SACRAMENTO COUNTY
TOBACCO SECURITIZATION CORPORATION
(A Component Unit of the
Tobacco Securitization Authority of Northern California)

Independent Auditors' Reports
and
Financial Statements

For the Year Ended June 30, 2018

SACRAMENTO COUNTY TOBACCO SECURITIZATION CORPORATION
FOR THE YEAR ENDED JUNE 30, 2018

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VAVRINEK, TRINE, DAY & CO., LLP
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

Board of Directors
Sacramento County Tobacco Securitization Corporation
Sacramento, California

Report on the Financial Statements

We have audited the accompanying financial statements of the Sacramento County Tobacco Securitization Corporation (Corporation), a component unit of the Tobacco Securitization Authority of Northern California, as of and for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the Corporation'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.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America 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 opinion.

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Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Corporation, as of June 30, 2018, and the changes in financial position, and cash flows thereof, for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Management has omitted management's discussion and analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing 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. Our opinion on the basic financial statements is not affected by this missing information.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated August 27, 2018, on our consideration of the Corporation'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 solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Corporation's 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 Corporation's internal control over financial reporting and compliance.

Vavrinek, Trine, Day & Co. LLP

Sacramento, California
August 27, 2018

SACRAMENTO COUNTY TOBACCO SECURITIZATION CORPORATION
STATEMENT OF NET POSITION
JUNE 30, 2018

ASSETS	
Current assets:	
Cash	$ 98,115
Tobacco settlement revenues receivable	7,507,812
Total assets	7,605,927
DEFERRED OUTFLOWS OF RESOURCES	
Tobacco settlement rights (net of accumulated Amortization of $39,592,618)	195,598,549
Total assets and deferred outflows of resources	$ 203,204,476
LIABILITIES	
Current liabilities:	
Accounts payable	$ 22,137
Noncurrent liabilities:	
Loan from Tobacco Securitization Authority of Northern California	195,598,549
Total liabilities	195,620,686
NET POSITION	
Unrestricted	7,583,790
Total liabilities and net position	$ 203,204,476

See accompanying notes to the basic financial statements.

SACRAMENTO COUNTY TOBACCO SECURITIZATION CORPORATION
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
FOR THE YEAR ENDED JUNE 30, 2018

OPERATING REVENUES	
Tobacco settlement revenues	$ 16,234,771
OPERATING EXPENSES	
Fiscal charges	73,256
Operating income	16,161,515
NONOPERATING REVENUES (EXPENSES)	
Interest expense on loan from Tobacco Securitization Authority of Northern California	(14,841,958)
Contribution to Tobacco Securitization Authority of Northern California	(173,666)
Contribution from Tobacco Securitization Authority of Northern California – operating subsidy	75,000
Nonoperating income (loss)	(14,940,624)
Change in net position	1,220,891
Net position, beginning of year	6,362,899
Net position, end of year	$ 7,583,790

See accompanying notes to the basic financial statements.

SACRAMENTO COUNTY TOBACCO SECURITIZATION CORPORATION
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2018

Cash flows from operating activities:	
Tobacco settlement revenues received	$ 18,069,140
Fiscal charges paid to vendors	(53,729)
Net cash provided by operating activities	18,015,411
Cash flows from noncapital financing activities:	
Payment of interest on loan from Tobacco Securitization Authority of Northern California	(14,841,958)
Payment of principal on loan from Tobacco Securitization Authority of Northern California	(3,053,516)
Operating Contribution to Tobacco Securitization Authority of Northern California	(173,666)
Operating Subsidy from Tobacco Securitization Authority of Northern California	75,000
Net cash used for noncapital financial activities	(17,994,140)
Net decrease in cash	21,271
Cash, beginning of the year	76,844
Cash, end of year	$ 98,115

Reconciliation of operating income to net cash provided by operating activities:	
Operating income	$ 16,161,515
Adjustments to reconcile operating income net cash provided by operating activities	
Change in:	
Tobacco settlement revenues receivable	(1,219,147)
Tobacco settlement rights	3,053,516
Accounts payable	19,527
Net cash provided by operating activities	$ 18,015,411

See accompanying notes to the basic financial statements.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

Sacramento County Tobacco Securitization Corporation (the Corporation) was incorporated August 21, 2001. It is a nonprofit public benefit organization as defined by *Internal Revenue Code* Section 501(c)(3).

The purpose of the Corporation is to purchase from the County of Sacramento (the County) its rights to receive tobacco settlement revenues, borrow monies necessary to pay the purchase price for such tobacco settlement revenues and secure such borrowing with the tobacco settlement revenues, receive tobacco settlement revenues and residual payments regarding tobacco settlement revenues of the County, and invest monies, incur expenses and otherwise distribute money for the benefit of the County and its residents.

The Corporation meets the criteria set forth in accounting principles generally accepted in the United States of America for inclusion as a blended component unit of the Tobacco Securitization Authority of Northern California (the Authority) because of the financial benefit/burden relationship of their activities. The Corporation obtained its funding to purchase from the County its rights to receive tobacco settlement revenues via a loan from the Authority.

Basis of Presentation and Accounting

The Corporation prepares its financial statements on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. Under this method, revenues are recorded when earned and expenses are recorded when liabilities are incurred.

Operating revenues and expenses are distinguished from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the principal ongoing operations. The principal operating revenues of the Corporation are tobacco settlement revenues. Operating expenses consist of fiscal charges. Transfers from the Authority are reported as transfers and interest payments on the loan from the Authority are reported as a nonoperating expenses. Because annual tobacco settlement revenues are based on cigarette sales from the preceding calendar year, the Corporation accrues an estimate of tobacco settlement revenues derived from sales from January 1 to the fiscal year-end.

Cash and Cash Equivalents

The Corporation considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

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. The Corporation only has one item that qualifies for reporting in this category. It is the Tobacco Settlement Rights reported in the Statement of Net Position.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amount reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Income Taxes

The Corporation is a tax-exempt corporation under section 501(c)(3) of the *Internal Revenue Code*.

Fair Value Measurement

The Corporation categorizes the fair value measurements of its investments based on the hierarchy established by generally accepted accounting principles. The fair value hierarchy, which has three levels, is based on the valuation inputs used to measure an asset's fair value: Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

NOTE 2 – CASH AND INVESTMENTS

The Corporation maintains a separate checking account in the name of the Corporation. At June 30, 2018, the reported amount of the Corporation's deposits was $98,115 and the bank balance was $98,115. Of the bank balance, $98,115 was covered by federal depository insurance.

NOTE 3 – TOBACCO SETTLEMENT RIGHTS

In November 1998, 46 states (including California), six other United States jurisdictions, and participating cigarette manufactures entered into a Master Settlement Agreement (the MSA) in settlement of certain cigarette smoking litigation. The MSA calls for the cigarette manufacturers to make annual payments to the settling states, beginning in 2000, and continuing in perpetuity. The State of California entered into a separate Memorandum of Understanding (the MOU) with all California counties and certain affected cities regarding the distribution and use of the State's share of Tobacco Settlement Revenues (TSRs). The MOU calls for 45% of the State's allocation to be distributed to the counties and certain affected cities based on population.

During the year ended June 30, 2002, the County entered into a purchase and sales agreement with the Corporation, a separate legal entity, whereby the County sold its rights, title, and interest in, to, and under the MSA and the MOU to the Corporation in exchange for cash consideration of $171,965,922. At the same time, the Corporation also entered into a loan agreement with the Authority to borrow the funds necessary to purchase those rights from the County. In return, the Corporation is obligated to pay all TSRs it receives to the Authority.

During the year ended June 30, 2006, the Corporation was able to borrow an additional $63,225,245 from the Authority as a result of the issuance of the 2005 Tobacco Securitization Refunding Bonds. These funds were granted by the Corporation to the County in accordance with a grant agreement dated November 15, 2005. The outstanding loan balance was $195,598,549 at June 30, 2018.

The obligation to the Authority is limited to the Corporation's interest in the Tobacco Settlement Rights. The unamortized Tobacco Settlement Rights, reported as deferred outflows of resources was $195,598,549 at June 30, 2018.

NOTE 4 – LOAN FROM TOBACCO AUTHORITY

The following summarizes the long-term debt activity during the year:

	Balance July 1, 2017	Additions	Retirements	Balance June 30, 2018
Loan from Tobacco Authority	$ 198,652,065		$ (3,053,516)	$ 195,598,549

NOTE 5 – CONTINGENCIES AND CONCENTRATION OF RISK

The Corporation purchased the County's rights to receive TSRs from the State of California (State). There are a number of risks associated with receipts of such TSRs, including litigation affecting the participating manufacturers and possible bankruptcy as a result thereof, increased growth of non-participating manufacturer's market share, a decline in cigarette consumption materially beyond forecasted levels, reduction in investment earnings due to unforeseen market conditions, and future adjustments to the calculation of the TSRs.

The Corporation's financial existence is contingent upon receiving the TSRs from the State. The risk of non-collection of the TSRs is considered remote; however, no assurance can be given as to the timing of the collections of TSRs. No assurance can be given that actual cigarette consumption in the United States during the term of the Series 2005 Bonds will be as assumed, or that the other assumptions underlying the bond structuring assumptions, including that certain adjustments and offsets will not apply to payments due under the MSA, will be consistent with future events. If actual events deviate from one or more of the assumptions underlying the bond structuring assumptions, the amount of TSRs available to make Turbo Redemption Payments will be affected and the resulting weighted average lives of the Turbo Term Bonds will vary. Any reinvestment risks from faster amortization or extension risks from slower amortization of the Series 2005 Term Bonds than anticipated will be borne entirely by the Holders of the Turbo Term Bonds. In addition, future increases in the rate of inflation above 3% per annum in the absence of other factors would materially shorten the life of the Series 2005 Bonds. No assurance can be given that these structuring assumptions, upon which the projections of the Series 2005 Bonds Turbo Redemptions are based, will be realized.

NOTE 6 – RISK MANAGEMENT

The Corporation is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions, for which the Corporation purchases commercial insurance.

During the year ended June 30, 2018, the Corporation did not reduce insurance coverage from coverage levels in place as of June 30, 2017. No settlements have exceeded coverage levels in place during 2015, 2016, 2017 and 2018.

NOTE 7 – FUTURE ACCOUNTING PRONOUNCEMENTS

The Governmental Accounting Standards Board (GASB) releases new accounting and financial reporting standards which may have a significant impact on the Corporation's financial reporting process. Future new standards which may impact the Corporation include the following:

GASB Statement No. 83 – In November 2016, GASB issued Statement No. 83, *Certain Asset Retirement Obligations*. This Statement addresses accounting and financial reporting for certain asset retirement obligations (AROs). An ARO is a legally enforceable liability associated with the retirement of a tangible capital asset. A government that has legal obligations to perform future asset retirement activities related to its tangible capital assets should recognize a liability based on the guidance in this Statement. This Statement also requires disclosure of information about the nature of a government's AROs, the methods and assumptions used for the estimates of the liabilities, and the estimated remaining useful life of the associated tangible capital assets. The requirements of this Statement are effective for reporting periods beginning after June 15, 2018, or the 2018-2019 fiscal year. Earlier application is encouraged. The Corporation has not determined the effect of the statement.

GASB Statement No. 84 - In January 2017, GASB issued Statement No. 84, *Fiduciary Activities*. The objective of this Statement is to improve guidance regarding the identification of fiduciary activities for accounting and financial reporting purposes and how those activities should be reported. The requirements of this Statement are effective for reporting periods beginning after December 15, 2018, or the 2019-2020 fiscal year. The Corporation has not determined the effect of the statement.

GASB Statement No. 87 – In June 2017, GASB issued Statement No. 87, *Leases.* The objective of this Statement is to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments. This Statement increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under this Statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources, thereby enhancing the relevance and consistency of information about governments' leasing activities. The Statement is effective for the reporting periods beginning after December 15, 2019, or 2020-2021 fiscal year. The Corporation has not determined the effect of the statement.

GASB Statement No. 88 – In April 2018, GASB issued Statement No. 88, *Certain Disclosures Related to Debt, Including Direct Borrowings and Direct Placements*. The primary objective of this Statement is to improve the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements. It also clarifies which liabilities governments should include when disclosing information related to debt. This Statement is effective for reporting periods beginning after June 15, 2018, or 2018-2019 fiscal year. The Corporation has not determined the effect of the statement.

GASB Statement No. 89 – In June 2018, GASB issued Statement No. 89, *Accounting for Interest Cost Incurred before the End of a Construction Period*. The objectives of this Statement are to enhance the relevance and comparability of information about capital assets and the cost of borrowing for a reporting period and to simply accounting for interest cost incurred before the end of a construction period. This Statement is effective for reporting periods beginning after December 15, 2019, or 2020-2021 fiscal year. The Corporation has not determined the effect of the statement.

OTHER REPORT

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

To the Board of Directors
Sacramento County Tobacco Securitization Corporation
Sacramento, California

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 Sacramento County Tobacco Securitization Corporation (Corporation), a component unit of the Tobacco Securitization Authority of Northern California, as of and for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the Corporation's basic financial statements, and have issued our report thereon dated August 27, 2018.

Internal Control over Financial Reporting

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

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Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Corporation'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 results 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.

Vavrinek, Trine, Day & Co. LLP

Sacramento, California
August 27, 2018

VAVRINEK, TRINE, DAY & CO., LLP
Certified Public Accountants

To the Board of Directors
Sacramento County Tobacco Securitization Corporation
Sacramento, California

We have audited the financial statements of Sacramento County Tobacco Securitization Corporation (Corporation), a component unit of the Tobacco Securitization Authority of Northern California (Authority), for the year ended June 30, 2018. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards and *Government Auditing Standards*, as well as certain information related to the planned scope and timing of our audit. We have communicated such information in our letter to you dated July 25, 2018. Professional standards also require that we communicate to you the following information related to our audit.

Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the Corporation are described in Note 1 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during fiscal year 2018. We noted no transactions entered into by the Corporation during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimate affecting the Corporation's financial statements was:

> Management's estimate used in determining the amount of Tobacco Settlement Revenue (TSR) proceeds expected to be collected after the balance sheet date but which pertain to the year ended June 30, 2018. We evaluated the key factors and assumptions used to develop this estimate and they appeared reasonable in relation to the financial statements taken as a whole.

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were:

> As described in Note 3 to the financial statements, during the years ended June 30, 2002 and June 30, 2006, the County of Sacramento (County) entered into a purchase and sales agreements with the Sacramento County Tobacco Securitization Corporation (Corporation), whereby the County sold its rights, title, and interest in, to and under the Master Settlement Agreement (MSA) and the State Memorandum of Understanding (MOU) with all California counties and certain affected cities, to the Corporation in exchange for total cash consideration of $235,191,167. At the same time, the Corporation also entered into a loan agreement with the Authority to borrow the funds necessary to purchase those rights from the County. In return, the Corporation is obligated to pay all TSRs it receives to the Authority. The obligation to the Authority is limited to the Corporation's interest in the tobacco settlement rights. The unamortized TSR was $195,598,549 at June 30, 2018.

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As described in Note 5 to the financial statements, the Corporation's financial existence is contingent upon receiving the TSRs from the State. The risk of non-collection of the TSRs is considered remote; however, no assurance can be given as to the timing of the collections of TSRs. No assurance can be given that actual cigarette consumption in the United States during the term of the Series 2005 Bonds will be as assumed, or that the other assumptions underlying the bond structuring assumptions, including that certain adjustments and offsets will not apply to payments due under the MSA, will be consistent with future events. If actual events deviate from one or more of the assumptions underlying the bond structuring assumptions, the amount of TSRs available to make turbo redemption payments will be affected and the resulting weighted average lives of the turbo term bonds will vary. As a result, no assurance can be given that these structuring assumptions, upon which the projections of the Series 2005 Bonds Turbo Redemptions are based, will be realized. The financial statement disclosures are neutral, consistent, and clear.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Disagreements with Management

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated August 27, 2018.

Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Corporation's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the Corporation's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

Restriction on Use

This information is intended solely for the use of the Board of Directors and management of the Sacramento County Tobacco Securitization Corporation and is not intended to be, and should not be, used by anyone other than these specified parties.

Vavrinek, Trine, Day & Co. LLP

Sacramento, California
August 27, 2018