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Brazil and International Financial Reporting Standards (IFRS)

First-time adoption of IFRS

Answers to Frequently Asked Questions

ADVISORY

The Brazilian Central Bank and the Brazilian Securities and Exchange Commission (CVM) defined 2010 as the deadline for adoption of International Financial Reporting Standards (IFRS) for the consolidated financial statements of financial institutions and publicly-held companies. Now, with the recent publication of Law 11.638/07, the transition to IFRS has also become a priority for other Brazilian companies.

By revising the accounting aspects of Company Law 6.404/76, Law 11.638/07, effective from January 1, 2008, is the most significant change in Brazilian corporate legislation in the last 31 years. The new law contains several important steps to convergence with IFRS although it does not require the immediate adoption of IFRS or mean total convergence between Brazilian and international accounting practices. The regulatory agencies of the accounting profession in Brazil are working on the detailed regulations to support the Law and are expected to release several statements in the mid-term.

The current situation is similar to that undergone by the 7,000 European companies that adopted IFRS in 2005 and puts Brazil in the privileged position of being able to learn from their mistakes and benefit from the advances subsequently made by the regulating body of the International Accounting Standards Board (IASB). Among these advancements, we highlight the publication of a specific rules for first-time IFRS adoption which undoubtedly contributed to IFRS becoming regarded as the global accounting standard.

IFRS adoption will be a big step towards more transparency in financial information and improvement in Corporate Governance practices of Brazilian companies. The easier the transparency and comparability of financial statements, the more useful they are, facilitating the decision-making process and increasing investors' confidence. More than a simple accounting change, IFRS adoption will require the analysis of impacts on businesses, processes and information systems and the need to train professionals involved directly or indirectly with IFRS.

The objective of this publication is to address some of the main issues and doubts arising at the start of the IFRS conversion process.

Specific Brazilian Aspects

1. At present, which companies should adopt the IFRS in Brazil?

In accordance with CVM Instruction 457 and the Brazilian Central Bank's Rule No. 14.259, publicly-held companies and all financial institutions shall publish IFRS consolidated financial statements from 2010. However, the individual financial statements of the parent company and its subsidiaries will continue to be presented in accordance with Brazilian GAAP.

2. Does Law 11.638/07 which revised existing Company Law require the adoption of IFRS from January 1, 2008 by all companies?

No. The revision of the Company Law was an important step towards more transparency and alignment of the Brazilian accounting practices with the international practices. Some sections of this Law, such as those relating to mergers and/or acquisitions and financial instruments require the recording at fair or market values instead of historical values, as previously required. The agencies that regulate the Brazilian accounting profession are expected to work intensely in the forthcoming months to issue detailed statements on the application of new procedures.

3. Can the companies listed under the differentiated rules of the CVM's Novo Mercado (New Market) which have already disclosed a reconciliation of net income and stockholders' equity between Brazilian GAAP and IFRS be considered to have presented IFRS financial statements?

No. In accordance with IFRS 1, this note does not constitute the adoption of IFRS, as it does not provide all disclosures required by the IFRS.

General Instruction on IFRS

4. When will be the first year of adoption of IFRS by financial institutions and publicly-held companies? What about the 2010 quarterly filings? Do comparatives have to be presented?

IFRS requires comparative financial statements. IFRS 1 establishes that the transition date is the start of the first period that is presented in the IFRS comparative financial statements. Consequently, considering that the year ended December 31, 2010 will be compared to December 31, 2009, the opening balance and transition date will be January 1, 2009. In practice, this means that all transactions occurring from January 1, 2009 must already consider the requirements of IFRS.

The 2010 quarterly filings will be published with the 2009 quarterly comparatives.

5. What information will be released to the market? Will a reconciliation between BRGAAP and IFRS be required?

IFRS 1 establishes that an opening balance sheet be prepared at the transition date, but need not to be disclosed. However, companies'management may want to anticipate the disclosure to the market of expected transition effects. In general, the main disclosures required by the IFRS 1 are the following:

- Reconciliation of stockholders' equity between BR GAAP and IFRS at the transition date (e.g. January 1st , 2009).
- Reconciliation of net income of the last year between BR GAAP and IFRS (e.g. year ending December 31, 2009).

The reconciliations should include sufficient information to enable a full understanding of the adjustments made and separately identify adjustments arising from changes in accounting policy (i.e. the adoption of the IFRS) from possible corrections of mistakes identified as of the transition date.

Some Myths

6. Are the IFRS adopted by the European Union the same that will be adopted by the Brazilian companies?

Not necessarily. IAS Regulation (EC 1606/2002), the legislation of the European Union that regulated the adoption of IFRS, requires the implementation of IFRS as approved by the European Union. Under this regulation, any new standard of interpretation issued by the IASB must be endorsed by the European Commission and published in the official journal of the European Union before becoming mandatory. At present, there are some standards that have not yet been endorsed and are, therefore, not yet mandatory for European companies (such as certain items related to the recognition and measurement of financial instruments –IAS 39 and the interpretation on the recording of concessions – IFRIC 12). Conversely, Brazilian companies must adopt all IFRS approved by the IASB.

7. Is it not true that IFRS permits alternative treatments for certain transactions that complicate comparison?

Prior to 2005, there a number of alternative treatments were permitted. However, the IASB reviewed the rules and many of the alternative treatments were limited or removed prior to the first cycle of IFRS adoption by European companies in 2005. At present, there are less than 26 alternative treatments in the standards, some of which will be excluded from 2009 (e.g. IAS 23 has been revised and interest on loans should be capitalized and can no longer be expensed directly in the income statement).

It is important to emphasise that all alternative treatments must be disclosed in companies' accounting policies. Any changes in treatment must be treated as changes in accounting policies and the appropriate disclosures made on a comparative basis.

KPMG has published a booklet entitled Choices In Practice which helps explain the main alternative treatments and how they were adopted by companies.

The Adoption in Practice

8. When adopting IFRS, should we adopt all standards retroactively?

This is the rule. However, to facilitate the transition to IFRS and minimize differences in subjective judgments that could have negatively impacted the 2005 adoption first wave, the IASB published IFRS 1 – First Time Adoption with several exceptions to the rules and some prohibitions. First time adoption to IFRS must follow IFRS 1.

9. So what is IFRS 1 and what are its basic principles?

IFRS 1 is actually a practical guidebook for conversion. It is the only IFRS standard that is 100% rules based and aims to facilitate the transition process, clarify doubts and avoid significant differences in treatments between companies. It contains several exceptions to rules and some prohibitions. The rationale for exceptions was to provide some relief for companies, mainly in obtaining information that may no longer be available. One of the prohibitions is the use of retrospective information when making estimates.

10. In general, what should be done to adopt IFRS?

The following procedures are necessary:
(i) identify the first financial statements to be prepared in accordance with IFRS;
(ii) prepare an opening balance sheet as of the transition date, i.e., as of the first day of the comparative financial year;
(iii) select the accounting policies in effect at the date of the first IFRS financial statements and apply them retroactively to the transition period;
(iv) consider what exceptions to rules on retroactive adoption should be adopted;
(v) apply the four prohibitions existing for retroactive adoption; and
(vi) extensively disclose the impacts of transition to IFRS and include a clear statement about full compliance with IFRS.

11. What adjustments should be made to the opening balance sheet so that it is IFRS compliant?

The opening balance sheet shall:
(i) Include all assets and liabilities required by IFRS.
(ii) Exclude any assets and liabilities required by IFRS.
(iii) Classify all assets, liabilities and stockholders' equity in accordance with IFRS; and
(iv) Evaluate and measure all items in accordance with IFRS.

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Fair Value

12. Is it true that the fair value concept is present in all IFRS rules? So can we abandon the concept of cost and prepare all recorded balances at fair value?

The fair value concept for the initial recording of transactions is included in all standards and the IASB has increasingly chosen to adopt it for subsequent valuations. Discussions have advanced and there are arguments both in favor and against the predominance of fair value in financial statements. However, the requirement of fair value measurement to all transaction applies only for the initial recognition. For example, financial instruments are initially measured at their fair values, but subsequently follow their respective rules (loans, receivables and investments held to maturity at amortized cost and other financial instruments and all derivatives at fair value).

13. Shall all assets and liabilities be stated at fair values as of the date of transition to IFRS? Will the fair value be determined at the transition date or inception date?

The rule is that fair value be determined at date of contracting/acquisition (inception date). However, IFRS 1 determines that the fair value be determined, in most cases, considering the conditions existing at the transition date. Leasing contracts are one of the few transactions that are not covered by IFRS 1 exceptions and the determination of fair value for comparitive purposes with the present value of minimum payments must be made considering the date of contracting (inception date). Business combinations is another matter with a differentiated treatment under IFRS 1 and for transactions that occurred before the transition date the companies may choose to maintain the treatment under the prior accounting principle and do not need to revalue to fair value.

If you are interested in knowing how KPMG in Brazil can advise your company about the conversion into the IFRS, send an email to ifrs@kpmg.com.br or visit our website at www.kpmgifrg.com.