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, 2012
And Independent Auditors' Report

ERIE TOBACCO ASSET SECURITIZATION CORPORATION
(A COMPONENT UNIT OF THE COUNTY OF ERIE, NEW YORK)
Table of Contents
Year Ended December 31, 2012

Page

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
Erie Tobacco Asset Securitization Corporation:

Report on the Financial Statements

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, 2012, and the related notes to the financial statements, which collectively comprise the ETASC's basic financial statements as listed in the table of contents.

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 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 from 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 opinions.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each major fund of ETASC, as of December 31, 2012, and the respective changes in financial position thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Note 2 to the financial statements, ETASC has restated its net position as of December 31, 2011. 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 as listed in the foregoing table of contents 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.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated March 29, 2013 on our consideration of ETASC'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 ETASC's internal control over financial reporting and compliance.

Drescher & Malecki LLP

March 29, 2013

ERIE TOBACCO ASSET SECURITIZATION CORPORATION
(A Component Unit of the County of Erie, New York)
Management Discussion and Analysis
Year Ended December 31, 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, 2012. For comparative purposes, certain items relating to the year ended December 31, 2011 presentation have been reclassified. 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.

Financial Highlights

- ♦ Total government-wide liabilities of ETASC exceeded government-wide assets by $279,944,763 at December 31, 2012. This compares to total government-wide liabilities of ETASC exceeding government-wide assets by $276,131,226, at December 31, 2011.
- ♦ ETASC's net position decreased by $3,813,537, for the year ended December 31, 2012. The reduction in ETASC's net position was largely due to accreted interest costs and continued declines in cigarette sales.
- ♦ At the close of the current year, ETASC's governmental funds reported combined fund balances of $20,326,107, an increase of $99,950 in comparison with the prior year. Approximately 1.48% of this amount ($301,096) is available for spending at ETASC's discretion (unassigned fund balance).

Overview of the Financial Statements

This discussion and analysis are intended to serve as an introduction to 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 position* presents information on all of ETASC's assets, liabilities, and deferred inflows/outflows of resources. 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 position*. Over time, increases or decreases in net position 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 position changed during the most recent fiscal year. All changes in net position 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 9-10 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 11-14 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 15-30 of this report.

Government-Wide Overall Financial Analysis

As noted earlier, net position may serve over time as a useful indicator of a government's financial position. In the case of ETASC, liabilities exceeded assets by $279,944,763 at December 31, 2012, as compared to $276,131,226, at December 31, 2011. Table 1, shown on the following page, presents the condensed statements of net position for ETASC at December 31, 2012 and December 31, 2011.

Table 1─Condensed statements of net position

	December 31,	
	2012	2011
Current assets	$ 35,692,463	$ 35,678,779
Deferred outflows	4,879,716	5,041,410
Total assets	40,572,179	40,720,189
Current liabilities	1,144,106	1,197,253
Noncurrent liabilities	319,372,836	315,654,162
Total liabilities	320,516,942	316,851,415
Net position	$ (279,944,763)	$ (276,131,226)

A portion of ETASC's net position ($19,990,556) represents resources that are subject to external restrictions on how they may be used. The remaining net position is considered to be an unrestricted deficit.

Total assets as of December 31, 2012, were $40.6 million, representing a decrease of $0.1 million from the prior year. The major components of the total assets at December 31, 2012 and 2011, consisted of the following: (1) cash and cash equivalents of $301,202 and $273,051 million, respectively; (2) investments of $20.0 million (79.3%) and $20.0 million (78.8%), respectively; (3) amounts receivable from New York State of $15.4 million (37.9%) and $15.4 million (37.8%), respectively; (4) prepaid items of $34,455 and $34,489; and (5) deferred inflow on forward purchase agreement swap of $4.9 million (19.4%) and $5.0 million (19.9%), respectively.

Total liabilities at December 31, 2012, were $320.5 million, compared to $316.9 million at December 31, 2011. The liabilities at December 31, 2012 and 2011 consisted of the following: (1) long-term liabilities of $314.5 million (98.1%) and $310.6 million (98.0%), respectively; (2) remittances payable to the County of $0 and $37,253, respectively; (3) accounts payable of $106 and $5,000, respectively; (4) $1.144 million and $1.155 million, respectively, in accrued interest payable; and (5) a derivative instrument valued at $4.9 million and $5.0 million, respectively.

Governmental Activities. During the current year, net position for governmental activities decreased $3,813,537 from the prior fiscal year for an ending balance of $(279,944,763). The statement of revenues, expenses and changes in net position presents revenues received and expenses paid by ETASC. Presented as Table 2 on the following page, is the condensed statement of revenues, expenses and changes in net position for the years ended December 31, 2012 and 2011, as restated.

Table 2─Condensed statements of revenues, expenses and changes in net position

	Year Ended December 31,	
	2012	2011
General revenues	$ 15,491,815	$ 15,219,217
Expenses—governmental activities	(19,305,352)	(21,806,786)
Change in net position	(3,813,537)	(6,587,569)
Net position—beginning	(276,131,226)	(281,228,915)
Restatement	-	11,685,258
Net position—beginning, restated	(276,131,226)	(269,543,657)
Net position—ending	$ (279,944,763)	$ (276,131,226)

Total revenues for the years ended December 31, 2012 and 2011 were $15.5 million and $15.2 million, respectively. The net increase in revenues of $0.3 million is primarily due to the increase in tobacco settlement revenues in 2012. Revenues for the years ended December 31, 2012 and 2011 consisted of $15.4 million (99.1%) and $15.1 million (99.2%), respectively, of tobacco settlement revenues, $131,725 and $115,569, respectively, of realized gains, and $886 and $5,619, respectively, of interest and other income.

A summary of sources of revenues for the years ended December 31, 2012 and December 31, 2011 is presented below in Table 3.

Table 3─Sources of revenues

	Year Ended December 31,		Dollar	Percentage
	2012	2011	Change	Change
Tobacco settlement revenues	$ 15,359,204	$ 15,098,029	$ 261,175	1.7 %
Interest and net earnings from investments	132,611	121,188	11,423	9.4 %
Total revenues	$ 15,491,815	$ 15,219,217	$ 272,598	1.8 %

Total expenses for the years ended December 31, 2012 and 2011 were $19.3 million and $21.7 million, respectively. The decrease in expenses of $2.4 million is primarily due to the decrease in CAB interest accretion in 2012. Expenses for the years ended December 31, 2012 and 2011 primarily consisted of $19.2 million (99.3%) and $21.5 million (99.3%), respectively, of bond interest expense, and $130,623 and $154,344 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, 2012 and December 31, 2011 is presented on the following page in Table 4.

Table 4─Operating expenses

	December 31, 2012	December 31, 2011	Dollar Change	Percentage Change
General government	$ 130,623	$ 154,344	$ (23,721)	(15.4)%
Interest and fiscal charges	19,174,729	21,652,442	(2,477,713)	(11.4)%
Total operating expenses	$ 19,305,352	$ 21,806,786	$ (2,501,434)	(11.5)%

Financial Analysis of Governmental Funds

As noted earlier, ETASC uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental Funds. The focus of ETASC's governmental funds is to provide information on near-term infows, outflows, and balances of spendable resources. Such information is useful in assessing ETASC's financing requirements. In particular, unassigned fund balance may serve as a useful measure of a government's net resources available for discretionary use as they represent the portion of fund balance which has not yet been limited to use for a particular purpose by either an external party, ETASC itself, or a group or individual that has been delegated authority to assign resources for use for particular purposes by ETASC's Board.

At December 31, 2012, ETASC's governmental funds reported combined fund balances of $20,326,107, an increase of $99,950 in comparison with the prior year. Approximately 1.48% of this amount ($301,096) constitutes unassigned fund balance, which is available for spending at ETASC's discretion. The remainder of the fund balance is either nonspendable or restricted to indicate that it is not in spendable form ($34,455), or restricted for a particular purpose ($19,990,556).

The general fund is the chief operating fund of ETASC. At the end of the current fiscal year, total fund balance of the general fund was unassigned fund balance in the amount of $301,096. As a measure of the general fund's liquidity, it may be useful to compare both unassigned fund balance and total fund balance to total general fund expenditures. Unassigned fund balance represents approximately 231.8% of total general fund expenditures.

The debt service fund, the remaining major governmental fund, had an increase in fund balance during the current year of $71,844 to bring the year end fund balance to $19,990,556. The increase essentially results from operating revenues during the current year. First, tobacco settlement revenue in the amount of $15,397,233 was received. Second, total investment and interest earnings of $138,555 were collected. The total increase in fund balance from these two amounts is $15,535,788. These revenues were offset by expenditures and transfers out totaling $15,377,946.

Debt Administration/Economic Factors

Long-Term Debt. As of December 31, 2012, ETASC had $264,980,000 of tobacco settlement asset-backed bonds outstanding, which are reported in the statement of net position net of unamortized discount on the sale of bonds of $9,706,050 and loss on defeasance of $18,229,933. Additionally, as of December 31, 2012, ETASC had accreted subordinate capital appreciation bonds ("CABs") of $81,067,438, which are reported in the statement of net position net of unamortized discount on the sale of bonds of $1,522,932 and loss on defeasance of $2,095,403. At December 31, 2012, ETASC's net tobacco settlement asset-backed bonds outstanding and net subordinate CABs were $237,044,017 and $77,449,103, respectively. While 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.

Principal payments of $2.2 million and $1.8 million were made during 2012 and 2011, respectively. Additional information on ETASC's long-term debt can be found in Note 6 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.

BASIC FINANCIAL STATEMENTS

** THIS PAGE INTENTIONALLY LEFT BLANK **

ERIE TOBACCO ASSET SECURITIZATION CORPORATION
(A Component Unit of the County of Erie, New York)
Statement of Net Position
December 31, 2012

	Governmental Activities
ASSETS	
Current assets:	
Cash and cash equivalents	$ 301,202
Investments	19,990,556
Due from New York State	15,359,204
Interest receivable	7,046
Prepaids	34,455
Total assets	35,692,463
DEFERRED OUTFLOWS OF RESOURCES	
Deferred outflow on forward purchase agreement swap	4,879,716
Total deferred outflows of resources	4,879,716
LIABILITIES	
Current liabilities:	
Accounts payable	106
Accrued interest payable	1,144,000
Noncurrent liabilities:	
Due in more than one year—bonds, net	237,044,017
Derivative instruments	4,879,716
Subordinate Turbo CABs payable, net	77,449,103
Total liabilities	320,516,942
NET POSITION	
Restricted for debt service	19,990,556
Unrestricted	(299,935,319)
Total net position	$ (279,944,763)

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, 2012

Functions/Programs	Expenses	Program Revenues	Net (Expenses) and Changes in Net Position
Governmental activities:			
General government support	$ 130,623	-	$ 130,623
Interest and fiscal charges	19,174,729	-	19,174,729
Total governmental activities	19,305,352	-	19,305,352
General revenues:			
Tobacco settlement revenue			15,359,204
Interest earnings			886
Net earnings on investments			131,725
Total general revenues			15,491,815
Change in net position			(3,813,537)
Net position—beginning, previously stated			(287,816,484)
Restatement, see note 2			11,685,258
Net position—beginning, as restated			(276,131,226)
Net position—ending			$ (279,944,763)

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, 2012

	Governmental Fund Types		
	General	**Debt Service**	**Total**
ASSETS			
Cash and cash equivalents	$ 301,202	$ -	$ 301,202
Investments	-	19,990,556	19,990,556
Interest receivable	-	7,046	7,046
Prepaids	34,455	-	34,455
Total assets	$ 335,657	$ 19,997,602	$ 20,333,259
LIABILITIES AND FUND BALANCES			
Liabilities:			
Accounts payable	$ 106	$ -	$ 106
Deferred revenue	-	7,046	7,046
Total liabilities	106	7,046	7,152
Fund balances:			
Nonspendable	$ 34,455	$ -	$ 34,455
Restricted for debt service	-	19,990,556	19,990,556
Unassigned	301,096	-	301,096
Total fund balances	335,551	19,990,556	20,326,107
Total liabilities and fund balances	$ 335,657	$ 19,997,602	$ 20,333,259

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 Position
December 31, 2012

Amounts reported for governmental activities in the statement of net position are different because:	
Total fund balance—governmental funds	$ 20,326,107
Other long-term assets are not available to pay for current period expenditures and, therefore, are reported as unavailable revenue in the funds.	15,366,250
Long-term liabilities, including bonds payable, are not due and payable in the current period and, therefore, are not reported in the funds.	(315,637,120)
Net position of governmental activities	$ (279,944,763)

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, 2012

	Governmental Fund Types		
	General	Debt Service	Total
REVENUES			
Tobacco settlement revenue	$ -	$15,397,233	$ 15,397,233
Interest earnings	146	740	886
Realized gains	-	137,815	137,815
Total revenues	146	15,535,788	15,535,934
EXPENDITURES			
Current:			
General government	129,882	741	130,623
Debt service:			
Principal	-	2,195,000	2,195,000
Interest	-	13,110,361	13,110,361
Total expenditures	129,882	15,306,102	15,435,984
Excess (deficiency) of revenues over (under) expenditures	(129,736)	229,686	99,950
OTHER FINANCING SOURCES (USES)			
Transfers in	157,842	-	157,842
Transfers out	-	(157,842)	(157,842)
Total other financing sources (uses)	157,842	(157,842)	-
Net change in fund balances	28,106	71,844	99,950
Fund balances – beginning	307,445	19,918,712	20,226,157
Fund balances – ending	$ 335,551	$19,990,556	$ 20,326,107

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, 2012

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

Net change in fund balances—total governmental funds	$ 99,950
Revenues in the statement of activities that do not provide current financial resources are not reported as revenues in the funds.	(44,119)
The issuance of long-term debt (e.g., bonds) provides current financial resources to governmental funds, while the repayment of the principal of long-term debt consumes the current financial resources of governmental funds. Neither transaction, however, has any effect on net position. Also, governmental funds report the effect of premiums, discounts, and similar items when debt is first issued, whereas these amounts are deferred and amortized in the statement of activities. This amount is the net effect of these differences in the treatment of long-term debt and related items.	(3,869,368)
Change in net position of governmental activities	$ (3,813,537)

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

** THIS PAGE INTENTIONALLY LEFT BLANK **

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements of the Erie Tobacco Asset Securitization Corporation ("ETASC") have been prepared in conformity with accounting principles generally accepted in the United States of America applied to government units. The Governmental Accounting Standards Board ("GASB") is the accepted standard setting body for establishing governmental accounting and financial reporting principles. The more significant of ETASC's accounting policies are described below.

Financial Reporting Entity

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, 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 the County Executive, one director shall be 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 by-laws 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 6 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 2011 is 299,340,305,323. According to the MSA Report, the amount shown as relevant shipments for the year 2011 was less than the shipment amount specified above, and therefore, a Consumption Decline Trapping Event has occurred.

Description of Government-Wide Financial Statements

The government-wide financial statements (i.e., statement of net position and the statement of changes in net position) report information on all the nonfiduciary activities of ETASC. All fiduciary activities are reported only in the fund financial statements. *Governmental activities*, which normally are supported by taxes, intergovernmental revenues, and other nonexchange transactions are reported separately from *business-type activities*, which rely to a significant extent on fees and charges for support. ETASC reports no business-type activities.

Basis of Presentation – Government-Wide Financial Elements

While separate government-wide and fund financial statements are presented, they are interrelated. The governmental activities column incorporates data from governmental funds. Separate financial statements are provided for governmental funds.

As a general rule, the effect of interfund activity has been eliminated from the government-wide financial statements.

Basis of Presentation – Fund Financial Statements

The fund financial statements provide information about ETASC's funds, and separate statements for governmental funds are presented. The emphasis of fund financial statements is on major governmental funds, each displayed in a separate column in the fund financial statements.

ETASC reports the following major governmental funds:

> The *general fund* is ETASC's primary operating fund. It accounts for all financial resources associated with ETASC except for those accounted for in another fund.
>
> The *debt service fund* is used to account for the accumulation of resources that are restricted for the payment principal and interest on long-term obligations of governmental funds.

During the course of operations the government has activity between funds for various purposes. Any residual balances outstanding at year end are reported as due from/to other funds and advances to/from other funds. While these balances are reported in fund financial statements, certain eliminations are made in the preparation of the government-wide financial statements. Balances between the funds included in governmental activities are eliminated so that only the net amount is included as internal balances in the governmental activities column.

Further, certain activity occurs during the year involving transfers of resources between funds. In fund financial statements these amounts are reported at gross amounts as transfers in/out. While reported in fund financial statements, certain eliminations are made in the preparation of the government-wide financial statements. Transfers between the funds included in governmental activities are eliminated so that only the net amount is included as transfers in the governmental activities column.

Measurement Focus and Basis of Accounting

The accounting and financial reporting treatment is determined by the applicable measurement focus and basis of accounting. Measurement focus indicates the type of resources being measured such as *current financial resources* or *economic resources.* The basis of accounting indicates the timing of transactions or events for recognition in the financial statements.

The government-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.

Tobacco settlement revenues are exchange transactions, based on the notion that the payments are made to the settling states in exchange for their agreement to release the tobacco companies from present and future litigation. Under the terms of the MSA, the tobacco companies have agreed to make annual payments in perpetuity. The MSA includes a schedule of projected annual base payments, subject to certain adjustments based on future events or circumstances. The most significant factor affecting the annual payments is a *volume adjustment,* which creates a direct relationship between domestic shipments of cigarettes and the annual payments. Based on the MSA, the tobacco companies have no obligation to make settlement payments until cigarettes are shipped.

The event that results in the recognition of an asset and revenue by a settling government is the domestic shipment of cigarettes (sales). Therefore, the County recognizes a receivable and revenue for tobacco settlement revenues when that event occurs. Because annual tobacco settlement revenue payments are based on cigarette sales from the preceding calendar year, the County estimates accrued tobacco settlement revenues that derive from sales from January 1 to their respective fiscal year ends. Under the modified accrual basis of accounting, revenue should be recognized to the extent that the event occurs and resources become *available*.

The governmental fund 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, ETASC considers revenues to be available if they are collected within 60 days of the end of the current fiscal period. Expenditures generally are recorded when a liability is incurred, as under accrual accounting. However, debt service expenditures are recorded only when the payment is due. Issuance of long-term debt and acquisitions under capital leases are reported as other financing sources.

Interest associated with the current fiscal period is considered to be susceptible to accrual and so have been recognized as revenues of the current fiscal period. Entitlements are recorded as revenues when all eligibility requirements are met, including any time requirements, and the amount is received during the period or within the availability period for this revenue source (within 60 days of year end). Expenditure-driven grants are recognized as revenue when the qualifying expenditures have been incurred and all other eligibility requirements have been met, and the amount is received during the period or within the availability period for this revenue source (within 60 days of year end). All other revenue items are considered to be measurable and available only when cash is received by the government.

Assets, Liabilities, Deferred Outflows/Inflows of Resources, and Net Position/Fund Balance

Cash and cash equivalents—Cash and cash equivalents are considered to be cash on hand, demand deposits, and short-term investments with original maturities of three months or less from the date acquired by ETASC.

Investments—Investments for ETASC are reported at fair value (generally based on quoted market prices).

Receivables—Receivables for ETASC include amounts due from New York State and represent the accrual of tobacco settlement revenue to be received in the subsequent year.

Deferred outflows/inflows of resources—In addition to assets, the statement of financial position will sometimes report a separate section for deferred outflows of resources. This separate financial statement element, *deferred outflows of resources,* represents a consumption of net position that applies to a future period(s) and so will *not* be recognized as an outflow of resources (expense/expenditure) until then.

In addition to liabilities, the statement of financial position will sometimes report a separate section for deferred inflows of resources. This separate financial statement element, *deferred inflows of resources,* represents an acquisition of net position that applies to a future period(s) and so will *not* be recognized as an inflow of resources (revenue) until that time.

At December 31, 2012, ETASC reported a deferred outflow of resources in the amount of $4,879,716 relating to the accumulated increase in fair value of its forward purchase agreement.

Net position flow assumption—Sometimes ETASC will fund outlays for a particular purpose from both restricted (e.g., restricted bond proceeds) and unrestricted resources. In order to calculate the amounts to report as restricted – net position and unrestricted – net position in the government-wide financial statements, a flow assumption must be made about the order in which the resources are considered to be applied. It is ETASC's policy to consider restricted – net position to have been depleted before unrestricted – net position is applied.

Fund balance flow assumption—Sometimes ETASC will fund outlays for a particular purpose from both restricted and unrestricted resources (the total of committed, assigned, and unassigned fund balance). In order to calculate the amounts to report as restricted, committed, assigned, and unassigned fund balance in the governmental fund financial statements, a flow assumption must be made about the order in which the resources are considered to be applied. If ETASC must use funds for emergency expenditures it shall expend funds first from funds classified under GASB 54 as nonspendable (if funds become available) then restricted funds. The use of committed and assigned funds as classified by GASB 54 will occur after the exhaustion of available restricted funds. Finally, if no other fund balances are available ETASC will use unassigned fund balance.

***Fund balance policies*—**Fund balance of governmental funds is reported in various categories based on the nature of any limitations requiring the use of resources for specific purposes. ETASC itself can establish limitations on the use of resources through either a commitment (committed fund balance) or an assignment (assigned fund balance).

The committed fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of ETASC's highest level of decision-making authority (ETASC Board). The governing board is the highest level of decision-making authority for the government that can, by adoption of an ordinance prior to the end of the fiscal year, commit fund balance. Once adopted, the limitation imposed by the ordinance remains in place until a similar action is taken (the adoption of another ordinance) to remove or revise the limitation.

Amounts in the assigned fund balance classification are intended to be used by the government for specific purposes but do not meet the criteria to be classified as committed. The governing board (ETASC Board) has by resolution authorized the sole Member to assign fund balance. The Board may also assign fund balance as it does when appropriating fund balance to cover a gap between estimated revenue and appropriations in the subsequent year's appropriated budget. Unlike commitments, assignments generally only exist temporarily. In other words, an additional action does not normally have to be taken for the removal of an assignment. Conversely, as discussed above, an additional action is essential to either remove or revise a commitment.

Revenues and Expenditures/Expenses

Program and General Revenues—Amounts reported as *program revenues* include 1) charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges provided by a given function or segment and 2) grants and contributions (including special assessments) that are restricted to meeting the operational or capital requirements of a particular function or segment. There are no program revenues in the current year. Items not properly included among program revenues are reported instead as *general revenues*.

Expenditures/Expenses—Expenditures are recorded on a 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. *Direct expenses* are those that are clearly identifiable with a specific function. Indirect expenses have been included as part of the program expenses reported for the various functional activities.

Reconciliation of Government-Wide and Fund Financial Statements

Explanation of Certain Differences between the Governmental Fund Balance Sheet and the Government-Wide Statement of Net Position—The governmental fund balance sheet includes a reconciliation between *fund balance – total governmental funds* and *net position – governmental activities* as reported in the government-wide statement of net position. One element of that reconciliation explains that "long-term liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds." The details of this $315,637,120 difference are as follows:

Tobacco Settlement bonds payable	$ 264,980,000
Subordinate turbo CABs payable	81,067,438
Less: Issuance discount	(11,228,982)
Less: Accrued loss on defeasance	(20,325,336)
Accrued interest payable	1,144,000
Net adjustment to reduce *fund balance - total governmental funds* to arrive at *net position - governmental activities*	$ 315,637,120

Explanation of Certain Differences between the Governmental Fund Statement of Revenues, Expenditures, and Changes in Fund Balances and the Government-Wide Statement of Activities—The governmental fund statement of revenues, expenditures, and changes in fund balances includes a reconciliation between *net changes in fund balances – total governmental funds* and *changes in net position of governmental activities* as reported in the government-wide statement of activities. The one element of that reconciliation states that "the issuance of long-term debt (e.g., bonds, leases) provides current financial resources to governmental funds, while the repayment of the principal of long-term debt consumes the current financial resources of governmental funds. Neither transaction, however, has any effect on net position. Also, governmental funds report the effect of premiums, discounts, and similar items when debt is first issued, whereas these amounts are deferred and amortized in the statements of activities. This amount is the net effect of these differences in the treatment of long-term debt and related items." The details of this $3,869,368 difference are presented on the following page.

Debt issued or incurred:	
Accreted interest on subordinate turbo CABs	$ 5,237,645
Amortization of bond discount	74,523
Amortization of loss on defeasance	763,200
Change in accrued interest payable	(11,000)
Principal repayments on tobacco settlement bonds	(2,195,000)
Net adjustment to decrease *changes in fund balances - total governmental funds* to arrive at *changes in net position of governmental activities*	$ 3,869,368

Stewardship, Compliance and Accountability

Adoption of New Accounting Pronouncements—During the year ended December 31, 2012, ETASC adopted the provisions of Governmental Accounting Standards Board ("GASB") Statements No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position,* and No. 65, *Items Previously Reported as Assets and Liabilities.* These statements require reporting of deferred outflows and inflows of resources separately from assets and liabilities and replace the term net assets with net position. In addition, certain items previously reported as assets and liabilities, such as bond issuance costs, are now recognized as outflows and inflows of resources. GASB No. 63 did not have a material impact on ETASC's financial position or results from operations. As a result of the implementation of GASB Statement No. 65, net position of governmental activities at December 31, 2011 has been restated for unamortized bond issuance costs of $3,711,975 associated with the issuance of the Subordinate Turbo CABs.

ETASC also implemented 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*; and No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions – an amendment of GASB Statement No. 53,* 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. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34*; No. 66, *Technical Corrections-2012-an amendment of GASB Statements No. 10 and No. 62,* effective for the year ending December 31, 2013; No. 67, *Financial Reporting for Pension Plans - an amendment of GASB Statement No. 25* and No. 69, *Government Combinations and Disposals of Government Operations,* effective for the year ending December 31, 2014; and No. 68, *Accounting and Financial Reporting for Pensions - an amendment of GASB Statement No. 27,* effective for the year ending December 31, 2015. ETASC is therefore unable to disclose the impact that adopting GASB Statements No. 61, 66, 67, 68 and 69 will have on its financial position and results of operations when such statements are adopted.

2. RESTATEMENTS AND CHANGES TO NET POSITION

Tobacco settlement payments to be received by the County during the year ending December 31, 2013 are based on tobacco sales made during the year ended December 31, 2012. While they are not considered receivable under the modified basis of accounting as discussed in Note 1, they are considered receivable within the governmental activities during the current year. Previously, ETASC recognized tobacco settlement revenues within the governmental activities in the period in which the payment was received. Net position at December 31, 2011 has been restated to report $15,397,233 of tobacco settlement revenues as receivable within the governmental activities.

As discussed in Note 1, during the year ended December 31, 2012, ETASC implemented GASB Statement No. 65. As a result of this implementation, existing ETASC bond issuance costs are expensed. Net position at December 31, 2011 has been restated to remove unamortized bond issuance costs of $3,711,975.

The effect of these restatements is as follows:

	Net Position
Net position, December 31, 2011 - as previously reported	$ (287,816,484)
Change in recognition of TSR Revenues	15,397,233
Recognition of unamortized bond issuance costs	(3,711,975)
Net position, December 31, 2011 - as restated	$ (276,131,226)

3. CASH AND INVESTMENTS

At December 31, 2012, ETASC's cash and cash equivalents and investments consisted of the following:

Description	Fair Value
Cash and cash equivalents — cash on deposit	$ 301,202
Investments:	
Institutional liquidity funds	5,019
Corporate commercial paper	19,985,537
	19,990,556
Total cash and cash equivalents and investments	$ 20,291,758

Deposits – All deposits including cash in bank and certain investments (i.e. certificates of deposit) are carried at fair value.

	Carrying Amount	Bank Balance
Insured (FDIC)	$ 250,000	$ 250,000
Uninsured:		
Collateral held by bank's agent in ETASC's name	51,202	51,202
Total	$ 301,202	$ 301,202

Investments – At December 31, 2012, investments were carried at fair value and held by a third party in ETASC's name.

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, 2012, 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. RECEIVABLES

Due from New York State—Represents amounts owed to ETASC for tobacco settlement revenue earned in 2012. ETASC has accrued $15,359,204 within governmental activities only, as it is not recognized on the modified accrual basis of accounting.

5. 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, 2012 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, 2012, the notional amount of the agreement totals $19,218,750, the fair value is $4,879,716, and net cash flows during the year totaled $689,339.

6. 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, 2012, 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
69,470,000	6.000	Series 2005E Taxable Bonds due June 1, 2028, Semiannual interest only payments through maturity, may be redeemed at the option of the ETASC at anytime in whole or in part after June 1, 2015.	June 1, 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, 2012, are as follows:

Description	Beginning Balance 1/1/2012	Additions	Deletions	Ending Balance 12/31/2012
Tobacco Settlement Bonds:				
2005A	$ 216,495,000	$ -	$ -	$ 216,495,000
2005E	50,680,000	-	2,195,000	48,485,000
Total Tobacco Settlement Bonds	267,175,000	-	2,195,000	264,980,000
Less:				
Bond discount	(9,770,466)	-	(64,416)	(9,706,050)
Loss on defeasance	(18,914,452)	-	(684,519)	(18,229,933)
Net Tobacco Settlement Bonds	$ 238,490,082	$ -	$ 1,446,065	$ 237,044,017

The ETASC's debt service requirements for the Series 2005A and 2005E as of December 31, 2012, are as follows:

Years Ending December 31	Principal	Interest	Total Debt Service
2013	$ -	$ 13,733,850	$ 13,733,850
2014	-	13,733,850	13,733,850
2015	-	13,733,850	13,733,850
2016	-	13,733,850	13,733,850
2017	-	13,733,850	13,733,850
2018-2022	-	68,669,250	68,669,250
2023-2027	-	68,669,250	68,669,250
2028-2032	78,815,000	53,303,550	132,118,550
2033-2037	-	46,541,250	46,541,250
2038-2042	74,685,000	29,737,125	104,422,125
2043-2046	111,480,000	13,935,000	125,415,000
	$ 264,980,000	$ 349,524,675	$ 614,504,675

Subordinate CABs—Series 2005B, C, D and 2006A—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, 2012 follows:

	Beginning Balance 1/1/2012	Additions & Annual Net Interest Accretion	Deletions & Turbo Redemption Payments	Ending Balance 12/31/2012
Subordinate CABs	$ 75,829,793	$ 5,237,645	$ -	$ 81,067,438
Less:				
Bond discount	(1,533,039)	-	(10,107)	(1,522,932)
Loss on defeasance	(2,174,084)	-	(78,681)	(2,095,403)
Net Subordinate CABs	$ 72,122,670	$ 5,237,645	$ (88,788)	$ 77,449,103

7. NET POSITION AND FUND BALANCE

The government-wide financial statements utilize a net position presentation. Net position is categorized as restricted and unrestricted components.

- ***Restricted for Debt Service—***This category restricts a portion of net position for payment of the debt service obligations of ETASC. At December 31, 2012, the balance of this restriction was $19,990,556.

- ***Unrestricted Component of Net Position—***This component represents net position of ETASC not restricted for any other purpose.

In the fund financial statements, nonspendable amounts represent net current financial resources that cannot be spent because they are either not in spendable form or legally or contractually required to be maintained intact. Nonspendable fund balance maintained by ETASC at December 31, 2012 includes:

- ***Prepaid items—***Represents amounts prepaid to ratings and surveillance agencies, to the Trustee for administration fees, and to ETASC's insurance provider that are applicable to future accounting periods. The General Fund reported a nonspendable fund balance in the amount of $34,455.

In the fund financial statements, restricted fund balances are amounts constrained to specific purposes (such as grantors, bondholders, and higher levels of government) through constitutional provisions or by enabling legislation. At December 31, 2012, ETASC reported $19,990,556 of fund balance restricted for debt service that must be used toward the future repayment of bonded debt.

As of December 31, 2012, ETASC reported no nonspendable, committed, or assigned fund balances.

8. DEBT SERVICE RESERVES

Under the indenture, the trustee will hold a segregated Liquidity Reserve Account totaling $19,985,537 at December 31, 2012. The Liquidity Reserve Account will be terminated when no current interest bonds remain outstanding. Such amounts are not available to make Turbo Redemption Payments.

9. CONTINGENCIES

The ability of ETASC to meet debt service payments of bonds is contingent upon the receipt of TSRs. TSRs are principally dependent upon future levels of domestic consumption. A significant decline in the overall consumption of cigarettes could have a material adverse effect on the payments by the OPMs under the MSA and the amounts available to ETASC to make payments of principal and interest on their bonds.

Certain smokers, smokers' rights organizations, consumer groups, cigarette importers, cigarette distributors, cigarette manufacturers, Native American tribes, taxpayers, taxpayers' groups and other parties have filed actions against some, and in certain cases all, of the signatories to the MSA. In the event of an adverse court ruling in such types of litigation, Bondholders could incur a complete loss of their investment.

Additionally, the OPM's are also exposed to liability from various lawsuits including individual lawsuits, class action lawsuits and health care cost recovery litigation. Ultimately, the outcome of these and any other pending or future lawsuits is uncertain. One or more adverse judgment could result in delays in, or reductions of amounts available for, payments on the bonds.

10. SUBSEQUENT EVENTS

Management has evaluated subsequent events through March 29, 2013, 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.

******

** THIS PAGE INTENTIONALLY LEFT BLANK **

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
Erie Tobacco Asset Securitization Corporation:

We have audited, in accordance with the 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 financial statements of the governmental activities and each major fund of Erie Tobacco Asset Securitization Corporation ("ETASC") as of and for the year ended December 31, 2012, and the related notes to the financial statements, which collectively comprise ETASC's basic financial statements, and have issued our report thereon dated March 29, 2013 (which report contains an emphasis of matter paragraph relating to the statement of beginning net position) .

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered ETASC'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 opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of ETASC's internal control. Accordingly, we do not express an opinion on the effectiveness of the ETASC's internal control.

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 entity's financial statements will not be prevented, or detected and corrected on a timely basis. 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether ETASC's 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*.

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 result of that testing, and not to provide an opinion on the effectiveness of the entity'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 entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Drescher & Malecki LLP

March 29, 2013