 2013.
- ✓ GASB Statement No. 61 – The Financial Reporting entity: Omnibus an amendment of GASB Statements No. 14 and No. 34, effective for the Corporation's fiscal year ending June 30, 2013.
- ✓ GASB Statement No. 62 – Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements, effective for the Corporation's fiscal year ending June 30, 2013.
- ✓ GASB Statement No. 63 – Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position, effective for the Corporation's fiscal year ending June 30, 2013.
- ✓ GASB Statement No. 64 – Derivative Instruments: Application of Hedge Accounting Termination Provisions – an amendment of GASB Statement No. 53, effective for the Corporation's fiscal year ending June 30, 2012.

The impact of these pronouncements on the Corporation's financial statements has not been determined.

***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.

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2011**

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

***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.

Assignment of fund balance includes the portion of the spendable fund balance that reflect funds intended to be used by the Corporation for specific purposes assigned by management. The amount of fund balance that is considered restricted can only be spent for future bond payments due to constraints on the spending because of legal restrictions. 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:

- Federal Agency or instrumentality bonds
- Certain repurchase agreements

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**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2011**

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

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

***Investments (Continued)***

- 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

***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.

***Accreted Interest***

The Corporation records the accumulation of accreted interest by accruing interest that is not due until the bond maturity date. The cumulative accreted interest is included as part of bonds payable and relates to the Tobacco Settlement Asset-Backed Bonds (2007 Series). The current year addition to accreted interest was \$14,340,588 as of June 30, 2011 for a cumulative balance of \$51,710,378.

***Subsequent Events***

The Corporation has evaluated subsequent events through September 29, 2011, the date the financial statements were available to be issued. In July 2011, the Corporation received final judgment for a pending lawsuit involving the Corporation and JP Morgan Securities, LLC. The Corporation received an award of \$2,319,668 during August 2011.

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2011**

**2. CASH AND CASH EQUIVALENTS**

At year end, the carrying amount of deposits considered cash and cash equivalents was \$158,509. The deposits were in The Wells Fargo Advantage 100% Treasury Plus Funds of \$151,626 which was rated AAAM-G by Standard and Poor's and Aaa-mf by Moody's, 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 Goldman Sachs Treasury Investments of \$6,883 was rated AAAM by Standard and Poor's and AAA by Moody's, as the portfolio is comprised of US Treasury securities only and the investment objective is to maximize current income consistent with preserving capital and maintaining daily liquidity. The weighted average maturity of the underlying investments for the Wells Fargo Advantage Treasury Plus Funds are fifty days and the Goldman Sachs Treasury Investments are twenty five days. The Wells Fargo 100% Treasury Plus Funds and the Goldman Sachs Treasury Investments were not participating in the U.S. Treasury Guarantee program for money market funds as of June 30, 2011 and are not FDIC insured. 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. INVESTMENTS**

At June 30, 2011, the corporation had the following investments:

<b><u>Description</u></b>	<b><u>Maturity</u></b>	<b><u>Fair Value</u></b>
<b><i>Commercial Paper</i></b>		
Banco Bilbao Vizcaya commercial paper	12/1/2011	38,014,779
Silver Tower US Funding commercial paper	12/1/2011	14,601,644
<b><i>Government Obligations</i></b>		
Federal Home Loan Mortgage Corp. Disc. Note	11/21/2011	<u>19,025,671</u>
<b><i>Total Investments</i></b>		<b><u>\$ 71,642,094</u></b>

*Concentration of Credit Risk.* The investments listed above represent 53.1%, 20.4%, and 26.5%, respectively, of the corporation's total investments. The stated investment policy of the Corporation, which was adopted in October 2008, requires the Corporation to attempt to diversify its investments by security type and institution, in the event guaranteed investment contracts are not in place. The policy will also minimize credit risk by establishing criteria to qualify investment providers which rely upon ratings of nationally recognized rating agencies, and establishing requirements for collateralization which take into account events in which ratings could change very quickly. The policy also requires regular credit monitoring and due diligence of these issuers, and by diversifying to the extent possible, the portfolio with respect to Investment Provider, maturity, issuer, and security types so that potential losses on individual securities will be minimized.

*Interest Rate Risk.* It is the policy of the corporation to minimize the risk that the market value of securities in the portfolio will materially fall due to changes in general interest rates by investing in securities which are appropriate for the executed holding period of the funds invested.

*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 has a formal investment policy for custodial credit risk.

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2011**

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**3. INVESTMENTS (Continued)**

Securities will be held in the Corporation's name by a third party trust custodian designated by the Corporation and evidenced by safekeeping receipts. Such a designation would usually take place upon receipt of the proceeds from the debt issuance.

Collateral shall have a market value at least equal to the percentage of the amount of the Corporation's investment provided in the underlying bond documents.

Collateral will always be held by the Trustee with whom the Corporation has a current Custodial Agreement. A clearly marked evidence of ownership, Safekeeping Receipt must be retained by Trustee on behalf of the Corporation.

The right of collateral substitution is granted if provided in the underlying bond documents.

As of June 30, 2011, the Corporation's investment in Banco Bilbao Vizcaya commercial paper, was rated A-1 by Standard and Poor's and P-1 by Moody's. The Corporation's investment in Silver Tower US Funding commercial paper, was rated A-1 by Standard and Poor's and P-1 by Moody's. The Corporation's investment in the Federal Home Loan Mortgage Corp. Disc. Note was rated AAA by Standard and Poor's and Aaa by Moody's.

**4. LONG-TERM DEBT**

On June 27, 2002 the Corporation issued \$685,390,000 of Tobacco Settlement Asset-Backed Bonds (2002 Series). 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, 2052. 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, 2011, 2010 and 2009 the Corporation utilized \$12,570,000, \$14,710,000, and \$21,100,000 of excess collections to early redeem an equal amount of outstanding bonds.

On June 27, 2007 the Corporation issued \$197,005,742 of additional Tobacco Settlement Asset-Backed Bonds (2007 Series). The bond proceeds were used to purchase the State's future rights to residual Tobacco Settlement Revenues which were not purchased under the 2002 purchase agreement.

The bonds are Capital Appreciation Bonds, on which no periodic interest payments are made, but which are issued at a deep discount from par and accreting to full value at maturity in the year 2052. At maturity, the bond redemption values represent accreted yields ranging from 6.000% to 6.750%. The bonds are subject to early redemption provisions, in whole or in part, at the redemption price of 100% of the issue amount plus accreted interest, without premium. 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.

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**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2011**

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

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

Year ending June 30,	Principal	Accreted Interest	Interest	Total
2012	\$ -	\$ -	\$ 37,405,975	\$ 37,405,975
2013			37,028,875	37,028,875
2014			37,028,875	37,028,875
2015			37,028,875	37,028,875
2016			37,028,875	37,028,875
2017-2021			185,144,375	185,144,375
2022-2026	58,195,000		176,415,125	234,610,125
2027-2031			167,685,875	167,685,875
2032-2036	168,260,000		131,615,138	299,875,138
2037-2041			116,156,250	116,156,250
2042-2046	371,700,000		34,846,875	406,546,875
2047-2051				-
2052	197,005,742	2,637,174,258		2,834,180,000
Total maturity value	795,160,742	\$ 2,637,174,258	\$ 997,385,113	\$ 4,429,720,113
Plus: accreted interest at June 30, 2011	51,710,378			
Net Total	\$ 846,871,120			

The changes in bonds payable for the year ended June 30, 2011 are as follows:

Beginning balance...	\$ 821,470,924
Amortization of bond discount...	1,334,625
Accretion of interest on capital appreciation bonds...	14,340,586
Bond principal retired...	<u>(12,570,000)</u>
Ending balance...	<u>\$ 824,576,135</u>

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...	\$ 882,395,742
Less: "Turbo Redemptions" through June 30, 2011...	(87,235,000)
Plus: Accretion of interest on capital appreciation bonds...	<u>51,710,378</u>
Outstanding balance of bonds payable...	846,871,120
Less: unamortized bond discount...	<u>(22,294,985)</u>
Bonds payable, per statement of net assets...	<u>\$ 824,576,135</u>

(CONTINUED)



**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2011**

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

General long-term debt consists of the long-term liabilities that are not recorded as fund liabilities (i.e. debt of general fund). Amounts are as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year	Amounts Due Thereafter
Bonds Payable	\$ 845,100,532	\$ 14,340,588	\$ 12,570,000	\$ 846,871,120	\$ -	\$ 846,871,120
Net unamortized premium/discount	(23,629,608)		(1,334,623)	(22,294,985)	-	(22,294,985)
Bonds payable:	<u>\$ 821,470,924</u>	<u>\$ 14,340,588</u>	<u>\$ 11,235,377</u>	<u>\$ 824,576,135</u>	<u>\$ -</u>	<u>\$ 824,576,135</u>

**5. COMMITMENTS AND CONTINGENCIES**

Litigation has been filed alleging, 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 through June 2011, many 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 amounts due failed to recognize a prescribed adjustment for non-participating manufacturers. The Corporation's share of these disputed payments is approximately \$27,081,000. However, there is no assurance that these funds will be collected by the Corporation in the future. Due to these 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.

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. No accrual for rebateable arbitrage is necessary as of June 30, 2011.

**6. 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.

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2011**

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**7. 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, 2011, there are no known 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.

**8. FUND BALANCES**

In accordance with the Corporation's revenue bond indenture and the intentions of management, fund balances have been classified as restricted or assigned for the following purposes:

Restricted for Debt Service	\$71,644,963
Assigned for future expenditures	<u>\$ 155,640</u>
Total	<u>\$71,800,603</u>

The Corporation was in compliance with its Debt Service Reserve requirements as of June 30, 2011.

(CONCLUDED)

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**SUPPLEMENTARY INFORMATION**

**Tobacco Settlement Financing Corporation**

Supplemental Calculation of Debt Service Coverage Ratios  
for the years ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Beginning balances...	\$ -	\$ -
Revenues:		
Tobacco revenue received...	45,812,110	48,620,449
Investment income...	4,354,178	3,409,658
Total sources...	<u>50,166,288</u>	<u>52,030,107</u>
Expense reserve...	<u>74,000</u>	<u>69,000</u>
Net Revenue Available for Debt Service...	<u>\$ 50,092,288</u>	<u>\$ 51,961,107</u>
Annual Debt Service:		
Required Interest Payments	\$ 37,783,075	\$ 38,613,342
Turbo Principal Payments	12,570,000	14,710,000
Total Annual Debt Service...	<u>\$ 50,353,075</u>	<u>\$ 53,323,342</u>
Coverage Ratio...	<u>0.99</u>	<u>0.97</u>

**Tobacco Settlement Financing Corporation**

**Supplemental Schedule of Actual MSA Receipts Compared to  
Base Case Projections at Time of Sale**

<u>Fiscal Year Ended June 30</u>	<u>2002 Series A &amp; B DRI-WEFA Base Case Expected MSA Revenue</u>	<u>2007 Series A, B &amp; C Global Insight 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		\$ 45,315,617	\$ (2,255,241)
2006	\$ 48,196,297		\$ 42,060,409	\$ (6,135,888)
2007	\$ 48,825,273		\$ 44,024,516	\$ (4,800,757)
2008	\$ 50,476,947	\$ 57,443,691	\$ 53,246,221	\$ 2,769,274
2009	\$ 51,191,991	\$ 58,186,214	\$ 58,038,800	\$ 6,846,809
2010	\$ 51,870,793	\$ 58,863,587	\$ 48,620,449	\$ (3,250,344)
2011	\$ 52,612,259	\$ 59,577,361	\$ 45,812,110	\$ (6,800,149)
2012	\$ 53,353,020	\$ 60,279,274		

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

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, 2011, and have issued our report thereon dated September 29, 2011. 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

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

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Corporation's financial statements will not be prevented, or detected and corrected, on a timely basis.

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

Compliance and Other Matters

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

Needham  
Boston  
Concord  
Taunton

Board of Directors  
Tobacco Settlement Financing Corporation

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 Corporation and is not intended to be and should not be used by anyone other than these specified parties.

Providence, Rhode Island  
September 29, 2011

*Bianchi, PC*