

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

## Brazil

### ACCOUNTING AND AUDITING

June 20, 2005

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#### Executive Summary

This report provides an assessment of accounting, financial reporting and auditing practices within the corporate sector in Brazil, using International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks, and drawing on international experience and good practices in those fields. The main objective of this ROSC assessment is to assist the Government in strengthening private sector accounting and auditing practices, and in enhancing financial transparency in Brazil's corporate sector. The development objectives these efforts address are improving the investment climate, fostering competitiveness and furthering regional and international economic integration.

Brazil is the largest economy in South America, with an estimated 187 million inhabitants and US\$ 1,067 billion of GDP in 2006. To increase investments in infrastructure, it seeks to reduce its cost of doing business and to improve enterprises' access to long term financing. Banks and, more recently, the capital market are the main source of financing for the private sector. Brazil has one of the most dynamic securities markets in Latin America, with almost 400 domestic companies listed on the Sao Paulo stock exchange; 37 of these are also listed in the US. Brazil's strategy to boost the development of its private sector will benefit from the further development of the stock market, which requires Brazilian corporations' financial reporting to meet the highest international standards. The principal findings of this ROSC are summarized hereafter.

1. Many accounting standards and financial reporting rules are codified in the Corporations Law of 1976 (amended 1997 and 2001). As a result, significant changes to the accounting and reporting framework would require that the law be amended. The problem with this is that the legislative process in Brazil can be lengthy and cumbersome, particularly when controversial issues are at stake. Hence, since 2000 it has been difficult to incorporate new accounting concepts reflecting increasingly complex business transactions.

⇒ *Recommendation: Amend the Corporations Law to remove detailed accounting standards and financial reporting rules, which should be set forth by sub-legislative acts (i.e., regulations, and instructions).*

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This report was prepared by a World Bank team on the basis of the findings from a diagnostic review carried out in Brasilia, Rio de Janeiro and São Paulo in February and April 2005. The task team was led by Henri Fortin (LCSFM) who was assisted by Ana Cristina Hirata Barros (ECSPS) and consultants Hirashima & Associados. Jamil Sopher (LCSFM) provided assistance with regard to quality review. The task team also received the support of the World Bank Group Units in Brasilia, São Paulo and Washington. The review was conducted in parallel with a Corporate Governance ROSC, through a participatory process involving various stakeholders and led by the Ministry of Finance and coordinated by the Securities Commission (CVM). This ROSC assessment was cleared for publication by the Ministry of Finance on September 25, 2007.

## Executive Summary (continued)

2. Many institutions are charged with issuing accounting standards, financial reporting rules and auditing requirements, which results in inefficiencies. Regulators of the securities market, the banking, insurance, pension funds and the electric energy sectors, as well as the two associations of accounting professionals, all issue accounting and reporting standards.

⇒ *Establish an independent standard-setter with required authority to issue pronouncements for all general-purpose, corporate sector financial statements. Current standard-setters, as well as representative bodies of the financial, business and academic communities, would be closely associated to the standard-setting process.*<sup>1</sup>

3. There are significant gaps between Brazil's GAAP<sup>2</sup> and IFRS: finance leases are not recorded as such in the financial statements; a cash flow statement is not required; etc. Taken as a whole, these gaps are detrimental to the quality of Brazilian companies' financial statements especially in the views of international investors

⇒ *Amend the Corporations Law and other relevant legislation in order to allow for full alignment between Brazilian standards and IFRS.*

4. Regarding Brazilian auditing standards, gaps with ISA are mostly nominal. On the contrary, the Federal Accounting Council's ethics code is significantly weaker than IFAC's.

⇒ *Adopt ISA in full, which should not pose any difficulty considering the high level of alignment that already exists;*

⇒ *Adopt IFAC's Code of Ethics for Professional Accountants.*

5. The audit practice in Brazil has undergone several recent improvements including (i) mandatory continuing professional education, (ii) a quality assurance system based on peer reviews, and (iii) an examination of minimum professional qualification. However, these mechanisms still fall short of international good practice especially due to the self-regulation arrangements under which they are implemented. On the securities market and in the financial sector, statutory auditors are subject to relatively stringent independence rules, including compulsory audit firm rotation and prohibition of a range of services to audit clients. These rules were established before the improvements noted above. Although strong regulation is required on matters of auditor independence, a mostly rules-based approach tends to place undue constraint on companies' ability to procure accounting and audited-related services.

⇒ *The Authorities should consider establishing a public oversight body for the auditing profession to ensure that statutory auditors in any type of company comply with their professional obligations; the oversight would include an active and formal monitoring of the quality control program managed by the national accounting professional body (CFC).*

⇒ *Review existing regulations regarding auditors to incorporate the recent improvements introduced within the profession.*

6. Enforcement of accounting standards is also scattered across many institutions, which results in inefficiencies. Regulatory agencies concerned with financial reporting should give more focus to, and strengthen, their enforcement activities. This may mean, in some cases, enacting new rules or enforcing current rules more stringently, but not always.

⇒ *Review existing regulations regarding auditors in light of the recent improvements introduced within the profession, to ensure such regulations bring actual benefits;*

⇒ *Increase regulatory agencies' enforcement capacity with respect to financial reporting;*

⇒ *Establish a single accounting standard-setter to allow regulators to focus their resources on enforcement activities.*

<sup>1</sup> While this measure would not be sufficient *per se* to align Brazilian generally accepted accounting principles (GAAP) with IFRS further, it would help streamline the standard-setting process and thus facilitate the convergence with international standards.

<sup>2</sup> This report uses the term Brazilian GAAP to refer to the full set of Brazilian accounting standards even though, given the multiplicity of sources, some standards may conflict and would therefore not necessarily be "generally accepted."

## Executive Summary (continued)

7. Not all public interest entities are required to follow high-quality accounting standards or be subject to a statutory audit or publication requirement. While financial institutions, listed companies and insurance companies are required to follow more stringent accounting, auditing and reporting rules, several of Brazil's largest companies do not.

⇒ *Mandate the use of IFRS by all public interest entities (PIEs<sup>3</sup>) for the publication of their consolidated financial statements. This requirement could be introduced through regulations by CVM, the Central Bank and other agencies in their respective domain;*

⇒ *These IFRS statements should be audited.*

8. S/As are required to establish in certain circumstances an independent body called *conselho fiscal* with wide ranging supervisory and audit functions. Except for those companies listed on US stock markets, the contribution of *conselhos fiscais* to the oversight of the company's financial reporting process is generally limited and these *conselhos* cannot be construed as an audit committee. Audit committees are only required for larger banks and insurance companies.

⇒ *Clarify and strengthen the function of the conselho fiscal so that its role be aligned with that of an audit committee as internationally defined; this would require changes in the law.*

9. A draft Law has been under discussion for several years by the Congress. According to the latest available public documents, it would introduce wide ranging changes to Brazil's corporate financial regime including in various matters discussed above. The proposed improvements would support the Government's objectives of enhanced private sector development and increased investment.

The recommendations of this ROSC pursue the following five main objectives:

- A) ***Adapting the legal framework to current needs*** – The constraints posed by the Corporations Law in its current form are such that any attempt at improving the accounting practice in Brazil would have limited results without certain amendments to the law.
- B) ***Simplifying the accounting standard-setting system*** – Consolidating the current accounting standard-setting processes into one hand would clarify and simplify the body of existing standards. It would also help regulators in their efforts to enhance their enforcement activities.
- C) ***Achieving greater quality and comparability of corporate financial statements in Brazil*** – In view of the growing acceptance of IFRS both internationally and in Brazil, they should be used as the base for developing the corporate financial information in Brazil. In the proposed move toward IFRS, Brazilian authorities should consider the following steps:
  - For the preparation of consolidated financial statements in all PIEs, adopt IFRS; this could be done through regulations, since consolidation is not addressed in the Corporations Law other than in a general way;
  - For legal entity financial statements, as noted above, an amendment to the Corporations Law is necessary; in addition, existing accounting pronouncements should be adapted in a way that would close some of the main areas of discrepancy with IFRS;
  - Additionally, in improving existing Brazilian GAAP, the proposed new standard-setter should address the specific needs of SMEs.
- D) ***Improving auditors' accountability*** – The CFC should adopt IFAC's code of ethics which enjoys high international recognition. Moreover, an oversight body should be established to ensure licensed auditors meet their professional obligations and adequately discharge their public interest function.
- E) ***Developing the capacity of the accounting and audit profession*** – Professional examinations and continuing education requirements should be strengthened in line with the standards of IFAC.

<sup>3</sup> PIEs would include listed companies, banks, insurance companies, pension funds, large non-listed companies, and state-owned enterprises.

### **Executive Summary (continued)**

10. *Significant developments in Brazil's accounting and auditing environment have occurred between the completion of this ROSC and its publication. These developments include mainly (i) Central Bank's and CVM's decisions (March 2006 and July 2007, respectively) to require entities under their supervision - financial institutions and listed companies - to publish consolidated financial statements according to IFRS as from 2010 and (ii) the creation of an independent accounting standard setter ("CPC"), hosted by CFC.*

**CURRENCY: REAL (BRL)**  
1 US\$ = 2.177 BRL as of 2006

### MAIN ABBREVIATIONS AND ACRONYMS

|         |  |        |   |
|---------|--|--------|---|
| AGM     | Annual General Meeting   | ISA    | International Standards on Auditing                 |
| ANEEL   | National Electric Energy Agency                                | LALUR  | Ledger for Computing Profits According to Tax Rules |
| BCB     | Central Bank of Brazil   |        |   |
| BNDES   | National Economic and Social Development Bank                  | MD&A   | Management Discussion & Analysis                    |
| BOVESPA | São Paulo Stock Exchange                                       | MEC    | Ministry of Education                               |
| CFC/CRC | Federal / Regional Accounting Council                          | MIF    | Multilateral Investment Fund                        |
| CGPC    | Management Council of Private Welfare                          | MoF    | Ministry of Finance                                 |
| CNE     | National Education Council                                     | NBC    | Brazilian Accounting Standard                       |
| CPE     | Continuing Professional Education                              | NPA    | Auditing Standard and Practice                      |
| CRE     | CFC's External Review Commission                               | NPC    | Accounting Standard and Practice                    |
| COSIF   | Accounting Plan for Financial Institutions                     | PIE    | Public-Interest Entity                              |
| CVM     | Securities Commission  | PIOB   | Public Interest Oversight Board                     |
| DOAR    | Statement of Origins and Applications of Funds                 | PL     | Draft Law   |
| EU      | European Union   | PPA    | Multi-year Strategic Plan                           |
| FDI     | Foreign Direct Investment                                      | ROSC   | Report on the Observance of Standards and Codes     |
| GAAP    | Generally Accepted Accounting Principles                       | S/A    | Corporation   |
| GAAS    | Generally Accepted Auditing Standards                          | SME    | Small and Medium Enterprise                         |
| GDP     | Gross Domestic Product   | SOE    | State-Owned Enterprise                              |
| IAASB   | International Auditing and Assurance Standards Board           | SPC    | Secretariat of Private Welfare                      |
| IASB    | International Accounting Standards Board                       | SPE    | MoF's Secretariat of Economic Policy                |
| IBRACON | Institute of Independent Auditors                              | SRF    | Federal Revenue Department                          |
| ICA     | Investment Climate Assessment                                  | SUSEP  | Superintendency of Private Insurance                |
| IDB     | Inter-American Development Bank                                | UNCTAD | United Nations Conference on Trade and Development  |
| IES     | International Education Standards for Professional Accountants | US     | United States of America                            |
| IFAC    | International Federation of Accountants                        |        |   |
| IFRIC   | International Financial Reporting Interpretations Committee    |        |   |
| IFRS    | International Financial Reporting Standards                    |        |   |

## I. BACKGROUND

1. The review of accounting and auditing practices in Brazil is a part of the joint initiative by the World Bank and International Monetary Fund on Reports on the Observance of Standards and Codes (ROSC). The accounting and auditing module is carried out by the World Bank. It focuses on the strengths and weaknesses of the accounting and auditing environment in the corporate sector, and how these influence the quality of corporate financial reporting. International Financial Reporting Standards (IFRS)<sup>1</sup> and International Standards on Auditing (ISA)<sup>2</sup>, as well international good practices are used as benchmarks for this assessment, which covers both statutory requirements and actual practices.

2. **With an estimated 187 million inhabitants and a gross domestic product (GDP) of US\$1,067 billion at the end 2006, Brazil is by far the largest economy in South America.** Throughout the last 10 years, the Government has undertaken a series of reforms aimed at making economic growth sustainable and equitable, encompassing education, health, fiscal discipline, privatization, de-regulation, strengthening of financial systems regulations, etc. Overall, these reforms have brought significant improvements in the levels of GDP and in various social indicators. In particular, the poverty rate decreased from 36% in 1992 to 22,8% at the end of 2005. Nonetheless, Brazil still faces a number of challenges, especially poverty both in rural areas, mainly in the North and North-East regions, and in the country's large urban areas. The Government implemented several measures aimed at alleviating the sources of external vulnerability for Brazil's economy, including by reducing since 2003 foreign exchange-indexed public debt and by adapting the structure of Brazil's foreign currency reserves, which increased from US\$16 billions in 2002 to US\$161 billions in July 2007.

3. **A significant issue facing Brazil is its relatively low levels of investments in infrastructure.** Over the last 10 years, the growth in the demand for infrastructure services in transportation, water and sanitation, etc. has not been matched with corresponding investments, mostly due to budgetary constraints on the part of federal, state and municipal governments. One of the solutions the Government is pursuing in order to tackle this problem, while also maintaining fiscal discipline, is increasing public-private partnerships, mainly by developing concessions. With the approval of the new Public-Private Partnerships Law by the Congress at the end of 2004, such partnerships could be an important mechanism for funding investments in infrastructure. In any event, one of the challenges associated with this solution is a requirement for good governance on the part of both public and private sectors, including accurate financial reporting. In the beginning of 2007, the Government launched a plan to release the investment in infrastructure, the Growth Acceleration Plan – PAC. The main objectives of the Plan are: eliminate the main bottlenecks that may constrain the growth of the economy; reduce costs and increase productivity; induce an increase in private investment; and reduce the regional inequalities within Brazil. The PAC's public and private investment plan amount BRL 504 billions (approximately US\$232 billions) for the period of 2007-2010.

4. **One of Brazil's priorities for increasing its levels of private investment is to reduce the cost of doing business, which is widely perceived as too high.** Among the components of the cost of doing business in Brazil (often dubbed "*custo Brasil*"), the following two are specifically targeted by the Government and are the object of a series of implemented or proposed institutional reforms:

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<sup>1</sup> IFRS correspond to a) the pronouncements issued by the International Accounting Standards Board (IASB), b) International Accounting Standards (IAS) issued by IASB's predecessor, the International Accounting Standards Committee, and c) related official interpretations.

<sup>2</sup> ISA are issued by the International Auditing and Assurance Standards Board (IAASB) within the International Federation of Accountants (IFAC).

- Spreads applied by banks on loans to enterprises are unusually high compared to those in other large emerging economies. This makes the cost of financing prohibitive, especially for long-term loans, and impedes investment; and
- Weaknesses in the regulatory environment, a heavy tax burden, and bureaucratic barriers, which in turn tend to act as incentives for informality in the private sector.<sup>3</sup>

5. **Maintaining fiscal discipline is required to reduce the public debt.** Even though the level of public debt in Brazil has dropped significantly in the recent period, from 52.4% in 2003, thanks to primary budget surpluses,<sup>4</sup> it still accounts for almost 45% of GDP at the end of 2006. At the same time, as noted above, Brazil's complex tax system is often viewed as a factor in the relatively high level of informality in the economy. In that context, Brazil needs to improve its tax administration, so as to make revenue collection fairer, and in turn less burdensome for certain enterprises, especially the larger ones, and therefore more conducive to private sector growth. One of the ways to achieve the dual objective of fiscal discipline and fostering private sector growth would be to curtail tax evasion and loopholes which represent a significant issue in Brazil. At this moment, the Federal Government is discussing with States and Municipalities Governments and private sector a new propose of Tax Reform. The project law will be sent to the Congress in the final of the second half of 2007.

6. **Brazil's main economic partners in terms of foreign direct investment (FDI) and trade are the European Union (EU) and the United States (US).** In addition, Brazil is a member of *Mercosul*, the economic zone comprising Argentina, Paraguay and Uruguay, with Bolivia and Chile as associates. Greater regional integration is a means to achieve the objective of sustained economic growth. In this context, Brazil needs to align its business standards with those of its main partners, especially industrialized nations, including in corporate financial reporting; the trend toward such harmonization with international practice has already begun to take place in Brazil over the recent period and needs to be accelerated.

7. **Brazil's securities market ranks among the most dynamic in Latin America, with almost 400 companies listed on the São Paulo Stock Exchange (BOVESPA).**<sup>5</sup> 37 of these domestic companies are also listed in the US, mostly in the form of American Depositary Receipts. The domestic securities market is dominated by government bonds and its liquidity is relatively low compared to large markets such as those in the US or Europe. Therefore, even if it is comparatively larger than those in most other Latin American countries, the stock exchange played a relatively modest role in providing long-term financing for Brazilian enterprises. This scenario is changing and in the recent period the importance of capital market has been increased. Further developing capital markets is therefore considered a key factor to promoting the growth of the private sector in Brazil<sup>6</sup>. One of the pillars for such development is market discipline, which can only be properly exercised when financial information provided by companies meets

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<sup>3</sup> In addition to the ROSC Accounting and Auditing, the World Bank has recently conducted two parallel exercises in Brazil: the Investment Climate Assessment (ICA) and the ROSC Corporate Governance, which address issues related to private sector development and improving the climate for investment.

<sup>4</sup> I.e., before interest on debt; the primary surplus is estimated at 3.8% of GDP overall for 2007, down from 3.88 in 2006.

<sup>5</sup> Trading of Brazilian government securities takes place on the Brazilian Mercantile and Futures Exchange (*Bolsa de Mercadorias e Futuros – BM&F*).

<sup>6</sup> Considering only the public offers registered in the CVM, the resources obtained in the Brazilian capital market evaluated from US\$ 6 billions in 2003 to US\$ 57 billions in 2006. In 2007, until August, it already reached US\$ 46 billions.

the needs of investors in terms of precision, timeliness, reliability and comparability on an international scale.

8. **Brazil's banking sector is the main source of financing for the private sector.** The banking sector underwent a thorough restructuring in the 1990s, with the liquidation of over 50 banks and the privatization of over 20 others, which had been owned by the federated States. Currently, there are 165 banks operating in Brazil, which can be grouped as follows: a) domestic, some of which are the largest in the country (e.g., *Bradesco*, *Itaú* and *Unibanco*); b) local subsidiaries or branches of international banks, mainly European; and c) state-owned banks. There are also some 465 non-banking institutions including leasing companies, securities dealers, and exchange bureaus. In June of 2007, the net worth of the banking sector as a whole totaled BRL 225 billion (approximately US\$ 103 billion – source BCB).

9. **The National Economic and Social Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social* or BNDES), a state-owned institution of the Federal Government, plays a major role in providing long-term financing to Brazil's private sector.** BNDES invests in or lends to private enterprises. The rates on its loans can be much lower than the standard SELIC rate based on Brazilian Treasury notes. Even though BNDES will remain an important source of long-term capital in Brazil for the foreseeable future, the expectation is that the share of private capital in the funding for private investment should grow significantly. This requires an adequate level of financial transparency and governance in the private sector for attracting investors, and therefore strong accounting and auditing practices.

10. **Brazil has developed a large, privately managed pension system in the 1990s to complement a public system with widening deficits.** This complementary system mobilizes long-term savings by workers in the private or para-statal sectors. There are two types of pension funds in Brazil: closed (i.e., accessible only to employees and retirees of a specific institution) and open. Closed pension funds are generally among the largest investors in companies listed on the BOVESPA. In April of 2007, there were 371 of them. They managed total assets of just over BRL 397 billion (equivalent to US\$182 billion).<sup>7</sup> To properly manage the funds entrusted to them by contributors and beneficiaries, privately-managed pension plan administrators must have access to reliable and informative financial statements from the corporate entities in which they invest.

11. **Many government business enterprises were privatized in the 1990s; nevertheless, Brazil's state-controlled sector is still relatively large today.** The Federal Government controls large business entities such as the *Petrobras* group, the *Eletrobras* group and the companies that manage the country's ports and airports. It also controls several major financial institutions, including the largest commercial bank (*Banco do Brasil*), BNDES and the country's largest savings and loans institution (*Caixa Econômica Federal*). In the federal budget for the year 2007, the aggregate amount of investments by state-owned enterprises (SOEs) is BRL 49.7 billion (approximately USD 25 billion). There were 70 SOEs as of January, 1, 2007.<sup>8</sup>

12. **Various government or semi-autonomous agencies regulate and supervise the private sector,** including the following:

- The Central Bank of Brazil (*Banco Central do Brasil* or BCB), which supervises the banking sector;

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<sup>7</sup> Source: SPC.

<sup>8</sup> Source: Ministry of Finance.

- The Securities Commission (*Comissão de Valores Mobiliários* or CVM), which oversees the securities market, including issuers and market participants;
- The Superintendency of Private Insurance (*Superintendência de Seguros Privados* or SUSEP), for the supervision of the insurance and open pension fund markets;
- Two Departments within the Ministry of Social Welfare, for closed pension funds; and
- Regulatory agencies in various sectors of the economy, including oil and gas, electricity, telecommunications, and water.

13. **Through strengthening its private sector accounting and auditing practices and improving the quality of its corporate financial reporting, Brazil can tackle some of the economic challenges it is presently facing.** The long-term benefits associated with improved corporate accounting and auditing practices include:

- Increased levels of trading on securities markets. Brazil's stock exchange is seeking to increase its volume of trading and improve access to the market for medium-sized corporations. This can be achieved by enhancing investors' confidence, which, among other factors, requires the availability of financial information that is sufficiently accurate and complete.
- Deepening the integration of Brazil's economy on an international scale, through further comparability and alignment of its standards and codes with those of its main partners, especially the EU and the US.
- Increased foreign direct investment, which can be achieved through greater confidence in, and improved comparability of financial information.
- Easier and cheaper access to financing for the SME sector: by enabling the provision to banks and venture capitalists of standardized, useful and reliable financial information, SMEs will increase their chances of borrowing at lower rates.
- Better diversification and investment opportunities for privately managed pension funds: improvements in the quality of financial reporting of listed companies will help foster higher levels of trading on the stock market; for non-listed companies, it will help develop private equity funds which are nascent in Brazil at the moment. In turn, this will allow pension funds to gain access to a broader choice of investments.

14. **In this context, the ROSC Accounting & Auditing in Brazil aims to support the strategic objective of furthering the development of Brazil's private sector,** thanks to improved access to long-term financing for domestic enterprises and a reduction of the cost of doing business in the country; this in turn will contribute to an increased participation of private investments in infrastructure.

## II. INSTITUTIONAL FRAMEWORK FOR PRIVATE SECTOR ACCOUNTING AND AUDITING

### A. Statutory Framework

15. **The Brazilian Civil Code<sup>9</sup> sets forth the different types of legal structures under which companies may be organized.** The most economically significant types are corporations (*sociedades anônimas*) and limited liability companies (*sociedades limitadas*). They have the following characteristics:

- *Sociedades anônimas* (S/As) are regulated by the Corporations Law of 1976.<sup>10</sup> S/As can be public (*abertas*) – registered at the CVM or private (*fechadas*). Only S/As may issue securities on the stock market. S/As are governed by a board of directors (*conselho de administração*) and, in certain circumstances, must convene a special supervisory/auditor board called *conselho fiscal* (discussed in paragraph 29).
- *Sociedades limitadas* can only be privately held. They are by far the most common type of company in Brazil, accounting for an estimated 90 to 95% of the total number of domestic companies. They range from small-sized enterprises with few shareholders, to some of Brazil's largest companies.<sup>11</sup>

### ACCOUNTING AND FINANCIAL REPORTING REQUIREMENTS

16. **Financial reporting by Brazilian corporate entities is governed by various laws and regulations, and several regulators are responsible for their monitoring and oversight.** The application of corporate financial reporting requirements to different enterprises is summarized in Table 1, which should be read in conjunction with paragraphs 17 to 31.

17. **The Corporations Law of 1976, as amended, prescribes the accounting and financial reporting requirements for corporations (S/As), whether listed or not.**<sup>12</sup> The Law deals with a variety of issues including the type of financial statements to be prepared, their presentation, the content of the explanatory notes, valuation methods for assets and liabilities and consolidation. It also stipulates that the CEO and CFO are responsible for the probity of financial statements. These provisions pertain for the most part to legal entity financial statements. Listed companies must publish consolidated financial statements.<sup>13</sup> Given the lengthy and complex legislative process in Brazil, the fact that important accounting and financial reporting provisions are set in the law can make it difficult to incorporate new concepts as demanded by the development of increasingly complex business transactions. For instance, Art. 188 of the Corporations Law requires companies to prepare a statement of origins and applications of funds, whereas investors nowadays require a statement of cash flows for financial analysis purposes.

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<sup>9</sup> Law 10,406 of January 10, 2002.

<sup>10</sup> Law 6,404 of December 15, 1976, as amended (referred to as *Lei das S/A*).

<sup>11</sup> In 2003, the 50 largest companies in Brazil included 13 *limitadas*, 11 of which were foreign-owned (source: *Exame's* list of the top 500 companies in Brazil, July 2004). *Limitadas* are governed by the Civil Code, Articles 1052-1087 (general provisions) and 1179-1195 (financial reporting).

<sup>12</sup> Corporations Law, Articles 175-205, 243-250 and 275.

<sup>13</sup> CVM Instruction 247 of March 27, 1996, requires consolidation for all listed companies. For non-listed S/As, the law provides that those that officially register as “groups of companies” with the local company registry are to publish consolidated financial statements. However, in practice, very few S/As apply for such “group” status.

**Table 1 – Summary of accounting and auditing requirements in Brazil by types of entities**

|   | <b>Regulatory Agency</b>                            | <b>Accounting and Financial Reporting Standards</b> <sup>ii, iii</sup> | <b>Audit Requirement</b>                    | <b>Publication and Other</b>  |
|---|---|--|---|---|
| <b>Listed corporations (S/A)</b>                  | CVM<br>BOVESPA <sup>i</sup>                         | Corporations Law<br>CVM rules<br>COSIF <sup>iv</sup>                   | Yes, by auditor registered with CVM         | Publication required – Audit Firm Rotation every 5 years                    |
| <b>Non-listed corporations (S/A)</b>              | -   | Corporations Law   | No  | Publication <sup>vi</sup> required  |
| <b>Limitadas</b>                                  | -   | Civil Code   | No  | No  |
| <b>Financial institutions</b>                     | BCB   | Corporations Law<br>COSIF<br>CVM rules <sup>v</sup>                    | Yes, by auditor registered with BCB and CVM | Publication required<br>Audit Firm Rotation every 5 years – Audit Committee |
| <b>Investment funds</b>                           | CVM   | Corporations Law<br>CVM rules<br>COSIF <sup>iv</sup>                   | Yes, by auditor registered with CVM         | Publication required<br>Audit Firm Rotation every 5 years                   |
| <b>Insurance companies and open pension funds</b> | SUSEP   | Corporations Law<br>CNSP/SUSEP rules                                   | Yes, by auditor registered with CVM         | Audit Firm Rotation every 5 years   |
| <b>Closed pension funds</b>                       | SPC   | CGPC rules   | Yes   | Audit Firm Rotation every 4 years   |
| <b>State-owned enterprises</b>                    | Ministry of Planning - DEST (all CVM (listed SOEs)) | Law that creates respective SOE<br>Corporations Law (for listed SOEs)  | Yes (listed SOEs)<br>No (non-listed SOEs)   | Same as in equivalent forms of privately sector enterprises                 |

<sup>i</sup> More stringent financial reporting requirements apply to companies listed on the special segments of BOVESPA (paragraph 20).

<sup>ii</sup> CFC/IBRACON accounting and financial reporting pronouncements are also applied although they are only legally binding for accounting professionals. They are mandatory for companies only to the extent that they are explicitly endorsed by the respective regulators.

<sup>iii</sup> ANEEL is the regulator for the electric energy sector and applies a specific set of accounting standards for the companies it regulates (Resolution 444/01 sets forth an “accounting manual” for power companies which be can either SOEs, listed companies or non-listed S/As.

<sup>iv</sup> COSIF applies to investments funds only insofar as it does not conflict with CVM requirements.

<sup>v</sup> CVM rules apply only to banks that are listed, and provided that they do not conflict with those of the Central Bank

<sup>vi</sup> Art. 294 of the Corporations Law exempts small non-listed S/As from the publication requirements. Financial institutions may not be exempted however. Small S/As are defined as having fewer than 20 shareholders and net equity of less than US\$420,000 (BRL 1 million). However, they are not exempt from the requirement to file the financial statements at the company registry.

18. **Listed companies are subject to specific provisions of the Corporations Law and CVM-issued accounting and auditing rules.** The Corporations Law requires listed companies to prepare audited annual financial statements comprising a balance sheet, income statement, statement of retained earnings, statement of origins and applications of funds,<sup>14</sup> explanatory notes, Directors’ report (*relatório da administração*), and consolidated financial statements, if

<sup>14</sup> *Demonstração de Origens e Aplicações de Recursos* or DOAR (Para. 62).

applicable. In addition, CVM requires listed companies to prepare a statement of changes in stockholders' equity.<sup>15</sup> Reports by an independent auditor and the *conselho fiscal* (when active), must be attached to the financial statements. These documents must be filed with the CVM at least 30 days before the shareholder's annual general meeting (AGM), which is equivalent to within 3 months of the fiscal year-end.<sup>16</sup> Additional reporting requirements to CVM include:<sup>17</sup>

- Electronic submission of quarterly audited financial statements within 45 days of each of the first three quarters' end;
- Electronic submission of an annual information form, which provides general information about the company, including a copy of its bylaws, main shareholders, and information on debts. It must be submitted no later than five months after the fiscal year-end, or 30 days after the AGM, whichever comes first;
- Notice of material events (*aviso de fato relevante*) – must be filed with CVM and published immediately; examples of such event include changes in accounting policies.

19. **Brazilian corporations listed in the US are subject to higher standards of reporting.** US securities laws require that foreign issuers of securities file either (i) a set of financial statements under US GAAP, or (ii) their Brazilian GAAP financial statements, together with the reconciliation of net income and shareholders' equity with the corresponding figures under US GAAP, as well as additional disclosure required by US GAAP. These filings can be accessed by any investor on-line. CVM requires that translations in Portuguese be made available simultaneously to investors in Brazil.

20. **In 2001, the BOVESPA stock exchange set up three new listing segments with higher financial reporting requirements, in addition to the regular segment.** Presently, 53 companies are listed on one of these special "corporate governance segments", called *Novo Mercado*, Level I, and Level II. Listing on these segments is voluntary; companies who choose to list on one of them must adhere to good practices of corporate governance, with *Novo Mercado* having the highest level of requirement and Level I the lowest of the three.<sup>18</sup> Companies on these three segments face the following financial additional reporting requirements: in addition to the Brazilian GAAP financial statements required by law, they must publish audited annual and quarterly IFRS- or US GAAP-based financial statements, in English,<sup>19</sup> as well as consolidated financial statements when applicable. Alternatively, they may publish a translation in English of their Brazilian GAAP financial statements provided they include a reconciliation of net income and shareholder's equity with IFRS or US GAAP.<sup>20</sup> Financial statements must include a cash flow statement. In addition, auditors must have proven experience with US GAAP/IFRS to audit the financial statements of companies listed on these segments.

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<sup>15</sup> CVM Instruction 59, of December 12, 1986.

<sup>16</sup> Corporations Law, Articles 132-133

<sup>17</sup> These requirements are set forth under CVM Instruction 202, of December 6, 1993 and CVM Instruction 358, of January 3, 2002. Refer to paragraphs 62 and 64 in Section III.A. for information on applicable accounting standards. Moreover, under CVM Instruction 247, all listed companies must present consolidated financial statements.

<sup>18</sup> For further information on the corporate governance aspects of *Novo Mercado* and Levels I and II, please refer to the 2005 Corporate Governance ROSC.

<sup>19</sup> Almost all companies prefer to use US GAAP; only one company prepares IFRS financial statements.

<sup>20</sup> In addition, companies must provide in the notes to the financial statement an explanation of the main differences between US GAAP and BR GAAP accounting rules.

21. **All corporations are required to publish their annual financial statements, whereas *Limitadas* face very limited reporting obligations.** The financial statements of corporations must be published in the official gazette as well as in a widely-circulated newspaper at least 30 days before the shareholders' AGM, to allow enough time for the shareholders to review the information.<sup>21</sup> *Limitadas* are only required to prepare an annual balance sheet and income statement, which should be approved at the AGM.<sup>22</sup> These unaudited financial statements must then be filed with the company registry, together with the minutes of the AGM. Since the public does not have access to the information filed by *limitadas* in the company registry, and the company registry has no responsibility to check the financial statements, actual compliance with the above obligations cannot be ascertained. *Limitadas* selectively provide their financial statements to third parties, namely banks, rating agencies and credit bureaus.

22. **Financial institutions, regardless of legal structure, are required to follow the Central Bank's accounting rules for both prudential and general purpose financial reporting.** Financial institutions, including investment funds (*fundos de investimento em títulos de valores mobiliários*),<sup>23</sup> are required to apply the Accounting Plan for Financial Institutions (*Plano Contábil das Instituições do Sistema Financeiro Nacional* or [COSIF](#)), which includes a compulsory chart of accounts, accounting methods and standard formats of reporting.<sup>24</sup> Financial institutions are required to publish audited annual financial statements within 90 days of end-December, and audited half-year financial statements within 60 days of end-June in a large circulation newspaper. In addition, financial institutions must provide quarterly financial information that includes, among other things, financial statements, explanatory notes, risk management policies, statistical data, and an auditor's report. There are also requirements for monthly financial reporting to the Central Bank. A management report (*relatório de administração*) is required under Art. 133 of the Corporations Law. Nevertheless, a Management Discussion and Analysis (MD&A) comparable to those published in the US or Canada is not required (large banks tend to publish MD&A voluntarily, however).

23. **Specific accounting rules for insurance companies and open pension funds are set by the insurance market supervisor, SUSEP.** Insurance and open pension fund companies must be incorporated as S/As. Their financial statements, along with the auditor's reports, must be published by end-August and end-February of each year. In addition, insurance and open pension fund companies must file the following with SUSEP:<sup>25</sup>

- Periodically: unaudited accounting information, as required by the Periodic Information Form;
- Quarterly: audited accounting information, as required by the Periodic Information Form, and auditor's report;
- Twice yearly (by September 15 and March 15): a copy of the half-year and annual financial statements, as they appeared in the official gazette and in a major newspaper.

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<sup>21</sup> Non-listed S/A with shareholders' equity below BRL 1 million are exempted from filing statements of changes in financial position.

<sup>22</sup> Even so, the AGM may be waived if all shareholders agree to resolve the issues that were to be discussed at the meeting through written correspondence.

<sup>23</sup> A new set of accounting rules for investment funds, separate from the COSIF, is being drafted as a result of the transfer of the supervision of these funds from BCB to CVM

<sup>24</sup> Central Bank Circular 1273 of December 29, 1987.

<sup>25</sup> Reporting obligations are set forth in SUSEP Circular 279 of December 29, 2004, Annex I, Section 5.

24. **Closed pension funds' accounting and financial reporting obligations are set out by a Department of the Ministry of Social Welfare.**<sup>26</sup> Closed pension funds must be set up as non-profit entities. They must file audited annual financial statements comprising balance sheet, income statement, cash flow statement (*demonstração de fluxos financeiros*), with explanatory notes, together with the reports of an independent actuary, auditor and *conselho fiscal*.<sup>27</sup> The financial statements need to be submitted to the regulator by March 10 of each year, and divulged to interested parties including employers, employees and beneficiaries by April 30 (publication is not mandatory). They are also required to divulge their investment policies and actuarial premises to interested parties periodically.

## AUDIT REQUIREMENTS

25. **The financial statements of listed companies, investment funds, financial institutions, insurance companies and open pension funds must be certified by an external auditor registered with CVM.** To obtain CVM registration, auditors must pass a professional qualification exam. For the financial sector (with the exception of closed pension funds), auditors must pass an additional qualification exam tailored to audits in the institutions in question (paragraph 43). Under the Corporations Law, the board of directors is responsible for appointing and dismissing independent auditors (Art. 142).<sup>28</sup> Dismissals of auditors must be communicated to the relevant supervisory body, along with a justification, within 15-20 days of termination of the audit contract.<sup>29</sup> Auditors are required to follow rules to safeguard their independence and are thus prohibited from carrying out a series of services (paragraph 39). Auditors are also prohibited from receiving contingent fees, per CFC regulations. The external auditor is also required to inform the board of any infractions.<sup>30</sup> Finally, these companies must undergo a statutory audit firm rotation at least every five years, and the firm may not be rehired for a three-year period following the rotation.

26. **The audit requirements of closed pension funds vary from those of open pension funds.** Auditors need only to be registered with the CRC. Mandatory audit firm rotation must take place every four years, and firms may not be rehired for a three-year period following the rotation. The advisory board (*conselho deliberativo*) is responsible for appointing the external auditor.<sup>31</sup>

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<sup>26</sup> It should be noted that Provisional Measure 233 of December 31, 2004, which was expected to be converted into law by the Congress, had introduced the following changes: the existing Secretariat for Pension Funds (SPC) was to be divided into three entities: (i) CNPC (National Council of Private Welfare, with standard-setting functions, which would take those functions over from the Managing Council of Private Welfare or CGPC), (ii) PREVIC (an autonomous enforcement arm—Para. 56), and (iii) a Secretariat for Pension Fund Policies (SPPC) responsible for setting national policies pertaining to closed pension funds. However, the proposed law to make Provisional Measure 233 permanent was not voted by the Congress; hence, the Measure has since expired and the changes were annulled.

<sup>27</sup> Resolution no. 5 of the CGPC, January 30, 2002 – Annex E, Section IV.19.

<sup>28</sup> Regulations of audit of (a) listed corporations companies and investment funds, (b) financial institutions, and (c) insurance companies and open pension funds are set-out respectively in CVM Instruction 308 of May 14, 1999 (in addition to the Corporations Law), BCB Regulation 3198 of May 27, 2004; and National Council of Private Insurance (CNSP) Resolution 118, of December 22, 2004.

<sup>29</sup> For banks and insurance companies, the regulator must be notified of dismissals within 15 days, and auditors who feel they have been wrongfully terminated may submit a formal dissent within 15 days; for listed companies, the deadlines are 20 and 30 days, respectively.

<sup>30</sup> In non-financial institutions, if the external auditor communicates an infraction to the board, and the board takes no action, the auditor is under no obligation to seek outside redress if he or she is not liable. This is not the case for external auditors of financial institutions (paragraph 31).

<sup>31</sup> Art. 13 of Law 108 of May 29, 2001. Audit requirements for closed pension funds are set forth in the aforementioned Resolution 05/02 – Annex E, Section IV.43.

27. **Non-listed corporations and *limitadas* (defined in Para. 15) are not subject to any statutory audit regardless of size.** This hampers confidence in the financial statements of these companies, as there is no independent verification that the information presented by such companies presents an accurate view of their situation. This issue is being addressed in the proposed amendments to the Corporations Law (Para. 32).

28. **SOEs are audited by independent auditors selected through a public procurement process which does not necessarily consider technical qualification.** Brazil's Public Procurement Law<sup>32</sup> sets forth different modalities for public tenders, including technical qualification and price, or price only. Some independent auditors have been selected using the price only modality; for tenders in which technical competence is considered, this does not always count for a significant percentage of the final decision, effectively making price the deciding factor. This may jeopardize the quality of independent audits in SOEs.

29. **Corporations, investment funds and closed pension funds are required in certain circumstances to form a special body with supervisory and audit functions, called "*conselho fiscal*".**<sup>33</sup> The Law requires companies to have a *conselho fiscal*, which can be either "permanent" (i.e., effectively established and operating) or not. Shareholders owning 10% of ordinary shares or 5% of preferred shares are entitled to request that the *conselho fiscal* be established. A permanent *conselho fiscal* is required for SOEs. Elected by shareholders, it comprises three to five members, plus an equal number of alternates. Board members and employees of a company, as well as their close relatives may not serve on the *conselho fiscal*. The *conselho fiscal* is independent from management and the board of directors and has wide powers and responsibilities, including a) supervising management and the board, b) issuing opinions on corporate transactions, and c) calling an AGM. Its members have the same liability as board members and management. They can put board members or managers under criminal investigation, and are obliged to denounce fraud, accounting misconduct or other wrongdoing to the board, and, if the board does not take action, to the AGM. Several of its duties pertain to accounting and financial reporting, among which:

- Reviewing the company's financial statements, at least on a quarterly basis. However, the Law does not provide a precise definition of what procedures and degree of assurance the review should entail. No specific competence, let alone accounting and financial expertise, is required from the members;
- Requesting information from the company's management; this includes asking that special financial statements be drawn up; and
- Inquiring on any matter with the external auditor. When the company has none, the *conselho fiscal* can demand that it retain one. In the report it issues at the end of each fiscal year, the *conselho fiscal* usually indicates that it relied on the work of external auditors with respect to the accuracy of the financial statements.

30. **The appropriateness and effectiveness of the *conselho fiscal*—which closely resembles Mexico's *comisario* and has equivalents in various countries in Latin America—has been debated in Brazil.** Originally, the *conselho fiscal* was created to be an independent body primarily responsible for protecting the interests of minority shareholders; however, their effectiveness in practice was low. With the introduction of the Sarbanes-Oxley Act

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<sup>32</sup> Law 8.666/93 on public tenders (*Lei das Licitações*).

<sup>33</sup> Corporations Law, Art. 161-165A (for S/As). *Conselhos fiscais* are optional for *limitadas*; in practice, the likelihood of *limitadas* actually establishing one is very low.

of 2002 (SOA)<sup>34</sup> in the US, and upon a ruling by US Securities and Exchange Commission (SEC), the *conselhos fiscais* of Brazilian companies with securities listed in the US were required to take on a more active role, acting in a similar fashion as an audit committee. In addition, this trend among US-listed Brazilian companies has had a trickle-down effect to the *conselhos fiscais* of some of the other large Brazilian companies. In addition, the amendments made to the Corporations Law in 2001 introduced individual liability as well as individual power to act for each *conselho fiscal* member. This increases the effectiveness of the *conselho fiscal* as an instrument that minority shareholders can use to monitor controlling shareholders. Currently, several participants in the stock market, including closed pension funds, view the *conselho fiscal's* contribution favorably. However, other stakeholders point to a series of shortcomings including an insufficient focus on its responsibilities, the fact that the *conselheiros* are not required to have any technical expertise, and their tendency to act exclusively in the interest of those who have elected them. In sum, there is great variation with respect to the effective contribution of the *conselho fiscal*.

31. **Since 2004 large banks, insurance companies and open pension funds must establish an audit committee.**<sup>35</sup> The audit committee as mandated by BCB and SUSEP is not a committee of the board of directors, as international good practice requires, even though it assumes similar functions as its international equivalents.<sup>36</sup> The committee must have a minimum of three members, at least one of whom should be an expert in accounting and auditing issues. Among its responsibilities, the audit committee is responsible for reviewing financial statements, monitoring the work of external auditors, and reporting to the board on issues pertaining to internal controls, external audit and the quality of financial statements. Management is required to communicate violations to the audit committee within 24 hours of detection. The audit committee (and/or external auditor) is then required to report the violation to the respective regulator within three days. For insurance companies that are a part of a financial conglomerate, a single audit committee can be created within the parent company.<sup>37</sup> Since audit committees were introduced very recently, it is not yet possible to gauge their effectiveness; nevertheless, the introduction of audit committees in the banking and insurance sectors has been generally perceived favorably. An audit committee is not required for other types of listed companies.

32. **A draft law to modernize the financial reporting environment in Brazil has been under discussion by the Brazilian Congress since 2000. It would extend the disclosure and audit requirement to virtually all “public interest entities” (PIEs).** Three criteria can be used to define whether an entity has significant public interest: (a) having securities listed; (b) the nature of the business (for example, banks, insurance companies and collective investment undertakings); and (c) the size of the business as measured according to yearly revenues, number of employees, etc. Good international practice requires such entities to follow higher standards of financial reporting and have their financial statements audited, which is currently not the case in

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<sup>34</sup> The SOA sets forth stringent accounting, financial reporting and auditing requirements for companies with securities listed in the US, including foreign companies.

<sup>35</sup> For banks, audit committees are regulated by Art. 10-17 of BCB Resolution 3198/04. For insurance companies and open pension funds they are regulated National Private Insurance Council (CNSP) Resolution 118/04, Art. 13-19.

<sup>36</sup> In their comments to this ROSC report, the authorities have expressed the view that some characteristics of the Brazilian environment support the separation between the audit committee and board of directors. First, since only listed companies are required to have a board of directors, a non-listed bank, insurance company or open pension fund would not be able to establish an audit committee as a board sub-committee. Second, since several large Brazilian banks are still family-controlled, their boards may not provide an appropriate venue for a fully independent audit committee. This matter is further discussed in the Corporate Governance ROSC.

<sup>37</sup> CNSP Resolution 118/04, Art. 14.

Brazil, especially for large non-listed enterprises.<sup>38</sup> The draft law attempts to address this issue, which is further explained in Box 1 below.

### Box 1 – An Overview of Draft Law 3741 of 2000

Draft law (*Projeto de Lei* or PL) no. 3741 aims to strengthen Brazil's corporate financial regime through several amendments to the Corporations Law of 1976. The draft law was authored by CVM in consultation with a wide range of stakeholders and has been under discussion in Congress since 2000. An amended version (*substitutivo*)<sup>39</sup> was approved by the Committee for Economic Development, Industry and Trade and has been under discussion in the Committee for Finance and Tax (CFT) since 2003. Based on the latest published version of the draft, as well as information from the recent public hearing on the subject, held in the CFT on May 17, 2005, the main provisions of the proposed law are as follows:

- **Non-listed companies:** all companies or groups of companies, regardless of legal structure (including S/As and *limitadas*), considered to be economically significant, i.e., with total revenues in excess of BRL 300 million (equivalent to US\$126 million) and total assets higher than BRL 240 million (equivalent to US\$100 million), would be required to publish audited annual financial statements. Such companies would also be subject to supervision by CVM.
- **IFRS convergence:** the proposed law would set various, broad accounting principles that are consistent with IFRS, and would determine that the accounting rules for listed corporations are to converge with IFRS. This would include leasing (equipment acquired under a finance lease arrangement would have to be recorded on the company's assets, with a corresponding liability recognized). Companies would also be required to present a statement of cash flows rather than the DOAR.
- **Creation of a single accounting standard setter:** a new entity, the Committee for Accounting Pronouncements (*Comitê de Pronunciamentos Contábeis* or CPC) would be created within the CFC to issue accounting standards for general purpose financial statements, which would be aligned with IFRS. While being a part of the CFC structure, this committee would be "impervious" to political pressure from the CFC, although it is not clear how this would be achieved. Relevant stakeholders, such as auditors, academics, and private sector representatives, would be represented in the committee. Regulators would participate in the committee on an ad-hoc basis, through specific agreements. In addition, because the law does not allow regulators to delegate their powers, including the power to set standards, to another institution, the committee's standards would have to be approved and enacted by the relevant regulatory agencies (BCB, CVM, etc.).
- **Process for preparing company tax returns and financial statements:** under the proposed law, companies would have the option to keep their "primary" accounting books according to tax rules. Necessary adjustments would then be made to generate general-purpose financial statements, rather than the other way around, as is currently the case (paragraph 62). The proposed changes are aimed at facilitating a more transparent set of financial statements and would not affect a company's income tax base.

<sup>38</sup> Although criteria (a) and (b) are followed for the most part, in order to comply with criterion (c), all large Brazilian companies would need to follow more stringent requirements.

<sup>39</sup> *Substitutivos* do not override the original draft law; rather, they are treated as separate proposals by the committees until reaching the Plenary (*Plenário*). Thus, when the draft law is voted by the Plenary (vote by the full Chamber), the original draft law and all *substitutivos* will be discussed. Deputies must then approve a final draft law, which usually draws on the changes set forth in the *substitutivos*, and is then sent to the Senate.

Three of these issues are generally considered to be contentious and are believed to have caused this bill to stall in Congress:

- (a) **Publication requirements for limitadas** – The current lack of a publication requirement is widely seen as hindering fair competition. Indeed, large companies incorporated as a *limitada*, especially Brazilian subsidiaries of foreign groups, can have access to fairly detailed information from the listed Brazilian groups they compete with, while conversely their Brazilian counterparts have very limited information on them and other *limitadas*. Critics of the proposed measure however argue that interested parties—particularly creditors, credit bureaus and rating agencies—already have access to this information, which is of little use to the general public, and would introduce another layer of burdensome regulation thereby increasing the “*custo Brasil*”<sup>40</sup>;
- (b) **New accounting rules for leases consistent with IFRS** – Leasing companies argue that the proposed treatment would make financial leases far less attractive for Brazilian enterprises; and
- (c) **Establishment of a single standard-setter** – Regulators were concerned with the potential risks attached to the transfer of their standard-setting powers to a private entity, and CFC seemed reluctant to give up its standard-setting privileges. However, these concerns seem to have been addressed in the latest version of the draft law.<sup>41</sup>

The draft law’s rapporteur in the CFT is expected to issue his opinion by end-June. Based on discussions with the MoF, the Government expected the law to be passed by the end of 2005; however, this is unlikely as it still needs to be approved by the Constitution and Justice Committee and the Plenary of the Chamber of Deputies,<sup>42</sup> as well as the Senate, before going on to Presidential sanction.

In addition, there is another draft law (PL 2813/00) that would require medium and large *limitadas* to publish audited financial statements. It was already approved by the Senate and is now under discussion in the Chamber of Deputies; despite this, very little attention has been given to this draft, in part because it deals with an issue that is already being discussed under PL 3741/00, and it is not as comprehensive. According to procedural rules, since both draft laws deal with a common issue they should be discussed in conjunction. It is likely that PL 2813 will be “absorbed” by PL 3741 at some point.

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<sup>40</sup> This issue has generated significant debate outside Brazil as well. For instance, in New Zealand, where such a measure is currently contemplated by lawmakers, a public hearing was held in 2004 to discuss the issue among others but no consensus has yet been reached. In Australia, publication requirements for non-listed limited liability companies were introduced recently; this measure faced a great deal of controversy and could only be passed after “grandfathering” existing companies from the new requirement. In the EU, the First Directive on Company Law requires all forms of joint-stock and limited liabilities companies to file their annual financial statements with a public registry where anyone can obtain a copy for a small fee.

<sup>41</sup> Mexico provides an interesting case: in 2001, an independent standard-setting body was established as a means to consolidate corporate financial reporting principles in Mexico, in lieu of the previous accounting standards committee of Mexico Institute of Public Accountants (IMCP). This was achieved through an agreement between all regulatory bodies concerned and the IMCP.

<sup>42</sup> Originally, this draft law was not required to go to the Plenary for voting; however, since an amended version (“*substitutivo*”) has been presented, a Plenary vote is now required.

## B. The Accounting and Audit Profession

33. **The Federal Accounting Council (*Conselho Federal da Contabilidade* or CFC) is the profession's oversight body under the Law.** The CFC is a 15-member body established by law in 1946.<sup>43</sup> It serves as the umbrella organization for the 27 Regional Accounting Councils (*Conselhos Regionais da Contabilidade* or CRC), one in each federated state. Its leadership is elected by an electoral college comprised of one representative for each CRC, which tends to limit the representation of the large states of the South-East. The CFC is a member of the International Federation of Accountants (IFAC). Even though the law does not explicitly entrust the CFC with standard-setting powers, it issues accounting and auditing standards, which are used in the context of general-purpose financial reporting. Furthermore, the CFC has issued several regulations interpreting the Law of 1946 on various aspects dealing with the organization of the accounting profession.

34. **Accounting and auditing activities in Brazil can only be conducted by persons or firms registered with a CRC.** Article 25 of the law of 1946 lists the services that are exclusive to licensed accounting professionals. These include bookkeeping services, assistance to a *conselho fiscal* and several activities that would normally be carried out by an external auditor. Accounting services other than bookkeeping are restricted to accountants with a university degree ("*contadores diplomados*," per Article 26). The terms "audit" or "auditor" are not used anywhere in the 1946 law.

35. **Brazil's accounting profession is comprised of a majority of accounting technicians with a level of qualification that does not meet the standards of IFAC.** CFC Resolution 960/03 of April 2003 contemplates the following two categories of practitioners with separate registries in each CRC: "accountants" (*contadores*, i.e., with a Bachelor degree in accounting,) and "accounting technician" (*técnicos em contabilidade*, who are only required to have the equivalent of a high school degree). As of April 2005, the membership of CFC comprised 170,000 accountants, 190,000 accounting technicians and 68,000 accounting firms. This two-tier structure within the profession is unusual in Latin America and in most industrialized countries, where all professional accountants are generally required to have a university degree.<sup>44</sup> This puts Brazil somehow at a disadvantage vis-à-vis its competitors.

36. **The Institute of Independent Auditors of Brazil (*Instituto dos Auditores Independentes do Brasil* or IBRACON) is a not-for-profit organization dedicated to research, accounting and auditing standard-setting and the advancement of the audit profession.** IBRACON, a member of IFAC, was established in 1971.<sup>45</sup> Its membership comprises both individual auditors and firms (most are from the South-East and South regions); as of end-2004, IBRACON had 1,689 members, including 85 firms. It cooperates with CFC and regulatory agencies on various issues of interest for the audit practice, including accounting and auditing standard-setting and professional examination. IBRACON plays a prominent role in the field of accounting research in Brazil and enjoys the support of most audit firms.

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<sup>43</sup> *Decreto-Lei* no. 9295 enacted May 27, 1946.

<sup>44</sup> Italy's accounting profession has two levels of professionals (*ragionieri commercialisti* and *dottori commercialisti*), but both have university degrees (respectively undergraduate and graduate).

<sup>45</sup> IBRACON is the successor of two separate professional organizations which merged in 1971 as the *Instituto dos Auditores Independentes do Brasil*, the latter being renamed in 2001 as IBRACON.

37. **As in most countries with a significant private sector, the four large international accounting firms (“Big 4”) dominate the market for audit services to public interest entities in Brazil.** Indeed, most listed companies, banks, insurance companies, pension funds, large subsidiaries of foreign groups and large non-listed groups are audited by one of the Big 4.<sup>46</sup> Nonetheless, some medium-sized firms have established a significant presence among public interest entities. For instance, the Brazilian affiliate of a “tier-2” international network ranked third among Brazilian audit firms for listed companies in 2004.

38. **CFC’s Code of Professional Ethics for Accountants is far less developed and comprehensive than IFAC’s.** The CFC code,<sup>47</sup> issued in 1996 to replace the 1970 code, is a much shorter document than the Code of Ethics for Professional Accountants of IFAC as revised in 2003, and sets fairly general principles on a narrower range of issues. It covers four topics including (1) Duties and Prohibitions, (2) Value of Professional Services, (3) Duties towards Colleagues and the Profession, and (4) Sanctions. Compared to IFAC’s, the CFC code has several shortcomings. For instance, it does not set as a distinguishing attribute of the accounting profession serving the public interest (it merely emphasizes the need for practitioners to act in conformity with laws and regulations); it does not provide any guidance on conflicts of interests, emphasize professional competence or address issues of auditor independence, even though, according to good international practice, these are considered critical to the profession.<sup>48</sup>

39. **CVM, BCB and SUSEP have set stringent requirements in relation to auditor independence.** For open corporations (*S/A abertas*), CVM has established a list of services that audit firms are forbidden to provide to companies whose financial statements they audit.<sup>49</sup> The intent of the regulator was to address the risks of conflicts-of-interest for external auditors, in the wake of several corporate failures in Brazil. In such cases, the role of the auditor had been seriously questioned, particularly in connection with widely publicized corporate failures in the banking sector. The audit profession reacted negatively to these regulations, arguing that the blanket prohibition set out in the regulations hamper companies’ ability to procure accounting services. The audit profession advocated a more flexible approach that would make it possible for auditors to provide some of the non-audit services targeted by the regulations, provided certain measures would be applied by auditors to safeguard their independence (this approach is often referred to as the “threats and safeguards” approach). This approach is widely endorsed internationally and is one of the key principles of IFAC’s Code of Ethics for Professional Accountants. A legal action by audit firms against CVM Instruction 308 is pending before a federal court.<sup>50</sup> BCB and SUSEP have also issued regulations on auditor independence that are

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<sup>46</sup> For the stock market, 53% of the companies listed on the BOVESPA had their financial statements audited by one of the Big 4 at the end of 2004, against 61% at the end of 2003 (source CVM). In the banking sector, Big 4 audited close to 80% of all banks at the end of 2004 and their clients accounted for more than 95% of the total assets of the National Financial System (source BCB).

<sup>47</sup> *Código de Ética Profissional do Contabilista* (CFC Resolution no. 803/96 of October 10, 1996).

<sup>48</sup> IFAC’s Code of Ethics contains ten pages on independence plus several pages of application guidance.

<sup>49</sup> A list of prohibited services listed in the CVM regulation reads as follows (translated from Portuguese): “advisory services on organizational restructuring; evaluation of companies; revaluation of assets; assessment of amounts in view of the recoding of provisions (...); tax planning; redesign of accounting information and internal control systems; and any other product of service that could influence management decisions in the audited entity” (CVM Instruction 308 of May 14, 1999, Article 23).

<sup>50</sup> The prohibition of certain types of non-audit services is relatively commonplace in many jurisdictions, when these services are clearly incompatible with the role of independent auditor. Nevertheless, legislators and regulators in industrialized countries tend to opt for a “principles-based” approach instead, avoiding outright prohibition and preferring a threat and safeguards approach. For instance, in the EU, the proposed new 8<sup>th</sup> Company Law Directive on statutory audits (March 2004 version) establishes a “threats and safeguards” approach, requiring “the statutory auditor or audit firm [to]

consistent with CVM rules.<sup>51</sup> The revenues an auditor can derive from a single client are capped at 25% of the auditor's total revenues. Finally, according to CVM Instruction 381 of 2003, companies must disclose, in nominal terms, the amount of both audit and non-audit fees paid to statutory auditors each year, the policies they have adopted to avoid conflicts of interests, as well as specific details regarding procurement of non-audit services.

40. **Several factors tend to constrain external auditors' accountability toward the users of financial statements, especially for non-listed enterprises.** Except to some extent in the financial sector, the law does not specify external auditor's liability for misconduct and improperly discharging their professional responsibilities. Even though there is a limited history of civil lawsuits against external auditors in Brazil, their role has been questioned in relation to several cases of misstatements in published financial statements in the past. In addition, as previously noted (Para. 21), when financial statements of non-listed companies are audited (for the needs of shareholders or banks or other parties), they are very rarely disclosed to the public. This limits the risk for outside auditors to be challenged by third parties with respect to the fulfillment of their professional obligations and standards. Also, no professional insurance is required from external auditors to cover their exposure to legal recourse by financial statements users.<sup>52</sup> Furthermore, audit committees, whose role includes monitoring external auditors' independence and effectiveness in delivering an audit of quality, are very infrequent among Brazilian companies. Taken as whole, these factors increase the risk that the audit work could be inadequate—particularly in non-listed enterprises, which are rarely subject to supervision by a regulatory agency—to ensure high quality published financial statements.

### C. Professional Education and Training

41. **A large number of universities in Brazil offer an accounting and auditing curriculum, although the quality of those curricula is very uneven.** Article 209 of Brazil's Constitution clearly states that universities have autonomy over curricula and administration. The general content of accounting education in Brazil is defined by the federal Ministry of Education (MEC). In addition, the National Council of Education (CNE), a body under the authority of the MEC, has defined a national undergraduate accounting curriculum which requires a minimum of 3,000 course-hours in accounting (auditing is not covered).<sup>53</sup> There are currently 844 accounting programs nationwide, mostly at the undergraduate level, 41% of which are in the South-East region. The number of undergraduate programs has been growing steadily over the years, from 458 in 1999 to 683 in 2003.<sup>54</sup> Part of this growth came about due to the creation of new night

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document in the audit working papers all threats to their independence as well as the safeguards applied to mitigate those threats" (Article 23-2).

<sup>51</sup> Central Bank Resolution 3198/04, Art. 6-8; CNSP Resolution 118/04, Art. 7-10.

<sup>52</sup> Audit firms members of international networks are usually covered under an international arrangement however.

<sup>53</sup> CNE Instructions no. 289/2003 and 329/2004 – The national curriculum encompasses three areas: (i) general academic requirements; (ii) professional skills and competence; and (iii) specific requirements. Curriculum objectives and contents take into account the general guidelines of Brazil's higher education system, as well as specific requirements for accounting degrees. The curriculum comprises an interdisciplinary core and a field research work, which may address taxation, environmental accounting, history of accounting, or accounting and auditing themes. According to the Instruction, after completing the curriculum, a student should possess several skills and abilities including using the professional terminology appropriately; understanding the impact of other disciplines on the study and practice of accounting; and complying with all accounting standards.

<sup>54</sup> Source: National Institute of Education Studies (INEP). Additionally, nine Brazilian universities offer a master's degree curriculum in accounting besides a bachelor level degree, and one has a doctorate program in that field.

courses, designed to attract a large number of students who work during the day. Few universities incorporate IFRS and ISA in their curriculum.<sup>55</sup> In practice, the content and academic levels of the curricula vary significantly from one university to another. This was evidenced by the results of a national examination organized by the MEC (dubbed the *provão* or “big exam”), which was taken by graduating students in all universities to serve as a basis for comparing the academic level.<sup>56</sup> Overall, accounting in Brazil is not perceived as a prestigious field and this is illustrated by the fact that the country’s leading business school, *Fundação Getúlio Vargas*, does not have an accounting curriculum.

42. **In 2000, a professional examination requirement was introduced in Brazil for all accountants and accounting technicians<sup>57</sup> to obtain a license to practice.** The minimum qualification exam (*exame de suficiência*) was introduced by CFC through Resolution 853/99. Until 1999, all graduates from an MEC-accredited undergraduate program in accounting were eligible for registration. Previously registered accountants or accounting technicians have been “grandfathered.” The introduction of a professional exam is consistent with IFAC’s International Education Standards for Professional Standards (IES) and has been viewed as a significant step toward the improvement of the accounting practice and the development of the profession in Brazil. Two sessions of the exam have been organized each year since 2000. The exam lasts four hours and consists of a 50-question, multiple-choice questionnaire covering rather basic issues, with a strong focus on taxation. It is clearly not comparable to international professional examinations in accounting (e.g., certified public accountant exam in the US), which cover a broader range of topics and include the “essay” type questions. The average pass/fail ratio since 2000 has been 60/40 for accountants and 45/55 for accounting technicians (source CFC). It should be noted that the minimum qualification exam has been challenged before state courts by accounting bachelors who argued that the exam impinged on their acquired rights to obtain a license solely as a result of having graduated from an accredited university. In several cases the courts issued injunctions in favor of the student, considering the CFC Resolution to lack the necessary authority to mandate an additional requirement for licensing. As a result of this situation, the CFC has decided to withdraw the examination and a bill (PL 2485/03) is currently being discussed before Congress to embed the examination requirement in the Law. The bill was approved by the Chamber of Deputies and has been sent to the Senate, where it is expected to pass.

43. **CVM, BCB, and very recently SUSEP require a professional qualification exam as part of the registration process to become a licensed external auditor in the sector under their purview.** Under CVM Instruction 308, Articles 2 and 30, independent auditors must pass a professional exam to be administered by the CFC in conjunction with IBRACON. In turn, the CFC issued a standard (NBC P 5) regulating the exam and establishing a registry of external auditors authorized to perform audits of listed companies.<sup>58</sup> The four-hour exam, which was implemented for the first time in November 2004, covers accounting, auditing, ethical and legal

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<sup>55</sup> A university in the South-East region has recently introduced a new curriculum based on an international benchmark developed by a group of experts convened by the United Nations Conference on Trade and Development (UNCTAD), fully incorporating IFRS. This newly introduced curriculum differs from the common structure of most Brazilian universities which tend to separate accounting from economics, business administration and information technology. The “global curriculum” developed by UNCTAD incorporates elements of IFAC’s International Educational Guidelines and relies on existing curricula in Canada and the UK, which are considered as benchmarks within the profession worldwide.

<sup>56</sup> Results of the *provão* are available at <http://www.inep.gov.br/superior/provao/sintese/sintese2002.htm>.

<sup>57</sup> As defined in paragraph 35.

<sup>58</sup> *Cadastro Nacional de Auditores Independentes* or CNAI (CFC Resolution no 1018 issued February 2, 2005). As of April 2005, there were 781 auditors registered on the CNAI (source: CFC).

issues. Regarding banks, financial institutions, insurance companies and open pension funds, the BCB and SUSEP require an additional four-hour exam which is also administered by the CFC in liaison with IBRACON. The first BCB exam was also offered in November 2004, while the SUSEP exam has not yet been offered. The supplemental exam must be retaken every five years.

44. **Continuing professional education is compulsory since 2003 for individual auditors and audit firms registered with the CVM and the BCB.**<sup>59</sup> Audit firms must have a continuing professional education (CPE) program in place for partners and staff, in accordance to guidelines issued by the CFC in cooperation with IBRACON. CFC has issued a standard on CPE for auditors<sup>60</sup> which (a) sets a minimum number of credits<sup>61</sup> to be acquired each year; (b) establishes a four-member Commission on CPE within the CFC to accredit training courses and events organized by private organizations in coordination with the CRCs; (c) delegates to the CRCs the monitoring of registered auditors' compliance with their training obligations; and (d) sets the requirements for the approval of third-party training. The institutions that are accredited to provide training include: CFC, CRC, IBRACON, the universities recognized by the MEC, specialized professional training firms, and audit firms. Auditors interviewed as part of the ROSC review pointed to (i) difficulties experienced by small and medium audit practices for accrediting in-house training courses with the CRC, (ii) a shortage of available CPE courses, particularly in regions other than the South East and (iii) the lack of consistency in the quality of CFC-accredited courses, due in part to the fact that CFC/CRC do not monitor the actual quality of the courses. By mandating continuing education for practicing auditors, Brazil is aligning itself with international good practice.<sup>62</sup> Further efforts are needed on the part of CFC and the CRCs for the accreditation of quality training programs.

45. **Overall, accounting and auditing education in Brazil has been making some progress but much more must be done to meet the needs for more and higher quality financial information in Brazil.** Academic curricula need to better take account of international standards and cover auditing. The notion of compulsory continuing education is fairly incipient and requires a more active policy on the part of the profession. Accountants play a key role in assisting companies in preparing quality financial statements. Similarly, auditors have a major responsibility in enforcing high quality financial reporting standards. This role is all the more important in the case of non-listed companies, which are not currently subject to statutory audits, and many of which likely do not have auditors even for their own purposes. Accordingly, continuous improvements in education and training of accountants and auditors will be critical to the success of Brazil's efforts to enhance its financial reporting regime and therefore to its ability to achieve the objectives of furthering the development of its private sector (paragraph 14).

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<sup>59</sup> CVM Instruction 308, Article 34, and BCB Resolution no. 3198, Article 27.

<sup>60</sup> NBC P 4 issued September 27, 2002 (CFC Resolution no. 945/02).

<sup>61</sup> Credits may be obtained in any of the following ways: i) taking CFC-accredited courses, conferences and other events of the same nature as well as graduate courses and executive education programs; ii) being a member of a technical committees of CFC, IBRACON and accounting bodies abroad; and iii) writing papers in the field of accounting.

<sup>62</sup> IFAC issued an education standard in May 2004 (IES 7) requiring CPE from its membership.

## D. Setting Accounting and Auditing Standards

46. **Generally Accepted Accounting Principles (GAAP) in Brazil arise from a variety of sources, including the Corporations Law and the standards and interpretations issued by up to eight different institutions.**<sup>63</sup> The country's two accountancy bodies, CFC and IBRACON (paragraphs 33 and 36) have issued accounting pronouncements, which represent the bulk of Brazilian GAAP. However, these standards do not have legal backing—i.e., the law does not require companies to abide by CFC rules in their financial statements, only CRC-registered accountants are required to abide by these—and therefore are not uniformly applied. Some of these standards conflict, or are considered by some to conflict, with the Corporations Law, tax rules, or other laws and regulations, in which case they are seldom applied. Examples of circumstances where such conflict have arisen are provided in paragraph 62 below. In addition, various regulatory agencies have the legal authority to issue accounting pronouncements, although so far only the National Electric Energy Agency (*Agência Nacional de Energia Elétrica* or ANEEL), has done so.<sup>64</sup> Even though it is not legally empowered as a standard-setter, IBRACON plays an important role, either by issuing its own accounting pronouncements<sup>65</sup> or contributing to the standard-setting process within CFC or regulatory agencies. In terms of the standard-setting process itself, it is fairly transparent with practically all draft regulations being exposed to the public for comments before being adopted. Once enacted, those regulations are posted on the respective websites.

47. **CVM plays an active role in setting accounting and reporting standards for listed companies.** CVM has issued a number of accounting standards on subjects of particular relevance to listed corporations,<sup>66</sup> as well as recommendations (*ofícios circulares*) including annual guidelines on the application of specific accounting, financial reporting and auditing requirements. The elaboration of these standards involves the staff of CVM's Superintendency of Accounting Norms (SNC) and a Consultative Committee which was set up in 1994. The Consultative Committee has a diverse membership representing a number of stakeholders including CFC, IBRACON, financial sector regulators, financial intermediaries, the business community, and prominent universities. Some of the standards prepared by the Consultative Committee and SNC over the recent period are very similar to the IFRS equivalent.

48. **The Central Bank has also been making efforts to align the accounting norms applicable to financial institutions with IFRS, insofar as they would not conflict with Brazilian banking law and within the framework of the Basel Committee's core principles especially in relation to prudential rules.** BCB has carried out an assessment to identify gaps between the COSIF and IFRS, and its Standards Department (*Departamento de Normas* or DENOR) has drafted a preliminary convergence plan which must still be approved by the board of BCB. Since the Central Bank is not bound by the Corporations Law, it has the ability to go

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<sup>63</sup> This report uses the term Brazilian GAAP to refer to the full set of Brazilian accounting standards even though, given the multiplicity of sources, some standards may conflict and would therefore not necessarily be “generally accepted.”

<sup>64</sup> ANEEL Resolution 444/01 sets forth an “accounting manual” for power companies.

<sup>65</sup> IBRACON's pronouncements are officially called Accounting Standards and Practices (*Normas e Procedimentos Contábeis* or NPC) or Auditing Standards and Practices (*Normas e Procedimentos de Auditoria* or NPA).

<sup>66</sup> The most significant of these standards are: Deliberation 26 on Disclosure of related party transactions; Deliberation 29 on Accounting Framework; Instruction 247, Consolidation of financial statements and Investment in associates – equity method; Instruction 273 on Employee benefits; Instruction 408 on Consolidation of special purpose entities; Instruction 59 on Statement of Changes in Stockholders' Equity; Deliberation 183 on Revaluation of property, plant and equipment; Deliberation 273 on Income tax credits; and Instruction 235, Financial Instruments – Disclosure.

much further in its alignment with IFRS without the need for legal amendments; still, some issues such as leasing, which are regulated by tax rules, require a change in the law in order to attain convergence.

49. **Auditing standards are set either by CFC or IBRACON.** CFC is the legally recognized standard-setter for auditing. IBRACON, which has its own standards, works closely with CFC in developing draft audit standards, which are open for public comment before being formally issued. Regulatory agencies participate in the standard-setting process, but they do not issue their own standards. Except for ethical aspects, auditing standards are not considered a major issue at present in Brazil.

50. **The fact that the responsibilities for accounting standard-setting are scattered across many institutions results in a series of inefficiencies.** First, since there is no single set of accounting standards applicable to general-purpose financial statements, each regulator must issue their own specific standard which often results in a duplication of effort. Second, the principal focus of a regulator should be the supervision of a specific sector or group of sectors; however, in Brazil, regulators must spend a significant proportion of their time elaborating standards rather than enforcing them. In addition, the multiplicity of standards may result in financial statements that are not easily compared, as well as a lack of clarity, consistency, and efficiency. A strong consensus exists at present among preparers, regulators, auditors and users of financial statements in favor of unifying the standard-setting process.

#### **E. Ensuring Compliance with Accounting and Auditing Standards**

51. **CVM has significantly increased its enforcement capacity over the recent period.** The Securities and Exchange Law no. 6385/76 (as amended) empowers CVM with the monitoring and enforcement of accounting and reporting requirements applicable to listed corporations. CVM's Superintendency of Company Relations (SEP, which has "front office" responsibilities in matters of enforcement) is responsible for most of that function. The Superintendency of Accounting Norms (SNC) has an advisory, "back office" role in addition to its responsibility for issuing accounting and auditing rules. SNC is also in charge of monitoring auditing requirements. SEP and SNC have staffs of 33 and 15 respectively, of which respectively 14 and 5 were recruited in 2004. Such an increase in capacity was partly dictated by the fact that the supervision of investment funds had been recently transferred to CVM from the BCB. SEP staff members have degrees in accounting, economics, engineering and business; staff at the SNC are all accountants, and most of them have experience as auditors or preparers. CVM conducts reviews of the financial statements for compliance on the basis of a sample. In addition, particular events—such as public offerings, investor complaints, and audit reports containing qualifications or emphasizing certain issues—trigger thorough financial statement analyses.

52. **CVM is empowered to inspect listed corporations and their independent auditors, and to conduct administrative inquiries.** It can impose administrative sanctions, which include warnings, fines, restatement orders, and cancellations of registration (the latter requiring a decision by the Board of Commissioners and being subject to appeal before the National Financial System Appeals Council). In the past year, CVM has suspended the registration of 50 companies; a total 180 companies are currently suspended. CVM has a policy of systematically requiring the restatement of financial statements when the auditor's report mentions a departure from accounting standards.<sup>67</sup> Even though its staff has been significantly increased, CVM needs

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<sup>67</sup> Between June 2000 and May 2005, 15 companies were required to restate their financial statements (source CVM). The reasons for restatements included recognizing contingent assets, underestimating

to further enhance its enforcement capacity especially to address the increasing complexity of corporate financial reporting on the BOVESPA. For instance, even though US GAAP- or IFRS-based financial information is not mandated by Law, it does play an important role for market discipline, and therefore should be monitored by the securities market regulator, especially in the case of companies that are not subject to the US Securities and Exchange Commission's supervision (paragraph 53).

53. **BOVESPA carries out some enforcement actions regarding financial reporting by issuers.** Five staff of the Office of Corporation Analysis review financial statements. If inconsistencies are detected, BOVESPA may order corporations to resubmit their corrected financial statements. It may also apply administrative sanctions to companies (fines, suspensions and, in extreme cases, de-listings<sup>68</sup>). However, BOVESPA has no punitive authority over the managers and employees of listed companies and investors; rather, if such individuals commit wrongdoings, BOVESPA must inform CVM, who is empowered to apply punitive sanctions. BOVESPA gives special attention to the financial statements of companies listed on *Novo Mercado* and Levels I and II. BOVESPA's recent efforts to assess compliance are commendable, but greater resources and capacity are needed to enforce the significantly higher level of requirements of the voluntary, special segments, particularly the use of IFRS or US GAAP, which requires a very high level of accounting expertise.

54. **The Central Bank enforces accounting standards using a two-tier supervision system.** Law 4.595 of December 31, 1964 and Law 9,447 of March 14, 1997 empower the Central Bank with the monitoring and enforcement of accounting and reporting requirements applicable to financial institutions. BCB's Department of Off-site Supervision and Information Management (DESIG, formerly DESIN) in Brasilia analyzes a large amount of information which it collects into a comprehensive database. The information provided by financial institutions in accordance with COSIF is cross-referenced against information from the Credit Risk Database, which contains data on each financial institution's full portfolio. The database compiles information on credit operations and identifies possible risk concentrations, as well as banks with high exposure. Based on this information, DESIG alerts the Department of On-Site Supervision (DESUP) of any potential problems; this notification then triggers an investigation through site visits and meetings with managers and other technical staff. In addition, as part of its risk-based supervision, DESUP calls on banks periodically (once or twice a year for large banks) for an informal meeting to discuss accounting issues, among others. Monthly meetings also take place between CVM and BCB to discuss listed banks. Banks interviewed as part of the ROSC have pointed to a substantial improvement in the Central Bank's supervision. Nevertheless, it seems that there is not enough manpower to conduct all the inspections needed, as evidenced by the backlog of cases for possible administrative sanctions. As of June 2005, there were close to 300 cases under investigation, but over 3,300 were waiting to be investigated. The BCB recognizes the importance of leveraging the work of external auditors not only for the purposes of its supervision but also as part of a trend toward greater market discipline within the banking sector as emphasized in the Basel Committee's core principles. Both CVM and BCB sanctions may be appealed to a Council<sup>69</sup> within the MoF (CRSFN), which is the highest administrative instance for appeals of cases pertaining to listed companies and financial institutions. However, no current data are available regarding the potential backlogs in this body.

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contingent liabilities, unsupported capitalization of expenses, improper revaluation of intangible assets, and inadequate disclosures.

<sup>68</sup> Five companies were delisted in 2002, four in 2003, and two in 2004 (source CVM).

<sup>69</sup> Conselho de Recursos do Sistema Financeiro Nacional.

55. **SUSEP has two Departments in charge of off site inspection: DECON (Economic Control Department) and DETEC (Technical Actuarial Department), which together are responsible for monitoring compliance with the accounting, reporting, and auditing requirements of insurance companies and open pension funds.** DECON has a staff of 26, and is subdivided into four divisions which have, among their competencies: (a) Insurance Market Monitoring (7 staff) issues guidance to the market regarding accounting procedures; (b) Statistics (4) maintains the databases that centralize companies' financial statements and other required information; (c) Registries (10) are empowered to suspend and cancel the licenses of insurance companies; (d) Assets Control (5) elaborates statistical models to analyze and monitor operational, legal and market risks. In DETEC, the Technical Reserves division (7 staff) is responsible for evaluating actuarial opinions. Although SUSEP does issue administrative sanctions—mostly in terms of fines for non-compliance—companies may appeal the sanctions to the CRSNSP.<sup>70</sup> This is a council within the MoF and is the highest administrative instance for appeals of cases pertaining to insurance companies and open pension funds. The CRSNSP faces an ever growing backlog of appeals; from April 2004 to April 2005, an average of 88 monthly cases were brought to the Council, and an average of 16 monthly decisions were issued. Currently, there are close to 2400 cases awaiting trial.

56. **In the closed pension fund sector, regulatory enforcement is at an incipient stage, and is expected to be strengthened considering the importance of this sector in Brazil.**<sup>71</sup> So far, enforcement actions towards compliance with applicable accounting and reporting have been minimal. A recent case which caught the public's attention and raised a series of articles in the national press involves the pension fund for Petrobras employees, Petros, where a large deficit in reserves was reported in early 2005. The deficit was due to an increase in the plan's actuarial liability by BRL 8 billion (approximately US\$ 3.5 billion), which in turn was caused by changes in certain actuarial assumptions including the mortality rates (on average actual mortality over the previous six years had been 40% below the figures taken into account by the actuaries; overestimating mortality led to understating the future pension cash outflows, and therefore the amount of the outstanding liability for the fund). There is a problem in both the closed and open pension funds sector in that actuaries are not subject to any oversight, and are therefore not required to apply comparable methodologies, and their actuarial premises are not required to be reviewed by management or the board.

57. **For non-listed companies in the non-financial sector, particularly SMEs, there is no system to effectively ensure that they adhere to Brazilian accounting standards in their financial statements.** The only enforcer of accounting standards for these companies is the CFC/CRC system, through the company's accountant. In other words, the company's accountant, as a CRC member, is required to follow Brazilian GAAP. However, since these companies are not required to undergo a statutory audit and are not required to have a *conselho fiscal*, there is no external verification of the quality of the financial statements. The ROSC team met with users of financial statements who mentioned the lack of quality of SME financial statements, and their relative disuse for credit decision, which contributes to the high spreads applied to these companies. Thus, it is essential that the CFC strengthen and extend enforcement capacity, as mentioned in paragraph 60 below, in order to promote better financial reporting by SMEs.

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<sup>70</sup> In 2004, of 2,490 sanctions applied by SUSEP, 824 appeals were sought.

<sup>71</sup> The Monitoring Department of SPC is responsible for monitoring compliance with the accounting, reporting, and auditing requirements of closed pension funds. Refer to Para.10, footnote 26 regarding the recent attempt to establish a separate agency ("PREVIC") charged with enforcement of pension fund regulations. SPC has been reinstated with its monitoring role in June 2005.

58. **Management, directors, independent auditors, members of the *conselho fiscal* and members of the audit committee are subject to a series of administrative, civil and/or criminal sanctions in the event of non-compliance with their respective obligations involving accounting, reporting or auditing.** Specific penalties include:

- ***Criminal penalties for management and persons with fiduciary responsibilities within S/As*** – Article 177 of the Criminal Code provides for one to four years of imprisonment for making false statements in prospectuses, financial statements, at shareholders meetings, etc. regarding the financial condition of a corporation, or withholding information with the intent to commit fraud. Criminal cases can be brought against an alleged wrongdoer by the company itself, shareholders, other interested parties, or the public prosecutor's office (on its own accord or upon request by regulators).
- ***Additional penalties pertaining to bankruptcy*** (for non-financial enterprises including *limitadas*) – Brazil's recently enacted bankruptcy law<sup>72</sup> prescribes 3½ to 8 years of imprisonment for fraudulent financial statements or bookkeeping resulting in losses to creditors, concealment or destruction of documents regarding accounting and deletion of accounting data from computer systems. Nine years of imprisonment can be applied for "off-the-book" accounting. These sentences can be applied to a broad range of individuals including management, accountants, accountant technicians, and auditors.
- ***Administrative sanctions against independent auditors and audit firms for wrongdoing within the securities market***<sup>73</sup> – According to Brazilian law, regulatory agencies are empowered to apply administrative sanctions only. In the case of CVM, 18 disciplinary procedures have been conducted against auditors since 2002, leading to various sanctions including temporary suspension in five cases.

59. **Although the law sets quite rigorous rules with regard to the liability of managers, directors, members of the *conselho fiscal* and independent auditors, this is mitigated by an inefficient justice system, with judges that are not always knowledgeable of financial or business issues.** In fact, there are no specialized commercial courts and commercial disputes are settled in the common court system.<sup>74</sup> Furthermore, there are few restrictions on the right to appeal a decision, which results in an enormous backlog of cases in the courts of higher instance; in practice, this means it can take years, from the time a suit is filed, to the time a final decision (non-appealable) is reached. As a result, market discipline suffers, as wrongdoers know that the chances of actually being punished for their offenses are low. Given the deficiencies in the justice system,<sup>75</sup> the relative importance of administrative sanctions in promoting market discipline is heightened.

60. **In 2001, CFC put in place a system of quality review of the audit practice, the first of its kind in Latin America.** Through Resolution no. 910/01, CFC established the External Review Committee (*Comitê Administrador do Programa de Revisão Externa de Qualidade* or CRE) and a professional norm (NBC T 14) defining a system of peer review among auditors (sole practitioners or firms) of listed companies. This Resolution was passed pursuant to CVM Instruction 308, which mandated that "independent auditors implement an internal program of quality control" (Art. 32). The CRE system was deployed in 2001, and has been well perceived by members of the profession. Notwithstanding, the CRE lacks a formal system for selecting reviewers and ensuring that they are qualified to perform reviews. Additionally, audit firms are

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<sup>72</sup> Art. 168 of Law 11,101/05.

<sup>73</sup> As set forth in Article 26 of Law 6385/76, as amended.

<sup>74</sup> A commercial court was, however, created in Rio de Janeiro which has managed to provide speedier conflict resolution. As a result, commercial litigation in Rio de Janeiro lasts up to 3 years, as compared to 6 years in São Paulo.

<sup>75</sup> According to the Authorities, efforts to improve the judicial system in Brazil are under way.

required to be reviewed by a peer (i.e., Big Four review other Big Four, tier-2 review other tier-2, etc.); such “peer review” system had been used in a number of countries in the past.<sup>76</sup> Although the CRE is sponsored by CFC with the participation of regulatory agencies, the conduct of the reviews is not directly monitored by CFC, regulators—even though ultimately it was set up to satisfy their needs—or any other independent body. Moreover, the sanctioning regime of the quality review needs strengthening to ensure the system achieves its objectives of fostering adherence to high quality audit practice by all licensed practitioners. Regulators noted that when they reported cases of non-compliance to CFC, the required sanctions were not applied, which has led some regulators to question the usefulness of the quality control system as a whole. Furthermore, in recent years, the US and European countries, among others, have introduced systems of independent oversight for statutory auditors to replace or strengthen existing arrangements that were based on reviews among peers and self-regulation within the audit profession. The Authorities have expressed the view that, after an initial stage during which the focus was placed on raising awareness among the profession on the issue of quality and compliance, the CRE has begun a new phase which should see more sanctions against errant auditors.

61. **On the whole, efforts to strengthen the enforcement of financial reporting and auditing requirements need to be expanded in order for the growing needs for quality financial information in Brazil to be met.** Recent changes have been made toward active enforcement, with specific and adequate resources, of financial reporting by listed companies, financial institutions and insurance companies; however, these changes are too recent for their effect on the quality of the financial reporting to be properly measured. The enforcement regime in its current stage is somewhat hampered by the fact that regulators dedicate important efforts to standard-setting. Specifically with respect to the audit practice, the recently introduced quality assurance system (CRE) was a positive step in the right direction but its largely self-regulated nature limits its effectiveness. Consistent with the trend observed over the last three years and with the fact that external audits are for the most part a requirement of the law, direct involvement of regulatory agencies in the quality assurance system is required.

### III. ACCOUNTING STANDARDS AS DESIGNED AND AS APPLIED

#### A. Standards as Designed

62. **Brazilian accounting standards for general purpose financial reporting differ significantly from IFRS in a number of key areas.** Over the last few years, some differences between Brazilian accounting standards and IFRS have been eliminated, for example, with the required disclosures of related party transactions.<sup>77</sup> In addition, an effort to achieve greater alignment with IFRS is underway with several exposure drafts recently issued by IBRACON and

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<sup>76</sup> The main objection to this system has to do with the fact that the pool of reviewers is the same as the pool of reviewed audit firms, which can create an environment of complacency and lead to review’s findings being less candid than they should be. This view has been particularly strong in the US and led to the adoption of an independent quality control system with the establishment through the Sarbanes-Oxley Act of the *Public Company Accounting Oversight Board* (PCAOB), an autonomous body.

<sup>77</sup> Another important gap related to the accounting treatment of foreign exchange losses arising from the 1999 devaluation, which the law allowed Brazilian companies to capitalize and amortize over a maximum of four years. This difference was extinguished after 2003. It is worth noting that the audit profession had opposed that treatment and that, moreover, CVM issued a resolution (294/1999 and 404/2001) requiring auditors to systematically qualify their opinion on that matter.

CVM.<sup>78</sup> However, one of the significant constraints to further converge with IFRS and other internationally recognized standards is the relationship between tax reporting and financial reporting; in fact, some companies refuse to employ certain accepted accounting practices for fear that they would be challenged by the tax authorities, thereby triggering a tax assessment.<sup>79</sup> The principal areas of divergence from IFRS (2004 version) and their main implications are briefly discussed hereafter. Nonetheless, in some cases, Brazilian rules are more effective than those in place in other markets: CVM's Rule 247 would prevent a similar case to Enron to happen in Brazil, as the control over a company is not defined over a defined percentage, but rather on effective control power. In addition, CVM's Rule 358 related to ongoing disclosure is much deeper to obligations on material events, being placed in an IOSCO paper as international example.

**a) Recognition and measurement of the various elements of the financial statements (assets, liabilities, income and expense):**

- *Leasing operations* – Companies can decide to acquire property, equipment or other assets through a leasing arrangement, which can be a financial lease (i.e., one that in substance amounts to a de facto acquisition of fixed asset financed by a debt), or an operating one. As required under the LALUR (see footnote 79), companies must always account for leases as through they were operating. Since tax authorities do not accept another accounting treatment, the end result is that neither asset nor debt is recognized. Under IAS 17, *Leases*, both the asset and the liability must be recorded in the accounts. This is especially important for financial analysts who pay particular attention to the level of indebtedness of companies.<sup>80</sup> Only a change in the legislation<sup>81</sup> could fix this problem and allow for an accounting practice consistent with IFRS and other internationally recognized GAAP.
- *Accounting for the tax consequences of revaluations* – Revaluations of property plant and equipment are permitted in Brazil and used to be relatively frequent. Under IBRACON's NPC XXV, *Accounting for Income Tax and Social Contribution*, companies that make such revaluations in their financial statements are required to recognize at the same time a deferred tax liability, unless the revaluation relates to land. According to IAS 12, *Income Taxes*, a deferred tax liability must be recognized for all types of assets, including land, which leads to a lower net equity value of the reporting company.

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<sup>78</sup> Recently issued exposure drafts are meant to mirror the following IASs: *Presentation of Financial Statements* (IAS 1), *Accounting Policies* (IAS 8), *Events after the Balance Sheet Date* (IAS 10), *Accounting for Government Grants* (IAS 20), and *Provisions, Contingent Liabilities and Contingent Assets* (IAS 37). This ROSC did not include a review the aforementioned drafts.

<sup>79</sup> Under the Brazilian tax code, corporate taxpayers are required to prepare their income tax returns on the basis of their accounting records plus a set of reconciling entries meant to adjust their accounting profit or loss to a tax profit and loss. The reconciling items must be recorded in a specific "ledger for computing tax profits" (*Livro de Apuração de Lucros Reais* or LALUR) to ensure their traceability. The logic of this system—which is commonplace worldwide, except for the need to keep a specific ledger of adjusting entries—is to allow companies both to keep books of accounts in accordance with GAAP and to prepare tax returns compliant with tax laws, and is perfectly sound. The issue however is that, in practice, tax authorities do not accept company tax returns that take into account reconciling items for matters that are not expressly provided in the law.

<sup>80</sup> It should be noted that CFC has issued a standard (NBC T 10.2) on the accounting of leases which has similar features as IAS 17, but the law takes precedence over the standard.

<sup>81</sup> Changes will be required in a number of areas, including the LALUR system, to the Corporations Law, and Laws 6,099/74 and 7,132/83.

- *Intangible assets* – Under Brazilian GAAP, a variety of costs can be deferred (i.e., capitalized) over several years, including pre-operating and start-up costs.<sup>82</sup> The capitalization of pre-operating and start-up costs is not allowed under IAS 38, *Intangible assets*, which requires such costs to be expensed as incurred and sets precise, stringent conditions for capitalization or other types of expenditure. Users of financial statements tend to be cautious on such soft assets and to prefer that they be expensed.
- *Use of “fair values”* – In general terms, Brazilian GAAP tend to follow the “historical cost model,” which uses acquisition price as a basis to report; conversely, IFRS tend to promote a “fair value model”, i.e., one that uses market prices or equivalent proxies intended to reflect current values. The merits of each model have been widely discussed internationally although, recently, there has been a clear trend in favor of fair values. This difference of approach is particularly evident in the way acquisitions of companies are accounted for in the consolidated financial statements in Brazil: IFRS 3, *Business combinations* requires that all assets and liabilities of the acquired entity be stated at fair value in the balance sheet of the acquirer, whereas Brazilian GAAP require to use historical book values as basis. Other examples of such difference concern Investment Property (IAS 40) and Biological Assets (IAS 41), for which there are no specific pronouncements and which are usually valued at cost in Brazil. The main problem in using historical cost is that it does not adequately reflect the current value of the asset or liability and therefore leads to understating or overstating the amount of equity, which is a key indicator of the company’s solvency.
- *Financial instruments* – Many Brazilian companies use derivatives and other types of financial instruments for hedging or other purposes. Except in the case of financial institutions, for which there are specific standards to follow, there is no Brazilian accounting standard that deals with the way these instruments should be recorded or valued.<sup>83</sup> This leaves a wide margin for companies to decide how to account for these, which leads to inconsistencies among financial statements, thus hindering their comparability and reliability. Additionally, financial assets held for trading or available for sale are carried at cost under Brazilian GAAP while according to IAS 39, *Financial instruments – Recognition and Measurement* they should be accounted for at their fair value.
- *Level of details in the standards* – Generally, Brazilian standards tend to be less precise than IFRSs and IASs, leaving more room for interpretation in the application of the standards. For instance, the Brazilian equivalent of IAS 36, *Impairment of assets* (IBRACON’s NPC VII) does not contain guidance on the identification of impairment problems. Similarly, no provision exists on the recognition of revenues arising from bartering agreements.

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<sup>82</sup> In effect, this means that a company’s start-up expenditures on non-capital goods can be treated as an asset, which is then amortized over a period of years. This is done so that, when presenting a company’s net equity in its first few years, it does not look like it is incurring large losses as a result of the substantial expenditures it incurred to begin operations. The problem here is that contrary to depreciable, capital goods, most of these expenditures either are “sunk costs” which means that they will not provide any future benefit, or the benefits they are expected to provide are uncertain; which lead IFRS to require they be expensed.

<sup>83</sup> Regarding financial instrument, the following rules apply for banks and investment funds: Central Bank Circulars 3,068/01, 3,082/02 and 3,086/02; for insurance companies and open pension funds: SUSEP Circulars 279/04 and 192/02; for closed pension funds, CGPC Resolution 5/02, as amended by CGPC Resolution 10/02)

- *Consolidation* – Consolidation of controlled companies is only required for the approximately 400 companies that are listed on the stock exchange (see footnotes 13 and 17), as well as financial institutions. This represents a significant weakness in the legal and regulatory framework, because parent company (non-consolidated) financial statements do not give a complete and accurate view of a company’s financial position and performance. The presentation of both consolidated and parent company statements should be mandated by the law for all non-listed companies above a certain size.
- *Proposed dividends* – Under the Corporations law, Brazilian companies must present their annual financial statements showing the future dividends as proposed by the board of directors as a reduction of equity, whereas under IFRS such dividend can only be recorded once the shareholders’ AGM has approved them.<sup>84</sup>
- *Measurement currency* – Under IAS 21, *Foreign Currency Translation*, companies whose activities, financial position and performance are predominantly influenced by a certain foreign currency must use that currency to measure all elements of the financial statements in preparing their financial statements. In Brazil, as in many other countries, all companies are required to report using the local currency as “measurement currency.” This difference of approach can lead to large variances in terms of the key financial indicators among companies with large exposure to international trade, especially when significant foreign currency fluctuations occur, as has been the case in Brazil over the last 40 years.<sup>85</sup>
- *Accounting for concessions* – Since the IASB has not yet issued a standard on concessions, Brazilian regulators are waiting to issue a pronouncement on this issue, so that will be aligned with the forthcoming international standard. In the interim, there is no specific pronouncement dealing with concessions, which leads to inconsistent accounting treatments.<sup>86</sup>
- *Construction contracts* – Under IBRACON NPC XVII revenues and profits on construction contracts may be recognized using one of three different methods (including the completed contract method whereby no effect is recognized in the results of the company until completion of such contract—except if the latter is expected to generate a loss). IAS 11, *Construction Contracts* only permits the use of the percentage-of-completion method.

**b) In terms of presentation of the financial statements:**

- *Statement of cash flows* – Brazil’s Corporations Law does not require the presentation of a cash flow statement, which, under IFRS and most national

<sup>84</sup> This point does not apply to the minimum mandatory dividends (*juros sobre capital próprio*), when those are required under the companies’ by-laws, as indeed they qualify as liabilities under IFRS.

<sup>85</sup> The case of *Companhia Siderúrgica Tubarão* (CST, a leading steel company listed on BOVESPA), illustrates this issue. CST is the only Brazilian company known to have reported under Brazilian GAAP, IFRS and US GAAP. According to published, audited information, CST uses the US\$ as its functional currency (worldwide steel prices are set in US\$) in both IFRS and US GAAP financial statements. The impact of modifying the valuation of its assets from BRL to US\$ represents an increase of CST’s net equity of 37% at December 31, 2004.

<sup>86</sup> Although the IASB has not issued a specific standard, IFRS includes several texts that apply to concessions to various degrees including IAS 11, 16, 17, 38; in addition, interpretation SIC 29 covers the disclosure of service concession arrangements. Three new draft interpretations were issued in March 2005 by the International Financial Reporting Interpretation Committee (IFRIC, a committee under IASB) on concessions.

accounting standards worldwide, is one of the four basic financial statements. Instead, Brazilian accounting rules require a Statement of Origins and Application of Funds (*Demonstração das Origens e Aplicações de Recursos* or DOAR), which does not show the breakdown of cash flows by main category of activities (operating, investing and financing), and its usefulness is considered limited by investors and other users. As a result, several users reported to the ROSC team that they are required to construct cash flow information based on the data contained in the DOAR and elsewhere in the financial statements. The need to “translate” the DOAR in order to gain a proper understanding of a company’s cash flows is an unnecessarily burdensome and inefficient exercise for investors and creditors.

- *Investment grants* – Article 182 of the Corporations Law requires companies that receive government grants<sup>87</sup> in relation to their investing activities record them directly as retained earnings. Under IAS 20, *Accounting for Government Grants*, these grants are to be recorded as income in the profit and loss statement over the life period of the asset for which the acquisition of which they were awarded. This way, the benefit is recognized in a consistent manner as the cost of the investment (depreciated over the useful life of the asset). This requires amending the Corporations Law to allow a presentation consistent with international practice.
  - *Presentation of the income statement* – Brazilian GAAP apply the concept of non-operating income or expense in the presentation of the income statement. These notions have been repealed in the 2004 version of IFRS (IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*). Additionally, in the case of a change in accounting policies or a correction of error in prior year financial statements, the latter are not restated to allow comparisons.
- c) ***Brazilian GAAP are less demanding than IFRS in terms of disclosure.*** Generally speaking, the accounting pronouncements of the various standard-setters are less detailed than their equivalent IFRS or IAS statement. This applies for instance to related-party transactions, which represents a key information for minority shareholders. Other specific examples of a lower level of disclosure are as follows:
- *Segment information (IAS 14)* – Until recently there was no pronouncement in Brazil requiring that information be provided in the notes regarding a company’s business segments (i.e., the different types of products and services, etc.). CVM recently issued a Circular that encourages disclosure of segment information, although it sets less precise and demanding guidelines than the requirements of IAS 14. Segment information is an important part of adequate disclosure on a company’s business, as it helps users understand its performance and cash flows, and therefore make more informed decisions overall.
  - *Earnings per share (IAS 33)* – Although Article 187 of the Corporations Law requires the disclosure of earnings per share (EPS), it provides no guidance on how it should be calculated. EPS is considered a major financial indicator by investors and its consistent and accurate computation is critical to allow investors to carry out a proper financial analysis. Hence, if companies are free to calculate EPS as they wish, comparing the EPS of different companies at face value becomes a futile exercise for investors; rather, they would be forced to carry out an extensive exercise of calculating EPS on their own, using consistent methodology. This may discourage foreign investment, as investors may wish to avoid such an unnecessary burden and

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<sup>87</sup> “Government grants” refers to a transfer of resources to a company by a governmental body in exchange for past or future compliance with certain conditions.

invest in markets that can already provide them with EPS that are calculated using consistent methodology and allow for easy comparisons.

- *Provisions, contingent assets and contingent liabilities (IAS 37)* – The applicable Brazilian standard (IBRACON’s NPC XXII) requires the disclosure of the nature of contingencies and provisions, and “other relevant information,” which is less precise than the requirements of IAS 37. If this information is not disclosed properly, it becomes very difficult for an investor to assess the size of a company’s total potential liabilities and assets, thus precluding a robust analysis of the company’s financial condition.

63. **Taken as a whole, these gaps may affect the international comparability of Brazilian companies’ financial statements especially in the views of international investors.** The gaps in accounting methods described above can lead to material differences with IFRS on some of the key indicators of a company’s financial situation or performance (e.g., debt and net asset value). For instance, a company that leases (as the lessee) a substantial part of the assets it uses, will show a possibly much lower level of debt by applying Brazilian GAAP rather than IFRS. This, added to a lower level of precision in the disclosure and significant differences of presentation, requires investors and other users to perform additional inquiries and analyses or limits the quality of the financial information available to them on Brazilian companies. Ultimately, it does not help foster confidence in the stock market and from lenders to the corporate sector, and therefore plays a role in constraining Brazilian companies’ access to long-term financing.

64. **Brazilian GAAP are less aligned with IFRS, as compared to their Chilean and Mexican<sup>88</sup> equivalents, mainly because of existing tax and legal constraints.** The Corporations Law has not been amended on accounting matters since its passing in 1976 (except for the issue of inflation accounting). This, in addition to the constraints associated with the process for preparing income tax returns (paragraph 62 above), has impeded the use of several accounting concepts which were developed on an international level and incorporated in IFRS.<sup>89</sup> In contrast, Chile and Mexico, where the law does not set specific accounting methods and tax rules have less influence of accounting, have been able to adopt standards that are closer to IFRS, including on such matters as leasing, government grants, and segment information.

65. **In the banking and insurance sectors, BCB- or SUSEP-issued accounting standards show a higher degree of alignment with IFRS than Brazilian GAAP applied to non-financial enterprises.** Banks and financial institutions must comply with the BCB’s Accounting Manual (*Manual de Contabilidade para Instituições Financeiras* or COSIF) when issuing financial statements to their shareholders and to inform the BCB. One of the main differences between the accounting norms contained in the COSIF and IFRS relates to loan loss provisions. Under Chapter 6 of the COSIF, these provisions are to be evaluated, at a minimum, using a matrix based on the number of past-due days<sup>90</sup> and fixed loss rates to be applied to each category of loans (consumer v. others; guarantees v. no guarantees; fixed v. variable interest; etc.).<sup>91</sup> Although this method is consistent with the approach generally followed by bank supervisors; it is likely to lead to significantly different values than those that would have been obtained applying IAS 39, *Financial Instruments: Recognition and Measurement* (revised 2004), which requires assessing loss provisions on the basis of estimated future cash flows by loan or group of loan. As for the

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<sup>88</sup> A ROSC Accounting & Auditing exercise has been conducted in Chile and Mexico respectively in 2004 and 2003.

<sup>89</sup> Such relatively recent concepts include finance leases, financial instruments, and segment information.

<sup>90</sup> Category “A”: less than 15 days; category “B”: between 15 and 30 days; ... category “H”: more than 180 days.

<sup>91</sup> The provision rates range from 0.5% for category “A” to 100% for category “H”.

insurance sector, SUSEP and CNSP standards are generally close to the BCB norms. Significant differences exist with IFRS relating to the accounting of specific features of an insurance contract.<sup>92</sup> These differences compared to IFRS could involve significant amounts.

66. **Closed pension funds' reporting framework is geared mainly toward supervision.** Applicable accounting and financial standards are set out in CGPC Resolution no. 5 of 2002 which prescribes a series of rules including a detailed chart of accounts, templates of financial statements and tables for specific accounts (investments, etc.), valuation methods and disclosure requirements. The latter methods and rules differ significantly with IAS 26, *Accounting and Reporting by Retirement Benefit Plans*, especially on the valuation of certain investments and on level of detail of disclosures. In particular, Resolution no. 5 does not require that actuarial assumptions used be disclosed. Even a slight change in an actuarial assumption (e.g., interest or mortality rates) can result in a significant increase in earnings (or losses) for a pension fund;<sup>93</sup> disclosing such assumptions to the users of the financial statements is therefore considered critical to the understanding they gain of, and the confidence they place in, those statements. This type of disclosure is an essential part of an adequate reporting framework and therefore for ensuring proper accountability of the pension fund managers vis-à-vis participants in the plan, employers and regulators.

## B. Observed Reporting Practices

67. **The ROSC review of a sample of audited financial statements of Brazilian corporations for the year 2004 under local GAAP did not detect any case of apparent, major departure.** Such a review is not meant to, and cannot, identify misstatements; only an independent audit could achieve that objective. The sample of companies reviewed included some 20 listed companies, 12 non-listed corporations (*S/A fechadas*) and six institutions of the financial sector. In general, non-listed companies appear to adhere less strictly to the disclosure requirements. The issues arising from the review are summarized hereafter:

- *Segment information* – Less than one-third of companies for which information by segment of business could be expected did provide such information. This confirms the views of interviewed practitioners that relatively few companies provide adequate segment information in Brazil.
- *Financial instruments* – A significant number of the financial statements reviewed did not present the company's exposure to financial risks and its risk management policies and did not provide details of the fair value calculations, including the criteria used for such calculations.
- *Directors' compensation* – Even though CVM requires<sup>94</sup> listed companies to disclose the remuneration of Board members in the notes to the financial statements, less than half complied and none provided a satisfactory analysis of such amounts.
- *Report of the Board of Directors* – The review noted that the quality and degree of precision of the financial information contained in the Directors' report (which is a local equivalent of the management discussion and analysis in the US) was inconsistent.

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<sup>92</sup> These differences relate mainly to (i) the possibility under IFRS 4, *Insurance contracts* to account separately for the insurance component and the deposit component of an insurance contract; and (ii) the approach to perform the so-called liability adequacy test.

<sup>93</sup> Refer to paragraph 56, which sets out a real example where inaccurate actuarial parameters had a serious, negative economic result.

<sup>94</sup> CVM Interpretation (*Parecer de Orientação*) no. 04/79.

Moreover, a majority of non-listed companies did not include a Directors' report in their publication.

- *Related-party transactions* – A significant minority of the sampled enterprises reported the existence of transactions with related parties. However, none provided information on pricing policies, as required by NBC T 17, *Related Parties* issued by CFC.
- *Leases* – Only three companies provided information on leases in the notes to the financial statements, and only one had a complete disclosure. The other companies did not give any indication of the existence of leasing arrangements.
- *Other* – Few companies had made the required disclosures of (a) the nature of contingent liabilities and related exposure, (b) information on their insurance coverage, (c) their revenue recognition methods (beyond the generic reference to the use of the accrual method, which is mandatory in any case), (d) the calculation of minority interests, (e) details on deferred charges; and (f) the accounting treatment of tax incentives.

68. **Based on the above, Brazil's accounting standards, while relatively well developed, need to be further aligned with IFRS and applied in a stricter manner.** The significant differences with IFRS discussed above negatively affect the comparability, transparency and usefulness of the financial statements of Brazilian companies who report under local GAAP only. They also explain why interviewed market participants clearly indicated their preference for financial statements under US GAAP issued by companies listed in the US. This has led BOVESPA to require Brazilian companies listed on the *Novo Mercado*, Levels I and II special segments to present financial statements under US GAAP or IFRS in addition to those under Brazilian GAAP (paragraph 20). Indeed, a higher level of financial comparability and transparency is needed in order for the securities market to grow in terms of the number of companies listed and in levels of trading, and especially to attract international investors.

#### IV. AUDITING STANDARDS AND PRACTICES

69. **Generally accepted auditing standards (GAAS) in Brazil are well developed and are broadly similar to ISA. Some differences exist and require further alignment with ISA.** Brazilian GAAS are comprised of CFC's Standards of Independent Audit of Financial Statements<sup>95</sup> and related interpretations and IBRACON's Audit Standards and Procedures.<sup>96</sup> The standards, which were developed in many cases with reference to ISA, tend to be less detailed and to offer less application guidance, which increases the risk that they could be inappropriately applied. A few recently-issued ISAs do not have an equivalent in Brazil and, for several other ISAs, several aspects covered in the standard are not addressed by its Brazilian equivalent. The main differences between Brazilian GAAS and ISA relate to:

- (a) *Management representations (ISA 580)*, on the adequacy of internal controls aimed at preventing fraud, which is not required under NBC T 11;
- (b) *Circumstances when the company outsources its bookkeeping (ISA 402)*, which is not addressed by Brazilian GAAS;
- (c) *Auditing segment information (ISA 501)*, for which there is no specific requirement, in the same way that segment information is not required under Brazilian GAAP;
- (d) *Using the work of experts (ISA 620)*, as the equivalent Brazilian standard does not require the auditor to assess the reliability of the expert's work; and

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<sup>95</sup> NBC T 11, *Normas de Auditoria Independente das Demonstrações Contábeis* (CFC Resolution no. 820/97).

<sup>96</sup> *Normas e Procedimentos de Auditoria* (NPA).

- (e) *Information in documents containing audited financial statements (ISA 720)* – This issue is only dealt with in a CVM Guidance which only applies to listed companies.

70. **The high number of Brazilian companies listed on international markets and sustained levels of FDI over the last ten years have led to the further alignment of domestic audit practice with international standards.** Information obtained from the leadership of CFC and IBRACON and the representatives of the six leading audit firms in Brazil, corroborated by other sources, indicate that audit firms with international affiliation follow standards that are in substance equivalent to ISA. In the case of the small and medium audit firms, these will require more time to align their practice with the international benchmark, especially since professional examination and CPE have only been introduced recently. Also, the fact that *limitadas* are not required to have an audit tends to limit the market base available to small- and medium-sized audit firms (listed companies and large *limitadas* generally use larger audit firms), which makes specialization in audit services more difficult for these small- and medium-sized firms.

## V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

71. **Perceptions on the quality of financial reporting in Brazil vary greatly, as there is great heterogeneity in the transparency, comprehensiveness, comparability and overall quality of financial statements.** Generally speaking, there are observable differences between the financial statements of listed versus non-listed companies; companies listed on the *Novo Mercado* versus “regular” listed companies; companies listed in the US versus those listed only domestically; exporters versus non-exporters; banks versus public companies; large companies versus SMEs—with the former tending to be perceived as of better quality than the latter.

72. **Overall, observers pointed to an improvement in quality in recent years, particularly in large listed companies.** They mentioned two important factors assumed to have driven this trend: better enforcement and market pressures. Observers commented that the work of regulators has improved dramatically in recent years, particularly that of BCB and CVM. With regard to BCB, they cite the creation of new databases as a significant contributor to their improved supervision, in addition to improvements in the quality of staff. They also mentioned the creation of the new listing segments as an important, positive step in promoting better quality financial reporting; all seven of the initial share offering in 2004 were in the new segments (5 in *Novo Mercado* and 2 in Level II). There has also been a spillover effect to other companies, which despite no legal obligation, are having their financial statements audited and divulging quarterly financial statements with an eye towards a possible IPO in the future, preferably on the *Novo Mercado*.

73. **Still, observers cautioned that for an external investor (i.e., foreign investor), Brazilian financial statements may not be readily understandable.** The complexity and multiplicity of rules used to draw up financial statements make it difficult for individuals, other than analysts trained in the local market, to understand them.

74. **With regard to non-listed companies, including SMEs, there is very little trust placed in financial statements.** With regard to credit decisions, for example, financial statements tend not to be a bank’s most important source of information for assessing credit risk. Banks mentioned that the financial statements do not contain enough information to warrant an opinion. Instead, they must draw on other sources of information, such as site visits, analysis of a company’s strategic plans, as well as information from secondary sources (newspapers, third-party analyses, etc.) to supplement the information from financial statements, which some banks mentioned only counts for about one-third of the final credit score. However, it is important to

note that not all non-listed companies and SMEs are perceived equally—exporters, for example, tend to have much better financial statements.

## VI. FINDINGS AND RECOMMENDATIONS

### A. Principal Findings

75. The regulatory regime for the accounting and auditing practice in Brazil has been significantly strengthened over the recent years, in a variety of ways. Improvements included, *inter alia*, (i) the introduction of professional qualifications and a system of quality assurance within the audit profession; and (ii) strengthened enforcement of corporate financial reporting obligations by regulatory agencies in the banking and insurance sectors and on the securities market. On other fronts, however, progress has been slow, partly because efforts to amend the Corporations Law have not advanced. Overall, Brazil's accounting and auditing standards need to be significantly improved, in order to provide investors and other stakeholders more complete and useful financial information for use in making a wide range of decisions that have a substantial economic impact. The main findings arising of this ROSC are presented hereafter:

- (a) The Corporations Law of 1976 sets forth the bookkeeping, financial reporting and external audit obligations of non-financial corporations (*sociedades anônimas*), whether listed or not. An overwhelming majority of enterprises in Brazil are incorporated as limited liability companies (*limitadas*). These are regulated by the civil code, which sets minimal accounting requirements. Listed corporations (S/A) are required to publish their audited annual financial statements (or, as in the case of non-listed corporations, unaudited) in a newspaper and the official gazette. *Limitadas*, many of which are very large enterprises, including wholly-owned subsidiaries of multinationals, are not required to make their financial statements available to third parties and are subject to no audit requirement. The absence of disclosure requirements confers on these *limitadas* a substantial competitive advantage. The lack of availability of a full set of audited financial statements makes it difficult to invest in and lend to a wide array of medium to large creditworthy companies, and may contribute to the high spreads on lending to enterprises.
- (b) In addition to the provisions of the Corporations Law, accounting standards are set by a number of regulators including the Central Bank of Brazil (BCB), the Securities Commission (CVM), the Insurance Supervisor (SUSEP), a Department of the Ministry of Welfare for Pension Funds (CNPC), and the electrical sector regulator agency, as well as by the Federal Accounting Council (CFC). In addition, although IBRACON, a voluntary association of audit firms and auditors, is not officially a standard-setter, it often recommends standards, which in turn are often endorsed and officially enacted by regulators. Although some coordination exists between the standard-setters, the existence of multiple sources of accounting principles contributes to a lack of clarity for the preparers and users of financial statements and increases the regulatory burden for them. This leads to inconsistent accounting among companies and a perception that corporate accounts are unreliable as a tool for making investment and lending decisions.
- (c) Brazilian Generally Accepted Accounting Principles (GAAP) have been converging with international standards over the recent period, but convergence has been hampered by the existence of certain accounting provisions in the Corporations Law and tax law. Major areas of inconsistency with IFRS at present include the absence of a proper cash flow statement, the treatment of finance leases and government grants, a limited use of fair

values and the fact that many companies are not required to present consolidated financial statements. These divergences inhibit harmonization of Brazilian accounting practices with those of its trading partners, and could have the effect of dampening foreign direct and portfolio investment. A higher level of financial comparability and transparency is needed in order for the securities market to grow in terms of the number of companies listed and in levels of trading, and especially to attract international investors. In addition, the accounting standards applicable to pension funds need strengthening in order to comply with IAS 26, *Accounting and Reporting by Retirement Benefit Plans*.

- (d) Being the largest economy in South America, Brazil has a significant stock market (BOVESPA), with almost 400 domestic companies listed, 38 of which are also listed on US stock exchanges. Further development of the local market is an important objective of the Brazilian Government, as part of its strategy to boost the development of the private sector. For BOVESPA to become an important player in international capital markets, the quality of corporate financial reporting by Brazilian corporations listed on it must meet the highest international standards.
- (e) Practicing accountants must be affiliated professionally with the CFC, a self-regulated organization established under a law of 1946. The CFC membership comprises two categories of practitioners, one with university level education (*contador*) and the other with high school level (*técnico em contabilidade*). A voluntary association, IBRACON, is dedicated to research and standard-setting activities on accounting and auditing, and performs well in the context of its limited mandate.
- (f) Brazilian Generally Accepted Auditing Standards (GAAS) are largely aligned with International Standards on Auditing (ISA) although some differences exist. By contrast, the ethics code developed by CFC is clearly insufficient especially if compared with IFAC's. With modest upgrades, Brazilian auditing practices can gain better recognition both domestically and internationally.
- (g) In 2000, CFC established that both *contadores* and *técnico em contabilidade* would be required to pass an examination of minimum professional qualification in order to obtain a license to practice. This requirement was an improvement, even though the exam was far less demanding than international equivalents. Nevertheless, some university graduates were successful in challenging the legal validity of the exam. A bill is under discussion to give the exam legal backing. Compulsory examination is required for registration as statutory auditor of listed companies, financial institutions, insurance companies and open pension funds; these exams are to be retaken every five years. Currently, Brazil does not have a system of professional certification comparable to what is in use in most OECD countries, including Mexico. An essential step in raising the credibility of the accounting profession and, consequently, the financial statements which are prepared or audited by them, is the rigorous enforcement of professional qualifications.
- (h) Continuing professional education (CPE) has been mandatory for registered auditors since 2003. The monitoring of this obligation has been delegated to CFC. There are no controls in place to ensure the quality of CPE courses. This jeopardizes the credibility of the audit function, which is essential to confidence in the quality of the corporate financial information and therefore to the development of capital markets and lending activities in Brazil.

- (i) A quality assurance system, based on peer review, was introduced within CFC pursuant to a regulation passed by CVM. Brazil is the first country in Latin America to have introduced such system, which is a commendable step for improving the audit practice. Nevertheless, the Brazilian system lacks the necessary oversight that would be required to instill public confidence in it. In the absence of external representation among the reviewers, appropriate sanctions are rarely applied.
- (j) Statutory (external) auditors are subject to relatively stringent independence rules set by CVM, BCB and SUSEP, including the compulsory rotation of audit firms and the outright prohibition of a range of accounting services to audit clients. These rules were established at a time when auditors' professional examination and quality assurance mechanisms had not been introduced in Brazil. Although strong regulation is required on matters of auditor independence, a mostly rules-based approach tends to place undue constraint on companies' ability to procure accounting and audited-related services.
- (k) Only the 400 listed companies, 160 banks and other entities of the financial sector (insurance companies, pension funds, etc.) are required to have their annual financial statements audited. Even though no statistics are available to assess the economic weight of private sector entities not subject to any statutory audit, such weight is widely assumed to be high, considering there are an estimated 3 million companies operating in Brazil.<sup>97</sup> From the perspective of increasing private lending and private investment, and also reducing lending spreads, it is essential to strengthen accounting, audit and reporting requirements for a larger number of companies.
- (l) Under the Corporations Law, S/As are required, at the request of a minimum number of shareholders, to establish an independent body called *conselho fiscal*, which has wide ranging supervisory and audit functions, some of which overlap with those of independent auditors. It is not clear whether and to what extent these *conselhos fiscais* provide constructive inputs, as they function in lieu of audit committees in the non-financial sector. Because they are not always "permanent", and their members do not necessarily have the required competence, their contribution to the oversight of the financial reporting process is often limited. They cannot be construed as audit committees. A notable exception is the case of companies listed in the US whose *conselhos fiscais*, despite their different legal form, are discharging similar governance functions as those of audit committees.
- (m) Audit committees as sub-committees of the board of directors are not required by law in Brazil. They are mandated by BCB and SUSEP for financial institutions above a certain size. Audit committees are considered to play a key role in overseeing the financial reporting process and in the relationship with auditors (both external and internal), contributing to the effectiveness of the audit process.
- (n) The securities market and financial sector regulators have taken steps to strengthen their enforcement of financial reporting and auditing requirements. These efforts are fairly recent and, considering stakeholders' expectations for quality financial information in Brazil, they need to be expanded.
- (o) As noted above, a draft Law which would amend the Corporations Law and is known as the "PL 3741" has been under discussion for several years before the Congress. The law would introduce wide ranging changes in Brazil's corporate financial reporting regime,

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<sup>97</sup> Source SERASA.

including: (i) an independent accounting standard-setting body within the CFC; (ii) various new accounting rules consistent with IFRS (such as the obligation to recode finance leases on the balance sheet and to present a cash flow statement); (iii) a new process for elaborating income tax returns and general-purpose financial statements aimed to eliminate interference of tax rules in the preparation of financial statements; (iv) requiring all large companies, regardless of legal structure to publish audited financial statements annually and subjecting these companies to CVM supervision. These necessary measures would support the Government's objectives of enhanced private sector development and increased investment.

## **B. Recommendations**

76. **The main objective of this ROSC assessment is to assist the Government in its efforts to enhance national economic development through improved accounting and auditing practices and greater financial transparency in the corporate sector.** The key development objectives these efforts seek to address are (a) supporting the development of the domestic private sector, through improved access to long-term financing for enterprises and a reduction of the cost of doing business in Brazil; one highly sought related objective would be to increase private sector participation in infrastructure investments; (b) creating a more attractive investment climate in Brazil, thereby leading to increased levels of foreign direct and portfolio investment.

77. **The policy recommendations set out in this Section will be discussed with in-country stakeholders at a workshop to be organized in Brazil.** Inputs from the stakeholders would then be incorporated into a country action plan that will be developed under the supervision of the Ministry of Finance, with the assistance of the World Bank and other donors including the Multilateral Investment Fund (MIF).<sup>98</sup> The recommendations involve government policies as well as capacity development within the accounting profession and, to a lesser extent, regulatory agencies.

78. **Strengthening the accounting and financial reporting practice in Brazil requires amending the Corporations Law.** The business and financial community in Brazil is increasingly aware of the need to provide quality financial reports for investors and lenders, and other interested parties, in both the private and public sectors. This has bolstered the process for amending the Corporations Law which was initiated in 2000 in the form of the PL 3741. The proposed law under discussion is expected to address several of the recommendations in this report, especially regarding the need for further alignment of Brazilian GAAP with IFRS. Nonetheless, the fact that the proposal has not been adopted for five years illustrates the sensitivity of this issue and the difficulty to pass the law.

### **ACCOUNTING STANDARDS AND STANDARD-SETTING**

79. **Mandate the use of IFRS by all public interest entities (PIEs) for the presentation of their consolidated financial statements. In addition, the consolidated financial statements of all PIEs should be published.** Legal entity financial statements (i.e., unconsolidated) and consolidated financial statements (i.e., those of an economic group as a whole, including the parent and its affiliates) serve different purposes: the latter are used mostly to measure the performance of the company, and therefore also its management, as well as the value of the company's securities; while the legal entity accounts are used mostly to fulfill legal and tax obligations and to determine the distribution of dividends to the ultimate owners of a corporate

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<sup>98</sup> The MIF is a multi-donor trust fund managed by the Inter-American Development Bank (IDB).

group. Accordingly, consolidated financial statements require a much higher level of quality in the accounting standards applied (particularly with regard to presentation and precision in disclosures). Moreover, legal and tax constraints limit the proper preparation of legal entity financial statements. To ensure a higher degree of quality, reliability and comparability of the financial information, requiring the use of IFRS for the preparation of consolidated financial statements of PIEs appears to be the most appropriate solution for Brazil. One of the benefits of such a measure would be that all 400 Brazilian listed corporations would be able to compete on more equal terms for external investment as their competitors in the EU and other significant economies, including Australia and New Zealand.<sup>99</sup> Additionally there is an expectation (although no guarantee at this point) that the US Securities and Exchange Commission will accept financial filings prepared under IFRS without requiring the reconciliation to US GAAP; if this happens, Brazilian companies interested in listing in both the US and EU would only have to prepare one set of financial statements. Requiring that consolidated financial statements of listed companies follow IFRS could be accomplished through a CVM regulation, since the Corporations Law poses no impediment to doing so. This regulation should also:

- ***Allow for a reasonable transition period*** so that companies, auditors, regulators, financial analysts and other stakeholders can prepare for the implications of such a change, take the necessary steps to meet the requirements of IFRS and acquire sufficient knowledge to comply with the new requirements. Since IFRS and US GAAP are similar to a large extent, and numerous Brazilian listed companies (i.e., those listed in the US and on BOVESPA's special segments) already apply US GAAP, the transition for many investors and analysts should be facilitated.
- ***Encourage early adoption of IFRS*** (i.e., on a voluntary basis), by authorizing their use in lieu of Brazilian GAAP.

The entities to which this recommendations applies (defined as PIEs) would include: (i) listed companies; (ii) banks, (iii) insurance companies, (iv) pension funds, (v) large non-listed companies (either S/A or *limitada*), and (vi) state-owned enterprises that do not fall in one of the previous categories. These entities would continue to apply Brazilian GAAP while preparing their legal entity financial statements (see below).

**80. Amend the Corporations Law in order to allow for full alignment between Brazilian GAAP and IFRS; in the meantime, regulators should continue to issue pronouncements that are consistent with IFRS.** In order to allow for non-listed companies to prepare financial statements using norms consistent with international standards, thereby increasing the quality of these statements, most existing gaps between Brazilian accounting standards and IFRS need to be bridged. As discussed in this report, since the Corporations Law sets forth fairly detailed accounting requirements, it needs to be amended in order to carry out significant reform; without amending the law, the potential impact of any attempted reform would be limited. Moreover, the constraint to preparing user-oriented accounting information is currently such that it also needs to be addressed explicitly in the law, as envisaged in PL 3741.

**81. Establish an independent accounting standard-setter with the necessary authority to issue pronouncements for all general-purpose, corporate financial statements.** The rationale for establishing such body is twofold: (a) to simplify and consolidate the standard-setting system and unify the body of existing pronouncements into a single set of standards with limited overlaps and no loopholes; and (b) to strengthen the institutional setting needed to support the desired improvements in corporate financial reporting and the adoption of IFRS. Indeed, the adoption of

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<sup>99</sup> Listed companies in the EU, Australia and New Zealand will be required to apply IFRS starting in 2005 or 2007.

IFRS requires the involvement of a national body even though IFRS are issued by an international organization. Interviews with investors, regulators and other interested parties during the ROSC confirmed a keen interest in Brazil for a single standard-setting body. To ensure the proposed acts effectively and on behalf of the public interest, its membership should include all relevant stakeholders including investors and lenders, companies, accountants and regulators. The governance of the body should follow the model of IASB or equivalent bodies in OECD countries, with the objective of protecting the process from undue interference. It is expected that the CFC, IBRACON, CVM, BCB, SUSEP, other regulators as well as representative bodies of the financial, business and academic communities would be closely associated to the standard-setting process. The main functions of the Accounting Standards Board would include:

- ***Reviewing and promulgating IFRS for their official use in Brazil*** – The review would consist of analyzing each standard issued or revised by the IASB, as well as related interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC), to assess the potential difficulties preparers, auditors and users might face, and possibly to determine certain additional requirements warranted in the Brazilian environment. This activity would be particularly critical during the transition process.
- ***Issuing guidelines for the proper implementation of IFRS and interpretations*** – This would facilitate the use of the standards in the national context especially on issues involving the consequences of tax and labor laws, as well as other legislation.
- ***Adopting a set of SME-specific accounting standards and reporting framework***, as suggested below.
- ***Issuing rulings on specific technical issues***, in coordination with relevant authorities including CVM, BCB, SUSEP, the pension fund regulator, the MoF's Federal Revenue Department (*Secretaria da Receita Federal* or SRF), as well as CFC and IBRACON.

82. **Regulators and the SRF should reach an agreement to ensure that tax rules do not interfere with preparing general purpose financial statements.** The proposed modification to the LALUR system (which would introduce the option for companies to keep their accounting books following tax rules and to make appropriate “off-books” adjustments to prepare the financial statements) in PL 3741 aims to allow companies to prepare financial statements free of any tax rules influence, and it would greatly alleviate this problem should it be passed. Still, the SRF and the relevant regulatory agencies should be able to reach an understanding on how companies could use accounting for both tax and external reporting purposes, without one hindering the other.

83. **The proposed Brazilian accounting standard-setter should develop a simplified financial reporting framework for use by small and medium enterprises (SMEs) based on existing Brazilian GAAP as aligned to IFRS as far as practicable.** An international consensus exists today in favor of simpler financial reporting requirements for SMEs, adapted to their smaller size, capacity and narrower range of stakeholders. In 2003, the IASB initiated a project to develop an SME version of IFRS, which is still under way. In addition, an international group of experts convened by the United Nations Conference on Trade and Development (UNCTAD) has developed two sets of accounting guidance for SMEs (one of medium-sized companies, the other for small and micro enterprises) on the basis of IFRS. In the case of Brazil, the best solution may be for the proposed Brazilian Accounting Standard Board to elaborate a set of accounting standards based on existing Brazilian pronouncements with a lesser level of disclosure and the historical cost model, and using the IASB and UNCTAD models as points of reference. These SME GAAP would also include standardized financial statements and notes to facilitate the preparation and use of the financial information for internal and external purposes. The availability of a simplified yet acknowledged system of financial reporting would help alleviate the efforts and costs for SMEs to seek bank or equity financing.

## ACCOUNTING AND AUDIT PROFESSION – PROFESSIONAL STANDARDS AND OVERSIGHT

84. **Adopt ISA and IFAC’s Code of Ethics of Professional Accountants.** Given that Brazilian GAAS prevailing at the moment are relatively close to ISA, adopting full ISA should not pose any difficulty to Brazil’s audit profession. Moreover, it would be consistent with its international commitments, since CFC and IBRACON are both members of IFAC.<sup>100</sup> Bringing its auditing standards to the level of ISA would enhance the robustness of the country’s audit practice as a whole; this, in turn, would mitigate the risk of a growing gap in the practice between the large audit firms subject to outside regulation through their respective international network of affiliation, on one hand, and small local firms or individual auditors, on the other. Indeed, in the wake of the further concentration within the large international networks (which are now down to four “Big-4”), fostering the development of quality domestic audit firms can help maintain an adequate level of competition among audit service providers, especially for the medium-sized registered companies or banks. More importantly, applying standards grounded on internationally-recognized norms, especially on professional ethics, would create an incentive for regulators not only to rely on external auditors but to alleviate the substantial regulatory burden that currently exists to safeguard auditors’ independence. **The adoption of ISA and IFAC’s ethics code should be initiated by CFC, in conjunction with IBRACON, which already supports this measure. Absent such adoption, the securities market and financial sector regulators could enact ISA in their regulations and require that all statutory auditors of entities under their purview to adhere to international standards.**

85. **A public oversight body should be established for the auditing profession to ensure that licensed auditors comply with their professional obligations.** The purpose of the oversight body is to ensure that quality assurance is in fact and appearance an exercise with sufficient public integrity. In addition, it should meet the objective of sustaining public confidence and demonstrating to regulators the adequate implementation of self-regulating responsibilities. The current proposal in the EU for a new “Eighth Directive” on Company Law,<sup>101</sup> which sets forth detailed requirements for a public oversight system for the audit profession, provides a useful benchmark for such a public oversight body. Considering the authority entrusted to CFC through the decree of 1946 and its level of resources, a solution for establishing the oversight board could be to embed it in the CFC/CRC system. This would follow the approach adopted by IFAC internationally, with the introduction in 2004 of a *Public Interest Oversight Board* (PIOB) independent from IFAC’s board and trustees.<sup>102</sup> The oversight body should be governed by board with a majority of non-practitioners so as to maintain the

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<sup>100</sup> Moreover, this would be the most efficient way to meet their responsibilities as members, which are codified in IFAC’s *Statements of Membership Obligations* (SMOs) issued in April 2004, especially:

- SMO 3 which requires members to “use their best endeavors to incorporate International Standards [...] issued by the IAASB into their national standards” and to “have as a central objective the convergence of national standards”;
- SMO 4 which sets a similar requirement regarding IFAC’s ethics code.

<sup>101</sup> The proposed new EU Eighth Directive issued by the European Commission in March 2004 aims at strengthening audit legislation in the 25 EU member countries. It is somewhat comparable in scope to the Sarbanes-Oxley Act of 2002 in the US.

<sup>102</sup> There are numerous examples of countries that have introduced independent auditor oversight bodies, including: Canada, France, Ireland, the UK, and the US (PCAOB, mentioned in footnote 76). Spain had established one (*Instituto de Contabilidad y Auditoría de Cuentas* or ICAC) as early as 1989. In the case of IFAC, the PIOB’s mission includes to “ensure that the standard-setting and compliance activities of IFAC are conducted in a manner which is consistent with the public interest, in order that the public can have confidence in financial reporting.”

organization's independence from those it would supervise. The oversight body would have the following responsibilities:<sup>103</sup>

- **Registration of statutory auditors** – This responsibility would include regulating and monitoring the professional examination required for registration on the CNAI, and enforcing registered auditors' obligations regarding continuing professional education (CPE). At first, the existing arrangements within CFC regarding professional examination for CVM and BCB purposes would be maintained; they would subsequently be improved, desirably by introducing a system of professional certification (Para. 88). The oversight body would not provide CPE courses but instead would accredit courses offered by CFC and private organizations.
- **Monitoring and inspections** – The oversight body would conduct inspections to enforce auditing and ethical standards. It would use as a starting point the system developed by CFC in 2001 (CRE), which should be adapted from a pure "peer-to-peer" review to a monitored review approach that is strictly defined and closely monitored by a permanent staff. A process for nominating reviewers would be introduced and it would include assessing the competence and experience of prospective reviewers. The oversight board should also be empowered to investigate infractions, when notified by regulators and others.
- **Disciplinary proceedings** would be conducted for identified cases of non-compliance under a due process similar to CVM's. The oversight board should have adequate sanctioning powers including reprimands, fines, and temporary and permanent exclusions from the CNAI.

86. **Securities market and financial sector supervisors should review existing regulations regarding auditors in light of the recent improvements introduced within the profession, e.g., quality reviews, professional examination and continuing education.** As a result of various regulations passed by CVM, BCB and SUSEP, auditors in Brazil are subject to relatively stringent obligations regarding their qualification. Most of these requirements correspond to internationally-recognized good practice in audit regulations and are in effect in most countries that are considered to have a well-developed accounting and auditing regulatory framework. Notwithstanding, two of the existing provisions, namely the prohibition of certain services to audit clients and the compulsory rotation of audit firms need to be reassessed to ensure that the incremental benefits they bring do not exceed their potential negative effects. Regarding the issue of non-audit services to audit clients, CVM Instruction 308, BCB Resolution 3198 and CNPC Resolution 118 should be reviewed to introduce a more principles-based approach to conflict of interest, using the threats-and-safeguards model. In addition, the types of services considered to entail a potential impairment of independence should be defined with more precision, to avoid any misinterpretation. The issue of rotation of auditors is more difficult and subject to controversy, especially in the absence of empirical evidence to support such a requirement.<sup>104</sup> Also, since Italy is the only other G20 country currently mandating rotation,

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<sup>103</sup> In their comments to this ROSC, the Authorities have expressed the view that the introduction of such public oversight system could require more time, including for assessing its effectiveness in those jurisdictions that have adopted it.

<sup>104</sup> Based on interviews with a few regulators and financial statements users, there is anecdotal evidence that supports that the quality of audit increased in some companies after the rotation. It is difficult, however, to attribute such improvements to the rotation alone, as several other measures were taken simultaneously to improve the quality of audit (e.g., independence requirements, CPE, sufficiency exam, etc.). In addition, there was a general trend in the audit industry for stricter adherence to auditing standards in the wake of the corporate scandals in the US and the EU.

Brazil should reevaluate the need for such a mechanism.<sup>105</sup> In any event, the ROSC team does not suggest that rotation should be eliminated without following a thorough process of review that involves all stakeholders.

## EDUCATION AND TRAINING

87. **Efforts should be made by universities, in cooperation with the accounting profession and the business community, to improve the quality of accounting curricula.** University accounting departments and faculties in the universities should develop creative ways to attract some of the best students, possibly by integrating accounting curricula with business and economics ones, by adopting the global curriculum developed under the aegis of UNCTAD and by establishing partnerships with accounting firms.

88. **Strengthen existing professional exams to make the licensing process more selective.** The technical content of the minimum sufficiency exam was quite limited; when reinstated, it should be elevated to IFAC standard. Specifically, as prescribed by IES 6, *Assessment of Professional Capabilities and Competence*, the number of questions should be sufficient to cover the whole range of capabilities and competencies required from the future licensee (these changes would require the exam to be taken over several sessions). It should address a wider variety of subjects and situations, and include case studies and “essay” type questions, so that candidates may demonstrate their ability to apply their knowledge in a professional context. **In addition, two years of professional experience should be a pre-requisite for taking the exam.**<sup>106</sup>

89. **Introduce mechanisms for monitoring compliance with continuing professional education and ensuring that the content of training is adequate.** Ultimately, existing professional education arrangements for auditors could be consolidated into a system of professional certification, which would be made compulsory at a later stage for accountants. Such system of certification would be consistent with IFAC’s International Education Standards and would put Brazil on equal footing as Canada, Mexico, the UK and the US who have adopted it (another Latin American country, Chile, is in the process of introducing it). Additionally, a program of CPE courses should be implemented nationwide, using distance learning to extend the outreach of CPE beyond geographical limitations.

## STATUTORY AUDIT REQUIREMENT

90. **Amend the law to extend the requirements for the publication of annual audited financial statements to all S/As and *limitadas* that have public-interest characteristics due to their size.** The rationale for such a measure, which many countries have adopted (including all 25 EU countries) is mainly to (a) assure a level-playing field in terms of basic public accountability among large companies operating in Brazil, (b) provide increased protection to creditors and other third parties who are not necessarily in a position to obtain information on the financial situation of these companies, (c) allow access to a broader range of financial information within a sector to lenders and financial analysts and (d) foster a greater level of transparency in the private sector as a whole.

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<sup>105</sup> Furthermore, the US and the EU recently considered introducing mandatory rotation of audit firms (respectively as part of the Sarbanes Oxley Act of 2002 and the proposed revision of the Fourth Directive of 2004) but ultimately decided not to include it in the respective new laws. A research paper on the issue of rotation was published in October 2004 by the European Federation of Accountants (*Fédération des Experts-Comptables Européens* or FEE) which concluded that rotation of the audit partner was preferable to rotation of the firm ([www.fee.org](http://www.fee.org)).

<sup>106</sup> IES 5, *Practical Experience Requirement*, paragraph 11.

91. **Clarify the function of the *conselho fiscal* and eliminate any redundancy with the role of the external auditor, preferably by amending the statutes.** For those companies required to have their financial statements certified by an external auditor, ideally, the functions of external auditor and *conselho fiscal* should be combined. However, the *conselho* is a body with several members<sup>107</sup> and operates under relatively complex mechanisms. Therefore, the best solution for the foreseeable future seems to be to review the scope of responsibilities of the *conselho fiscal* to eliminate any overlap with external auditors so as to give the *conselho* a more focused and effective role. Moreover, audit committees should ultimately be required in all listed companies in lieu of a *conselho fiscal*.

#### **OTHER ISSUES**

92. **Simplify the process by which companies make their financial statements available to the public.** Considering the high cost of publishing a full set of financial statements in a large circulation newspaper and the official gazette, companies should be allowed to publish their financial statements in an abridged instead of a complete version, provided they post an electronic copy of the complete financial statements on their website, as most listed companies already do.

93. **Increase regulatory agencies' enforcement capacity with respect to financial reporting, including by reassigning existing staff from current standard-setting functions.** Regulators should have sufficient specific resources to perform systematic in-depth analysis of corporate financial statements, conduct frequent on-site inspections of companies, and enquire with their external auditors. The staff of regulatory agencies should receive training to enforce compliance with US GAAP and IFRS, especially for CVM as these standards are already applied on the new segments of BOVESPA. The unifying of standard-setting responsibilities would free up human resources for supervision purposes, which would also require training to adapt them to new functions. Moreover, CVM is considering setting up a division specifically dedicated to enforcement; this would help enhance compliance by listed companies especially in the perspective of the adoption of IFRS as discussed above (Para. 79).

94. **The recommendations of this ROSC Accounting & Auditing are expected to benefit a wide range of in-country stakeholders, including:**

- ***Brazil's stock exchange***, which is exposed to international competition, especially from US markets. By adhering to recognized international standards, the BOVESPA can increase its capacity to attract foreign investors. Moreover, improvements in corporate financial reporting lead to greater transparency on the market and therefore benefit local investors;
- ***The banking sector*** – Thanks to the availability of large *limitadas*' financial statements, banks will be able to make more comprehensive comparative analysis of financial data by sectors. This, combined with a more qualitative financial information, can help Brazil's commercial banks better manage their credit risk;
- ***Brazilian enterprises*** – The inflows of long term capital which the development of the stock exchange entails will help reduce the cost of financing of large Brazilian enterprises. The availability of *limitadas*' financial statements will facilitate the activities of private equity funds and venture capitalists, and therefore will contribute to creating more opportunities for medium-sized companies to access long-term capital at affordable costs;

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<sup>107</sup> In other Latin American countries where similar functions as the *conselho fiscal* exist (e.g., *comisario* in Mexico, and *revisor fiscal* in Colombia), these functions are exercised by individuals.

- **Brazilian retirees** – High quality standards of reporting and effective audits are critical to investors’ confidence and therefore condition the development of the securities market in Brazil. It will lead to greater transparency on the stock market, and offers more investment opportunities to foreign or domestic investors and pension funds;
- **Employees of the private and state-owned sectors**, who have an important stake in their company’s success, and are therefore entitled to receive complete and accurate financial information;
- **The public sector** – Reinforcing accounting and auditing practices in the corporate sector would support the Government’s efforts to curtail corporate tax evasion in the country;
- **Brazil’s accounting profession** – Introducing a professional certification for accountants will elevate the image of the profession and the confidence investors and corporate entities place in external audits and accounting services. Increased recognition of the profession and perceived value of the services it offers, added to an expanded market base with the requirement for *limitadas* to present audited accounts, will in turn allow an increase in revenues. In the longer run, the profession will also gain recognition abroad and Brazilian accountants, especially those in small- and medium-sized practices will be able to compete on an international level.

## VII. SUBSEQUENT DEVELOPMENTS<sup>108</sup>

95. **A number of developments in Brazil’s accounting environment have taken place between the finalization of this report and its publication which are important in the context of the objectives of this ROSC.**

96. **As a result of a decision by the Central Bank in March 2006, all Brazilian financial institutions will be required to publish their consolidated financial statements in accordance with IFRS starting in the reporting year ending December 31, 2010.**<sup>109</sup> This decision—which will affect not only commercial banks but leasing companies, savings and loans institutions, investment banks, and credit unions operating in Brazil—aims at enhancing the quality of information disclosed by banks in order to strengthen market discipline in the financial sector, in line with the Basel II recommendations. The broader objectives of this measure are to strengthen the reliability of accounting information, facilitate the monitoring process and the comparison of the economic, financial condition and the performance of the institutions, optimize capital allocation, reduce the cost of capital, and reduce operational costs by eliminating the need to prepare multiple financial statements by internationally active institutions. Furthermore, auditing will be required to adhere to international standards established by International Federation of Accountants (IFAC). This measure will implement the report’s recommendations in Para. 79 and 85 for banks and other financial institutions.

97. **In October 2005, an independent accounting standard-setting body, the Accounting Standards Committee (*Comitê de Pronunciamentos Contábeis* or CPC) was established, hosted by CFC.** CPC’s membership includes representatives of (a) the Association of Listed Corporations (ABRASCA), (b) the Association of Market Analysts (APIMEC), (c) BOVESPA, (d) CFC, (e) the University of São Paulo’s Accounting Research Institute (FIPECAFI) and (f) IBRACON, which are its founding institutions.<sup>110</sup> CVM, the Central Bank and other regulators

<sup>108</sup> Prepared on the basis of information provided by BCB and CVM.

<sup>109</sup> BCB Communiqué 14.259 dated March 10, 2006.

<sup>110</sup> Further details at [www.cpc.org.br](http://www.cpc.org.br).

participate by monitoring and endorsing CPC's standards, similarly to what has been done in the past regarding IBRACON's standards.

98. **CPC has issued two standards (“Pronunciamentos Técnicos”) to date.** Two corresponding draft CVM Rules (“*Deliberação*”) have been issued in order to make these standards compulsory for listed companies. These are undergoing a public hearing process with period of comments ending on July 31, 2007. The two standards deal with the following issues:

- Impairment of Assets (CPC 01, based on IAS 36) and
- Conversion of Financial Statements to the National Currency (CPC 02, based on IAS 21).

99. **CVM has prepared a draft Instruction that would require listed companies to publish their consolidated financial statements according to IFRS, starting for all reporting periods ending in 2010.** The Instruction has been enacted (CVM's Rule 457, July 2007). This decision would implement the recommendation set out in Para. 79 for listed companies.

100. **Moreover, before CPC became operational CVM approved four accounting standards issued by IBRACON based on IFRS,** as follows: (a) *Deliberação* 488, Financial Statements, Presentation and Disclosure (based on IAS 1); (b) *Deliberação* 489, Provisions, Liabilities, Contingent Assets and Contingent Liabilities (based on IAS 37); (c) *Deliberação* 505, Subsequent Events (based on IAS 10) and (d) *Deliberação* 506, Changes in Accounting Estimates and Correction of Errors (based on IAS 8).

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