THE METHODOLOGY OF THE STATEMENT OF COMPREHENSIVE INCOME AND ITS IMPACT ON PROFITABILITY: THE CASE OF LATVIA

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Received 16 March 2018; accepted 17 May 2018; published 30 September 2018.

Abstract. The financial statements of a company are used by external users as the main source of information in order to take financially informed decisions. The author of the article has summarized the study on one of the financial statements – a statement of comprehensive income (CI statement) that enables creditors and investors to assess the process of the formation of company’s profit and profitability. Purpose: on the basis of the study of the specificity of the preparation of the statement of comprehensive income to analyze and evaluate the influence of CI statement items on the profitability of Latvian companies. In order to achieve the purpose, the author has structured the research in two parts. In the first part of the article the author describes the theoretical framework of the core, type and content of CI statement and describes the components of other comprehensive income. In the second part of the article the author has analyzed the methodology for the preparation of CI statement at Latvian companies and impact of other comprehensive income on profitability. The subject of research was a sample of 26 financial statements of Latvian companies. The author applied quantitative and qualitative research methods generally accepted in economics: classification, comparative analysis and synthesis, statistical methods. The essence of research findings is that the core of items of CI statement and the division into the reclassified and not reclassified items of other comprehensive income (OCI) are important for the company’s financial result – evaluation of profit. Research showed that most of Latvian companies under research were influenced by reclassified items; besides, positively influenced profitability ratios of ROE and ROA. The author believes that, when evaluating the profitability of assets and the equity of the company, the financial analysts shall take into account the reclassified items of OCI, and the calculations shall be performed using the modifications of ROE and ROA formulas.

Keywords: assets; comprehensive income; equity; financial statements; profitability

Reference to this paper should be made as follows: Būmane, I. 2018. The methodology of the statement of comprehensive income and its impact on profitability: the case of Latvia, Entrepreneurship and Sustainability Issues 6(1): 77-86. http://doi.org/10.9770/jesi.2018.6.16

JEL Classifications: M41, M49

1. Introduction

The financial statements of companies are used by external users as the main information source in order to analyze, assess and forecast the companies’ financial situation, results of performance, cash flow and, on the basis
of above mentioned, to take the financially informed decisions. Measures of profitability will be important for a variety of users. Shareholders will want to be reassured that the firm will be able to generate and sustain profits from which to distribute dividends. Banks and other lending institutions will also be interested in profitability since it will affect company’s liquidity, its capacity to finance debt and, ultimately, its ability to repay loans (O’Regan, 2007). The result of companies’ annual performance – profit or losses, are disclosed in the statement of profit or loss (statement of P/L) or in the statement of comprehensive income (CI statement). It should be pointed out that historically the requirement to prepare CI statement was first applied to the US companies that for the first time prepared this financial statement in conformity with SFAS (Statement of Financial Accounting Standards) No.130 “Reporting Comprehensive Income” – requirements set for the beginning of a fiscal year after 15 December 1997 (FASB, 1997). Some years later the requirement to prepare CI statement was applied to the companies that arranged their accounting in compliance to the requirements set in the International Accounting Standard/International Financial Reporting Standard (IAS/IFRS), namely, these companies prepared CI statement for the first time in conformity with the amended IAS No.1 “Presentation of Financial Statements” for annual periods beginning on or after 1 January 2009 (IASB, 2016). The documents, regulating accounting in Latvia, provide for several requirements that only partially are in compliance with the internationally adopted regulations concerning recognition, evaluation (Bumane, Kasale, 2012). In conformity with the requirements of European Commission Regulation (EC) No.1126/2008 of 3 November 2008 “Adopting Certain IAS in accordance with Regulation (EC) No.1606/2002 of the European Parliament and of the Council”, in the EU Member States (including Latvia) such separate financial statement shall be prepared since the same date, when the amended IAS No.1 came into effect, i.e., for annual periods beginning on or after 1 January 2009. Thus the CI statement for those companies in Latvia that have to prepare annual financial statements in conformity with the requirements of IAS/IFRS is a relatively new financial statement. The CI statement may be prepared by applying different methodologies (type, classification of expenses, items of other comprehensive income), therefore it is important to study the methodology of the preparation of this statement in Latvia and the influence of its items on the indicators of companies’ profit. Similar study on the core and significance of CI statement has been carried out by Slovak scientists (Lapkova, Stašova, 2014), Italian scientists (Cristofaro, Falzago, 2014 and Gazzola, Amelio, 2014) and Dutch scientist (Detzen, 2016). As well as, by means of CI statement and the analysis of its items some aspects have been studied by: Chambers (2007); Dyczkowska (2009); Gad (2015); Mackenzie, Coetsee, et al. (2014); Mackevičius (2007, 2014); Mahn-Bena (2010); Praulīņš and (2012); Picker, Stanton, et al. (2016); Rankin, Stantin, et al. (2012).

The purpose of the research: on the basis of the study of the specificity of the preparation of comprehensive income statement to analyze and evaluate the influence of CI statement items on the profitability of Latvian companies. In order to achieve the purpose, the author has structured the research in two parts. In the first part of the article the author describes the theoretical framework of the core, type and content of CI statement and describes the components of other comprehensive income. In the second part of the article the author has analyzed the methodology for the preparation of CI statement at Latvian companies and impact of other comprehensive income on profitability. The subject of research was a sample of 26 financial statements of Latvian companies.

The author applied quantitative and qualitative research methods generally accepted in economics: classification, comparative analysis and synthesis, statistical methods. At the end of the article there have been presented the conclusions drawn as a result of research performed and the suggestions for the improvement of methodology used to calculate the profitability of companies.

2. Theoretical Framework

Initially, when SFAS No.130 “Reporting Comprehensive Income” was adopted in June 1997, CI statement was introduced in the companies’ financial statements in the USA. The above mentioned statement replaced the Income Statement. The FASB defines the comprehensive income as “the change in equity [net assets] of a
business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners” (FASB, 1997). Thus the aim of the preparation of such statement is “a measure of all changes in equity of an enterprise that result from recognized transactions and other economic events of the period other than transactions with owners in their capacity as owners” (FASB, 1997). Similar description of the core of CI statement is provided by IASB: “the statement of comprehensive income shall present, in addition to the profit or loss and other comprehensive income sections: (a) profit or loss (the total of income less expenses, excluding the components of other comprehensive income); (b) total other comprehensive income (items of income and expense, including reclassification adjustments, that are not recognised in profit or loss as required or permitted by other IFRSs); (c) comprehensive income for the period, being the total of profit or loss and other comprehensive income (the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners) (IASB, 2016).

Having compared descriptions provided by FASB and IASB, we can draw a conclusion that the international standard provides more explanation on separate components of CI statement. With regard to IFRS No.130 “Reporting Comprehensive Income”, the Dutch specialist (Detzen, 2016) states that: “From a reporting perspective, the SFAS No.130 achieved its objective and brought about transparency. However, by labeling items excluded from income as OCI, it left behind conceptual considerations and created a definitional dilemma, exacerbating the difficult sense-making of current accounting practice. That is, SFAS No.130 defined OCI accounting, not as a concept, but as a practice and, thus doing it, institutionalized it without a clear meaning”.

Since for Latvia as the EU Member State are binding the requirements set in IASB, the author will emphasize the requirements set in IAS regarding the preparation of CI statement. IAS No.1 provides that an entity may present CI statement in two ways. One way - as one statement consisting of two sections: Profit or Loss (P/L) section and Other Comprehensive Income (OCI) section, and the other way – as two separate statements: Statement of P/L and the Statement of OCI Statement (see Table 1).

As we can see in Table 1, irrespective of the type of CI statement, the content of this statement is identical. The only formal difference - if CI statement is prepared as two separate statements, then the Statement of OCI starts with the item ‘profit or loss for the period’. There is no also difference, when disclosing which items have affected the profit or loss for the period. Like before coming into force of the amended IAS No.1 “Presentation of Financial Statements”, now the companies can choose the method for the classification of expenses: based on their nature or their function.

As a conceptual difference from the previous P/L statement, it should be pointed out that there is a new section included into the CI statement - other comprehensive income (OCI). In this section the company must show the items of income and expense, including reclassification adjustments, that are not recognised in the profit or loss as required or permitted by other IFRS. The components of other comprehensive income include: (a) changes in revaluation surplus, (b) remeasurements of defined benefit plans, (c) gains and losses arising from translating the financial statements of a foreign operation, (d) gains and losses from investments in equity instruments designated at fair value through other comprehensive income, (e) the effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income, (f) for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability’s credit risk, (g) changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value, and (h) changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the
changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument as the hedging instrument (IASB, 2016).

| Table 1. Type and Content of the Statement of Comprehensive Income |
|---------------------------------------------------------------|
| **Two statements** | **One statement** |
| 1. Statement of Profit or Loss | Profit or Loss section |
| Based on the nature or based on the function: | |
| • Revenues | |
| • Costs and Expenses arising in the course of the ordinary activities of the entity | |
| • Gains and Losses recognized in profit or loss | |
| Profit or Loss for the period | |
| 2. Statement of Other Comprehensive Income | Other Comprehensive Income section |
| Profit or Loss for the period | |
| Grouped into those that will not be reclassified or will be reclassified subsequently to profit or loss: | |
| • Gains and Losses not recognized in profit or loss classified by their nature | |
| • Amounts the share of the other comprehensive income of associates and joint ventures accounted for using the equity method | |
| Total other comprehensive income | Total comprehensive income for the period |

Source: compiled by the author

Gazzola, Amelio (2014, p.175-176) state: "Basically, these are items (items of OCI - author) that are politically unpalatable to the accounting standard setters for inclusion in traditional net income because of their volatility. OCI is those expenses, gains, revenues and losses which are excluded from net income. These items usually appear in other comprehensive income when they have not yet been realized. It is believed that other comprehensive income is made to give the management a more comprehensive view of the company’s financial statement. The OCI adjustments are mainly revaluations coming from the new fair-value orientation of accounting standards". Similar point of view on the core of OCI items is presented by Mackenzie B., Coetzee D. et al. (2014, 72. p.), who state that: “However, unrealized gains and losses also reflect real economic transactions and events and are of great interest to decision makers. ... Both the financial reporting entities themselves and the financial analyst community go to great lengths to identify those elements within reported income which are likely to be continuing into the future, since expected earnings and cash flows of future periods are main drivers of share prices”.

In addition to this it should be mentioned that, in conformity with the requirements of IAS No.1, items of other comprehensive income shall be disclosed in two parts: items, which will not be reclassified subsequently to profit or loss, and, which will be reclassified subsequently to profit or loss. The company may present these items either: 1. as net of related tax effects, or 2. before related tax effects with one amount shown for the aggregated amount of income tax related to those items. The author of the article agrees to the point of view expressed by scientists Mackenzie B., Coetzee D. et al. (2014, 73. p.) that: “The information provided by the statement of profit or loss, relating to individual items of income and expense, as well as to the relationships between and among these items (such as the amounts reported as gross margin or profit before interest and taxes), facilitates financial analysis,
especially that relating to the reporting entity’s historical and possible future profitability. Even with the ascendancy of the statement of financial position as the premier financial statement, financial statement users will always devote considerable attention to the statement of profit or loss”.

The author’s point of view is that the requirement to prepare CI statement will enable the external users of financial statements, especially – creditors and investors, to obtain more complete information on the company’s profit development processes.

3. The Analysis of Comprehensive Income Statement in Latvia

3.1. Research Resources and Design

In Latvia the preparation of the financial statements of companies is regulated by the law of the Republic of Latvia “Law on the Annual Financial Statements and Consolidated Financial Statements”. It provides the regulation in relation to the statement of P/L structure, description and content of items, which corresponds both Directive No.2013/34/EU “On the Annual Financial Statements, Consolidated Financial Statements and Related Reports of Certain Types of Undertakings” and IAS No.1 “Presentation of Financial Statements” statement of P/L or P/L section preparation requirements. However, in both present and previous editions of this law there are criteria indicated for the companies that shall prepare their financial statements in conformity with IAS/IFRS.

In conformity with the requirements of Regulation (EC) No.1606/2002 of the European Parliament and of the Council of 19 July 2002 “On the Application of International Accounting Standards”, since the year 2005 all consolidated statements of Latvian companies, if, at the balance sheet date, their transferable securities are admitted to trading on a regulated market of any EU Member State, must be prepared according to IAS/IFRS. The financial statements shall be prepared in conformity with IAS/IFRS also by financial sector (banks, insurers, leasing companies etc.) and companies the transferable securities of which are included into the official list of stock market or if their debt securities are included into the regulated market. At the same time it should be pointed out that no company in Latvia is prohibited to prepare financial statements in conformity with IAS/IFRS. However, if a company voluntarily chooses to prepare a financial statement in conformity with the requirements of IAS/IFRS, it shall have to prepare a financial statement also in conformity with the laws and regulations of Latvia. This gives more privileges to the holding companies and large State capital companies of Latvia for which the legislation envisages an opportunity to choose: to prepare their consolidated statements either in conformity with the requirements of IAS/IFRS or the requirements of Latvian legislation.

The subject of research was a sample of 26 financial statements of Latvian companies: 15 banks and 11 non-financial companies that prepare their statements in conformity with the requirements of IAS/IFRS. The information about the financial statements of banks has been obtained from their home pages in the internet, but the information about the financial statements of non-financial companies – in the publicly available Nasdaq Baltic stock market from the Baltic regulated market list. According to the author’s opinion, in order to get assurance the company’s financial statements are prepared in accordance with regulatory framework, it is useful to include into this research the listed companies. The regulations of the NASDAQ OMX Riga stock exchange require that all the listed companies must include into their audited annual reports also their corporate management issues. The stock exchange also encourages the development of corporate social responsibilities (CSR) principles by presenting various awards on the level of the Baltic States (Sneidere, Vigante, 2014). In order a company could list its securities at the Baltic stock market, it should be in operation for at least 3 years; it should have at least EUR 4 million market capitalization and at least 25% of shares, or shares worth of EUR 10 million, in public hands (NASDAQBALTIC).
The author divided the chosen companies into three groups: banks, production and trade companies and service companies. The author examined their CI statement for the year 2017 according to the following indications:
1. The form of the CI statement (one or two statements),
2. Expenses classification method (based on the nature or the function) in the statement of P/L or P/L section,
3. Method for the disclosure of OCI items (after or before tax),
4. The OCI items and their impact on the reported profit or loss of in studied entities,
5. The impact of the methodology of CI statement preparation on the indicators of company’s profit, using the ratios of profitability.

Within the framework of research, the author chose two basic indicators of profitability - Return on Equity (ROE) and Return on Assets (ROA). Where a business has a policy of regular revaluation of assets, the ROA is likely to provide a better measure of economic performance (O’Regan, 2007). Such ratio measures the profit that an enterprise is generating relative to the assets employed and shows productivity of capital (Fridson, Alvarez, 2011). In its turn, ROE is a comprehensive indicator of a firm’s performance because it provides an indication of how well managers are employing the funds invested by the shareholders to generate returns (Palepu, Healy, Bernard, 2004).

For the practical calculations of profitability indicators, the author used the formulas, where Net Income is an equal item to Profit or Loss for the period:

\[
\text{ROE}, \% = \left( \frac{\text{NET INCOME}}{\text{EQUITY}} \right) \times 100 \quad \text{[Fridson, Alvarez, 2011]} \quad (1)
\]

\[
\text{ROA}, \% = \left( \frac{\text{NET INCOME}}{\text{ASSETS}} \right) \times 100 \quad \text{[Palepu, Healy, Bernard, 2004]} \quad (2)
\]

In order to evaluate the impact of CI statement methodology on the company’s profitability, the author modified these formulas (\(\text{ROE}_{RC} \), \(\text{ROA}_{RC} \)) by reclassified items of OCI:

\[
\text{ROE}_{RC}, \% = \left( \frac{\text{NET INCOME} + \text{RECLASSIFIED OCI}}{\text{EQUITY}} \right) \times 100 \quad (3)
\]

\[
\text{ROA}_{RC}, \% = \left( \frac{\text{NET INCOME} + \text{RECLASSIFIED OCI}}{\text{ASSETS}} \right) \times 100 \quad (4)
\]

3.2. Results

The results of the analysis on the CI statement methodology and OCI impact on profit or loss are summarized in Table 2.

Table 2. Statement of Comprehensive Income Preparation Methodology and OCI Impact on Profit or Loss (number of companies)

| Company             | Number of companies | Type of CI statement | Method of P/L statement | Reported profit or loss | Items of OCI | OCI items impact on reported P or L |
|---------------------|---------------------|----------------------|-------------------------|-------------------------|--------------|-------------------------------------|
|                     |                     | 1 stat. | 2 stat. | nature | function | profit | loss | no item | after tax | before tax | incr. | decr. | no impact |
| Banks               | 15                  | 10      | 5       | 6      | 9        | 12     | 3    | 1       | 12        | 2         | 11    | 3     | 1        |
| Production and trade companies | 7                 | 7       | 0       | 1      | 6        | 5      | 2    | 1       | 3         | 3         | 4     | 1     | 2        |
| Service companies   | 4                   | 2       | 2       | 1      | 3        | 1      | 3    | 2       | 1         | 1         | 0     | 1     | 3        |
| Total               | 26                  | 19      | 7       | 8      | 18       | 18     | 8    | 4       | 16        | 6         | 15    | 5     | 6        |

Source: compiled by the author

As we can see in Table 2, most of the companies (73%) have prepared CI statement as one statement consisting of two sections – a P/L section and an OCI section. Most of the companies (69%) have prepared their statements of P/L on the basis of the function of expenses. Most of the companies (85%) recognize in their CI statement the
items of other comprehensive income, and most of them (72%) recognize these items after tax. Having analyzed those companies in details, which recognize the items of OCI, the author found that most of them (77% or 17 companies) in this part disclose only such gains and losses, which will be reclassified subsequently to profit or loss, but 14% or 3 companies disclose the items, which will be both reclassified and not reclassified, the other 2 companies disclose only those items, which will not be reclassified. All banks and one production and trade company in the reclassified items of OCI disclose the gains and losses due to the fluctuations of the fair value of financial assets available for sale, which most often (58%) is the item included into this section. The second most often reclassified OCI item (38%) is gains and losses arising from translating the financial statements of a foreign operation; this can be observed in the statements of five banks, four production and trade companies and one service company. Such not reclassified OCI item as changes in the intangible assets and fixed assets revaluation surplus has been identified in the statements of 4 companies (two banks, one production and trade company and one service company). Only in 2 statements there has been included the non-reclassified item – remeasurements of defined benefit plans (in the statements of one production and trade company and one service company), but the reclassified item - the effective portion of gains and losses on hedging instruments in a cash flow hedge – has been disclosed in the statement of one service company.

At the next stage of research the author evaluated how OCI items that will be reclassified in the statement of P/L in the next reporting period have impact on the reported profit or loss. In Table 2 it is indicated that most of the companies studied (69%) reported profit in the year 2017 and most of these companies (89%) recognized some OCI items. Insignificant part of companies (31%) reported loss, and most of them (75%) recognized OCI items. Besides, it should be pointed out that most of the companies’ (77%) OCI items have impact on the reported profit or loss.

As we can see in Table 2, out of all 26 companies under research, in case of 77% or 20 companies it is possible to observe the impact of OCI items on the reported profit or loss, including 14 banks, 5 production and trade companies and 1 service company. Therefore the author will perform the calculations of profitability only for these companies. The analysis of the impact of reclassified OCI items on the banks and production and trade companies’ ROE and ROA has been shown in Tables 3 and 4.

Table 3. OCI Impact on Banks’ ROE and ROA

| Ratios     | Number of banks |
|------------|-----------------|
|            | 1   | 2   | 3   | 4   | 5   | 6   | 7   | 8   | 9   | 10  | 11  | 12  | 13  | 14  |
| ROE,%      | 5.3 | -4.5| -1.4| 15.3| -15.6| 20.3| 20.7| 0.6 | 11.9| 14.6| 14.1| 10.3| 7.6 | 2.0 |
| ROE_Rc,%   | 9.0 | -1.9| -3.0| 21.8| -7.2 | 28.0| 44.0| 10.0| 15.0| 14.4| 15.1| 17.0| 9.4 | 1.4 |
| ROA, %     | 0.6 | -0.3| -0.1| 1.9 | -1.1 | 2.8 | 2.0 | 0.1 | 0.9 | 1.2 | 0.9 | 1.6 | 1.0 | 0.2 |
| ROA_Rc,%   | 1.1 | -0.1| -0.2| 2.6 | -0.5 | 3.8 | 4.3 | 0.9 | 1.1 | 1.1 | 1.0 | 2.6 | 1.2 | 0.1 |

Source: compiled by the author

Table 4. OCI Impact on Production and Trade Companies’ ROE and ROA

| Ratios     | Number of production and trade company |
|------------|----------------------------------------|
|            | 1        | 2        | 3        | 4        | 5        |
| ROE,%      | 11.2     | 1.0      | 9.9      | -32.5    | 8.4      |
| ROE_Rc,%   | 11.3     | 0.9      | 12.2     | -30.7    | 8.5      |
| ROA, %     | 9.4      | 0.7      | 4.1      | -5.7     | 5.9      |
| ROA_Rc,%   | 9.5      | 0.6      | 5.1      | -5.4     | 6.0      |

Source: compiled by the author
The research shows (Tables 3 and 4) that reclassified OCI items influence the level of profitability indicators. Most of the companies studied (banks -79%, production and trade companies -80%) present positive impact on the assets and equity profitability, because the profitability level is higher. Out of four service companies under research, the OCI items of one company have negative impact on ROE and ROA, namely, the profitability indicators diminish. The calculations performed by author enable to draw a conclusion that by using formula modifications ROE$_{RC}$ and ROA$_{RC}$ and by including the reclassified items into the calculation, the creditors and investors obtain more complete idea of the profit development process at the companies.

**Conclusions**

Measures of profitability will be important for different users of financial statements. The main financial statement, which shows company’s income, expenses and final financial result - profit or loss - is the Profit or Loss Statement. Since 2009 there have been changed the requirements regarding the preparation of Profit or Loss Statement, and IAS/IFRS provides for a new type - the comprehensive income statement. For those entities in Latvia that shall prepare annual financial statements in conformity with the requirements of IAS/IFRS it is a relatively new financial statement and it should be prepared for annual periods beginning on or after 1 January 2009.

The research showed that Latvian companies prepare comprehensive income statement according to different types; most of them prepare this statement as one statement consisting of two sections: a profit or loss section and other comprehensive income section. Most of the investigated entities recognize in their comprehensive income statement the items of other comprehensive income, besides, it is established that most of them in this section disclose only such gains and losses, which will be reclassified subsequently to profit or loss. Most often the reclassified item used is gains and losses due to the fluctuations of the fair value of financial assets available for sale; it is included into the statements of all banks and in the statements of one production and trade company. The second most often reclassified item of OCI is gains and losses arising from translating the financial statements of a foreign operation; this can be observed in the statements of five banks, four production and trade companies and one service company. Out of the not reclassified OCI items the most often is mentioned gains and losses arising from changes in intangible assets and fixed assets revaluation surplus, which is included into the statements of two banks, one production and trade company and one service company.

The core of items of other comprehensive income (gains or loss) and the division into the reclassified and not reclassified items are important for the company’s financial result – evaluation of profit. The research showed that most of Latvian companies under research were influenced by reclassified items, besides, positively - profitability ratios of ROE and ROA. Of course, the impact of reclassified items on profit depends on the core of these items, i.e., whether they increase or decrease the company’s profit or loss for the period. The author’s point of view is that the requirement to prepare the statement of comprehensive income will enable the external users of financial statements to obtain more complete information on the process of the development of companies’ profit, as well as to evaluate more precisely the profitability. The author believes that, when evaluating the profitability of assets and the equity of the company, the financial analysts shall take into account the reclassified items of other comprehensive income, and the calculations shall be performed using the modifications of ROE$_{RC}$ and ROA$_{RC}$ formulas. The substantiation is that these gains and losses arise from the transactions, events and conditions of the reported period, although they will be related to profit or loss in the subsequent periods when specific conditions are met.
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