

VIRGINIA TOBACCO SETTLEMENT FOUNDATION

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2006**



AUDIT SUMMARY

Our audit of the Virginia Tobacco Settlement Foundation found:

- proper recording and reporting of all transactions, in all material respects, in the Commonwealth Accounting and Reporting System;
- no matters involving internal control and its operations necessary to bring to management's attention; and
- no instances of noncompliance with applicable laws and regulations or other matters that are required to be reported.

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FOUNDATION HIGHLIGHTS

Foundation Overview

The Virginia Tobacco Settlement Foundation (Foundation) receives annually, ten percent of the Commonwealth of Virginia's (Commonwealth) portion of funds from the Master Settlement Agreement (MSA) with tobacco manufacturers. A Board of Trustees (Board), comprised of 23 members, governs and administers the Foundation. The Board establishes the Foundation's budget and specific criteria and procedures for distributing money in the Virginia Tobacco Settlement Fund. The Foundation uses its funding to finance educational and awareness programs on the health effects of tobacco use by youth and research related to the prevention of tobacco use among youths.

The Board also approves members of its nine Regional Advisory Boards. The Regional Advisory Boards provide a local connection between the Foundation and communities throughout the Commonwealth. The Advisory Boards oversee the review process to select recipients that receive program grants to fund prevention programs that discourage tobacco use by minors. Additionally, the Board funds a statewide marketing campaign to reduce the use of tobacco among youths.

The Department of Health acts as the fiscal agent for the Foundation and provides fiscal and payroll services. The Foundation employs an executive and deputy director, a business manager, and 12 staff members. The staff includes five regional grant program administrators. These administrators are responsible for managing the program grants issued throughout the Commonwealth.

Financial Operations

The following table shows actual revenues and expenses as compared to the Foundation's Board approved budget for fiscal year 2006.

	<u>Budget</u>	<u>Actual</u>	<u>Variance Positive/(Negative)</u>
Revenues:			
Master Settlement payments	\$12,777,019	\$11,963,023	\$(813,996)
Interest on securities	125,000	163,626	38,626
Proceeds from security transactions	<u>-</u>	<u>52,716</u>	<u>-</u>
Total revenues:	<u>12,902,019</u>	<u>12,179,365</u>	<u>(722,654)</u>
Expenses:			
Administration	1,514,240	1,407,817	106,423
Marketing campaign	4,650,000	5,105,740	(455,740)
Program grants	4,725,000	3,956,036	768,964
Research and evaluation	2,220,000	2,017,409	202,591
State general fund transfers out	75,000	78,843	(3,843)
Expenses for securities lending	-	52,716	(52,716)
Accounting services, Department of Health	<u>75,000</u>	<u>65,715</u>	<u>9,285</u>
Total expenses	<u>\$13,259,240</u>	<u>\$12,684,276</u>	<u>\$ 574,964</u>
Revenues over /(under) expenses	<u>\$ (357,221)</u>	<u>\$ (504,911)</u>	<u>\$(147,690)</u>

Source: Budget – Board Approved Budget, approved June 15, 2005, Actual – Adjusted Annual Report to the Board

The Board develops the Foundation's budget using an accrual basis of accounting. At year-end, the Foundation had a cash balance of \$7,247,729 and grants payable of \$608,941, which the above schedule reflects as an expense. Similar to fiscal years 2005 and 2006, the Foundation does not expect for their current cash balance to last until their next scheduled MSA payment, scheduled to occur in April 2007. To cover this timing difference the Foundation, as they have done in the past, will start drawing on its line of credit when their cash balance drops to zero. Currently, management expects they will start using their line of credit in February and will need a total of \$2 million to make it to their next MSA payment. During fiscal years 2005 and 2006, the Foundation used \$3 million and \$2 million, respectively, of its line of credit to cover its expenses the months before its April MSA payment.

A majority of the Foundation's revenues are from the MSA payments. This amount varies annually, as it is dependent on actual tobacco sales. The MSA payment for fiscal year 2006 was \$11,963,023 and \$813,996 less than originally budgeted. The Foundation expects total revenues of \$12 million for fiscal year 2007.

Over the past three years, MSA payments have fluctuated due to rises and falls of tobacco sales, requiring the Foundation to adjust its budget accordingly. Payments for 2003, 2004 and 2005 were \$15,002,990, \$12,839,652 and \$13,031,549, respectively. To handle such unexpected changes in the budget, the Board reviews the budget at every board meeting to discuss and approve any changes needed.

The table below compares the Foundation's original budget for fiscal year 2007, which was approved on March 23, 2004 to their current operating budget, approved on June 15, 2006.

	<u>Original</u>	<u>Current</u>	<u>Variance Positive/(Negative)</u>
Revenues:			
Master Settlement payments	\$12,777,019	\$11,816,627	\$ (960,392)
Interest on securities	125,000	100,000	(25,000)
Carry forward grants projects	<u>-</u>	<u>125,000</u>	<u>125,000</u>
Total projected revenue	<u>12,902,019</u>	<u>12,041,627</u>	<u>(860,392)</u>
Expenses:			
Administration	1,574,810	1,400,000	(174,810)
Marketing campaign	4,650,000	4,350,000	(300,000)
Program grants	4,725,000	4,156,434	(568,566)
Research and evaluation	2,155,000	2,113,000	(42,000)
State general fund transfers out	75,000	75,000	-
Accounting services, Department of Health	<u>75,000</u>	<u>75,000</u>	<u>-</u>
Total budgeted expenses	<u>\$13,254,810</u>	<u>\$12,169,434</u>	<u>\$(1,085,376)</u>
Budget over/under revenue	<u>\$ (352,791)</u>	<u>\$ (127,807)</u>	<u>\$ 224,984</u>

Source: Original – Board Approved Budget, approved March 23, 2004, Current, Board Approved Budget, approved June 15, 2006

The Board reduced the Foundation's fiscal year 2007 budget as a result of tobacco manufacturers holding ten percent (\$1.6 million) of the Foundation's April 2006 MSA payment in escrow. Tobacco manufacturers are withholding the ten percent because they are losing market share to those manufacturers that did not participate in the MSA. Currently, the issue is in litigation; therefore, the Foundation is still unsure whether they will receive these additional funds. The Foundation plans to reduce the amount of program grants awarded and marketing contract amounts in fiscal year 2007 to absorb the reduction in funding.

Marketing Campaign

In 2001, the Foundation launched a statewide multimedia marketing campaign called the Y Campaign. The mission of the Y-Campaign is to reduce youth tobacco use in the Commonwealth by empowering Virginia youth to choose a healthy lifestyle. The campaign integrates messages through a multimedia marketing effort, including television, and radio commercials, an interactive web site (www.ydouthink.com), internet banner ads, outdoor and cinema advertising, a series of music festivals, and street marketing activities.

In order to achieve the goals of the Y-Campaign the Foundation administers the following contracts. The marketing contracts cover the period of July 1, 2005 through June 30, 2006.

<u>Contract</u>	<u>Amount</u>
Barber Martin Advertising	\$4,000,000
Rescue Social Change Group (Y-Campaign)	600,000
Rescue Social Change Group (web-site/media)	145,000
Southeastern Institute of Research	175,000
Free Radical (cancelled in October 2005)	<u>175,000</u>
Total in Marketing Contracts	<u>\$5,095,000</u>

Source: The Foundation's Marketing Contracts

Barber Martin Advertising purchases media to place current and new advertisements in various medium outlets, develops new creative concepts and ideas, and produces ideas into finished advertising deliverables. The target market is 10 to 17-year olds across the Commonwealth.

Rescue Social Change Group, previously Rescue Productions, schedules and manages all campaign events, employs personnel to conduct the events, and develops new concepts and ideas for reaching Virginia's youth. The focus of the street marketing effort is to provide strategic support for the Y-Campaign by directly interacting with 10 to 17-year olds across the Commonwealth. Rescue Social Change Group also provides the service of website development and management, interactive media development, and interactive media planning, purchasing, and placement for the Y-Campaign. The Foundation contracted with Rescue Social Change Group for these additional services in an emergency procurement during fiscal year 2006 due to the unforeseen closure of their former supplier (Free Radical). Southeastern Institute of Research, Inc. evaluates the effectiveness of the Y-Campaign by conducting tracking studies twice a year and preparing the Foundation with reports for each study.

The Foundation monitors the marketing contracts by tracking performance through monthly, quarterly, and annual reviews. Contracts renewals only occur if a vendor achieves the performance standards stipulated in their contracts.

Program Grants

The Foundation awards grants to schools, houses of faith, and other entities located in the Commonwealth for the purpose of implementing tobacco prevention programs. The programs address issues related to tobacco use including prevention education, tobacco cessation, early tobacco intervention and reduction, advocacy, youth empowerment, and social skills building. The Foundation issued a total of \$3,631,609 in grants for fiscal year 2006 to include 70 program grants (\$3,450,842), 40 special project mini-grants (\$117,831), and 29 community service board mini-grants (\$62,936). The Foundation monitors and administers the program grants to ensure recipients meet the program objectives.

Research Grants

Four universities received grants from the Foundation during fiscal year 2006 to implement collaborative research projects for preventing the use of tobacco by youths. The research topics cover areas such as etiology of youth tobacco use, psychosocial aspects, genetic predisposition to nicotine addiction, progression from experimentation to addiction, and specific youth interventions.

As a part of its research efforts, the Foundation formed the Virginia Research Consortium (Consortium). The Consortium is a collaborative network of institutions of higher learning in the Commonwealth that conduct tobacco prevention research and assist the Foundation in ensuring that research methodology and projects are appropriate and scientifically based. The Foundation requires that institutions that receive research funds participate in the Consortium to help promote and ensure collaboration and coalition building between institutions. The following table shows the amount of research grants that the Foundation awarded to each university during fiscal year 2006.

<u>Research Grant Recipient</u>	<u>Amount</u>
Virginia Commonwealth University	\$ 534,817
University of Virginia	487,500
George Mason University	440,000
James Madison University	<u>240,000</u>
Total	<u>\$1,702,317</u>

Source: The Foundation's Research Grants

Enforcement Initiatives

Enforcement of tobacco access laws is another component of the Foundation's comprehensive youth tobacco use prevention program. The Foundation paid the Department of Alcoholic Beverage Control (ABC) \$288,190 during fiscal year 2006 to conduct compliance checks. This amount is included in program expenses. Each month, ABC, at random, tests approximately 400 tobacco retailers to see if they will sell tobacco products to under-age buyers.



Commonwealth of Virginia

Walter J. Kucharski, Auditor

Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

October 12, 2006

The Honorable Timothy M. Kaine
Governor of Virginia
State Capital
Richmond, Virginia

The Honorable Thomas K. Norment, Jr.
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

We have audited the financial records and operations of the **Virginia Tobacco Settlement Foundation** (Foundation) for the year ended June 30, 2006. We conducted our audit in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

INDEPENDENT AUDITOR'S REPORT

Audit Objectives

Our audit's primary objectives were to evaluate the accuracy of recorded financial transactions on the Commonwealth Accounting and Reporting System, review the adequacy of the Foundation's internal controls, and test compliance with applicable laws and regulations.

Audit Scope and Methodology

The Foundation's management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

We gained an understanding of the overall internal controls, both automated and manual, sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances:

- Master Settlement Agreement payments
- Contract and grant management
- Vendor payments
- Small purchase charge card
- Foundation's board approved budget

We performed audit tests to determine whether the Foundation's controls were adequate, had been placed in operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws and regulations. Our audit procedures included inquiries of appropriate personnel, inspection of documents, records, vouchers, small purchase charge card receipts and reconciliations, marketing and research contracts, program grants, and observation of the Foundation's operations. We tested transactions and performed analytical procedures, including budgetary and trend analyses.

Conclusions

We found that the Foundation properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System. The Foundation records its financial transactions on the cash basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The financial information presented in this report came directly from the Commonwealth Accounting and Reporting systems and the Foundation's records.

We noted no matters involving internal control and its operation that we consider necessary to be reported to management. The results of our tests of compliance with applicable laws and regulations disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

EXIT CONFERENCE AND REPORT DISTRIBUTION

We discussed this report with management on October 17, 2006.

This report is intended for the information and use of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

GDS:sks
sks: 46

VIRGINIA TOBACCO SETTLEMENT FOUNDATION

Marty Kilgore, Executive Director

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