# VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

## Financial Statements

### For the Year Ended June 30, 2010

# VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

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Clifton Gunderson LLP
Certified Public Accountants & Consultants

## Independent Auditor's Report

To the Board of Directors
Virginia Tobacco Settlement Financing Corporation
Richmond, Virginia

We have audited the accompanying basic financial statements of Virginia Tobacco Settlement Financing Corporation as of and for the year ended June 30, 2010, which collectively comprise Virginia Tobacco Settlement Financing Corporation's basic financial statements as listed in the table of contents. These financial statements are the responsibility of Virginia Tobacco Settlement Financing Corporation's management. Our responsibility is to express an opinion on these 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 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Virginia Tobacco Settlement Financing Corporation as of June 30, 2010, and the changes in financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 28, 2010 on our consideration of Virginia Tobacco Settlement Financing Corporation'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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 6 is not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information.

Clifton Gunderson LLP

Richmond, Virginia
October 28, 2010



Member of HLB International

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, 2010. 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 (the "MSA") between cigarette manufacturers and 46 states and other United States jurisdictions (the "Tobacco Assets").

In fiscal year 2007, the Corporation issued $1,149,273,283 in Tobacco Settlement Asset-Backed Bonds, Series 2007 A, B, C and D (the "2007 Bonds"). Under an amended and restated Purchase and Sale Agreement, the 2007 Bonds financed the purchase of the Commonwealth's future right, title and interest to fifty percent of the Commonwealth's allocation under the MSA. A portion of the proceeds of the 2007 Bonds was used to defease and refund all of the outstanding Series 2005 Bonds, which were issued in May 2005 for $448,260,000.

## Overview of the Financial Statements

This discussion and analysis is an introduction to the Corporation's basic financial statements, which are comprised of two components: 1) government-wide and fund financial statements and 2) notes to the 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 Corporation'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 Corporation's financial position is improving or declining.

The Statement of Activities presents information showing how the Corporation'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 using a Debt Service Fund. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the Corporation uses to keep track of specific sources of funding and spending for a particular purpose.

All of the Corporation's activity is reported using a governmental fund type. 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 Corporation

The Corporation was formed to purchase Tobacco Assets from the Commonwealth. The purchase was financed with the issuance of bonds. The Virginia Department of the Treasury provides staff support for the Corporation. Operating costs of the Corporation are funded from corporation income. Current assets of the Corporation are funds held to pay costs of issuance on the bonds and to pay operating costs of the Corporation over the next year. Current assets also include revenues received that will be used for the next interest payment on the outstanding bonds. Noncurrent assets are primarily bond proceeds held in the liquidity reserve account and restricted to the payment of debt service on the Bonds. The Corporation owns no capital assets.

Following is summarized financial data for the fiscal years ended June 30, 2010 and 2009:

**Condensed Statements of Net Assets**
**(in thousands)**

| | June 30, 2010 | June 30, 2009 |
|---|---|---|
| Current assets | $ 31,623 | $ 116,797 |
| Noncurrent assets | 123,894 | 42,584 |
| Total assets | 155,517 | 159,381 |
| Current liabilities | 7,867 | 7,497 |
| Noncurrent liabilities | 1,126,647 | 1,112,704 |
| Total liabilities | 1,134,514 | 1,120,201 |
| Net assets: | | |
| Restricted | 147,107 | 150,686 |
| Unrestricted | (1,126,104) | (1,111,506) |
| Total net assets (deficit) | $ (978,997) | $ (960,820) |

**Condensed Statements of Activities**
**(in thousands)**

| | Years ended June 30, 2010 | Years ended June 30, 2009 |
|---|---|---|
| Revenues | $ 57,587 | $ 75,148 |
| Expenses | 75,764 | 76,464 |
| Change in net assets | (18,177) | (1,316) |
| Net deficit, beginning of year | (960,820) | (959,504) |
| Net deficit, end of year | $ (978,997) | $ (960,820) |

Revenues for the year are comprised of tobacco settlement revenues, interest on investments and the net increase in the market value of investments. Expenses reflect bond interest expense and amortization of issuance costs, loss on refunding, and bond discounts. The decrease in net assets resulted primarily from interest expense on the outstanding bonds exceeding tobacco settlement revenues. Tobacco settlement revenues were lower this year for three reasons. First, revenues in FY 2009 included a one-time $5 million payment which was the result of the release of an amount held in a disputed payment account pursuant to the MSA. Second, a decline in domestic tobacco consumption resulted in lower MSA payments for all participants. Third, a decline in market interest rates resulted in lower investment earnings during fiscal year 2010.

## Financial Analysis of the Corporation's Funds

All investments held by the corporation relate to the issuance of the Series 2007 Bonds.

## Debt Administration

As a financing entity, the business of the Corporation is debt administration. In 2007, the Corporation issued Bonds to purchase Tobacco Assets from the Commonwealth and to refinance bonds previously issued to purchase Tobacco Assets from the Commonwealth. The outstanding Bonds are secured solely by fifty percent of future tobacco settlement revenues allocated to the Commonwealth and investment earnings. As of June 30, 2010, there were no plans for the Corporation to issue additional debt. The table below summarizes bond activity during the year.

**Summary of Bond Obligations**
**(in millions)**

| | Tobacco Settlement Asset-Backed Bonds |
|---|---|
| Outstanding, 7/1/09 | $ 1,115 |
| Amortization of discount and other deferrals | 15 |
| Outstanding, 6/30/10 | $ 1,130 |

## Requests for Information

The financial report is designed to provide an overview of the Corporation's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Department of the Treasury, Division of Debt Management, P. O. Box 1879, Richmond, Virginia, 23218-1879.

## VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

### Governmental Fund Balance Sheet and Statement of Net Assets
### As of June 30, 2010

| | DEBT SERVICE FUND | ADJUSTMENTS (NOTE 1-C) | STATEMENT OF NET ASSETS |
|---|---|---|---|
| **ASSETS** | | | |
| Current Assets: | | | |
| Cash equivalents | $ 117,122 | $ - | $ 117,122 |
| Prepaid expenses | 22,560 | - | 22,560 |
| Interest receivable | 2 | - | 2 |
| Restricted: | | | |
| Cash equivalents | 31,282,948 | - | 31,282,948 |
| Interest receivable | 199,951 | - | 199,951 |
| Total current assets | 31,622,583 | - | 31,622,583 |
| Noncurrent Assets: | | | |
| Unamortized bond issuance costs | - | 8,270,740 | 8,270,740 |
| Restricted assets: | | | |
| Investments | 84,872,930 | - | 84,872,930 |
| Tobacco settlement receivable | - | 30,751,087 | 30,751,087 |
| Total noncurrent assets | 84,872,930 | 39,021,827 | 123,894,757 |
| Total assets | $ 116,495,513 | 39,021,827 | 155,517,340 |
| **LIABILITIES** | | | |
| Current Liabilities: | | | |
| Bonds payable | $ - | 2,940,000 | 2,940,000 |
| Accrued interest payable | - | 4,927,282 | 4,927,282 |
| Total current liabilities | - | 7,867,282 | 7,867,282 |
| Noncurrent liabilities - bonds payable | - | 1,126,647,337 | 1,126,647,337 |
| Total liabilities | - | 1,134,514,619 | 1,134,514,619 |
| **FUND BALANCE/NET ASSETS** | | | |
| Fund Balance - reserved for debt service | 116,495,513 | (116,495,513) | - |
| Total liabilities and fund balance | $ 116,495,513 | | |
| Net Assets (Deficit) | | | |
| Restricted for debt service | | 147,106,916 | 147,106,916 |
| Unrestricted | | (1,126,104,195) | (1,126,104,195) |
| Total net assets (deficit) | | $ (978,997,279) | $ (978,997,279) |

*The accompanying notes are an integral part of this statement.*

## VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

**Governmental Fund Revenues, Expenditures,**
**and Changes in Fund Balance and Statement of Activities**
**For the Year Ended June 30, 2010**

| | DEBT SERVICE FUND | ADJUSTMENTS (NOTE 1-C) | STATEMENT OF ACTIVITIES |
|---|---|---|---|
| **REVENUES** | | | |
| Tobacco settlement revenues | $ 60,811,537 | $ (3,338,220) | $ 57,473,317 |
| Investment interest | 80,013 | - | 80,013 |
| Net increase in fair value of investments | 33,919 | - | 33,919 |
| Total revenues | 60,925,469 | (3,338,220) | 57,587,249 |
| **EXPENDITURES/EXPENSES** | | | |
| General and administrative | 60,537 | - | 60,537 |
| Amortization of bond issuance costs and discount | - | 8,683,140 | 8,683,140 |
| Debt service: | | | |
| Interest | 61,166,252 | 5,855,050 | 67,021,302 |
| Total expenditures/expenses | 61,226,789 | 14,538,190 | 75,764,979 |
| Excess (deficiency) of revenues over (under) expenditures/expenses | (301,320) | 301,320 | N/A |
| Change in net assets | N/A | (18,177,730) | (18,177,730) |
| Fund balance/net assets (deficit) at beginning of year | 116,796,833 | (1,077,616,382) | (960,819,549) |
| Fund balance/net assets (deficit) at end of year | $ 116,495,513 | $ (1,095,492,792) | $ (978,997,279) |

*The accompanying notes are an integral part of this statement.*

## ORGANIZATION AND NATURE OF ACTIVITIES

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.

In May 2007, the Corporation issued $1,149,273,282 of its Tobacco Settlement Asset-Backed Bonds, Series 2007 A, B-1, B-2, C and D. Proceeds of the sale were used to fully defease the Corporation's outstanding Tobacco Settlement Asset-Backed Bonds Series 2005. Pursuant to an Amended and Restated Sale Agreement dated as of May 1, 2007, net proceeds from the sale in the amount of $613,994,236 were transferred to the Tobacco Indemnification and Community Revitalization Endowment Fund as consideration for the purchase of an additional 25% share of TSRs received by the Commonwealth starting April 27, 2007, and in perpetuity under the MSA.

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 are funded with Corporation 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 Governmental Accounting Standards Board (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, unamortized bond issuance costs, and discounts on issued bonds 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.

### D. CASH EQUIVALENTS AND INVESTMENTS

Cash equivalents consist of money market funds, which are stated at fair value. Investments consist of direct investments in Federal National Mortgage Association Notes. Investments are stated a 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, 2010.

### G. LONG-TERM OBLIGATIONS

Long-term obligations are reported net of unamortized discounts and loss on defeasance.

### H. DEFERRED BOND ISSUANCE COSTS

The total bond issuance costs of $8,980,194 relating to the issued bonds are being amortized using the straight-line method over the life of the bonds.

### I. 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.

### J. 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.

### K. ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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.

## 2. CASH EQUIVALENTS

At June 30, 2010, the Corporation has cash equivalents totaling $31,400,070, which is held in the JPMorgan US Government Money Market Fund, as presented on the Statement of Net Assets and Debt Service Fund Balance Sheet. The Fund is rated Aaa by Moody's Investors Service.

## 3. INVESTMENTS

At June 30, 2010, investments of $84,872,930, as presented on the Statement of Net Assets and Debt Service Fund Balance Sheet, consist of the following:

| Investment Type | Fair Value | Percentage of Investments | Maturity - Less Than 1 Year | Moody's Ratings |
|---|---|---|---|---|
| Federal National Mortgage Association Note due, 4/28/11 | 84,872,930 | 100.00% | 84,872,930 | Aaa |
| Total investments | 84,872,930 | | | |

*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 Standard & Poor's, P-1 or higher by Moody's Investors Service, and F-1 or higher 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. Investments that represent more than 5 percent of the Corporation's net investments are noted above.

*Interest Rate Risk:* This risk is defined as the risk that changes in interest rates will adversely affect the fair value of an investment. Originally, the Corporation mitigated interest rate risk by structuring investment maturities to meet cash requirements as outlined in the indenture. However, with the termination of the original guaranteed investment contract in fiscal year 2009, and the inability to obtain a similar instrument in fiscal year 2010 under the current investment climate, the Corporation purchased a Federal National Mortgage Association ("FNMA") Note on May 25, 2010, which matures on April 28, 2011. The FNMA Note is guaranteed as a United States agency security.

*Reserve Requirements*: An investment balance of $84,872,930, is held for the Senior Liquidity Reserve Requirement. These investments, along with cash equivalents of $395,423 also held in the Senior Liquidity Reserve Account, are insufficient to cover the Corporation's reserve balance requirement of $85,392,039 at June 30, 2010, leaving a Senior Liquidity Reserve Requirement shortage of $123,686. Upon its maturity on

April 28, 2011, the FNMA Note owned by the Corporation will generate sufficient earnings to cause the Senior Liquidity Reserve Account to be fully funded.

All investments of the Corporation must follow the restrictive guidelines as outlined in the bond documents.

## 4. LONG-TERM DEBT

Activity in the bonds payable and related accounts for fiscal year 2010 was as follows:

| | Balance at June 30, 2009 | Increases | Decreases | Balance at June 30, 2010 | Amount due Within One Year |
|---|---|---|---|---|---|
| Total bonds outstanding | $ 2,021,045,000 | $ - | $ - | $ 2,021,045,000 | $ 2,940,000 |
| Less: | | | | | |
| Unaccreted capital appreciation bonds | (875,555,494) | - | 8,397,666 | (867,157,828) | - |
| Unamortized issuance discounts | (6,788,485) | - | 61,436 | (6,727,049) | - |
| Deferral on debt defeasance | (23,597,742) | - | 6,024,956 | (17,572,786) | - |
| | $ 1,115,103,279 | $ - | $ 14,484,058 | $ 1,129,587,337 | $ 2,940,000 |

Long-term debt is comprised of the following:

| | |
|---|---|
| Series 2007A Turbo Term Bonds due June 1, 2046, with interest of 6.706% due semiannually June 1 and December 1, commencing on December 1, 2007 | $ 661,870,000 |
| Series 2007B-1 Turbo Term Bonds due June 1, 2047, with interest of 5% due semiannually June 1 and December 1, commencing on December 1, 2007 | 335,625,000 |
| Series 2007B-2 Senior Convertible Bonds due June 1, 2046, convertible to interest bearing bonds on December 1, 2011 with interest of 5.2% due semiannually June 1 and December 1, commencing on June 1, 2012, accreted value at conversion of $33,910,000 | 31,532,785 |
| Series 2007C First Subordinate Capital Appreciation Bonds due June 1, 2047, with approximate yield of 5.67%, maturity value $724,870,000 | 92,324,828 |
| Series 2007D Second Subordinate Capital Appreciation Bonds due June 1, 2047, with approximate yield of 5.77%, maturity value $264,770,000 | 32,534,559 |
| Total long-term debt | 1,153,887,172 |
| Unaccreted Capital Appreciation Bonds | 867,157,828 |
| Total Outstanding Maturities | $ 2,021,045,000 |

In May 2007, the Corporation issued $1,149,273,282 of its Tobacco Settlement Asset-Backed Bonds, Series 2007 A, B-1, B-2, C and D. Proceeds from the issuance were used to fully defease the Corporation's outstanding Tobacco Settlement Asset-Backed Bonds Series 2005. The debt defeasance resulted in an accounting loss that is deferred and amortized over the remaining life of the old debt. Therefore, Bonds Payable has been reduced by $17,572,786 to reflect the unamortized deferral on debt defeasance at June 30, 2010.

The bonds were also issued to finance the Corporation's purchase of an additional 25% of the Commonwealth's future receipts from the MSA with participating cigarette manufacturers. The bonds are secured by the Corporation's claim to 50% of these future receipts. The claim is on parity with the claim of the Commonwealth to the ownership of the remaining 50% 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 capital appreciation bonds were issued at an aggregate discount from par of $892,551,718. The discount is being amortized using the effective interest method over the life of the bonds.

The bond indenture states that the Series 2007 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 are obligated or pledged to the payment of the principal of or interest on the bonds.

The 2007B-2, 2007C, and 2007D Bonds have Capital Appreciation Bonds with unaccreted values of $2,377,215, $632,545,172, and $232,235,441, respectively, as of June 30, 2010.

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

| Fiscal Year | Sinking Fund Installments and Term Bond Maturities | Interest | Term Bond Maturities | Interest |
|---|---|---|---|---|
| 2011 | 2,940,000 | 61,166,252 | - | 61,166,252 |
| 2012 | 2,640,000 | 60,969,096 | - | 62,194,856 |
| 2013 | 2,800,000 | 60,792,057 | - | 62,929,572 |
| 2014 | 3,400,000 | 60,604,289 | - | 62,929,572 |
| 2015 | 4,000,000 | 60,376,285 | - | 62,929,572 |
| 2016-2020 | 44,900,000 | 295,866,145 | - | 314,647,861 |
| 2021-2025 | 75,500,000 | 276,103,563 | - | 314,647,861 |
| 2026-2030 | 108,030,000 | 246,758,107 | - | 314,647,861 |
| 2031-2035 | 157,130,000 | 204,354,057 | - | 314,647,861 |
| 2036-2040 | 223,560,000 | 143,382,099 | - | 314,647,861 |
| 2041-2045 | 266,080,000 | 75,270,458 | | 314,647,861 |
| 2046-2047 | 1,130,065,000 | 10,635,000 | 2,021,045,000 | 74,466,691 |
| | $ 2,021,045,000 | $ 1,556,277,408 | $ 2,021,045,000 | $ 2,274,503,681 |

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 2007 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 by the indenture for debt service. The composition of restricted net assets is as follows:

| | | |
|---|---|---|
| Cash Equivalents and Investments | $ | 116,155,878 |
| Tobacco settlement receivable | | 30,751,087 |
| Interest receivable | | 199,951 |
| Net assets restricted for debt service | $ | 147,106,916 |

## 6. UNRESTRICTED NET ASSETS (DEFICIT)

Generally accepted accounting principles direct that governmental funds recognize revenues in the accounting period in which they become both measurable and available to finance expenditures of the fiscal period. The Tobacco Settlement Asset-Backed Bonds issued in fiscal year 2007 are secured by future TSRs. TSRs are computed annually based on tobacco-related sales combined with other factors and the future payment amounts are not known at this time. Accordingly, outstanding obligations are reported on the Statement of Net Assets while the related future revenues have not yet been reported. Therefore as of June 30, 2009, the Corporation reflects deficit net assets of $978,997,279 on the Statement of Net Assets.

## 7. TOBACCO SETTLEMENT REVENUES AND RECEIVABLE

Tobacco Settlement Revenues (the “TSRs”) consist of the amounts to be received under the terms of the MSA among participating cigarette manufacturers and 46 states and six other U.S. jurisdictions (the “Settling States”). The MSA is an industry-wide settlement of litigation between the Settling States and the Original Participating Manufacturers (the “OPMs”) and was entered into between the attorneys general of the Settling States and the OPMs on November 23, 1998. The MSA provides for other tobacco companies, referred to as Subsequent Participating Manufacturers (the “SPMs”), to become parties to the MSA. The four OPMs together with the 30+SPMs are referred to as the Participating Manufacturers (the “PMs”). The settlement represents the resolution of a potential financial liability of the PMs for smoking-related injuries, the cost of which have been borne and will likely continue to be borne by cigarette consumers. Pursuant to the MSA, the Settling States agreed to settle all their past and future smoking-related claims against the PMs in exchange for agreements and undertakings by the PMs concerning a number of issues. These issues include, among other things, making payments to the Settling States, abiding by more stringent advertising restrictions and funding educational programs, all in accordance with the terms and conditions set forth in the MSA. Distributors of the PMs are also covered by the settlement of such claims to the same extent as the PMs.

Under the MSA, the PMs are required to pay to the Settling States (i) five initial payments, the first of which was due on November 12, 1999, with the remaining four due on January 10, 2000 through 2003 (Initial Payments); (ii) annual payments required to be made on April 15, commencing April 15, 2000, and continuing in perpetuity (Annual Payments) and (iii) ten annual payments required to be made on each April 15, commencing on April 15, 2008, and continuing through April 15, 2017 (Strategic Contribution Payments). Before forming the Corporation, the PMs made all five required Initial Payments and the Annual Payments due April 15, 2000 through 2005, none of which the Corporation had any right to receive.

The TSRs due under the MSA are subject to numerous adjustments, some of which are material. Such adjustments include, among others, reductions for decreased domestic cigarette shipments, reductions for amounts paid by PMs to four states that had previously settled their claims independently of the MSA, and in the case of Annual Payments and Strategic Contribution Payments, increases related to inflation of not less than 3% per annum.

Much of the TSRs represent a portion of future sales of tobacco products. GASB Technical Bulletin No. 2004-1 clarified guidance relating to the recognition of revenues and receivables. Specifically, the bulletin allows for the recognition of revenue to be received based on the shipment of domestic cigarettes. The amount recognized is estimated to be 50% of the next projected payment due from the MSA. Accordingly, the Statement of Net Assets includes an estimated receivable of $30,751,087.

## 8. ADMINISTRATIVE EXPENSES

Administration expenses for the year ending June 30, 2010 were $60,537, for trustee, accounting, and rating agency fees.

## 9. 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.

*Guaranteed Investment Contract:*
Upon issuance of the Tobacco Bonds in 2005 and 2007, the Corporation entered into Reserve Fund Agreements among Lehman Brothers Special Financing Inc. and The Bank of New York Mellon Trust Company, National Association, as successor to The Bank of New York Trust Company, N.A., as trustee under the bond indenture. Under the Agreements, Lehman Brothers Special Financing Inc. guaranteed to provide qualifying securities for investment from funds available in the Reserve Funds at a guaranteed rate of return through June 1, 2047, unless sooner terminated. In December 2008, Lehman Brothers Special Financing Inc. defaulted on their contractual obligation when they failed to deliver securities as proscribed in the Agreements. As a result, the Corporation exercised its right to terminate the Agreements and so notified Lehman Brothers Special Financing Inc. on March 19, 2009.

The Corporation has filed a claim against Lehman Brothers Special Financing Inc. in accordance with the parameters established by the Bankruptcy Court for the Southern District of New York. First Southwest Company, financial advisor to the Corporation, estimates the cost to the Corporation of executing replacement agreements with the same guaranteed rate of return at $14,469,695, related to the 2005 Bonds and $35,952,063 related to the 2007 Bonds. It is unclear at this time what amount, if any, may be paid to the Corporation pursuant to this claim. As of June 30, 2010, the Corporation has no additional information to report.

## 10. SUBSEQUENT EVENT

*Downgrade of Tobacco Bonds:*
On August 4, 2010, Standard & Poor's ("S&P") revised its rating on numerous series of bonds secured by payments from tobacco manufacturers under the MSA, including the Series 2007 Bonds. The actions result from revisions to S&P's base-case and stress-case volume decline assumptions for U.S. cigarette sales and stress case assumptions for domestic cigarette manufacturer market shares. The Corporation's bonds are repaid solely from amounts received under the MSA, which is based on tobacco sales and market share. The ratings action changed the outlook on Series 2007 A1, B-1, and B-2 Bonds from BBB/Negative Outlook to BBB/Credit Watch with negative implications. Ratings on the Series 2007-C Bonds changed from BB/Negative Outlook to BB/Credit Watch with negative implications, and Series 2007-D Bonds changed from BB-/Negative Outlook to BB-/Credit Watch with negative implications.

**Independent Auditor's 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 Board of Directors
Virginia Tobacco Settlement Financing Corporation
Richmond, Virginia

We have audited the basic financial statements of the Virginia Tobacco Settlement Financing Corporation (the Corporation) as of and for the year ended June 30, 2010 and have issued our report thereon dated October 28, 2010. 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.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the Corporation's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Corporation's internal control over financial reporting.

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 misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Corporation 's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

## Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Corporation'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*.

This report is intended solely for the information and use of the Board of Directors, the Auditor of Public Accounts, management, and federal and state awarding agencies and pass-through entities and is not intended to be, and should not be, used by anyone other than these specified parties.

Clifton Gunderson LLP

Richmond, Virginia
October 28, 2010