

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

TSFC

Financial Statements

Fiscal Year

2017

Tobacco Settlement Financing Corporation

Financial Statements

Fiscal Years Ended October 31, 2017 and 2016

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RESPONSIBILITY FOR FINANCIAL REPORTING


The financial statements of the Tobacco Settlement Financing Corporation (the “Corporation”), for the fiscal years ended October 31, 2017 and 2016, are the responsibility of management. The financial statements were prepared in accordance with U.S. generally accepted accounting principles.

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 and has 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 to provide engagement related updates and communications.

The independent auditors conducted their audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of 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’ unmodified report expresses that the financial statements are presented, in all material respects, in accordance with U.S. generally accepted accounting principles.


RuthAnne Visnauskas
President/Chief Executive Officer


Sheila Robinson
Senior Vice President/Chief Financial Officer

January 25, 2018



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Report of Independent Auditors on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Management and Members of the Board
Tobacco Settlement Financing Corporation
New York, New York

We have audited, in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the 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, 2017 and the related notes to the financial statements, which collectively comprise the Corporation's basic financial statements, and have issued our report thereon dated January 25, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Corporation's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of the Corporation's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Ernst + Young LLP

January 25, 2018

TOBACCO SETTLEMENT FINANCING CORPORATION

A component unit of the State of New York

MANAGEMENT'S DISCUSSION AND ANALYSIS FISCAL YEARS ENDED OCTOBER 31, 2017 AND 2016

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, 2017 ("fiscal 2017") and 2016 ("fiscal 2016"), with selective comparative information for the fiscal year ended October 31, 2015 ("fiscal 2015"), and must 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 fiscal 2017, compared to the fiscal 2016 and fiscal 2015. The MD&A provides a discussion of financial highlights and an assessment of how the Corporation's position has changed from the past years. It also identifies the factors that, in management's view, significantly affected the Corporation's overall financial position. It may contain opinions, assumptions or conclusions made 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 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. 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 both measurable and available to finance expenditures in the current period. The reconciliations of the entity-wide financial

statements and the governmental funds financial statements 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;
- 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.

In connection with the issuance of the Series 2003 A Bonds, the State sold to the Corporation, fifty percent (50%) of the State's Share of (i) the Annual Payments and Strategic Contribution Fund Payments and of all adjustments to prior payments, payable to the State pursuant to the Master Settlement Agreement ("MSA"), and received on and after January 1, 2004 and (ii) all Lump Sum Payments payable to the State pursuant to the MSA and received at any time on or after June 19, 2003.

In connection with the issuance of the Series 2003 B Bonds, the State sold to the Corporation, fifty percent (50%) of the State's Share of (i) the Annual Payments and Strategic Contribution Fund Payments and of all adjustments to prior payments, payable to the State pursuant to the MSA and received on and after January 1, 2004 and (ii) all Lump Sum Payments payable to the State pursuant to the MSA and received at any time on or after December 2, 2003.

As of October 31, 2017, all outstanding bonds have been redeemed.

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

As stated in the Purchase and Sale Agreement and the notes to the financial statements:

In connection with the issuance of the bonds by the Corporation, the Corporation and the State entered into agreements pursuant to which, among other things, at such time as the State may direct (but only after all bonds, notes and other obligations and financing arrangements issued or

entered into by the Corporation under the Act are no longer outstanding in accordance with their terms and the terms of the documents pursuant to which such arrangements were entered into by the Corporation), the Corporation shall (1) pay, transfer, assign or otherwise convey to the State for deposit into such fund or account of the State as the law may require, all or any portion of the moneys of the Corporation, (ii) sell, transfer, assign and otherwise convey to the State the right to receive any remaining payments belong to the Corporation under the MSA, and (iii) execute and deliver to the escrow agent under the MSA inevitable instructions to make all remaining payments to the State.

The right of the State to so direct the Corporation is embodied in certain “residual certificates” provided to the State by the Corporation, which represent the entitlement to deliver to the holder of the residual certificates (the State) 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. See Note 3.

Until such time as the State shall direct the Corporation, as set forth above. Tobacco Settlement Revenues, pursuant to the MSA, will continue to be due to the Corporation.

Financial Highlights and Overall Analysis - Entity-Wide Financial Statements

Condensed Statements of Net Position

	Fiscal Year Ended			% Change	
	2017	October 31, 2016	2015	2017-2016	2016-2015
(In thousands)					
Assets:					
Other assets	\$ 106,638	\$ 469,467	\$ 487,251	(77.3%)	(3.6%)
Total Assets	106,638	469,467	487,251		
Deferred Outflows of Resources	-	696,984	1,383,591	(100.0%)	(49.6%)
Liabilities:					
Bonds payable, net	-	720,440	1,475,310	(100.0%)	(51.2%)
Other liabilities	270	13,846	28,620	(98.0%)	(51.6%)
Total Liabilities	270	734,286	1,503,930		
Deferred Inflows of Resources	-	31,465	38,217	(100.0%)	(17.7%)
Net Position:					
Restricted for Debt Service	-	400,700	328,695		
Unrestricted	106,368	-	-		
Total Net Position	\$ 106,368	\$ 400,700	\$ 328,695		

Significant Changes in Assets and Liabilities:

Other Assets

Other assets which is primarily comprised of investments decreased from \$469.5 million in fiscal 2016 to \$106.6 million in fiscal 2017, a decrease of approximately \$362.8 million, or 77.3%. The decrease was a result of all outstanding bonds being redeemed in June 2017.

Deferred Outflows of Resources

Funds made available from the sale of the Series 2003 A and Series 2003 B Bonds and paid to the State for the purchase of future Tobacco Settlement Revenues ("TSRs") are recorded as deferred outflow of resources. At the time of the sale of such bonds, \$2.2 billion and \$2.0 billion, respectively, totaling \$4.2 billion were transferred to the State. The Corporation has not paid funds to the State since 2003.

Since all outstanding bonds have been called, all deferred inflows and outflows of resources have been written off in fiscal 2017.

Bonds Payable, net

To the extent allowed under the provisions of the bond resolution, 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 call bonds. Using excess funds on deposit, all outstanding bonds were called in June 2017. Therefore, bonds payable decreased from approximately \$720.4 million as of October 31, 2016, to \$0 at October 31, 2017, a decrease of 100%. This compares with a decrease from \$1.5 billion as of October 31, 2015, to \$720.4 million at October 31, 2016, a decrease of approximately \$754.9 million, or 51.2%, which resulted from amortization and early bond calls, using excess MSA funds on deposit as allowed under the provisions of the bond resolution in June 2016.

Condensed Statements of Activities

	Fiscal Year Ended			% Change	
	2017	2016	2015	2017-2016	2016-2015
(In thousands)					
Program Revenues:					
Tobacco Settlement Revenues	\$ 324,256	\$ 762,832	\$ 382,782	(57.5%)	99.3%
Claim Settlement and Other Revenues	8,457	6,110	4,593	38.4%	33.0%
Total Revenues	<u>332,713</u>	<u>768,942</u>	<u>387,375</u>		
Program Expenses:					
Amortization of Deferred Outflows of Resources	696,984	686,607	351,315	1.5%	95.4%
Interest Expense	(72,880)	9,702	42,934	(851.2%)	(77.4%)
Professional Consulting Fees	2,230	-	-	N/A	-
General and Administrative Expenses	711	628	647	13.2%	(2.9%)
Total Expenses	<u>627,045</u>	<u>696,937</u>	<u>394,896</u>		
Total Change in Net Position	<u>\$ (294,332)</u>	<u>\$ 72,005</u>	<u>\$ (7,521)</u>		

Significant Changes in Revenues and Expenses:

Tobacco Settlement Revenues

Tobacco settlement revenues ("TSRs") decreased from \$762.8 million in fiscal 2016 to \$324.3 million in fiscal 2017, a decrease of approximately \$438.6 million, or 57.5% primarily as a result of released funds in the amount of \$362.4 million in fiscal 2016 from the Disputed Payment Account relating to the Non-Participating Manufacturer ("NPM") Adjustment Settlement Agreement pursuant to New York's October 2015 settlement of NPM disputes. This compared with the increase from \$382.8 million in fiscal 2015 to \$762.8 million in 2016, an increase of approximately \$380.0 million, or 99.3%.

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.

As previously discussed, although all outstanding bonds have been called, until such time as the State shall direct the Corporation otherwise, Tobacco Settlement Revenues, pursuant to the MSA, will continue to be due to the Corporation.

Claim Settlement and Other Revenues

Claim settlement and other revenues increased from \$6.1 million in fiscal 2016 to \$8.5 million in fiscal 2017, an increase of approximately \$2.4 million, or 38.4%. The change was primarily attributable to funds received in connection with Morgan Stanley Capital Services in Termination of TSFC 2003 Series A Debt Service Reserve Fund Agreement. This compares with an increase from \$4.6 million in fiscal 2015 to \$6.1 million in 2016, an increase of approximately \$1.5 million, or 33.0%. Other Revenues also includes funds received in relation to the jointly administered

Chapter 11 Plan of Lehman Brothers Holdings Inc. and its Affiliated Debtors as confirmed by the Bankruptcy Court on December 6, 2011, which totaled approximately \$2.0 million in fiscal 2015, \$1.6 million in fiscal 2016 and \$646.5 thousand in fiscal 2017.

Amortization of Deferred Outflows of Resources

Amortization of deferred outflows of resources increased from \$686.6 million in fiscal 2016 to \$697.0 million in fiscal 2017, an increase of \$10.4 million, or 1.5%, as a result of the write off of the balances at the time of the 2017 bond redemption. This compares with an increase from \$351.3 million in fiscal 2015 to \$686.6 million in fiscal 2016, an increase approximately \$335.3 million, or 95.4%, which resulted from increased amortization of the deferred charge which had been amortized using the outstanding principal method, as more bonds were called prior to maturity, the amortization accelerated.

Interest Expense

As a result of the write off of bond premium and deferred gain on refunding at the time all of the bonds were called in June 2017, interest expense changed from \$9.7 million in fiscal 2016 to (\$72.9) million in fiscal 2017, a fluctuation of approximately (\$82.6) million, or 851.2%, as compared with a decrease from \$42.9 million in fiscal 2015 to \$9.7 million in fiscal 2016, a decrease of approximately \$33.2 million, or 77.4%, which resulted from the decrease in bonds outstanding.

Professional Consulting Fees

Professional consulting fees consist primarily of payments made at the direction of the State in the amount of \$2.2 million during fiscal 2017. This covered the cost of an independent investigator as required under the MSA, pursuant to the settlement that was accepted by the State in 2015. The payments were required to be made after all bonds under the TFSC indenture have been fully paid (or defeased), which occurred in June, 2017.

General and Administrative Expenses

General and Administrative expenses increased from \$628 thousand in fiscal 2016 to \$711 thousand in fiscal 2017, an increase of approximately \$83 thousand, or 13.2%. Expenses have increased in fiscal 2017 primarily as a result of the allocation of payroll expenses which increased due to salary adjustments and new hires. This compares with a decrease from \$647 thousand in fiscal 2015 to \$628 thousand in fiscal 2016, a decrease of approximately \$19 thousand or 2.9%.

Tobacco Settlement Financing Corporation

(A Component Unit of the State of New York)

STATEMENTS OF NET POSITION

(Amounts in Thousands)

	October 31,	
	2017	2016
Assets		
Cash and cash equivalents	\$ 103,595	\$ 32
Investments	3,006	467,442
Accrued interest receivable	37	1,993
Total assets	106,638	469,467
Deferred Outflows of Resources		
Deferral of Cost from Purchase of Future TSRs	-	696,984
Liabilities		
Accrued interest payable	-	13,686
Payable to the State of New York Municipal Bond Bank Agency	253	146
Accounts Payable	17	14
Bonds payable (net)		
Portion payable within one year	-	179,000
Portion payable after one year	-	541,440
Total liabilities	270	734,286
Deferred Inflows of Resources		
Deferred Gain on Refundings	-	31,465
Net Position:		
Restricted for Debt Service	-	400,700
Unrestricted Net Position	106,368	-
Total Net Position	\$ 106,368	\$ 400,700

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,	
	2017	2016
Program Expenses		
Amortization of deferred outflows	\$ 696,984	\$ 686,607
Interest expense:		
Amortization of bond premium and deferred gain on refunding	(92,040)	(43,851)
Interest	19,160	53,553
Total interest expense	(72,880)	9,702
Professional consulting fees	2,230	-
General and administrative expenses	711	628
Total expenses	627,045	696,937
Program Revenues		
Tobacco settlement revenue	324,256	762,832
Settlement Revenue resulting from Investment Agreement Termination	5,309	1,593
Earnings on investments	3,148	4,517
Total revenues	332,713	768,942
Change in net position	(294,332)	72,005
Net Position, beginning of fiscal year	400,700	328,695
Net Position, end of fiscal year	\$ 106,368	\$ 400,700

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)

	<u>October 31, 2017</u>
	<u>Total</u>
	<u>Governmental/ General Fund</u>
Assets	
Cash and cash equivalents	\$ 103,595
Restricted investments	3,006
Accrued interest receivable	37
	<hr/>
Total assets	106,638
	<hr/>
Liabilities	
Payable to the State of New York Municipal Bond Bank Agency	253
Accounts Payable	17
	<hr/>
Total liabilities	270
	<hr/>
Fund Balances	
Unassigned	106,368
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Total fund balances	106,368
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Total Liabilities and Fund Balances	\$ -
	<hr/> <hr/>

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, 2017		
	General Fund	Debt Service	Total Governmental Funds
Revenues			
Tobacco settlement revenues	\$ -	\$ 324,256	\$ 324,256
Earnings on investments	-	3,148	3,148
Other Income	-	5,309	5,309
Total revenues	-	332,713	332,713
Expenditures			
Principal amount of bonds retired	-	659,865	659,865
Interest expense	-	32,846	32,846
Professional consulting fees	-	2,230	2,230
General and administrative expenses	711	-	711
Total expenditures	711	694,941	695,652
Deficiency of Revenues Over Expenditures	(711)	(362,228)	(362,939)
Transfers	107,239	(107,239)	-
Net Change in Fund Balances	106,528	(469,467)	(362,939)
Fund (Deficit) Balances, Beginning of fiscal year	(160)	469,467	469,307
Fund Balances, End of fiscal year	\$ 106,368	\$ -	\$ 106,368

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, 2016		
	General Fund	Debt Service	Total Governmental Funds
Assets			
Cash and cash equivalents	\$ -	32	\$ 32
Restricted investments	-	467,442	467,442
Accrued interest receivable	-	1,993	1,993
Total assets	-	469,467	469,467
Liabilities			
Payable to the State of New York Municipal Bond Bank Agency	146	-	146
Accounts Payable	14	-	14
Total liabilities	160	-	160
Fund Balances (Deficits)			
Unassigned	(160)	-	(160)
Restricted for debt service	-	469,467	469,467
Total fund balances	(160)	469,467	469,307
Total Liabilities and Fund Balances	\$ -	\$ 469,467	\$ 469,467

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, 2016		
	General Fund	Debt Service	Total Governmental Funds
Revenues			
Tobacco settlement revenues	\$ -	\$ 762,832	\$ 762,832
Earnings on investments	-	4,517	4,517
Other Income	-	1,593	1,593
Total revenues	-	768,942	768,942
Expenditures			
Principal amount of bonds retired	-	717,770	717,770
Interest expense	-	68,344	68,344
General and administrative expenses	628	-	628
Total expenditures	628	786,114	786,742
Deficiency of Revenues Over Expenditures	(628)	(17,172)	(17,800)
Transfers	612	(612)	-
Net Change in Fund Balances	(16)	(17,784)	(17,800)
Fund (Deficit) Balances, Beginning of fiscal year	(144)	487,251	487,107
Fund (Deficit) Balances, End of fiscal year	\$ (160)	\$ 469,467	\$ 469,307

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,	
	2017	2016
Total fund balance - governmental funds	\$ 106,368	\$ 469,307
 Amounts reported for governmental activities in the statement of net assets are different because:		
 Deferred outflows of resources, which represent the amortized balance relating to funds transferred to the State that are not available to pay for current-period expenditures and therefore are deferred and not reported in the funds		
	-	696,984
 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)	-	(751,905)
Accrued interest on bonds	-	(13,686)
	<hr/>	<hr/>
Net position of governmental activities	\$ 106,368	\$ 400,700

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,	
	2017	2016
Net change in fund balances - total government funds	\$ (362,939)	\$ (17,800)
 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 lives of the debt as interest income (expenses).	60,575	37,100
Governmental funds report the effect of deferred outflows of resources when debt is first issued but these amounts are deferred and amortized in the statement of activities.	(604,943)	(686,607)
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.	(46,890)	21,542
Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the statement of net position.	659,865	717,770
 Change in Net Position	\$ (294,332)	\$ 72,005

See notes to financial statements.

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

Notes to Financial Statements

Fiscal Years Ended October 31, 2017 and 2016

NOTE 1. Tobacco Settlement Financing Corporation

The 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 Corporation does not have financial accountability to the Agency; accordingly, the Corporation 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*. Therefore, the financial activities of the Corporation are not included in the Agency's financial statements.

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 position and the statements of activities, are presented to display information about the reporting entity as a whole. 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 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. The Corporation presents their financial statements in accordance with generally accepted accounting principles as promulgated by GASB.

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. When bonds were outstanding, the Debt Service Fund contained three accounts: the Debt Service Account, the Supplemental Fund Account and the Debt Service Reserve Account. The cash and investments in the Debt Service Account were available to pay current debt service on bonds. At October 31, 2017 and 2016, \$0 and \$16.5 million (including accrued interest receivable), respectively, were on deposit in this account.

The purpose of the Debt Service Reserve Account was to pay principal of and interest on the outstanding bonds, if there was 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, 2017 and 2016, were as follows:

	2017	2016
	(in Millions)	
On Deposit	\$ -	\$ 451.4
Reserve Requirement	-	449.1
Excess	<u>\$ -</u>	<u>\$ 2.3</u>

The Funds on deposit in the Supplemental Fund Account in the amounts of \$106.6 million and \$1.4 million as of October 31, 2017 and 2016 respectively. Since all of the outstanding bonds have been redeemed, the remaining funds on deposit as of October 31, 2017 will be remitted directly to the State less an allowance for expenses. Accordingly, these funds were transferred from the Debt Service fund to the General fund. The funds on deposit as of October 31, 2016 represent the excess of the amount allowed to be used for optional bond calls, in accordance with the provisions of the Corporation's bond resolutions.

- 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. Investments

Investments are recorded at fair value.

- F. Unamortized Bond Premiums

Bond premiums were capitalized and amortized over the lives of the related debt in the entity-wide financial statements. Bond premiums were amortized using the bond outstanding method, which approximates the effective interest method. The remaining balance at the time of the 2017 bond call was written off.

- G. Deferred Gains and Losses on Refunding

Gains or losses in connection with advanced refundings were recorded as either a

deferred inflows (gain) or deferred outflows (loss) of resources on the entity-wide financial statements 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.

The remaining balance at the time of the 2017 bond redemption was written off.

H. 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.

I. Deferral of Cost from Purchase of Future TSRs

The Corporation records the transfer of funds made to the State for the purchase of future TSRs as deferred outflow of resources.

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 \$2.2 billion and \$2.0 billion respectively. Each transfer was made at the time of the respective bond sale.

As of October 31, 2017, all outstanding bonds have been redeemed and the deferral of cost from purchase of future TSRs was written off at that time.

Through fiscal 2016, the Corporation had amortized the deferred outflows of resources in proportion to bonds redeemed during the fiscal year (the bonds outstanding method).

J. Tobacco Settlement Revenue

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 payment is received.

K. Net Position

The Corporation's "Net Position" represents the excess of assets and deferred outflows over liabilities and deferred inflows on the government-wide financial 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

The Corporation's "Fund Balance" on the Governmental Financial Statements represents the difference between assets and liabilities. 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. Reclassification

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

NOTE 3. Tobacco Settlement Revenues

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 (the "State's Share"), pursuant to the Master Settlement Agreement ("MSA"), less certain unsold payments which remain the property of the State. In connection with the issuance of the Series 2003 A Bonds, the State sold TSFC fifty percent (50%) of the State's Share of (i) the annual payments and strategic contribution fund payments and of all adjustments to prior payments, payable to the State pursuant to the MSA and received on and after January 1, 2004 and (ii) all lump sum payments payable to the State pursuant to the MSA and received at any time on or after June 19, 2003.

In connection with the issuance of the Series 2003 B Bonds, the State sold TSFC fifty percent (50%) of the State's Share of (i) the annual payments and strategic contribution fund payments and of all adjustments to prior payments, payable to the State pursuant to the MSA and received on and after January 1, 2004 and (ii) all lump sum payments payable to the State pursuant to the MSA and received at any time on or after December 2, 2003.

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 4. 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 \$659,000 and \$594,000 for various expenses, including salaries, in fiscal years 2017 and 2016, respectively. As of October 31, 2017 and 2016 the Corporation owed the Agency the amounts of \$253,000 and \$146,000, respectively in accordance with the TSFC Service Agreement.

NOTE 5. Deposits and Investments

All of the Corporation's funds are held in trust accounts and are governed by the applicable bond resolution (when bonds were outstanding) and agreements with the State. 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, (when bonds were outstanding) in the Corporation's name. The agents or their custodians take possession of the securities. For the fiscal years ended October 31, 2017 and 2016, all the Corporation funds were invested in accordance with the applicable policy (described below) or resolution. At October 31, 2017 and 2016, investments (exclusive of accrued interest receivable) held by the trustee in the Corporation's name amounted to \$106.6 million and \$467.4 million respectively. There was no uncollateralized cash on deposit for the fiscal years ended October 31, 2017 and 2016.

Credit Risk

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.

Custodial Credit Risk

The Corporation manages custodial credit risk by limiting its investments to highly rated institutions and/ or requiring high quality collateral be held by the counterparty in the name of the Corporation.

Interest Rate Risk

Interest rate risk is minimal due to the short term duration of the Corporation's investments.

The Corporation had the following investments and maturities:

Values below are at fair value excluding accrued interest as of October 31, 2017:

<u>Restricted Funds:</u> Investment Type	Investment Maturities (In Years)		
	Fair Value	Less than 1	More than 1
	(\$ in Thousands)		
Money Market	\$ 19	\$ 19	\$ -
U.S. Treasury Bills	106,582	106,582	-
	106,601	106,601	-
Less: Amounts reported as cash equivalents	103,595	103,595	-
Total Investments	\$ 3,006	\$ 3,006	\$ -

NOTE 6. Fair Value Measurements

The Corporation categorizes its fair value measurements within the fair value hierarchy established by U.S. generally accepted accounting principles. The hierarchy is based on the evaluation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

As of October 31, 2017, US Treasury Bills held by the Corporation are measured at fair value at \$106.6 million and are within the Level 2 inputs category of fair value hierarchy. These financial instruments are valued using matrix pricing.

NOTE 7. Bonds Payable

In fiscal 2016, when the Corporation had outstanding bonds, such bonds were secured by the pledged settlement payments. In addition, they were 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 monies 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 monies are available to the State and the State incurs no liability beyond the monies available to it and appropriated for such purpose. As of October 31, 2017, all bonds were retired.

A summary of changes in outstanding bonds during the fiscal year ended October 31, 2017 is as follows:

	Schedule of Bonds Outstanding October 31, 2017				
	Original Face Amount	Balance October 31, 2016	Bonds Issued	Retired/ Principal Payments	Balance October 31, 2017
	(in Thousands)				
Series 2011:					
Sub-Series 2011A (Refunding Bonds) 2% - 5%, maturing in varying annual installments to 2018	\$ 415,600	\$ 182,000	\$ -	\$ 182,000	\$ -
Sub-Series 2011B (Refunding Bonds) 4% - 5%, maturing in varying annual installments to 2018	543,595	194,000	-	194,000	-
Series 2013:					
Sub-Series 2013A (Refunding Bonds) 3% - 5%, maturing in varying annual installments to 2022	660,090	145,390	-	145,390	-
Sub-Series 2013B (Refunding Bonds) 5%, maturing in varying annual installments to 2022	565,655	138,475	-	138,475	-
Total Bond Indebtedness	2,184,940	659,865	-	659,865	-
Unamortized Bond Premium	-	60,575	-	60,575	-
Total Net Bond Indebtedness	\$2,184,940	\$ 720,440	\$ -	\$ 720,440	\$ -

NOTE 8. Settlement Revenue from Investment Agreement Termination

In fiscal 2017 and 2016, the amounts of \$646.5 thousand and \$1.6 million respectively, were received in connection with the jointly administered Chapter 11 Plan of Lehman Brothers Holdings Inc. and its Affiliated Debtors as confirmed by the Bankruptcy Court on December 6, 2011. The amount received was in connection with (i) a Reserve Fund Agreement dated as of June 19, 2003 (the "June 2003 RFA") and (ii) a Reserve Fund Agreement dated as of December 2, 2003 (the "December 2003 RFA" and, together with the June 2003 RFA, collectively, the "RFAs"), each

entered into among, inter alia, the Tobacco Settlement Financing Corporation (“TSFC”) and Lehman Brothers Special Financing Inc. (“LBSF”). The obligations of LBSF under each RFA were guaranteed by Lehman Brothers Holdings Inc. (“LBHI” and, together with LBSF, collectively, “Lehman”).

The RFAs served as investment vehicles through which TSFC invested certain reserve funds that served as a source of backup payment for debt service owed on its Bonds. The RFAs enabled TSFC to invest the reserve funds by purchasing qualifying securities from LBSF at purchase prices that were set to ensure that TSFC received certain guaranteed rates of investment. Under the RFAs, LBSF would cause qualified dealers to deliver qualifying securities to Bank of New York, as trustee for the Corporation on specified deposit dates which occurred every 6 months. Following such delivery, the Trustee would immediately purchase such securities by paying the qualified dealer an aggregate purchase price as close as possible to, but not exceeding, certain scheduled reserve amount

Subsequent to the Lehman bankruptcy filing, LBSF failed to deliver qualifying securities to the Trustee on both November 28, 2008 and May 29, 2009. Litigation ensued and the amounts received in fiscal 2017, 2016 and 2015 represent a portion of the settlement for the lost interest earnings. The bankruptcy filings of Lehman had no impact on the principal amounts of the RFAs, which amounts remained unchanged from inception.

During fiscal 2017, in connection with Morgan Stanley Capital Services in Termination of TSFC 2003 Series A Debt Service Reserve Fund Agreement, the Corporation received \$4,662,000 which was used to redeem the outstanding bonds.



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Report of Independent Auditors

Management and Members of the Board
Tobacco Settlement Financing Corporation
New York, New York

Report on the Financial Statements

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, 2017 and 2016, and the related notes to the financial statements, which collectively comprise the Corporation's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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

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

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each major fund of the Corporation as of October 31, 2017 and 2016, and the respective changes in financial position thereof for the years then ended in conformity with U.S. generally accepted accounting principles.

Required Supplementary Information

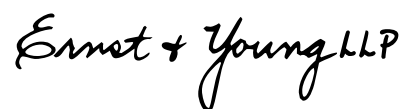
U.S. generally accepted accounting principles require that Management's Discussion and Analysis, as listed in the table of contents, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

The Introductory Section has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we also have issued our report dated January 25, 2018 on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Corporation's internal control over financial reporting and compliance.



January 25, 2018