

## NECESSITY OF IMPROVEMENT OF LONG-TERM FINANCIAL INVESTMENT EVALUATION MECHANISM IN PUBLIC SECTOR COMPANIES IN LATVIA

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### **Abstract**

Key findings of the research are as follows: long-term financial investments done by public sector is a significant part of its total assets. Starting with the fact that no single definition and terminology exists for concept, it comes to other findings – besides being valuable assets with a potential long-term financial investments are difficult to be assessed; different evaluation methods are applicable both having pros and cons what makes information for its user incomparable and useless for analysis and judgment of financial health of a company, local municipality and state.

The aim of the paper is to investigate, summarize and systematize concept and evaluation methods of long-term financial investment, identify potential problematic aspects and develop recommendations for its improvement.

Research is limited to long-term financial investments done by public sector, in detail is examined case of Latvia with slight touch of international regulation.

Since long-term financial investments are subject for private as well as for public sector, research provides complex look to the problem and is relevant for shareholders in private companies, local municipalities and state owned companies.

**Key words** – long-term financial investments; public sector; public sector companies; long-term financial investment evaluation; information disclosure; holding company.

### **1. Introduction**

Long-term financial investments in other companies and their performance are part of the building blocks what make the holding's company market value.

Value growth of holding company is a result of the successful management and should be objectively reflected in the financial statements of leading company of holding. Similarly, the holding company management and owners should understand the basic principles of evaluation and information disclosure about long-term financial investments in order to understand what value they manage or what value they own and how to increase this value and to reflect objectively in financial statements to get attention from potential investors, partners and creditors. This is particularly important if regulatory rules permit variations in financial investment evaluation and information disclosure as it is in the public sector in Latvia, when disclosing information about its participation in companies. This will be discussed in this research in detail.

Much of the public sector (state, municipalities) delegated functions (e.g. water supply, central heating, healthcare etc.) in Latvia are being implemented by public sector fully or partially owned companies. Since public sector have a number of functions which are implemented by public sector owned companies, they form a group of companies where the leading role is for municipality or state. Thus in its economic substance (however not from a legal view point) some type of holding company is being created.

The aim of the paper is to investigate, summarize and systematize information about the concept and evaluation methods of long-term financial investments based on scientific studies and regulatory norms; identify potential problematic aspects of long-term financial investment evaluation in public sector in Latvia and develop recommendations for its improvement.

Since long-term financial investments are subject for private companies as well as for municipalities and state, study of long-term financial investment concept, evaluation and impact on the investor's value is relevant both for private companies and local municipalities and state.

The methodology of the research includes qualitative, theoretical research approach, involving literature review, data collection from published financial reports, data analysis and drawing conclusions.

By "public sector" in this article are understood local municipalities and state authorities. Holding company and group of companies are used as synonyms. Local level is attributed to Latvia, international – scope that is subject to International accounting standards (hereinafter – IAS) and International public sector accounting standards (hereinafter – IPSAS). Reader may be more familiar with term financial fixed asset instead of long-term financial investment which is key terminology used in research. This is the first problem to be discussed in next section.

Following parts of the paper will represent the concept and different definitions of long-term financial investments; reveal existing evaluation methods of long-term financial investments with a practical example to better highlight the difference between the two evaluation methods. Also evaluation practice of long-term financial investments in public sector in Latvia is discussed. In the final conclusions and recommendations for future research are presented.

## 2. Long-term financial investments: concept and definition

Significant problem facing the long-term financial investment analysis is a single international use of the term and its definition. Laws and regulations either name the consisting components (Latvian practice) or define components itself (international practice), while researchers tend to focus on the economic substance of the concept. Next, in Table 1 author has summarized terms and definitions in use for long-term financial investments (some definitions are abbreviations made by the author).

Table 1

**Definitions of long term financial investment**

Source of information	Definition, description of long-term financial investment
IAS 32 Financial Instruments: Presentation, § 11	<b>Financial asset</b> is any asset that is a) cash b) an equity instrument of another company c) a contractual right to receive cash or another financial asset from another entity or to exchange financial assets or liabilities with another entity d) a contract that will or may be settled in the entity's own equity instruments and is a non-derivative or a derivative
Latvian law on annual reports	<b>Long-term financial investments:</b> Investment in subsidiaries and loans to subsidiaries; Investments in associated companies and loans to associated companies, other securities and investments, other loans and other long-term debtors; own shares, loans to shareholders and management
Regulations of Cabinet of Ministers "Procedures for the Budgetary authority accounting"	<b>Long-term investments</b> of all types of resources that Budgetary authority intends to use more than one year, as well as all types of assets, payment for which is more than a year after the balance sheet date. Long-term investments are classified into the following groups: intangible assets, fixed assets, long-term financial investments
Fédération des experts comptables européens, 1991 (FEE European survey of published accounts)	<b>Investment</b> is an asset held by an enterprise for acceration of wealth through distribution, for capital appreciation or for other benefits to the investing enterprise such as those obtained through trading relationships.
Susan Thomas, 2010 (Lecture notes on Financial assets; The Indra Gandhi Institute of Development Research (IGIDR), Bombay, India)	Any <b>financial asset</b> is "defined cashflow" expected at "defined maturity". Cashflows can be either fixed or random, positive or negative. Cashflow-maturity describes at what point in time is the cashflow expected. Based on these two features, financial assets fall into following broad categories: 1) assets with fixed cashflows and fixed maturities:loans, bonds 2) assets with fixed cashflows and uncertain maturities:insurance products 3) assets with uncertain cashflows and fixed income:derivatives 4) assets with uncertain cashflows and uncertain maturities:equity
Aivars Ludborzs, 2003 ("Financial Accounting for trade". Lietišķās informācijas dienests, Rīga)	<b>Long-term financial investments</b> are assets of company, which serve as a source of growth in material well-being. Such an increase may occur: 1) by receiving income from the investment object - dividends, interest, fees for use rights, 2) by increase in investment value, 3) acquiring other types of economic benefits
Harald A.Benink, 1992 (Financial integration in Europe)	<b>Financial fixed assets</b> are those intended for use in a continuing basis in the normal course of an undertaking's activities. This term is nevertheless necessary in connection with the valuation rules
Hervé Stolowy, Michel Lebas, 2006 (Financial accounting and reporting: a global perspective)	<b>Financial fixed asset</b> is an active investment, where the investing firm has right or possibility to influence the behavior of the enterprise. Active in the sence that the investing firm chooses to apply its resources to deliberately grow its value creation potential and do so with a long term, strategic view, requiring that it take an active role in the decision-making process of the firm in which it has invested
Translators discussions about fiancial asset term (available at: <a href="http://www.proz.com/kudoz/spanish_to_english/accounting/3439921-inmovilizado_financiero.html">http://www.proz.com/kudoz/spanish_to_english/accounting/3439921-inmovilizado_financiero.html</a> )	Assets of a purely financial nature which a firm owns and which are not directly used in the production process. Its objective is to maintain control of its affiliates/subsidiaries and stable equity participation in other companies via the ownership of shares, debts/obligations, credits, bonds, etc.
The financial literates (available at <a href="http://www.tfindia.in/2010/06/long-term-and-short-term-investments.html">http://www.tfindia.in/2010/06/long-term-and-short-term-investments.html</a> )	<b>Long term financial investment</b> which beat inflation is equity and it is equity which creates wealth in long term. Ownership assets have short term fluctuations but in long haul, they beat inflation and create wealth

The summary of definitions shows following:

- 1) There is no single term and definition for long-term financial investment;
- 2) Diversity in terms makes difficult to identify existing researches and studies;
- 3) International regulation makes emphasis on the concept of financial assets – IAS does not make distinction between fixed and current financial assets. Financial fixed assets from provided definition of financial assets by IAS 32, § 11 include equity instrument of another company and contractual right to receive financial asset from another entity. Identical in substance is the definition for the public sector - IPSAS (see IPSAS 15, § 9), only with exclusion of derivatives as there are no opportunities to acquire the shares of public sector. While the current version of IAS 39 no longer defines the financial assets and refers to definition in IAS 32 where the term of financial asset is defined.

Previous version of IAS 39 (however still valid in IPSAS 29, § 10) described four categories of assets-financial instruments. Hervé Stolowy and Michel Lebas, 2006 suggested to apply fifth category "in our mind" because IAS 39 does not apply directly to investments in subsidiaries, associates and joint ventures.

In practice, say Hervé Stolowy and Michel Lebas, 2006, two main types of financial fixed assets will be found under available-for sale headings: 1) all equity securities, eg, long-term equity investments held for return without intention to influence the business whose shares are held as an asset 2) investments in non-consolidated companies (because they do not meet required threshold) or speculative investment (i.e., not part of an "industrial strategy") included in the parent company's or any subsidiary's separate balance sheet. This opinion from other researchers put together with IPSAS 6, § 53 solves the problem of how to evaluate and disclose investment where participation is under 20%. However this still stays open question in Latvian regulatory norms.

- 4) Latvian regulatory norms put emphasis on long-term investments, long-term financial investments identifying as a part of long-term investment and further on components of long-term financial investments are being identified, without defining the concept of long term financial investments as such. Different terms are used for same concepts, for example, related company, subsidiary, daughter company, however neither one nor the other term are defined;

- 5) Finally, researchers' definitions emphasize economic substance of long-term financial investments concept.

The existence of ambiguity in first, definition phase, is significant problem since the definition of a long-term financial investment is the basis for its classification, recognition and measurement in investor's financial reports.

### **3. Evaluation methods of long-term financial investments**

Generally exist two methods how evaluate and disclose long-term financial investments in investor's separate financial statements – cost method and equity method. Concept of methods, application in local and international level in public sector, as well as positive and negative features in view of the author's, are summarized in Table 2. The Table 2 is designed by the author based on study of relevant literature, discussion with representatives from local municipalities and the author's personal experience in this field.

Table 2

## Comparison of cost and equity methods

Cost method		Equity method	
<b>Concept/idea</b>			
Investor's investment in an investee is shown at acquisition cost without indicating the effect of the investee's profit or loss on the investment		Investments in an investee is initially recorded at acquisition cost and then is either increased or decreased to reflect the investor's share of profit or loss of the investee's operations after the acquisition date	
<b>Definition of the concept in regulatory documentation</b>			
Latvia	International	Latvia	International
Regulations of Cabinet of Ministers "Procedures for the Budgetary authority accounting" Article 76	IPSAS 7, Definition "Cost method"	Regulations of Cabinet of Ministers "Procedures for the Budgetary authority accounting" Article 78	IPSAS 6, Definition "Equity method"; IPSAS 7, Definition "Equity method"
<b>Application in investor's separate financial statements</b>			
Latvia	International	Latvia	International
Regulations of Cabinet of Ministers "Procedures for the Budgetary authority accounting" Article 75: investments in subsidiaries and associated companies assess and disclose under the cost or equity method.	IPSAS 6, § 53, controlled entities that are included in consolidation procedure <u>may choose between equity method or accounting for as an investment</u> ; controlled entities that are excluded form consolidation <u>should be accounted for as investment</u>	Regulations of Cabinet of Ministers "Procedures for the Budgetary authority accounting" Article 75: investments in subsidiaries and associated companies assess and disclose under the cost or equity method.	IPSAS 6, § 53, controlled entities that are included in consolidation procedure <u>may choose between equity method or accounting for as an investment</u> IPSAS 7, § 23, 26, investment in associate (regardless of investor issues consolidated fin. statement), <u>should be either accounted using equity method or cost method or accounted for as investment</u>
<b>Strengths</b>			
<ul style="list-style-type: none"> <li>Investor's opportunity to reassess the investment value that is sufficiently subjective process, it is an estimate</li> <li>It is not possible artificially inflate the value thus misleading potential investors, creditors</li> <li>Has advantage over equity method when there is no fair, easily determinable value for the investment</li> <li>Includes less paperwork and calculations than the equity method</li> </ul>		<ul style="list-style-type: none"> <li>Reflects the investment performance in investor's accounts</li> <li>Facilitate the investment analysis and is more useful for management decisions</li> <li>Investment is a value formative object of investor</li> <li>Objectively describing the situation of information users</li> </ul>	
<b>Weaknesses</b>			
<ul style="list-style-type: none"> <li>Shows only historical investment and do not reflect the investment's value changes, so does not describe either growth or failure</li> <li>When revaluating the investment, it should be done on regular basis, consistently and arguable that is additional work</li> </ul>		<ul style="list-style-type: none"> <li>Net profit can be a subjective concept when there is absence of single accounting principles for related companies</li> <li>Investment value is pegged to the investor's accounting politics (eg. provisioning, etc..) which the investor may not always directly supervise</li> <li>Cost of acquisition, which is most likely different from the investor's fair part in the net assets of investee. That reflects in goodwill what makes the understanding more intangible</li> </ul>	

The summary of comparison of cost and equity methods shows that in public sector, where the use of method is not clearly determined and the choice option for evaluation and information disclosure exists, makes information in financial statements incomparable; there are situations where the regulation is not clearly evident (investment in equity till 20% which is not short-term investments); both evaluations methods have their pros and cons.

Division of characteristics of methods into strengths and weaknesses depends also on whether these characteristics are attributed to provider or user of the financial information and the objective information is used for. Therefore one and the same characteristic can be strength as well as weakness, as it is, for example,

with the possibility to reassess the investment in other companies. Therefore, it is difficult clearly distinguish opportunities and threats for both methods as threat in one case can be opportunity in another. For example, if the related company is suffering losses, cost method gives the opportunity to the owner company unduly raise the value of investment in its financial statements, while it is threat for the information user to get wrong impression about the financial situation of owner company.

Also Polkuamdee, 2007, recognizes that each method could present an advantage or a disadvantage to a given company. Investors should understand the principles of accounting so they can recognise what is a fair price and distinguish the differences.

#### 4. Evaluation methods of long-term financial investments: practical example

To show the difference between cost and equity method in evaluation and information disclosure of long-term financial investment, simplified example is being considered. In the example, an investor (it could be either private enterprise, municipality or state) establishes fully owned company that suffers losses initially, but later on has the opportunity to attract granted funds, that significantly improves its performance.

How the company's operating results reflect in the investor's balance sheet, depending on the applied evaluation method, see in Table 3.

Table 3

**Comparison of cost and equity method: practical example**

Year of operation	Description of situation	Value of investment in assets of investor at the end of the year	
		cost method	equity method
<b>Year 1</b>	An investor sets up fully owned company "X" with investment estimated 1 million lats what is recognized as company's share capital	<b>1 million lats</b>	<b>1 million lats</b>
<b>Year 2</b>	Due to several unfavourable factors (increasing resource prices, decrease of demand) company "X" concludes year with loss of 0.2 million lats	<b>1 million lats</b>	<b>0,8 million lats</b>
<b>Year 3</b>	Company "X" has favorable conditions to access grant funding for the project financing that leads to a technology change that reduces the company's dependence on resources price rise. The company "X" execute the project of total amount of 6 million lats, acquiring new technologies where 50% of the cost or 3 million lats is a grant*. Due to new technologies operating results (including depreciation of new technologies) turns to positive 0.05 million lats.	<b>1 million lats</b>	<b>1,15 million lats</b>
<b>Year 4</b>	Performance from operations is identical to the previous year	<b>1 million lats</b>	<b>1,5 million lats</b>
<b>Year 5</b>	Performance from operations is identical to the previous year	<b>1 million lats</b>	<b>1,85 million lats</b>

\* According Latvian legislation granted funds gradually, according to the period of depreciation of purchased assets, are "transferred" to the company's equity through income statement. Assuming that the acquired technology lifetime is 10 years, company "X" within a year using new asset, gradually in its equity include the amount of revenue of 0.3 million lats and during 10 years this amounts to 3million lats.

This is a simplified example to provide clarity on differences in evaluation and information disclosure of long-term investment in investor's financial statement.

Example shows that cost method gives unreasonably favorable situation to investor in case of financial distress of investee. However, successfully attracted funding and implemented project, which is clearly advantageous for investment value, cost method can not reflect in investor's financial statement.

Besides above mentioned, some other situations are worth noting when the original book value does not provide an objective perspective on the value of investment and does not allow to make objective analysis of the financial situation of the municipality and state. So, for example, a municipality may undertake or guarantee the obligations for its fully or partly owned company's development projects. After successful implementation of project, the project value will not be reflected in financial statement if the investments in companies are valued at cost, only liabilities will be disclosed.

As well problems arise when reorganization of enterprises is carried out and one company is added to another, without increasing the acquiring company's share capital and merging company's equity records as restructuring reserve. Assuming company's share capital as figure reflecting cost of investment and thus using the cost method, equity that is being added to acquiring company will simply "disappear" of being disclosed.

**5. Evaluation practice of long-term financial investments in public sector in Latvia**

The question of public sector's long-term financial investment evaluation and disclosure in Latvia has come in sight to experts and controlling institutions from time to time.

Thus Kursīte, 2002, who is a certified auditor and author of many publications on public sector financial accounting in her publication point that Latvian municipalities have no single procedure for long-term financial investment evaluation and accounting. She says, State Treasury instructions in year 2002 for first time gives instructions that in accounting for investments in associates and subsidiaries might be used two different methods - cost and equity method, of course, with no further explanation [25].

While the State Audit Office of the Republic of Latvia, which is the supreme audit institution in the state, in a number of its audit reports on long-term financial investment accounting compliance with the regulatory norms in Latvian local municipalities from year 2005 and 2006, has acknowledged that applied cost method for long-term financial investment accounting does not show true financial position of the municipality of its long-term investment value in companies' equity. Hence State Audit Office has advised to consider application of equity method in long-term financial investment evaluation in order to reflect the true financial position of municipalities on long-term financial investments in fully or partly owned company equity [17].

Thus optional choice for long-term financial investment evaluation results in situation that local municipalities financial statement and national state balance, which inter alia includes local municipalities participation in companies equity, operate under different long-term financial investment evaluation methods, what makes information unsuitable for analysis.

Consolidated balance sheet of state of Latvia for year 2009 in total amounts to 14.9 billion lats and includes participation in subsidiaries, associated companies and other long term financial investments in total of 3.8 billion lats or 26% of the total balance sheet value and is therefore a significant public asset and asset evaluation and management should be discussed. Notes of annual report show that long-term financial investments in subsidiaries and associated companies, that are valued at cost, is recalculated using the equity method [15]. Fact that the equity method is used should be welcomed however it is worth to point that one evaluation method can not be recalculated into another, it can only be disclosed on the basis of provided data.

Structure of state balance and a significant part of long-term financial investments in it is shown in Figure 1, where data are taken from Annual report of 2009 of Latvian state budget and local government budgets

**Figure 1**

**Assets structure of consolidated balance sheet of state of Latvia as on 2009**

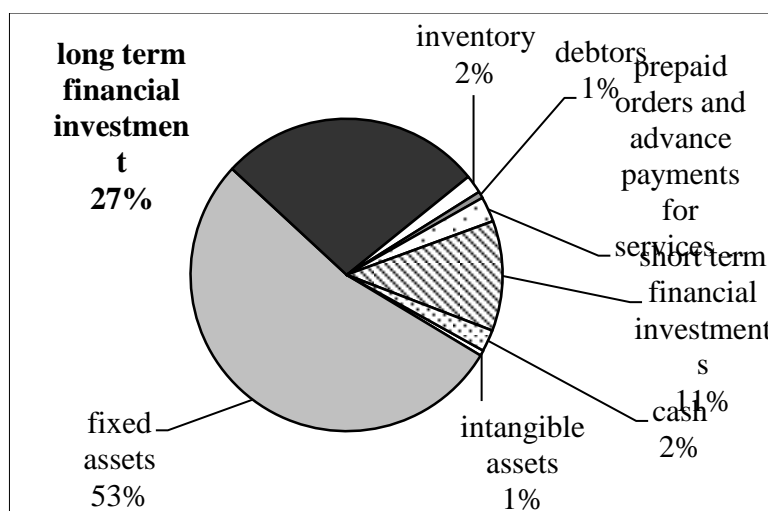


Table 4 shows proportion of long-term financial investments in companies' capitals in local municipalities of national importance and their various reflection in financial statements.

Table 4

### Long-term financial investments in local municipalities, thousands of LVL

No	Major (national importance) city of Latvia	Year	Consolidated Balance sheet in total	Participation in subsidiaries	Participation in associates	Other long-term financial investments in companies' equity	% of total balance	Notes
1	2	3	4	5	6	7	8 $((5+6+7)/4)$	9
2	Rīga	2 009	2 364 900	357 868	32 238	1 654	17%	Cost method (it is mentioned that participation in share capital of companies are disclosed)
3		2 008	1 953 618	313 775	31 087	1 013	18%	
4	Daugavpils	2 009	133 832	36 293	142	0	27%	Cost method (mentioned in annual report)
5		2 008	116 203	33 948	142	2	29%	
6	Liepāja	2 009	198 905	49 381	1 779	0,1	26%	Cost method (it is mentioned that participation in share capital of companies are disclosed)
7		2 008	191 520	51 492	1 467	0,1	28%	
8	Ventspils	2 009	289 465	25 899	1 228	163 131	66%	Cost method
9		2 008	268 670	26 382	1	153 709	67%	
10	Jelgava	2 009	105 807	29 652	217	596	29%	Cost method (mentioned in annual report)
11		2 008	92 627	28 836	217	522	32%	
12	Rēzekne	2 009	57 691	9 603	359	4	17%	Equity method
13		2 008	49 535	8 480	271	0,2	18%	
14	Jūrmala	2 009	151 564	14 168	2,8	0,5	9%	Cost method
15		2 008	148 373	14 089	2,8	0,5	9%	
16	Valmiera	2 009	69 950	14 730	2 426	79	25%	Cost method
17		2 008	56 157	10 394	1 010	38	20%	
18	Jēkabpils	2 009	38 058	10 234	8	0,1	27%	Cost method
19		2 008	29 570	5 816	9	0,1	20%	
20	total in Year 2009			547 829	38 400	165 465	18%	% of total long-term financial investments of state
21	total in Year 2008			493 213	34 207	155 285	22%	

Although in author's view equity method provides more objective picture of the overall public-sector participation in company capital, there is another obstacle in the disclosed data, which suggests that the information user does not receive adequate information on public participation in the companies' equity on the reporting date.

Deadline for submission of reports for consolidated statement of state is 1st of May of the following year [4, article 30, 32]. This is the time before the legal terms permit to submit annual report and thus to judge about participation in those companies' equity that are so-called "large enterprises", whose annual reports should be submitted to legal authorities no later than seven months after the current year ends. Such companies are not so few in number and they are significant value-building blocks of state, such as energetic corporation JSC Latvenergo, air carrier JSC Air Baltic Corporation, managing company of state-owned forests JSC Latvijas valsts meži and others.

To solve the problem, information about state and local municipalities participation in equity is disclosed with one year shift, which do not represent the true and fair view about situation at the end of the reporting period.

## 6. Conclusions and recommendations

Based on the research, author has come to the following main conclusions:

- Company owners and managers should be familiar with basic aspects of long-term financial investment management, which includes evaluation and information disclosure in financial statements in order to understand what value they are managing or what value they own and how to increase this value and objectively reflect to get attention from potential investors, partners and creditors. Besides they must be familiar because the company management takes responsibility for financial statements to give a true and fair view of the company's financial position and operating results.

- Long-term financial investments of public sector is a valuable asset of state and local municipalities, which potentially can be used as a guarantee of development project funding, attracting partners or subject of disposal.
- Considering the significant proportion of long term financial investments in the total assets of state, the issue of development of an evaluation mechanism of long-term financial investment, including establishment and implementation of single accounting, is relevant: for understanding what value is invested in companies; correctly disclose it in total assets and effectively manage to raise its value. In addition, public sector partly or fully owned companies generally represent industries which often are natural monopolies with a broad and persistent customer base, which is important revenue generating asset for state and local governments.
- The research has shown that there is no single definition for long-term financial investment and different terminology is used in analysis. This is essential problem, because the definition of a long-term financial investment is the basis for its classification, recognition and measurement.
- Different evaluation methods are applicable for long-term financial investment both having pros and cons. When choice of applicable method exists, information from financial statements is incomparable and useless for analysis. Practical example reflected to problems that appear by using different methods - the company's financial difficulties or successfully implemented projects may not be reflected in the financial statements. As a result it is not possible to assess the financial health of the company, local municipality or state.
- Each of the long-term financial investment evaluation method permits variations in investment value measurement what makes it less readable for information user, as well not necessarily objective - using the cost method, it is investor's estimate of the value of the investment, while using the equity method, these are different accounting politics used by partly or fully owned companies.
- Summarizing the research, need for improvement of public sector long-term financial investment evaluation and management mechanism results. As currently available information on public sector long-term financial investment is not comparable, we clearly and currently do not know what we (i.e. the state and local municipalities) own and how to analyze and evaluate it.

Following recommendations might be useful for improvement of long-term financial investment evaluation and management mechanism for public sector:

- To improve long-term financial investment regulatory framework, making it less receptive to different interpretations;
- Establish and implement a common framework for long-term financial investment evaluation and disclosure in public sector of Latvia;
- In financial statement notes information on long-term financial investment value should be presented according both evaluation methods regardless of that one chosen as reporting in balance sheet;
- To expand discussion on the most appropriate applicable evaluation method to be used in public sector and analyze the practice of long-term financial investment assessment and presentation of the public sector in other countries;
- To centralize overlapping functions and activities in public sector controlled companies thus making management more effective.

## **7. Recommendations for future research**

For future research directions author recommends the following:

- Long-term financial investment regulatory framework and its historical development in local and international private sector and its impact on long-term financial investment value;
- Practice of long-term financial investment presentation and management in public sector in other countries;
- Problematic aspects in managing long-term financial investments, e.g., the decision-making process, power sources and distribution within the holding company etc;
- In depth studies on the long-term financial investment impact on the value of an investor;
- Various aspects of financial investment value - fair value, recoverable value, market value, purchase value, the value of start-up business versus value of a running business, shareholders equity as a value basis for financial investment; cost method in evaluation of financial investment and business valuation;

- Accounting estimates and their impact on long-term financial investment value, e.g., savings as value assessment;
- Advantages and disadvantages of applying practice of holding company management principles for public sector company management.

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