Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Financial Report

June 30, 2008

McGladrey & Pullen

Certified Public Accountants

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McGladrey & Pullen
Certified Public Accountants

Independent Auditor's Report

The Board of the Tobacco Settlement Authority
Des Moines, Iowa

We have audited the accompanying financial statements of the governmental activities and the General Fund of the Tobacco Settlement Authority (the Authority), a component unit of the State of Iowa, as of and for the year ended June 30, 2008, which collectively comprise the Authority's basic financial statements as listed in the table of contents. These basic financial statements are the responsibility of the Authority's management. Our responsibility is to express opinions on these basic financial statements based on our audit.

We conducted our audit 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 audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and the General Fund of the Tobacco Settlement Authority, as of June 30, 2008, and the respective changes in financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As stated in Note 7, the Authority implemented Governmental Accounting Standards Board Statement No. 48. As a result, the Authority changed from reporting as an enterprise fund/business-type activities to a governmental fund/governmental activities and the net assets of governmental activities were restated.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 14, 2008 on our consideration of the Authority's internal control over financial reporting and 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 the 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.

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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 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.

McGladrey & Pullen, LLP

Davenport, Iowa
November 14, 2008

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Management's Discussion and Analysis
Year Ended June 30, 2008

We present the financial statements of the Tobacco Settlement Authority (the Authority) and offer readers of these financial statements this narrative overview and analysis of the financial activities of the Tobacco Settlement Authority for the year ended June 30, 2008.

The Tobacco Settlement Authority implemented Governmental Accounting Standards Board Statement No. 48 during the current year. As a result, the Authority changed from reporting as an enterprise fund/business-type activities to a governmental fund/governmental activities and the fund balance/net assets (deficit) were restated. Therefore, comparative information is not available for the fund financial statements. Comparative fund analysis will be provided in subsequent MD&As.

Financial Highlights

The liabilities of the Tobacco Settlement Authority exceeded its assets at the close of the most recent fiscal year by $(12,485,699) (net assets). For the year ended June 30, 2007, assets exceeded liabilities by $38,355,485.

The Authority's total net assets decreased ($50,841,184) during the fiscal year ended June 30, 2008.

As of the close of the current fiscal year, the Authority's General Fund reported an ending fund balance of $767,114,640, a decrease of $(54,405,504). Approximately 93 percent of this total amount, $716,121,828, is reserved for specific purposes.

Overview of the Financial Statements

This Discussion and Analysis is intended to serve as an introduction to the Authority's basic financial statements. The Authority's basic financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements and 3) notes to financial statements.

Government-wide financial statements: The government-wide financial statements are designed to provide readers with a broad overview of the Authority's finances, in a manner similar to a private-sector business.

The Statement of Net Assets presents information on all of the Authority's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the Authority is improving or deteriorating.

The Statement of Activities presents information showing how the Authority's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods.

Fund financial statements: A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financial requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund Balance Sheet and the governmental fund Statement of Revenues, Expenditures and Changes in Fund Balances (Deficit) provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

Notes to financial statements: The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements.

Government-Wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. The Authority's total net assets have decreased from a year ago. Table 1 reflects total net assets of $(12,485,699) as of June 30, 2008, which represents a decrease of $(50,841,184) from June 30 2007.

Table 1 - Authority's Net Assets

	Governmental Activities	
	2008	2007
Assets		
Current and other assets	**$ 770,748,932**	$ 825,125,613
Capital assets, net of depreciation	**-**	-
Total assets	**770,748,932**	825,125,613
Liabilities		
Current liabilities	**21,826,622**	31,474,623
Long-term liabilities outstanding	**761,408,009**	755,295,505
Total liabilities	**783,234,631**	786,770,128
Net Assets		
Invested in capital assets, net of related debt	**-**	-
Restricted	**82,417,738**	78,314,845
Unrestricted	**(94,903,437)**	(39,959,360)
Total net assets	**$ (12,485,699)**	$ 38,355,485

The Authority's total assets decreased $54,376,681 due to a decrease in the advance to the State. Total liabilities decreased $(3,535,497) primarily due to debt payments.

The Authority's total net assets decreased $(50,841,184) during the current fiscal year. Table 2 highlights the Authority's revenues and expenses for the year ended June 30, 2008. These two main components are subtracted to yield the change in net assets. This table utilizes the full accrual method of accounting.

Table 2 - Authority's Changes in Net Assets

	Governmental Activities
Revenues, general revenues, investment earnings	$ 3,418,970
Expenses:	
Current:	
Administrative	66,424
Enforcement	1,186,054
Distribution to State	215,522
Debt service, interest	52,625,531
Amortization	166,623
Total expenses	54,260,154
Change in net assets	(50,841,184)
Net assets, beginning of year, as restated	38,355,485
Net assets, end of year	$ (12,485,699)

Financial Analysis of the Governmental Fund

As noted earlier, the Authority uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

As of the end of the current fiscal year, the Authority's General Fund reported an ending fund balance of $767,114,640, a decrease of $(54,405,504) in comparison with the prior year. Approximately 6.6 percent of this amount, $50,992,812, constitutes unreserved fund balance. The remainder of the fund balance is reserved.

Debt Administration

As of June 30, 2008, the Authority had $778,959,080 in revenue bonds. In the current year, the Authority paid $14,700,000 in principal and $41,656,474 in interest on outstanding debt.

Additional information about the Authority's long-term debt can be found in Note 3 to the financial statements.

Table 3 - Outstanding Debt, June 30

	Governmental Activities	
	2008	2007
Term bonds	**$ 611,625,000**	$ 626,325,000
Convertible capital appreciation bonds	**178,010,000**	178,010,000
Capital appreciation bonds	**551,790,000**	551,790,000
Less deferred amount	**(562,465,920)**	(572,683,889)
	$ 778,959,080	$ 783,441,111

Economic Factors

The Authority pledged all surplus collections, if any, to the turbo redemption of Series 2005 bonds.

Requests for Information

These financial statements and discussions are designed to provide our citizens, taxpayers, investors and creditors with a complete disclosure of the Authority's finances and to demonstrate a high degree of accountability. If you have questions about this report or need additional information, please contact the State Treasurer's Office, Lucas State Office Building, Des Moines, Iowa 50319.

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Governmental Fund Balance Sheet/Statement of Net Assets (Deficit)
June 30, 2008

	Governmental Fund Balance Sheet	Adjustments	Statement of Net Assets (Deficit)
Assets			
Current assets:			
Cash on deposit with Treasurer of State	$ 4,518,652	$ -	$ 4,518,652
Due from State	46,728,658	-	46,728,658
Interest receivable	213,949	-	213,949
Total current assets	51,461,259	-	51,461,259
Noncurrent assets:			
Restricted assets:			
Cash and cash equivalents	23,218,822	-	23,218,822
Investments	59,198,916	-	59,198,916
Advance to the State	633,704,090	-	633,704,090
Deferred charges	-	3,165,845	3,165,845
Total noncurrent assets	716,121,828	3,165,845	719,287,673
Total assets	$ 767,583,087	3,165,845	770,748,932
Liabilities			
Current liabilities:			
Accounts payable	$ 341,895	-	341,895
Due to State	126,552	-	126,552
Bonds payable, current portion	-	20,190,177	20,190,177
Unamortized bond discount, current portion	-	(847,217)	(847,217)
Unamortized deferral on refunding, current portion	-	(1,791,889)	(1,791,889)
Accrued interest payable	-	3,807,104	3,807,104
Total current liabilities	468,447	21,358,175	21,826,622
Noncurrent liabilities:			
Bonds payable, net of current portion	-	813,087,904	813,087,904
Unamortized bond discount, net of current portion	-	(19,425,892)	(19,425,892)
Unamortized deferral on refunding, net of current portion	-	(32,254,003)	(32,254,003)
Total noncurrent liabilities	-	761,408,009	761,408,009
Total liabilities	468,447	782,766,184	783,234,631
Fund Balances			
Fund balances:			
Unreserved	50,992,812	(50,992,812)	-
Reserved for advance	633,704,090	(633,704,090)	-
Reserved for debt service	82,417,738	(82,417,738)	-
Total fund balances	767,114,640	(767,114,640)	
Total liabilities and fund balances	$ 767,583,087	$ (12,485,699)	
Net assets (deficit)			
Restricted for debt service			82,417,738
Unrestricted			(94,903,437)
Total net assets (deficit)			$ (12,485,699)

See Notes to Financial Statements.

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Reconciliation of Governmental Fund Balance Sheet to the Statement of Net Assets (Deficit)
June 30, 2008

Amounts reported for governmental activities in the Statement of Net Assets (Deficit) are different because:		
Total fund balance for governmental fund		$ 767,114,640
Long-term liabilities applicable to governmental activities are not due and payable in the current period and, accordingly, are not reported as fund liabilities. Interest on long-term debt is not accrued in governmental funds, but rather is recognized as an expenditure when due. All liabilities, both current and long-term, are reported in the statement of net assets.		
Accrued interest on bonds		(3,807,104)
Bonds payable	$ (833,278,081)	
Unamortized deferred amount on refunding	34,045,892	
Unamortized deferred amount for issuance discount	20,273,109	
Unamortized deferred charges	3,165,845	(775,793,235)
Total net assets (deficit) of governmental activities		$ (12,485,699)

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Statement of Governmental Fund Revenues, Expenditures and Changes in Fund Balances (Deficit)/Statement of Activities
Year Ended June 30, 2008

	Statement of Revenues, Expenditures and Changes in Fund Balances	Adjustments	Statement of Activities
General revenues, investment income	$ 3,418,970	$ -	$ 3,418,970
Expenditures/expenses:			
Current:			
Administrative expenses	66,424	-	66,424
Enforcement expenses	1,186,054	-	1,186,054
Distribution to State	215,522	-	215,522
Debt Service:			
Principal	14,700,000	(14,700,000)	-
Interest	41,656,474	10,969,057	52,625,531
Amortization of bond issuance costs	-	166,623	166,623
Total expenditures/expenses	57,824,474	(3,564,320)	54,260,154
Excess (deficiency) of revenues over (under) expenditures/expenses	(54,405,504)	3,564,320	(50,841,184)
Fund balances and net assets (deficit):			
Beginning of year, as restated	821,520,144	(783,164,659)	38,355,485
End of year	$ 767,114,640	$ (779,600,339)	$ (12,485,699)

See Notes to Financial Statements.

Tobacco Settlement Authority
(A Component Unit of the State of Iowa)

Reconciliation of Statement of Governmental Fund Revenues, Expenditures and Changes in Fund Balances (Deficit) to the Statement of Activities
Year Ended June 30, 2008

Amounts reported for governmental activities in the Statement of Net Assets (Deficit) are different because:		
Net change in fund balances, total governmental funds		$ (54,405,504)
Repayment of bond principal is an expenditure in governmental funds, but reduces the liability in the Statement of Net Assets (Deficit)		14,700,000
Under the modified accrual basis of accounting used in governmental funds, expenditures are not recognized for transactions that are normally paid with expendable available resources. In the statement of activities, however, which is presented on the accrual basis, expenses and liabilities are reported regardless of when financial resources are available. In addition, interest on long-term debt is not recognized under the modified accrual basis of accounting until due, rather than when it accrues. This adjustment combines the net changes of five balances.		
Amortization of bond issuance costs	$ (166,623)	
Amortization of advanced refunding difference	(1,791,889)	
Amortization of bond discount	(772,505)	
Accretion of interest on capital appreciation bonds	(7,653,575)	
Accrued interest on bonds	(751,088)	(11,135,680)
Change in net assets (deficit) of governmental activities		$ (50,841,184)

See Notes to Financial Statements.

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies

Nature of operations:

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 to: (a) 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) enter into sales agreements, (c) issue bonds and enter into funding options including refunding and refinancing its debt and obligations, (d) 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) invest funds available to provide for a source of revenue in accordance with the program plan, (f) enter into agreements with the State for the periodic distribution of amounts due the State under any sales agreement, (g) refund and refinance the Authority's debts and obligations, and to manage its funds, obligations, and investments as necessary, (h) sell, pledge, or assign, as security or consideration, all or a portion of the State's share to implement alternative funding options, and (i) implement the purposes of Chapter 12E of the Code of Iowa.

Reporting entity:

The Authority is a component unit of the State of Iowa. The basic 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 basic 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 and Basis of Accounting:

The Authority-wide basic financial statements are reported using the “economic resources measurement focus” and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred regardless of the timing of related cash flows.

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies (Continued)

Governmental fund basic financial statements are reported using the "current financial resources measurement focus" and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Authority considers revenues to be available if they are collected within 60 days of the end of the current fiscal period. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. However, debt service expenditures are recorded only when payment is due.

Authority-wide and fund basic financial statements: The basic financial statements combine both an Authority-wide perspective and governmental perspective.

The Authority is classified as a special revenue fund in the State's comprehensive annual financial report. Special revenue funds account for the proceeds of specific revenue sources (other than permanent or capital projects) that are legally restricted to expenditure for a specified purpose. The difference between assets and liabilities are referred to as "fund balance."

The Authority-wide basic financial statements, the Statement of Net Assets (Deficit) and the Statement of Activities, report information on all of the activities of the Authority. Governmental activities generally are those normally financed through taxes, intergovernmental revenues and other nonexchange revenues.

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 46 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:

- Five initial payments, the last of which was paid in January 2003;
- Annual payments which are required to be made on April 15 of each year and will continue in perpetuity; and
- Ten strategic contribution fund payments which are required to be made annually on April 15, beginning April 15, 2008 through April 15, 2017.

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies (Continued)

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 health care, 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 Legislature 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.

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.

The sales agreement includes the following provisions:

The net proceeds shall be used solely for the benefit of the State, including for payment of all amounts due and to become due to the State pursuant to this Agreement, the Act or other applicable law. The Authority shall administer and invest the Trust Fund in accordance with the Act and this Agreement. It is agreed that consistent with Section 4.03 and Section 5.05, the State, through an Authorized Officer, and the Authority, through an Authorized Officer, are authorized to execute a Tax Agreement with respect to each series of tax-exempt Tobacco Bonds. The Authority shall establish and maintain two accounts within the Trust Fund named the Tax-Exempt Bond Proceeds Restricted Capital Funds Account (the "Restricted Capital Funds Account") and the Endowment for Iowa's Health Account (the "Health Endowment Account").

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies (Continued)

Restricted Capital Funds Account: The Authority shall deposit the net proceeds of any Tax-Exempt Tobacco Bonds issued to provide funds for capital projects, certain debt service on outstanding obligations that funded capital projects (other than Tax-Exempt Tobacco Bonds issued for Section 12.65 purposes) and attorney fees related to the MSA in the Restricted Capital Funds Account pursuant to Section 12E.12(1)(b)(1) of the Act. All moneys in the Restricted Capital Funds Account, including all dividends, investment income, securities, investments and other assets acquired by or through the use of such moneys, shall be moneys of the State and shall be held by the Authority solely for the benefit of the State until appropriated by, or paid or transferred to, the State pursuant to the Act and/or this Agreement. The Authority shall invest all moneys in the Restricted Capital Funds Account from any issuance of Tax-Exempt Tobacco Bonds in accordance with the terms of this Agreement, the Act and the Tax Agreement relating to any such Tax-Exempt Tobacco Bonds. Promptly upon the State's request from time to time, the Authority shall pay to the State from the Restricted Capital Funds Account such amounts as may be required to either reimburse the State for all payments of attorney fees related to the MSA made by or on behalf of the state after the original closing date or to provide funds sufficient to enable the State to make all payments of such attorney fees. Attorney fees related to the MSA include the attorney fees or other amounts payable to certain Iowa Special Counsel as set forth in the Amendment to Engagement and Contingency Agreement dated November 1999 between the State and such Iowa Special Counsel. The Authority has $23,218,822 of restricted cash and investments in the account as of June 30, 2008.

Health Endowment Account: The Authority shall deposit the net proceeds of any Taxable Tobacco Bonds or Tax-Exempt Tobacco Bonds issued to provide funds for Section 12.65 Purposes in the Health Endowment Account pursuant to Section 12E.12(1)(b)(2) of the Act. All other moneys of the Authority not pledged to the payment of Tobacco Bonds or otherwise obligated shall be deposited in the Health Endowment Account of the Trust Fund. Such moneys include the unencumbered TSRs, the Assigned Attorney Fees, any pledged TSRs that are subsequently released free and clear from the pledge and lien to the payment of the Tobacco Bonds (and after a payment or provision for payment by the Authority of Operating Expenses) and any moneys appropriated by the State for deposit in the Health Endowment Account. All moneys in the Health Endowment Account, including all dividends, investment income, securities, investments and other assets acquired by or through the use of such moneys, shall constitute moneys of the Authority until paid or transferred to the State in accordance with the Act or appropriated by the State pursuant to applicable law for Section 12.65 purposes or other lawful purposes. The Authority shall hold in trust and invest all of the moneys and assets in the Health Endowment Account for the sole benefit of the State in accordance with the terms of this Agreement and the Act. In addition, the Authority shall hold in trust, use and invest the net proceeds of any series of Tax-Exempt Tobacco Bonds deposited in the Health Endowment Account and the investment earnings thereon in accordance with the Tax Agreement relating to such series of Tax-Exempt Tobacco Bonds.

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies (Continued)

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.

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 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.

Significant accounting policies:

The basic 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: The cash balances of the Authority are pooled and invested by the Treasurer of State. 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 as of June 30, 2008 include a guaranteed investment contract totaling $59,198,916.

Investments: Investments in debt and equity securities are recorded at fair value in the balance sheet/statement of net assets (deficit) with the change in fair value of investments recorded in the statements of revenues, expenses and changes in fund balance/statement of activities. Investments in guaranteed investment contracts are reported at fair value determined by the fund’s current share price.

Due from State/Advance to the State: The receivable consists primarily of the amount the State of Iowa has committed from the future amounts to be received by the State under the Master Settlement Agreement

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.

Note 1. Nature of Operations, Reporting Entity, Measurement Focus and Basis of Accounting and Significant Accounting Policies (Continued)

Bond payable: The Authority reports bonds payable at face value, net of discounts and accretion of capital appreciation. Bond discounts and issuance costs are capitalized and amortized over the life of the related debt in the entity-wide basic financial statements. The governmental fund basic financial statements recognize bond discounts, as well as bond issuance costs, in their entirety, during the current period. Issuance costs, whether or not withheld from the actual debt proceeds received, are reported as expenditures. Gains and losses associated with the reacquisition of bonds payable are amortized over the remaining life of the refunded debt for the entity-wide basic financial statements. In the entity-wide statements, such gains and losses arise from the difference between the repurchase price and the par value of the bonds, along with any forfeited unamortized bond discount and costs of issuance amounts.

Interest expense is recognized on the accrual basis in the entity-wide basic financial statements. Interest expenditures are recognized when paid in the individual governmental fund basic financial statements.

Fund balance: The financial activities of the Authority are restricted by bond resolution and legislative intent.

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 basic financial statements in conformity with U.S. generally accepted accounting principles. Actual results could differ from those estimates.

Fund equity: In the fund basic financial statements, governmental funds report reservations of fund balance for amounts that are not available for appropriation or are legally restricted by outside parties for use for a specific purpose.

Net assets: Net assets represents the difference between assets and liabilities. Net assets are reported as restricted when there are limitations imposed on their use through enabling legislation or through external restrictions imposed by creditors, grantors or laws or regulations of other governments. The Authority has restricted net assets of $82,417,738 for debt service by debt agreement and sales agreement. The Authority first applied restricted resources when an expense is incurred for purposes for which both restricted and unrestricted net assets are available.

Note 2. Deposits and Investments

The cash balance of $4,518,652 was held by the State in pooled money funds. Investments as of June 30, 2008 are as follows:

Investment Type	Fair Value	Investment maturities (in years) Less than 1	1 - 2	3 - 5	Concentration
Open-End Mutual Fund	$ 23,218,822	$ 23,218,822	$ -	$ -	27%
State Treasurer Investment Pool	4,518,652	4,518,652	-	-	5
Guaranteed Investment Contract, Security Benefit Life Insurance Co.	59,198,916	-	-	59,198,916	68
	$ 86,936,390	$ 27,737,474	$ -	$ 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; and other obligations, securities, agreements or contracts that are noncallable and are acceptable to each nationally recognized rating service agency.

The Authority's investments in the State Pool Security Benefit Life Insurance Co. guaranteed investment contract and the open-end mutual fund are not subject to credit risk categorization.

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. The Authority's investments in the State Pool, open-end mutual fund and guaranteed investment contract are not subject to custodial credit risk.

Note 2. Deposits and Investments (Continued)

Subsequent to year-end, the credit and liquidity crisis in the United States and throughout the global financial system has resulted in substantial volatility in financial markets and the banking system. These and other economic events have had a significant adverse impact on investment portfolios. As a result, the Authority's investments have likely incurred a significant decline in fair value since June 30, 2008.

Note 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 percent to 7.125 percent 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, 2008 was $778,959,080 ($1,341,425,000 net of unamortized bond discounts and deferred amounts of $562,465,920).

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.

Note 3. Bonds Payable (Continued)

(b) The Series 2005 A, B, and C bonds are secured by and are payable solely from (i) 78 percent of the future amounts to be received by the State of Iowa under the MSA, (ii) investment earnings on certain accounts pledged under the bond indenture, (iii) amounts held in the debt service reserve 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 percent 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 extraordinary prepayment account and such other accounts as deemed necessary. The amount in the required debt service account is $23,218,822 as of June 30, 2008.

(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.

Note 3. Bonds Payable (Continued)

The Authority is subject to certain nonfinancial covenants related to the Series 2005 Bonds. The Authority did not file with the Trustee the fiscal year 2007 basic financial statements within 180 days after the close of the fiscal year ended June 30, 2007, as required by Section 6.05(ii) of the bond indenture. As of October 24, 2008, the Authority obtained a waiver of this covenant.

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

Year Ending June 30	Series 2005 A Term Bonds Principal	Interest Rate	Interest	Series 2005 B Convertible Capital Appreciation Bonds Principal	Interest Rate	Interest
2009	$ 23,190,000	6.50%	$ 12,928,500	$ -	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	33,555,000	6.50	4,904,900	-	5.60	9,968,560
2014 - 2018	57,915,000	6.50	3,042,894	-	5.60	49,842,800
2019 - 2023	-	-	-	-	5.60	49,842,800
2024 - 2028	-	-	-	-	5.60	49,842,800
2029 - 2033	-	-	-	-	5.60	49,842,800
2034	-	-	-	178,010,000	5.60	9,137,847
	$ 198,900,000		$ 46,882,469	$ 178,010,000		$ 258,351,847

Year Ending June 30	Series 2005 C Term Bonds Principal	Interest Rate	Interest	Series 2005 C Term Bonds Principal	Interest Rate	Interest
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	-	5.375	5,561,781	-	5.50	7,431,600
2014 - 2018	-	5.375	27,808,906	-	5.50	37,158,000
2019 - 2023	-	5.375	27,808,906	-	5.50	37,158,000
2024 - 2028	-	5.375	27,808,906	-	5.50	37,158,000
2029 - 2033	-	5.375	27,808,906	-	5.50	37,158,000
2034 - 2038	103,475,000	5.375	27,345,426	-	5.50	37,158,000
2039 - 2042	-	5.375	-	135,120,000	5.50	29,107,100
	$ 103,475,000		$ 166,389,955	$ 135,120,000		$ 252,055,100

Note 3. Bonds Payable (Continued)

Year Ending June 30	Series 2005 C Term Bonds Principal	Interest Rate	Interest	Series 2005 D Capital Appreciation Bonds Principal	Interest Rate	Interest
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	-	5.625	9,794,812	-	6.25	-
2014 - 2018	-	5.625	48,974,060	-	6.25	-
2019 - 2023	-	5.625	48,974,060	-	6.25	-
2024 - 2028	-	5.625	48,974,060	-	6.25	-
2029 - 2033	-	5.625	48,974,060	-	6.25	-
2034 - 2038	-	5.625	48,974,060	-	6.25	-
2039 - 2043	-	5.625	48,974,060	-	6.25	-
2044 - 2046	174,130,000	5.625	23,670,796	190,800,000	6.25	-
	$ 174,130,000		$ 366,489,216	$ 190,800,000		$ -

Year Ending June 30	Series 2005 E Capital Appreciation Bonds Principal	Interest Rate	Interest	Total Principal	Interest
2009	$ -	7.125%	$ -	$ 23,190,000	$ 45,685,253
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	-	7.125	-	33,555,000	37,661,653
2014 - 2018	-	7.125	-	57,915,000	166,826,660
2019 - 2023	-	7.125	-	-	163,783,766
2024 - 2028	-	7.125	-	-	163,783,766
2029 - 2033	-	7.125	-	-	163,783,766
2034 - 2038	-	7.125	-	281,485,000	122,615,333
2039 - 2043	-	7.125	-	135,120,000	78,081,160
2044 - 2046	360,990,000	7.125	-	725,920,000	23,670,796
	$ 360,990,000		$ -	$ 1,341,425,000	$ 1,090,168,587

Note 3. Bonds Payable (Continued)

The following summarizes the bond payable activity for the Authority for the year ended June 30, 2008:

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Bonds payable:					
Term bonds	$ 626,325,000	$ -	$ (14,700,000)	$ 611,625,000	$ 23,190,000
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	(21,045,614)	-	772,505	(20,273,109)	(847,217)
Capital appreciation discount	(515,800,494)	-	7,653,575	(508,146,919)	(2,999,823)
Deferral on refunding	(35,837,781)	-	1,791,889	(34,045,892)	(1,791,889)
Total bonds payable	$ 783,441,111	$ -	$ (4,482,031)	$ 778,959,080	$ 17,551,071

Note 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 percent to 6.50 percent to advance refund $639,460,000 of outstanding Tobacco Settlement Asset-Backed Bonds, Series 2001 A and 2001 B with interest rates ranging from 5.30 percent to 6.79 percent.

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 2001 A 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

Note 4. Debt Defeasance (Continued)

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 22 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) as of June 30, 2008, is $616,810,000.

Note 5. Deficit Net Asset Balance

The deficit net asset balance will be paid with future MSA revenues and investment income. The payments to be received by the State of Iowa under the MSA represent a share of anticipated future sales of tobacco products. Although the Authority expects to receive certain amounts from the State, the collections are not assured.

Note 6. Tobacco Litigation Risk

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

Note 7. Accounting Change and Restatement

Governmental Accounting Standards Board (GASB) Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, was implemented for the year ended June 30, 2008. The statement addresses accounting and financial reporting standards for transactions in which a government receives, or is entitled to, resources in exchange for future cash flows generated by collecting specific receivables or specific future revenues. Receivables and revenues have been appropriately recorded in the basic financial statements.

Note 7. Accounting Change and Restatement (Continued)

As a result, the reporting of the entity changed from an enterprise fund to a governmental fund. Beginning net assets have been restated to include the receivable at July 1, 2007 for pledged receivables resulting from the implementation of GASB Statement No. 48, as follows:

	Governmental Activities
Net assets (deficit) June 30, 2007, as previously reported in business-type activity	$ (675,255,512)
GASB Statement No. 48 adjustment to recognize the receivable from the State	713,610,997
Net assets, July 1, 2007, as restated in governmental activities	$ 38,355,485

	Fund Balance/ Net Assets
Net assets (deficit) June 30, 2007, as previously reported in an enterprise fund	$ (675,255,512)
GASB Statement No. 48 adjustments to report as a governmental fund	1,496,775,656
Fund balance, July 1, 2007, as restated in governmental funds	$ 821,520,144

Note 8. Pending Pronouncements

The Authority implemented the following GASB statement during the year:

- GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.* This Statement establishes accounting and financial reporting standards for transactions in which an entity receives, or is entitled to, resources in exchange for future cash flows generated by collecting specific receivables or specific future revenues. It also provides disclosure requirements for an entity that pledges or commits future cash flows from a specific revenue source. In addition, this Statement establishes accounting and financial reporting standards for intra-entity transfers of assets and future revenues. This Statement resulted in a change of reporting and restatement to net assets as described in Note 7.

Note 8. Pending Pronouncements (Continued)

As of June 30, 2008, the GASB has issued the following statement not yet implemented by the Authority that may have a future impact as follows:

- GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, issued June 2008, will be effective for the Authority beginning with its year ending June 30, 2010. This Statement will improve how state and local governments report information about derivative instruments in their basic financial statements. The Statement specifically requires governments to measure most derivative instruments at fair value in their basic financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting. The guidance in this Statement also addresses hedge accounting requirements.

The Authority's management has not yet determined the effect this Statement will have on the Authority's basic financial statements.

Independent Auditor's 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 of the Tobacco Settlement Authority
Des Moines, Iowa

We have audited the basic financial statements of the governmental activities and General Fund of the Tobacco Settlement Authority (the Authority), a component unit of the State of Iowa, as of and for the year ended June 30, 2008, and have issued our report thereon dated November 14, 2008. We conducted our audit 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Authority's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the 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 accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the entity's basic 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 basic 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.

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an affiliation of separate and independent legal entities.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority's basic 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 an instance of noncompliance or other matters, described below, that is required to be reported under *Government Auditing Standards*.

08-01 Noncompliance with bond covenants

Condition: The Authority did not file with the Trustee the fiscal year 2007 audited basic financial statements within 180 days after the close of the fiscal year as required by Section 6.05(ii) of the bond indenture.

Response: The Authority will implement procedures to comply with all covenants, document compliance with all debt covenants or obtain waivers prior to the required timeline.

Conclusion: Response accepted.

The Authority's response to the above finding identified in our audit is described above. We did not audit the Authority's response and, accordingly, we express no opinion on it.

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

McGladrey & Pullen, LLP

Davenport, Iowa
November 14, 2008