

Tobacco Settlement Financing Corporation

(a blended component unit of the Government of the United States
Virgin Islands)

**Management's Discussion and Analysis
and Basic Financial Statements
September 30, 2004 and 2003**

Report of Independent Auditors

To the Board of Directors of
Tobacco Settlement Financing Corporation

In our opinion, the accompanying statements of net assets and governmental fund balance sheet, the related statements of activities and governmental fund revenues, expenditures and changes in fund balance and statements of fiduciary net assets present fairly, in all material respects, the respective financial position of the governmental activities, the debt service fund and the fiduciary fund of the Tobacco Settlement Financing Corporation (a blended component unit of the Government of the United States Virgin Islands) at September 30, 2004 and 2003 and the respective changes in financial position thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these financial statements in accordance with auditing standards generally accepted in the United States of America. 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The management's discussion and analysis on pages 1 through 6 are 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.

PricewaterhouseCoopers LLP

May 19, 2005

CERTIFIED PUBLIC ACCOUNTANTS
(OF PUERTO RICO)
License No. 216 Expires Dec. 1, 2007
Stamp 2039618 of the P.R. Society of
Certified Public Accountants has been
affixed to the file copy of this report

TOBACCO SETTLEMENT FINANCING CORPORATION
(a blended component unit of The Government of the United States Virgin Islands)
Management's Discussion and Analysis
September 30, 2004 and 2003

The Board of Directors of the Tobacco Settlement Financing Corporation (the "Corporation") is pleased to present the following discussion and analysis of the Corporation's financial performance during the fiscal years that ended on September 30, 2004 and 2003. For discussion and analysis purposes, comparative information for 2002 has also been included. Please note that this information should be read in conjunction with the financial statements and their accompanying notes, which follow this section.

The Corporation

The Corporation was formed in September, 2001. On November 1, 2001, the Corporation entered into a Purchase and Sale Agreement with the Government of the U.S. Virgin Islands to purchase the rights, title, and interest in Tobacco Settlement fund litigation awards for the amount of \$18.4 million, under the Master Settlement Agreement (the "MSA"). The MSA was entered into on November 23, 1998, among the Attorneys General of 46 states, 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 provides for other tobacco companies, referred to as "Subsequent Participating Manufacturers" or "SPMs" to become parties to the MSA. The four OPMs together with over 30 SPMs are referred to as the "Participating Manufacturers" or "PMs". The MSA resolved cigarette smoking-related litigation among the Settling States and the PMs, released the PMs 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 Corporation is not a party to the MSA.

Initial Payments under the MSA to the settling states have been received from 1999 to 2004. Annual Payments under the MSA are required if the cigarette market share increases higher than the 1998 level or 125% of the 1997 level. Annual Payments due on April 15, commenced in 2000, and continuing in perpetuity. In addition to Initial and Annual Payments, participating cigarette manufacturers are required to make Strategic Contribution Fund Payments in the amount of \$861 million annually on April 15, in the years of 2008 through 2017. Each type of payment under MSA is contingent upon future volume of cigarette sales, inflation adjustments, final legal adjustments, upon settlement with the four states and other United States jurisdictions not participating in the agreement, and various offsets for miscalculated or disputed payments with the parties. The Government of the Virgin Islands' share of the MSA was .0173593% of Initial and Annual Payments, and .1800232% of Strategic Contribution Fund Payments. The Corporation received \$1.1 million in the fiscal year ended September 30, 2004, \$1.58 million in payments during the fiscal year ended September 30, 2003, and \$1.26 million during the fiscal year ended September 30, 2002.

On November 20, 2001, the Corporation issued \$21.7 million aggregate principal amount of Tobacco Settlement Financing Corporation Asset-Backed Bonds (the "Bonds"). The Bonds are secured by, and payable from, collections—including all Tobacco Settlement Revenues (the "TSRs") to be received by the corporation, reserves, amounts held in other accounts established by the indenture, and the Corporation's rights under the purchase agreement. The proceeds were used for the purpose of purchasing all rights, title, and interest in certain litigation awards under the MSA entered into by participating cigarette manufacturers and providing funds for hospital and healthcare projects in the United States Virgin Islands.

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As of September 30, 2004, there remained outstanding \$22.3 million of the debt originally issued by the Corporation; as of September 30, 2003 and 2002, there were \$22.6 million and \$23.7 million outstanding respectively. These decreases have been due to the repayment and partial turbo redemption of the bonds payable outstanding.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Corporation's basic financial statements. The Corporation's basic financial statements consist of four components: 1) government-wide financial statements, 2) governmental fund financial statements, 3) statement of fiduciary net assets, and 4) notes to the financial statements. Due to the single-purpose nature of the activities of the Corporation, the government-wide and governmental 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 Corporation's assets and liabilities and provides information about the nature and amounts of investments in resources (assets), and the obligations to Corporation creditors (liabilities). It also provides the basis for computing rate of return, evaluating the capital structure of the Corporation, and assessing the liquidity and financial flexibility of the Corporation. The Statement of Net Assets column reports information about the Corporation using accounting methods similar to those used by private sector companies (accrual basis of accounting) and presents all assets and liabilities of the Corporation—both current and long-term. The Governmental Fund Balance Sheet focuses on the Corporation's balances of spendable resources available for the payment of Governmental expenditures including payment of Debt Service requirements at the end of the fiscal year. The government-wide financial statements are prepared on an economic resources and the accrual basis of accounting.
- 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 Corporation's operations over the past year and can be used to determine the Corporation's ability to meet its financial objectives and credit-worthiness. The Statement of Activities column presents information on how the Corporation'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 current year's *Statement of Fiduciary Net Assets* reports fiduciary funds held in an agency capacity for the benefit of the Government of the Virgin Islands related to hospital and healthcare projects for residents of the United States Virgin Islands. Fiduciary funds are not reflected in the government-wide financial statements because the resources are not available to support the Corporation's own programs. Agency funds are reported using the economic resources measurement focus on a full accrual basis and only present a statement of assets and liabilities.

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Summary of Financial Results

Government-Wide Financial

Statements

Statement of Net Assets--Table 1 summarizes the Corporation's Statement of Net Assets for the periods ending September 30, 2004, 2003, and 2002.

	<u>September 2004</u>	<u>September 2003</u>	<u>September 2002</u>
Restricted assets	\$ 3,338,612	\$ 3,240,939	\$ 2,892,354
Other assets	2,280,396	2,697,282	3,099,764
Total assets	<u>\$ 5,619,008</u>	<u>\$ 5,938,221</u>	<u>\$ 5,992,118</u>
Current liabilities	156,501	107,694	107,694
Bonds payable	22,310,000	22,645,000	23,685,000
Other liabilities	4,509	4,509	4,509
Total liabilities	<u>\$ 22,471,010</u>	<u>\$ 22,757,203</u>	<u>\$ 23,797,203</u>
Total net assets	<u>\$ (16,852,002)</u>	<u>\$ (16,818,982)</u>	<u>\$ (17,805,085)</u>

For Fiscal Year 2004, the Corporation's assets amounted to \$5.6 million, of which \$2.5 million represented restricted investments and approximately \$827,000 represented accrued TSRs which have been also restricted; and total liabilities amounted to \$22.5 million, of which \$22.3 million are bonds payable. The decrease in total assets has been mainly due to the amortization or serial bond accretion and bond issuance cost which has been partially offset by the investing of returns on the corporation's investments. In Fiscal Year 2003, the Corporation's assets amounted to \$5.9 million, of which \$2.4 million represented restricted investments and approximately \$827,000 represented accrued TSRs which have been also restricted; and total liabilities amounted to \$22.8 million, of which \$22.6 million were bonds payable. Changes during 2003 are due to the same reason discussed for 2004. For Fiscal Year 2002, the Corporation's assets amounted to \$5.9 million, of which \$2.9 million represented restricted investments; and total liabilities amounted to \$23.8 million, of which \$23.7 million are bonds payable. The net decrease in total assets is due to the turbo redemption of a portion of the bonds and payment of accretion and amortization expenses offset by the accrual of tobacco settlement revenues.

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Statement of Activities--Table 2 summarizes the Corporation's Statement of Activities for the periods ending September 30, 2004, 2003, and 2002.

	<u>September 2004</u>	<u>September 2003</u>	<u>September 2002</u>
General and program revenues	\$ 1,187,790	\$ 1,670,655	\$ 1,360,774
Expenses	<u>1,220,810</u>	<u>1,511,173</u>	<u>19,165,859</u>
Change in net assets	(33,020)	159,482	(17,805,085)
Net assets -			
Beginning of year (as restated)	<u>(16,818,982)</u>	<u>(16,978,464)</u>	<u>-</u>
Net assets -			
End of year	<u>\$ (16,852,002)</u>	<u>\$ (16,818,982)</u>	<u>\$ (17,805,085)</u>

For Fiscal Year 2004, general revenues of \$1.2 million reflect the receipt of \$1.1 million in TSRs, along with investment earnings of approximately \$86,000. The Corporation's expenses primarily included interest expense of approximately \$721,000, general and administrative expenses of \$83,000, accretion expense of \$320,000 and amortization expense of bond discount and issuance costs of \$97,000. The decrease in 2004 is mainly due to the reduced returns on the Corporation's investments coupled with increased operational expenses.

In Fiscal Year 2003, general revenues of \$1.7 million reflect the receipt of \$1.6 million in TSRs, and investment earnings of approximately \$94,000. The Corporation's expenses included interest expense of approximately \$761,000, general and administrative expenses of \$27,000, accretion expense of \$305,000, amortization expense of bond discount and issuance costs of \$97,000, and a transfer to the Tobacco Fiduciary Fund of \$321,000. The increases noted in 2003 were due to the collection of higher than expected TSRs and low operational expenses.

For Fiscal Year 2002, general revenues of \$1.4 million reflect the receipt of \$1.3 million in TSRs, along with investment earnings of \$98,000. The Corporation's expenses primarily included the purchase of tobacco settlement rights for \$18.4 million, interest expense of \$376,000, accretion expense of \$252,000, and amortization expense of bond discount and issuance costs of \$83,000.

Governmental Fund Financial Statements

Governmental Fund Balance Sheet--Table 3 summarizes the Corporation's Balance Sheet for the periods ending September 30, 2004, 2003, and 2002.

	<u>September 2004</u>	<u>September 2003</u>	<u>September 2002</u>
Restricted assets	\$ 2,511,991	\$ 2,414,318	\$ 2,892,354
Total assets	<u>2,511,991</u>	<u>2,414,318</u>	<u>2,892,354</u>
Total liabilities	<u>161,010</u>	<u>112,203</u>	<u>112,203</u>
Total fund balance	<u>\$ 2,350,981</u>	<u>\$ 2,302,115</u>	<u>\$ 2,780,151</u>

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In Fiscal Year 2004, the Corporation's assets, as reported on the Governmental Fund Balance Sheet, amounted to \$2.5 million, which are restricted investments. Total liabilities amounted to approximately \$161,000. For Fiscal Year 2003, the Corporation's assets amounted to \$2.4 million, of which \$2.4 million were restricted investments. Total liabilities amounted to approximately \$112,000. The increase in assets during 2004 is due to TSRs and interest earned on accounts; the addition to liabilities is the result of increased general and administrative expenses. The decrease noted during 2003 as compared to 2002 was mainly due to bond principal payments made during 2003.

In Fiscal Year 2002, the Corporation's assets, as reported on the Governmental Fund Balance Sheet, amounted to \$2.9 million, which were restricted investments. Total liabilities amounted to \$112,000.

Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balance--Table 4 summarizes the Corporation's Governmental Fund Revenues, Expenditures, and Changes in Fund Balance for the periods ending September 30, 2004, 2003, and 2002.

	<u>September 2004</u>	<u>September 2003</u>	<u>September 2002</u>
General and program revenues	\$ 1,187,790	\$ 1,670,655	\$ 25,045,774
Expenses	1,138,924	2,148,691	22,265,623
Excess of revenues (expenses)	<u>\$ 48,866</u>	<u>\$ (478,036)</u>	<u>\$ 2,780,151</u>
Fund balance:			
Beginning of year	<u>2,302,115</u>	<u>2,780,151</u>	<u>-</u>
Fund balance:			
End of year	<u>\$ 2,350,981</u>	<u>\$ 2,302,115</u>	<u>\$ 2,780,151</u>

General and program revenues for the year ending September 30, 2004, of \$1.2 million reflect the receipt of \$1.1 million in TSRs, and investment earnings of approximately \$86,000. The Corporation's expenses included \$335,000 for bond principal expense, interest expense of \$721,000, and \$83,000 for general and administrative expenses.

For the year ending September 30, 2003, general and program revenues of \$1.7 million reflect receipt \$1.6 million in TSRs and investment earnings of approximately \$94,000. The Corporation's expenses included \$1.04 million for bond principal expense, \$761,000 for interest expense, \$27,000 for general and administrative expenses, and a transfer to the Tobacco Fiduciary Fund of \$321,000.

For the year ending September 30, 2002, general and program revenues of \$25 million reflect the receipt of \$23.7 million in Bond issuance proceeds, \$1.2 million in TSRs, and investment earnings of \$98,000. The Corporation's expenses primarily included the purchase of tobacco settlement rights from the Government of the United States Virgin Islands for \$18.4 million, \$2 million for bond accretion, \$376,000 for interest expense, bond discount of \$124 thousand and costs of issuance amounting to \$1.3 million.

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Statement of Fiduciary Net Assets--Table 5 summarizes the Corporation's Statement of Fiduciary Net Assets for the periods ended September 30, 2004, 2003, and 2002.

	<u>September 2004</u>	<u>September 2003</u>	<u>September 2002</u>
Restricted assets	\$ 10,695,760	\$ 14,794,308	\$ 15,775,243
Total assets	<u>\$ 10,695,760</u>	<u>\$ 14,794,308</u>	<u>\$ 15,775,243</u>
Noncurrent liabilities	10,695,760	14,794,308	15,770,734
Other liabilities	-	-	4,509
Total liabilities	<u>\$ 10,695,760</u>	<u>\$ 14,794,308</u>	<u>\$ 15,775,243</u>

The Corporation's restricted investments consist of investments held on behalf of the Government of the Virgin Islands for healthcare projects consistent with the single purpose for which it was created. The decrease in total assets is due to payments made on behalf on the government for the construction and program costs of healthcare projects.

At the end of Fiscal Year 2004, the liabilities consisted of \$10.7 million Due to Government of the Virgin Islands. For Fiscal Year 2003, the liabilities consisted of \$14.8 million Due to Government of the Virgin Islands. For Fiscal Year 2002, the liabilities included \$107,000 due to the Virgin Islands Public Finance Authority, \$15.7 million due to Government of the Virgin Islands, and other liabilities of \$4,000. The reduction in liabilities is due to payment of construction and program costs for healthcare facilities.

Long-Term Debt Activity

The Bonds issued by the Corporation are thirty-year obligations scheduled to retire in ordinary course on May 15, 2031. However, under early redemption provisions, particularly 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 years ended September 30, 2004 through 2002, resulted in Turbo Redemptions of approximately \$310,000 on May 17, 2004, \$25,000 on November 15, 2003, \$520,000 on May 15, 2003, and \$520,000 on November 15, 2002.

Because the Corporation has pledged all future TSRs to the Bonds currently outstanding until those Bonds have been retired, the Corporation cannot issue additional debt without effecting a refunding of currently outstanding Bonds. Presently, the Corporation has no plans to undertake any transaction that would result in an increase in currently outstanding debt. The Corporation 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 fiscal years of 2004, 2003, or 2002.

Significant Currently-Known Facts

The following are currently known facts that could have a potential significant effect on financial position and changes in financial position in future years:

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Payment Collections

On November 23, 1998, participating cigarette manufacturers, entered into a Master Settlement Agreement with 46 states and five other jurisdictions. The remaining four states settled previously under separate agreements. The Master Settlement Agreement provides for Tobacco Settlement payments in exchange for a release from claims. Tobacco Settlement payments consist of Initial Payments received through 2003; Annual Payments, to be made on April 15, continuing in perpetuity; and Strategic Contribution Payments, to be made on April 15, 2008, continuing annually through 2017.

Payments may vary based on inflation adjustments, volume adjustments of cigarette sales, litigation adjustments from non-settling states, offsets for miscalculated or disputed payments, federal tobacco legislation offsets, litigation releasing parties offsets, and offsets for claims over the amounts of the award.

The ability of the Corporation to make debt service payments on bonds is contingent upon the receipt of Tobacco Settlement payments. The bonds issued by the Corporation do not constitute a claim against the full faith, credit, or taxing powers of the Government of the Virgin Islands.

Contacting the Corporation

This financial report is designed to provide bond holders with a general overview of the Corporation's finances. If you have questions about this report or need additional financial information, contact the Corporation:

Tobacco Settlement Financing Corporation
#24 Honduras
Frenchtown
St. Thomas, VI 00802
340-714-1635

TOBACCO SETTLEMENT FINANCING CORPORATION
(a blended component unit of The Government of the United States Virgin Islands)
Statement of Net Assets and Governmental Fund Balance Sheet
September 30, 2004

	<u>Debt Service Fund and Total Government Fund</u>	<u>Adjustments</u>	<u>Statement of Net Assets</u>
Assets			
Current assets:			
Restricted investments	\$ 2,511,991	\$ -	\$ 2,511,991
Accrued tobacco settlement revenues	-	826,621	826,621
Total current assets	<u>2,511,991</u>	<u>826,621</u>	<u>3,338,612</u>
Noncurrent assets:			
Serial bond accretion, net	-	1,098,484	1,098,484
Bond issuance costs, net	-	1,081,221	1,081,221
Original issue discount, net	-	100,691	100,691
Total noncurrent assets	-	<u>2,280,396</u>	<u>2,280,396</u>
Total assets	<u>\$ 2,511,991</u>	<u>\$ 3,107,017</u>	<u>\$ 5,619,008</u>
Liabilities			
Current liabilities:			
Accrued expenses payable	\$ 48,807	\$ -	\$ 48,807
Due to U.S. Virgin Islands Public Finance Authority	107,694	-	107,694
Total current liabilities	<u>156,501</u>	<u>-</u>	<u>156,501</u>
Noncurrent liabilities:			
Bonds payable	-	22,310,000	22,310,000
Other liabilities	4,509	-	4,509
Total noncurrent liabilities	<u>4,509</u>	<u>22,310,000</u>	<u>22,314,509</u>
Total liabilities	<u>161,010</u>	<u>22,310,000</u>	<u>22,471,010</u>
Fund Balance/Net Assets			
Fund balance:			
Reserved for debt service	2,350,981	(2,350,981)	-
Total fund balance	<u>2,350,981</u>	<u>(2,350,981)</u>	<u>-</u>
Total liabilities and fund balance	<u>\$ 2,511,991</u>		
Net assets:			
Restricted assets		(16,852,002)	(16,852,002)
Total net assets		<u>\$ (16,852,002)</u>	<u>\$ (16,852,002)</u>

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

TOBACCO SETTLEMENT FINANCING CORPORATION
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Statement of Net Assets and Governmental Fund Balance Sheet
As of September 30, 2003

	<u>Debt Service Fund and Total Government Fund</u>	<u>Adjustments</u>	<u>Statement of Net Assets</u>
Assets			
Current assets:			
Restricted investments	\$ 2,414,318	\$ -	\$ 2,414,318
Accrued tobacco settlement revenues	-	826,621	826,621
Total current assets	<u>2,414,318</u>	<u>826,621</u>	<u>3,240,939</u>
Noncurrent assets:			
Serial bond accretion, net	-	1,418,004	1,418,004
Bond issuance costs, net	-	1,170,292	1,170,292
Original issue discount, net	-	108,986	108,986
Total noncurrent assets	-	<u>2,697,282</u>	<u>2,697,282</u>
Total assets	<u>\$ 2,414,318</u>	<u>\$ 3,523,903</u>	<u>\$ 5,938,221</u>
Liabilities			
Current liabilities:			
Due to U.S. Virgin Islands Public Finance Authority	\$ 107,694	\$ -	\$ 107,694
Total current liabilities	<u>107,694</u>	<u>-</u>	<u>107,694</u>
Noncurrent liabilities:			
Bonds payable	-	22,645,000	22,645,000
Other liabilities	4,509	-	4,509
Total noncurrent liabilities	<u>4,509</u>	<u>22,645,000</u>	<u>22,649,509</u>
Total liabilities	<u>112,203</u>	<u>22,645,000</u>	<u>22,757,203</u>
Fund Balance/Net Assets			
Fund balance:			
Reserved for debt service	2,302,115	(2,302,115)	-
Total fund balance	<u>2,302,115</u>	<u>(2,302,115)</u>	<u>-</u>
Total liabilities and fund balance	<u>\$ 2,414,318</u>		
Net assets:			
Restricted assets		<u>(16,818,982)</u>	<u>(16,818,982)</u>
Total net assets		<u>\$ (16,818,982)</u>	<u>\$ (16,818,982)</u>

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

TOBACCO SETTLEMENT FINANCING CORPORATION
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Statement of Activities and Governmental Fund Revenues, Expenditures, and Changes in Fund Balance
For the year ended September 30, 2004

	Debt Service Fund and Total Government Fund	Adjustments	Statement of Activities
General and Program Revenues			
Tobacco settlement revenues	\$ 1,102,161	\$ -	\$ 1,102,161
Interest income:			
Cash and investments	85,629	-	85,629
Total general and program revenues	<u>1,187,790</u>	<u>-</u>	<u>1,187,790</u>
General and Program Expenses			
General and administrative expenses	82,799	-	82,799
Bond principal expense	335,000	(335,000)	-
Bond interest expense	721,125	-	721,125
Accretion expense	-	319,520	319,520
Amortization expense	-	97,366	97,366
Total general and program expenses	<u>1,138,924</u>	<u>81,886</u>	<u>1,220,810</u>
Excess (deficit) of revenues over expenses	48,866	(48,866)	
Change in net assets		(33,020)	(33,020)
Fund Balance/Net Assets			
Beginning of year	<u>2,302,115</u>	<u>(19,121,097)</u>	<u>(16,818,982)</u>
Ending of year	<u>\$ 2,350,981</u>	<u>\$ (19,202,983)</u>	<u>\$ (16,852,002)</u>

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

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Statement of Activities and Governmental Fund Revenues, Expenditures, and Changes in Fund Balance
For the year ended September 30, 2003

	Debt Service Fund and Total Government Fund	Adjustments	Statement of Activities
General and Program Revenues			
Tobacco settlement revenues	\$ 1,576,791	\$ -	\$ 1,576,791
Interest income:			
Cash and investments	93,864	-	93,864
Total general and program revenues	<u>1,670,655</u>	<u>-</u>	<u>1,670,655</u>
General and Program Expenses			
General and administrative expenses	26,515	-	26,515
Bond principal expense	1,040,000	(1,040,000)	-
Bond interest expense	760,750	-	760,750
Other financing uses:			
Transfer to tobacco fiduciary fund	321,426	-	321,426
Accretion expense	-	305,117	305,117
Amortization expense	-	97,365	97,365
Total general and program expenses	<u>2,148,691</u>	<u>(637,518)</u>	<u>1,511,173</u>
Excess (deficit) of revenues over expenses	(478,036)	478,036	
Change in net assets		159,482	159,482
Fund Balance/Net Assets			
Beginning of year (as restated)	<u>2,780,151</u>	<u>(19,758,615)</u>	<u>(16,978,464)</u>
Ending of year	<u>\$ 2,302,115</u>	<u>\$ (19,121,097)</u>	<u>\$ (16,818,982)</u>

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

TOBACCO SETTLEMENT FINANCING CORPORATION
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Statement of Fiduciary Net Assets
As of September 30, 2004 and 2003

	Agency Funds	
	<u>2004</u>	<u>2003</u>
Assets		
Restricted investments	\$ 10,695,760	\$ 14,794,308
Total assets	<u>\$ 10,695,760</u>	<u>\$ 14,794,308</u>
Liabilities		
Due to Government of the U.S. Virgin Islands	10,695,760	14,794,308
Total liabilities	<u>\$ 10,695,760</u>	<u>\$ 14,794,308</u>

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

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Notes to Basic Financial Statements
September 30, 2004 and 2003

1. Reporting Entity

The Tobacco Settlement Financing Corporation (the "Corporation") is a special-purpose, independent, instrumentality of the United States Virgin Islands, created by Virgin Islands Act No. 6428 for the purposes of managing the tobacco settlement program by (i) purchasing all rights, title, and interest in certain litigation awards under the Master Settlement Agreement entered into by participating cigarette manufacturers, (ii) issuing Tobacco Settlement Asset-Backed Bonds to pay the purchase price for the rights, and (iii) providing funds for hospital and healthcare projects in the United States Virgin Islands. The Board of Directors consists of three members: the Governor, and two independent members—one appointed by the governor and one appointed by the legislature.

2. Summary of Significant Accounting Policies

General

In its accounting and financial reporting in conformity with accounting principles generally accepted in the United States of America, the Corporation follows the pronouncements of the Governmental Accounting Standards Board (GASB), which is the accepted, standard-setting, body for establishing governmental accounting principles and reporting standards. In accordance with Government Accounting Standard No. 20, the Corporation follows all Financial Accounting Standard Board pronouncements (FASB's) and certain other pronouncements issued prior to November 30, 1989 that do not conflict with GASB standards. In accordance with paragraph 7 of GASB Statement No. 20, the Authority has elected to follow all non-conflicting FASB and other pronouncements issued after November 30, 1989. Basic financial statements are issued annually by the Corporation.

Government-wide and Fund Financial Statements/New Accounting Standard Adopted

The government-wide financial statements are prepared using the accrual basis of accounting and the economic resources measurement focus. Government-wide financial statements (i.e. the statement of net assets and the statement of activities) do not provide information by fund or account group.

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 the Corporation's program. 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 program. Unrestricted interest income and Tobacco Settlement Rights not properly included among program revenues are reported as general revenues.

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In addition to the government-wide financial statements, the Corporation has prepared financial statements for the Corporation's only governmental fund. Governmental fund financial statements continue to use the modified accrual basis of accounting and the current financial resources measurement focus. Accordingly, the accounting and financial reporting of the fund financial statements is similar to that previously presented in the Corporation's financial statements. Due to the single-purpose nature of the activities of the Corporation, the government-wide and fund financial statements have been presented together with an adjustments column reconciling the differences. In addition, the financial statements of the Corporation's Fiduciary (agency) fund are separately presented.

Effective for periods beginning after June 15, 2003, GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, provides guidance in accounting for organizations that are closely related to a primary government. The adoption of this statement did not have a material effect on the Authority's financial statements.

The GASB has issued Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, dated April, 2004, and effective for periods ending after June 15, 2004, which clarifies guidance based on the *financial accountability* criteria in GASB Statement 14, as to whether Tobacco Corporations should be considered component units of a Government and should be included in a Government's financial reporting entity by blending or discrete presentation due to the *exclusive benefit* criterion also in Statement 14.

The Technical Bulletin also discusses how tobacco settlement assets and revenues are to be recognized, and notes that the Participating Tobacco Manufacturers' obligations to make the Annual Payments in perpetuity depend upon the volume of tobacco products shipped domestically; therefore, assets and revenues related to these payments should not be recognized until the obligation has been met, or in other words, until the tobacco has been shipped.

It also discusses the reporting of debt issuances and payments by the Corporation to the Government, which should be recognized as an expense or liability during the period in which proceeds are received.

The Corporation early adopted Technical Bulletin 2004-1 in 2003 and accrued an estimate of the 2004 TSRs calculated at \$827 thousand based upon prior payments as well as expected tobacco settlement payments related to the 2004 calendar year. The accrued estimate of 2003 tobacco settlement revenues of \$827 thousand was based upon the payments received subsequent to September 30, 2003 related to the 2003 calendar year and reflected as a restatement of beginning of year net assets in 2003. Such accrual was calculated as nine-twelfths of the 2003 calendar year receipts collected by the Corporation during the fiscal year 2004 and have been reflected as part of the beginning of year net assets in the September 30, 2003 statement of activities.

Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The government-wide financial statements 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.

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Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. 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 Corporation 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.

Fiduciary financial statements are reported on a full accrual basis and only present a statement of assets and liabilities. The Corporation has one Agency fund for capital improvement funds held for the Government of the U.S. Virgin Islands. The fund is used by Government of the U.S. Virgin Islands to provide funds for hospital and healthcare projects for the resident of the United States Virgin Islands.

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

The Corporation reports one governmental fund—the Debt Service Fund. As a blended component unit of the U.S. Virgin Islands Government, the government wide financial statements are combined into the financial statements of the U.S. Virgin Islands Government in its basic financial statements. When both restricted and unrestricted resources are available for use, it is the Corporation's policy to use restricted resources first, then unrestricted resources as they are needed.

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 Corporation.

Investments

Under GASB Statement 31, *Accounting and Financial Reporting for Certain Investments and for Most External Investments Pools*, the Corporation reports investments at fair value in the balance sheet and changes in the fair value in the statement of income. 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.

Taxes

The Corporation is exempt from the payment of all U.S. Virgin Islands taxes on all assets and income of the corporation.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 revenues and expenses during the reporting period. Actual results could differ from those estimates.

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3. Restricted Investments

The Corporation maintains restricted investments for the purpose of Debt Service. The Corporation also manages the Tobacco Settlement Health Care & Capital Improvement Fund for the Government of the Virgin Islands in an agency capacity.

Restricted investments at September 30, 2004 and September 30, 2003 were as follows:

Debt Service:	2004	2003
Debt service reserve	<u>\$ 2,511,991</u>	<u>\$ 2,414,318</u>
Tobacco Settlement Health Care and Capital Improvement Fund:		
Investments: Beginning of year	14,794,308	15,775,243
Disbursements for capital projects	(4,200,630)	(1,435,848)
Additions	-	321,426
Earnings	<u>102,082</u>	<u>133,487</u>
Investments: End of year	<u>10,695,760</u>	<u>14,794,308</u>
Total Investments:		
End of year	<u><u>\$ 13,207,751</u></u>	<u><u>\$ 17,208,626</u></u>

The investments may be categorized into three levels to provide an indication of risk assumed:

- Category 1 - Includes investments that are insured, or registered, or for which the securities are held by the Corporation or its agent in the Corporation's name.
- Category 2 - Includes investments that are uninsured and/or unregistered for which the securities are held by the brokers' or dealers' trust department or agent, in the Corporation's name.
- Category 3 - Uncollateralized

Restricted investments, included all within category 1, as of September 30, 2004 were as follows:

	<u>Debt Service</u>	<u>Agency</u>	<u>Total</u>
Money market fund	\$ -	\$ 10,695,760	\$ 10,695,760
Commercial paper	729,991	-	729,991
Federal home loan bank notes	<u>1,782,000</u>	<u>-</u>	<u>1,782,000</u>
	<u>\$ 2,511,991</u>	<u>\$ 10,695,760</u>	<u>\$ 13,207,751</u>

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Restricted investments, included all within category 1, as of September 30, 2003 were as follows:

	<u>Debt Service</u>	<u>Agency</u>	<u>Total</u>
Money market fund	\$ -	\$ 14,794,308	\$ 14,794,308
Commercial paper	632,318	-	632,318
Federal home loan bank notes	1,782,000	-	1,782,000
	<u>\$ 2,414,318</u>	<u>\$ 14,794,308</u>	<u>\$ 17,208,626</u>

4. Bonds Payable

On November 20, 2001, the Corporation issued the 2001 Tobacco Settlement Financing Corporation Asset-Backed Bonds (Term and Capital Appreciation Bonds) amounting to \$23,685,000, with an issue value of \$21,709,862 net of accretion of \$1,975,138. The bonds are secured and payable from collections including all Tobacco Settlement Revenues to be received by the corporation, reserves, amounts held in other accounts established by the indenture and the corporation's rights under the purchase agreement. The proceeds have been used for the purpose of (i) purchasing all rights, title, and interest in certain litigation awards under the MSA entered into by participating cigarette manufacturers, (ii) issuing Tobacco Settlement Asset-Backed Bonds to pay the purchase price for the rights, and (iii) providing funds for hospital and healthcare projects in the United States Virgin Islands.

Bonds payable at September 30, 2004 amounted to \$22,310,000. Bonds payable at September 30, 2003 amounted to \$22,645,000.

Interest on the 2001 bonds is payable semi-annually on each May and November 15, beginning with May 2002 for the Term Bonds. The Corporation is responsible for all principal and interest payments on the bonds. The convertible Capital Appreciation Bonds will accrete interest prior to November 15, 2007 and will accrue interest subsequent to that date. Interest will compound on May and November 15. The Capital Appreciation Bonds shall be recorded at the nominal value with a separate restatement of accretion.

Interest paid during the year ended September 30, 2004, was \$721 thousand. Interest paid during the year ended September 30, 2003, was \$761 thousand.

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Future maturity dates and debt service requirements, for the Term Bonds and Capital Appreciation Bonds are as follows:

	SERIES 2001 BONDS		
	Principal	Interest	Total
2005	\$ -	\$ 705,000	\$ 705,000
2006	-	705,000	705,000
2007	-	705,000	705,000
2008	910,000	705,000	1,615,000
2009-2013	5,895,000	3,525,000	9,420,000
2014-2018	1,405,000	3,525,000	4,930,000
2019-2023	6,055,000	2,768,125	8,823,125
2024-2028	-	2,011,250	2,011,250
2029-2031	8,045,000	1,005,625	9,050,625
	<u>\$ 22,310,000</u>	<u>\$ 15,655,000</u>	<u>\$ 37,965,000</u>

Other Information

The Series 2001 Tobacco Bonds are not subject to optional redemption prior to May 15, 2011. The Series 2001 Tobacco Bonds maturing on or after May 15, 2012, are redeemable at the option of the Authority, in whole or in part, at a redemption price of 100% of the principal amount thereof, plus accrued interest to the date of redemption.

The Corporation has covenanted to apply 100% of any surplus collections under the MSA to the special mandatory par redemption of the Term Bonds in order of maturity.

"Turbo Redemptions" represent the requirement contained in the Indenture of the Bonds payable to apply 100% of all collections that are in excess of Indenture requirements 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(reflected as Bonds Payable) 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. The Tobacco Settlement Financing Corporation exercised its optional redemption on Term Bonds in the amounts of approximately \$310,000 in May 2004, \$25,000 in November 2003, \$520,000 in May 2003, and \$520,000 in November 2002. Such redemptions have been recorded as bond expense in the Statement of Activities and Government Fund Revenues, Expenditures, and changes in Fund Balance.

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5. Concentration of Credit Risk

The payment of the Series 2001 Term Bonds is dependent on the receipt of TSRs. The amount of TSRs 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 Corporation. In the event that the assets of the Corporation 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 Government, and no recourse may be had thereto for payment of amounts owing on the Series 2001 Term Bonds. The Corporation's only source of funds for payments on the Series 2001 Term Bonds is the TSRs. The Corporation has no taxing power.

Because of the many adjustments included in the MSA, it is not possible to know the exact future collections under the MSA.

6. Contingencies

The assets of the Corporation are not available to pay any creditor of the Government of the Virgin Islands. The Bonds issued by the Corporation do not constitute a claim against the full faith, credit and taxing power of the General Funds of the Government. The ability of the Corporation to meet debt service payments of bonds is contingent upon the receipt of Tobacco Settlement awards.

In relation, the ability of the PMs to make the tobacco settlement payments is contingent upon many other influences. There have been several multi-million, and a few multi-billion dollar verdicts against the tobacco companies in the recent years. Additionally, there are certain consumer groups that have introduced litigation against the tobacco manufacturers asserting that the MSA violates certain provisions of the United States Constitution, federal antitrust laws, and others.