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

JUNE 30, 2008
September 29, 2008

The Honorable Mark Sanford, Governor
and
Members of the Tobacco Settlement Revenue
Management Authority
Columbia, South Carolina

This 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 of the Tobacco Settlement Revenue Management Authority for the fiscal year ended June 30, 2008, was issued by Rogers Laban, PA, Certified Public Accountants, under contract with the South Carolina Office of the State Auditor.

If you have any questions regarding this report, please let us know.

Respectfully submitted,

Richard H. Gilbert, Jr., CPA
Deputy State Auditor

RHGjr/cwc
INDEPENDENT AUDITORS’ REPORT ON INTERNAL
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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

Mr. Richard H. Gilbert, Jr., CPA
Deputy State Auditor
State of South Carolina
Columbia, South Carolina

We have audited the financial statements of the Tobacco Settlement Revenue Management Authority (the Authority) as of and for the year ended June 30, 2008, and have issued our report thereon dated September 12, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting
In planning and performing our audit, we considered the Authority’s internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Authority’s internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Authority’s internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified a deficiency in internal control over financial reporting that we consider to be significant deficiency.

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

Going Beyond The Numbers.

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

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that the significant deficiency described on the schedule of findings is a material weakness.

**Compliance and Other Matters**

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

This report is intended solely for the information and use of the Governor, State Auditor, Members of the Authority and management and is not intended to be and should not be used by anyone other than these specified parties.

September 12, 2008
SCHEDULE OF FINDINGS
During the current year the Authority issued $275,730,000 Tobacco Settlement Revenue Asset-backed Refunding Bonds, Series 2008. The proceeds of the bonds were used to defease a portion of the $200,000,000 Series 2001A and $734,530,000 Series 2001B bonds. We determined that the Authority did not properly account for the substance of the defeasance in its financial statements. As a result significant adjustments were made to the financial statements and related notes pertaining to the bond issuance and defeasance. The Authority's staff has the expertise to prepare financial statements and notes reporting basic accounting transactions. However, when they encounter financial transactions that are more advanced i.e., transactions that they do not encounter on a frequent basis, they have difficulty properly reporting the transactions.

Management is responsible for establishing internal controls to ensure the fair presentation of financial statements. Recent issued auditing standards emphasize that management should not rely on its external auditor to be part of the entity's system of internal control.

We recommend that the Authority evaluate its needs and consider contracting with consultants as necessary to assist with the preparation of its financial statements.
MANAGEMENT'S RESPONSE

APPENDIX A
September 30, 2008

Mr. Richard H. Gilbert, Jr., CPA
Deputy State Auditor
State of South Carolina
Columbia, South Carolina

Re: Tobacco Settlement Revenue Management Authority

Dear Mr. Gilbert:

I am responding to the deficiency identified in the Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards, which report is dated September 12, 2008. The schedule of findings states that

"During the current year the Authority issued $275,730,000 Tobacco Settlement Revenue Asset-backed Refunding Bonds, Series 2008. The proceeds of the bonds were used to defease a portion of the $200,000,000 Series 2001A and $734,530,000 Series 2001B bonds. We determined that the Authority did not properly account for the substance of the defeasance in its financial statements. As a result significant adjustments were made to the financial statements and related notes pertaining to the bond issuance and defeasance. The Authority's staff has the expertise to prepare financial statements and notes reporting basic accounting transactions. However, when they encounter financial transactions that are more advanced i.e., transactions that they do not encounter on a frequent basis, they have difficulty reporting the transactions.

Management is responsible for establishing internal controls to ensure the fair presentation of financial statements. Recently issued auditing standards emphasize that management should not rely on its external auditor to be part of the entity's system of internal control.

We recommend that the Authority evaluate its needs and consider contracting with consultants as necessary to assist with the preparation of its financial statements."

Following discussion of the finding with Mr. Laban, it is my understanding that the material deficiency he has documented is primarily a consequence of his assessment of the differences in the statements and notes between the first draft furnished to him and the final draft that was submitted for review by the State Auditor and the Office of Comptroller General.
Before responding to the documented deficiency, I believe that there is benefit to understanding the processes of general preparation of the statements, with particular focus on integrating the transaction described in the finding into this year's statements.

The Office of State Treasurer provides staff support (hereinafter referred to as "staff") to the Authority, primarily because the Authority securitized the amounts due to the State under the tobacco master settlement agreement by the issuance of Bonds in March, 2001.

The contractual obligations of the Authority with the bondholders of the securitized indebtedness place the majority of the Authority's assets under the control of a bond trustee. Accordingly, except for a modest amount of revenue due the Authority to pay its expenses of operation (along with legislatively directed transfers to the Office of Attorney General for reimbursement of certain of its actual expenses), most financial transactions are processed by the trustee. Hence, the financial statements of the Authority are prepared largely from trustee statements, with staff categorizing and grouping those transactions into the presentation format for the financial statement. Significantly, for several years, staff has prepared these financial statements with little assistance, direction or intervention from the independent auditor.

In every year to this point, staff has worked under the assumption that all drafts prior to submission for review by the State Auditor and Office of Comptroller General were informal and preliminary. Accordingly, in undertaking the preparation of this year's statements, staff sought first to identify both the ordinary and extraordinary transactions that arose in connection with the defeasance of the 2001 bonds, and prepared the initial draft primarily as a starting point for discussion, and to some degree, to facilitate the independent auditor's understanding of the defeasance transaction. Also of some significance is the fact that in prior years, certain of the Authority's expenses in connection with the issuance of the 2001 bonds had not been subject to the accounting treatment prescribed by GASB34. This fact introduced a question of whether or not prior statements would need to be restated to maintain conformance with a presumptive requirement that the current statement would be subject to the accounting treatment prescribed by GASB34. Hence, the original draft was prepared with the expectation that revisions, perhaps material, would be necessary before releasing the formal draft for review, but never with the expectation that this assumption would result in a reportable finding as a consequence.

Moreover, the development of the Authority's financial statements occurs under tight time constraints, particularly in view of the Authority's reliance on outside parties for the data needed to produce the statements. While the Authority's fiscal year ends on June 30, certain accruals and adjustments are not known until statements are received from the trustee for the month of July, which are received in early August, and Month 13 transactions have been closed by the Office of Comptroller General, which occurs during the month of July. Additionally, because its assets are invested in marketable securities, the Authority relies on the receipt of GASB40 compliant reports from State's custodian, which are generally not produced until mid-August. This time constraint impacts the production of the financial statements and in this year particularly, left little time for research of the accounting treatment of the defeasance transaction. Notwithstanding, staff did consult with both the investment banking and law firms engaged to the defeasance transaction, particularly with respect to disclosure requirements in the notes to
financial statements. While they provided helpful advice, without exception, each deferred discretion for both inclusion and presentation of disclosure related to accounting matters to that of the independent auditor.

The initial draft of the statements focused on the totality of the defeasance transaction, and the notes to financial statements were based in large part on the legal and economic disclosures that had been carefully developed at the time the transaction was undertaken. Noteworthy is the fact that the defeasance transaction included at least three integrated but separate components utilizing both common and different financial resources to arrive at the ultimate financial result:

1. A statutory authorization to utilize funds in the Healthcare Tobacco Trust fund, including a conversion of the portfolio to pre-refunded municipals to comply with federal tax rules;
2. An integrated purchase offer for the 2028 maturity of the Series 2001B bonds; and
3. A refinancing of the principal amount that remained outstanding following application and completion of the transactions undertaken in 1 and 2 above.

This fact is material in that we were unable to identify any published precedent for an integrated transaction incorporating all of the complexities described above. Because of its high integration and crossovers in funding sources and uses, initially it only occurred to staff to treat the entire transaction as a single transaction, consistent with the treatment for legal and financial purposes documented in the transaction's closing memorandum.

Notwithstanding, all of the financial components were identified and disclosed even in the first draft and work papers. The most significant difference between the initial and formal drafts centers on the amortization of premiums paid for acquisition of legal securities for the escrow deposit from the endowed funds of the healthcare trust fund, and on premiums paid for the outright purchase (rather than defeasance) of Series 2001 bonds. Both of these transactions were integral to the plan of finance, and were a part of the overall legal defeasance and discharge of the Authority's obligations to holders of the 2001 bonds.

Although the ultimate treatment of these transactions from an accounting perspective was more insular, the fact remains that none of the components of the transaction were or would have been exclusively undertaken from a business or economic perspective based solely on their singular merits. Because this was a comprehensive transaction from a business and economic perspective, it did not occur to staff that the accounting rules would dictate segregation of each component such that premiums would be treated differently from an accounting perspective. Moreover, the economic benefit of the premiums paid will materialize as economic gains over time in the escrow fund. Finally, it was not clear which entity (i.e., the Authority or the State, as the owner and ultimately the "donor" of the healthcare trust) would suffer the effects of the premium expense, since the healthcare trust fund had pre-purchased the securities and delivered them in kind at face value for the escrow deposit. The character of these transactions is unique, and the

To put this difference in perspective, the difference in unrestricted net assets between the initial and final drafts was $75.9 million, of which amount, $75.6 million was attributable to the treatment of premiums paid in connection with various components of the defeasance as special item expenses rather than as amortized amounts.
ultimate treatment we have employed is not altogether consistent with examples of similar transactions where entities have funded escrow trusts for the defeasance of securities with proceeds of bonds supplemented by cash contributions. In short, staff was unable to locate on its own or through its advisors to the defeasance transaction a precedent for the accounting treatment of a transaction having the same unique features presented by this one.

Staff noted the complexities and challenges posed by this transaction with the independent auditor on the first day of the audit. Those discussions were not intended to "turf" their resolution to the independent auditor, nor to engage him in any way that would cross the line such that he would have been deemed to have prepared the financial statements: rather, it was staff's intent to seek advice and guidance as to their proper treatment, largely because the independent auditor would need to be satisfied with their presentation and treatment in any event.

From that point, staff believes that the independent auditor consulted with others in the state about presentation and treatment of the premium amounts, and staff assumes that the resulting conversations, along with his own research, influenced the ultimate recommendations that, through staff's consultation with him, were incorporated into the statements. It is important to note here that the independent auditor did not indicate discomfort in conducting this research. Had he stated at the time that he was prohibited under auditing standards from collaborating with staff, making recommendations or conducting research, staff could have sought advice from other sources.

Heretofore, staff has enjoyed a congenial relationship with the independent auditor, and has always appreciated the depth and expanse of the firm's experience with governmental accounting, which has been regarded as value-added and a service distinction. However, staff recognizes the importance of independence of the auditor, and in its view has never knowingly nor intentionally imposed expectations on the firm such that its compliance with its ethical canons or practice guidelines might be compromised. Staff has viewed the interactive role with the independent auditor consistent with the following statement contained in Gauthier: Governmental Accounting, Auditing, and Financial Reporting: Using the GASB 34 Model:

"For practical reasons, the independent auditor often plays a role in preparing the financial statements (e.g., formatting, accruals). Nonetheless, regardless of the assistance provided by the independent auditor, the financial statements always remain management's responsibility. That is, financial statements are management's representations concerning the government's finances, and management cannot transfer its responsibility for its own representations to a third party."

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2 See particularly the fiscal year 2006-07 financial statements for the South Carolina Transportation Infrastructure Bank, which contain a defeasance transaction and supplemental cash contribution, accounted for in a single transaction.

3 By way of example, the final draft utilizes the category "special items" for the unique treatment of certain aspects of the transaction. Admittedly, staff was unfamiliar with this term and was unable to locate a recently published financial statement for any South Carolina entity incorporating it into its financial statements. Gauthier at p. 401 (cites omitted).
How this philosophy integrates with the recent guidance of the Auditing Standards Board is not entirely clear to the Authority, nor should it necessarily be, since the guidance of the ASB is not a standard directly applicable to the Authority. Accordingly, the Authority must rely on the judgment of the independent auditor, to whom the standard does directly apply, for application of those standards to the process of preparation of its financial statements.

Given the limited financial resources of the Authority for its operating expenses, coupled with the remote likelihood that such an extraordinary transaction is likely to present itself in the foreseeable future, the recommendation to consider engagement of outside consultants does not immediately appear to be a financially feasible or prudent undertaking. Staff has ordered as a reference guide Gauthier's Governmental Accounting, Auditing, and Financial Reporting: Using the GASB 34 Model and believes that this reference will be useful in preparing future statements.

Staff fundamentally disagrees with the finding in view of the circumstances described above and the independent auditor's failure to communicate his concerns during the course of the audit. Moreover, staff is of the further opinion that the finding fails to recognize the deliberation and care that were in fact exercised in the preparation of the statements within the context of this extraordinarily complex financial transaction.

Respectfully submitted,

F. Richard Harmon, Jr.
Senior Assistant State Treasurer
On behalf of the Authority

c: The Honorable Converse A. Chellis, III, CPA
   Authority Treasurer
   Barry S. Laban, CPA
   Rogers & Laban, PA

   Financial Statement (Excerpts): Final
   Sources and Uses of Funds
   Closing Memorandum