

Government reforms: consequences for determining the “financial equilibrium”

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Abstract

Governmental cameralistic/cash accounting is still playing an important role to budgetary decisions and controlling the spending of resources. Driven by NPM, governments have introduced accrual accounting and sometimes have changed their financial management system. Therefore, an important question is what influence these reforms will have on determining the conditions of government's financial equilibrium, taking into account its pursued going concern, specific governmental characteristics and issues like intergenerational equity and sustainability. This study presents an analytical research that is conducted to develop a new model for measuring financial equilibrium and it examines the usefulness and adequacy of applied accrual accounting data.

Key words: *financial equilibrium, accounting reform*

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Introduction

During the last decades, many countries have reformed their public sector entities. These reforms show a number of characteristics often summarized in terms of New Public Management (NPM) (Hood, 1991; Osborne and Gaebler, 1992). In NPM-reforms, traditional concepts and instruments are changed to businesslike tools and styles. According to Hood (1995: 94), the emphasis of NPM lays on the diminution of the differences between public and private sector and the shift from process accountability towards greater accountability in terms of results.

Accounting reforms were often a first phase of reforming governments. In particular, accrual accounting was introduced in many public sector entities and organizations. The main objective of these reforms was to present besides revenues and expenses, also costs, revenues, and the composition and financing of the patrimony and to offer in this manner the public organisations an instrument in order to monitor their financial condition.

The introduction of this new accounting system is widely discussed and described for many countries and it is clear that the introduction has not always the consequences as it has been proposed. Notwithstanding these introduction problems, questions can be asked whether the new accrual accounting system could give new insights in definitions and procedures to determine the financial management of a municipality.

Although New Public Management and accrual accounting have been seen as an important way to improve the management of public sectors and to increase the efficiency and transparency, cameralistic or cash accounting is still playing an important role to budgetary decisions, controlling the spending of resources and determining the financial equilibrium. The decisions made by the municipal board are mostly taken on the basis of documents produced by this accounting system.

This study presents an analytical research that is conducted to develop a new model for measuring financial equilibrium, taking into account and based on the specific governmental characteristics and issues like intergenerational equity. In the remainder of the paper we first give an overview of the existing literature. After defining the research questions in the third

section, the characteristics and consequences of the introduction of NPM were discussed in the fourth section. In this section we also present a simple mathematical model, based on the discussed characteristics. Part five concludes this paper with some general remarks for further research.

Literature overview

The financial condition of a municipality is an old, but not that much-discussed subject in the international literature. Lorig (1941) underlined the importance of the determination of the current financial position of a city. He stressed the fact that financial equilibrium goes further than its debt-paying ability and referred to the financial condition of a municipality as "its ability to meet all current requirements in the form of expenses, current liabilities, and provisions for meeting long-term indebtedness" (Lorig, 1941, p. 42).

Local governments are still using cameralistic accounting-methods for making decisions, controlling the spending of resources and for the determination of financial equilibrium. Cameralistic accounting is still in many public sector organisations the basis of accounting for financial management. The extensive use of this method results from two important characteristics of cameralistic accounting. First, cameralistic accounting gives information about the ascertainment of revenues and the undertaking of expenditures. In this way, the method makes it possible to control the financial resources. Second, it indicates the realisation of revenues, namely their real receipts, and the payment of expenditures. In this respect, Goddard (2005) emphasize this vision by stating that "(there is) the more significant contribution to accountability made by budgeting practices rather than NPM practices". Another basic characteristic of the cameralistic method is the separation of the money management from the management of other tangible assets, i.e. the asset management. In other words, the difference between the so-called ordinary and extra-ordinary management. (Filius, 1983, p. 443-445)

However, the introduction of NPM has changed a lot in public sector. Businesslike management styles and techniques were introduced in many countries all over the world. The reasons for the introduction were multiple: some spoke about the ideological reasons, like the

proclaimed dominance of the private sector over the public sector (Van Helden, 2000), others referred to the existence of financial stress (Hood 1995).

In each of the countries where NPM was introduced, a different policy was followed to obtain an efficient, effective and decentralized government or organisation, working in a market-environment and using private sector-style management instruments (Hood, 1991; Olson et al., 2001; Green-Pederson, 2002). A notable element of the New Public Management (NPM) movement is the seemingly endless set of accounting-based techniques that are introduced (Guthrie et al., 1999).

One of the most changing introductions for public sector organisations, was the introduction of a new businesslike accounting system, the so-called accrual accounting. The introduction underlined some weak characteristics of cameralistic accounting. First of all, the cameralistic view do not provide any information about the composition and financing of the patrimony. It also provides only a limited long-term view. As Osborne and Gaebler (1992) stated

"Hence governments can rack up enormous future obligations – far beyond their capacity to pay – and their accounts will look perfectly balanced. Government accounting, in other words, is future-blind."

In spite of these disadvantages, cameralistic accounting is still used in many public organisations. This is mainly due to the smooth shift towards the new accrual accounting system. The reasons for these introduction problems were mainly due to the fact that municipalities were not used to work with the new accounting system, the lack of a framework and the existing cash cameralistic accounting system that remained dominant (Christiaens and Van Peteghem, 2004).

Aside from the introduction of NPM, some authors have tried to find an answer to how municipalities could find financial equilibrium or how they could determine problems. Brown (1993) set up a ten-point test that gives a view shot of a municipalities' current fiscal health. He therefore calculates ten ratios concerning the incomes, expenditures, operating position and the debt structure. The results of these ratios were then compared with the results of other similar municipalities.

Alter et al. (1984) tried to predict the trends in incomes and expenditures. First, historical information of incomes and expenditures was looked up. To detect more specific factors, some of the items were split up in smaller categories. One-times events, changes in administration or in tax rates were naturally identified and eliminated. The different categories were then plotted over time to find trends.

Groves and Valente (1994) developed a set of 36 indicators for the International City/County Management Association (USA). This set of indicators evaluates the financial condition of a municipality, covering the aspects of incomes, expenditures, operating position and debt structure. The results are plotted over time, so warning trends could be viewed.

None of these authors indicate however when a municipality becomes financial vulnerable. The question is that difficult because of the fact that municipalities can not and may not fail, in contrast with the private sector, where the declaration of bankruptcy is the most clear case of financial vulnerability.

Chang and Tuckman defined a financial vulnerable organisation as "one that lacks the ability to avoid cutbacks in the programs and/or services that it offers when a financial shock occurs" (Chang and Tuckman, 1991, p. 659). They developed a model with four criteria for identifying financial vulnerable organisations:

- inadequate equity

The higher the net worth of the municipality is, the greater its ability to replace revenue.

- revenue concentration

The more revenue sources a municipality has, the more it is able to balance a gain in one revenue source against a loss in another.

- administrative costs

The higher the administrative costs, the easier it will be to cut back in the costs without affecting the administration of their program

- reduced operating margins

The larger the net operating margin, the larger the net surpluses a municipality can draw down in the event of a financial shock.

Chang and Tuckman (1991) identifies the level of equity statistically as the most important reason of financial vulnerability. Tyler (1993) follows this determination saying that the use of reserve funds is important for planning the future and avoiding frequent tax increases. The English Charity Commission (2002) also stresses the importance of building up reserves. The Commission underlines the need for a comprehensive financial policy containing the following aspects:

- description of the reserves policy
- explanation why they hold or do not hold reserves and, if they do, in respect of what future needs, opportunities, contingencies or risks; and
- giving the level of reserves at the last day of the financial year to which the report relates

Feenstra and Van Helden (2003), based on the research of Chang and Tuckman (1991) and based on the empirical research on profit organisations which shows that increasing risks are associated with higher equity, build up a normative model for calculating the needed reserves in Dutch university hospitals. Their model takes one's stand on the classical vision of liquidation: which reserve fund must be available in case of set-back. However, the reasons for building up reserve funds is multiple:

1. short term

A fund to tide over a period of temporary decreasing incomes or temporary increasing expenditures (p.e. the cancelling of a subsidy).

2. opportunistic reasons

Funds for unexpected opportunities.

3. long term

Funds for drastic changes in the environment of the municipalities (p.e. costs of pensions, ...).

Greenlee and Trussel (2000) and Trussel (2002) were using the four variables determined by Chang and Tuckman, in a predictive model. Such a model enables to predict financial problems on the basis of financial data. It was Beaver (1966) who was one of the first to use financial ratios to predict financial problems. The technique is quite established in private sector, but is almost not used in public sector, for the most part due to the difficulty of determining financial vulnerability in public sector.

This difficulty finds expression in the multiplicity of definitions found for the term. Greenlee and Trussel (2000) indicate an organisation as financial vulnerable if it has decreased its program service expenditures (as a portion of total revenues) in any three consecutive years. A year later, a vulnerable organization is defined as one that had a significant decrease in equity balances over a three-year period (Greenlee and Trussel, 2001). Trussel (2002) refined the definition indicating that an organization must have had more than a 20 percent decrease in its fund balance over three years to be classified as financially vulnerable. These always changing definitions are in shrill contrast to the 'private definition' of a financial vulnerable organisation as one that is filed for bankruptcy.

Research question

The literature overview clearly defines a lack of a consistent definition for financial equilibrium and a shortage of information about the current and future consequences of past and current decisions. This information however is not always supplied by the existing cameralistic cash accounting system. Taking into account the introduction of the principles of New Public Management, questions can be asked which influence this introduction could have on the determination (of a new definition) of financial equilibrium.

Based on the aims of NPM (transparency, efficiency, ...) and the introduction of accrual accounting in public sector, the following research questions could be stated:

- 1. What is the effect of the introduction of NPM in general and the introduction of accrual accounting in specific on the determination of financial equilibrium*
- 2. Based on the indicated advantages and disadvantages of the introduction, which definition, that clearly defines the conditions and can be used as a management tool, can be used for the determination of financial equilibrium.*

Financial equilibrium-model

Consequences of governmental reforms

Characteristics of local governments

When searching for a new definition of financial equilibrium within the outlines of new public management and accrual accounting, the specific characteristics of public sector in general and those of local governments in specific also have an influence on the definition.

First of all, it must be stressed that financial equilibrium is not a case of increasing taxes or lessen the service provisions for finding a balance. The former is only felt after one year, for the latter holds that most of the municipal services are inevitable: or they are obliged by law, or they are part of the minimum service provision offered by the municipality (p.e. police, administration, fire protection, sanitary, ...) The degrees of freedom for reaching financial equilibrium are thus limited.

As stated by Osborne and Gaebler (1991), it must be stressed that cameralistic accounting pays almost no attention to the future implications of current decisions. In this respect, the following elements can be indicated.

1. The dynamic character of municipalities.

A local municipality is not a static entity, but a continuously changing dynamic entity (in- and outflow of people due to births, deceases, immigration, ...), where also the evolution of demography can play a role.

2. The long-term view of decisions.

These elements can play an important role in the decision-making process. Financial equilibrium can not only be seen as a case of sufficient liquid resources. That view especially stresses the importance of self-supporting character of a municipality in the short term. For a sound financial management, the consequences of current decisions must be seen in the light of the future (financial) evolutions.

3. The use of the model as a financial tool.

It is important for a municipality to know if its financial condition is acceptable or terrifying. When searching for a definition of financial equilibrium, we must search for a for-seeing model, which can be used as an financial management tool. Therefore, it is important that the current financial equilibrium gives expression to the current and future costs and revenues of the offered services, and not longer to the current incomes and expenditures.

Charateristics of accural accounting

One of the most changing introductions for public sector organisations, was the introduction of a new businesslike accounting system, the so-called accrual accounting. In comparison with cameralistic accounting, accrual accounting introduces some new principles.

First of all, the new system not longer works on the basis of receipts and expenditures, but on the basis of costs and revenues. So, it is possible that the investment in a fixed capital not longer has an influence on one year (cash accounting), but - according to the matching principle - the costs are connected to the appropriate period, contrary to cash accounting where no such matching exists.

In addition, accrual accounting gives insight into the composition and financing of the patrimony of the municipality. Many authors also stresses the importance of accrual accounting in playing an invaluable role as a managerial decision tool and in the monitoring of managerial performance at the agency level (e.g. Clarke, 1994, p. 11). However, Robinson (1998) declared that there is a stronge case for accrual accounting as an indicator of the intergenerational equity implications of fiscal policy.

Intergenerational accounting

As Mahoney stated "the interperiod equity concept plays a supposedly pivotal role in the development of financial accounting principle applicable to state and local governmental entities" (Mahoney, 2002, p. 204-5). This view is also found back in the Concept Statement No. 1 of the GASB.

"The Board also believes that financial reporting should provide information to assist users in assessing interperiod equity by showing whether current-year revenues are

sufficient to pay for current-year services or whether future taxpayers will be required to assume burdens for services previously provided."

(GASB, 1987, §61)

Also the Australian Accounting Standards Board keeps the same view:

"It provides information about intergenerational equity, which is concerned with the appropriate balance between taxation and borrowings to finance current period services and capital infrastructure. Information about intergenerational equity helps users to assess whether future generations are required to assume the burden of financing current period services and to assess whether current and future generations equitably contribute to the stock of infrastructure."

(AAS 31, p. 20-21, §10.1.1)

Intergenerational equity requires that the tax burden must be the same for all present and future generations.

"(With intergenerational accounting) it will be possible to measure if the present decisions made by the people in charge of a certain public organization will affect the decisions that in the future must adopt the corresponding people in charge and, at the same time, it will be able to detect the influence that last decisions have in present and the future ones." (Fernandez-Santos, 2005, p. 4)

The importance of intergenerational equity is cranked up by the literature concerning generational accounting. Generational accounts indicate in present value what a member of a generation can expect, on net, to pay to the government now and in the future (Auerbach, Gokhale and Kotlikoff, 1992). Therefore the present value of net payments by current generations and those of future generations must be enough to pay the present value of the governmental consumption minus the governmental net worth.

Disadvantages

In spite of the mentioned advantages, also some disadvantages must be mentioned.

First of all, it must be mentioned that so far the financial criteria are stressed. However, for public organisations the emphasis must not be placed on the financial outputs, but on the

realised outcomes. In this context Chang and Tuckman (1991) spoke about the social efficiency. Essential is that the annual accounts not only contain financial information, but also non-financial information.

The reporting of non-financial information is a view that can be found back in the GASB Concept Statement 2 "Service Efforts and Accomplishments" (1994). Also Chan (2004) emphasizes that (Canadian) municipalities use too much business-related instruments (such as paying back-method, return-rate, ...) in their decision evaluation model.

"There is little emphasis and analysis on determining whether the benefits of the capital projects outweigh its cost, both tangibles and intangibles." (Chang, 1994, p. 42)

She stated that this way of working leads to suboptimal allocations of resources.

However, in the remainder of this paper and in the theoretical model, we only try to determine the definition of the equilibrium on the basis of financial information. The extension with non-financial information however deserves further research.

Second, the limited introduction of the new accounting system can be mentioned. As ter Bogt and Van Helden (2001, p. 264) mentioned: "to what extent do such changes take root in the financial management of the organizations concerned? Do technical changes automatically result in changes in the usage of accounting data in an organization."

Christiaens and Van Peteghem (2004) confirm this view in their longitudinal study of the implementation of accrual accounting in local governments. They found that there was no selfregulating effect in the implementation of governmental reform. The introduction problems were mainly due to the fact that municipalities were not used to work with the new accounting system, the lack of suitable framework and the remained dominance of the existing cash cameralistic accounting system.

The Simple Mathematics of Financial Equilibrium

Model

Based on the projections of current and future service provisions and tax plans, based on the principles of intergenerational equity and based on the long-term perspective of the current decisions, financial equilibrium can be defined as:

$$\sum_{i=t}^{\infty} \frac{C_i}{(1+r)^i} = \sum_{i=t}^{\infty} \frac{Rev_i}{(1+r)^i} + Eq_t - FEQ$$

The basic approach to calculating financial equilibrium is based on the net present value of the costs and revenues of the operation of a municipality. The term in the left-hand side of the equation denotes all the costs made for the current and future municipal services, calculated at the present value. The first term in the right-hand side of the equation indicates all the current and future revenues the municipality can make. Both these terms requires projections of the future offered services and the decisions about the future tax-level. Eq refers to the current net wealth of the municipality. This amount is the buffer the municipality has build up during the previous years and can be used if an unbalanced situation occurs.

The last term of the right-hand side, FEQ, is the restterm, denoting the financial equilibrium position of the municipality. If the term is negative, this points to an unbalanced negative financial situation. This means that the municipality has to increase her revenues (taxes) or decrease her costs of service. The inverse reasoning is of course also possible. The term Re is then positive, which means that there is a positive financial unbalance. This situation seems less important, however it means that the municipality is enriching oneself without offering the needed service to its population.

This model is an attempt to assume different research questions considering the search for a new definition of financial equilibrium.

1. In contradiction to the previous discussed models, this model clearly defines the conditions of financial equilibrium and the way the equilibrium could be computed.

2. According to the principles of NPM, the model could be used as a financial management tool. It provides information to the local decision-makers in order to monitor their local policy, but it also provides information to the oversight bodies.
3. It assesses the intergenerational stance of policy

Illustrating Financial Equilibrium in Flemish municipalities

Table 1 illustrates the new financial equilibrium definition for 3 Flemish municipalities. The table includes four aspects. First, it reports the current costs and revenues, found back in the annual accounts of the municipality. Second, the net present value of the future costs and revenues are provided for a period of 30 years. These figures are calculated on the basis of the current costs and revenues and on the historical data indicating some interesting trends. For the estimation of the future costs and revenues, the method of Mozes (1992) is used. The third column indicates the net wealth of a municipality. In this manner, in the fourth column, the financial equilibrium position (F.E.P.) is mentioned.

The selection of the municipalities is done on the basis of the contribution per capita the municipality receives from the Flemish government. This contribution is based on several parameters such as their 'centrumfunction', their fiscal poverty, some social criterion, etc... The hypothesis behind this methodology is the fact that municipalities with a greater contribution per capita are supposed to be richer than municipalities with a smaller contribution (in other words: they need it more to fulfill all their services).

Three municipalities were chosen: Gent (highest contribution per capita = 949 euro), Vosselaar (one of the lowest contributions per capita = 107 euro) and Hoegaarden (median with 153 euro).

TABLE 1
Financial Equilibrium position

	Gent	Hoegaarden	Vosselaar
Current cost	444.555.013	4.591.139	4.344.411
Current revenues	457.864.549	4.758.651	4.815.268
Future estimated costs	9.958.543.041	130.947.330	116.576.568
Future estimated revenues	7.681.423.915	82.554.911	135.521.186
Net assets (Eq)	866.080.318	23.265.213	18.876.251
FEQ	-1.397.729.273	-24.959.694	38.291.726

Note: period 96-99, discount rate 3.75%

Operational problems

This model however knows some operational problems.

1. The determination of the net wealth.

There is a difference between the restricted and unrestricted funds.

2. The determination of the discount rate

In this case, we used the so-called technical rate, used in the assurance sector. This rate is not too high, because otherwise the influence of the future results is subsidiary, but is also not zero, because otherwise the time-value of the money disappears (3,75%).

3. The determination of the future costs and revenues

The method used for the determination of the future costs and revenues, used in the above example, is based on the methode of Mozes (1992). The future information is based on historical data. However, this method can not be completely correct and errors may occur, due to the dynamic evolution of municipalities and the chosen policy.

Due to these reasons, the development of a predictive model could be interesting to facilitate this difficult and time-spending method. The methodes used in private sector and the preliminary research of Trussel and Greenlee (2000, 2001 and 2002) could be of interest. However, further research for this predictive model has still to be done.

Conclusion

The introduction of New Public Management has had a significant influence in public sector. One of the consequences was the introduction of the so-called (business-like) accrual accounting. Nevertheless, the cameralistic or cash accounting is still playing an important role to budgetary decisions, controlling the spending of resources and determining the financial equilibrium.

In this paper, we have tried to look for a new definition. A definition that takes into account the introduction of the new NPM-aims and instruments and issues such as intergenerational equity, the going-concern principle, ...

The proposed mathematic model knows some restrictions and the time-consuming and complex operationalisation does not facilitate the use of the model. Therefore further research has to be done tries to set up a predictive model, taking into account both financial as non-financial data to calculate some ratios, which can be used in the model.

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