ERIE TOBACCO ASSET SECURITIZATION CORPORATION

(A Component Unit of the County of Erie, New York)
Basic Financial Statements and Required Supplementary Information for the Year Ended December 31, 2011
And Independent Auditors' Report

ERIE TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF ERIE, NEW YORK)
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Drescher & Malecki LLP
3083 William Street, Suite 5
Cheektowaga, New York 14227
Telephone: 716.565.2299
Fax: 716.565.2201

Certified Public Accountants

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 the Erie Tobacco Asset Securitization Corporation (the "ETASC"), a component unit of the County of Erie, New York, as of and for the year ended December 31, 2011, which collectively comprise ETASC's basic financial statements as listed in the foregoing table of contents. These financial statements are the responsibility of the ETASC's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free 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 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, at December 31, 2011, 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.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 10, 2012, on our consideration of the 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 read in conjunction with this report in considering the results of our audit.

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

Drescher & Malecki LLP

April 10, 2012

As management of the Erie Tobacco Asset Securitization Corporation ("ETASC"), a blended component unit of the County of Erie (the "County"), we offer readers of ETASC's financial statements this narrative overview and analysis of the financial activities of ETASC for the fiscal year ended December 31, 2011. We encourage readers to consider the information presented here in conjunction with additional information contained in the financial statements and notes to the financial statements. All amounts, unless otherwise indicated, are expressed in dollars. Certain items from the year ended December 31, 2010 have been reclassified to conform to the current years presentation.

Financial Highlights

- Total government-wide liabilities of ETASC exceeded government-wide assets by $287,816,484 at December 31, 2011. This compares to total government-wide liabilities of ETASC exceeding government-wide assets by $281,228,915 at December 31, 2010.
- ETASC's net assets decreased by $6,587,569, which increased its net deficit, for the year ended December 31, 2011. The increase in ETASC's net deficit was largely due to accreted interest costs coupled by the declining cigarette sales which may be attributed to the increase in cigarette taxes.

Overview of the Financial Statements

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

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

The *statement of net assets* presents information on all ETASC's assets and liabilities, assets denote resources available to continue the operations of ETASC, while liabilities essentially indicate how much ETASC owes lending institutions. The difference between the two is reported as *net assets (deficit)*. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of ETASC is improving or deteriorating.

The *statement of activities* presents information showing how the government's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods.

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

Fund financial statements. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. ETASC, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. Both of ETASC's funds are classified as governmental funds.

Governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

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

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

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 14-24 of this report.

Financial Analysis

As noted earlier, net assets (deficit) may serve over time as a useful indicator of a government's financial position. In the case of ETASC, liabilities exceeded assets by $287,816,484 at December 31, 2011, as compared to $281,228,915 at December 31, 2010. Table 1, shown on the following page, presents the condensed statements of net assets (deficit) for ETASC at December 31, 2011 and December 31, 2010.

Table 1─Condensed statements of net assets (deficit)

	December 31,	
	2011	2010
Current assets	$ 20,281,546	$ 20,284,240
Noncurrent assets	8,753,385	4,932,850
Total assets	29,034,931	25,217,090
Current liabilities	1,197,253	1,214,999
Noncurrent liabilities	315,654,162	305,231,006
Total liabilities	316,851,415	306,446,005
Net assets (deficit)	$ (287,816,484)	$ (281,228,915)

Total assets as of December 31, 2011, were $29.0 million, representing an increase of $3.818 million from the prior year. The major components of the total assets at December 31, 2011 and 2010, consisted of the following: (1) cash and cash equivalents of $0.273 million and $0.226 million, respectively; (2) investments of $20.0 million (68.7%) and $20.0 million (79.3%), respectively; (3) bond issuance costs (net) of $3.7 million (12.8%) and $3.8 million (15.2%); (4) prepaid expenses of $34,489 and $44,005; and (5) deferred inflow on forward purchase agreement swap of $5.0 million (17.4%) and $1.1 million (4.4%), respectively.

Total liabilities at December 31, 2011, were $316.9 million, compared to $306.4 million at December 31, 2010. The liabilities at December 31, 2011 and 2010, consisted of the following: (1) long-term liabilities of $310.6 million (98.0%) and $304.1 million (99.2%), respectively; (2) remittances payable to the County of $37,253 and $37,253, respectively; (3) accounts payable of $5,000 and $13,746, respectively; (4) $1.155 million and $1.164 million, respectively, in accrued interest payable; and (5) a derivative instrument valued at $5.0 million and $1.1 million, respectively.

The statement of revenues, expenses and changes in net assets (deficit) presents revenues received and expenses paid by ETASC. Presented as Table 2, is the condensed statement of revenues, expenses and changes in net assets for the years ended December 31, 2011 and 2010.

Table 2─Condensed statements of revenues, expenses and changes in net assets (deficit)

	Year Ended December 31,	
	2011	2010
General revenues	$ 15,219,217	$ 16,025,590
Expenses—governmental activities	(21,806,786)	(17,852,136)
Change in net assets	(6,587,569)	(1,826,546)
Net assets (deficit)—beginning	(281,228,915)	(279,402,369)
Net assets (deficit)—ending	$ (287,816,484)	$ (281,228,915)

Total revenues for the years ended December 31, 2011 and 2010, were $15.2 million and $16.0 million, respectively. The net decrease in revenues of $0.8 million is primarily due to the decrease in tobacco settlement revenues in 2011. Revenues for the years ended December 31, 2011 and 2010, consisted of

$15.1 million (99.2%) and $15.9 million (99.4%), respectively, of tobacco settlement revenues, $115,569 and $84,847, respectively, of realized gains, and $5,619 and $15,932, respectively, of interest and other income.

A summary of sources of revenues for the years ended December 31, 2011 and December 31, 2010 is presented below in Table 3.

Table 3─Sources of revenues

	Year Ended December 31,		Dollar	Percentage
	2011	2010	Change	Change
Tobacco settlement revenues	$ 15,098,029	$ 15,924,811	$ (826,782)	(5.2)%
Interest and net earnings from investments	121,188	100,779	20,409	20.3 %
Total revenues	$ 15,219,217	$ 16,025,590	$ (806,373)	(5.0)%

Total expenses for the years ended December 31, 2011 and 2010, were $21.8 million and $17.9 million, respectively. The increase in expenses of $4.0 million is primarily due to the increase in CAB interest accretion in 2011. Expenses for the years ended December 31, 2011 and 2010 primarily consisted of $21.7 million (99.3%) and $17.7 million (99.3%), respectively, of bond interest expense, and $154,344 and $132,559 respectively, of general government support expenses incurred in connection with the operations of the ETASC.

A summary of operating expenses for the years ended December 31, 2011 and December 31, 2010 is presented below in Table 4.

Table 4─Operating expenses

	December 31,		Dollar	Percentage
	2011	2010	Change	Change
General government	$ 154,344	$ 132,559	$ 21,785	16.4 %
Interest and fiscal charges	21,652,442	17,719,577	3,932,865	22.2 %
Total operating expenses	$ 21,806,786	$ 17,852,136	$ 3,954,650	22.2 %

Debt Administration/Economic Factors

As of December 31, 2011, ETASC had $267,175,000 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 $9,770,466 and loss on defeasance of $18,914,452. Additionally, as of December 31, 2011, ETASC had accreted subordinate capital appreciation bonds ("CABs") of $75,829,793, which are reported in the statement of net assets (deficit) net of unamortized discount on the sale of bonds of $1,533,039 and loss on defeasance of $2,174,084. At December 31, 2011, ETASC's net tobacco settlement asset-backed bonds outstanding and net subordinate CABs were $238,490,082 and $72,122,670, respectively. While at December 31, 2010, ETASC's net tobacco settlement asset-backed bonds outstanding and net subordinate CABs were $239,554,364 and $64,568,472, respectively.

Principal payments of $1.8 million and $2.9 million were made during 2011 and 2010, 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.

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ERIE TOBACCO ASSET SECURITIZATION CORPORATION
(A Component Unit of the County of Erie, New York)
Statement of Net Assets (Deficit)
December 31, 2011

	Governmental Activities
ASSETS	
Current assets:	
Cash and cash equivalents	$ 273,051
Investments	19,960,870
Interest receivable	13,136
Prepaids	34,489
Noncurrent assets:	
Deferred inflow on forward purchase agreement swap	5,041,410
Bond issuance costs — net	3,711,975
Total assets	29,034,931
LIABILITIES	
Current liabilities:	
Accounts payable	5,000
Due to Erie County	37,253
Accrued interest payable	1,155,000
Noncurrent liabilities:	
Due in more than one year—bonds, net	238,490,082
Derivative instruments	5,041,410
Subordinate Turbo CABs payable, net	72,122,670
Total liabilities	316,851,415
NET ASSETS (DEFICIT)	
Restricted for debt service	19,918,712
Unrestricted	(307,735,196)
Total net assets (deficit)	$ (287,816,484)

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

ERIE TOBACCO ASSET SECURITIZATION CORPORATION
(A Component Unit of the County of Erie, New York)
Statement of Activities
Year Ended December 31, 2011

Functions/Programs	Expenses	Program Revenues	Net (Expenses) and Changes in Net Asset
Governmental activities:			
General government support	$ 154,344	-	$ 154,344
Interest and fiscal charges	21,652,442	-	21,652,442
Total governmental activities	21,806,786	-	21,806,786
	General revenues:		
	Tobacco settlement revenue		15,098,029
	Interest earnings		5,619
	Net earnings on investments		115,569
	Total general revenues		15,219,217
	Change in net assets (deficit)		(6,587,569)
	Net assets (deficit)—beginning		(281,228,915)
	Net assets (deficit)—ending		$ (287,816,484)

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

ERIE TOBACCO ASSET SECURITIZATION CORPORATION
(A Component Unit of the County of Erie, New York)
Balance Sheet—Governmental Funds
December 31, 2011

	Governmental Fund Types		
	General	**Debt Service**	**Total**
ASSETS			
Cash and cash equivalents	$ 273,051	$ -	$ 273,051
Investments	-	19,960,870	19,960,870
Interest receivable	-	13,136	13,136
Due from other funds	4,905	-	4,905
Prepaids	34,489	-	34,489
Total assets	$ 312,445	$ 19,974,006	$ 20,286,451
LIABILITIES AND FUND BALANCES			
Liabilities:			
Accounts payable	$ 5,000	$ -	$ 5,000
Due to Erie County	-	37,253	37,253
Due to other funds	-	4,905	4,905
Deferred revenue	-	13,136	13,136
Total liabilities	5,000	55,294	60,294
Fund balances:			
Nonspendable	34,489	-	$ 34,489
Restricted for debt service	-	19,918,712	19,918,712
Unassigned	272,956	-	272,956
Total fund balances	307,445	19,918,712	20,226,157
Total liabilities and fund balances	$ 312,445	$ 19,974,006	$ 20,286,451

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

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)
December 31, 2011

Amounts reported for governmental activities in the statement of net assets are different because:

Total fund balance—governmental funds		$ 20,226,157
Revenues in the statement of activities that do not provide current financial resources are reported as deferred revenue in the funds.		13,136
Long-term liabilities, including bonds payable and accumulated interest on capital appreciation bonds, are not due and payable in the current period and therefore are not reported in the funds. Those liabilities consist of:		
Bonds payable	$ (267,175,000)	
Capital appreciation bonds	(75,829,793)	
Bonds discount	11,303,505	
Accrued loss on defeasance	21,088,536	
Accrued interest	(1,155,000)	(311,767,752)
Costs associated with the issuance of bonds are capitalized in the statement of net assets (deficit) and are expenditures in the governmental funds in the year the bonds are issued.		3,711,975
Net assets (deficit) of governmental activities		$ (287,816,484)

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

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
Year Ended December 31, 2011

	Governmental Fund Types		
	General	**Debt Service**	**Total**
REVENUES			
Tobacco settlement revenue	$ -	$15,098,029	$ 15,098,029
Interest earnings	138	564	702
Realized gains	-	115,569	115,569
Total revenues	138	15,214,162	15,214,300
EXPENDITURES			
Current:			
General government	153,802	542	154,344
Debt service:			
Principal	-	1,805,000	1,805,000
Interest	-	13,253,821	13,253,821
Total expenditures	153,802	15,059,363	15,213,165
Excess (deficiency) of revenues over (under) expenditures	(153,664)	154,799	1,135
OTHER FINANCING SOURCES (USES)			
Transfers in	200,000	-	200,000
Transfers out	-	(200,000)	(200,000)
Total other financing sources (uses)	200,000	(200,000)	-
Net change in fund balances	46,336	(45,201)	1,135
Fund balances – beginning	261,109	19,963,913	20,225,022
Fund balances – ending	$ 307,445	$19,918,712	$ 20,226,157

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

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 Balance of Governmental Funds to the Statement of Governmental Activities
Year Ended December 31, 2011

Amounts reported for governmental activities in the statement of activities are different because:

Net change in fund balances—total governmental funds		$ 1,135
Interest is recognized as an expenditure in the governmental funds when it is due. In the statement of activities, interest expense is recognized as it accrues, regardless of when it is due. The net effect of the difference in accrued interest for general obligation bonds and accreted interest for Subordinate Turbo CAB's between the beginning of the year and the end of the year is:		
General obligation bonds	$ 9,000	
Subordinate Turbo CAB's	(7,460,590)	(7,451,590)
Changes in accrual of interest receivable on investments.		4,917
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 new bonds:		
Amortization of bond issuance costs	$ (112,705)	
Amortization of bond discount	(71,126)	
Amortization of loss on defeasance	(763,200)	(947,031)
Payments of long-term liabilities are reported as an expenditure in the governmental 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.		1,805,000
Change in net assets (deficit) of governmental activities		$ (6,587,569)

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

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1. ORGANIZATION

Erie Tobacco Asset Securitization Corporation ("ETASC") is a special purpose, bankruptcy remote, local development corporation organized under the Not-for-Profit Corporation Law of the State of New York. ETASC is an instrumentality of, but separate, and apart from the County of Erie, New York (the "County"). Although legally separate from the County, ETASC is a component unit of the County. Based on the nature and significance of ETASC's relationship with the County and the criteria set forth in GASB Statement No. 14, *The Financial Reporting Entity,* as amended by GASB Statement No. 39*, Determining Whether Certain Organizations are Component Units,* ETASC is included within the County basic financial statements as a blended component unit.

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.

Payments for principal and interest on the bonds (Series 2005 and Series 2006A) are contingent upon the receipt of TSRs which are driven by the consumption levels of the OPMs tobacco products. Additionally, as disclosed with the issuances the bonds shall not be a debt of either the State of New York or the County, and neither the State of New York nor the County shall be liable thereon, nor shall they be payable out of any funds other than those of ETASC pledged therefor.

In accordance with the Bond Indenture and to the extent contained in the Master Settlement Agreement ("MSA") Report, a trapping event is occurring. A Consumption Decline Trapping Event occurs when shipments of cigarettes in or to the 50 United States, the District of Columbia and Puerto Rico as measured under the MSA, are less in any year preceding a deposit date than the amount opposite such year under the "Consumption Decline Trapping Event" definition, which number for the year 2010 is 305,664,161,271. According to the MSA Report, the amount shown as relevant shipments for the year 2010 was less than the shipment amount specified above, and therefore, a Consumption Decline Trapping Event has occurred.

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 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, 2011, was $200,000.

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.

Tax Status—ETASC is a local development corporation organized pursuant to Section 1411 of the Not-for-Profit Corporation Law of the State of New York and is exempt from Federal income taxes and New York State taxes. Accordingly, no provision for income taxes has been made in the accompanying financial statements.

Adoption of New Accounting Pronouncements—During the year ended December 31, 2011, ETASC adopted the provisions of Governmental Accounting Standards Board ("GASB") Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which requires ETASC to change its fund balance classifications for governmental funds. The new classifications are explained below:

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

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

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

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

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

ETASC also implemented GASB Statement No. 59, *Financial Instruments Omnibus*, which had no impact on ETASC's financial position or results of operations.

Future Impacts of Accounting Pronouncements—ETASC has not completed the process of evaluating the impact that will result from adopting GASB Statements No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*; No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*; No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*; No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*; and No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions – an amendment of GASB Statement No. 53*, effective for the year ending December 31, 2012; and No. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34*; No. 65, *Items Previously Reported As Assets and Liabilities*; and No. 66, *Technical Corrections-2012-an amendment of GASB Statements No. 10 and No. 62,* effective for the year ending December 31, 2013. ETASC is therefore unable to disclose the impact that adopting GASB Statements No. 57, 60, 61, 62, 63, 64, 65, and 66 will have on its financial position and results of operations when such statements are adopted.

3. CASH AND INVESTMENTS

At December 31, 2011, ETASC's cash and cash equivalents and investments consisted of the following:

Description	Fair Value
Cash and cash equivalents — cash on deposit	$ 273,051
Investments:	
Institutional liquidity funds	401,518
Corporate commercial paper	19,559,352
	19,960,870
Total cash and cash equivalents and investments	$20,233,921

At December 31, 2011, 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, 2011, 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.

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, 2011 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, 2011, the notional amount of the agreement totals $19,218,750, the fair value is $5,041,410, and net cash flows during the year totaled $665,879.

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 2005A, E) and capital appreciation bonds ("CABs") (Series 2005B, C, D), 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 CABs, 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. The 2005 Series B, C, and D and the Series 2006A are subordinate CABs and accrue interest throughout the life of the bonds but is payable at redemption. Series 2005B, C, and D CABs are subject to redemption at the option of ETASC beginning in years after 2016. The Series 2006A CABs may be redeemed after May 31, 2017.

Details of long-term debt as of December 31, 2011, 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, 2031
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, 2038
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, 2045
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, 2047
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, 2050
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, 2055
50,680,000	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, 2028

(Continued)

Series 2006
$17,694,720
Term Bond

Issue Amount	Rate	Description	Projected Final Turbo Redemption Date
$ 17,694,720	7.600 %	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, 2060

(Concluded)

Changes in bonds payable for the year ended December 31, 2011, are as follows:

Description	Beginning Balance 1/1/2011	Additions	Deletions	Ending Balance 12/31/2011
Tobacco Settlement Bonds:				
2005A	$ 216,495,000	$ -	$ -	$ 216,495,000
2005E	52,485,000	-	1,805,000	50,680,000
Total Tobacco Settlement Bonds	268,980,000	-	1,805,000	267,175,000
Less:				
Bond discount	(9,826,665)	-	(56,199)	(9,770,466)
Loss on defeasance	(19,598,971)	-	(684,519)	(18,914,452)
Net Tobacco Settlement Bonds	$ 239,554,364	$ -	$ 1,064,282	$ 238,490,082

The ETASC's debt service requirements for the Series 2005A and 2005E as of December 31, 2011, are as follows:

Years Ending December 31	Principal	Interest	Total Debt Service
2012	$ -	$ 13,865,550	$ 13,865,550
2013	-	13,865,550	13,865,550
2014	-	13,865,550	13,865,550
2015	-	13,865,550	13,865,550
2016	-	13,865,550	13,865,550
2017-2021	-	69,327,750	69,327,750
2022-2026	-	69,327,750	69,327,750
2027-2031	81,010,000	57,926,700	138,936,700
2032-2036	-	46,541,250	46,541,250
2037-2041	74,685,000	33,471,375	108,156,375
2042-2046	111,480,000	19,509,000	130,989,000
	$ 267,175,000	$ 365,431,575	$ 632,606,575

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

A summary of the Subordinate CABs net bond balance activity for the year ended December 31, 2011 follows:

	Beginning Balance 1/1/2011	Additions & Annual Net Interest Accretion	Deletions & Turbo Redemption Payments	Ending Balance 12/31/2011
Subordinate CABs	$ 68,369,203	$ 7,460,590	$ -	$ 75,829,793
Less:				
Bond discount	(1,547,966)	-	(14,927)	(1,533,039)
Loss on defeasance	(2,252,765)	-	(78,681)	(2,174,084)
Net Subordinate CABs	$ 64,568,472	$ 7,460,590	$ (93,608)	$ 72,122,670

6. DEBT SERVICE RESERVES

Under the indenture, the trustee will hold a segregated Liquidity Reserve Account totaling $19,559,352 at December 31, 2011. The Liquidity Reserve Account will be terminated when no current interest bonds remain outstanding. Such amounts are not available to make Turbo Redemption Payments.

7. SUBSEQUENT EVENTS

Management has evaluated subsequent events through April 10, 2012, which is the date the financial statements are available for issuance, and have determined there are no subsequent events that require disclosure under generally accepted accounting principles.

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Drescher & Malecki LLP
3083 William Street, Suite 5
Cheektowaga, New York 14227
Telephone: 716.565.2299
Fax: 716.565.2201

Certified Public Accountants

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*

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, 2011, and have issued our report thereon dated April 10, 2012. 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 *Governmental 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 opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the ETASC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the 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 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 internal control over financial reporting was for the limited purposed described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting 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 the 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 *Government Auditing Standards*.

This report is intended solely for the information and use of the ETASC's Board of Directors and others within the ETASC, the Erie County Legislators, the Office of the State Comptroller of New York, and the Authority Budget Office of New York State and is not intended to be and should not be used by anyone other than these specified parties.

Drescher & Malecki LLP

April 10, 2012