Tobacco Settlement Financing Corporation

TSFC

Financial Statements
Fiscal Year

2011

Tobacco Settlement Financing Corporation

Financial Statements

Fiscal Years Ended October 31, 2011 and 2010

Contents

RESPONSIBILITY FOR FINANCIAL REPORTING

The financial statements of the Tobacco Settlement Financing Corporation (the "Corporation"), for the fiscal years ended October 31, 2011 and 2010, 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.

Darryl C. Towns President/Chief Executive Officer	Joanne Hounsell Senior Vice President/ Interim Chief Financial Officer

January 25, 2012

Ernst & Young LLP
5 Times Square
New York, NY 10036-6530
Tel: +1 212 773 3000
Fax: +1 212 773 6350
www.ey.com

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 years ended October 31, 2011 and 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.

We conducted our audits 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 audits 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 audits provide a reasonable basis for our opinions.

In our opinion, the 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, 2011 and 2010, and the respective changes in financial position thereof for the year then ended in conformity with US generally accepted accounting principles.

As discussed in Note 2, the Agency adopted Government Accounting Standards Board Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* and Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position* as of November 1, 2010.

The Management's Discussion and Analysis on pages 4 through 9 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 25, 2012

MANAGEMENT'S DISCUSSION AND ANALYSIS
FISCAL YEARS ENDED OCTOBER 31, 2011 AND 2010

Overview of the Financial Statements - The following is a narrative overview of the financial performance of the Tobacco Settlement Financing Corporation (the "Corporation") for the fiscal years ended October 31, 2011 and 2010, with selective comparative information for the fiscal year ended October 31, 2009, 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, 2011, compared to the fiscal years ended October 31, 2010 and October 31, 2009. 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 position 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 position 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 net position 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

- The notes 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.

Background

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 to pay 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

Condensed Statements of Net Position
(in thousands)

	October 31,			% Change	
	2011	**2010**	**2009**	**2011-2010**	**2010 - 2009**
Deferred charges	$ 2,583,806	$ 2,819,332	$ 3,048,961	(8.4%)	(7.5%)
Other assets	525,456	531,470	536,585	(1.1%)	(1.0%)
Total Assets	3,109,262	3,350,802	3,585,546		
Bonds payable, net	2,868,855	3,118,547	3,384,121	(8.0%)	(7.8%)
Other liabilities	52,444	66,897	72,109	(21.6%)	(7.2%)
Total Liabilities	2,921,299	3,185,444	3,456,230	(8.3%)	(7.8%)
Total Net Position	$ 187,963	$ 165,358	$ 129,316		

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 has not transferred funds to the State since 2003.

As a result of amortization, deferred charges decreased by $235 million, from approximately $2.8 billion at October 31, 2010 to approximately $2.6 billion at October 31, 2011, or 8.4%, as compared with a decrease from approximately $3 billion at October 31, 2009 to approximately $2.8 billion at October 31, 2010, a decrease of $230 million, or 7.5%.

Bonds Payable

Bonds payable decreased from approximately $3.1 billion at October 31, 2010, to approximately $2.9 billion at October 31, 2011, a decrease of $249.7 million, or 8.0%, as compared with a decrease from approximately $3.4 billion at October 31, 2009, to approximately $3.1 billion at October 31, 2010, a decrease of $265.6 million, or 7.8%.

On June 1, 2011 the aggregate amount of bonds retired was $235.6 million as follows:

- Scheduled redemptions were paid in the total amount of $148.3 million as follows: $25 million of the Series 2003 A-1 Bonds, $22.3 million of the Series 2003 B-1 Bonds, $78.8 million of the Series 2008 A Refunding Bonds and $22.2 million of the Series 2008 B Refunding Bonds.

- Bonds subject to optional redemption were called at par value and without premium: Series 2003A-1C Bonds totaling $16.5 million, and Series 2003B-1C Bonds totaling $70.8 million.

On July 7, 2011, the Corporation partially refunded Series 2003A-1C Bonds, and Series 2003B-1C Bonds in the aggregate principal amount of $1.05 billion, through the issuance of Series 2011A and Series 2011B Refunding Bonds in the aggregate principal amount of $959.2 million, which was sold at a premium in the amount of approximately $109.9 million.

As of October 31, 2011 and 2010, principal on bonds outstanding was $2.7 billion and $3 billion, respectively. All of the Corporation's outstanding bond debt is in the form of fixed rate bonds. As of October 31, 2011, $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 $2.1 billion are uninsured.

Unamortized bond premium increased from approximately $106.6 million at October 31, 2010, to $167.7 million at October 31, 2011, an increase of $61.1 million, or 57.3%. The increase is attributable to bond premium relating to the sale of 2011 refunding bonds in the amount of $109.9 million less amortization of $8.5 million, and a reduction in the 2010 balance in the amount of $40.3 million relating to the 2011 refunding. This compares with a decrease 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%, which resulted from amortization.

Condensed Statements of Activities
(in thousands)

	Fiscal Year Ended October 31, 2011	2010	2009	% Change 2011-2010	2010 - 2009
Program Revenues:					
Tobacco Settlement Revenues	$ 387,470	$ 410,189	$ 490,967	(5.5%)	(16.5%)
Other Revenues	2,786	2,891	4,652	(3.6%)	(37.8%)
Total Revenues	390,256	413,080	495,619		
Program Expenses:					
General and Administrative Expenses	699	783	489	(10.7%)	60.1%
Amortization of Deferred Charges	221,513	225,945	305,416	(2.0%)	(26.0%)
Other Expenses	145,439	150,310	157,133	(3.2%)	(4.3%)
Total Expenses	367,651	377,038	463,038	(2.5%)	(18.6%)
Total Change in Net Position	$ 22,605	$ 36,042	$ 32,581		

Significant Changes in Expenses and Revenues:

Tobacco Settlement Revenues

Tobacco settlement revenues ("TSRs") decreased from approximately $410 million in fiscal 2010 to $387 million in fiscal 2011, a decrease of $23 million, or 5.5%, as compared with a decrease from approximately $491 million in fiscal 2009 to approximately $410 million in 2010, a decrease of $81 million, or 16.5%. 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.

The decline in TSRs from fiscal 2009 to fiscal 2011 is partially attributable to the continued decline in Cigarette sales, which drive the MSA payments, and hence the Corporation's TSRs. The decline in Cigarette sales moderated somewhat is fiscal 2011 in which the decline was approximately 3.8% as compared with a decline of 5.27% in 2010. In addition, in connection with the 2008 NPM (Non-Participating Manufacturers) Adjustment, during fiscal 2011 funds which would have made up part of the TSR payment were placed into a Disputed Payments Account (held by the MSA Escrow agent) in the amount of $267 million. This reduced the amount of the fiscal 2011 TSRs by as much as $17.4 million.

Amortization of Deferred Charges

Amortization of deferred charges decreased from approximately $225.9 million in fiscal 2010 to approximately $221.5 million in fiscal 2011, a decrease of $4.4 million, or 1.9%, as compared with a decrease from approximately $305.4 million in fiscal 2009 to approximately $225.9 million in fiscal 2010, a decrease of $79.5 million, or 26.0%.

The Corporation amortizes deferred charges in proportion to bonds redeemed during the fiscal year (the bond outstanding method), which totaled approximately $235.5 million in fiscal 2011 as compared to approximately $244.9 million in fiscal 2010.

General and Administrative Expenses

General and administrative expenses decreased from $783 thousand in fiscal 2010 to $699 thousand in fiscal 2011, a decrease of $84 thousand, or 10.7%, as compared with an increase from $489 thousand in fiscal 2009 to $783 thousand in fiscal 2010, an increase of $294 thousand, or 60.1%. In fiscal 2011, the Corporation paid approximately $212 thousand in arbitration expenses incurred by the office of the New York State Attorney General, compared with approximately $280 thousand in fiscal 2010 resulting in a significant portion of the reduction.

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, 2011, cash and investments held in the Debt Service Fund totaled approximately $525.4 million as compared to approximately $531.5 million at October 31, 2010, a decrease of $6.1 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, 2011, cash held in the General Fund totaled $85 thousand as compared to $0 thousand at October 31, 2010.

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Tobacco Settlement Financing Corporation

(A Component Unit of the State of New York)

STATEMENTS OF NET POSITION

(Amounts in Thousands)

	October 31,	
	2011	**2010**
Assets		
Cash	$ 85	$ -
Restricted cash and cash equivalents	1,087	471,202
Restricted investments	522,994	56,886
Accrued interest receivable	1,290	3,382
Deferred charges	2,583,806	2,819,332
Total assets	**3,109,262**	**3,350,802**
Liabilities		
Accrued interest payable	52,190	66,728
Payable to the State of New York Municipal Bond Bank Agency	254	169
Bonds payable (net)		
Portion payable within one year	212,920	148,270
Portion payable after one year	2,655,935	2,970,277
Total liabilities	**2,921,299**	**3,185,444**
Net Position Restricted for Debt Service	**187,963**	**165,358**

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)

	Fiscal Year Ended October 31,	
	2011	**2010**
Program Expenses		
General and administrative expenses	$ 699	$ 783
Interest expense	145,439	150,310
Amortization of deferred charges	221,513	225,945
Total expenses	**367,651**	**377,038**
Program Revenues		
Tobacco settlement revenue	387,470	410,189
Earnings on investments	2,786	2,891
Total revenues	**390,256**	**413,080**
Change in net position	**22,605**	**36,042**
Net Position, beginning of fiscal year	**165,358**	**129,316**
Net Position, end of fiscal year	**$ 187,963**	**$ 165,358**

See notes to financial statements.

Tobacco Settlement Financing Corporation

(A Component Unit of the State of New York)

GOVERNMENTAL FUNDS BALANCE SHEET

(Amounts in Thousands)

	October 31, 2011		
	General Fund	**Debt Service**	**Total Governmental Funds**
Assets			
Cash and cash equivalents	$ 85	$ 74,955	$ 75,040
Restricted investments	-	449,126	449,126
Accrued interest receivable	-	1,290	1,290
Total assets	**85**	**525,371**	**525,456**
Liabilities			
Payable to the State of New York Municipal Bond Bank Agency	254	-	254
Total liabilities	**254**	**-**	**254**
Fund Balances (Deficits)			
Unassigned	(169)	-	(169)
Restricted for debt service	-	525,371	525,371
Total fund balances	**(169)**	**525,371**	**525,202**
Total Liabilities and Fund Balances	**$ 85**	**$ 525,371**	**$ 525,456**

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

(Amounts in Thousands)

	Fiscal Year Ended October 31, 2011		
	General Fund	Debt Service	Total Governmental Funds
Revenues			
Earnings on investments	$ -	$ 2,786	$ 2,786
Tobacco settlement revenues	-	387,470	387,470
Total revenues	**-**	**390,256**	**390,256**
Expenditures			
General and administrative expenses	699	-	699
Cost of issuance	-	5,123	5,123
Principal amount of bonds retired	-	235,530	235,530
Interest expense	-	165,866	165,866
Total expenditures	**699**	**406,519**	**407,218**
Deficiency of Revenues Over Expenditures	**(699)**	**(16,263)**	**(16,962)**
Other Financing Sources (Uses)			
Proceeds from refunding bonds	-	959,195	959,195
Payment to refunding bond escrow agent		(1,058,188)	(1,058,188)
Premium on bonds issued	-	109,856	109,856
Total other financing sources	**-**	**10,863**	**10,863**
Transfers	**699**	**(699)**	**-**
Net Change in Fund Balances	**-**	**(6,099)**	**(6,099)**
Fund (Deficit) Balances, Beginning of fiscal year	**(169)**	**531,470**	**531,301**
Fund (Deficit) Balances, End of fiscal year	**$ (169)**	**$ 525,371**	**$ 525,202**

See notes to financial statements.

Tobacco Settlement Financing Corporation

(A Component Unit of the State of New York)

GOVERNMENTAL FUNDS BALANCE SHEET

(Amounts in Thousands)

	October 31, 2010		
	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 (Deficits)			
Unassigned	(169)	-	(169)
Restricted 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

(Amounts in Thousands)

	Fiscal Year Ended October 31, 2010		
	General Fund	**Debt Service**	**Total Governmental Funds**
Revenues			
Earnings on investments	$ 9	$ 2,882	$ 2,891
Tobacco 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 (Deficit) Balances, Beginning of fiscal year	**(273)**	**536,583**	**536,310**
Fund (Deficit) 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)

RECONCILIATION OF THE GOVERNMENTAL FUNDS BALANCE SHEETS TO THE STATEMENTS OF NET ASSETS

(Amounts in Thousands)

	October 31,	
	2011	**2010**
Total fund balance - governmental funds	$ 525,202	$ 531,301
Amounts reported for governmental activities in the statement of net assets are different because:		
Deferred charges, which represent the amortized balance relating to funds transferred to the State are not available to pay for current-period expenditures and therefore are deferred and not reported in the funds	2,555,423	2,776,936
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.	28,383	42,396
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)	(2,868,855)	(3,118,547)
Accrued interest on bonds	(52,190)	(66,728)
Net position of governmental activities	**$ 187,963**	**$ 165,358**

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

(Amounts in Thousands)

	Fiscal Year Ended October 31, 2011	Fiscal Year Ended October 31, 2010
Net change in fund balances - total government funds	**$ (6,099)**	**$ (5,009)**
Amounts reported for governmental activities in the statement of activities are different because:		
Bonds proceeds provide current financial resources to governmental funds, but debt issued increases long term liabilities in the staement of net position.	(959,195)	-
Bond premium, underwriters discount, and cost of issuance for debt issued during the fiscal year.	(104,733)	-
Governmental funds report bond premium/ discounts as other financing sources (uses). However, in the statement of activities, bond premiums/discounts are amortized over the lives of the debt as interest income (expenses).	5,324	16,985
Governmental funds report the effect of deferred charges when debt is first issued but these amounts are deferred and amortized in the statement of activities.	(221,513)	(225,945)
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.	15,103	5,106
Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the statement of net position.	1,281,290	244,905
Payment of principal and interest of defeased bonds is recognized as an expenditure in the governmental funds but increases the long-term debt on the statement of net position and does not impact the statement of activities.	12,428	-
Change in Net Position	**$ 22,605**	**$ 36,042**

See notes to financial statements.

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, it is not a component unit of the Agency in accordance with the requirements of Governmental Accounting Standards Board (GASB) Statement No. 61, *The Financial Reporting Entity: Omnibus.* GASB Statement No. 61 is designed to improve financial reporting for governmental entities by amending the requirements of GASB Statement No. 14, *The Financial Reporting Entity,* and GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* to better meet user needs and address reporting entity issues that have come to light since those Statements were issued in 1991 and 1999, respectively.

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 position 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, 2011 and 2010, $74.0 million and $80.1 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, 2011 and 2010, were as follows:

	2011	2010
	(in Millions)	
On Deposit	$ 451.3	$ 451.3
Reserve Requirement	449.1	449.1
Excess	$ 2.2	$ 2.2

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. Unamortized Bond Premiums

Bond premiums 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. Deferred Losses and Gains on Refunding

In accordance with GASB Statement No. 7, *Advance Refunding Resulting in Defeasance of Debt,* gains or losses in connection with advanced refundings are deferred and amortized as an adjustment to interest expense over the original life of the refunded bonds or the life of the refunding bonds, whichever is shorter.

G. Use of Net Position

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

H. Investments

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

I. 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, 2011 and 2010, the Corporation amortized $221.5 million and $225.9 million, respectively, in deferred charges. The unamortized balance of the Deferred Charge at October 31, 2011 and 2010 totaled $2.6 billion and $2.8 billion, respectively.

J. 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. Therefore, since the receivable is not reasonably estimable, the Corporation recognizes tobacco settlement revenue when the cash is received.

K. Net Position

The difference between fund assets and liabilities is "Net Position" on the government-wide, proprietary, and fiduciary fund statements and "Fund Balance" on governmental fund statements. Net position is reported in two categories:

- Restricted net position is restricted due to legal restrictions from creditors, grantors, or laws and regulations of other governments.

- Unrestricted net position consists of net position which do not meet the definition of the preceding category.

L. Fund Balances

During 2011 fiscal year, the Corporation adopted GASB Statement No. 54, "*Fund Balance Reporting and Governmental Fund Type Definitions*," which establishes new standards of accounting and financial reporting that are intended to improve the clarity and consistency of the fund balance information provided to financial report users. The classifications are based primarily on the extent to which the Corporation is bound to honor constraints on the specific purposes for which the amounts in those funds can be spent. Fund balances are reported in the following categories:

- Restricted fund balances are restricted due to legal restriction from creditors, grantors, or laws and regulations of other governments.

- Unassigned fund balance is the residual classification for the general fund. This classification represents fund balance that has not been assigned to other funds and that has not been restricted, committed, or assigned to specific purposes within the general fund. Any negative fund balances are unassigned.

M. Recently Implemented Accounting Pronouncements

In December 2010, GASB issued Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 Financial Accounting Standards Board ("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 adoption of this standard did not have any impact on the presentation of the Corporation's financial statements.

N. Recently Adopted Accounting Pronouncements

In June 2011, GASB issued Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position.* The objective of this Statement is to provide guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position. Amounts that are required to be reported as deferred outflows should be reported in a statement of financial position in a separate section following assets. Similarly, amounts required to be reported as deferred inflows of resources should be reported in a separate section following liabilities. The statement of net position should report the residual amount as net position, rather than net assets. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2011; however the Corporation elected to early-adopt this Statement in the 2011 fiscal year.

The Corporation did not have any deferred inflows or outflows of resources at October 31, 2011 and 2010. The adoption of this pronouncement resulted in a change in the presentation of the Balance Sheets to what is now referred to as the Statements of Net Position and the term "net assets" is changed to "net position" throughout the financial statements.

In June 2011, GASB issued Statement No. 64, *Derivative Instruments; Application of Hedge Accounting Termination Provisions.* The objective of this Statement is to clarify GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments,* as it applies to termination provisions when a counterparty of an interest rate or commodity swap is replaced. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2011. The Agency has not entered into any interest rate or commodity swaps and does not anticipate the implementation of this standard will have an impact on its financial statements.

O. Reclassifications

As a result of the implementation of GASB No. 63, certain reclassifications have been made to prior year in order to conform to 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 $441,000 and $414,000 for various expenses, including salaries, in fiscal years 2011 and 2010, respectively. As of October 31, 2011 and 2010 the Corporation owed the Agency the amounts of $254,000 and $169,000, 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.

Through the issuance of the Series 2011A and 2011B Refunding Bonds (the "2011 Bonds"), portions of the Series 2003A and 2003B bonds were defeased. As a result of the defeasance, a gain was recognized in the amount of $12.4 million with a calculated present value savings in the amount of $149.7 million over the life of the 2011 Bonds. The defeasance was accomplished by placing in irrevocable trustee escrow accounts, cash and amounts invested in U.S. Treasury obligations that will generate funds sufficient to meet future payments of all interest, principal and call premiums, if applicable, on the defeased bonds. Accordingly, the defeased bonds and related assets placed in the irrevocable escrow accounts are not included in the Agency's financial statements since the Agency has legally satisfied its obligations with respect thereto, in accordance with GASB Statement No. 7.

As of October 31, 2011 the principal amount bonds outstanding that were defeased by the issuance of the 2011 Bonds were: Series 2003 A in the amount of $111.6 million and Series 2003 B in the amount of $108.1 million, totaling $219.7 million.

A summary of changes in outstanding bonds during the fiscal year ended October 31, 2011 is as follows:

Schedule of Bonds Outstanding
October 31, 2011

	Original Face Amount	Balance October 31, 2010	Bonds Issued	Retired/ Principal Payments	Balance October 31, 2011
	(in Thousands)				
Series 2003 A:					
Sub-Series 2003 A1C - 4.0% to 5.5%	$ 1,796,940	$ 1,289,055	$ -	$ 466,880	$ 822,175
Sub-Series 2003 A-1 - 1.75% to 5.0%	296,265	50,000	-	25,000	25,000
Series 2003 B:					
Sub-Series 2003 B1C - 4.0% to 5.5%	1,713,235	1,361,655	-	666,140	695,515
Sub-Series 2003 B-1 - 3.125% to 5.0%	302,180	43,795	-	22,270	21,525
Series 2008:					
Sub-Series 2008 A (Refunding Bonds) 3% - 5%	219,935	165,795	-	78,830	86,965
Sub-Series 2008 B (Refunding Bonds) 5%	223,940	101,600	-	22,170	79,430
Series 2011:					
Sub-Series 2011A (Refunding Bonds) 2% - 5%	415,600	-	415,600	-	415,600
Sub-Series 2011B (Refunding Bonds) 4% - 5%	543,595	-	543,595	-	543,595
Total Bond Indebtedness	5,511,690	3,011,900	959,195	1,281,290	2,689,805
Bond Premium	-	106,647	109,856	48,773	167,730
Unamortized deferred gain on refunding	-	-	-	11,320	11,320
Total Net Bond Indebtedness	**$ 5,511,690**	**$ 3,118,547**	**$ 1,069,051**	**$ 1,341,383**	**$ 2,868,855**

Future debt service requirements are as follows:

Fiscal year ending October 31,	Principal	Interest	Total
		($ in Thousands)	
2012	$ 212,920	$ 131,583	$ 344,503
2013	131,595	126,636	258,231
2014	136,600	121,680	258,280
2015	143,000	115,152	258,152
2016	172,000	108,301	280,301
2017 - 2021	1,601,290	360,571	1,961,861
2022 - 2026	292,400	15,502	307,902
Total	$ 2,689,805	$ 979,425	$ 3,669,230

NOTE 5. Deposits and Investments

All the Corporation funds are held in trustee accounts and are governed by the applicable bond resolution. All of the Corporation's investments that are securities are in registered form, and are held by agents of the Corporation or by the trustee under the applicable bond resolution, in the Corporation's name. The agents or their custodians take possession of the securities. For the fiscal years ended October 31, 2011 and 2010, all the Corporation funds were invested in accordance with the applicable policy (described below) or resolution. At October 31, 2011 and 2010, investments (exclusive of accrued interest receivable) held by the trustee in the Corporation's name amounted to $524,081,000 and $528,088,000 respectively. Uncollateralized cash on deposit amounted to $85,000 and $0, respectively.

The Corporation has a formal investment policy which is approved annually by the Corporation's board. The investment policy is in compliance with the New York State Comptroller's Investment Guidelines and 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 Debt Service Reserve Fund Agreement.

The terms of the Debt Service 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 Debt Service Reserve Fund Agreement with Morgan Stanley & Co. Inc. amounted to $56.9 million or 10.9% of the Corporation's investments at October 31, 2011. Morgan Stanley & Co. Inc. was rated A and A2 by S&P and Moody's, respectively at October 31, 2011.

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 Fund Agreements category.

Under the terms of the Debt Service Reserve Fund 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.

The Corporation had the following investments and maturities:

October 31, 2011:

		Investment Maturities (In Years)	
	Fair Value	Less than 1	More than 10
Restricted Funds:	($ in Thousands)		
Investment Type			
Money Market	$ 1,087	$ 1,087	$ -
Debt Service Reserve Fund Agreement	56,886	-	56,886
U.S. Treasury Bills	392,240	392,240	
U.S. Treasury Notes	73,868	73,868	-
	524,081	467,195	56,886
Less: Amounts reported as cash equivalents	1,087	1,087	-
Total Investments	$ 522,994	$ 466,108	$ 56,886

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