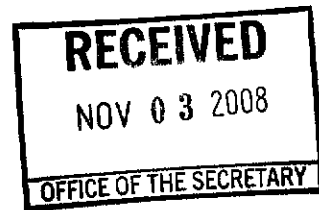


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Nancy M. Morris, Secretary  
SEC  
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File Number S7-20-07

second submission

Morning notes comments from JP Morgan are attached.

A unilateral decision.

Reached without due process.

Possibility of more changes by month end {October}  
suggested.

Coming on top of the problems I previously found in the  
SEC Concept Release this should be the death knell.  
Mirabile dictu, if US companies were on this standard our  
banks, brokerages, insurance companies would not have such  
massive losses and writeoffs.

*David Norr*

J.P.Morgan

Europe Equity Research  
16 October 2008

## EU Accounting Decision

### Credibility of European Accounting at Stake

- \* The European Union today endorsed the amended version of IAS 39 issued on Monday by the IASB. The European Commission's Accounting Regulatory Committee voted unanimously in favour of endorsement. However, the Commission has proposed there should be further amendments to IAS 39 by the end of October, and we believe the threat of a possible EU carve-out of parts of IAS 39 remains. In our view, investors should be very concerned. We believe that the EU proposals for further changes to IAS 39 would be unworkable, would reduce the quality of companies' financial reports, and there are would be very damaging for investor confidence.
- \* We were disappointed at the IASB's decision on Monday to amend IAS 39 to permit certain reclassifications of financial instruments, without following the normal due process (see our note *Lowering Standards*). Accounting standards must be set by independent standard-setters, not by politicians, we believe. Nevertheless, EU endorsement was essential.
- \* We understand that the EU authorities considered carving out certain words from paragraph 50 of IAS 39. This carve out would permit companies to reclassify any financial instruments currently measured at fair value out of this category, without any restrictions. It is unclear how such a carve out would work, for example whether the EU would provide guidance on the valuation when reclassified or would require appropriate disclosure about such instruments.
- \* The Commission has now identified further concerns with IAS 39, such as the "fair value option", the treatment of instruments containing embedded derivatives, and impairment rules. It plans to consult with stakeholders, at a meeting in Brussels on 21 October. Unfortunately, it seems that investors' interests have largely been overlooked in the deliberations to date.
- \* We also believe that the developments of the last week have been a setback for convergence of US GAAP and IFRS. Any further political intervention in standard setting could undermine, perhaps fatally, the goal of a single set of high quality accounting standards used worldwide.

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**See page 4 for analyst certification and important disclosures, including non-US analyst disclosures.**

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Although the EU decided today (15 October) to endorse the amended version of IAS 39, the risk of further political influence over the standard-setting process is not yet entirely removed, in our view. We believe that accounting standards should be set by an independent standard-setting body and so this political influence should be a matter of urgent concern to investors.

## EU Endorsement

EU listed companies are required to apply IFRSs as adopted by the European Union. The endorsement process gives the EU the power to reject specific IFRS standards or parts of standards, although it cannot (at present) issue additional material. So far, all of the standards issued by the IASB have been endorsed by the European Union, except for a limited carve out of parts of IAS 39 affecting some banks. The IASB is an independent body responsible for developing a single set of high quality accounting standards, which are used by companies in over 100 countries.

The IASB issued an amended IAS 39 on Monday. It also amended IFRS 7, covering associated disclosures. The previous version of IAS 39 did not permit financial instruments measured at fair value through profit or loss to be reclassified to a different accounting basis, but the amended version permits such reclassifications in limited circumstances (See our note *Lowering Standards*<sup>1</sup> for details). We believe the IASB amended IAS 39 due to political pressure from the EU, not because the Board members believed it to be an improvement.

The European Commission's Accounting Regulatory Committee today voted unanimously to endorse the amended IAS 39 which was issued by the IASB on Monday. This was followed by endorsement by the European Parliament, leading to the Commission formally adopting the Regulation amending IAS 39. However, the Commission issued a press release which leaves open the possibility of further action. It states that "The Commission will continue to work closely with all stakeholders and will organize a meeting within the next few days to consider other possible issues under IAS 39 and IFRS 7...The Commission will propose further amendments to IAS 39 and IFRS 7 by the end of October."

A meeting with stakeholders will take place next Tuesday (21 October) and afterwards the Commission may present the IASB with suggestions for potential improvements to IAS 39. If the IASB makes any further significant changes to IAS 39 in the near term as a result of EU pressure, it will lose its credibility as an independent standard-setter, in our view. We do not expect this to happen. However, if the IASB refuses EU requests for further changes, then the EU may still take action, for example in the form of a carve out.

## What Next?

As discussed in previous research, there have been many proposals to amend accounting for financial instruments during the credit crisis. The IASB responded by

<sup>1</sup> *Lowering Standards: IASB decision on fair value*, dated 13 October 2008.

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permitting transfers of financial instruments out of the fair value through P&L category in some circumstances.

The Commission has raised further concerns such as the fair value option, embedded derivatives, and impairment calculations. The recent IAS 39 amendment permits companies to reclassify previously held for trading assets (other than derivatives) out of the fair value through P&L category but does not permit transfers of assets which the company had elected to measure at fair value (using the fair value option). This is consistent with US GAAP, which also permits rare reclassifications out of the trading category but does not permit reclassifications of assets for which the company elected fair value treatment.

If the EU carved out IAS 39 paragraph 5), then any reclassifications out of the fair value through P&L category would be permitted. It is unclear how carving out this paragraph would work, for example whether the EU would provide guidance on the valuation of such transfers (or subsequent measurement, eg of derivatives), or would require appropriate disclosure of the fair value of such instruments and other information which would be essential for investors.

We expect that various further amendments to IAS 39 will be proposed by some parties in the stakeholder consultation, such as changes to impairment calculations, changes to fair value calculations, or more flexibility in permitting reclassifications out of the held to maturity category. Most of these proposals are intended to permit greater deferral of loss recognition and thus help maintain reported regulatory capital, or otherwise permit greater earnings management. Such changes, if made, would reduce consistency, comparability and transparency of financial statements, in our view. It seems obvious to us this would reduce investor confidence. We do not think it is exaggerating to say that the credibility of European accounting is at stake.

We also believe that the developments of the last week have been a set back for convergence of US GAAP and IFRS. Any further political intervention in standard setting could undermine, perhaps fatally, the goal of a single set of high quality accounting standards used worldwide.