

**GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE INSPECTOR GENERAL**

DISTRICT OF COLUMBIA

**TOBACCO SETTLEMENT
FINANCING CORPORATION**

**Financial Statements and
Independent Auditor's Report
Years Ended September 30, 2013, and 2012**



**BLANCHE L. BRUCE
INTERIM INSPECTOR GENERAL**

GOVERNMENT OF THE DISTRICT OF COLUMBIA
Office of the Inspector General

Inspector General



June 23, 2014

The Honorable Vincent C. Gray
Mayor of the District of Columbia
Mayor's Correspondence Unit, Suite 316
John A. Wilson Building
1350 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

The Honorable Phil Mendelson
Chairman
Council of the District of Columbia
John A. Wilson Building, Suite 504
1350 Pennsylvania Avenue, N.W.
Washington, D.C. 20004

Dear Mayor Gray and Chairman Mendelson:

As part of our contract for the audit of the District of Columbia's general purpose financial statements for fiscal year (FY) 2013, Bazilio Cobb Associates (BCA) submitted the enclosed final report on the Tobacco Settlement Financing Corporation (TSFC) Financial Statements and Independent Auditor's Report for the years ended September 30, 2013, and 2012 (OIG No. 14-1-16TT).

BCA opined that the financial statements present fairly, in all material respects, the financial position of TSFC for the years ended September 30, 2013, and 2012, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

If you have questions or need additional information, please contact Ronald W. King, Assistant Inspector General for Audits, at (202) 727-2540.

Sincerely,

A handwritten signature in blue ink, appearing to read "Blanche L. Bruce".

Blanche L. Bruce
Interim Inspector General

BLB/ws

Enclosure

cc: See Distribution List

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The Honorable Barbara Mikulski, Chairwoman, Senate Committee on Appropriations, Attention: Kali Matalon (via email)

The Honorable Richard Shelby, Ranking Member, Senate Committee on Appropriations, Attention: Dana Wade (via email)

The Honorable Tom Udall, Chairman, Senate Subcommittee on Financial Services and General Government, Attention: Marianne Upton (via email)

The Honorable Mike Johanns, Ranking Member, Senate Subcommittee on Financial Services and General Government, Attention: Dale Cabaniss (via email)

Mr. Paul Geraty, CPA, Public Sector Audit Division KPMG LLP (1 copy)



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

Years Ended September 30, 2013 and 2012



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**District of Columbia
Tobacco Settlement Financing Corporation**

Financial Statements and
Independent Auditor's Report

Years Ended September 30, 2013 and 2012

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
FINANCIAL STATEMENTS AND INDEPENDENT AUDITOR'S REPORT
YEARS ENDED SEPTEMBER 30, 2013 AND 2012**

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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

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 sheets as of September 30, 2013 and 2012, and the related statements of revenues, expenditures, and change in fund balance for the years then ended and the related notes to the financial statements.

Management’s Responsibility for the Financial Statements

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

Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of TSFC as of September 30, 2013 and 2012, and the changes in its financial position for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Other 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, 2013 and 2012, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Other Matter-*Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the management discussion and analysis on page 3 through 7 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.

Washington, D.C.
January 17, 2014

Bazilio Cobb Associates, P.C.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT’S DISCUSSION AND ANALYSIS
(Required Supplementary Information – Unaudited)**

INTRODUCTION

We are pleased to provide this overview and analysis of the financial activities of the District of Columbia Tobacco Settlement Financing Corporation (“TSFC”) for the fiscal years ended September 30, 2013 and 2012. Please read it in conjunction with the financial statements on pages 8 and 9.

This overview summarizes TSFC’s financial position as of September 30, 2013 and 2012, which incorporates the results of its operations over the course of the fiscal years, as reflected in the Statements of Revenues, Expenditures, and Changes in Fund Balance.

OVERVIEW OF REQUIRED BASIC FINANCIAL STATEMENTS

The basic financial statements report information about TSFC based upon the modified accrual basis of accounting method. These statements offer information about TSFC’s activities.

Balance Sheet

This statement includes all of TSFC’s assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to TSFC creditors (liabilities). The assets and liabilities are presented in order of liquidity. The resulting fund balance presented in these statements is displayed as reserved or unreserved.

Statement of Revenues, Expenditures, and Change in Fund Balance

The Statement of Revenues, Expenditures, and Change in Fund Balance reports the revenues and expenditures of TSFC during the fiscal year and the change in TSFC’s fund balance. All of the current year’s revenue and expenses are accounted for in the Statement of Revenues, Expenses and Changes in Fund Balance. This statement measures the activities of TSFC’s operations over the past year 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, 2013 and 2012. In accordance with the modified accrual basis of accounting for governmental funds, the Tobacco Settlement Revenues (“TSRs”) receivable in the future and the Tobacco Settlement Asset-Backed Bonds (“Tobacco Bonds”) are recorded only to the extent that they are receivable in the current period.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
(Required Supplementary Information – Unaudited)**

Assets

As of September 30, 2013, TSFC's assets totaled \$85,477,250, consisting of \$56,434,895 in cash/cash equivalents and investments, \$29,011,832 in accrued tobacco settlement revenue receivable, and \$123 in accrued interest. As of September 30, 2012, TSFC's assets totaled \$83,428,579, consisting of \$55,243,431 in cash/cash equivalents and investments, \$28,185,033 in accrued tobacco settlement revenue receivable, and \$115 in accrued interest receivables. Restricted cash and cash equivalents as of September 30, 2013 and 2012 consist of \$13,140,139 and \$14,052,924, respectively, in the following two accounts: the debt service account, from which debt service payments on the Tobacco Bonds are made, and the Trapping Account, in which, under certain circumstances, TSRs in excess of amounts needed for annual debt service payments are to be held (see Note 5 to the financial statements). The cash in the Collection Account, into which TSRs are initially deposited before allocation to another account, along with the cash in the Operating Account, which is used for ongoing operating expenses of the Corporation, is considered unrestricted. As of September 30, 2013 and 2012, unrestricted cash totaled \$2,045,597 and \$128,978, respectively. Restricted investments of \$ 41,249,159 and \$41,061,529 in the debt service reserve fund as of September 30, 2013 and 2012, respectively, represent funds required to be held to cover any shortfalls in the availability of funds to pay debt service on the Tobacco Bonds in the future.

Liabilities

TSFC liabilities as of September 30, 2013 and 2012 consisted of accrued operating expenses of \$207,147 and \$285,276, respectively.

Fund Balance

TSFC's fund balances as of September 30, 2013 and 2012 were \$85,270,103 and \$83,143,303, respectively. Of these amounts, the vast majority, \$83,431,653 and \$83,299,601 as of September 30, 2013 and 2012, respectively, were in TSFC accounts held by the Trustee and represent balances reserved for debt service and related purposes of the Tobacco Bonds. There was a surplus of \$2,126,800 and deficiency of \$156,298, respectively in unassigned fund balance as of September 30, 2013 and 2012. The surplus in 2013 resulted due to approximately \$20 million in additional tobacco settlement revenue received in 2013 from the settlement of NPM adjustment dispute (see Note 7 to the financial statements). Unassigned fund balance represents funds in the TSFC operating and collection accounts at year-end that were not earmarked for payment of the year-end accrued expenses and were not mandated to be reserved for a specific purpose.

Statement of Revenues, Expenditures, and Change in Fund Balance

Revenues

Revenues consisted primarily of TSRs, which are payments to the TSFC resulting from a purchase and sale agreement between the District and TSFC, through which the TSFC purchased

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
(Required Supplementary Information – Unaudited)**

from the District the right to receive such payments, and the Master Settlement Agreement (“MSA”) entered into by certain cigarette manufactures, 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. TSRs received by TSFC in fiscal years 2013 and 2012 totaled \$57,937,051 and \$38,324,749, respectively, taking into account the calculation of accrued TSRs in accordance with Government Accounting Standards Board (“GASB”) Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*. The increase is due to approximately \$20 million in additional payments received from the settlement of NPM adjustment dispute for the years 2004 through 2012. The other source of revenue was interest income and unrealized gain on investments totaling \$2,498,310 and \$2,284,258 on various funds held by TSFC during fiscal years 2013 and 2012, respectively.

Expenditures

Expenditures consisted primarily of debt service, 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 purpose of the issuance of 2001 Tobacco Bonds was to obtain funds to defease certain debt obligations of the District, in exchange for TSFC obtaining the right to receive the annual TSRs, allowing the District to receive the benefit of future TSRs upfront. The purpose of the issuance of the 2006 Tobacco Bonds was to further leverage future TSRs to receive an upfront benefit to be transferred to the District, primarily for use on health-care related initiatives. Total debt service expenditures in fiscal year 2013 amounted to \$57,862,678, and consisted of \$28,102,678 in interest expense and \$29,760,000 in principal repayment of the Tobacco Bonds. Total debt service expenditures in fiscal year 2012 were \$41,950,255, and consisted of \$28,880,255 in interest expense and \$13,070,000 in principal repayment of the Tobacco Bonds. General and administrative expenses totaled \$445,883 and \$416,340 for the years ended September 30, 2013 and 2012, respectively.

The general and administrative expenses included the payment of legal fees, trustee fees, rating agency fees, liability insurance premium, and other administrative expenses.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
(Required Supplementary Information – Unaudited)**

Condensed Financial Statements

	<u>2013</u>	<u>2012</u>	<u>2011</u>	Variance	
				<u>2013/2012</u>	<u>2012/2011</u>
Assets					
Cash, cash equivalents, and investments	\$ 56,434,895	\$ 55,243,431	\$ 56,809,275	\$ 1,191,464	\$ (1,565,844)
Tobacco settlement revenue receivable	29,011,832	28,185,033	28,192,179	\$ 826,799	\$ (7,146)
Interest receivable and prepaid expenses	30,523	115	128	\$ 30,408	\$ (13)
Total Assets	<u>85,477,250</u>	<u>83,428,579</u>	<u>85,001,582</u>	<u>2,048,671</u>	<u>(1,573,003)</u>
Liabilities					
Accrued Expenses	207,147	285,276	100,691	(78,129)	184,585
Total Liabilities	<u>207,147</u>	<u>285,276</u>	<u>100,691</u>	<u>(78,129)</u>	<u>184,585</u>
Fund Balance					
Unassigned	1,838,450	(156,298)	49,242	1,994,748	(205,540)
Restricted for Debt Service	83,431,653	83,299,601	84,851,649	132,052	(1,552,048)
Total Fund Balance	<u>85,270,103</u>	<u>83,143,303</u>	<u>84,900,891</u>	<u>2,126,800</u>	<u>(1,757,588)</u>
Total Liabilities and Fund Balance	<u>\$ 85,477,250</u>	<u>\$ 83,428,579</u>	<u>\$ 85,001,582</u>	<u>\$ 2,048,671</u>	

Assets increased by \$2,048,671 or 2% from September 30, 2012 to September 30, 2013, primarily due to the balance on Debt Collection Account and excess of revenues over expenditures for the fiscal year, as shown below.

The following table presents the statement of revenues and expenditures:

	<u>2013</u>	<u>2012</u>	<u>2011</u>	Variance	
				<u>2013/2012</u>	<u>2012/2011</u>
Revenues					
Tobacco Settlement Revenue	\$ 57,937,051	\$ 38,324,749	\$ 37,210,753	\$ 19,612,302	\$ 1,113,996
Investment and Other Income	2,498,310	2,284,258	2,325,783	214,052	(41,525)
Total Revenues	<u>\$ 60,435,361</u>	<u>\$ 40,609,007</u>	<u>\$ 39,536,536</u>	<u>19,826,354</u>	<u>1,072,471</u>
Expenditures					
Interest Expense	\$ 28,102,678	\$ 28,880,255	\$ 29,455,530	(777,577)	\$ (575,275)
Bond Principal Payment	29,760,000	13,070,000	9,490,000	16,690,000	3,580,000
General and Administrative Expenses	445,883	416,340	301,932	29,543	114,408
Total Expenditures	<u>\$ 58,308,561</u>	<u>\$ 42,366,595</u>	<u>\$ 39,247,462</u>	<u>\$ 15,941,966</u>	<u>\$ 3,119,133</u>
(Deficiency) Excess of Revenues over Expenditures	<u>\$ 2,126,800</u>	<u>\$ (1,757,588)</u>	<u>\$ 289,074</u>	<u>\$ 3,884,388</u>	<u>\$ (2,046,662)</u>

(a) Revenues Compared to Prior Year

Total revenues in fiscal year 2013 increased by \$19,612,302 or 51% as compared to fiscal year 2012. This was primarily due to approximately \$20 million in additional payments received in 2013 from settlement of NPM adjustment dispute. The amount of the TSRs received is based on the MSA and the cigarette consumption formula referenced above.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
(Required Supplementary Information – Unaudited)**

(b) Expenditures Compared to Prior Year

Total expenditures in fiscal year 2013 increased by \$15,941,966 or 38% as compared to fiscal year 2012. This was primarily due to higher principal payments of \$16,690,000 offset by lower interest payments of \$777,577 due to the reduction in the principal balance of outstanding bonds payable by TSFC resulting from prior years' principal payments made by TSFC.

(c) Excess of Revenues Over Expenditures

Due to the fact that the debt service payments on the Tobacco Bonds that are covered by a given year's TSRs cross fiscal years, and due to 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 problem or irregularity.

In fiscal year 2013, TSFC's operating results produced a surplus of \$2,126,800 compared to a deficiency of \$1,757,588 in fiscal year 2012. The operating surplus for 2013 resulted from \$20 million in additional payments received in 2013 from settlement of NPA adjustment dispute offset by additional \$17 million in additional bond principal payments made during the year.

Contact Information

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 was to receive 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 (see Note 3 to the financial statements). Any questions or requests regarding this report should be directed to: District of Columbia Tobacco Settlement Financing Corporation, 1350 Pennsylvania Ave., N.W., Suite 200, Washington, D.C. 20004, or (202) 727-6055.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
BALANCE SHEETS
SEPTEMBER 30, 2013 AND 2012**

	2013	2012
<u>ASSETS</u>		
Unrestcited cash and cash equivalents	\$ 2,045,597	\$ 128,978
Restricted cash and cash equivalents	13,140,139	14,052,924
Restricted investments	41,249,159	41,061,529
Interest Receivable	123	115
Tobacco Settlement Revenue Receivable	29,011,832	28,185,033
Prepaid Expense	30,400	-
Total Assets	\$ 85,477,250	\$ 83,428,579
<u>LIABILITIES AND FUND BALANCE</u>		
Accrued Expenses	\$ 207,147	\$ 285,276
Total Liabililites	207,147	285,276
Fund Balance:		
Unassigned	1,838,450	(156,298)
Restricted for Debt Service	83,431,653	83,299,601
Total Fund Balance	85,270,103	83,143,303
Total Liabilities and Fund Balance	\$ 85,477,250	\$ 83,428,579

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

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
STATEMENTS OF REVENUES, EXPENDITURES, AND CHANGE IN FUND BALANCE
FOR THE YEARS ENDED SEPTEMBER 30, 2013 AND 2012**

	<u>2013</u>	<u>2012</u>
Revenues		
Tobacco Settlement Revenue	\$ 57,937,051	\$ 38,324,749
Investment Income	2,482,272	2,284,258
Miscellaneous Income	16,038	-
Total Revenues	<u>60,435,361</u>	<u>40,609,007</u>
 Expenditures		
Interest Expense	28,102,678	28,880,255
Bond Principal Payment	29,760,000	13,070,000
General and Administrative Expenses	445,883	416,340
Total Expenditures	<u>58,308,561</u>	<u>42,366,595</u>
 Excess (Deficiency) of Revenues Over Expenditures	2,126,800	(1,757,588)
 Fund Balance, Beginning of the Year	<u>83,143,303</u>	<u>84,900,891</u>
 Fund Balance, End of Year	<u><u>\$ 85,270,103</u></u>	<u><u>\$ 83,143,303</u></u>

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, 2013 AND 2012**

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

The District of Columbia Tobacco Settlement Financing Corporation (“TSFC” or the “Corporation”) 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 his designee, the Chairman of the Council of the District or his designee, the Chief Financial Officer of the District and two private citizens, one of whom is appointed by the Mayor and the other 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 of Columbia’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 right, 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 states and five 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.

The purchase price of the District’s right, title and interest in the TSRs has been financed by the issuance by TSFC of 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 aforesaid 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 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, 2013 and

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2013 AND 2012**

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Basis of Presentation (Continued)

2012 and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America. The District provides certain legal, central accounting and other services to TSFC.

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. The TSFC recognizes revenue from tobacco settlement collections as the collections are received. In addition, an estimated receivable (Master Settlement Agreement receivable) is accrued 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 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 determining the reported amounts of revenues and expenses during the reporting period. The most significant estimate contained within the financial statements is that determined for the Tobacco Settlement Revenue Receivable in the amount of \$29,011,832 and \$28,185,033 as of September 30, 2013 and 2012, respectively. 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 and mature in such a short period of time that their values are effectively immune from changes in interest rates. Cash equivalents include short-term investments with an original maturity of three months or less.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2013 AND 2012**

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fund Balance

TSFC implemented GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund-type Definitions* during fiscal year 2011. This statement establishes 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. The fund balance classifications are described below.

- **Nonspendable:** 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 City Council or the Board of Directors for use for specific purposes. Commitments are made and can be rescinded only via resolution of the City Council or the Board of Directors.
- **Assigned:** Intent to spend resources 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.

Accounting Pronouncements-Adopted

During the year, TSFC adopted the following accounting pronouncements with no impact on its financial statements.

- GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Agreements* ("GASB 60"). GASB 60 was effective for financial statement periods beginning after December 15, 2011.
- GASB Statement No. 61, *The Financial Reporting Entity: Omnibus – An Amendment of GASB Statement No. 14 and No. 34* ("GASB 61"). GASB 61 was effective for financial statement periods beginning after June 15, 2012.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2013 AND 2012**

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Accounting Pronouncements-Adopted (Continued)

- GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 GASB and AICPA Pronouncements* (“GASB 62”). GASB 62 was effective for financial statement periods beginning after December 15, 2011.
- GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position* (“GASB 63”). GASB 63 was effective for financial statements for periods beginning after December 15, 2011.

NOTE 2: CASH AND CASH EQUIVALENTS

TSFC's cash and cash equivalents consist of bank deposits and money market funds. As of September 30, 2013 and 2012, total cash and cash equivalents are summarized as follows:

	2013	2012
Unrestricted:		
Cash-FDIC insured	\$ 155,805	\$ 128,978
Cash equivalents	1,889,792	-
Total unrestricted	2,045,597	128,978
 Restricted for Debt Service:		
Cash-FDIC insured	-	-
Cash equivalents	13,140,139	14,052,924
Total restricted	13,140,139	14,052,924
Total cash and cash equivalents	\$ 15,185,736	\$ 14,181,902

TSFC's cash and cash equivalents and investments consist of bank deposits and short-term, fixed-income investment instruments consistent with the permitted investments of the TSFC pursuant to the bond indenture held by TSFC's agent in TSFC's name. As of September 30, 2013, cash and cash equivalents consisted of \$155,805 cash balance in the operating account, \$1,889,792 and \$13,140,139 invested in money market mutual funds in debt collection account and debt service account respectively. As of September 30, 2012, cash and cash equivalents consisted of \$128,978 in operating cash and investments in money market funds totaling \$14,052,924, respectively. As of September 30, 2012, there

**DISTRICT OF COLUMBIA
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SEPTEMBER 30, 2013 AND 2012**

NOTE 2: CASH AND CASH EQUIVALENTS (Continued)

was no balance on the debt collection account. The cash balance in operating account as of September 30, 2013 and 2012 were available to fund operating costs of TSFC. The remaining funds were restricted for distribution in accordance with the Tobacco Bonds indenture.

NOTE 3 RESTRICTED INVESTMENTS

The investments, including cash equivalents, as of September 30, 2013 and 2012 are summarized as follows:

	2013	2012
Money Market Funds		
DEXIA Credit Local Commerical		
Paper Discount (Maturing within one year)	\$ 41,246,924	\$ -
Wells Fargo Advantage Government		
Money Market (Maturing within one year)	2,235	\$1,814
BANK OF CHINA/HONG KONG		
Commerical Paper Discount (Maturing within one year)	-	41,059,715
Total Restricted	\$ 41,249,159	\$ 41,061,529

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 balances in this account as of September 30, 2013 and 2012 were \$41,249,159 and \$41,061,529, respectively, which included investment earnings on the required balance. As of September 30, 2013 and 2012, respectively, TSFC had investments in commercial paper totaling \$41,249,159 and \$41,061,529 with maturities of less than one year.

Interest Rate Risk

TSFC's investments are all short-term (less than one year) based on the need to have the funds available for the purposes of the Corporation. Repurchase agreements, money market mutual funds, and corporate commercial paper are the investment instruments in which TSFC's funds are invested.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2013 AND 2012**

NOTE 3 RESTRICTED INVESTMENTS (Continued)

Because these investments are either able to be liquidated at cost value plus accrued interest or are invested to the maturity of the security, there is no risk of loss of any of the principal of TSFC's investments due to interest rate fluctuations.

Credit Risk

TSFC's repurchase agreements and money market funds are backed by U.S. Government and/or U.S. Government agency securities, and are thus virtually free of credit risk. Its commercial paper investments are required to be in securities rated in the highest commercial paper rating category by Moody's and Standard & Poor's rating agencies. There is obviously some credit risk associated with commercial paper investments, given the risk of failure of the issuer; however, this risk is minimized due to the requirement that TSFC's commercial paper investments be rated in the highest category.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event a counterparty fails to uphold their agreement to a transaction, the TSFC would not be able to recover the value of investment or collateral securities in the possession of an outside party. All of TSFC's investments are represented by securities held in TSFC's name by a custodial bank, and in its fiduciary duty and under its contractual relationship with TSFC, the custodian is required by law to either transfer possession of the securities or liquidate the securities and transfer the liquidated value of the securities of the TSFC in the event of circumstances that call for TSFC to obtain possession of its investments. As such, TSFC's custodial credit risk is minimal.

NOTE 4: 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 a number of potential adjustments to this schedule, including an inflation adjustment and cigarette volume adjustment. In addition, there are numerous risks regarding whether the District will receive the full amount to which it is entitled under the terms of the Master Settlement Agreement, including various lawsuits outside the District alleging that the Master Settlement Agreement is void or voidable.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2013 AND 2012**

NOTE 4: TOBACCO SETTLEMENT ASSET-BACKED BONDS (Continued)

At September 30, 2013 and 2012 the following Bond Principals were outstanding.

	Outstanding Principal Balance at September 30, 2011			Outstanding Principal Balance at September 30, 2012			Outstanding Principal Balance at September 30, 2013
	Issued	Principal Retired or Defeased	Issued	Principal Retired or Defeased	Issued	Principal Retired or Defeased	
Series 2001	\$ 442,025,000	\$ -	\$ 13,070,000	\$ 428,955,000	\$ -	\$ 29,760,000	\$ 399,195,000
Series 2006	248,264,046	-	-	248,264,046	-	-	248,264,046
	<u>\$ 690,289,046</u>	<u>\$ -</u>	<u>\$ 13,070,000</u>	<u>\$ 677,219,046</u>	<u>\$ -</u>	<u>\$ 29,760,000</u>	<u>\$ 647,459,046</u>

In 2001, the Tobacco Corporation issued \$521,105,000 principal amount of its Tobacco Settlement Asset-Backed Bonds, Series 2001, of which \$399,195,000 and \$428,955,000 were outstanding as of September 30, 2013 and 2012, respectively.

In 2006, the Tobacco Corporation issued \$248,264,046 principal amount of its Tobacco Settlement Asset-Backed Bonds, Series 2006. There were no payments made on these bonds during fiscal year 2012 and 2011 and the amount of principal outstanding as of September 30, 2013 and 2012 was \$248,264,046. The payment of these bonds is secured by the distributions under the Master Settlement Agreement. Payments received by the Tobacco Corporation under the Master Settlement Agreement in excess of 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 year 2013. 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 the portion of the payments to be received under the MSA in excess of the amounts 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 the Tobacco Corporation 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 the Tobacco Corporation upon receipt, and the balance of such funds is an asset of the District and not the Tobacco Corporation. Because the Tobacco Corporation 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

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
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NOTE 4: TOBACCO SETTLEMENT ASSET-BACKED BONDS (Continued)

Tobacco Settlement Revenues and do not constitute a direct debt of the District, they are not a part of the District's debt burden.

The District retains the rights to the 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.

As of September 30, 2013 and 2012, the total outstanding balance for all Tobacco Bonds was \$647,459,046 and \$677,219,046, respectively.

Debt service requirements for planned principal and interest payments, at September 30, 2013, are as follows:

<u>Year Ending September 30</u>	<u>Maturities</u>	<u>Interest Due</u>	<u>Total Debt Service</u>
2014	\$ 19,060,000	\$ 13,139,406	\$ 32,199,406
2015	18,980,000	12,559,456	31,539,456
2016	20,765,000	11,966,331	32,731,331
2017	22,740,000	11,297,100	34,037,100
2018	23,600,000	10,558,050	34,158,050
2019-2023	147,805,000	39,859,675	187,664,675
2024-2026	146,245,000	11,384,550	157,629,550
2046	159,732,846	1,697,592,154	1,857,325,000
2055	88,531,200	2,478,468,800	2,567,000,000
Total	<u>\$ 647,459,046</u>	<u>\$ 4,286,825,523</u>	<u>\$ 4,934,284,569</u>

The principal payments shown above represent the amount of the principal that TSFC has covenanted to pay to the extent that there are sufficient available TSRs collected. At September 30, 2013 and 2012, TSFC maintained its required debt service reserve account.

NOTE 5: TOBACCO SETTLEMENT REVENUES AND RECEIVABLE

Tobacco Settlement Revenues represent a portion of future sales of tobacco products. GASB Technical Bulletin No. 2004-1 clarified guidance relating to the recognition of revenues and receivables. Specifically, the bulletin allows for the recognition of revenue to be received based on the shipment of domestic cigarettes. The amount recognized is estimated to be 75% of the next projected

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TOBACCO SETTLEMENT FINANCING CORPORATION
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NOTE 5: TOBACCO SETTLEMENT REVENUES AND RECEIVABLE (Continued)

payment due from the MSA. Accordingly, the Statement of Revenues, Expenditures, and Changes in Fund Balance includes an estimated receivable of \$29,011,832.

NOTE 6: RESIDUAL INTEREST

As part of the purchase and sale agreement between the District and TSFC, the District obtained the “Residual Interest,” which is the right to receive from TSFC the portion of the payments received under the Master Settlement Agreement not required in each year to pay expenses, debt service, or reserves for the Tobacco Bonds. The Residual Interest is required to be transferred to the District. During fiscal year 2009, \$23,068,393 of Residual Interest was transferred to the District. There were no transfers during fiscal year 2013 or 2012.

The indenture pursuant to which the Tobacco Bonds were issued provides that in the event one of the four original participating tobacco manufacturers that is a party to the Master Settlement Agreement is rated below investment grade (defined as a “Trapping Event”), the Residual Interest shall be used to fund a special reserve account (the “Trapping Account”). As a result of downgrades of the credit rating of R.J. Reynolds Tobacco Holdings, Inc.’s senior unsecured debt to below investment grade in June and July of 2003, the Residual Interest for fiscal year 2004 and subsequent fiscal years was accordingly retained by the Corporation until the balance retained was equal to 25% of the principal amount of the Tobacco Bonds or until at least one year after R.J. Reynolds Tobacco Holdings, Inc.’s (RJR’s) ratings were restored to investment grade. RJR’s ratings were restored to investment grade in fiscal year 2008, and in June 2009, the Trapping Event ended, allowing the transfer of the accumulated Residual Interest of \$23,068,393 to the District.

NOTE 7: 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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TOBACCO SETTLEMENT FINANCING CORPORATION
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NOTE 8: NPM DISPUTE SETTLEMENT IN 2013

During recent years, the District's 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 Non-Participating Tobacco Product Manufacturers ("NPMs"). In December 2012, the District, Puerto Rico and seventeen other signatory States to the Master Settlement Agreement ("MSA") entered into a settlement term sheet with the PMs to resolve any and all NPM Adjustment claims for MSA payment years 2004 through 2015. In March 2013, the settlement was approved by an arbitration panel over the objections of certain non-settling States. As a result of the settlement, the District received approximately \$20 million in additional MSA revenue in 2013, representing its net settlement share of the potential NPM Adjustment amounts that the PMs had withheld from MSA payments due in 2004 through 2012. The settlement also caps the amounts that the PMs may withhold from future MSA payments based on potential NPM Adjustments. As a result, the settlement will likely increase the District's MSA payment revenue over the next several years

NOTE 9: CONCENTRATION IN CREDIT RISK

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

NOTE 10: GENERAL AND ADMINISTRATIVE EXPENSES

The general and administrative expenses include legal fees, trustee fees, rating agency fees, liability insurance premiums, DC Treasurer Office of Attorney General Attorney cost of \$160,000 for diligent enforcement compliance activities, and other administrative costs. The other administrative costs include central services costs of \$80,000 and DC Treasurer Office of Tax and Revenue Compliance Officer cost of \$85,000 which are part of the accrued expenses recorded in the current liabilities section of the financial statements and covers allocable personnel and other services performed by District employees on TSFC's behalf.

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NOTE 11: SUBSEQUENT EVENTS

In preparing these financial statements, TSFC evaluated events and transactions for potential recognition through January 17, 2013, 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.