TOBACCO SETTLEMENT AUTHORITY

(A Component Unit of the State of Iowa)

Basic Financial Statements

June 30, 2004 and 2003

(With Independent Auditors' Report Thereon)

TOBACCO SETTLEMENT AUTHORITY
(A Component Unit of the State of Iowa)

Table of Contents

KPMG LLP
2500 Ruan Center
666 Grand Avenue
Des Moines, IA 50309

Independent Auditors' Report

The Board
Tobacco Settlement Authority:

We have audited the accompanying financial statements of the Tobacco Settlement Authority (the Authority), a component unit of the State of Iowa, as of and for the years ended June 30, 2004 and 2003, as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express opinions on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tobacco Settlement Authority as of June 30, 2004 and 2003, and the respective changes in financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As described in note 6, the Authority adopted on July 1, 2002, Governmental Accounting Standards Board (GASB) Technical Bulletin (TB) 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues.*

In accordance with *Government Auditing Standards,* we have also issued our report dated October 14, 2004 on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 2 through 5 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. 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.

KPMG LLP

Des Moines, Iowa
October 14, 2004

The Tobacco Settlement Authority (Authority) provides this Management's Discussion and Analysis of the Authority's annual financial statements. This narrative overview and analysis of the financial activities of the Authority is for the fiscal years ended June 30, 2004 and 2003. We encourage readers to consider this information in conjunction with the Authority's basic financial statements, which follow this section.

Using These Financial Statements

This discussion and analysis is intended to serve as an introduction to the Authority's basic financial statements, which consist of the statements of net assets (deficit), the statements of revenues, expenses, and changes in net assets (deficit), and the statements of cash flows (pages 6 through 8). These basic financial statements provide information about the activities of the Authority as a whole and include all assets and liabilities using the accrual basis of accounting, which is similar to the accounting used by most private-sector companies. They also include the notes to the financial statements, which explain some of the information in the basic financial statements in greater detail and are further described as follows:

The Statements of Net Assets (Deficit)

The statements of net assets (deficit) present all of the Authority's assets and liabilities, with the differences between the two reported as "net assets (deficit)." Over time, increases or decreases in the Authority's net assets may serve as a useful indicator of whether the financial position of the Authority is improving or deteriorating.

The Statements of Revenues, Expenses, and Changes in Net Assets (Deficit)

The statements of revenues, expenses, and changes in net assets (deficit) present information showing how the Authority's net assets (deficit) changed during the most recent fiscal year. All changes in net assets (deficit) are reported as soon as the event or change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in these statements for some items that will not result in cash flows until future fiscal periods.

The Statements of Cash Flows

The statements of cash flows report the net increase (or decrease) in cash and cash equivalents (highly liquid investments with a maturity of three months or less when purchased) for the fiscal year. These statements include cash flows from operating activities, cash flows from non-capital financing activities (such as issuance of or payments on bonds), and cash flows from investing activities. The resulting net increase (or decrease) in cash and cash equivalents is then added to the balance of cash and cash equivalents at the beginning of the year to determine the FY04 and FY03 ending cash and cash equivalents balance.

Notes to the Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements. The notes to the financial statements can be found beginning on page 9.

Financial Analysis of the Authority

The principal activity of the Authority was the sale of approximately $644 million of bonds at a discount, providing approximately $630 million of proceeds and the initial distribution of approximately $579 million of the proceeds to the State of Iowa (State), after providing for payment of issuance costs and establishment of reserve funds required by the bond resolutions. In return for distribution to the State, the Authority will receive 78% of the payments the State is entitled to under the Master Settlement Agreement signed in 1998 between 46 states and the four major tobacco industry manufacturers to be used to repay the bonds issued.

The Authority's financial activity resulted in negative net assets of approximately $535 million and $540 million at June 30, 2004 and 2003, respectively. The negative net assets result from the Authority recording a liability, in accordance with accounting principles generally accepted in the United States of America, for the entire amount of outstanding bonds, which are payable only from proceeds from the Master Settlement Agreement, while being precluded by those same principles from recording anticipated receipt of those proceeds. However, by purchasing the bonds, the buyers of the Authority's bonds demonstrated their belief that those proceeds will be realized by the Authority and will be used to repay the bonds. If the Authority does not realize sufficient proceeds, not all bonds will be repaid.

(Continued)

Condensed financial information as of and for the years ended June 30, 2004, 2003, and 2002 is as follows:

	2004	2003	2002
Net assets:			
Current assets	$ 17,496,384	21,370,201	17,766,961
Noncurrent assets	78,724,440	70,723,052	80,089,166
Total assets	96,220,824	92,093,253	97,856,127
Current liabilities	3,681,294	3,328,305	4,290,312
Noncurrent liabilities	627,899,434	628,547,359	629,028,159
Total liabilities	631,580,728	631,875,664	633,318,471
Net assets (deficit)	(535,359,904)	(539,782,411)	(535,462,344)
Total net assets (deficit)	$ (535,359,904)	(539,782,411)	(535,462,344)
Operating revenue:			
Tobacco settlement revenues	$ 38,642,388	53,508,749	66,980,252
Operating expenses:			
Distributions to the State of Iowa	—	(23,959,250)	(579,396,212)
Operating expenses	(106,656)	(104,865)	(101,179)
Enforcement expenses	(305,535)	—	—
Total operating expenses	(412,191)	(24,064,115)	(579,497,391)
Operating income (loss)	38,230,197	29,444,634	(512,517,139)
Nonoperating expenses, net	(33,807,690)	(33,764,701)	(22,945,205)
Change in net assets (deficit)	4,422,507	(4,320,067)	(535,462,344)
Net assets (deficit) beginning of year, as restated	(539,782,411)	(535,462,344)	—
Net assets (deficit) end of year	$ (535,359,904)	(539,782,411)	(535,462,344)

Net Assets

The Authority's net assets increased approximately $4.4 million during fiscal year 2004 due to the following:

(a) Tobacco settlement collections decreased approximately $15 million during the year. The MSA sets forth the schedule and calculation of payments to be made by the tobacco industry manufacturers to the states. However, these payments are subject to various adjustments and offsets, some of which could be material.

In addition, due to the implementation of Governmental Accounting Standards Board (GASB) Technical Bulletin 2004-1, a receivable was recorded for estimated MSA payments. The estimated receivable for June 30, 2004 is approximately $4.3 million less than the balance at June 30, 2003. See note 6 to the financial statements for more information.

(b) The Authority did not distribute any excess tobacco settlement collections to the State of Iowa during the year ended June 30, 2004, whereas approximately $24 million was distributed during the year ended June 30, 2003. In June 2003, there was a significant downgrade in the Moody/S&P rating of one of the tobacco industry manufacturers participating in the MSA. As a result, the indenture trustee established an additional account, the Trapping Account, into which pledged MSA payments were deposited. As a result, no funds were available for transfer to the State.

(c) Cash and investments increased approximately $8 million due to the Authority holding tobacco settlement collections in the Trapping Account at June 30, 2004, as required by the bond indenture.

In fiscal year 2003, the Authority's net assets decreased by $4.3 million. The decrease was a result of the following:

(a) Investment income increased approximately $1 million.

(b) The distribution to the State of Iowa in the prior year consisted of the bond proceeds received by the Authority, whereas the distribution in the current fiscal year consisted of excess tobacco settlement collections that were not needed for the Authority's current year expenses or debt payments.

(c) Interest expense on the bonds increased approximately $12 million from the prior year.

(d) A Master Settlement Agreement receivable was recorded as a result of the Authority's adoption of GASB Technical Bulletin 2004-1. The estimated receivable for June 30, 2003 is approximately $3.7 million more than the balance at June 30, 2002.

Long-Term Debt

At June 30, 2004 and 2003, the Authority had $640,950,000 and $642,275,000, respectively, in tobacco settlement asset-backed bonds outstanding. More detailed information about the Authority's debt is presented in note 3 to the financial statements.

Known Facts

During June 2003, there was a significant downgrade in the Moody/S&P rating of one of the tobacco manufacturers participating in the MSA. As a result, the indenture trustee established an additional reserve account, the trapping account, into which pledged MSA payments (that otherwise would have been released from the lien of the bond indenture) will be deposited to the extent required by the bond indenture.

Contacting the Tobacco Settlement Authority Financial Management

This financial report is designed to present users with a general overview of the Authority's finances and to demonstrate the Authority's accountability for the funds generated. If you have any questions about the report or need additional financial information, please contact the Office of the State Treasurer, State Capitol Building, Des Moines, IA 50319.

TOBACCO SETTLEMENT AUTHORITY
(A Component Unit of the State of Iowa)

Statements of Net Assets (Deficit)

June 30, 2004 and 2003

Assets	**2004**	**2003**
Current assets:		
Cash on deposit with Treasurer of State	$ 259,173	—
Accounts receivable	60,337	—
Master settlement agreement receivable	16,802,110	21,083,664
Interest receivable	307,577	219,350
Deferred charges	67,187	67,187
Total current assets	17,496,384	21,370,201
Noncurrent assets:		
Restricted assets:		
Cash and cash equivalents	1,407,072	21,087,549
Investments	75,884,414	48,135,362
Deferred charges	1,432,954	1,500,141
Total assets	96,220,824	92,093,253
Liabilities		
Current liabilities:		
Accounts payable	193,032	—
Bonds payable, current portion	647,925	480,800
Accrued interest payable	2,840,337	2,847,505
Total current liabilities	3,681,294	3,328,305
Noncurrent liabilities:		
Bonds payable, net of current portion	627,899,434	628,547,359
Total liabilities	631,580,728	631,875,664
Net assets (deficit), as restated	$ (535,359,904)	(539,782,411)

See accompanying notes to financial statements.

TOBACCO SETTLEMENT AUTHORITY
(A Component Unit of the State of Iowa)

Statements of Revenues, Expenses, and Changes in Net Assets (Deficit)

Years ended June 30, 2004 and 2003

	2004	2003
Operating revenues:		
Tobacco settlement revenues	$ 38,642,388	53,508,749
Operating expenses:		
Distribution to the State of Iowa	—	(23,959,250)
Operating expenses	(106,656)	(104,865)
Enforcement expenses	(305,535)	—
Total operating expenses	(412,191)	(24,064,115)
Operating income	38,230,197	29,444,634
Nonoperating revenues (expenses):		
Interest income	2,837,626	3,007,842
Amortization of bond issuance costs	(67,187)	(60,980)
Interest expense	(36,578,129)	(36,711,563)
Total nonoperating expenses, net	(33,807,690)	(33,764,701)
Change in net assets (deficit)	4,422,507	(4,320,067)
Net assets (deficit) beginning of year, as restated	(539,782,411)	(535,462,344)
Net assets (deficit) end of year	$ (535,359,904)	(539,782,411)

See accompanying notes to financial statements.

TOBACCO SETTLEMENT AUTHORITY
(A Component Unit of the State of Iowa)

Statements of Cash Flows

June 30, 2004 and 2003

		2004	2003
Cash flows from operating activities:			
Cash received from tobacco settlement agreement	$	42,863,604	49,772,130
Distribution to the State of Iowa		—	(23,959,250)
Cash payments to suppliers		(219,158)	(104,865)
Net cash provided by operating activities		42,644,446	25,708,015
Cash flows from noncapital financing activities:			
Principal payment on bonds		(1,325,000)	(1,970,000)
Payment of bond issuance costs		—	(78,634)
Payment of interest on bonds		(35,741,097)	(35,874,860)
Net cash used in noncapital financing activities		(37,066,097)	(37,923,494)
Cash flows from investing activities:			
Purchases of investments		(132,590,907)	(108,437,404)
Sale/maturities of investments		104,841,854	138,245,560
Interest received on investments		2,749,400	3,033,164
Net cash (used in) provided by investing activities		(24,999,653)	32,841,320
(Decrease) increase in cash and cash equivalents		(19,421,304)	20,625,841
Cash and cash equivalents, beginning of year		21,087,549	461,708
Cash and cash equivalents, end of year	$	1,666,245	21,087,549
Reconciliation of operating income to net cash provided by operating activities:			
Operating income	$	38,230,197	29,444,634
Adjustments to reconcile operating income to net cash provided by operating activities:			
Decrease (increase) in receivables		4,221,217	(3,736,619)
Increase in payables		193,032	—
Net cash provided by operating activities	$	42,644,446	25,708,015

See accompanying notes to financial statements.

(1) Summary of Significant Accounting Policies and Related Matters

Organization

The Tobacco Settlement Authority (the Authority) was authorized by the provisions of Chapter 12E of the Code of Iowa on May 19, 2000. The purposes of the Authority include: (a) to implement and administer a program plan and to establish a stable source of revenue to be used for purposes designated in Chapter 12.65 of the Code of Iowa, (b) to enter into sales agreements, (c) to issue bonds and enter into funding options including refunding and refinancing its debt and obligations, (d) to sell, pledge, or assign, as security, all or a portion of the State's share, to provide for and secure the issuance of its bonds, (e) to invest funds available to provide for a source of revenue in accordance with the program plan, (f) to enter into agreements with the State for the periodic distribution of amounts due the State under any sales agreement, (g) to refund and refinance the Authority's debts and obligations, and to manage its funds, obligations, and investments as necessary, (h) to sell, pledge, or assign, as security or consideration, all or a portion of the State's share to implement alternative funding options, and (i) to implement the purposes of Chapter 12E of the Code of Iowa.

Reporting Entity

The Authority is a component unit of the State of Iowa (State). The financial statements of the Authority are included in the State's comprehensive annual financial report.

For financial reporting purposes, the Authority has included all funds, organizations, agencies, boards, commissions, and authorities. The Authority has also considered all potential component units for which it is financially accountable, and other organizations for which the nature and significance of their relationship with the Authority are such that exclusion would cause the Authority's financial statements to be misleading or incomplete. The Governmental Accounting Standards Board (GASB) has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body, and (1) the ability of the Authority to impose its will on that organization or (2) the potential for the organization to provide specific benefits to, or impose specific financial burdens on the Authority. The Authority has no component units which meet the GASB criteria.

Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The Authority is accounted for 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.

In reporting the financial activity of the Authority, the Authority applies all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989 unless these pronouncements conflict with or contradict GASB pronouncements: *Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure.*

For financial statement purposes, the Authority is treated as an enterprise fund, a proprietary fund type. Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations, which includes the monetization of the State's future tobacco settlement payments. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

The Authority's board consists of the Treasurer of State, Auditor of State, and the Director of the Department of Management of the State.

Master Settlement Agreement

On November 23, 1998, a Master Settlement Agreement (MSA) was entered into between 46 states (including the state of Iowa) and the four major tobacco industry manufacturers. The MSA represents the resolution of a large potential financial liability of the tobacco industry manufacturers for smoking-related injuries. The forty-six states agreed to settle all past, present, and future smoking-related claims against the tobacco industry manufacturers in exchange for agreements and undertakings by the tobacco industry manufacturers concerning a number of issues.

The MSA sets forth the schedule and calculation of payments to be made by the tobacco industry manufacturers to the states. These payments are subject to various adjustments and offsets. Payments to be received under the MSA include:

(a) five initial payments, the last of which is due January 10, 2003;

(b) annual payments which are required to be made on April 15 of each year and will continue in perpetuity; and

(c) ten strategic contribution fund payments which are required to be made annually on April 15 beginning April 15, 2008 through April 15, 2017.

Program Plan

Chapter 12E.10 of the Code of Iowa directs the Authority to establish a Tobacco Settlement Program Plan (Program Plan) to provide the State with a secure and stable source of revenue for the purposes designated in Chapter 12.65 of the Code of Iowa. These purposes relate to healthcare, substance abuse treatment and enforcement, tobacco use prevention and control, and other purposes related to the needs of children, adults, and families in the State and to create a savings account for healthy Iowans invested to provide an ongoing source of investment earnings.

The Program Plan was submitted to the Legislative and Executive Council of the State. Implementation of the Program Plan was authorized by a constitutional majority of each house of the General Assembly and approved by the Governor of the State.

(Continued)

Sales Agreement

Upon approval of the Program Plan, the State and the Authority entered into a sales agreement in which the State agreed to sell to the Authority all of its right, title, and interest in certain amounts payable to the State under the MSA. In return, the Authority agreed to issue tobacco settlement bonds and remit the net bond proceeds to the State.

Tobacco Settlement Asset-Backed Bonds, Series 2001

The Authority issued Tobacco Settlement Asset-Backed Bonds, Series 2001 (Series 2001 Bonds), dated October 1, 2001, in the amount of $644,245,000. The Series 2001 Bonds are special revenue obligations of the Authority secured by, and payable solely and only out of, the monies, assets, or revenues pledged by the Authority pursuant to the indenture, are not a general obligation or general indebtedness of the Authority, and do not constitute an obligation or indebtedness of the State or any political subdivision of the State.

The financial statements of the Authority have been prepared in conformity with accounting principles generally accepted in the United States of America as applied to governmental units. The more significant of the Authority's accounting policies are described below.

Significant Accounting Policies

Cash Equivalents

For purposes of the statements of cash flows, all highly liquid investments with a maturity of three months or less when purchased are considered to be cash equivalents. Investments not meeting the definition of cash equivalents at June 30, 2004 include U.S. Government securities and a corporate note totaling $75,884,414 and at June 30, 2003 a guaranteed investment contract totaling $48,135,362.

Investments

Investments in debt and equity securities are recorded at fair value in the statements of net assets (deficit) with the change in fair value of investments recorded in the statements of revenues, expenses, and changes in net assets (deficit).

Deferred Charges

Deferred charges represent bond issuance costs which are deferred and amortized as an adjustment to interest expense over the life of the related bond issue using the straight-line method.

Bond Discounts

Bond discounts are deferred and amortized as an adjustment to interest expense over the life of the related bond issue using the effective interest method.

(Continued)

Revenue Recognition

Future tobacco settlement collections are contingent upon future tobacco products sales subject to various adjustments as outlined in the MSA. The Authority recognizes revenue from tobacco settlement collections as the collections are received by the Authority. In addition, an estimated receivable (Master Settlement Agreement receivable) is accrued at year-end for estimated product sales occurring from January 1 through June 30 of each year.

Use of Estimates

Management of the Authority has made a number of estimates and assumptions relating to the reporting of assets, liabilities, revenues, and expenses and the disclosure of contingent assets or liabilities to prepare these financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from those estimates.

(2) Cash, Cash Equivalents, and Investments

At June 30, 2004 and 2003, the Authority's bank balances of $2,658 and $1,174, respectively, are covered by federal depository insurance. Cash balances of $259,173 and $0, respectively, are held by the State in pooled money funds at June 30, 2004 and 2003, respectively. Cash equivalents at June 30, 2004 and 2003 includes $1,404,414 and $1,869,763, respectively, invested in open-end mutual funds and $0 and $19,216,612, respectively, invested in commercial paper. At June 30, 2004, investments included $17,891,710 in a U.S. Government security which matures on October 20, 2004, $48,135,135 in a corporate note which matures on December 1, 2004, and $9,857,569 in a U.S. Government security which matures on April 7, 2005. At June 30, 2003, investments included a guaranteed investment contract of $48,135,362 which matured on December 1, 2003.

Under bond resolutions of the Official Statement of the Tobacco Settlement Asset-Backed Bonds, Series 2001, the Authority is authorized to invest in defeasance collateral; non-callable senior debt obligations of U.S. Government-sponsored agencies that are not backed by the full faith and credit of the U.S. Government; demand and time deposits in or certificates of, or banker's acceptances issued by, any bank or trust company, savings and loan association, or savings bank; municipal obligations of any state of the United States or the State or any political subdivision thereof; commercial or finance company paper; repurchase obligations; securities bearing interest or sold at a discount issued by any corporation incorporated under the laws of the United States or any state, municipality, or political subdivision thereof; units of taxable money market funds; investment agreements, forward delivery agreements, or guaranteed investment contracts rated, or with any financial institution or corporation; and other obligations, securities, agreements, or contracts that are non-callable and are acceptable to each nationally recognized rating service agency.

The Authority's investments are categorized to give an indication of the level of custodial risk assumed by the Authority at year-end. Category I includes investments that are insured or registered for which the securities are held by the Authority or its agent in the Authority's name. Category II includes uninsured or unregistered investments for which the securities are held by the Authority. Category III includes uninsured and unregistered investments for which the securities are held by a counterparty or by its trust department or agent, but not in the Authority's name. At June 30, 2004, the Authority's investments in

(Continued)

U.S. Government securities and a corporate note, totaling $27,749,279 and $48,135,135, respectively, are classified as Category I risk. At June 30, 2003, the Authority's investments in a guaranteed investment contract and commercial paper, totaling $48,135,362 and $19,216,612, respectively, were classified as Category I risk.

(3) Bonds Payable

The Tobacco Settlement Asset-Backed Bonds were issued in two series: the Series 2001 A Bonds in the principal amount of $40,000,000, which are federally taxable, and the Series 2001 B Bonds in the principal amount of $604,245,000, which are federally tax-exempt.

The bonds bear interest at rates ranging from 5.30% to 6.79% and mature in varying annual amounts ranging from $1,490,000 to $71,340,000 with the final (Super Sinker Redemption) maturities due in the year ending June 30, 2027. The balance outstanding on June 30, 2004 and 2003 was $628,547,359 ($640,950,000 net of unamortized bond discount of $12,402,641) and $629,028,159 ($642,275,000 net of unamortized bond discount of $13,246,841), respectively.

The bond documents include the following provisions:

(a) The Series 2001 Bonds are special revenue obligations of the Authority secured by, and payable solely and only out of, the monies, assets, or revenues pledged by the Authority pursuant to the Indenture. The bonds are not a general obligation or general indebtedness of the Authority, and do not constitute an obligation or indebtedness of the State or any political subdivision of the State. The Authority may not pledge the credit or taxing power of the State or any political subdivision of the State, or create a debt or obligation of the State. The Authority has no taxing power. The Series 2001 Bonds constitute neither a general, legal, or moral obligation of the State or any of its political subdivisions and the State has no obligation or intention to satisfy any deficiency or default of any payment of the bonds.

(b) The bonds are secured by and are payable solely from (i) 78% of the future amounts to be received under the MSA, (ii) investment earnings on certain accounts pledged under the bond indenture, (iii) amounts held in the debt service reserve account and the trapping account established under the bond indenture, (iv) amounts held in other accounts established under the bond indenture, and (v) certain rights of the Authority as specified in the sales agreement.

(c) The proceeds of the Series 2001 Bonds, except as deposited in the debt service reserve account, are not pledged to the payment of, and therefore not available to, the holders of the Series 2001 bonds.

(d) A bond fund is established with the bond indenture trustee and money will be deposited in the fund as provided in the bond indenture. The money will be held in trust and, except as otherwise provided in the bond indenture, will be applied solely to the payment of debt service. The bond fund includes: the debt service account, the debt service reserve account, the trapping account, the extraordinary prepayment account, and such other accounts as deemed necessary.

(e) The debt service reserve account was funded from bond proceeds in the amount of $48,135,624. The account will be available to pay (i) the principal and interest on the bonds to the extent that collections under the MSA are insufficient and (ii) after an event of default, extraordinary prepayments. Upon the occurrence of an event of default, the outstanding bonds will be prepaid pro-rata among all outstanding bonds, and other unpaid amounts due on the bonds will be paid from available funds.

(f) An additional reserve account, the trapping account, is to be established and held by the Indenture Trustee and funded to the trapping requirement during the existence of a trapping event. A trapping event occurs in any calendar year preceding a deposit date when: (i) the shipment of cigarettes in or around the 50 states is less than the amount as measured under the MSA, (ii) there is a significant downgrade in the Moody or S&P rating of one of the tobacco manufacturers participating in the MSA, or (iii) the market share of one of the tobacco manufacturers who are not participating in the MSA exceeds 7%. Following the occurrence of a trapping event, pledged MSA payments that otherwise would have been released from the lien of the bond indenture will be deposited in the trapping account to the extent required by the bond indenture and will be available to pay interest, extraordinary prepayments, principal, and Super Sinker Redemptions.

(g) If an event of default has occurred, collections remaining after the payment of certain expenses and all current and past due interest on bonds will be deposited in the extraordinary prepayment account and will be applied, together with amounts in the trapping account and the debt service reserve account, to extraordinary prepayments of the bonds on each succeeding distribution date.

Annual debt service requirements to maturity for the bonds are as follows:

Year ending	Series 2001 A Term Bonds (1)			Series 2001 B Serial Maturities (2)			Series 2001 B Term Bonds(1)			Series 2001 B Term Bonds(1)			Total	
June 30,	**SSR**	**Int. Rate**	**Interest**	**Principal**	**Int. Rate**	**Interest**	**SSR**	**Int. Rate**	**Interest**	**SSR**	**Int. Rate**	**Interest**	**SSR/Principal**	**Interest**
2005	$ 1,490,000	6.79%	$ 2,492,269	—	—	$ 3,372,050	—	—	$ 10,910,050	—	—	$ 18,876,760	1,490,000	35,651,129
2006	2,050,000	6.79%	2,391,099	—	—	3,372,050	—	—	10,910,050	—	—	18,876,760	2,050,000	35,549,959
2007	3,285,000	6.79%	2,251,903	—	—	3,372,050	—	—	10,910,050	—	—	18,876,760	3,285,000	35,410,763
2008	17,315,000	6.79%	2,028,852	—	—	3,372,050	—	—	10,910,050	—	—	18,876,760	17,315,000	35,187,712
2009	12,565,000	6.79%	853,164	—	—	3,372,050	8,410,000	5.30%	10,910,050	—	—	18,876,760	20,975,000	34,012,024
2010 – 2014	—	—	—	61,310,000	5.50%	11,940,500	77,145,000	5.30%	43,540,560	—	—	94,383,800	138,455,000	149,864,860
2015 – 2019	—	—	—	—	—	—	120,295,000	5.30%	13,937,940	18,680,000	5.60%	94,383,800	138,975,000	108,321,740
2020 – 2024	—	—	—	—	—	—	—	—	—	163,740,000	5.60%	72,028,600	163,740,000	72,028,600
2025 – 2027	—	—	—	—	—	—	—	—	—	154,665,000	5.60%	19,066,600	154,665,000	19,066,600
	$ 36,705,000		$ 10,017,287	61,310,000		$ 28,800,750	205,850,000		$ 112,028,750	337,085,000		$ 374,246,600	640,950,000	525,093,387

(1) The "Super Sinker Redemption" of the term bonds represents the amount that the Authority has agreed to pay, to the extent of available collections. The debt service reserve account will not be available to make Super Sinker Redemption payments. To the extent that Super Sinker Redemption payments are made, they will be credited against the respective rated maturities. Failure to make a Super Sinker Redemption payment will not constitute an event of default.

If the Authority is able to make payments on the term bonds in accordance with the schedules of Super Sinker Redemptions, the average life of the term bonds will be significantly shorter than if paid on their respective maturity dates. If the Authority is unable to make payments on term bonds in accordance with the schedule of Super Sinker Redemptions, the term bonds remain outstanding until their respective maturity dates without triggering an event of default.

The rated maturity amounts and maturity dates are as follows:

	Rated maturity amount	Maturity date
Series 2001 A Term Bonds	$ 40,000,000	June 1, 2010
Series 2001 B Term Bonds	205,850,000	June 1, 2025
Series 2001 B Term Bonds	337,085,000	June 1, 2035

To avoid triggering an event of default, at least $40,000,000 must be paid by June 1, 2010, an additional $205,850,000 by June 1, 2025, and an additional $337,085,000 by June 1, 2035.

(2) The "Serial Maturities" of the Series 2001 bond must be paid on the stated maturity date in order to avoid an event of default.

The following summarizes the bond payable activity for the Authority for the years ended June 30, 2004 and 2003:

	2004	2003
Bonds payable, net of bond discount beginning of year	$ 629,028,159	630,150,799
Principal payment on bonds	(1,325,000)	(1,970,000)
Accretion of bond discount	844,200	847,360
Bonds payable, net of bond discount end of year	$ 628,547,359	629,028,159

(4) Deficit Net Asset Balance

The payments to be received under the MSA represent a share of anticipated future sales of tobacco products. Although the Authority expects to receive certain amounts under the MSA, the collections are not assured.

Under accounting principles generally accepted in the United States of America, such contingent amounts cannot be recognized as a receivable or revenue. Accordingly, the Authority is reporting a restricted net asset (deficit) balance of $535,359,904 and $539,782,411 at June 30, 2004 and 2003, respectively.

(5) Trapping Event

In June 2003, there was a significant downgrade in the Moody/S&P rating of one of the tobacco industry manufacturers participating in the MSA (known as a downgrade trapping event). As a result, the Indenture Trustee established an additional reserve account, the trapping account, into which pledged MSA payments that otherwise would have been released from the lien of the bond indenture were deposited.

According to the indenture, the downgrade trapping requirement means that up to 25% of the principal amount of outstanding bonds will be deposited into the trapping account until one year after the end of a downgrade trapping event.

The cash and investments balance in the trapping account at June 30, 2004 and 2003 was $10,007,023 and $0, respectively.

(6) Accounting Change

GASB Technical Bulletin No. 2004-1 (Bulletin), Tobacco Settlement Recognition and Financial Reporting Entity Issues, was issued April 2004 and was adopted by the Authority on July 1, 2002.

The Bulletin provides guidance regarding the recognition of an asset and related revenue for future MSA payments. Annual tobacco settlement revenues (TSR) payments are based on cigarette sales from the preceding calendar year. Accordingly, governments are required to estimate accrued TSRs derived from sales from January 1 to their respective fiscal year-ends. The financial statements of all prior periods presented are restated for this accounting change.

The effect of GASB Technical Bulletin No. 2004-1 is as follows:

Net assets (deficit) June 30, 2002, as previously reported	$	(552,809,389)
Accounting change		17,347,045
Net assets (deficit) July 1, 2002, as restated	$	(535,462,344)