

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

Basic Financial Statements

June 30, 2003

(With Independent Auditors' Report Thereon)

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

**Table of Contents**

	<b>Page</b>
Independent Auditors' Report	1
Management's Discussion and Analysis	3
Basic Financial Statements:	
Statement of Net Assets and Governmental Fund Balance Sheet	9
Statement of Activities and Governmental Fund Revenues, Expenditures, and Changes in Fund Balance	10
Notes to Basic Financial Statements	11
Required Supplementary Information (Other than Management's Discussion and Analysis) (Unaudited):	
Budgetary Comparison Schedule – Budgetary General Fund	20
Notes to Required Supplementary Information – Budgetary	21
Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i>	22

State of South Carolina



Office of the State Auditor

1401 MAIN STREET, SUITE 1200  
COLUMBIA, S.C. 29201

THOMAS L. WAGNER, JR., CPA  
STATE AUDITOR

(803) 253-4160  
FAX (803) 343-0723

October 22, 2003

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, 2003, was issued by KPMG, LLP, 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 that reads "Tom Wagner".

Thomas L. Wagner, Jr., CPA  
State Auditor

TLWjr/trb



303 Peachtree Street, N.E.  
Suite 2000  
Atlanta, GA 30308

## Independent Auditors' Report

The Honorable Mark Sanford, Governor, and  
Members of the Tobacco Settlement Revenue  
Management Authority  
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, 2003, which collectively comprise the Authority's basic 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.

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, 2003, 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 12, 2003 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 grants. 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 20 through 21 are not a required part of the basic 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.

KPMG LLP

September 12, 2003

## **TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY**

### Management's Discussion and Analysis

June 30, 2003

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, 2003. 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.

As of June 30, 2003, there remained outstanding \$869.87 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 discussion and analysis are intended to serve as an introduction to the Authority's basic financial statements. The Authority's basic financial statements consist of three components: 1) government-wide financial statements, 2) governmental fund financial statements, and 3) notes to the financial statements. Because the

Authority's activities are single purpose in nature, the government-wide and fund financial statements have been presented together with an adjustments column reconciling the differences.

- The *Statement of Net Assets and Governmental Fund Balance Sheet* includes all of the Authority's assets and liabilities and provides information about the nature and amounts of investments in resources (assets) and the obligations to Authority creditors (liabilities). It also provides 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 column 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 balances of spendable resources available 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*. These statements measure the success of the Authority's operations over the past year and can be used to determine the Authority's ability to meet its financial objectives and credit-worthiness. The Statement of Activities column 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 spendable resources for the fiscal year.

## Summary of Financial Results

### Government-Wide Financial Statements

*Statement of Net Assets.* Table 1 summarizes the Authority's Net Assets for the period ending June 30, 2003, along with comparative data for the prior fiscal year.

**Table 1: Summary of Net Assets**

	June 30, 2003	June 30, 2002	Difference	% Difference
Cash and Cash Equivalents	\$ 130,714	\$ 126,281	\$ 4,433	3.5%
Restricted Assets	117,521,202	117,937,367	(416,165)	(0.4%)
Total Assets	\$ 117,651,916	\$ 118,063,648	\$ (411,732)	(0.3%)
Accrued Interest Payable	\$ 7,044,300	\$ 7,361,002	\$ (316,702)	(4.3%)
Long-Term Liabilities	869,870,000	902,920,000	(33,050,000)	(3.7%)
Total Liabilities	\$ 876,914,300	\$ 910,281,002	\$ (33,366,702)	(3.7%)
Total Net Assets (Deficit)	\$ (759,262,384)	\$ (792,217,354)	\$ 32,954,970	4.2%

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 in the amount of \$869,870,000 and accrued interest payable on those Bonds at the end of the fiscal year.

The Authority's cash and cash equivalents increased 3.5% as a result of a permitted inflationary adjustment for amounts paid from TSRs to the Authority for its authorized operating expenses. Restricted assets decreased marginally as a consequence of lower earnings on investments. Accrued interest payable and long term liabilities decreased in an amount 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 as a result, TSRs do not meet asset recognition criteria under accounting principals 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.

*Statement of Activities.* Table 2 summarizes the Authority's activities for the period ending June 30, 2003.

**Table 2: Summary of Activities**

	<b>Year Ended June 30, 2003</b>	<b>Year Ended June 30, 2002</b>	<b>Difference</b>	<b>% Difference</b>
General Revenues	\$ 91,687,905	\$ 93,522,216	(1,834,311)	(2.0%)
Expenses	58,732,935	61,091,240	(2,358,305)	(3.9%)
Change in Net Assets	\$ 32,954,970	\$ 32,430,976	523,994	1.6%
Net Assets (Deficit) – Beginning of Year	\$ (792,217,354)	\$ (824,648,330)	32,430,976	3.9%
Net Assets (Deficit) – End of Year	\$ (759,262,384)	\$ (792,217,354)	32,954,970	4.2%

General revenues of \$91.7 million reflect the receipt of \$86.3 million in TSRs, along with investment earnings of \$5.4 million. The Authority's expenses primarily consisted of interest on the Bonds totaling \$58.6 million.

The decline in general revenues was the consequence of lower earnings on investments during the fiscal year. Expenses decreased by 3.9%, primarily from lower interest expense. Decreases in expenses and Net Deficit are proportionate to the principal amount of bonds redeemed during the fiscal year under the trust indenture's Turbo Redemption provisions.

Governmental Fund Financial Statements

*Governmental Fund Balance Sheet.* Table 3 summarizes the Authority's Balance Sheet for its General Fund for the period ending June 30, 2003.

**Table 3: Governmental Fund Balance Sheet**

	<b>June 30, 2003</b>	<b>June 30, 2002</b>	<b>Difference</b>	<b>% Difference</b>
Cash and Cash Equivalents	\$ 130,714	\$ 126,281	\$ 4,433	3.5%
Restricted Assets	117,521,202	117,937,367	(416,165)	(0.4%)
<b>Total Assets</b>	<b>\$ 117,651,916</b>	<b>\$ 118,063,648</b>	<b>\$ (411,732)</b>	<b>(0.3%)</b>
Total Liabilities	--	--	--	--
<b>Total Fund Balance</b>	<b>\$ 117,651,916</b>	<b>\$ 118,063,648</b>	<b>\$ (411,732)</b>	<b>(0.3%)</b>

The Authority's assets as reported on the fund statements are the same as the assets presented on Statement of Net Assets. There are no liabilities on the Governmental Fund Balance Sheet because all of the Authority's liabilities are long-term in nature or relate to liabilities reported on a cash basis. Explanations for variances from the prior year are the same as those for the Government-Wide Financial Statements above.

*Governmental Fund Statement of Revenue, Expenditures, and Changes in Fund Balance.* Table 4 summarizes the Authority's Governmental Fund Revenues, Expenditures and Changes in Fund Balance for the period ending June 30, 2003.

**Table 4: Summary Governmental Fund Statement of Revenues, Expenditures and Changes in Fund Balance**

	<b>Year Ended June 30, 2003</b>	<b>Year Ended June 30, 2002</b>	<b>Difference</b>	<b>% Difference</b>
General Revenues	\$ 91,687,905	\$ 93,522,216	\$ (1,834,311)	(2.0%)
Expenses	92,099,637	102,030,519	(9,930,882)	(9.7%)
Excess (Deficiency) of Revenues Over (under) Expenditures	\$ (411,732)	\$ (8,508,303)	\$ 8,096,571	95.2%
Fund Balance – Beginning of Year	\$ 118,063,648	\$ 126,571,951	\$ (8,508,303)	(6.7%)
Fund Balance – End of Year	\$ 117,651,916	\$ 118,063,648	\$ (411,732)	(0.3%)

General revenues of \$91.7 million reflect the receipt of \$86.3 million in TSRs, along with investment earnings of \$5.4 million. The Authority's expenditures primarily consisted of interest on the Bonds totaling \$58.9 million and early extinguishment of debt of \$33.1 million.

The decline in general revenues was the consequence of lower earnings on investments during the fiscal year. Expenditures decreased by 9.7%, primarily from lower interest expense. Decreases in expenditures and Net Deficit are related to the principal amount of bonds redeemed during the fiscal year under the trust indenture's Turbo Redemption provisions.

### **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, 2003 resulted in the Turbo Redemption of \$33.05 million in outstanding debt.

Over the course of the fiscal year, 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 were precipitated initially by increased uncertainty surrounding the effect of a class-action lawsuit filed in the Illinois court system captioned *Miles v. Philip Morris*, and the potential effect of that litigation on the financial condition of Philip Morris. Moreover, rating agencies cited a general "adverse litigation environment" in the tobacco industry, declines in industry volume shipments during first quarter 2003 relative to the same quarter of 2002, 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 Poor's respectively at fiscal year end. Subsequent to year end, on August 28, 2003, Standard and Poor's again downgraded the bonds to a level of "BBB". The rating action reflects "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." 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 refunding 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, 2003, actual expenditures for operations were less than budgeted amounts by \$25,698. The variance was principally caused by certain planned expenditures of approximately \$34,000 for contractual services and administrative costs not occurring until the first quarter following the 2003 budget year. This variance was offset by approximately \$9,400 of the unplanned expenditures resulting from an increase in investment expenditures, due to a fee increase imposed by the indenture trustee. 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 rates of consumption of tobacco products.

## **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 [harmr@sto.state.sc.us](mailto:harmr@sto.state.sc.us).

**TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY**  
(A Component Unit of the State of South Carolina)  
Statement of Net Assets and Governmental Fund Balance Sheet  
June 30, 2003

	<b>General Fund</b>	<b>Adjustments (Note 3)</b>	<b>Statement of Net Assets</b>
<b>Assets</b>			
Cash and cash equivalents	\$ 130,714	\$ -	\$ 130,714
Restricted assets:			
Cash and cash equivalents	7,929	-	7,929
Investments	115,109,405	-	115,109,405
Accrued interest receivable	2,403,868	-	2,403,868
Total assets	<u>\$ 117,651,916</u>	<u>-</u>	<u>117,651,916</u>
<b>Liabilities</b>			
Liabilities payable from restricted assets:			
Accrued interest payable	\$ -	7,044,300	7,044,300
Long-term debt:			
Due after one year	-	869,870,000	869,870,000
Total liabilities	<u>-</u>	<u>876,914,300</u>	<u>876,914,300</u>
<b>Fund Balance/Net Assets (Deficit)</b>			
Fund balance:			
Reserved for debt service	117,521,202	(117,521,202)	-
Unreserved	130,714	(130,714)	-
Total fund balance	117,651,916	(117,651,916)	-
Total liabilities and fund balance	<u>\$ 117,651,916</u>		
Net assets (deficit):			
Unrestricted		(759,262,384)	(759,262,384)
Total net assets (deficit)		<u>\$ (759,262,384)</u>	<u>\$ (759,262,384)</u>

See accompanying notes to basic financial statements.

**TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY**  
(A Component Unit of the State of South Carolina)  
Statement of Activities and Governmental Fund  
Revenues, Expenditures, and Changes in Fund Balance  
For the Year Ended June 30, 2003

	<b>General Fund</b>	<b>Adjustments (Note 3)</b>	<b>Statement of Activities</b>
<b>Expenditures/expenses:</b>			
General government	\$ 161,622	\$ -	\$ 161,622
Debt service:			
Principal	33,050,000	(33,050,000)	-
Interest	58,888,015	(316,702)	58,571,313
Total expenditures/expenses	92,099,637	(33,366,702)	58,732,935
Net program expense			58,732,935
 <b>General revenues:</b>			
Tobacco settlement revenues	86,312,916	-	86,312,916
Investment earnings	5,374,989	-	5,374,989
Total general revenues	91,687,905	-	91,687,905
Excess (deficiency) of revenues over (under) expenditures	(411,732)	411,732	-
Change in net assets	-	(32,954,970)	32,954,970
 <b>Fund balance/net assets (deficit)</b>			
Beginning of the year	118,063,648	(910,281,002)	(792,217,354)
End of the year	\$ 117,651,916	\$ (942,824,240)	\$ (759,262,384)

See accompanying notes to basic financial statements.

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

Notes to Basic Financial Statements

June 30, 2003

**(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 11-49-30 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. See further explanation in notes 5 and 6.

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 Governor serves as chairman; in the

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

Notes to Basic Financial Statements

June 30, 2003

absence of the Governor, the meeting must be 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 noncurrent 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. Revenues 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. Due to the single purpose nature of the activities of the Authority, the government-wide and fund financial statements have been presented together with an adjustments column reconciling the differences.

The future collection of Tobacco Settlement Revenue (TSRs) is dependent on many factors, including future cigarette consumption. As such the future collection is not measurable and is not recorded as an asset in either the government-wide financial statements or the governmental fund financial statements.

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

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

Notes to Basic Financial Statements

June 30, 2003

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.

**(c) 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.

**(d) 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.

**(e) 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, 2003 of \$88,265,530. 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. The balance of the Interest Reserve Subaccount at June 30, 2003 is \$28,237,132. The balance in the Collections Account, the Partial Lump Sum Payment Account, and the Turbo Redemption Account at June 30, 2003 is \$1,010,004.

**(f) 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 should report the Authority's unrestricted net assets as restricted as the amounts are legally restricted by the bond indenture to be spent on the general operations and debt service of the Authority and are not unrestricted for the State as a whole.

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

Notes to Basic Financial Statements

June 30, 2003

**(g) Administrative Expenses**

The State of South Carolina performs certain accounting, legal, and administrative services for the Authority for which it receives no compensation. The value of such service was deemed immaterial to the Authority's financial statements.

**(h) 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) Reconciliation of government-wide and fund financial statements**

**(a) Explanation of adjustments between the governmental fund balance sheet and the government-wide statement of net assets**

The Governmental fund balance sheet is adjusted for the following items to report the statement of net assets.

Interest on long-term debt is not accrued in governmental funds, but rather is recognized as an expenditure when due.	\$ 7,044,300
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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.	869,870,000
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**TOBACCO SETTLEMENT REVENUE MANAGEMENT AUTHORITY**  
(A Component Unit of the State of South Carolina)

Notes to Basic Financial Statements

June 30, 2003

**(b) Explanation of adjustments between the governmental fund statement of revenues, expenditures, and changes in fund balance and the government-wide statement of activities**

The Governmental fund statement of revenues, expenditures, and changes in fund balance is adjusted for the following items to report the statement of activities.

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. \$ 33,050,000

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 being calculated for bonds payable being recorded in the statement of activities. 316,702

**(4) Deposits and Investments**

At June 30, 2003, the Authority's deposits and investments consisted of the following:

Description	Maturity date	Fair value and reported value June 30, 2003
Cash and cash equivalents – cash on deposit (bank balance and carrying value)		\$ <u>138,643</u>
Investments:		
Federal National Mortgage Association	November 14, 2003	\$ 28,176,505
Federal Home Loan Mortgage Corporation	August 14, 2003	85,922,897
Money Market Funds - uncategorizable		<u>1,010,003</u>
Total		\$ <u><u>115,109,405</u></u>

**Deposits** – Most 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 State Treasurer bank balances. The State Treasurer must correct any deficiencies in collateral within two days. At June 30, 2003, all State Treasurer bank balances were fully insured or collateralized with securities held by the State.

**Investments** – The Authority's investment policy provides for eligible investments in 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

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

Notes to Basic Financial Statements

June 30, 2003

securities that are investment agreements or guaranteed investment contracts and other obligations or securities that are noncancelable.

The Authority's investments are held by the trustee in several restricted accounts in the name of the Authority. The Authority's investments are categorized to give an indication of the level of risk assumed by the entity at year-end. The credit risk categories are concerned with custodial credit risk, which is the risk that a government will not be able to recover the value of investment or collateral securities that are in the possession of an outside party if the counterparty to the investment transaction fails. There are three categories of credit risk. Category 1 includes investments that are insured or registered or for which the securities are held by the entity or its agent in the Authority's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the Authority's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the Authority's name. The Authority's investments at June 30, 2003, except as not to be uncategorizable funds, are considered category 2.

**(5) 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 Master Settlement Agreement (the MSA) and the Consent Decree and Final Judgment (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. Also, the State (primary government) transferred \$75,000 to the Authority to finance initial activities prior to the issuance of the bonds.

The MSA is an industry-wide settlement of litigation between the Settling States and the Original Participating Manufacturers (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 25 SPMs are referred to as the Participating Manufacturers (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.

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.

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

Notes to Basic Financial Statements

June 30, 2003

Long-term debt at June 30, 2003 is composed 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	\$ 135,340,000
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>\$ 869,870,000</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 will be deposited in an account established and maintained by the trustee under the Indenture (the Turbo Redemption Account). Turbo Redemptions will be 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 to be 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, or suspended. Amounts in the Liquidity Reserve Account will not be available to make Turbo Redemptions. As all originally scheduled principal payments for 2003 were paid with Turbo Redemptions in prior years, all payments made in 2003, which totaled \$33,050,000, were Turbo Redemptions.

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

Notes to Basic Financial Statements

June 30, 2003

The Authority's debt service requirements based upon required sinking fund and interest payments, as adjusted for the Turbo Redemptions made as of June 30, 2003, are as follows:

	<u>Sinking fund payments</u>	<u>Interest</u>	<u>Total debt service</u>
Twelve months ended June 30:			
2004	\$ —	56,354,402	56,354,402
2005	—	56,354,402	56,354,402
2006	—	56,354,402	56,354,402
2007	—	56,354,402	56,354,402
2008	—	56,354,402	56,354,402
2009 – 2013	95,845,000	269,974,419	365,819,419
2014 – 2018	102,555,000	234,606,719	337,161,719
2019 – 2023	211,315,000	187,804,688	399,119,688
2024 – 2028	298,770,000	111,064,931	409,834,931
2029 – 2030	161,385,000	15,596,119	176,981,119
	<u>\$ 869,870,000</u>	<u>1,100,818,886</u>	<u>1,970,688,886</u>

The Authority's long-term liability activity for the year ended June 30, 2003, was as follows:

<u>Bonds</u>	<u>Balance June 30, 2002</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance June 30, 2003</u>
Series 2001 Bonds	\$ 902,920,000	-	33,050,000	869,870,000

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

Notes to Basic Financial Statements

June 30, 2003

**(6) Concentration of Credit Risk**

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 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 are the TSRs. The Authority has no taxing power.

**(7) 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.

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

Required Supplementary Information (unaudited)  
Budgetary Comparison Schedule  
General Fund - Non-GAAP Budgetary Basis  
For the Year Ended March 31, 2003

	<b>Budgeted Amounts</b>		<b>Actual</b>	<b>Variance with</b>
	<b>Original</b>	<b>Final</b>		<b>Final Budget</b>
				<b>Positive</b>
				<b>(Negative)</b>
<b>Revenue:</b>				
Revenue from tobacco settlement receipts used for administrative costs	\$ 106,090	106,090	71,042	(35,048)
Investment earnings used for related fees	-	-	9,350	9,350
Total expenditures/expenses	<u>106,090</u>	<u>106,090</u>	<u>80,392</u>	<u>(25,698)</u>
<b>Expenditures:</b>				
Contractual services	96,590	96,590	69,374	27,216
Fixed charges and contributions	2,000	2,000	1,640	360
Investment expenditures	-	-	9,350	(9,350)
Miscellaneous administrative	7,500	7,500	28	7,472
Total general revenues	<u>106,090</u>	<u>106,090</u>	<u>80,392</u>	<u>25,698</u>
Excess (deficiency) of revenues over (under) expenditures	<u>\$ -</u>	<u>-</u>	<u>-</u>	<u>-</u>

See accompanying notes to required supplementary information.

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

Notes to Required Supplementary Information - Budgetary

June 30, 2003

**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 principals generally accepted in the United States of America. The Authority's officially adopted budget for fiscal year 2003 is based on the sinking fund year ending March 31, 2003. 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. During 2003, there were no revisions to the originally adopted budget.

**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 the 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, 2003 rather than the financial reporting year end used for GAAP statements of June 30, 2003.

		<u>Actual Amounts</u>
Excess (deficiency) of revenues over (under) expenditures, budgetary basis	\$	-
Basis differences		(411,732)
Perspective differences		-
		<hr/>
Excess (deficiency) of revenues over (under) expenditures, GAAP basis	\$	<u>(411,732)</u>



303 Peachtree Street, N.E.  
Suite 2000  
Atlanta, GA 30308

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

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

We have audited the basic financial statements 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, 2003, and have issued our report thereon dated September 12, 2003. 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.

### **Compliance**

As part of obtaining reasonable assurance about whether the Authority's basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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 that are required to be reported under *Government Auditing Standards*.

### **Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the Authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

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

**KPMG LLP**

September 12, 2003

