

TOBACCO SETTLEMENT FINANCING CORPORATION
STATE OF LOUISIANA



FINANCIAL STATEMENT AUDIT
ISSUED DECEMBER 9, 2009

**LEGISLATIVE AUDITOR
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LOUISIANA LEGISLATIVE AUDITOR
DARYL G. PURPERA, CPA, CFE

November 13, 2009

Independent Auditor's Report

TOBACCO SETTLEMENT FINANCING CORPORATION
STATE OF LOUISIANA
Baton Rouge, Louisiana

We have audited the accompanying financial statements of the debt service fund and governmental activities of the Tobacco Settlement Financing Corporation (Corporation), a blended component unit of the State of Louisiana, as of and for the year ended June 30, 2009, which collectively comprise the Corporation's basic financial statements as listed in the table of contents. These financial statements are the responsibility of management of the Corporation. 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 debt service fund and governmental activities of the Corporation as of June 30, 2009, and the respective changes in financial position for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 9 to the basic financial statements, the Corporation changed its reporting of the unamortized bond issue discount from a deferred charge to a reduction in bonds payable. In addition, the Corporation changed its reporting of restricted net assets to unrestricted. The effect of the change in reporting the bond issue discount represents a decrease in noncurrent assets and bonds payable of \$16,049,321. The effect of the change in reporting restricted net assets represents a \$181,081,533 shift from restricted net assets to unrestricted net assets.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 13, 2009, on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, 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 control 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 considered in assessing the results of our audit.

Management's discussion and analysis on pages 5 through 7 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Corporation's basic financial statements. The accompanying supplementary information schedule of per diem paid to board members is presented for purposes of additional analysis and is not a required part of the basic financial statements. The accompanying supplementary information schedule of per diem paid to board members has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Respectfully submitted,



Daryl G. Purpera, CPA, CFE
Temporary Legislative Auditor

BF:WDD:EFS:PEP:sr

TSFC09

This section of the Tobacco Settlement Financing Corporation's (Corporation) annual financial report represents management's analysis of the Corporation's financial performance during the year ended June 30, 2009, in comparison to that of the previous fiscal year. Please read it in conjunction with the financial statements, which follows this section.

FINANCIAL HIGHLIGHTS

- The Corporation's net asset deficit decreased \$54,181,643 (6.83%) to \$739,350,315 as of June 30, 2009. This represents the net financial position of the Corporation on the full accrual basis of accounting. On the modified accrual basis, \$129,769,844 of fund balance is available for debt service and operations.
- The revenues of the Corporation increased \$10,629,264 (10.42%).
- The expenses of the Corporation decreased \$2,722,670 (4.45%).

The Corporation was formed by an act of the Louisiana Legislature for the purpose of purchasing Tobacco Settlement Revenues (TSRs) from the State of Louisiana. This purchase was financed by the issuance of bonds to be repaid solely from the TSRs. The TSRs consist of amounts to be collected as part of a Master Settlement Agreement (MSA) among cigarette manufacturers (PMs) and 46 states and other U.S. jurisdictions (Settling States). Under the MSA, the PMs are required to pay the Settling States annual payments in perpetuity.

Much of the TSRs represent a portion of future sales of tobacco products, the amount of which is to be determined based upon future sales. Under generally accepted accounting principles (GAAP), such contingent amounts can be recognized as a receivable and revenue when the domestic sale of tobacco products is known. Under the modified accrual basis of accounting, revenue should be recognized as the sales occur and resources become available.

OVERVIEW OF THE FINANCIAL STATEMENTS

These financial statements consist of two sections--Management's Discussion and Analysis (this section) and the basic financial statements (including the notes to the financial statements).

GOVERNMENT-WIDE FINANCIAL STATEMENTS

The Statement of Net Assets and the Statement of Activities are two basic financial statements that report information about the Corporation as a whole, using a long-term economic resources focus. The financial data is reported using the accrual basis of accounting and provides insight as to the Corporation's total long-term financial position and whether or not the Corporation's total financial position has improved as a result of the current year's activities.

Comparative condensed Statements of Net Assets and Activities for fiscal years 2009 and 2008 are as follows:

**Statement of Net Assets
June 30, 2009 and 2008**

	June 30, 2009	June 30, 2008	Increase (Decrease)	Percentage Change
Current assets	\$215,683	\$184,711	\$30,972	16.77%
Noncurrent assets	189,098,145	188,797,353	300,792	0.16%
Total assets	<u>189,313,828</u>	<u>188,982,064</u>	<u>331,764</u>	0.18%
Current liabilities	99,820,821	91,312,282	8,508,539	9.32%
Noncurrent liabilities	828,843,322	891,201,740	(62,358,418)	(7.00%)
Total liabilities	<u>928,664,143</u>	<u>982,514,022</u>	<u>(53,849,879)</u>	(5.48%)
Total net assets (deficit) - unrestricted	<u>(\$739,350,315)</u>	<u>(\$793,531,958)</u>	<u>\$54,181,643</u>	6.83%

**Statement of Activities
For the Years Ended June 30, 2009 and 2008**

	June 30, 2009	June 30, 2008	Increase (Decrease)	Percentage Change
Tobacco settlement revenues	\$107,949,470	\$96,440,793	\$11,508,677	11.93%
Investment income	4,680,812	5,560,225	(879,413)	(15.82%)
Total revenues	<u>112,630,282</u>	<u>102,001,018</u>	<u>10,629,264</u>	10.42%
Total expenses	<u>58,448,639</u>	<u>61,171,309</u>	<u>(2,722,670)</u>	(4.45%)
Increase in net assets	<u>\$54,181,643</u>	<u>\$40,829,709</u>	<u>\$13,351,934</u>	32.70%

The net asset deficit is a result of bonds payable and other liabilities exceeding recognized assets. The bonds are recognized as a liability while the resources to repay the bonds--the future TSRs -- are not recognized as assets until the underlying sales of tobacco products are known.

Revenues of the Corporation increased by approximately 10.42% compared to prior year's increase of 4.53%. The increase is attributable to a stream of payments that commenced in 2008 identified in the settlement agreement as the "strategic contribution payments." This stream of payments is expected to continue through 2017.

Expenses of the Corporation decreased because of a reduction of interest expense due to a lower level of outstanding principal on the bonds.

FUND FINANCIAL STATEMENTS

The fund financial statements provide detailed information about the Corporation as a debt service fund. A fund is a fiscal and accounting entity with a self-balancing set of accounts that a governmental entity uses to keep track of specific sources of funding and spending for a particular purpose.

As a debt service fund, all of the Corporation's transactions are reported in the governmental fund financial statements. The governmental fund financial statements focus on near-term inflows and outflows of spendable resources. This approach applies a flow of current financial resources measurement focus and the modified accrual basis of accounting. These statements provide a detailed short-term view of the Corporation's finances that assist in determining whether there will be adequate financial resources available to meet the current needs of the Corporation.

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 government's near-term financing decisions. Both the Governmental Funds Balance Sheet and the Governmental Funds Statement of Revenues, Expenditures, and Changes in Fund Balance provide a reconciliation to facilitate this comparison between the governmental funds and the governmental activities. These reconciliations are presented in the adjustment column in each of the financial statements.

LONG-TERM DEBT ACTIVITY

At June 30, 2009, the Corporation has \$938,005,000 in outstanding bonded debt which reflects principal bond payments of \$53,675,000 during the year ended June 30, 2009, as well as pay-downs from previous years. The Corporation has issued no debt since issuing its initial offering of 2001 A & B series. A description of the long-term debt activity is located at note 4. The Corporation's bonds carried a BBB negative rating from Standard & Poors as of June 30, 2009.

CONTACTING THE TOBACCO SETTLEMENT FINANCING CORPORATION'S MANAGEMENT

This financial report is designed to provide a general overview of the Corporation's finances and to demonstrate the Corporation's accountability for the money it receives. If you have any questions about this report or need additional information, contact the Tobacco Settlement Financing Corporation, Post Office Box 44154, Baton Rouge, Louisiana 70804.

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**TOBACCO SETTLEMENT FINANCING CORPORATION
STATE OF LOUISIANA**

**Governmental Fund Balance Sheet and
Statement of Net Assets, June 30, 2009**

	DEBT SERVICE FUND	ADJUSTMENTS*	STATEMENT OF NET ASSETS - GOVERNMENTAL ACTIVITIES
ASSETS			
Current Assets:			
Cash (note 2)	\$215,683		\$215,683
Investments (note 3)	129,554,528	(\$129,554,528) (1)	
Accrued interest receivable	9,633	(9,633) (1)	
Total current assets	<u>129,779,844</u>	<u>(129,564,161)</u>	<u>215,683</u>
Noncurrent Assets:			
Unamortized bond issue cost		8,016,612 (3)	8,016,612
Restricted assets:			
Investments (note 3)		129,554,528 (1)	129,554,528
Tobacco settlement receivable (note 5)		51,517,375 (2)	51,517,375
Accrued interest receivable		9,630 (1)	9,630
Total noncurrent assets	<u>NONE</u>	<u>189,098,145</u>	<u>189,098,145</u>
Total Assets	<u>\$129,779,844</u>	<u>59,533,984</u>	<u>\$189,313,828</u>
LIABILITIES			
Current Liabilities:			
Fees payable	\$10,000		\$10,000
Accrued interest payable		6,698,464 (3)	6,698,464
Bonds payable, net of discount (note 4)		93,112,357 (3)	93,112,357
Total current liabilities	<u>10,000</u>	<u>99,810,821</u>	<u>99,820,821</u>
Noncurrent liabilities -			
bonds payable, net of discount (note 4)	<u>NONE</u>	<u>828,843,322 (3)</u>	<u>828,843,322</u>
Total Liabilities	<u>10,000</u>	<u>928,654,143</u>	<u>928,664,143</u>
FUND BALANCE/NET ASSETS			
Fund balance - reserved for debt service	<u>129,769,844</u>	<u>(129,769,844)</u>	<u>NONE</u>
Total Liabilities and Fund Balance	<u>\$129,779,844</u>		
Total Net Assets (Deficit) - unrestricted (note 8)		<u>(\$739,350,315)</u>	<u>(\$739,350,315)</u>

*Explanations:

- (1) Investments and receivables restricted for debt service are reported as noncurrent restricted assets on the Statement of Net Assets.
- (2) Full accrual receivables are recorded on the Statement of Net Assets but not within the fund statements of the Debt Service Fund.
- (3) Bonds payable liabilities and unamortized bond issue costs are recorded on the Statement of Net Assets but not within the fund statements of the Debt Service Fund.

The accompanying notes are an integral part of this statement.

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**TOBACCO SETTLEMENT FINANCING CORPORATION
STATE OF LOUISIANA**

**Statement of Governmental Fund Revenues, Expenditures,
and Changes in Fund Balance and Statement of Activities
For the Year Ended June 30, 2009**

	DEBT SERVICE FUND	ADJUSTMENTS*	STATEMENT OF ACTIVITIES - GOVERNMENTAL ACTIVITIES
REVENUES			
Tobacco settlement revenues (note 5)	\$105,301,955	\$2,647,515 (1)	\$107,949,470
Investment income	4,680,812		4,680,812
Total revenues	<u>109,982,767</u>	<u>2,647,515</u>	<u>112,630,282</u>
EXPENDITURES/EXPENSES			
Bank fees	89,126		89,126
Professional services	37,527		37,527
Bond issue cost amortization		750,983 (2)	750,983
Debt service:			
Principal retirement	53,675,000	(53,675,000) (3)	
Interest expense	57,745,879	(174,876) (2)	57,571,003
Total expenditures/expenses	<u>111,547,532</u>	<u>(53,098,893)</u>	<u>58,448,639</u>
EXCESS (Deficiency) OF REVENUES OVER (Under) EXPENDITURES/EXPENSES	(1,564,765)	55,746,408	54,181,643
FUND BALANCE/NET ASSETS (Deficit) AT BEGINNING OF YEAR (note 9)	<u>131,334,609</u>	<u>(924,866,567)</u>	<u>(793,531,958)</u>
FUND BALANCE/NET ASSETS (Deficit) AT END OF YEAR	<u>\$129,769,844</u>	<u>(\$869,120,159)</u>	<u>(\$739,350,315)</u>

*Explanations:

- (1) Full accrual revenues are recorded on the Statement of Net Assets but not within the fund statements of the Debt Service Fund.
- (2) Debt service funds report the effects of issuance costs, discounts, and similar items when the debt is first issued, whereas these amounts are amortized in the Statement of Activities.
- (3) Principal retirement is an expenditure in the Debt Service Fund but not in the Statement of Activities.

The accompanying notes are an integral part of this statement.

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INTRODUCTION

The Tobacco Settlement Financing Corporation (Corporation) was created by Act 1145 of the 2001 Regular Session of the Louisiana State Legislature codified under the provisions of Louisiana Revised Statutes (R.S.) 39:99.1 through 39:99.20. The Corporation is a special purpose, public corporate entity, an instrumentality independent of the state.

On November 23, 1998, the State of Louisiana entered into a Master Settlement Agreement with the major United States tobacco product manufacturers that should result in Louisiana receiving substantial monies in perpetuity. The Corporation is authorized and empowered to, among other things, (1) purchase the state's allocation of monies to be received as a result of the Master Settlement Agreement and receive, or authorize the indenture trustee to receive, the tobacco settlement payments when they become due; (2) issue bonds; (3) determine the amounts of the residual interests and pay and transfer such residual interests to the state treasurer, semiannually, in accordance with the provisions of the Louisiana Revised Statutes noted above; and (4) do any and all other acts and things necessary, convenient, appropriate or incidental in carrying out the provisions of the Louisiana Revised Statutes noted above.

Income of the Corporation and bond proceeds, if any, not previously paid to the state, that are in excess of the Corporation's requirements to pay its operating expenses, debt service, sinking fund requirements, reserve fund requirements, and any other contractual obligations to the holders or that may be incurred in connection with the issuance of the bonds, the amounts of which shall be determined by the board on or before January 1 and July 1 of each year for the next 12 months, and which, within 10 days after each such determination, shall be transferred and paid by the Corporation to the state treasurer for deposit in and credit to the Millennium Trust.

The Corporation shall have perpetual existence provided; however, the board shall dissolve and terminate the existence of the Corporation no later than two years after the date of final payment of all outstanding bonds and the payments or satisfaction of all other outstanding obligations and liabilities of the Corporation. Upon dissolution of the Corporation, title to all assets and properties of the Corporation shall vest in and become the property of the State of Louisiana and shall be deposited in and credited to the Millennium Trust.

The Corporation is governed by a board consisting of 13 members as follows: (i) the Governor or his designee; (ii) the State Treasurer or his designee; (iii) the Attorney General or his designee; (iv) the President of the Senate or his designee; (v) the Speaker of the House of Representatives or his designee; (vi) seven members appointed by the Governor from each of the seven congressional districts; and (vii) one additional member appointed from the state. The State Treasurer serves as the secretary-treasurer of the Corporation and the board. The Corporation is a blended component unit of the state and is included in the state's financial statements.

Operations of the Corporation were funded initially with a portion of bond proceeds but are now funded with Corporation investment income. The Corporation has no employees. R.S. 39:99.8(A) states the staff of the Department of the Treasury, including that of the state Bond

Commission, may, pursuant to a cooperative endeavor agreement, serve as staff to the Corporation under the supervision of the State Treasurer.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. REPORTING ENTITY

Using the criteria in Governmental Accounting Standards Board (GASB) Codification Section 2100, the Division of Administration, Office of Statewide Reporting and Accounting Policy, has defined the governmental reporting entity to be the State of Louisiana. The Office of Statewide Reporting and Accounting Policy considers the Corporation to be a blended component unit of the State of Louisiana because the state has financial accountability for fiscal matters as follows: (1) a majority of the members of the governing board are appointed by the governor; (2) the state has control and exercises authority over budget matters; (3) no later than two years after the full payment of tobacco settlement asset-backed bonds principal and interest, the board shall dissolve and terminate the existence of the Corporation; and (4) services are provided entirely to the primary government. Annually, the State of Louisiana issues financial statements, which include the activity contained in the accompanying financial statements. Those basic financial statements are audited by the Louisiana Legislative Auditor.

B. MEASUREMENT FOCUS AND BASIS OF ACCOUNTING

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the GASB. These principles are found in the *Codification of Governmental Accounting and Financial Reporting Standards*, published by the GASB. GASB is the accepted standard setting body for establishing governmental accounting principles and reporting standards.

The accompanying governmental fund financial statements are presented using the current financial resources measurement focus and the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recognized when they become measurable and available to fund current operations. Expenditures are recognized when the related fund liability is incurred, except for principal and interest on long-term debt, which is recognized when due.

The accompanying government-wide statements (Statement of Net Assets and Statement of Activities) are presented using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when they are earned and expenses are recognized when the related liability is incurred, regardless of the timing of related cash flows.

The Corporation applies all GASB pronouncements and those Financial Accounting Standards Board (FASB) statements and interpretations which were issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. In accordance with the State of Louisiana's Division of Administration's accounting policy, the board has elected to follow GASB statements issued after November 30, 1989, rather than the FASB statements and interpretations.

C. FUND ACCOUNTING

The activities of the Corporation are accounted for in a debt service fund. Debt service funds account for the accumulation of resources for, and the payment of, long-term debt principal and interest. The Corporation's Debt Service Fund balance sheet portrays the current assets and current liabilities of the Corporation with the difference being fund balance reserved for debt service.

D. ADJUSTMENTS

The adjustments column represents the conversion of the fund financial statements (modified accrual) to the government-wide financial statements (full accrual) and includes adjustments for the following:

- Recording of bonds payable as liabilities
- Unamortized bond issue cost as an asset
- Full accrual revenues and receivables
- Reclassification of restricted assets

E. CASH AND INVESTMENTS

Cash consists of demand deposits. Investments consist of direct investments in commercial paper and money market funds. Under state law, the Corporation may deposit funds within a fiscal agent bank organized under the laws of the State of Louisiana, the laws of any other state in the Union, or the laws of the United States.

Funds held by the Corporation or by the indenture trustee may be invested and reinvested in investments and securities as allowed under an indenture of trust within the limitations for investments under the laws of the State of Louisiana as defined in R.S. 49:342(C). The Corporation's investments, with the exception of the money market mutual funds, are stated at amortized cost, which approximates fair value, in accordance with GASB Statement No. 31. The money market mutual funds are stated at fair market value.

F. RESTRICTED ASSETS

Restricted assets represent resources set aside for the purpose of funding debt service payments or providing reserve amounts in accordance with bond resolutions.

G. BOND ISSUANCE COSTS

Bond issuance costs are capitalized and amortized over the lives of the related debt using the interest method or methods that approximate the interest method.

H. NET ASSETS

Net assets represent the difference between assets and liabilities and are classified as unrestricted net assets that are free of restrictions.

**I. FUTURE SETTLEMENT PAYMENTS
PURCHASED FROM THE STATE
AND REVENUE RECOGNITION**

As described more fully in notes 4 and 5, the Corporation initially purchased 60% of the future revenues to be received under the Master Settlement Agreement with bond proceeds. The Corporation follows GASB technical bulletin 2004-1 as amended by GASB Statement No. 48 in establishing accounting policy for the purchase of future settlement collections which, for the Corporation, allow no asset recognition.

In accordance with GASB Technical Bulletin 2004-1, settlement payments to be received by the Corporation are recognized as revenue as the underlying cigarette sales occur.

J. ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates. The most significant estimate contained within the financial statements is that determined for the Tobacco Settlement Revenue Receivable of \$51,517,375 (note 5).

2. CASH

For deposits in financial institutions, custodial credit risk is the risk that, in the event of failure of the financial institution, the Corporation will not be able to recover the value of its deposits.

At June 30, 2009, the Corporation has cash (book balances) totaling \$215,683, which is held in a demand deposit account, as presented on Statement A. Of this amount, \$215,683 in deposits (collected bank balances) is secured from risk by federal deposit insurance. The Corporation does not have a formal policy for custodial credit risk for cash.

3. INVESTMENTS

At June 30, 2009, investments of \$129,554,528, as presented on Statement A, consist of the following:

<u>Investment Type</u>	<u>Reported Amount</u>	<u>*Credit Quality Rating</u>	<u>Percentage of Investments</u>	<u>Maturity - Less Than One Year</u>
JPMorgan U.S. Government Money Market Fund - Capital Shares	\$39,894,498	AAAm	30.79%	\$39,894,498
Barclays U.S. Funding, LLC - Commercial Paper	<u>89,660,030</u>	A-1+	<u>69.21%</u>	<u>89,660,030</u>
Total investments	<u><u>\$129,554,528</u></u>		<u><u>100.00%</u></u>	<u><u>\$129,554,528</u></u>

*Credit quality ratings obtained from Standard & Poor's Investor Services.

Of the total investment balance of \$129,554,528, an amount of \$103,920,481 is held in separate accounts to satisfy the Liquidity Reserve Requirements provided for by the bond indenture. The 2001-A bond series reserve requirement is \$14,764,534 while the 2001-B bond series reserve requirement is \$89,155,947. The Corporation met its reserve balance requirements at June 30, 2009.

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 investment that is in the possession of an outside party.

The \$39,894,498 of money market mutual funds are not exposed to custodial credit risk because their existence is not evidenced by securities that exist in physical or book entry form. The commercial paper investments totaling \$89,660,030 at amortized cost are held by the counterparty. The Corporation does not have a formal investment policy for custodial credit risk.

Credit Risk: This risk is defined as the risk that an issuer or other counterparty to an investment transaction will not fulfill its obligations. The Corporation does not have a formal credit risk policy. However, in practice, credit risk is minimized by investing in money market funds containing underlying securities which are guaranteed by the U.S. government, and commercial paper of domestic U.S. corporations rated A-1 or A-1+ by Standard & Poor's.

Concentration of Credit Risk: The Corporation does not have a formal policy for this type of risk, which is defined as the risk of loss attributed to the magnitude of the Corporation's investment in a single issuer. As indicated in the listing of investments above, the Corporation's portfolio contains concentrations in single debt issuers in excess of 5% of its total portfolio.

Interest Rate Risk: This risk is defined as the risk that changes in interest rates will adversely affect the fair value of an investment. To minimize this risk, the Corporation has entered into a reserve fund agreement with Lehman Brothers Special Financing Inc. (Lehman Brothers), which guaranteed an annual investment rate of return of 4.36% on the 2001-A Liquidity Reserve Requirement balance. However, as a result of the bankruptcy filing of Lehman Brothers in

October 2008, that agreement has been terminated. The securities being held under the agreement matured and were subsequently placed into money market funds. The Corporation has an agreement with Bayerische Hypo-Und Vereinsbank AG, New York Branch which guarantees an annual investment rate of return of 4.63% on the 2001-B Liquidity Reserve Requirement balance. The Corporation does not have a formal interest rate risk policy.

4. LONG-TERM DEBT

Long-term debt is composed of the following:

Series 2001A (Taxable) Term Bonds due May 15, 2025, with interest of 6.36% due semiannually on May 15 and November 15, commencing on May 15, 2002	\$18,210,000
Series 2001B (Tax Exempt) Term Bonds due May 15, 2030, with interest of 5.50% due semiannually on May 15 and November 15, commencing on May 15, 2002	230,390,000
Series 2001B (Tax Exempt) Term Bonds due May 15, 2039, with interest of 5.875% due semiannually on May 15 and November 15, commencing on May 15, 2002	<u>689,405,000</u>
Total bonded debt	938,005,000
Less unamortized bond discount	<u>(16,049,321)</u>
Total bonded debt, net of unamortized bond issue discount	<u><u>\$921,955,679</u></u>

The following is a summary of the debt obligation transactions for the year ended June 30, 2009:

	Bonded Debt Payable at June 30, 2008, as restated (1)	Additions	Deductions	Bonded Debt Payable at June 30, 2009	Amounts Due Within One Year
Tobacco Settlement Asset-Backed bonds:					
Series 2001A (Taxable) due May 15, 2025	\$71,885,000		(\$53,675,000)	\$18,210,000	\$18,210,000
Series 2001B (Tax Exempt) due May 15, 2030	230,390,000			230,390,000	75,675,000
Series 2001B (Tax Exempt) due May 15, 2039	689,405,000			689,405,000	
Total	991,680,000	NONE	(53,675,000)	938,005,000	93,885,000
Less unamortized discounts	<u>(16,295,315)</u>	<u>\$245,994</u>		<u>(16,049,321)</u>	<u>(772,643)</u>
Total, net of unamortized discounts	<u><u>\$975,384,685</u></u>	<u><u>\$245,994</u></u>	<u><u>(\$53,675,000)</u></u>	<u><u>\$921,955,679</u></u>	<u><u>\$93,112,357</u></u>

(1) In prior fiscal years, the unamortized discount was included in the unamortized bond issuance costs on the Statement of Net Assets. In the current fiscal year, the unamortized bond discount is being reclassified as a reduction of bonds payable (see note 9).

On November 7, 2001, the Corporation issued \$1,202,770,000 in Tobacco Settlement Asset-Backed Bonds. The bonds were issued to finance the Corporation's purchase of 60% of the state's future receipts from the MSA with participating cigarette manufacturers. The bonds are secured by the Corporation's claim to 60% of these future receipts. The claim is on parity with the claim of the state to the ownership of the remaining 40% of all amounts expected to be paid to the state under the MSA. In addition, the bonds are secured by all earnings on investments held in certain accounts established under an indenture of trust.

The bond indenture states that the Series 2001 Bonds shall not be deemed to be nor constitute a debt or obligation of the state or a pledge of the full faith or credit of the state or any political subdivision thereof. The Corporation has no taxing power. No assets or revenues of the state or any political subdivision thereof is or shall be obligated or pledged to the payment of the principal of or interest on the bonds.

The proceeds of this issue were used for the following:

Payment to the state for 60% of expected MSA proceeds	\$1,069,510,895
Liquidity reserve accounts	103,920,481
Capitalized operating expenses	75,000
Costs of Issuance Account	2,274,000
Underwriters' discount	9,294,328
Original issue discount	<u>17,695,296</u>
Total bond proceeds	<u><u>\$1,202,770,000</u></u>

Debt service requirements, including interest to maturity, are as follows:

Fiscal Year	Term Bond Maturities		Sinking Fund Maturities		Turbo Maturities	
	Principal	Interest	Principal	Interest	Principal	Interest
2010		\$54,332,150		\$54,332,150	\$93,885,000	\$54,332,150
2011		54,332,150		54,332,150	68,170,000	49,011,869
2012		54,332,150		54,332,150	73,590,000	45,262,519
2013		54,332,150		54,332,150	79,360,000	41,215,069
2014		54,332,150		54,332,150	85,575,000	36,601,250
2015-2019		271,660,749		271,660,749	532,870,000	99,478,731
2020-2024		271,660,749		271,660,749	4,555,000	267,606
2025-2029	\$18,210,000	267,028,125	\$194,720,000	253,461,275		
2030-2034	230,390,000	215,184,169	318,675,000	183,691,619		
2035-2039	689,405,000	202,512,719	424,610,000	75,481,706		
Total	938,005,000	<u>\$1,499,707,261</u>	938,005,000	<u>\$1,327,616,848</u>	938,005,000	<u>\$326,169,194</u>
Less unamortized discount	<u>(16,049,321)</u>		<u>(16,049,321)</u>		<u>(16,049,321)</u>	
Total, net of unamortized bond discount	<u>\$921,955,679</u>		<u>\$921,955,679</u>		<u>\$921,955,679</u>	

Term bond maturities represent the minimum amount of principal that the Corporation must pay as of specific distribution dates to avoid an event of default under the indenture.

Sinking fund maturities represent the amount of principal that the Corporation will pay according to the terms of the indenture. The Corporation is required to make these payments to the extent

that funds are available for payment. Failure by the Corporation to make a sinking fund installment according to the terms of the indenture will not constitute an event of default under the terms of the indenture. The amount of any sinking fund installments made will be credited against term maturities in ascending chronological order.

Turbo maturities represent the requirement contained in the indenture to apply 100% of all collections that are in excess of the funding requirements of the indenture to redemption of the Series 2001 Term Bonds. The amount of any turbo redemption made will be credited against both sinking fund installments and term bond maturities in ascending chronological order.

5. TOBACCO SETTLEMENT REVENUES AND RECEIVABLE

Tobacco Settlement Revenues (TSRs) consist of the amounts to be received under the terms of a MSA among participating cigarette manufacturers and 46 states and six other U.S. jurisdictions (Settling States). The MSA is an industry wide settlement of litigation between the Settling States and the Original Participating Manufacturers (OPMs) and was entered into between the attorneys general of the Settling States and the OPMs on November 23, 1998. The MSA provides for other tobacco companies, referred to as Subsequent Participating Manufacturers (SPMs), to become parties to the MSA. The four OPMs together with the 30+ SPMs are referred to as the Participating Manufacturers (PMs). The settlement represents the resolution of a large potential financial liability of the PMs for smoking-related injuries, the cost of which has been borne and will likely continue to be borne by cigarette consumers. Pursuant to the MSA, the Settling States agreed to settle all their past and future smoking-related claims against the PMs in exchange for agreements and undertakings by the PMs concerning a number of issues. These issues include, among other things, making payments to the Settling States, abiding by more stringent advertising restrictions and funding educational programs, all in accordance with the terms and conditions set forth in the MSA. Distributors of the PMs are also covered by the settlement of such claims to the same extent as the PMs.

Under the MSA, the PMs are required to pay to the Settling States (i) five initial payments, the first of which was due on November 12, 1999, with the remaining four due on January 10, 2000 through 2003 (Initial Payments); (ii) annual payments required to be made on April 15, commencing April 15, 2000, and continuing in perpetuity (Annual Payments); and (iii) 10 annual payments required to be made on each April 15, commencing April 15, 2008, and continuing through April 15, 2017 (Strategic Contribution Payments). Before the formation of the Corporation, the PMs made the first of the three required Initial Payments and the Annual Payments due April 15, 2000 and 2001, none of which the Corporation had any right to receive.

The TSRs due under the MSA are subject to numerous adjustments, some of which may be material. Such adjustments include, among others, reductions for decreased domestic cigarette shipments, reductions for amounts paid by PMs to four states that had previously settled their claims independently of the MSA, and in the case of Annual Payments and Strategic Contribution Payments, increases related to inflation of not less than 3% per annum. Furthermore, TSRs are subject to a Nonparticipating Manufacturer (NPM) adjustment which may be triggered by, among other occurrences, the determination that the MSA has contributed to market share loss. The PMs have disputed the amount of their annual March payments for the last four years in applying these adjustments. The disputed amounts for several of the PMs have

been deposited into separate accounts outside of the control of the PMs and the Settling States. One of the PMs withheld its amounts from the annual payment. Despite these ongoing disputes over the adjustments, approximately \$7.3 million was received during the year ended June 30, 2009, toward settlement of past disputes related to these adjustments. The Settling States are engaged in ongoing deliberations with the OPMs regarding these disputes.

Much of the TSRs represent a portion of future sales of tobacco products. Technical Bulletin 2004-1 clarified guidance relating to the recognition of revenues and receivables. Specifically, the bulletin allows for the recognition of revenue based on the shipment of domestic cigarettes. The receivable recognized in the financial statements represents an estimate of the shipments and is equal to approximately 50% of the next projected payment due from the MSA, adjusted for historical trends.

6. ADMINISTRATIVE EXPENSES

The State of Louisiana performs certain accounting and administrative services for the Corporation for which it receives no compensation. The value of such services was immaterial to the Corporation's financial statements.

7. CONTINGENCIES

Certain smokers, consumer groups, cigarette manufacturers, cigarette importers, cigarette distributors, native American tribes, taxpayers, taxpayers' groups, and other parties have instituted litigation against various tobacco manufacturers, including the PMs, as well as certain Settling States, including Louisiana, and other federal and public entities. The lawsuits allege, among other things, that the MSA or other tobacco-related legislation violates certain provisions of the U.S. Constitution, state constitutions, the federal antitrust laws, federal civil rights laws, state consumer protection laws and unfair competition laws, while other suits allege breach of the MSA. These actions, if ultimately successful, could result in a determination that the MSA is void or unenforceable. The lawsuits seek, among other things, an injunction against one or more of the Settling States from collecting any monies under the MSA and/or a determination that the MSA is void or unenforceable. To date, no such lawsuits have been successful. The enforcement of the terms of the MSA may, however, continue to be challenged in the future. In the event of an adverse court ruling, the Corporation may not have adequate financial resources to make payment on the bonds.

Specific to the Corporation, a case challenging the MSA was filed in federal court in Shreveport, Louisiana, on August 2, 2005. This case (A.B. Coker, et al. v. Charles C. Foti, Jr., CV-05-1372S) raises a multitude of constitutional challenges in an attempt to overturn the MSA. On October 31, 2005, the State of Louisiana filed a motion to dismiss this case. In November 2006, the district judge granted Louisiana's motion to dismiss as to the Tenth Amendment claim, but denied the motion as to the other claims. The remaining claims in Coker are based on Federal Cigarette Labeling and Advertising Act (FCLAA) preemption and alleged violations of the Commerce, Due Process, and Compact Clauses of the U.S. Constitution. The defendant filed a motion for summary judgment dismissing S & M Brands, Inc.'s claims for lack of standing in July 2008. The plaintiff filed an opposition in early August 2008, and oral arguments were heard

on February 9, 2009. On September 24, 2009, summary judgment was granted to Louisiana, rejecting the plaintiff's claims. The case is pending appeal.

Also specific to the Corporation, Xcaliber International Limited, LLC vs. Foti [(Civil Action No. 04-0069 Section "S" (4)] was filed on January 12, 2004, in the United States District Court for the Eastern District of Louisiana whereby a plaintiff seeks declaratory and injunctive relief regarding the constitutionality of R.S. 13:5061-5063 (the Escrow Statutes), particularly 13:5063 (c)(2)(b)--the allocable share amendment. The plaintiff alleges it was harmed by the allocable share amendment and seeks to have the amendment declared unconstitutional and an injunction issued against the enforcement of that amendment. This challenge is based on antitrust preemption and constitutional grounds. In May 2009, the court granted summary judgment in favor of the State of Louisiana. The case is pending appeal.

The State of Louisiana is also a defendant in litigation filed in New York - the United States District Court, Southern District of New York [Grand River Enterprises Six Nations Ltd., et al. v. Troy King, No. 02-Civ. 5068 (JFK/DLE)]. This case is also an attack on the MSA, including constitutional challenges to the escrow statute(s) of defendant states. In March 2008, the plaintiff filed an amended and supplemental complaint. In August 2008, defendants filed a Motion for Summary Judgment. Currently, cross motions for summary judgment have been briefed and are pending before the court.

The PMs and the Settling States, including Louisiana, were previously involved in diligent enforcement proceedings (see Foti v. Philip Morris, et al., Suit No. 98-6473) regarding the manufacturers' responsibilities and the states' positions relative to the diligent enforcement efforts of individual states and a potential downward adjustment of the annual payment made to the states. Louisiana is currently in preparation for a multi-state arbitration of such matters with the Participating Manufacturers, before an arbitration panel, whereby Louisiana is prepared to show, if necessary, its efforts in the enforcement of R.S. 13:5061 et seq. The participating states and manufacturers are currently in the process of negotiations for the various procedures and decision-making for the aforementioned arbitration; therefore, the arbitration will likely not begin until early 2010.

The Corporation is also exposed to various risks of loss related to torts, theft of assets, and errors and omissions that could occur in the normal course of business. The Corporation retains the risk of loss in the event of any judgments against it. As of June 30, 2009, no known asserted or unasserted claims or judgments were 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, shall not be subject to any personal liability resulting from carrying out the powers and duties conferred on them pursuant to R.S. 39:99.5 and shall have the indemnification rights provided in R.S. 13:5108.1 with respect to such actions.

8. UNRESTRICTED NET ASSETS (DEFICIT)

The net assets deficit is a result of bonds payable and other liabilities exceeding recognized assets. The bonds are recognized as a liability, while the resources to repay the bonds, consisting of future TSRs are not recognized as assets until the underlying sales of tobacco products are known.

9. PRIOR PERIOD ADJUSTMENTS

For the years ended June 30, 2003-2008, the Corporation reported unamortized bond issue discount of approximately \$17 million to \$16 million as a deferred charge (asset) on the statement of net assets as part of unamortized bond issuance costs. Upon further consideration, it was determined that these costs would have been more appropriately classified as a reduction of bonds payable. The current year financial statements reflect this change in application of accounting principles.

For the years ended June 30, 2003-2008, net assets were reported under two classifications: net assets restricted for debt service and unrestricted net assets. The amount reported as restricted net assets for June 30, 2008, was \$180,029,758 and the amount reported as unrestricted net assets was negative \$973,561,716. Recent accounting guidance issued by the GASB provided clarity regarding issues of classification between the components of net assets that was needed due to a divergence of application of accounting principles. In applying that guidance, the amounts previously reported as restricted net assets should have been included in the calculation of unrestricted net assets. Thus, no amount would have been reported as restricted net assets and negative \$793,531,958 would have been reported as unrestricted net assets as of June 30, 2008.

These changes had no effect on total net assets or the changes in net assets in any of the previous years' financial statements. The current year financial statements reflect this change in application of accounting principles.

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SUPPLEMENTARY INFORMATION

SCHEDULE OF PER DIEM PAID TO BOARD MEMBERS

Schedule 1 presents the per diem paid board members for the year ended June 30, 2009. Louisiana Revised Statute 39:99.5 provides that appointed members of the board shall receive a per diem allowance to be established by the board in an amount not to exceed the amount of per diem authorized for members of the legislature for attendance at meetings of the corporation or committees thereof or for other official duties of the corporation or board. This schedule is prepared in compliance with House Concurrent Resolution No. 54 of the 1979 Session of the Louisiana Legislature.

**TOBACCO SETTLEMENT FINANCING CORPORATION
STATE OF LOUISIANA**

**Schedule of Per Diem Paid to Board Members
For the Year Ended June 30, 2009**

	<u>AMOUNT</u>
Anderson, James	\$50
Talbot, Byron	<u>50</u>
Total	<u><u>\$100</u></u>

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OTHER REPORT REQUIRED BY
GOVERNMENT AUDITING STANDARDS

The following pages contain a report on internal control over financial reporting and on compliance with laws and regulations and on other matters as required by *Government Auditing Standards*, issued by the Comptroller General of the United States. This report is based solely on the audit of the financial statements and includes, where appropriate, any significant deficiencies and/or material weaknesses in internal control, compliance, or other matters that would be material to the presented financial statements.



LOUISIANA LEGISLATIVE AUDITOR
DARYL G. PURPERA, CPA, CFE

November 13, 2009

Report on Internal Control Over Financial Reporting and on
Compliance and Other Matters Based on an Audit of the Financial Statements
Performed in Accordance With *Government Auditing Standards*

**TOBACCO SETTLEMENT FINANCING CORPORATION
STATE OF LOUISIANA**

Baton Rouge, Louisiana

We have audited the financial statements of the debt service fund and the governmental activities of the Tobacco Settlement Financing Corporation (Corporation), a blended component unit of the State of Louisiana, as of and for the year ended June 30, 2009, which collectively comprise the Corporation's basic financial statements and have issued our report thereon dated November 13, 2009. Our report was modified to include an explanatory paragraph on the change in reporting of unamortized bond issue discounts and restricted net assets. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the 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 control deficiency 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 significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Corporation's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the

Corporation's financial statements that is more than inconsequential will not be prevented or detected by the Corporation's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Corporation's internal control.

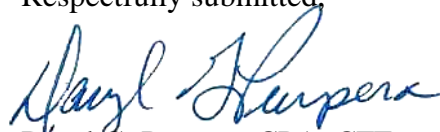
Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any 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, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Corporation, its board of directors and management, and the Louisiana Legislature and is not intended to be, and should not be, used by anyone other than these specified parties. Under Louisiana Revised Statute 24:513, this report is distributed by the Legislative Auditor as a public document.

Respectfully submitted,



Daryl G. Purpera, CPA, CFE
Temporary Legislative Auditor

BF:WDD:EFS:PEP:sr

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