

Changes* made to the Brazilian Corporation Law Federal Law no. 11,638/2007

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Content

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On December 28, 2007, the President of Brazil signed Federal Law 11638, which alters and revokes certain provisions of Law 6404/1976 (the Brazilian Corporation Law) and Law 6385/1976 (regulations about the securities market and the Brazilian Securities Commission (CVM)), including extending the financial statement preparation and disclosure requirements to large privately-held businesses. These changes are effective January 1, 2008 for calendar-year companies.

This publication summarizes the main changes:



Financial Statements

(amendments to articles 176, 177, 187 and 188 of Law 6404/76)

In accordance with the Corporation Law, at the end of each fiscal year, management shall prepare, based on the commercial accounting records of the corporation, financial statements which express clearly the situation of the corporation's net assets and the changes which occurred during the year.

In addition to the financial statements previously required (balance sheet, statement of retained earnings or accumulated deficit and statement of operations), the law has added two new required statements: (i) the statement of cash flows and (ii) for listed corporations only, the statement of added value. The statement of changes in financial position was discontinued.

In accordance with the new law, closely-held corporations with net assets lower than R\$ 2 million at the year-end will not be required to prepare and disclose the statement of cash flows.

It should be observed that, in accordance with Article 7 of Law 11638, the new statements (cash flows and added value) may be presented in 2008 without including comparative amounts for the prior year (2007).

- **Accounting**

The corporation's accounting must be maintained in permanent records and prepared in accordance with the provisions of the commercial law, Law 6404/76 and Brazilian generally accepted accounting principles. The accounting methods and criteria should be uniform over time, and the accrual basis of accounting must be applied.

The new law innovates by providing that:

- I. Regardless of whether the corporation is required to utilize specific accounting criteria or prepare specific accounting statements to comply with the tax law or legislation specific to the corporation's activity, the corporation is required, for the purposes defined in the Corporation Law, to prepare its financial statements in accordance with the requirements mentioned above using one of the following methods:
 - (i) recording adjustments in auxiliary books and records, without changing the commercial accounting records; or
 - (ii) for tax-basis statements, recording adjustments in the commercial accounting records themselves, provided that additional accounting entries are made to support the preparation and disclosure of the financial statements in compliance with the requirements mentioned above, in which case these statements should be audited by an independent auditor registered with the CVM.
- II. The accounting rules to be issued by the CVM should be prepared in accordance with international accounting standards adopted in the main securities markets.
- III. Closely-held corporations may elect to follow the CVM's rules for financial statements prepared by listed corporations.
- IV. Accounting adjustments made exclusively to harmonize the accounting rules, and the related statements and calculations resulting from those adjustments, may not serve as the basis for the levy of taxes and contributions nor have other tax effects.

• **Statement of Operations**

The new law provides that the annual statement of operations should disclose separately, but not as expenses, the participations in earnings attributed to debenture-holders, employees and managers, even when paid in the form of financial instruments, and employee assistance and pension plans.

The new law also revoked paragraph 2 of Art. 187 of Law no. 6404, which provided that the increase in the value of assets recorded as revaluation reserve could be considered as income for dividend distribution or profit sharing purposes.

In accordance with Article 6 of Law 11638, the existing balances of the revaluation reserve should be maintained until they are realized or else be reversed up to the end of the fiscal year in which the law becomes effective (2008).

• **Statements of Cash Flows and Added Value**

These new statements shall include at least the following:

- I. Statement of Cash Flows: the changes in cash and cash equivalents segregated among three categories: (a) operating; (b) financing; and (c) investing.
- II. Statement of Added Value: the amount of the wealth generated by the corporation; the distribution of that wealth among the elements which contributed to generating it, such as employees, lenders, stockholders, government and others; and the portion of the wealth which was not distributed.

Balance Sheet

(amendments to articles 178, 179, 182, 183 and 184 of Law 6404/76)

When describing the groupings of accounts, Law 11638/2007 provides that:

- Permanent assets will be composed of: investments; property, plant and equipment; intangible assets and deferred charges.
- Net equity should be composed of: capital, capital reserves, market value adjustments, profit reserves, treasury shares and accumulated deficit (previously this group also included revaluation reserves and retained earnings).

In addition to the provisions already contained in Law 6404, the new law changed the classification of certain asset accounts as follows:

- **property, plant and equipment:** rights to tangible assets intended or used to maintain the corporation or its activities, including those arising from arrangements which transfer the benefits, risks and control over these assets (no longer includes “industrial or commercial property”);
- **deferred charges:** pre-operating expenses and restructuring expenditures which will effectively contribute to increasing the profitability of the corporation in more than one fiscal year and which are not merely reductions in costs or increases in operating efficiency;
- **intangible assets:** rights related to intangible assets intended or used to maintain the corporation’s activities, including acquired goodwill.

With respect to the net equity, the law provides that adjustments in the market value of certain assets and liabilities be recorded through a market value adjustments account (formerly a revaluation reserve) in net equity until they are eventually reflected in operating results under the accrual method of accounting.

Moreover, the law changed article 183 of Law 6404 to provide new criteria for recording the following assets:

- investments in financial instruments, including derivatives, and in rights and securities, classified as current assets or in long-term receivables:
 - (a) for those classified as trading investments or investments available for sale -- at their market value (as detailed in the Law) or equivalent; and
 - (b) for other investments and credit rights -- at amortized acquisition cost or issuance value, adjusted to probable realization value, if lower;
- intangible assets -- at acquisition cost, net of accumulated amortization; and
- long-term receivables -- at present value (applicable to short-term receivables also, if there would be a material difference).



The corporation should periodically analyze the recoverability of property, plant and equipment, intangible assets and deferred charges:

- (1) if there is a decision to discontinue a business or certain activities, or if it is proven that a business unit will not generate sufficient results to recover the carrying value of the assets, the estimated impairment loss should be recorded; and
- (2) the criteria used to determine the estimated economic useful lives and to calculate depreciation, depletion and amortization should be reviewed and adjusted, if necessary.

In this context, the paragraph in the former law which addressed the amortization of deferred charges and related items was revoked.

The law also changed the valuation criteria of certain liabilities by providing that obligations, charges and risks classified as long-term liabilities be adjusted to present value (applicable to short-term liabilities also, if there would be a material difference).



Profit Reserves and Retained Profits

(inclusion of article 195-A and amendments to articles 197 and 199 of Law 6404/76)

Law 11638 introduced the tax incentive reserve. The shareholders present at the general meeting may, through a specific proposal by the board of directors, transfer to this reserve the portion of net income arising from fiscal incentive investments, and thereby exclude this net income from the calculation of the compulsory dividend.

Moreover, as regards the unrealized profit reserve, the law states that only the following items may be excluded from the annual net income to arrive at the realized profit: the positive result from equity accounting in investees and the net profit, income, gains or market value adjustments resulting from transactions that will be realized financially only after the end of the next fiscal year.

The new law also included the tax incentive reserve in the calculation of the maximum profit reserve limit.

In addition, the new law revoked items 'c' and 'd' of paragraph 1 of art. 182 of the Corporation Law, which provided that the premiums received on the issuance of debentures, as well as investment donations and subsidies, be classified as capital reserves.

Transformation, Merger, Combination and Split-off

(amendments to article 226 of Law 6404/76)

In accordance with the new law, in the event of a merger, amalgamation or split-off transaction between unrelated parties and involving the effective transfer of control, the assets and liabilities of the merged or split-off entity will be recorded at their market value.

Valuation of Investments in Related Companies and Subsidiaries

(amendments to article 248 of Law 6404/76)

Article 248 was amended to determine that the equity method of accounting should be used for investments in affiliates in which the corporation has significant influence, or in which it holds 20% or more of the voting capital, as well as investments in subsidiaries and other companies which are part of the same group or are under common control.



Financial Statements of Large Companies

In accordance with articles 3 and 4 of Law 11638, certain large companies, regardless of legal form, are required to follow the provisions of Law 6404/76 regarding the preparation of financial statements and the obligation to have an independent audit performed by a firm registered with the CVM.

Large companies include companies or group of companies under common control with total assets in excess of R\$ 240 million or annual gross revenues in excess of R\$ 300 million, with both figures based on the prior year's financial statements.

The CVM is permitted to establish different rules by category of listed corporation or issuer of securities, such as size, type and class of securities, etc., regarding the content and frequency of disclosure, the management report, the financial statements, the accounting standards, reports and independent auditors' opinions.

Agreements

(new article 10-A of Law 6385/76)

The Brazilian Securities Commission, the Brazilian Central Bank and other regulatory bodies and agencies are authorized to enter into an agreement with an entity for the purpose of studying and disclosing accounting and auditing principles, rules and standards and may, as part of their regular activities, adopt that entity's pronouncements and other technical guidelines fully or in part.

The entity mentioned above must be composed mostly by accountants and should also comprise, on an equitable basis, representatives of entities that prepare financial statements, entities that audit and analyze financial statements, the federal organ responsible for supervising the accounting profession and universities or research institutes with renowned expertise in the accounting and capital market areas.

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