Accounting and Its Environment in Brazil

Jorge Katsumi Niyama
University of Brasilia

Cesar Augusto Tiburcio Silva
University of Brasilia

RESUMO: This paper analyses the development of the business and the legal and regulatory environment of the Brazilian accounting, including the accounting education, the structure of ownership, the development of the capital market, auditing and the accounting profession. Brazilian accounting was influenced by tax legislation. Nowadays, this influence is more strong by the corporate Law and the regulation from governmental bodies. However, in recent years has undergone significant changes. Nevertheless, important differences between Brazilian accounting standards and international accounting remain, although efforts made by Brazilian bodies to adapt their accounting norms to the international financial reporting standards. Brazilian accounting profession and representative councils are not politically strong enough to influence the government. The Brazilian accounting standards published by the Federal Accountancy Council don’t have legal authority. Shortcomings in the education of accounting in Brazil have brought about the necessity for a proficiency examination and continued professional development under the Federal Accountancy Council.

Key words: accounting, regulatory environment, education, capital market.

Received in 16/06/2005; revised in 17/06/2005; accept in 20/06/2005.

* Corresponding authors:

Jorge Katsumi Niyama
Doutor em Contabilidade e Contabilidade
Universidade de Brasilia
Adress: Campus Universitário Darcy Ribeiro – Prédio da FA - 2º Andar - Salas B1-02, Asa Norte, 70910-900 – Brasilia – DF – Brazil
Email: jkatsumi@unb.br
Telephone: (61) 31070798

Cesar Augusto Tiburcio Silva
Doutor em Controladoria e Contabilidade
Universidade de Brasilia
Email: brasilcesartiburcio@unb.br
Telephone: (61) 32731105
I. INTRODUCTION

Brazilian accounting has developed under the influence of European countries (mainly Italy) and United States accounting practices. However, traditionally, Brazilian accounting has also been influenced by legislation (tax and corporate law) and the regulation from governmental bodies such as the Central Bank of Brazil, the Brazilian Securities Commission, and the Agency of Insurance Supervision, among others.

Education in accounting is very weak and accounting is always confused with bookkeeping, rather regarded as a science. The professional accounting bodies publish Brazilian accounting standards.

Over three decades, the Brazilian government made efforts in order to decrease the inflation rate. Brazil is famous for developing a monetary adjustment system to recognize the effects of changing prices on financial statements. After the last economic plan (the Real Plan, 1994) which was considered successful, the Brazilian economy improved and so became more attractive to foreign investors. Brazilian accounting has followed the tendency towards globalization, adopting international financial reporting standards as a benchmark.

II. THE BUSINESS AND LEGAL ENVIRONMENT AND THE ACCOUNTING PROFESSION

2.1 Historical Development of Accounting in Brazil

The recent history of Accounting in Brazil had its beginnings in the seventies, with the development of the stock market and the national financial system reforms. Some of these reforms were: a) a requirement of listed companies to have their financial statements audited by independent auditors; b) a requirement of listed companies to follow a standard of financial reporting under Instruction nº 179/72 issued by the Central Bank of Brazil; c) the introduction of Corporate Law influenced by the United States of America’s accounting practices, including discussion about accounting principles.

Until then, Brazilian accounting was strongly influenced by tax legislation. In 1976, the CVM - Brazilian Securities Commission - was created to supervise the stock market, and govern the establishment of accounting standards for listed companies.

The development of accounting in Brazil is also related to the economic development of the country. During the period between 1970 and 1975, Brazil achieved extraordinary economic growth rates in Gross National Product (GNP) and as a result, attracted the interest of investors and foreign banks.

However, the inflation rate also started to show a significant growth, which forced the Government to change the exchange rate by 30% a day in 1979. This fact was meaningful in Brazilian accounting history considering that the Government (Federal Tax Revenue Service) did not allow the loss arising from foreign currency exchange rates to be excluded for tax purposes. The Brazilian government required this expense to be included as a deferred asset and to be amortized in five years. Of course, this procedure was not acceptable under accounting principles and resulted in misleading financial statements for the companies with foreign debts.

Generally speaking, Brazilian companies could be classified in the following categories:
a) a listed company licensed by the CVM\textsuperscript{iii} and other non-listed companies; b) banks and financial institutions; c) transnational companies (subsidiaries) in Brazil; d) other private limited partnerships.

Both listed and non-listed companies are subject the conditions of the Corporate Law but non-listed companies are not required to have their financial statements audited by independent auditors. Furthermore, such non-listed companies have followed, in essence, the accounting standards established by the CVM even though not required to do so.

On the other hand, banks and financial institutions are required to follow accounting norms established by the National Monetary Council and the Central Bank of Brazil and have their own chart of accounts\textsuperscript{iii}, besides being audited by independent auditors.

The number of institutions under the control and supervision of the Central Bank of Brazil exceeds 2,473 institutions\textsuperscript{iv}, although ten of the biggest banks make up more than 65% of the total assets of the National Financial System. Generally speaking, banks and financial institutions follow in essence, recognition, measurement and disclosure criteria in accordance with international financial reporting standards.

Transnational or subsidiaries of foreign companies consisting of the automobile, chemical, pharmaceutical, paper and cardboard and food industries among others, experience problems of financial reporting: they are usually limited partnerships and are not required to report any information or disclose their financial statements. The independent auditor’s report is not reported and is used only for managerial decisions.

Other companies not included in the previous categories are not required to report and disclose their financial statements or be audited by independent auditors. They are required to provide some company information only to the Federal Tax Revenue Service, in accordance with tax law.

\subsection*{2.2 The legal and regulatory environment}

As previously mentioned, Brazilian Accounting was traditionally subject to legislation and regulation by governmental bodies. However, the professional institutes and representative councils of the accounting profession were not politically strong enough to influence the government. The environment in which Brazilian Accounting developed shows a strong relationship with bookkeeping. In the same line of thought, accounting education courses offered reveal two different levels: secondary level and from 1946 undergraduate course level.

Therefore, only in 1972 was the expression “accounting principles” included as a requirement to reporting financial statements of listed companies for the CFC - Federal Accountancy Council (Resolution no. 321/72) and for the BC - Central Bank of Brazil (Instruction no. 179/72). However, the CFC and the BC\textsuperscript{v} had not defined what and which were the accounting principles. These principles were those given in accounting undergraduate courses under the influence of the United States’ accounting practice school of accounting.

The Institute of Independent Auditors of Brazil - IAIB (now called IBRACON), even with the responsibility to define models and standards of auditors’ reports did not actually detail which were the generally accepted accounting principles that would have to be followed by the listed company for reporting their financial statements. It is important to say that the auditor’s report has to be transparent about whether the financial statements are or are not in accordance with generally accepted accounting principles.

Only in 1981, did the CFC publish a resolution defining which were the basic accounting principles (as opposed to generally accepted accounting principles). However, no
practical effect had been brought about by this for the profession (accountants and auditors) since the feeling prevailed that it was more important that the financial statements be in accordance with legislation or regulation requirements, rather than accounting principles.

In 1993, the CFC published another resolution replacing the previous one, defining seven basic accounting principles: Entity, Continuity, Original Cost, Prudence, Accrual Basis, Objectivity and Monetary Adjustment. Furthermore, the CFC organized a specific working group to develop Brazilian Accounting Standards in accordance with the International Financial Reporting Standards. However, the Brazilian Accounting Standards established by the CFC don’t have legal authority and although accountants can be punished for not following the CFC’s requirement, listed or non-listed companies are not punished for not following the CFC’s rules. According to RADEBAUGH (2002), “if such standards are approved by the CVM (the Brazilian Securities Commission), they become obligatory for listed companies, and in general it appears that the CVM tends to rely on the accounting profession to develop accounting standards”.

Each of the regulating bodies is looking to adapt their accounting norms to the international financial reporting standards (IFRS) established by the IASB. The financial statements of banks and financial institutions under the control and supervision of the Central Bank of Brazil are more adjusted or more conforming with the IFRS in this process of harmonization of international accounting standards.

2.3 Accounting Education

“The quality of the education in the accounting area has a significant impact in the quality and the type of information as well as the accounting system is able to produce. In certain countries with a long history in accounting, the Accounting is a major field of study in undergraduate (i.e. bachelor), graduate (i.e. master’s) and even doctoral (i.e. Ph.D.) and the attractiveness of the accounting in the educational field is in a high level. However, in other countries, the Accounting in education terms is weak, because is often equated to bookkeeping and it is regarded as a vocation rather than a profession. Many times are limited to the secondary level, not unavailable in universities” (SAUDAGARAN, 2004).

This statement, in some points seems to apply to the education of accounting in Brazil. First, because we have two professional categories (accounting technician from secondary level and accountant, undergraduate bachelor from university). Second, because in general, the opinion prevails in society that an accountant is responsible for bookkeeping and corporate tax. Third, because masters and PhD programs in accounting are not able to enroll not even 1% of undergraduate students in accounting.

According to the Ministry of Education (2002), they authorized 696 university courses in accounting courses to operate in the entire country. However, 64% of them (or 449) are located in the southern and southeastern regions, and the total is approximately 147,000 students.

The first accounting school in Brazil was the FECAP – the Alvares Penteado Foundation in São Paulo (1906), under the strong influence of the Italian School of Accounting, with special emphasis on the double-entry bookkeeping and not so much emphasis on financial statements, which is more useful. This style of accounting education influenced by the Italian School prevailed until middle of the seventies, when the Corporate Law (6.404/76) was approved to establish criteria and accounting procedures predominantly influenced by the United States of America’s School of Accounting. After that, accounting education was changed and nowadays, institutions follow either the American or Italian style of accounting.
Furthermore, it is important to emphasize that the *Universidade de São Paulo-USP*, was the first institution of education authorized regularly to accept students for Masters and PhD programs in accounting in Brazil. Twelve programs of Masters and PhD Programs in Accounting are authorized to operate in the country but only *USP* is authorized to have a PhD degree program. They are also strongly concentrated in the southern and southeastern regions and have less than 1,000 students. (www.capes.gov.br).

Until 31.05.2005, *USP* had approved only 135 PhD Degrees in Accounting. We have no exact number of Masters in Accounting, but are not likely more than 850 in the whole country. However, we agree that only one PhD Program in Accounting (in the whole country) is not good for the evolution and development of accounting research.

Finally, it is useful to present some data about the higher education in Brazil, mainly data extracted from the Census of 2000, for the Ministry of the Education, as follows. Approximately 6.8% (5.8 million people) of the Brazilian population over 25 years completed undergraduate courses. The majority graduated in Administration (1 million people, 17%) and Law (690,000, 12%). Accounting is ranked in sixth with 147,475 enrolled students. The Masters and PhD’s in all areas (including of course, Accounting) are represented by 173,716 men and 131,080 women (total of 304,796).

### 2.4 Development of the capital market and financial system

The historical development of the capital market and financial system had their beginnings in the seventies after two basic laws had been passed:

a) The Banking Reform Law (Law 4.595, 31.12.64) - There were many bodies responsible for the management of monetary politics, credit and public finances which were divided between the Treasury Department, the Supervisor of the Currency (*Superintendencia da Moeda e do Crédito*) and the Bank of Brazil. This structure already did not correspond to the increasing responsibilities of governing the economic policy. The above mentioned law created the National Monetary Council and the Central Bank of Brazil in order to restructure and develop controls to guide economic policy and create new rules for the financial system.

b) Law of the Stock Market (Law 4.728, 14.07.65). - One of the attempts by the Brazilian government to encourage the investment in the stock market in order to increase the money supply was the passing of Decree 157 that allowed the reduction of the income tax by those who could prove that they had investments in investment funds managed by banks and authorized financial institutions, who invested in the stock market, mainly to acquire shares in companies of national interest. Mentioned law created new rules to the stock market.

Between 1966 and 1971, the primary volume of the stock market increased to approximately an annual average tax of 53% in real terms (not considering inflation rate), but this growth also brought companies of all types and thousands of unprepared investors to the capital market. After that, the investors disappeared and the stock market revealed that it was not still able to manage such great investments. The Brazilian legislation was also shown to be inadequate. (ANDREZO, 2000)

On the other hand, between apparently 1964 and 1973 the inflation rate was under control. This period coincided with the Age of Military Government Dictatorship, with annual growth rates around 8% a year.
The eighties were characterized by high inflation and attempts to decrease it by adopting many radical economic plans. There was a general loss of confidence in the Brazilian government ability to manage the economy, both from within the country and internationally. As a result, the first moratorium (1985) was inevitable with negative international repercussions.

However, some facts of the eighties must be remembered for their importance: a) the fall of the military dictatorship and the establishment of a democracy with the election of a new president; b) a new Federal Constitution, in 1988; c) the creation of universal banks by changing the structure of the financial system.

The nineties are considered to be of great importance to the Brazilian stock market because of many alterations carried out by the Brazilian government. It became more attractive and accessible to foreign investors. In this period, the net cash flow of foreign resources was US$386 million in 1991, to reach an annual average of US$ 3.3 billion between 1993 and 1996 (GLEDSON, 2000).

On the other hand, the National Financial System had a strong impact in 1994 with the implementation of the Real Plan. Most of the banks were accustomed to profits made by floating, so they had to learn again how to deal with credit (corporate and customer loans) in a stabilized economy. (Or an economy without inflation). However, many of them could not adapt to the new conditions and went broke.

Currently, the Central Bank of Brazil supervises following types of institutions: a) 23 commercial banks; b) 138 universal banks; c) four development banks; d) one public saving bank; e) 20 investment banks; f) 46 finance companies; g) 140 brokers; h) 47 brokers of currency exchange; i) 138 dealers of marketable securities; j) 48 leasing companies; k) 18 saving companies l) 6 real estate and mortgage companies; m) 1,429 cooperatives (specialized in credit); n) 353 consortium companies; o) 50 other institutions.

The biggest bank is a state bank (Banco do Brasil S.A) with approximately US$ 80 billion in assets, 3,296 branches and 97,258 employees.

2.5 Structure of ownership

Generally speaking, Brazilian companies could be classified in two groups: the stock companies and limited partnerships. Stock companies must follow the Corporate Law (Law 6.404/76). Classified as stock companies, the listed companies are supervised by the Brazilian Securities Commission while other stock companies (not listed companies) are usually under the control of family or economic groups and don’t have shares in the capital market. Stock companies have legal and mandatory requirements to publish financial statements. The listed companies follow the general regulations under corporate law but their financial statements are audited by independent auditors.

On the other hand, limited partnerships are not required to publish financial statements nor are they required to give any type of information about their operational performance or net profit / gross sales. Transnational companies are classified in this category of company.

The biggest listed Brazilian company classified according to net equity (or net assets) is PETROBRAS, a state company of approximately US$ 15 billion. According to Brazilian Board of Trade (Junta Comercial) 6,102,132 sole or legal entities are licensed in all the country, as follows: a) sole proprietorship: 3,176,425 (52%); b) limited partnerships: 2,901,519 (47.6%); c) stock companies 12,014 (0.2%) and d) other types 12,174 (0.2%). According to these figures stock companies don’t represent even 1% of all of the Brazilian
companies which are dominated by sole proprietorships and limited partnerships (ANDREZO, 2000).

The stock companies are required to publish the following financial statements: Balance Sheet, Profit and Loss Statement, Statement of Changes in Financial Position and Statement of Retained Earnings or Statement of Changes in the Shareholder’s Equity. On the other hand, Cash Flow Statement and Added Value Statement are not required.

The main difference between a listed company and a non-listed company is the access of financial information to customers, suppliers, investors, employees and financial statement users in general and the requirement to have their financial statements audited by independent auditors or not.

2.6 Development of Auditing

Auditing became more relevant in the seventies, after listed companies were required to have their financial statements audited by independent auditors. Until then, auditing was usually required for the following: a) statutory requirements; b) subsidiaries of transnational companies; c) a requirement by private or public financial institutions to approve a loan.

Currently, besides listed companies, other services regulated by the Federal Government are required to have their financial statements audited by independent auditors, such as: Banks and similar financial institutions, Insurance Companies, Telephone Companies, Electric Energy Companies, among others.

The professional auditing body is IBRACON – the Institute of Independent Auditors of Brazil, similar to the Institute of Chartered Accountants of New Zealand. For accreditation as an independent auditor, an accountant is required to be licensed by the Regional Accountancy Council and authorized by the Brazilian Securities Commission in order to act as an independent auditor.

Currently, for new accreditations, the Brazilian Securities Commission requires that the accountant must have passed the Examination of Technical Qualification to be accredited as an independent auditor.

According to the Brazilian Securities Commission VII, 398 companies are authorized as independent auditors. The biggest five companies according to the number of customers, are the following ones: a) Deloitte & Touche & Komatsu, 101; b) Price Waterhouse, 56 c) KPMG, 36; d) Ernst Young, 35 e) Trevisan, 40 (a Brazilian company).

The Brazilian Securities Commission (for listed companies) and the Central Bank of Brazil (for financial institutions) require the rotation of the independent auditors every five years and that they are contracted again only after 3 years, in order to preserve and protect investors considering that a very long time period of custom can compromise the credibility of the auditor and inhibit its independence.

The peer-review is already an alternative procedure adopted by independent auditors according to the legislation and effective regulation. The auditing standards adopted by the Brazilian independent auditor companies are substantially similar to the ones adopted by the AICPA (American Institute of Certified Public Accountants) and for the IFAC (International Federation of Accountants). Besides that, following international conventions, consulting activities are forbidden. However, the activities related to tax planning and similar activities are not prohibited because they are considered compatible.
2.7 Brazilian Accountancy Profession

Two bodies are designated for the regulation and supervision of the accounting profession in Brazil: the Federal Accountancy Council - CFC; b) the Institute of Independent Auditors of Brazil - IBRACON. The Federal Accountancy Council is a representative agency of the Brazilian accounting profession created by Decree 9295/46 with its main purpose to supervise the practice of the accounting profession.

Since 1999, the CFC has carried out its Examination of Professional Proficiency two times a year, in order to license accountants. The candidate (a graduate in accounting or an accounting technician, from secondary level) must be pass the examination in order to be licensed as an accountant.

Until then, before 1999, all bachelors in accounting who graduated from an authorized course by the Ministry of the Education were qualified to practice the profession by registering with the Regional Accountancy Council. After 1999, because of the new regulations the average pass rate fluctuated between 50% and 65% of the enrolled candidates.

In 2003, for example, 66,998 candidates, including graduates and accounting technicians, had enrolled themselves in the Examination in the whole country. According to the Federal Accountancy Council, 360.478 accountants are licensed being 190.235 (53%) accounting technicians (secondary level) and 170.243 (47%) bachelors graduated from universities. (CFC, 2005).

Furthermore, the CFC established rules for continued education of independent auditors requiring them to prove at least 24 annual hours (2003) and 32 hours (from 2004) of participation in events or activities included in this Resolution 945/02. This program of Continued Professional Development will, in the future, be extended to all accountants licensed by the Council.

In 1996, CFC implemented a working group of experts in accounting and reporting in order to develop Brazilian Accounting standards. Participants of this working group included members of several Brazilian regulating bodies such as the Brazilian Securities Commission, the Central Bank of Brazil, the Agency of Insurance Supervision, the Department of Federal Tax Revenue Service, the National Treasury and the Institute of the Independent Auditors of Brazil. The main purpose of this working group was to harmonize accounting practices by means of the establishment of Brazilian Accounting Standards according to the international financial reporting standards established by the IASB.

However, as previously mentioned, the CFC still doesn’t have legal authority. Only as an example, even though the CFC requires that a lease with predominantly financial characteristics must be classified and reported as a sale and a financing (according to international standards); this lease agreement is reported as rent in financial statements, following the tax legislation.

### III. CHARACTERISTICS OF BRAZILIAN FINANCIAL ACCOUNTING AND REPORTING

#### 3.1 Accounting for leases

According to international financial reporting standards, leases are classified as a capital (finance) or operating lease. The accounting treatment in many countries follows this classification and operating leases are recorded as a rental, whereas capital leases are recorded as a purchase (by the lessees) and financing sales (by the lessors).

Brazilian leases (arrendamento mercantil) present the following characteristics:
a) a guarantee of the residual value (usually a fixed price or a percentage of the asset) by the lessee;
b) a bargain purchase option or a price which is expected to be sufficiently lower than the fair value, at the inception of the lease. So, it is reasonably certain that the purchase option will be exercised;
c) all the risks and rewards of the leased assets are transferred to the lessee;
d) advanced payment of the guaranteed residual value (not purchase option), during the lease term;
e) the present value of the lease payments is equal or more than the fair value of the leased asset.

According to Brazilian Law, a lease should be only contracted by a financial institution as a lessor, under the control and supervision of the Central Bank of Brazil.

However, in contrast to this requirement, capital leases are recorded as a rental, similar to operating leases. Therefore, the rights and liabilities arising from a capital lease are not reflected on the lessee’s financial statements.

In a legalistic view of assets, assets cannot be included on the balance sheet unless they are owned by the company. On the other hand, those with an economic view of assets, (not a legalistic view), prefer that the substance should be more important than the legal form, even though the asset is not legally owned.

In this discussion, the traditional division comes across between Anglo-Saxon countries, which take an economic view and the Continental European countries, which have a more legally oriented view of accounting.

The Federal Accountancy Council - CFC issued the Resolution 945/01 requiring the capitalization of leased assets in lessee’s financial statements as assets and liabilities, following international financial reporting standards. However, this Resolution doesn’t have a legal authority. Brazilian law and the instructions of the Central Bank of Brazil require the capitalization of leased assets in lessor’s financial statements.

Furthermore, according to the Brazilian Securities Commission, there are no special disclosure requirements about leases in listed company’s financial statements. In this situation, an adequate understanding of the true and fair financial position of the lessee requires that the balance sheet would have to be restated so as not to be misleading.

3.2 Accounting for Intangible Assets (including goodwill)

According to IAS 38, an intangible asset is an identifiable, non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Besides that, IAS 38 requires that a company recognize an intangible asset if, and only if:

a) it is probable that the future economic benefits that are attributable to the asset will follow to the entity; and
b) the cost of the asset can be measured reliably.

Therefore, internally generated goodwill, brands, mastheads, publishing titles and customer lists should not be recognized as an asset.

Furthermore, IAS 38 requires as a benchmark, that the intangible asset should be amortized on a systematic basis over the best estimate of the useful life of the asset, not
exceeding 20 years. On the other hand, if the useful life of the asset will be a specific period longer than 20 years an entity can:

a) amortize the intangible asset over the best estimate of its useful life;
b) estimate the recoverable amount of the intangible asset at least annually to identify whether there is any impairment; and
c) disclose the reasons why the presumption that the useful life on an intangible asset will not exceed 20 years.

Generally speaking, an intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the entity could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of the future economic benefits that flow from other assets used in the same revenue earning activity (ICANZ, ED 87, 1999).

Goodwill could be defined, according to some authors, as follow:

a) the difference between the cost of the shares in the subsidiary and the fair value of the net assets acquired (WALTON, 1998).
b) excess of the value of ongoing business over the value of the individual identifiable net assets of the business (SAUDAGARAN, 2004)
c) the present value of the right to receive expected super-profits defined as the amount by which the future revenue, increase or advantage is expected to exceed any or all economic expenditure incidental to its production. (WESTWOOD, 2000).

The main questions related to goodwill are:

a) should it be included as an asset or should it be charged against earnings/retained earnings?
b) if it is an asset, how can it be amortized?

There are many arguments for and against the capitalization and amortization of goodwill because of the difficulties of identifying objective criteria of measurement, and the period of amortization is not clearly defined as a period of the decline of the value of the goodwill.

So, goodwill could be considered an intangible asset that presumably enables a company to generate a higher rate of return than could be earned only by the tangible assets. That is to say that the value of the business is likely different from the total value of the identifiable assets, both tangible and intangible. This is because the value of the business as a whole will be estimated by reference to the expected future flow of income from the business. This difference is generally identified as goodwill.

According to Brazilian law, intangible assets should be recognized only by their cost. Examples of intangible assets are:

a) patents, licenses and trademarks: they are included as an asset by the price paid for registration costs or legal fees and represent only a fraction of the true and fair value of this asset;
b) concessions: they are included as an asset by the price paid to obtain the concession and are usually amortized by the term of the concession agreement.
c) goodwill: it is included as an asset by the difference between the total price paid for an acquired business (market value) and the fair value of the net assets of the company and is usually reported in a separate account in “Long Term Investments in Equity Securities”. As a consequence, internally generated goodwill is not allowed to be included as an asset. All of the costs should be written off as an expense as incurred.

According to the Brazilian Securities Commission, listed companies must identify the economic reasons for paying the excess treated as a goodwill. The difference between the market value and the historical cost of the assets should be amortized according to the useful economic life of the asset. Furthermore, listed companies should disclose the expectation of future economic benefits, not exceeding ten years.

Finally, tax legislation allows the inclusion of goodwill as an asset for ”other economic reasons” and should be amortized before five years.

3.3 Research and development costs

Research and development costs are becoming more significant and increasing importance, especially in industries such as chemical industries and pharmaceuticals.

According to Accounting Theory, some expenses produce their effects over several financial years and it is logical to recognize them over those years in the same proportion as the revenues generated by them. This procedure is only applied to costs whose effects are not immediate, such as research and development costs.

According to Financial Reporting Standards no.13 (ICANZ, 1995), “development” and “research” are used with these meanings:

a) development is the application of the research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use;

b) research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

The main question from the accounting perspective is whether these costs should be capitalized as an asset (with amortization following any criteria) or as expenses as they are incurred.

According to IAS 38 (WALTON, 1998), research must be considered as an expense immediately as incurred and development costs may, however be capitalized if they meet the following conditions:

a) the product or process in question is clearly defined;
b) the attributable costs can be separately identified and measured reliably;
c) the technical feasibility of the product or process can be demonstrated;
d) the enterprise intends to produce and market or use it;
e) there exists a market for the product or process, or if it is to be used internally, its usefulness can be demonstrated;
f) There exist adequate resources or these are available to complete the project.

Development costs which do not satisfy these conditions should, in principle, like research costs, be considered as an expense as they are incurred.
Besides that, IAS requires that costs which have been capitalized, should be amortized systematically from the time the product is put on sale or the process is ready for use. In the case of any uncertainty, the IASB determines the maximum amortization period as five years.

However, according to the USGAAP, all R & D cost outlays should be considered as an expense when they are incurred because of the uncertainty of future economic benefits.

Other countries, such as France, require the capitalization of R & D as an asset, as a general rule, while Japan allows the capitalization to be amortized over a five-year-period.

However, considering as an expense is the dominant practice. In Germany, Canada and United Kingdom, research costs are immediately written-off as an expense, and development costs may be capitalized if they meet certain asset recognition criteria. (SAUDAGARAN, 2004).

According to Brazilian Corporate Law, R & D should be capitalized as an asset and amortized during the expected period of future economic benefits, not exceeding ten years.

On the other hand, if the asset recognition criteria may not be met because there is insufficient probability that the future economic benefits will be realized as a result of specific R & D, such costs are recognized as an expense in the period in which they are incurred.

3.4 Revaluation

According to the Brazilian Corporate Law, and Brazilian Tax Law, revaluation of property, plants and equipments to market value is allowed in Brazil.

Revaluation practice doesn’t follow the Historical Cost Principle and it is not common, but it is a legal procedure carried out in order to reduce the distance from historical cost and the market value.

Some companies have adopted the practice of revaluation very often in past years, mainly for two reasons:

a) to improve debt-to-asset ratios in order to inflate their equity and increase their debt capacity.

b) when the official monetary adjustment index was much lower than the actual inflation rate, writing-up fixed asset to market value made the financial statements more meaningful.

According to the CVM -Brazilian Securities Commission, listed companies can recognize only revaluation of properties. The revaluation increment is credited in two separate accounts:

a) the shareholder’s equity (reserve of revaluation);

b) liabilities (provision for deferred corporate tax)

An unusual procedure admitted by the CVM is “negative” revaluation, when the market value of a fixed asset is significantly lower than book value. In this situation, the adjustment is recognized by:

a) reducing the reserve of revaluation, if possible;

b) Including the adjustment as a non-operating expense (profit and loss statement).

Although historical cost remains the generally accepted practice, revaluation of fixed assets is allowed by international standards as an alternative treatment. The EC Directive also
allows this practice. National regulation in this area, is very diverse. According to WALTON (1998), there are three clear groups of countries:

a) those that allow revaluation, sometimes with conditions: UK, Australia, Belgium, France, Netherlands;
b) those that allow this only from time to time, under circumstances fixed by law: Spain, Japan, Italy;
c) those that forbid any revaluation: Germany and USA.

According to a new proposal for the Brazilian Corporate Law, revaluation practice should be accepted only for specific situations related to business combinations.

3.5 Mark to Market accounting

Generally speaking, mark to market accounting is becoming more common in Brazil, in accordance with international financial reporting standards. However, it is important to identify and to separate different standards required for the government bodies, as follows:

a) Banks and similar financial institutions.

According to the Central Bank of Brazil, mark-to-market accounting is required for most of the current assets, including marketable securities, derivatives (future, forward, swaps, options), gold (including financial gold and operations with gold) and financial instruments (except loans and other receivables not held for negotiation, investments that the bank intends and is able to hold until the maturity and other financial assets for which there is no dynamic market or whose fair value cannot be reliably measured.

c) Listed companies.

According to the Brazilian Securities Commission, listed companies are not required to adopt mark-to-market accounting. They follow the classic rule of LOCOM – Lower of cost or market applicable for financial assets. Certain assets such as a gold (financial gold) and foreign currency supply are evaluated using market value (not LOCOM) and the respective gains and losses are recognized in the profit and loss statement. Furthermore, derivatives and financial instruments are off-balance-sheet items and their market value must be disclosed in footnotes.

3.6 Inflation and monetary adjustment systems

The Historical Cost Accounting Model, which dominates financial reporting practices in most countries, does not accept changes in the purchasing power of currency.

A good example to understand how inflation can distort financial statements is mentioned by SAUDAGARAN (2004) when he reviewed the recent history of general changes in purchasing power in the United States. The consumer price index in the US rose from 24.1 in 1950 to 172.2 in 2000, showing that the purchasing power of one US dollar in 1950 was equal to more than seven US dollars in 2000.

To recognize the effects of changes in the purchasing power of the Brazilian currency, the Corporate Law requires that financial statements be monetarily adjusted for inflation. However, since 1995, according to Law 9249, any monetary adjustment system is no longer allowed to recognize the effects of changes in the purchasing power of currency.
This prohibition applies to both financial reporting and for tax purposes. However, the Brazilian government allows the inclusion of “opportunity costs” as a deductible expense in order to reduce income tax viii.

Since 1995, the inflation rates measured according to the General Price Index, are as follow:

a) 1995 – 21.98%

b) 1996 – 9.12%

c) 1997 – 4.34%

d) 1998 – 2.49%

e) 1999 - 8.43%

f) 2000 - 5.27%

g) 2001 - 9.44%

h) 2002 - 14.74%

i) 2003-10.38%

The Federal Accountancy Council published a resolution requiring the recognition of the effects of changes in the purchasing power of currency when the accumulated inflation rate in three years exceeds 100%. However, this resolution doesn’t have legal authority requiring it to be followed by Brazilian companies.

3.7 Foreign Currency Translation

Generally speaking, Brazilian accounting treatment for foreign currency translation follows international financial reporting standards. It is important to distinguish between “The Translation of Transactions” and “The Translation of Financial Statements”. The former is a record of the transaction carried out in foreign currency on the company’s books. On the other hand, “The Translation of Financial Statements” refers to the procedures that are usually adopted to prepare and consolidate financial statements (of the company and their branches or subsidiaries located in foreign countries) at the end of the financial year.

3.7.1 Translation of Transactions

According to NOBES (2002) “non-monetary assets are entered in the books at their historical cost in terms of home currency. However, in the case of monetary assets and liabilities, the situation is rather different and could be translated:

a) at the historical rate (no translation of gain, or losses reported).

b) at the closing rate (translation results in gains and losses in the profit and loss statement);

c) at either of the lower or higher of historical rate or closing rate for assets or liabilities (it is prudential to choose the lower rate for assets and the higher for liabilities).

Furthermore, according to WALTON (1998), this matter brings up another question: exchange gains and losses should be immediately recognized in the profit and loss statement or recognition should be deferred?

According to Brazilian accounting standards, the following criteria must be adopted to translation of transactions:
a) non-monetary items must be translated at the original (historical) rate of exchange;
b) monetary items must be translated at the current (closing) rate of exchange;
c) exchange gains and losses should be immediately recognized in the profit and loss statement and not be allowed to be deferred.

3.7.2 Translation of Financial Statements

According to WALTON (1998), the most popular approaches to Foreign Currency Financial Statements are:

a) the closing (current) rate approach
All assets and liabilities balances are translated at the financial statement date. The gains and losses should be taken direct to equity, not in the profit and loss statement;

b) the monetary and non-monetary approach
The monetary assets and liabilities are translated at the closing (current) rate and non-monetary items are at the historical cost;

c) the temporal approach
It is very similar to the monetary and non-monetary approach. “Temporal” refers to time, so some assets such as inventory or investments written down to net realizable value or revalued fixed assets are translated at the rate of the valuation adjustment date;

d) the current/non current approach
Current assets and liabilities (and non monetary assets) are translated at the current rate. Non-current assets and liabilities are translated at the historical rate.

According to Brazilian accounting standards, in the translation of financial statements, the above criteria are essentially the temporal approach.

3.8 Accounting for Retirement Benefit Plans (Superannuation schemes)

Retirement Benefit Plans (private programs) are not so common in Brazil because all companies are obliged to make monthly contributions to a Government sponsored agency for social security and pensions, in order to pay a pension to all retired Brazilian employees.

However, considering that the government pension is generally lower than the salary before retirement, several companies (mainly listed companies, state companies, banks and transnational companies) have decided to pay additional benefits to their employees.

Brazilian companies usually have another separate company (“private pension entity”) to manage the retirement benefit plans, only for their employees. The private pension entities are responsible for assets of around $ 85 billion (New Zealand dollars) and almost 15% of the Brazilian Gross National Product (2002).

The main question relating to accounting for retirement benefit plans is how the cost of the pension and benefit should be recognized and how it should be reported in financial statements. As a rule, they are recorded as an expense for accounting and tax purposes, when they are paid, except in listed companies.
According to the Brazilian Securities Commission, listed companies were required to adjust their financial statements in December, 2001 in order to adopt, in essence, the international financial reporting standards, which include recognition, measurement and disclosure of retirement benefit plans.

On the other hand, other companies not classified as listed companies (such as state companies and transnational companies) are not required to report and disclose any information about retirement benefit plans. Therefore, their financial statements could be misleading for not showing a fair and true view of their financial position.

IV. CREATIVE ACCOUNTING OR MANIPULATING PROFIT? A BRAZILIAN EXPERIENCE

According to NOBES (2002), “creative accounting” is the use of financial reports to mislead rather than inform. Other authors such as GRIFFITH (1995), ELLIOT (1996) and SUTTON (2000) have made criticisms, but at the same time instruct on how to commit this practice or demonstrate a variety of techniques to paint a more positive picture of their financial position than the reality could ever justify.

Examples of creative accounting have included:
   a) manipulation of revenue recognition;
   b) classification of ordinary items (losses) as extraordinary items;
   c) delaying the recognition of expenses;
   d) keeping “off-balance sheet” items (for example: classifying a finance lease as an operating lease);
   e) capitalization of interests;
   f) depreciation policy;
   g) revaluation of fixed assets;
   h) manipulation of provisions;
   i) contingencies not included as liabilities even those required to be included.

Some authors such as NOBES (2002) and WESTWOOD (2002), understand that the existence of creative accounting can, in many situations, be attributed to some deficiency in accounting standards, or in practical, creative accounting represents a manipulation of accounting information within the framework of accounting standards. The existence of optional treatments, gaps in the standards, or an absence of standards enables the adoption of creative accounting.

Some examples of creative accounting adopted in Brazil can be summarized as follows:

4.1 Accounting for leases

According to Brazilian law and its regulations, leases with finance characteristics are recorded as operating leases. Therefore, the rights and liabilities arising from a finance lease are not reflected in the lessee’s financial statements. Along the same line of thought, receivables arising from the finance lease are not reflected in the lessor’s financial statements.

In fact, in the first instance, the lessor adopts the rental method, reporting the leased asset as a fixed asset (including its depreciation), adopting the legalistic view rather than an economic view (substance over form), considering lessor as the owner of the asset.
How can a finance lease be recorded as a receivable instead of a fixed asset? It is relatively simple. According to the instructions of the Central Bank of Brazil and the Brazilian Securities Commission, the lessor’s financial statements are required to be adjusted following these steps:

a) calculate the present value of minimum lease payments (including residual value) using the implicit interest rate of the lease agreement;

b) match this against the fixed assets balance (historical cost decreased by accumulated depreciation);

c) The difference between “a” and “b” should be recorded as “insufficiency or over-depreciation”, increasing or decreasing the fixed assets’ balance and recognizing it an expense or a profit in the Profit and Loss Statement.

This procedure allows the net profit (profit and loss statement) and shareholder’s equity (balance sheet) to be adjusted to a finance lease rather than operating lease.

4.2 Effects of Changes in Exchange Rates – Capitalization as a Deferred Asset rather than an expense

In three different years, the Brazilian government required companies to capitalize the effects in exchange rates (1979/1983 and 1999), as a deferred asset. Of course, there was not any change, but those changes could be classified as an abnormal exchange (around 30% per day). Which meant that that company’s foreign debt increased by 30% overnight.

However, the Brazilian government didn’t allow companies to write-down the effects of this change in exchange rates as an expense in the Profit an Loss Statement because it was not accepted in the same year to reduce income tax. Included as an asset, it was allowed to amortize over five years for tax purposes.

This procedure does not follow accounting principles because it doesn’t follow the accrual basis.

4.3 Effects of Economic Plan Adjustments – banks and financial institutions

Generally speaking, banks and financial institutions are more vulnerable to the effects of economic plan adjustments adopted by the Brazilian Government in order to decrease inflation rates.

The main reason is the reliability of customers because it is usual to reduce the money-supply and some banks can experience financial difficulties. Furthermore, inflation is, from purely financial point of view, useful for banks because of floating.

Therefore, many banks and financial institutions were forced to make redundant part of their taskforce or close some branches to adapt to an economic plan. These effects are, in general, treated as an expense, but they were allowed to be included as a deferred asset and amortize over three years, in order to avoid any reduction in their profit or lose their reliability or image.

Of course, this procedure is not in accordance with accounting principles, because it doesn’t follow the accrual basis.

4.4 Revaluation of fixed assets in order to substitute the inflation
According to Brazilian law, any system of monetary adjustment is prohibited in order to recognize the effects of changes in the purchasing power of Brazilian currency.

However, the Brazilian inflation rate during the period 1995-2003 reached 125.20% which probably means that all fixed assets are below their fair value.

Some companies adopted revaluation of fixed assets in order to substitute the inflation.

Even though this is acceptable under the “true and fair view” of the assets approach, it is not acceptable under accounting principles.

4.5 Contingent Liabilities

Some companies with contingencies (possible and probable) avoided recognizing them as liabilities in financial statements in order to avoid deteriorating the relation debt/equity. Therefore, these companies have adopted a policy of disclosing contingencies in footnotes rather than as liabilities.

Of course, this procedure is not in accordance with accounting principles because it doesn’t follow the accrual basis.

V. MANAGEMENT ACCOUNTING

Brazilian management accounting practices were heavily influenced by three economic events during the nineties.

First, the Brazilian government allowed the importation of commodities, in general, that until 1990 had been prohibited in order to protect national industries. It also meant that before 1990, Brazilian companies or foreign companies already set up in Brazil were not worried about competitors and, as a consequence, saw no need to improve management practices at that time. The automobile industry is a good example. Until then, it was almost impossible to import cars because of Brazilian law prohibition. New foreign companies were not encouraged to come to Brazil because of obstacles including a lot of red tape. Therefore, even foreign companies already set up in Brazil were not interested in developing and researching new products or adopting modern technologies because they didn’t have competitors.

Second, nineties saw the privatization of Brazilian companies that were under the control of the government. The effect of the Real Plan also meant that companies such as banks faced greater competition and so were further privatized. As a result, the privatization process brought in new foreign companies, bringing more competition to these sectors, and improved management practices.

Third, after 1994, the inflation rate decreased radically and allowed the adoption of management and cost accounting practices (until then, almost impossible). In fact, after the implementation of the Real Plan, more and more of biggest Brazilian companies adopted costing systems. The Brazilian Cost Congress started up after this economic stabilization and became one of the biggest accounting and business academic congresses in Brazil.

Generally speaking, most Brazilian companies adopt absorption costing rather than direct costing because of tax requirements. According to Nascimento Neto & Miranda (2003), the ABC costing system is more usual in foreign companies and large Brazilian companies. However, according to this research, the choice of the cost system is arbitrary, i.e, not based on accurate studies that would identify the most appropriate system.

Besides the costing systems traditionally known, two other systems were developed by Brazilian researchers: the Unit Effort of Production and the Economic Management of Costs.
The UEP was developed in the Southern part of Brazil and some companies of this region trialed its use. The main idea is to choose one typical product and adopt it as a reference. For each production step, the effort made or all the resources that were used are calculated. After that, the same procedure is adopted for products in order to find the equivalent or proportional product. According to the UEP, the relationship between the typical product and each product should be constant all the time. This system is adoptable only by manufacturers, which is its main weakness. For administrative expenses, those companies adopted activities costing.

GECON was developed in the eighties by researchers at the University of Sao Paulo and became popular in this school. The main idea is to measure the economic value of each transaction, adopting the transfer pricing concept based on the market or trading value of the different units or departments. According to GECON, cost allocation is not allowed and therefore, this concept is radically opposite from the traditional costing system. The main disadvantage and likely its weak point is that it has no practical application because of cost-benefit relationship. Some of the biggest Brazilian companies under government control such as Banco do Brasil and Petrobrás experimented with GECON but they found it to be unsuccessful. The GECON creates the worst effect in accounting research terms because it focuses on the cost approach rather than the positive accounting approach.

VI. CONCLUSIONS

Brazilian accounting has undergone significant changes in recent years. Nevertheless, some important differences between Brazilian accounting standards and international accounting practices remain, although efforts have been made by Brazilian bodies to adapt their accounting norms to the international financial reporting standards established by IASB. Brazilian accounting is already heavily influenced by the government and the accounting profession, although representative councils are not politically strong enough to influence the government. Shortcomings in the education of accounting in Brazil have brought about the necessity for a proficiency examination and continued professional development under the Federal Accountancy Council. The management accounting practices were heavily influenced during the nineties.

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i Similar to the SEC - Securities and Exchange Commission of the United States.
ii Companies that are authorized to have their shares traded in the Stock Exchange.
iii Accounting Plan for the Institutions of the National Financial System.
v Responsible for the supervision of the stock market until the creation of the CVM.
viii This procedure is similar to dividends paid, so it is not in essence an expense, but an income allocation.
ix See chapter 3.1 – Accounting for leases.
x Such as telecommunication, steelworker and railway industries.
xii Unidade de Esforço de Produção
xiii Gestão Econômica de Custos