

# DISTRICT OF COLUMBIA OFFICE OF THE INSPECTOR GENERAL

OIG Project No. 22-1-39TT

January 2023



## **TOBACCO SETTLEMENT FINANCING CORPORATION**

### **Financial Statements and Independent Auditor's Report For Fiscal Year Ended September 30, 2022**



#### *GUIDING PRINCIPLES*

*ACCOUNTABILITY \* INTEGRITY \* PROFESSIONALISM  
TRANSPARENCY \* CONTINUOUS IMPROVEMENT \* EXCELLENCE*

## **Mission**

Our mission is to independently audit, inspect, and investigate matters pertaining to the District of Columbia government in order to:

- prevent and detect corruption, mismanagement, waste, fraud, and abuse;
- promote economy, efficiency, effectiveness, and accountability;
- inform stakeholders about issues relating to District programs and operations; and
- recommend and track the implementation of corrective actions.

## **Vision**

Our vision is to be a world-class Office of the Inspector General that is customer-focused and sets the standard for oversight excellence!

## **Core Values**

Accountability \* Integrity \* Professionalism  
Transparency \* Continuous Improvement \* Excellence



GOVERNMENT OF THE DISTRICT OF COLUMBIA  
Office of the Inspector General

Inspector General



January 31, 2023

The Honorable Muriel Bowser  
Mayor of the District of Columbia  
Mayor's Correspondence Unit  
John A. Wilson Building  
1350 Pennsylvania Avenue, N.W., Suite 316  
Washington, D.C. 20004

The Honorable Phil Mendelson  
Chairman  
Council of the District of Columbia  
John A. Wilson Building  
1350 Pennsylvania Avenue, N.W., Suite 504  
Washington, D.C. 20004

Dear Mayor Bowser and Chairman Mendelson:

Enclosed is the final report entitled *Tobacco Settlement Financing Corporation Financial Statements and Independent Auditor's Report, for Fiscal Year Ended September 30, 2022* (OIG No. 22-1-39TT). McConnell Jones, LLP (MJ) submitted this component report as part of our overall contract for the audit of the District of Columbia's general-purpose financial statements for fiscal year 2022. MJ is contractually required to review the work papers of BCA Watson Rice LLP (BCAWR), which audited the financial statements of the Tobacco Settlement Financing Corporation to independently determine whether the financial statements are fairly presented.

On January 3, 2023, BCAWR issued its opinion and concluded that the financial statements are presented fairly in all material respects, in accordance with accounting principles generally accepted in the United States of America. BCAWR identified no material weaknesses in internal control over financial reporting. MJ concurred with BCAWR's opinion and conclusions.

If you have questions about this report, please contact me or Fekede Gindaba, Assistant Inspector General for Audits, at (202) 727-2540.

Sincerely,



Daniel W. Lucas  
Inspector General

DWL/ws

Enclosure

cc: See Distribution List

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Mr. Wayne McConnell, Managing Partner, McConnell & Jones LLP





**District of Columbia**  
**Tobacco Settlement Financing Corporation**  
Financial Statements and  
Independent Auditor's Report

*September 30, 2022*



**WatsonRice**  
Accountants & Advisors

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**DISTRICT OF COLUMBIA  
TOBACCO SETTLEMENT FINANCING CORPORATION  
FINANCIAL STATEMENTS  
SEPTEMBER 30, 2022**

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## INDEPENDENT AUDITOR'S REPORT

To the Mayor and Members of  
The Council of the Government of the District of Columbia, and  
The Board of Directors of the District of Columbia Tobacco Settlement Financing Corporation

### Report on the Financial Statements

#### *Opinion*

We have audited the accompanying financial statements of the District of Columbia Tobacco Settlement Financing Corporation ("TSFC"), a blended component unit of the Government of the District of Columbia, which comprise the balance sheet as of September 30, 2022, and the related statement of revenues, expenditures, and changes in fund balance for the year then ended and the related notes to the financial statements.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of TSFC as of September 30, 2022, and the changes in its financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

#### *Basis for Opinion*

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS) and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of the TSFC and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### *Emphasis of Matter*

As discussed in Note 1, the financial statements present only TSFC and do not purport to, and do not, present fairly the financial position of the Government of the District of Columbia as of September 30, 2022, and the changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

#### *Responsibilities of Management for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the TSFC's ability to continue as a going concern for one year from the date of the financial statements, including any currently known information that may raise substantial doubt shortly thereafter.

### ***Auditor's Responsibilities for the Audit of the Financial Statements***

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS and *Government Auditing Standards* will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS and *Government Auditing Standards*, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the TSFC's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the TSFC's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

### ***Required Supplementary Information***

Accounting principles generally accepted in the United States of America require that the management discussion and analysis on pages 4 through 8 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.



### ***Report on Summarized Comparative Information***

TSFC's financial statements as of and for the year ended September 30, 2021, were audited by us and we expressed an unmodified audit opinion in our report dated December 17, 2022. In our opinion, the summarized comparative information presented herein as of and for the year ended September 30, 2021, is consistent, in all material respects, with the audited financial statements from which it has been derived.

### ***Other Reporting Required by Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated January 3, 2023, on our consideration of the TSFC's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering TSFC's internal control over financial reporting and compliance.

Washington, D.C. *Watson Rice LLP*  
January 3, 2023

**DISTRICT OF COLUMBIA  
TOBACCO SETTLEMENT FINANCING CORPORATION  
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)  
SEPTEMBER 30, 2022**

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## **INTRODUCTION**

We are pleased to provide this overview and analysis of the financial activities of the District of Columbia Tobacco Settlement Financing Corporation (TSFC) for the fiscal year ended September 30, 2022. Please read it in conjunction with the financial statements and notes to the basic financial statements presented on pages 11 through 18.

This overview summarizes TSFC's financial position as of September 30, 2022, and the results of its operations during the fiscal year as reflected in the Statement of Revenues, Expenditures, and Changes in Fund Balance.

## **OVERVIEW OF REQUIRED BASIC FINANCIAL STATEMENTS**

The TSFC basic financial statements are presented on the modified accrual basis of accounting.

### **Balance Sheet**

This statement includes all assets and liabilities and provides information about its resources (assets) and obligations (liabilities). Assets and liabilities are presented in order of liquidity. The resulting fund balance presented in the statements is displayed as restricted and unassigned.

### **Statement of Revenues, Expenditures, and Changes in Fund Balance**

The Statement of Revenues, Expenditures, and Changes in Fund Balance reports the revenues and expenditures of TSFC during the fiscal year and the change in TSFC's fund balance. This statement measures the activities of TSFC's operations and is used to identify TSFC's debt service and operational costs.

## **FINANCIAL HIGHLIGHTS**

### **Balance Sheet**

The Balance Sheet reports the financial position of TSFC as of September 30, 2022. In accordance with the modified accrual basis of accounting for governmental funds, the Tobacco Settlement Revenues (TSRs) and Tobacco Settlement Asset-Backed Bond debt service payments are recorded only to the extent that they are receivable or payable in the current period.

#### *Assets*

As of September 30, 2022, TSFC's assets totaled \$75,913,946 consisting of \$48,203,914 in cash and cash equivalents, \$91,080 in interest receivable, \$27,604,952 in accrued tobacco settlement receivable and \$14,000 in prepaid expenses.

**DISTRICT OF COLUMBIA  
TOBACCO SETTLEMENT FINANCING CORPORATION  
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)  
SEPTEMBER 30, 2022**

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Restricted cash and cash equivalents as of September 30, 2022 consist of \$47,523,993 in the following four accounts: the Debt Service Account, from which debt service payments on TSFC's outstanding bonds are paid; the Trapping Account, in which, under certain circumstances, TSRs in excess of amounts required for annual debt service payments are held (Note 5); the 2006 Revenue Account, in which excess amounts are held related to the 2006 bond issuance costs (Note 5); the Debt Service Reserve fund in which funds are required to be held to cover debt service payment shortfalls.

As of September 30, 2022, unassigned cash totaled \$679,921. The Collection Account, into which TSRs are initially deposited before allocating to other designated accounts and the Operating Account, which is for TSFC's ongoing operating expenses, are considered unassigned cash.

*Liabilities*

TSFC liabilities as of September 30, 2022 consisted of accrued operating expenses of \$150.

*Fund Balance*

TSFC's fund balance as of September 30, 2022 was \$75,913,796. Of this amount, the vast majority, \$75,234,025 was held in TSFC's trustee accounts and represent balances reserved for debt service and related purposes for TSFC's outstanding bonds. There was a surplus of \$679,771 in unassigned fund balance as of September 30, 2022. Unassigned fund balance represents funds in the TSFC's operating and collection accounts that were not earmarked for payment of liabilities and were not mandated to be reserved for a specific purpose.

**Statement of Revenues, Expenditures, and Changes in Fund Balance**

*Revenues*

Revenues consisted primarily of TSRs, which are payments resulting from a purchase and sale agreement between the District and TSFC. In this agreement, TSFC purchased the right to receive such payments from the District based upon a Master Settlement Agreement ("MSA") entered into by certain cigarette manufacturers, the District, 46 states, and five other U.S. jurisdictions in November 1998 in settlement of certain smoking-related litigation. The amount of TSRs received each year pursuant to the MSA is calculated based on a formula in which a key variable is cigarette consumption in the United States of America. The TSRs for fiscal year 2022 totaled \$48,083,796 compared to \$41,726,675 in fiscal year 2021, an increase of \$6,357,121 or 15.2%. Other revenue includes interest income totaling \$337,046.

**DISTRICT OF COLUMBIA**  
**TOBACCO SETTLEMENT FINANCING CORPORATION**  
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)  
SEPTEMBER 30, 2022

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*Expenditures*

Expenditures consisted primarily of debt service payments, i.e., principal and interest payments on TSFC's outstanding bonds. TSFC issued \$521,105,000 and \$248,264,046 of Tobacco Settlement Asset-Backed Bonds (the "Tobacco Bonds") in March 2001 and August 2006, respectively. The 2001 Tobacco Bonds were issued to obtain funds to defease certain debt obligations of the District in exchange for TSFC obtaining the right to receive the annual TSRs. The exchange allowed the District to receive the benefit of future TSRs upfront. The 2006 Tobacco Bonds issuance was to further leverage future TSRs in exchange for an upfront benefit transferred to the District for use primarily on health-care related initiatives. Total debt service expenditures in fiscal year 2022 were \$45,643,550, which consisted of \$16,028,550 in interest expense and \$29,615,000 in principal repayment of the Tobacco Bonds.

The general and administrative expenses included payment of legal fees, trustee fees, rating agency fees, and other administrative expenses totaling \$242,339 for the year ended September 30, 2022.

**CONDENSED FINANCIAL INFORMATION**

The following table presents the condensed balance sheets as of September 30, 2022 and 2021.

	<u>2022</u>	<u>2021</u>	<u>Variance</u>
<b>Assets</b>			
Total Assets	\$ 75,913,946	\$ 73,528,886	\$ 2,385,060
<b>Liabilities</b>			
Current Liabilities	\$ 150	\$ 150,043	\$ (149,893)
Total Liabilities	150	150,043	(149,893)
<b>Fund Balance</b>			
Unassigned	679,771	908,068	(228,297)
Restricted for Debt Service	75,234,025	72,470,775	2,763,250
Total Fund Balance	75,913,796	73,378,843	2,534,953
<b>Total Liabilities and Fund Balance</b>	<u>\$ 75,913,946</u>	<u>\$ 73,528,886</u>	<u>\$ 2,385,060</u>

For fiscal year 2022, total fund balance increased by \$2,534,953 or 3.0%. Assets increased by \$2,385,060 or 3.2% from the prior fiscal year due to moderately higher tobacco settlement revenue receivables. Current liabilities decreased by \$149,893 or 99.9% from the prior fiscal year due to a substantially lower accrued payable, as shown above.

**DISTRICT OF COLUMBIA**  
**TOBACCO SETTLEMENT FINANCING CORPORATION**  
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)  
SEPTEMBER 30, 2022

The following table presents the condensed statements of revenues and expenditures for the years ended September 30, 2022 and 2021.

	<u>2022</u>	<u>2021</u>	<u>Variance</u>
<b>Revenues</b>			
Tobacco Settlement Revenue	\$ 48,083,796	\$ 41,726,675	\$ 6,357,121
Investment Income	337,046	1,332,046	(995,000)
Total Revenues	<u>48,420,842</u>	<u>43,058,721</u>	<u>5,362,121</u>
<b>Expenditures</b>			
Interest Expense	16,028,550	17,893,075	(1,864,525)
Bond Principal Payment	29,615,000	28,685,000	930,000
General and Administrative Expenses	<u>242,339</u>	<u>236,633</u>	<u>5,706</u>
Total Expenditures	<u>45,885,889</u>	<u>46,814,708</u>	<u>(928,819)</u>
Excess (Deficiency) of Revenues over Expenditures	<u>\$ 2,534,953</u>	<u>\$ (3,755,987)</u>	<u>\$ 6,290,940</u>

*(a) Revenues Comparison*

Total revenues in fiscal year 2022 increased by \$5,362,121 or 12.5% as compared to fiscal year 2021. Increased revenues were attributable to adjusted payments received from the Non-Participating Tobacco Product Manufacturer ("NPM") for the period covering 2018-2022.

*(b) Expenditures Comparison*

Total expenditures in fiscal year 2022 decreased by \$928,819 or 2.0% as compared to fiscal year 2021. The overall decrease in 2022 was due to lower interest expense.

*(c) Excess (Deficiency) of Revenues over Expenditures*

Due to the fact that the debt service payments on the Tobacco Bonds are covered by a given year's TSRs that cross fiscal years and the variability in the amount of TSRs and investment earnings from year to year, there are likely to be operating surpluses or deficits from year to year, neither of which would indicate a fiscal concern or irregularity.

In fiscal year 2022, TSFC's operating results produced substantially higher excess revenues over expenditures of \$2,534,953 as compared to a deficiency of revenue over expenditures of \$3,755,987 in fiscal year 2021.



**DISTRICT OF COLUMBIA**  
**TOBACCO SETTLEMENT FINANCING CORPORATION**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)**  
**SEPTEMBER 30, 2022**

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**Contacting TSFC**

This report is intended to provide TSFC stakeholders with a general overview of the financial activities and position of TSFC. TSFC is functioning as it was designed to function, fulfilling its mission of being a vehicle for leveraging the TSRs through the issuance of the Tobacco Bonds; providing the District with upfront compensation representing the value of TSRs that it was to receive in future years; affording the District the ability to shift (to Tobacco bondholders) most of the risk associated with the prospect of future non-payment of TSRs by tobacco manufacturers; servicing the Tobacco Bonds in accordance with the structure and requirements associated with the transaction; and providing the District with ongoing revenue from any annual residual TSRs from the tobacco manufacturers. Any questions or requests regarding this report should be directed to: District of Columbia Tobacco Settlement Financing Corporation, Attn: Assistant Treasurer, 1350 Pennsylvania Ave., N.W., Suite 200, Washington, D.C. 20004, or (202) 727-6055.

**DISTRICT OF COLUMBIA**  
**TOBACCO SETTLEMENT FINANCING CORPORATION**  
**BALANCE SHEET**  
**SEPTEMBER 30, 2022**  
*(With Comparative Totals for 2021)*

	<u><b>2022</b></u>	<u><b>2021</b></u>
<b>ASSETS</b>		
Current Assets:		
Cash and Equivalents		
Unrestricted	\$ 679,921	\$ 1,058,111
Restricted:		
Debt Service Reserve	40,299,163	40,117,701
Debt Service	7,091,084	8,015,298
Trapping Account	71	70
SRS Revenue Account	133,675	133,020
Interest Receivable	91,080	174
Tobacco Settlement Revenue Receivable	27,604,952	24,186,611
Prepaid Expenditures	<u>14,000</u>	<u>17,900</u>
Total Assets	<u><u>\$ 75,913,946</u></u>	<u><u>\$ 73,528,886</u></u>
<b>LIABILITIES AND FUND BALANCE</b>		
Current Liabilities:		
Accrued Expenditures	<u>\$ 150</u>	<u>\$ 150,043</u>
Total Liabilities	<u>150</u>	<u>150,043</u>
Fund Balance:		
Unassigned	679,771	908,068
Restricted for Debt Service	<u>75,234,025</u>	<u>72,470,775</u>
Total Fund Balance	<u>75,913,796</u>	<u>73,378,842</u>
Total Liabilities and Fund Balance	<u><u>\$ 75,913,946</u></u>	<u><u>\$ 73,528,886</u></u>

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

**DISTRICT OF COLUMBIA**  
**TOBACCO SETTLEMENT FINANCING CORPORATION**  
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE  
YEAR ENDED SEPTEMBER 30, 2022  
*(With Comparative Totals for 2021)*

	<b>2022</b>	<b>2021</b>
<b>Revenues</b>		
Tobacco Settlement Revenue	\$ 48,083,796	\$ 41,726,675
Investment Income	337,046	1,332,046
Total Revenues	<u>48,420,842</u>	<u>43,058,721</u>
 <b>Expenditures</b>		
Interest Expense	16,028,550	17,893,075
Bond Principal Payment	29,615,000	28,685,000
General and Administrative Expenses	242,339	236,633
Total Expenditures	<u>45,885,889</u>	<u>46,814,708</u>
 Excess (Deficiency) of Revenues Over Expenditures	 2,534,953	 (3,755,987)
 <b>Other Financing Sources</b>		
Transfer in	-	-
 Fund Balance, Beginning	 <u>73,378,843</u>	 <u>77,134,830</u>
Fund Balance, Ending	<u>\$ 75,913,796</u>	<u>\$ 73,378,843</u>

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

**DISTRICT OF COLUMBIA**  
**TOBACCO SETTLEMENT FINANCING CORPORATION**  
**NOTES TO THE FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2022**

**NOTE 1      SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Organization***

The District of Columbia Tobacco Settlement Financing Corporation ("TSFC") is a special purpose, independent instrumentality of the Government of the District of Columbia (the "District") created by the Tobacco Settlement Financing Act of 2000 (the "Act"). TSFC is governed by a five-person board of directors consisting of the Mayor of the District or designee, the Chairman of the Council of the District or designee, the Chief Financial Officer of the District and two private citizens. One citizen is appointed by the Mayor and one citizen is appointed by the Council. Although legally separate from the District, TSFC is a blended component unit of the District and, accordingly, is included in the District's financial statements.

Pursuant to the Act, and a purchase and sale agreement dated as of February 1, 2001 between the District and TSFC, the District sold to TSFC on March 13, 2001, substantially all of its rights, title and interest in certain amounts paid or payable to the District under the Master Settlement Agreement (the "MSA") entered into by participating cigarette manufacturers ("PCMs"), the District, forty-six (46) states and five (5) other U.S. jurisdictions in November 1998 in the settlement of certain smoking-related litigation. The sale included certain initial and annual payments already received by the District and the District's right to receive future initial, annual, and strategic contribution fund payments (the "tobacco settlement revenues" or "TSRs") to be made to the PCMs under the MSA.

TSFC financed the District's rights, title and interest in the TSRs by issuing the Tobacco Settlement Asset-Backed Bonds (the "Tobacco Bonds").

TSFC issued its first series of Tobacco Bonds in the amount of \$521,105,000 on March 13, 2001. In accordance with the aforementioned purchase and sale agreement, TSFC deposited the net proceeds of the Tobacco Bonds into irrevocable escrow accounts held by a trustee in TSFC's name to defease certain obligations of the District.

***Basis of Presentation***

TSFC's financial transactions are accounted for as a special revenue fund in the District's financial statements. The accompanying financial statements present the financial results of only TSFC and do not purport to, and do not, present fairly the financial position of the District as of September 30, 2022 and the changes in its financial position for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

***Basis of Accounting***

The accompanying financial statements are prepared on the modified accrual basis of accounting. Under this method, TSFC recognizes revenue when it becomes susceptible to accrual, which is when it becomes both measurable and available to finance expenditures in the current fiscal year. Expenditures are recognized when the related liability is incurred or, in the case of debt service, when payments are due.

Future tobacco settlement collections are contingent upon future tobacco product sales subject to various adjustments as outlined in the MSA. TSFC recognizes revenue from

**DISTRICT OF COLUMBIA**  
**TOBACCO SETTLEMENT FINANCING CORPORATION**  
NOTES TO FINANCIAL STATEMENTS  
SEPTEMBER 30, 2022

**NOTE 1      SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Basis of Accounting (Continued)***

tobacco settlement collections as the collections are received. In addition, an accrued receivable (Master Settlement Agreement receivable) is recorded at year end for estimated product sales occurring from January 1 to September 30 of each year.

***Use of Estimates***

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires TSFC's 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 basic financial statements determining the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Cash Equivalents***

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash with an original maturity of three (3) months or less.

***Investments***

TSFC follows the District's investment policy. Investments are limited to obligations of the United States and agencies, money market funds, municipal obligations, collateralized or insured certificates of deposit, prime commercial paper, bankers' acceptances and repurchase agreements fully collateralized in obligations of the United States government and agency securities.

Money market funds such as short-term, highly liquid debt instrument and participating interest earning investments, such as repurchase agreements that at the time of purchase of one year or less, are carried at amortized cost which approximates fair value. Other investments are stated at fair value.

***Fund Balance***

Governmental accounting standards establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed on the use of the resources reported in governmental funds.

- **Nonspendable:** Amounts that are not in spendable form or are legally or contractually required to be maintained intact.
- **Restricted:** Amounts that are legally restricted by outside parties, constitutional provisions, or enabling legislation for use for a specific purpose. Restricted fund balance is to be used for the purpose of paying future debt service and related expenses associated with the Tobacco Bonds.
- **Committed:** Amounts that have been formally set aside by the City Council or the Board of Directors for use for specific purposes. Commitments are made and can be rescinded only via resolution of the City Council or the Board of Directors



**DISTRICT OF COLUMBIA  
TOBACCO SETTLEMENT FINANCING CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
SEPTEMBER 30, 2022**

**NOTE 1      SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

- **Assigned:** Amounts that are intended to be spent on specific purposes expressed by the governing body.
- **Unassigned:** Amounts that are available for any purpose. TSFC intends the amounts to be used for the subsequent fiscal years' operating expenses.

At September 30, 2022, the TSFC had two fund balance classifications: unassigned and restricted.

**NOTE 2      DEPOSITS AND INVESTMENTS**

Cash and cash equivalents consist of bank deposits and money market funds which are permitted investments under the bond indenture.

	<b>2022</b>
<b>Unassigned:</b>	
Cash	\$       671,980
Money Market Funds	7,941
Total unassigned	<u>679,921</u>
 <b>Restricted for Debt Service</b>	
Morgan Stanley Institutional Liquidity Funds	<u>47,523,993</u>
Total restricted	<u>47,523,993</u>
 Total cash and cash equivalents	<u>\$    48,203,914</u>

TSFC's unassigned cash and cash equivalents are held in operating and collections accounts. Restricted cash and cash equivalents are invested in money market funds and, as of September 30, 2022, consist of \$7,224,830, which is maintained in trapping, revenue and debt service accounts and \$40,299,163, which is maintained in the debt service reserve account.

Unassigned cash and cash equivalents as of September 30, 2022, was available to fund operating costs of the TSFC. The remaining funds were restricted for distribution in accordance with the Tobacco Bonds indenture.

***Concentration of Credit Risk***

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. TSFC's investment was with one single issuer. However, TSFC routinely purchases and sells permitted investments with different issuers.

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**NOTE 2        DEPOSITS AND INVESTMENTS (Continued)**

***Interest Rate Risk***

Interest rate risk is the risk that changes in market interest rates will adversely affect the fair value of an investment. An investment with a longer maturity will generally have greater sensitivity to fair value changes that are related to market interest rates. As a means to limiting its exposure to fair value losses resulting from rising interest rates, the TSFC investment policy limits the portfolio to maturities of less than one year.

***Credit Risk***

TSFC's policy requires that for investments in (a) commercial paper, the issuing corporation, or its guarantor have a short-term credit rating of not less than A-1 (or its equivalent) by at least two credit rating agencies; and (b) repurchase agreements, the counterparty has a long-term credit rating of AA or the equivalent, and does not have a negative outlook associated with such rating, has been in operation for at least five years, and is reputable among market participants. The Morgan Stanley Institutional Liquidity Fund invests in high-quality debt securities issued by the U.S. government and is rated AAAm by Standard and Poor's (S&P) rating service.

***Custodial Credit Risk***

Custodial credit risk investments is the risk that, in the event a counterparty fails to uphold their agreement to a transaction, an entity would not be able to recover the value of its investment or collateral securities in the possession of an outside party. TSFC's investments are collateralized by securities held in TSFC's name by a custodial bank.

***Reserve Requirements***

Pursuant to the Tobacco Bonds offering, TSFC was required to establish a Debt Service Reserve Account to be held by the indenture trustee. The balance of the account must be maintained, to the extent available, at the lesser of (i) the initial deposit of \$40,111,100 or (ii) the principal amount of the Senior Bonds outstanding. The balance in this account as of September 30, 2022, was \$40,299,163 which included investment earnings on the required balance which met the required debt service reserve account threshold.

**NOTE 3        FAIR VALUE MEASUREMENTS**

TSFC categorizes its fair value measurements within the fair value hierarchy established by U.S. generally accepted accounting principles. The hierarchy is based on the evaluation inputs used to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

As of September 30, 2022, the Morgan Stanley Institutional Liquidity Funds of \$47.5 million held by the TSFC are measured at fair value and are within the Level 1 input category of the fair value hierarchy. These instruments are traded and valued using net asset value.

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**NOTE 4      ACCRUED TOBACCO SETTLEMENT RECEIVABLE**

Tobacco settlement revenues represent a portion of future sales of tobacco products expected to be received in a calendar year. GASB Technical Bulletin 2004-1, "*Tobacco Settlement Recognition and Financial Reporting Issues*", allows for the recognition of revenue to be based on the shipment of domestic cigarettes. TSFC has recognized an accrued receivable and revenue in the financial statements that is estimated to be 75% of the next projected payment due from the MSA. Accordingly, the balance sheet includes an estimated accrued tobacco settlement receivable of \$27,604,952 for fiscal year 2022.

**NOTE 5      TOBACCO SETTLEMENT ASSET-BACKED BONDS**

In November 1998, the District (along with a number of other States and various jurisdictions) signed a Master Settlement Agreement with the major U.S. tobacco companies that ended litigation over health care treatment costs incurred for smoking-related illnesses. Under the settlement, the District is scheduled to receive total annual payments aggregating an estimated \$1.2 billion by 2025. There are several potential adjustments to this schedule, including an inflation adjustment and cigarette volume adjustment.

In 2001, TSFC issued \$521,105,000 principal amount of its Tobacco Settlement Asset-Backed Bonds, Series 2001, of which \$209,765,000 was outstanding as of September 30, 2022.

In 2006, TSFC issued \$248,264,046 in principal amount of its Tobacco Settlement Asset-Backed Bonds, Series 2006. There were no payments made on these bonds during fiscal year 2022 and the amount of principal outstanding as of September 30, 2022, was \$248,264,046. The payment of these bonds is secured by the distributions under the MSA. Payments received by the TSFC under the MSA in excess of the annual debt service requirements for the Tobacco Bonds may revert to the District's General Fund. There was no transfer of funds from Tobacco proceeds to the General Fund in fiscal year 2022. The Tobacco Bonds are neither general nor moral obligations of the District and are not secured by a pledge of the full faith and credit of the District.

The 2006 Tobacco Bonds are subordinate to the 2001 Tobacco Bonds and are payable from payments received under the MSA in excess of the amount required to pay the debt service and other obligations associated with the 2001 Tobacco Bonds. The portion of the MSA payments due to the District is known as "Residual Interest". Rights to such residual interest were sold by the District to TSFC in exchange for the proceeds of the 2006 Tobacco Bonds with certain conditions.

The proceeds of the 2006 Tobacco Bonds were transferred to the District by TSFC upon receipt, and the balance of such funds is an asset of the District and not TSFC. Because TSFC is an instrumentality of the District and is accounted for as a blended component unit, its debt is considered to be a component of the long-term debt of the District. However, since the Tobacco Bonds are revenue bonds payable solely from Tobacco Settlement Revenues and do not constitute a direct debt of the District, they are not a part of the District's debt burden.

**DISTRICT OF COLUMBIA  
TOBACCO SETTLEMENT FINANCING CORPORATION  
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**NOTE 5 TOBACCO SETTLEMENT ASSET-BACKED BONDS (Continued)**

The District retains the rights to the residual interest in excess of the amounts needed to retire the 2006 Tobacco Bonds. The proceeds of the 2006 Tobacco Bonds have been fully allocated and expended. A nominal balance allocated for the cost of issuance is being held in the SRS Revenue account pursuant to the 2006 Tobacco Bond Indenture.

As of September 30, 2022, the total outstanding balance for all Tobacco Bonds was \$458,029,046, as follows:

	<b>Outstanding Principal Balance at September 30, 2021</b>			<b>Outstanding Principal Retired Principal Balance at or Defeased September 30, 2022</b>	
		<b>Issued</b>			
Series 2001	\$ 239,380,000	\$ -	\$ 29,615,000	\$ 209,765,000	
Series 2006	248,264,046	-	-	248,264,046	
	<u>\$ 487,644,046</u>	<u>\$ -</u>	<u>\$ 29,615,000</u>	<u>\$ 458,029,046</u>	

Debt service requirements for planned principal and interest payments, as of September 30, 2022, are as follows:

<b>Series</b>	<b>Year Ending September 30</b>	<b>Maturities</b>	<b>Interest Due</b>	<b>Total Debt Service</b>
Series 2001	2023	63,520,000	14,103,575	77,623,575
Series 2001	2024	33,635,000	9,871,537	43,506,537
Series 2001	2025	34,145,000	7,601,175	41,746,175
Series 2001	2026	78,465,000	5,296,388	83,761,388
Series 2006	2046	159,732,846	1,697,592,154	1,857,325,000
Series 2006	2055	88,531,200	2,478,468,800	2,567,000,000
	<b>Total</b>	<u>\$ 458,029,046</u>	<u>\$ 4,212,933,629</u>	<u>\$ 4,670,962,675</u>

The principal payments shown above represent the amount of principal that TSFC alone has covenanted to pay to the extent that sufficient available TSRs are collected. Tobacco Bonds are revenue bonds payable solely from Tobacco Settlement Revenues and not a direct debt of the District nor a part of the District's debt burden. As such, the District is not responsible for payment of Tobacco Bonds should revenues fall short of scheduled principal and interest payment amounts. When collected revenues are insufficient to cover principal payments in a given year, a partial principal payment and interest earned thereon is made. The remaining unpaid principal portion and interest due thereon is carried forward and added to outstanding principal for the next succeeding year. Principal payments in the out years are made to the extent revenue is sufficient to cover payments and revert to the method described herein whenever collected revenues are not sufficient to cover payments.

**DISTRICT OF COLUMBIA**  
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**NOTE 6            CONCENTRATION OF CREDIT RISK**

TSFC's projected revenue is derived from a MSA entered into by certain cigarette manufacturers. Projected revenue to be recognized in future years may be subject to variability due to cigarette consumption levels and financial stability of some of the tobacco companies along with disputed claims filed by other tobacco manufacturers.

**NOTE 7            GENERAL AND ADMINISTRATIVE EXPENSES**

The general and administrative expenses include legal, trustee and rating agency fees, shared services, and other ancillary costs, which totaled \$242,339 for fiscal year 2022. Shared services costs totaled \$160,006 for fiscal year 2022, which cover \$159,506 in tax compliance personnel services performed by District employees on TSFC's behalf and space rental of \$500.

**NOTE 8            NPM ADJUSTMENT DISPUTE SETTLEMENTS**

During recent years, the District's MSA payments have been reduced by amounts that the Participating Tobacco Product Manufacturers ("PMs") have withheld for expected NPM Adjustments. An NPM Adjustment is a potential percentage reduction applied against each year's MSA payment based on the combined national market share of Non-Participating Tobacco Product Manufacturers ("NPMs"). In December 2012, the District, Puerto Rico and seventeen (17) other signatory States to the Master Settlement Agreement ("MSA") entered into a settlement term sheet with the PMs to resolve any and all NPM adjustment claims for MSA payment years 2004 through 2015. Subsequently, seventeen (17) more states became signatories to the term sheet. In 2017, the term sheet was reduced to a formal written settlement agreement and NPM adjustment claims for 2016 and 2017 were settled. The 2018 - 2022 NPM Adjustment Settlement Agreement carries forward the terms of the 2016 - 2017 NPM Adjustment Settlement Agreement whereby the Settling States and Participating Tobacco Manufacturers agree to split the amount of the annual NPM Adjustment for each year 2018 through 2022 using a 75/25 ratio with the States receiving 75% and the Tobacco Companies receiving 25%. This resolves any potential liability the States, including DC, may have for an NPM Adjustment during those years, and provides for the immediate release of these funds to the States that would otherwise be sitting in a Disputed Payments Account until any NPM Adjustment disputes for 2018-2022 were resolved by arbitration many years in the future. No amounts were released in fiscal year 2022.

**NOTE 9            CONTINGENCIES**

TSFC's legal counsel asserts that there have been no material claims, suits, or complaints filed nor are any pending against the corporation. In the opinion of management, all other matters which are asserted or unasserted are without merit and would not have a significant effect on the financial position or changes in net assets if disposed of unfavorably.



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**NOTE 10      SUBSEQUENT EVENTS**

In preparing these financial statements, TSFC evaluated events and transactions for potential recognition through January 3, 2023, the date the financial statements were available to be issued. There were no additional events or transactions that were discovered during the evaluation that required further disclosure.

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**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON  
COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL  
STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING  
STANDARDS*.**

To the Mayor and Members of  
The Council of the Government of the District of Columbia, and  
The Board of Directors of the District of Columbia Tobacco Settlement Financing Corporation

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of District of Columbia Tobacco Settlement Financing Corporation ("TSFC"), as of and for the year ended September 30, 2022, and the related notes to the financial statements, which collectively comprise the TSFC's basic financial statements, and have issued our report thereon dated January 3, 2023.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered the TSFC's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the TSFC's internal control. Accordingly, we do not express an opinion on the effectiveness of the TSFC's internal control.

*A deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the TSFC's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

**Compliance and Other Matters**

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

### **Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the TSFC's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the TSFC's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

This report is intended solely for the information and use of the Trustees and management and is not intended to be and should not be used by anyone other than these specified parties.

Washington, D.C. *Watson Rice LLP*  
January 3, 2023

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