# TOBACCO SETTLEMENT FINANCING CORPORATION STATE OF LOUISIANA

FINANCIAL STATEMENT AUDIT
ISSUED MARCH 18, 2009

**LEGISLATIVE AUDITOR**
**1600 NORTH THIRD STREET**
**POST OFFICE BOX 94397**
**BATON ROUGE, LOUISIANA 70804-9397**



Under the provisions of state law, this report is a public document. A copy of this report has been submitted to the Governor, to the Attorney General, and to other public officials as required by state law. A copy of this report has been made available for public inspection at the Baton Rouge office of the Legislative Auditor.

This document is produced by the Legislative Auditor, State of Louisiana, Post Office Box 94397, Baton Rouge, Louisiana 70804-9397 in accordance with Louisiana Revised Statute 24:513. Five copies of this public document were produced at an approximate cost of $16.90. This material was produced in accordance with the standards for state agencies established pursuant to R.S. 43:31. This report is available on the Legislative Auditor's Web site at www.lla.la.gov. When contacting the office, you may refer to Agency ID No. 7138 or Report ID No. 80080101 for additional information.

In compliance with the Americans With Disabilities Act, if you need special assistance relative to this document, or any documents of the Legislative Auditor, please contact Wayne "Skip" Irwin, Director of Administration, at 225-339-3800.

LOUISIANA LEGISLATIVE AUDITOR
**STEVE J. THERIOT, CPA**

February 9, 2009

Independent Auditor's Report
on the Financial Statements

**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, 2008, 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 examining, on a test basis, evidence supporting the amounts and disclosures in the basic financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall basic 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, 2008, 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.

During August and September of 2005, the State of Louisiana suffered considerable damage from two major hurricanes, Katrina and Rita, resulting in the President of the United States declaring Louisiana a major disaster area. Because of the severity of these two separate events and the resulting losses sustained, it is unknown exactly what economic impact recovery will have on state and local governmental operations in Louisiana. While the Corporation did not

1600 NORTH THIRD STREET • POST OFFICE BOX 94397 • BATON ROUGE, LOUISIANA 70804-9397
WWW.LLA.LA.GOV • PHONE: 225-339-3800 • FAX: 225-339-3870

directly suffer any major effects of these two hurricanes, the long-term effects of these events directly on the Corporation cannot be determined at this time.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 9, 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 read in conjunction with this report in considering 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 primarily 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.

Respectfully submitted,

Steve J. Theriot, CPA
Legislative Auditor

LDW:BDC:BQD:THC:sr

TSFC08

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, 2008, in comparison to that of the previous fiscal year. Please read it in conjunction with the financial statements, which follow this section.

## FINANCIAL HIGHLIGHTS

- The Corporation's net asset deficit decreased $40,829,709 (4.89%) to $793,531,958 as of June 30, 2008. This represents the net financial position of the Corporation on the full accrual basis of accounting. On the modified accrual basis, $131,334,609 of fund balance is available for debt service and operations.

- The revenues of the Corporation increased $4,417,823 (4.53%).

- The expenses of the Corporation decreased $1,845,672 (2.93%).

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) between 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, and 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 to the extent that the event occurs 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 2008 and 2007 are as follows:

**Statement of Net Assets**
**June 30, 2008 and 2007**

| | June 30, 2008 | June 30, 2007 |
|---|---|---|
| Current assets | $184,711 | $276,909 |
| Noncurrent assets | 205,092,668 | 208,174,076 |
| Total assets | 205,277,379 | 208,450,985 |
| | | |
| Current liabilities | 91,644,337 | 77,522,652 |
| Noncurent liabilities | 907,165,000 | 965,290,000 |
| Total liabilities | 998,809,337 | 1,042,812,652 |
| | | |
| Net assets - restricted for debt service | 180,029,758 | 182,188,908 |
| Net assets (deficit) - unrestricted | (973,561,716) | (1,016,550,575) |
| | | |
| Total net assets (deficit) | ($793,531,958) | ($834,361,667) |

**Statement of Activities**
**For the Years Ended June 30, 2008 and 2007**

| | June 30, 2008 | June 30, 2007 |
|---|---|---|
| Revenues | $102,001,018 | $97,583,195 |
| Expenses | (61,171,309) | (63,016,981) |
| | | |
| Increase in net assets | $40,829,709 | $34,566,214 |

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 all recognized as assets until the underlying sales of tobacco products are known.

Revenues of the Corporation increased by approximately 5%, a slight increase when compared to prior year's increase of 22%, which was 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 the Corporation 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. 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. 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, 2008, the Corporation has $991,680,000 in outstanding debt bonded which reflects principal bond payments of $43,540,000 during the year ended June 30, 2008, 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 this 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, 2008.

## 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.

This page is intentionally blank.

# TOBACCO SETTLEMENT FINANCING CORPORATION
# STATE OF LOUISIANA

## Governmental Fund Balance Sheet and Statement of Net Assets, June 30, 2008

| | DEBT SERVICE FUND | ADJUSTMENTS* | | STATEMENT OF NET ASSETS - GOVERNMENTAL ACTIVITIES |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Current Assets: | | | | |
| Cash (note 2) | $184,711 | | | $184,711 |
| Investments (note 3) | 131,020,826 | ($131,020,826) | (1) | |
| Interest receivable | 139,072 | (139,072) | (1) | |
| Total current assets | 131,344,609 | (131,159,898) | | 184,711 |
| Noncurrent Assets: | | | | |
| Unamortized bond issue cost | | 25,062,910 | (3) | 25,062,910 |
| Restricted assets: | | | | |
| Investments (note 3) | | 131,020,826 | (1) | 131,020,826 |
| Tobacco settlement receivable (note 6) | | 48,869,860 | (2) | 48,869,860 |
| Interest receivable | | 139,072 | (1) | 139,072 |
| Total noncurrent assets | NONE | 205,092,668 | | 205,092,668 |
| Total Assets | $131,344,609 | 73,932,770 | | 205,277,379 |
| **LIABILITIES** | | | | |
| Current Liabilities: | | | | |
| Fees payable | $10,000 | | | 10,000 |
| Accrued interest payable | | 7,119,337 | (3) | 7,119,337 |
| Bonds payable (note 4) | | 84,515,000 | (3) | 84,515,000 |
| Total current liabilities | 10,000 | 91,634,337 | | 91,644,337 |
| Noncurrent liabilities - bonds payable (note 4) | NONE | 907,165,000 | (3) | 907,165,000 |
| Total Liabilities | 10,000 | 998,799,337 | | 998,809,337 |
| **FUND BALANCE/NET ASSETS** | | | | |
| Fund balance - reserved for debt service | 131,334,609 | (131,334,609) | | NONE |
| Total Liabilities and Fund Balance | $131,344,609 | | | |
| Net Assets (Deficit): | | | | |
| Restricted for debt service (note 5) | | 180,029,758 | | 180,029,758 |
| Unrestricted (note 9) | | (973,561,716) | | (973,561,716) |
| Total Net Assets (Deficit) | | ($793,531,958) | | ($793,531,958) |

*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.

This page is intentionally blank.

# 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, 2008

| | DEBT SERVICE FUND | ADJUSTMENTS* | | STATEMENT OF ACTIVITIES - GOVERNMENTAL ACTIVITIES |
|---|---|---|---|---|
| **REVENUES** | | | | |
| Tobacco settlement revenues (note 6) | $96,375,746 | $65,047 | (1) | $96,440,793 |
| Investment income | 5,560,225 | | | 5,560,225 |
| Total revenues | 101,935,971 | 65,047 | | 102,001,018 |
| **EXPENDITURES/EXPENSES** | | | | |
| Bank fees | 88,933 | | | 88,933 |
| Professional services | 31,990 | | | 31,990 |
| Amortization of bond issue cost | | 690,030 | (2) | 690,030 |
| Debt service: | | | | |
| Principal retirement | 43,540,000 | (43,540,000) | (3) | |
| Interest and fiscal charges | 60,469,549 | (109,193) | (2) | 60,360,356 |
| Total expenditures/expenses | 104,130,472 | (42,959,163) | | 61,171,309 |
| **EXCESS (Deficiency) OF REVENUES OVER (Under) EXPENDITURES/EXPENSES** | (2,194,501) | 43,024,210 | | 40,829,709 |
| **FUND BALANCE/NET ASSETS (Deficit) AT BEGINNING OF YEAR** | 133,529,110 | (967,890,777) | | (834,361,667) |
| **FUND BALANCE/NET ASSETS (Deficit) AT END OF YEAR** | $131,334,609 | ($924,866,567) | | ($793,531,958) |

*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.

This page is intentionally blank.

**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 (Balance Sheet and Statement of Revenues, Expenditures, and Changes in Fund Balance) 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 as well as Financial Accounting Standards Board (FASB) statements and interpretations 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 are stated at amortized cost, which approximates fair value, in accordance with GASB Statement No. 31.

**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 DISCOUNTS AND ISSUANCE COSTS

Bond discounts and issuance costs are capitalized and amortized over the life 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 in the following components:

- Restricted net assets consist of external constraints placed on net asset use by creditors, grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.

- Unrestricted net assets are free of restrictions such as those listed above.

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

As described more fully in notes 4 and 6, 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 $48,869,860 (note 6).

## 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, 2008, the Corporation has cash (book balances) totaling $184,711, which is held in a demand deposit account, as presented on Statement A. Of this amount, $100,000 in deposits (collected bank balances) is secured from risk by federal deposit insurance. The remaining $84,711 is uninsured and uncollateralized. The Corporation does not have a formal policy for custodial credit risk for cash.

## 3. INVESTMENTS

At June 30, 2008, investments of $131,020,826, as presented on Statement A, consist of the following:

| Investment Type | Fair Value | *Credit Quality Rating | Percentage of Investments | Maturity - Less Than One Year |
|---|---|---|---|---|
| JPMorgan Federal Money Market | $26,585,262 | AAAm | 20.29% | $26,585,262 |
| Royal BK Scotland - Commercial Paper | 89,671,030 | A-1+ | 68.44% | 89,671,030 |
| Briarwood Commercial Paper Trust - Commercial Paper | 14,608,926 | A-1+ | 11.15% | 14,608,926 |
| General Electric Capt. Corp. Commercial Paper | 155,608 | A-1+ | 0.12% | 155,608 |
| Total investments | $131,020,826 | | 100.00% | $131,020,826 |

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

*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 $26,585,262 of money market mutual funds are not required to be classified as to category of custodial credit risk by GASB Codification Section I50.126 because their existence is not evidenced by securities that exist in physical or book entry form. The commercial paper investments totaling $104,435,564 in amortized cost are held by the counterparty in the Corporation's name. 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. 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 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.

*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., that guarantees an annual investment rate of return of 4.36% on the 2001-A Liquidity Reserve Requirement balance and has entered into an agreement with Bayerische Hypo-Und Vereinsbank AG, New York Branch that guarantees an annual investment rate of return of 4.63% on the 2001-B Liquidity Reserve Requirement balance.

## 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 | $71,885,000 |
| 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 | 689,405,000 |
| Total bonded debt | $991,680,000 |

The following is a summary of the debt obligation transactions for the year ended June 30, 2008:

| | Bonded Debt Payable at June 30, 2007 | Additions | Deductions | Bonded Debt Payable at June 30, 2008 |
|---|---|---|---|---|
| Tobacco Settlement Asset-Backed bonds: | | | | |
| Series 2001A (Taxable) due May 15, 2025 | $115,425,000 | | $43,540,000 | $71,885,000 |
| Series 2001B (Tax Exempt) due May 15, 2030 | 230,390,000 | | | 230,390,000 |
| Series 2001B (Tax Exempt) due May 15, 2039 | 689,405,000 | | | 689,405,000 |
| Total | $1,035,220,000 | NONE | $43,540,000 | $991,680,000 |

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 | 17,695,296 |
| Total bond proceeds | $1,202,770,000 |

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

| | Term Bond Maturities | | Sinking Fund Maturities | | Turbo Maturities | |
|---|---|---|---|---|---|---|
| Fiscal Year | Principal | Interest | Principal | Interest | Principal | Interest |
| 2009 | | $57,745,880 | | $57,745,880 | $84,515,000 | $57,745,880 |
| 2010 | | 57,745,880 | | 57,745,880 | 63,045,000 | 52,479,344 |
| 2011 | | 57,745,880 | | 57,745,880 | 68,170,000 | 49,011,869 |
| 2012 | | 57,745,880 | | 57,745,880 | 73,590,000 | 45,262,519 |
| 2013 | | 57,745,880 | | 57,745,880 | 79,360,000 | 41,215,069 |
| 2014-2018 | | 288,729,399 | | 288,729,399 | 497,110,000 | 128,683,944 |
| 2019-2023 | | 288,729,399 | $7,280,000 | 288,729,399 | 125,890,000 | 7,663,644 |
| 2024-2028 | $71,885,000 | 279,585,627 | 191,435,000 | 265,551,319 | | |
| 2029-2033 | 230,390,000 | 227,855,619 | 294,070,000 | 200,579,881 | | |
| 2034-2038 | | 202,512,719 | 413,720,000 | 99,787,756 | | |
| 2039-2043 | 689,405,000 | 40,502,544 | 85,175,000 | 5,004,031 | | |
| Total | $991,680,000 | $1,616,644,707 | $991,680,000 | $1,437,111,185 | $991,680,000 | $382,062,269 |

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. RESTRICTED NET ASSETS

Restricted net assets represent the assets restricted for debt service. The composition of restricted net assets is as follows:

| | |
|---|---|
| Investments | $131,020,826 |
| Tobacco settlement receivable (estimate) | 48,869,860 |
| Interest receivable | 139,072 |
| Net assets restricted for debt service | $180,029,758 |

## 6. TOBACCO SETTLEMENT REVENUES AND RECEIVABLE

Tobacco Settlement Revenues (TSRs) consist of the amounts to be received under the terms of an 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. One of the four OPMs has reduced its annual March payment due for the last three years in applying this adjustment. The Settling States have not agreed to this adjustment and are engaged in deliberations with the OPMs regarding this matter.

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.

## 7. 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.

## 8. 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 public entities. The lawsuits allege, among other things, that the MSA violates certain provisions of the United States 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 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 barring the PMs from collecting cigarette price increases related to the MSA and/or a determination that the MSA is void or unenforceable. In addition, class action lawsuits have been filed in several federal and state courts alleging that under the federal Medicaid law, any amount of tobacco settlement funds that the Settling States receive in excess of what they paid through the Medicaid program to treat tobacco-related diseases should be paid directly to Medicaid recipients. 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-05-1372 S) 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 a 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 federal constitution. The defendant filed a motion for summary judgment dismissing S & M Brands, Inc.'s claims for lack of standing in July 2008. The defendant then filed an opposition in early August. The motion is set for hearing in September without oral argument. The case is in the discovery stage and trial will likely begin in early 2009.

This is just the most recent in a string of constitutional challenges to the MSA and related statutes, every one of which has been rejected. See Star Scientific, Inc v. Beales, 278 F.3d 339 (4th Cir.), *cert. denied sub nom*. Star Scientific, Inc. v. Kilgore, 537 U.S. 818 (2002) (due process, equal protection, Commerce Clause, Compact Clause); Mariana v. Fisher, 226 F.Supp.2d 575 (M.D. Pa. 2002), *aff'd on other grounds*, 338 F.3d 189 (3d Cir. 2003), *cert. denied sub nom*. Mariana v. Pappert, 540 U.S. 1179 (2004) (Commerce Clause, Compact Clause); Grand River Enter. Six Nations Ltd. v. Pryor, 2003 WL 22232974 (S.D.N.Y. Sep. 29, 2003) (Commerce Clause, due process, equal protection, preemption, First Amendment), *vacated in part on other grounds*, 2004 WL 1594869 (S.D.N.Y. Jul. 15, 2004), *appeal pending* (2d Cir. No. 03-9179cv); Freedom Holdings, Inc. v. Spitzer, 357 F.3d 205 (2d Cir. 2004) (Commerce Clause); Forces Action Project, LLC v. State of California, No. C99-0607MJJ (N.D. Cal. Jan. 15, 2002), *aff'd*, 2003 WL 1900848 (9th Cir. Apr. 17, 2003) (No. 02-15336) (motion to amend complaint to add Commerce Clause claim denied on ground of futility); Xcaliber Int'l Ltd. v. Ieyoub, 377 F.Supp.2d 567 (E.D.La. 2005), *appeal pending* (5th Cir. No. 05-30323) (First Amendment, due process, equal protection, Commerce Clause); Xcaliber Int'l Ltd, LLC v. Edmondson, No. 04-CV-0922-CVE-PJC (N.D. Okla Apr. 5, 2005), *reconsideration denied* (Aug. 31, 2005) (First Amendment, due process, equal protection, Commerce Clause); North American Trading Co. v. National Ass'n of Attys Gen'l, Civ. Action No. 01-01600 (D.D.C. Sep. 18, 2001), *aff'd on other grounds*, No. 01-7173 (D.C. Cir. Nov. 25, 2002) (Commerce Clause); Star Scientific, Inc. v. Carter, 2001 WL 1112673 (S.D. Ind. Aug. 20, 2001) (Commerce Clause); PTI, Inc. v. Philip Morris Inc., 100 F. Supp.2d 1179 (C.D. Cal. 2000) (Compact Clause, Commerce Clause, equal protection); Hise v. Philip Morris, Inc., 46 F. Supp.2d 1201 (N.D. Okla. 1999), *aff'd mem*., 208 F.3d 226 (10th Cir.), *cert. denied*, 531 U.S. 959 (2000) (Compact Clause).

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 plaintiffs are seeking 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 plaintiffs allege they are harmed by the MSA and seek to have the MSA declared unconstitutional and an injunction issued against the enforcement of that amendment. This challenge is based on antitrust preemption and constitutional grounds. The case is still ongoing and in the discovery phase of the lawsuit. Trial will likely begin in early 2009.

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, 2008, 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.

## 9. 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.

## 10. SUBSEQUENT EVENTS

The Reserve Fund Agreement (Agreement), dated as of November 7, 2001, among the Tobacco Settlement Financing Corporation (the Issuer), The Bank of New York Mellon Trust Company, N.A., successor to Bank One Trust Company, N.A., as Trustee (in such capacity, the trustee) and Lehman Brothers Special Financing (LBSF) requires LBSF to deliver securities on specified dates equal to the principal amount invested plus the contracted interest earnings rate. In September 2008, Lehman Brothers filed for bankruptcy and its ability to deliver under the terms of the contract became a concern.

On November 17, 2008, the Chairman of the Issuer, Commissioner Angele Davis, asked the trustee to notify LBSF that the Issuer wishes to preserve all of its rights under the terms of the agreement. In the correspondence, the Issuer gave notice of the occurrence of Lehman Events of Default under the agreement, among other reasons, because Lehman failed to cause a Qualified Dealer to deliver Qualified Securities as required on or before November 14, 2008, in accordance with Section 2.4 of the Agreement. However, as a result of the Trustee bank holding Qualified Securities, the Issuer was paid in full for principal plus interest through November 14, 2008.

On November 21, 2008, the Corporation ratified the actions of the Chairman in a public meeting and gave further instructions to bid out the reinvestment of the reserve fund to provide for increased interest earnings for future periods. It is unclear at this time whether the Corporation will seek any further actions against LBSF regarding termination payments since the legal cost may exceed any projected earnings.

This page is intentionally blank.

## 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
**STEVE J. THERIOT, CPA**

February 9, 2009

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

**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, 2008, which collectively comprise the Corporation's basic financial statements and have issued our report thereon dated February 9, 2009. Our report was modified to include an emphasis of a matter regarding the impact of hurricanes Katrina and Rita. 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.

1600 NORTH THIRD STREET • POST OFFICE BOX 94397 • BATON ROUGE, LOUISIANA 70804-9397
WWW.LLA.LA.GOV • PHONE: 225-339-3800 • FAX: 225-339-3870

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 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,

Steve J. Theriot, CPA
Legislative Auditor

LDW:BDC:BQD:THC:sr

TSFC08