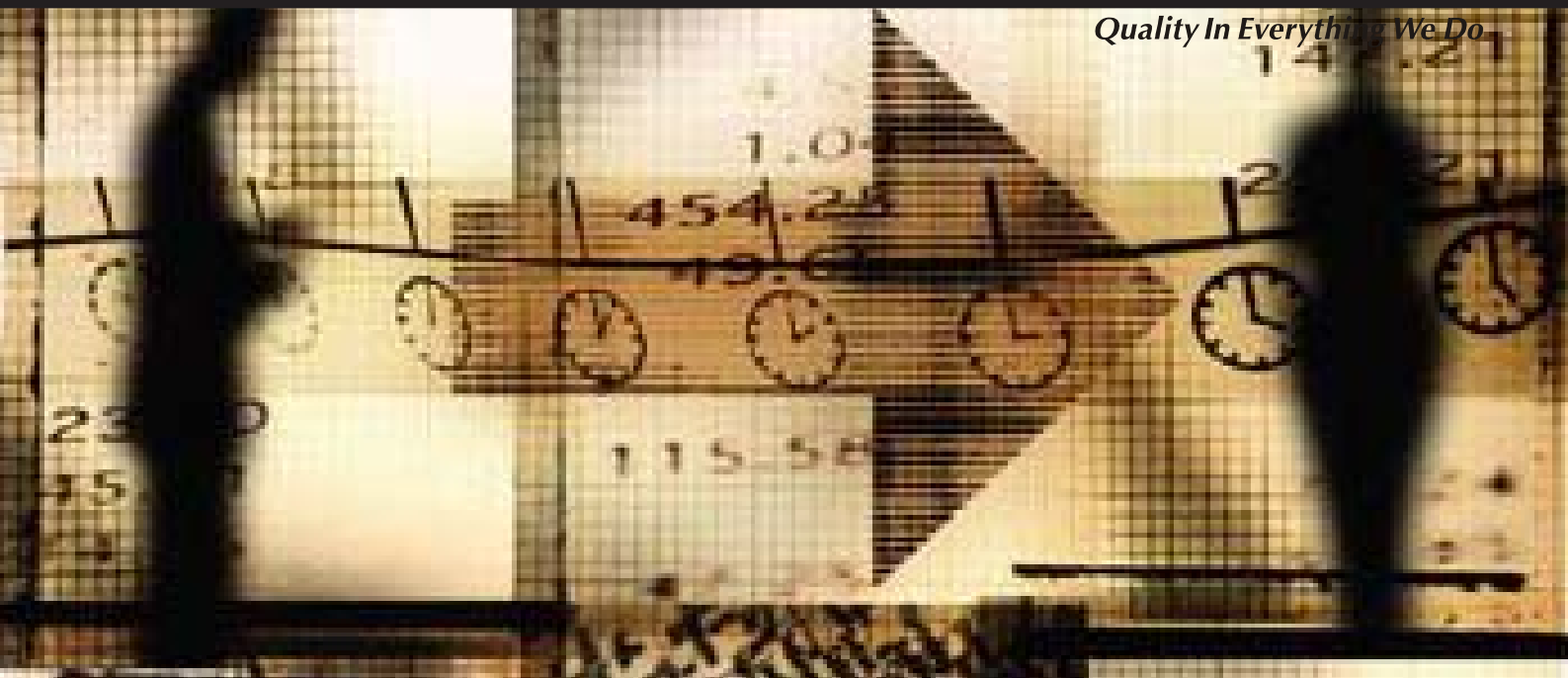


Brazil's Economic and Business Brief 2005

 **ERNST & YOUNG**

Quality In Everything We Do



The political turbulences and the effects arising from foot-and-mouth disease focuses in Mato Grosso do Sul on the balance of trade did not suffice to shake market confidence on the Brazilian economy in 2005. With inflation under control, a trend towards downward interest rates and stable exchange rates, the country's scenario showed stability. Those expecting a bolder pace of growth in 2005, however, had to content themselves with a modest rate, possibly around 2.5%.



The revision of the original forecasts of a 3.5% Gross Domestic Product (GDP) growth followed a drop in industrial production in the third quarter, triggered by the appreciation in real. The segments more affected were durable and non-durable consumer goods, due to loss of competitiveness in exports.

With the trend towards downward interest rates, the manufacturing industry can reverse this picture in the short term, but achieving a more consistent and long-lasting growth depends on the advancement of structural reforms, on the taxation system improvement, and on the creation of regulatory frameworks for certain sectors of the economy with a view to stimulating private investments.

Jorge Menegassi

Chairman, Ernst & Young Brazil

Taxation has kept an upward trend, which requires of companies good planning in order to minimize the tax effects on the production chain. In the first six-month period alone, the tax volume reached 39.3% of the GDP, against 37.8% in the same period of 2004. The trade surplus estimate of US\$ 43 billion contributed to preserving market confidence in Brazil's economy and to attaining a lower country risk of less than 400 points.

The pitfalls set for the Brazilian economic growth are the subject of the article written by Federal Representative and Former Minister Antonio Delfim Netto especially for this issue of the "Financial Reporting Guide". In his analysis, the economist defends that giving incentive to economic expansion is the best way for the government to overcome market mistrust in relation to achieving a balance in the Debt-to-GDP ratio and having the country move into a more virtuous cycle.

In another article, Sergio Citeroni, lead partner of Ernst & Young Brazil's Assurance and Advisory Business Services, highlights the benefits brought about by Sarbanes-Oxley Act to companies that are already compliant with the new US market requirements. Pedro Farah, Audit partner of Ernst & Young, focuses on gains that Brazilian companies can attain from harmonization of the country's accounting standards with the accounting principles adopted in the United States and Europe.

With this Guide, we hope to contribute towards improving quality and reliability of Brazilian financial reporting. ■

the benefits from Sarbanes

Sergio Citeroni

Some US companies have already started to realize efficiency gains that result from compliance with the new legal requirements. With more effective internal control structures, management responsibility increases and financial processes are improved.

Much has been said about the high cost of compliance with Section 404 of Sarbanes-Oxley Act (SOX). And investments are really high. A survey conducted by Ernst & Young this year, with US companies that have been subject to the compliance implementation process, reveals that 85% of the participating companies, with annual revenues greater than US\$ 20 billion, invested more than US\$ 10 million to meet Section 404 compliance requirements. In smaller companies – those with annual revenues between US\$ 1 billion and US\$ 20 billion – there was a more significant change in investment level, as a result of factors such as geographic dispersion of operations, growth over time via acquisitions, and IT environment complexity. For some 30% of these companies, the compliance implementation process has required investments between US\$ 2.5 million and US\$ 5 million.

The discussion about the investment cost to meet the legal requirements on time has typically put in second place a debate on the benefits that companies will enjoy at the end of this process. It is a fact, for example, that implementation of preventive and corrective internal controls will make companies less susceptible to the universe of corporate risks which their managers must deal with every day – and which result in financial losses reaching, in some cases, millions of reais. To cite but one example, US companies are estimated to have an annual loss equivalent to 6% of their revenues due to fraud. Had a more effective control environment been



in place, such resources would most certainly be reincorporated into the companies' gains.

Although the level of effort put forth in the compliance implementation process has been much higher than the one originally estimated (for some 70% of the companies surveyed by Ernst & Young, costs related to Section 404 were more than 50% above estimate), the survey revealed many deficiencies in internal controls, in addition to having identified opportunities for improvement of processes, systems and controls. In 70% of the companies, there were significant remediation efforts concerning IT controls and systems. In over 25% of the companies with annual sales greater than US\$ 5 billion, more than 500 individual controls were remediated in the first year alone.

87% of the companies see management's greater responsibility for the company's controls as an additional benefit out of the SOX project.

Irrespective of the severe criticism made to the excessive strictness, particularly in relation to the provisions contained in Section 404, the companies can already see some significant benefits out of their compliance with the new law. Apart from improvement in their internal control structure, 87% of the companies surveyed by Ernst & Young see management's greater responsibility for the company's controls as an additional benefit out of the SOX project, while 83% consider improvement in financial processes a major benefit.

In a round table hosted by the Securities and Exchange Commission (SEC) in April current year to discuss the experience of implementing compliance with Section 404, public traded companies, investors and audit firms

mentioned some examples of benefits perceived over the process. These include, but are not limited to, greater senior management involvement in financial reporting; more awareness and responsibility of operational management concerning internal controls; and more reliability on certifications issued by CEOs and CFOs under Section 302.

This international experience may be quite helpful for Brazilian companies trading on the New York Stock Exchange. Recently, they have picked up steam in the wage against time to have their internal control structure conform to the US legal requirements. The SEC's decision to defer the effective date for FPIs (Foreign Private Issuers) to comply with the requirements of Section 404 must not, however, be viewed as consent for these businesses to reduce or postpone their efforts towards compliance with such legislation. The deadline extension was mainly aimed at giving FPIs opportunity to obtain better alignment among their internal processes, thereby minimizing the risk of republishing their financial statements – which could be a strong sign of the ineffectiveness of internal controls.

It is common sense that implementing Section 404 successfully is critical to preserve capital market reliability. In today's corporate environment, only companies that have proper corporate governance policies in place will be able to count on renewed flow of investments. Under this scenario, financial information transparency and a more secure environment will help reduce funding expenses and will make public offering easier in the future. With this in mind, current SOX project costs can be put second, given that its associated benefits, in the medium and long run, tend to make up for the substantial investments that have been made. ■

SERGIO CITERONI IS THE LEAD PARTNER OF ERNST & YOUNG BRAZIL'S ASSURANCE AND ADVISORY BUSINESS SERVICES PRACTICE.

accounting harmonization, a key to growth

Pedro Farah

Global harmonization of accounting standards is no doubt an inevitable change towards integration that moves swiftly forward. Brazil must assume a position in order to follow this trend so as to make accounting reporting feasible among companies established locally and in the world's largest economic centers.

The economic crisis in Asia in 1997 caused unpleasant surprises for many investors, mostly Europeans, who had not detected in the balance sheets of diverse Asian corporations the critical financial situation they were going through. This was because analysts did not know, indeed, how financial statements were prepared. Actually, not only has the crisis revealed certain structural weaknesses in the financial system but it also has raised awareness of the urge for international harmonization of accounting standards and better quality of the information. This opportunity was seized by the International Accounting Standards Board (IASB), which began reviewing and modernizing international accounting standards, making them known through an extensive program of visits to countries worldwide.

In tandem with this, as a consequence of the need for reconciling the European and the US money markets, a project is currently underway moving toward convergence of accounting standards followed in the United States (US GAAP) – substantiated on the pronouncements from the Financial Accounting Standards Board (FASB) – to the European model, the IFRS (International Financial Reporting Standards), which is expected to be completed between 2007 and 2009. Integration moves swiftly forward, to the point that the Securities and Exchange Commission (SEC), the US market regulatory body, has informed that beginning 2007 they will accept IFRS financial statements of foreign companies whose shares are traded in the United States.



Therefore, global harmonization of accounting standards is no doubt inevitable. Accordingly, Brazil must also assume a position in order to follow this change, which will be championed by at least 92 countries. To this end, it is important to get to know the pros of having this set of rules adopted by Brazilian companies. Proper understanding of financial statements by international analysts will provide these organizations with:

- More agility in funding and foreign loan raising activities, such as those for imports. This is because clearer financial statements will reduce doubts and uncertainties, particularly those entertained by creditors and analysts, which will cause the financial cost of funding activities to drop.
- More confidence on the part of foreign importers, since they tend to build stronger business relationship with companies that are transparent and able to show, clearly, their sound financial health, critical factors that reveal they can ensure supply of goods to their customers in the near future.
- Improved conditions for going public on the world's largest stock exchanges.
- Less rework for accountants, notably in relation to multinationals, since at present these professionals have to prepare financial statements in conformity with tax and technical requirements set by their head offices.

Branches of multinationals based in Europe or in the United States, for instance, have to report the results of their operations to their head offices under IFRS or under US GAAP. These standards are disseminated in Brazil as the number of foreign companies established in the country is quite significant. Large companies, which account for a substantial portion of the Gross Domestic Product, already follow international accounting standards, whether US or European.

On top of that, large Brazilian companies need to adjust the financial statements received from their subsidiaries abroad in order for them to conform to local requirements. In a few years,

these companies will also need to prepare their financial statements in accordance with the international model so they can be used in Europe, in view of the increasing number of business partnerships with corporations from that continent.

Within this context, Brazil has to reconcile two needs: adopt a set of accounting standards that is understood globally and modernize the rules in force in the country for 30 years, under the Corporation Law (No. 6404/76), unfortunately far closer to tax concepts than technical ones.

It is critical, therefore, that local standards make such accounting reporting feasible among companies established locally and in the world's largest economic centers. Out of the key accounting standards currently existing, Brazil tends to adopt a model closer to the IFRS, a set of principle-based standards.

The immutability of the Brazilian law since 1976 has allowed different bodies to dictate accounting standards and rules.

It is a system that provides more room for the accountants' exercise of professional judgment. Since its parameters are based on principles rather than on specific rules – as is the case of US GAAP – the trend towards changes is lower.

The immutability of the Brazilian law since 1976, contrasting with the need for modernization imposed by the market, has allowed different bodies to dictate accounting standards and rules, such as the Brazilian Securities Commission (CVM), for publicly traded companies; the Central Bank (BACEN), for banks; the Superintendence of Private Insurance Plans (Susep), for insurers; the National Telecommunications Agency (Anatel), for telecoms; and the National Electric Energy Agency (Aneel), for electric energy companies. Needless to mention the Federal Board of Accountancy (CFC), body responsible for chartering and overseeing the accountant's profession, which also prepares and issues accounting standards.

Therefore, apart from dictating rules for publicly traded companies, CVM also has specific rules for the sectors it regulates, such as financial services and insurance. Also, there are certain isolated efforts – the São Paulo Stock Exchange (Bovespa) for one, requires of New Market entrants a reconciliation between “BR GAAP” and US GAAP. These actions constitute market responses, given that our country's ruling standards do not meet the international requirements.

Accordingly, one sees that global harmonization of accounting standards is a topic of great interest for the companies. The pure and simple adoption of the IRFS is not a solution for the problem today since Brazil's Federal Constitution does not allow any set of foreign rules and standards to be followed locally. In order for this to happen, the Brazilian legislation must change, which is a time-consuming process. Bill No. 3741 has been under discussion in Congress since 2000, and is aimed at introducing changes to the Corporation Law regarding accounting policies. This discussion, however, means an intense and quite slow political process.

Bill No. 3741 defends formal segregation between accounting and tax legislation since these are distinct elements.

Bill No. 3741 deals with some core issues including but not limited to creation of an independent entity that would be responsible for setting accounting standards and which would act as a sort of local regulatory agency. The CVM rules must follow the international rules, which in practice already happens. An example of this is CVM Resolution No. 489, which deals with provisions, contingent assets and liabilities, applicable to publicly traded companies, which is, in essence, a translation of the international rule. The government agency cannot change the Corporation Law, but it has introduced a procedure that has been followed by companies whose shares are traded on Bovespa.

The bill also defends formal segregation between accounting and tax legislation since these are distinct elements. It also introduces the requirement for presentation of cash flow and statement of value-added applicable to publicly traded companies. The bill sets forth that large privately-held companies are required to publish their audited financial statements.

It would be important that the regulatory agencies which are today's accounting standards setters should delegate this prerogative to the new entity that would concentrate responsibility for Brazilian technical rules. The Ministry of Finance has expressed its intent to support the approval of Bill No. 3741, which may be passed by the House of Representatives in early 2006. It is indispensable that such





legislation be endorsed by Congress as soon as possible because even if this occurs next year, the new wording will become effective in 2007 only, when convergence of the US model to the European one will take place.

Working in tandem, various institutions, such as the CFC, Ibracon, Abrasca, Fipecafi, Apimec Nacional and Bovespa, concluded that early creation of the new accounting standard setter provided for in referred bill was advisable, which occurred a month ago. Named as “Comitê de Pronunciamentos Contábeis” (CPC), a committee acting as Brazil's Financial Accounting Standards Board, it will be formed by people nominated by these institutions and will likely have members invited by the Central Bank and CVM as well. The CPC is instituted under Resolution No. 1055/05 from the Federal Board of Accountancy (CFC) and will act concertedly with the institution.

The objective of the CPC is to study, prepare and issue technical accounting pronouncements, on top of disclosing related information. The Committee aims to centralize the process for production of accounting standards in Brazil and make it uniform, taking into account the need for convergence of local rules to international standards. Once Bill No. 3741 is approved, it is important that the CPC be designated as the institution responsible for setting accounting standards in Brazil.

This is the only country where accounting standards are provided for by law and not a prerogative of a technical specialized institution.

Brazil can only benefit from harmonizing its accounting standards with the international principles. However, to this end, certain legislative changes are required. This is the only country where accounting standards are provided for by law and not a prerogative of a technical specialized institution. This makes some companies believe one must follow what is provided by the law rather than accounting principles that are internationally accepted today, which would, undoubtedly, bring them significant benefits concerning market relations. The 1976 legislation was progressive at the time, but it has to be updated.

Concentrating responsibility for setting accounting standards on the CPC will represent an institutional advancement to the country. This landmark effort will very much contribute to stability of the rules and transparency of disclosures by companies. These positive factors will doubtlessly contribute to the companies' business expansion, with indirect benefits to the growth of Brazil, job creation, and people's income and welfare increase. ■

the limits of a VICIOUS circle

Delfim Netto

The rise in the Debt-to-GDP ratio could be mitigated by a vigorous expansion of the economy, but it is inhibited by the behavior of interest rates, which remained high precisely to support debt financing. Once this hurdle is overcome, the country could move into a more virtuous cycle.

In Brazil, the "market" aided by the IMF established a limit for the PSND (Public Sector Net Debt) related to the GDP. In much the same way of Newton's universal constant, Einstein's hypothesis of a constant limit for speed of light (now contested by João Magueijo, a Portuguese physicist) and Planck's action constant in the quantum world, there may indeed be in Brazil a natural limit to the PSND / GDP ratio. This limit was first discovered by the "market" and later on by the economists using "tarometrics (taro cards + econometrics) who believe they are the defenders of a "hard science" that identified this mysterious value: 0.56. By using sophisticated econometric methodologies for non-linear equations, some economists (Brazilian and foreign) "proved" that 0.56 is a kind of limit: when the ratio threatens to grow beyond this value, the entire economic system becomes unsettled and anxious... In the same way that universal constants are in fact "super-human" and establish bases for our physical reality, the limit of PSND/GDP ratio = 0.56 would constitute a foundation for a credible Brazilian economy in the financial world, related to the Brazilian economy. It is pointless to insist that it may be worthwhile to suspect that the result, determined by the equation, was in fact unexpectedly introduced into the system by researchers' beliefs. But this is totally irrelevant! A country that is as deeply in debt as Brazil can not simply ignore the belief systems of its internal and external creditors. If we continue on this way, it's important to acknowledge that this fact indeed acts as a restriction to the degree of freedom of the economic policy in the country.



CACALOS GARRASTAZU / VALOR ECONÓMICO / AGÊNCIA O GLOBO

TABLE 1

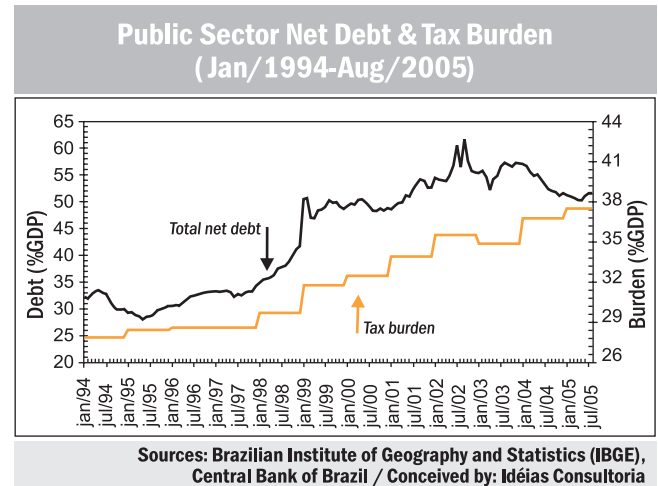
Evolution of the Public Sector Net Debt, in relation to the GDP (shown in R\$ billion)					
	2001	2002	2003	2004	Aug/2005
1. PSND	660.9	881.1	913.1	957.0	973.1
Internal	530.1	654.3	726.7	818.1	889.2
External	130.8	226.8	186.4	138.9	84.5
2. GDP*	1,255.7	1,587.7	1,596.8	1,852.0	1,885.0
3. PSND/GDP	0.526	0.555	0.572	0.517	0.517

* GDP last 12 months based on monthly prices indicated.
Source: Central Bank of Brazil

The Public Sector Net Debt includes three levels of internal and external public administration debts as well as those of respective state-owned companies. The federal debt level obviously includes the Central Bank of Brazil debt, excluding international reserves. Over the last four and a half years, the evolution of this debt is demonstrated in Table 1.

The Brazilian society has suffered a permanent increase in the gross tax burden as shown in Chart 1, in which the PSND/GDP ratio is also indicated. This value grew in an alarming manner but after some small fluctuations resulting from electoral noise in 2002, it seemed to stabilize. The numbers show a fantastic increase in the tax burden during the Fernando Henrique Cardoso Administration (from 28% in 1994 to 35% in 2002). The problem was aggravated even more by the slight increase experienced in 2003 and an even larger increase in 2004, contrary to promises made by the Lula Administration. In order to meet this political commitment, the 2005 budget must account for the “excess revenues”, quietly amassed from the 2004 budget, and return these funds to society by completely eliminating tax charges on capital goods and by reducing income taxes on stock market earnings. The tax collection “exaggerations” practiced

CHART 1



in 2004 could be transformed into a formidable stimulus for the investment segment and thus encourage growth of the economy and the job marketplace.

The first Presidential Mandate of the FHC Government (1995-98) was a fiscal disaster in which public maintenance and repair expenditures grew much more than the GDP.

After a primary surplus totaling 5.21% of the GDP recorded in the first year of the Itamar Administration, in which the PSND/GNP ratio actually decreased, the primary surplus result lost ground. Only in the second mandate, under strong pressure exerted by the IMF, did primary surpluses reappear as shown in Chart 2.

The Government was accustomed to defending itself by saying the debt increase was due to “the absorption of skeletons”, that is to say, debts incurred but not acknowledged, a hypothesis which can be easily refuted by analyzing the Table 2.

It is clear that, discounting the sale of public wealth through privatizations, the “skeletons” do not represent even 5% of the accumulated debt in the period.

In December 1994, the PSND/GDP ratio was about 30%. In December of 2002, it reached 56%, despite a suffocating gross tax burden increase that continues to be one of the major inhibitors impeding a more robust economic development. The year 2002 was atypical. The electoral process held in that year provoked a volatile scenario in the foreign exchange rate cycle. The final result obliged Brazil to pay out 14.5% of the GDP to cover interest payments on the national debt and, after having built a primary surplus of 4%, the country accumulated a nominal deficit totaling 10.5% of the GDP!

**Everyone knows that the Constant
"0.56" simply does not exist. The
problem is: disrespecting it produces
serious consequences.**

The "market" considers - and the IMF and some "taro-econometric" experts confirm - that the PSND/GDP ratio is one of the basic indicators that help measure the resistance capacity of the Brazilian economy when facing natural external impacts that consistently appear on the horizon. The real truth of the matter does not seem to be an issue. What seems to be important is the "belief" that, when the PSND exceeds 56% of GNP, Brazil will have a problem honoring its debts. This naturally raises the external spreads and interest rates capable of sustaining the refinancing of the debt and its eventual expansion. Under these conditions, the National Treasury (or the Central Bank of Brazil) is not able to renew the debt at current interest rate and is forced to increase it, which in fact aggravates the problem even more. The same thing happens when doubts are raised considering the country's capability of foreign debt renewal (included in the PSND), which only serves to increase spread and reduce external financing, elevating the nominal foreign exchange rate. Once again, the movement is in the direction of an increased aggravation of an already unbalanced scenario since higher

interest rates end up provoking a lack of confidence among external agents in regard to Brazil's debt solvency. In the Middle Ages, everyone believed that the Unicorn was real but this so-called "truth" was of no consequence. In more modern times, in Brazil, everyone knows that the Constant "0.56" simply does not exist. The problem is: disrespecting it produces serious consequences.

The dramaticity of the problem resides in the fact that the key factor which could diminish the growth of the PSND/GDP ratio would be a robust GDP increase, frequently inhibited by the behavior of interest rates. This is the vicious circle that we must find a way to break.





The factors that control the PSND/GDP ratio: what are they? The PSND numerator basically depends on the ratio recorded in the previous year, the interest rate and the effective foreign exchange rate of the current year. The GDP denominator basically depends on the real growth rate of the national product. What is the truly “optimal” condition expected both by the “market” and the IMF and confirmed by the taro-econometric experts? They of course hope the ratio settles down at 56%, with an eventual gradual decrease. This was the objective of Minister Palocci when early in 2003 he affirmed that “we would create the necessary primary surplus so as to stabilize the PSND/GDP ratio” and unilaterally increased the surplus target to 4.25%

The PSND/GDP ratio does not depend on the Minister’s “desire”, or on internal government doubts or even economic “tricks”. It depends on the real interest rate, the real foreign exchange rate and the real economic growth of the country. If in 2003 we had recorded growth at 3% and not -0.2%, the ratio would have been smaller than it was and would have produced a positive signal to internal and external creditors. On the other hand, we know that a negative relation exists between the real growth rate and the real interest rate. The foreign exchange rate in 2004 approximated the point of equilibrium in terms of current accounting with a GDP growth rate about 4%.

We have lost precious time over the last 18 months with an excessively conservative policy at the Central Bank of Brazil.

Objective conditions continue existing for a consistent reduction of the PSND/GDP ratio which has initiated a more virtuous movement than we have been experiencing. We have lost precious time over the last 18 months with an excessively conservative policy at the Central Bank of Brazil, stopping the SELIC index from falling, which would have decreased the cost of interest. The situation today is more difficult but at least we have learned the “cost” of this policy.

Looking at another angle, the acceleration of exports is improving and is reinforcing other important indicators used to define the “national situation”: 1 - the Foreign Debt/GDP ratio and; 2 - Amortizations + Interest/GDP. This confirms the possibility of our constructing an external image more adequate for the objective conditions of our economy, which would in fact reduce the so-called Brazil “Risk”. It is necessary to stimulate even more the export activities and take advantage of any opportunity to reduce the real interest rate while insisting on the idea of expanding national and foreign investor confidence, which will bring to an end, once and for all, the regulatory influence in their relations with the Federal

TABLE 2

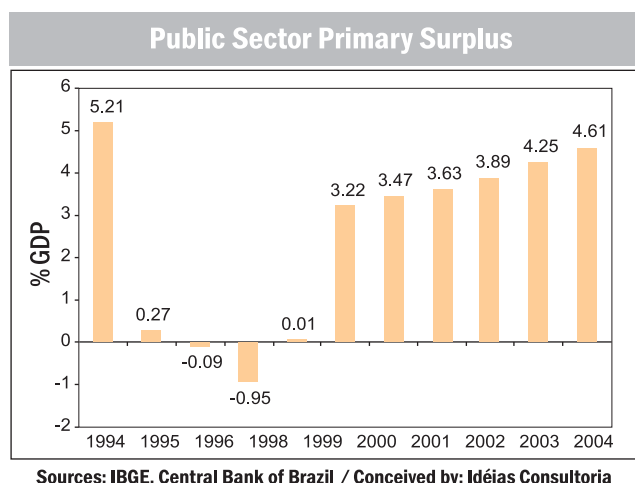
PSND Evolution (1995-2002) (in R\$ billion)		
1. PSND at 12/31/1994		153.2
2. PSND at 12/31/2004		957.0
3. PSND Growth (1994 - 2004)		803.8
4. Interest paid	835.2	
5. Primary surpluses	(-) 306.1	529.1
6. Foreign exchange adjustment		211.3
7. Skeletons	104.5	
8. Sale of wealth (privatizations)	(-) 65.4	39.1
9. Foreign Debt (small adjustments)		24.3
10. Total		803.8

Government and will assure them total legal security. Without this kind of changeover, the public-private-partnership will never get off the launching pad and will delay even further the necessary investments in infrastructure, which will, in a very short space of time, inhibit growth of the nation's agri-business, the most vibrant sector in the economy.

It has also become absolutely necessary that the Central Bank of Brazil come to terms with the weight of the bank sector concentration they have built up over the last few years by issuing of effective measures that boost competition and reduce the internal spread which is the main enemy of every small and medium-sized business enterprise in Brazil.

Authorities can no longer ignore the evident fatigue felt by society from paying interest (their own obligations and the government's) that in 2003 totaled 145.2 billion reais, clearly understood to be an exaggeration. This tends to stimulate

CHART 2



the imagination of some economists to seek out faster solutions (and in general - wrong ones) to encourage economic growth.

Brazil finalized the year 2004 in a situation that was better than that in 2003, however 2005 is showing a mediocre growth rate, close to the 3.5% cited by "taro-econometric" forecasts. We know that "growth" is articulated by the private sector when, operating within adequate institutional parameters (including total respect for private property), the Government "creates" incentives for the free-flow of the "market", for workers to appropriate part of the earnings generated by productivity and for encouraging.

It is the Government's responsibility to reduce the uncertainties that the future always hides from private agents. It is the Government's job to assure that the effective demand will continue to grow and, in combination with a



reduction in capital costs and an expansion of credit, that will motivate the unfolding of an “untamed spirit” among the business class.

When these same business people start taking “risks” linked to new investments, the simultaneous growth in global supply and demand will take over and move forward the virtuous process of economic expansion. Sooner or later this process will affect the level of employment and, with the reduction in the unemployed labor force, will end up proportioning an increase in the real salary base which is the way for the worker in Brazil to participate in the economic growth of the country.

This reinforces the fact that even after elapsing of ten months of this current year, not even the size nor the quality of the numbers and results experienced in 2005 have been completely determined. This could have been a year of maximum market activity, the year of drastically reduced bureaucratic obstacles, the rationalization of taxes combined with a general decrease in the tax burden resulting from the expansion of the formal economy, the incorporation of the informal sector, the correction of extravagantly prudent legislation imposed on the banking system, the reduction of production costs, the mobilization of governmental financial agencies to encourage the creation of credit lines for small and medium-sized business enterprises through systems that reduce the monopolies exercised by the banking system, the effective practice of public-private-partnerships and the incentivating of greater competition in the sectors, both commercial and industrial, where great concentrations of market shares were formed over the last ten years. ■

DELFIN NETTO IS MEMBER OF THE FEDERAL HOUSE OF REPRESENTATIVES (PMDB-SP), ECONOMIST AND FORMER MINISTER OF FINANCE (1967-74) AND PLANNING (1979-85).

2005 Financial Statements Preparation Guide

U.S. ACCOUNTING STANDARDS

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

— SFAS 123R

Share-based Payment - Requires that share-based payments to employees, including stock option plans, be expensed at fair value. This Standard is applicable for years beginning after June 15, 2005, in the case of large and medium publicly-held SEC registrants, and for the years beginning after December 15, 2005, in the case of small and publicly-held SEC registrants.

— SFAS 151

Inventory Costs - Revises ARB No. 43 - Chapter 4 – Establishes that the abnormal portions of idle costs, freight, handling costs and wasted materials (spoilage) must be expensed in the period incurred. This Standard is applicable for years beginning after June 15, 2005.

— SFAS 154

Accounting Changes and Error Corrections – Establishes that a voluntary change in accounting policy, must be applied retrospectively in prior period financial statements, unless it is impracticable to do so. This Standard replaced APB 20 and Statement No. 3 and is applicable for years beginning after December 15, 2005.



— EITF ISSUE 05-6

Determining the Amortization Period for Leasehold Improvements. Is applicable for leasehold improvements after June 29, 2005. This pronouncement can be applied to prior periods for which financial statements have not yet been issued.

— POSTPONEMENT OF THE REQUIREMENT TO CERTIFY INTERNAL CONTROLS FOR NON-ACCELERATED FILERS AND SMALL FOREIGN PRIVATE ISSUERS

Section 404 becomes applicable for non-accelerated filers and small foreign private issuers, i.e. those whose market value is lower than US\$ 75 million, only for the years ending after July 15, 2007. As regards other foreign private issuers, Section 404 is applicable to years ending after July 15, 2006.

BRAZILIAN SEC (CVM) RULINGS AND RESOLUTIONS

RESOLUTIONS

— CVM RESOLUTION No. 488, OF OCTOBER 3, 2005

Approves IBRACON Pronouncement NPC No.27, which provides general guidance regarding the presentation of financial statements, their structure and gives the minimum requirements for their contents. Adoption of this Resolution is required for financial statements for years ending after and at December 31, 2005 and also requires that opening balances must be adjusted for comparison purposes.

— CVM RESOLUTION No. 489, OF OCTOBER 6, 2005

Approves Ibracon Pronouncement NPC No.22 on Provisions, Liabilities, Contingent Assets and Liabilities. Provides the definitions of and differences between a liability (present obligation involving incurred events, the settlement of which entails the outflow of economic benefits) and a contingent liability (a possible obligation to be confirmed on the basis of future events, beyond the control

of management, or a present obligation not accounted for in view of improbable settlement or non-measurability). The resolution also defines a contingent asset, and clarifies when possible assets and liabilities should be accounted for.

This resolution also provides accounting guidance, among other matters, for restructuring provisions, contracts to be performed, onerous contracts, deposits in court and legal obligations. The first time application of the resolution may produce effects that, when not involving changes to estimates, should be accounted for as prior year adjustments.

FEDERAL ACCOUNTING BOARD (CFC) RESOLUTIONS

— CFC RESOLUTION No. 1011, OF JANUARY 21, 2005

Approves NBC-T 10.1 Long-term Contracts, which establishes the treatment and recognition of revenues and costs of long-term contracts.

— CFC RESOLUTION No. 1025, OF APRIL 15, 2005

Approves NBC-T 19.1 Fixed Assets, which establishes the criteria and procedures to register tangible fixed assets.

— CFC RESOLUTION No. 1026, OF APRIL 15, 2005

Approves NBC-T 19.4. Establishes the accounting procedures and basic information to be disclosed in the notes to the financial statements by private entities benefiting from tax incentives, tax subsidies, contributions, and government assistance and donations. This resolution shall be in force on January 1, 2006, but anticipated adoption is encouraged.

— CFC RESOLUTION No. 1027, OF APRIL 15, 2005

Approves NBC-T 19.5. Establishes the criteria and procedures to record depreciation, amortization and depletion of fixed assets.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

— AMENDMENTS TO INTERNATIONAL ACCOUNTING STANDARD (IAS) 39

Financial Instruments: Recognition and Measurement. The International Accounting Standards Board (IASB) issued amendments to IAS 39, giving new guidance on the accounting treatment to be adopted in hedge operations involving forecast intragroup transactions, restricting the application of the fair value option for financial instruments and in addition, also new accounting requirements for financial guarantees resulted in amendments to IAS 39 and IFRS 4 Insurance Contracts.

— AMENDMENTS TO INTERNATIONAL FINANCIAL REPORTING STANDARD (IFRS) 1

First-Time Adoption of International Financial Reporting Standards and IFRS 6 – Exploration for and Evaluation of Mineral Resources. These amendments aimed to clarify and detail the exceptions allowed for application of IFRS 6 (applicable to companies engaged in exploration of mineral resources) to companies adopting international accounting standards for the first time.

— INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) No. 7

Financial Instruments: Disclosures and Amendments to IAS 1 Presentation of Financial Statements: Capital Disclosures. Provides supplementary guidance on disclosure of financial instruments in the financial statements.

— INTERNATIONAL FINANCIAL REPORTING INTERPRETATION COMMITTEE (IFRIC) No. 6

Liabilities Arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment. This Interpretation provides guidance for recognition in the financial statements for the provisions for liabilities related to the treatment of waste or residuals.



NATIONAL MONETARY BOARD (CMN) AND CENTRAL BANK OF BRAZIL (BACEN) REGULATIONS



— RESOLUTION No. 3.271, OF MARCH 24, 2005

Revises Resolution No. 3198/2004, which regulates the provision of independent audit services to financial institutions, other institutions authorized to operate by the Central Bank of Brazil and to clearing houses.

— RESOLUTION No. 3305, OF JULY 29, 2005

Revises Resolution No. 3121/2003, which establishes the rules for investments by closed ended private pension entities.

— RESOLUTION No. 3308, OF AUGUST 31, 2005

Changes the rules for investments related to reserves and provisions and funds of insurance companies, of private equity investment firms and pension funds, as well as the acceptance of underlying assets as a guarantee of those reserves pursuant to the laws and regulations currently in force.

INCOME TAX

— WITHHOLDING INCOME TAX (IRRF) – LEVY ON NET EARNINGS AND GAINS ON FIXED AND VARIABLE INCOME TRANSACTIONS AND ON INVESTMENT FUNDS

Brazilian IRS Regulatory Ruling No. 489, of January 7, 2005. Changes Brazilian IRS Regulatory Ruling No. 487/04, which provides for income tax on net earnings and gains on fixed and variable income transactions and on investment funds.

IRRF AND SOCIAL SECURITY

Regulatory Ruling jointly issued by the Commissioners of the Brazilian IRS, Private Pension Plans and by the Superintendence of Private Insurance (Susep) No. 524, of March 11, 2005. Regulates the determination of the accrual period, for purposes of defining the income tax rate applicable to redemptions or payment of benefits to members or their beneficiaries as regards defined or variable contribution private pension plans.

INDIVIDUAL INCOME TAX (IRPF) – UPDATING THE PROGRESSIVE INCOME TAX RATE SCHEDULE

Law No. 11119, of May 25, 2005. Updates the progressive income tax rate schedules for computation of Individual Income Tax as from January 1, 2005.

MANDATORY CONTRIBUTION ON REVENUE FOR SOCIAL INTEGRATION PROGRAM (PIS) AND MANDATORY CONTRIBUTION ON REVENUE FOR SOCIAL SECURITY FINANCING (COFINS)

COMPUTATION OF CREDIT ON SALES OPERATIONS

Brazilian IRS Interpretive Declaratory Statute No. 2, of February 17, 2005. Provides for computation of PIS and Cofins credits on freight upon sales.

BEVERAGES/FUELS

Brazilian IRS Regulatory Ruling No. 526, of March 15, 2005. Provides the option for the special PIS and Cofins levy systems due by legal corporations that produce or import malt beer, composition of soft drink, gasoline, among others.

HEDGE OPERATIONS

Decree No. 5442, of May 9, 2005. Reduces to zero PIS and Cofins rates levied on financial income from hedge operations. Also provides that PIS and Cofins must be levied on financial income arising from interest on shareholders' equity.

IT PRODUCTS

Decree No. 5467, of June 15, 2005. Provides for and regulates the terms and conditions to reduce to zero PIS and Cofins rates on revenues from sales of IT products addressed by the Digital Inclusion Program instituted by paragraph 2 of article 28 of Provisional Measure No. 252.

COMPANIES ESTABLISHED IN THE MANAUS FREE TRADE ZONE

Brazilian IRS Regulatory Ruling No. 546, of June 22, 2005. Provides for PIS and Cofins on revenues earned by companies established in the Manaus Free Trade Zone.

IMPORT

Brazilian IRS Regulatory Ruling No. 552, of June 30, 2005. Provides the formula to compute PIS and Cofins on import of assets and services.

STATE VAT (ICMS)

ICMS AGREEMENT No. 52, OF JULY 1, 2005

Provides for a new tax base for ICMS taxation under unmeasured cable TV services (addressed by Complementary Law No. 87/96).

ICMS AGREEMENT No. 53, OF JULY 1, 2005

Addresses unmeasured services for Internet access and procedures to abide by the provisions of paragraph 6 of article 11 of Complementary Law No. 87/96, and also sets ICMS tax base at 50% of the price charged to subscriber, under situations similar to those involving unmeasured cable TV services regulated by ICMS Agreement No. 52/05.

CONFAZ ICMS AGREEMENT No. 103, OF SEPTEMBER 30, 2005

Revises ICMS Agreement No. 87/02, which declared ICMS exempt in the operations involving pharmaceutical and medicines intended for Federal, State and Municipal Administration Offices.



Tax on Financial Operations (IOF) and Provisional Mandatory Contribution on Financial Transactions (CPMF)

==== **MINISTRY OF FINANCE ADMINISTRATIVE RULING No. 19, OF FEBRUARY 11, 2005**

Reduces to zero IOF rate on operations with Certificate of Agribusiness Credit Rights (CDCA), with Agribusiness Bills of Credit (LCA) and with Certificate of Agribusiness Receivables (CRA).

CONSTITUTIONAL AMENDMENT

==== **CONSTITUTIONAL AMENDMENT No. 47, OF JULY 5, 2005**

Revises articles 37, 40, 195 and 201 of the Federal Constitution related to social security matters and other provisions.

AMENDMENTS TO THE NATIONAL TAX CODE

==== **COMPLEMENTARY LAW No. 118, OF FEBRUARY 9, 2005**

Revises and adds provisions to the National Tax Code, as well as for the interpretation of item I of article 168. Among the amendments, the following highlights are worth reporting: addition of paragraphs to articles 133 (provides for successors' tax responsibility), 155 (default), 174 (prescription) and 185 (regulations on tax credit guarantees and privileges).

IMPORT

==== **BRAZILIAN IRS REGULATORY RULING No. 571, OF OCTOBER 20, 2005**

Establish formulas for computation of PIS and Cofins payables on import of assets and services.

NEW BRAZILIAN IRS

PROVISIONAL MEASURE No. 258, OF JULY 21, 2005

Institutes the new Brazilian IRS and creates the special nature title of Commissioner General of the Brazilian IRS, determines the applicable jurisdiction for collection, audit, management, levy and regulation of payment of mandatory social contributions, among other procedures. This Provisional Measure was not approved by the National Congress.

AMENDMENT TO SERVICE TAX (ISS) IN THE CITY OF SÃO PAULO

SP MAYOR LAW No. 14042, OF AUGUST 30, 2005

Revises the ISS provisions as regards the parties in charge of tax payment and withholding at source and obligation of the service provider of another city that issues invoices to a beneficiary established in the city of São Paulo to register with the Finance Office of the City of São Paulo. Amendments were also made to provisions on the procedures to be adopted by the municipal government divisions in case of lack of payment by agreed deadline.

REGULATIONS APPLICABLE TO INSURANCE COMPANIES AND PRIVATE PENSION ENTITIES

NATIONAL PRIVATE INSURANCE BOARD (CNSP) No. 120, OF DECEMBER 24, 2004

Provides for new regulations for technical reserves to be set up by insurance companies, life insurance companies and capitalization entities effective January 1, 2005. Revoked CNSP Resolution No. 89, of August 19, 2002.

SUSEP CIRCULAR No. 295, OF JUNE 14, 2005

Provides for the new chart of accounts of Insurance Companies, Reinsurance Companies, Capitalization Entities and Open-ended Private Pension Entities. The Circular also addresses basic accounting standards, minimum notes to the financial statements and models of aggregation of accounts for purposes of presenting financial statements. Revoked Susep Circular No. 279, of December 29, 2004.

NATIONAL SUPPLEMENTARY HEALTH OFFICE

REGULATORY RESOLUTION No. 94, OF MARCH 23, 2005

Provides for the criteria to defer the cover of risk reserve conditional upon the adoption of health care and disease prevention programs by health plan operators to their customers.

PRIVATE PENSION OFFICE

RESOLUTION No. 15, OF AUGUST 23, 2005

Provides for the procedures to be adopted for sale of federal public securities classified as "held to maturity" by closed ended private pension entities.



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