VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

Unaudited Financial Statements

June 30, 2005

VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

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MANAGEMENT'S DISCUSSION AND ANALYSIS (Unaudited)

This section of the annual financial report of the Virginia Tobacco Settlement Financing Corporation ("the Corporation") presents an analysis of the Corporation's financial performance during the fiscal year that ended on June 30, 2005. This information should be considered in conjunction with the information contained in the financial statements, which follow this section.

Corporation Activities and Highlights

The Corporation is a public body corporate and an independent instrumentality of the state created by the Tobacco Settlement Financing Corporation Act, Chapters 482 and 488 of the 2002 Virginia Acts of the General Assembly (the "Act"). The Corporation is authorized under the Act to purchase up to fifty percent of the annual amount received by the Commonwealth of Virginia (the "Commonwealth") under the Master Settlement Agreement (MSA) between cigarette manufacturers and 46 states and other United States jurisdictions (the "Tobacco Assets").

On May 16, 2005, the Corporation issued $448,260,000 of its Tobacco Settlement Asset-Backed Bonds, Series 2005 (the "Bonds") to finance the purchase the Commonwealth's future right, title and interest to twenty-five percent of the Commonwealth's allocation under the MSA. The Bonds are secured solely by those future payments. These financial statements reflect the Corporation's financial activity from the date of issuance of the Bonds through the end of the fiscal year on June 30, 2005.

Overview of the Financial Statements

This discussion and analysis is an introduction to the Authority's basic financial statements, which are comprised of two components: 1) combined government-wide and fund financial statements and 2) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements.

Government-wide Financial Statements

The Statement of Net Assets and the Statement of Activities are two basic financial statements that report information about the Corporation as a whole. These statements are prepared using the economic resources measurement focus and the accrual basis of accounting, similar to the accounting used by most private-sector companies. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of the related cash flows. The Statement of Net Assets presents all of the Authority's assets and liabilities, with the difference between the two reported as "net assets." Over time, increases and decreases in net assets measure whether the Authority's financial position is improving or deteriorating.

The Statement of Activities presents information showing how the Authority's net assets changed during the most recent fiscal year. Changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods.

Fund Financial Statements

The fund financial statements provide detailed information about the Corporation as a debt service fund. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the Authority uses to keep track of specific sources of funding and spending for a particular purpose.

All of the Authority's activity is reported in Governmental Funds Financial Statements. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental funds financial statements focus on near-term inflows and outflows of spendable resources. This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. These statements provide a detailed short-term view of the Corporation's finances that assists in determining whether there will be adequate financial resources available to meet the current needs of the Corporation.

The focus of the governmental fund financial statements is narrower than that of the government-wide financial statements. Therefore it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and the governmental activities. These reconciliations are presented in the adjustment column in each of the financial statements.

Notes to the Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and the fund financial statements.

Government-wide Financial Analysis of the Authority

The Corporation was formed to purchase Tobacco Assets from the Commonwealth. The purchase was financed with the issuance of bonds. The Department of the Treasury provides staff support for the Corporation. Operating costs of the Corporation were initially funded with bond proceeds and will be funded in future years from corporation investment income. Current assets of the Corporation are bond proceeds held to pay costs of issuance on the Bonds and to pay operating costs of the Corporation over the next year. Noncurrent assets are primarily bond proceeds held in the capitalized interest and liquidity reserved accounts and restricted to the payment of debt service on the Bonds. The Corporation owns no capital assets.

Virginia Tobacco Settlement Financing Corporation's Net Assets
(in thousands)

	2005
Current assets	$ 347
Noncurrent assets	58,899
Total assets	59,246
Current liabilities	3,137
Noncurrent liabilities	448,260
Total liabilities	451,397
Net assets:	
Restricted	45,771
Unrestricted	(437,921)
Total net assets	$ (392,150)

Virginia Tobacco Settlement Corporation's Changes in Net Assets
(in thousands)

	2005
Revenues	$ 704
Expenditures	392,854
Decrease in net assets	(392,150)
Net assets July 1	-
Net assets June 30	$ (392,150)

Revenues for the year are comprised on interest on investments and net increases in the value of investments. Expenditures include the payment of $389.8 million to the Commonwealth for the purchase of 25% of the Commonwealth’s Tobacco Assets.

Financial Analysis of the Corporation’s Funds

As noted above, this is the first year of Corporation activity, and all balances relate to the issuance of the Series 2005 Bonds.

Debt Administration

As a financing entity, the whole business of the Corporation is debt administration. The Corporation issued Bonds to purchase Tobacco Assets from the Commonwealth. The Bonds are secured solely by twenty-five percent of future tobacco settlement revenues allocated to the Commonwealth and investment earnings. As of June 30, 2005, there were no plans for the Corporation to issue additional debt. The table below summarizes bond issuance activity during the year.

Summary of Corporation Bond Obligations
(in millions)

	Tobacco Settlement Asset-Backed Bonds, Series 2005
Outstanding, 7/1/04	$ -
Issued during year	448
Retired during year	-
Defeased during year	-
Outstanding, 6/30/05	$ 448

VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

Governmental Fund Balance Sheet and Statement of Net Assets, June 30, 2005

	DEBT SERVICE FUND	ADJUSTMENTS (NOTE 1-C)	STATEMENT OF NET ASSETS - GOVERNMENTAL ACTIVITIES
ASSETS			
Current Assets:			
Cash (note 2)	$ 347,468		$ 347,468
Investments (note 3)	45,769,790	$ (45,769,790)	-
Receivable	870	(870)	-
Total current assets	46,118,128	(45,770,660)	347,468
Noncurrent Assets:			
Unamortized bond issue cost		13,128,764	13,128,764
Restricted assets:			-
Investments (note 3)		45,769,790	45,769,790
Interest receivable		870	870
Total noncurrent assets	NONE	58,899,424	58,899,424
Total Assets	46,118,128	13,128,764	59,246,892
LIABILITIES			
Current Liabilities:			
Accrued expenses payable	13,200		13,200
Issuance costs payable	94,455		94,455
Accrued interest payable		3,029,515	3,029,515
Total current liabilities	107,655	3,029,515	3,137,170
Noncurrent Liabilities - bonds payable (note 4)	NONE	448,260,000	448,260,000
Total Liabilities	107,655	451,289,515	451,397,170
FUND BALANCE/NET ASSETS			
Fund Balance - reserved for debt service	46,010,473	(46,010,473)	NONE
Total Liabilities and Fund Balance	$ 46,118,128		
Net Assets (Deficit)			
Restricted for debt service (note 5)		45,770,660	45,770,660
Unrestricted (note 6)		(437,920,938)	(437,920,938)
Total Net Assets (Deficit)		$ (392,150,278)	$ (392,150,278)

The accompanying notes are an integral part of this statement.

VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

Statement of Governmental Fund Revenues, Expenditures, and Changes in Fund Balance and Statement of Activities
For the period from May 16, 2005 (Inception) through June 30, 2005

	DEBT SERVICE FUND	ADJUSTMENTS (NOTE 1-C)	STATEMENT OF ACTIVITIES - GOVERNMENTAL ACTIVITIES
REVENUES			
Investment interest	$ 27,084		$ 27,084
Net increase in fair value of investments	677,260		677,260
	704,344		704,344
OTHER FINANCING SOURCES			
Principal amount of bonds issued	448,260,000	$ (448,260,000)	-
Bond discount	(7,732,904)	7,732,904	-
Total revenue & other financing sources	441,231,440	(440,527,096)	704,344
EXPENDITURES/EXPENSES			
General & administrative	13,200		13,200
Bond issue cost	5,431,092	(5,431,092)	
Amortization of bond issue cost		35,232	35,232
Purchase of 25% of future tobacco settlement revenues from the Commonwealth of Virginia	389,776,675		389,776,675
Debt service:			
Interest		3,029,515	3,029,515
Total expenditures/expenses	395,220,967	(2,366,345)	392,854,622
EXCESS (Deficiency) OF REVENUES OVER (Under) EXPENDITURES/EXPENSES	46,010,473	(438,160,751)	(392,150,278)
FUND BALANCE/NET ASSETS (Deficit) AT BEGINNING OF YEAR			
FUND BALANCE/NET ASSETS (Deficit) AT END OF YEAR	$ 46,010,473	$ (438,160,751)	$ (392,150,278)

The accompanying notes are an integral part of this statement.

INTRODUCTION

The Tobacco Settlement Financing Corporation (Corporation) was created by the Tobacco Settlement Financing Corporation Act, Chapters 482 and 488 of the Acts of the General Assembly of the Commonwealth of Virginia (Commonwealth) during the 2002 General Session. The Corporation is a public corporate entity and an independent instrumentality of the state, managed by a six-member board, including the State Treasurer.

The purpose of the Corporation is to purchase from the Commonwealth portions of its future right, title and interest in the Tobacco Settlement Revenues (TSRs) under the Master Settlement Agreement and the Consent Decree and Final Judgment (MSA). The MSA resolved tobacco-related litigation between the settling states and the Participating Manufacturers (PMs), released the PMs from past and present tobacco-related claims of the settling states, and provides for a continuing release of future tobacco-related claims, in exchange for certain payments to be made to the settling states, as well as certain tobacco advertising and marketing restrictions, among other things.

In May 2005, pursuant to a Purchase and Sale Agreement with the Commonwealth, the Commonwealth sold to the Corporation 25% of its future right, title and interest in the TSRs. Specifically, these rights include a 25% share of TSRs received by the Commonwealth starting May 15, 2005, and in perpetuity under the MSA. Consideration paid by the Corporation to the Commonwealth for TSRs consisted of a cash amount deposited into an endowment to fund the long-term spending plan approved by the Tobacco Indemnification and Community Revitalization Commission.

The bonds of the Corporation are asset-backed instruments secured solely by the TSRs, and the Corporation's right to receive TSRs is expected to produce funding for its obligations. The TSR payments are dependent on a variety of factors, some of which are:

- the financial capability of the participating cigarette manufacturers to pay TSRs,
- future cigarette consumption which impacts the TSR payment, and
- future legal and legislative challenges against the tobacco manufacturers and the master settlement agreement providing for the TSRs.

Changes in these factors could affect the amount of funds available to pay scheduled debt service requirements.

Operations of the Corporation were funded initially with a portion of bond proceeds and in subsequent years will be funded with Corporation investment income.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. MEASUREMENT FOCUS AND BASIS OF ACCOUNTING

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by the GASB. These principles are found in the *Codification of Governmental Accounting and Financial Reporting Standards*, published by the GASB. GASB is the accepted standard setting body for establishing governmental accounting principles and reporting standards.

The accompanying governmental fund financial statements (Balance Sheet and Statement of Revenues, Expenditures, and Changes in Fund Balance) are presented using the current financial resources measurement focus and the modified accrual basis of accounting. Under the modified accrual basis of accounting, revenues are recognized when they become measurable and available to fund current operations. Expenditures are recognized when the related fund liability is incurred, except for principal and interest on long-term debt, which is recognized when due.

The accompanying government-wide statements (Statement of Net Assets and Statement of Activities) are presented using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when they are earned and expenses are recognized when the related liability is incurred, regardless of the timing of related cash flows.

B. FUND ACCOUNTING

Fund level activities of the Corporation are accounted for in the Debt Service Fund. The Debt Service Fund accounts for the accumulation of resources for, and the payment of, long-term debt principal and interest. The Debt Service Fund consists of the current assets and liabilities of the Corporation with the difference being fund balance reserved for debt service.

C. ADJUSTMENTS

The adjustments column represents the recording of bonds payable liabilities and unamortized bond issue cost on the Statement of Net Assets and the related effect of these transactions on the Statement of Activities. Governmental fund statements do not reflect bonds payable. This column is also used to record full accrual revenues and receivables and to reclassify current assets as restricted assets on the Statement of Net Assets.

D. CASH AND INVESTMENTS

Cash consists of money market funds. Investments consist of direct investments in commercial paper and Fannie Mae discount notes. Investments are stated at fair value, as determined by quoted market values, in accordance with GASB Statement No. 31.

E. RESTRICTED ASSETS

Restricted assets represent resources set aside for the purpose of funding debt service payments in accordance with bond resolutions.

F. CAPITAL ASSETS

The Corporation has no capital assets at June 30, 2005.

G. LONG-TERM OBLIGATIONS

Long-term obligations are reported at face value.

H. COMPENSATED ABSENCES, PENSION BENEFITS AND POSTEMPLOYMENT HEALTH CARE AND LIFE INSURANCE BENEFITS

The Corporation has no employees. Therefore, no compensated absences, pension benefits, or postretirement benefits are provided by the Corporation.

I. NET ASSETS

Net assets comprise the various net earnings from revenues and expenses. Net assets generally are classified in the following components:

> Restricted net assets consist of external constraints placed on net asset use by creditors, grantors, contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.
>
> Unrestricted net assets consist of all other net assets that are not included in restricted net assets.

J. ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires 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 and the reported amounts of revenue and expenditures during the reporting period. Actual results could differ from those estimates.

K. ADOPTION OF NEW ACCOUNTING STANDARDS

For the year ended June 30, 2005, the Corporation implemented GASB Technical Bulletin 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues.* Specifically, this bulletin allows for the recognition of an asset (receivable) and revenue once the domestic shipment of cigarettes (sales) takes place. The amount can not be reasonably estimated for domestic shipments of cigarettes made for the period from May 16, 2005 (inception) through June 30, 2005.

2. CASH

At June 30, 2005, the Corporation has cash (book balances) totaling $347,468, which is held in JPMorgan US Government money market funds, as presented on the Governmental Fund Balance Sheet and Statement of Net Assets.

3. INVESTMENTS

At June 30, 2005, investments of $45,769,790, as presented on the Governmental Fund Balance Sheet and Statement of Net Assets, consist of the following:

Investment Type	Fair Value	Percentage of Investments	Maturity - Less Than 1 Year
Fannie Mae Discount Note	$12,461,650	27.23%	$12,461,650
American General Finance - Commercial Paper	33,308,140	72.77%	33,308,140
Total investments	$45,769,790	100.00%	$45,769,790

Custodial Credit Risk: For an investment, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Corporation will not be able to recover the value of its investment that are in the possession of an outside party. The Corporation does not have a formal investment policy for custodial credit risk.

Credit Risk: This risk is defined as the risk that an issuer or other counterparty to an investment transaction will not fulfill its obligations. The Corporation's bond indenture restricts the Corporation to investments rated A-1 or higher by Standards & Poor's, P-1 by Moody's Investor's Service, and F-1 by Fitch.

Concentration of Credit Risk: The Corporation does not have a policy for this type of risk, which is defined as the risk of loss attributed to the magnitude of the Corporation's investment in a single issuer.

Interest Rate Risk: This risk is defined as the risk that changes in interest rates will adversely affect the fair value of an investment. The Corporation mitigates interest rate risk by structuring investment maturities to meet cash requirements as outlined in the indenture.

Reserve Requirements: Of the total investment balance of $45,769,790, an amount of $32,682,406 consists of the Liquidity Reserve Requirement provided for by the bond indenture. The Corporation met its reserve balance requirements at June 30, 2005**.**

4. LONG-TERM DEBT

Long-term debt is composed of the following:

Series 2005 Turbo Term Bonds due June 1, 2013, with interest of 4.00% due semiannually June 1 and December 1, commencing on December 1, 2005	$40,310,000
Series 2005 Turbo Term Bonds due June 1, 2019, with interest of 5.25% due semiannually June 1 and December 1, commencing on December 1, 2005	51,585,000
Series 2005 Turbo Term Bonds due June 1, 2026, with interest of 5.50% due semiannually June 1 and December 1, commencing on December 1, 2005	104,020,000
Series 2005 Turbo Term Bonds due June 1, 2037, with interest of 5.625% due semiannually June 1 and December 1, commencing on December 1, 2005	252,345,000
Total long-term debt	$448,260,000

On May 16, 2005, the Corporation issued $448,260,000 in Tobacco Settlement Asset-Backed Bonds. The bonds were issued to finance the Corporation's purchase of 25% of the state's future receipts from the MSA with participating cigarette manufacturers. The bonds are secured by the Corporation's claim to 25% of these future receipts. The claim is on parity with the claim of the Commonwealth to the ownership of the remaining 75% of all amounts expected to be paid to the Commonwealth under the MSA. In addition, the bonds are secured by all earnings on amounts on deposit in certain accounts pledged under the indenture and the amounts held in certain accounts established under the indenture.

The bond indenture states that the Series 2005 Bonds shall not be deemed to be nor constitute a debt or obligation of the Commonwealth or a pledge of the full faith or credit of the Commonwealth or any political subdivision thereof. The Corporation has no taxing power. No assets or revenues of the Commonwealth or any political subdivision thereof is or shall be obligated or pledged to the payment of the principal of or interest on the bonds.

The proceeds of this issue were used for the following:

Payment to the Commonwealth for 25% of the expected MSA proceeds	$389,776,675
Liquidity reserve accounts	32,682,406
Capitalized interest	12,411,923
Capitalized operating expenses	225,000
Costs of Issuance	1,427,455
Underwriters' discount	4,003,637
Original issue discount	7,732,904
Total Bond Proceeds	$448,260,000

Debt service requirements, including interest to maturity, are as follows:

Fiscal Year	Sinking Fund Installments and Turbo Term Bond Maturities	Interest	Term Bond Maturities	Interest
2006	2,895,000	24,178,219		27,265,634
2007	3,630,000	24,047,719		24,236,119
2008	5,960,000	23,855,919		24,236,119
2009	4,290,000	23,650,919		24,236,119
2010	5,140,000	23,462,319		24,236,119
2011-2015	32,155,000	113,552,833	40,310,000	117,825,906
2016-2020	50,025,000	103,584,700	51,585,000	110,192,220
2021-2025	74,760,000	86,490,831		99,577,531
2026-2030	91,310,000	63,344,275	104,020,000	76,232,265
2031-2037	178,095,000	37,566,986	252,345,000	98,217,405
	448,260,000	523,734,720	448,260,000	626,255,436

Term bond maturities represent the minimum amount of principal that the Corporation must pay as of specific distribution dates in order to avoid an event of default under the indenture.

Sinking fund maturities represent the amount of principal that the Corporation will pay according to the terms of the indenture. The Corporation is required to make these payments to the extent that funds are available for payment. Failure by the Corporation to make a sinking fund installment according to the terms of the indenture will not constitute an event of default under the terms of the indenture. The amount of any sinking fund installments made will be credited against term maturities in ascending chronological order.

Turbo maturities represent the requirement contained in the indenture to apply 100% of all collections that are in excess of the funding requirements of the indenture to redemption of the Series 2005 Term Bonds. The amount of any turbo redemption made will be credited against both sinking fund installments and term bond maturities in ascending chronological order.

5. RESTRICTED NET ASSETS

Restricted net assets represent the assets restricted for debt service. The composition of restricted net assets is as follows:

Investments	$45,769,790
Interest receivable	870
Net assets restricted for debt service	$45,770,660

6. UNRESTRICTED NET ASSETS (DEFICIT)

On May 16, 2005, the Corporation issued $448,260,000 in Tobacco Settlement Asset-Backed Bonds. During the fiscal year ended June 30, 2005, a total of $389,776,674 was deposited into an endowment to fund the long-term spending plan approved by the Tobacco Indemnification and Community Revitalization Commision. Of the remaining assets related to the bond issuance and other operations of the Corporation at June 30, 2005, a total of $45,770,660 is restricted for debt service, resulting in a deficit for unrestricted net assets of $437,920,938, as presented on the Governmental Fund Balance Sheet and Statement of Net Assets.

7. ADMINISTRATIVE EXPENSES

Administration fees for the period from May 16, 2005 (inception) through June 30, 2005 were $13,200, related to services provided by the trustee.

8. CONTINGENCIES

Tobacco Litigation Risk

The amount of revenue recognized by the Corporation could be adversely impacted by certain third party litigation involving tobacco companies and others.