

The Children's Trust

(A Component Unit of the Commonwealth of Puerto Rico)

**Basic Financial Statements and Required Supplementary
Information as of and for the Year Ended June 30, 2010,
and Independent Auditors' Report**

THE CHILDREN'S TRUST
(A Component Unit of the Commonwealth of Puerto Rico)

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
The Children's Trust

We have audited the accompanying financial statements of the governmental activities and each major fund of The Children's Trust (the "Trust"), a component unit of the Commonwealth of Puerto Rico, as of and for the year ended June 30, 2010, which collectively comprise the Trust's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion 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 of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Trust's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each major fund of The Children's Trust as of June 30, 2010, and the respective changes in financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 2 through 5 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Trust's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Deloitte & Touche LLP

December 13, 2010

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THE CHILDREN'S TRUST
(A Component Unit of the Commonwealth of Puerto Rico)

MANAGEMENT'S DISCUSSION AND ANALYSIS
AS OF AND FOR THE YEAR ENDED JUNE 30, 2010

As management of The Children's Trust (the "Trust"), we offer readers of the Trust's financial statements this narrative overview and analysis of the Trust's financial performance during the fiscal year ended June 30, 2010. Please read it in conjunction with the Trust's basic financial statements including the notes thereto, which follow this section.

(1) Financial highlights:

- The Trust's net deficit increased by \$15.5 million over the course of the year's operations ending with a net deficit of \$1,132.3 million, from a total net deficit at beginning of year of \$1,116.8 million.
- Global Settlement Agreement (GSA) revenues for the fiscal year amounted to \$75.6 million, a decrease of \$16.6 million, or 18.0%, from the \$92.2 million for 2009.
- The Trust's operating expenses consist of payments for programs and activities permitted by the enabling legislation. Grants for education and related programs and activities during 2010 totaled \$874 thousand, a decrease of \$4.0 million, or 82.1%, from the \$4.9 million granted during 2009. Grants for intergovernmental projects totaled \$1.7 million, a decrease of \$2.3 million, or 58.4%, from the \$4.0 million granted during 2009.

(2) Overview of the financial statements:

The financial statements include the management's discussion and analysis section, the independent auditors' report, and the basic financial statements of the Trust. The basic financial statements also include notes that explain in more detail some of the information in the basic financial statements.

(3) Required financial statements:

- The statement of net deficit provides information about the nature and amounts of resources (assets) and the Trust's obligations.
- Current year's revenues and expenses are accounted for in the statement of activities. This statement measures the results of the Trust's operations during the past year.
- Governmental funds' financial statements present the financial position and results of operations for the Trust's two governmental fund types using a current financial resources measurement focus. The statement of revenues, expenditures, and changes in fund balances can be used to determine, for example, whether and how the Trust met its debt service requirements for the year.

(4) Financial analysis of the Trust:

One of the most important questions asked about the Trust's finances is "Is the Trust as a whole better or worse as a result of this year's activities?" The statement of net deficit and the statement of activities report information about the Trust's activities in a way that will help answer this question. These two statements report the net deficit of the Trust and the changes in them.

One can think of the Trust's net deficit — the difference between assets and liabilities — as one way to measure financial health or financial position. Over time, increases or decreases in the Trust's net deficit are one indicator of whether its financial health is improving or deteriorating. However, one will need to consider other non-financial factors such as changes in economic conditions including economic conditions of the tobacco industry, and new or changed government legislation.

(5) Government-wide financial analysis:

The government wide financial statements were designed so that the user could determine whether the Trust is in a better or worse financial condition from the prior year. The following is a condensed summary of net deficit of the Trust compared with prior year (amounts in thousands):

	June 30,		Change	
	2010	2009	Amount	Percent
Assets:				
Current assets	\$ 56,426	\$ 62,273	\$ (5,847)	(9.4%)
Non-current restricted assets	161,885	164,017	(2,132)	(1.3%)
Total assets	<u>218,311</u>	<u>226,290</u>	<u>(7,979)</u>	<u>(3.5%)</u>
Liabilities:				
Current liabilities	19,755	23,907	(4,152)	(17.4%)
Non-current liabilities	1,330,864	1,319,175	11,689	0.9%
Total liabilities	<u>1,350,619</u>	<u>1,343,082</u>	<u>7,537</u>	<u>0.6%</u>
Net deficit	<u><u>\$ (1,132,308)</u></u>	<u><u>\$(1,116,792)</u></u>	<u><u>\$ (15,516)</u></u>	<u>1.4%</u>

As noted above, the Trust's net deficit increased by \$15.5 million, from a net deficit of \$1,116.8 million in 2009 to \$1,132.3 million in 2010. This increase results from two major facts: decrease in total assets of \$8.0 million mainly resulting from grant disbursements of approximately \$5.5 million during the year, and \$7.5 million increase in liabilities mainly due to amortization of loss on refunded bonds and discount of approximately \$4.8 million and the effect of interest capitalization for fiscal year 2010 of approximately \$26.8 million, net of the payment of principal on bonds of approximately \$23.5 million.

Condensed program revenues, expenses, and change in net deficit are presented below (amounts in thousands):

Function/program	Year ended June 30,		Change	
	2010	2009	Amount	Percent
Governmental activities:				
Education	\$ 874	\$ 4,893	\$ (4,019)	(82.1%)
Health	2,254	607	1,647	271.3%
Recreation	681	954	(273)	(28.6%)
Intergovernmental	1,682	4,041	(2,359)	(58.4%)
Interest on long-term debt and other – net	85,675	85,300	375	0.4%
	<u>91,166</u>	<u>95,795</u>	<u>(4,629)</u>	<u>(4.8%)</u>
General revenues:				
Investment earnings	67	749	(682)	(91.1%)
Global settlement agreement	<u>75,583</u>	<u>92,219</u>	<u>(16,636)</u>	<u>(18.0%)</u>
	<u>75,650</u>	<u>92,968</u>	<u>(17,318)</u>	<u>(18.6%)</u>
Change in net deficit	<u>\$ (15,516)</u>	<u>\$ (2,827)</u>	<u>\$ (12,689)</u>	448.9%

While comparative statements of net deficit show the changes in financial position, the statement of activities provides answers as to the nature and source of these changes. As noted, the increase in the change in deficit of \$12.7 million is mainly due to the decrease of \$16.6 million in Global Settlement agreement revenues, netted against the effect of the decrease in governmental activities of \$4.6 million.

(6) Governmental fund financial analysis:

The Trust's governmental funds reported fund balances of \$167.9 million as of June 30, 2010, which is \$6.9 million less than prior year. The decrease in fund balance in the governmental funds is mainly due to grants disbursement of \$5.5 million during fiscal year 2010.

(7) Debt administration:

During the year ended June 30, 2010, the Trust repaid \$23.5 million of its bonds payable, and has a remaining balance of bonds outstanding of \$1,343 million, net of \$26.6 million of unaccrued bond discount and an unamortized deferred loss on refunded bonds of \$36.4 million, due through year 2057.

(8) Request for information:

This financial report is designed to provide those interested with a general overview of the Trust's finances and to enhance the Trust's accountability for the funds it receives. Questions about this report or requests for additional information should be addressed to The Children's Trust, PO Box 42001, San Juan, Puerto Rico, 00940-2001.

THE CHILDREN'S TRUST
(A Component Unit of the Commonwealth of Puerto Rico)

STATEMENT OF NET DEFICIT
AS OF JUNE 30, 2010

ASSETS

CURRENT ASSETS:

Interest-bearing deposits with Government Development Bank for Puerto Rico	\$ 24,523,187
Investments and investment contracts	31,901,213
Accrued interest receivable	<u>1,986</u>
Total current assets	56,426,386

NON-CURRENT TEMPORARILY RESTRICTED ASSETS:

Investments and investment contracts	111,676,091
Accrued interest receivable	442,014
Receivable from Global Settlement Agreement to be applied to debt service	40,670,628
Deferred bond issue costs	<u>9,096,233</u>
Total assets	<u>218,311,352</u>

LIABILITIES

CURRENT LIABILITIES:

Accounts payable	687,503
Liabilities payable from restricted assets:	
Accrued interest payable	6,932,766
Bonds payable due in one year	<u>12,135,000</u>
Total current liabilities	19,755,269

NON-CURRENT LIABILITY —

Bonds payable due in more than one year	<u>1,330,863,927</u>
Total liabilities	<u>1,350,619,196</u>

NET DEFICIT

\$ (1,132,307,844)

See notes to basic financial statements.

THE CHILDREN'S TRUST
(A Component Unit of the Commonwealth of Puerto Rico)

STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2010

Functions/Programs	Expenses	Program Revenues		Net Expenses and Change in Net Deficit
		Investment Earnings	Operating Contributions	
GOVERNMENTAL ACTIVITIES:				
Education	\$ 874,253	\$ -	\$ -	\$ 874,253
Health	2,253,781			2,253,781
Recreation	680,849			680,849
Intergovernmental grants	1,682,401			1,682,401
Interest on long term-debt and other	<u>89,084,125</u>	<u>3,408,884</u>	<u>75,583,340</u>	<u>10,091,901</u>
Total governmental activities	<u>\$ 94,575,409</u>	<u>\$ 3,408,884</u>	<u>\$ 75,583,340</u>	<u>15,583,185</u>
GENERAL REVENUES —				
Investment earnings				<u>66,656</u>
CHANGE IN NET DEFICIT				(15,516,529)
NET DEFICIT — Beginning of year				<u>(1,116,791,315)</u>
NET DEFICIT — End of year				<u>\$ (1,132,307,844)</u>

See notes to basic financial statements.

THE CHILDREN'S TRUST
(A Component Unit of the Commonwealth of Puerto Rico)

BALANCE SHEET — GOVERNMENTAL FUNDS
AS OF JUNE 30, 2010

	<u>General Fund</u>	<u>Tobacco Settlement Asset-Backed Bonds Debt Service Fund</u>	<u>Total Governmental Funds</u>
ASSETS:			
Interest-bearing deposits with Government			
Development Bank for Puerto Rico	\$ 24,523,187	\$ -	\$ 24,523,187
Investments and investment contracts	31,901,213	111,676,091	143,577,304
Accrued interest receivable	1,986	442,014	444,000
Receivable from Global Settlement Agreement	<u> </u>	<u>40,670,628</u>	<u>40,670,628</u>
 Total assets	 <u>\$ 56,426,386</u>	 <u>\$ 152,788,733</u>	 <u>\$ 209,215,119</u>
LIABILITIES AND FUND BALANCES:			
LIABILITIES:			
Accounts payable	\$ 687,503	\$ -	\$ 687,503
Deferred revenue	<u> </u>	<u>40,670,628</u>	<u>40,670,628</u>
 Total liabilities	 <u>687,503</u>	 <u>40,670,628</u>	 <u>41,358,131</u>
FUND BALANCES:			
Reserved for debt service		112,118,105	112,118,105
Unreserved and undesignated	<u>55,738,883</u>	<u> </u>	<u>55,738,883</u>
 Total fund balances	 <u>55,738,883</u>	 <u>112,118,105</u>	 <u>167,856,988</u>
 Total liabilities and fund balances	 <u>\$ 56,426,386</u>	 <u>\$ 152,788,733</u>	 <u>\$ 209,215,119</u>

See notes to basic financial statements.

THE CHILDREN'S TRUST
(A Component Unit of the Commonwealth of Puerto Rico)

**RECONCILIATION OF BALANCE SHEET OF GOVERNMENTAL FUNDS TO THE
STATEMENT OF NET DEFICIT
AS OF JUNE 30, 2010**

**AMOUNTS REPORTED FOR GOVERNMENTAL ACTIVITIES IN THE STATEMENT
OF NET DEFICIT ARE DIFFERENT BECAUSE:**

FUND BALANCES OF GOVERNMENTAL FUNDS	\$ 167,856,988
Bond issue costs are reported as an expenditure in the governmental funds financial statements; however, these costs are capitalized and amortized over the life of the bonds and are included in the statement of net deficit.	9,096,233
Discount on bonds issued is reported as an other financing use in the governmental funds financial statements; however, such discount is deferred and accreted over the life of the bonds and is included within bonds payable in the statement of net deficit.	26,585,375
Unamortized loss on bonds defeasance is not reported as an expenditure in the governmental fund financial statements; however, such loss is deferred and amortized over the life of the bonds and is included within bonds payable in the statement of net deficit.	36,383,108
Receivable from Global Settlement Agreement to be applied to debt service will not be received in the current period, and therefore, is not reported in the fund financial statements.	40,670,628
Accrued interest payable is not due and payable in the current period and, therefore, is not reported in the fund financial statements.	(6,932,766)
Bonds payable are not due and payable in the current period and, therefore, are not reported in the fund financial statements.	<u>(1,405,967,410)</u>
NET DEFICIT OF GOVERNMENTAL ACTIVITIES	<u>\$(1,132,307,844)</u>

See notes to basic financial statements.

THE CHILDREN'S TRUST
(A Component Unit of the Commonwealth of Puerto Rico)

**STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND
BALANCES — GOVERNMENTAL FUNDS
FOR THE YEAR ENDED JUNE 30, 2010**

	<u>General Fund</u>	<u>Tobacco Settlement Asset-Backed Bonds Debt Service Fund</u>	<u>Total Governmental Funds</u>
REVENUES:			
Investment earnings	\$ 66,656	\$ 3,408,884	\$ 3,475,540
Revenue from Global Settlement Agreement		75,441,994	75,441,994
Total revenues	<u>66,656</u>	<u>78,850,878</u>	<u>78,917,534</u>
EXPENDITURES:			
Current:			
Education	874,253		874,253
Health	2,253,781		2,253,781
Recreation	680,849		680,849
Intergovernmental	1,682,401		1,682,401
Other	252,081	10,780	262,861
Debt service:			
Principal		23,525,000	23,525,000
Interest		56,494,955	56,494,955
Total expenditures	<u>5,743,365</u>	<u>80,030,735</u>	<u>85,774,100</u>
OTHER FINANCING SOURCES (USES) —			
Transfers in (out)	<u>241,433</u>	<u>(241,433)</u>	
NET CHANGES IN FUND BALANCES	(5,435,276)	(1,421,290)	(6,856,566)
FUND BALANCES — Beginning of year	<u>61,174,159</u>	<u>113,539,395</u>	<u>174,713,554</u>
FUND BALANCES — End of year	<u>\$ 55,738,883</u>	<u>\$ 112,118,105</u>	<u>\$ 167,856,988</u>

See notes to basic financial statements.

THE CHILDREN'S TRUST

(A Component Unit of the Commonwealth of Puerto Rico)

RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES – GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES FOR THE YEAR ENDED JUNE 30, 2010

AMOUNTS REPORTED FOR GOVERNMENTAL ACTIVITIES IN THE STATEMENT OF ACTIVITIES ARE DIFFERENT BECAUSE:

NET CHANGE IN FUND BALANCE OF GOVERNMENTAL FUNDS	\$ (6,856,566)
Net change in receivable from Global Settlement Agreement is reported as revenue in the statement of activities, but is not reported in the fund financial statement since it does not provide current financial resources.	141,346
Net change in interest payable reported in the statement of activities that does not require the use of current financial resources, and therefore, are not reported as an expenditure in the governmental funds.	138,611
Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces bonds payable in the statement of net deficit; this is the amount of redemption on bond principal during the year.	23,525,000
Interest capitalization on Tobacco Settlement Asset-Backed Bonds Series 2005 do not require the use of current financial resources, and therefore, are not reported as expenditure in governmental funds.	(9,665,124)
Interest capitalization on Tobacco Settlement Asset-Backed Bonds Series 2008 do not require the use of current financial resources, and therefore, are not reported as expenditure in governmental funds.	(17,140,573)
The amortization of deferred bond issue costs, bonds discount and loss on bonds refunded do not require the use of current financial resources and, therefore, are not reported as expenditures in the governmental funds:	
Amortization of bond issue costs	(851,582)
Amortization of bond discount	(1,843,640)
Amortization of loss on bonds refunded	<u>(2,964,001)</u>
CHANGE IN NET DEFICIT OF GOVERNMENTAL ACTIVITIES	<u>\$ (15,516,529)</u>

See notes to basic financial statements.

THE CHILDREN'S TRUST

(A Component Unit of the Commonwealth of Puerto Rico)

NOTES TO BASIC FINANCIAL STATEMENTS AS OF AND FOR THE YEAR ENDED JUNE 30, 2010

1. REPORTING ENTITY

The Children's Trust (the "Trust") is a component unit of the Commonwealth of Puerto Rico (the "Commonwealth") created by Act No. 173 of the Legislature of the Commonwealth on July 30, 1999, as amended, (the "Act"), and an affiliate of the Government Development Bank for Puerto Rico (the "Bank"), a component unit of the Commonwealth. The Trust was created for the purpose of developing programs aimed at promoting a better quality of life and the well-being of families, children, and youth in Puerto Rico, especially in the areas of education, recreation and health. These programs are financed with the moneys to be received by the Commonwealth from the Global Settlement Agreement dated November 23, 1998 (the "Agreement" or "GSA") between certain tobacco companies and certain states, territories, and other jurisdictions of the United States of America, including the Commonwealth. Pursuant to the Act, the Commonwealth assigned and transferred to the Trust the contributions which the Commonwealth is entitled to receive under the Agreement. The Agreement calls for annual payments through the year 2025, which will vary due to inflationary and volume adjustments. After 2025, the tobacco companies shall continue making contributions in perpetuity.

The Act provides that the Bank will act as the trustee of the Trust. The Trust is exempt from taxation in Puerto Rico, pursuant to the Act.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of changes in net assets and revenues and expenditures during the reporting period. Actual results could differ from those estimates.

The accounting and reporting policies of the Trust conform to accounting principles generally accepted in the United States of America, as applicable to governmental entities. The Trust follows Governmental Accounting Standards Board ("GASB") under the hierarchy established by Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, in the preparation of its financial statements.

Following is a description of the Trust's most significant accounting policies:

Government-Wide and Fund Financial Statements

Government-Wide Financial Statements — The statement of net deficit and the statement of activities report information on all activities of the Trust. The Trust has only governmental activities. The effect of interfund balances has been removed from the statement of net assets. Governmental activities are financed through revenue from the Agreement, intergovernmental revenue, and other financing sources.

The statement of net deficit presents the Trust's assets and liabilities, with the difference reported as net deficit.

The statement of activities demonstrates the degree to which the direct expenses of a given function or segment is offset by program revenues. Direct expenses are those that are clearly identifiable within a specific function. Program revenues include earnings (losses) on investments. Other items not meeting the definition of program revenues are reported as general revenues.

Governmental Fund's Financial Statements — Separate financial statements are provided for governmental funds. Major individual governmental funds are reported as separate columns in the fund financial statements. All funds of the Trust are major funds.

Measurement Focus, Basis of Accounting and Financial Statement Presentation — The accounts of the Trust are organized on the basis of funds, each of which is considered a separate accounting entity. The operations of each fund are accounted for within a separate set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenue, and expenditures, as appropriate. Government resources are allocated to and accounted for in individual funds based upon the purpose for which they are to be spent and the means by which spending activities are controlled.

Government-Wide Financial Statements — Government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenue is recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

Grants and similar items are recognized as revenue as soon as all of the eligibility requirements imposed by the provider have been met.

Governmental Fund's Financial Statements — The governmental fund's financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized when they become measurable and available.

Revenue resulting from the Tobacco Settlement Agreement is recognized on an annual basis, upon collection. Interest income is recognized when earned, since it is available and measurable. Expenditures are recorded when the related liability is incurred. An exception to this general rule includes principal and interest on general long-term debt, which is recognized when due. Revenue is considered to be available when it is collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Trust considers revenues to be available if they are to be collected within 60 days after the end of the current fiscal year-end.

Fund Accounting — The financial activities of the Trust are recorded in individual funds, each of which is deemed to be a separate accounting entity. Fund accounting is designed to demonstrate legal compliance and to aid financial management by segregating transactions related to certain government functions or activities. A fund is a separate accounting entity with a self-balancing set of accounts.

The financial activities of the Trust that are reported in the accompanying basic financial statements have been classified into the following major governmental funds:

General Fund — The general fund is used to account for grants awarded to promote a better quality of life and the well-being of families, children, and youth in Puerto Rico. During the year ended June 30, 2010, grants were awarded for education, health and recreational activities.

Tobacco Settlement Asset-Backed Bonds Debt Service Fund — This debt service fund is used to account for proceeds from the Agreement and for the payment of interest and principal on long-term obligations.

Budgetary Accounting — The Trust is not required by the Act to submit a budget for approval by the Legislature of the Commonwealth; consequently, no formal budgetary accounting procedures are followed.

Investments and Investment Contracts — Investments and investment contracts are carried at fair value, except for money market investments and participating investment contracts with a remaining maturity at the time of purchase of one year or less, and non-participating investment contracts, which are carried at cost. Fair value is determined based on quoted market prices, except for investments in Puerto Rico municipal bonds and notes for which fair value is based on quotations received from independent broker/dealers.

Restricted Assets — Certain resources are set aside for the repayment of bonds payable. These assets are classified as restricted assets on the accompanying Statement of Net Deficit and Balance Sheet – Governmental Funds.

Deferred Bond Issue Costs and Bond Discount — Deferred bond issue costs and bond discount are amortized over the life of the debt in the government-wide financial statements. Deferred bond issue costs and discounts are recognized in the period when the related long-term debt is issued in the governmental funds financial statements, and therefore are not accounted for in subsequent periods.

Interfund Transactions — The Trust has operating transfers which are legally required transfers that are reported when incurred as “Transfers-in” by the recipient fund and as “Transfers-out” by the disbursement fund.

Reservations of Fund Balance — Reservations of fund balance represent portions of fund balances that are legally segregated for a specific future use or are not appropriated for expenditure. The Trust has reservations of fund balance, which represent assets available to finance future debt service payments.

Refundings — Refundings involve the issuance of new debt whose proceeds are used to repay immediately (current refunding) or at a future time (advance refunding) previously issued debt. The difference between the reacquisition price and the net carrying amount of the old debt is deferred and amortized as a component of interest expense in the statement of activities, over the remaining life of the old debt or the life of the new debt, whichever is shorter. The deferred amount is reported on the statement of net deficit as an addition to or deduction from the new debt.

Tobacco Settlement Recognition — The Trust follows the GASB Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issue* (the “TB”), as amended by GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*, which provides accounting guidance for entities created to obtain the rights to all or a portion of future tobacco settlement resources and for the governments that create such entities.

The TB indicates that the entity created to obtain the rights, which is called the Tobacco Settlement Authority (“TSA”), should be considered a component unit of the government that created it and that the component unit should be blended. The TB also states that the government receiving the payments from the tobacco companies under the Agreement, which is called settling government, should recognize a receivable and revenue for tobacco settlement resources when an event occurs.

The event that results in the recognition of an asset and revenue by a settling government is the domestic shipment of cigarettes. The TB indicates that accruals should be made by the settling government and TSAs for estimated shipments from January 1 to their respective fiscal year-ends, since the annual payments are based on a calendar year. However, under the modified-accrual basis of accounting at the fund level, revenue should be recognized only to the extent that resources are available.

In accordance with the TB, a receivable of \$40,670,628 was recorded for estimated shipments from January 1, 2010 to June 30, 2010, which will be utilized for debt service upon collection. Additionally, the TB indicates that the TSA should recognize a liability for the bonds payable and an expense (and a liability if unpaid) in the same period in its stand-alone financial statements. The expense (and liability if unpaid) recognizes the contractual obligation to remit the proceeds to the settling government. Finally, the TB addresses the question of how the settling governments should report the receipt of the resources provided by the TSA's remittances of the proceeds of the bonds sold. Since the TSA should be reported as a blended component unit, the TB indicates these remittances should be reported as transfers into the fund receiving the proceeds and transfers out in the fund that accounts for the activities of the TSA.

Since the Trust has no contractual obligation, under its enabling legislation or elsewhere, to remit all bond proceeds or assets related to the GSA to the settling government (the Commonwealth), the Trust has not recognized an expense and liability for unpaid proceeds from the bonds since it records expenses as amounts are disbursed for grants to its settling government (including its instrumentalities) or third parties.

The GASB has issued the following accounting pronouncements that have effective date after June 30, 2010:

- (a) GASB Statement No. 54 — *Fund Balance Reporting and Governmental Fund Type Definitions*, which is effective for periods beginning after June 15, 2010.
- (b) GASB Statement No. 57 — *OPEB Measurements by Agent Employers and Agent Multiple-Employer's Plans*, which is effective for periods beginning after June 15, 2011.
- (c) GASB Statement No. 59 — *Financial Statements Omnibus*, which is effective for periods beginning after June 15, 2010.

The impact of these pronouncements in the Trust's financial statements has not yet been determined.

3. CUSTODIAL CREDIT RISK

Custodial credit risk is the risk that in the event of a bank failure, the Trust's deposits may not be returned. The Trust does not have a deposit policy for custodial credit risk. As of June 30, 2010, all of the Trust's depository bank balance, aggregating approximately \$24,523,000, was exposed to custodial credit risk since such deposits, all of which are maintained at the Bank, are uninsured and uncollateralized.

4. TRANSACTIONS WITH GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

As described in Note 1, the Bank acts as the trustee of the Trust and the Trust's personnel are provided by the Bank. During the year ended June 30, 2010, the Bank provided certain management and administrative services to the Trust for \$175,000 under a management contract.

5. INVESTMENTS AND INVESTMENT CONTRACTS

In accordance with investment guidelines promulgated by the Bank for agencies and public corporations of the Commonwealth under the authority provided by Act No. 113 of August 3, 1995, and Executive Order 1995-50A (the "investment guidelines"), the Trust is authorized to purchase or enter into the following investment instruments:

- United States government and agencies obligations
- Certificates of deposit
- Bankers' acceptances
- Commercial paper
- Participations in the Puerto Rico Government Investment Trust Fund
- Obligations of the Commonwealth, its agencies, municipalities, public corporations, and instrumentalities
- Obligations of state and local governments of the United States of America
- Mortgage and asset-backed securities
- Corporate debt, including investment contracts
- External investment pools

The investment guidelines also establish limitations and other guidelines.

Investments consist of a guaranteed investment contract of \$83,684,235 with Bayerische Hypo-und Vereinsbank AG; external investments pools of \$59,826,372, which includes \$31,834,516 invested in Puerto Rico Government Investment Trust Fund (PRGITF) (an internal investment pool of the Commonwealth) and \$27,991,856 invested with Deutsche Bank Trust Company Americas; and State and Local Government securities issued by the United States Treasury Department of \$66,697.

As of June 30, 2010, the rating of PRGITF was AAAM by Standard & Poor's. The rating of Deutsche Bank Trust Company Americas was A/Stable/A-1 by and, the rating of Bayerische Hypo-und Vereinsbank AG was A/Stable/A-1 with Standard & Poor's.

Investment in guaranteed investment contracts represents 58% of the Trust's investments. In addition, this investment is held by the counterparty, not in the name of the Trust.

6. BONDS PAYABLE

On October 10, 2002, the Trust refunded its then outstanding \$390,170,000 Tobacco Settlement Asset Backed Bonds, Series 2000 dated as of October 1, 2000, with new 2002 Series bonds (the "Series 2002 Bonds") in the amount of \$1,171,200,000.

As of June 30, 2010, the outstanding balance of these bonds consist of \$58,710,000 serial bonds maturing from May 15, 2011 to 2014 bearing interest at rates ranging from 4.00% to 4.25%, and single

rated term bonds (the "Term Bonds") maturing from May 15, 2020 to 2033 (\$358,505,000 at 5.375%), from May 15, 2034 to 2039 (\$310,380,000 at 5.5%) and from May 15, 2040 to 2043 (\$296,255,000 at 5.625%).

The Term Bonds are subject to mandatory redemption in whole or in part prior to their respective stated maturity dates from Surplus Collections, as defined, on each Distribution Date at the redemption price of 100% of the principal amount thereof together with interest accrued thereon to the date fixed for redemption. The Term Bonds are subject to Turbo Redemption, as defined, in order of maturity.

On June 30, 2005, the Trust issued a new series of Tobacco Settlement Asset-Backed Bonds, Series 2005A and 2005B (the "Series 2005A and 2005B Bonds"), for \$108,209,446. The Series 2005A and 2005B consist of term bonds maturing on May 15, 2050 (\$74,523,430 at 6.50%), plus accreted interest and May 15, 2055 (\$33,686,016 at 7.25%), plus accreted interest, respectively. As of June 30, 2010, the outstanding balances of Series 2005A and 2005B consist of \$102,620,870 and \$48,100,213 respectively.

On April 30, 2008, the Trust issued a new series of Tobacco Settlement Asset-Backed Bonds, Series 2008A and 2008B (the "Series 2008A and 2008B Bonds"), for \$195,878,970. The Series 2008A and 2008B consist of term bonds maturing on May 15, 2057 (\$139,003,082 at 7.625%), plus accreted interest and May 15, 2057 (\$56,875,888 at 8.375%), plus accreted interest, respectively. As of June 30, 2010, the outstanding balances of Series 2008A and 2008B consist of \$163,456,823 and \$67,939,504 respectively.

The Series 2008A and 2008B Bonds are subordinated to the Trust's Tobacco Settlement Asset-Backed Bonds, Series 2002 and Series 2005 Bonds, and are not entitled to receive any payments until the date when the Series 2002 Bonds and the Series 2005 Bonds are no longer outstanding. In addition, the Series 2008B Bonds are subordinated to the Series 2008A Bonds and are not entitled to receive any payments until the date when the Series 2008A Bonds are no longer outstanding. The bonds are secured by 100% of the annual payments received by the Commonwealth under the Agreement.

Changes in bonds payable for the year ended June 30, 2010, are summarized as follows (in thousands):

	Balance at June 30, 2009	Debt Issued	Debt Paid	Increase (Decrease)	Balance at June 30, 2010	Due Within One Year
Bonds payable	\$1,402,687	\$ -	\$23,525	\$ 26,805	\$1,405,967	\$ 12,135
Less:						
Unaccreted bond discounts	(28,429)			1,844	(26,585)	
Unamortized deferred loss on advance refunding of bonds	(39,347)			2,964	(36,383)	
Bonds payable	<u>\$1,334,911</u>	<u>\$ -</u>	<u>\$23,525</u>	<u>\$ 31,613</u>	<u>\$1,342,999</u>	<u>\$ 12,135</u>

As of June 30, 2010, debt service requirements for bonds outstanding were as follows (in thousands):

Year Ending June 30,	Principal	Interest	Total
2011	\$ 12,135	\$ 55,462	\$ 67,597
2012	13,805	54,927	68,732
2013	15,505	54,374	69,879
2014	17,265	53,739	71,004
2015		53,005	53,005
2016–2020	930	265,024	265,954
2021–2025	284,686	253,850	538,536
2026–2030	390,766	222,052	612,818
2031–2035	197,405	178,353	375,758
2036–2040	288,650	115,004	403,654
2041–2045	229,725	26,400	256,125
2046–2050			
2051–2055			
2056–2057	<u>8,634,580</u>	<u> </u>	<u>8,634,580</u>
	10,085,452	<u>\$ 1,332,190</u>	<u>\$ 11,417,642</u>
Less:			
Unaccredited discount	26,585		
Unamortized deferred loss on advanced refunding on bonds	36,383		
Unaccreted interest	<u>8,679,485</u>		
	<u>\$ 1,342,999</u>		

7. COMMITMENTS

At June 30, 2010, the Trust had approved commitments to provide assistance to several entities through forty-nine contracts with balances amounting to approximately \$43,950,000.

8. GLOBAL SETTLEMENT AGREEMENT

On November 23, 1998, the Agreement was entered into by and between certain tobacco companies and certain states, territories, and other jurisdictions of the United States of America, including the Commonwealth. The Agreement calls for annual payments through the year 2025 which will vary due to inflationary and volume adjustments. After 2025, the tobacco companies shall continue making contributions in perpetuity.

Following is a summary of estimated payments to be received by the Trust through the year ending June 30, 2025 (unaudited, in thousands):

Year Ending June 30,	Amount
2011	\$ 78,918
2012	79,891
2013	80,809
2014	81,698
2015	82,562
2016–2025	<u>967,253</u>
	<u>\$ 1,371,131</u>

Actual collections from the Agreement will fluctuate due to future cigarette consumption, which could be affected by factors such as inflation, demographics, cigarette prices, disposable income, employment, advertising expenditures, and regulations, among others. During 2010 and 2009, actual collections were \$75,441,994 and \$90,072,384 respectively, 3.21% less than the projected amount in the official statement for the year 2010, and for the year 2009 it was 16.9% more than the projected amount in the official statement for year 2009.

All of the revenue received under the Agreement and investment earnings on certain accounts under the bond indentures are pledged as collateral for the following bond issuances:

- Tobacco Settlement Asset — Backed Bonds, Series 2002
- Tobacco Settlement Asset — Backed Bonds, Series 2005
- Tobacco Settlement Asset — Backed Bonds, Series 2008

As of June 30, 2010, the approximate amount of the pledge is \$1,343,000,000 representing the approximate remaining principal and interest of bond issuances, which are committed through May 15, 2057. Accordingly, until May 15, 2057, such revenues are not available for other purposes.

Amounts received under the bond issuances were used to finance programs aimed at promoting a better quality of life and the well-being of families, children, and youth in Puerto Rico especially in the areas of education, recreation and health in form of grants. In addition, part of the proceeds from the Series 2008A and 2008B Bonds were used to pay certain operating expenses of the Commonwealth.

During the year ended June 30, 2010, pledged revenues amounted to \$78,840,098 (net of operating expenses of \$10,780), which were used to pay for \$80,019,955 of related principal and interest of the bond issuances.

9. INTERGOVERNMENTAL GRANTS

The detail of intergovernmental grants for the year ended on June 30, 2010, is as follows (in thousands):

Description	Amount
Department of Transportation and Public Works	\$ 567
Public Buildings Authority	146
Puerto Rico Infrastructure Financing Authority	518
Office for the Improvement of Public Schools	<u>451</u>
	<u>\$1,682</u>

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