



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

Part 3: Ensuring Compliance and Financial Integrity – Preventing Improper Payments and Managing Regulatory Risk

This is the final installment in our series, Navigating Fiscal Uncertainty. Having explored budgetary and revenue risks, we now turn to compliance — a cornerstone of public sector accountability.



INTRODUCTION

In an environment of heightened fiscal scrutiny and increasing regulatory complexity, compliance is not just a legal requirement – it is a cornerstone of public trust and financial integrity. For state and local governments, the prevention of improper payments and adherence to regulatory mandates are essential for maintaining both fiscal discipline and the public's confidence. In Part III of our series, we explore how to conduct compliance risk assessments, prevent improper payments, and establish robust internal controls to manage regulatory risk.

UNDERSTANDING COMPLIANCE RISK

Compliance risk encompasses the challenges associated with making sure all financial operations meet statutory, regulatory, and internal standards. For state and local governments, noncompliance can result in:

- ▶ **Funding Clawbacks:** The return of funds due to noncompliance.
- ▶ **Penalties and Legal Challenges:** Potential fines, litigation, or sanctions under laws such as the False Claims Act.
- ▶ **Reputational Damage:** Eroding the public's trust in the management of government funds.

Example

A local government might face a situation where insufficient documentation for vendor payments triggers an audit, resulting in the recovery of funds and significant negative media coverage. Such incidents underscore the importance of rigorous compliance measures.

APPROACHING A COMPLIANCE RISK ASSESSMENT

1. Inventory Regulatory Requirements

Mapping the Regulatory Landscape: Begin by identifying all applicable regulations – from federal requirements (such as 2 CFR Part 200 and OMB circulars) to state-specific mandates and internal policies.

Items to Consider:

- ▶ What specific federal, state, or local regulations govern your operations?
- ▶ Are there any recent regulatory changes that impact your current processes?
- ▶ How are these requirements documented and communicated across the organization?

Develop a Compliance Matrix: Create a detailed compliance matrix that links each regulatory requirement to specific internal controls and reporting deadlines. This matrix acts as a roadmap to make sure no requirement is overlooked.

Example

A county government may develop a matrix that clearly outlines deadlines for submitting grant expenditure reports, documenting employee time for federally funded projects, and procedures for vendor verification. This matrix is reviewed regularly to make sure it reflects current regulations.



2. Evaluate Internal Policies and Controls

Review and Gap Analysis: Conduct a thorough review of existing internal policies, procedures, and controls. Compare these against the compliance matrix to identify any gaps or areas that need improvement.

Items to Consider:

- ▶ Are current policies up to date with the latest regulatory requirements?
- ▶ What internal controls are in place to prevent improper payments?
- ▶ How is documentation managed, and are records readily accessible in the event of an audit?

Documentation Practices: Establish rigorous documentation standards for all financial transactions, approvals, and compliance-related communications. Effective documentation is the first line of defense in audits and regulatory reviews.

Example

A state department might notice through internal audits that certain expense claims are not supported by adequate documentation. By revising internal guidelines and conducting training sessions, the department improves its record-keeping practices, thereby reducing the risk of noncompliance.

3. Implement Continuous Monitoring and Training

Internal Audits and Real-Time Monitoring: Schedule regular internal audits focusing on high-risk areas like payroll, vendor payments, and subrecipient oversight. In parallel, use compliance management software to monitor key indicators in real time.

Items to Consider:

- ▶ What frequency is appropriate for internal audits of high-risk areas?
- ▶ Which automated tools can provide early warnings of compliance issues?
- ▶ How are audit findings communicated and remedied?

Employee Training and Culture: Invest in ongoing training programs for finance and administrative staff to make sure everyone understands regulatory requirements and proper procedures. Cultivating a culture of compliance helps prevent errors and fraud before they occur.

Example

A municipal finance department might institute quarterly compliance training sessions and utilize an online learning platform to keep staff updated on new regulatory changes. This proactive approach not only minimizes errors but also reinforces the importance of ethical financial management.

4. Preventing Improper Payments

Segregation of Duties and Pre-Payment Reviews:

Implement robust internal controls that separate the responsibilities for authorizing, processing, and reconciling payments. Pre-payment reviews are crucial to make sure each disbursement is supported by the necessary documentation.

Items to Consider:

- ▶ Are there clear, defined roles in the payment process to prevent conflicts of interest?
- ▶ What checks are in place to verify that payments align with approved budgets and vendor contracts?
- ▶ How are duplicate or erroneous payments detected and prevented?

Automated Detection Tools: Leverage technology like AI-driven analytics and duplicate payment detection systems to flag anomalies. These tools can analyze large volumes of transactions to identify irregular patterns that might indicate improper payments.

Example

A local government might adopt a financial software system that automatically compares vendor invoices with contract terms. When discrepancies are detected – like a duplicate invoice or an invoice that exceeds the agreed-upon amount, the system alerts the finance team for further review.

KEY CONSIDERATIONS AND CONCERNS

- ▶ **Evolving Regulations:** The regulatory environment is continually changing. CFOs must stay informed about legislative updates and adjust internal controls accordingly.
- ▶ **Subrecipient and Vendor Oversight:** For organizations that distribute funds to subrecipients or rely on multiple vendors, making sure all partners comply with guidelines is essential. Lapses in oversight can have cascading effects on overall compliance.
- ▶ **Integration with Overall Risk Management:** Compliance should be integrated with broader risk management processes. This established that financial, operational, and regulatory risks are not viewed in isolation but are addressed holistically.

STRATEGIC RECOMMENDATIONS FOR COMPLIANCE

- ▶ **Build a Comprehensive Compliance Framework:** Integrate compliance risk assessments into your overall risk management strategy. Use a combination of internal audits, automated monitoring tools, and periodic external reviews to establish ongoing compliance.
- ▶ **Regularly Update Training Programs:** Keep all employees informed about the latest regulatory changes and internal policy updates. Regular training and clear communication channels help reinforce a culture of accountability.
- ▶ **Engage External Expertise:** Consider partnering with third-party auditors or consultants to provide an objective assessment of your compliance framework. This external perspective can highlight blind spots and offer recommendations for improvement.
- ▶ **Establish Clear Reporting Channels:** Implement secure, anonymous channels for staff to report potential compliance issues or irregularities. An effective whistleblower program not only detects problems early but also reinforces organizational commitment to integrity.

Establishing compliance and preventing improper payments is a critical component of financial management for state and local governments. Through comprehensive compliance risk assessments, robust internal controls, continuous monitoring, and ongoing staff training, CFOs and directors of finance can safeguard public funds and maintain the trust of their communities. By proactively addressing compliance challenges, organizations can minimize legal risks, avoid funding clawbacks, and build a resilient financial infrastructure capable of withstanding future uncertainties.





Series Conclusion: A Proactive Roadmap to Fiscal Resilience

This three-part series has explored the essential elements of managing fiscal uncertainty in state and local government finance. We began with budgetary risk management – emphasizing realistic forecasting, monitoring, and contingency planning. We then examined revenue risk assessments – focusing on diversification, accurate forecasting, and cash flow strategies. Finally, we addressed the critical area of compliance – outlining how to prevent improper payments and manage regulatory risks effectively.

For CFOs and directors of finance, the challenges are significant, but so too are the opportunities. By integrating these risk assessments into strategic planning, leveraging technology, and fostering a culture of transparency and accountability, financial leaders can transform uncertainty into a catalyst for innovation and long-term stability. In doing so, they not only protect public funds but also reinforce the trust that the community places in its government institutions.

As you work to build a resilient financial framework, consider the insights and strategies outlined in this series as a roadmap to navigating today's complex fiscal environment. Whether you are refining your budgetary forecasts, diversifying revenue streams, or enhancing compliance protocols, proactive risk management will empower your organization to thrive in even the most uncertain times.

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