GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE INSPECTOR GENERAL

DISTRICT OF COLUMBIA

TOBACCO SETTLEMENT FINANCING CORPORATION

Financial Statements and
Independent Auditors' Report
Years Ended September 30, 2012, and 2011

CHARLES J. WILLOUGHBY
INSPECTOR GENERAL

OIG No. OIG 13-1-23TT **April 5, 2013**

GOVERNMENT OF THE DISTRICT OF COLUMBIA
Office of the Inspector General

Inspector General

April 5, 2013

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) 2012, 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, 2012, and 2011 (OIG No. 13-1-12TT).

BCA opined that the financial statements present fairly, in all material respects, the financial position of TSFC for the years ended September 30, 2012, and 2011, and changes in its financial position for the years then ended in conformity with U.S. generally accepted accounting principles.

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

Sincerely,

Charles J. Willoughby
Charles J. Willoughby
Inspector General

CJW/ws

Enclosure

cc: See Distribution List

DISTRIBUTION:

Mr. Allen Y. Lew, City Administrator, District of Columbia (via email)
Mr. Victor L. Hoskins, Deputy Mayor for Planning and Economic Development, District of Columbia
The Honorable Kenyan McDuffie, Chairperson, Committee on Government Operations, Council of the District of Columbia (via email)
Mr. Brian Flowers, General Counsel to the Mayor (via email)
Mr. Christopher Murphy, Chief of Staff, Office of the Mayor (via email)
Ms. Janene Jackson, Director, Office of Policy and Legislative Affairs (via email)
Mr. Pedro Ribeiro, Director, Office of Communications, (via email)
Mr. Eric Goulet, Budget Director, Mayor's Office of Budget and Finance
Ms. Nyasha Smith, Secretary to the Council (1 copy and via email)
Mr. Irvin B. Nathan, Attorney General for the District of Columbia (via email)
Dr. Natwar M. Gandhi, Chief Financial Officer (1 copy and via email)
Mr. Mohamad Yusuff, Interim Executive Director, Office of Integrity and Oversight, Office of the Chief Financial Officer (via email)
Ms. Yolanda Branche, D.C. Auditor
Mr. Phillip Lattimore, Director and Chief Risk Officer, Office of Risk Management (via email)
Mr. Steve Sebastian, Managing Director, FMA, GAO, (via email)
The Honorable Eleanor Holmes Norton, D.C. Delegate, House of Representatives, Attention: Bradley Truding (via email)
The Honorable Darrell Issa, Chairman, House Committee on Oversight and Government Reform, Attention: Howie Denis (via email)
The Honorable Elijah Cummings, Ranking Member, House Committee on Oversight and Government Reform, Attention: Yvette Cravins (via email)
The Honorable Thomas Carper, Chairman, Senate Committee on Homeland Security and Governmental Affairs, Attention: Holly Idelson (via email)
The Honorable Tom Coburn, Ranking Member, Senate Committee on Homeland Security and Governmental Affairs, Attention: Katie Bailey (via email)
The Honorable Mark Begich, Chairman, Senate Subcommittee on Emergency Management, Intergovernmental Relations and the District of Columbia, Attention: Cory Turner (via email)
The Honorable Rand Paul, Ranking Member, Senate Subcommittee on Emergency Management, Intergovernmental Relations and the District of Columbia
The Honorable Harold Rogers, Chairman, House Committee on Appropriations, Attention: Amy Cushing (via email)
The Honorable Nita Lowey, Ranking Member, House Committee on Appropriations, Attention: Laura Hogshead (via email)
The Honorable Ander Crenshaw, Chairman, House Subcommittee on Financial Services and General Government, Attention: Amy Cushing (via email)
The Honorable José E. Serrano, Ranking Member, House Subcommittee on Financial Services and General Government, Attention: Laura Hogshead (via email)

The Honorable Barbara Mikulski, Chairwoman, Senate Committee on Appropriations, Attention: Ericka Rojas (via email)
The Honorable Richard Shelby, Ranking Member, Senate Committee on Appropriations, Attention: Dana Wade (via email)
The Honorable Frank Lautenberg, 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

September 30, 2012 and 2011

Bazilio Cobb Associates
Certified Public Accountants and Consultants
1920 N Street NW, Suite 800 Washington, DC 20036
t: (202) 737-3300 f: (202) 737-2684

District of Columbia Tobacco Settlement Financing Corporation

Financial Statements and
Independent Auditor's Report

September 30, 2012 and 2011

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
FINANCIAL STATEMENTS AND INDEPENDENT AUDITOR'S REPORT
SEPTEMBER 30, 2012 AND 2011

TABLE OF CONTENTS

PAGE

Bazilio Cobb Associates
Certified Public Accountants and Consultants
1920 N Street NW, Suite 800 Washington, DC 20036
t: (202) 737-3300 f: (202) 737-2684

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

We have audited the accompanying balance sheets of the District of Columbia Tobacco Settlement Financing Corporation ("TSFC"), a blended component unit of the Government of the District of Columbia, as of September 30, 2012 and 2011, and the related statements of revenues, expenditures, and change in fund balance for the years then ended. These financial statements are the responsibility of TSFC's management. Our responsibility is to express an opinion on the 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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, 2012 and 2011, 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of TSFC as of September 30, 2012 and 2011 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.

Accounting principles generally accepted in the United States of America require that the management discussion and analysis on pages 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 25, 2013

Bazilio Cobb Associates

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, 2012 and 2011. 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, 2012 and 2011, which incorporates the results of its operations over the course of the fiscal years, as reflected in the Statements of Revenues, Expenditures, and Change 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 Change 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, 2012 and 2011. 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.

Assets

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. As of September 30, 2011, TSFC's assets totaled

$85,001,582, consisting of $56,809,275 in cash/cash equivalents and investments, $28,192,179 in accrued tobacco settlement revenue receivable, and $128 in accrued interest receivables. Restricted cash and cash equivalents as of September 30, 2012 and 2011 consist of $14,052,924 and $15,574,747, 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 4 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, 2012 and 2011, unrestricted cash totaled $128,978 and $151,840, respectively. Restricted investments of $41,061,529 and $41,085,688 in the debt service reserve fund as of September 30, 2012 and 2011, 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, 2012 and 2011 consisted of accrued operating expenses of $285,276 and $100,691, respectively.

Fund Balance

TSFC's fund balances as of September 30, 2012 and 2011 were $83,143,303 and $84,900,891, respectively. Of these amounts, the vast majority, $83,299,601 and $84,851,649 as of September 30, 2012 and 2011, 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 deficiency of $156,298 in unassigned fund balance as of September 30, 2012 as total expenditures exceeded the total revenues. As of September 30, 2011, there was a relatively small unassigned fund balance of $49,242 that represents funds in the TSFC operating account 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.

<u>Statement of Revenues, Expenditures, and Change in Fund Balance</u>

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 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 2012 and 2011 totaled $38,324,749 and $37,210,753, 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 other source of revenue was interest income and unrealized gain on investments totaling $2,284,258 and $2,325,783 on various funds held by TSFC during fiscal years 2012 and 2011, 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 2012 amounted to $41,950,255, and consisted of $13,070,000 in interest expense and $28,880,255 in principal repayment of the Tobacco Bonds. Total debt service expenditures in fiscal year 2011 were $38,945,530, and consisted of $29,455,530 in interest expense and $9,490,000 in principal repayment of the Tobacco Bonds. General and administrative expenses totaled $416,340 and $301,932 for the years ended September 30, 2012 and 2011, respectively.

The general and administrative expenses included the payment of legal fees, trustee fees, rating agency fees, liability insurance premium, and other administrative expenses. The increase in general and administrative expenses in fiscal year 2012 were due to the cost of legal work related to the recently agreed upon legal settlement with the tobacco companies over Non-Participating Tobacco Product Manufacturers ("NPMs") Adjustments (see Note 5).

Condensed Financial Statements

	2012	2011	Variance
Assets			
Current Assets	$ 83,428,579	$ 85,001,582	$ (1,573,003)
Total Assets	83,428,579	85,001,582	(1,573,003)
Liabilities			
Current Liabilities	285,276	100,691	184,585
Total Liabilities	285,276	100,691	184,585
Fund Balance			
Unassigned	(156,298)	49,242	(205,540)
Restricted for Debt Service	83,299,601	84,851,649	(1,552,048)
Total Fund Balance	83,143,303	84,900,891	(1,757,588)
Total Liabilities and Fund Balance	$ 83,428,579	$ 85,001,582	$ (1,573,003)

Assets decreased by $1,573,003 or 1.85% from September 30, 2011 to September 30, 2012, primarily due to a decrease in restricted cash - debt service of $1,518,823 and excess of expenditures over revenue for the fiscal year, as shown below.

The following table presents the statement of revenues and expenditures:

	2012	2011	Variance
Revenues			
Tobacco Settlement Revenue	$ 38,324,749	$ 37,210,753	$ 1,113,996
Investment Income	2,284,258	2,325,783	(41,525)
Total Revenues	$ 40,609,007	$ 39,536,536	1,072,471
Expenditures			
Interest Expense	$ 28,880,255	$ 29,455,530	(575,275)
Bond Principal Payment	13,070,000	9,490,000	3,580,000
General and Administrative Expenses	416,340	301,932	114,408
Total Expenditures	$ 42,366,595	$ 39,247,462	$ 3,119,133
(Deficiency) Excess of Revenues over Expenditures	$ (1,757,588)	$ 289,074	

(a) Revenues Compared to Prior Year

Total revenues in fiscal year 2012 increased by $1,072,471 or 2.7% as compared to fiscal year 2011. This was primarily due to modest increases in the amount of TSRs received based on the MSA and the cigarette consumption formula referenced above.

(b) Expenditures Compared to Prior Year

Total expenditures in fiscal year 2012 increased by $3,119,133 or 7.95% as compared to fiscal year 2011. This was primarily due to higher principal payments of $3,580,000 offset by lower interest payments of $575,275 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 Expenditures Over Revenues

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 2012, TSFC's operating results produced a deficiency of $1,757,588 compared to a surplus of $289,074 in fiscal year 2011 due to higher principal payments.

Conclusion

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, 2012 AND 2011

	2012	2011
ASSETS		
Current Assets:		
Cash and Equivalents		
Unrestricted	$ 128,978	$ 151,840
Restricted:		
Debt Service Reserve	41,061,529	41,085,688
Debt Service	14,052,856	15,571,679
Trapping Account	68	68
Accrued Interest Receivable	115	128
Accrued Tobacco Settlement Revenue Receivable	28,185,033	28,192,179
Total Assets	$ 83,428,579	$ 85,001,582
LIABILITIES AND FUND BALANCE		
Current Liabilities:		
Accrued Expenses	$ 285,276	$ 100,691
Total Liabililites	285,276	100,691
Fund Balance:		
Unassigned	(156,298)	49,242
Restricted for Debt Service	83,299,601	84,851,649
Total Fund Balance	83,143,303	84,900,891
Total Liabilities and Fund Balance	$ 83,428,579	$ 85,001,582

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, 2012 AND 2011

	2012	2011
Revenues		
Tobacco Settlement Revenue	$ 38,324,749	$ 37,210,753
Investment Income	2,284,258	2,325,783
Total Revenues	40,609,007	39,536,536
Expenditures		
Interest Expense	28,880,255	29,455,530
Bond Principal Payment	13,070,000	9,490,000
General and Administrative Expenses	416,340	301,932
Total Expenditures	42,366,595	39,247,462
(Deficiency) Excess of Revenues Over Expenditures	(1,757,588)	289,074
Fund Balance, Beginning	84,900,891	84,611,817
Fund Balance, Ending	$ 83,143,303	$ 84,900,891

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

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 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, 2012 and 2011 and the changes in its financial position for the years then ended in

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Basis of Presentation (Continued)

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 $28,185,033 and $28,192,179 as of September 30, 2012 and 2011, 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.

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.

NOTE 2: CASH AND CASH EQUIVALENTS AND INVESTMENTS

Cash and Cash Equivalents

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, 2012, cash and cash equivalents consisted of investments in repurchase agreements totaling $128,978 and investments in money market mutual funds totaling $14,052,924. As of September 30, 2011, cash and cash equivalents consisted of investments in repurchase agreements totaling $151,840 and investments in money market mutual funds totaling

NOTE 2: CASH AND CASH EQUIVALENTS AND INVESTMENTS (Continued)

***Cash and Cash Equivalents* (Continued)**

$15,571,747, respectively. The investments in repurchase agreements as of September 30, 2012 and 2011 were available to fund operating costs of TSFC. The remaining funds were restricted for distribution in accordance with the Tobacco Bonds indenture.

Investments - Restricted Debt Service Reserve

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, 2012 and 2011 were $41,061,529 and $41,085,688, respectively, which included investment earnings on the required balance. As of September 30, 2012 and 2011, respectively, TSFC had investments in commercial paper totaling $41,061,529 and $41,085,688 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.

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.

NOTE 2: CASH AND CASH EQUIVALENTS AND INVESTMENTS (Continued)

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 3: 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.

In 2001, the Tobacco Corporation issued $521,105,000 principal amount of its Tobacco Settlement Asset-Backed Bonds, Series 2001, of which $428,955,000 and $442,025,000 were outstanding as of September 30, 2012 and 2011, 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, 2012 and 2011 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 2010.

NOTE 3: TOBACCO SETTLEMENT ASSET-BACKED BONDS (Continued)

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 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, 2012 and 2011, the total outstanding balance for all Tobacco Bonds was $677,219,046 and $690,289,046, respectively.

NOTE 3: TOBACCO SETTLEMENT ASSET-BACKED BONDS (Continued)

Debt service requirements for planned principal and interest payments, at September 30, 2012, are as follows:

Year Ending September 30	Maturites	Interest Due	Total Debt Service
2013	$ 29,760,000	$ 28,102,678	$ 57,862,678
2014	19,060,000	26,278,812	45,338,812
2015	18,980,000	25,118,913	44,098,913
2016	20,765,000	23,932,663	44,697,663
2017	22,740,000	22,594,200	45,334,200
2018	23,600,000	21,116,100	44,716,100
2019-2023	147,805,000	79,719,350	227,524,350
2024-2026	146,245,000	22,769,100	169,014,100
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	$ 677,219,046	$ 4,425,692,770	$ 5,102,911,816

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, 2012 and 2011, TSFC maintained its required debt service reserve account.

NOTE 4: 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 2012 or 2011.

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

NOTE 4: RESIDUAL INTEREST (Continued)

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 5: 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.

The District continues to engage in a national arbitration involving the Participating Manufacturers and the Settling States to determine whether each Settling State, including the District, "diligently enforced" its "Model Act" during calendar year 2003. Under the MSA, if the District did not diligently enforce its "Model Act" during the entire calendar year 2003, then the District would be subject to an "NPM Adjustment" that would reduce or eliminate its tobacco settlement payment for 2004, which was based on PM sales during 2003. However, as provided by the subsequent agreement that set up this national arbitration proceeding to resolve the diligent enforcement issue, the amount of any NPM Adjustment to the District's tobacco settlement payment for 2004 is to be reduced by 20 percent. The District's maximum potential exposure from this potential NPM Adjustment is now equal to 80 percent of its tobacco settlement payment for 2004 ($38,286,656). If there is any adjustment for 2004, it will have the effect of reducing or eliminating one or more of the District's future tobacco settlement payments. If, on the other hand, the District prevails in the diligent enforcement proceeding, it will be entitled to receive the unpaid balance of its tobacco settlement payment for 2004.

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 Participating Tobacco Product Manufacturers ("PMs") to resolve any and all claims by the PMs to NPM Adjustments for the years 2004 through 2015. An NPM Adjustment is a potential percentage reduction applied against each year's

NOTE 5: CONTINGENCIES (Continued)

MSA payment based on the combined national market share of Non-Participating Tobacco Product Manufacturers ("NPMs"). The settlement term sheet has been submitted for approval to an arbitration panel currently hearing a dispute over whether to apply an NPM Adjustment to the MSA payment made in April 2004. If the term sheet is approved by the arbitration panel and results in a settlement that survives any legal challenges to its effectiveness, the settlement will resolve the PMs' claims to recover all or part of the District's MSA payments in 2004 through 2015 due to an NPM Adjustment. The settlement will also cap 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 during the years immediately following the effective date of the settlement.

NOTE 6: 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 7: GENERAL AND ADMINISTRATIVE EXPENSES

The general and administrative expenses include legal fees, trustee fees, rating agency fees, liability insurance premiums 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.

NOTE 8: SUBSEQUENT EVENTS

In preparing these financial statements, TSFC evaluated events and transactions for potential recognition through January 25, 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.