

Exhibit 04-7D, Addendum

**DISCUSSION AND ILLUSTRATION OF A FUNDAMENTAL DIFFERENCE
BETWEEN CASH FLOW AND FAIR VALUE APPROACHES**

Introduction

This Exhibit highlights a fact that the FASB staff believes will assist the Task Force in confirming its understanding of one of the fundamental differences, as the staff understands it, between the cash flow approach and the fair value approach. As described in paragraph 28 of the Issue Summary Supplement, the staff believes that probabilities assigned and cash flows projected for purposes of preparing an expected loss and expected residual return calculation would be the same under both the fair value and the cash flow approaches, with the *only* difference being the discount rate used to compute the present value of the expected cash flows and, in turn, variability. Some simple calculations follow to illustrate these concepts.

Background

The terms "expected losses" and "expected residual returns" are defined in paragraph 2(b) of FIN 46R as amounts derived from expected cash flows as described in CON 7. The paragraph goes on to clarify that such calculations refer to amounts discounted and otherwise adjusted for market factors and assumptions rather than undiscounted cash flows. Appendix A of FIN 46R provides an illustration of an expected loss and expected residual returns calculation. In the most basic sense, the CON 7 approach to estimating fair value involves the following steps:

- (1) Projecting multiple cash flow scenarios
- (2) Assigning a probability as to the occurrence of each scenario
- (3) Discounting the future estimated cash flows at a risk free rate to obtain an expected probability-weighted present value for each scenario
- (4) Taking the sum of the present value of each probability weighted scenario.

As illustrated in paragraph 46 of CON 7, the risk free rate used to discount the estimated future cash flows varies based on the time horizon of the cash flow. In other words, all cash flows expected to be received at the end of Year 1 are discounted at the then current 1-year risk free rate, while all cash flows expected to be received at the end of Year 2 are discounted at the then current 2-year risk free rate, and so forth. This implies a constant yield curve.

Cash Flow Approach (Issue 1, View B)

Proponents of the cash flow approach believe FIN 46R requires the use of a strict interpretation of CON 7 and discount the cash flows in the expected loss and expected residual returns calculation using a fixed set of risk free rates, equating to a constant yield curve. Under the cash flow approach, a VIE that holds only a fixed-rate U.S. Treasury security will *never* have expected losses because there is only one cash flow scenario (that is, earning the risk free rate). Discounting estimated cash flows derived from the risk free rate to the present using the same

risk free rate will, by definition, yield no variability, as illustrated in the following numerical calculation:

Example B1– Cash Flow Approach/Fixed Rate U.S. Treasury Security

Facts: One-year \$1,000 U.S. Treasury security (fair value equals current face amount) will pay interest and principal at the end of Year 1 based on a fixed 2.4 percent rate of interest. The underlying risk free rate is estimated to vary based on the following probabilities:

<u>Scenario</u>	Risk Free	<u>Probability</u>
	<u>Rate</u>	
1	1%	20%
2	2	30
3	3	40
4	4	10

An expected loss calculation can be shown as follows:

<u>Scenario</u>	Risk Free <u>Rate</u>	Estimated <u>Cash Flows</u>	Disc. <u>Rate</u>	PV of Est. <u>Cash Flows</u> ¹	<u>Probability</u>	PV of Expected <u>Cash Flows</u>
1	1%	\$1,024	2.4%	\$1,000	20%	\$ 200
2	2	1,024	2.4	1,000	30	300
3	3	1,024	2.4	1,000	40	400
4	4	1,024	2.4	1,000	10	<u>100</u>
						\$1,000 (A)

<u>PV of Estimated Cash Flows</u>	<u>PV of Expected Cash Flows (A)</u>	<u>Diff.</u>	<u>Probability</u>	<u>Expected Losses</u>	<u>Expected Res. Returns</u>
\$1,000	\$1,000	\$ -	20%	\$ -	\$ -
1,000	1,000	-	30	-	-
1,000	1,000	-	40	-	-
1,000	1,000	-	10	-	-

¹Cash flows discounted in each scenario using a single discount rate equal to the current one-year risk free rate of 2.4 percent.

Likewise, under the cash flow approach, a VIE that holds only a variable rate U.S. Treasury security will *always* have expected losses and expected residual returns because there are multiple cash flow scenarios. Discounting estimated cash flows derived from various estimates of the future risk free rate to the present using a constant risk free rate will yield variability, as illustrated in the following numerical calculation:

Example B2– Cash Flow Approach/Variable Rate U.S. Treasury Security

Facts: One-year \$1,000 U.S. Treasury security will pay interest and principal at the end of Year 1 based on a variable rate of interest with the following probabilities:

<u>Scenario</u>	<u>Earned</u>	
	<u>Rate</u>	<u>Probability</u>
1	1%	20%
2	2	30
3	3	40
4	4	10

An expected loss calculation can be shown as follows:

<u>Scenario</u>	<u>Earned Rate</u>	<u>Estimated Cash Flows</u>	<u>Disc. Rate</u>	<u>PV of Est. Cash Flows¹</u>	<u>Probability</u>	<u>PV of Expected Cash Flows</u>
1	1%	\$1,010	2.4%	\$ 986	20%	\$ 197
2	2	1,020	2.4	996	30	299
3	3	1,030	2.4	1,006	40	402
4	4	1,040	2.4	1,016	10	102
						<u>\$1,000 (A)</u>

<u>PV of Estimated Cash Flows</u>	<u>PV of Expected Cash Flows (A)</u>	<u>Diff.</u>	<u>Probability</u>	<u>Expected Losses</u>	<u>Expected Res. Returns</u>
\$ 986	\$1,000	\$ (14)	20%	\$ 2.8	\$ -
996	1,000	(4)	30	1.2	-
1,006	1,000	6	40	-	(2.4)
1,016	1,000	16	10	-	(1.6)
				<u>\$ 4.0</u>	<u>\$ (4.0)</u>

¹Cash flows discounted in each scenario using a single discount rate equal to the current one-year risk free rate of 2.4 percent.

Fair Value Approach (Issue 1, View A)

Proponents of the fair flow approach focus on the *fair value* of the cash flows received and do not believe that FIN 46R restricts the use of different discount rates for each scenario. In fact, to View A proponents, it seems intuitive to vary the risk free rate used to discount estimated cash flows that vary directly with that same risk free rate. Under the fair value approach, variability is caused by changes in *fair value*. Therefore, a VIE that holds only a variable rate U.S. Treasury security will *never* have expected losses or expected residual returns because the *fair value* of those variable cash flows is always constant (that is, never changes), as it is always at market rates. In this case, each cash flow scenario results from a different estimate of future risk free rates of return. By definition, discounting estimated cash flows using those same risk free rates will yield no variability, as illustrated in the following numerical calculation:

Example A1 – Fair Value Approach/Variable Rate U.S. Treasury Security

Facts: One-year \$1,000 U.S. Treasury security will pay interest and principal at the end of Year 1 based on a variable rate of interest with the following probabilities:

<u>Scenario</u>	<u>Earned</u>	
	<u>Rate</u>	<u>Probability</u>
1	1%	20%
2	2	30
3	3	40
4	4	10

An expected loss calculation can be shown as follows:

<u>Scenario</u>	<u>Earned Rate</u>	<u>Estimated Cash Flows</u>	<u>Disc. Rate</u>	<u>PV of Est. Cash Flows¹</u>	<u>Probability</u>	<u>PV of Expected Cash Flows</u>
1	1%	\$1,010	1%	\$1,000	20%	\$ 200
2	2	1,020	2	1,000	30	300
3	3	1,030	3	1,000	40	400
4	4	1,040	4	1,000	10	100
						<u>1,000 (A)</u>

<u>PV of Estimated Cash Flows</u>	<u>PV of Expected Cash Flows (A)</u>	<u>Diff.</u>	<u>Probability</u>	<u>Expected Losses</u>	<u>Expected Res. Returns</u>
\$1,000	\$1,000	\$ -	20%	\$ -	\$ -
1,000	1,000	-	30	-	-
1,000	1,000	-	40	-	-
1,000	1,000	-	10	-	-

¹Cash flows discounted in each scenario using a discount rate equal to the corresponding one-year risk free rate earned under that scenario.

Under the fair value approach, a VIE that holds only a fixed rate U.S. Treasury security will *always* have expected losses or expected residual returns because the *fair value* of those fixed cash flows changes as underlying market rates change (that is, the fixed cash flows will be worth more or less as market interest rates change). Discounting estimated cash flows that are fixed using various risk free rates will yield variability, as illustrated in the following numerical calculation:

Example A2 – Fair Value Approach/Fixed Rate U.S. Treasury Security

Facts: One-year \$1,000 U.S. Treasury security (fair value equals current face amount) will pay interest and principal at the end of Year 1 based on a fixed 2.4 percent rate of interest. The underlying risk free rate is estimated to vary based on the following probabilities:

<u>Scenario</u>	<u>Risk Free Rate</u>	<u>Probability</u>
1	1%	20%
2	2	30
3	3	40
4	4	10

An expected loss calculation can be shown as follows:

<u>Scenario</u>	<u>Risk Free Rate</u>	<u>Estimated Cash Flows</u>	<u>Disc. Rate</u>	<u>PV of Est. Cash Flows¹</u>	<u>Probability</u>	<u>PV of Expected Cash Flows</u>
1	1%	\$1,024	1%	\$1,014	20%	\$ 203
2	2	1,024	2	1,004	30	301
3	3	1,024	3	994	40	398
4	4	1,024	4	985	10	98
						<u>\$1,000 (A)</u>

<u>PV of Estimated Cash Flows</u>	<u>PV of Expected Cash Flows (A)</u>	<u>Diff.</u>	<u>Probability</u>	<u>Expected Losses</u>	<u>Expected Res. Returns</u>
\$1,014	\$1,000	\$ 14	20%	\$ -	\$ 2.8
1,004	1,000	4	30	-	1.1
994	1,000	(6)	40	(2.4)	-
985	1,000	(15)	10	<u>(1.5)</u>	<u>-</u>
				<u>\$ (3.9)</u>	<u>\$ 3.9</u>

¹Cash flows discounted in each scenario using a discount rate equal to the corresponding one-year risk free rate that could have been earned under that scenario in lieu of the fixed rate actually earned.

Combination Approach (View C)

Proponents of the combination approach believe that both fair value and cash flow variability are relevant and, as such, a VIE that is holding either a fixed rate U.S. Treasury security or a variable rate U.S. Treasury security will have expected losses and expected residual returns. In other words, proponents of the combination approach apply the CON 7 model to calculate expected losses and expected residual returns by applying (1) a constant set of risk free discount rates to estimated cash flows that give rise to cash flow variability and (2) multiple discount rates to estimated cash flows that give rise to fair value variability. Proponents of the combination approach calculate expected losses and expected residual returns for cash flow variability and

fair value variability in the same manner as illustrated in the foregoing example for View A and View B independently.

Summary

The table below summarizes the outcome of the above calculations, which are consistent with Views A, B, and C for Issue 1 of this Issue Summary Supplement.

	Cash Flow Approach (B)	Fair Value Approach (A)	Combination Approach (C)
<u>Asset Held By the VIE</u>	Constant Set of Risk Free <u>Discount Rates</u>	Different Sets of Risk Free Discount Rates for Each CF Scenario	Constant or Varying Risk Free Rate Based on the Risk
Fixed Rate Treasury	No Expected Losses	Expected Losses	Expected Losses
Variable Rate Treasury	Expected Losses	No Expected Losses	Expected Losses