



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:

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Michigan
Office of the Auditor General
REPORT SUMMARY

Financial Audit

*Michigan Tobacco Settlement Finance Authority
 (A Blended Component Unit of the State of Michigan)
 Fiscal Year Ended September 30, 2009*

Report Number:
 271-0285-10

Released:
 February 2010

A financial audit determines if the financial statements are fairly presented; considers internal control over financial reporting; and determines compliance with 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 unqualified opinions 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 Energy, Labor & Economic Growth, and 5 members appointed by the Governor with the 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 were deposited in the State of Michigan's School Aid Fund and General Fund and used to finance projects under the 21st Century Jobs Trust Fund. As of September 30, 2009, the Authority had made three issuances totaling \$1.09 billion of taxable and tax-exempt tobacco settlement asset-backed bonds. The bonds are special revenue obligations of the Authority secured solely by and payable solely from 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



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

February 2, 2010

Mr. Robert J. Kleine, State Treasurer and 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 October 1, 2008 through September 30, 2009.

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

Independent Auditor's Report on the Financial Statements

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

Dear Mr. Kleine:

We have audited the accompanying financial statements of the governmental activities and each major fund of the Michigan Tobacco Settlement Finance Authority, a blended component unit of the State of Michigan, as of and for the fiscal year ended September 30, 2009, which collectively comprise the Authority's basic financial statements as identified 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 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 opinions.

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 component units as of September 30, 2009 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 respective financial position of the governmental activities and each major fund of the Michigan Tobacco Settlement Finance Authority as of September 30, 2009 and the respective 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 accordance with *Government Auditing Standards*, we have also issued our report dated January 21, 2010 on our consideration of the 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 13 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

January 21, 2010

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Michigan Tobacco Settlement Finance Authority (the "Authority") provides this Management's Discussion and Analysis of the Authority's financial statements. The following narrative and overview of the financial activities of the Authority is for the fiscal years ended September 30, 2009 and September 30, 2008. The Authority encourages readers to consider this information in conjunction with the Authority's financial statements, which follow this section.

Using the Financial Report

These financial statements are 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 entity-wide financial statements and fund level financial statements and a reconciliation between the two statements. The Authority's basic financial statements include a statement of net assets and governmental fund balance sheet and a statement of activities and governmental fund statement of revenues, expenditures, and changes in fund balance.

Financial Analysis of the Authority

During fiscal year 2008-09, the Authority did not have any new bond issuances. The Authority did receive tobacco settlement revenues of \$39.3 million and used these funds to make scheduled debt service payments and redeemed \$3.5 million of principal on the Series 2006A turbo term bonds.

The principal activity of the Authority for fiscal year 2007-08 was the sale of approximately \$202.4 million of bonds. The proceeds were used to refund the Series 2006B and 2006C bonds. In addition, the State of Michigan's General Fund received \$60.0 million from the net proceeds. In accordance with the Purchase and Sale Agreement between the State and the Authority, the Authority received 13.34% of tobacco settlement revenues beginning in April 2008 and will receive an additional 10.77% in April 2010 under the Master Settlement Agreement (MSA) signed in 1998. These payments will be used to pay principal and interest on the issued bonds.

The Authority's financial activity for the period resulted in negative net assets of approximately \$929.9 million and \$921.9 million at September 30, 2009 and September 30, 2008, respectively. The negative net assets for the period resulted from the Authority recording liabilities for the entire amount of outstanding bonds, in accordance with accounting principles generally accepted in the United States of

America. The bonds are payable only from proceeds from the Authority's share of future MSA receipts; however, accounting principles preclude the Authority 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. If the Authority does not realize sufficient proceeds, not all bonds will be repaid.

Condensed entity-wide financial information as of September 30, 2009 and September 30, 2008 is as follows:

| | <u>2009</u> | <u>2008</u> |
|---|-------------------------|-------------------------|
| Assets: | | |
| Current assets | \$ 83,321,208 | \$ 105,148,793 |
| Noncurrent assets | 78,446,669 | 58,845,397 |
| Total assets | <u>\$ 161,767,877</u> | <u>\$ 163,994,190</u> |
| Liabilities: | | |
| Current liabilities | \$ 26,874,476 | \$ 23,008,435 |
| Noncurrent liabilities | 1,064,825,344 | 1,062,868,566 |
| Total liabilities | <u>\$1,091,699,820</u> | <u>\$1,085,877,001</u> |
| Net Assets: | | |
| Unrestricted | <u>\$ (929,931,943)</u> | <u>\$ (921,882,811)</u> |
| Total net assets (deficit) | <u>\$ (929,931,943)</u> | <u>\$ (921,882,811)</u> |
| Revenues: | | |
| Interest income | \$ 4,166,733 | \$ 6,548,000 |
| Miscellaneous income | (413,135) | 5,934 |
| Tobacco revenues | 62,330,773 | 38,895,927 |
| Total revenues | <u>\$ 66,084,371</u> | <u>\$ 45,449,861</u> |
| Expenses: | | |
| General government | \$ 493,508 | \$ 502,734 |
| Bond interest | 73,343,334 | 71,075,042 |
| Compensated absences | 2,912 | 3,709 |
| Total expenses | <u>\$ 73,839,754</u> | <u>\$ 71,581,485</u> |
| Excess of revenues over (under) expenses | <u>\$ (7,755,383)</u> | <u>\$ (26,131,624)</u> |
| Discount on bonds issued | \$ (293,749) | \$ (206,094) |
| Transfers to other funds | | (60,000,000) |
| Total other financing sources (uses) | <u>\$ (293,749)</u> | <u>\$ (60,206,094)</u> |
| Excess of revenues and other sources over (under) expenses and other uses | \$ (8,049,132) | \$ (86,337,718) |
| Net assets - Beginning of fiscal year | (921,882,811) | (835,545,093) |
| Net assets - End of fiscal year | <u>\$ (929,931,943)</u> | <u>\$ (921,882,811)</u> |

Total assets decreased approximately \$2.2 million during fiscal year 2008-09 due to a decrease in investments. The interest received from the Series 2007 bond proceeds was used to make interest payments on the bonds payable, resulting in a decrease of cash for investments.

Total liabilities increased approximately \$5.8 million in fiscal year 2008-09 due to the increase in the accretion of capital appreciation bonds. This increase in value resulted in the overall increase in liabilities.

The **statement of activities** presents information showing how the Authority's net assets (deficit) changed during the fiscal year. Tobacco revenues increased by \$23.4 million in fiscal year 2008-09 as a result of a larger payment under the terms of the Master Settlement Agreement and the Purchase and Sale Agreement between the Authority and the State of Michigan.

Expenses increased by approximately \$2.3 million from fiscal year 2007-08 to fiscal year 2008-09 as a result of the increase in bond interest expense.

In addition, during fiscal year 2008-09, the Authority did not make any transfers to the State of Michigan.

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 generated. If you have questions about the report or need additional information, please visit the Department of Treasury Web site at www.michigan.gov/treasury and go the section titled "Bond (Loan) Finance & Investments." The contact information for the Authority is:

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

BASIC FINANCIAL STATEMENTS

MICHIGAN TOBACCO SETTLEMENT FINANCE AUTHORITY
Statement of Net Assets and Governmental Fund Balance Sheet
As of September 30, 2009

| | Governmental Fund Balance Sheet | | |
|--|---------------------------------|----------------------|----------------|
| | Special Revenue Fund | Debt Service Fund | Total |
| ASSETS | | | |
| Current assets: | | | |
| Equity in common cash (Note 3) | \$ 146,296 | \$ | \$ 146,296 |
| Investments (Note 3) | 31,587,044 | | 31,587,044 |
| Due from component unit | 49 | | 49 |
| Accrued interest receivable | 822,579 | | 822,579 |
| Deferred bond issuance costs | | | |
| Receivable - Tobacco revenue | 50,512,672 | | 50,512,672 |
| Total current assets | \$ 83,068,640 | \$ 0 | \$ 83,068,640 |
| Noncurrent assets: | | | |
| Investments (Note 3) | \$ 70,801,532 | \$ | \$ 70,801,532 |
| Deferred bond issuance costs (Note 4) | | | |
| Total noncurrent assets | \$ 70,801,532 | \$ 0 | \$ 70,801,532 |
| Total assets | \$ 153,870,173 | \$ 0 | \$ 153,870,173 |
| LIABILITIES | | | |
| Current liabilities: | | | |
| Accounts payable and other liabilities | \$ 5,803 | \$ | \$ 5,803 |
| Accrued interest payable | | | |
| Bonds payable (Note 5) | | | |
| Deferred revenue | 50,512,672 | | 50,512,672 |
| Total current liabilities | \$ 50,518,476 | \$ 0 | \$ 50,518,476 |
| Noncurrent liabilities: | | | |
| Bonds payable (Note 5) | | | |
| Compensated absences payable | | | |
| Total liabilities | \$ 50,518,476 | \$ 0 | \$ 50,518,476 |
| FUND BALANCE/NET ASSETS | | | |
| Fund balance: | | | |
| Unreserved | 103,351,697 | | 103,351,697 |
| Total liabilities and fund balance | \$ 153,870,173 | \$ 0 | \$ 153,870,173 |
| Net assets: | | | |
| Unrestricted (deficit) (Note 6) | | | |
| Total net assets | | | |

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

| Adjustments (Note 7) | Governmental Activities Statement of Net Assets |
|-------------------------|--|
| \$ | \$ 146,296 |
| | 31,587,044 |
| | 49 |
| | 822,579 |
| 252,568 | 252,568 |
| | 50,512,672 |
| <u>\$ 252,568</u> | <u>\$ 83,321,208</u> |
| | |
| \$ | \$ 70,801,532 |
| 7,645,137 | 7,645,137 |
| <u>\$ 7,645,137</u> | <u>\$ 78,446,669</u> |
| | |
| <u>\$ 7,897,705</u> | <u>\$ 161,767,877</u> |
| | |
| \$ | \$ 5,803 |
| 20,498,673 | 20,498,673 |
| 6,370,000 | 6,370,000 |
| (50,512,672) | |
| <u>\$ (23,643,999)</u> | <u>\$ 26,874,476</u> |
| | |
| 1,064,791,795 | 1,064,791,795 |
| 33,549 | 33,549 |
| <u>\$ 1,041,181,345</u> | <u>\$ 1,091,699,820</u> |
| | |
| <u>(103,351,697)</u> | |
| <u>\$ 937,829,647</u> | <u>\$ 1,091,699,820</u> |
| | |
| | <u>\$ (929,931,943)</u> |
| | <u>\$ (929,931,943)</u> |

MICHIGAN TOBACCO SETTLEMENT FINANCE AUTHORITY

Statement of Activities and Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balance
For the Period October 1, 2008 through September 30, 2009

| | Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balance | | |
|---|---|------------------------|------------------------|
| | Special Revenue Fund | Debt Service Fund | Total |
| REVENUES | | | |
| Interest income | \$ 4,166,733 | \$ | \$ 4,166,733 |
| Net increase (decrease) in the fair value of investments | (413,135) | | (413,135) |
| Tobacco revenues (Note 2) | 39,332,734 | | 39,332,734 |
| Total revenues | <u>\$ 43,086,332</u> | <u>\$ 0</u> | <u>\$ 43,086,332</u> |
| EXPENDITURES/EXPENSES | | | |
| General government | \$ 240,149 | \$ | \$ 240,149 |
| Debt service (Note 5): | | | |
| Bond interest | | 61,190,213 | 61,190,213 |
| Bond principal | | 6,620,000 | 6,620,000 |
| Compensated absences | | | |
| Total expenditures/expenses | <u>\$ 240,149</u> | <u>\$ 67,810,213</u> | <u>\$ 68,050,362</u> |
| Excess of revenues over (under) expenditures/expenses | <u>\$ 42,846,184</u> | <u>\$ (67,810,213)</u> | <u>\$ (24,964,029)</u> |
| OTHER FINANCING SOURCES (USES) | | | |
| Discount on bonds issued | \$ | \$ | \$ |
| Transfers from other funds (Note 8) | | 67,810,213 | 67,810,213 |
| Transfers to other funds (Note 8) | (67,810,213) | | (67,810,213) |
| Transfers to primary government | (1,307) | | (1,307) |
| Total other financing sources (uses) | <u>\$ (67,811,520)</u> | <u>\$ 67,810,213</u> | <u>\$ (1,307)</u> |
| Excess of revenues and other sources over (under) expenditures/expenses and other uses | <u>\$ (24,965,336)</u> | <u>\$ 0</u> | <u>\$ (24,965,336)</u> |
| Fund balance/Net assets - Beginning of fiscal year | <u>128,317,033</u> | | <u>128,317,033</u> |
| Fund balance/Net assets - End of fiscal year | <u>\$ 103,351,697</u> | <u>\$ 0</u> | <u>\$ 103,351,697</u> |

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

| Adjustments (Note 7) | Governmental Activities Statement of Activities |
|---------------------------|--|
| \$ | \$ 4,166,733 |
| | (413,135) |
| 22,998,039 | 62,330,773 |
| <u>\$ 22,998,039</u> | <u>\$ 66,084,371</u> |
| \$ 253,359 | \$ 493,508 |
| 12,153,121 | 73,343,334 |
| (6,620,000) | |
| 2,912 | 2,912 |
| <u>\$ 5,789,392</u> | <u>\$ 73,839,754</u> |
| <u>\$ 17,208,647</u> | <u>\$ (7,755,383)</u> |
| \$ (293,749) | \$ (293,749) |
| (67,810,213) | |
| 67,810,213 | |
| 1,307 | |
| <u>\$ (292,442)</u> | <u>\$ (293,749)</u> |
| \$ 16,916,205 | \$ (8,049,132) |
| (1,050,199,844) | (921,882,811) |
| <u>\$ (1,033,283,639)</u> | <u>\$ (929,931,943)</u> |

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, which was amended by Act 18, P.A. 2007. 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 were deposited in the State of Michigan's School Aid Fund and General Fund and 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 the changes in financial position of the Authority, a blended component unit of the State of Michigan, as of September 30, 2009 and for the fiscal year then ended. 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 Energy, Labor & 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 Accounting Standards Board (GASB) Statement No. 34 requires the Authority to provide financial statements prepared on both the modified accrual basis of accounting (fund level presentation) and the full accrual basis of accounting (entity-wide level presentation). GASB Statement No. 34 also provides for combining these financial statements

using a format that reconciles the individual line items of the fund level to the entity-wide level.

Governmental fund financial statements are presented using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as they become susceptible to accrual, when 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. Expenditures are recorded when a liability is incurred; however, debt service expenditures are recorded only when payment is due and payable.

The Authority reports the following major funds:

- The Special Revenue Fund accounts for bond proceeds and disburses those proceeds for the intended purposes stated in the Official Statement of each bond series.
- The Debt Service Fund accounts for debt service payments issued by the Authority.

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.

The adjustment column on the financial statements represents transactions necessary to reconcile between the fund level (modified accrual basis of accounting) to the entity-wide financial statement (accrual basis of accounting).

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.

In 2006, 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.

In 2007, the Authority purchased an additional 10.77% of future tobacco settlement revenue that will be received by the State and that is payable to the State on or after April 1, 2010.

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.

As of September 30, 2009, the State of Michigan is currently in litigation over the application and interpretation of the market share adjustment and diligent enforcement provisions of the MSA. At best, the State of Michigan will avoid any reduction of its tobacco payments. At worse, an entire year's payment can be eliminated through application of the market share adjustment. The net effect of these adjustments on future payments is unclear; therefore, only receivables and deferred revenues that can be reasonably estimated have been recorded for future payments.

For the governmental fund level statements, the estimated tobacco receivable reflects revenue earned from January 2009 through September 2009; however, the revenue is reported as deferred because it will not be available to pay liabilities of the current period, in accordance with the modified accrual basis of accounting. The entity-wide statements reflect the estimated tobacco receivable as earned revenue in accordance with the accrual method of accounting.

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 \$146,296 in the State Treasurer's common cash fund at September 30, 2009. 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. As of September 30, 2009, 99.9% of the State's common cash was either covered by federal depository insurance or collateralized with securities held in the State's name by the State's agent.

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 a counterparty. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the Authority, and are held by either the counterparty or the counterparty's trust department or agent but not in the Authority's name. 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, 2009, the following investment securities were held by the counterparty's trust department or agent:

| Type of Investment | Carrying Value | How Held |
|--------------------|----------------|---------------------------------|
| Municipal bonds | \$ 33,000,000 | 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, 2009, 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 | \$ 31,587,044 | \$31,587,044 | \$ | \$ | \$ |
| Guaranteed investment contracts | 37,801,532 | | | | 37,801,532 |
| Municipal bonds | 33,000,000 | | | | 33,000,000 |
| Total Investments | <u>\$102,388,576</u> | <u>\$31,587,044</u> | <u>\$ 0</u> | <u>\$ 0</u> | <u>\$70,801,532</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, 2009, 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 (JPMorgan) | \$ 18,967,515 | AAAm-G |
| Government money market funds (Dreyfus) | \$ 12,619,529 | AAAm |
| Guaranteed investment contracts - DEPFA Bank plc | \$ 37,801,532 | Unrated |
| Municipal bonds | \$ 33,000,000 | AA- / A-2 |

(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. Treasury investments or government agencies.

At September 30, 2009, the Authority had the following investments that represent 5% or more of total investments:

| Issuer | Fair Value |
|--|---------------|
| Guaranteed investment contracts - DEPFA Bank plc | \$ 37,801,532 |
| Municipal bonds | \$ 33,000,000 |

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, 2009:

| Series | Date of Issue | Original Issue | Average Interest Rate Percentage | Ultimate Maturity Value |
|--|-----------------|------------------------|----------------------------------|-------------------------|
| Tobacco settlement asset-backed bonds: | | | | |
| Series 2006A - Serial | May 17, 2006 | \$ 363,115,000 | 7.31 | \$ 363,115,000 |
| Series 2007A - Serial | August 20, 2007 | 480,125,000 | 5.125 to 6.00 | 480,125,000 |
| Series 2007B - Capital appreciation | August 20, 2007 | 35,649,948 | 7.25 | 865,290,000 |
| Series 2007C - Capital appreciation | August 20, 2007 | 7,216,749 | 7.50 | 195,100,000 |
| Series 2008A - Serial | July 7, 2008 | 114,860,000 | 6.875 | 114,860,000 |
| Series 2008B - Capital appreciation | July 7, 2008 | 29,874,650 | 8.50 | 700,625,000 |
| Series 2008C - Capital appreciation | July 7, 2008 | 57,673,814 | 8.875 | 4,395,870,000 |
| Subtotal | | <u>\$1,088,515,161</u> | | <u>\$ 7,114,985,000</u> |
| Unamortized accretion interest on capital appreciation bonds | | | | (6,009,584,326) |
| Bond principal payment | | | | (15,020,000) |
| Refunding of bonds (loss) | | | | (1,173,168) |
| Discount on bonds payable | | | | (18,045,711) |
| Total bonds payable outstanding as of September 30, 2009 | | | | <u>\$ 1,071,161,795</u> |

The annual requirements to service debt outstanding as of September 30, 2009, including both principal and interest, are as follows:

| Fiscal Year | Principal | Interest | Total |
|---|-------------------------|-------------------------|-------------------------|
| 2010 | \$ 6,370,000 | \$ 61,496,020 | \$ 67,866,020 |
| 2011 | 7,475,000 | 61,089,172 | 68,564,172 |
| 2012 | 8,610,000 | 60,612,645 | 69,222,645 |
| 2013 | 9,840,000 | 60,064,131 | 69,904,131 |
| 2014 | 11,210,000 | 59,437,334 | 70,647,334 |
| 2015 - 2019 | 77,040,000 | 284,653,008 | 361,693,008 |
| 2020 - 2024 | 215,125,000 | 253,556,616 | 468,681,616 |
| 2025 - 2029 | 133,520,000 | 179,392,885 | 312,912,885 |
| 2030 - 2034 | 183,805,000 | 126,750,238 | 310,555,238 |
| 2035 - 2039 | 87,780,000 | 77,107,200 | 164,887,200 |
| 2040 - 2044 | 118,305,000 | 47,250,300 | 165,555,300 |
| 2045 - 2049 | 784,625,000 | 10,188,000 | 794,813,000 |
| 2050 - 2054 | 1,060,390,000 | | 1,060,390,000 |
| 2055 - 2058 | 4,395,870,000 | | 4,395,870,000 |
| Total | <u>\$ 7,099,965,000</u> | <u>\$ 1,281,597,549</u> | <u>\$ 8,381,562,549</u> |
| Unamortized discount | (18,045,711) | | (18,045,711) |
| Loss on refunding | (1,173,168) | | (1,173,168) |
| Unpaid accretion for capital appreciation bonds | (6,009,584,326) | | (6,009,584,326) |
| Total | <u>\$ 1,071,161,795</u> | <u>\$ 1,281,597,549</u> | <u>\$ 2,352,759,344</u> |

Changes in bonds for the fiscal year ended September 30, 2009 are summarized as follows:

| | Beginning Balance | Additions | Reductions | Ending Balance | Amounts Due Within One Year | Amounts Due Thereafter |
|--|------------------------|-----------------|---------------------|------------------------|-----------------------------------|---------------------------|
| Ultimate maturity value | \$ 7,114,985,000 | \$ | \$ | \$7,114,985,000 | | |
| Unamortized discount | (18,332,165) | | 286,454 | (18,045,711) | | |
| Unamortized accretion of capital appreciation bonds | (6,021,114,442) | | 11,530,116 | (6,009,584,326) | | |
| Bond principal paid | (8,400,000) | | (6,620,000) | (15,020,000) | | |
| Loss on refunding | (1,180,463) | 7,295 | | (1,173,168) | | |
| Total bonds payable | <u>\$1,065,957,930</u> | <u>\$ 7,295</u> | <u>\$ 5,196,570</u> | <u>\$1,071,161,795</u> | \$6,370,000 | \$ 1,064,791,795 |

Note 6 Deficit Net Asset Balance

The Authority is reporting a net asset deficit balance of \$929,931,943 at September 30, 2009. 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 ensured.

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 - Governmental funds | \$ 103,351,697 |
| Adjustments: | |
| Deferred bond issuance costs are expended in governmental funds whereas they are capitalized and amortized for net assets | 7,897,705 |
| Accrued interest payable on bonds is not recorded by governmental funds | (20,498,673) |
| Bonds payable are not reported in governmental funds until they are due and payable | (1,071,161,795) |
| Tobacco revenue receivable due in April 2010 is not recognized as earned revenue by governmental funds and is recorded as deferred revenue. For purposes of net assets, this is recognized as revenue earned. | 50,512,672 |
| Compensated absences payable is not recorded by governmental funds | <u>(33,549)</u> |
| Net assets (deficit) | <u><u>\$ (929,931,943)</u></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 balance and the statement of activities, which reconciles the net change in fund balance to the change in net assets:

| | |
|--|------------------------------|
| Net change in fund balance - Governmental funds | \$ (24,965,336) |
| Tobacco revenue receivable due in April 2010 is not recognized as earned revenue by governmental funds and is recorded as deferred revenue. For purposes of net assets, this is recognized as revenue earned. | 22,998,039 |
| The issuance of bonds provides current financial resources and bond issuance costs and discounts are uses of current financial resources: | |
| Amortization of discount on bonds issued | (293,749) |
| Amortization of deferred bond issuance costs | (252,052) |
| Bond principal payments are recognized as expenditures by governmental funds. For purposes of net assets, these are not recognized as expenditures | 6,620,000 |
| Bond interest payable is not recorded by governmental funds but is reported under interest expenses for purposes of net assets | (12,153,121) |
| Compensated absences expense is not recorded by governmental funds but is reported as an expense for purposes of net assets | (2,912) |
| Change in net assets | <u><u>\$ (8,049,132)</u></u> |

Note 8 Transfers

The Authority transferred \$67.8 million from the Special Revenue Fund to the Debt Service Fund for the December 2008 and June 2009 debt service payments.

INDEPENDENT AUDITOR'S REPORT ON
INTERNAL CONTROL AND COMPLIANCE



STATE OF MICHIGAN
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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, State Treasurer and Chair
Michigan Tobacco Settlement Finance Authority
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Kleine:

We have audited the financial statements of the governmental activities and each major fund of the Michigan Tobacco Settlement Finance Authority, a blended component unit of the State of Michigan, as of and for the fiscal year ended September 30, 2009, which collectively comprise the Authority's basic financial statements, and have issued our report thereon dated January 21, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

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

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

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

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, 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 Governor, the Legislature, the Michigan Tobacco Settlement Finance Authority's Board of Directors, and management and others within the Department of Treasury 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

January 21, 2010

GLOSSARY

Glossary of Acronyms and Terms

| | |
|---|--|
| control deficiency in internal control over financial reporting | The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. |
| 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 presented fairly in all material respects in conformity with the disclosed basis of accounting. |
| GASB | Governmental Accounting Standards Board. |
| internal control | A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to 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 in internal control over financial reporting | A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial schedules and/or financial statements will not be prevented or detected. |
| MSA | Master Settlement Agreement. |

significant deficiency
in internal control over
financial reporting

A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial schedules and/or financial statements that is more than inconsequential will not be prevented or detected.

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.

