

**THE COUNCIL for TOBACCO RESEARCH -
U.S.A., INC.**

FINANCIAL STATEMENTS

For the year ended October 31, 1997

Report of Independent Accountants

The Board of Directors of
The Council for Tobacco Research - U.S.A., Inc.
New York, New York:

We have audited the accompanying statement of financial position of THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC. (the "Council") as of October 31, 1997, and the related statements of activities and cash flows for the year then ended. These financial statements are the responsibility of the Council's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Council at October 31, 1997 and the changes in its net assets and the cash flows for the year then ended, in conformity with generally accepted accounting principles.



New York, New York
November 21, 1997.

THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC.

Statement of Financial Position

October 31, 1997

| ASSETS: | |
|--|----------------------------|
| Cash and cash equivalents | \$ 1,420,762 |
| Dues receivable | <u>18,698,164</u> |
| Total assets | <u><u>\$20,118,926</u></u> |
| LIABILITIES: | |
| Accounts payable and accrued expenses | \$ 3,710,956 |
| Unexpended appropriations for authorized grants and contracts (Note 5) | 13,878,043 |
| Postretirement benefits other than pensions | <u>152,000</u> |
| Total liabilities | 17,740,999 |
| Unrestricted net assets | <u>2,377,927</u> |
| Total liabilities and net assets | <u><u>\$20,118,926</u></u> |

The accompanying notes are an integral part of these financial statements.

THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC.

Statement of Activities

For the year ended October 31, 1997

Income:

| | |
|---|------------------|
| Dues from members for current year (Note 3) | \$ 45,852,000 |
| Less, Decrease in dues assessed for 1996 | <u>(245,496)</u> |
| | 45,606,504 |

| | |
|----------|---------------|
| Interest | <u>49,015</u> |
|----------|---------------|

Total income \$ 45,655,519

Expenses:

| | |
|--|-----------------|
| Appropriations for authorized research grants and contracts (Note 5) | 19,864,742 |
| Less, Refunds of grants previously appropriated and paid | <u>(65,879)</u> |
| | 19,798,863 |

General, administrative and other operating expenses:

| | |
|--|-------------------|
| Salary, Chairman | 341,667 |
| Salary, Secretary | 82,167 |
| Expenses, Chairman | 62,371 |
| Salaries, Scientific Director and assistants | 447,250 |
| Expenses, Scientific Director and assistants | 48,400 |
| Per diem allowances and expenses related to activities of Scientific Advisory Board | 371,012 |
| Retirement plan contributions (Note 2) | 128,067 |
| Postretirement benefits | 151,964 |
| Research and analysis | 29,277 |
| Printing, booklets, reprints, subscriptions and miscellaneous publications | 108,178 |
| Administrative salaries and other services | 169,867 |
| Rent and maintenance (Note 7) | 313,340 |
| Professional fees | 21,204,910 |
| Insurance, group health and other | 166,913 |
| Telephone | 11,216 |
| Payroll taxes | 54,211 |
| Postage, express and messenger service | 10,526 |
| Stationery and office supplies | 2,993 |
| Bank service charges | 19,896 |
| | <u>23,724,225</u> |

Total expenses 43,523,088

Change in net assets 2,132,431

Unrestricted net assets, October 31, 1996 245,496

Unrestricted net assets, October 31, 1997 \$ 2,377,927

The accompanying notes are an integral part of these financial statements.

THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC.

Statement of Cash Flows

For the year ended October 31, 1997

| | |
|--|----------------------------|
| Cash flows from operating activities: | |
| Change in net assets | \$ 2,132,431 |
| Adjustments to reconcile change in net assets to net cash used by operating activities: | |
| Increase in dues receivable | (3,585,881) |
| Increase in accounts payable and accrued expenses | 1,346,036 |
| Decrease in unexpended appropriations for authorized grants and contracts | (454,495) |
| Increase in postretirement benefits other than pensions | <u>79,000</u> |
| Net cash used by operating activities | <u>(482,909)</u> |
| Net decrease in cash and cash equivalents | (482,909) |
| Cash and cash equivalents at the beginning of the year | <u>1,903,671</u> |
| Cash and cash equivalents at the end of the year | <u><u>\$ 1,420,762</u></u> |

The accompanying notes are an integral part of these financial statements.

THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC.

Notes to Financial Statements

1. Organization and Policy

The Council is the sponsoring agency of a program of research into questions of tobacco use and health. The Council is the outgrowth of an organization initiated in 1954 by tobacco manufacturers, growers and warehousemen. Research support has been primarily through a program of grants-in-aid, supplemented by contracts for research with institutions and laboratories as well as co-sponsorship of various conferences and meetings. The Council itself does not operate any research facilities.

The Scientific Advisory Board to the Council, a group of distinguished leaders in various fields of biomedical research, meets regularly to evaluate applications for research support. These applications are judged on the basis of scientific merit, topical importance, innovative ideas or methodology, and relevance.

The Council awards research grants to independent scientists who are assured complete scientific freedom in conducting their investigations. Grants are administered by the institution with which the grantee is affiliated. Grantees alone are responsible for reporting their findings in the accepted scientific manner through medical and scientific journals and societies. Publication of research results is encouraged in all instances.

2. Summary of Significant Accounting Policies

The significant accounting policies of the Council are summarized below:

- Assets and liabilities, and income and expenses are recognized on the accrual basis of accounting.
- The Council has a defined contribution retirement plan for the benefit of employees, to which employees may contribute. The plan provides for the payment of benefits to all employees (as defined), generally commencing at age 65, with 100% vesting after seven years of service. The Council makes contributions on behalf of each employee equal to 15% of the employee's annual salary. Total pension expense for the year ended October 31, 1997 amounted to \$128,067.
- Financial instruments which potentially subject the Council to concentrations of credit risk consist of cash and dues receivable. The Council's cash is deposited with a single, high-quality financial institution. The Council's dues receivable are payable by major cigarette-manufacturers. Management does not believe significant credit risk exists at October 31, 1997.

THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC.

Notes to Financial Statements, Continued

- The preparation of financial statements in conformity with generally accepted accounting principles requires management 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 the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.
- For purposes of the statement of cash flows, the Council considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents. No such investments were held during fiscal 1997.

3. Dues Assessed

The Board of Directors approved an increase in the dues assessed against the cigarette-manufacturing corporate members for the year ended October 31, 1997 in order to accommodate the increased budget for the year. Such amount has been decreased by the net asset surplus applicable to the year ended October 31, 1996.

4. Functional Expense Allocation

The costs of providing research grants and other activities have been summarized on a functional basis. Accordingly, certain costs have been allocated among research grant administration and general administration.

| | |
|-------------------------------|---------------------|
| Research grants | \$19,798,864 |
| Research grant administration | 1,549,442 |
| General administration | <u>22,174,782</u> |
| | <u>\$43,523,088</u> |

5. Unexpended Appropriations for Authorized Grants and Contracts

The change in unexpended appropriations for authorized grants and contracts since October 31, 1996 is as follows:

| | |
|---|----------------------|
| Balance, October 31, 1996 | \$ 14,332,538 |
| Appropriations for authorized research grants and contracts | <u>19,864,742</u> |
| | 34,197,280 |
| Payments, net | <u>20,319,237</u> |
| Balance, October 31, 1997 | <u>\$ 13,878,043</u> |

Continued

THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC.

Notes to Financial Statements, Continued

6. Postretirement Health Benefits

The Council provides certain health care benefits for active and retired employees. These benefits are provided through an insurance company whose premiums are based on the benefits paid during the year.

As of November 1, 1995, the Council adopted Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions" ("SFAS 106"). The Council has elected to use the prospective transition approach and is amortizing the transition obligation of \$694,000 over a twenty-year period.

The following sets forth the plan's funded status reconciled with amounts reported in the Council's balance sheet as of October 31, 1997:

| | |
|---|---------------------|
| Accumulated postretirement benefit obligation (APBO): | |
| Retirees and dependents | \$ (516,000) |
| Actives fully eligible for benefits | (319,000) |
| Actives not yet fully eligible | <u>(200,000)</u> |
| Total APBO | (1,035,000) |
| Plan assets at fair value | <u>0</u> |
| APBO in excess of plan assets | (1,035,000) |
| Unrecognized net (gain) loss | 259,000 |
| Unrecognized transition obligation | <u>624,000</u> |
| (Accrued)/prepaid postretirement health benefit cost | <u>\$ (152,000)</u> |

Net periodic postretirement benefit cost for fiscal 1997 was calculated using a discount rate of 7.5% and included the following components:

| | |
|---|-------------------|
| Service cost - benefits attributed to service during the period | \$ 19,000 |
| Interest cost on accumulated postretirement benefit obligation | 61,000 |
| Amortization of transition obligation | <u>39,000</u> |
| Net periodic postretirement benefit cost | <u>\$ 119,000</u> |

A 9.0% annual rate of increase in the per capita costs of covered health care benefits was assumed for fiscal 1997, decreasing by 0.5% each year to 5.0% in fiscal 2006 and remaining level thereafter. Increasing the assumed health care cost trend rates by one percentage point in each year would increase the APBO as of October 31, 1997 by approximately \$119,000 and increase the aggregate of the service cost and interest cost components of net periodic postretirement benefit cost for fiscal 1996 by approximately \$12,000. A discount rate of 7.25% was used to determine the APBO at October 31, 1997.

THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC.

Notes to Financial Statements, Continued

7. Lease Commitments

Under the terms of the lease agreement for office space expiring December 31, 2002, the Council is obligated for the payment of annual base rent plus escalation charges. Rent expense amounted to \$313,340 for fiscal 1997. Minimum lease payments under this noncancelable lease are as follows:

| <u>Years</u> | <u>Amounts</u> |
|--------------|---------------------|
| 1998 | \$ 282,975 |
| 1999 | 297,267 |
| 2000 | 300,125 |
| 2001 | 300,125 |
| 2002 | 300,125 |
| Thereafter | 50,021 |
| Total | <u>\$ 1,530,638</u> |

8. Contingent Liabilities

Litigation

The Council, together with cigarette manufacturers and others, is a defendant in numerous actions brought by individual plaintiffs (exclusive of the actions brought as class actions, as described below). In some of these cases, plaintiffs allege that one or more of them (or a decedent represented by one or more of them) was injured because such persons contracted one or more diseases as a result of smoking cigarettes; plaintiffs in other cases allege that they or their decedents were injured as a result of exposure to environmental tobacco smoke. In most of these actions, plaintiffs assert that the Council negligently and fraudulently misrepresented and/or concealed information regarding the hazards of tobacco and the addictive nature of nicotine. In each of these pending cases, plaintiffs seek compensatory and punitive damages, in some cases in unspecified amounts and in other cases in very substantial amounts that are specified.

The Council, together with cigarette manufacturers and others, is a defendant in various cases brought as class actions in which plaintiffs allege various causes of action against the Council and seek various forms of relief. Classes have been certified in a number of these cases, although the courts have refused to certify classes in a number of others. Relief sought includes compensatory and punitive damages.

The Council, together with cigarette manufacturers and others, is a defendant in pending actions brought by the Attorneys General (or other officials or agencies) of certain states. Plaintiffs in these actions seek various forms of relief, including money damages (including recovery of amounts allegedly spent by the States for medical expenses of persons who smoked cigarettes, and payment of future such expenses on an ongoing basis), together with treble damages and punitive damages, injunctive relief (including the funding of smoking cessation

THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC.

Notes to Financial Statements, Continued

programs and public education programs, injunctions against certain marketing practices and the marketing of cigarettes to minors, the provision of nicotine replacement therapy, the funding of agricultural programs for non-tobacco crops, and disclosures about the nature and effects of tobacco), disgorgement of profits from the sale of cigarettes, and restitution of amounts allegedly spent by plaintiffs because of defendants' unlawful conduct. In addition, plaintiffs in a number of these actions also seek the dissolution of the Council or the divestiture by the Council's members of their sponsorship, and membership of the Council

The Council, together with cigarette manufacturers and others, is a defendant in three pending actions in one state brought as "private attorney general" actions seeking to enjoin certain alleged unlawful business practices under that State's Business and Professions Code. Relief sought includes a variety of injunctive relief, such as corrective advertising and smoking cessation programs, as well as disgorgement and restitution. The Council, together with the cigarette manufacturers and others, is also a defendant in a fourth action brought by the taxpayers as "private attorneys general" in one state in which the plaintiff seeks relief similar to that sought in the actions brought by the Attorneys General of certain states described in the paragraph above.

The Council, together with cigarette manufacturers and others, is a defendant in two actions brought by an asbestos company. In both actions the plaintiff alleges that the personal injuries of persons who brought claims against it, and other asbestos companies, were contributed to or caused by smoking, and it seeks contribution and/or indemnity from the Council for an unidentified portion of the amounts paid to such claimants in judgments or settlements. The plaintiff asserts claims against the Council based on negligence, strict liability and fraud.

The Council, together with cigarette manufacturers and others, is a defendant in two actions brought by Native American tribes. Since the year end, these two actions have been dismissed.

The Council, together with cigarette manufacturers and others, is a defendant in one pending action and one threatened action in foreign courts. In one action the plaintiff has brought an action in which it seeks to recover amounts expended for health care costs of persons who allegedly have incurred diseases as a result of smoking. In the other action the Council has received a letter of intent to commence an action against the Council, along with the cigarette manufacturers and others, based on the allegation that the plaintiff was injured as a result of his smoking and his exposure to environmental tobacco smoke.

The Council intends to contest the pending litigation vigorously. The Council and its attorneys cannot predict the outcome of the litigation at this time.

THE COUNCIL for TOBACCO RESEARCH - U.S.A., INC.

Notes to Financial Statements, Continued

Proposed Tobacco Settlement Agreement

On June 20, 1997 a Memorandum of Understanding was signed by the Attorneys General of several states and the tobacco companies which sponsor the Council finalizing a proposed "Tobacco Settlement Agreement". This agreement makes recommendation to the Congress of the United States for legislation which would prescribe the conditions of a settlement of various legal actions against the tobacco industry. Included in this recommendation is a provision that the Council will be dissolved. At present it is not clear whether such legislation will be effected, or what its provisions will be if it is effected, and it is therefore uncertain whether the Council will be dissolved.

However, in the spirit of the agreement, in good faith, and with prudent reflection, the Council has decided to suspend further granting activities. Accordingly no new grants are being awarded for biomedical research at this time. On the other hand, the Council has made commitments and obligations to fund grants that extend into the future nearly three years. It is the Council's intention to honor these obligations and commitments, and it is the Council's understanding that it will be permitted under the existing laws of the United States and The State of New York to meet its existing commitments.

Other Commitments

Commitments of the Council include not only the grants outstanding, but also certain commitments with respect to certain benefits of its employees. These obligations must be met over a number of years into the future, and it is the Council's intention to take appropriate measures to see to it that these obligations are met.

9. Taxation

The Council is a nonprofit organization exempt from Federal income taxes under Section 501(c)(6) of the Internal Revenue Code.