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

Basic Financial Statements

June 30, 2007 and 2006

(With Independent Auditors' Report Thereon)

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

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KPMG LLP
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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, 2007 and 2006, 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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, 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, 2007 and 2006, and the respective changes in financial position and cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 3, 2007 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 3 through 6 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. 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

December 3, 2007

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, 2007 and 2006. 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 7 through 9). 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 (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 noncapital 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 fiscal years 2007 and 2006 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 10.

Financial Analysis of the Authority

In 2001, the Authority issued 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 2005, the Authority authorized the issuance of bonds to advance refund the Series 2001 bonds and provide additional proceeds to the State. Approximately, $153.5 million were distributed to the State as a result of the debt restructuring. In return for distributions 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 Series 2005 bonds.

The Authority's financial activity resulted in negative net assets of approximately $675 million and $676 million at June 30, 2007 and 2006, respectively. The negative net assets result from the Authority recording a liability, in accordance with U.S. generally accepted accounting principles, 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, 2007, 2006, and 2005 is as follows:

		2007	2006	2005
Assets:				
Current assets	$	30,033,926	21,836,418	18,281,718
Noncurrent assets		81,480,690	81,450,964	87,545,798
Total assets		111,514,616	103,287,382	105,827,516
Current liabilities		31,474,623	17,703,845	4,231,854
Noncurrent liabilities		755,295,505	761,662,078	626,689,120
Total liabilities		786,770,128	779,365,923	630,920,974
Unrestricted net assets (deficit)	$	(675,255,512)	(676,078,541)	(525,093,458)
Operating revenues:				
Tobacco settlement revenues	$	49,700,938	40,154,165	44,011,224
Miscellaneous income		14,316	281,159	—
Total operating revenues		49,715,254	40,435,324	44,011,224
Operating expenses:				
Administrative expenses		95,682	60,260	54,181
Enforcement expenses		650,588	519,491	315,433
Total operating expenses		746,270	579,751	369,614
Operating income		48,968,984	39,855,573	43,641,610
Nonoperating expenses, net		(48,145,955)	(190,840,656)	(33,375,164)
Change in net assets (deficit)		823,029	(150,985,083)	10,266,446
Net assets (deficit) beginning of year		(676,078,541)	(525,093,458)	(535,359,904)
Net assets (deficit) end of year	$	(675,255,512)	(676,078,541)	(525,093,458)

Net Assets

The Authority's net assets did not change significantly during fiscal year 2007.

The Authority's net assets decreased approximately $151 million during fiscal year 2006 due to the bond restructuring and related transfer to the State.

Long-Term Debt

At June 30, 2007 and 2006, the Authority had $783,441,111 and $775,785,321, 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.

(Continued)

Known Facts

On March 16, 2007, Governor Chet Culver signed a bill that raised Iowa's state excise tax on tobacco from $0.36 to $1.36 per pack. The dollar increase moved Iowa's cigarette tax from the 42nd highest in the country to the 17th highest.

The Authority has covenanted to apply all surplus collections, if any, to the turbo redemption of Series 2005 bonds. Turbo redemptions paid during the fiscal year 2007 totaled $6,755,000.

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, 2007 and 2006

Assets	**2007**	**2006**
Current assets:		
Cash on deposit with Treasurer of State	$ 3,940,243	3,381,097
Accounts receivable	14,316	4,500
Master settlement agreement receivable	25,676,919	17,859,536
Interest receivable	235,825	424,662
Deferred charges	166,623	166,623
Total current assets	30,033,926	21,836,418
Noncurrent assets:		
Restricted assets:		
Cash and cash equivalents	19,115,929	281,307
Investments	59,198,916	77,837,189
Deferred charges	3,165,845	3,332,468
Total assets	111,514,616	103,287,382
Liabilities		
Current liabilities:		
Accounts payable	273,001	144,819
Deferred revenue	—	343,177
Bonds payable, current portion	28,145,606	14,123,243
Accrued interest payable	3,056,016	3,092,606
Total current liabilities	31,474,623	17,703,845
Noncurrent liabilities:		
Bonds payable, net of current portion	755,295,505	761,662,078
Total liabilities	786,770,128	779,365,923
Net Assets		
Unrestricted net assets (deficit)	$ (675,255,512)	(676,078,541)

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, 2007 and 2006

	2007	2006
Operating revenues:		
Tobacco settlement revenues	$ 49,700,938	40,154,165
Miscellaneous income	14,316	281,159
Total operating revenues	49,715,254	40,435,324
Operating expenses:		
Administrative expenses	95,682	60,260
Enforcement expenses	650,588	519,491
Total operating expenses	746,270	579,751
Operating income	48,968,984	39,855,573
Nonoperating revenues (expenses):		
Distributions to the State of Iowa	—	(151,363,457)
Interest income	3,506,137	4,788,788
Amortization of bond issuance costs	(166,623)	(83,312)
Interest expense	(51,485,469)	(44,182,675)
Total nonoperating expenses, net	(48,145,955)	(190,840,656)
Changes in net assets (deficit)	823,029	(150,985,083)
Net assets (deficit) beginning of year	(676,078,541)	(525,093,458)
Net assets (deficit) end of year	$ (675,255,512)	(676,078,541)

See accompanying notes to financial statements.

TOBACCO SETTLEMENT AUTHORITY
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Statements of Cash Flows

Years ended June 30, 2007 and 2006

		2007	2006
Cash flows from operating activities:			
Cash received from tobacco settlement agreement	$	41,540,378	39,687,098
Miscellaneous receipts		4,500	808,789
Cash payments to suppliers		(618,088)	(624,195)
Net cash provided by operating activities		40,926,790	39,871,692
Cash flows from noncapital financing activities:			
Distributions to the State of Iowa		—	(151,363,457)
Proceeds from issuance of bonds		—	809,880,632
Principal payment on bonds		(6,755,000)	(669,399,892)
Payment of interest on bonds		(37,111,269)	(36,517,199)
Payment of bond issuance costs		—	(2,149,449)
Net cash used in noncapital financing activities		(43,866,269)	(49,549,365)
Cash flows from investing activities:			
Purchases of investments		(79,177,233)	(254,223,409)
Sales/maturities of investments		97,815,506	262,499,506
Interest received on investments		3,694,974	4,829,763
Net cash used in investing activities		22,333,247	13,105,860
Increase in cash and cash equivalents		19,393,768	3,428,187
Cash and cash equivalents, beginning of year		3,662,404	234,217
Cash and cash equivalents, end of year	$	23,056,172	3,662,404
Reconciliation of operating income to net cash provided by operating activities:			
Operating income	$	48,968,984	39,855,573
Adjustments to reconcile operating income to net cash provided by operating activities:			
Increase in receivables		(7,827,199)	(282,614)
(Decrease) increase in accounts payable and deferred revenue		(214,995)	298,733
Net cash provided by operating activities	$	40,926,790	39,871,692

See accompanying notes to financial statements.

(1) Summary of Significant Accounting Policies and Related Matters

(a) 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 of Iowa's (State) 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.

(b) Reporting Entity

The Authority is a component unit of the State of Iowa. 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 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.

(c) 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.

(Continued)

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.

(d) Master Settlement Agreement

On November 23, 1998, a Master Settlement Agreement (MSA) was entered into between forty-six 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 was paid in January 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.

(e) 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.

(f) 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.

(g) Tobacco Settlement Asset-Backed Bonds, Series 2001

The Authority issued Tobacco Settlement Asset-Backed Bonds, Series 2001 (Series 2001 Bonds), dated October 25, 2001, in the amount of $644,245,000. The Series 2001 Bonds were advance refunded from the proceeds of the Tobacco Settlement Asset-Backed Bonds, Series 2005 issued November 30, 2005.

(h) Tobacco Settlement Asset-Backed Refunding Bonds, Series 2005

The Authority issued Tobacco Settlement Asset-Backed Bonds, Series 2005 (Series 2005 Bonds), dated November 30, 2005, in the amount of $831,962,030. The Series 2005 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 Series 2005 Bonds contain turbo redemption features, which require that all tobacco revenue collections in excess of operating expenditures and scheduled debt service be applied to the redemption of the bonds. The turbo redemptions are not scheduled amortization payments and are to be made only from surplus collections, if any. Failure to make a turbo principal payment will not constitute default.

(i) Significant Accounting Policies

The financial statements of the Authority have been prepared in conformity with U.S. generally accepted accounting principles, as applied to government units. The more significant of the Authority’s accounting policies are described below.

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, 2007 include a guaranteed investment contract totaling $59,198,916 and at June 30, 2006 include corporate notes and a guaranteed investment contract totaling $77,837,189.

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). Investments in guaranteed investment contracts are reported at contract value.

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.

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 U.S. generally accepted accounting principles. Actual results could differ from those estimates.

(2) Deposits and Investments

At June 30, 2007 and 2006, the Authority's bank balances of $0 and $0 respectively, were covered by federal depository insurance or by the State Sinking Fund in accordance with Chapter 12C of the Code of Iowa. Cash balances of $3,940,243 and $3,381,097, respectively, were held by the State in pooled money funds. Cash equivalents at June 30, 2007 and 2006 included $19,115,929 and $281,307, respectively, invested in open-end mutual funds. Investments are as follows for the year ended June 30, 2007:

		Investment maturities (in years)			
Investment type	**Fair value**	**Less than 1**	**1 – 2**	**3 – 5**	**Concentration**
State Treasurer Investment Pool	$ 3,940,243	3,940,243	—	—	6%
Guaranteed investment contract: Security Benefit Life Insurance Co.	59,198,916	—	—	59,198,916	94
	$ 63,139,159	3,940,243	—	59,198,916	100%

Investments are as follows for the year ended June 30, 2006:

Investment type		Fair value	Investment maturities (in years): Less than 1	1 – 2	3 – 5	Concentration
Debt securities:						
PB Financial Services Corp.	$	18,638,273	18,638,273	—	—	23%
State Treasurer’s investment pool		3,381,097	3,381,097	—	—	4
Guaranteed investment contract:						
Security Benefit Life Insurance Co.		59,198,916	—	—	59,198,916	73
	$	81,218,286	22,019,370	—	59,198,916	100%

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

Credit Risk: Under bond resolutions of the Official Statement of the Tobacco Settlement Asset-Backed Bonds, Series 2005, the Authority is authorized to invest in defeasance collateral; noncallable 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; other obligations, securities, agreements or contracts that are noncallable and are acceptable to each nationally recognized rating service agency.

As of June 30, 2007 and 2006, the Authority’s investment in Security Benefit Life Insurance Co. guaranteed investment contract is not subject to credit risk categorization. As of June 30, 2006, the Authority’s investment in PB Financial Services Corp. commercial paper was rated A1 by Standard & Poor’s and P-1 by Moody’s Investors Service.

Concentration of Credit Risk: The Authority places no limit on the amount that may be invested in any one issuer. Concentration percentages by investment type are included in the above table.

Custodial Credit Risk: The Authority’s deposits in financial institutions were covered by the Federal Deposit Insurance Corporation, or by the State Sinking Fund in accordance with Chapter 12C of the Code of Iowa. The Authority’s investments are all held by the State of Iowa or held by the State of Iowa’s agent in the name of the Authority.

(3) Bonds Payable

The Tobacco Settlement Asset-Backed Bonds were issued in five series: the Series 2005 A Bonds in the principal amount of $222,910,000, which are federally taxable turbo term bonds, the Series 2005 B Bonds in the principal amount of $159,368,793, which are federally tax-exempt turbo convertible capital appreciation bonds, the Series 2005 C Bonds in the principal amount of $412,725,000, which are federally tax-exempt turbo term bonds, the Series 2005 D Bonds in the principal amount of $15,775,344, which are federally tax-exempt turbo convertible capital appreciation bonds payable only when no current interest bond or convertible capital appreciation bond remains outstanding, and the Series 2005 E Bonds, which are federally tax-exempt turbo convertible capital appreciation bonds, in the principal amount of $21,182,893, which are federally tax-exempt turbo convertible capital appreciation bonds payable only when no current interest bond, convertible capital appreciation bond, or Series D Bond remains outstanding.

The bonds bear interest at rates of 5.375% to 7.125% and mature in varying annual amounts ranging from $1,830,000 to $360,990,000 with the final term and capital appreciation maturities due in the year ending June 30, 2046. The balance outstanding on June 30, 2007 and 2006 was $783,441,111 ($1,356,125,000 net of unamortized bond discounts of $572,683,889) and $775,785,321 ($1,362,880,000 net of unamortized bond discounts of $587,094,679), respectively.

The bond documents include the following provisions:

(a) The Series 2005 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 2005 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 Series 2005 A, B, and C 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. Subject to the prior payment rights of the Series 2005 A, B, and C bonds, the Series 2005 D and E bonds will be similarly secured and payable from the same sources, except the debt service reserve account will not be available as security.

(c) The “Turbo Redemptions” of the term bonds represents the requirement to apply 100% of all collections which are in excess of requirements for the funding of operating expenses and the debt service account to the special mandatory par redemption of the Series 2005 Bonds on each distribution date in ascending order of maturity and pro rata within a maturity for the Series 2005 A Bonds and by lot within a maturity for all other Series 2005 Bonds.

(d) The proceeds of the Series 2005 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 2005 bonds.

(e) 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.

(f) The debt service reserve account was funded from bond proceeds in the amount of $59,198,916. The account will be available to pay (i) the principal and interest on the Series 2005 A, B and C bonds to the extent collections under the MSA are insufficient and (ii) after an event of default, extraordinary prepayments. Amounts in the debt service reserve account will not be available to make (a) turbo redemptions on any bonds or (b) any payment of Series 2005 D or Series 2005 E bonds. 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.

(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 debt service account, the debt service reserve account, and the extraordinary prepayments account and the partial lump sum payment account, to the extraordinary prepayments of the bonds for principal or, in the case of capital appreciation bonds, the accreted value of outstanding bonds will be paid, in whole or in part, on each succeeding distribution date. The accreted value of capital appreciation bonds and any interest that has accrued will be payable only after all other bonds have been fully paid.

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

	Series 2005 A Term Bonds			Series 2005 B Convertible Capital Appreciation Bonds		
Year ending June 30	**Principal**	**Interest rate**	**Interest**	**Principal**	**Interest rate**	**Interest**
2008	$ 30,710,000	6.50%	$ 13,884,000	—	5.60%	$ 4,984,280
2009	23,190,000	6.50	11,887,850	—	5.60	9,968,560
2010	25,490,000	6.50	10,380,500	—	5.60	9,968,560
2011	28,025,000	6.50	8,723,650	—	5.60	9,968,560
2012	30,725,000	6.50	6,902,025	—	5.60	9,968,560
2013 – 2017	75,460,000	6.50	7,947,794	—	5.60	49,842,800
2018 – 2022	—		—	—	5.60	49,842,800
2023 – 2027	—		—	—	5.60	49,842,800
2028 – 2032	—		—	—	5.60	49,842,800
2033 – 2037	—		—	178,010,000	5.60	19,106,407
2038 – 2042	—		—	—		—
2043 – 2047	—		—	—		—
	$ 213,600,000		$ 59,725,819	178,010,000		$ 263,336,127

	Series 2005 C Term Bonds			Series 2005 C Term Bonds		
Year ending June 30	**Principal**	**Interest rate**	**Interest**	**Principal**	**Interest rate**	**Interest**
2008	$ —	5.375%	$ 5,561,781	—	5.50%	$ 7,431,600
2009	—	5.375	5,561,781	—	5.50	7,431,600
2010	—	5.375	5,561,781	—	5.50	7,431,600
2011	—	5.375	5,561,781	—	5.50	7,431,600
2012	—	5.375	5,561,781	—	5.50	7,431,600
2013 – 2017	—	5.375	27,808,906	—	5.50	37,158,000
2018 – 2022	—	5.375	27,808,906	—	5.50	37,158,000
2023 – 2027	—	5.375	27,808,906	—	5.50	37,158,000
2028 – 2032	—	5.375	27,808,906	—	5.50	37,158,000
2033 – 2037	—	5.375	27,808,906	—	5.50	37,158,000
2038 – 2042	103,475,000	5.375	5,098,300	135,120,000	5.50	36,538,700
2043 – 2047	—		—	—		—
	$ 103,475,000		$ 171,951,735	135,120,000		$ 259,486,700

	Series 2005 C Term Bonds			Series 2005 D Capital Appreciation Bonds		
Year ending June 30	**Principal**	**Interest rate**	**Interest**	**Principal**	**Interest rate**	**Interest**
2008	$ —	5.625%	$ 9,794,812	—	6.25%	$ —
2009	—	5.625	9,794,812	—	6.25	—
2010	—	5.625	9,794,812	—	6.25	—
2011	—	5.625	9,794,812	—	6.25	—
2012	—	5.625	9,794,812	—	6.25	—
2013 – 2017	—	5.625	48,974,060	—	6.25	—
2018 – 2022	—	5.625	48,974,060	—	6.25	—
2023 – 2027	—	5.625	48,974,060	—	6.25	—
2028 – 2032	—	5.625	48,974,060	—	6.25	—
2033 – 2037	—	5.625	48,974,060	—	6.25	—
2038 – 2042	—	5.625	48,974,060	—	6.25	—
2043 – 2047	174,130,000	5.625	38,363,014	190,800,000	6.25	—
	$ 174,130,000		$ 381,181,434	190,800,000		$ —

	Series 2005 E Capital Appreciation Bonds			Total	
Year ending June 30	**Principal**	**Interest rate**	**Interest**	**Principal**	**Interest**
2008	$ —	7.125%	$ —	30,710,000	41,656,473
2009	—	7.125	—	23,190,000	44,644,603
2010	—	7.125	—	25,490,000	43,137,253
2011	—	7.125	—	28,025,000	41,480,403
2012	—	7.125	—	30,725,000	39,658,778
2013 – 2017	—	7.125	—	75,460,000	171,731,560
2018 – 2022	—	7.125	—	—	163,783,766
2023 – 2027	—	7.125	—	—	163,783,766
2028 – 2032	—	7.125	—	—	163,783,766
2033 – 2037	—	7.125	—	178,010,000	133,047,373
2038 – 2042	—	7.125	—	238,595,000	90,611,060
2043 – 2047	360,990,000	7.125	—	725,920,000	38,363,014
	$ 360,990,000		$ —	1,356,125,000	1,135,681,815

The following summarizes the bond payable activity for the Authority for the years ended June 30, 2007 and 2006:

2007	Beginning balance	Additions	Reductions	Ending balance	Due within one year
Bonds payable:					
Term bonds	$ 633,080,000	—	(6,755,000)	626,325,000	30,710,000
Convertible capital appreciation bonds	178,010,000	—	—	178,010,000	—
Capital appreciation bonds	551,790,000	—	—	551,790,000	—
Less deferred amounts:					
For issuance discounts	(21,733,830)	—	688,216	(21,045,614)	(772,505)
Capital appreciation discount	(527,731,179)	—	11,930,685	(515,800,494)	—
On refunding	(37,629,670)	—	1,791,889	(35,837,781)	(1,791,889)
Total bonds payable	$ 775,785,321	—	7,655,790	783,441,111	28,145,606

2006	Beginning balance	Additions	Reductions	Ending balance	Due within one year
Bonds payable:					
Term bonds	$ 578,150,000	635,635,000	(580,705,000)	633,080,000	16,600,000
Serial bonds	61,310,000	—	(61,310,000)	—	—
Convertible capital appreciation bonds	—	178,010,000	—	178,010,000	—
Capital appreciation bonds	—	551,790,000	—	551,790,000	—
Less deferred amounts:					
For issuance discounts	(11,560,566)	(22,081,398)	11,908,134	(21,733,830)	(684,868)
Capital appreciation discount	—	(533,472,970)	5,741,791	(527,731,179)	—
On refunding	—	(38,525,615)	895,945	(37,629,670)	(1,791,889)
Total bonds payable	$ 627,899,434	771,355,017	(623,469,130)	775,785,321	14,123,243

(4) Debt Defeasance

During the year ended June 30, 2006, the Authority issued $664,552,153 in revenue bonds with interest rates ranging from 5.375% to 6.50% to advance refund $639,460,000 of outstanding Tobacco Settlement Asset-Backed Bonds, Series 2001A and 2001B with interest rates ranging from 5.30% to 6.79%.

Net proceeds of $594,662,216, combined with $19,715,522 of trapping account and $52,467,154 of debt service reserve funds totaling $666,844,892 were placed in an irrevocable escrow trust fund with the Bank of New York as trustee. The escrow fund is sufficient to fully service all remaining principal and interest due on the bonds. The Tobacco Settlement Asset-Backed Bonds, Series 2001A will be paid from escrow on the respective maturity or redemption dates, at the redemption prices (as expressed as percentages of the principal amount of the refunded bonds to be redeemed) as follows:

	Maturity date	Redemption price
Series 2001 A Term Bonds	June 1, 2009	100%
Series 2001 B Term Bonds	June 1, 2010	101
Series 2001 B Term Bonds	June 1, 2011	101

The reacquisition price exceeded the net carrying amount of the old debt by $38,525,615. This amount has been netted against the new debt and is being amortized over the remaining life of the refunded debt, which is shorter than the life of the new debt. This advance refunding resulted in an increase in aggregate debt service of $94,938,174 over the next twenty-two years and an economic loss (difference between present value of the old and new debt service payments) of $13,779,395 based upon projections of turbo bond redemptions.

The amount of defeased debt outstanding but removed from the statement of net assets (deficit) at June 30, 2007 and 2006, is $634,125,000 and $637,410,000, respectively.

(5) 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 U.S. generally accepted accounting principles, such contingent amounts cannot be fully recognized as a receivable or revenue. Accordingly, the Authority is reporting an unrestricted net asset (deficit) balance of $675,255,512 and $676,078,541 at June 30, 2007 and 2006, respectively.

(6) Tobacco Litigation Risk

The amount of revenue recognized by the Tobacco Settlement Authority could be adversely impacted by certain third-party litigation involving tobacco companies and others.

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Independent Auditors' 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*

The Board
Tobacco Settlement Authority:

We have audited the financial statements of the Tobacco Settlement Authority, a component unit of the State of Iowa, as of and for the year ended June 30, 2007, and have issued our report thereon dated December 3, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, Chapter 11 of the Code of Iowa, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

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

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

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

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

Compliance and Other Matters

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

This report is intended solely for the information and use of management of the Tobacco Settlement Authority, a component unit of the State of Iowa, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

December 3, 2007