

Tobacco Settlement Financing Corporation

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

**Management's Discussion and Analysis
and Basic Financial Statements
September 30, 2007 and 2006**

TOBACCO SETTLEMENT FINANCING CORPORATION
(a blended component unit of the Government of the United States Virgin Islands)
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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 net assets/fund balance and fiduciary net assets present fairly, in all material respects, the respective financial position of the governmental activities fund, 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, 2007 and 2006 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 Corporation'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 2 through 8 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.

PricewaterhouseCoopers LLP

May 9, 2008

CERTIFIED PUBLIC ACCOUNTANTS
(OF PUERTO RICO)
License No. 216 Expires Dec. 1, 2010
Stamp 2289260 of the P.R. Society of
Certified Public Accountants has been
affixed to the file copy of this report

TOBACCO SETTLEMENT FINANCING CORPORATION
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The Board of Directors of 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, 2007 and 2006. For discussion and analysis purposes, comparative information for 2005 has also been included. Please note 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 OPMs, released the OPMs from past and present smoking-related claims by the Settling States, and provides for a continuing release of future smoking-related claims in exchange for certain payments to be made to the Settling States. The MSA also provides for the imposition of certain tobacco advertising and marketing restrictions, among other things. The MSA represents the resolution of a large potential financial liability of the OPMs for smoking-related injuries, the costs of which have been borne and will likely be borne by cigarette consumers. The Corporation is not a party to the MSA.

Initial Payments under the MSA to the Settling States have been received from 1999 to 2003. 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 are due on April 15, having commenced April 15, 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, subject to adjustment, 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. In addition, 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. The Corporation received \$2.1 million in the fiscal year ended September 30, 2007, \$973 thousand in the fiscal year ended September 30, 2006, and \$1.1 million in the fiscal year ended September 30, 2005 pursuant to the rights purchased from the Government of the U.S. Virgin Islands.

On November 20, 2001, the Corporation issued \$21.7 million aggregate principal amount of Tobacco Settlement Financing Corporation Asset-Backed Bonds (the "2001 Series 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

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purchasing all rights, title, and interest in certain litigation awards under the MSA entered into by participating cigarette manufacturers, and, ultimately providing funds for hospital and healthcare projects in the United States Virgin Islands.

On March 15, 2006, the Corporation issued \$48.1 million aggregate principal amount of Tobacco Settlement Asset-Backed Subordinate Series 2006 A, B, C & D Turbo Capital Appreciation Bonds (the "Series 2006 Bonds") pursuant to an amendment of the indenture between the Corporation and the Trustee, dated November 1, 2001. The Series 2006 Bonds are secured by and are payable solely from the TSRs, investment earnings and amounts held in certain accounts, and the Corporation's rights under the purchase agreement. The proceeds were used for the purpose of financing several capital hospital and health department projects, including the Charlotte Kimelman Cancer Institute on St. Thomas and the construction of the V.I. Cardiac Center on St. Croix, and to fund operating costs of the Corporation.

As of September 30, 2007, the Corporation had outstanding bonds of \$29.3 million. As of September 30, 2006 and 2005, there were \$28.7 million and \$21.1 million outstanding, respectively.

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 method 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, 2007, 2006, and 2005.

Table 1: Summary of Statement of Net Assets

	September 2007	September 2006	September 2005
Restricted assets	\$ 4,590,773	\$ 3,362,876	\$ 3,282,141
Other assets	1,678,727	1,803,774	1,084,546
Total assets	<u>\$ 6,269,500</u>	<u>\$ 5,166,650</u>	<u>\$ 4,366,687</u>
Current liabilities	\$ 72,422	\$ 45,022	\$ 102,261
Bonds payable	29,332,791	28,765,026	21,176,092
Other liabilities	19,638	33,324	4,509
Total liabilities	<u>\$ 29,424,851</u>	<u>\$ 28,843,372</u>	<u>\$ 21,282,862</u>
Total net assets	<u>(23,155,351)</u>	<u>(23,676,722)</u>	<u>(16,916,175)</u>

For Fiscal Year 2007, the Corporation's assets amounted \$6.2 million, of which \$2.7 million represented restricted investments and approximately \$1.8 million represented accrued TSRs which are restricted; and total liabilities amounted to \$29.4 million, of which \$29.3 are bonds payable. The increase in total assets reflect the receipt of a strategic contribution during the current year. For Fiscal Year 2006, the Corporation's assets amounted to \$5.1 million, of which \$2.6 million represented restricted investments and approximately \$784 thousand represented accrued TSRs which have been also restricted; and total liabilities amounted to \$28.8 million, of which \$28.7 million are bonds payable. The increase in total assets and liabilities has been primarily due to the new bond issuance. For Fiscal Year 2005, the Corporation's assets amounted to \$4.4 million, of which \$2.5 million represented restricted investments and approximately \$827 thousand represented accrued TSRs which have been also restricted; and total liabilities amounted to \$21.3 million, of which \$21.1 million are bonds payable.

Statement of Activities—Table 2 summarizes the Corporation's Statement of Activities for the periods ending September 30, 2007, 2006, and 2005.

Table 2: Summary of Statement of Activities

	September 2007	September 2006	September 2005
General and program revenues	\$ 2,266,829	\$ 1,070,918	\$ 1,172,363
Expenses	1,745,458	7,831,465	1,236,536
Change in net assets	\$ 521,371	\$ (6,760,547)	\$ (64,173)
Net assets - beginning of year	<u>(23,676,722)</u>	<u>(16,916,175)</u>	<u>(16,852,002)</u>
Net assets - end of year	<u>\$ (23,155,351)</u>	<u>\$ (23,676,722)</u>	<u>\$ (16,916,175)</u>

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For Fiscal Year 2007, general revenues reflect the receipt of \$2.1 million in TSRs, along with investment earnings of approximately \$110 thousand. The Corporation's expenses included interest expense of \$673 thousand, general and administrative expenses of approximately \$80 thousand, accretion expense of approximately \$868 thousand, and amortization expense of bond discount and issuance costs of \$125 thousand.

For Fiscal Year 2006, general revenues of \$1.1 million reflect the receipt of \$973 thousand in TSRs, along with investment earnings of approximately \$98 thousand. The Corporation's expenses included a transfer of bond proceeds of \$6.4 million to the Tobacco Settlement Health Care and Capital Improvement Fund, an agency fund administered by the Corporation, interest expense of \$686 thousand, general and administrative expenses of approximately \$31 thousand, accretion expense of approximately \$574 thousand, and amortization expense of bond discount and issuance costs of \$111 thousand. The decrease in revenues during 2006 is due to the decrease in TSRs revenues. The increase in expenses is primarily due to the transfer of \$6.4 million to the Tobacco Settlement Healthcare and Capital Improvement Fund for capital projects.

For Fiscal Year 2005, general revenues reflect the receipt of \$1.1 million in TSRs, along with investment earnings of approximately \$78 thousand. The Corporation's expenses included interest expense of \$704 thousand, general and administrative expenses of \$100 thousand, accretion of bond discount of approximately \$335 thousand, and amortization expense of bond discount and issuance costs of \$97 thousand. Operational results in Fiscal Year 2005 were consistent with Fiscal Year 2004.

Governmental Fund Financial Statements

Governmental Fund Balance Sheet - Table 3 summarizes the Corporation's Balance Sheet for the fiscal years ending September 30, 2007, 2006, and 2005.

Table 3: Summary of Governmental Fund Balance Sheet

	September 2007	September 2006	September 2005
Restricted assets	\$ 2,712,521	\$ 2,578,732	\$ 2,455,520
Total assets	\$ 2,712,521	\$ 2,578,732	\$ 2,455,520
Total liabilities	\$ 92,060	\$ 78,346	\$ 106,770
Total fund balance	\$ 2,620,461	\$ 2,500,386	\$ 2,348,750

In Fiscal Year 2007, the Corporation's assets, as reported on the Governmental Fund Balance Sheet, amounted to \$2.7 million, which are restricted investments. Total liabilities amounted to \$92 thousand. For Fiscal Year 2006, the Corporation's assets, as reported on the Governmental Fund Balance Sheet, amounted to \$2.6 million, which are restricted investments. Total liabilities amounted to approximately \$78 thousand. For Fiscal Year 2005, the Corporation's assets amounted to \$2.5 million, which were restricted investments. Total liabilities amounted to \$107 thousand. The increase in assets during 2007 is due to an increase in TSRs collected during the year.

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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 fiscal years ending September 30, 2007, 2006, and 2005.

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

	September 2007	September 2006	September 2005
General and program revenues	\$ 1,172,721	\$ 8,403,404	\$ 1,172,363
Expenses	1,052,646	8,251,768	1,174,594
Excess of revenues (expenses)	\$ 120,075	\$ 151,636	\$ (2,231)
Fund balance:			
Beginning of year	\$ 2,500,386	\$ 2,348,750	\$ 2,350,981
Fund balance:			
End of year	\$ 2,620,461	\$ 2,500,386	\$ 2,348,750

General and program revenues for the year ending September 30, 2007 reflect the receipt of \$1.1 million in TSRs, and investment earnings of approximately \$110 thousand. The Corporation's expenses included interest paid of \$673 thousand, principal expense of \$300 thousand, and \$80 thousand for general and administrative expenses.

General and program revenues for the year ending September 30, 2006 of \$8.4 million reflect the issuance of \$7.3 million (total value of bonds of \$48,145,000 less a discount of \$40,854,991) in bonds, the receipt of \$973 thousand in TSRs, and investment earnings of approximately \$98 thousand. The Corporation's expenses included \$6.4 million transferred to the Corporation's Tobacco Settlement and Capital Improvement Fund for capital projects, interest paid of \$686 thousand, cost of issuance of bonds of \$830 thousand, principal expense of \$275 thousand, and \$31 thousand for general and administrative expenses. The increase in revenue and expenses is primarily due to the new bond issuance and transfer of funds to the Tobacco Settlement Health Care and Capital Improvement Fund.

General and program revenues for the year ending September 30, 2005 of \$1.2 million reflect the receipt of \$1.1 million in TSRs, and investment earnings of \$78 thousand. The Corporation's expenses included \$370 thousand for bond principal expense, interest expense of \$704 thousand, and \$100 thousand for general and administrative expenses. There were no significant changes from the prior year.

Statement of Fiduciary Net Assets—Table 5 summarizes the Corporation's Statement of Fiduciary Net Assets for the fiscal years ended September 30, 2007, 2006, and 2005.

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Table 5: Summary of Statement of Fiduciary Net Assets

	September 2007	September 2006	September 2005
Restricted assets	\$ 8,479,207	\$ 8,664,522	\$ 4,092,221
Total assets	<u>\$ 8,479,207</u>	<u>\$ 8,664,522</u>	<u>\$ 4,092,221</u>
Noncurrent liabilities	\$ 8,479,207	\$ 8,664,522	\$ 4,092,221
Total liabilities	<u>\$ 8,479,207</u>	<u>\$ 8,664,522</u>	<u>\$ 4,092,221</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 increase in total assets in 2006 is due to the proceeds from the new bond issuance. The liabilities consist of unexpended project funds.

Long-Term Debt Activity

The 2001 Series Bonds issued by the Corporation are twenty and thirty-year obligations scheduled to retire in ordinary course on May 15, 2021 and May 15, 2035. However, under early redemption provisions, particularly Turbo Redemptions, any TSR collections exceeding annual debt service requirements of the Bonds must be applied to early redemption of the Series 2001 Term Bonds in order of maturity. No excess shall be applied to the early redemption of the Series 2006 Bonds until full payment of the 2001 Series Bonds. TSRs and earnings on the trust funds during the fiscal years ending September 30, 2007 through 2005, resulted in Turbo Redemptions of \$295 thousand on May 15, 2007, \$5 thousand on November 15, 2006, \$265 thousand on May 3, 2006, \$10 thousand on November 15, 2005, \$345 thousand on May 16, 2005 and \$25 thousand on November 15, 2004.

The 2006 Series Bonds issued by the Corporation are thirty-year obligations maturing on May 15, 2035. The 2006 Series Bonds are subject to mandatory redemption in whole or part on each May 15 and November 15 subsequent to the date on which all Series 2001 Bonds have been paid in full but not before 2016.

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 2007, 2006, or 2005.

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:

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.

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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
P.O. Box 430
St. Thomas, VI 00804
340-714-1635

TOBACCO SETTLEMENT FINANCING CORPORATION
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Statement of Net Assets and Governmental Fund Balance Sheet
September 30, 2007

	Debt Service Fund and Total Government Fund	Adjustments	Statement of Net Assets
Assets			
Current assets:			
Restricted investments	\$ 2,712,521	\$ -	\$ 2,712,521
Accrued tobacco settlement revenues	-	1,878,252	1,878,252
Total current assets	<u>2,712,521</u>	<u>1,878,252</u>	<u>4,590,773</u>
Noncurrent assets:			
Bond issuance costs, net	-	1,262,408	1,262,408
Original issue discount, net	-	416,319	416,319
Total noncurrent assets	<u>-</u>	<u>1,678,727</u>	<u>1,678,727</u>
Total assets	<u>\$ 2,712,521</u>	<u>\$ 3,556,979</u>	<u>\$ 6,269,500</u>
Liabilities			
Current liabilities:			
Accrued expenses payable	72,422	-	72,422
Total current liabilities	<u>72,422</u>	<u>-</u>	<u>72,422</u>
Noncurrent liabilities:			
Bonds payable	-	29,332,791	29,332,791
Other liabilities	19,638	-	19,638
Total noncurrent liabilities	<u>19,638</u>	<u>29,332,791</u>	<u>29,352,429</u>
Total liabilities	<u>92,060</u>	<u>29,332,791</u>	<u>29,424,851</u>
Fund Balance/Net Assets			
Fund balance:			
Reserved for debt service	2,620,461	(2,620,461)	-
Total fund balance	<u>2,620,461</u>	<u>(2,620,461)</u>	<u>-</u>
Total liabilities and fund balance	<u>\$ 2,712,521</u>		
Net assets:			
Restricted for debt service		4,590,773	4,590,773
Unrestricted		(27,746,124)	(27,746,124)
Total net assets		<u>\$ (23,155,351)</u>	<u>\$ (23,155,351)</u>

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

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	Debt Service Fund and Total Government Fund	Adjustments	Statement of Net Assets
Assets			
Current assets:			
Restricted investments	\$ 2,578,732	\$ -	\$ 2,578,732
Accrued tobacco settlement revenues	-	784,144	784,144
Total current assets	<u>2,578,732</u>	<u>784,144</u>	<u>3,362,876</u>
Noncurrent assets:			
Bond issuance costs, net	-	1,367,212	1,367,212
Original issue discount, net	-	436,562	436,562
Total noncurrent assets	<u>-</u>	<u>1,803,774</u>	<u>1,803,774</u>
Total assets	<u>\$ 2,578,732</u>	<u>\$ 2,587,918</u>	<u>\$ 5,166,650</u>
Liabilities			
Current liabilities:			
Accrued expenses payable	45,022	-	45,022
Total current liabilities	<u>45,022</u>	<u>-</u>	<u>45,022</u>
Noncurrent liabilities:			
Bonds payable	-	28,765,026	28,765,026
Other liabilities	33,324	-	33,324
Total noncurrent liabilities	<u>33,324</u>	<u>28,765,026</u>	<u>28,798,350</u>
Total liabilities	<u>78,346</u>	<u>28,765,026</u>	<u>28,843,372</u>
Fund Balance/Net Assets			
Fund balance:			
Reserved for debt service	2,500,386	(2,500,386)	-
Total fund balance	<u>2,500,386</u>	<u>(2,500,386)</u>	<u>-</u>
Total liabilities and fund balance	<u>\$ 2,578,732</u>		
Net assets:			
Restricted for debt service		3,362,876	3,362,876
Unrestricted		(27,039,598)	(27,039,598)
Total net assets		<u>\$ (23,676,722)</u>	<u>\$ (23,676,722)</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 Net Assets/Fund Balance

For the year ended September 30, 2007

	<u>Debt Service Fund and Total Government Fund</u>	<u>Adjustments</u>	<u>Statement of Activities</u>
General and Program Revenues			
Tobacco settlement revenues	\$ 1,063,053	\$ 1,094,108	\$ 2,157,161
Interest income:			
Cash and investments	109,668	-	109,668
Total general and program revenues	<u>1,172,721</u>	<u>1,094,108</u>	<u>2,266,829</u>
General and Program Expenses			
General and administrative expenses	80,021	-	80,021
Bond principal expense	300,000	(300,000)	-
Bond interest expense	672,625	-	672,625
Other financing uses			
Accretion expense	-	867,765	867,765
Amortization expense	-	125,047	125,047
Total general and program expenses	<u>1,052,646</u>	<u>692,812</u>	<u>1,745,458</u>
Excess (deficit) of revenues over expenses	120,075	(120,075)	-
Change in net assets	-	521,371	521,371
Fund Balance/Net Assets			
Beginning of year	<u>2,500,386</u>	<u>(26,177,108)</u>	<u>(23,676,722)</u>
Ending of year	<u>\$ 2,620,461</u>	<u>\$ (25,775,812)</u>	<u>\$ (23,155,351)</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 Net Assets/Fund Balance
For the year ended September 30, 2006**

	Debt Service Fund and Total Government Fund	Adjustments	Statement of Activities
General and Program Revenues			
Tobacco settlement revenues	\$ 1,015,626	(42,477)	\$ 973,149
Interest income:			
Cash and investments	97,769	-	97,769
Other Financing Sources			
Issuance of bonds	<u>7,290,009</u>	<u>(7,290,009)</u>	<u>-</u>
Total general and program revenues	<u>8,403,404</u>	<u>(7,332,486)</u>	<u>1,070,918</u>
General and Program Expenses			
General and administrative expenses	30,509	-	30,509
Bond principal expense	275,000	(275,000)	
Bond interest expense	686,250	-	686,250
Other financing uses			
Cost of issuance	830,435	(830,435)	
Accretion expense	-	573,925	573,925
Amortization expense	-	111,207	111,207
Transfer to the Tobacco Settlement Health Care and Capital Improvement Fund	<u>6,429,574</u>	<u>-</u>	<u>6,429,574</u>
Total general and program expenses	<u>8,251,768</u>	<u>(420,303)</u>	<u>7,831,465</u>
Excess (deficit) of revenues over expenses	151,636	(151,636)	-
Change in net assets	-	(6,760,547)	(6,760,547)
Fund Balance/Net Assets			
Beginning of year	<u>2,348,750</u>	<u>(19,264,925)</u>	<u>(16,916,175)</u>
Ending of year	<u>\$ 2,500,386</u>	<u>\$ (26,177,108)</u>	<u>\$ (23,676,722)</u>

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

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Statements of Fiduciary Net Assets
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	Agency Funds	
	2007	2006
Assets		
Restricted investments	<u>\$ 8,479,207</u>	<u>\$ 8,664,522</u>
Total assets	<u>\$ 8,479,207</u>	<u>\$ 8,664,522</u>
Liabilities		
Due to Government of the U.S. Virgin Islands	<u>8,479,207</u>	<u>8,664,522</u>
Total liabilities	<u>\$ 8,479,207</u>	<u>\$ 8,664,522</u>

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

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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 Healthcare and Capital Improvement Fund 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 Standards Board Statement No. 20, the Corporation follows all Financial Accounting Standard Board (FASB) pronouncements 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 segments 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.

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. 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.

The GASB 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

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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 the liability for the bonds is recognized.

The Corporation accrued an estimate of \$1.8 million in 2007 and \$784 thousand in 2006 and \$827 thousand in 2005 for TSRs based upon prior payments as well as expected tobacco settlement payments related to the 2007 calendar year.

Effective for periods beginning after December 15, 2006, GASB Statement No. 48, Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues, addresses common transactions in which a government exchanges an interest in its expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments and provides guidance as to whether the transaction should be regarded as a sale or as a collateralized borrowing. The statement establishes criteria that a transferor government will use to make this determination generally based on the extent to which the government either retains or relinquishes control over the receivables or future revenues through its continuing involvement with them. The impact of the adoption of this statement has not been determined by management.

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.

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, the Tobacco Settlement Healthcare and Capital Improvement Fund, for capital improvement funds held for the Government of the U.S. Virgin Islands and for which assets are reflected as restricted in the Statement of Fiduciary Assets. The fund is used by the Government of the United States Virgin Islands to provide funds for hospital and healthcare projects for the residents of the United States Virgin Islands.

The future collection of Tobacco Settlement Revenue (TSRs) is dependent on many factors, including future cigarette consumption and the domestic shipment of cigarettes (sales). As such, the future collection of TSR due to future sales is not reasonably estimable and is not recorded as an asset in either the government-wide financial statements or the governmental fund financial statements as the funds are not yet available and such sale has not occurred.

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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 basic financial statements of the U.S. Virgin Islands Government. 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

The Corporation reports investments at fair value in the Statement of Net Assets and changes in the fair value in the Statement of Activities. 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 its assets and income.

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.

3. Restricted Investments

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

Restricted investments at September 30, 2007 and 2006 were as follows:

Debt Service Fund:	2007		2006	
	Fair value	Maturity	Fair value	Maturity
Investment Type				
Money Market Fund	603,017		462,820	
Federal National Mortgage Assoc. Repurchase Agreement	1,773,283	11/13/07	1,772,912	11/7/06
	336,221	5/15/31	343,000	5/15/31
Debt service reserve	<u>\$ 2,712,521</u>		<u>\$ 2,578,732</u>	

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Tobacco Settlement Health Care and Capital Improvement Fund (Agency Fund):

	<u>2007</u>	<u>2006</u>
	<u>Fair Value</u>	<u>Fair Value</u>
Money Market Fund	8,479,207	8,664,522
Agency Fund	<u>\$ 8,479,207</u>	<u>\$ 8,664,522</u>

Activity in the agency fund for 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
Investments: Beginning of year	8,664,522	4,092,221
Disbursements for capital projects	(301,606)	(2,129,626)
Other disbursements	(292,767)	
Additions	-	6,459,574
Earnings	409,058	242,353
Investments: End of year	<u>\$ 8,479,207</u>	<u>\$ 8,664,522</u>

Interest Rate Risk. The Corporation does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair market value losses arising from increasing interest rates

Credit Risk. Authorizing legislation of the Corporation does not limit investments by credit rating categories. The Corporation does not have an investment policy that limits its investment choices. At September 30, 2007, the Corporation's investment in money market funds was rated AAAM by Standard & Poor's, and Aaa by Moody's Investors Service; the Corporation's investment in a Federal Home Loan Mortgage Corporation note was rated AAA by Standard & Poor's, and Aaaa by Moody's Investors Service, and the Corporation's investment in a repurchase agreement was rated A- by Standard & Poor's and A3 by Moody's Investors Service.

Concentration of Credit Risk. The Corporation places no limit on the amount that may be invested in one issuer.

Governmental Funds: At September 30, 2007, the Corporation's Governmental Fund investments were invested in: AIM Short Term Inv. Co. Treasury No. 2 Money Market Fund (21.4%), Federal Home Loan Mortgage Corporation note (65.4%), and a PSA Master Repurchase Agreement with Bayerische Bank (12.4%).

Agency Funds: At September 30, 2007, agency fund investments were invested in AIM Short Term Inv. Co. Treasury No. 2 Money Market Fund (46.1%) and Goldman Financial Square Money Market Fund (53.9%).

Custodial Credit Risk. The Corporation does not have a custodial credit risk policy. This is the risk that the Government will not be able to recover the value of its investments that are in the possession of an outside party. At September 30, 2007 and 2006, all investments of the Corporation were held in the name of The Bank of New York Trust Company, N.A. as Trustee for the Corporation.

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4. Bonds Payable

On March 15, 2006, the Corporation issued the 2006 Tobacco Settlement Financing Corporation Asset-Backed Bonds, Subordinated Series 2006 (Turbo and Capital Appreciation Bonds) amounting to \$48,145,000, with an issue value of \$7,290,009, net of accretion of \$40,854,991. 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) financing several capital, hospital and health development projects for the benefit of the Virgin Islands and its residents, (ii) pay certain costs of issuance relating to the Series 2006 Bonds, and (iii) fund operating costs.

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, 2007 amounted to \$29,332,791. Bonds payable at September 30, 2006 amounted to \$28,765,026.

Interest on the Series 2001 Bonds is five percent (5%) and 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.

Interest on the Series 2006 Bonds is not paid currently but accretes from the date of delivery, compounded every May 15 and November 15, commencing May 15, 2006 and is paid at maturity or upon prior redemption, provided however that the 2001 Series Bonds have been paid in full.

Interest paid during the year ended September 30, 2007, was \$673 thousand. Interest paid during the year ended September 30, 2006, was \$686 thousand.

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Future maturity dates and debt service requirements for the 2001 Term Bonds and 2006 Capital Appreciation Bonds are as follows:

	Principal	Interest	Total
2008	910,000	657,750	1,567,750
2009	1,030,000	657,750	1,687,750
2010	1,100,000	657,750	1,757,750
2011	1,165,000	657,750	1,822,750
2012	1,265,000	657,750	1,922,750
2013-2017	2,740,000	3,288,750	6,028,750
2018-2022	5,110,000	2,777,750	7,887,750
2023-2027	-	2,011,250	2,011,250
2028-2032	8,045,000	1,407,875	9,452,875
2033-2035	48,145,000	-	48,145,000
Less: Future accretion	(40,177,209)	-	(40,177,209)
	<u>\$ 29,332,791</u>	<u>\$ 12,774,375</u>	<u>\$ 42,107,166</u>

Change in Outstanding Debt

	<u>Total Series</u>	<u>Series 2001</u>	<u>Series 2006</u>
Balance at Sept. 30, 2006	\$ 28,765,026	\$ 21,251,429	\$ 7,513,597
Principal payments	(300,000)	(300,000)	
Accretion of discount	867,765	366,909	500,856
Balance at Sept. 30, 2007	<u>\$ 29,332,791</u>	<u>\$ 21,318,338</u>	<u>\$ 8,014,453</u>

Other Information

The Series 2006 Bonds are subordinated in right of payment and lien priority to the Senior Bonds and so long as any Senior Bond remains outstanding, no payment on the Series 2006 Bonds may be made.

The Indenture Trustee, the Bondholders, and the Beneficial Owners cannot exercise any rights or remedies with respect to the Series 2006 Bonds, and no default or event default can exist or be declared. The Series 2006 Bonds do not pay any current interest. All interest on this series accretes until both the principal and accreted interest are paid.

The Series 2001 Tobacco Bonds are not subject to optional redemption prior to May 15, 2011. The Series 2001 Tobacco Bonds maturing 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.

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— "Turbo Redemptions" represent the requirement contained in the Indenture to apply 100% of all
— collections that are in excess of the requirements in the Indenture for the funding of the operating
— expenses; the deposits to the "Debt Service Account" for the funding of interest, sinking fund
— installments, and Term Bond maturities; maintenance of the Liquidity Reserve Account and the
— "Operating Contingency Account" (such excess, surplus collections); to the redemption of Series
— 2001 Term Bonds on each distribution date (each a Turbo Redemption Date) in ascending order of
— maturity. Such surplus collections will be deposited in an account established and maintained by
— the trustee under the Indenture (the Turbo Redemption Account). Turbo Redemptions will be
— credited against sinking fund installments for any particular Series 2001 Term Bonds in ascending
— order of sinking fund installment dates. Turbo Redemptions are not scheduled amortization
— payments and are to be made only from surplus collections, if any, and from amounts on deposit in
— the "Partial Lump-Sum Payment Account" with confirmation from each rating agency that no rating
— then in effect, with respect to the Series 2001 Term Bonds, from such rating agency will be
— withdrawn, reduced, or suspended. The Tobacco Settlement Financing Corporation exercised its
— optional redemption on Term Bonds in the amounts of \$295 thousand in May 2007, \$5 thousand in
— November 2006, \$265 thousand in May 2006, \$10 thousand in November 2005, \$345 thousand in
— May 2005, \$25 thousand in November 2004 (in fiscal years 2007 through 2005). Such redemptions
— have been recorded as bond expense in the Statement of Activities.

— **5. Concentration of Credit Risk**

— The payment of the Series 2001 Term Bonds and 2006 Capital Appreciation 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 and 2006 Capital Appreciation 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 and the 2006 Capital Appreciation Bonds.
— These Bonds are not legal or moral obligations of the State, and no recourse may be had thereto
— for payment of amounts owing on the Series 2001 Term Bonds and 2006 Capital Appreciation 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.

— The ability of the OPMs 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 laws.