

DISTRICT OF COLUMBIA OFFICE OF THE INSPECTOR GENERAL

OIG Project No. 23-1-17TT



January 31, 2024

TOBACCO SETTLEMENT FINANCING CORPORATION

**Financial Statements and Independent Auditor's Report
Fiscal Year Ended September 30, 2023**

GUIDING PRINCIPLES

ACCOUNTABILITY * INTEGRITY * PROFESSIONALISM

TRANSPARENCY * CONTINUOUS IMPROVEMENT * EXCELLENCE



OUR MISSION

We independently audit, inspect, and investigate matters pertaining to the District of Columbia government to

- prevent and detect corruption, mismanagement, waste, fraud, and abuse.
- promote economy, efficiency, effectiveness, and accountability.
- inform stakeholders about issues relating to District programs and operations; and
- recommend and track the implementation of corrective actions.

OUR VISION

Our vision is to be a world-class Office of the Inspector General that is customer-focused and sets the standard for oversight excellence!

OUR GUIDING PRINCIPLES

- Accountability
- Continuous Improvement
- Excellence
- Integrity
- Professionalism
- Transparency





DISTRICT OF COLUMBIA | OFFICE OF THE INSPECTOR GENERAL

January 31, 2024

The Honorable Muriel Bowser
Mayor of the District of Columbia
Mayor's Correspondence Unit
John A. Wilson Building
1350 Pennsylvania Avenue NW, Suite 316
Washington, DC 20004

The Honorable Phil Mendelson
Chairman
Council of the District of Columbia
John A. Wilson Building
1350 Pennsylvania Avenue NW, Suite 504
Washington, DC 20004

Subject: **TOBACCO SETTLEMENT FINANCING CORPORATION | 23-1-17TT**

Dear Mayor Bowser and Chairman Mendelson:

Enclosed is the final report entitled *Tobacco Settlement Financing Corporation Financial Statements and Independent Auditor's Report for Fiscal Year Ended September 30, 2023* (OIG No. 23-1-17TT). McConnell Jones, LLP (MJ) submitted this component report as part of our overall contract for the audit of the District of Columbia's general-purpose financial statements for fiscal year 2023. MJ is contractually required to review the work papers of Watson Rice, LLP (WR), which audited the financial statements of the Tobacco Settlement Financing Corporation to independently determine whether the financial statements are fairly presented.

On December 19, 2023, WR issued its opinion and concluded that the financial statements are presented fairly in all material respects, in accordance with accounting principles generally accepted in the United States of America. WR identified no material weaknesses in internal control over financial reporting. MJ concurred with WR's opinion and conclusions.

If you have questions about this report, please contact me or Eileen Shanklin-Andrus, Acting Assistant Inspector General for Audits, at (202) 727-2540.

Sincerely,



Daniel W. Lucas
Inspector General

DWL/ws

Enclosure

cc: See Distribution List

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The Honorable Brian L. Schwalb, Attorney General for the District of Columbia

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Mr. Jed Ross, Director and Chief Risk Officer, Office of Risk Management

Mr. Wayne McConnell, Managing Partner, McConnell & Jones LLP



District of Columbia
Tobacco Settlement Financing Corporation
Financial Statements and
Independent Auditor's Report

September 30, 2023



WatsonRice
Accountants & Advisors

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Washington, DC 20036 www.watsonrice.com

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
FINANCIAL STATEMENTS
SEPTEMBER 30, 2023**

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INDEPENDENT AUDITOR'S REPORT

To the Mayor and Members of
The Council of the Government of the District of Columbia, and
The Board of Directors of the District of Columbia Tobacco Settlement Financing Corporation

Report on the Financial Statements

Opinion

We have audited the accompanying financial statements of the District of Columbia Tobacco Settlement Financing Corporation ("TSFC"), a blended component unit of the Government of the District of Columbia, which comprise the balance sheet as of September 30, 2023, and the related statement of revenues, expenditures, and changes in fund balance for the year then ended and the related notes to the financial statements.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of TSFC as of September 30, 2023, and the changes in its financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS) and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of the TSFC and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Emphasis of Matter

As discussed in Note 1, the financial statements present only TSFC and do not purport to, and do not, present fairly the financial position of the Government of the District of Columbia as of September 30, 2023, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Responsibilities of Management for the Financial Statements

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

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the TSFC's ability to continue as a going concern for one year from the date of the financial statements, including any currently known information that may raise substantial doubt shortly thereafter.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS and *Government Auditing Standards* will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS and *Government Auditing Standards*, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the TSFC's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the TSFC's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management discussion and analysis on pages 4 through 8 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Report on Summarized Comparative Information

TSFC's financial statements as of and for the year ended September 30, 2022, were audited by us and we expressed an unmodified audit opinion in our report dated January 3, 2023. In our opinion, the summarized comparative information presented herein as of and for the year ended September 30, 2022, is consistent, in all material respects, with the audited financial statements from which it has been derived.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December 19, 2023, on our consideration of the TSFC's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering TSFC's internal control over financial reporting and compliance.

Washington, DC *Watson Rice LLP*
December 19, 2023

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT’S DISCUSSION AND ANALYSIS (UNAUDITED)
SEPTEMBER 30, 2023**

INTRODUCTION

The District of Columbia Tobacco Settlement Financing Corporation (“TSFC”) is a special purpose, independent instrumentality of the Government of the District of Columbia (the “District”) created by the Tobacco Settlement Financing Act of 2000 (the “Act”).

We are pleased to provide this overview and analysis of the financial activities of the TSFC for the fiscal year ended September 30, 2023. Please read it in conjunction with the financial statements and notes to the basic financial statements presented on pages 8 and 9.

This overview summarizes TSFC’s financial position as of September 30, 2023, and the results of its operations during the fiscal year, as reflected in the Statement of Revenues, Expenditures, and Changes in Fund Balance.

OVERVIEW OF REQUIRED BASIC FINANCIAL STATEMENTS

The TSFC basic financial statements are presented on the modified accrual basis of accounting.

Balance Sheet

This statement includes all assets and liabilities and provides information about its resources (assets) and obligations (liabilities). Assets and liabilities are presented in order of liquidity. The resulting fund balance presented in the statements is displayed as restricted and unassigned.

Statement of Revenues, Expenditures, and Changes in Fund Balance

The Statement of Revenues, Expenditures, and Changes in Fund Balance reports the revenues and expenditures of TSFC during the fiscal year and the change in TSFC’s fund balance. This statement measures the activities of TSFC’s operations and is used to identify TSFC’s debt service and operational costs.

FINANCIAL HIGHLIGHTS

Balance Sheet

The Balance Sheet reports the financial position of TSFC as of September 30, 2023. In accordance with the modified accrual basis of accounting for governmental funds, the Tobacco Settlement Revenues (TSRs) and Tobacco Settlement Asset-Backed Bond debt service payments are recorded only to the extent they are receivable or payable in the current period.

Assets

As of September 30, 2023, TSFC’s assets totaled \$75,465,330 consisting of \$49,171,712 in cash and cash equivalents, \$209,665 in interest receivable, \$26,069,953 in accrued tobacco settlement receivable and \$14,000 in prepaid expenses.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)
SEPTEMBER 30, 2023

Restricted cash and cash equivalents as of September 30, 2023 consist of \$48,565,009 in the following four accounts: the Debt Service Account, from which debt service payments on TSFC's outstanding bonds are paid; the Trapping Account, in which, under certain circumstances, TSRs in excess of amounts required for annual debt service payments are held (Note 5); the SRS Revenue Account, in which excess amounts are held related to the 2006 bond issuance costs (Note 5); the Debt Service Reserve fund in which funds are required to be held to cover debt service payment shortfalls.

As of September 30, 2023, unrestricted cash totaled \$606,703. The Collection Account, into which TSRs are initially deposited before being allocated to other designated accounts and the Operating Account, which is utilized for TSFC's ongoing operating expenses, are considered unrestricted cash and cash equivalent accounts.

Liabilities

TSFC's liabilities as of September 30, 2023, consisted of accrued operating expenses of \$160,736.

Fund Balance

TSFC's fund balance as of September 30, 2023, was \$75,304,594. Of this amount, the vast majority, \$74,858,627 was held in TSFC's trustee accounts and represents balances reserved for debt service and related purposes for TSFC's outstanding bonds. There was a surplus of \$445,967 in unassigned fund balance as of September 30, 2023. Unassigned fund balance represents funds in TSFC's operating and collection accounts that were not earmarked for payment of liabilities and were not mandated to be reserved for a specific purpose.

Statement of Revenues, Expenditures, and Changes in Fund Balance

Revenues

Revenues totaling \$41,383,159 for the year ended September 30, 2023, is primarily \$39,236,836 of TSRs and \$2,146,323 of interest income. TSRs are payments resulting from a purchase and sale agreement between the District and TSFC. In this agreement, TSFC purchased the right to receive such payments from the District based upon a Master Settlement Agreement ("MSA") entered into by certain cigarette manufacturers, the District, 46 states, and five other U.S. jurisdictions in November 1998 in settlement of certain smoking-related litigation. The amount of TSRs received each year pursuant to the MSA is calculated based on a formula in which a key variable is cigarette consumption in the United States of America. The TSRs for fiscal year 2023 totaled \$39,236,836 compared to \$48,083,796 in fiscal year 2022, a decrease of \$8,846,960 or 18.4%. The decrease was largely due to an adjusted Non-Participating Manufacturers ("NPM") settlement payment received in fiscal year 2022.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)
SEPTEMBER 30, 2023**

Expenditures

Expenditures consisted primarily of debt service payments, i.e., principal and interest payments on TSFC's outstanding bonds. TSFC issued \$521,105,000 and \$248,264,046 of Tobacco Settlement Asset-Backed Bonds (the "Tobacco Bonds") in March 2001 and August 2006, respectively. The 2001 Tobacco Bonds were issued to obtain funds to defease certain debt obligations of the District in exchange for TSFC obtaining the right to receive the annual TSRs. The exchange allowed the District to receive the benefit of future TSRs upfront. The 2006 Tobacco Bonds issuance was to further leverage future TSRs in exchange for an upfront benefit transferred to the District for use primarily on health-care related initiatives. Total debt service expenditures in fiscal year 2023 were \$41,763,575, which consisted of \$14,103,575 in interest expense and \$27,660,000 in principal repayment of the Tobacco Bonds.

General and administrative expenses include payment of current legal fees, trustee fees, rating agency fees, and other expenses totaling \$228,786 for the year ended September 30, 2023.

CONDENSED FINANCIAL INFORMATION

The following table presents the condensed balance sheets as of September 30, 2023, and 2022.

	<u>2023</u>	<u>2022</u>	<u>Variance</u>
Assets			
Total Assets	<u>\$ 75,465,330</u>	<u>\$ 75,913,946</u>	<u>\$ (448,616)</u>
Liabilities			
Current Liabilities	<u>160,736</u>	<u>150</u>	<u>160,586</u>
Total Liabilities	<u>160,736</u>	<u>150</u>	<u>160,586</u>
Fund Balance			
Unassigned	445,967	679,771	(233,804)
Restricted for Debt Service	<u>74,858,627</u>	<u>75,234,025</u>	<u>(375,398)</u>
Total Fund Balance	<u>75,304,594</u>	<u>75,913,796</u>	<u>(609,202)</u>
Total Liabilities and Fund Balance	<u>\$ 75,465,330</u>	<u>\$ 75,913,946</u>	<u>\$ (448,616)</u>

For fiscal year 2023, total fund balance decreased by \$609,202 or 0.8%. Assets decreased by \$448,616 or 0.6% from the prior fiscal year due to moderately lower tobacco settlement revenue receivables; current liabilities increased by \$160,586 or 107,057.33% from the prior fiscal year due to tax compliance resource wages, administrative expense and rental and vendor fees, and the timing of payments at the end of the fiscal year.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)
SEPTEMBER 30, 2023

The following table presents the condensed statements of revenues and expenditures for the years ended September 30, 2023 and 2022.

	<u>2023</u>	<u>2022</u>	<u>Variance</u>
Revenues			
Tobacco Settlement Revenue	\$ 39,236,836	\$ 48,083,796	\$ (8,846,960)
Investment Income	2,146,323	337,046	1,809,277
Total Revenues	<u>41,383,159</u>	<u>48,420,842</u>	<u>(7,037,683)</u>
Expenditures			
Interest Expense	14,103,575	16,028,550	(1,924,975)
Bond Principal Payment	27,660,000	29,615,000	(1,955,000)
General and Administrative Expenses	228,786	242,339	(13,553)
Total Expenditures	<u>41,992,361</u>	<u>45,885,889</u>	<u>(3,893,528)</u>
(Deficiency) Excess of Revenues over Expenditures	<u>\$ (609,202)</u>	<u>\$ 2,534,953</u>	<u>\$ (3,144,155)</u>

(a) Revenues Comparison

Total revenues in fiscal year 2023 decreased by \$7,037,683 or 14.5% as compared to fiscal year 2022. This is due to a decrease of \$8,846,960 or 18.4% in Tobacco Settlement Revenue, which was offset by an increase in interest income of \$1,809,277 or 536.8% due to several federal reserve rate hikes during the reporting period. Fiscal year 2022's payment included a settlement payment received from NPM for the period covering 2018-2022. No settlement payment was expected nor received in fiscal year 2023.

(b) Expenditures Comparison

Total expenditures in fiscal year 2023 decreased by \$3,893,528 or 8.5% as compared to fiscal year 2022. The decrease in expenditures was primarily due to decreases of \$1,955,000 in bond principal payment and \$1,924,975 in interest expense.

(c) (Deficiency) Excess of Revenues over Expenditures

Due to the fact that the debt service payments on the Tobacco Bonds are covered by a given year's TSRs that cross fiscal years and the variability in the amount of TSRs and investment earnings from year to year, there are likely to be relatively small operating surpluses or deficits from year to year, neither of which would indicate a fiscal concern or irregularity.

In fiscal year 2023, TSFC ended the year with moderately higher expenses over revenues of \$609,202 as compared to an excess of revenues over expenditures of \$2,534,953 in fiscal year 2022.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)
SEPTEMBER 30, 2023

Contacting TSFC

This report is intended to provide TSFC stakeholders with a general overview of the financial activities and position of TSFC. TSFC is functioning as it was designed to function, fulfilling its mission of being a vehicle for leveraging the TSRs through the issuance of the Tobacco Bonds; providing the District with upfront compensation representing the value of TSRs that it would have received in future years; affording the District the ability to shift (to Tobacco bondholders) most of the risk associated with the prospect of future non-payment of TSRs by tobacco manufacturers; servicing the Tobacco Bonds in accordance with the structure and requirements associated with the transaction; and providing the District with ongoing revenue from any annual residual TSRs from the tobacco manufacturers. Any questions or requests regarding this report should be directed to: District of Columbia Tobacco Settlement Financing Corporation, Attn: Assistant Treasurer, 1350 Pennsylvania Ave., N.W., Suite 200, Washington, D.C. 20004, or (202) 727-6055.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
BALANCE SHEET
SEPTEMBER 30, 2023
(With Comparative Totals for 2022)

	2023	2022
ASSETS		
Current Assets:		
Cash and Equivalents		
Unrestricted	\$ 606,703	\$ 679,921
Restricted:		
Debt Service Reserve	42,037,089	40,299,163
Debt Service	6,388,406	7,091,084
Trapping Account	74	71
SRS Revenue Account	139,440	133,675
Interest Receivable	209,665	91,080
Tobacco Settlement Revenue Receivable	26,069,953	27,604,952
Prepaid Expense	14,000	14,000
 Total Assets	 \$ 75,465,330	 \$ 75,913,946
LIABILITIES AND FUND BALANCE		
Current Liabilities:		
Accrued Expenditures	\$ 160,736	\$ 150
Total Liabilities	160,736	150
 Fund Balance:		
Unassigned	445,967	679,771
Restricted for Debt Service	74,858,627	75,234,025
Total Fund Balance	75,304,594	75,913,796
 Total Liabilities and Fund Balance	 \$ 75,465,330	 \$ 75,913,946

The accompanying notes are an integral part of these financial statements

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE
YEAR ENDED SEPTEMBER 30, 2023
(With Comparative Totals for 2022)

	2023	2022
Revenues		
Tobacco Settlement Revenue	\$ 39,236,836	\$ 48,083,796
Investment Income	2,146,323	337,046
Total Revenues	41,383,159	48,420,842
Expenditures		
Interest Expense	14,103,575	16,028,550
Bond Principal Payment	27,660,000	29,615,000
General and Administrative Expenses	228,786	242,339
Total Expenditures	41,992,361	45,885,889
 (Deficiency) Excess of Revenues Over Expenditures	(609,202)	2,534,953
Other Financing Sources		
Transfer in	-	-
 Fund Balance, Beginning	75,913,796	79,669,783
Fund Balance, Ending	\$ 75,304,594	\$ 82,204,736

The accompanying notes are an integral part of these financial statements

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2023

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

The District of Columbia Tobacco Settlement Financing Corporation (“TSFC”) is a special purpose, independent instrumentality of the Government of the District of Columbia (the “District”) created by the Tobacco Settlement Financing Act of 2000 (the “Act”). TSFC is governed by a five-person board of directors consisting of the Mayor of the District or designee, the Chairman of the Council of the District or designee, the Chief Financial Officer of the District and two private citizens. One citizen is appointed by the Mayor and one citizen is appointed by the Council. Although legally separate from the District, TSFC is a blended component unit of the District and, accordingly, is included in the District’s financial statements.

Pursuant to the Act, and a purchase and sale agreement dated as of February 1, 2001 between the District and TSFC, the District sold to TSFC on March 13, 2001, substantially all of its rights, title and interest in certain amounts paid or payable to the District under the Master Settlement Agreement (the “MSA”) entered into by participating cigarette manufacturers (“PCMs”), the District, forty-six (46) states and five (5) other U.S. jurisdictions in November 1998 in the settlement of certain smoking-related litigation. The sale included certain initial and annual payments already received by the District and the District’s right to receive future initial, annual, and strategic contribution fund payments (the “tobacco settlement revenues” or “TSRs”) to be made to the PCMs under the MSA.

TSFC financed the District’s rights, title and interest in the TSRs by issuing the Tobacco Settlement Asset-Backed Bonds (the “Tobacco Bonds”).

TSFC issued its first series of Tobacco Bonds in the amount of \$521,105,000 on March 13, 2001. In accordance with the aforementioned purchase and sale agreement, TSFC deposited the net proceeds of the Tobacco Bonds into irrevocable escrow accounts held by a trustee in TSFC’s name to defease certain obligations of the District.

Basis of Presentation

TSFC’s financial transactions are accounted for as a special revenue fund in the District’s financial statements. The accompanying financial statements present the financial results of only TSFC and do not purport to, and do not, present fairly the financial position of the District as of September 30, 2023 and the changes in its financial position for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis of Accounting

The accompanying financial statements are prepared on the modified accrual basis of accounting. Under this method, TSFC recognizes revenue when it becomes susceptible to accrual, which is when it becomes both measurable and available to finance expenditures in the current fiscal year. Expenditures are recognized when the related liability is incurred or, in the case of debt service, when payments are due.

Future tobacco settlement collections are contingent upon future tobacco product sales subject to various adjustments as outlined in the MSA.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 2023

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

TSFC recognizes revenue from tobacco settlement collections as the collections are received. In addition, an accrued receivable (Master Settlement Agreement receivable) is recorded at year end for estimated product sales occurring from January 1 to September 30 of each year.

Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires TSFC's management to use estimates and make assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the basic financial statements. The use of estimates may also affect the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates.

Cash Equivalents

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash with an original maturity of three (3) months or less.

Investments

TSFC follows the District's investment policy. Investments are limited to obligations of the United States and agencies, money market funds, municipal obligations, collateralized or insured certificates of deposit, prime commercial paper, bankers' acceptances and repurchase agreements fully collateralized in obligations of the United States government and agency securities.

Money market funds such as short-term, highly liquid debt instruments and participating interest earning investments, such as repurchase agreements that at the time of purchase were maturing in one year or less, are carried at amortized cost which approximates fair value. Other investments are stated at fair value.

Fund Balance

Governmental accounting standards establish fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed on the use of the resources reported in governmental funds.

- **Non-spendable:** Amounts that are not in spendable form or are legally or contractually required to be maintained intact.
- **Restricted:** Amounts that are legally restricted by outside parties, constitutional provisions, or enabling legislation for use for a specific purpose. Restricted fund balance is to be used for the purpose of paying future debt service and related expenses associated with the Tobacco Bonds.
- **Committed:** Amounts that have been formally set aside by the Council or TSFC Board of Directors for use for specific purposes. Commitments are made and can be rescinded only via resolution of the Council or TSFC Board of Directors.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 2023**

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

- **Assigned:** Amounts that are intended to be spent on specific purposes expressed by the governing body.
- **Unassigned:** Amounts that are available for any purpose. TSFC intends the amounts to be used for the subsequent fiscal years' operating expenses.

As of September 30, 2023, the TSFC had two fund balance classifications: unassigned and restricted.

NOTE 2 CASH AND INVESTMENTS

Cash and investments consist of bank deposits and cash equivalents such as money market funds which are permitted investments under the bond indenture.

Unrestricted :

Cash-FDIC insured	\$	603,780
Cash equivalents		<u>2,923</u>
Total unrestricted		<u>606,703</u>

Restricted for Debt Service:

Morgan Stanley Institutional Liquidity Funds		<u>48,565,009</u>
Total restricted		<u>48,565,009</u>

\$ 49,171,712

Amounts restricted for debt service are invested in money market funds and as of September 30, 2023, consist of \$6,527,920 which is maintained in the trapping, revenue and debt service accounts and \$42,037,089 which is maintained in the debt service reserve account.

Unrestricted funds as of September 30, 2022, was available to fund operating costs of the TSFC. The remaining funds are restricted for distribution in accordance with the Tobacco Bonds indenture.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. TSFC's investment was with one single issuer. However, TSFC routinely purchases and sells permitted investments with different issuers.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
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NOTE 2 CASH AND INVESTMENTS (CONTINUED)

Interest Rate Risk

Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment. An investment with a longer maturity will generally have greater sensitivity to fair value changes that are related to market interest rates. As a means to limiting its exposure to fair value losses resulting from rising interest rates, the TSFC investment policy limits the portfolio to maturities of less than one year.

Credit Risk

TSFC's policy requires that for investments in (a) commercial paper, the issuing corporation, or its guarantor have a short-term credit rating of not less than A-1 (or its equivalent) by at least two credit rating agencies; and (b) repurchase agreements, the counterparty has a long-term credit rating of AA or the equivalent, and does not have a negative outlook associated with such rating, has been in operation for at least five years, and is reputable among market participants.

Custodial Credit Risk

Custodial credit risk investments is the risk that, in the event a counterparty fails to uphold their agreement to a transaction, an entity would not be able to recover the value of its investment or collateral securities in the possession of an outside party. All of TSFC's investments are collateralized by securities held in TSFC's name by a custodial bank.

Reserve Requirements

Pursuant to the Tobacco Bonds offering, TSFC was required to establish a Debt Service Reserve Account to be held by the indenture trustee. The balance of the account must be maintained, to the extent available, at the lesser of (i) the initial deposit of \$40,111,100 or (ii) the principal amount of the Senior Bonds outstanding. The balance in this account as of September 30, 2023, was \$42,037,089 which included investment earnings on the required balance.

NOTE 3 FAIR VALUE MEASUREMENTS

TSFC categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles (GAAP) in accordance with Governmental Accounting Standards Board (GASB) Statement No. 72, *Fair Value Measurement and Application*. Statement No. 72 established a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of the asset or liability as of the measurement date. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

As of September 30, 2023, the Morgan Stanley Institutional Liquidity Funds of \$48.6 million held by the TSFC are measured at fair value and are within the Level 1 input category of the fair value hierarchy. These instruments are traded in an active market, with a transactional and market value net asset value.

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NOTE 4 ACCRUED TOBACCO SETTLEMENT RECEIVABLE

Tobacco settlement revenues represent a portion of future sales of tobacco products expected to be received in a calendar year. GASB Technical Bulletin 2004-1, “*Tobacco Settlement Recognition and Financial Reporting Issues*”, allows for the recognition of revenue to be based on the shipment of domestic cigarettes. TSFC has recognized an accrued receivable and revenue in the financial statements that is estimated to be 75% of the next projected payment due from the MSA. Accordingly, the balance sheet includes an estimated accrued tobacco settlement receivable of \$26,069,953 for fiscal year 2023.

NOTE 5 TOBACCO SETTLEMENT ASSET-BACKED BONDS

In November 1998, the District (along with a number of other States and various jurisdictions) signed a Master Settlement Agreement with the major U.S. tobacco companies that ended litigation over health care treatment costs incurred for smoking-related illnesses. Under the settlement, the District is scheduled to receive total annual payments aggregating an estimated \$1.2 billion by 2025. There are several potential adjustments to this schedule, including an inflation adjustment and cigarette volume adjustment.

In 2001, TSFC issued \$521,105,000 principal amount of its Tobacco Settlement Asset-Backed Bonds, Series 2001, of which \$182,105,000 was outstanding as of September 30, 2023.

In 2006, TSFC issued \$248,264,046 in principal amount of its Tobacco Settlement Asset-Backed Bonds, Series 2006. There were no payments made on these bonds during fiscal year 2023 and the amount of principal outstanding as of September 30, 2023, was \$248,264,046. The payment of these bonds is secured by the distributions under the MSA. Payments received by the TSFC under the MSA exceeding the annual debt service requirements for the Tobacco Bonds may revert to the District’s General Fund. There was no transfer of funds from Tobacco proceeds to the General Fund in fiscal 2023. The Tobacco Bonds are neither general nor moral obligations of the District and are not secured by a pledge of the full faith and credit of the District.

The 2006 Tobacco Bonds are subordinate to the 2001 Tobacco Bonds and are payable from payments received under the MSA more than the amount required to pay the debt service and other obligations associated with the 2001 Tobacco Bonds. The portion of the MSA payments due to the District is known as “Residual Interest”. Rights to such residual interest were sold by the District to TSFC in exchange for the proceeds of the 2006 Tobacco Bonds with certain conditions.

The proceeds of the 2006 Tobacco Bonds were transferred to the District by TSFC upon receipt, and the balance of such funds is an asset of the District and not TSFC. Because TSFC is an instrumentality of the District and is accounted for as a blended component unit, its debt is considered to be a component of the long-term debt of the District. However, since the Tobacco Bonds are revenue bonds payable solely from Tobacco Settlement Revenues and do not constitute a direct debt of the District, they are not a part of the District’s debt burden.

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NOTE 5 TOBACCO SETTLEMENT ASSET-BACKED BONDS (CONTINUED)

The District retains the rights to residual interest in excess of the amounts needed to retire the 2006 Tobacco Bonds. The proceeds of the 2006 Tobacco Bonds have been fully allocated and expended. A nominal balance allocated for the cost of issuance is being held in the SRS Revenue account pursuant to the 2006 Tobacco Bond Indenture.

At September 30, 2023, the following bonds were outstanding.

	Principal Balance at September 30, 2022	Issued	Principal Retired or Defeased	Principal Balance at September 30, 2023
Series 2001	\$ 209,765,000	\$ -	\$ 27,660,000	\$ 182,105,000
Series 2006	248,264,046	-	-	248,264,046
	<u>\$ 458,029,046</u>	<u>\$ -</u>	<u>\$ 27,660,000</u>	<u>\$ 430,369,046</u>

Debt service requirements for planned principal and interest payments, as of September 30, 2023, are as follows:

	Year Ending September 30	Maturities	Interest Due	Total Debt Service
Series 2001	2024	69,495,000	12,292,088	81,787,088
Series 2001	2025	34,145,000	7,601,175	41,746,175
Series 2001	2026	78,465,000	5,296,388	83,761,388
Series 2006	2046	159,732,846	1,697,592,154	1,857,325,000
Series 2006	2055	88,531,200	2,478,468,800	2,567,000,000
	Total	<u>\$ 430,369,046</u>	<u>\$ 4,201,250,605</u>	<u>\$ 4,631,619,651</u>

The principal payments shown above represent the principal amount that TSFC has covenanted to pay to the extent that there are sufficient available TSRs collected. Tobacco Bonds are revenue bonds payable solely from Tobacco Settlement Revenues and not a direct debt of the District nor a part of the District's debt burden. As such, the District is not responsible for payment of Tobacco bonds should revenues fall short of scheduled principal and interest payment amounts. When collected revenues are insufficient to cover principal payments in a given year, a partial payment and interest thereon is carried forward and added to outstanding principal for the next succeeding year. Principal payments in the out years are made to the extent revenue is sufficient to cover payments and revert to the method described herein whenever collected revenues are not sufficient to cover payments.

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NOTE 6 **CONCENTRATION OF CREDIT RISK**

TSFC's projected revenue is derived from an MSA entered into by certain cigarette manufacturers. Projected revenue to be recognized in future years may be subject to variability due to cigarette consumption levels and financial stability of some of the tobacco companies along with disputed claims filed by other tobacco manufacturers.

NOTE 7 **GENERAL AND ADMINISTRATIVE EXPENSES**

General and administrative expenses include legal fees, trustee and rating agency fees, shared services, and other expenses, which totaled \$228,786 for fiscal year 2023. Shared services costs totaled \$150,736 for fiscal year 2023. It covers \$150,236 for tax compliance personnel services performed by a District employee on behalf of TSFC and administrative support and space rental totaling \$500.

NOTE 8 **NPM ADJUSTMENT DISPUTE SETTLEMENTS**

During recent years, the District's Master Settlement Agreement ("MSA") payments have been reduced by amounts that the Participating Tobacco Product Manufacturers ("PMs") have withheld for expected NPM Adjustments. An NPM Adjustment is a potential percentage reduction applied against each year's MSA payment based on the combined national market share of NPMs. In December 2012, the District, Puerto Rico and seventeen (17) other signatory states to the entered into a settlement term sheet with the PMs to resolve any and all NPM Adjustment claims for MSA payment years 2004 through 2015.

Subsequently, seventeen (17) more states became signatories to the term sheet. In 2017, the term sheet was reduced to a formal written settlement agreement and NPM adjustment claims for 2016 and 2017 were settled. The 2018 - 2022 NPM Adjustment Settlement Agreement carries forward the terms of the 2016 - 2017 NPM Adjustment Settlement Agreement whereby the Settling States and Participating Tobacco Manufacturers agree to split the amount of the annual NPM Adjustment for years 2018 through 2022 using a 75/25 ratio with states receiving 75% and tobacco companies receiving 25%.

This resolves any potential liability the states, including the District, may have for an NPM Adjustment during those years, and provides for the immediate release of these funds to the states that would otherwise be sitting in a Disputed Payments Account until any NPM Adjustment disputes for 2018-2022 were resolved by arbitration many years in the future.

NOTE 9 **CONTINGENCIES**

TSFC's legal counsel asserts that there have been no material claims, suits, or complaints filed nor are any pending against the corporation. In the opinion of management, all other matters which are asserted or unasserted are without merit and would not have a significant effect on the financial position or changes in net assets if disposed of unfavorably.

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NOTE 10 SUBSEQUENT EVENTS

In preparing these financial statements, TSFC evaluated events and transactions for potential recognition through December 19, 2023, the date the financial statements were available to be issued. There were no additional events or transactions that were discovered during the evaluation that required further disclosure.

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 Mayor and Members of
The Council of the Government of the District of Columbia, and
The Board of Directors of the District of Columbia Tobacco Settlement Financing Corporation

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of District of Columbia Tobacco Settlement Financing Corporation (“TSFC”), as of and for the year ended September 30, 2023, and the related notes to the financial statements, which collectively comprise the TSFC’s basic financial statements, and have issued our report thereon dated December 19, 2023.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the TSFC’s internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the TSFC’s internal control. Accordingly, we do not express an opinion on the effectiveness of the TSFC’s internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the TSFC’s financial statements will not be prevented or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the TSFC 's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

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

This report is intended solely for the information and use of the Trustees and management and is not intended to be and should not be used by anyone other than these specified parties.

Washington, DC *Watson Rice LLP*
December 19, 2023

REPORT WASTE, FRAUD, ABUSE, AND MISMANAGEMENT.

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