COMMONWEALTH OF PENNSYLVANIA

TOBACCO SETTLEMENT FUND
AUDIT REPORT

HARRISBURG, PENNSYLVANIA

FOR THE FISCAL YEARS ENDED JUNE 30, 2013 AND 2012

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BACKGROUND

Act 77 of 2001 ("Act 77") established the Commonwealth of Pennsylvania Tobacco Settlement Fund ("COPA TSF") which receives revenue annually in accordance with the Master Settlement Agreement ("MSA") entered into on November 23, 1998, by the Commonwealth of Pennsylvania ("Commonwealth") and leading United States tobacco product manufacturers approved by the Court of Common Pleas, Philadelphia County, on January 13, 1999. Act 77 addresses both current and future healthcare needs of Pennsylvanians. The majority of the annual MSA deposits provide funding for home and community-based services for seniors, tobacco use prevention and cessation, broad-based health research, long-term care for seniors, medical care for workers with disabilities, and hospital uncompensated care in accordance with the resource allocation plan set forth in Act 77, which may be statutorily amended annually. The Commonwealth Universal Research Enhancement Program ("CURE"), administered by the Department of Health, is also funded by the COPA TSF, awarding grants for clinical, health services and biomedical research.

Other portions of the annual MSA payments, along with Strategic Contribution Payments (as defined in Act 77), were to be invested in the Health Endowment Account for Long-Term Hope ("Endowment") to preserve a portion of the receipts to ensure funding for healthcare needs in the event MSA payments decreased or ceased. The Endowment investment strategy was to focus on long-term return. Due to ongoing budget constraints for the Commonwealth, the appropriations laid out in Act 77 have been reapportioned annually according to different allocation percentages. In addition, annual legislation has slowly transferred assets held in the Endowment account to the Tobacco Settlement Account and appropriated those assets for various budgetary needs. In August 2013, the remaining balance in the Endowment Account was transferred to the Tobacco Settlement Account pursuant to Act 71 of 2013 ("Act 71").

A Health Venture Investment Account ("HVIA") was also established by Act 77 to provide additional capital investment in private venture firms that extend financial resources to emerging life sciences companies in the Commonwealth. Additionally, Act 77 provided for the creation of the Regional Biotechnology Research Centers, which are known as the Life Sciences Greenhouses ("LSG"). Together, the HVIA and LSG initiatives provide funding to support the early stages of the business life cycle for biotechnology innovation from university research to full commercialization. Act 71 stipulated that all assets, non-liquid investments, contractually obligated money, return on investment and any other money or assets in the HVIA account are to remain in the account. Act 71 also restricts any new partnerships or long-term investments with the HVIA through June 30, 2014.

Commonwealth of Pennsylvania
Department of the Auditor General
Harrisburg, PA 17120-0018
Facebook: Pennsylvania Auditor General
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EUGENE A. DEPASQUALE
AUDITOR GENERAL

Independent Auditor's Report

The Honorable Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, PA 17120

Report on the Financial Statements

We have audited the accompanying financial statements of the Commonwealth of Pennsylvania Tobacco Settlement Fund (TSF), a Special Revenue Fund, which comprise the Balance Sheets as of June 30, 2013 and 2012, and the related Statements of Revenues, Expenditures, and Changes in Fund Balances for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits 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 involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the TSF as of June 30, 2013 and 2012 and the results of its operations for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 4 to the financial statements, an arbitration panel hearing the non-participating manufacturer adjustment dispute with respect to the Master Settlement Agreement (MSA) payment received in 2004 issued a decision adverse to the Commonwealth. While the litigation has not concluded, if the decision stands the Commonwealth's MSA payment in April 2014 will be reduced by $178 million. An arbitration panel will commence in the near future regarding the 2005 disputed MSA payment. Although the amount cannot be determined with any certainty, if the decision is adverse in that litigation, it could reduce a future MSA payment in its entirety. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 5 through 6 be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the 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 financial statements, and other knowledge we obtained during our

audits of the 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.

Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the TSF financial statements as a whole. The Statement of Revenues, Expenditures, and Changes in Fund Balances by Account, Schedule of Cash Receipts and Disbursements by Account, and Schedule of Investment Detail by Account as of and for the fiscal year ended June 30, 2013 are presented for purposes of additional analysis and are not a required part of the TSF financial statements. This supplementary information is the responsibility of management and was derived from, and relate directly to, the underlying accounting and other records used to prepare the TSF financial statements. Such information has been subjected to the auditing procedures applied by us in the audit of the TSF financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the TSF financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, based on our audit, the Statement of Revenues, Expenditures, and Changes in Fund Balances by Account, Schedule of Cash Receipts and Disbursements by Account, and Schedule of Investment Detail by Account as of and for the fiscal year ended June 30, 2013 are fairly stated in all material respects in relation to the TSF financial statements taken as a whole.

Other Information

The Background has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 2, 2013, on our consideration of the Commonwealth's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Commonwealth's internal control over financial reporting and compliance.

December 2, 2013

EUGENE A. DEPASQUALE
Auditor General

TSF Management's Discussion and Analysis

This discussion and analysis of the Tobacco Settlement Fund's performance provides an overview of the financial activities for the fiscal year ended June 30, 2013. Please read it in conjunction with the financial statements.

The financial statements consist of the Balance Sheet and the Statement of Revenues, Expenditures and Changes in Fund Balance. Together these statements provide information about the activities of the Tobacco Settlement Fund as a whole. These statements include all assets and liabilities using a modified accrual basis of accounting. All of the current year's revenues and expenses are taken into account regardless of when the cash is received or paid.

Condensed, comparative, financial statement information for the Tobacco Settlement Fund is as follows (amounts in millions):

Description	2013	2012	2011	2013 Inc/- Dec Amount	2013 Inc/- Dec %	2012 Inc/- Dec %
Cash and investments	$ 371	$ 431	$ 572	$ (60)	-14%	-25%
Other assets	114	203	213	(89)	-44%	-5%
Total assets	**$ 485**	**$ 634**	**$ 785**	**$ (149)**	**-24%**	**-19%**
Accounts payable	$ 63	$ 86	$ 165	$ (23)	-27%	-48%
Securities lending obligations	3	3	12	0	0%	-75%
Other liabilities	82	171	169	(89)	-52%	1%
Total liabilities	**$ 148**	**$ 260**	**$ 346**	**$ (112)**	**-43%**	**-25%**
Total fund balance	**$ 337**	**$ 374**	**$ 439**	**$ (37)**	**-10%**	**-15%**
Total liabilities and fund balance	**$ 485**	**$ 634**	**$ 785**	**$ (149)**	**-24%**	**-19%**
Intergovernmental	$ 141	$ 147	$ 170	$ (6)	-4%	-14%
Investment income	(22)	(6)	29	(16)	267%	-121%
Other revenues	350	350	418	0	0%	-16%
Total revenues	**$ 469**	**$ 491**	**$ 617**	**$ (22)**	**-4%**	**-20%**
Protection of persons and property	$ 0	$ 0	$ 116	$ 0	0%	-100%
Health and human services	477	529	474	(52)	-10%	12%
Economic development	3	3	3	0	0%	0%
Total expenditures	**$ 480**	**$ 532**	**$ 593**	**$ (52)**	**-10%**	**-10%**
Net transfers in (out)	$ (25)	$ (25)	$ (412)	$ 0	0%	-94%
Net change in fund balances	**$ (36)**	**$ (66)**	**$ (388)**	**$ (30)**	**-45%**	**-83%**

TSF Management's Discussion and Analysis (Continued)

In September 2013, an arbitration panel hearing the non-participating manufacturer adjustment dispute with respect to Master Settlement Agreement (MSA) payments received in 2004 issued a decision adverse to the Commonwealth. This decision reduced the anticipated April 2014 MSA payment by $178 million, of which $89 million was recorded to reduce Accounts Receivable and Unearned Revenue as of June 30, 2013.

During the fiscal year, investment income decreased by $16 million due to an increase in realized and unrealized losses in Temporary and Long Term Investments as of and during the fiscal year ended June 30, 2013. Health and human services expenditures year-over-year decrease of $52 million is primarily due to a decrease in appropriated monies for the Health Related Research program in the amount of $16 million and the Medical Assistance Long Term Care Program in the amount of $41 million.

COMMONWEALTH OF PENNSYLVANIA
TOBACCO SETTLEMENT FUND
SFYE JUNE 30, 2013 AND 2012

COMPARATIVE BALANCE SHEETS
JUNE 30, 2013 AND 2012

ASSETS

	June 30, 2013	June 30, 2012
Assets:		
Temporary Investments – Note 2	$ 182,345,846	$ 207,210,450
Long-Term Investments – Note 2	184,740,121	220,035,044
Securities Lending Collateral – Note 2	3,682,499	3,353,624
Accounts Receivable – Note 1	79,095,620	168,095,620
Accrued Investment Income Receivable	165,611	456,099
Investment Sales Receivable – Temporary Investments – Note 1	900,957	2,286,614
Due From Federal Government – Note 1	34,558,036	32,118,159
TOTAL ASSETS	$ 485,488,690	$ 633,555,610

LIABILITIES AND FUND BALANCE

Liabilities:		
Accounts Payable and Accrued Liabilities	$ 62,389,633	$ 83,815,983
Investment Purchases Payable – Temporary Investments – Note 1	1,014,676	2,188,716
Securities Lending Obligations – Note 2	3,677,900	3,348,750
Due to Other Funds	662,510	266,026
Due to Political Subdivisions	983,309	2,438,214
Due to Other Governments	670	1,115
Unearned Revenue – Note 1	79,095,620	168,095,620
Due to Fiduciary Funds	1,109	1,580
TOTAL LIABILITIES	$ 147,825,427	$ 260,156,004
Fund Balance:		
Committed for Health Related Purposes – Note 1	$ 337,663,263	$ 373,399,606
TOTAL FUND BALANCE	$ 337,663,263	$ 373,399,606
TOTAL LIABILITIES AND FUND BALANCE	$ 485,488,690	$ 633,555,610

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

COMPARATIVE STATEMENTS OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES JUNE 30, 2013 AND 2012

	July 1, 2012 to June 30, 2013	July 1, 2011 to June 30, 2012
REVENUES:		
Master Settlement Agreement Payments – Note 1	$ 315,825,343	$ 316,021,614
Master Settlement Agreement Strategic Contribution Payment – Note 4	21,360,194	21,341,295
Community Health Reinvestment – Note 4	-	926,946
Intergovernmental Revenues – Federal	141,025,269	147,309,354
Charges for Sales and Services	13,491,194	12,160,404
Redeposit of Checks	6,443	951
Investment Income:		
Interest on Deposits	57,918	72,080
Interest and Dividend Income	3,168,924	3,274,123
Increase/(Decrease) in Fair Value of Investments – Note 1	(25,673,447)	(10,075,477)
Total Investment Income	$ (22,446,605)	$ (6,729,274)
TOTAL REVENUES	$ 469,261,838	$ 491,031,290
EXPENDITURES:		
Program Expenditures:		
State Funded Programs		
Home and Community Based Services	$ 41,444,966	$ 41,194,602
Tobacco Use Prevention and Cessation	12,938,543	12,276,538
Health and Related Research	42,538,100	58,483,666
Uncompensated Care	23,761,100	25,348,000
Health Investment Insurance	71,350,975	67,380,942
Medical Assistance Long-Term Care	121,713,000	162,583,000
Life Science Greenhouses	2,999,993	2,993,276
Total State Funded Programs	$ 316,746,677	$ 370,260,024
Federally Funded Programs		
Home and Community Based Services	$ 46,586,553	$ 41,803,914
Uncompensated Care	30,690,000	31,248,000
Health Investment Insurance	85,379,288	88,539,689
Total Federally Funded Programs	$ 162,655,841	$ 161,591,603
Total Program Expenditures	$ 479,402,518	$ 531,851,627
Administrative Expenditures:		
Salaries and Benefits	$ 140,489	$ 198,585
Board Expenditures	41,578	(167,915)
Investment Management Fees	30,753	127,241
Consulting Fees	63,750	60,000
Commissions on Futures	-	320
Taxes and Insurance	32,822	32,822
Legal Fees	-	1,533
Miscellaneous	4,271	2,296
Total Administrative Expenditures	$ 313,663	$ 254,882
TOTAL EXPENDITURES	$ 479,716,181	$ 532,106,509
EXCESS/(DEFICIENCY) OF REVENUES OVER/(UNDER) EXPENDITURES	$ (10,454,343)	$ (41,075,219)

COMPARATIVE STATEMENTS OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES JUNE 30, 2013 AND 2012 (CONTINUED)

	July 1, 2012 to June 30, 2013	July 1, 2011 to June 30, 2012
OTHER FINANCING SOURCES (USES):		
Transfer to Pacenet	$ (25,282,000)	$ (24,790,000)
NET OTHER FINANCING SOURCES (USES)	$ (25,282,000)	$ (24,790,000)
NET CHANGE IN FUND BALANCE	$ (35,736,343)	$ (65,865,219)
Fund Balance, June 30, 2012 and 2011	373,399,606	439,264,825
Fund Balance, June 30, 2013 and 2012	$ 337,663,263	$ 373,399,606

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

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Commonwealth of Pennsylvania Tobacco Settlement Fund ("COPA TSF") was established in 2001 as a special revenue fund of the Commonwealth of Pennsylvania ("Commonwealth") pursuant to Act 77 of 2001, Section 303 (a), also known as the Tobacco Settlement Act ("Act"). All payments pursuant to the Master Settlement Agreement ("MSA") between the settling states and participating tobacco manufacturers are deposited by the Commonwealth Treasury Department ("Treasury") into the COPA TSF.

The Tobacco Settlement Investment Board ("TSIB") was created to manage, invest and reinvest money in the COPA TSF in accordance with the Act. The TSIB consists of eleven members, including the Secretary of the Department of Community and Economic Development, the Secretary of Budget, three members appointed by the Governor, two appointees by the President pro tempore of the Senate, two appointees by the House Speaker, an appointee by the Minority Leader of the House and an appointee by the Minority Leader of the Senate.

The Department of Community and Economic Development, the Office of the Budget's Office of Comptroller Operations ("OCO"), and certain other Commonwealth agencies provide staff personnel and other services to the COPA TSF. Certain salaries, benefits and other costs are charged to the COPA TSF.

The COPA TSF has an administrative budget, which is approved by the TSIB each fiscal year but does not have a formal adopted budget for the other activities of the COPA TSF.

Basis of Accounting

The TSIB follows U.S. Generally Accepted Accounting Principles ("GAAP"). GAAP allows specialized accounting for government entities, which is governed by pronouncements set by the Governmental Accounting Standards Board ("GASB"). The COPA TSF's statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered to be available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the COPA TSF considers revenues to be available if collected within 60 days of the end of the current fiscal period. Expenditures generally are recorded when a liability is incurred.

Master Settlement Agreement Revenues

The TSIB implemented GASB Technical Bulletin No. 2004-1: Tobacco Settlement Recognition and Financial Reporting Issues ("Bulletin"), effective July 1, 2003. The Bulletin requires the COPA TSF to recognize MSA asset and revenues when the event giving rise to recognition occurs (the domestic shipment of cigarettes by the tobacco product manufacturers).

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Future collections are contingent upon future tobacco product sales subject to various adjustments as outlined in the MSA. The COPA TSF recognizes revenue from tobacco settlement collections as the collections are received by the COPA TSF. In addition, a receivable is accrued for estimated product sales from January 1 through June 30 of each year.

Accounts Receivable

Accounts receivable represents one-half of the estimated MSA payment to be received in April of the following fiscal year. The total in this asset classification is unearned at fiscal year-end.

Investments

Investments are reported at fair value as of the financial statement date based upon values provided by the custodian bank. Investment receivables and payables are recorded separately from investment balances. Receivables and payables are caused by a difference between trade date and settlement date on investment transactions. Securities lending asset and liability amounts are equal to 1) the value of cash and securities purchased with cash received and 2) amounts owed to the counterparty that are part of the Commonwealth's Treasury Security Lending Program. Private equity investments are valued primarily based on amounts estimated by the general partners which are consistent with the guidelines established by the Private Equity Industry Guidelines Group and accepted by the TSIB.

Due from Federal Government

Within the Commonwealth, each fund supports its own federal appropriations. COPA TSF must pay expenditures charged to federal appropriations and await reimbursement from the federal government. Both the Department of Aging and the Department of Public Welfare have federal appropriations for medical assistance programs. There is a maximum ten day lag between the expenditure and the reimbursement from the federal government.

Fund Balance Category

Committed for Health Related Purposes

Commonwealth law, enacted by the General Assembly (legislature) and approved by the Governor, is the Commonwealth's highest level of decision-making authority. Both legislative enactment and gubernatorial approval on or prior to fiscal year end are necessary formal actions to establish, modify and/or rescind amounts committed. The enabling legislation (as amended from time to time) for the TSF provides committed purposes; related amounts are reported as committed fund balance.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Commitments

As of June 30, 2013, private equity investment purchase commitments were as follows:

Tobacco Settlement Account	$ 47,863,398
Health Venture Account	$ 3,490,193

Reclassifications

Certain 2012 amounts have been reclassified in conformity with the 2013 presentation. These reclassifications had no effect on fund balance or the change in fund balance.

New Accounting Pronouncements – Adopted

GASB issued Statement No. 60 "Accounting and Financial Reporting for Service Concession Arrangements" in November 2010. This statement provides accounting and financial reporting requirements for reporting service concession arrangements (SCAs). An SCA is an arrangement between a transferor (a government) and an operator (governmental or nongovernmental entity) in which (1) the transferor conveys to an operator the right and related obligation to provide services through the use of infrastructure or another public asset in exchange for significant consideration and (2) the operator collects and is compensated by fees from third parties.

GASB issued Statement No. 61 "The Financial Reporting Entity: Omnibus" in November 2010. This statement is an amendment of GASB Statements No. 14 "The Financial Reporting Entity", and No. 34 "Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments". GASB Statement No. 61 amends certain requirements for inclusion of component units in the reporting government's financial reporting entity. The amendments to the criteria for including component units allow users of financial statements to better assess the accountability of elected officials by ensuring that the financial reporting entity includes only organizations for which the elected officials are financially accountable or that are determined by the government to be misleading to exclude. It also requires consolidation, as a blended component unit, organizations which serve as financing vehicles for the primary government.

GASB issued Statement No. 62 "Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements" in December 2010. The statement incorporates into the GASB's own pronouncements certain accounting and financial reporting guidance that is included in the following pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements:

1. Financial Accounting Standards Board (FASB) Statements and interpretations;
2. Accounting Principles Board Opinions; and,

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

3. Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure

GASB issued Statement No. 63 "Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position" in June 2011. This statement provides accounting and financial reporting requirements for deferred outflows of resources and deferred inflows of resources as introduced and defined in GASB's Concepts Statement No. 4, "Elements of Financial Statements". This Statement amends the net asset reporting requirements in Statement No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments."

New Accounting Pronouncements – To Be Adopted

GASB issued Statement No. 65 "Items Previously Reported as Assets and Liabilities" in March 2012. This statement establishes accounting guidance for the reporting of certain assets and liabilities as deferred outflows or inflows. It also provides guidance on the reporting of certain revenues and expenditures/expenses as deferred outflows or inflows.

The GASB issued Statement No. 66 "Technical Corrections – 2012" in March 2012. This statement improves accounting and financial reporting by resolving conflicting guidance for GASB Statements No. 54, "Fund Balance Reporting and Governmental Fund Type Definitions," and No. 62, "Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements."

The GASB issued Statement No. 67 "Financial Reporting for Pension Plans, an amendment of GASB Statement No. 25" in June 2012. The objective of this Statement is to improve the usefulness of pension information included in the general purpose external financial reports of state and local governmental pension plans for making decisions and assessing accountability. It specifies the required approach to measuring the pension liability of employers and nonemployer contributing entities for benefits provided through the pension plan (the net pension liability), about which information is required to be presented.

GASB issued Statement No.68 "Accounting and Financial Reporting for Pensions, an amendment of GASB Statement No. 27" in June 2012. This statement establishes standards for measuring and recognizing liabilities, deferred outflows of resources, and deferred inflows of resources, and expense/expenditures. For defined benefit pensions, this Statement identifies the methods and assumptions that should be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The GASB issued Statement No. 69 "Government Combinations and Disposals of Government Operations" in January 2013. This Statement establishes accounting and financial reporting standards related to government combinations and disposals of government operations. As used in this Statement, the term government combinations include a variety of transactions referred to as mergers, acquisitions, and transfers of operations.

The GASB issued Statement No. 70 "Accounting and Financial Reporting for Nonexchange Financial Guarantees" in April 2013. This Statement requires a government that extends a nonexchange financial guarantee to recognize a liability when qualitative factors and historical data, if any, indicate that it is more likely than not that the government will be required to make a payment on the guarantee.

The new standards must be adopted as follows:

GASB Statement No. 65	Effective July 1, 2013 for financial statements for the fiscal year ending June 30, 2014.
GASB Statement No. 66	Effective July 1, 2013 for financial statements for the fiscal year ending June 30, 2014.
GASB Statement No. 67	Effective July 1, 2013 for financial statements for the fiscal year ending June 30, 2014.
GASB Statement No. 68	Effective July 1, 2014 for financial statements for the fiscal year ending June 30, 2015.
GASB Statement No. 69	Effective July 1, 2014 for financial statements for the fiscal year ending June 30, 2015.
GASB Statement No. 70	Effective July 1, 2013 for financial statements for the fiscal year ending June 30, 2014.

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

Risk Management Policies

In May of 2010, the COPA TSF established a contractual arrangement with investment manager Standish Mellon, identifying investment objectives while also providing strict limitations on 'allowable' investment purchases which are limited to U.S. Treasury and Agency securities, including agency mortgage-backed securities such as those issued by Government National Mortgage Association ("GNMA"), Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Association ("FHLMC"). Cash Equivalent securities may be invested in short-term investment funds that consist entirely of U.S. Treasury or Agency securities. At June 30, 2013, approximately 0.18 percent of COPA TSF holdings remain in Corporate Obligations. The establishment of the new policy in May 2010 restricted the purchase of new investments, but did not require the COPA TSF to liquidate existing holdings in other investment classes. At this time the COPA TSF continues to hold corporate obligations and equities.

Portfolios are prohibited from investing in any type of securities or investment vehicles other than U.S. Treasury or Agency securities and from entering into short sales or margin purchases.

The COPA TSF also consists of pooled assets within the Treasury Global Investment Fund ("Pool 124") and is subject to its own investment policy. Pool 124 is a short-term investment vehicle that seeks to maintain a stable net asset value per share ("NAV") of $1 by investing exclusively in fixed income securities, primarily of short duration. The only approved investments are cash and cash equivalents and fixed income. Given the purpose of the Pool, these funds should assume significant liquidity needs and minimum risk tolerance.

Investments by Type: At June 30, 2013, the investment types and related amounts of the COPA TSF are as follows:

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

Investment Type	Amount
Cash Equivalents	$ 1,560,400
Corporate Obligations	669,380
Equities	55,551
Mortgage-Backed Securities	1,570,259
Private Equity	153,589,360
Treasury Investment Program	185,441,591
U.S. Government-Sponsored Enterprises	2,464,266
U.S. Treasury Obligations	21,735,160
Total	**$ 367,085,967**

Custodial Credit Risk: Custodial credit risk for investments is the risk that, in the event a counterparty fails to uphold its agreement to a transaction, the COPA TSF would not be able to recover the value of investment or collateral securities in the possession of an outside party. In accordance with a contractual relationship between the Treasury Department and its custodial agents, substantially all investments, where securities are used as evidence of the investment, are held by the custodians in book entry form in the name of the Commonwealth or the custodian. Similarly, investments of the COPA TSF are registered in the name of the Commonwealth, as the Treasury Department is the statutory custodian for such investments. At June 30, 2013, no investment securities were subject to custodial credit risk.

Concentration Risk: Concentration risk is the risk of loss attributed to the magnitude of the government's investment in a single issuer. As of May 2010, portfolios are prohibited from investing in any type of securities or investment vehicles other than U.S. Treasury or Agency securities. The following concentrations existed as of June 30, 2013:

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

Issuer Name	Amount	Percentage Concentration
Treasury Investment Program	$ 185,441,591	50.52%
Chrysalis Capital Partners	30,917,553	8.42%
United States Treasury	21,735,160	5.92%
McCoy Investment LP	21,167,724	5.77%
LB Crossroads Partnership	19,264,132	5.25%
Pantheon	18,730,678	5.10%

Credit Quality Risk: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is measured by Nationally Recognized Statistical Rating Agencies ("NRSRA").

The TSIB established an investment policy statement, effective May 2010, limiting portfolios to be constructed of only U.S. Treasury or Agency securities with no stated restrictions to investment grade requirements. Certain investments of the COPA TSF are not rated by Fitch as detailed below.

At June 30, 2013, approximately 58 percent of the total investments held by the COPA TSF are fixed income investments susceptible to credit quality rating; the remainder is primarily private equity. The following table discloses aggregate fair value, by the lowest credit quality rating category, at June 30, 2013 for the COPA TSF fixed income investments:

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

Fitch Rating Inc.		**Amount**
AA	$	26,439,065
Rated subtotal	**$**	**26,439,065**
Unrated		
Cash Equivalents	$	1,560,400
Treasury Investment Program.		185,441,591
Unrated subtotal	**$**	**187,001,991**
Total Fixed Income Investments	**$**	**213,441,056**

Interest Rate Risk: Interest rate risk is the risk that an investment's value will change, advantageously or adversely, due to a change in the absolute value of interest rates. The COPA TSF measures interest rate risk using duration. Duration is a measure of an investment's sensitivity to changes in interest rates. The higher the duration, the greater the changes in fair value when interest rates change. The COPA TSF measures interest rate risk using option-adjusted duration, which takes into account embedded options affecting cash flows. The COPA TSF portfolios are not expected to be exposed to high levels of interest rate risk, as the effective duration is expected to have a targeted duration within a band of +/- 20% around the effective duration of the benchmark index. At June 30, 2013, the COPA TSF had the following option-adjusted durations (in years) by investment type:

Investment Type	**Amount of Securities with Duration**	**Amount of Securities with no Duration**	**Option-Adjusted Duration**
Cash Equivalents	$ -	$ 1,560,400	-
Corporate Obligations	669,380	-	1.27
Mortgage-Backed Securities	1,380,673	189,586	2.03
Treasury Investment Program	185,441,591	-	0.00
U.S. Government-Sponsored Enterprises	2,464,266	-	2.52
U.S. Treasury Obligations	21,735,160	-	2.11
Total	**$ 211,691,070**	**$ 1,749,986**	

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

Foreign Currency Risk: Foreign currency risk is the risk of an investment's value changing, advantageously or adversely, due to changes in currency exchange rates. At June 30, 2013 the COPA TSF reported the following foreign currency-denominated holdings:

Currency Name	Equities	Private Equity	Cash Equivalents	Total
Euro Currency Unit	$ -	$ 3,624,291	$ 304,942	$ 3,929,233
Canadian Dollar	55,551	-	548	56,099
British Pound Sterling	-	-	109	109
Australian Dollar	-	-	7	7
Total	**$ 55,551**	**$ 3,624,291**	**$ 305,606**	**$ 3,985,448**

Securities Lending Program

In accordance with a contract between the Treasury Department and its custodial agent, the COPA TSF participates in a securities lending program. A contract between the Treasury Department and its custodian, acting as lending agent, provides that the custodian lends securities owned by the participants to independent brokers, dealers and banks, acting as borrowers.

Lending agreements between the custodian and the borrowers require that the custodian receive collateral from the borrowers in exchange for the securities lent. For securities lent which are not denominated in U.S. dollars or whose primary trading market is located outside the U.S., the fair value of the collateral received must be at least 105 percent of the fair value of the securities lent. For all other securities lent, the fair value of the collateral received must be at least 102 percent. Securities lent consists of both domestic and foreign equity securities and U.S. Treasury and foreign debt obligations. Almost all collateral received consists of cash; a very small portion of collateral received consists of letters of credit, U.S. Treasury, corporate and/or foreign debt obligations. Collateral is marked-to-market daily. Additional collateral from borrowers is required if the fair value of the collateral received declines below lending agreement requirements. The lending agent cannot pledge or sell collateral securities received unless the borrower defaults. Accordingly, neither collateral securities received from borrowers nor the related obligations to borrowers are reported.

NOTE 2 – INVESTMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

To the extent collateral received consists of cash, the lending agent may use or invest the cash in accordance with reinvestment guidelines approved by the Treasury Department. Either the participant or the borrower may terminate lending agreements on demand. Lending agreements are typically of very short duration - usually overnight. Therefore, the duration of lending agreements do not generally match the maturities of the investments made with cash collateral. The resulting rate risk is mitigated by the lending agent's ability to reallocate lending agreements among program participants.

The program requires that the lending agent indemnify the Treasury Department for all claims, liabilities and costs resulting from the lending agent's negligence or intentional misconduct. During the fiscal year ended June 30, 2013, there were no failures by any borrower to return securities lent or pay distributions thereon that would impact the COPA TSF. Also, there were no losses resulting from a lending agent or borrower default and there were no Treasury Department restrictions on the amount of the loans that could be made that would impact the COPA TSF.

At June 30, 2013, there was no Treasury Department or participant credit risk to the borrowers that would adversely affect the COPA TSF because the fair value of collateral received was greater than the fair value of the securities lent, consistent with the lending agreements outstanding.

The fair values of the securities lent, along with type of investments lent, are:

Securities Lent Amount	U.S. Treasury Obligations	U.S. Government Sponsored Enterprises
$3,604,278	$3,305,579	$298,699

NOTE 3 – RELATED PARTIES

The COPA TSF employed one full-time and one part-time salaried staff members and owns no capital assets; the remaining employees performing services for the COPA TSF are employees from OCO. The COPA TSF reimburses the OCO for services rendered by Comptroller employees. Applicable to the fiscal year ended June 30, 2013, the services provided by the OCO to the COPA TSF and recorded as administrative expenses resulted in a net refund of $348 due to an overbilling for Fiscal Year 2011-2012.

NOTE 4 – COMMITMENTS AND CONTINGENCIES

In the years immediately following execution of the Master Settlement Agreement (MSA), litigation was filed alleging, among other claims, that the MSA violates provisions of the U.S. Constitution, state constitutions, federal antitrust and civil rights laws, and state consumer protection laws. In addition, class action lawsuits were filed in jurisdictions alleging violations of state Medicaid agreements. These actions, if ultimately successful, could result in a determination that the MSA is void or unenforceable and could prevent the states from collecting any monies under the MSA. No such lawsuits have been successful and none are currently pending.

The enforcement of the terms of the MSA may continue to be challenged in the future. In the event of an adverse court ruling, the COPA TSF may not have adequate financial resources to continue its programs and services.

In April 2013, 2012, 2011, 2010, 2009, 2008, 2007, and 2006 many of the tobacco product manufacturers participating in the MSA either withheld all or portions of their payments due, or remitted their payments to an escrow account, largely stemming from a dispute regarding the applicability of a possible adjustment to the calculations of amounts due under the Agreement. The adjustment at issue, known as the non-participating manufacturer (NPM) adjustment, comes into play in certain instances when the percentage of national cigarette sales by non-participating manufacturers exceeds a threshold. The Commonwealth of Pennsylvania's anticipated portion of these disputed payments by fiscal year is approximately:

Fiscal Year	Amount
2006	$ 46,759,401
2007	43,670,479
2008	33,201,419
2009	30,147,888
2010	38,306,575
2011	50,873,568
2012	42,978,584
2013	45,537,007
	$ 331,474,921

NOTE 4 – COMMITMENTS AND CONTINGENCIES (CONTINUED)

Due to uncertainties regarding the ultimate collection of the remaining amount of these disputed payments, they have not been recognized as revenue in the accompanying financial statements. The COPA TSF and other affected parties are taking actions prescribed in the MSA to arrive at a resolution of these matters.

In September 2013, an arbitration panel hearing the NPM adjustment dispute with respect to MSA payments received in 2004 issued a decision adverse to the Commonwealth. While the litigation has not concluded, if the decision stands the Commonwealth's MSA payment in April 2014 will be reduced by approximately $178 million. As a result, Accounts Receivable and Unearned Revenue was reduced by $89 million as of June 30, 2013.

An arbitration regarding the NPM adjustment dispute with respect to MSA payments received in 2005 will commence in the near future. It is uncertain when it will conclude. If the Commonwealth receives an adverse decision in that litigation, the Commonwealth's MSA payment the following April would be reduced. The amount of that reduction cannot be calculated with any degree of certainty because it would depend upon the results of similar arbitrations involving other states, but the possibility exists that it would be large enough to eliminate in its entirety the Commonwealth's expected MSA payment.

As of June 30, 2013, the COPA TSF had the following commitments related to private equity investments:

	Capital Committed	Capital Called	Recallable Capital	Reserved Capital
Tobacco Settlement Account	$224,906,000	$191,755,510	$14,712,908	$ 47,863,398
Health Venture Account	66,000,000	63,973,274	1,463,467	3,490,193

The Community Health Reinvestment Account balance at June 30, 2013 was $0. The agreement providing for revenues ended December 31, 2010. The Adult Basic Program funded by this account was discontinued on February 28, 2011.

In order to meet various legislative requirements of Act 77 of 2001, the Health Endowment Account for Long Term Hope ("Endowment") was re-opened during the fiscal year ended June 30, 2012, whereby the TSIB transferred $1,691,498 in lapsed TSF appropriations, from the Tobacco Settlement Account to the Endowment Account.

NOTE 4 – COMMITMENTS AND CONTINGENCIES (CONTINUED)

During the fiscal year ended June 30, 2013, the TSIB transferred the strategic payment received in fiscal year 2011-2012 totaling $21,341,295 from the Endowment Account to the Tobacco Settlement Account in accordance with Act 87 of 2012. The TSIB also transferred the Endowment Account investment earnings from fiscal year 2011-2012 in the amount of $8,152 to the Tobacco Settlement Account to cover a portion of TSIB salaries and expense, and $4,245,612 in lapsed TSF appropriations to the Endowment Account in accordance with Act 77 of 2001. A balance of $27,312,264 existed in the Endowment Account at June 30, 2013.

Act 77 of 2001 provides funding for various state and federal programs. The federal programs receive federal financial assistance in the form of grants from the federal government. Receipt of grants is generally conditioned upon compliance with terms and conditions of the grant agreements or federal regulations. Federal grants are subject to audits or reviews by the grantor agencies of the federal government or its designees. The Commonwealth's management believes possible disallowances, if any, will not have a material effect on the TSF financial statements.

NOTE 5 – SUBSEQUENT EVENTS

Through fiscal year ending June 30, 2014, the fiscal year 2012-13 strategic contribution payment and all assets and cash in the Endowment account shall be transferred to the Tobacco Settlement Account by August 1, 2013 per Act 71 of 2013. Act 71 of 2013 also repeals Sections 303, 306, and 307 of Act 77 of 2001.

TOBACCO SETTLEMENT FUND

SUPPLEMENTAL INFORMATION

COMMONWEALTH OF PENNSYLVANIA
TOBACCO SETTLEMENT FUND

STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES BY ACCOUNT
JULY 1, 2012 THROUGH JUNE 30, 2013

	Health Endowment	Health Venture	Tobacco Settlement	Commercialization	Total
REVENUES:					
Master Settlement Agreement Payments - Note 1	$ -	$ -	$ 315,825,343	$ -	$ 315,825,343
Master Settlement Agreement Strategic Contribution Payment - Note 4	21,360,194	-	-	-	21,360,194
Community Health Reinvestment - Note F	-	-	-	-	-
Intergovernmental Revenues - Federal	-	-	141,095,269	-	141,095,269
Charges for Sales and Services	-	-	13,491,194	-	13,491,194
Redeposit of Checks	-	-	6,443	-	6,443
Investment Income:					
Interest on Deposits	-	-	57,918	-	57,918
Interest and Dividend Income	14,473	1,270,046	1,894,398	9	3,168,924
Increase/(Decrease) in Fair Value of Investments - Note 1	18	(8,328,245)	(17,345,220)	-	(25,673,447)
Total Investment Income	$ 14,491	$ (7,058,201)	$ (15,402,904)	$ 9	$ (22,446,605)
TOTAL REVENUES	**$ 21,374,685**	**$ (7,058,201)**	**$ 454,945,345**	**$ 9**	**$ 469,261,838**
EXPENDITURES:					
Program Expenditures:					
State Funded Programs					
Home and Community Based Services	$ -	$ -	$ 41,444,966	$ -	$ 41,444,966
Tobacco Use Prevention and Cessation	-	-	12,938,543	-	12,938,543
Health and Related Research	-	-	42,538,100	-	42,538,100
Uncompensated Care	-	-	23,761,100	-	23,761,100
Health Investment Insurance	-	-	71,350,975	-	71,350,975
Medical Assistance Long-Term Care	-	-	121,713,000	-	121,713,000
Life Science Greenhouses	-	-	2,999,993	-	2,999,993
Total State Funded Programs	$ -	$ -	$ 316,746,677	$ -	$ 316,746,677
Federally Funded Programs					
Home & Community Based Services	$ -	$ -	$ 46,586,553	$ -	$ 46,586,553
Uncompensated Care	-	-	30,690,000	-	30,690,000
Health Investment Insurance	-	-	85,379,288	-	85,379,288
Total Federally Funded Programs	$ -	$ -	$ 162,655,841	$ -	$ 162,655,841
Total Program Expenditures	$ -	$ -	$ 479,402,518	$ -	$ 479,402,518
Administrative Expenditures:					
Salaries and Benefits	$ 140,489	$ -	$ -	$ -	$ 140,489
Board Expenditures	41,578	-	-	-	41,578
Private Equity Activity		-		-	-
Investment Management Fees	-	-	30,753	-	30,753
Consulting Fees	-	-	63,750	-	63,750
Commissions on Futures	-	-	-	-	-
					-
Taxes and Insurance	-	-	32,822	-	32,822
Legal Fees	-	-	-	-	-
Miscellaneous	-	-	4,271	-	4,271
Total Administrative Expenditures	$ 182,067	$ -	$ 131,596	$ -	$ 313,663
TOTAL EXPENDITURES	**$ 182,067**	**$ -**	**$ 479,534,114**	**$ -**	**$ 479,716,181**
EXCESS/(DEFICIENCY) OF REVENUES OVER/(UNDER) EXPENDITURES	**$ 21,192,618**	**$ (7,058,201)**	**$ (24,588,769)**	**$ 9**	**$ (10,454,343)**
OTHER FINANCING SOURCES (USES):					
Transfer to PSERS per Act 46 of 2010		-	-	-	-
Transfer to Pacenet	$ -	$ -	$ (25,282,000)	$ -	$ (25,282,000)
NET OTHER FINANCING SOURCES (USES)	**$ -**	**$ -**	**$ (25,282,000)**	**$ -**	**$ (25,282,000)**
NET CHANGE IN FUND BALANCE	**$ 21,192,618**	**$ (7,058,201)**	**$ (49,870,769)**	**$ 9**	**$ (35,736,343)**
Fund Balance, June 30, 2012					**373,399,606**
Fund Balance, June 30, 2013					**$ 337,663,263**

COMMONWEALTH OF PENNSYLVANIA
TOBACCO SETTLEMENT FUND

SCHEDULE OF CASH RECEIPTS AND DISBURSEMENTS BY ACCOUNT
JULY 1, 2012 THROUGH JUNE 30, 2013

	Health Endowment	Health Venture	Tobacco Settlement	Commercialization	Total
Investment Fair Market Value - July 1, 2012	$ 23,041,414	$ 53,900,640	$ 350,820,235	$ 4,083	$ 427,766,372
RECEIPTS					
Master Settlement Agreement Payments	$ -	$ -	$ 315,825,343	$ -	$ 315,825,343
Master Settlement Agreement Strategic Contribution Payment	21,360,194	-	-	-	21,360,194
Intergovernmental Revenues - Federal	-	-	138,585,391	-	138,585,391
Charges for Sales and Services	-	-	13,465,153	-	13,465,153
Redeposit of Checks	-	-	6,443	-	6,443
Investment Income:					
Interest on Deposits	-	-	57,918	-	57,918
Interest and Dividend Income	14,473	1,270,044	1,884,398	$	3,168,924
Increase/(Decrease) in Fair Value of Investments	18	(8,328,245)	(17,311,827)	-	(25,640,054)
Total Investment Income	14,491	(7,058,201)	(15,369,511)	$	(22,413,212)
TOTAL RECEIPTS	**$ 21,374,685**	**$ (7,058,201)**	**$ 452,512,819**	**$ 9**	**$ 466,829,312**
DISBURSEMENTS					
Total Program Expenditures Paid	$ -	$ -	$ 527,130,563	$ -	$ 527,130,563
Administrative Expenditures:					
Salaries and Benefits	$ -	$ -	$ 151,154	$ -	$ 151,154
Board Expense	-	-	44,513	-	44,513
Private Equity Activity	-	-	-	-	-
Investment Management Fees	-	-	30,753	-	30,753
Consulting	-	-	63,750	-	63,750
Commisions on Futures	-	-	-	-	-
Taxes and Insurance	-	-	32,822	-	32,822
Legal Fees	-	-	-	-	-
Miscellaneous	-	-	4,271	-	4,271
Total Administrative Expenditures Paid	-	-	327,263	-	327,263
TOTAL DISBURSEMENTS	**$ -**	**$ -**	**$ 527,457,826**	**$ -**	**$ 527,457,826**
TRANSFERS					
Transfer Dividend Proceeds	-	-	-	-	-
Transfer Lapsed Appropriations per Act 77 of 2001	-	-	-	-	-
Transfer FY2011-2012 Strategic Contribution per Act 87 of 2012	$ (21,341,295)	$ -	$ 21,341,295	$ -	$ -
Transfer Board Salaries and Expenditures per Act 77 of 2001	(8,152)	-	8,152	-	-
Transfer FY2012-2013 Lapses per Act 77 of 2001	4,245,612	-	(4,245,612)	-	-
TOTAL TRANSFERS	**$ (17,103,835)**	**$ -**	**$ 17,103,835**	**$ -**	**$ -**
Investment Fair Market Value - June 30, 2013	$ 27,312,264	$ 46,842,439	$ 292,979,063	$ 4,092	$ 367,137,858

COMMONWEALTH OF PENNSYLVANIA
TOBACCO SETTLEMENT FUND

SCHEDULE OF INVESTMENT DETAIL BY ACCOUNT
JUNE 30, 2013

	Health Endowment	Health Venture	Tobacco Settlement	Commercialization	Total
Temporary Investments					
Cash & Cash Equivalents	$ 27,312,264	$ -	$ 128,575,650	$ 4,092	$ 155,892,006
Fixed Income Securities	-	-	26,439,065	-	26,439,065
Equity	-	-	55,551	-	55,551
Total Temporary Investments	$ 27,312,264	$ -	$ 155,070,266	$ 4,092	$ 182,386,622
Long Term Investments					
Cash & Cash Equivalents	$ -	$ 31,161,877	$ -	$ -	$ 31,161,877
Private Equity	-	15,680,562	137,908,798	-	153,589,360
Total Long Term Investments	$ -	$ 46,842,439	$ 137,908,798	$ -	$ 184,751,237
Total Investments	$ 27,312,264	$ 46,842,439	$ 292,979,064	$ 4,092	$ 367,137,859

Total investments includes interest receivable, investments sold receivable, and investment purchases payable. Cash and cash equivalents include plus investments from the Treasury Investment Program and certain U.S. Treasury Obligations.

Commonwealth of Pennsylvania
Department of the Auditor General
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EUGENE A. DEPASQUALE
AUDITOR GENERAL

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*

Independent Auditor's Report

The Honorable Tom Corbett
Governor
Commonwealth of Pennsylvania
Harrisburg, PA 17120

We have audited, 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, the accompanying Balance Sheets, and the Statements of Revenues, Expenditures, and Changes in Fund Balances of the Commonwealth of Pennsylvania Tobacco Settlement Fund (TSF) as of and for the fiscal years ended June 30, 2013 and 2012, and the related notes to the financial statements and have issued our report thereon dated December 2, 2013.

Internal Control Over Financial Reporting

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

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying Finding Section, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the TSF financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying Finding No. 13-1 to be material weaknesses.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying Finding No. 13-2 to be significant deficiencies.

Compliance and Other Matters

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

The Commonwealth's Response to Findings

The Commonwealth's response to the findings identified in our audit is described in the accompanying Finding Section. The Commonwealth's response was not subjected to the auditing procedures applied in the audit of the TSF financial statements, and accordingly, we express no opinion on it.

Purpose of this Report

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

December 2, 2013 EUGENE A. DEPASQUALE
Auditor General

Finding 13 – 1:

Department of Health

DOH Did Not Timely Review Annual Audits of Tobacco Use Prevention and Cessation Contractors (A Similar Condition Was Noted in Prior Finding 12-1)

Condition: In lieu of performing its own audits of contractors, DOH requires its contractors to have annual audits completed and to submit them to DOH for review. DOH's Audit Requirements policy states that contractors that spent more than $500,000 of Tobacco Settlement funds during the fiscal year must submit an audit. For our current audit, eight contractors under the Tobacco Use Prevention and Cessation program were required to submit audits during the SFYE June 30, 2013. Our review of those audits disclosed that DOH received all eight audits timely. However, as of October 8, 2013, nearly a year after the audit submissions, DOH had not completed its review of these reports.

Criteria: The Tobacco Settlement Act 77 of 2001 applicable to Tobacco Use Prevention and Cessation states:

Section 709. Accountability.

(a) Audits. Contracts with Statewide contractors and primary contractors and grants to service providers shall be subject to audit as provided by law. Contracts with Statewide contractors and primary contractors and grants to service providers shall be subject to an annual audit by the department. Audits of these contracts and grants are to be conducted in accordance with generally accepted government auditing standards.

Additionally, DOH's Audit Requirements policy requires contractors that expend funds of $500,000 or more during the state fiscal year to have an audit performed in accordance with generally accepted government auditing standards as issued by the U.S. Government Accountability Office.

While audits are required as noted above, prudent business practice dictates that DOH review the audits timely in order to identify any deficiencies found and take appropriate action as soon as possible.

Cause: DOH management stated that the audits were not reviewed because DOH lacked sufficient staff and resources to conduct the reviews timely. Additionally, other tasks were given priority.

Effect: The failure to timely review Tobacco Use Prevention and Cessation audits increases the risk that Tobacco Settlement funds may not be spent in compliance with the Tobacco Settlement Act.

Recommendation: DOH should review all audit reports timely to ensure that management is aware of any deficiencies found and takes timely appropriate action, if necessary.

Agency Response: DOH acknowledges that, as of October 8, 2013, it had not completed its review of these reports. However, as of November 22, 2013, DOH has completed its review and accepted all but one of these reports. DOH will make the review and final acceptance of the remaining report a priority, and should complete the review and acceptance of this report no later than December 31, 2013.

Further, DOH will make the timely review and final acceptance of audit reports received from contractors under the Tobacco Use Prevention and Cessation program a priority in subsequent audit periods. This will ensure that DOH management is made aware in a timely manner of any deficiencies found so that appropriate action can be taken, if necessary.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

Finding 13 – 2:

Office of Comptroller Operations – Bureau of Accounting and Financial Management

Material Weakness Over Financial Reporting in the Tobacco Settlement Fund

Condition: The Tobacco Settlement Fund's (TSF) financial statements contained a material misstatement in its Statement of Revenues, Expenditures and Changes in Fund Balance that required adjustment. The TSF revenues did not include over $13.4 million in premiums paid by individuals enrolled in the Medical Assistance for Workers with Disabilities (MAWD) program. The premiums were improperly recorded as refunds of expenditures in the financial statements, causing an understatement of revenues and expenditures. These errors went undetected by management.

Criteria: Strong internal controls should ensure that account balances and adjustments are reported accurately in the TSF financial statements in accordance with GAAP. This includes an effective review and approval process by management.

Cause: Office of Comptroller Operations' (OCO) internal review procedures of TSF account balances failed to detect and correct the improper recording of MAWD premiums as described above. The premiums were recorded as refunds of expenditures to facilitate proper accounting for the purpose of managing the federal program and federal funding.

Effect: Revenues and expenditures account balances on the TSF financial statements were materially misstated and required adjustment. Additionally, weaknesses in the OCO's internal review procedures for TSF account balances could result in future misstatements in the TSF financial statements.

Recommendation: We recommend that OCO improve its internal review procedures for the TSF account balances, including premiums, to ensure the amounts reported in the TSF financial statements are accurate.

Agency Response: OCO agrees that the Medical Assistance for Workers with Disabilities (MAWD) participant premiums have been inappropriately reported as a net reduction to program expenditures and further agrees that the premiums should be appropriately reported as program revenues on the Statement of Revenues, Expenditures and Changes in Fund Balance.

OCO is aware that program knowledge serves a critical role in fostering a confident approach and resulting assurance of financial reporting, and continually prioritizes this comprehensive knowledge as the forefront of training and guidance from management to subordinate.

Auditors' Conclusion: Based on the agency response, the finding and recommendation remain as previously stated. We will review any corrective action in the subsequent audit.

COMMONWEALTH OF PENNSYLVANIA
TOBACCO SETTLEMENT FUND
JUNE 30, 2013 AND 2012
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This report was initially distributed to the following:

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