

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

Financial Report
June 30, 2017

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RSM US LLP

Independent Auditor's Report

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

Report on the Financial Statements

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, 2017, and the related notes to the financial statements, which collectively comprise the Authority's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Authority's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

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 (a component unit of the State of Iowa) as of June 30, 2017, and the respective changes in its financial position for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters*Required Supplementary Information*

Accounting principles generally accepted in the United States of America require Management's Discussion and Analysis on pages 3 through 7 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

RSM US LLP

Des Moines, Iowa
November 13, 2017

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

**Management's Discussion and Analysis
Year Ended June 30, 2017**

We present the financial statements of the Tobacco Settlement Authority, a component unit of the State of Iowa (the Authority) and offer readers of these financial statements this narrative overview and analysis of the financial activities of the Authority for the year ended June 30, 2017.

Overview of the Authority

In 2001, the Authority purchased all payments required to be made by tobacco product manufacturers to the State of Iowa (the State) and the State's rights to receive such payments pursuant to the Master Settlement Agreement (Tobacco Settlement Revenues). The Authority issued approximately \$644 million of Tobacco Settlement Asset-Backed Bonds (Series 2001 Bonds) and pledged 78 percent of Tobacco Settlement Revenues to pay principal and interest on the bonds. As consideration for 78 percent of the payments, the Authority distributed approximately \$579 million of net proceeds to the State from the issuance of bonds. As consideration for the unpledged portion of Tobacco Settlement Revenues, the Authority has standing instructions for 22 percent of the Tobacco Settlement Revenues to be paid directly to the State.

In 2005, the Authority issued approximately \$832 million of Tobacco Settlement Asset-Backed Bonds. The proceeds of the 2005 bonds were used to refund the Series 2001 bonds, fund a debt service reserve account, pay costs of issuance and provide approximately \$154 million in net proceeds to the State. The Series 2005 bonds are special revenue obligations of the Authority secured solely by, and payable solely and only out of, the moneys, assets or revenues pledged by the Authority pursuant to the Series 2005 bond indenture, are not a general obligation or general indebtedness of the Authority and do not constitute an obligation or indebtedness of the State of Iowa or any political subdivision of the State of Iowa.

In fiscal year 2017, the primary activity of the Authority was the investment of bond reserves, the payment of administrative and enforcement expenses and the payment of principal and interest on the Series 2005 bonds. During the year, the Authority received \$51,378,626 in pledged Tobacco Settlement Revenues.

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 are comprised of 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.

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

**Management's Discussion and Analysis
Year Ended June 30, 2017**

The Statement of Net Position presents information on all of the Authority's assets and deferred outflows of resources and liabilities with the difference between these reported as net position. Over time, increases or decreases in net position 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 position changed during the most recent fiscal year. All changes in net position 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 used to maintain control over resources 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 the Authority's near-term financial requirements.

Because the focus of governmental funds is narrower than 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 Authority's near-term financing decisions. Both the governmental fund Balance Sheet and the governmental fund Statement of Revenues, Expenditures and Changes in Fund Balance provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

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

Government-Wide Financial Analysis

The Authority has total deficit net position as of June 30, 2017 and 2016. This indicates the Authority's liabilities, primarily the bonds, exceed the Authority's ability to pay those liabilities without additional funding. This is expected since debt service on the bonds is to be paid from future Tobacco Settlement Revenues.

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

**Management's Discussion and Analysis
Year Ended June 30, 2017**

Table 1 reflects total net position of \$(439,904,835) as of June 30, 2017, which represents a decrease of \$45,006,949 from June 30, 2016. The Authority's total assets decreased \$51,080,794, primarily due to a decrease in the advance to the State. Total liabilities decreased \$7,865,734, primarily due to the repayment of debt.

Table 1 - Authority's Net Position

	Governmental Activities	
	June 30,	
	2017	2016
Assets		
Current assets	\$ 137,843,634	\$ 151,042,779
Noncurrent assets	146,106,806	183,988,455
Total assets	283,950,440	335,031,234
Deferred outflows of resources	17,918,891	19,710,780
Liabilities		
Current liabilities	84,922,787	98,626,225
Long-term liabilities	656,851,379	651,013,675
Total liabilities	741,774,166	749,639,900
Net Position (Deficit)		
Restricted for debt service	17,748,168	18,175,779
Unrestricted	(457,653,003)	(413,073,665)
Total net position (deficit)	\$ (439,904,835)	\$ (394,897,886)

**Tobacco Settlement Authority
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**Management's Discussion and Analysis
Year Ended June 30, 2017**

Table 2 highlights the Authority's revenues and expenses for the years ended June 30, 2017 and 2016. This table utilizes the full accrual method of accounting.

Table 2 - Authority's Changes in Net Position

	Governmental Activities	
	Year Ended June 30,	
	2017	2016
General revenues, investment income	\$ 2,704,494	\$ 2,652,650
Expenses:		
Current:		
Administrative	54,759	58,772
Enforcement	1,158,468	998,271
Debt service, interest	46,498,216	47,164,424
Total expenses	47,711,443	48,221,467
Decrease in net position (deficit)	(45,006,949)	(45,568,817)
Net position (deficit), beginning of year	(394,897,886)	(349,329,069)
Net position (deficit), end of year	\$ (439,904,835)	\$ (394,897,886)

Financial Analysis of the Governmental Fund

As noted earlier, the Authority uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. The fiscal year 2017 ending fund balance of the Authority's governmental fund decreased \$51,387,837 from fiscal year 2016. The decrease is due primarily to the principal and interest payments made in the current year. The ending fund balance is restricted for debt service.

Debt Administration

As of June 30, 2017 and 2016, the Authority had \$720,187,488 and \$726,492,895, respectively, of outstanding revenue bonds, as shown in Table 3. In the current year, the Authority paid \$13,935,000 of principal and incurred \$46,498,216 of interest on outstanding debt.

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

**Tobacco Settlement Authority
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**Management's Discussion and Analysis
Year Ended June 30, 2017**

Table 3 - Outstanding Debt, June 30

	Governmental Activities	
	2017	2016
Term bonds	\$ 493,980,000	\$ 507,915,000
Convertible capital appreciation bonds	178,010,000	178,010,000
Capital appreciation bonds	551,790,000	551,790,000
Less deferred amounts	(503,592,512)	(511,222,105)
	<u>\$ 720,187,488</u>	<u>\$ 726,492,895</u>

Economic Factors

The Authority pledged all surplus collections, if any, to the turbo redemption of the Series 2005 bonds. Tobacco Settlement Revenues, the primary revenue source for the Authority, is dependent on future tobacco product sales. The amount of future revenue recognized by the State of Iowa and by the Tobacco Settlement Authority could, therefore, be adversely impacted by consumption trends within the tobacco industry.

Requests for Information

These financial statements and discussion 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
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**Governmental Fund Balance Sheet/Statement of Net Position (Deficit)
June 30, 2017**

	General Fund Balance Sheet	Adjustments	Statement of Net Position (Deficit)
Assets			
Current assets:			
Cash on deposit with Treasurer of State	\$ 5,107,880	\$ -	\$ 5,107,880
Due from the State	51,264,095	-	51,264,095
Advance to the State	81,255,000	-	81,255,000
Interest receivable, restricted	216,659	-	216,659
Total current assets	<u>137,843,634</u>	-	<u>137,843,634</u>
Noncurrent assets:			
Restricted assets:			
Cash and cash equivalents	17,748,168	-	17,748,168
Investments	59,198,916	-	59,198,916
Advance to the State	69,159,722	-	69,159,722
Total noncurrent assets	<u>146,106,806</u>	-	<u>146,106,806</u>
Total assets	<u>283,950,440</u>	-	<u>283,950,440</u>
Deferred outflow of resources, deferred charge on refunding	-	17,918,891	17,918,891
Total assets and deferred outflows of resources	<u>\$ 283,950,440</u>		
Liabilities			
Current liabilities:			
Accounts payable	\$ 211,181	-	211,181
Due to the State	286,745	-	286,745
Bonds payable, current portion	-	81,255,000	81,255,000
Accrued interest payable	-	3,169,861	3,169,861
Total current liabilities	<u>497,926</u>	<u>84,424,861</u>	<u>84,922,787</u>
Noncurrent liabilities, bonds payable, net	-	656,851,379	656,851,379
Total liabilities	<u>497,926</u>	<u>741,276,240</u>	<u>741,774,166</u>
Fund balance			
Restricted for debt service	283,452,514	(283,452,514)	-
Total liabilities and fund balances	<u>\$ 283,950,440</u>		
Net position (deficit)			
Restricted for debt service		17,748,168	17,748,168
Unrestricted (deficit)		(457,653,003)	(457,653,003)
Total net position (deficit)		<u>\$ (439,904,835)</u>	<u>\$ (439,904,835)</u>

See notes to financial statements.

**Tobacco Settlement Authority
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**Reconciliation of the Governmental Fund Balance Sheet to the Statement of
Net Position (Deficit)
June 30, 2017**

Amounts reported for governmental activities in the statement of net position (deficit) are different because:

Total fund balance for the governmental fund		\$ 283,452,514
<p>Long-term liabilities applicable to governmental activities are not due and payable in the current year and, accordingly, are not reported as fund liabilities. Interest on long-term debt is not accrued in the governmental fund, but rather is recognized as an expenditure when due. All liabilities, both current and long-term, are reported in the statement of net position (deficit).</p>		
Accrued interest on bonds		(3,169,861)
Bonds payable	\$ (1,223,780,000)	
Unamortized appreciation discount	472,373,658	
Unamortized bond discount	<u>13,299,963</u>	(738,106,379)
Deferred outflow of resources for deferred charge on refunding		<u>17,918,891</u>
Total net position (deficit) of governmental activities		<u><u>\$ (439,904,835)</u></u>

See notes to financial statements.

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

Statement of Revenues, Expenditures and Changes in Fund
Balance/Statement of Activities
Year Ended June 30, 2017

	General Fund Statement of Revenues, Expenditures and Changes in Fund Balance	Adjustments	Statement of Activities
General revenues, investment income	\$ 2,704,494	\$ -	\$ 2,704,494
Expenditures/expenses:			
Current:			
Administrative	54,759	-	54,759
Enforcement	1,158,468	-	1,158,468
Debt service:			
Principal	13,935,000	(13,935,000)	-
Interest	38,944,104	7,554,112	46,498,216
Total expenditures/expenses	54,092,331	(6,380,888)	47,711,443
Net change in fund balance/net position (deficit)	(51,387,837)	6,380,888	(45,006,949)
Fund balance/net position (deficit), beginning of year	334,840,351	(729,738,237)	(394,897,886)
Fund balance/net position (deficit), end of year	<u>\$ 283,452,514</u>	<u>\$ (723,357,349)</u>	<u>\$ (439,904,835)</u>

See notes to financial statements.

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

**Reconciliation of the Statement of Revenues, Expenditures and
Changes in Fund Balance to the Statement of Activities
Year Ended June 30, 2017**

Net change in fund balance		\$ (51,387,837)
Repayment of bond principal is an expenditure in the governmental fund but reduces the liability in the statement of net position (deficit)		13,935,000
<p>Under the modified accrual basis of accounting used for the governmental fund, expenditures are recognized for transactions 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 three balances, as follows:</p>		
Amortization of bond discount	\$ (722,205)	
Accretion of interest on capital appreciation bonds	(5,115,499)	
Accrued interest on bonds	75,481	(5,762,223)
Amortization of deferred charge on refunding		<u>(1,791,889)</u>
Net change in net position (deficit) of governmental activities		<u><u>\$ (45,006,949)</u></u>

See notes to financial statements.

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

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: (a) implementing and administering a program plan and establishing a stable source of revenue to be used for purposes designated in Chapter 12.65 of the Code of Iowa, (b) entering into sales agreements, (c) issuing bonds and entering into funding options, including refunding and refinancing its debt and obligations, (d) selling, pledging or assigning as security all or a portion of the State of Iowa's (the State) share to provide for and secure the issuance of its bonds, (e) investing funds available to provide for a source of revenue in accordance with the program plan, (f) entering into agreements with the State for the periodic distribution of amounts due the State under any sales agreement, (g) refunding and refinancing the Authority's debts and obligations and managing its funds, obligations and investments, as necessary, (h) selling, pledging or assigning, as security or consideration, all or a portion of the State's share to implement alternative funding options and (i) implementing the purposes of Chapter 12E of the Code of Iowa.

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

Reporting entity: The Authority is a component unit of the State of Iowa (the State). The basic financial statements of the Authority are included in the State's Comprehensive Annual Financial Report.

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.

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 year or soon enough thereafter to pay liabilities of the current year. For this purpose, the Authority considers revenues to be available if they are collected within 60 days after the end of the current fiscal year. 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 a governmental fund 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) legally restricted to expenditure for a specified purpose. The difference between assets plus deferred outflows of resources and liabilities plus deferred inflows of resources is referred to as "fund balance."

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

Notes to Financial Statements

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

The Authority-wide basic financial statements, the statement of net position (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.

Master Settlement Agreement: On November 23, 1998, a Master Settlement Agreement (the 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, from April 15, 2008 through April 15, 2017.

Program Plan: Chapter 12E.10 of the Code of Iowa directs the Authority to establish a Tobacco Settlement Program Plan (Program Plan) to provide the State with a secure and stable source of revenue for the purposes designated in Chapter 12.65 of the Code of Iowa. These purposes relate to 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 to be invested to provide an ongoing source of investment earnings.

The Program Plan was submitted to the Legislature and the 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 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 and any unpledged moneys to the State.

Tobacco Settlement Asset-Backed 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 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.

**Tobacco Settlement Authority
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Notes to Financial Statements

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

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 governmental 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, 2017 are a guaranteed investment contract totaling \$59,198,916.

Investments: Investments in guaranteed investment contracts are reported at cost determined by the fund's contract value, plus interest earned.

Due from the 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 MSA. Due from the State represents amounts expected to be received by the Authority during the year ending June 30, 2018 under the MSA. A portion of the Advance to the State, equal to the principal payments due during the year ending June 30, 2018 for the Series 2005 A bonds as stipulated by the turbo redemption requirement as discussed in Note 3, is classified as a current asset. The remaining balance of Advance to the State is not expected to be received during the year ending June 30, 2018 and is classified as a noncurrent asset.

Bonds payable: In the Authority-wide financial statements, the Authority reports bonds payable at face value, net of discounts and accretion of capital appreciation on the statement of net position. Bond discounts are deferred and amortized using the effective interest method over the life of the related debt. Issuance costs are reported as an expense in the year costs are incurred. Interest expense is recognized on the accrual basis.

In the governmental fund financial statements, bond discounts, in their entirety, are recognized in the current period as other financing uses. Principal payments, interest expense, and bond issuance costs, whether or not withheld from the actual debt proceeds received, are reported as expenditures when paid or when due and payable.

Deferred outflows of resources: In addition to assets, the statement of net position (deficit) sometimes reports deferred outflows of resources. This financial statement element, deferred outflows of resources, represents a consumption of net position that applies to future period(s) and so will not be recognized as an outflow of resources (expense/expenditure) until that time. The Authority has one item which qualifies for reporting in this category, the deferred charge on refunding resulting from the difference in the carrying value of refunded debt along with any forfeited unamortized bond discount amounts, and its reacquisition price. This amount is deferred and amortized over the shorter of the life of the refunded debt or the refunding debt.

Fund balance: In the governmental fund financial statements, the fund balance is classified as restricted. Amounts are restricted to specific purposes when constraints placed on the use of the resources are either externally imposed by creditors, grantors or state or federal laws or imposed by law through constitutional provisions or enabling legislation.

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Notes to Financial Statements

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

Net position (deficit): Net position (deficit) represents the difference between assets plus deferred outflows of resources and liabilities. Net position is 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 a restricted net position of \$17,748,168 for debt service by the sales agreement. The Authority first applies restricted resources when an expense is incurred for purposes for which both restricted and unrestricted net position are available.

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.

Budget: The Authority does not, and is not required to, have an appropriation budget.

Note 2. Deposits and Investments

Cash and cash equivalents as of June 30, 2017 included the cash balance of \$5,107,880 held by the Treasurer of State in pooled money funds and cash equivalents of \$17,748,168 invested in open-ended money market funds. Investments as of June 30, 2017 represent the guaranteed investment contract of \$59,198,916.

The Authority participates in the Treasurer of State's investment pool but does not own the underlying investments of the pool. For more information in regards to the credit risk, interest rate risk and concentration of credit risk of the Treasurer of State's investment pool, see the State of Iowa Comprehensive Annual Financial Statement.

Credit risk: Credit risk is the risk an issuer or other counterparty to an investment will not fulfill its obligation to the Authority. 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 investment in the guaranteed investment contract is not subject to credit risk categorization.

Interest rate risk: Interest rate risk is the risk changes in interest rates will adversely affect the value of the investment. The Authority's investment in the guaranteed investment contract is not subject to interest rate risk.

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Notes to Financial Statements

Note 2. Deposits and Investments (Continued)

Concentration of credit risk: Concentration of credit risk is the risk of loss that may be attributed to the magnitude of the Authority's investment in a single issuer. The Authority places no limit on the amount that may be invested in any one issuer. The Authority's investment in the guaranteed investment contract is not subject to concentration of credit risk.

Custodial credit risk: Custodial credit risk for deposits is the risk the Authority's deposits may not be returned to it in the event of a bank failure. 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 the State of Iowa's agent in the name of the Authority. The Authority's investment in the guaranteed investment contract is not subject to custodial credit risk.

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 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 ranging from 5.375 percent to 7.125 percent per annum and mature in varying annual amounts ranging from \$81,255,000 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, 2017 was \$720,187,488 (\$1,223,780,000 net of unamortized bond discounts and deferred amounts of \$503,592,512).

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 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.

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 3. Bonds Payable (Continued)

- (c) The "Turbo Redemptions" of the term bonds represent 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 are not available to the holders of, the Series 2005 A, B, C, D and E 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 \$59,198,916 as of June 30, 2017.
- (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, 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.

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 3. Bonds Payable (Continued)

The Authority is subject to certain nonfinancial covenants related to the Series 2005 Bonds. The Authority is in compliance with these covenants.

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

Year Ending June 30	Series 2005 A Term Bonds			Series 2005 B Convertible Capital Appreciation Bonds		
	Principal	Interest Rate	Interest	Principal	Interest Rate	Interest
2018	\$ 81,255,000	6.500%	\$ 5,281,575	\$ -	5.600%	\$ 9,968,560
2019	-	-	-	-	5.600	9,968,560
2020	-	-	-	-	5.600	9,968,560
2021	-	-	-	-	5.600	9,968,560
2022	-	-	-	-	5.600	9,968,560
2023-2027	-	-	-	-	5.600	49,842,800
2028-2032	-	-	-	-	5.600	49,842,800
2033-2037	-	-	-	178,010,000	5.600	19,106,407
2038-2042	-	-	-	-	-	-
2043-2046	-	-	-	-	-	-
	<u>\$ 81,255,000</u>		<u>\$ 5,281,575</u>	<u>\$ 178,010,000</u>		<u>\$ 168,634,807</u>

Year Ending June 30	Series 2005 C Term Bonds			Series 2005 C Term Bonds		
	Principal	Interest Rate	Interest	Principal	Interest Rate	Interest
2018	\$ -	5.375%	\$ 5,561,781	\$ -	5.500%	\$ 7,431,600
2019	-	5.375	5,561,781	-	5.500	7,431,600
2020	-	5.375	5,561,781	-	5.500	7,431,600
2021	-	5.375	5,561,781	-	5.500	7,431,600
2022	-	5.375	5,561,781	-	5.500	7,431,600
2023-2027	-	5.375	27,808,906	-	5.500	37,158,000
2028-2032	-	5.375	27,808,906	-	5.500	37,158,000
2033-2037	-	5.375	27,808,906	-	5.500	37,158,000
2038-2042	103,475,000	5.375	5,098,300	135,120,000	5.500	36,538,700
2043-2046	-	-	-	-	5.500	-
	<u>\$ 103,475,000</u>		<u>\$ 116,333,923</u>	<u>\$ 135,120,000</u>		<u>\$ 185,170,700</u>

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 3. Bonds Payable (Continued)

Year Ending June 30	Series 2005 C Term Bonds			Series 2005 D Capital Appreciation Bonds		
	Principal	Interest Rate	Interest	Principal	Interest Rate	Interest
2018	\$ -	5.625%	\$ 9,794,812	\$ -	6.250%	\$ -
2019	-	5.625	9,794,812	-	6.250	-
2020	-	5.625	9,794,812	-	6.250	-
2021	-	5.625	9,794,812	-	6.250	-
2022	-	5.625	9,794,812	-	6.250	-
2023-2027	-	5.625	48,974,060	-	6.250	-
2028-2032	-	5.625	48,974,060	-	6.250	-
2033-2037	-	5.625	48,974,060	-	6.250	-
2038-2042	-	5.625	48,974,060	-	6.250	-
2043-2046	174,130,000	5.625	38,363,014	190,800,000	6.250	-
	<u>\$ 174,130,000</u>		<u>\$ 283,233,314</u>	<u>\$ 190,800,000</u>		<u>\$ -</u>

Year Ending June 30	Series 2005 E Capital Appreciation Bonds			Total	
	Principal	Interest Rate	Interest	Principal	Interest
2018	\$ -	7.125%	\$ -	\$ 81,255,000	\$ 38,038,328
2019	-	7.125	-	-	32,756,753
2020	-	7.125	-	-	32,756,753
2021	-	7.125	-	-	32,756,753
2022	-	7.125	-	-	32,756,753
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
2043-2046	360,990,000	7.125	-	725,920,000	38,363,014
	<u>\$ 360,990,000</u>		<u>\$ -</u>	<u>\$ 1,223,780,000</u>	<u>\$ 758,654,319</u>

**Tobacco Settlement Authority
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Notes to Financial Statements

Note 3. Bonds Payable (Continued)

The following summarizes the bond payable activity for the Authority for the year ended June 30, 2017:

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Bonds payable:					
Term bonds	\$ 507,915,000	\$ -	\$ (13,935,000)	\$ 493,980,000	\$ 81,255,000
Convertible capital appreciation bonds	178,010,000	-	-	178,010,000	-
Capital appreciation bonds	551,790,000	-	-	551,790,000	-
Less:					
Issuance discounts	(14,022,168)	-	722,205	(13,299,963)	-
Capital appreciation discount	(477,489,157)	-	5,115,499	(472,373,658)	-
Deferral on refunding	(19,710,780)	-	1,791,889	(17,918,891)	-
Total bonds payable, net	<u>\$ 726,492,895</u>	<u>\$ -</u>	<u>\$ (6,305,407)</u>	<u>\$ 720,187,488</u>	<u>\$ 81,255,000</u>

Note 4. Deficit Net Position Balance

The deficit net position balance will be paid with future MSA revenues and investment income. The payments to be received by the State 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 5. Tobacco Litigation Risk

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

Note 6. Risk Management

The Authority has not purchased commercial insurance for risks of losses to which it is exposed. Instead, the Authority manages its risks internally and pays claim settlements directly. There have been no claims in any of the past three fiscal years against the Authority.

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Notes to Financial Statements

Note 7. Pending Governmental Accounting Standards Board (GASB) Pronouncements

The GASB has issued several Statements not yet implemented by the Authority. The Statement which may impact the Authority is as follows.

- GASB Statement No. 86, *Certain Debt Extinguishment Issues*, issued May 2017, will be effective for the Authority beginning with its fiscal year ending June 30, 2018. Statement No. 86 is designed to improve consistency in accounting and financial reporting for in-substance defeasance of debt by providing guidance for transactions in which cash and other monetary assets acquired with only existing resources—resources other than the proceeds of refunding debt—are placed in an irrevocable trust for the sole purpose of extinguishing debt. This Statement also improves accounting and financial reporting for prepaid insurance on debt that is extinguished and notes to financial statements for debt that is defeased in substance.

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

