

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

**FINANCIAL STATEMENTS**  
**YEAR ENDED JUNE 30, 2012**

**TOBACCO SETTLEMENT FINANCING CORPORATION**

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## **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, 2012, 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, 2012 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 October 26, 2012 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

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on Pages 3 through 17 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audit was conducted for the purpose of forming opinions on the 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 are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the basic financial statements as a whole.

*Brian P.C.*

Providence, Rhode Island  
October 26, 2012

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

### **Fiscal Year Ended June 30, 2012**

This section of the Tobacco Settlement Financing Corporation's (hereinafter referred to as "TSFC" or the "Corporation") annual financial report represents our narrative overview and financial performance analysis for the fiscal year ended June 30, 2012. Please read it in conjunction with the financial statements, notes and supplementary information 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 2007A, 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.

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 of Rhode Island 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 Future Years' Revenue" and the "Economic Outlook" sections of this MD&A.

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 2012 fiscal year by \$754,993,181.
- Revenues, consisting of Tobacco Settlement Revenue, investment income, and a non-recurring settlement relating to litigation amounted to \$52,264,028.
- Expenses, primarily interest expense, amounted to \$53,518,080.

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

- Net assets of the Corporation decreased by \$1,254,052 during the fiscal year.
- The Corporation had \$15,735,000 in turbo redemptions of outstanding bonds during the fiscal year. However, the ending balance of bonds payable increased by \$694,475 due to accretion of interest on capital appreciation bonds and amortization of bond discount. See Note 4 of the Notes to Financial Statements for further details.

### **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, a 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 during the fiscal year.

	<b>Condensed Statements of Net Assets</b>	
	<u>June 30, 2012</u>	<u>June 30, 2011</u>
Current assets	\$71,226,341	\$71,800,603
Other assets	<u>2,058,155</u>	<u>\$2,122,144</u>
Total assets	<u>\$73,284,496</u>	<u>\$73,922,747</u>
Current liabilities	3,007,067	3,085,741
Long-term debt	<u>825,270,610</u>	<u>824,576,135</u>
Total liabilities	<u>828,277,677</u>	<u>827,661,876</u>
Net Assets (Deficiency)	<u>\$(754,993,181)</u>	<u>\$(753,739,129)</u>

## Overview of Annual Financial Report (continued)

	<b>Condensed Statements of Activities</b>	
	<u>Year ended June 30, 2012</u>	<u>Year ended June 30, 2011</u>
Revenues	\$ 52,264,028	\$ 50,166,288
Expenses	<u>53,518,080</u>	<u>53,553,427</u>
Decrease in Net Assets	<u>\$ (1,254,052)</u>	<u>\$ (3,367,139)</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 2012, the Corporation received \$52.3 million of revenues from TSRs, investment income, and a non-recurring litigation settlement award of \$2.3 million reflecting an increase of \$2.1 million from FY 2011 revenues of \$50.2 million. This reflects an increase of \$0.9 million in TSRs and a decrease of \$1.2 million in interest earnings due primarily to the current interest rate environment.

The Corporation incurred \$52.1 million in interest on long-term bonds and paid \$15.7 million in principal on long-term debt pursuant to the turbo redemption provisions of the Trust Indenture relating to the Tobacco Settlement Asset-Backed Bonds, Series 2002A issued in June 2002.

### Analysis of Fund Financial Statements

For the General Fund as of June 30, 2012 there was a fund balance of \$148,542 that was assigned for future expenditures. This amount decreased slightly from the balance at June 30, 2011 of \$155,640.

The Debt Service Fund as of June 30, 2012 had a fund balance of \$71,077,799 which is all restricted to pay future debt service. The balance decreased \$567,164 from June 30, 2011. This decrease was caused by an excess of debt service payments over investment income and net operating transfers in.

### 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", "Baa3", and "Ba1" by Moody's Investors Service for the 2023, 2032, and 2042 maturities, respectively, reflecting improvements to the 2032 and 2042 Term Bonds from "Ba1" and "B1", respectively, announced on January 24, 2012. The 2002 Series A Bonds had previously been rated "Baa1", "Ba1", and "B1" due to changes announced on September 8, 2011. The 2002 Series A Bonds were previously downgraded to "Baa3" from "Baa2" on April 21, 2004 and had been 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+", "BBB+", "BBB-" by Fitch Ratings for the 2023, 2032, and 2042 maturities, respectively, reflecting a downgrade from "BBB+" to "BBB-" for the 2042 Term Bond announced on August 22, 2012 due to a rating criteria change.

### **Long-Term Debt (continued)**

All three maturities had been previously upgraded on January 28, 2008 from "BBB" to "BBB+". 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 "BB," reflecting a downgrade from "BBB" on January 27, 2012. The 2002 Series A Bonds had been downgraded from "A" to "A-" on April 18, 2003 and again from "A-" to "BBB" on August 28, 2003 by Standard & Poor's.

In June 2007, the TSFC issued \$197,005,742 of bonds, which included \$176,974,412 of Series 2007 A Bonds, \$17,336,217 of Series 2007 B Bonds and \$2,695,112 of Series 2007 C Bonds. The Series C Bonds were unrated. Standard & Poor's Rating Services rates the TSFC 2007 Series A debt "CCC+", reflecting a downgrade from "B" on January 27, 2012. The 2007 Series A debt had been previously downgraded to "B" from "BB" on November 11, 2010 and to "BB" from "BBB" on September 11, 2009. Standard & Poor's Rating Services rates the 2007 Series B debt "CCC", reflecting a downgrade from "B-" on January 27, 2012. The 2007 Series B debt had been previously downgraded to "B-" from "BB-" on November 11, 2010 and to "BB-" from "BBB" on September 11, 2009.

In general, the rating changes reflect the increased vulnerability of tobacco companies to adverse litigation in some jurisdictions, concerns about litigation relating to the model statutes enacted by the various states and declining levels of tobacco consumption. Ratings are subject to change at any time.

During fiscal year 2012, the Corporation paid \$15.7 million in principal on long-term debt pursuant to the turbo redemption provisions of the Trust Indenture relating to its outstanding bonds. The amount of principal determined by the Trustee to be subject to the turbo redemption was based upon actual cash available in June 2012.

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

### **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 and 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 Future 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.



## **Risk Factors and Future Revenue (continued)**

Many adjustments are included in the calculation of an 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 Original Participating Manufacturers' (OPMs') 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 factor in the PMs' market share loss of 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 Attorneys General (NAAG) 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.

## **Risk Factors and Future Revenue (continued)**

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 to 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 States 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 whom 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 to Rhode Island of the April 15, 2006 MSA payment in dispute 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.

## **Risk Factors and Future Revenue (continued)**

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 would 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 the 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 States have submitted briefs 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 of 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 of greater than 2% of the PMs' market share from 1997. For the significant factor determination 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 of 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.

## **Risk Factors and Future Revenue (continued)**

In 2007, participating manufacturers withheld or deposited in the 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 the 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 2008 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 initiate 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.

The Independent Auditor calculated that the MSA payment due April 16, 2012 was \$6,924,308,841.56. On April 16 and 18, 2012, the participating manufacturers paid the Settling States \$6,140,121,872.39 for 2011. The participating manufacturers paid \$776,000,700.86 into the Disputed Payments Account on account of the NPM Adjustment, and \$3,853,374.45 was paid into the DPA on other grounds. The participating manufacturers withheld \$3,032,745.06 on account of the Liggett Group LLC "Liggett" "Net vs. Gross" dispute, and \$1,300,148.80 was defaulted upon (\$1,223,043.46 of the amount defaulted upon was paid late and will be distributed next year). Rhode Island received an MSA payment in the amount of \$46,710,284.97.

## **Risk Factors and Future Revenue (continued)**

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 of 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.

In addition, please see Note 5 of the Notes to Financial Statements for additional information about Commitments and Contingencies.

## **Economic Outlook**

Future payments of all types on the Bonds are contingent on Actual MSA Receipts. These Receipts are dependent on a number of factors, including, but not limited to, the rates of consumption of tobacco products.

In structuring the financial transactions for the issuance of the bonds, the Corporation engaged the services of independent consultants to develop forecasts of these Receipts.

It should be noted that shipments of cigarettes have decreased at a rate greater than was projected when the Corporation issued bonds. Over the past few years there have been significant increases in tobacco excise taxes in various jurisdictions and at the Federal level, and varying restrictions on public smoking have been enacted, further contributing to a decline in tobacco consumption.

Please see the "Supplemental Schedule of Actual MSA Receipts Compared to Base Case Projections at Time of Sale" in the Supplementary Information section of this report for more information about this.

### **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, 2012

<b>Assets:</b>	
Current assets:	
Cash and cash equivalents...	\$ 1,558,416
Investments - restricted...	<u>69,667,925</u>
Total current assets	<u>71,226,341</u>
 Noncurrent assets:	
Bond issue costs, net...	<u>2,058,155</u>
 Total Assets	<u>\$ 73,284,496</u>
 <b>Liabilities:</b>	
Current liabilities:	
Accrued interest...	\$ <u>3,007,067</u>
Total current liabilities	<u>3,007,067</u>
 Noncurrent liabilities:	
Bonds payable, net of unamortized discount...	<u>825,270,610</u>
Total noncurrent liabilities	<u>825,270,610</u>
 Total Liabilities...	<u>828,277,677</u>
 <b>Net Assets:</b>	
Restricted for debt service	71,077,799
Unrestricted/(deficiency)...	<u>(826,070,980)</u>
 Total Net Assets...	<u>\$ (754,993,181)</u>

See Notes to Financial Statements.

**Tobacco Settlement Financing Corporation**

Statement of Activities  
for the year ended June 30, 2012

Revenues:	
Tobacco Settlement Revenues...	\$ 46,710,285
Investment income...	3,234,075
Litigation award settlement...	<u>2,319,668</u>
Total revenues...	<u>52,264,028</u>
Expenses:	
General and administrative...	74,415
Amortization of bond issue and discount costs...	1,303,155
Interest expense...	<u>52,140,510</u>
Total expenses...	<u>53,518,080</u>
Net decrease in Net Assets	(1,254,052)
Net Assets/(Deficiency):	
Beginning of the year...	(753,739,129)
End of the year...	<u>\$ (754,993,181)</u>

See Notes to Financial Statements.



**Tobacco Settlement Financing Corporation**

Statement of Cash Flows  
for the year ended June 30, 2012

Cash flows from operating activities:	
Cash received from Tobacco Settlement Revenues...	\$ 46,710,285
Cash received from litigation award settlement...	2,319,668
Payments to vendors...	<u>(74,415)</u>
Net cash provided by operating activities...	<u>48,955,538</u>
Cash flows from non-capital financing activities:	
Principal paid on long-term debt...	(15,735,000)
Interest paid on long-term debt...	<u>(37,028,875)</u>
Net cash used for non-capital financing activities...	<u>(52,763,875)</u>
Cash flows from investing activities:	
Change in investments - restricted...	1,974,169
Investment earnings...	<u>3,234,075</u>
Net cash provided by investing activities...	<u>5,208,244</u>
Net increase in cash...	1,399,907
Cash, beginning of year...	<u>158,509</u>
Cash, end of year...	<u>\$ 1,558,416</u>
Reconciliation of increase in net assets to net cash provided by/(used for) operating activities:	
Decrease in net assets...	\$ (1,254,052)
Amortization of bond issue costs...	63,989
Amortization of bond discount...	1,239,166
Change in Accrued interest...	(78,675)
Interest expense...	37,028,875
Accretion of interest on capital appreciation bonds...	15,190,310
Investment earnings...	<u>(3,234,075)</u>
Net cash provided by operating activities...	<u>\$ 48,955,538</u>

See Notes to Financial Statements.

**Tobacco Settlement Financing Corporation**

Balance Sheet, Governmental Funds  
as of June 30, 2012

	<u>General Fund</u>	<u>Debt Service Fund</u>	<u>Total Governmental Funds</u>
<b>Assets:</b>			
Cash and cash equivalents...	\$ 148,542	\$ 1,409,874	\$ 1,558,416
Investments...	-	69,667,925	69,667,925
<b>Total Assets</b>	<u><u>\$ 148,542</u></u>	<u><u>\$ 71,077,799</u></u>	<u><u>\$ 71,226,341</u></u>
<b>Liabilities and Fund Balances:</b>			
<b>Liabilities:</b>			
Accounts payable...	\$ -	\$ -	\$ -
<b>Total Liabilities</b>	<u><u>-</u></u>	<u><u>-</u></u>	<u><u>-</u></u>
<b>Fund Balances:</b>			
Restricted for debt service...	-	71,077,799	71,077,799
Assigned for future expenditures...	148,542	-	148,542
<b>Total Fund Balances</b>	<u><u>148,542</u></u>	<u><u>71,077,799</u></u>	<u><u>71,226,341</u></u>
<b>Total Liabilities and Fund Balances</b>	<u><u>\$ 148,542</u></u>	<u><u>\$ 71,077,799</u></u>	<u><u>\$ 71,226,341</u></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, 2012

	<u>General Fund</u>	<u>Debt Service Fund</u>	<u>Total Governmental Funds</u>
Revenues:			
Investment income...	\$ 40	\$ 3,234,035	\$ 3,234,075
Tobacco Settlement Revenues...	46,710,285		46,710,285
Litigation award settlement...	2,319,668		2,319,668
Total Revenues	<u>49,029,993</u>	<u>3,234,035</u>	<u>52,264,028</u>
Expenditures:			
Current:			
General and administrative...	74,415		74,415
Debt Service: Principal...		15,735,000	15,735,000
Debt Service: Interest...		37,028,875	37,028,875
Total Expenditures	<u>74,415</u>	<u>52,763,875</u>	<u>52,838,290</u>
Excess of Revenues over/(under) Expenditures	<u>48,955,578</u>	<u>(49,529,840)</u>	<u>(574,262)</u>
Other Financing Sources/(Uses):			
Operating transfers in...	17	48,962,693	48,962,710
Operating transfers out...	(48,962,693)	(17)	(48,962,710)
Net Other Financing Sources/(Uses)	<u>(48,962,676)</u>	<u>48,962,676</u>	<u>-</u>
Excess of Revenues and Other Financing Sources Over/Under Expenditures and Other Financing Uses	(7,098)	(567,164)	(574,262)
Fund Balances:			
Beginning of the year...	155,640	71,644,963	71,800,603
End of the year...	<u>\$ 148,542</u>	<u>\$ 71,077,799</u>	<u>71,226,341</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...			(828,277,677)
Long-term assets do not represent currently expendable resources and therefore are not reported in the funds...			2,058,155
Net Assets in Statement of Net Assets...			<u><u>\$ (754,993,181)</u></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, 2012

Net change in fund balances for governmental funds	\$ (574,262)
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.	(1,239,166)
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.	15,735,000
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 is not recorded in governmental funds. However, in the statement of activities these amounts are included in interest expense.	(15,190,310)
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.	78,675
Change in Net Assets in Statement of Activities	<u>\$ (1,254,052)</u>

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2012**

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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 (the State), 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. However, the future receipts of TSR payments are dependent on a variety of significant factors, which include:

- the financial capability of the participating cigarette manufacturers to pay TSR's;
- future cigarette consumption which impacts the TSR payments; and
- future legal and legislative challenges against the tobacco manufacturers and the MSA 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.

***Recently Issued Accounting Standards***

- ✓ 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 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.

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**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2012**

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

***Recently Issued Accounting Standards (Continued)***

- ✓ 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. 65 – Items Previously Reported as Assets and Liabilities, effective for the Corporation's fiscal year ending June 30, 2014.
- ✓ GASB Statement No. 66 – Technical Corrections – an amendment of GASB Statements No. 10 and No. 62, effective for the Corporation's fiscal year ending June 30, 2014.
- ✓ GASB Statement No. 67 – Financial Reporting of Pension Plans – and amendment of GASB Statement No. 25, effective for the Corporation's fiscal year ending June 30, 2014.
- ✓ GASB Statement No. 68 – Accounting and Financial Reporting for Pensions – an amendment of GASB Statement No. 27, effective for the Corporation's fiscal year ending June 30, 2015.

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.

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

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

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

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2012**

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

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

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.

***Equity Classifications***

**Government-Wide Statements**

Equity is classified as net assets and displayed in three components:

- (a) Restricted net assets - Consists of net assets with constraints placed on the use either by 1) external groups such as creditors, grantors, contributors, or laws or regulations of other governments, or 2) law through constitutional provisions or enabling legislation.
- (b) Unrestricted net assets - All other net assets that do not meet the definition of "restricted".

**Fund Financial Statements**

Governmental fund equity is classified as fund balance in accordance with GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. Fund balance is classified as non-spendable, restricted, committed, assigned or unassigned as described below:

- Non-Spendable – the amount of fund balance that cannot be spent because it is either not in spendable form or there is a legal or contractual requirement for the funds to remain intact.
- Restricted – the amount of fund balance that can only be spent on specific expenses due to constraints on the spending because of legal restrictions, outside party creditors, and grantor/donor requirements. The Corporation's restricted fund balance amounts can only be spent for future bond payments due to constraints on the spending because of legal obligations. The financial activities of the Corporation are limited by its enabling legislation and by its revenue bond resolution.

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2012**

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

***Equity Classifications (Continued)***

- **Committed** – the Corporation’s Board of Directors, as the Corporation’s highest level of decision-making authority, may commit fund balance for specific purposes pursuant to constraints imposed by formal actions taken, such as an ordinance or resolution. These committed amounts cannot be used for any other purpose unless the Corporation’s Board of Directors removes or changes the specific use through the same type of formal action taken to establish the commitment. This constraint must be imposed prior to the fiscal year end, but the specific amount may be determined at a later date.
- **Assigned** – the amount of fund balance that includes the portion of the spendable fund balance that reflects funds intended to be used by the government for specific purposes assigned by management. The assigned fund balance, delegated by the Corporation’s Board of Directors, represents a “plan” for spending the amount, but it is not restricted or committed.
- **Unassigned** – the amount of fund balance that remains from residual positive net resources of the General Fund and Debt Service Fund in excess of what can properly be classified in one of the other four categories, not subject to any constraints or intended use, no external or self-imposed limitations, no set spending plan and are available for any purposes. Unassigned fund balance is commonly used for emergency expenditures not previously considered. In addition, the resources classified as unassigned can be used to cover expenditures for revenues not yet received.

Fund balance classifications are presented consistent with the bond indentures (restricted amounts) or as committed or assigned by the Corporation’s Board of Directors. The Corporation does not maintain a formal spending policy in accordance with GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. See Note 8 for current year classifications of fund balance.

***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
- 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.

(CONTINUED)



**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2012**

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

***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 \$15,190,310 as of June 30, 2012 for a cumulative balance of \$66,900,688.

***Revenue Recognition***

The Corporation recognizes revenue from the Master Settlement Agreement 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. Future tobacco settlement revenues are not accrued.

***Subsequent Events***

The Corporation has evaluated subsequent events through October 26, 2012, the date the financial statements were available to be issued.

**2. CASH AND CASH EQUIVALENTS**

At year end, the carrying amount of deposits considered cash and cash equivalents was \$1,558,416. Deposits in the amount of \$1,556,684 were in The Wells Fargo Advantage 100% Treasury Plus Funds which is rated AAAM 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 \$1,732 is rated AAAM by Standard and Poor's and AAA-mf 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 100% Treasury Plus Funds are fifty six days and the Goldman Sachs Treasury Investments are fifty three days.

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2012**

**3. INVESTMENTS**

At June 30, 2012, 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>		
Prudential PLC commercial paper	12/3/2012	\$ 52,558,628
<b><i>Government Obligations</i></b>		
Federal Home Loan Mortgage Corp. Disc. Note	11/26/2012	<u>17,109,297</u>
<b><i>Total Investments</i></b>		<u><u>\$ 69,667,925</u></u>

*Concentration of Credit Risk.* The investments listed above represent 75.4% and 24.6%, 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.

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, 2012, the Corporation's investment in Prudential PLC 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 not rated by Standard and Poor's and rated P-1 by Moody's.

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**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2012**

**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, 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, 2012, 2011 and 2010 the Corporation utilized \$15,735,000, \$12,570,000, and \$14,710,000 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 bond is a Capital Appreciation Bond, 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.

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

Year ending June 30,	Principal	Accreted Interest	Interest	Total
2013	\$ -	\$ -	\$ 36,084,775	\$ 36,084,775
2014			36,084,775	36,084,775
2015			36,084,775	36,084,775
2016			36,084,775	36,084,775
2017			36,084,775	36,084,775
2018-2022			180,423,875	180,423,875
2023-2027	42,460,000		170,233,475	212,693,475
2028-2032	168,260,000		167,685,875	335,945,875
2033-2037			116,156,250	116,156,250
2038-2042	371,700,000		116,156,250	487,856,250
2043-2047				-
2048-2052	197,005,742	2,637,174,258		2,834,180,000
Total maturity value	779,425,742	\$ 2,637,174,258	\$ 931,079,600	\$ 4,347,679,600
Plus: accreted interest at June 30, 2012	66,900,688			
Net Total	\$ 846,326,430			

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2012**

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

The changes in bonds payable for the year ended June 30, 2012 are as follows: —

Beginning balance...	\$ 824,576,135
Amortization of bond discount...	1,239,165
Accretion of interest on capital appreciation bonds...	15,190,310
Bond principal retired...	<u>(15,735,000)</u>
Ending balance...	<u>\$ 825,270,610</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, 2012...	(102,970,000)
Plus: Accretion of interest on capital appreciation bonds...	<u>66,900,688</u>
Outstanding balance of bonds payable...	846,326,430
Less: unamortized bond discount...	<u>(21,055,820)</u>
Bonds payable, per statement of net assets...	<u>\$ 825,270,610</u>

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	\$ 846,871,120	\$ 15,190,310	\$ 15,735,000	\$ 846,326,430	\$ -	\$ 846,326,430
Net unamortized premium/discount	<u>(22,294,985)</u>		<u>(1,239,165)</u>	<u>(21,055,820)</u>	<u>-</u>	<u>(21,055,820)</u>
Bonds payable:	<u>\$ 824,576,135</u>	<u>\$ 15,190,310</u>	<u>\$ 14,495,835</u>	<u>\$ 825,270,610</u>	<u>\$ -</u>	<u>\$ 825,270,610</u>

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2012**

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**5. COMMITMENTS AND CONTINGENCIES**

According to the Master Settlement Agreement ("MSA"), for any year in which the Participating Manufacturers ("PMs") suffer a loss of market share of more than two percent as compared to their collective market share in 1997, there is the potential of a Non-Participating Manufacturer Adjustment ("NPM Adjustment"), which would permit the tobacco manufacturers to reduce their MSA payments for that year. Whether such an adjustment is applicable depends on whether (1) an economic firm jointly selected by the Settling States and the PMs determines that the disadvantages experienced by the PMs as a result of the provisions of the MSA were a "significant factor" contributing to the market share loss ("Significant factor proceeding")<sup>1</sup>; and (2) the State is found to not have diligently enforced its escrow statute.

From April 2005 through April 2012, 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 apply the NPM Adjustment. The Corporation's share of these disputed payments is approximately \$27,400,000.

Currently, the Settling States and the PMs are engaged in arbitration proceedings in connection with the issue of Diligent Enforcement for the calendar year 2003. However, Rhode Island's Diligent Enforcement is no longer being challenged for 2003. Future NPM Adjustments could be as large as or exceed the reported potential \$1.2 billion calendar year 2003 NPM adjustment. The resolution of the substance of such disputes could take years. Moreover, 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.

In addition to NPM Adjustment arbitration, litigation has been filed alleging, among other claims, that the MSA violates provisions of the U.S. Constitution, state constitutions, federal antitrust and civil rights laws, and 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.

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, 2012.

<sup>1</sup> For calendar years 2003, 2004, 2005 and 2006, there have been four Significant Factor Proceedings in which the firm found in favor of the PMs. There will not be a Significant Factor Proceedings for calendar years 2007, 2008, 2009, 2010, 2011 and 2012.

(CONTINUED)

**TOBACCO SETTLEMENT FINANCING CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**JUNE 30, 2012**

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**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.

**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, 2012, 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 the Board of Director's, fund balances have been classified as restricted or assigned for the following purposes:

Restricted for Debt Service	\$71,077,799
Assigned for future expenditures	<u>148,542</u>
Total	<u>\$71,226,341</u>

The Corporation was in compliance with its Debt Service Reserve requirements as of June 30, 2012.

**9. LITIGATION AWARD**

On July 8, 2011, a final judgment was made on the Securities and Exchange Commission versus J.P. Morgan Securities, LLC lawsuit, ordering J.P. Morgan Securities to pay approximately \$51 million to various governmental entities, which had purchased guaranteed investment contracts. The Corporation's portion of the litigation award was \$2,319,668 and was received during August 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, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Beginning balances...	\$ -	\$ -
Revenues:		
Tobacco Settlement Revenues...	46,710,285	45,812,110
Investment income...	3,234,075	4,354,178
Total sources...	<u>49,944,360</u>	<u>50,166,288</u>
Expense reserve...	<u>74,415</u>	<u>74,000</u>
Net Revenue Available for Debt Service...	<u>\$ 49,869,945</u>	<u>\$ 50,092,288</u>
Annual Debt Service (interest only):		
Required Interest Payments	<u>\$ 37,028,875</u>	<u>\$ 37,783,075</u>
Total required interest payments	37,028,875	37,783,075
Coverage Ratio before Turbo Principal Payments...	135%	133%
Annual Debt Service (interest and principal):		
Turbo Principal Payments	15,735,000	12,570,000
Total Annual Debt Service...	<u>\$ 52,763,875</u>	<u>\$ 50,353,075</u>
Coverage Ratio after Turbo Principal Payments...	95%	99%



**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 of DRI-WEFA Compared to Actual</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	\$ 46,710,285	\$ (6,642,735)
2013	\$ 54,057,103	\$ 60,971,444		

**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, 2012, and have issued our report thereon dated October 26, 2012. 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

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  
October 26, 2012

*Baron P.C.*