

Audited Financial Statements

**Tobacco Settlement Finance Authority
of West Virginia**

Year Ended June 30, 2011

**Gibbons
& Kawash**
Certified Public Accountants

TOBACCO SETTLEMENT FINANCE AUTHORITY
OF WEST VIRGINIA

Year Ended June 30, 2011

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INDEPENDENT AUDITOR'S REPORT

To the Members of the
Tobacco Settlement Finance Authority of West Virginia
Charleston, West Virginia

We have audited the accompanying financial statements of the governmental activities and the major fund of the Tobacco Settlement Finance Authority of West Virginia (the Authority), a component unit of the State of West Virginia, as of and for the year ended June 30, 2011, which collectively comprise the Authority's financial statements as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the governmental activities and the major fund of the Tobacco Settlement Finance Authority of West Virginia as of June 30, 2011, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 18, 2011, on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Authority has omitted Management's Discussion and Analysis that accounting principles generally accepted in the United States of America requires to be presented to supplement the financial statements. Such missing information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. Our opinion on the financial statements is not affected by this missing information.

J. Wilson & Kanash, A.C.

October 18, 2011

Tobacco Settlement Finance Authority

**Governmental Fund Balance Sheet/
Statement of Net Assets
June 30, 2011
(Expressed in Thousands)**

	Tobacco Settlement Finance Authority	Adjustments	Statement of Net Assets
Assets:			
Cash Equivalents	\$ 31,913	\$ —	\$ 31,913
Investments	71,181	—	71,181
Receivables, Net	36,105	—	36,105
Deferred Charge	666,820	—	666,820
Other Assets	<u>—</u>	<u>6,099</u>	<u>6,099</u>
Total Assets	<u>\$806,019</u>	<u>\$ 6,099</u>	<u>\$ 812,118</u>
Liabilities:			
Current:			
Deferred Revenue	\$ 36,101	\$ (36,101)	\$ —
Noncurrent:			
Revenue Bonds Payable	<u>—</u>	<u>887,962</u>	<u>887,962</u>
Total Liabilities	<u>36,101</u>	<u>851,861</u>	<u>887,962</u>
Fund Balances:			
Nonspendable	666,824	(666,824)	
Restricted for Debt Service	<u>103,094</u>	<u>(103,094)</u>	
Total Fund Balances	<u>769,918</u>	<u>(769,918)</u>	
Total Liabilities and Fund Balances	<u>\$806,019</u>		
Net Assets:			
Restricted for Debt Service		103,094	103,094
Unrestricted		<u>(178,938)</u>	<u>(178,938)</u>
		<u>\$ (75,844)</u>	<u>\$ (75,844)</u>

The accompanying notes are an integral part of the financial statements.

Tobacco Settlement Finance Authority

**Reconciliation of Governmental Fund
Balance Sheet to the Statement of Net Assets
June 30, 2011
(Expressed in Thousands)**

Total Fund Balance - Governmental Fund	\$ 769,918
Amounts reported in the statement of net assets differ from the governmental fund balance sheet because of the following:	
Long-term debt obligations are not due and payable in the current period and therefore are not reported in the governmental fund balance sheet.	(887,962)
Bonds issued have associated costs that are paid from current available financial resources in the fund. However, these costs are reported as other assets on the statement of net assets.	6,099
Intergovernmental revenues associated with the master settlement agreement are earned but not available and therefore are deferred in the fund.	<u>36,101</u>
Net Assets of Governmental Activities	<u>\$ (75,844)</u>

Tobacco Settlement Finance Authority

**Statement of Governmental Fund Revenues,
Expenditures, and Changes in Fund Balance -
Governmental Fund/Statement of Activities
For the Year Ended June 30, 2011
(Expressed in Thousands)**

	<u>Tobacco Settlement Finance Authority</u>	<u>Adjustments</u>	<u>Statement of Activities</u>
Revenues:			
Investment Earnings	\$ 3,931	\$ —	\$ 3,931
Intergovernmental	<u>62,451</u>	<u>(1,218)</u>	<u>61,233</u>
Total Revenues	<u>66,382</u>	<u>(1,218)</u>	<u>65,164</u>
Expenditures/Expenses:			
Current:			
General and Administrative	27	218	245
Interest Expense	—	67,204	67,204
Amortization of Deferred Charge	20,829	—	20,829
Debt Service:			
Principal	6,690	(6,690)	—
Interest	<u>59,925</u>	<u>(59,925)</u>	<u>—</u>
Total Expenditures/Expenses	<u>87,471</u>	<u>807</u>	<u>88,278</u>
Excess of Revenues Over (Under) Expenditures	<u>(21,089)</u>	<u>21,089</u>	<u>—</u>
Change in Net Assets		<u>(23,114)</u>	<u>(23,114)</u>
Fund Balance/Net Assets, Beginning of Year	<u>791,007</u>	<u>(843,737)</u>	<u>(52,730)</u>
Fund Balance/Net Assets, End of Year	<u>\$769,918</u>	<u>\$(845,762)</u>	<u>\$(75,844)</u>

The accompanying notes are an integral part of the financial statements.

Tobacco Settlement Finance Authority

**Reconciliation of the Statement of Revenues,
Expenditures, and Changes in Fund Balance -
Governmental Fund to the Statement of Activities
For the Fiscal Year Ended June 30, 2011
(Expressed in Thousands)**

Net Change in Fund Balance - Governmental Fund	\$(21,089)
Amounts reported in the statement of activities differ from the statement of governmental fund revenues, expenditures, and changes in fund balances because of the following:	
Amortization of other assets associated with long-term debt obligations do not affect current financial resources and are not reported in the governmental fund.	(7,497)
Repayment of long-term debt is reported as an expenditure in the governmental fund, but the repayment reduces long-term liabilities in the statement of net assets.	6,690
Revenues in the statement of activities that do not provide current financial resources are not reported as revenues in the fund. Unearned revenues increased by this amount this year.	<u>(1,218)</u>
Change in Net Assets of Governmental Activities	<u>\$(23,114)</u>

NOTE 1

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Reporting Entity

The Tobacco Settlement Finance Authority (TSFA) is a blended component unit of the State of West Virginia (the State) and is governed by a five-member board, including the Secretary of Administration, the Treasurer of the State, and three persons appointed by the Governor. The TSFA was created under the provisions of Chapter 4, Article 11A, Section 6 of the Code of West Virginia, 1931, as amended, to issue bonds related to the State's portion of the tobacco settlement revenue (TSR) from the Master Settlement Agreement (MSA) between tobacco manufacturers and the covered states. The TSFA is blended in the special revenue funds of the State, since its activities only benefit the State.

Basis of Presentation

The accompanying basic financial statements of the Tobacco Settlement Finance Authority conform to the United States generally accepted accounting principles (GAAP) for governments. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for governmental accounting and financial reporting.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Adjustments to estimates are recorded, as appropriate, in periods in which they are determined.

Government-wide and Fund Financial Statements

The TSFA's financial statements present the government-wide financial statements (statement of net assets and the statement of activities) and the fund financial statements (balance sheet and statement of revenues, expenditures, and changes in fund balance) in a combined format, which presents the fund financial statements with required adjustments as a separate column and the government-wide financial statements on the same set of statements.

In the government-wide column of the financial statements, the statement of net assets presents the TSFA's assets and liabilities, with the difference reported as net assets. Net assets are reported in two categories: 1) Restricted net assets result when constraints are placed on net asset use by external creditors, grantors, contributions, etc. or imposed by law through constitutional provisions or enabling legislation; and, 2) Unrestricted net assets consist of net assets which do not meet the definition of the preceding category.

The statement of activities demonstrates the degree to which the direct expenses of the program are offset by program revenues.

Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual bases of accounting. Revenues are recognized when they become both measurable and available. "Available" means expected to be collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period. For this purpose, revenues are primarily considered available if received in the first 60 days of the new fiscal year. The TSFA has implemented GASB Statement No. 48, "Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues". This statement establishes accounting and financial reporting standards for transactions in which a government receives, or is entitled to, resources in exchange for future cash flows generated by collecting specific receivables or specific future revenues. A receivable for the revenues is recognized based upon the annual estimated payment under the Master Settlement Agreement. At June 30, 2011, \$36.1 million of receivables has been recognized. Expenditures generally are recorded when the related liability is incurred, as under accrual accounting.

Actual revenues in the past five years have been approximately 87.9 percent of revenues projected by the Master Settlement Agreement. Deferred revenues and charges will be amortized until 2039, by applying the ratio of the bond proceeds (\$807 million) to the total estimated TSRs sold (\$2.372 billion). Therefore, deferred balances will be reduced by amounts that represent 34.02 percent of TSRs recognized.

Governmental Fund Types

Special Revenue Funds are used to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditures for specified purposes.

Assets and Liabilities

Cash Equivalents – Cash equivalents are short-term investments with original maturities of three months or less and are stated at fair value as determined by quoted market sources.

Long-term Liabilities – In the government-wide financial statements, long-term obligations are reported as liabilities. Bond premiums and discounts, as well as issuance costs, are deferred and amortized over the life of the bonds using the straight-line method, which approximates the effective-interest method. Bonds payable are reported net of the applicable bond discount. Bond issuance costs are reported as other assets and amortized over the term of the related debt.

In the fund financial statements, bond discounts, as well as bond issuance costs, are recognized during the period of issuance. Issuance costs, whether or not withheld from the actual debt proceeds received, are reported as debt service expenditures.

Net Assets/Fund Balance – The difference between fund assets and liabilities is “Net Assets” on the government-wide financial column, and “Fund Balance” on the governmental fund column.

Restricted Net Assets – Restrictions of net assets are the result of constraints placed on net asset use which have been imposed through debt covenants and by law through enabling legislation. When both general purpose and restricted funds are available for use, it is the policy to use restricted resources first.

Nonspendable Fund Balance – Includes amounts that cannot be spent because they are either (a) not in spendable form or (b) legally or contractually required to be maintained intact.

Restricted Fund Balance – Reported when constraints placed on the use of resources are either (a) externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or (b) imposed by law through constitutional provisions or enabling legislation.

NOTE 2

INVESTMENTS

(Expressed in Thousands)

The TSFA’s bond proceeds may be invested in any security or obligation approved by the board and specified in the trust indenture or resolution pursuant to which the bonds must be issued.

Interest Rate Risk

As of June 30, 2011 the TSFA had the following investments:

<u>Investment Type</u>	<u>Fair Value</u>	<u>Investment Maturities (in Years)</u>			
		<u>Less than 1</u>	<u>1-5</u>	<u>6-10</u>	<u>More than 10</u>
Repurchase Agreement	\$ 71,181	\$ —	\$—	\$—	\$71,181
Money Market	<u>31,913</u>	<u>31,913</u>	<u>—</u>	<u>—</u>	<u>—</u>
	<u>\$103,094</u>	<u>\$31,913</u>	<u>\$—</u>	<u>\$—</u>	<u>\$71,181</u>

Concentration of Credit Risk

As of June 30, 2011, the TSFA had investment balances with the following issuers which are greater than or equal to 5 percent of the investment balance:

<u>Security Type</u>	<u>Fair Value</u>	<u>Issuer</u>	<u>Percentage of Concentration</u>
Repurchase Agreement	\$71,181	DEPFA Bank, PLC	69.04%
Money Market	31,913	Wells Fargo Advantage Money Market Service	30.96%

The TSFA’s investment guidelines manage concentration of credit risk by limiting its investment activity to the following: non-callable, direct obligations of the United States, GNMA, FNMA, and FHLMC senior debt obligations rated “AAA” by S&P and “Aaa” by Moody’s all with a maturity of ten years or less. Investments in FNMA and FHLMC mortgage-backed securities and Collateralized Mortgage Obligations and Real Estate Mortgage Conduits and derivative securities are not permitted.

Acceptable collateral for the repurchase agreement is 100% for cash, 106% for U.S. Treasuries, and 108% for U.S. Agencies of the carrying value of the bonds that is held by the Authority’s custodian in the Authority’s name. As of June 30, 2011, the repurchase agreement is fully collateralized.

Credit Risk

The following table provides information on the credit ratings of the TSFA's third-party's trustee investments as of June 30, 2011:

<u>Security Type</u>	<u>Fair Value</u>	<u>Credit Rating</u>	
		<u>S&P</u>	<u>Moody's</u>
Repurchase Agreement	\$71,181	—	Aaa
Money Market	31,913	AAAm	Aaa

Reconciliation to Financial Statements

The following schedule reconciles the amount disclosed as deposits and investments included in this footnote to cash equivalents and investments in the Statement of Net Assets at June 30, 2011:

Deposits:

Cash Equivalents as Reported on the Statement of Net Assets	\$ 31,913
Less:	
Cash Equivalents Disclosed as Investments	<u>(31,913)</u>
Reported Value of Deposits as Disclosed in this Footnote	<u>\$ —</u>

Investments:

Investments as Reported on the Statement of Net Assets	\$ 71,181
Add:	
Cash Equivalents Disclosed as Investments	<u>31,913</u>
Reported Value of Investments as Disclosed in this Footnote	<u>\$103,094</u>

NOTE 3

REVENUE BONDS PAYABLE

(Expressed in thousands)

	<u>Balance</u> <u>June 30, 2010</u>	<u>Additions</u>	<u>Reduction</u>	<u>Balance</u> <u>June 30, 2011</u>	<u>Amount</u> <u>Due</u> <u>Within</u> <u>1 Year</u>
2007 Tobacco Settlement Finance Authority Interest Rate, 7.47-8.50, Maturing June 1, 2047	\$887,373	\$7,279	\$(6,690)	\$887,962	\$ —

The Taxable Tobacco Settlement Asset-Backed Bonds, Series 2007 were issued by the TSFA created by Chapter 4, Article 11A of the Code of West Virginia (the Code) on June 26, 2007. Pursuant to the Code, and a Purchase and Sale Agreement, dated June 1, 2007, by and between the TSFA and the State, the State sold to the TSFA its right, title, and interest in and to all tobacco settlement revenue that is received by the State, under the terms of the MSA entered into by participating tobacco product manufacturers, West Virginia, 45 other states, and six other U.S. jurisdictions in November 1998.

The Taxable Tobacco Settlement Asset-Backed Bonds, Series 2007 are comprised of two series of turbo term bonds, the Taxable Tobacco Settlement Asset-Backed Bonds, Series 2007A, which are current interest bonds in the original amount of \$845,810,000, and the Taxable Tobacco Settlement Asset-Backed Bonds, Series 2007B, which are capital appreciation bonds in the original amount of \$65,331,503. The Series 2007 Bonds are secured by and are payable solely from the right, title, and interest of the TSFA of 100% of the Tobacco Receipts, and investment earnings on the accounts with the trustee under the Indenture.

The tobacco receipts through 2039 are estimated to be approximately \$2.4 billion, using 85% (the percentage actually received 2005-2007) of the amount calculated by the National Governor's Association. Assuming a 5.2% interest rate, the net present value of the receipts is \$897 million.

Principal repayment of the Series 2007A bonds are required on June 1, 2047. Principal payments as disclosed are projected to be paid, as MSA revenues over required interest payments permit, under the turbo redemption provisions of the bonds.

Tobacco Settlement Finance Authority

Future amounts projected to pay principal payments and required interest payments on the Series 2007A revenue bonds at June 30, 2011, were as follows (expressed in thousands):

<u>Year Ended June 30</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2012	\$ 18,740	\$ 58,799	\$ 77,539
2013	20,495	57,334	77,829
2014	22,395	55,733	78,128
2015	24,435	53,984	78,419
2016	26,645	52,077	78,722
2017-2021	131,705	231,217	362,922
2022-2026	200,745	171,619	372,364
2027-2031	338,285	75,431	413,716
2032	<u>13,375</u>	<u>500</u>	<u>13,875</u>
Total Series 2007A	796,820	<u>\$756,694</u>	<u>\$1,553,514</u>

Future amounts required to pay principal and interest payments on the Series 2007B capital appreciation bonds at June 30, 2011, were as follows (expressed in thousands):

<u>Year Ended June 30</u>	<u>Principal Net of Accreted Amounts</u>	<u>Future Accreted Amounts</u>	<u>Total</u>
2012	\$ —	\$ 7,911	\$ 7,911
2013	—	8,598	8,598
2014	—	9,344	9,344
2015	—	10,155	10,155
2016	—	11,037	11,037
2017-2021	—	71,328	71,328
2022-2026	—	108,146	108,146
2027-2031	—	163,968	163,968
2032-2036	—	149,684	149,684
2037-2040	<u>91,143</u>	<u>31,748</u>	<u>122,891</u>
Total Series 2007B	<u>91,143</u>	<u>\$571,919</u>	<u>\$663,062</u>
Total Series 2007A and B Bonds	<u>\$887,963</u>		

NOTE 4

TRANSACTIONS WITH THE STATE OF WEST VIRGINIA

During the year ended June 30, 2011, the TSFA reports a deferred charge from the State's General Fund for the deferred revenue related to the sale of the MSA tobacco revenues of \$666,820,000.

The TSFA reported intergovernmental revenue from the State's General Fund for the FY 2011 MSA tobacco revenues of \$62,451,000. The amortization of the deferred charge of the future tobacco settlement revenue of the TSFA resulted in an \$20,829,000 reduction in the State's General Fund payable to the TSFA.

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

To the Members of the
Tobacco Settlement Finance Authority of West Virginia
Charleston, West Virginia

We have audited the financial statements of the governmental activities and the major fund of the Tobacco Settlement Finance Authority of West Virginia (the Authority) as of and for the year ended June 30, 2011, which collectively comprise the Authority's financial statements and have issued our report thereon dated October 18, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the Authority is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Authority'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 Authority's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Authority's internal control over financial reporting.

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

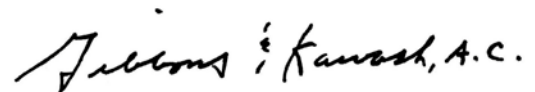
Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations,

contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management, the members of the Authority and the State of West Virginia and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink that reads "Jillson & Kanash, A.C." The signature is written in a cursive, flowing style.

October 18, 2011