

DISTRICT OF COLUMBIA OFFICE OF THE INSPECTOR GENERAL

OIG Project No. 21-1-09TT

January 2021



DISTRICT OF COLUMBIA TOBACCO SETTLEMENT FINANCING CORPORATION

**Financial Statements (and Independent Auditor's Report)
For Fiscal Years Ended September 30, 2020 and 2019**



Guiding Principles

*Workforce Engagement * Stakeholders Engagement * Process-oriented * Innovation
* Accountability * Professionalism * Objectivity and Independence * Communication * Collaboration
* Diversity * Measurement * Continuous Improvement*

Mission

Our mission is to independently audit, inspect, and investigate matters pertaining to the District of Columbia government in order 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.

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!

Core Values

Excellence * Integrity * Respect * Creativity * Ownership
* Transparency * Empowerment * Courage * Passion
* Leadership



GOVERNMENT OF THE DISTRICT OF COLUMBIA

Office of the Inspector General

Inspector General



January 29, 2021

The Honorable Muriel Bowser
Mayor of the District of Columbia
Mayor's Correspondence Unit
1350 Pennsylvania Avenue, N.W., Suite 316
Washington, D.C. 20004

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

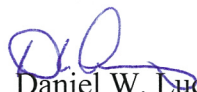
Dear Mayor Bowser and Chairman Mendelson:

Enclosed is the final report entitled *District of Columbia Tobacco Settlement Financing Corporation Financial Statements (and Independent Auditor's Report) for the Fiscal Years Ended September 30, 2020 and 2019* (OIG No. 21-1-09TT). BCA Watson Rice LLP (BCAWR) conducted the audit and 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 2020.

On January 6, 2021, BCAWR 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. BCAWR identified no material weaknesses in internal control over financial reporting.

If you have questions about this report, please contact me or Fekede Gindaba, 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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District of Columbia
Tobacco Settlement Financing Corporation
Financial Statements and
Independent Auditor's Report

September 30, 2020

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
FINANCIAL STATEMENTS
SEPTEMBER 30, 2020**

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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 sheet as of September 30, 2020, 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.

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 the financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free 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 TSFC'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 TSFC'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, 2020, 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.

Report on Summarized Comparative Information

TSFC's financial statements as of and for the year ended September 30, 2019 were audited by other auditors who expressed an unmodified audit opinion in their report dated January 8, 2020. In our opinion, the summarized comparative information presented herein as of and for the year ended September 30, 2020, is consistent, in all material respects, with the audited financial statements from which it has been derived.

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, 2020 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.

Other Matters

Required Supplementary Information

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.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated January 6, 2021 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, D.C. *BCA Watson Rre LLP*
January 6, 2021

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
SEPTEMBER 30, 2020**

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 year ended September 30, 2020. 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, 2020, 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 method.

Balance Sheet

This statement includes all of TSFC's assets and liabilities and provides information about its resources (assets) and obligations (liabilities). The 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 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. 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, 2020. 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 that they are receivable or payable in the current period.

Assets

As of September 30, 2020, TSFC's assets totaled \$77,136,429 consisting of \$51,125,323 in cash and cash equivalents, \$155 in interest receivable, \$25,992,806 in tobacco settlement revenue receivable, \$246 in other income receivable, and \$17,900 in prepaid expenses.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (*Continued*)
SEPTEMBER 30, 2020

Restricted cash and cash equivalents as of September 30, 2020 consist of \$50,324,880 in the following four accounts: the debt service account, from which debt service payments on the Tobacco 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) and the 2006 Revenue Account, in which excess amounts are held related to the 2006 bond issuance costs (Note 5) and the debt service reserve fund in which funds are required to be held to cover debt service payment shortfalls. The Collection Account, in which TSRs are initially deposited before allocation to other accounts as designated and the Operating Account, which is used for ongoing operating expenses of TSFC, are considered unrestricted cash.

As of September 30, 2020, unrestricted cash totaled \$800,443. Restricted cash equivalents of \$41,243,619 in the debt service reserve fund as of September 30, 2020 represents funds required to be held to cover any shortfalls in the availability of funds to pay debt service payments of the Tobacco Bonds in the future.

Liabilities

TSFC liabilities as of September 30, 2020 consisted of accrued operating expenses of \$1,600.

Fund Balance

TSFC's fund balance as of September 30, 2020 was \$77,134,829. Of this amount, the vast majority, \$76,334,141 as of September 30, 2020 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 \$800,688 in unassigned fund balance as of September 30, 2020. Unassigned fund balance represents other income receivables and funds in the TSFC operating and collection accounts 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 Changes 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 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. The TSRs for fiscal year 2020 totaled \$36,880,863. Other revenue includes other income totaling \$246 which represents the amount overbilled for the Tax Compliance Officer supporting the Tobacco Corporation and interest income and unrealized gains on investments totaling \$2,349,722.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS *(Continued)*
SEPTEMBER 30, 2020

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 the 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 2020 were \$41,658,550, which consisted of \$19,343,550 in interest expense and \$22,315,000 in principal repayment of the Tobacco Bonds.

The general and administrative expenses included payment of legal fees, trustee fees, rating agency fees, and other administrative expenses totaling \$234,156 for the year ended September 30, 2020.

CONDENSED FINANCIAL INFORMATION

The following table represents the condensed balance sheets as of September 30, 2020 and 2019.

	<u>2020</u>	<u>2019</u>	<u>Variance</u>
Assets			
Total Assets	<u>\$ 77,136,429</u>	<u>\$ 79,801,847</u>	<u>\$ (2,665,418)</u>
Liabilities			
Current Liabilities	<u>1,600</u>	<u>5,143</u>	<u>(3,543)</u>
Total Liabilities	<u>1,600</u>	<u>5,143</u>	<u>(3,543)</u>
Fund Balance			
Unassigned	800,688	688,550	112,138
Restricted for Debt Service	<u>76,334,141</u>	<u>79,108,154</u>	<u>(2,774,013)</u>
Total Fund Balance	<u>77,134,829</u>	<u>79,796,704</u>	<u>(2,661,875)</u>
Total Liabilities and Fund Balance	<u>\$ 77,136,429</u>	<u>\$ 79,801,847</u>	<u>\$ (2,665,418)</u>

For fiscal year 2020, total fund balance decreased by \$2,661,875. Assets decreased by \$2,665,418 or 3.3% from the prior fiscal year due to lower revenue collections that were partially offset by lower interest expense; liabilities decreased by \$3,543 or 69% from the prior fiscal year due to lower accrued expenses, as shown above.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS *(Continued)*
SEPTEMBER 30, 2020

The following table presents the condensed statements of revenues and expenditures for the year ended September 30, 2020 and 2019.

	<u>2020</u>	<u>2019</u>	Variance
Revenues			
Tobacco Settlement Revenue	\$ 36,880,863	\$ 37,668,899	\$ (788,036)
Investment Income	2,349,722	2,457,919	(108,197)
Other Income Receivable	246	-	246
Total Revenues	<u>39,230,831</u>	<u>40,126,818</u>	<u>(895,987)</u>
Expenditures			
Interest Expense	19,343,550	20,804,425	(1,460,875)
Bond Principal Payment	22,315,000	22,475,000	(160,000)
General and Administrative Expenses	234,156	211,945	22,211
Total Expenditures	<u>41,892,706</u>	<u>43,491,370</u>	<u>(1,598,664)</u>
Deficiency of Revenues Over Expenditures	(2,661,875)	(3,364,552)	702,677
Other Financing Sources			
Transfer in	<u>\$ -</u>	<u>\$ 129,507</u>	<u>\$ (129,507)</u>

(a) Revenues Comparison

Total revenues in fiscal year 2020 decreased by \$895,987 or 2% as compared to fiscal year 2019. The decrease resulted from a slight reduction in cigarette sales volume which resulted in a lower adjusted Non-Participating Tobacco Product Manufacturer ("NPM") payment than was received in fiscal year 2019. Consequently, the annual MSA payments from Participating Tobacco Product Manufacturers ("PM") were lower in 2020 as compared to 2019 TSRs under the MSA and the cigarette consumption formulas.

(b) Expenditures Comparison

Total expenditures in fiscal year 2020 decreased by \$1,598,664 or 4% as compared to fiscal year 2019. The overall decrease in 2020 was primarily due to lower interest expense.

(c) Excess (Deficiency) of Revenues over Expenditures

Due to the fact that the debt service payments on the Tobacco Bonds are covered by a given year 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 problem or irregularity.

In fiscal year 2020, TSFC's operating results produced a deficiency of revenues over expenditures of \$2,661,875 compared to a deficiency of revenues over expenditures of \$3,364,552 in fiscal year 2019. This is primarily due to lower revenue receipts as a result of reduced tobacco sales, reduced NPM withholdings and lower interest expense.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS *(Continued)*
SEPTEMBER 30, 2020

Contacting the District 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 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). Any questions or requests regarding this report should be directed to: District of Columbia Tobacco Settlement Financing Corporation, Attn: Vice President and 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, 2020
(With Comparative Totals for 2019)

	2020	2019
ASSETS		
Current Assets:		
Cash and Equivalents		
Unrestricted	\$ 800,443	\$ 693,693
Restricted:		
Debt Service Reserve	41,243,619	41,205,119
Debt Service	8,948,189	9,786,790
Trapping Account	70	70
SRS Revenue Account	133,002	132,082
Interest Receivable	155	17,443
Tobacco Settlement Revenue Receivable	25,992,806	27,948,750
Other Income Receivable	246	-
Prepaid Expenses	17,900	17,900
	\$ 77,136,429	\$ 79,801,847
LIABILITIES AND FUND BALANCE		
Current Liabilities:		
Accrued Expenses	\$ 1,600	\$ 5,143
Total Liabilities	1,600	5,143
Fund Balance:		
Unassigned	800,688	688,550
Restricted for Debt Service	76,334,141	79,108,154
Total Fund Balance	77,134,829	79,796,704
	\$ 77,136,429	\$ 79,801,847

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
FOR THE YEAR ENDED SEPTEMBER 30, 2020
(With Comparative Totals for 2019)

	2020	2019
Revenues		
Tobacco Settlement Revenue	\$ 36,880,863	\$ 37,668,899
Investment Income	2,349,722	2,457,919
Other Income Receivable	246	-
Total Revenues	39,230,831	40,126,818
Expenditures		
Interest Expense	19,343,550	20,804,425
Bond Principal Payment	22,315,000	22,475,000
General and Administrative Expenses	234,156	211,945
Total Expenditures	41,892,706	43,491,370
Deficiency of Revenues Over Expenditures	(2,661,875)	(3,364,552)
Other Financing Sources		
Transfer in	-	129,507
Fund Balance, Beginning	79,796,704	83,031,749
Fund Balance, Ending	\$ 77,134,829	\$ 79,796,704

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, 2020

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 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’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.

The purchase price of the District’s rights, 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 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, 2020 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. The 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.

DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2020

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

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. 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 instrument and participating interest earning investments, such as repurchase agreements that at the time of purchase of 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 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.

- **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:** 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.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2020**

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

At September 30, 2020, the TSFC had two fund balance classifications: unassigned and restricted.

NOTE 2 CASH AND CASH EQUIVALENTS

TSFC's cash and cash equivalents consist of unrestricted bank deposits and money market funds, as well as restricted short-term investments in US Treasury Bills and money market funds (see Note 3). As of September 30, 2020, total cash and cash equivalents are summarized as follows:

	2020
Unrestricted	
Cash	\$ 799,458
Money Market	985
Total unrestricted	800,443
 Restricted for Debt Service	
Money Market	10,026,089
US Treasury Bill	40,298,791
Total restricted	50,324,880
Total cash and cash equivalents	\$ 51,125,323

TSFC's cash and cash equivalents consist of cash, money market funds and treasuries which are in accordance with the permitted investments under the bond indenture. The cash and cash equivalents are collateralized by securities held by TSFC's agent in TSFC's name. As of September 30, 2020, cash and cash equivalents consisted of \$799,458 in the operating account and \$50,325,865 invested in money market funds in the collection, trapping, revenue, debt service reserve and debt service accounts.

The unrestricted cash and cash equivalents as of September 30, 2020 was available to fund operating costs of the TSFC. The remaining funds were restricted for distribution in accordance with the Tobacco Bonds indenture.

**DISTRICT OF COLUMBIA
TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2020**

NOTE 3 RESTRICTED SHORT-TERM INVESTMENTS

TSFC categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles (GAAP). GAAP 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. The three levels are defined as follows:

- Level 1 - Observable market inputs that are unadjusted quoted prices for identical assets or liabilities in active markets that a government can access at the measurement date.
- Level 2 - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly (for example, quoted prices for similar assets or liabilities in active markets).
- Level 3 - Unobservable inputs

TSFC's short-term investments are considered Level 1; measured at fair value as of September 30, 2020 are summarized as follows:

	2020
US Treasury Bill	\$ 40,298,791
Money Market Fund	944,828
Total Restricted	\$ 41,243,619

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, 2020 was \$41,243,619 which included investment earnings on the required balance.

Concentration of Credit Risk

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

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TOBACCO SETTLEMENT FINANCING CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
SEPTEMBER 30, 2020

NOTE 3 RESTRICTED SHORT-TERM INVESTMENTS (Continued)

Interest Rate Risk

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 policy requires that for investments in (a) commercial paper, the issuing corporation, or its guarantor have a short term 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 of an 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 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 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.

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 receivable of \$25,992,806 for fiscal year 2020.

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

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TOBACCO SETTLEMENT FINANCING CORPORATION
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NOTE 5 TOBACCO SETTLEMENT ASSET-BACKED BONDS (Continued)

At September 30, 2020 the following Bond Principals were outstanding.

	Outstanding Principal Balance at September 30, 2019	Issued	Principal Retired or Deceased		Outstanding Principal Balance at September 30, 2020
Series 2001	\$ 290,380,000	\$ -	\$ 22,315,000	\$	268,065,000
Series 2006	248,264,046	-	-		248,264,046
	<u>\$ 538,644,046</u>	<u>\$ -</u>	<u>\$ 22,315,000</u>		<u>\$ 516,329,046</u>

In 2001, TSFC issued \$521,105,000 principal amount of its Tobacco Settlement Asset-Backed Bonds, Series 2001, of which \$268,065,000 was outstanding as of September 30, 2020.

In 2006, TSFC 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 2020 and the amount of principal outstanding as of September 30, 2020 was \$248,264,046. The payment of these bonds is secured by the distributions under the Master Settlement Agreement. Payments received by the TSFC 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 2020. 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 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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TOBACCO SETTLEMENT FINANCING CORPORATION
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NOTE 5 TOBACCO SETTLEMENT ASSET-BACKED BONDS (Continued)

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. A nominal balance allocated for the cost of issuance is being held in the 2006 Revenue account pursuant to the 2006 Tobacco Bond Indenture.

As of September 30, 2020, the total outstanding balance for all Tobacco Bonds was \$516,329,046.

Debt service requirements for planned principal and interest payments, at September 30, 2020, are as follows:

<u>Series</u>	<u>Year Ending September 30</u>	<u>Maturities</u>	<u>Interest Due</u>	<u>Total Debt Service</u>
Series 2001	2021	58,370,000	17,893,075	76,263,075
Series 2001	2022-2026	209,695,000	48,914,850	258,609,850
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>\$ 516,329,046</u>	<u>\$ 4,242,868,879</u>	<u>\$ 4,759,197,925</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, 2020, TSFC maintained its required debt service reserve account.

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, trustee and rating agency fees, shared service and other ancillary costs, which totaled \$234,156 for fiscal year 2020. Shared service cost was \$144,391 for fiscal year 2020. It covers allocable tax compliance personnel services performed by District employees on TSFC's behalf of \$143,891 and space rental of \$500.

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NOTE 8 NPM ADJUSTMENT DISPUTE SETTLEMENTS

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 (17) 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. 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 essentially 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 each year 2018 through 2022 using a 75/25 ratio with the States receiving 75% and the Tobacco Companies receiving 25%. This resolves any potential liability the States, including DC, 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.

NOTE 10 SUBSEQUENT EVENTS

As result of the incidence of COVID-19, economic uncertainties may negatively impact the financial position and results of operations of TSFC. The duration of these uncertainties and the ultimate financial effects cannot be reasonably estimated at this time.

In preparing these financial statements, TSFC evaluated events and transactions for potential recognition through January 6, 2021, 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, 2020, and the related notes to the financial statements, which collectively comprise the TSFC’s basic financial statements, and have issued our report thereon dated January 6, 2021.

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, D.C. *BCA Watson Rre LLP*
January 6, 2021