

**DUTCHESS TOBACCO ASSET
SECURITIZATION CORPORATION**
(A COMPONENT UNIT OF THE COUNTY OF
DUTCHESS, NEW YORK)

*Basic Financial Statements and Required Supplementary
Information for the Year Ended December 31, 2012
and Independent Auditors' Reports*

DUTCHESS TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF DUTCHESS, NEW YORK)

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INDEPENDENT AUDITORS' REPORT

Board of Directors
Dutchess Tobacco Asset Securitization Corporation

Report on the Financial Statements

We have audited the accompanying financial statements of the governmental activities and each major fund of the Dutchess Tobacco Asset Securitization Corporation (the "DTASC"), a component unit of the County of Dutchess, New York, as of and for the year ended December 31, 2012, and the related notes to the financial statements, which collectively comprise the DTASC'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 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 from material misstatement.

An audit involves performing procedures to obtain 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 entity'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 entity'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 that 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, each major fund of DTASC, as of December 31, 2012, and the respective changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 2 to the financial statements, DTASC has restated its fund balance and net position as of December 31, 2011. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis as listed in the foregoing table of contents be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, 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.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated March 21, 2013 on our consideration of DTASC's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering DTASC's internal control over financial reporting and compliance.



March 21, 2013

DUTCHESS TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF DUTCHESS, NEW YORK)
Management's Discussion and Analysis
Year Ended December 31, 2012

As management of the Dutchess Tobacco Asset Securitization Corporation ("DTASC"), a blended component unit of the County of Dutchess, New York (the "County"), we offer readers of DTASC's financial statements this narrative overview and analysis of the financial activities of DTASC for the fiscal year ended December 31, 2012. Certain data from the prior year has been reclassified to conform with the current year presentation. We encourage readers to consider the information presented here in conjunction with additional information contained in the financial statements and notes to the financial statements. All amounts, unless otherwise indicated, are expressed in dollars.

Financial Highlights

- ◆ Total government-wide liabilities of DTASC exceeded government-wide assets by \$66,983,451 at December 31, 2012. This compares to total government-wide liabilities of DTASC exceeding government-wide assets by \$65,839,348 at December 31, 2011, as restated.
- ◆ DTASC's net position decreased by \$1,144,103 for the year ended December 31, 2012. This decrease in DTASC's net position was largely due to accreted interest costs and declining cigarette sales which may be attributed to recent increases in cigarette taxes.
- ◆ At the close of the current year, DTASC's governmental funds reported combined fund balances of \$3,533,223, an increase of \$241 in comparison with the prior year. Approximately 1.11% of this amount (\$39,317) is available for spending at DTASC's discretion (unassigned fund balance).

Overview of the Financial Statements

This discussion and analysis are intended to serve as an introduction to the DTASC's basic financial statements. DTASC's basic financial statements comprise three components: 1) government-wide financial statements, 2) fund financial statements and 3) notes to the financial statements.

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

The *statement of net position* presents information on all DTASC's assets, liabilities, and deferred inflows/outflows of resources, with the difference reported as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of DTASC is improving or deteriorating.

The *statement of activities* presents information showing how DTASC'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.

The government-wide financial statements can be found on pages 8-9 of this report.

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. DTASC, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Both of DTASC's funds are classified as governmental funds.

Governmental funds. 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 financing 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 provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

DTASC maintains two individual governmental funds, the General Fund and the Debt Service Fund. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balance for the both funds.

The basic governmental fund financial statements can be found on pages 10-13 of this report.

Notes to the 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. The notes to the financial statements can be found on pages 14-25 of this report.

Government-Wide Overall Financial Analysis

As noted earlier, net position may serve over time as a useful indicator of a government's financial position. In the case of DTASC, liabilities exceeded assets by \$66,983,451 at December 31, 2012, as compared to \$65,839,348 at December 31, 2011, as restated. Table 1, shown on the following page, presents the condensed statements of net position (deficit) for DTASC at December 31, 2012 and December 31, 2011, as restated.

Table 1—Condensed Statements of Net Position

	December 31,	
	2012	2011
Current assets	<u>\$ 7,045,525</u>	<u>\$ 7,009,961</u>
Total assets	<u>7,045,525</u>	<u>7,009,961</u>
Current liabilities	174,942	171,568
Noncurrent liabilities	<u>73,854,034</u>	<u>72,677,741</u>
Total liabilities	<u>74,028,976</u>	<u>72,849,309</u>
Net position	<u>\$ (66,983,451)</u>	<u>\$ (65,839,348)</u>

A portion of DTASC's net position (\$6,995,914) represents resources that are subject to external restrictions on how they may be used. The remaining net position is considered to be an unrestricted deficit.

At December 31, 2012, total DTASC assets were \$7,045,525; and, \$7,009,961 at December 31, 2011. The largest asset held by DTASC was an amount Due from New York State of \$3,502,008 at December 31, 2012 and of \$3,476,979 at December 31, 2011.

DTASC's liabilities totaled \$74,028,976 at December 31, 2012; and, \$72,839,309 at December 31, 2011. The largest portion of the liabilities is outstanding debt totaling \$73,854,034 and \$72,667,741 at December 31, 2012 and 2011, respectively.

Governmental Activities. During the current year, net position for governmental activities decreased \$1,144,103 from the prior fiscal year for an ending balance of \$(66,983,451). The statement of revenues, expenses and changes in net position presents revenues received and expenses paid by DTASC. Presented as Table 2, is the condensed statement of revenues, expenses and changes in net position for the years ended December 31, 2012 and 2011, as restated.

Table 2—Condensed Statements of Revenues, Expenses and Changes in Net Position

	Year Ended December 31,	
	2012	2011
General revenues	<u>\$ 3,698,671</u>	<u>\$ 3,637,363</u>
Expenses--governmental activities	<u>4,842,774</u>	<u>4,773,669</u>
Change in net position	(1,144,103)	(1,136,306)
Net position—beginning	(65,839,348)	(63,737,910)
Restatement	<u>-</u>	<u>(965,132)</u>
Net position—ending	<u>\$ (66,983,451)</u>	<u>\$ (65,839,348)</u>

General revenues are received from the tobacco settlement and from interest on investments. Expenses—governmental activities are associated with meeting debt service requirements and the administrative and maintenance costs associated with operating DTASC.

A summary of sources of revenues for the years ended December 31, 2012 and 2011 is presented below in Table 3.

Table 3—Sources of revenues

	<u>2012</u>	<u>2011</u>	Increase/(Decrease)	
			<u>\$</u>	<u>%</u>
Tobacco settlement revenues	\$ 3,533,970	\$ 3,472,672	\$ 61,298	1.8
Interest earnings	<u>164,701</u>	<u>164,691</u>	<u>10</u>	0.0
Total revenues	<u>\$ 3,698,671</u>	<u>\$ 3,637,363</u>	<u>\$ 61,308</u>	1.7

For the year ended December 31, 2012, total general revenues increased by 1.7%, due to an increase in tobacco settlement revenues.

The most significant source of revenue, for both years, was tobacco settlement revenue, which was 95.5% of total revenues for both the years ended December 31, 2012 and 2011. The next largest source of revenue each year was interest earnings which comprised 4.5% of total revenues for both the years ended December 31, 2012 and 2011.

A summary of expenses for the years ended December 31, 2012 and 2011 is presented below in Table 4.

Table 4—Operating expenses

	<u>2012</u>	<u>2011</u>	Increase/(Decrease)	
			<u>\$</u>	<u>%</u>
Expenses:				
General government support	\$ 71,107	\$ 79,028	\$ (7,921)	(10.0)
Interest and fiscal charges	<u>4,771,667</u>	<u>4,599,622</u>	<u>172,045</u>	3.7
Total expenses	<u>\$ 4,842,774</u>	<u>\$ 4,678,650</u>	<u>\$ 164,124</u>	3.5

DTASC's most significant expense items are interest and fiscal charges and general government, which comprised 98.5% and 1.5%, respectively, of total expenses for the year ended December 31, 2012, and 98.3% and 1.7%, respectively, for the year ended December 31, 2011.

DTASC total operating expenses for the year ended December 31, 2012, increased by 3.5% from the previous year. The increase was primarily due to an increase in interest and fiscal charges paid on long term debt.

Financial Analysis of Governmental Funds

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

Governmental Funds. The focus of DTASC's governmental funds is to provide information on near-term infows, outflows, and balances of spendable resources. Such information is useful in assessing DTASC's financing requirements. In particular, unassigned fund balance may serve as a useful measure of a government's net resources available for discretionary use as they represent the portion of fund balance which has not yet been limited to use for a particular purpose by either an external party, DTASC itself, or a group or individual that has been delegated authority to assign resources for use for particular purposes by DTASC's Board.

At December 31, 2012, DTASC's governmental funds reported combined fund balances of \$3,533,223, an increase of \$241 in comparison with the prior year. Approximately 1.11% of this amount (\$39,317) constitutes unassigned fund balance, which is available for spending at DTASC's discretion. The remainder of the fund balance is restricted to indicate that it is restricted for a particular purpose (\$3,493,906).

The general fund is the chief operating fund of DTASC. At the end of the current fiscal year, total fund balance of the general fund was unassigned fund balance in the amount of \$39,317. As a measure of the general fund's liquidity, it may be useful to compare both unassigned fund balance and total fund balance to total general fund expenditures. Both unassigned fund balance and total fund balance represent approximately 93.3% of total general fund expenditures.

Debt Administration

Long-Term Debt. At the end of the current fiscal year, DTASC had Tobacco Settlement Bonds outstanding of \$33,280,000 and Subordinate Turbo CABs outstanding of \$41,900,467. During the year ended December 31, 2012, DTASC made principal payments of \$1,585,000 on its Tobacco Settlement Bonds and accreted interest of \$2,685,551 on its Subordinate Turbo CABs.

Requests for Information

This financial report is designed to provide a general overview of DTASC's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Dutchess Tobacco Asset Securitization Corporation, c/o Dutchess County, 22 Market Street, Poughkeepsie, New York 12601.

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BASIC FINANCIAL STATEMENTS

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DUTCHESS TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF DUTCHESS, NEW YORK)
Statement of Net Position
December 31, 2012

ASSETS

Cash and cash equivalents	\$ 3,543,517
Due from New York State	<u>3,502,008</u>
Total assets	<u>7,045,525</u>

LIABILITIES

Current liabilities:

Accounts payable	10,294
Accrued interest payable	<u>164,648</u>
Total current liabilities	<u>174,942</u>

Non-current liabilities:

Due within more than one year - bonds, net of discount of \$1,326,613	31,953,387
Subordinate Turbo CABs	<u>41,900,647</u>
Total noncurrent liabilities	<u>73,854,034</u>
Total liabilities	<u>74,028,976</u>

NET POSITION

Restricted for debt service	6,995,914
Unrestricted (Deficit)	<u>(73,979,365)</u>
Total net position	<u>\$ (66,983,451)</u>

The notes to the financial statements are an integral part of this statement.

DUTCHESS TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF DUTCHESS, NEW YORK)
Statement of Activities
Year Ended December 31, 2012

<u>Functions/Programs</u>	<u>Expenses</u>	<u>Program Revenues</u>	<u>Revenue and Changes in Net Position</u> <u>Governmental Activities</u>
Primary Government:			
Governmental activities:			
General government support	\$ 71,107	\$ -	\$ (71,107)
Interest and fiscal charges	<u>4,771,667</u>	<u>-</u>	<u>(4,771,667)</u>
Total governmental activities	<u>\$ 4,842,774</u>	<u>\$ -</u>	<u>(4,842,774)</u>
General revenues:			
Interest earnings			164,701
Tobacco settlement revenues			<u>3,533,970</u>
Total general revenues			<u>3,698,671</u>
Change in net position			(1,144,103)
Net position—beginning, as previously stated			(64,874,216)
Restatement, see note 2			<u>(965,132)</u>
Net position—beginning, as restated			<u>(65,839,348)</u>
Net position—ending			<u>\$ (66,983,451)</u>

The notes to the financial statements are an integral part of this statement.

DUTCHESS TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF DUTCHESS, NEW YORK)
Balance Sheet—Governmental Funds
December 31, 2012

	General	Debt Service	Total Governmental Funds
ASSETS			
Cash and cash equivalents	\$ 49,611	\$ 3,493,906	\$ 3,543,517
Total assets	\$ 49,611	\$ 3,493,906	\$ 3,543,517
LIABILITIES AND FUND BALANCES			
Liabilities:			
Accounts payable	10,294	-	10,294
Total liabilities	10,294	-	10,294
Fund balances:			
Restricted for debt service	-	3,493,906	3,493,906
Unassigned	39,317	-	39,317
Total fund balances	39,317	3,493,906	3,533,223
Total liabilities and fund balances	\$ 49,611	\$ 3,493,906	\$ 3,543,517

The notes to the financial statements are an integral part of this statement.

DUTCHESS TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF DUTCHESS, NEW YORK)
Reconciliation of the Balance Sheet of Governmental Funds
to the Statement of Net Position
December 31, 2012

Amounts reported for governmental activities in the statement of net position are different from those reported in the balance sheet for governmental funds because:

Total fund balances—governmental funds	\$ 3,533,223
Other long-term assets are not available to pay for current period expenditures and, therefore, are reported as unavailable revenue in the funds.	3,502,008
Long-term liabilities, including bonds payable and accumulated interest on capital appreciation bonds, are not due and payable in the current period and, therefore, are not reported in the funds.	<u>(74,018,682)</u>
Total net position—governmental activities	<u>\$ (66,983,451)</u>

The notes to the financial statements are an integral part of this statement.

DUTCHESS TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF DUTCHESS, NEW YORK)
Statement of Revenues, Expenditures and Changes in Fund Balances
Governmental Funds
Year Ended December 31, 2012

	General	Debt Service	Total Governmental Funds
REVENUES			
Tobacco settlement revenue	\$ -	\$ 3,508,941	\$ 3,508,941
Interest and investment earnings	27	164,674	164,701
Total revenues	<u>27</u>	<u>3,673,615</u>	<u>3,673,642</u>
EXPENDITURES			
Current:			
General government support	42,154	28,953	71,107
Debt service:			
Principal	-	1,585,000	1,585,000
Interest	-	2,017,294	2,017,294
Total expenditures	<u>42,154</u>	<u>3,631,247</u>	<u>3,673,401</u>
Excess (deficiency) of revenues under expenditures	<u>(42,127)</u>	<u>42,368</u>	<u>241</u>
OTHER FINANCING SOURCES (USES)			
Transfers in	30,000	-	30,000
Transfers out	-	(30,000)	(30,000)
Total other financing sources (uses)	<u>30,000</u>	<u>(30,000)</u>	<u>-</u>
Net change in fund balances	(12,127)	12,368	241
Fund balances—beginning, as previously stated	51,444	6,958,517	7,009,961
Restatement	-	(3,476,979)	(3,476,979)
Fund balances—beginning, restated	<u>51,444</u>	<u>3,481,538</u>	<u>3,532,982</u>
Fund balances—ending	<u>\$ 39,317</u>	<u>\$ 3,493,906</u>	<u>\$ 3,533,223</u>

The notes to the financial statements are an integral part of this statement.

DUTCHESS TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF DUTCHESS, NEW YORK)
Reconciliation of the Statement of Revenues, Expenditures and Changes in Fund Balances
of Governmental Funds to the Statement of Activities
Year Ended December 31, 2012

Amounts reported for governmental activities in the statement of activities are different from those reported in the statement of revenues, expenditures and changes in fund balances of governmental funds because:

Net change in fund balances—total governmental funds	\$	241
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Revenues in the statement of activities that do not provide current financial resources are not reported as revenues in the funds.		25,029
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The issuance of long-term debt (e.g., bonds) provides current financial resources to governmental funds, while the repayment of the principal of long-term debt consumes the current financial resources of government funds. Neither transaction, however, has any effect on net position. Also, governmental funds report the effect of issuance costs, premiums discounts, and similar items when debt is first issued, whereas these amounts are deferred and amortized in the statement of activities. This amount is the net effect of these differences in the treatment of long-term debt and related items.

		<u>(1,169,373)</u>
Change in net position of governmental activities	\$	<u>(1,144,103)</u>

The notes to the financial statements are an integral part of this statement.

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DUTCHESS TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF DUTCHESS, NEW YORK)
Notes to the Financial Statements
December 31, 2012

1. ORGANIZATION

The Dutchess Tobacco Asset Securitization Corporation (“DTASC”) is a special purpose, bankruptcy remote, local development corporation organized under the Not-for-Profit Corporation Law of the State of New York. DTASC is an instrumentality of, but separate and apart from, the County of Dutchess, New York (the “County”). Although legally separate and independent of the County, DTASC is considered an affiliate organization under Governmental Accounting Standards Board (“GASB”) Statement No. 39, *Determining Whether Certain Organizations are Component Units*. Accordingly, DTASC is reported as a blended component unit of the County.

The board of directors of DTASC has three members, one appointed by the County Executive, one appointed by the Chairman of the Dutchess County Legislature, and one jointly appointed by the County Executive and Chairman of the County Legislature.

The DTASC was formed on December 1, 2003 for the purpose of issuing Asset Backed Bonds in order to provide funds to purchase from the County all of the County’s right, title and interest under the Master Settlement Agreement (the “MSA”) and the Consent Decree and Final Judgment (the “Decree”) as described herein. DTASC has issued bonds in two series: 1) the New York Counties Tobacco Trust III issued in 2003 and 2) Subordinate Capital Appreciation Bonds issued in 2005.

The MSA was entered into on November 23, 1998, among the attorneys general of 46 states (including New York), the District of Columbia, the Commonwealth of Puerto Rico, Guam, the U.S. Virgin Islands, American Samoa and the Territory of the Northern Marianas and for the four largest United States tobacco manufacturers: Philip Morris Incorporated, R.J. Reynolds Tobacco Company, Brown and Williamson Tobacco Company and Lorillard Tobacco Company (collectively the “Original Participating Manufacturers” or “OPMs”) in settlement of certain smoking-related litigation and the Decree entered in New York Supreme Court, including the County’s right to receive certain initial and annual payments to be made by the OPMs under the MSA. On January 5, 2004, R.J. Reynolds was incorporated as a holding company to facilitate the combination of the U.S. assets, liabilities and operations of Brown and Williamson with those of Reynolds Tobacco.

In 2003 and 2005, DTASC used \$41,970,000 and \$25,500,000, respectively, in bond proceeds to purchase tobacco settlement rights from the County.

Subsequent to the initial sale of the Bonds, the County has the right to receive net proceeds of future bond issuances and the revenues of DTASC that are in excess of DTASC’s expenses, debt service and contractual obligations, pursuant to the Indenture. In the current year, there were no payments to the County resulting from these excess revenues.

During the year ended December 31, 2005, DTASC participated in the New York Counties Tobacco Trust V (“NYCTT V”), along with twenty-three other New York County Tobacco Corporations, and issued subordinate Capital Appreciation Bonds (“CABs”) in various series for the purpose of securitizing additional future tobacco settlement revenues. Net proceeds of the 2005 series, after closing costs, amounted to \$26,236,279. The County has set these proceeds aside in their entirety for capital projects. With the issuance of the 2005 CAB, the County is no longer entitled to any residual cash receipts until such time that the 2005 CAB is retired.

The following *acronyms* that have been used throughout this report:

CAB	Capital Appreciation Bond
FDIC	Federal Depository Insurance Corporation
FHLMC	Federal Home Loan Mortgage Corporation
FNMA	Federal National Mortgage Association
GASB	Governmental Accounting Standards Board
MSA	Master Settlement Agreement
NPM	Non-Participating Manufacturers
DTASC	Dutchess Tobacco Asset Securitization Corporation
NYCTT	New York Counties Tobacco Trust V
OPMs	Original Participating Manufacturers
TSR	Tobacco Settlement Revenues

Description of Government-Wide Financial Statements

The government-wide financial statements (i.e., statement of net position and the statement of changes in net position) report information on all the nonfiduciary activities of DTASC. All fiduciary activities are reported only in the fund financial statements. *Governmental activities*, which normally are supported by taxes, intergovernmental revenues, and other nonexchange transactions are reported separately from *business-type activities*, which rely to a significant extent on fees and charges for support. DTASC reports no business-type activities.

Basis of Presentation – Government-Wide Financial Elements

While separate government-wide and fund financial statements are presented, they are interrelated. The governmental activities column incorporates data from governmental funds. Separate financial statements are provided for governmental funds.

As a general rule, the effect of interfund activity has been eliminated from the government-wide financial statements.

Basis of Presentation – Fund Financial Statements

The fund financial statements provide information about DTASC's funds, and separate statements for governmental funds are presented. The emphasis of fund financial statements is on major governmental funds, each displayed in a separate column in the fund financial statements.

DTASC reports the following major governmental funds:

The *general fund* is DTASC's primary operating fund. It accounts for all financial resources associated with DTASC except for those accounted for in another fund.

The *debt service fund* is used to account for the accumulation of resources that are restricted for the payment principal and interest on long-term obligations of governmental funds.

During the course of operations the government has activity between funds for various purposes. Any residual balances outstanding at year end are reported as due from/to other funds and advances to/from other funds. While these balances are reported in fund financial statements, certain eliminations are made in the preparation of the government-wide financial statements. Balances

between the funds included in governmental activities are eliminated so that only the net amount is included as internal balances in the governmental activities column.

Further, certain activity occurs during the year involving transfers of resources between funds. In fund financial statements these amounts are reported at gross amounts as transfers in/out. While reported in fund financial statements, certain eliminations are made in the preparation of the government-wide financial statements. Transfers between the funds included in governmental activities are eliminated so that only the net amount is included as transfers in the governmental activities column.

Measurement Focus and Basis of Accounting

The accounting and financial reporting treatment is determined by the applicable measurement focus and basis of accounting. Measurement focus indicates the type of resources being measured such as *current financial resources* or *economic resources*. The basis of accounting indicates the timing of transactions or events for recognition in the financial statements.

The government-wide 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 the related cash flows.

Tobacco settlement revenues are exchange transactions, based on the notion that the payments are made to the settling states in exchange for their agreement to release the tobacco companies from present and future litigation. Under the terms of the MSA, the tobacco companies have agreed to make annual payments in perpetuity. The MSA includes a schedule of projected annual base payments, subject to certain adjustments based on future events or circumstances. The most significant factor affecting the annual payments is a *volume adjustment*, which creates a direct relationship between domestic shipments of cigarettes and the annual payments. Based on the MSA, the tobacco companies have no obligation to make settlement payments until cigarettes are shipped.

The event that results in the recognition of an asset and revenue by a settling government is the domestic shipment of cigarettes (sales). Therefore, the County recognizes a receivable and revenue for tobacco settlement revenues when that event occurs. Because annual tobacco settlement revenue payments are based on cigarette sales from the preceding calendar year, the County estimates accrued tobacco settlement revenues that derive from sales from January 1 to their respective fiscal year ends. Under the modified accrual basis of accounting, revenue should be recognized to the extent that the event occurs and resources become *available*.

The governmental fund 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, DTASC 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 the payment is due. Issuance of long-term debt and acquisitions under capital leases are reported as other financing sources.

Interest associated with the current fiscal period is considered to be susceptible to accrual and so have been recognized as revenues of the current fiscal period. Entitlements are recorded as revenues when all eligibility requirements are met, including any time requirements, and the amount is received during the period or within the availability period for this revenue source (within 60 days of year

end). Expenditure-driven grants are recognized as revenue when the qualifying expenditures have been incurred and all other eligibility requirements have been met, and the amount is received during the period or within the availability period for this revenue source (within 60 days of year end). All other revenue items are considered to be measurable and available only when cash is received by the government.

Assets, Liabilities, Deferred Outflows/Inflows of Resources, and Net Position/Fund Balance

Cash and cash equivalents—Cash and cash equivalents are considered to be cash on hand, demand deposits, and short-term investments with original maturities of three months or less from the date acquired by DTASC.

Investments—Investments for DTASC are reported at fair value (generally based on quoted market prices).

Deferred outflows/inflows of resources—In addition to assets, the statement of financial position will sometimes report a separate section for deferred outflows of resources. This separate financial statement element, *deferred outflows of resources*, represents a consumption of net position that applies to a future period(s) and so will *not* be recognized as an outflow of resources (expense/expenditure) until then.

In addition to liabilities, the statement of financial position will sometimes report a separate section for deferred inflows of resources. This separate financial statement element, *deferred inflows of resources*, represents an acquisition of net position that applies to a future period(s) and so will *not* be recognized as an inflow of resources (revenue) until that time.

DTASC does not have any deferred outflows or inflows of resources at December 31, 2012.

Net position flow assumption—Sometimes DTASC will fund outlays for a particular purpose from both restricted (e.g., restricted bond proceeds) and unrestricted resources. In order to calculate the amounts to report as restricted – net position and unrestricted – net position in the government-wide financial statements, a flow assumption must be made about the order in which the resources are considered to be applied. It is DTASC’s policy to consider restricted – net position to have been depleted before unrestricted – net position is applied.

Fund balance flow assumption—Sometimes DTASC will fund outlays for a particular purpose from both restricted and unrestricted resources (the total of committed, assigned, and unassigned fund balance). In order to calculate the amounts to report as restricted, committed, assigned, and unassigned fund balance in the governmental fund financial statements a flow assumption must be made about the order in which the resources are considered to be applied. If DTASC must use funds for emergency expenditures it shall expend funds first from funds classified under GASB 54 as nonspendable (if funds become available) then restricted funds. The use of committed and assigned funds as classified by GASB 54 will occur after the exhaustion of available restricted funds. Finally, if no other fund balances are available DTASC will use unassigned fund balance.

Fund balance policies—Fund balance of governmental funds is reported in various categories based on the nature of any limitations requiring the use of resources for specific purposes. DTASC itself can establish limitations on the use of resources through either a commitment (committed fund balance) or an assignment (assigned fund balance).

The committed fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of DTASC’s highest level of decision-making authority

(DTASC Board). The governing board is the highest level of decision-making authority for the government that can, by adoption of an ordinance prior to the end of the fiscal year, commit fund balance. Once adopted, the limitation imposed by the ordinance remains in place until a similar action is taken (the adoption of another ordinance) to remove or revise the limitation.

Amounts in the assigned fund balance classification are intended to be used by the government for specific purposes but do not meet the criteria to be classified as committed. The governing board (DTASC Board) has by resolution authorized the sole Member to assign fund balance. The Board may also assign fund balance as it does when appropriating fund balance to cover a gap between estimated revenue and appropriations in the subsequent year’s appropriated budget. Unlike commitments, assignments generally only exist temporarily. In other words, an additional action does not normally have to be taken for the removal of an assignment. Conversely, as discussed above, an additional action is essential to either remove or revise a commitment.

Revenues and Expenditures/Expenses

Program and General Revenues—Amounts reported as *program revenues* include 1) charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided by a given function or segment and 2) grants and contributions (including special assessments) that are restricted to meeting the operational or capital requirements of a particular function or segment. Items not properly included among program revenues are reported instead as *general revenues*.

Expenditures/Expenses—Expenditures are recorded on a modified accrual basis of accounting. Payments to the County are recorded when the obligation is incurred. General administration costs consist of operating expenses for professional service fees and are paid from General Fund revenues. *Direct expenses* are those that are clearly identifiable with a specific function. Indirect expenses have been included as part of the program expenses reported for the various functional activities.

Reconciliation of Government-Wide and Fund Financial Statements

Explanation of Certain Differences between the Governmental Fund Balance Sheet and the Government-Wide Statement of Net Position—The governmental fund balance sheet includes a reconciliation between *fund balance – total governmental funds* and *net position – governmental activities* as reported in the government-wide statement of net position. One element of that reconciliation explains that “long-term liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds.” The details of this \$74,018,682 difference are as follows:

Tobacco Settlement bonds payable	\$ 31,953,388
Subordinate turbo CABs payable	41,900,646
Accrued interest payable	<u>164,648</u>
Net adjustment to reduce <i>fund balance - total governmental funds</i> to arrive at <i>net position - governmental activities</i>	<u><u>\$ 74,018,682</u></u>

Explanation of Certain Differences between the Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balances and the Government-Wide Statement of Activities—The governmental fund statement of revenues, expenditures, and changes in fund balances includes a reconciliation between *net changes in fund balances – total governmental funds* and *changes in net position of governmental activities* as reported in the government-wide statement of activities. One element of that reconciliation states that “the issuance of long-term debt (e.g., bonds, leases) provides current financial resources to governmental funds, while the repayment of the principal of long-term debt consumes the current financial resources of governmental funds. Neither transaction, however, has any effect on net position. Also, governmental funds report the effect of premiums, discounts, and similar items when debt is first issued, whereas these amounts are deferred and amortized in the statements of activities. This amount is the net effect of these differences in the treatment of long-term debt and related items.” The details of this \$1,169,373 difference are as follows:

Debt issued or incurred:	
Accreted interest on subordinate turbo CABs	\$ 2,685,551
Change in accrued interest payable	(6,920)
Amortization of bond discount	75,742
Principal repayments:	
Tobacco settlement bonds	<u>(1,585,000)</u>
Net adjustment to decrease <i>changes in fund balances - total governmental funds</i> to arrive at <i>changes in net position of governmental activities</i>	<u>\$ 1,169,373</u>

Stewardship, Compliance and Accountability

Adoption of New Accounting Pronouncements—During the year ended December 31, 2012, DTASC adopted the provisions of Governmental Accounting Standards Board (“GASB”) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which requires the DTASC to change its fund balance classifications for governmental funds. The new classifications are explained below:

Nonspendable fund balance—Amounts that are not in a spendable form (such as inventory or prepaids) or are required to be maintained intact (such as the corpus of an endowment fund).

Restricted fund balance—Amounts constrained to specific purposes by their providers (such as grantors, bondholders, and higher levels of government) through constitutional provisions or by enabling legislation.

Committed fund balance—Amounts constrained to specific purposes by a government itself using its highest level of decision-making authority (DTASC Board); to be reported as committed, amounts cannot be used for any other purpose unless the government takes the same highest-level action to remove or change the constraint.

Assigned fund balance—Amounts a government intends to use for a specific purpose; intent can be expressed by the governing body or by an official or body to which the governing body delegates the authority.

Unassigned fund balance—Amounts that are available for any purpose; these amounts are reported only in the general fund.

Also during the year ended December 31, 2012, DTASC adopted the provisions of GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, and GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*. DTASC elected to early implement GASB Statement No. 65. GASB Statement No. 63 amends the net asset reporting requirements in GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, and other pronouncements by incorporating deferred outflows of resources and deferred inflows of resources into the definitions of the required components of the residual measure and by renaming that measure as net position, rather than net assets. GASB Statement No. 65 establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. GASB No. 63 did not have a material impact on DTASC’s financial position or results from operations. As a result of the implementation of GASB Statement No. 65, net position of governmental activities at December 31, 2011 has been restated for unamortized bond issuance costs of \$965,132.

Additionally, during the year ended December 31, 2012, DTASC completed the process of evaluating the impact that resulted from adopting GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*, GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, and GASB Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions—an amendment of GASB Statement No. 53*. GASB Statement Nos. 57, 60, 62 and 64 did not have a material impact on DTASC’s financial position or results from operations.

Future Impacts of Accounting Pronouncements—DTASC has not completed the process of evaluating the impact that will result from adopting GASB Statement No. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34*, and GASB Statement No. 66, *Technical Corrections-2012—an amendment of GASB Statements No. 10 and No. 62*, effective for the year ending December 31, 2013; GASB Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, and GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*, effective for the year ending December 31, 2014; and GASB Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, effective for the year ending December 31, 2015. DTASC is, therefore, unable to disclose the impact that adopting GASB Statements Nos. 61, 66, 67, 68 and 69 will have on its financial position and results of operations.

2. RESTATEMENTS AND CHANGES TO FUND BALANCE AND NET POSITION

Tobacco settlement payments to be received by the County during the year ending December 31, 2013 are based on tobacco sales made during the year ended December 31, 2012. While they are not considered receivable under the modified accrual basis of accounting as discussed in Note 1, they are considered receivable within the governmental activities during the current year. Previously, DTASC accrued an estimate of the tobacco settlement revenue to be received in the subsequent year in both the governmental fund financial statements and the government-wide financial statements. Fund balance at December 31, 2011 has been restated to remove the tobacco settlement revenue receivable of \$3,476,979 from the fund financial statements.

The effect of this change to beginning fund balance is summarized below:

	Governmental Fund
	<u>Debt Service Fund</u>
Fund balance, December 31, 2011, as previously reported	\$ 6,958,517
Change in recognition of TSR Revenues	<u>(3,476,979)</u>
Fund balance, December 31, 2011, as restated	<u>\$ 3,481,538</u>

As discussed in Note 1, during the year ended December 31, 2012, DTASC implemented GASB Statement No. 65. As a result of this implementation, existing DTASC bond issuance costs are expensed. Net position at December 31, 2011 has been restated to remove unamortized bond issuance costs of \$965,132.

The effect of this change to beginning net position is summarized below:

	<u>Net Position</u>
Net position, December 31, 2011 - as previously reported	\$ (64,874,216)
Recognition of unamortized bond issuance costs	<u>(965,132)</u>
Net position, December 31, 2011 - as restated	<u>\$ (65,839,348)</u>

3. CASH AND CASH EQUIVALENTS

At December 31, 2012, DTASC's cash was insured by either the Federal Depository Insurance Corporation ("FDIC") or collateralized by securities held in the pledging bank's trust department in DTASC's name. DTASC's investment policy provides for eligible investments in defeasance collateral, obligations of FHLMC, FNMA, or the Federal Farm Credit System, demand and time deposit accounts and certificates of deposit, general obligations of states and guaranteed state obligations, commercial or finance company paper, repurchase obligations, corporate securities bearing interest or sold at discount, taxable money market funds, investment agreements or guaranteed investment contracts, and other obligations or securities that are non-callable.

At December 31, 2012, DTASC's cash and cash equivalents consisted of the following:

<u>Description</u>	<u>Maturity Date</u>	<u>Fair Value at 12/31/2012</u>
Cash and cash equivalents:		
Cash on deposit		\$ 49,611
Money market funds		53,018
Domestic commercial paper	2/28/2013	<u>3,440,888</u>
		<u>\$ 3,543,517</u>

Deposits – All deposits including cash in bank and certain investments (i.e. certificates of deposit) are carried at fair value.

	Carrying Amount	Bank Balance
Insured (FDIC)	<u>\$ 102,629</u>	<u>\$ 102,629</u>
Total	<u>\$ 102,629</u>	<u>\$ 102,629</u>

Investments – Investments include money market accounts and a discount note with a maturity date within three months of year end and are, therefore, considered to be cash equivalents. These investments are carried at fair value.

	Carrying Amount	Bank Balance
Discount Note	<u>\$ 3,440,888</u>	<u>\$ 3,440,888</u>
	<u>\$ 3,440,888</u>	<u>\$ 3,440,888</u>

Custodial credit risk – deposits – Custodial credit risk is the risk that in the event of a bank failure, the DTASC’s deposits may not be returned to it. As noted above, by State statute all deposits in excess of FDIC insurance coverage must be collateralized. As of December 31, 2012, the DTASC’s deposits were FDIC insured or collateralized.

4. RECEIVABLES

Due from New York State—Represents amounts owed to DTASC for tobacco settlement revenue earned in 2012. The DTASC has accrued \$3,502,008 within the government-wide statements only, because it does not meet the revenue recognition criteria for fund financial statement purposes.

5. LONG-TERM DEBT

In 2003, DTASC issued \$47,815,000 of the New York Counties Tobacco Trust III Tobacco Settlement Pass-Through Bonds, Series 2003 pursuant to an indenture dated as of December 18, 2003. The issue value of the bonds was \$45,912,363, net of a bond discount of \$1,902,637. Proceeds of \$41,970,350 were paid to the County for deposit to an escrow fund as a purchase from the County of all of the County’s right, title and interest, under the MSA and the Decree, including the Tobacco Settlement Revenues (“TSR”).

The payment of the Series 2003 Term Bonds is dependent on the receipt of TSRs. The amount of TSRs actually collected is dependent on many factors including cigarette consumption and the continued operations of the OPMs. Such bonds are secured by and payable solely from TSRs and investment earnings pledged under the Bond Indenture and amounts established and held in accordance with the Bond Indenture. The Series 2003 Term Bonds are subject to “Turbo Redemptions”, which represent the requirement contained in the Indenture to apply 100% of all collections that are in excess of the requirements in the Indenture for the funding of the operating expenses; interest, sinking fund installments, and term bond maturities; maintenance of the Liquidity Reserve Account; to the redemption of Series 2003 Term Bonds on each distribution date in ascending order of maturity. Such surplus collections will be deposited in an account established and maintained by the trustee under the Indenture (the Turbo Redemption Account). Turbo Redemptions will be credited against sinking fund installments for any particular Series 2003 Term Bonds in ascending order of sinking fund installment dates. Turbo Redemptions are not scheduled amortization payments are to be made only from surplus collections. In June 2012, DTASC made a Turbo Redemption payment of \$1,585,000.

In the event sufficient funds are not available to meet Planned Payment Maturities, Rated Maturity dates will be used.

Interest is payable on the Series 2003 Term Bonds on June 1 and December 1 of each year. Planned Principal Payments and Rate Maturities are scheduled only on June 1 of each year although principal could be paid semiannually if actual principal payments are slower than Planned Principal Payments. Failure to pay interest on the Series 2003 Term Bonds when due or principal of the Series 2003 Term Bonds when due on a Rated Maturity Date will constitute a default.

On November 15, 2005, DTASC participated in New York Counties Tobacco Trust V (“NYCTT”), along with 23 other New York County Tobacco Corporations, and issued Tobacco Settlement Pass-Through Bonds—Subordinate Turbo CABs in various series for the purpose of securitizing additional future tobacco settlement revenues. The proceeds of these bonds, \$25,500,000 (after the deduction of \$736,279 in bond issuance and underwriter costs), were used to purchase tobacco settlement rights from the County. The issuance has four components and payments on the Subordinate Turbo CABs are subordinate to the Series 2003 Term Bonds.

Changes in Tobacco Settlement Bonds, Series 2003, for the year ended December 31, 2012 is as follows:

Description	Year of Maturity	Yield	Beginning Balance 1/1/2012	Additions	Deletions	Ending Balance 12/31/2012
Tobacco Settlement Bonds:						
Series 2003	2043	various	\$ 34,865,000	\$ -	\$ 1,585,000	\$ 33,280,000
Less:						
Bond Discount			1,402,355	-	75,742	1,326,613
Net Tobacco Settlement Bonds			<u>\$ 33,462,645</u>	<u>\$ -</u>	<u>\$ 1,660,742</u>	<u>\$ 31,953,387</u>

DTASC debt service requirements based upon planned principal payments for Tobacco Settlement Bonds, Series 2003 are as follows:

Year ended December 31,	Principal	Interest	Total
2013	\$ -	\$ 1,975,775	\$ 1,975,775
2014	-	1,975,775	1,975,775
2015	-	1,975,775	1,975,775
2016	-	1,975,775	1,975,775
2017	-	1,975,775	1,975,775
2018-2022	-	9,878,875	9,878,875
2023-2027	-	9,878,875	9,878,875
2028-2032	6,720,000	9,011,487	15,731,487
2033-2037	9,805,000	6,575,838	16,380,838
2038-2042	13,510,000	3,103,800	16,613,800
2043	3,245,000	97,350	3,342,350
	<u>\$ 33,280,000</u>	<u>\$ 48,425,100</u>	<u>\$ 81,705,100</u>

Subordinate Turbo CABs—Interest on the Subordinate Turbo CABs is compounded semiannually on June 1 and December 1, but is not payable until bond maturity. Interest accretes until both principal and accreted interest are paid. Future interest accretion has been recorded as bond discount and amortized as the current interest accretes. The accreted interest on the Subordinate Turbo CABs is reflected within the Subordinate Turbo CABs payable liability.

A summary of the Subordinate Turbo CABs net bond balance activity for the year ended December 31, 2012 follows:

	Interest Rate	Original Principal	Beginning Balance 1/1/2012	Annual Net Interest Accretion	Turbo Redemption Payments	Ending Balance 12/31/2012
Subordinate	6.00% -					
Turbo CABs	7.85%	<u>\$ 26,236,279</u>	<u>\$ 39,215,096</u>	<u>\$ 2,685,551</u>	<u>\$ -</u>	<u>\$ 41,900,647</u>

Redemption of the Subordinate Turbo CABs consist of four installments, and will be due and payable on the following maturity dates:

Series 2005 S1	June 1, 2038
Series 2005 S2	June 1, 2050
Series 2005 S3	June 1, 2055
Series 2005 4B	June 1, 2060

6. NET POSITION AND FUND BALANCE

The government-wide financial statements utilize a net position presentation. Net position is categorized as restricted and unrestricted components.

- ◆ ***Restricted for Debt Service***—This category restricts a portion of net position for payment of the debt service obligations of DTASC. At December 31, 2012, the balance of this restriction was \$6,995,914.
- ◆ ***Unrestricted Component of Net Position***—This component represents net position of DTASC not restricted for any other purpose.

In the fund financial statements, restricted fund balances are amounts constrained to specific purposes (such as grantors, bondholders, and higher levels of government) through constitutional provisions or by enabling legislation. At December 31, 2012, DTASC reported \$3,493,906 of fund balance restricted for debt service that must be used toward the future repayment of bonded debt.

As of December 31, 2012, DTASC reported no nonspendable, committed, or assigned fund balances.

7. CONTINGENCIES

The ability of the Corporation to meet debt service payments of bonds is contingent upon the receipt of TSRs. TSRs are principally dependent upon future levels of domestic consumption. A significant decline in the overall consumption of cigarettes could have a material adverse effect on the payments

by the OPMs under the MSA and the amounts available to DTASC to make payments of principal and interest on their bonds.

Certain smokers, smokers' rights organizations, consumer groups, cigarette importers, cigarette distributors, cigarette manufacturers, Native American tribes, taxpayers, taxpayers' groups and other parties have filed actions against some, and in certain cases all, of the signatories to the MSA. In the event of an adverse court ruling in such types of litigation, Bondholders could incur a complete loss of their investment.

Additionally, the OPM's are also exposed to liability from various lawsuits including individual lawsuits, class action lawsuits and health care cost recovery litigation. Ultimately, the outcome of these and any other pending or future lawsuits is uncertain. One or more adverse judgment could result in delays in, or reductions of amounts available for, payments on the bonds.

8. SUBSEQUENT EVENTS

Management has evaluated subsequent events through March 21, 2013, which is the date the financial statements are available for issuance, and have determined there are no subsequent events that require disclosure under generally accepted accounting principles.

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

To the Board of Directors
Dutchess Tobacco Asset Securitization Corporation

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities and each major fund of Dutchess Tobacco Asset Securitization Corporation ("DTASC") as of and for the year ended December 31, 2012, and the related notes to the financial statements, which collectively comprise DTASC's basic financial statements, and have issued our report thereon dated March 21, 2013, (which report contains an emphasis of matter paragraph relating to the restatements of beginning fund balance and net position).

Internal Control Over Financial Reporting

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

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

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

Compliance and Other Matters

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

Purpose of this Report

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

Handwritten signature of Duesch & Melch LLP in cursive script.

March 21, 2013