

Consolidated Financial Statements and Report of
Independent Certified Public Accountants
American Legacy Foundation
June 30, 2004 and 2003

American Legacy Foundation

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Report of Independent Certified Public Accountants

Board of Directors
American Legacy Foundation

We have audited the accompanying consolidated statements of financial position of the American Legacy Foundation (the Foundation) as of June 30, 2004 and 2003, and the related consolidated statements of activities and changes in net assets and cash flows for the years then ended. The consolidated financial statements are the responsibility of the Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Foundation as of June 30, 2004 and 2003, and the changes in its net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Grant Thornton CP

Vienna, Virginia
August 25, 2004

American Legacy Foundation

Consolidated Statements of Financial Position

<i>June 30,</i>	2004	2003
Assets		
Current Assets		
Cash and cash equivalents	\$ 177,986,573	\$ 165,181,234
Investments, at market (Note C)	871,444,152	794,827,968
Accrued interest receivable	597,371	950,209
Loan receivable (Note H)	56,503	53,621
Prepaid expenses	593,099	696,989
Inventory	26,011	—
Total Current Assets	1,050,703,709	961,710,021
Fixed Assets, net (Note D)	37,403,400	34,753,107
Other Assets	957,533	401,317
Long-term Loan Receivable, net of current portion (Note H)	820,571	879,191
Total Assets	\$ 1,089,885,213	\$ 997,743,636
Liabilities and Net Assets		
Current Liabilities		
Accrued expenses	\$ 17,757,046	\$ 13,300,487
Grants payable	1,735,199	4,806,800
Other payable	113,198	107,325
Loans payable (Notes H and I)	61,285,555	30,053,621
Trades to be settled	2,229,776	473,111
Total Current Liabilities	83,120,774	48,741,344
Long-term Liabilities		
Loans payable (Notes H and I)	19,591,519	879,191
Sublease liability	849,421	—
Total Long-term Liabilities	20,440,940	879,191
Net Assets—Unrestricted	986,323,499	948,123,101
Total Liabilities and Net Assets	\$ 1,089,885,213	\$ 997,743,636

The accompanying notes are an integral part of these statements.

American Legacy Foundation

Consolidated Statements of Activities and Changes in Net Assets

<i>Year ended June 30,</i>	2004	2003
Revenue and Support		
Settlement proceeds:		
Base	\$ 25,000,000	\$ 25,000,000
Public education	3,406,581	272,752,749
Smokeless tobacco	11,607,185	10,139,376
	<hr/>	<hr/>
	40,013,766	307,892,125
Investment income (Note C)	140,884,953	33,630,813
Other income	7,468,384	2,491,143
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Total Revenue and Support	188,367,103	344,014,081
Program Expenses		
Counter-marketing and public education	84,539,004	75,800,544
Strategic partnerships	2,761,618	2,350,795
Communications and outreach	6,160,402	5,227,793
Evaluation and research	6,160,703	9,377,995
Technical assistance and training	3,393,882	5,205,936
Priority populations	7,884,868	8,094,199
Grants	19,073,043	22,986,836
Policy and government relations	1,013,533	977,717
Call center	388,760	—
Quitline consortium	93,932	—
President's office	214,131	—
	<hr/>	<hr/>
Total Program Expenses	131,683,876	130,021,815
Supporting Expenses		
General and administrative (Note C)	15,122,527	7,545,111
Building Operating Expenses		
	2,488,710	1,164,823
Interest Expense		
	694,170	332,003
Income Tax Expense		
	177,422	172,000
	<hr/>	<hr/>
Total Expenses	150,166,705	139,235,752
Change in Net Assets	38,200,398	204,778,329
Net Assets, beginning of year	948,123,101	743,344,772
	<hr/>	<hr/>
Net Assets, end of year	\$ 986,323,499	\$ 948,123,101

The accompanying notes are an integral part of these statements.

American Legacy Foundation

Consolidated Statements of Cash Flows

<i>Year ended June 30,</i>	2004	2003
Cash Flows from Operating Activities		
Change in net assets	\$ 38,200,398	\$ 204,778,329
Adjustments to reconcile change in net assets to net cash and cash equivalents provided by operating activities:		
Unrealized gain on investments	(76,566,434)	(54,068,500)
Realized (gain) loss on investments	(46,885,078)	35,934,324
Other investment (income) loss	(263,968)	406,826
Loss on disposal of fixed assets	39,827	—
Depreciation	1,727,256	1,166,627
Accrued interest receivable	352,838	(88,913)
Loan receivable	55,738	(932,812)
Inventory	(26,011)	—
Other assets	(556,216)	(244,458)
Prepaid expenses	103,890	(475,033)
Current liabilities	3,147,496	(2,277,685)
Sublease liability	849,421	—
Net Cash (Used in) Provided by Operating Activities	(79,820,843)	184,198,705
Cash Flows from Investing Activities		
Purchase of fixed assets and leasehold improvements	(4,417,376)	(33,550,171)
Proceeds from sale of investments	8,642,398,844	8,504,091,331
Purchases of investments	(8,595,299,548)	(8,674,260,822)
Net Cash Provided by (Used in) Investing Activities	42,681,920	(203,719,662)
Cash Flows from Financing Activities		
Borrowings under line-of-credit agreement	30,000,000	30,000,000
Proceeds from loan payable	20,000,000	967,500
Payments on loan payable	(55,738)	(34,688)
Net Cash Provided by Financing Activities	49,944,262	30,932,812
Net Increase in Cash and Cash Equivalents	12,805,339	11,411,855
Cash and Cash Equivalents, beginning of year	165,181,234	153,769,379
Cash and Cash Equivalents, end of year	\$ 177,986,573	\$ 165,181,234
Cash Paid for Income Taxes	\$ 177,422	\$ 172,000

The accompanying notes are an integral part of these statements.

American Legacy Foundation

Notes to Consolidated Financial Statements

June 30, 2004 and 2003

NOTE A—NATURE OF OPERATIONS

In November 1998, a coalition of 46 state attorneys general successfully settled their civil cases with the tobacco companies. As a result, the settling states and the participating tobacco manufacturers entered into two separate settlement agreements: the Master Settlement Agreement (MSA) and the Smokeless Tobacco Master Settlement Agreement (STMSA). The two settlement agreements provided for the establishment and initial funding of a Section 501(c)(3) organization to reduce tobacco usage in the United States. Pursuant to these agreements, an organization named Master Settlement Agreement Foundation (MSA Foundation) was created in March 1999, and later renamed American Legacy Foundation (the Foundation). The Foundation's mission is to build a world where young people reject tobacco and anyone can quit.

The Foundation is a non-profit organization organized and operated exclusively for charitable, scientific, and educational purposes within the meaning of the Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the Code). All references to sections of the Code include the corresponding provisions of any subsequent federal tax law. More specifically, the purpose for which the Foundation was formed is to support (1) the study of and programs to reduce youth tobacco product usage and youth substance abuse in the United States, and (2) the study of and educational programs to prevent diseases associated with the use of tobacco products in the United States.

The Foundation is governed by a Board of Directors, which is comprised of state governors, legislators, attorneys general and experts in the medical, education and public health fields.

The functions of the Foundation shall be:

1. Carrying out a nationwide sustained advertising and education program to (a) counter the use by youth of tobacco products, and (b) educate consumers about the cause and prevention of diseases associated with the use of tobacco products;
2. Developing and disseminating model advertising and education programs to counter the use by youth of substances that are unlawful for the use or purchase by youth, with an emphasis on reducing youth smoking; monitoring and testing the effectiveness of such model programs and, based on the information received from such monitoring and testing, continuing to develop and disseminate revised versions of such model programs, as appropriate;
3. Developing and disseminating model classroom education programs and curriculum ideas about smoking and substance abuse in the K-12 school system, including specific target programs for special at-risk populations, monitoring and testing the effectiveness of such model programs and ideas and, based on the information received from such model programs or ideas, continuing to develop and disseminate revised versions of such model programs, as appropriate;

American Legacy Foundation

Notes to Consolidated Financial Statements—Continued

June 30, 2004 and 2003

NOTE A—NATURE OF OPERATIONS—Continued

4. Developing and disseminating criteria for the effectiveness cessation program; monitoring and testing the effectiveness of such criteria; and continuing to develop and disseminate revised versions of such criteria, as appropriate;
5. Commissioning studies, funding research, and publishing reports and factors that influence youth smoking and substance abuse, and developing strategies to address the conclusions of such studies and research;
6. Developing other innovative youth smoking and substance abuse prevention programs;
7. Providing targeted training and information for parents;
8. Maintaining a library, open to the public, of the Foundation-funded studies, reports and other publications related to the cause and prevention of youth smoking and substance abuse;
9. Tracking and monitoring youth smoking and substance abuse, with a focus on the reasons for any increases in or failures to decrease youth smoking and substance abuse and what actions can be taken to reduce youth smoking and substance abuse; and
10. Receiving, controlling, and managing contributions and funds provided by other entities for further purposes described in the Foundation's certificate of incorporation.

In order to meet the general goals and specific focus areas set forth above, the Foundation is organized into three major sections: one for administration, fiscal, personnel, legal and board relations; another section focusing on public education by means of counter-marketing of tobacco use, public relations, policy and strategic partnerships; and a third section focusing on grant-giving for research-commissioned studies, program initiatives related to the Foundation's goals, and the rigorous evaluation of the Foundation's programs.

NOTE B—SUMMARY OF ACCOUNTING POLICIES

Organization

In December 2002, the Foundation purchased the property at 2030 M Street, NW, Washington, D.C. through M Street Holdings LLC, a single-member LLC, 100 percent owned by the Foundation. Space in the building is occupied by the Foundation as well as leased to other tenants. The Foundation's control, combined with its economic interest, supports consolidation of M Street Holdings LLC.

All significant intercompany transactions have been eliminated in the consolidated financial statements.

American Legacy Foundation

Notes to Consolidated Financial Statements—Continued

June 30, 2004 and 2003.

NOTE B—SUMMARY OF ACCOUNTING POLICIES—Continued

Basis of Presentation

These consolidated financial statements present the financial position, activities and cash flows of the Foundation prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. These net assets represent expendable funds that are available for support of the Foundation's operations.

Settlement Revenue

The Foundation's main sources of revenue are derived from the two settlement agreements: the MSA and the STMSA. Certain payments received pursuant to the settlement agreements can be utilized at the Foundation's discretion. Other payments are intended to assist the Foundation in carrying out a nationwide sustained advertising and education program.

These agreements contain various provisions and conditions that ultimately determine the amount and timing of payments to be received. Consequently, revenue is recognized at the time payments either are received or can be reasonably estimated and are receivable.

Investments

Investments are recorded at fair value as determined by quoted market prices. Realized and unrealized gains and losses are recorded as a component of investment income in the statements of activities.

Fixed Assets

Fixed assets are recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets, which range from three to 39-½ years. Leasehold improvements are amortized using the straight-line method over the lesser of the estimated useful lives of the assets or the related lease terms.

Cash and Cash Equivalents

For purposes of the statements of cash flows, the Foundation considers all short-term, highly liquid debt instruments to be cash equivalents, including commercial paper, money market funds, and certificates of deposit purchased with an original maturity of three months or less.

Allocation of Expenses

Expenses are either directly charged to program services as incurred or proportionately allocated to functional categories based on various allocation methods.

Inventory of Merchandise

Inventory is stated at the lower of cost or market using the first-in, first-out (FIFO) method.

American Legacy Foundation

Notes to Consolidated Financial Statements—Continued

June 30, 2004 and 2003

NOTE B—SUMMARY OF ACCOUNTING POLICIES—Continued

Use of Estimates in Preparing Financial Statements

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenue and expenses during the reporting period.

NOTE C—INVESTMENTS

Investments at fair value consisted of the following at June 30:

	2004	2003
U.S. government securities	\$ 157,525,801	\$ 159,299,685
Corporate obligations	41,958,069	55,126,345
U.S. equity securities	408,379,371	426,319,361
Non-U.S. securities	263,580,911	154,082,577
	<u>\$ 871,444,152</u>	<u>\$ 794,827,968</u>

Investment return consisted of the following at June 30:

	2004	2003
Interest, dividends, and accretion income	\$ 17,169,473	\$ 15,903,463
Realized gain (loss) on investments	46,885,078	(35,934,324)
Unrealized gain on investments	76,566,434	54,068,500
Currency gain (loss) and foreign taxes on investments	263,968	(406,826)
	<u>\$ 140,884,953</u>	<u>\$ 33,630,813</u>

Custodial and investment advisory fees of \$3,685,202 and \$2,499,174 for fiscal years 2004 and 2003, respectively, are reflected in general and administrative expenses on the consolidated statement of activities.

American Legacy Foundation

Notes to Consolidated Financial Statements—Continued

June 30, 2004 and 2003

NOTE D—FIXED ASSETS

Fixed assets consisted of the following at June 30:

	2004	2003
Furniture and fixtures	\$ 1,149,264	\$ 611,205
Computers	1,821,298	1,282,499
Office equipment	731,269	262,917
Improvements	567,942	567,942
Building and improvements	35,588,894	33,073,700
Assets in progress	475	96,942
Vehicles	1,418,760	1,418,760
	<hr/>	<hr/>
	41,277,902	37,313,965
Less: accumulated depreciation and net disposals	(3,874,502)	(2,560,858)
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	\$ 37,403,400	\$ 34,753,107

NOTE E—INCOME TAXES

The Foundation is exempt from federal income taxes under Section 501(a) of the Code as an organization described in Section 501(c)(3).

M Street Holdings, LLC is a single-member LLC and, as such, is a “disregarded entity” for federal income tax purposes, pursuant to section 7701 of the Code.

The Foundation had unrelated business income; the Foundation paid \$177,422 and \$172,000 in federal and D.C. taxes for 2004 and 2003, respectively.

American Legacy Foundation

Notes to Consolidated Financial Statements—Continued

June 30, 2004 and 2003

NOTE F—COMMITMENTS AND CONTINGENCIES

Operating Leases

The Foundation leases office space and equipment under non-cancelable operating lease agreements. Minimum future lease payments are as follows:

<i>Year ending June 30,</i>	Minimum Lease Commitments	Sublease Offset	Net Lease Commitment
2005	\$ 878,681	\$ (650,904)	\$ 227,777
2006	679,419	(543,301)	136,118
2007	690,587	(554,167)	136,420
2008	704,351	(565,250)	139,101
2009	718,416	(576,555)	141,861
Thereafter	546,851	(439,853)	106,998
	\$ 4,218,305	\$ (3,330,030)	\$ 888,275

On January 31, 2000, the Foundation entered into a lease agreement for office space with 15,043 square feet under a 10-year term and an additional 6,379 square feet under a five-year term that can be extended to the 10-year term. The lease includes scheduled rent increases, which are being amortized on a straight-line basis over the term of the lease. Total operating lease expenses under all office and equipment leases were \$938,892 and \$1,043,010 for the years ended June 30, 2004 and 2003, respectively. The Foundation has a sublease liability in the amount of \$849,421 stemming from rental space at 1001 G Street, for which the Foundation is still under contract. The liability will be reduced ratably over the life of the lease.

Financial Instruments

The Foundation continually monitors its positions with, and the credit quality of, the financial institutions, which are counter-parties to its financial instruments, and does not anticipate non-performance by the counter-parties. Financial instruments representing significant concentrations consist primarily of cash and cash equivalents and investment securities.

NOTE G—RETIREMENT PLANS

The Foundation maintained two retirement plans during the year: a defined contribution money purchase plan and an employees' 401(k) savings plan. Effective in January 2004, the Foundation combined the money purchase plan into the 401(k) savings plan.

American Legacy Foundation

Notes to Consolidated Financial Statements—Continued

June 30, 2004 and 2003

NOTE G—RETIREMENT PLANS—Continued

Employees who are at least 21 years of age are eligible for enrollment and participation in the first month following the completion of 90 days of employment. The Foundation contributes 15 percent of the base compensation for each employee. Participants may elect to defer up to 10 percent of their compensation subject to statutory limitations. Expenses related to the retirement plan amounted to \$809,733 and \$746,555 for the years ended June 30, 2004 and 2003, respectively.

NOTE H—RELATED-PARTY TRANSACTION

Loan to Officer

In September 2002, the Foundation provided a \$967,500 mortgage loan to the President/CEO secured through a note on the D.C. property purchased, as well as other personal assets. The term of the loan is for seven years, with an amortization rate of 15 years at a fixed interest rate of 4.99 percent. The mortgage loan is funded through an unsecured direct bank loan to the Foundation with the same terms. The balance of the loan due to the Foundation, and, in turn, the financial institution at June 30, 2004, is \$877,074.

The classification of the notes receivable and offsetting mortgage loan in the accompanying consolidated balance sheet is as follows:

Current portion	\$	56,503
Long-term portion		820,571
		<hr/>
	\$	877,074

NOTE I—DEBT

Terms and Balance

In February 2003, the Foundation obtained a revolving master borrowing line with a financial institution for \$30,000,000. The effective interest rate on the line is the London Interbank Offered Rate (LIBOR) plus .10 percent as established on the first business day of each month by the British Bankers Association. The note will mature on January 31, 2005, unless extended. The balance outstanding at June 30, 2004 is \$30,000,000.

In October 2003, the Foundation obtained a 15-year revolving master borrowing line with a financial institution for \$30,000,000. This line is used for operating expenses. The effective interest rate on the line is LIBOR plus .10 percent as established on the first business day of each month by the British Bankers Association. The note will mature on June 30, 2005, unless extended. The balance outstanding at June 30, 2004 is \$30,000,000.

