



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT



THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof.

– Article IV, Section 53 of the Michigan Constitution

Audit report information can be accessed at:

<http://audgen.michigan.gov>



Michigan
Office of the Auditor General
REPORT SUMMARY

Financial Audit

*Michigan Tobacco Settlement Finance Authority
 (A Blended Component Unit of the State of Michigan)
 November 21, 2005 through September 30, 2006*

Report Number:
 271-0285-07

Released:
 March 2007

A financial audit determines if the financial statements are fairly presented; considers internal control over financial reporting; and determines compliance with State compliance requirements material to the financial statements. This financial audit of the Michigan Tobacco Settlement Finance Authority was conducted as part of the constitutional responsibility of the Office of the Auditor General.

Financial Statements:

Auditor's Report Issued

We issued an unqualified opinion on the Michigan Tobacco Settlement Finance Authority's financial statements.

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Internal Control Over Financial Reporting

We did not report any findings related to internal control over financial reporting.

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**Noncompliance and Other Matters
 Material to the Financial Statements**

We did not identify any instances of noncompliance or other matters applicable to the financial statements that are required to be reported under *Government Auditing Standards*.

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Background:

The Michigan Tobacco Settlement Finance Authority was authorized by the provisions of Act 226, P.A. 2005. The Authority is administered by a board that consists of 7 members. The members are the State Treasurer, the director of the Department of Labor and Economic Growth, and 5 members appointed by the Governor with consent from the Legislature.

The Authority's purpose is to issue bonds secured by a pledge of a percentage of the State of Michigan's tobacco settlement receipts, which will be used to finance projects under the 21st Century Jobs Trust Fund. On May 17, 2006, the Authority issued \$490,500,589 of taxable tobacco settlement asset-backed bonds. The bonds are special revenue obligations of the Authority secured solely by and payable solely from the tobacco settlement revenue pledged under the bond indenture. The bonds are not an obligation of the State of Michigan and are not backed by the credit, revenues, or taxing power of the State.

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A copy of the full report can be
obtained by calling 517.334.8050
or by visiting our Web site at:
<http://audgen.michigan.gov>



Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

Thomas H. McTavish, C.P.A.
Auditor General

Scott M. Strong, C.P.A., C.I.A.
Deputy Auditor General



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

March 1, 2007

Mr. Robert J. Kleine, Chair
Michigan Tobacco Settlement Finance Authority
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine:

This is our report on the financial audit of the Michigan Tobacco Settlement Finance Authority, a blended component unit of the State of Michigan, for the period November 21, 2005 through September 30, 2006.

This report contains our report summary, our independent auditor's report on the financial statements, the Authority management's discussion and analysis, and the Authority's financial statements and notes to the financial statements. This report also contains our independent auditor's report on internal control over financial reporting and on compliance and other matters and a glossary of acronyms and terms.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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INDEPENDENT AUDITOR'S REPORT



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on the Financial Statements

Mr. Robert J. Kleine, Chair
Michigan Tobacco Settlement Finance Authority
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine:

We have audited the accompanying financial statements of the Michigan Tobacco Settlement Finance Authority, a blended component unit of the State of Michigan, as of and for the period ended September 30, 2006, as identified in the table of contents. These financial statements are the responsibility of the Michigan Tobacco Settlement Finance Authority's management. Our responsibility is to express an opinion 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 the 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 opinion.

As described in Note 1, the financial statements present only the Michigan Tobacco Settlement Finance Authority and do not purport to, and do not, present fairly the financial position of the State of Michigan or its components units as of September 30, 2006 and the changes in financial position thereof for the fiscal year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the financial position of the Michigan Tobacco Settlement Finance Authority as of September 30, 2006 and the changes in financial position for the period November 21, 2005 through September 30, 2006 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 December 21, 2006 on our consideration of the Michigan Tobacco Settlement Finance Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 11 through 15 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

AUDITOR GENERAL

December 21, 2006

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Michigan Tobacco Settlement Finance Authority is pleased to present its financial statements. This section contains the analysis of the Authority's financial performance during the period November 21, 2005 through September 30, 2006. Please read it in conjunction with the financial statements and their accompanying notes, which follow this section.

The Authority is a public body corporate and politic of the State of Michigan, separate and distinct from the State, exercising public and essential governmental functions and created by the Michigan Tobacco Settlement Finance Authority Act, i.e., Act 226, P.A. 2005 (Sections 129.261 - 129.279 of the *Michigan Compiled Laws*), effective as of November 21, 2005. The Authority is a blended component unit of the State of Michigan and is governed by a board consisting of 7 members, 5 of whom have been appointed by the Governor. The Authority's purpose is to issue bonds secured by a pledge of a percentage of the State's tobacco settlement receipts, which will be used to finance projects under the 21st Century Jobs Trust Fund. The Act authorized the Authority to purchase an interest in the State's receipts under the master settlement agreement (MSA).

The MSA was entered into in November 1998 by 46 states, 6 other U.S. jurisdictions, and the 4 major tobacco companies. The MSA resolved cigarette smoking-related litigation among settling states and provides for a continuous 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. The Authority is not a party to the MSA.

The State is entitled to certain periodic payments made under the MSA. Pursuant to the purchase and sale agreement by and between the State and the Authority, the Authority purchased the right, title, and interest in and to 13.34% of (i) all tobacco settlement revenue that is received by the State that is required to be made under the terms of the MSA and that is payable to the State on or after April 1, 2008, (ii) all lump sum or partial lump sum payments of tobacco settlement revenue, whenever received, that is allocable to a payment that is payable on or after April 1, 2008 under the terms of the MSA, and (iii) the State's rights to receive the tobacco settlement revenue referred to in (i) and (ii).

On May 17, 2006, the Authority issued \$490,500,589 of taxable tobacco settlement asset-backed bonds pursuant to an indenture between the Authority and J.P. Morgan Trust Company, National Association (subsequently acquired by the Bank of New York

Trust Company, N.A.), as trustee. The bonds are special revenue obligations of the Authority secured solely by and payable solely from the pledged tobacco settlement revenue and other collateral pledged under the bond indenture. Payments on the bonds are an obligation of the Authority, and such payments are dependent on receipt by the trustee, as assignee of the Authority, of the tobacco settlement revenue. 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 proceeds of the bonds were used for the purpose of (i) making a payment in the amount of \$400 million to the State, (ii) funding the liquidity reserve account, (iii) paying certain operating expenses, and (iv) paying capitalized interest through December 1, 2007 and the cost of issuance of the Series 2006 bonds.

Using the Financial Report

This financial report is prepared in accordance with Governmental Accounting Standards Board Statement (GASB) No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*.

The reporting standards require a statement of net assets; a governmental fund balance sheet; a statement of activities; and a governmental fund statement of revenues, expenditures, and changes in fund balance.

The reporting standards also require that governmental type component units provide fund financial statements and entity-wide financial statements. GASB Statement No. 34 provides for combining these statements using a format that reconciles the two statements.

The following narrative and overview of the financial activities of the Authority is for the period November 21, 2005 through September 30, 2006, the first year of operations of the Authority. The Authority encourages readers to consider this information in conjunction with the Authority's financial statements, which follow this section. The basic financial statements, which follow, provide information about the activities of the Authority as a whole and include all assets and liabilities. They also include notes to the financial statements, which explain some of the information in the basic financial statements in greater detail.

Financial Analysis of the Authority

Because this is the first year of operation for the Authority, an analysis of the financial statements does not provide insight about the financial position of the Authority. In the

future, a comparative analysis of the financial statements from one year to the next should indicate the extent to which tobacco settlement collections contribute to debt reduction.

The principal activity of the Authority was the sale of approximately \$490.5 million of bonds. The proceeds were used to finance a \$400.0 million transfer to the State's 21st Century Jobs Trust Fund, to make a \$4.7 million payment of bond issuance costs, and to establish reserved funds as required by the bond resolutions. In return for distribution to the State, the Authority will receive 13.34% of the payments beginning in 2008 under the MSA signed in 1998. These payments will be used to repay the bonds issued and interest.

The Authority's financial activity for the period resulted in negative net assets of approximately \$411.3 million at September 30, 2006. The negative net assets for the period resulted from the Authority recording a liability, in accordance with accounting principles generally accepted in the United States of America, for the entire amount of outstanding bonds, which are payable only from proceeds from the MSA, while being precluded by those same principles from recording anticipated receipt of those proceeds because the underlying economic event has not yet occurred. However, by purchasing the bonds, the buyers of the Authority's bonds demonstrated their belief that those proceeds will be realized by the Authority and will be used to repay the bonds.

Contacting the Michigan Tobacco Settlement Finance Authority

The financial report is designed to present users with a general overview of the Authority's finances and to demonstrate the Authority's accountability for the funds. If you have questions about the report or need additional information, please visit the Department of Treasury Web site at <<http://www.michigan.gov/treasury>> and go to the section entitled "Bond (Loan) Finance & Investments." The contact information for the Authority is:

Michigan Tobacco Settlement Finance Authority
Richard H. Austin Building, 1st Floor
430 W. Allegan
Lansing, MI 48922
Phone (517) 335-0994

FINANCIAL STATEMENTS

MICHIGAN TOBACCO SETTLEMENT FINANCE AUTHORITY
Statement of Net Assets and Governmental Fund Balance Sheet
As of September 30, 2006

	<u>Governmental Fund Balance Sheet</u>	<u>Adjustments (Note 7)</u>	<u>Statement of Net Assets</u>
ASSETS			
Current Assets:			
Equity in common cash (Note 3)	\$ 698,313	\$	\$ 698,313
Investments (Note 3)	31,799,315		31,799,315
Accrued interest receivable	1,476,457		1,476,457
Deferred bond issuance costs		85,567	85,567
Total Current Assets	<u>\$ 33,974,085</u>	<u>\$ 85,567</u>	<u>\$ 34,059,652</u>
Noncurrent Assets:			
Investments (Note 3)	\$ 54,253,979	\$	\$ 54,253,979
Deferred bond issuance costs (Note 4)		4,649,135	4,649,135
Total Noncurrent Assets	<u>\$ 54,253,979</u>	<u>\$ 4,649,135</u>	<u>\$ 58,903,114</u>
Total Assets	<u>\$ 88,228,064</u>	<u>\$ 4,734,702</u>	<u>\$ 92,962,766</u>
LIABILITIES			
Current Liabilities:			
Accrued interest payable	\$	\$ 11,889,237	\$ 11,889,237
Cost of issuance payable		87,938	87,938
Total Current Liabilities	<u>\$ 0</u>	<u>\$ 11,977,175</u>	<u>\$ 11,977,175</u>
Noncurrent Liabilities:			
Accrued interest payable		1,730,870	1,730,870
Bonds payable (Note 5)		490,478,802	490,478,802
Compensated absences payable		27,488	27,488
Total Liabilities	<u>\$ 0</u>	<u>\$ 504,214,335</u>	<u>\$ 504,214,335</u>
FUND BALANCE/NET ASSETS			
Fund Balance:			
Unreserved	<u>\$ 88,228,064</u>	<u>\$ (499,479,633)</u>	
Total Liabilities and Fund Balance	<u>\$ 88,228,064</u>		
Net Assets:			
Unrestricted (deficit) (Note 6)			<u>\$ (411,251,569)</u>
Total Net Assets			<u>\$ (411,251,569)</u>

The accompanying notes are an integral part of the financial statements.

Notes to the Financial Statements

Note 1 Significant Accounting Policies

a. Organization

The Michigan Tobacco Settlement Finance Authority was authorized by the provisions of Act 226, P.A. 2005, effective as of November 21, 2005. The Authority's purpose is to issue bonds secured by a pledge of a percentage of the State of Michigan's tobacco settlement receipts, which will be used to finance projects under the 21st Century Jobs Trust Fund. The purpose of the Act is to provide for the sale by the State and the purchase by the Authority of all or a portion of tobacco settlement assets and to authorize the issuance of bonds.

b. Reporting Entity

The accompanying financial statements report the financial position and changes in financial position of the Authority, a blended component unit of the State of Michigan, as of September 30, 2006 and for the period November 21, 2005 through September 30, 2006. Accordingly, they do not purport to, and do not, present fairly the financial position and the changes in financial position of the State of Michigan or its component units in conformity with accounting principles generally accepted in the United States of America. The financial statements of the Authority are included in the *State of Michigan Comprehensive Annual Financial Report*. The Authority is administered by a board that consists of 7 members. The members are the State Treasurer, the director of the Department of Labor and Economic Growth, and 5 members appointed by the Governor with consent from the Legislature.

c. Basis of Accounting, Measurement Focus, and Financial Statement Presentation

Governmental fund financial statements are reported using the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. Debt service expenditures are recorded only when payment is due.

Entity-wide statements of net assets and statements of activities are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

Note 2 Master Settlement Agreement (MSA) and Purchase Agreement

In November 1998, an MSA was entered into by 46 states, 6 other U.S. jurisdictions, and the 4 major tobacco companies. The MSA sets forth the schedule and calculations of payments to be made by the tobacco companies to the states. These payments are subject to various adjustments and offsets, some of which could be material.

The Authority and the State entered into a purchase agreement in which the Authority has purchased the right, title, and interest in and to 13.34% of all tobacco settlement revenue that is received by the State that is required under the terms of the MSA and that is payable to the State on or after April 1, 2008.

Future tobacco settlement collections are contingent upon future tobacco product sales and are subject to various adjustments as outlined in the MSA. Because of the uncertainty of the factors affecting tobacco product sales and the various adjustments, the Authority estimates the amount of tobacco settlement payment that will be received in April of each year based on tobacco product sales from the prior calendar year. The Authority recognizes the revenue and a receivable for the tobacco settlement payment in the accounting period that it will become measurable and available. In accordance with the purchase agreement between the State and the Authority, the first payment from the MSA will occur on or after April 1, 2008 and, therefore, will be reflected in subsequent financial statements.

Note 3 Deposits and Investments

The Authority is authorized by State statutes to invest any money of the Authority, at the Authority's discretion, in any obligations it determines as proper. The Authority records investments at fair value based on quoted market prices, except for short-term money market funds and nonparticipating interest earning investment contracts.

The Authority's deposits and investments are subject to several types of risk, which are examined in more detail below:

a. Deposits

Custodial credit risk

Custodial credit risk for deposits is the risk that, in the event of a depository financial institution's failure, the Authority's deposits may not be returned to it. The Authority had \$698,313 of bank deposits in the State Treasurer's common cash fund at September 30, 2006. The State Treasurer evaluates each financial institution it deposits funds with and assesses the level of risk of each institution. Only those institutions with an acceptable estimated risk level are used as depositories. To lessen credit risk, 2.3% of the total common cash fund is covered by federal depository insurance and 97.4% is collateralized with securities held in the State's name by the State's agent. The remaining 0.3% of the total common cash fund is uninsured and uncollateralized and exposed to custodial credit risk.

b. Investments

(1) Custodial credit risk

Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty to a transaction, the Authority will not be able to recover the value of its investment securities that are in the possession of an outside party. All financial institutions holding the Authority's investment must be a member of the Federal Reserve Bank, must be a member of the Federal Deposit Insurance Corporation, must have combined surplus and undivided profits of not less than \$25 million, and must provide confirmation that they hold the securities, free and clear of any lien. At September 30, 2006, the following investment securities were held by the counterparty's trust department or agent:

Type of Investment	Carrying Value	How Held
Government money market funds	\$ 858,168	Counterparty's trust department
Guaranteed investment contracts	\$ 37,801,532	Counterparty's trust department
U.S. government agencies - sponsored	\$ 47,393,595	Counterparty's trust department

(2) Interest rate risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. For investments held in trust, investment maturities are structured to meet cash requirements as outlined in the bond indentures and other financing documents.

At September 30, 2006, the average maturities of investments were as follows:

Type of Investment	Fair Value	Less Than 1 Year	1 to 5 Years	6 to 10 Years	More Than 10 Years
Government money market funds	\$ 858,168	\$ 858,168	\$	\$	\$
Guaranteed investment contracts	37,801,532				37,801,532
U.S. government agencies - sponsored	47,393,595	30,941,148	16,452,447		
Total Investments	<u>\$86,053,295</u>	<u>\$31,799,315</u>	<u>\$16,452,447</u>	<u>\$ 0</u>	<u>\$37,801,532</u>

(3) Credit risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Authority's bond indenture restricts the Authority to investments rated A-1 or higher by Standard & Poor's, P-1 by Moody's Investors Service, and F1 by Fitch Ratings.

At September 30, 2006, the credit quality ratings of debt securities were as follows:

Type of Investment	Fair Value	Standard & Poor's Credit Quality Rating
Government money market funds	\$ 858,168	AAAm
Guaranteed investment contracts	\$ 37,801,532	AA-
U.S. government agencies - sponsored (short-term)	\$ 30,941,148	A-1+
U.S. government agencies - sponsored (long-term)	\$ 16,452,447	AAA

(4) Concentration of credit risk

Concentration of credit risk is the risk of loss attributed to the magnitude of the Authority's investments with a single issuer. The trust indenture limits investments in any single issuer or corporate

entity to 20% of the aggregate principal amount of all eligible investments held. These limitations do not apply to U.S. treasuries, government agencies, or instrumentalities.

At September 30, 2006, the Authority had the following investments that represent 5% or more of total investments:

Issuer	Fair Value
Federal Home Loan Mortgage Corporation	\$ 15,452,367
Guaranteed investment contracts - DEPFA Bank plc	\$ 37,801,532
Federal National Mortgage Association	\$ 31,941,228

Note 4 Deferred Bond Issuance Costs

Deferred bond issuance costs are the costs associated with the issuance of the bonds that will be amortized over the life of the bonds. The Authority has elected to use the interest method of amortization.

Note 5 Bonds Payable

Bonds payable consisted of the following at September 30, 2006:

Series	Date of Issue	Original Issue	Average Interest Rate Percentage	Amounts Outstanding
Tobacco settlement asset-backed bonds,				
Series 2006A	May 17, 2006	\$ 363,115,000	7.31	
Series 2006B	May 17, 2006	72,620,000	Variable	
Series 2006C	May 17, 2006	54,765,589	8.50	
Subtotal				\$ 490,500,589
Discount on bonds payable				(21,787)
Total Bonds Payable				<u>\$ 490,478,802</u>

The Authority issued taxable tobacco settlement asset-backed bonds, Series 2006, dated May 17, 2006. The bonds consist of three series: (1) fixed rate turbo term bonds, (2) indexed floating rate turbo term bonds, and (3) capital appreciation turbo term bonds. The bonds are special revenue obligations of the Authority secured solely by and payable solely from the tobacco settlement revenue pledged under the bond indenture. The bonds do not constitute an obligation of the State.

Interest on the Series 2006B bonds for each periodic interest accrual period beginning on or after December 1, 2006 will accrue at the rate of 2.15% *per annum* above the London interbank offered rate ("LIBOR"). During the period May 17, 2006 through December 1, 2006, the Series 2000B bonds will bear interest at the rate of 7.43% *per annum*.

The annual requirements to service debt outstanding as of September 30, 2006, including both principal and interest, are as follows:

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$	\$ 33,315,305	\$ 33,315,305
2008	1,750,000	32,082,935	33,832,935
2009	3,745,000	31,968,538	35,713,538
2010	4,370,000	31,760,206	36,130,206
2011	5,075,000	31,480,637	36,555,637
2012 - 2016	38,000,000	151,206,923	189,206,923
2017 - 2021	61,920,000	133,933,035	195,853,035
2022 - 2026	88,695,000	107,177,268	195,872,268
2027 - 2031	128,655,000	68,487,960	197,142,960
2032 - 2036	103,525,000	15,715,833	119,240,833
2037 - 2041			
2042 - 2046	54,765,589	1,480,144,411	1,534,910,000
	<u>\$ 490,500,589</u>	<u>\$ 2,117,273,052</u>	<u>\$ 2,607,773,641</u>

Changes in bonds for the period ended September 30, 2006 are summarized as follows:

	<u>Beginning Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending Balance</u>	<u>Amounts Due Within One Year</u>	<u>Amounts Due Thereafter</u>
Total Bonds Payable		\$490,500,589		\$490,550,589		\$490,550,589

Note 6 Deficit Net Asset Balance

The Authority is reporting a net asset deficit balance of \$411,251,569 at September 30, 2006. The payments to be received under the MSA represent a share of anticipated future sales of tobacco products. Although the Authority expects to receive certain amounts under the MSA, the collections are not assured.

Under accounting principles generally accepted in the United States of America, such contingent amounts cannot be recognized as a receivable or revenue until the amount is measurable and available. However, the Authority's bond issuance is recorded as a liability on the entity-wide financial statements.

Note 7 Reconciliation Between the Fund Level and the Entity-Wide Financial Statements

a. Balance Sheet to Statement of Net Assets

The following is an explanation of the adjustments between the governmental fund balance sheet and the statement of net assets, which reconciles fund balance to net assets:

Fund balance	\$ 88,228,064
Adjustments:	
Deferred bond issuance costs are expended in governmental funds whereas they are capitalized and amortized for net assets	4,734,702
Accrued interest payable on bonds is not recorded by governmental funds	(13,620,107)
Cost of issuance payable is not recorded by governmental funds	(87,938)
Bonds payable are not reported in governmental funds until they are due and payable	(490,500,589)
Discount on bonds issued is reported as an other financing use in governmental funds whereas it is capitalized and amortized for net assets (and deducted from bonds payable)	21,787
Compensated absences payable is not recorded by governmental funds	<u>(27,488)</u>
Net Assets (deficit)	<u>\$ (411,251,569)</u>

b. Statement of Revenues, Expenditures, and Changes in Fund Balance to Statement of Activities

The following is an explanation of the adjustments between the governmental fund statement of revenues, expenditures, and changes in fund balances and the statement of activities, which reconciles the net change in fund balance to the change in net assets:

Net change in fund balance	\$ 88,228,064
The issuance of bonds provides current financial resources and bond issuance costs and discounts are uses of current financial resources:	
Proceeds from bonds issued	(490,500,589)
Discount on bonds issued	21,787
Cost of issuance and underwriter's discount paid as general government expense	4,646,764
Bond interest expense is not recorded by governmental funds but is reported under interest for purposes of net assets	(13,620,107)
Compensated absences expense is not recorded by governmental funds but is reported as an expense for purposes of net assets	<u>(27,488)</u>
Change in net assets	<u><u>\$ (411,251,569)</u></u>

Note 8 Transfers

The Michigan Tobacco Settlement Finance Authority sold bonds and transferred \$400 million into the 21st Century Jobs Trust Fund to fund economic development projects in accordance with Act 226, P.A. 2005.

The Authority received an appropriation in the amount of \$1.0 million from the General Fund for the fiscal year ended September 30, 2006. The appropriation amount was provided for the payment of operating expenses and funding of reserve requirements.

INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters

Mr. Robert J. Kleine, Chair
Michigan Tobacco Settlement Finance Authority
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine:

We have audited the financial statements of the Michigan Tobacco Settlement Finance Authority, a blended component unit of the State of Michigan, as of and for the period ended September 30, 2006, as identified in the table of contents, and have issued our report thereon dated December 21, 2006. 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 Michigan Tobacco Settlement Finance Authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion 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 that might be material weaknesses. A material weakness is a reportable 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 caused by error or fraud 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.

Compliance and Other Matters

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

This report is intended solely for the information and use of the Michigan Tobacco Settlement Finance Authority's Board of Directors and management and the Legislature and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

AUDITOR GENERAL

December 21, 2006

GLOSSARY

Glossary of Acronyms and Terms

financial audit	An audit that is designed to provide reasonable assurance about whether the financial schedules and/or financial statements of an audited entity are fairly presented in conformity with the disclosed basis of accounting.
GASB	Governmental Accounting Standards Board.
internal control	A process, effected by management, designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
material misstatement	A misstatement in the financial schedules and/or financial statements that causes the schedules and/or statements to not present fairly the financial position or the changes in financial position or cash flows in conformity with the disclosed basis of accounting.
material weakness	A reportable condition related to the design or operation of internal control that does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial schedules and/or financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
MSA	master settlement agreement.
reportable condition	A matter coming to the auditor's attention relating to a significant deficiency in the design or operation of internal control that, in the auditor's judgment, could adversely affect the entity's ability to initiate, record, process, and report

financial data consistent with the assertions of management in the financial schedules and/or financial statements.

unqualified opinion

An auditor's opinion in which the auditor states that the financial schedules and/or financial statements presenting the basic financial information of the audited agency are fairly presented in conformity with the disclosed basis of accounting.

