

A low-angle photograph of a large American flag waving in front of a classical building with tall columns. The sky is blue with some clouds. The image is partially obscured by a white diagonal shape on the left and a red triangle at the bottom right.

NAVIGATING FISCAL UNCERTAINTY:
RISK MANAGEMENT STRATEGIES FOR
STATE AND LOCAL GOVERNMENTS

Part 1: Budgetary Risk Management and Financial Planning in Uncertain Times

In today's rapidly changing fiscal environment, state and local governments face mounting challenges – from shrinking budgets and volatile revenue streams to an evolving regulatory landscape – that demands uncompromising financial integrity. As financial stewards, Chief Financial Officers (CFOs) and finance directors must not only plan for uncertainty but also proactively manage risk across every facet of their organization.

This article, the first in our three-part series, explores budgetary risk management in uncertain times, offering a framework to assess risks, strengthen forecasting practices, and implement real-time monitoring systems. We provide practical insights and examples to help finance leaders balance fiscal discipline with flexibility, ensuring their organizations remain resilient through economic and political turbulence.



INTRODUCTION

For state and local governments, the annual budgeting process is more than an exercise in accounting, it is a strategic imperative that must balance fiscal discipline with the need to respond to changing economic and political realities. In uncertain times, a misaligned budget can spell the difference between operational stability and disruptive fiscal shortfalls. In this first part of our series, we explore the process of budgetary risk assessment, outline the key items to consider, and share real-world examples that illustrate both pitfalls and best practices.

UNDERSTANDING BUDGETARY RISK

Budgetary risk refers to the uncertainty and potential variability inherent in any financial plan. For state and local governments, these risks are compounded by factors like:

- ▶ **Optimistic Revenue Projections:** Assuming that federal, state, or local revenues will continue at historical levels without considering economic downturns.
- ▶ **Unexpected Expenditures:** Rapidly rising costs in public service delivery, infrastructure maintenance, or emergency response can strain budgeted funds.
- ▶ **Dependence on External Funding:** Federal or state appropriations, which may be subject to political shifts and policy changes, can be unpredictable.

Example

Consider a local government that bases its annual budget on a projected 5% increase in federal funding, a figure derived from a period of robust funding. When a subsequent change in federal policy results in only a 2% increase, the shortfall creates a ripple effect forcing cuts to essential services and prompting a scramble to reallocate funds. This scenario underscores the importance of building conservative assumptions and contingency funds.

APPROACHING A BUDGETARY RISK ASSESSMENT

1. Establish a Historical Baseline

Gather and Analyze Data: Begin by reviewing multiple years of historical data to identify trends. Examine past budget-to-actual variances, cost overruns, and any recurring issues flagged by previous audits.

Items to Consider:

- ▶ What were the key assumptions made in previous budgets?
- ▶ How closely did actual spending match these assumptions?
- ▶ What corrective actions were taken in response to variances?

Example

A mid-sized city might review its public works budget over the past five years. If the analysis reveals that capital project costs consistently exceeded estimates by 15% due to unforeseen environmental compliance costs, then future budgets must adjust the baseline assumptions accordingly.

2. Develop Realistic Forecasts and Scenario Planning

Budget Assumptions: It is critical to document every assumption whether related to revenue growth, inflation, or anticipated costs. Use conservative estimates to guard against overly optimistic forecasts.

Items to Consider:

- ▶ Are revenue forecasts based on solid economic indicators and historical trends?
- ▶ Do expenditure projections account for rising costs in key areas like employee benefits, technology upgrades, or regulatory compliance?
- ▶ What external factors (e.g., economic downturns, political shifts) might impact the forecast?

Scenario Planning – Develop multiple scenarios:

- ▶ **Best-Case:** Assumes favorable economic conditions and full appropriation of federal funds.
- ▶ **Base-Case:** Uses moderate assumptions based on recent historical data.
- ▶ **Worst-Case:** Accounts for funding cuts, unexpected cost increases, or economic shocks.

Example

A county government might plan three different scenarios for its transportation budget. In the worst-case scenario, if federal funding were to drop by 20% due to a recession, the government would identify which projects could be delayed or re-scoped without compromising essential services.

3. Implement Monitoring and Early Warning Systems

Regular Variance Analysis: Establish a routine process (monthly or quarterly) to compare actual expenditures against the budget. This might include variance reports that highlight areas where spending deviates significantly from forecasts.

Items to Consider:

- ▶ What thresholds will trigger an investigation?
- ▶ How will information be communicated to decision-makers?
- ▶ **Early Warning Systems:** Utilize dashboards and automated tools that flag significant deviations in real time. These systems allow for timely adjustments and corrective actions.

Example

A city's finance department could implement a dashboard that tracks key performance indicators (KPIs) such as expenditure variances and budget burn rates. When the dashboard signals that a department's spending is exceeding its monthly budget by more than 10%, an immediate review is triggered to understand and rectify the discrepancy.



4. Establish Adequate Contingency Planning

Contingency Funds: Maintain reserves or rainy-day funds to address unexpected expenditures. These funds provide a buffer and help maintain operational continuity during fiscal shortfalls.

Items to Consider:

- ▶ What percentage of the overall budget should be allocated to contingencies?
- ▶ How frequently should the adequacy of these funds be reviewed and adjusted?

Example

A state government might set aside 5-10% of its annual operating budget as a contingency reserve. If an emergency, like a natural disaster, suddenly requires additional resources, this reserve can prevent drastic cuts in other essential services.

Budgetary risk management is a dynamic process that requires continuous attention, realistic forecasting, and the flexibility to adapt as conditions change. For CFOs and directors of finance in state and local governments, establishing robust baseline data, developing conservative and flexible scenarios, and maintaining effective monitoring systems are essential steps to safeguard public funds. By planning for the unexpected and keeping a finger on the pulse of fiscal performance, finance leaders can steer their organizations through uncertain times with confidence.





What's Next in the Series

While strong budgeting builds the foundation for fiscal resilience, managing unpredictable revenues is the next challenge. In the second installment, we will explore revenue risk assessments—how to diversify funding streams, improve forecasting, and establish cash flow stability throughout the fiscal cycle.

CONTACT US

LEE KLUMPP

Assurance National Technical Principal
lklumpp@bdo.com

Our purpose is helping people thrive, every day. Together, we are focused on delivering exceptional and sustainable outcomes and value for our people, our clients and our communities. BDO is proud to be an ESOP company, reflecting a culture that puts people first. BDO professionals provide assurance, tax and advisory services for a diverse range of clients across the U.S. and in over 160 countries through our global organization.

BDO is the brand name for the BDO network and for each of the BDO Member Firms. BDO USA, P.C., a Virginia professional corporation, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. For more information, please visit: www.bdo.com.

© 2025 BDO USA, P.C. All rights reserved.

