# Educational Enhancement Funding Corporation

**2013**
**ANNUAL**
**REPORT**

**EDUCATIONAL ENHANCEMENT FUNDING CORPORATION**
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
2013 ANNUAL REPORT

**EDUCATIONAL ENHANCEMENT FUNDING CORPORATION**
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
TABLE OF CONTENTS
For the Year Ended June 30, 2013

## EDUCATIONAL ENHANCEMENT FUNDING CORPORATION

330 South Poplar, Suite 102
Pierre, South Dakota 57501
605-224-9200

## CORPORATION DIRECTORS



## CORPORATION STAFF

### Executive Secretary

Donald A. Templeton

## CORPORATION COUNSEL

Todd Meierhenry
Danforth & Meierhenry, L.L.P.
Sioux Falls, South Dakota

427 SOUTH CHAPELLE
C/O 500 EAST CAPITOL
PIERRE SD 57501-5070
(605)773-3595
FAX(605)773-6454

MARTIN L. GUINDON, CPA
AUDITOR GENERAL

# 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*

The Honorable Dennis Daugaard
Governor of South Dakota

and

Board of Directors
Educational Enhancement Funding 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 Educational Enhancement Funding Corporation, which comprise the statement of net position as of June 30, 2013, and the related statements of revenues, expenses and changes in net position, and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated December 17, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Educational Enhancement Funding 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 Educational Enhancement Funding Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of the Educational Enhancement Funding 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 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 the Educational Enhancement Funding Corporation's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, 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. As required by South Dakota Codified Law 4-11-11, this report is a matter of public record and its distribution is not limited.

Martin L. Guindon, CPA
Auditor General

December 17, 2013

427 SOUTH CHAPELLE
C/O 500 EAST CAPITOL
PIERRE SD 57501-5070
(605)773-3595
FAX(605)773-6454

MARTIN L. GUINDON, CPA
AUDITOR GENERAL

# INDEPENDENT AUDITOR'S REPORT

The Honorable Dennis Daugaard
Governor of South Dakota

and

Board of Directors
Educational Enhancement Funding Corporation

## *Report on the Financial Statements*

We have audited the accompanying financial statements of the Educational Enhancement Funding Corporation, a component unit of the State of South Dakota, as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the Educational Enhancement Funding 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.

## *Auditor's 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.

*Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Educational Enhancement Funding Corporation as of June 30, 2013, and the changes in its financial position and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

*Other Matters*

*Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 8–10 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 Information*

The listing of officials on page 3 has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

*Other Reporting Required by Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 17, 2013 on our consideration of the Educational Enhancement Funding Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Educational Enhancement Funding Corporation's internal control over financial reporting and compliance.

Martin L. Guindon, CPA
Auditor General

December 17, 2013

## MANAGEMENT'S DISCUSSION AND ANALYSIS
## June 30, 2013

This section of the Educational Enhancement Funding Corporation (the "Corporation") annual financial report presents management's discussion and analysis of the Corporation's financial performance during the fiscal year ended June 30, 2013 (FY 2013). This analysis should be read in conjunction with the Independent Auditor's Report, financial statements and notes to the financial statements.

### Financial Highlights

- Total assets of the Authority decreased $11.4 million or (24.6%).
- Total liabilities of the Authority decreased $29.1 million or (15.9%).
- Net position of the Authority increased $17.7 million or 12.9%.
- Cash, cash equivalents and investments of the Authority decreased $9.8 million or (31.8%).

### Financial Statement Elements

**Changes in Assets, Liabilities and Net Position**
(in thousands of dollars)

| | 2013 | 2012 | Dollar Change | % Change |
|---|---|---|---|---|
| **Assets** | | | | |
| Cash and cash equivalents | $ 20,976.5 | $ 94.1 | $ 20,882.4 | 22,191.7 |
| Investments | 0.0 | 30,675.4 | (30,675.4) | (100.0) |
| Accrued interest | .3 | 92.9 | (92.6) | (99.7) |
| Prepaid insurance | 7.3 | 7.3 | 0.0 | 0.0 |
| Receivable from Participating Manufacturers | 12,013.1 | 12,226.7 | (213.6) | (1.7) |
| Unamortized bond issuance costs | 1,766.0 | 3,027.4 | (1,261.4) | (41.7) |
| **Total Assets** | $ 34,763.2 | $ 46,123.8 | (11,360.6) | (24.6) |
| **Liabilities and Net Position** | | | | |
| Liabilities: | | | | |
| Accounts payable | 6.0 | 7.2 | (1.2) | (16.7) |
| Bonds payable, net of unamortized premium, deferred amount of refunding, discount | 153,930.8 | 182,387.7 | (28,456.9) | (15.6) |
| Accrued interest payable | 394.2 | 1,007.3 | (613.1) | (60.9) |
| Total Liabilities | 154,331.0 | 183,402.2 | (29,071.2) | (15.9) |
| Net Position | (119,567.8) | (137,278.4) | 17,710.6 | 12.9 |
| **Total Liabilities and Net Position** | $ 34,763.2 | $ 46,123.8 | (11,360.6) | (24.6) |

**Changes in Net Position**
(in thousands of dollars)

| | 2013 | 2012 | Dollar Change | % Change |
|---|---|---|---|---|
| **Revenues:** | | | | |
| Payments from Participating Manufacturers | $ 23,913.8 | $ 24,358.7 | ($ 444.9) | (1.8) |
| Premium on bonds | 185.3 | 0.0 | 185.3 | 100.0 |
| Investment earnings | 893.7 | 1,202.5 | (308.8) | (25.7) |
| Realized gain on termination of Debt Service Reserve Fund Agreement | 5,540.0 | 0.0 | 5,540.0 | 100.0 |
| Total Revenues | 30,532.8 | 25,561.2 | 4,971.6 | 19.5 |
| **Expenses:** | | | | |
| General and administrative | 96.2 | 111.2 | (15.0) | (13.5) |
| Insurance | 50.0 | 50.3 | (.3) | (.6) |
| Amortization | 164.9 | 152.0 | 12.9 | 8.5 |
| Bond interest | 10,828.4 | 12,974.5 | (2,146.1) | (16.5) |
| Distributed to State of South Dakota Education Enhancement Trust Fund | 1,682.7 | 0.0 | 1,682.7 | 100.0 |
| Total expenses | 12,822.2 | 13,288.0 | (465.8) | (3.5) |
| **Change in Net Position** | $ 17,710.6 | $ 12,273.2 | 5,437.4 | 44.3 |

**Analysis:**

Principal paid on bonds for FY-13 was $19.3 million, a $4.9 million increase over the previous period. Payments from Participating Manufacturers for FY-13 were $23.9 million, a $445,000 decrease over the previous period. Interest paid on bonds for FY-13 was $10.8 million, a $2.1 million decrease over the previous period.

**Debt Administration:**

The Corporation issued a total of $148.5 million in taxable and $129.5 million in tax-exempt bonds in fiscal year 2003. In fiscal year 2013, the corporation issued a total of $123,010,000 in Series 2013A taxable and $46,635,000 in Series 2013B tax-exempt bonds to current refund the Series 2002A and 2002B, respectively.

Outstanding bonds payable bear interest at rates ranging from .855% to 5%. There was $18,800,000 of regularly scheduled bonds redeemed in the Series 2013A and $545,000 of bonds turbo redeemed(paid in advance of scheduled maturities) in the Series 2002A during fiscal year 2013.

The Series 2013A bonds and Series 2013B bonds are rated "A" and "A-", respectively by Standard and Poor's.

More detailed information about the Corporation's debt can be found in Note 3, Long-term Debt.

**Overview:**

Payments from Participating Manufacturers are the major source of revenue for the Corporation. Future payments are to be used redeem outstanding bonds.

This report is presented to provide additional information regarding operations of the Corporation and to meet the requirements of GASB Statement No. 34.

In 2007 EEFC was examined by the Internal Revenue Service. Extensive testing was done by the Internal Revenue Service on investment policies, investments and debt service reserve requirements in regards to the Series 2002B bonds. The examination resulted in no changes in tax exempt status of the Series 2002B bonds.

This page intentionally left blank.

**EDUCATIONAL ENHANCEMENT FUNDING CORPORATION**
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
STATEMENT OF NET POSITION
June 30, 2013

| | |
|---|---|
| **ASSETS** | |
| Current assets: | |
| Cash and cash equivalents | $ 743,913 |
| Restricted cash and cash equivalents | 20,232,608 |
| Accrued interest receivable | 294 |
| Prepaid insurance | 7,255 |
| Receivable from Participating Manufacturers | 12,013,109 |
| Unamortized bond issue costs | 174,648 |
| Total current assets | 33,171,827 |
| Non-current assets: | |
| Unamortized bond issue costs | 1,591,374 |
| Total Assets | 34,763,201 |
| **LIABILITIES** | |
| Current liabilities payable from restricted assets: | |
| Accounts payable | 6,000 |
| Bonds payable – Net of unamortized premiums and deferred amount of refunding | 14,216,738 |
| Accrued interest payable | 394,171 |
| Total current liabilities | 14,616,909 |
| Non-current liabilities payable from restricted assets: | |
| Bonds payable – Net of unamortized premiums and deferred amount of refunding | 139,714,114 |
| Total Liabilities | 154,331,023 |
| **NET POSITION** | |
| Restricted for Debt Service | 20,232,608 |
| Unrestricted (Deficit) | (139,800,430) |
| **TOTAL NET POSITION (DEFICIT)** | $ (119,567,822) |

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

**EDUCATIONAL ENHANCEMENT FUNDING CORPORATION**
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
For the Year Ended June 30, 2013

| | |
|---|---|
| **OPERATING REVENUES** | |
| Premium amortization | $ 185,292 |
| Payments from Participating Manufacturers | 23,913,774 |
| Total operating revenues | 24,099,066 |
| **OPERATING EXPENSES** | |
| General and administrative expenses | 96,190 |
| Insurance expense | 49,966 |
| Amortization expense | 164,942 |
| Bond interest expense | 10,828,456 |
| Total operating expenses | 11,139,554 |
| Operating income | 12,959,512 |
| **NON-OPERATING REVENUES/(EXPENSES)** | |
| Investment earnings | 893,771 |
| Realized gain on termination of Debt Service Reserve Fund Agreement | 5,540,000 |
| Distributed to State of South Dakota Education Enhancement Trust Fund | (1,682,682) |
| Net non-operating revenues/(expenses) | 4,751,089 |
| Change in net position | 17,710,601 |
| NET POSITION(DEFICIT) – Beginning of Year | (137,278,423) |
| **NET POSITION(DEFICIT) – END OF YEAR** | $ (119,567,822) |

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

**EDUCATIONAL ENHANCEMENT FUNDING CORPORATION**
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2013

| | | |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Receipts from Participating Manufacturers | $ 24,127,368 | |
| Payments for general expenses | (147,305) | |
| Net cash provided by operating activities | | 23,980,063 |
| **Cash flows from noncapital financing activities:** | | |
| Proceeds from bonds | 169,645,000 | |
| Premium on bonds issued | 9,026,384 | |
| Principal payments on bonds | (18,800,000) | |
| Principal payments in advance of scheduled maturity | (184,120,000) | |
| Premium paid on refunded bonds | (1,295,400) | |
| Costs of issuance | (1,816,962) | |
| Interest payments on bonds | (11,255,757) | |
| Distributed to State of South Dakota Education Enhancement Trust Fund | (1,682,682) | |
| Net cash used for noncapital financing activities | | (40,299,417) |
| **Cash flows from investing activities:** | | |
| Receipts from interest income on investments | 1,086,941 | |
| Realized gain on termination of Debt Service Reserve Fund Agreement | 5,540,000 | |
| Purchase of investment securities | (41,788,412) | |
| Proceeds from sale and maturity of investments | 72,363,269 | |
| Net cash provided by investing activities | | 37,201,798 |
| Net increase in cash and cash equivalents during the fiscal year | | 20,882,444 |
| Cash and cash equivalents at beginning of year | | 94,077 |
| Cash and cash equivalents at end of year | | $ 20,976,521 |
| **Reconciliation of operating income to net cash provided by operating activities** | | |
| Operating income | | $ 12,959,512 |
| **Adjustments to reconcile operating income to net cash provided by operating activities** | | |
| Amortization expense | 164,942 | |
| Premium on bonds | (185,292) | |
| Interest expense | 10,828,456 | |
| **Decrease in assets:** | | |
| Receivable from Participating Manufacturers | 213,595 | |
| **Decrease in liabilities:** | | |
| Accounts payable | (1,150) | |
| Total adjustments | | 11,020,551 |
| Net cash provided by operating activities | | $ 23,980,063 |

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

**EDUCATIONAL ENHANCEMENT FUNDING CORPORATION**
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2013

**Reconciliation of cash and cash equivalents to the statement of net position**

| | |
|---|---|
| Cash and cash equivalents | $ 743,913 |
| Restricted cash and cash equivalents | 20,232,608 |
| Total cash and cash equivalents reported on the Statement of Net Position | $ 20,976,521 |

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

**EDUCATIONAL ENHANCEMENT FUNDING CORPORATION**
A COMPONENT UNIT OF THE STATE OF SOUTH DAKOTA
NOTES TO FINANCIAL STATEMENTS
For the Year Ended June 30, 2013

## NOTE 1 – THE CORPORATION

The Educational Enhancement Funding Corporation ("EEFC") is a special purpose corporation, organized under the South Dakota Codified Laws (Chapter 5-12). EEFC is an instrumentality of, but separate and apart from the State of South Dakota (the "State"). EEFC is governed by a board of directors that consists of nine members appointed by the Governor. Although legally separate from the State of South Dakota, EEFC is a component unit of the State and, accordingly, is included in the State's financial statements.

Pursuant to a Purchase and Sale Agreement with the State, the State sold to EEFC all of its future right, title and interest in the Tobacco Settlement Revenues ("TSRs") under the Master Settlement Agreement ("MSA"). The MSA resolved cigarette smoking-related litigation between the settling states and the Participating Manufacturers ("PMs"), released the PMs from past and present smoking-related claims, and provides for a continuing release of future smoking-related claims, in exchange for certain payments to be made to the settling states, as well as certain tobacco advertising and marketing restrictions, among other things. The purchase price of the State's future right, title and interest in the TSRs has been financed by the issuance of the Bonds and the Residual Certificate. The Residual Certificate represents the right of the State to receive all amounts required to be distributed after payment of all outstanding bonds and other liabilities of EEFC as set forth in the Trust Indenture. Pursuant to the resolution EEFC is prohibited from selling additional bonds, other than refunding bonds. The Bonds represent limited obligations of EEFC, payable solely from and secured solely by the pledged TSRs and the pledged amounts. The Bonds are not a debt or liability of the State or of any political subdivision or agency thereof. EEFC has no taxing power.

## NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Basis of Accounting*. The EEFC is reported on the accrual basis of accounting. Revenue is recognized in the accounting period in which it is earned and expenses are recognized when they are incurred. The EEFC follows all Governmental Accounting Standards Board (GASB) pronouncements.

*Cash and Cash Equivalents*. This account includes cash and investments with original maturities of ninety days or less. Cash and cash equivalents reported in the Statement of Cash Flows represent all investments with an original maturity of ninety days or less.

*Operating and Nonoperating Revenue*. The EEFC's single source of operating revenues are the Tobacco Settlement Revenues ("TSRs"). Nonoperating revenue is generated solely by investment earnings. See Note 4 for additional investment disclosure.

*Net Position.* The net deficit position balance of ($119,567,822) at June, 30 2013 reflects an unrestricted net deficit position as defined by GASB Statement No. 34. This balance is comprised of amounts from five accounts. The unrestricted Operating Account had a net position balance of $243,852 at June 30, 2013. The unrestricted Special Reserve Subaccount had a net position balance of $500,061 at June 30, 2013. The restricted Liquidity Reserve Subaccount had a net position balance equal to the Liquidity Reserve Requirement of $17,867,146 at June 30, 2013. The restricted Debt Service Account had a net position balance of $2,365,462 at June 30, 2013. The unrestricted bond account had a net deficit position balance of ($140,544,343) at June 30, 2013. Management believes that the present value of the TSR's allocated to EEFC approximates the net deficit position, however, no receivable for future payments from participating manufacturers has been recorded or reported due to the uncertainty of the exact amounts or the timing of future receipts

*Tobacco Settlement Revenues.* The purchase and sale agreement between the EEFC and the State of South Dakota conveyed the right to all of the Tobacco Settlement Revenues ("TSRs") for the fiscal year ended June 30, 2003 until all of the bonds are redeemed. They are to be deposited with the EEFC's Trustee on its behalf until such time as the bond obligations are fully paid.

In September 2006, the GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues* effective for financial statements periods beginning on or after December 15, 2006. This Statement requires the EEFC to recognize the purchase of TSRs from the State of South Dakota as a purchase of a future revenue stream as well as recognize a deferred charge on its Statement of Net Position for any future transaction. However, the Statement permits, but does not require the EEFC to apply the Statement to previous transactions. Application to prior transactions would require restatement with application of the cumulative impact to the beginning net position of the current year reported in the statements. The initial impact of electing to implement GASB 48 for the existing transaction would result in a positive net position at restatement with an annual reduction in net position (or a loss on bond operations each year) until the bonds are fully redeemed. Management believes that restatement would not offer any significant value to the readers of the EEFC financial statements since they are accustomed to the current presentation. Further, management believes that such implementation would limit historical comparability and, therefore its predictive value, so retrospective application of this section of the Statement was not implemented.

In this case, GASB 48 provides that the event that results in the recognition of an asset and revenue is the domestic shipment of cigarettes. The EEFC estimates accrued TSRs that derive from sales of cigarettes from January 1, 2013 to June 30, 2013 according to the annual TSRs payment that are based on cigarette sales from the preceding calendar year and historical payment trends. TSRs recognized for 2013 included an accrual of $12,013,109.

*Recent Accounting Pronouncements.* In March 2012, the GASB issued Statement No. 65, *Items Previously Reported as Assets and Liabilities*, will result in a reclassification of some financial statement line items on the balance sheet of governments. The objective of this statement is to either (a) properly classify certain items that were previously reported as assets and liabilities as deferred outflows of resources or deferred inflows of resources or (b) recognize certain items that were previously reported as assets and liabilities as expenses or revenues, such as debt issuance costs, fees and costs associated with mortgage banking activities, lending activities and loan purchases. The requirements of this statement are effective for financial statements for periods beginning after December 15, 2012. Accounting changed adopted to conform to the provisions of this Statement will be applied retroactively by restating financial statements for all periods presented. The EEFC is currently evaluating the impact this statement will have on financial reporting.

## NOTE 3 – LONG-TERM DEBT

In connection with the purchase of the State's future right, title and interest in the Tobacco Settlement Revenues ("TSRs"), EEFC issued bonds in an aggregate principal amount of $278,045,000 on September 24, 2002. On March 14, 2013, EEFC issued The Series 2013A and 2013B bonds in an aggregate principal amount of $169,645,000 with an average interest rate of 3.96% to current refund $54,035,000 and $129,540,000 of outstanding maturities in the EEFC Series 2002A bonds and Series 2002B bonds, which had interest rates of 6.72% and 6.5%, respectively. The net proceeds of approximately $184,870,400, including bond premiums, other sources of funds and after payment of underwriting fees and issuance costs were used to retire $35,215,000 and $18,820,000 of outstanding maturities in the Series 2002A bonds on March 29, 2013 and June 1, 2013, respectively, and to retire $129,540,000 of outstanding maturities in the Series 2002B bonds on March 29, 2013. The current refundings resulted in a difference between the reacquisition prices and the net carrying amount of the old debts of $5,875,858. This difference is being charged to operations through fiscal year 2018 using the effective-interest method. The EEFC completed the current refunding for a net economic gain of $108,373,461. The difference between the cash flows of the Series 2002A and Series 2002B refunded bonds and the Series 2013A and Series 2013B refunding bonds is a $151,270,857 reduction in debt service payments.

The EEFC has pledged to bondholders certain accounts established and maintained by the Trustee pursuant to the Trust Indenture. These pledged accounts include the Collections Account (except to the extent that money therein is allocable to the Operating Account or to the Special Reserve Subaccount), the Debt Service Account, and the Liquidity Reserve Subaccount. These accounts include the TSRs, net of amounts allocated to the EEFC for operating purposes and to pay arbitrage rebate. The Operating Account and Special Reserve Subaccount for EEFC are not pledged to bondholders. EEFC applied all TSRs received during fiscal year June 30, 2013 to pay its operating expenses and to the payment of scheduled debt service and turbo redemption bonds, a residual amount of $1,682,682 was distributed to the state of South Dakota's Education Enhancement Trust Fund. Outstanding bonds payable bear interest at rates ranging from .855% to 5.00%. There was $18,800,000 of regularly scheduled bonds redeemed in the Series 2013A and $545,000 of bonds were turbo redeemed in the Series 2002A during fiscal year 2013. The balance of bonds outstanding at year end was:

| Fiscal Year Ending June 30 | Principal | Interest | Total Debt Service |
|---|---|---|---|
| 2014 | $ 13,995,000 | $ 4,730,057 | $ 18,725,057 |
| 2015 | 13,225,000 | 4,610,400 | 17,835,400 |
| 2016 | 12,535,000 | 4,453,287 | 16,988,287 |
| 2017 | 11,935,000 | 4,258,869 | 16,193,869 |
| 2018 | 11,500,000 | 4,031,388 | 15,531,388 |
| 2019-2023 | 50,990,000 | 15,193,504 | 66,183,504 |
| 2024-2027 | 36,665,000 | 4,368,000 | 41,033,000 |
| | $150,845,000 | $ 41,645,505 | $192,490,505 |

The following is a schedule of Bonds Payable as of June 30, 2013:

| Bond Series | Maturity Through | Percent Interest Rate | Balance 6/30/12 | Issued | Retired | Balance 6/30/13 | Amount Due Within One Year |
|---|---|---|---|---|---|---|---|
| 2002A | | | $ 54,580,000 | $ - | $ 54,580,000 | $ - | $ - |
| 2002B | | | 129,540,000 | - | 129,540,000 | - | - |
| 2013A | 2027 | .855 - 3.539 | - | 123,010,000 | 18,800,000 | 104,210,000 | 13,995,000 |
| 2013B | 2027 | 5.00 | - | 46,635,000 | - | 46,635,000 | - |
| Total | | | 184,120,000 | 169,645,000 | 202,920,000 | 150,845,000 | 13,995,000 |
| Unamortized bond premiums | | | | | | 8,841,091 | |
| Unamortized deferred amount of refunding | | | | | | (5,755,239) | |
| Bonds payable, net of premium and deferred amount of refunding | | | | | | $ 153,930,852 | |

## NOTE 4 – CASH AND INVESTMENTS

All of the EEFC's cash and investments are held and administered by a bank trust department. Separate accounts are maintained for the required Liquidity Reserve Subaccounts and other purposes as stipulated in the indentures. All investments are held on behalf of the EEFC by the bank as trustee.

For purposes of reporting cash flows, the EEFC considers all highly liquid investments (maturities of three months or less) and all investments with insignificant risk of changes in value because of changes in interest rates to be cash and cash equivalents. Cash equivalents are reported at fair value. The balance in cash and cash equivalents as of June 30, 2013 was $20,976,521 at fair value.

Deposits:

*Custodial Credit Risk*. Custodial credit risk is the risk in the event of a bank failure, the EEFC's deposits may not be returned to it. At June 30, 2013 the EEFC had uninsured deposits with a bank trust department of $20,726,521 that were in the bank's name.

*Interest Rate Risk.* The EEFC does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

*Credit Risk*. The EEFC does not have a formal investment policy with respect to credit risk. At June 30, 2013 $20,976,521 was invested in the The First American Government Obligation Fund Class D, which was rated AAAm by Standard and Poor's and Aaa-mf by Moody's at June 30, 2013.

*Concentration Credit Risk.* The EEFC places no limit on the amount the corporation may invest in any one investment.

---

## NOTE 5 – COMMITMENTS AND CONTINGENCIES

*Contingency 1.* The EEFC purchased future Tobacco Settlement Revenues ("TSRs") from the State of South Dakota by issuing long-term bonds. The future collection of the TSRs will be used to pay the debt service of the EEFC.

*Contingency 2.* South Dakota received only a portion of its expected April 2013 annual MSA payment, in part due to a dispute with certain Participating Manufacturers over the applicability of a Nonparticipating Manufacturer ("NPM") Adjustment. The NPM Adjustment procedure is found in Section IX(d) of the Master Settlement Agreement ("MSA").

A MSA Settling State will not be subject to an NPM Adjustment for a particular year if it is found to have "diligently enforced" its Qualifying Statute throughout that year. The nationwide arbitration involving the Participating Manufacturers and most of the MSA Settling States regarding the 2003 NPM Adjustment is still pending at this time. In that arbitration South Dakota learned that its "diligent enforcement" for the year 2003 is no longer contested. Thus, South Dakota will not be subject to a 2003 NPM Adjustment. Litigation over the NPM Adjustment for 2004 will follow.

Several Participating Manufacturers reduced their April 2013 annual MSA payments to many of the MSA Settling States, either withholding a portion of the payment or placing the disputed amount into a disputed payment account. Again, it is anticipated that these amounts will not be disbursed to the States until the dispute is resolved with finality.

Likewise, it is expected that several Participating Manufacturers will seek an NPM Adjustment with respect to the annual MSA payment due in April 2014. As in the past, the Participating Manufacturers might withhold the disputed amount or place it in a disputed payment account until the issue is resolved. Whether such a reduction will be made, and if so, the amount of the reduction, is not known at this time.

## NOTE 6 – RISK MANAGEMENT

The EEFC is exposed to various risks of loss related to officers' and directors' errors and omissions. These risks are covered through the purchase of Directors' and Officers' insurance with a liability limit of $5,000,000 and a retention limit of $250,000.

## NOTE 7 – REALIZED GAIN ON TERMINATION OF DEBT SERVICE RESERVE FUND AGREEMENT

The Series 2002A & B Liquidity Reserve Subaccounts were subject to a Debt Service Reserve Fund Agreement dated September 24, 2002. Under the agreement, Morgan Stanley was obligated to deliver investments to EEFC on a semiannual basis with a fixed rate of return of 4.606%. The agreement was to mature on June 1, 2032 or earlier upon redemption of all bonds or if EEFC exercised its optional termination right. On February 27, 2013, the EEFC exercised its optional termination right to terminate this agreement, resulting in a recognized gain on the termination of the Debt Service Reserve Fund Agreement of $5,540,000.