

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY
(A Component Unit of the State of South Carolina)

Financial Statements
June 30, 2007
(With Independent Auditor's Report Thereon)

State of South Carolina



Office of the State Auditor

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September 20, 2007

The Honorable Mark Sanford, Governor
and
Members of the Tobacco Settlement Revenue
Management Authority
Columbia, South Carolina

This report on the audit of the financial statements of the Tobacco Settlement Revenue Management Authority for the fiscal year ended June 30, 2007, was issued by Rogers Laban, PA, Certified Public Accountants, under contract with the South Carolina Office of the State Auditor.

If you have any questions regarding this report, please let us know.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Richard H. Gilbert Jr.", written in a cursive style.

Richard H. Gilbert, Jr., CPA
Deputy State Auditor

RHGjr/cwc

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY
(A Component Unit of the State of South Carolina)

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INDEPENDENT AUDITOR'S REPORT

Mr. Richard H. Gilbert, Jr., CPA
Deputy State Auditor
State of South Carolina
Columbia, South Carolina

We have audited the accompanying financial statements of the governmental activities and the major fund of the Tobacco Settlement Revenue Management Authority (the Authority), a component unit of the State of South Carolina, as of and for the year ended June 30, 2007, which collectively comprise the Authority's financial statements as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

As described in Note 1, the financial statements referred to above include only the financial activities of the Authority and do not purport to and do not present fairly the financial position and results of operations of the State of South Carolina or other agencies or component units of the State of South Carolina in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the major fund of the Tobacco Settlement Revenue Management Authority as of June 30, 2007, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated September 7, 2007, on our consideration of the Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

The management's discussion and analysis and budgetary comparison information on pages 3 through 8 and 23 and 24 are not a required part of the financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. 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.

Rogers Lalan, PA

September 7, 2007

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

(A Component Unit of the State of South Carolina)

Management's Discussion and Analysis (unaudited)

June 30, 2007

This Section of the annual financial report of the Tobacco Settlement Revenue Management Authority (the "Authority") presents the analysis of the Authority's financial performance during the fiscal year that ended on June 30, 2007. Please read it in conjunction with the financial statements and their accompanying notes, which follow this section.

The Authority

The Authority was created by Act No. 387 of the Acts and Joint Resolutions of the General Assembly of the State of South Carolina, Regular Session of 2000, as codified at S.C. Code Ann. §§ 11-49-10 et seq. (the "Act"), as an instrumentality of the State of South Carolina (the "State"). The Act created the Authority to receive all of the State's payments under the Master Settlement Agreement (the "MSA"). The MSA was entered into on November 23, 1998, among the attorneys general of 46 states (including South Carolina), the District of Columbia, the Commonwealth of Puerto Rico, Guam, the U.S. Virgin Islands, American Samoa and the Commonwealth of the Northern Mariana Islands (collectively the "Settling States") and the four largest United States tobacco manufacturers: Philip Morris Incorporated, R. J. Reynolds Tobacco Company, Brown & Williamson Tobacco Corporation, and Lorillard Tobacco Company (collectively the "Original Participating Manufacturers" or "OPMs"). The MSA resolved cigarette smoking-related litigation among the Settling States and the OPMs, released the OPMs from past and present smoking-related claims by the Settling States, and provides for a continuing release of future smoking-related claims in exchange for certain payments to be made to the Settling States. The MSA also provides for the imposition of certain tobacco advertising and marketing restrictions, among other things. The Authority is not a party to the MSA.

The State is entitled to certain periodic payments made under the MSA. Pursuant to the Act, the Authority has been assigned all Tobacco Settlement Receipts ("TSRs"), which are the State's right, title and interest in payments due after June 30, 2001 under the MSA. On March 18, 2001, the Authority issued \$934,530,000 aggregate principal amount of Tobacco Settlement Asset-Backed Bonds (the "Bonds") pursuant to an indenture between the Authority and United States Trust Company of New York (subsequently acquired by the Bank of New York), as trustee, dated as of March 1, 2001, and the Tobacco Settlement Revenue Management Authority Act. The Bonds are secured by and payable from i) the TSRs and all investment earnings on amounts on deposit in certain accounts established under the indenture and ii) all amounts, if any, on deposit in certain accounts under the indenture. Payments on the Bonds are a special obligation of the Authority, and such payments are dependent on receipt by the Trustee, as assignee of the Authority, of TSRs. The Authority has no financial assets other than the TSRs, the accounts established under the indenture, and investment earnings on those accounts. The Bonds are not a debt of the State, and the Authority does not have the power to pledge the credit, revenues or taxing power of the State. The Authority does not have taxing power.

At June 30, 2007, there remained outstanding \$769.755 million of the debt originally issued by the Authority. A discussion concerning the status of the bonds follows in the sections following entitled "Summary of Financial Results" and "Long Term Debt Activity".

Overview of the Financial Statements

This analysis is intended to serve as an introduction to the Authority's financial statements. The Authority's financial statements consist of three components: 1) government-wide financial statements, 2) governmental fund financial statements, and 3) notes to the financial statements.

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- *The Statement of Net Assets and Governmental Fund Balance Sheet* include all of the Authority's assets and liabilities and provide information about the nature and amounts of investments in resources (assets) and the obligations to Authority creditors (liabilities). They also provide the basis for computing rate of return, evaluating the capital structure of the Authority and assessing the liquidity and financial flexibility of the Authority. The *Statement of Net Assets* reports information about the Authority using accounting methods similar to those used by private sector companies and presents all assets and liabilities of the Authority – both current and long-term. The *Governmental Fund Balance Sheet* of the General Fund focuses only on the Authority's resources available for expenditure at the end of the fiscal year.
- All of the current year's activity is accounted for in the *Statement of Activities and Governmental Fund – Revenues, Expenditures and Changes in Fund Balance/Net Deficit*. These statements measure the success of the Authority's operations over the past year and can be used to determine the Authority's credit-worthiness and ability to meet its financial objectives. The *Statement of Activities* presents information on how the Authority's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. The *Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balance for the General Fund* focuses only on the Authority's near-term inflows and outflows of resources available for expenditure for the fiscal year.

Summary of Financial Results

The Authority's financial results are summarized, discussed and compared to the prior fiscal year in the sections following.

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Management's Discussion and Analysis (unaudited)

June 30, 2007

Statement of Net Assets. Table 1 summarizes the Authority's Net Assets for the period ending June 30, 2007, along with comparative data for the prior fiscal year.

Table 1: Summary of net assets

	June 30, 2007	June 30, 2006	Difference	%
Assets				
Cash and cash equivalents	\$ 533,160	\$ 430,240	\$ 102,920	23.9%
Restricted assets	<u>154,066,890</u>	<u>147,562,630</u>	<u>6,504,260</u>	4.4%
Total assets	<u>154,600,050</u>	<u>147,992,870</u>	<u>6,607,180</u>	4.5%
Liabilities				
Accrued interest payable	6,084,948	6,345,065	(260,117)	-4.1%
Long term liabilities	<u>769,755,000</u>	<u>796,900,000</u>	<u>(27,145,000)</u>	-3.4%
Total liabilities	<u>775,839,948</u>	<u>803,245,065</u>	<u>(27,405,117)</u>	-3.4%
Total net assets (deficit)	<u>\$ (621,239,898)</u>	<u>\$ (655,252,195)</u>	<u>\$ 34,012,297</u>	-5.2%

The Authority's assets include cash and cash equivalents, investments, and accrued earnings on those investments. Approximately 99% of the Authority's assets are comprised of investments held in various reserve funds by the bond trustee, as security for the bondholders. The remaining assets are held by the Authority to pay its authorized operating expenses. Total liabilities consist of the principal balance of the Bonds outstanding and accrued interest payable on those Bonds at the end of the fiscal year.

The Authority's cash and cash equivalents increased 23.9% over the course of the fiscal year, due primarily to an increase in the Authority's funding for MSA enforcement. Total assets increased by 4.5% reflecting an increase in TSRs receivable associated with the requirement under the MSA for Participating Manufacturers ("PMs") to make Strategic Contribution Payments beginning on April 15, 2008 and continuing on or about each April 15 through the year 2017.

Accrued interest payable and long term liabilities decreased in amounts proportionate to the principal amount of bonds redeemed during the fiscal year under the trust indenture's Turbo Redemption provisions.

The deficit reflected on the Authority's Statement of Net Assets is a result of the Authority having no financial assets other than the TSRs, the accounts established under the indenture, and investment earnings on those accounts. Future TSRs are dependent on many factors including future tobacco consumption and the financial capability of the OPMs and consequently, except as noted above, TSRs do not meet asset recognition criteria under accounting principles generally accepted in the United States of America ("GAAP"). Accordingly, the financial statements reflect a deficit arising as a consequence of the full recognition of Authority liabilities, comprised primarily of the outstanding Bonds, without attendant currently recognizable Authority assets.

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Management's Discussion and Analysis (unaudited)

June 30, 2007

Statement of Activities. Table 2 summarizes the Authority's activities for the period ending June 30, 2007 with comparative amounts for the prior fiscal year.

Table 2: Summary of activities

	June 30, 2007	June 30, 2006	Difference	%
Revenues	\$ 84,914,772	\$ 73,797,796	\$ 11,116,976	15.1%
Expenses	50,477,475	52,364,511	(1,887,036)	-3.6%
Change in net assets before transfers	34,437,297	21,433,285	13,004,012	60.7%
Transfers	(425,000)	(450,000)	25,000	-5.6%
Change in net assets	34,012,297	20,983,285	13,029,012	62.1%
Net assets (deficit) - beginning of year	(655,252,195)	(676,235,480)	20,983,285	-3.1%
Net assets (deficit) - end of year	\$ (621,239,898)	\$ (655,252,195)	\$ 34,012,297	-5.2%

General revenues of \$84.9 million reflect the receipt and accrual for \$79.9 million in TSRs and investment earnings of \$5.0 million. The Authority's general revenues increased primarily as a result of the anticipated increase in TSRs for the ensuing fiscal year discussed above, partially offset by amounts withheld by the PMs during the fiscal year (see "Economic Factors and Outlook – Disputed Payments" of this discussion and analysis and Note 7 of the Notes to Financial Statements).

The Authority's expenses primarily consisted of interest on the Bonds totaling \$50.4 million, \$0.1 million in administrative and operating expenses of the Authority, and \$0.5 million in mandated transfers to related parties. Expenses decreased by 3.6%, primarily from lower interest expense on the bonds.

Long Term Debt Activity

The Bonds issued by the Authority are thirty-year obligations scheduled to retire in ordinary course on May 15, 2030. However, under early redemption provisions ("Turbo Redemptions"), any MSA payments exceeding annual debt service requirements of the Bonds must be applied to early redemption of principal. TSRs and earnings on the trust funds during the fiscal year ended June 30, 2007 resulted in the Turbo Redemption of \$27.145 million in outstanding debt. To date, the Authority has redeemed a total of \$164.775 million in bonds outstanding as Turbo Redemptions, compared to \$174.495 million originally projected through June 30, 2007. Note 4 of the Notes to Financial Statements includes a table reflecting expected and actual Turbo Redemptions through June 30, 2007.

Over the course of the past few years, ratings of tobacco securitization bonds in general, and those of the Authority specifically, were revised downward by all three of the major credit rating agencies. These rating actions have been precipitated by rating agency concerns including, among others, a general "adverse litigation environment" in the tobacco industry, declines in industry volume shipments, market share losses, and "heightened liquidity risk" as contributors to the initial and subsequent rating actions. Consequently, the Authority's bonds were downgraded from a level of "Aa3", "A+", and "A" by Moody's, Fitch Ratings and Standard and Poor's respectively, to a level of "Baa1", "BBB", and "A-" by Moody's, Fitch Ratings and Standard and

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Poor's respectively during 2003. Subsequently, on August 28, 2003, Standard and Poor's again downgraded the bonds to a level of "BBB". That rating action reflected "the adverse litigation environment for the tobacco industry in the U.S., weak market conditions in the U.S. cigarette industry, and Standard & Poor's expectation that domestic cigarette market conditions will continue to decline as a result of recent and expected future increases in state excise taxes, anti-smoking legislation, continued growth of deep discount manufacturers, and declining social acceptability of smoking." On April 21, 2004, Moody's again downgraded its ratings on all municipal tobacco transactions and, as a result, South Carolina's tobacco securitization bonds were downgraded to Baa2 for the 2001A Bonds and Baa3 for the 2001B Bonds. As required by the trust indenture and its covenant to disclose subsequent material events to the secondary market, the Authority provided required notices upon the occurrence of each reportable event to central repositories of secondary market information, in strict compliance with its disclosure obligations.

Because the Authority has pledged all future TSRs to the Bonds until those Bonds have been retired, the Authority cannot issue additional debt without effecting a defeasance of currently outstanding Bonds. Presently, the Authority has no plans to undertake any transaction that would result in an increase in currently outstanding debt. The Authority monitors market conditions for circumstances conducive to undertaking a refunding transaction that would result in savings of interest expense over time. No such conditions arose during the most recently completed fiscal year.

Budgetary Highlights

The Authority annually adopts an operating budget as required by its by-laws and the trust indenture. For the budget year ending March 31, 2007, the Authority realized \$85 thousand in excess revenues over expenditures. The variance was principally a result of timing differences. As required by the trust indenture, all additional revenue received under the MSA was applied entirely to the early redemption of principal.

Economic Factors and Outlook

Payment of debt service and orderly retirement of the Bonds are conditioned exclusively on the Authority's receipt of TSRs. TSRs are contingent on among other things, the financial stability of the OPMs. In structuring the financial transaction for issuance of the Bonds, the Authority engaged the services of an independent consultant to develop a forecast of future tobacco rates of consumption and likely TSRs based on those forecasted rates of consumption. All future payments on the Bonds, including timely debt service, sinking fund redemption payments, and Turbo Redemptions are contingent on future TSRs, and those TSRs are dependent on a number of factors, including rates of consumption of tobacco products and compliance by the tobacco companies who are parties to the Master Settlement Agreement with the terms of that agreement.

Disputed Payments. During the periods ending June 30, 2006 and June 30, 2007, a number of participating manufacturers ("PMs") deposited a portion of their tobacco settlement payments into a disputed payments account, incidental to a finding by an independent arbitrator that MSA disadvantages were a significant factor in market share losses experienced by the PMs in calendar years 2003 and 2004. Under the provisions of the MSA, PMs are potentially entitled to an adjustment of their required payments under the MSA (a Non-Participating Manufacturer or NPM Adjustment) in the event that all of the PMs, in the aggregate, lose more than two percentage

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points of market share compared to the market share of the PMs in 1997. However, the adjustment cannot be applied against settling states that have enacted and diligently enforced an escrow fund statute under the MSA.

As a result of the PMs' deposit into the disputed payments account, South Carolina's share of payments under the MSA due was reduced. While this payment reduction resulted in a smaller Turbo Redemption of the Authority's tobacco securitization bonds than projected, the reduction did not impact the Authority's ability to meet its payment obligations when due.

Note 7 of the Notes to Financial Statements includes a summary of originally projected TSRs, actual TSRs, and disputed payments.

At the request of the state's Attorney General, the South Carolina General Assembly made provision in the state's fiscal year 2006-07 Appropriation Act for monies to be used to fund the costs of legal action to determine whether the state has diligently enforced its escrow fund statutes. The Authority cannot presently predict the timing or outcome of this action.

Contacting the Authority

Persons needing additional information concerning this report or otherwise needing to contact the Authority may do so by writing or telephoning F. Richard Harmon, Jr., Senior Assistant State Treasurer, State of South Carolina, 122 Wade Hampton Office Building, Capitol Complex, Columbia, South Carolina 29201; telephone (803) 734-2114; facsimile (803) 734-2039; e-mail rick.harmon@sto.sc.gov.

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

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Statement of Net Assets

June 30, 2007

Assets

Cash and cash equivalents	\$ 533,160
Restricted assets	
Cash and cash equivalents	7,285
Accrued income receivable	25
Investments	111,750,186
Tobacco settlement payments receivable	<u>42,309,394</u>
Total assets	<u>154,600,050</u>

Liabilities

Liabilities payable from restricted assets	
Accrued interest payable	6,084,948
Long-term debt	
Due after one year	<u>769,755,000</u>
Total liabilities	<u>775,839,948</u>

Net assets (deficit)

Unrestricted	<u>(621,239,898)</u>
Total net assets (deficit)	<u>\$ (621,239,898)</u>

See accompanying notes to financial statements.

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

(A Component Unit of the State of South Carolina)

Statement of Activities

June 30, 2007

Expenses	
General government	\$ 91,485
Debt service	
Interest	<u>50,385,990</u>
Total expenses	<u>50,477,475</u>
Net program expense	<u>50,477,475</u>
Revenues	
Tobacco settlement revenues	79,911,637
Investment earnings	<u>5,003,135</u>
Total general revenues	<u>84,914,772</u>
Change in net assets before transfers	<u>34,437,297</u>
Transfers	
Transfers to other state agencies	<u>(425,000)</u>
Total transfers	<u>(425,000)</u>
Change in net assets	34,012,297
Net assets (deficit)	
Beginning of the year	<u>(655,252,195)</u>
End of the year	<u>\$ (621,239,898)</u>

See accompanying notes to financial statements.

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

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Governmental Fund Balance Sheet

June 30, 2007

Assets

Cash and cash equivalents	\$ 533,160
Restricted assets	
Cash and cash equivalents	7,285
Accrued income receivable	25
Investments	111,750,186
Tobacco settlement payments receivable	<u>42,309,394</u>
Total assets	<u>154,600,050</u>

Liabilities

Liabilities payable from restricted assets	<u>-</u>
Total liabilities	<u>-</u>

Fund balance

Reserved for debt service	154,066,890
Unreserved	<u>533,160</u>
Total fund balance	<u>154,600,050</u>
Total liabilities and fund balance	<u>\$ 154,600,050</u>

Reconciliation to the statement of net assets

Fund balance - governmental fund	\$ 154,600,050
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Amounts reported for government activities in the statement of net assets are different because:

Interest on long-term debt is not accrued in governmental funds, but rather is recognized as an expenditure when paid	(6,084,948)
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Long-term liabilities applicable to the Authority's governmental activities are not due and payable in the current period and accordingly are not reported as fund liabilities. All liabilities – both current and long-term – are reported in the statement of net assets	<u>(769,755,000)</u>
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Total net assets (deficit)	<u>\$ (621,239,898)</u>
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See accompanying notes to financial statements.

TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY

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Governmental Fund Statement of Revenues, Expenditures and Changes in Fund Balance

June 30, 2007

Expenditures

General government	\$ 91,485
Debt service	
Principal	27,145,000
Interest	<u>50,646,107</u>
Total expenditures	<u>77,882,592</u>

Revenues

Tobacco settlement revenues	79,911,637
Investment earnings	<u>5,003,135</u>
Total revenues	<u>84,914,772</u>

Excess (deficiency) of revenues over (under) expenditures before transfers	7,032,180
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Transfers

Transfers to other state agencies	<u>(425,000)</u>
Excess (deficiency) of revenues over (under) expenditures	6,607,180

Fund balance

Beginning of the year	<u>147,992,870</u>
End of the year	<u>\$ 154,600,050</u>

Reconciliation to the statement of activities

Excess (deficiency) of revenues over (under) expenditures	\$ 6,607,180
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Amounts reported for government activities in the statement of activities are different because:

Repayment of bond principal is reported as an expenditure in governmental funds and, thus, has the effect of reducing fund balance because current financial resources have been used. For the Authority as a whole, however, the principal payments reduce the liabilities in the statement of net assets and do not result in an expense in the statement of activities

27,145,000

Interest expense in the statement of activities differs from the amount reported in the governmental funds due to the change in accrued interest between fiscal year ends on bonds payable

260,117

Change in net assets

\$ 34,012,297

See accompanying notes to financial statements.

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Notes to Financial Statements

June 30, 2007

(1) Reporting Entity

The Tobacco Settlement Revenue Management Authority (the "Authority") is a public body and an instrumentality of the State of South Carolina (the "State") established in 2001 pursuant to Section 11-49-10 et seq. of the South Carolina Code of Laws as amended. The State transferred to the Authority all of its rights and interests under the Master Settlement Agreement (the "MSA") and the Consent Decree and Final Judgment (the "Decree") between all participating States and the participating Tobacco manufacturers. These rights include the State's share of all Tobacco Settlement revenue received after June 30, 2001 and in perpetuity to be received under the MSA.

The core of a financial reporting entity is the primary government which has a separately elected governing body. As required by accounting principles generally accepted in the United States of America, the financial reporting entity includes both the primary government and all of its component units. Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. In turn, component units may have component units.

An organization other than a primary government may serve as a nucleus for a reporting entity when it issues separate financial statements. That organization is identified herein as a primary entity. The Authority has determined it has no component units and that the Authority qualifies as a primary entity.

In accordance with Governmental Accounting Standards Board ("GASB") Statement No. 14, The Financial Reporting Entity, a primary government or entity is financially accountable if its officials or appointees appoint a voting majority of an organization's governing body including situations in which the voting majority consists of the primary entity's officials serving as required by law (e.g., employees who serve in an ex officio capacity on the component unit's board are considered appointments by the primary entity) and (1) it is able to impose its will on that organization or (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary entity. The primary entity also may be financially accountable if an organization is fiscally dependent on it even if it does not appoint a voting majority of the board. An organization is fiscally independent if it holds all of the following powers:

- (1) Determines its budget without another government having the authority to approve and modify that budget.
- (2) Levies taxes or sets rates or charges without approval by another government.
- (3) Issues bonded debt without approval by another government.

The organization is fiscally dependent on the primary government or entity that holds one or more of the above powers. Based on these criteria, the Authority is a blended component unit of the primary government of the State. Accordingly, the financial statements are blended in the State's special revenue funds in its Comprehensive Annual Financial Report.

The Authority is governed by a board, which consists of five members. The members are the Governor or his designee, the State Treasurer, the Comptroller General, the Chairman of the Senate Finance Committee, and the Chairman of the House Ways and Means Committee. The

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Notes to Financial Statements

June 30, 2007

Governor serves as chairman; in the absence of the Governor, the meeting is chaired by the State Treasurer. All members of the Board serve ex officio.

(2) Summary of Significant Accounting Policies

- (a) General. In its accounting and financial reporting in conformity with accounting principles generally accepted in the United States of America, the Authority follows the pronouncements of the GASB.
- (b) Measurement Focus, Basis of Accounting, and Financial Statement Presentation. GASB Statement No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments, requires government-wide financial statements to be prepared using the accrual basis of accounting and the economic resources measurement focus. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Government-wide financial statements (i.e., the statement of net assets and the statement of activities) do not provide information by fund. Significantly, the statement of net assets includes non-current liabilities, which are not included in the fund statements.

The statement of activities demonstrates the degree to which direct expenses of a given function or segment are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function or segment. Program revenues include (1) charges to customers who purchase, use, or benefit from the services provided by a given function or segment and (2) grants and contributions that are restricted to meeting the operational or capital requirements of a particular function or segment. Unrestricted interest income and other items not properly included among program revenues are reported as general revenues. The Authority has no program revenues.

In addition to the government-wide financial statements, the Authority has prepared financial statements for the Authority's only governmental fund. Governmental fund financial statements use the modified accrual basis of accounting and the current financial resources measurement focus. Tobacco Settlement Revenues ("TSRs") are recognized as soon as they are considered measurable and available. Revenues are considered available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Authority considers revenues to be available if they are collected within one year after the end of the current fiscal period. Expenditures generally are recorded when a liability is incurred.

The Authority reports one governmental fund – the General Fund – which is the general operating fund of the Authority. It is used to account for all financial resources of the Authority. As a blended component unit of the State, the Authority's General Fund is reported as a special revenue fund in the financial statements of the State.

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

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Notes to Financial Statements

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- (c) **Asset Recognition Criteria for TSRs.** The Authority implemented GASB Technical Bulletin No. 2004-1: Tobacco Settlement Recognition and Financial Reporting Entity Issues (the "Bulletin"), effective July 1, 2003. The Bulletin requires the Authority to recognize TSRs when the event giving rise to recognition occurs (the domestic shipment of cigarettes by the tobacco manufacturers) in the government-wide financial statements, and when the event occurs and the TSRs become available in the fund financial statements. Other than the asset recognition criteria required by the Bulletin, future collections are not measurable and are therefore not recorded as assets in either the government-wide financial statements or the government fund financial statements.
- (d) **Cash and Cash Equivalents.** Cash includes cash on hand, demand deposits, and short term investments with original maturities of three months or less from the date acquired by the Authority.
- (e) **Investments.** Investments are recorded on the statement of net assets and the balance sheet at fair value. All investment income, including changes in the fair value of investments, is reported as revenue in the statement of activities and the statement of revenues, expenditures, and changes in fund balance.
- (f) **Restricted Assets.** The bond indenture states that the trustee shall establish and maintain the following segregated trust accounts in the issuer's name: (1) the Collections Account; (2) the Debt Service Account; (3) the Partial Lump Sum Payment Account; (4) the Liquidity Reserve Account; and (5) the Turbo Redemption Account.

The Liquidity Reserve Account has a balance at June 30, 2007 of \$86,705,863. The Authority is required to maintain a balance equal to the maximum annual debt service on the Series 2001 Term Bonds as of their date of issuance, based on the assumption that all sinking fund installments are paid when due, in the Liquidity Reserve Account, to the extent of available funds.

Amounts on deposit in the Liquidity Reserve Account will be available to pay term bond maturities and sinking fund installments of, and interest on, the Series 2001 Term Bonds to the extent collections are insufficient for such purpose. Any amount remaining after such payments in excess of the Liquidity Reserve Requirement will be deposited in the "Collection Account." Unless an event of default has occurred, amounts withdrawn from the Liquidity Reserve Account will be replenished from collections.

Within the Debt Service Account, there is an Interest Reserve subaccount. At June 30, 2007, the balance of the Interest Reserve subaccount is \$24,491,041 and the balance in the Turbo Redemption Account is \$2,412. The balance in the Collections Account is \$558,181, and the balance in the Partial Lump Sum Payment Account at June 30, 2007 is \$0.

- (g) **Fund Equity.** In the governmental fund financial statements, reservations of fund balance are reported for amounts that are legally restricted by the bond indenture for debt service. The State reports the Authority's unrestricted net assets as restricted, as the amounts are legally restricted by the bond indenture to be spent on the general

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operations and debt service of the Authority and are not unrestricted for the State as a whole.

- (h) **Administrative Expenses.** The State of South Carolina performs certain accounting and administrative services for the Authority for which the state receives no compensation. The value of these services is deemed immaterial to the Authority's financial statements.
- (i) **Use of Estimates.** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(3) Deposits and Investments

Deposits. Other than incidental amounts held by the Trustee pending permanent investment or distribution, the Authority's cash deposits are under the control of the State Treasurer who, by law, has sole authority for investing State funds. State law requires full collateralization of all bank balances under the control of the State Treasurer. The State Treasurer must correct any deficiencies in collateral within two days. At June 30, 2007, all bank balances under the control of the State Treasurer were fully insured or collateralized with securities held by the State's agent in the name of the State Treasurer.

Investments. All of the Authority's investments are held by the trustee in several restricted accounts in the name of the Authority. The Indenture (as hereinafter defined) provides the circumstances under which money in the accounts held by the trustee may be invested in Eligible Investments (as defined in the Indenture and hereinafter described). Included in the Indenture's definition of Eligible Investments are obligations of FHLMC, FNMA, or Federal Farm Credit System, demand and time deposit accounts and certificates of deposit, general obligations of states and guaranteed state obligations, commercial or finance company paper, repurchase obligations, corporate securities bearing interest or sold at discount, taxable money market funds, investment agreements or guaranteed investment contracts, and other obligations or securities that are investment agreements or guaranteed investment contracts and other obligations or securities that are non-cancelable; provided, however, that such investments must be permitted under the laws of the State of South Carolina. The Authority has not adopted a formal investment policy because the Indenture contains these investment restrictions.

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The following schedule reflects the Authority's deposits and investments at their fair and reported values at June 30, 2007, and reconciles the amounts reported in the statement of net assets to the notes.

Notes	Statements
Deposits	Cash and cash equivalents \$ 540,445
Held by State Treasurer	
\$ 533,160	
Total Deposits	
533,160	
Investments	Investments 111,750,186
Federal Home Loan Mortgage Corporation	
Discount Notes	
86,705,694	
Federal Home Loan Bank	
Discount Notes	
25,044,492	
Treasury Tri-Party Repurchase Agreements	
7,285	
Total Investments	
111,757,471	
Totals	
\$ 112,290,631	\$ 112,290,631

Custodial Credit Risk. Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty, the Authority will not be able to recover the value of the investments or collateral securities that are in the possession of an outside party. At June 30, 2007, all of the Authority's investments were insured and registered.

The following table presents the fair value of investments as of June 30, 2007.

	Fair Value
Short Term Investments:	
U. S. Government Agency	\$ 111,750,186
Repurchase Agreements	7,285
Total	\$ 111,757,471

Interest Rate Risk. Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. This risk is managed within the portfolio using effective duration. Effective duration is a measure of the price sensitivity of a bond or a portfolio of bonds to interest rate movements given a 50 basis point change in interest rates. It takes into account that expected cash flows will fluctuate as interest rates change and provides a measure of risk that changes proportionately with market rates. The following schedule presents the Authority's interest rate risk.

	Fair Value	Effective Duration
Short Term Investments:		
U. S. Government Agency	\$ 111,750,186	0.37
Repurchase Agreements	7,285	0.00
Total	\$ 111,757,471	0.37

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Credit Risk. Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation to the Authority. Credit risk ratings are not required for obligations of the U.S. government or those obligations explicitly guaranteed by the U.S. government. As of June 30, 2007, the Authority's rated debt investments were rated by Standard & Poor's and are presented below.

	Fair Value	Quality Ratings	
		AAA	A-1
Short Term Investments:			
U. S. Government Agency	\$ 111,750,186	\$ 111,750,186	\$ -
Repurchase Agreements	7,285	-	7,285
Total	<u>\$ 111,757,471</u>	<u>\$ 111,750,186</u>	<u>\$ 7,285</u>

Concentration of credit risk is the risk of loss attributed to the magnitude of the government's investment in a single issuer. At June 30, 2007, the Authority had approximately 99% of its investments in U.S. Government Agency securities, and had less than 1% of its investments in an overnight repurchase agreement with the Bank of New York, which repurchase agreement was fully collateralized by United States Treasury obligations.

Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. At June 30, 2007, the Authority did not have any deposits or investments denominated in foreign currencies.

(4) Bonds Payable

On March 22, 2001, the Authority issued asset backed bonds pursuant to an indenture between the Authority and United States Trust Company of New York, as trustee, dated as of March 1, 2001 (the "Indenture"). The State transferred to the Authority all of its rights and interests under the MSA and the Decree. These rights include the State's share of all Tobacco Settlement revenue received after June 30, 2001 and in perpetuity to be received under the MSA. The consideration paid by the Authority to the State for such rights consisted of \$785,750,514 cash.

The MSA is an industry wide settlement of litigation between the Settling States and the Original Participating Manufacturers (the "OPMs") and was entered into between the attorneys general of the Settling States and the OPMs on November 23, 1998. The MSA provides for other tobacco companies, referred to as Subsequent Participating Manufacturers (the "SPMs"), to become parties to the MSA. The four OPMs together with the SPMs are referred to as the Participating Manufacturers (the "PMs"). The settlement represents the resolution of a large potential financial liability of the PMs for smoking related injuries, the costs of which have been borne and will likely continue to be borne by cigarette consumers. Pursuant to the MSA, the Settling States agreed to settle all their past, present, and future smoking related claims against the PMs in exchange for agreements and undertakings by the PMs concerning a number of issues. These issues include, among others, making payments to the Settling States, abiding by more stringent advertising restrictions, and funding educational programs, all in accordance with the terms and conditions set forth in the MSA. Distributors of PMs' products are also covered by the settlement of such claims to the same extent as the PMs.

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In 2001, the Authority issued \$934,530,000 of Tobacco Settlement Asset Backed Bonds consisting of \$200,000,000 Series 2001A (Taxable) Term Bonds and \$734,530,000 Series 2001B (Tax Exempt) Term Bonds (collectively, the Series 2001 Term Bonds). The Series 2001 Term Bonds were issued by the Authority pursuant to an Indenture between the Authority and United States Trust Company of New York, as trustee, dated as of March 1, 2001.

Long term debt at June 30, 2007 is comprised of the following:

2001 Series A (Taxable) Term Bonds due May 15, 2016 with interest of 7.666% due semiannually on May 15th and November 15th, commencing on November 15, 2001	\$ 35,225,000
2001 Series B (Tax-Exempt) Term Bonds due May 15, 2022 with interest of 6% due semiannually on May 15th and November 15th, commencing November 15, 2001	225,880,000
2001 Series B (Tax-Exempt) Term Bonds due May 15, 2028 with interest of 6.375% due semiannually on May 15th and November 15th, commencing November 15, 2001	347,265,000
2001 Series B (Tax-Exempt) Term Bonds due May 15, 2030 with interest of 6.375% due semiannually on May 15th and November 15th, commencing November 15, 2001	<u>161,385,000</u>
	<u>\$ 769,755,000</u>

The sinking fund installment of the Series 2001 Term Bonds represents the amount of principal that the Authority will pay as of the specified distribution date (each a sinking fund payment date) from collections of TSRs and, if necessary, the Liquidity Reserve Account.

A failure by the Authority to pay the sinking fund installment of the Series 2001 Bonds on the applicable sinking fund installment payment date will not constitute an event of default under the Indenture. However, a failure to pay interest on the Series 2001 Term Bonds when due or principal of the Series 2001 Term Bonds by their maturity dates will constitute an event of default under the Indenture.

Turbo Redemptions represent the requirement contained in the Indenture to apply 100% of all collections that are in excess of the requirements in the Indenture for the funding of the operating expenses, the deposits to the Debt Service Account for the funding of interest, sinking fund installments, and term bond maturities, maintenance of the Liquidity Reserve Account and the Operating Contingency Account (such excess, surplus collections), to the redemption of Series 2001 Term Bonds on each distribution date (each a Turbo Redemption Date) in ascending order of maturity. Such surplus collections are deposited into the Turbo Redemption Account, established and maintained by the trustee under the Indenture. Turbo Redemptions are credited against sinking fund installments for any particular Series 2001 Term Bonds in ascending order of sinking fund installment dates. Turbo Redemptions are not scheduled amortization payments and are made only from surplus collections, if any, and from amounts on deposit in the Partial Lump Sum Payment Account with confirmation from each rating agency that no rating then in effect, with respect to the Series 2001 Term Bonds, from such rating agency will be withdrawn, reduced,

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or suspended. Amounts in the Liquidity Reserve Account are not available to make Turbo Redemptions. As all originally scheduled principal payments for 2007 were paid with Turbo Redemptions in prior years, all payments made in 2007, which totaled \$27,145,000, were Turbo Redemptions. A history of expected and actual Turbo Redemptions and sinking fund installments through June 30, 2007, is as follows:

Series 2001A Term Bonds Maturing May 15, 2016			
Turbo Redemptions			
Twelve months ended June 30	Expected	Actual	Sinking Fund Installments
2002	\$ 30,230,000	\$ 31,610,000	\$ -
2003	31,875,000	34,635,000	9,205,000
2004	23,640,000	22,655,000	1,015,000
2005	26,375,000	24,725,000	1,085,000
2006	29,500,000	24,005,000	6,215,000
2007	32,875,000	27,145,000	7,755,000
Total	<u>\$ 174,495,000</u>	<u>\$ 164,775,000</u>	<u>\$ 25,275,000</u>

The Authority's debt service requirements based upon required sinking fund and interest payments, as adjusted for all Turbo Redemptions effected through of June 30, 2007, are as follows:

Twelve months ended June 30	Sinking fund payments	Interest	Total debt service
2008	\$ -	\$ 48,679,586	\$ 48,679,586
2009	-	48,679,586	48,679,586
2010	-	48,679,586	48,679,586
2011	-	48,679,586	48,679,586
2012	-	48,679,586	48,679,586
2013 – 2017	65,650,000	238,805,229	304,455,229
2018 – 2022	195,455,000	199,531,988	394,986,988
2023 – 2027	279,050,000	128,854,369	407,904,369
2028 – 2030	229,600,000	30,233,119	259,833,119
	<u>\$ 769,755,000</u>	<u>\$ 840,822,635</u>	<u>\$ 1,610,577,635</u>

The Authority's long-term liability activity for the year ended June 30, 2007, was as follows:

	Balance June 30, 2006	Additions	Reductions	Balance June 30, 2007
Bonds:				
Series 2001 bonds	\$ 796,900,000	-	27,145,000	769,755,000

(5) Other Credit Risks – Tobacco Settlement Receipts and Other Issue-Specific Security

The payment of the Series 2001 Term Bonds is dependent on the receipt of TSRs. The amount of TSRs actually collected is dependent on many factors, including cigarette consumption and the

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continued financial capability of the OPMs. Such bonds are secured by and payable solely from TSRs and investment earnings pledged under the Bond Indenture and amounts established and held in accordance with the Bond Indenture. The Series 2001 Term Bonds are payable only from the assets of the Authority. In the event that the assets of the Authority have been exhausted, no amounts will thereafter be paid on the Series 2001 Term Bonds. The Series 2001 Term Bonds are not legal or moral obligations of the State, and no recourse may be had thereto for payment of amounts owing on the Series 2001 Term Bonds. The Authority's only source of funds for payments on the Series 2001 Term Bonds is the TSRs. The Authority has no taxing power.

(6) Contingencies

Certain smokers, consumer groups, cigarette manufacturers, cigarette importers, cigarette distributors, native American tribes, taxpayers, taxpayers' groups, and other parties have instituted litigation against various tobacco manufacturers, including the PMs, as well as certain of the Settling States and other public entities. The lawsuits allege, among other things, that the MSA violates certain provisions of the United States Constitution, state constitutions, the Federal antitrust laws, Federal civil rights laws, state consumer protection laws, and unfair competition laws, certain of which actions, if ultimately successful, could result in a determination that the MSA is void or unenforceable. The lawsuits seek, among other things, an injunction against one or more of the Settling States from collecting any monies under the MSA and barring the PMs from collecting cigarette price increases related to the MSA and/or a determination that the MSA is void or unenforceable. In addition, class action lawsuits have been filed in several Federal and state courts alleging that under the Federal Medicaid law, any amount of tobacco settlement funds that the Settling States receive in excess of what they paid through the Medicaid program to treat tobacco related diseases should be paid directly to Medicaid recipients. To date, no such lawsuits have been successful or are on appeal. The enforcement of the terms of the MSA may, however, continue to be challenged in the future. In the event of an adverse court ruling, the Authority may not have adequate financial resources to make payment on the Series 2001 Term Bonds.

(7) Disputed Payments

During the periods ending June 30, 2006 and June 30, 2007, a number of participating manufacturers ("PMs") deposited a portion of their tobacco settlement payments due on or about April 15 into a disputed payments account, incidental to findings by an independent arbitrator that MSA disadvantages were a significant factor in market share losses experienced by the PMs in calendar years 2003 and 2004. Under the provisions of the MSA, PMs are potentially entitled to an adjustment of their required payments under the MSA (a Non-Participating Manufacturer or NPM Adjustment) in the event that all of the PMs, in the aggregate, lose more than two percentage points of market share compared to the market share of the PMs in 1997. However, the adjustment cannot be applied against settling states that have enacted and diligently enforced an escrow fund statute under the MSA.

As a result of the PMs' deposit into the disputed payments account, South Carolina's share of payments under the MSA has been reduced for the past two fiscal years. While this payment reduction resulted in a smaller Turbo Redemption of the Authority's tobacco securitization bonds than projected, the reduction did not impact the Authority's ability to meet its payment obligations when due. A summary of these disputed payments follows:

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Twelve months ended June 30	Total Payments Expected by the Authority	Actual Amount Calculated by Independent Auditor	Deposited into Disputed Payments Account	Payments Received by the Authority
2006	\$ 76,829,052	\$ 77,371,882	\$ 9,390,246	\$ 67,981,636
2007	77,834,167	79,435,780	8,029,314	71,406,466
Total	<u>\$ 154,663,219</u>	<u>\$ 156,807,662</u>	<u>\$ 17,419,560</u>	<u>\$ 139,388,102</u>

(8) Related Party Transactions

The State of South Carolina, through the Office of Attorney General, provides certain legal and enforcement services to the Authority. During the fiscal year ended June 30, 2007, the Authority transferred a total of \$425,000 from its general fund to the Office of Attorney General to cover costs of providing these services.

Additionally, the Office of State Treasurer provides administrative, investment, operations, record keeping, and other support services to the Authority. During the fiscal year ended June 30, 2007, the Authority reimbursed a total of \$25,859 to the Office of State Treasurer to cover costs of providing these services.

(9) Risk Management

The Authority is exposed to risks of loss from torts and maintains State coverage for these risks. Management believes such coverage is sufficient to preclude any significant uninsured losses for the covered risks. There were no significant reductions in insurance coverage from coverage in the prior year. The insurer promises to pay to or on behalf of the insured for covered economic losses sustained during the policy period in accord with insurance policy and benefit program limits except for the deductibles. The Authority and other entities pay premiums to the State's Insurance Reserve Fund (IRF) which issues policies, accumulates assets to cover the risks of loss, and pays claims incurred for covered losses related to torts.

The IRF is a self-insurer whose rates are determined actuarially.

No payments for uninsured losses were made during the fiscal year ended June 30, 2007.

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Required Supplementary Information (unaudited)

Budgetary Comparison Schedule

General Fund

Year ended June 30, 2007

	<u>Budgeted Amounts</u>		<u>Actual</u>	<u>Variance</u>
	<u>Original</u>	<u>Final</u>		
Revenue				
Revenue from tobacco settlement receipts used for administrative costs	\$ 275,927	\$ 640,927	\$ 640,927	\$ -
Total revenue	<u>275,927</u>	<u>640,927</u>	<u>640,927</u>	<u>-</u>
Expenditures				
Contractual services	109,800	184,800	102,971	(81,829)
Fixed charges and contributions	2,400	2,400	2,925	525
Miscellaneous administrative	<u>3,727</u>	<u>3,727</u>	<u>-</u>	<u>(3,727)</u>
Total expenditures	<u>115,927</u>	<u>190,927</u>	<u>105,896</u>	<u>(85,031)</u>
Transfers				
Transfer to other state agency	<u>(160,000)</u>	<u>(450,000)</u>	<u>(450,000)</u>	<u>-</u>
Total transfers	<u>(160,000)</u>	<u>(450,000)</u>	<u>(450,000)</u>	<u>-</u>
Excess of revenue over expenditures	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 85,031</u>	<u>\$ 85,031</u>

See accompanying notes to required supplementary information.

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Notes to Required Supplementary Information (unaudited)

Budgetary Comparison Schedule

General Fund

Year ended June 30, 2007

(1) Basis of Presentation

Section 11-49-60 of the Code of Laws requires the Authority to adopt an annual budget for its operational expenditures. Expenditures for debt service are excluded from the budgetary requirement and thus the basis for budgeting and the presentation of actual results differs from accounting principles generally accepted in the United States of America. The Authority's officially adopted budget for fiscal year 2007 is based on the sinking fund year ending March 31, 2007. The accompanying budgetary comparison schedule compares the Authority's legally adopted budget to actual results on the budgetary basis.

(2) Budgetary Revisions

The Authority maintains budgetary control at the object category of expenditure and must approve any transfer of appropriations between the object categories.

(3) Reconciliation of Budget to GAAP Reporting Differences

The accompanying budgetary comparison schedule compares the Authority's legally adopted budget with actual results in accordance with the Authority's basis of budgeting. Budgetary accounting principles, however, differ significantly from GAAP. These different accounting principles result in basis and perspective differences in the excess (deficiency) of revenues over (under) expenditures. Basis differences exist because the basis of budgeting excludes revenues and debt service expenditures recorded in accordance with GAAP. Perspective differences exist due to the budgetary comparison schedule being presented on a sinking fund year end of March 31, 2007 rather than the financial reporting year end used for GAAP statements of June 30, 2007.

	<u>Actual Amounts</u>
Excess of revenues	
over expenditures, budgetary basis	\$ 85,031
Basis differences	7,123,665
Perspective differences	<u>(601,516)</u>
Deficiency of revenues	
under expenditures, GAAP basis	<u>\$ 6,607,180</u>

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED
IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

Mr. Richard H. Gilbert, Jr., CPA
Deputy State Auditor
State of South Carolina
Columbia, South Carolina

We have audited the financial statements of the Tobacco Settlement Revenue Management Authority (the Authority) as of and for the year ended June 30, 2007, and have issued our report thereon dated September 7, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

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

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

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

Compliance and Other Matters

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

This report is intended solely for the information and use of the State Auditor, management of the Authority and is not intended to be and should not be used by anyone other than these specified parties.

Rogers Lalan, PA

September 7, 2007