VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

Financial Statements

For the Year Ended June 30, 2014

VIRGINIA TOBACCO SETTLEMENT FINANCING CORPORATION

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BROWNEDWARDS
certified public accountants

INDEPENDENT AUDITOR'S REPORT

To the Honorable Members of the Board of Directors of the
Virginia Tobacco Settlement Financing Corporation and the
Virginia Department of the Treasury
Richmond, Virginia

Report on the Financial Statements

We have audited the accompanying financial statements of the Virginia Tobacco Settlement Financing Corporation (the "Corporation") as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the Corporation's basic financial statements as listed in the table of contents.

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 opinions 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, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and *Specifications for the Audits of Authorities, Boards, and Commissions*, issued by the Auditor of Public Accounts of the Commonwealth of Virginia. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

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Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Corporation, as of June 30, 2014, and the changes in financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As noted in the statement of net position and Note 13, the Corporation has a net deficit of $1,024,801,594 and has, in the past, been required to make unscheduled draws from the senior liquidity reserve account to pay interest on the bonds. The uncertainty of future tobacco settlement revenue collections and investment earnings are also discussed in Note 13. Our opinion is not modified with respect to that matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis 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 October 31, 2014 on our consideration of the 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 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 the Corporation's internal control over financial reporting and compliance.

Brown, Edwards & Company, L. L. P.

CERTIFIED PUBLIC ACCOUNTANTS

Roanoke, Virginia
October 31, 2014

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, 2014. 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 was 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 $1,149,273,282 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 the outstanding Series 2005 Bonds, which were issued in May 2005 in the amount of $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 Position 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 Position presents all of the Corporation's assets and liabilities, with the difference between the two reported as "net position." Over time, increases and decreases in net position measure whether the Corporation's financial position is improving or declining.

The Statement of Activities presents information showing how the Corporation's net position changed during the most recent fiscal year. Changes in net position 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 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, 2014 and 2013:

Condensed Statements of Net Position
(in thousands)

	June 30, 2014	June 30, 2013
Current assets	$ 28,557	$ 42,322
Noncurrent assets	114,631	105,646
Total assets	143,188	147,968
Current liabilities	8,976	8,376
Noncurrent liabilities	1,159,014	1,151,002
Total liabilities	1,167,990	1,159,378
Net position:		
Restricted	142,982	147,795
Unrestricted	(1,167,784)	(1,159,205)
Total net position (deficit)	$ (1,024,802)	$ (1,011,410)

Condensed Statements of Activities
(in thousands)

	June 30, 2014	June 30, 2013
Revenues	$ 57,016	$ 89,669
Expenses	70,408	76,782
Change in net position	(13,392)	12,887
Net deficit, beginning of year, as restated	(1,011,410)	(1,024,297)
Net deficit, end of year	$ (1,024,802)	$ (1,011,410)

Revenues for the year are comprised of tobacco settlement revenues, interest on investments and the net change in the market value of investments. Expenses reflect bond interest expense and amortization of bond discounts. The decrease in net position resulted primarily from interest expense on the outstanding bonds exceeding tobacco settlement revenues. Tobacco settlement revenues were lower this year for two main reasons. First, in fiscal year 2013 the Corporation received a one-time windfall of approximately $28 million as a result of Virginia's participation in a settlement with tobacco companies; a similar amount was not received in fiscal year 2014. Second, a decline in domestic tobacco consumption resulted in lower MSA payments for all participants.

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Financial Analysis of the Corporation's Funds

All investments held by the corporation relate to the issuance of the Series 2007 Bonds. As such, all amounts held are considered to be restricted as to their use.

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, 2014, 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, 7/1/13	$ 1,154
Principal payments during year	-
Amortization of discount and other deferrals	9
Outstanding, 6/30/14	$ 1,163

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 Position
As of June 30, 2014

	DEBT SERVICE FUND	ADJUSTMENTS (NOTE 1-D)	STATEMENT OF NET POSITION
ASSETS			
Current Assets:			
Cash equivalents	$ 184,014	$ -	$ 184,014
Prepaid expenses	22,126	-	22,126
Interest receivable	2	-	2
Restricted:			
Cash equivalents	28,350,409	-	28,350,409
Interest receivable	241	-	241
Total current assets	28,556,792	-	28,556,792
Noncurrent Assets:			
Restricted assets:			
Investments	85,228,774	-	85,228,774
Tobacco settlement receivable	-	29,402,464	29,402,464
Total noncurrent assets	85,228,774	29,402,464	114,631,238
Total assets	$ 113,785,566	29,402,464	143,188,030
LIABILITIES			
Current Liabilities:			
Bonds payable	$ -	4,000,000	4,000,000
Accrued interest payable	-	4,975,610	4,975,610
Total current liabilities	-	8,975,610	8,975,610
Noncurrent liabilities - bonds payable	-	1,159,014,014	1,159,014,014
Total liabilities	-	1,167,989,624	1,167,989,624
FUND BALANCE/NET POSITION			
Restricted for debt service	113,579,424	(113,579,424)	-
Restricted for operations	206,142	(206,142)	-
Total fund balance	113,785,566	(113,785,566)	-
Total liabilities and fund balance	$ 113,785,566		
Net Position (Deficit)			
Restricted for debt service		142,981,888	142,981,888
Unrestricted		(1,167,783,482)	(1,167,783,482)
Total net position (deficit)		$ (1,024,801,594)	$ (1,024,801,594)

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 Year Ended June 30, 2014

	DEBT SERVICE FUND	ADJUSTMENTS (NOTE 1-D)	STATEMENT OF ACTIVITIES
REVENUES			
Tobacco settlement revenues	$ 58,144,580	$ (1,193,712)	$ 56,950,868
Investment interest	55,563	-	55,563
Net increase in fair value of investments	9,928	-	9,928
Total revenues	58,210,071	(1,193,712)	57,016,359
EXPENDITURES/EXPENSES			
General and administrative	89,974	-	89,974
Amortization of bond issuance discount	-	8,612,235	8,612,235
Debt service:			
Interest	61,705,392	-	61,705,392
Total expenditures/expenses	61,795,366	8,612,235	70,407,601
Excess (deficiency) of revenues over (under) expenditures/expenses	(3,585,295)	3,585,295	N/A
Excess (deficiency) of revenues over (under) expenditures/expenses	(3,585,295)	3,585,295	-
Change in net position	-	(13,391,242)	(13,391,242)
Fund balance/net position (deficit) at beginning of year, as restated	117,370,861	(1,128,781,213)	(1,011,410,352)
Fund balance/net position (deficit) at end of year	$ 113,785,566	$ (1,138,587,160)	$ (1,024,801,594)

The accompanying notes are an integral part of this statement.

ORGANIZATION AND NATURE OF ACTIVITIES

The Tobacco Settlement Financing Corporation ("the 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 ("the 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 ("the TSRs") under the Master Settlement Agreement and the Consent Decree and Final Judgment ("the MSA"). The MSA resolved tobacco-related litigation between the settling states and the Participating Manufacturers ("the 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. The Corporation's right to receive TSRs was, at the time of issuance, 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,
- cigarette consumption which impacts the TSR payment, and
- 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 revenues.

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, which 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 Position 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. CHANGE IN ACCOUNTING PRINCIPLES

The Corporation implemented GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, in the fiscal year ending June 30, 2014. In accordance with GASB Statement No. 65, the remaining unamortized bond issuance cost of $7,598,626 was applied to the net position beginning balance. The 2007 bonds incurred cost of issuance expense of $8,980,194 in May of 2007.

D. ADJUSTMENTS

The adjustments column represents the recording of bonds payable liabilities and discounts on issued bonds on the Statement of Net Position 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.

E. CASH EQUIVALENTS AND INVESTMENTS

Cash equivalents consist of money market funds, which are stated at fair value. Investments consist of direct investments in Federal Home Loan Mortgage Corporate Notes and General Electric Credit Corporation Commercial Paper. Investments are stated at fair value, as determined by quoted market values, in accordance with GASB Statement No. 31.

F. RESTRICTED ASSETS

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

G. CAPITAL ASSETS

The Corporation has no capital assets at June 30, 2014.

H. LONG-TERM OBLIGATIONS

Long-term obligations are reported net of unamortized discounts.

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. FUND BALANCE

Fund balance is comprised of the Corporation's cash, investments, and receivables. The majority of the Corporation's assets were derived from the sale of bonds and subsequent collection of revenues to be used for debt service. Use of these assets is controlled by bond covenants. As such, amounts derived from bond proceeds and revenue collections for debt service have been restricted for debt service in accordance with GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*.

Additionally, the Corporation has accounts established to pay bond issuance costs and operating expenses. Both accounts were initially funded with bond proceeds and these initial amounts are controlled by bond covenants. Continuing operations are funded through the Corporation's income, the use of which is also defined in the bond documents. Therefore, these amounts have been designated as restricted for operations.

K. NET POSITION

Net position comprises the various net earnings from revenues and expenses. Net position generally is classified in the following components:

> Restricted net position consists of external constraints placed on net position 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 position consists of all other net positions that are not included in restricted net position.

L. 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, 2014, the Corporation has cash equivalents totaling $28,534,423, which is held in the JPMorgan US Government Money Market Fund, as presented on the Statement of Net Position and Debt Service Fund Balance Sheet. The Fund is rated Aaa-mf by Moody's Investors Service.

3. INVESTMENTS

At June 30, 2014, investments of $85,228,774, as presented on the Statement of Net Position and Debt Service Fund Balance Sheet, consist of the following:

Investment Type	Fair Value	Percentage of Investments	Maturity - Less Than 1 Year	Rating	Rating Agency
Federal Home Loan Mortgage Corporate Note, due 4/30/15	$ 82,530,616	96.83%	$ 82,530,616	AA+	S&P
General Electric Credit Corporation Commercial Paper, due 11/26/2014	2,698,158	3.17%	2,698,158	P-1	Moody's
Total investments	$ 85,228,774				

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 investments 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. All investments of the Corporation are noted on the preceding page.

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 continued inability to obtain a similar instrument in fiscal year 2014 under the current investment climate, the Corporation purchased Federal Home Loan Mortgage Corporate Notes in May, 2014, which mature on April 30, 2015.

Reserve Requirements: An investment balance of $85,228,774 is held for the Senior Liquidity Reserve Requirement. These investments, along with cash equivalents of $304,907 also held in the Senior Liquidity Reserve Account, satisfy the Corporation's reserve balance requirement of $85,392,039 at June 30, 2014.

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 2014 was as follows:

	Balance at June 30, 2013	Increases	Decreases	Balance at June 30, 2014	Amount due Within One Year
Total bonds outstanding	$ 2,002,790,000	$ -	$ -	$ 2,002,790,000	$ 4,000,000
Less:					
Unaccreted capital appreciation bonds	(841,865,058)	-	8,537,181	(833,327,877)	-
Unamortized issuance discounts	(6,523,164)	-	75,055	(6,448,109)	-
	$ 1,154,401,778	$ -	$ 8,612,236	$ 1,163,014,014	$ 4,000,000

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	$	643,615,000
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		33,910,000
Series 2007C First Subordinate Capital Appreciation Bonds due June 1, 2047, with approximate yield of 5.67%, maturity value $724,870,000		115,464,542
Series 2007D Second Subordinate Capital Appreciation Bonds due June 1, 2047, with approximate yield of 5.77%, maturity value $264,770,000		40,847,581
Total long-term debt		1,169,462,123
Unaccreted Capital Appreciation Bonds		833,327,877
Total Outstanding Maturities	$	2,002,790,000

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 was deferred and amortized over the remaining life of the old debt.

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 2007C and 2007D Bonds have Capital Appreciation Bonds with unaccreted values of $609,405,458 and $223,922,419, respectively, as of June 30, 2014. The 2007B-2 bonds are fully accreted.

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

Fiscal Year	Sinking Fund Installments and Term Bond Maturities	Interest	Term Bond Maturities	Interest
2015	$ 4,000,000	$ 61,705,392	$ -	$ 61,705,392
2016	4,900,000	61,437,152	-	61,705,392
2017	5,800,000	61,108,558	-	61,705,392
2018	10,600,000	60,719,610	-	61,705,392
2019	11,500,000	60,008,775	-	61,705,392
2020-2024	70,100,000	287,450,002	-	308,526,960
2025-2029	100,200,000	260,123,052	-	308,526,960
2030-2034	146,670,000	220,835,280	-	308,526,960
2035-2039	208,255,000	163,993,212	-	308,526,960
2040-2044	247,445,000	92,194,880		308,526,960
2045-2047	1,193,320,000	20,819,000	2,002,790,000	135,049,918
	$ 2,002,790,000	$ 1,350,394,913	$ 2,002,790,000	$ 1,986,211,678

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. Through June 30, 2014, $39,035,000 of bonds have been redeemed through scheduled and turbo sinking fund payments.

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. DEFEASED DEBT

In 2007, the Corporation issued refunding bonds to defease the outstanding 2005 bonds. The refunding placed the proceeds of the new bonds in an irrevocable trust with an escrow agent to provide for all future debt service on the defeased bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included on the Authority's financial statements.

At June 30, 2014, $302,470,000 of bonds outstanding is considered defeased for financial reporting purposes.

6. NET POSITION BEGINNING BALANCE RESTATEMENT

Due to the Corporation's implementation of GASB Statement No. 65, the net position beginning balance was adjusted by the remaining unamortized bond issuance costs of $7,598,626. This restatement adjusted the deficit net assets from $1,003,811,726 to $1,011,410,352 as of June 30, 2013.

7. RESTRICTED NET POSITION

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

Cash Equivalents and Investments	$	113,579,183
Tobacco settlement receivable		29,402,464
Interest receivable		241
Net position restricted for debt service	$	142,981,888

8. UNRESTRICTED NET POSITION (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 Position while the related future revenues have not yet been reported. Therefore as of June 30, 2014, the Corporation reflects deficit net position of $1,024,801,594 on the Statement of Net Position.

9. TOBACCO SETTLEMENT REVENUES AND RECEIVABLE

Tobacco Settlement Revenues 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 the formation of 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 Position includes an estimated receivable of $29,402,464.

10. ADMINISTRATIVE EXPENSES

Administration expenses for the year ending June 30, 2014 were $89,974, for legal, trustee, accounting, and rating agency fees.

11. RATINGS DOWNGRADE

On February 20, 2014, Moody's Investors Service announced that Series 2007A, 2007B-1 and 2007B-2 bonds issued by the Corporation were downgraded from B2 to B3. Moody's indicated that there was a change in their rating methodology for tobacco settlement revenue bonds in response to a settlement reached in December 2012 on non-participating manufacturer adjustment disputes.

12. 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 itself, Lehman Brothers Special Financing Inc., and The Bank of New York Mellon Trust Company, National Association, as successor to JP Morgan Trust Company, National Association, 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.

On July 15, 2014, the Corporation entered into a termination agreement among Lehman Brothers Special Financing Inc. and Lehman Brothers Holdings Inc. relating to certain reserve fund agreements dated as of May 26, 2005 and May 3, 2007, as amended. The termination agreement, among other things, provided for settlement of the claims asserted by the Corporation in certain of the Lehman bankruptcy cases. Absent the sale of these claims, the Corporation will receive periodic distributions on these claims as a holder of these allowed claims. The Corporation received its first distribution from the settlement on October 3, 2014 in the aggregate amount of approximately $13.6 million.

13. UNSCHEDULED DRAWS ON DEBT SERVICE RESERVES REFLECTING FINANCIAL DIFFICULTY

On May 21, 2014, the Corporation provided notice pursuant to its contractual undertakings under Rule 15c2-12 of the Securities and Exchange Commission that Total Collections pledged to the payment of debt service on the Bonds would not be sufficient to pay the scheduled 2014 interest payments on the Bonds. However, as a result of the July 15, 2014 settlement, as described in Note 11, and the subsequent receipt of the first distribution from that settlement, it has been determined that the settlement funds will be available for the upcoming 2014 interest payment. Therefore, no unscheduled draw on the Senior Liquidity Reserve Account will be required in fiscal year 2015.

Due to the uncertainty of future TSR collections and lower than expected investment earnings, the Corporation anticipates that draws against the reserve funds will be needed to make future interest payments. Certain events may occur that could improve the financial outlook for the Corporation. One such event would be a change in market conditions that could provide a higher rate of return on funds held in the Senior Liquidity Reserve Account. The Corporation is actively monitoring investment alternatives to maximize the rate of return.

BROWNEDWARDS
certified public accountants

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 Honorable Members of the Board of Directors of the
Virginia Tobacco Settlement Financing Corporation and the
Virginia Department of the Treasury
Richmond, Virginia

We have audited, in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States; and *Specifications for Audits of Authorities, Boards, and Commissions* issued by the Auditor of Public Accounts of the Commonwealth of Virginia, the financial statements of the Virginia Tobacco Settlement Financing Corporation (the "Corporation"), as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the Corporation's basic financial statements, and have issued our report thereon dated October 31, 2014.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Corporation'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 Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of the Corporation'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 entity'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.

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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.*

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 entity'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 entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Brown, Edwards & Company, L.L.P.

CERTIFIED PUBLIC ACCOUNTANTS

Roanoke, Virginia
October 31, 2014