TOBACCO SETTLEMENT
FINANCING CORPORATION

FINANCIAL STATEMENTS
YEAR ENDED JUNE 30, 2013

TOBACCO SETTLEMENT FINANCING CORPORATION

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REPORT OF INDEPENDENT AUDITORS

The Board of Directors
Tobacco Settlement Financing Corporation

Report on the Financial Statements

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, 2013, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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 involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Tobacco Settlement Financing Corporation as of June 30, 2013, and the respective changes in financial position, and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on Pages 3 through 12 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.

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The supplementary information contained on pages 29 through 30 is presented for purposes of additional analysis and are not a required part of the 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 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 financial statements as a whole.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated November 25, 2013, on our consideration of Corporation's internal control over financial reporting and on 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering Tobacco Settlement Financing Corporation's internal control over financial reporting and compliance.

Braver, P.C.

Braver P.C.

Providence, Rhode Island
November 25, 2013

Management's Discussion and Analysis
Fiscal Year Ended June 30, 2013

Management's discussion and analysis (MD&A) provides a narrative overview and analysis of the financial activities of the Tobacco Settlement Financing Corporation (hereinafter referred to as "TSFC" or the "Corporation") for the fiscal year ended June 30, 2013. MD&A is intended to serve as an introduction to the Corporation's basic financial statements, which have the following components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements. The MD&A is designed to (a) assist the reader in focusing on significant financial matters, (b) provide an overview of the Corporation's financial activities, and (c) highlight individual fund matters. The following presentation is by necessity highly summarized, and in order to gain a thorough understanding of the Corporation's financial condition, the following financial statements, notes and supplementary information should be reviewed in their entirety.

This section of the annual financial report represents our narrative overview and financial performance analysis for the fiscal year ended June 30, 2013. 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 (MSA), 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 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 revenue bonds outstanding exceeding the assets recognized, the liabilities of TSFC exceeded its assets at June 30, 2013 by $735,252,715. This results primarily because, with the exception of one-half of the estimated TSR revenue to be received for calendar 2013 in April 2014 being established as a receivable, no receivables for future revenues were recognized. Please see Note 1 for a description of the Corporation's revenue recognition policy. This compares with a net deficiency of $731,469,180 at June 30, 2012. The increase is primarily the result of interest expense, which includes accreted interest due in the future, exceeding Tobacco Settlement Revenues (TSRs) and investment income.
- Revenues, consisting of TSRs and investment income amounted to $49,745,702 for fiscal year 2013. This compares to $50,376,028 for fiscal year 2012. The decrease of $630,326 is primarily attributable to a one time litigation award settlement received in fiscal year 2012 offset to an extent by additional TSR's recognized on an accrual basis in fiscal year 2013 as compared to fiscal year 2012.
- Expenses, primarily interest expense, amounted to $53,529,237 for fiscal year 2013. This compares to $53,518,080 for fiscal year 2012.
- The Corporation had $14,265,000 in turbo redemptions of outstanding bonds during the fiscal year. However, the ending balance of bonds payable increased by $3,132,888 due to accretion of interest on capital appreciation bonds and amortization of bond discount. See Note 5 of the Notes to Financial Statements for further details.
- Please see Notes 1 and 9 of the Notes to Financial Statements for a discussion of a change made in the Corporation's policy with respect to the recognition of certain revenue from TSRs.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Corporation's basic financial statements. The basic financial statements include three components:

1. Government-wide financial statements
2. Fund financial statements
3. Notes to the financial statements

This report also contains other supplementary information in addition to the basic financial statements.

Government-wide Financial Statements

The government-wide financial statements provide a broad view of the Corporation's finances. The statements provide both short-term and long-term information about the Corporation's financial position, which assist in assessing the Corporation's financial condition at the end of the year. These financial statements are prepared using the accrual basis of accounting, which recognizes all revenues and grants when earned, and expenses at the time the related liabilities are incurred.

- The Statement of Net Position presents all of the Corporation's assets, deferred outflows, liabilities, and deferred inflows with the difference being reported as "net position." Over time,

(Continued)

increases and decreases in the government's net position may serve as a useful indicator of whether the financial position of the Corporation is improving or deteriorating.

- The Statement of Activities presents information showing how the government's net position changed during the fiscal year. All changes in net position are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in this statement for some items that will not result in cash flows until future fiscal periods.

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Corporation uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The fund financial statements focus on the individual parts of the Corporation and report the Corporation's operations in more detail than the government-wide financial statements.

- Governmental funds: All of the Corporation's activities are financed through governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on spendable resources available at the end of the fiscal year. Such information helps determine whether there are more or fewer financial resources that can be spent in the near future to finance the Corporation's activities.

  Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the Corporation's near-term financial decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and the governmental activities.

Notes to the Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found immediately following the fund financial statements.

Other Supplementary Information

Supplementary information, which follows the notes to the financial statements, includes the calculation of debt service coverage ratios and information about the actual MSA receipts compared to base case projections at the time the revenue bonds were sold.

Entity-wide Financial Statement Analysis

The Corporation's net deficiency totaled $735,252,715 at the end of fiscal year 2013, compared to $731,469,180 at the end of the prior fiscal year. This increase in the net deficiency results primarily from interest expense exceeding tobacco settlement revenue and investment income. The most significant liability, bonds payable, increased by $3,132,888 as accretion of discount on outstanding bonds exceeded principal payments on outstanding bonds during the fiscal year.

The deficiency in net position is attributable to long-term receivables for future TSR revenues not being recognized while the full amount of bonds payable are reflected on the Statement of Net Position.

A condensed statement of activities for fiscal years 2013 and 2012 follows:

		Fiscal year ended June 30, 2013		Fiscal year ended June 30, 2012		Change
Revenues	$	49,745,702	$	50,376,028	$	(630,326)
Expenses		53,529,237		53,518,080		11,157
Decrease in net position	$	(3,783,535)	$	(3,142,052)	$	(641,483)

Amounts in the table above for the fiscal year ended June 30, 2012 have been restated to reflect the effect of the accounting principle change discussed in Notes 1 and 9 of the Notes to Financial Statements.

During fiscal year 2013, the Corporation earned $46,370,088 of revenues from TSRs and investment income of $3,375,614. Substantially all of the Corporation's investment income is earned pursuant to the terms of two investment contracts that are discussed in Notes 3 and 4 of the Notes to Financial Statements. As a result of these contracts, investment income remains relatively constant from year to year despite fluctuations in market interest rates. The decrease in total revenue when compared to fiscal year 2012 was principally the result of two factors. Tobacco settlement revenues, the Corporation's primary source of revenues, increased when measured on an accrual basis by $1,547,803 in fiscal year 2013 when compared to the amounts earned in fiscal year 2012. Offsetting this was the effect of a one-time litigation award settlement in the amount of $2,319,668 that was received in fiscal year 2012.

The Corporation incurred $52,163,708 in interest expense on bonds and paid $14,265,000 in principal on bonds 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

The governmental fund had a combined fund balance of $94,112,810 at June 30, 2013. This represents a decrease of $637,531 from June 30, 2012, as restated. This decrease is primarily attributable to debt service expenses exceeding tobacco settlement revenues and investment income for fiscal year 2013.

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. On January 22, 2013 Moody's announced that all three maturities had been "Placed Under Review Direction Uncertain".

The TSFC 2002 Series A Bonds are rated "BBB+", "BBB+", and "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. 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. The 2007 Series A and the 2007 Series B Bonds are both rated "B2" by Moody's Investors Service. This downgrade from a May 3, 2007 rating of "Baa3" for both 2007 Series A and 2007 Series B Bonds was announced on September 8, 2011. On January 22, 2013, Moody's announced that the 2007 Series A and 2007 Series B Bonds had been "Placed Under Review Direction Uncertain."

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. Fitch Ratings has not rated the TSFC 2007 Series A or Series B debt.

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 on the bonds are subject to change at any time and readers should refer to information available from the rating services for the most current ratings**.

During fiscal year 2013, the Corporation paid $14,265,000 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 2013.

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

Risk Factors and Future Revenue

The Corporation has little or no control over the level of revenues that are collected. 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 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 Rhode Island 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.

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 believed 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 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.

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 at a later date). Rhode Island received an MSA payment in the amount of $46,710,284.97 in 2012.

The Independent Auditor calculated that the MSA payment due April 15, 2013 was $6,105,975,023.36. On April 15, 17, and 24, 2013, the participating manufacturers paid the Settling States $5,265,513,662.23 for 2012. The participating manufacturers paid $830,807,622.95 into the Disputed Payments Account on account of the NPM Adjustment and on other grounds, $6,992,964.31 was withheld by Farmers and Liggett, and $319,445.38 was defaulted upon by Virginia Carolina Corporation, Inc. Rhode Island received an MSA payment in the amount of $46,692,088.33.

(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 6 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 Position
June 30, 2013

Assets:		
Current assets		
Cash and cash equivalents	$	1,591,968
Investments-restricted		69,318,843
Receivables		23,202,000
Total current assets		94,112,811
Noncurrent assets:		
Derivative instruments		26,883,273
Bond issuance costs, net		1,973,711
		28,856,984
Total assets		122,969,795
Liabilities:		
Current liabilities:		
Accrued interest		2,935,739
Total current liabilities		2,935,739
Noncurrent liabilities:		
Bonds payable, net of unamortized discount		828,403,498
Total noncurrent liabilities		828,403,498
Total liabilities		831,339,237
Deferred inflows of resources:		
Accumulated increase in the fair value of hedging derivatives		26,883,273
Total deferred inflows of resources		26,883,273
Net position:		
Restricted for debt service		93,932,448
Unrestricted/(deficiency)		(829,185,163)
	$	(735,252,715)

The notes to the financial statements are an integral part of these financial statements

(Continued)

Tobacco Settlement Financing Corporation

Statement of Activities
For the Fiscal Year Ended June 30, 2013

Revenues:		
Tobacco settlement revenues	$	46,370,088
Investment income		3,375,614
Total revenues		49,745,702
Expenses:		
General and administrative		33,458
Amortization of bond issuance and discount costs		1,332,071
Interest expense		52,163,708
Total expenses		53,529,237
Decrease in net position		(3,783,535)
Net position/(Deficiency)		
Beginning of the year, as restated		(731,469,180)
End of year	$	(735,252,715)

The notes to the financial statements are an integral part of these financial statements

Tobacco Settlement Financing Corporation

Statement of Cash Flows
For the Fiscal Year Ended June 30, 2013

Cash flows from operating activities:		
Cash received from tobacco settlement revenues	$	46,692,088
Payments to vendors		(33,458)
Net cash provided by operating activities		46,658,630
Cash flows from non-capital financing activities:		
Principal paid on long-term debt		(14,265,000)
Interest paid on long-term debt		(36,084,775)
Net cash used for non-capital financing activities		(50,349,775)
Cash flows from investing activities		
Change in investments-restricted		349,083
Investment earnings		3,375,614
Net cash provided by investing activities		3,724,697
Net increase in cash		33,552
Cash and cash equivalents, July 1, 2012		1,558,416
Cash and cash equivalents, June 30, 2013	$	1,591,968

Reconciliation of decrease in net position to net cash provided by operating activities:

Decrease in net position	$	(3,783,535)
Amortization of bond issuance costs		84,443
Amortization of bond discounts		1,247,627
Change in accrued interest		(71,326)
Change in tobacco revenue receivable		322,000
Accretion of interest on capital appreciation bonds		16,150,260
Not classified as operating		
Interest expense		36,084,775
Investment earnings		(3,375,614)
	$	46,658,630

The notes to the financial statements are an integral part of these financial statements

(Continued)

Tobacco Settlement Financing Corporation

Balance Sheet, Governmental Funds
June 30, 2013

Assets:			
Current assets			
Cash and cash equivalents			$ 1,591,968
Investments			69,318,843
Receivables			23,202,000
Total assets			$ 94,112,811
Liabilities and Fund Balances:			
Liabilities:			
Accounts payable			
Total liabilities			
Fund balances:			
Restricted for debt service			$ 93,932,448
Assigned for future expenditures			180,363
			94,112,811
Total liabilities and fund balances			$ 94,112,811
Amounts reported in the Statement of Net Position differ because:			
Bonds, accrued interest and other liabilities are not due and payable in the current period and therefore are not reported in the funds.			
	Bonds payable	$ (765,160,742)	
	Deferred discounts	19,808,192	
	Accreted interest	(83,050,948)	
	Accrued interest	(2,935,739)	
			(831,339,237)
Deferred inflows of resources are reported at the fair values of corresponding derivative instruments in the statement of net position			(26,883,273)
Long-term assets do not represent currently expendable resources and therefore are not reported in the funds.			
	Derivative instruments		26,883,273
	Deferred issuance costs		1,973,711
Net Position in Statement of Net Position			$ (735,252,715)

The notes to the financial statements are an integral part of these financial statements

(Continued)

Tobacco Settlement Financing Corporation

Statement of Revenues, Expenditures, Other Financing Sources and Users and Changes in Fund Balances, Governmental Funds
For the Fiscal Year Ended June 30, 2013

Revenues:		
Tobacco settlement revenues	$	46,370,088
Investment income		3,375,614
Total revenues		49,745,702
Expenditures:		
Current:		
General and administrative		33,458
Debt service:		
Principal		14,265,000
Interest		36,084,775
Total expenditures		50,383,233
Excess of Revenues over/(under) expenditures		(637,531)
Fund balance - beginning as restated		94,750,342
Fund balance - ending	$	94,112,811

Net change in fund balance - total governmental funds		$	(637,531)
Amounts reported in the Statement of Activities differ because:			
Bond proceeds provide current financial resources to governmental funds by issuing debt which increases long-term debt in the Statement of Net Position. Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the Statement of Net Position. Interest expense, bond issuance costs and bond discounts are recognized when the transaction occurs in the governmental funds.			
	Principal paid on debt		14,265,000
	Accrued interest		71,326
	Accreted interest		(16,150,260)
	Amortization of discount		(1,247,627)
	Amortization of issuance costs		(84,443)
Change in Net Position in the Statement of Activities		$	(3,783,535)

The notes to the financial statements are an integral part of these financial statements

(Continued)

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 (TSRs) 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 TSRs will revert back to the State.

The future receipts of TSR payments are dependent on a variety of significant factors, which include but are not limited to:

- the financial capability of the participating cigarette manufacturers to pay TSRs;
- 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.

Changes in these factors could affect the amount of funds available to pay scheduled debt service requirements.

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.

Recently Issued Accounting Standards

During the fiscal year ended June 30, 2013, the Corporation adopted the following new accounting standards issued by GASB:

- GASB Statement No. 60 – *Accounting and Financial Reporting for Service Concession Arrangements.*

(Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recently Issued Accounting Standards (Continued)

- GASB Statement No. 61 – *The Financial Reporting entity: Omnibus an amendment of GASB Statements No. 14 and No. 34.*
- GASB Statement No. 62 – *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements.*
- GASB Statement No. 63 – *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position.*

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

- 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. 69 – *Government Combinations and Disposals of Governmental Operations*, 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 except for GASB Statement No. 65. GASB 65 requires that certain items no longer be reported in statements of net position since they do not meet the definition of either assets or liabilities. Effective July 1 the Corporation will be required to expense its financing costs as incurred. As a result of adopting GASB 65, the Corporation will be required to restate its 2013 financial statements and estimates that the net deficit position of July 1, 2014 will increase by approximately $1,974,000.

Basis of Presentation – Entity-wide Financial Statements

The Statement of Net Position 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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Basis of Presentation – Fund Financial Statements (Continued)

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 specified activities or objectives. 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 a single fund for financial reporting purposes, which is an amalgamation of multiple funds established by the trustee under the bond indentures.

The flow of current financial resources measurement focus and the modified accrual basis of accounting are utilized in the preparation of the fund financial statements. 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.

Equity Classifications

Government-Wide Statements

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

- Restricted net position - Consists of net position 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.

- Unrestricted net position – that portion of net position that does 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)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fund Financial Statements (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, designated 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 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 (for the 2002 Series only)
- Certain repurchase agreements
- Certain bankers acceptances
- Shares in certain Investment Companies
- Certain Obligations of any state, or political subdivision, or municipal corporation
- Investment Agreements approved by the rating agencies
- Commercial paper

In addition, see Notes 3 and 4 for information regarding investment contracts.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Income Taxes

The Corporation is exempt from federal and state income taxes.

Use of Estimates

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

Amortization of Bond Discount and Issuance Costs

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

Cash and Cash Equivalents

The Corporation does not have any cash 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 $16,150,260 as of June 30, 2013 for a cumulative balance of $83,050,947.

Revenue Recognition

In September 2006, the GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* effective for financial statement periods beginning on or after December 15, 2006. The Statement requires the Corporation to recognize any purchases of TSRs from the State of Rhode Island after the effective date of the Statement as a purchase of a future revenue stream as well as recognize a deferred charge on its Statement of Net Position for any future transaction. Both of the Corporation's purchases of TSRs occurred before the effective date of the Statement. The Statement permits, but does not require, the Corporation to apply the Statement to previous transactions.

Application to prior transactions would require restatement with application of the cumulative impact to the beginning net position of the earliest year reported. The initial impact of electing to implement GASB 48 for the existing transactions would result in a positive net position at restatement with an annual reduction in net position until the bonds are fully redeemed.

(Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Revenue Recognition (Continued)

Management believes that restatement would not offer any significant value to the readers of the Corporation's financial statements since they are accustomed to the current presentation. In addition, management believes such implementation would limit historical comparability, and therefore its predictive value, so retrospective application of this section of the Statement was not adopted.

In addition, GASB 48 and other applicable pronouncements provide that the event that results in the recognition of an account receivable and revenue with respect to TSRs is the domestic shipment of cigarettes. Effective for the fiscal year ending June 30, 2013 the Corporation adopted that provision and began accruing at June 30th for TSRs that are derived from sales of cigarettes from January 1 to June 30. This accrual is estimated based upon the historical TSR payments for the prior three fiscal years.

TSRs recognized for fiscal year 2013 included an accrual of $23,202,000. In addition the beginning net position at July 1, 2012 has been restated to reflect the cumulative effect of the adoption of this revenue recognition principle as of that date. This restatement resulted in a $23,524,000 reduction in the net position (deficiency) as of July 1, 2012.

Deferred Inflows/Outflows – Derivative Investments

The change in the fair value of derivative investments is deferred and recognized as investment income consistent with the timing of the purchase of investments pursuant to the related investment contract.

2. CASH AND CASH EQUIVALENTS

At year end, the carrying amount of deposits considered cash and cash equivalents was $1,591,968.

Description	Fair Value	Average Days to Maturity	Moody's Rating	Standard and Poor's Rating
Wells Fargo Advantage 100% Treasury Money Market Fund	$1,587,970	55	Aaa-mf	AAAm
Goldman Sachs Financial Square Treasury Instruments Fund	3,998	57	Aaa-mf	AAAm
	$1,591,968			

3. INVESTMENTS

At June 30, 2013, the Corporation owned the following investments:

Description	Fair Value	Maturity	Moody's Rating	Standard and Poor's Rating
Commercial paper				
Banco Santander Chile Commercial Paper	$52,632,682	12/2/2013	P-1	A-1
Government obligations				
Federal Home Loan Bank discount note	16,686,160	11/29/2013	P-1	AA+/A-1+
	$69,318,842			

These investments were purchased under the terms of two contracts that are discussed in Note 4.

Concentration of Credit Risk. The investments listed above represent 75.9% and 24.1%, respectively, of the Corporation's total investments.

The stated investment policy of the Corporation requires the Corporation to attempt to diversify its investments by security type and institution, in the event interest earning 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 holding period of the funds invested and through the use of interest earning investment contracts as discussed in Note 4.

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 investments reflected above are currently held in the name of a trustee designated by the Corporation.

4. DERIVATIVES

In connection with the issuance of revenue bonds in June 2002 the Corporation entered into two interest earning investment contracts. The contracts are considered hedging derivatives. The contracts are a type of investment in which the investor, in this case the Corporation, purchases eligible securities selected by the agreement provider on a periodic basis from the agreement provider at a fixed rate of return that is specified in the contract.

(Continued)

4. DERIVATIVES (Continued)

One contract, having a notional amount of $51,351,531, with Morgan Stanley & Co. Inc. as provider, generates a fixed annual rate of return of 5.48% through June 1, 2042. As of June 30, 2013 Morgan Stanley & Co. Inc. long-term debt was rated Baa1 by Moody's and A- by Standard & Poor's. At June 30, 2013 the Banco Santander Chile Commercial Paper reflected in Note 3 is held pursuant to this contract.

The other contract, the notional amount of which varies based on the Corporation's debt service payment requirements, is with JP Morgan Chase Bank, N.A. as provider and generates a fixed annual rate of return of 4.013% through June 1, 2022 or the date on which the trustee and the Corporation have satisfied all of their obligations under the agreement. As of June 30, 2013 JP Morgan Chase Bank, N.A. long-term debt was rated A2 by Moody's and A- by Standard & Poor's. At June 30, 2013 the Federal Home Loan Bank Discount Note reflected in Note 3 is held pursuant to this contract.

The interest earning investment contracts provide for a fixed annual rate of return for investments held within the Corporation's debt service reserve fund and debt service fund. The counterparty to the investment contract purchases investments based on types permitted by the Corporation's trust indenture. When the earnings on such investments are less than the fixed annual return rate as specified in the contract, the counterparty is required to make an additional payment to the trustee on behalf of the Corporation.
Through the interest earning investment contracts, the Corporation is exposed to concentration of credit risk since the counterparty is required to purchase only permitted investments but not necessarily diversify such holdings. The fair value of the investment contracts is estimated based on the present value of their estimated future cash flows and is sensitive to interest rate changes. The terms of the investment contracts generally coincide with the Corporation's outstanding indebtedness and maintenance of the debt service and debt service reserve fund. The contracts provide for the payment of a termination amount under certain conditions specified in the agreement (e.g., defeasance, default). The termination amount payable between the provider and the Corporation would vary depending on prevailing interest rates at the time the termination amount was calculated. Under certain market conditions, the termination amount payable by the Corporation (or its trustee) could be substantial. In addition, the contracts also require the providers to pledge collateral in certain circumstances.

5. 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 (TSRs) 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, 2013, 2012 and 2011 the Corporation utilized $14,265,000, $15,735,000, and $12,570,000 of excess collections to early redeem an equal amount of outstanding bonds.

5. LONG-TERM DEBT (Continued)

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.

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

Fiscal Year Ending June 30	Principal	Accreted Interest	Interest	Total
2014	$	$	$ 35,228,875	$ 35,228,875
2015			35,228,875	35,228,875
2016			35,228,875	35,228,875
2017			35,228,875	35,228,875
2018			35,228,875	35,228,875
2019 - 2023	28,195,000		176,144,375	204,339,375
2024 - 2028			167,685,875	167,685,875
2029 - 2033	168,260,000		157,379,950	325,639,950
2034 - 2038			116,156,250	116,156,250
2039 - 2043	371,700,000		92,925,000	464,625,000
2044 - 2048				
2052	197,005,742	2,637,174,258		2,834,180,000
	$ 765,160,742	$ 2,637,174,258	$ 886,435,825	$ 4,288,770,825

The changes in bonds payable for the year ended June 30, 2013 are as follows:

Beginning balance	$ 825,270,610
Amortization of bond discount	1,247,627
Accretion of interest on capital appreciation bonds	16,150,261
Bond principal retired	(14,265,000)
Ending balance	$ 828,403,498

5. LONG-TERM DEBT (Continued)

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

Original bond principal	$	882,395,742
Turbo redemptions through June 30, 2013		(117,235,000)
Accretion of interest on capital appreciation bonds		83,050,948
		848,211,690
Unamortized bond discount		(19,808,192)
Bonds payable, per statement of net position	$	828,403,498

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	$ 846,326,430	$ 16,150,261	$ 14,265,000	$ 848,211,691	$	$ 848,211,691
Net unamortized discount	(21,055,820)		(1,247,627)	(19,808,193)		(19,808,193)
	$ 825,270,610	$ 16,150,261	$ 13,017,373	$ 828,403,498	$	$ 828,403,498

6. 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"); and (2) the State is found to not have diligently enforced its escrow statute. 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.

From April 2005 through April 2013, 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 at June 30, 2013 is approximately $37,700,000.

(Continued)

6. COMMITMENTS AND CONTINGENCIES (Continued)

There has been a long-standing dispute between the PMs and the MSA Settling States relating to NPM Adjustment Disputes, and up until December 2012, all MSA Settling States and the PMs were engaged in an arbitration proceeding regarding the issue of Diligent Enforcement for the calendar year 2003 ("2003 Dispute") (Rhode Island's Diligent Enforcement is no longer being challenged for 2003). In December 2012, the PMs reached a settlement agreement with certain MSA States & Territories ("Term Sheet States") in connection with certain claims relating to NPM Adjustment Disputes, including the 2003 Dispute. The general terms thereof were memorialized in a Term Sheet ("Term Sheet") with the PMs. In March of 2013, the Panel, which was convened for the 2003 Dispute, issued a Stipulated Partial Settlement and Award ("Award") that incorporated certain provisions of the Term Sheet. Also, the Award included specific instructions to the Independent Auditor directing it to implement the provisions provided therein, which it did in preparing final calculations for the 2013 MSA payments.

Thirty (30) MSA States and Territories ("NSS") have not accepted the terms of the Term Sheet, so the NPM Adjustment disputes between the NSS and PMs remain unresolved. 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, 2013.

7. 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)

8. 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, 2013, 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, state law and a memorandum of understanding between the Corporation and the State.

9. FUND BALANCES

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

Restricted for debt service	$ 93,932,448
Assigned for future expenditures	180,363
	$ 94,112,811

The Corporation was in compliance with its Debt Service Reserve requirements as of June 30, 2013.

10. PRIOR PERIOD ADJUSTMENT AND CHANGES IN PRESENTATION

The Corporation adopted certain provisions of GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.* This Statement provides guidance on recognizing other assets and liabilities arising from the sale of specific receivables or future revenues.

GASB Statement No. 48 and other applicable pronouncements provide that the event that results in the recognition of an account receivable and revenue with respect to TSRs is the domestic shipment of cigarettes. Effective for the fiscal year ending June 30, 2013 the Corporation adopted that provision and began accruing at year end for TSRs that are derived from shipments of cigarettes from January 1 to June 30.

TSRs recognized for fiscal year 2013 included an accrual for such receivables of $23,202,000. In addition the beginning net position at July 1, 2012 has been restated to reflect the cumulative effect of the adoption of this revenue recognition principle as of that date. This restatement resulted in a $23,524,000 reduction in the net position (deficiency) as of July 1, 2012.

The Corporation applied the provisions of GASB Statement No. 53, *Accounting and Reporting for Derivative Instruments*, and accordingly reported the fair value of interest earning investment contracts and related deferred inflows of resources on the financial statements.

11. SUBSEQUENT EVENTS

The Corporation has evaluated subsequent events through November 25, 2013, the date the financial statements were available to be issued.

SUPPLEMENTARY INFORMATION

Tobacco Settlement Financing Corporation

Supplemental Calculation of Debt Service Coverage Ratio
For the Years Ended June 30, 2013 and 2012

	2013	2012
Revenues:		
Tobacco settlement revenues, cash basis	$ 46,692,088	$ 46,710,285
Investment income	3,375,614	3,234,075
Total revenues	50,067,702	49,944,360
Expense reserve	33,458	74,415
Net reserve available for debt service	$ 50,034,244	$ 49,869,945
Annual debt service (interest only):		
Required interest payments	$ 36,084,775	$ 37,028,875
Total required interest payments	36,084,775	37,028,875
Covered ratio before turbo principal payments	139%	135%
Annual debt service (principal and interest)		
Turbo principal payments	14,265,000	15,735,000
Total annual debt service	$ 50,349,775	$ 52,763,875
Coverage ratio after turbo principal payments	99%	95%

Tobacco Settlement Financing Corporation

Supplemental Schedule of Actual MSA Receipts Compared to Base Case Projections at Time of Sale For the Years Ended June 30, 2013 and 2012

Fiscal Year Ended June 30	A 2002 Series A & B DRI-WEFA Base Case Expected MSA Revenue	B 2007 Series A, B. & C Global Insight Base Case Expected MSA Revenue	C Actual MSA Revenue Received	C-A Variance of DRI-WEFA Compared to Actual	C-B Variance of Global Insight Compared to Actual
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	$ (4,197,470)
2009	$ 51,191,991	$ 58,186,214	$ 58,038,800	$ 6,846,809	$ (147,414)
2010	$ 51,870,793	$ 58,863,587	$ 48,620,449	$ (3,250,344)	$ (10,243,138)
2011	$ 52,612,259	$ 59,577,361	$ 45,812,110	$ (6,800,149)	$ (13,765,251)
2012	$ 53,353,020	$ 60,279,274	$ 46,710,285	$ (6,642,735)	$ (13,568,989)
2013	$ 54,057,103	$ 60,971,444	$ 46,692,088	$ (7,365,015)	$ (14,279,356)
2014	$ 54,744,345	$ 61,641,825			

REPORT OF INDEPENDENT AUDITORS 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

Board of Commissioners
Tobacco Settlement Financing Corporation
Providence, Rhode Island

We have audited, in accordance with the 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, the financial statements of Tobacco Settlement Financing Corporation (the "Corporation") a component unit of the State of Rhode Island, as of and for the year ended June 30, 2013, and have issued our report thereon dated November 25, 2013.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered Rhode Island Resource Recovery Corporation's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Tobacco Settlement Financing Corporation's internal control.

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 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 entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or, significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

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*.

Purpose of this Report

This report is intended solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Braver, P.C.

Braver P.C.

Providence, Rhode Island
November 25, 2013