Tobacco Settlement Financing Corporation

TSFC

Financial Statements Fiscal Year

2010

Tobacco Settlement Financing Corporation

Financial Statements

Fiscal Years Ended October 31, 2010 and 2009

Contents

RESPONSIBILITY FOR FINANCIAL REPORTING

The financial statements of the Tobacco Settlement Financing Corporation (the "Corporation"), for the fiscal years ended October 31, 2010 and 2009, are the responsibility of management. The financial statements were prepared in accordance with accounting principles generally accepted in the United States of America.

The Corporation maintains a system of internal control. The objectives of an internal control system are to provide reasonable assurance as to the protection of, and accountability for, assets, compliance with applicable laws and regulations, proper authorization and recording of transactions, and the reliability of financial records for preparing financial statements. The system of internal control is subject to periodic review by management and the internal audit staff.

The Corporation's annual financial statements have been audited by Ernst & Young LLP, independent auditors appointed by the Members of the Corporation. Management has made available to Ernst & Young LLP all the financial records and related data of the Corporation as well as having provided access to all the minutes of the meetings of the Members of the Corporation. The independent auditors periodically meet with the Members of the Corporation.

The independent auditors conducted their audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that they plan and perform the audit to obtain reasonable assurance about whether the respective financial statements are free of material misstatement. The audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, the independent auditors do not express an opinion on the effectiveness of the Corporation's internal control over financial reporting. The audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. The independent auditors' unqualified report attests that the financial statements are presented, in all material respects, in accordance with accounting principles generally accepted in the United States of America.

Brian E. Lawlor
Chief Executive Officer

Joanne Hounsell
Senior Vice President/
Interim Chief Financial Officer

January 20, 2011

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Report of Independent Auditors

The Members
Tobacco Settlement Financing Corporation
New York, New York

We have audited the accompanying financial statements of the governmental activities and each major fund of the Tobacco Settlement Financing Corporation (the "Corporation") a component unit of the State of New York, as of and for the year ended October 31, 2010, which collectively comprise the Corporation's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express opinions on these financial statements based on our audit. The financial statements of the Corporation for the year ended October 31, 2009, were audited by other auditors whose report dated January 12, 2010, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in 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. We were not engaged to perform an audit of the Corporation's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the 2010 financial statements referred to above present fairly, in all material respects, the financial position of the governmental activities and each major fund of the Corporation as of October 31, 2010, and the respective changes in financial position thereof for the year then ended in conformity with US generally accepted accounting principles.

The Management's Discussion and Analysis on pages 3 through 8 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. 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. However, we did not audit the information and express no opinion on it.

Ernst + Young LLP

January 20, 2011

TOBACCO SETTLEMENT FINANCING CORPORATION
A component unit of the State of New York

MANAGEMENT'S DISCUSSION AND ANALYSIS
FISCAL YEARS ENDED OCTOBER 31, 2010 AND 2009

Overview of the Financial Statements - The following is a narrative overview of the financial performance of the Tobacco Settlement Financing Corporation's (the "Corporation") financial activities for the fiscal years ended October 31, 2010 and 2009, with selective comparative information for the fiscal year ended October 31, 2008, and should be read in conjunction with the financial statements and the notes to the financial statements.

The annual financial statements consist of four parts: (1) management's discussion and analysis (this section); (2) the Corporation's entity-wide financial statements; (3) the governmental funds financial statements and (4) the notes to the financial statements.

Management's Discussion and Analysis:

- This section of the Corporation's financial statements, Management's Discussion and Analysis ("MD&A"), presents an overview of the Corporation's financial performance during the fiscal year ended October 31, 2010, compared to the fiscal years ended October 31, 2009 and October 31, 2008. It provides a discussion of financial highlights and an assessment of how the Corporation's position has changed from the past years. It identifies the factors that, in management's view, significantly affected the Corporation's overall financial position. It may contain opinions, assumptions or conclusions by the Corporation's management that should not be considered a replacement for, and must be read in conjunction with, the financial statements described below.

The Entity-Wide Financial Statements:

- The entity-wide financial statements of the Corporation, which include the statements of net assets and the statements of activities, are presented to display information about the reporting entity as a whole, in accordance with Governmental Accounting Standards Board ("GASB") Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments* ("GASB No. 34"). The statements of net assets and the statements of activities are prepared using the economic resources measurement focus and the accrual basis of accounting. All revenues and expenses are taken into account regardless of when cash is paid or received. This is to provide the reader with a broad overview of the Corporation's finances, similar to private-sector financial statements.

Governmental Funds Financial Statements:

The focus of the Corporation's governmental funds financial statements is to provide information on short-term inflows, outflows, and balances of expendable resources. Such information is useful in assessing the Corporation's financial activity.

- The Corporation's governmental funds financial statements are presented using the current financial resources measurement focus and the modified accrual basis of accounting. Revenue is recognized when it becomes susceptible to accrual, which is when it becomes both measurable and available to finance expenditures in the current period. The reconciliations of the statement of revenues, expenditures and changes in fund balances of governmental funds to the statement of activities are presented to assist the reader in understanding the differences between entity-wide and governmental funds financial statements.

The Notes to the Financial Statements provide:

- Information that is essential to understanding the financial statements, such as the Corporation's accounting methods and policies providing information about the content of the financial statements.
- Details of contractual obligations, as well as future commitments and contingencies of the Corporation when applicable.
- Information regarding any other events or developing situations that could materially affect the Corporation's financial position.

General

Pursuant to the Tobacco Settlement Financing Corporation Act (the "Act") of the State of New York (the "State"), the Corporation was created in 2003 as a subsidiary of the State of New York Municipal Bond Bank Agency (the "Agency"). By terms of its creation, the Corporation is treated and accounted for as a legal entity, separate from the State and the Agency, with separate corporate purposes. The Agency does not have financial accountability for the Corporation; accordingly, the Corporation is not a component unit of the Agency. Although legally separate from the State, the Corporation is a component unit of the State and, accordingly, is included in the State's financial statements.

As security for the bonds issued by the Corporation, pursuant to the Act and the Purchase and Sale Agreement, the State has sold to the Corporation 100% of the annual payments, strategic contribution payments and lump sum payments payable to the State, pursuant to the Master Settlement Agreement ("MSA"), less certain unsold payments which remain the property of the State. The purchase price of the State's future right, title and interest to the payments sold to the Corporation was financed with the proceeds of the Series 2003 Series A and 2003 Series B Bonds and transferred to the State at the time of such sale.

MSA payments are due annually to the Corporation. The MSA funds are used for debt service due on the Corporation's outstanding bonds, to pay administrative expenses and for certain arbitration expenses of the NYS Attorney General's Office.

Financial Highlights and Overall Analysis - Entity-Wide Financial Statements

Bonds Outstanding and Retired

On June 1, 2010, scheduled redemptions were paid in the total amount of $168.2 million as follows: $25 million of the Series 2003 A-1 Bonds, $25 million of the Series 2003 B-1 Bonds, $34.1 million of the Series 2008 A Refunding Bonds and $84.1 million of the Series 2008 B Refunding Bonds.

In addition, on June 1, 2010, the following bonds subject to optional redemption were called at par value and without premium: Series 2003A-1C Bonds totaling $65.3 million, and Series 2003B-1C Bonds totaling $11.4 million. On June 1, 2010 the aggregate amount of bonds retired was $244.9 million.

For the fiscal years ended October 31, 2010 and October 31, 2009, bonds outstanding were $3 billion and $3.3 billion, respectively. All of the Corporation's outstanding bond debt is in the form of fixed rate bonds. As of October 31, 2010, $595 million of the Series 2003 A1-C Bonds maturing from 2020 to 2022 are insured by a financial guaranty insurance policy. The outstanding balances of Series 2003A, Series 2003B, Series 2008A and Series 2008B Bonds in the amount of $2.4 billion are uninsured.

Condensed Statements of Net Assets
(in thousands)

		October 31,			% Change	
		2010	2009	2008	2010-2009	2009 - 2008
Deferred charges	$	2,819,332	3,048,961	3,358,536	(7.5%)	(9.2%)
Other assets		531,470	536,585	561,264	(1.0%)	(4.4%)
Total Assets	$	3,350,802	3,585,546	3,919,800	(6.5%)	(8.5%)
Bonds payable	$	3,011,900	3,256,805	3,588,055	(7.5%)	(9.2%)
Bond premium		106,647	127,316	156,277	(16.2%)	(18.5%)
Other liabilities		66,897	72,109	78,733	(7.2%)	(8.4%)
Total Liabilities		3,185,444	3,456,230	3,823,065	(7.8%)	(9.6%)
Total Net Assets	$	165,358	129,316	96,735	27.9%	33.7%

Significant Changes in Assets and Liabilities:

Deferred Charges

Funds made available from the sale of the Series 2003 A and Series 2003 B Bonds and transferred to the State are recorded as a deferred charge. At the time of the sale of such bonds, $2.2 billion and $2 billion, respectively, totaling $4.2 billion were transferred to the State. The Corporation did not transfer funds to the State during fiscal 2010 or 2009.

As a result of amortization, deferred charges decreased by $230 million, from approximately $3 billion at October 31, 2009 to $2.8 billion at October 31, 2010, or 7.5%, as compared with a decrease from approximately $3.3 billion at October 31, 2008 to $3 billion at October 31, 2009, a decrease of $309.8 million, or 9.2%.

Investments

Investments are reported at fair value net of accrued interest receivable which is separately stated on the Statement of Net Assets.

Restricted cash and investments at October 31, 2010 totaled $531.5 million and consist of investments in the Debt Service Fund. As of October 31, 2010 there were no unrestricted investments.

Bonds Payable

Bonds payable decreased from approximately $3.3 billion at October 31, 2009, to $3 billion at October 31, 2010, a decrease of $244.9 million, or 7.5%, as compared with a decrease from approximately $3.6 billion at October 31, 2008, to $3.3 billion at October 31, 2009, a decrease of $331.3 million, or 9.2%.

The Corporation, as required under the indenture, redeemed bonds in the amount of $76.7 million and $228 million in fiscal 2010 and fiscal 2009, respectively, before the stated maturity dates.

Unamortized bond premium decreased from approximately $127.3 million at October 31, 2009, to $106.6 million at October 31, 2010, a decrease of $20.7 million, or 16.2%, as compared with a decrease from approximately $156.3 million at October 31, 2008, to $127.3 million at October 31, 2009, a decrease of $29 million, or 18.5%.

The decreases in bond premium during fiscal 2010 and 2009 are attributable to amortization. The Corporation employs the effective interest method when amortizing bond premium.

Condensed Statements of Activities
For the Fiscal Year Ended
(in thousands)

		October 31,			% Change	
		2010	**2009**	**2008**	**2010-2009**	**2009 - 2008**
Settlement Revenues	$	410,189	490,967	448,302	(16.5%)	9.5%
Other Revenues		2,891	4,652	21,267	(37.8%)	(78.1%)
Total Revenues	$	413,080	495,619	469,569	(16.7%)	5.5%
General and Administrative Expenses	$	783	489	872	60.1%	(43.9%)
Amortization of Deferred Charges		225,945	305,416	260,465	(26.0%)	17.3%
Bond Issuance Expense		-	-	3,107	-	(100%)
Other Expenses		150,310	157,133	177,659	(4.3%)	(11.5%)
Total Expenses		377,038	463,038	442,103	(18.6%)	4.7%
Total Changes to Net Assets	$	36,042	32,581	27,466	10.6%	18.6%

"_" indicate a percentage of less than 1%

Significant Changes in Expenses and Revenues:

Tobacco Settlement Revenues

Tobacco settlement revenues ("TSRs") decreased from approximately $491 million in fiscal 2009 to $410 million in fiscal 2010, a decrease of $81 million, or 16.5%, as compared with an increase from approximately $448.3 million in fiscal 2008 to $491 million in 2009, an increase of $42.7 million, or 9.5%. Any MSA funds received in excess of the minimum amount required to pay the scheduled annual debt service and administrative expenses have been used to redeem additional bonds ("Turbo calls").

TSRs consist primarily of the Pledged Settlement Payments sold by the State to the Corporation pursuant to the Purchase and Sale Agreement between the State and the Corporation. Pledged TSRs are contingent on tobacco sales and other factors, which cannot be predicted and therefore are only recognized when the payment is received by the Corporation.

Amortization of Deferred Charges

Amortization of deferred charges decreased from approximately $305.4 million in fiscal 2009 to $225.9 million in fiscal 2010, a decrease of $79.5 million, or 26.0%, as compared with an increase from approximately $260.5 million in fiscal 2008 to $305.4 million in fiscal 2009, an increase of $44.9 million, or 17.3%.

The Corporation amortizes deferred charges in proportion to bonds redeemed during the fiscal year (the bond outstanding method). Bond principal redemptions totaled approximately $244.9 million in fiscal 2010 as compared to approximately $331.3 million in fiscal 2009 causing the decrease. An increase to tobacco settlement revenues, as well as investment revenues that are applied to bond principal redemptions, result in accelerated amortization of deferred charges. When tobacco settlement revenues and investment earnings decline, less funds are available to call bonds and amortization of deferred charges decrease.

General and Administrative Expenses

General and administrative expenses increased from $489 thousand in fiscal 2009 to $783 thousand in fiscal 2010, an increase of $294 thousand, or 60.1%, as compared with a decrease from $872 thousand in fiscal 2008 to $489 thousand in fiscal 2009, a decrease of $383 thousand, or 43.9%. In fiscal 2010 the Corporation paid approximately $280 thousand in arbitration expenses incurred by the office of the New York State Attorney General. The decrease in fiscal 2008 was primarily attributable to cost savings resulting from the early retirement of auction rate bonds in March 2008. Broker dealer fees were incurred with the outstanding auction rate bonds. In fiscal 2009, the Corporation did not incur broker dealer fees as compared with $510 thousand in fiscal 2008.

Financial Highlights and Overall Analysis - Governmental Funds Financial Statements

The Governmental Fund consists of the Debt Service Fund and the General Fund. The purpose of the Debt Service Fund is to account for the Debt Service Reserve Account and the funds available to pay debt service on bonds. At October 31, 2010, cash and investments held in the Debt Service Fund totaled approximately $531.5 million as compared to $536.6 million at October 31, 2009, a decrease of $5.1 million.

The General Fund accounts for all financial resources associated with the Corporation except for those required to be accounted for in the Debt Service Fund. At October 31, 2010, cash held in the General Fund totaled $0 as compared to $2 thousand at October 31, 2009.

Currently Known Facts

Cigarette sales, which drive the MSA payments, and hence the Corporation's TSRs, have been declining steadily for several years, however, the industry experienced a precipitous drop in 2009. Published reports attribute the 8.6% drop to the recession and a sharp increase in the federal excise tax on tobacco products. This drop has lead to numerous rating agency downgrades for other issuer's MSA bond issues. No such action has been taken with respect to the Corporation's bonds. Furthermore the TSRs received in fiscal year 2010 continued to exceed the amount necessary to pay debt service.

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Tobacco Settlement Financing Corporation
(A Component Unit of the State of New York)

STATEMENTS OF NET ASSETS
(Amounts in Thousands)

		October 31, 2010	October 31, 2009
Assets			
Cash and cash equivalents	$	-	2
Restricted cash and cash equivalents		471,202	17
Restricted investments		56,886	530,404
Accrued interest receivable		3,382	6,162
Deferred charges		2,819,332	3,048,961
Total assets		**3,350,802**	**3,585,546**
Liabilities			
Accrued interest payable		66,728	71,834
Payable to the State of New York Municipal Bond Bank Agency		169	275
Bonds payable (net)			
Portion payable within one year		148,270	168,210
Portion payable after one year		2,970,277	3,215,911
Total liabilities		**3,185,444**	**3,456,230**
Net Assets (Deficit)			
Restricted for debt service		531,470	536,583
Unrestricted (deficit)		(366,112)	(407,267)
Total Net Assets	**$**	**165,358**	**129,316**

See notes to financial statements.

Tobacco Settlement Financing Corporation
(A Component Unit of the State of New York)

STATEMENTS OF ACTIVITIES
FOR FISCAL YEARS ENDED
(Amounts in Thousands)

		October 31,	
		2010	**2009**
Expenses			
General and administrative expenses	$	783	489
Interest expense		150,310	157,133
Amortization of deferred charges		225,945	305,416
Total expenses		**377,038**	**463,038**
Revenues			
Tobacco settlement revenue		410,189	490,967
Earnings on investments		2,891	4,652
Total revenues		**413,080**	**495,619**
Change in net assets		**36,042**	**32,581**
Net Assets, beginning of fiscal year		**129,316**	**96,735**
Net Assets, end of fiscal year	**$**	**165,358**	**129,316**

See notes to financial statements.

Tobacco Settlement Financing Corporation
(A Component Unit of the State of New York)

GOVERNMENTAL FUNDS BALANCE SHEET
OCTOBER 31, 2010
(Amounts in Thousands)

		General Fund	Debt Service	Total Governmental Funds
Assets				
Restricted cash and cash equivalents	$	—	471,202	471,202
Restricted investments		—	56,886	56,886
Accrued interest receivable		—	3,382	3,382
Total assets		**—**	**531,470**	**531,470**
Liabilities				
Payable to the State of New York Municipal Bond Bank Agency		169	—	169
Total liabilities		**169**	**—**	**169**
Fund Balances				
Unreserved		(169)	—	(169)
Reserved for debt service		—	531,470	531,470
Total fund balances		**(169)**	**531,470**	**531,301**
Total Liabilities and Fund Balances	**$**	**—**	**531,470**	**531,470**

See notes to financial statements.

Tobacco Settlement Financing Corporation
(A Component Unit of the State of New York)

STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES
FOR THE FISCAL YEAR ENDED OCTOBER 31, 2010
(Amounts in Thousands)

		General Fund	Debt Service	Total Governmental Funds
Revenues				
Earnings on investments	$	9	2,882	2,891
Settlement Revenues		—	410,189	410,189
Total revenues		**9**	**413,071**	**413,080**
Expenditures				
General and administrative expenses		783	—	783
Principal amount of bonds retired		—	244,905	244,905
Interest expense		—	172,401	172,401
Total expenditures		**783**	**417,306**	**418,089**
Deficiency of Revenues Over Expenditures		**(774)**	**(4,235)**	**(5,009)**
Transfers		**878**	**(878)**	**—**
Net Change in Fund Balances		**104**	**(5,113)**	**(5,009)**
Fund Balances, Beginning of fiscal year		**(273)**	**536,583**	**536,310**
Fund Balances, End of fiscal year	**$**	**(169)**	**531,470**	**531,301**

See notes to financial statements.

Tobacco Settlement Financing Corporation
(A Component Unit of the State of New York)

GOVERNMENTAL FUNDS BALANCE SHEET
OCTOBER 31, 2009
(Amounts in Thousands)

		General Fund	Debt Service	Total Governmental Funds
Assets				
Cash and cash equivalents	$	2	17	19
Investments		—	—	—
Restricted investments		—	530,404	530,404
Accrued interest receivable		—	6,162	6,162
Total assets		**2**	**536,583**	**536,585**
Liabilities				
Payable to the State of New York Municipal Bond Bank Agency		275	—	275
Total liabilities		**275**	**—**	**275**
Fund Balances				
Unreserved		(273)	—	(273)
Reserved for debt service		—	536,583	536,583
Total fund balances		**(273)**	**536,583**	**536,310**
Total Liabilities and Fund Balances	**$**	**2**	**536,583**	**536,585**

See notes to financial statements.

Tobacco Settlement Financing Corporation
(A Component Unit of the State of New York)

STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES
FOR THE FISCAL YEAR ENDED OCTOBER 31, 2009
(Amounts in Thousands)

		General Fund	Debt Service	Total Governmental Funds
Revenues				
Earnings on investments	$	38	4,614	4,652
Tobacco settlement revenues		—	490,967	490,967
Total revenues		**38**	**495,581**	**495,619**
Expenditures				
General and administrative expenses		489	—	489
Principal amount of bonds retired		—	331,250	331,250
Interest expenses		—	188,744	188,744
Total expenditures		**489**	**519,994**	**520,483**
Deficiency of Revenues Over Expenditures		**(451)**	**(24,413)**	**(24,864)**
Transfers		**(3,947)**	**3,947**	**—**
Net Change in Fund Balances		**(4,398)**	**(20,466)**	**(24,864)**
Fund Balances, Beginning of Fiscal Year		**4,125**	**557,049**	**561,174**
Fund Balances (Deficit), End of Fiscal Year	**$**	**(273)**	**536,583**	**536,310**

See notes to financial statements.

Tobacco Settlement Financing Corporation
(A Component Unit of the State of New York)

RECONCILIATION OF THE GOVERNMENTAL FUNDS BALANCE SHEETS
TO THE STATEMENTS OF NET ASSETS
OCTOBER 31, 2010 AND 2009
(Amounts in Thousands)

		2010	2009
Total fund balance - governmental funds	$	531,301	536,310
Amounts reported for governmental activities in the statement of net assets are different because:			
Deferred charges represent the amortized balance relating to funds transferred to the State		2,776,936	3,002,881
Costs of debt issuance are expenditures in government activities. However, in the statement of net assets, the costs of debt issuance are reported as capitalized assets and amortized over the lives of the debt.		42,396	46,080
Some liabilities are not due and payable in the current period from currently available financial resources and are therefore not reported in the governmental funds financial statements. Those liabilities consist of:			
Bonds payable (net)		(3,118,547)	(3,384,121)
Accrued interest on bonds		(66,728)	(71,834)
Net assets	**$**	**165,358**	**129,316**

See notes to financial statements.

Tobacco Settlement Financing Corporation
(A Component Unit of the State of New York)

RECONCILIATION OF THE GOVERNMENTAL FUNDS STATEMENTS OF REVENUES EXPENDITURES AND CHANGES IN FUND BALANCES TO THE STATEMENTS OF ACTIVITIES FOR THE FISCAL YEARS ENDED OCTOBER 31, 2010 AND 2009
(Amounts in Thousands)

		2010	2009
Net change in fund balances - total government funds	$	**(5,009)**	**(24,864)**
Amounts reported for governmental activities in the statement of activities are different because:			
Governmental funds report bond premium/ discounts as other financing sources (uses). However, in the statement of activities, bond premiums/discounts are amortized over the the lives of the debt as interest income (expense).		16,985	24,802
Amortization of deferred changes.		(225,945)	(305,416)
Interest expense is reported in the statement of activities on the accrual basis, but interest is reported as an expenditure in governmental funds when the outlay of financing resources is required.		5,106	6,809
Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the statement of net assets.		244,905	331,250
Change in net assets	**$**	**36,042**	**32,581**

See notes to financial statements.

Tobacco Settlement Financing Corporation
(State of New York)

Notes To Financial Statements

Fiscal Years Ended October 31, 2010 and 2009

NOTE 1. Tobacco Settlement Financing Corporation

Tobacco Settlement Financing Corporation (the “Corporation”) is a public benefit corporation of the State of New York (the “State”) created as a subsidiary of the State of New York Municipal Bond Bank Agency (the “Agency”) and created pursuant to the Tobacco Settlement Financing Corporation Act (the “Act”), Part D3 of Chapter 62 of the Laws of the State of New York of 2003. By the terms of the Act, the Corporation shall be treated and accounted for as a legal entity separate from the State and the Agency with its separate corporate purposes set forth in the Act. The directors of the Agency are the members of the Corporation. The Corporation is governed by a seven-member board: the Chairman of the Agency, the Secretary of State, the Director of the Budget of the State, three directors appointed by the Governor of the State and the State Comptroller or his appointee. Although legally separate from the State, the Corporation is a component unit of the State and, accordingly, is included in the State's financial statements.

The Agency does not have financial accountability for the Corporation; accordingly, the Corporation is not a component unit of the Agency in accordance with the requirements of Governmental Accounting Standards Board (“GASB”) Statement No. 14, *The Financial Reporting Entity* (“GASB No. 14”) and GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units* (“GASB No. 39”).

Pursuant to the Act and the Purchase and Sale Agreement, the State has sold to the Corporation 100% of the annual payments, strategic contribution payments and lump sum payments payable to the State, pursuant to the Master Settlement Agreement (“MSA”), less certain unsold payments which remain the property of the State.

The MSA (a) resolved cigarette smoking related litigation between the settling states and certain other jurisdictions and the Participating Manufacturers (“PMS”), (b) released the PMS from past and present smoking-related claims, and (c) provides for a continuing release of future smoking-related claims in exchange for certain payments to be made to the settling states and certain other jurisdictions and certain tobacco advertising and marketing restrictions, among other things. A decree was entered by the Supreme Court of the State allocating to the State a share of the Tobacco Settlement Revenue (“TSRs”) under the MSA.

The purchase price of the State's future right, title and interest to the payments sold to the Corporation has been financed by the issuance of certain series of bonds of the Corporation and by the issuance of certain residual certificates in connection therewith. The residual certificates represent the entitlement to deliver to the holder of the residual certificates any amounts remaining in any of the accounts established under the Trust Indenture to which the residual certificate applies, after making all deposits and payments set forth in the Indenture, and provided that there are no outstanding bonds and no obligations to make payments to any beneficiaries which are secured by the pledge of the Indenture to which the residual certificate applies.

NOTE 2. Summary of Significant Accounting Policies

A. Basis of Accounting

The entity-wide financial statements of the Corporation, which include the statements of net assets and the statements of activities, are presented to display information about the reporting entity as a whole, in accordance with Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments* ("GASB No. 34"). The statements of net assets and the statements of activities are prepared using the economic resources measurement focus and the accrual basis of accounting.

The Corporation's governmental fund financial statements are presented using the current financial resources measurement focus and the modified accrual basis of accounting. They recognize revenue when it becomes susceptible to accrual, which is when it becomes both measurable and available to finance expenditures in the current fiscal period. Expenditures are recognized when the related liability is incurred, except for unmatured interest and principal which is recognized when due.

B. The governmental funds consist of the General Fund and the Debt Service Fund. The General Fund accounts for all financial resources associated with the Corporation except for those required to be accounted for in the Debt Service Fund. The Debt Service Fund accounts for the accumulation of resources for payment of principal and interest on long-term debt and the Debt Service Reserve Account.

C. The Debt Service Fund contains two accounts: the Debt Service Account and the Debt Service Reserve Account. The cash and investments in the Debt Service Account are available to pay current debt service on bonds. At October 31, 2010 and 2009, $80.1 million and $86.2 million (including accrued interest receivable), respectively, were on deposit in this account.

The Debt Service Reserve Account was funded with bond proceeds in the total amount of $449.1 million. The purpose of the Debt Service Reserve Account is to pay principal of and interest on the outstanding bonds, if there is a shortfall in available funds. Cash and Investments, including accrued interest, in the Debt Service Reserve Account, as valued in accordance with the respective bond resolutions at October 31, 2010 and 2009, were as follows:

		2010	2009
		($ in Millions)	
On Deposit	$	451.3	450.4
Reserve Requirement		449.1	449.1
Excess	$	2.2	1.3

D. Cash and Cash Equivalents

All highly liquid investments with a maturity when purchased of 90 days or less are considered to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value.

E. Bond Premiums

Bond premiums and issuance costs are capitalized and amortized over the lives of the related debt in the entity-wide financial statements. Bond premiums are amortized using the effective interest method. The governmental funds financial statements recognize bond premiums during the current period.

The face amount of debt issued and any premium thereon is reported as other financing sources in the fund financial statements.

F. Use of Restricted Net Assets

When both restricted and unrestricted resources are available for a particular restricted use, it is the Corporation's policy to use restricted resources first, and then unrestricted as needed.

G. Investments

Investments are recorded at amortized cost, which approximates fair value, in accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and External Investment Pools* ("GASB No. 31") (see Note 5).

H. Deferred Charges

Deferred charges are those where the liability recognition criteria have been met, but where expenditure recognition criteria have not been met. Such amounts include the following:

Issuance Costs:

In the governmental funds financial statements, issuance costs are recognized as expenditures in the period incurred. Issuance costs recorded in the government-wide financial statements are deferred and amortized over the terms of the bonds using the straight-line method.

Deferral of Cost from Purchase of Future TSRs:

In accordance with the GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* ("GASB No. 48"), the Corporation recorded the transfer of funds made to the State as a Deferred Charge.

Funds made available resulting from the sale of Series 2003 A and Series 2003 B Bonds allowed for transfers to the State in the amounts of $2.201 billion and $1.999 billion respectively. Each transfer was made at the time of the respective bond sale.

For the fiscal years ended October 31, 2010 and 2009, the Corporation amortized $225.9 million and $305.4 million, respectively, in deferred charges. The unamortized balance of the Deferred Charge at October 31, 2010 and 2009 totaled $2.8 billion and $3 billion, respectively.

I. Contingencies

The amount of revenue recognized by the Corporation could be adversely impacted by certain third party litigation involving tobacco companies and others. Therefore, the Corporation cannot predict the actual amount of pledged settlement payments that it ultimately will receive, and, therefore, the Corporation recognizes revenue when the cash is received.

J. Recent Accounting Pronouncements

In February 2009, GASB issued Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* ("GASB No. 54"). The Statement affects the display of fund balances in the financial statements and requires that governments disclose their fund balance classifications, policies and procedures in the Notes. Fund balances will be classified as nonspendable, restricted, committed, assigned, and/or unassigned, as defined in the Statement. Additionally, GASB No. 54 refines the definitions of each of the governmental fund types, such as debt service and capital projects funds. The requirements for GASB No. 54 are effective for periods beginning after June 15, 2010. While the Corporation's governmental fund financial statement presentation will be impacted by the implementation of GASB No. 54, the Corporation has not completed the process of evaluating the impact of GASB No. 54 on its financial statements.

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and American Institute of Certified Public Accountants (“AICPA”) Pronouncements* (“GASB 62”). This Standard will improve financial reporting by incorporating into the GASB’s authoritative literature certain accounting and financial reporting guidance that is included in FASB and AICPA pronouncements issued on or before November 30, 1989, which does not conflict or contradict GASB pronouncements. GASB 62 will supersede Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting.* The requirements of GASB 62 are effective for financial statements for periods beginning after December 15, 2011. The Agency has not completed the process of evaluating the impact of GASB 62 on its financial statements.

K. Reclassifications

Certain reclassifications have been made to the prior year in order to conform to the current year presentation.

NOTE 3. Service Agreement

The Corporation has an agreement with the Agency whereby the Agency provides managerial, administrative and financial services to the Corporation. Pursuant to this agreement, the Corporation was charged approximately $414,000 and $350,000 for various expenses, including salaries, in fiscal years 2010 and 2009, respectively. As of October 31, 2010 and 2009 the Corporation owed the Agency the amounts of $169,000 and $275,000, respectively in accordance with the TSFC Service Agreement.

NOTE 4. Bonds Payable

Outstanding Bonds are secured by the Pledged Settlement Payments. In addition, they are further secured by a pledge of all of the Corporation's interest under a Contingency Contract entered into between the Corporation and the State which provides for payment to the Corporation of such amounts, if any, as shall be necessary to provide for the payment of principal of and interest on the Bonds coming due on the next payment date if all other funds pledged and available, including Pledged Settlement Payments and moneys in the Debt Service Reserve Account, are inadequate. The State's obligation to make such payments under the Contingency Contract exists only to the extent moneys are available to the State and the State incurs no liability beyond the moneys available to it and appropriated for such purpose.

A summary of changes in outstanding bonds during the fiscal year ended October 31, 2010 is as follows:

Schedule of Bonds Outstanding
October 31, 2010

		Original Face Amount	Balance October 31, 2009	Bonds Issued	Retired/ Principal Payments	Balance October 31, 2010
		Series 2003 A				
		($ in Thousands)				
Series 2003 A1C - 4.0% to 5.5%	$	1,796,940	1,354,395	-	65,340	1,289,055
Series 2003 A-1 - 3.0% to 5.0%		296,265	75,000	-	25,000	50,000
Sub-total Series 2003 A	$	2,093,205	1,429,395	-	90,340	1,339,055
		Series 2003 B				
Series 2003 B1C - 4.0% to 5.5%	$	1,713,235	1,373,010	-	11,355	1,361,655
Series 2003 B-1 - 4.0% to 5.0%		302,180	68,795	-	25,000	43,795
Sub-total Series 2003 B	$	2,015,415	1,441,805	-	36,355	1,405,450
		Series 2008				
Series 2008 A (Refunding Bonds) 3% - 5%	$	219,935	199,935	-	34,140	165,795
Series 2008 B (Refunding Bonds) 5%		223,940	185,670	-	84,070	101,600
Sub-total Series 2008 A & B	$	443,875	385,605	-	118,210	267,395
Total Bond Indebtedness	$	4,552,495	3,256,805	-	244,905	3,011,900
Bond Premium		-	127,316	-	20,669	106,647
Total Net Bond Indebtedness	**$**	**4,552,495**	**3,384,121**	**-**	**265,574**	**3,118,547**

Future debt service requirements are as follows:

Fiscal year ending October 31,		Principal	Interest	Total
			($ in Thousands)	
2011	$	148,270	160,147	308,417
2012		212,920	152,897	365,817
2013		39,680	143,430	183,110
2014		139,265	141,347	280,612
2015		182,180	133,776	315,956
2016 – 2020		1,599,335	458,939	2,058,274
2021 – 2022		690,250	52,296	742,546
Total		3,011,900	1,242,832	4,254,732

NOTE 5. Deposits and Investments

All the Corporation funds are held in trustee accounts and are governed by the applicable bond resolution. For the fiscal years ended October 31, 2010 and 2009, all the Corporation funds were invested in accordance with the applicable policy or resolution. At October 31, 2010 and 2009, investments (exclusive of accrued interest receivable) held by the trustee in the Corporation's name amounted to $528,088,000 and $530,423,000, respectively. Uncollateralized cash amounted to $0 and $2,000, respectively.

The Corporation has a formal investment policy which governs the investment of all the Corporation's monies. These guidelines and policies are designed to protect principal by limiting credit risk. A summary of permitted investment policies and procedures is as follows:

- General obligations of, or obligations guaranteed by any state of the United States of America or political subdivision thereof, or the District of Columbia or any agency or instrumentality of any of them (excluding FNMA and FHLMC obligations as Defeasance Collateral);

- Certificates of deposit, savings accounts, demand and time deposits or other obligations or accounts of banks or trust companies in the State, secured as required by the Corporation;

- Obligations in which the State Comptroller is authorized to invest pursuant to Section 98 or 98-a of the State Finance Law;

- Commercial or finance company paper payable not more than 190 days after the date of issuance;

- Units of taxable money market funds which funds are regulated investment companies and seek to maintain a constant net asset value per share;

- Repurchase Obligations, Investment Agreements or Guaranteed Investment Contracts;

- Non-AMT Tax-Exempt obligation (Supplemental Account only).

There are minimum ratings requirements associated with the authorized investments described above. Additionally, there are restrictions on the call features of investments used as Defeasance Collateral.

Debt Service Reserve Account Investment

A portion of monies in the Debt Service Reserve Account are invested in a Reserve Fund Agreement.

The terms of the Reserve Fund Agreement requires the Corporation to make funds available in the Debt Service Reserve Account at the time of delivery by the Counterparty of qualified securities for purchase by the Corporation and deposit into the Debt Service Reserve Account. On deposit dates, the Counterparty sells the Corporation qualified securities that will mature on or prior to the related bond payment dates in amounts equal to the amounts deposited plus the guaranteed rate for the period. This Reserve Fund Agreement with Morgan Stanley & Co. Inc. amounted to $56.9 million or 10.8% of the Corporation's investments at October 31, 2010. Morgan Stanley & Co. Inc. was rated A and A2 by S&P and Moody's, respectively at October 31, 2010.

Interest Rate Risk

Securities purchased with tobacco settlement revenues are invested in U.S. Treasury Obligations with maturities as close as practical to the next debt service payment date or date of usage, typically less than one year. Interest rate risk is therefore minimal due to the short term duration of the Corporation's investments in the other than Debt Service Reserve Agreements category.

Under the terms of the Debt Service Reserve Agreement, the Corporation is guaranteed a certain rate of return by the Counterparty. If, however, the Counterparty is not in compliance with the terms of the agreement, the Corporation could sustain interest rate risk if the Corporation is unable to invest liquidated funds at comparable rates.

As of October 31, 2010, the Corporation had the following investments (exclusive of accrued interest):

Investment Type		Fair Value ($ in thousands)	Weighted Average Maturity (Years)
U.S. Treasury Notes	$	471,183	0.08
Reserve Fund Agreement		56,886	12.58
	$	528,069	
Less Amounts Reported as Cash Equivalents		471,183	0.08
Total		56,886	12.58
Portfolio Weighted Average Maturity			1.42

As of October 31, 2009, the Corporation had the following investments (exclusive of accrued interest):

Investment Type		Fair Value ($ in thousands)	Weighted Average Maturity (Years)
Federal Agencies	$	86,111	0.08
U.S. Treasury Notes		387,407	0.08
Reserve Fund Agreement		56,886	13.58
Total	$	530,404	
Portfolio Weighted Average Maturity			1.53

As of October 31, 2010 and October 31, 2009, the Corporation had the following investments and maturities:

Values below are at fair value excluding accrued interest as of October 31, 2010.

		Investment Maturities (In Years)		
		Fair Value	Less than 1	More than 10
Restricted Funds:		($ in Thousands)		
Investment Type				
Reserve Fund Agreement	$	56,886	-	56,886
U.S. Treasury Notes		471,183	471,183	-
	$	528,069	471,183	56,886
Less: Amounts reported as cash equivalents		471,183	471,183	-
Total Investments	$	56,886	-	56,886

Values below are at fair value excluding accrued interest as of October 31, 2009.

		Investment Maturities (In Years)		
		Fair Value	Less than 1	More than 10
Restricted Funds:		($ in Thousands)		
Investment Type				
Reserve Fund Agreement	$	56,886	-	56,886
Federal Agencies		86,111	86,111	
U.S. Treasury Notes		387,407	387,407	-
	$	530,404	473,518	56,886

* * * * * * *

TSFC
New York State

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