# Erie Tobacco Asset Securitization Corporation

(A Component Unit of the County of Erie, New York)

Basic Financial Statements and Required Supplementary Information as of and for the Year Ended December 31, 2010, and Reports of Independent Auditors on the Basic Financial Statements and 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*

# ERIE TOBACCO ASSET SECURITIZATION CORPORATION
**(A Component Unit of the County of Erie, New York)**

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Deloitte & Touche LLP
6500 Sheridan Drive
Suite 216
Williamsville, NY 14221-4842
USA
Tel: +1 716 843 7200
Fax: +1 716 856 7760
www.deloitte.com

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Erie Tobacco Asset Securitization Corporation:

We have audited the accompanying financial statements of the governmental activities and each major fund of Erie Tobacco Asset Securitization Corporation (ETASC), a component unit of the County of Erie, New York, as of and for the year ended December 31, 2010, which collectively comprise ETASC's basic financial statements as listed in the table of contents. These financial statements are the responsibility of ETASC's management. Our responsibility is to express an opinion on the respective financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 ETASC'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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each major fund of ETASC as of December 31, 2010, and the respective changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 4 to the financial statements, in 2010, ETASC adopted Governmental Accounting Standards Board (GASB) Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 28, 2011, on our consideration of ETASC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis as listed on pages 3 through 5 is not a required part of the basic financial statements but is supplementary information required by the GASB. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Deloitte & Touche LLP

December 28, 2011

## OVERVIEW OF THE FINANCIAL STATEMENTS

The following is a narrative overview and analysis of the financial performance of the Erie Tobacco Asset Securitization Corporation's (ETASC) financial activities for the fiscal year ended December 31, 2010. Please read it in conjunction with ETASC's entity-wide financial statements, governmental funds financial statements, and the notes to the financial statements.

The annual financial statements consist of three parts: (1) management's discussion and analysis, (2) the entity-wide financial statements, and (3) the governmental funds financial statements.

The entity-wide financial statements of ETASC, which include the statement of net assets (deficit) and the statement of governmental activities, are presented to display information about the reporting entity as a whole, in accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements — and Management's Discussion and Analysis — for State and Local Governments*. The statement of net assets (deficit) and the statement of governmental activities are prepared using the economic resources measurement focus and the accrual basis of accounting. All revenues and expenses are taken into account regardless of when cash is paid or received. This is to provide the reader with a broad overview of ETASC's finances, similar to private-sector financial statements.

ETASC's governmental funds financial statements are presented using the current financial resources measurement focus and the modified accrual basis of accounting. Under this basis of accounting, revenue is recognized when it becomes both measurable and available to finance expenditures in the current fiscal period.

The reconciliation of the statement of revenues, expenditures, and changes in fund balances of governmental funds to the statement of activities is presented to assist the reader in understanding the differences between entity-wide and governmental funds financial statements.

## FINANCIAL HIGHLIGHTS AND OVERALL ANALYSIS — ENTITY-WIDE FINANCIAL STATEMENTS

Total assets as of December 31, 2010, were $25.2 million, representing an increase of $0.642 million from the prior year. The major components of the total assets at December 31, 2010 and 2009, consisted of the following: (1) cash and cash equivalents of $0.226 million and $0.126 million, respectively; (2) investments of $20.0 million (79.3%) and $20.5 million (83.2%), respectively; (3) bond issuance costs (net) of $3.8 million (15.2%) and $3.9 million (16.0%); (4) prepaid expenses of $44,005 and $54,575; and (5) deferred inflow on forward purchase agreement swap of $1.1 million (4.4%) and $0, respectively.

Total liabilities at December 31, 2010, were $306.4 million, compared to $304.0 million at December 31, 2009. The liabilities at December 31, 2010 and 2009, consisted of the following: (1) long-term liabilities of $286.3 million (93.4%) and $288.4 million (94.9%), respectively; (2) remittances payable to the County of $37,253 and $37,253, respectively; (3) accounts payable of $13,746 and $3,810, respectively; (4) $19.0 million (6.2%) and $15.6 million (5.1%), respectively, in accrued interest payable; and (5) a derivative instrument valued at $1.1 million and $0, respectively.

Total revenues for the years ended December 31, 2010 and 2009, were $16.0 million and $19.4 million, respectively. The net decrease in revenues of $3.4 million is primarily due to the decrease in tobacco settlement revenues of $3.2 million and a decrease in realized gains of $0.2 million in 2010. Revenues for the years ended December 31, 2010 and 2009, consisted of $15.9 million (99.4%) and $19.1 million (98.7%), respectively, of tobacco settlement revenues, $84,847 and $244,978, respectively, of realized gains, and $15,932 and $15,549, respectively, of interest and other income.

Total expenses for the years ended December 31, 2010 and 2009, were $17.9 million and $18.0 million, respectively. The decrease in expenses of $0.1 million is primarily due the decrease in interest expense in 2010. Expenses for the years ended December 31, 2010 and 2009 primarily consisted of $17.7 million (99.3%) and $17.9 million (99.1%), respectively, of bond interest expense, and $132,559 and $163,379 respectively, of general and administrative expenses incurred in connection with the operations of the ETASC.

## FINANCIAL HIGHLIGHTS AND OVERALL ANALYSIS — GOVERNMENTAL FUNDS FINANCIAL STATEMENTS

Total assets at December 31, 2010 and 2009 were $20.3 million and $20.6 million, respectively. The components of the total assets at December 31, 2010 and 2009 were as follows: (1) cash and cash equivalents of $225,945 and $126,289, respectively; (2) investments of $20.0 million (98.6%) and $20.5 million (99.1%), respectively; (3) interest receivable of $8,219 and $2,452, respectively; (4) due from other funds of $4,905; and (5) prepaid expenses of $44,005 and $54,575, respectively.

Total liabilities at December 31, 2010, were $64,123, an increase of $15,703 from total liabilities of $48,420 at December 31, 2009.

Total revenues for the year ended December 31, 2010, were $16.0 million, as compared to $19.4 million for the year ended December 31, 2009. The $16.0 million in revenues for the year ended December 31, 2010 primarily consisted of $15.9 million of tobacco settlement revenues.

Total expenditures for the year ended December 31, 2010, were $16.4 million, as compared to $19.0 million for the year ended December 31, 2009. The $16.3 million (99.2%) of debt service expenditures for the year ended December 31, 2010 includes principal of $2.9 million and bond interest of $13.4 million.

## DEBT ADMINISTRATION/ECONOMIC FACTORS

As of December 31, 2010, ETASC had $319,544,400 of tobacco settlement asset-backed bonds outstanding, which are reported in the statement of net assets (deficit) net of unamortized discount on the sale of bonds of $11,374,631 and loss on defeasance of $21,851,736. ETASC’s bonds outstanding were $322,419,400 at December 31, 2009. The amount reflected in the 2009 statement of net assets (deficit) for bonds payable was net of unamortized discount on the sale of bonds of $11,442,535 and loss on defeasance of $22,614,936.

Principal payments of $2.9 million and $5.3 million were made during 2010 and 2009, respectively.

Additional information on ETASC’s long-term debt can be found in Note 5 to the financial statements.

## CONTACTING THE CORPORATION'S FINANCIAL MANAGEMENT

This financial report is designed to provide a general overview of ETASC's finances for all those with an interest in ETASC's finances. Questions concerning any of the information provided in this report, or requests for additional financial information, should be addressed to the Erie Tobacco Asset Securitization Corporation, President, 95 Franklin Street, Room 1600, Buffalo, NY 14202.

# ERIE TOBACCO ASSET SECURITIZATION CORPORATION
**(A Component Unit of the County of Erie, New York)**

**STATEMENT OF NET ASSETS (DEFICIT)**
**GOVERNMENTAL ACTIVITIES**
**AS OF DECEMBER 31, 2010**

| | |
|---|---|
| ASSETS: | |
| Cash and cash equivalents | $ 225,945 |
| Investments | 20,006,071 |
| Interest receivable | 8,219 |
| Prepaid expenditures | 44,005 |
| Deferred inflow on forward purchase agreement swap | 1,108,170 |
| Bond issuance costs — net | 3,824,680 |
| Total assets | 25,217,090 |
| LIABILITIES: | |
| Accounts payable | 13,746 |
| Due to Erie County | 37,253 |
| Interest payable | 18,968,803 |
| Long-term liabilities — due in more than one year | 286,318,033 |
| Derivative instrument | 1,108,170 |
| Total liabilities | 306,446,005 |
| NET ASSETS (DEFICIT): | |
| Restricted for debt service | 995,110 |
| Unrestricted deficit | (282,224,025) |
| TOTAL NET DEFICIT | $ (281,228,915) |

See notes to financial statements.

## ERIE TOBACCO ASSET SECURITIZATION CORPORATION
**(A Component Unit of the County of Erie, New York)**

### STATEMENT OF GOVERNMENTAL ACTIVITIES
### FOR THE YEAR ENDED DECEMBER 31, 2010

| | |
|---|---|
| GENERAL REVENUES: | |
| Tobacco settlement revenue | $ 15,924,811 |
| Realized gains | 84,847 |
| Interest | 5,913 |
| Other income | 10,019 |
| Total general revenues | 16,025,590 |
| EXPENSES: | |
| General and administrative | 132,559 |
| Interest expense | 17,719,577 |
| Total expenses | 17,852,136 |
| CHANGE IN NET DEFICIT | (1,826,546) |
| NET DEFICIT — Beginning of year | (279,402,369) |
| NET DEFICIT — Ending of year | $ (281,228,915) |

See notes to financial statements.

# ERIE TOBACCO ASSET SECURITIZATION CORPORATION
**(A Component Unit of the County of Erie, New York)**

**BALANCE SHEET**
**GOVERNMENTAL FUNDS**
**AS OF DECEMBER 31, 2010**

| | General | Debt Service | Total Governmental Funds |
|---|---|---|---|
| **ASSETS** | | | |
| CASH AND CASH EQUIVALENTS | $ 225,945 | $ - | $ 225,945 |
| INVESTMENTS | - | 20,006,071 | 20,006,071 |
| INTEREST RECEIVABLE | - | 8,219 | 8,219 |
| DUE FROM OTHER FUNDS | 4,905 | - | 4,905 |
| PREPAID EXPENDITURES | 44,005 | - | 44,005 |
| TOTAL | $ 274,855 | $ 20,014,290 | $ 20,289,145 |
| **LIABILITIES AND FUND BALANCES** | | | |
| LIABILITIES: | | | |
| Accounts payable | $ 13,746 | $ - | $ 13,746 |
| Due to Erie County | | 37,253 | 37,253 |
| Due to other funds | - | 4,905 | 4,905 |
| Deferred revenue | - | 8,219 | 8,219 |
| Total liabilities | 13,746 | 50,377 | 64,123 |
| FUND BALANCES: | | | |
| Reserved for prepaid expenditures | 44,005 | - | 44,005 |
| Reserved for debt service | | 19,963,913 | 19,963,913 |
| Unreserved — undesignated | 217,104 | - | 217,104 |
| Total fund balances | 261,109 | 19,963,913 | 20,225,022 |
| TOTAL | $ 274,855 | $ 20,014,290 | $ 20,289,145 |

See notes to financial statements.

# ERIE TOBACCO ASSET SECURITIZATION CORPORATION
**(A Component Unit of the County of Erie, New York)**

## RECONCILIATION OF THE BALANCE SHEET OF GOVERNMENTAL FUNDS TO THE STATEMENT OF NET ASSETS (DEFICIT) AS OF DECEMBER 31, 2010

| | |
|---|---|
| TOTAL FUND BALANCE — Governmental funds | $ 20,225,022 |
| AMOUNTS REPORTED FOR GOVERNMENTAL ACTIVITIES IN THE STATEMENT OF NET ASSETS ARE DIFFERENT BECAUSE: | |
| Revenues in the statement of activities that do not provide current financial resources are reported as deferred revenue in the funds | 8,219 |
| Certain current and long-term liabilities are not due and payable in the current period from currently available financial resources and are therefore not reported in the governmental funds financial statements. Those liabilities consist of: | |
| Bonds payable | (319,544,400) |
| Bonds discount | 11,374,631 |
| Accrued loss on defeasance | 21,851,736 |
| Accrued interest | (18,968,803) |
| | (305,286,836) |
| Costs associated with the issuance of bonds are capitalized in the statement of net assets (deficit) and are expenses in the governmental funds in the year the bonds are issued. | 3,824,680 |
| NET DEFICIT OF GOVERNMENTAL ACTIVITIES | $ (281,228,915) |

See notes to financial statements.

# ERIE TOBACCO ASSET SECURITIZATION CORPORATION
**(A Component Unit of the County of Erie, New York)**

**STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES**
**GOVERNMENTAL FUNDS**
**FOR THE YEAR ENDED DECEMBER 31, 2010**

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| | General | Debt Service | Total Governmental Funds |
|---|---|---|---|
| REVENUES: | | | |
| Tobacco settlement revenues | $ - | $ 15,924,811 | $ 15,924,811 |
| Interest and investment income | 105 | 41 | 146 |
| Realized gains | - | 84,847 | 84,847 |
| Other income | 10,019 | - | 10,019 |
| Total revenues | 10,124 | 16,009,699 | 16,019,823 |
| EXPENDITURES: | | | |
| Current — general administration | 132,527 | 32 | 132,559 |
| Debt service: | | | |
| Principal | - | 2,875,000 | 2,875,000 |
| Interest and fiscal charges | - | 13,381,670 | 13,381,670 |
| Total expenditures | 132,527 | 16,256,702 | 16,389,229 |
| DEFICIENCY OF REVENUES OVER EXPENDITURES | (122,403) | (247,003) | (369,406) |
| OTHER FINANCING SOURCES (USES): | | | |
| Transfers in (out) | 201,553 | (201,553) | - |
| Total other financing sources (uses) | 201,553 | (201,553) | - |
| NET CHANGE IN FUND BALANCES | 79,150 | (448,556) | (369,406) |
| FUND BALANCE — Beginning of year | 181,959 | 20,412,469 | 20,594,428 |
| FUND BALANCE — End of year | $ 261,109 | $ 19,963,913 | $ 20,225,022 |

See notes to financial statements.

## ERIE TOBACCO ASSET SECURITIZATION CORPORATION
**(A Component Unit of the County of Erie, New York)**

### RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES OF GOVERNMENTAL FUNDS TO THE STATEMENT OF GOVERNMENTAL ACTIVITIES FOR THE YEAR ENDED DECEMBER 31, 2010

| | |
|---|---|
| NET CHANGE IN FUND BALANCES — Total governmental funds | $ (369,406) |
| AMOUNTS REPORTED FOR GOVERNMENTAL ACTIVITIES IN THE STATEMENT OF ACTIVITIES ARE DIFFERENT BECAUSE: | |
| Changes in accrual of interest payable on bonds. | (3,394,100) |
| Changes in accrual of interest receivable on investments. | 5,767 |
| Costs associated with financing bonds are recognized as expenses in the governmental funds in the year paid, but in the entity-wide financial statements such costs are amortized over the remaining life of the debt. Additionally, differences in the amounts of the old debt and new debt are deferred and charged to interest expense over the shorter of the life of the old or new bonds: | |
| Amortization of bond issuance costs | (112,703) |
| Amortization of bond discount | (67,904) |
| Amortization of loss on defeasance | (763,200) |
| Net adjustment | (943,807) |
| Payments of long-term liabilities are reported as an expenditure in government funds and as a reduction of debt in the statement of net assets. In the current year, there were principal payments on bonds which were not included on the statement of activities. | 2,875,000 |
| CHANGE IN NET DEFICIT OF GOVERNMENTAL ACTIVITIES | $ (1,826,546) |

See notes to financial statements.

## 1. ORGANIZATION

Erie Tobacco Asset Securitization Corporation (ETASC) is a special-purpose local development corporation organized under the Not-for-Profit Corporation Law of the State of New York. In accordance with Governmental Accounting Standards Board (GASB) Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, ETASC is reported as a blended component unit of the County of Erie, New York (the "County").

ETASC was incorporated on August 15, 2000, for the purpose of issuing tobacco settlement asset-backed bonds (the "2000 Series 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 (MSA) and the Consent Decree and Final Judgment (the "Decree") as described herein.

The sole member of ETASC is the County Executive of the County. The board of directors of ETASC has five directors. One director shall be an individual designated by the County Executive, one director shall be an individual designated by the County Comptroller, and one director (the "Designated Director") shall be designated jointly by the Chairperson of the County Legislature and the Minority Leader of the County Legislature; two independent directors shall be designated jointly by a majority of the other three directors in accordance with the provisions of the Certificate of Incorporation of the Corporation.

The MSA was entered into on November 23, 1998, among the attorney generals 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 product 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.

In conjunction with the sale of the 2000 Series Bonds, the County had dedicated the discounted net proceeds of the sale as a source of funds for certain capital expenditures and the defeasance of debt. ETASC allocated the net proceeds of the sale of bonds on behalf of the County as follows: $211,722,302 was allocated to the County to finance certain capital projects and $25,046,347 was disbursed to the Liquidity Reserve Accounts and Debt Service Accounts held by the Indenture Trustee. Tobacco proceeds of $151,722,302 allocated to the County were disbursed to the County in 2000. The remaining $60,000,000 was deposited by ETASC in eligible investments on behalf of the County. All cash and investments remaining of the original $60,000,000 had been remitted to the County in 2005.

In August 2005, ETASC entered into an agreement (the "2005 Bonds") to defease the original 2000 Series Bonds and to securitize additional proceeds to be received under the MSA for years subsequent to 2016. The total debt issued in 2005 amounted to $318,834,680. Net proceeds after issuance cost and discounts amounted to $305,330,026, with $265,013,936 used to fund a defeasance escrow account and enable the ETASC to release previously restricted funds for debt service and trapping events to the

County. Trapping events are defined economic circumstances that trigger a mandatory deposit of all residual payments into a trapping account. See Note 5 for additional information related to long-term debt.

In January 2006, ETASC issued $17,694,750 Tobacco Settlement Asset-Backed Bonds, Series 2006A, subordinate to the 2005 Bonds. These bonds are payable from and secured by all Tobacco Settlement Revenues (TSRs) allocated to the County under the MSA; investment earnings on amounts in certain funds and accounts established under the ETASC Indenture; any amounts on deposit in such funds and accounts held as security for the ETASC's Series 2006A bonds; and certain amounts expected to become available from funds and accounts created under the ETASC Indenture as security for prior bonds upon their retirement. The Series 2006A bonds are subject to mandatory redemption from amounts on deposit in the Turbo Redemption Account and ETASC with 100% of all surplus revenues, if any. A turbo redemption occurs when all excess revenues, after the payment of operation expenses, interest and rated principal, are used to retire term bonds early in order of maturity. Disbursements to the County from 2006 bond proceeds totaled $15,673,077 for the year ended December 31, 2006.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**General** — In its accounting and financial reporting in conformity with accounting principles generally accepted in the United States of America, ETASC follows all applicable GASB pronouncements.

**Basis of Accounting and Measurement Focus** — The entity-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.

Governmental fund financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Under the current financial resources measurement focus, only current assets and liabilities generally are included on the balance sheet. Under the modified accrual basis of accounting, revenues are recognized in the accounting period in which they become both measurable and available to finance expenditures of the fiscal period. Expenditures are recognized in the accounting period in which the fund liability is incurred, if measurable. Transfers among funds are recognized in the accounting period in which the interfund receivable and payable arise.

**Basis of Presentation** — The entity-wide financial statements (i.e., statement of net assets (deficit) and the statement of governmental activities) report information on all the governmental activities of ETASC. The statement of governmental activities demonstrates the degree to which the direct expenses of a given function are offset by program revenues. Direct expenses are those that are clearly identifiable with a specific function. Program revenues include charges to those who purchase, use, or directly benefit from goods, services, or privileges provided by a given function. Items not properly included among program revenues are reported instead as general revenues.

Separate financial statements are provided for governmental funds. Major individual governmental funds are reported as separate columns in the governmental fund financial statements.

The financial transactions of ETASC are recorded in individual funds. ETASC reports the following major governmental funds:

*General Fund* — The General Fund is used for all financial resources associated with ETASC except for those required to be accounted for in another fund.

*Debt Service Fund* — The Debt Service Fund is used to account for the accumulation of resources for, and for the payment of, general long-term bond principal, interest, and related costs.

**Cash and Cash Equivalents** — Cash and cash equivalents includes amounts in demand deposits as well as short-term investments with original maturities of three months or less from the date acquired by ETASC.

**Investments** — Investments are recorded on the balance sheet at fair value pursuant to the provisions of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*.

ETASC's Debt Service Fund investments represent investments held to meet reserve requirements (see Note 6). Increases or decreases in ETASC's Debt Service Fund investment account are recorded within ETASC's statement of revenues, expenditures, and changes in fund balances or the statement of governmental activities.

**Bond Issuance Costs** — Bond issuance costs are netted against bond proceeds and recognized in the period incurred within the governmental funds. Within the entity-wide financial statements, bond issuance costs are capitalized and amortized over the life of the related debt issue on a straight-line basis.

**Bond Defeasances and Refunding** — In the entity-wide financial statements, gains or losses on bond refunding transactions, representing the difference between the reacquisition price required to repay previously issued debt and the net carrying amount of the retired debt, are deferred as an addition to or are deducted from the new bonded liability. In subsequent years, these amounts are amortized as a component of interest expense over the shorter of the life of the old debt or the life of the new debt.

**Expenditures** — Expenditures are recorded on a modified accrual basis of accounting in the governmental fund financial statements and under the accrual basis of accounting in the entity-wide financial statements.

Under the 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. An interfund transfer is made from the Debt Service Fund to the General Fund in order to fund such general administration costs. The total interfund transfer reported for the year ended December 31, 2010, was $201,553.

**Use of Estimates** — 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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Future Impacts of Accounting Pronouncements** — ETASC implemented GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments* ("GASB 53") in 2010 (see Note 4). ETASC also implemented GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets,* and GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies,* effective for the year ended December 31, 2010, which had no impact on ETASC's financial position or results of operations.

ETASC has not completed the process of evaluating the impact that will result from adopting GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, and GASB Statement No. 59, *Financial Instruments Omnibus,* effective for the year ending December 31, 2011; 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*, and GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements,* effective for the year ending December 31, 2012; and GASB Statement No. 61, *The Financial Reporting Entity: Omnibus — an amendment of GASB Statements No 14 and No. 34,* effective for the year ending December 31, 2013. ETASC is therefore unable to disclose the impact that adopting these statements will have on its financial position and results of operations when such statements are adopted.

## 3. CASH AND INVESTMENTS

At December 31, 2010, ETASC's cash and cash equivalents and investments consisted of the following:

| Description | Fair Value |
|---|---|
| Cash and cash equivalents — cash on deposit | $ 225,945 |
| Investments: | |
| Institutional liquidity funds | 427,129 |
| Corporate commercial paper | 19,578,942 |
| | 20,006,071 |
| Total cash and cash equivalents and investments | $ 20,232,016 |

At December 31, 2010, investments were carried at fair value and held by a third party in ETASC's name.

ETASC does not have formal investment policies.

**Interest Rate Risk** — As a means of limiting its exposure to fair value losses arising from fluctuating interest rates, it is ETASC's practice to generally limit investments to 180 days or less.

**Credit Risk** — For investments, this is the risk that, in the event of the failure of the counterparty, ETASC will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. For deposits, this is the risk that in the event of a bank failure, ETASC's deposits may not be returned to it.

At December 31, 2010, ETASC's cash was insured by the Federal Depository Insurance Corporation. ETASC's investment practice provides for eligible investments in defeasance collateral, obligations of the Federal Home Mortgage Corporation, Federal National Mortgage Association, 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.

## 4. DERIVATIVE INSTRUMENT

In connection with the 2005 Bonds, ETASC entered into a forward purchase agreement and an effective swap of variable market rate returns with a fixed rate return with Merrill Lynch Capital Services, Inc. (MLCS) and The Bank of New York (the "Trustee"). Under the terms of such agreement, MLCS shall deliver to the Trustee qualified securities selected by MLCS or any dealer in eligible securities selected by MLCS (the "Qualified Dealer"). At the time of such delivery, the Trustee shall, out of the funds provided by ETASC, purchase such qualified security and pay to the Qualified Dealer or MLCS, an amount equal to the price which will produce a rate of return equal to a fixed rate of 4.168% for the period commencing on either June 1 or December 1 and terminating on the following June 1 or December 1, respectively.

Concurrently with the delivery of any qualified securities, the Trustee shall pay the Qualified Dealer or MLCS the market value thereof. If the Qualified Dealer requires that the Trustee purchase qualified securities at a price higher than the fixed rate, MLCS shall pay to the Trustee an amount equal to the excess of the price at which the Qualified Dealer requires the Trustee to purchase such qualified securities over the fixed rate of such qualified securities.

The forward purchase agreement will expire by its terms on the final maturity of the asset-backed bonds on June 1, 2055. ETASC entered into this forward purchase agreement to facilitate investment of the monies in the Debt Service Reserve Fund while the 2005 ETASC bonds are outstanding.

ETASC adopted GASB 53 in 2010. This pronouncement addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. ETASC's forward purchase swap agreement was deemed to be an effective hedge at December 31, 2010, requiring changes in the fair value of the hedging derivative instrument to be recognized as deferred inflows/outflows in the statement of net assets (deficit). As a result of the implementation of this pronouncement, ETASC recorded an asset with an offsetting liability of $1,108,170, which are presented as a deferred inflow on forward purchase agreement swap asset and a derivative instrument liability, respectively, in the accompanying statement of net assets (deficit).

From ETASC's perspective, the relevant risks associated with the forward purchase agreement are credit risks, termination risk, and market risk. The credit risks to ETASC, i.e., the risk that MLCS will not fulfill its obligations, will occur if MLCS becomes insolvent or fails to deliver qualified securities to the trustee as required. The credit rating for Bank of America Corporation, the parent company of MLCS at December 31, 2010 was A as issued by Standard and Poor's. The termination risk to ETASC will occur if the agreement is terminated at a point of the securities purchase and sale process at which ETASC would be required to make a termination payment to MLCS. The market risk to ETASC will occur given the market gains or losses of the securities purchased under the agreement, resulting in a required forward purchase agreement fair value disclosure of the asset or liability position of the agreement at each period end date. These risks are mitigated by the credit rating of the counterparty and the level of eligible securities and guarantees contained in the agreement.

ETASC has evaluated the forward purchase agreement using the consistent critical terms method and deemed it to be effective. As of December 31, 2010, the notional amount of the agreement totals $19,218,750, the fair value is $1,108,170, and net cash flows during the year totaled $678,430.

## 5. LONG-TERM DEBT

In 2000, ETASC issued $246,325,000 of tobacco settlement asset-backed bonds, Series 2000, pursuant to an indenture dated as of September 1, 2000. The $246,325,000 bond issuance was comprised of $196,985,000 tobacco settlement asset-backed bonds Series 2000A and $49,340,000 tobacco settlement asset-backed bonds Series 2000B. The net proceeds of the Series 2000 Bonds were used to purchase from the County all of the County's right, title, and interest to TSR to which the County would otherwise be entitled under the MSA and the Decree.

On August 15, 2005, ETASC issued $318,834,680 in tobacco settlement asset-backed bonds, Series 2005, with interest rates ranging from 5.00% to 6.75% to advance refund $239,060,000 of outstanding Series 2000 Bonds bearing interest rates ranging from 5.0% to 6.5% originally issued in 2000. The net proceeds amounted to $305,330,026 after original issuance discount and payment of $13,504,654 for underwriting fees, insurance, and other issuance costs, of which $267,037,311 was used to fund an irrevocable trust to defease the remaining original bonds. This transaction enabled ETASC to release $55,231,709 in previously restricted funds for debt service and trapping events to the County.

On September 15, 2005, ETASC entered into an agreement with the bondholders to replace the government securities in the irrevocable trust with government agency securities. This transaction generated a savings of $2,802,806. Of this, $1,331,893 was transferred to the County and the remainder less costs of sale was paid to the bondholders for their concessions. During 2010, the bonds were called and the balance in the irrevocable trust was used to satisfy all required debt payments.

On January 5, 2006, ETASC issued $17,694,720 of tobacco settlement asset-backed bonds, Series 2006A, with an interest rate of 7.65%. ETASC entered into a purchase and sale agreement with the County on January 1, 2006, in which ETASC purchased the County's sole undivided beneficial interest in and to the trust established by ETASC pursuant to the Declaration and Agreement of Trust dated September 1, 2000, between ETASC and the Wilmington Trust Company ("2000 Residential Trust"), in its capacity as trustee, including the County's right to receive residual tobacco settlement revenues payable to the County, as sole beneficiary of the 2000 Residential Trust. The net proceeds of $15,638,465 were transferred to the County.

The payment of the Series 2005 and Series 2006 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 Indenture and amounts established and held in accordance with the Indenture. ETASC has no financial assets other than the collections and reserves and amounts held in the other funds and accounts established under the Indenture.

ETASC has covenanted to apply 100% of all surplus revenues, if any, in the turbo redemption account to the special mandatory redemption ("Turbo Redemption") of the authorized denominations of the Series 2005 Bonds in order of maturity and then to the Series 2006A Bonds to the extent that there exists excess funds. Any such surplus revenues shall be applied on each distribution date beginning on June 1, 2006.

Interest on the Series 2005A and E bonds are payable each June 1 and December 1. Interest on the 2005 Series B, C, and D bonds and the Series 2006A bonds accrues throughout the life of the bonds but is payable at redemption. Series 2005B, C, and D Bonds are zero-coupon bonds and are subject to redemption at the option of ETASC beginning in years after 2016. The Series 2006A bonds may be redeemed after May 31, 2017. Details of long-term debt as of December 31, 2010, are as follows:

**Series 2005**
**$318,834,680**
**Term Bond**

| Issue Amount | Rate | Description | Projected Final Turbo Redemption Date |
|---|---|---|---|
| $ 30,330,000 | 5.000 % | Series 2005A Bonds due June 1, 2031, Semiannual interest-only payments through maturity, may be redeemed at the option of the ETASC at anytime in whole or in part after June 1, 2015. | June 1, 2018 |
| 74,685,000 | 5.000 | Series 2005A Bonds due June 1, 2038, Semiannual interest-only payments through maturity, may be redeemed at the option of the ETASC at anytime in whole or in part after June 1, 2015. | June 1, 2022 |
| 111,480,000 | 5.000 | Series 2005A Bonds due June 1, 2045, Semiannual interest-only payments through maturity, may be redeemed at the option of the ETASC at anytime in whole or in part after June 1, 2015. | June 1, 2027 |
| 9,163,000 | 5.750 | Series 2005B Bonds due June 1, 2047, Semiannual interest accrued but not payable until maturity, subject to redemption at the option of ETASC anytime after June 1, 2015 at accreted values as follows: June 1, 2015 through May 31, 2016, 102%; June 1, 2016 through May 31, 2017, 101%; and June 1, 2017 and thereafter, 100%. | June 1, 2027 |
| 12,565,080 | 6.250 | Series 2005C Bonds due June 1, 2050, Semiannual interest accrued but not payable until maturity, subject to redemption at the option of ETASC anytime after June 1, 2015 at accreted values as follows: June 1, 2015 through May 31, 2016, 102%; June 1, 2016 through May 31, 2017, 101%; and June 1, 2017 and thereafter, 100%. | June 1, 2029 |
| 11,141,600 | 6.750 | Series 2005D Bonds due June 1, 2055, Semiannual interest accrued but not payable until maturity, subject to redemption at the option of ETASC anytime after June 1, 2015 at accreted values as follows: June 1, 2015 through May 31, 2016, 102%; June 1, 2016 through May 31, 2017, 101%; and June 1, 2017 and thereafter, 100%. | June 1, 2032 |
| 69,470,000 | 6.000 | Series 2005E Taxable Bonds due June 1, 2028, Semiannual interest only payments through maturity, may be redeemed at the option of the ETASC at anytime in whole or in part after June 1, 2015. | June 1, 2016 |

(Continued)

**Series 2006**
**$17,694,720**
**Term Bond**

| Issue Amount | Rate | Description | Projected Final Turbo Redemption Date |
|---|---|---|---|
| $ 17,694,720 | 7.650 % | Series 2006A Taxable Bonds due June 1, 2060, Semiannual interest accrued but not payable until maturity, subordinate to the Series 2005A-E Bonds, subject to redemption at the option of ETASC anytime after June 1, 2016 at accreted values as follows: June 1, 2016 through May 31, 2017, 102%; June 1, 2017 through May 31, 2018, 101%; and June 1, 2018 and thereafter, 100%. | June 1, 2037 |

(Concluded)

Changes in bonds payable for the year ended December 31, 2010, are as follows:

| | |
|---|---|
| Bonds payable at January 1, 2010 | $ 322,419,400 |
| Principal payments during 2010 | (2,875,000) |
| Bonds payable at December 31, 2010 | $ 319,544,400 |

The amount reflected in the statement of net assets (deficit) for bonds payable is net of unamortized discount on the sale of the bonds of $11,374,631 and loss on defeasance of $21,851,736.

The ETASC's debt service requirements based upon the due dates excluding turbo redemption payments as of December 31, 2010, are as follows:

| Years Ending December 31 | Principal | Interest | Total Debt Service |
|---|---|---|---|
| 2011 | $ - | $ 13,973,850 | $ 13,973,850 |
| 2012 | - | 13,973,850 | 13,973,850 |
| 2013 | - | 13,973,850 | 13,973,850 |
| 2014 | - | 13,973,850 | 13,973,850 |
| 2015 | - | 13,973,850 | 13,973,850 |
| 2016–2020 | - | 69,869,250 | 69,869,250 |
| 2021–2025 | - | 69,869,250 | 69,869,250 |
| 2026–2030 | 52,485,000 | 61,996,500 | 114,481,500 |
| 2031–2035 | 30,330,000 | 47,299,500 | 77,629,500 |
| 2036–2040 | 74,685,000 | 37,205,625 | 111,890,625 |
| 2041–2045 | 111,480,000 | 25,083,000 | 136,563,000 |
| 2046–2050 | 21,728,080 | 56,811,838 | 78,539,918 |
| 2051–2055 | 11,141,600 | 37,226,871 | 48,368,471 |
| 2056–2060 | 17,694,720 | 67,912,335 | 85,607,055 |
| | $ 319,544,400 | $ 543,143,419 | $ 862,687,819 |

## 6. DEBT SERVICE RESERVES

Under the indenture, the trustee will hold a segregated Liquidity Reserve Account totaling $19,578,942 at December 31, 2010. The Liquidity Reserve Account will be terminated when no current interest bonds remain outstanding. Such amounts are not available to make Turbo Redemption Payments.

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Deloitte & Touche LLP
6500 Sheridan Drive
Suite 216
Williamsville, NY 14221-4842
USA
Tel: +1 716 843 7200
Fax: +1 716 856 7760
www.deloitte.com

# 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 of
Erie Tobacco Asset Securitization Corporation:

We have audited the financial statements of Erie Tobacco Asset Securitization Corporation (ETASC), a component unit of the County of Erie, New York, as of and for the year ended December 31, 2010, and have issued our report thereon dated December 28, 2011. 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

Management of ETASC is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered ETASC'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 ETASC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of ETASC's internal control over financial reporting.

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 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.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in the internal control that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

## Compliance and Other Matters

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

This report is intended solely for the information and use of management, the Board of Directors, the County of Erie, New York, and others within the entity, and is not intended to be, and should not be, used by anyone other than these specified parties.

Deloitte & Touche LLP

December 28, 2011