

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 2: Revenue Risk Assessments – Diversification, Forecasting, and Cash Flow Strategies

This article is Part II of our series on Navigating Fiscal Uncertainty. Building on our discussion of budgetary risk, we now turn to revenue risk—the unpredictability of income that can undermine even the most well-crafted financial plan.



INTRODUCTION

Revenue stability is the lifeblood of any public sector organization. For state and local governments, the challenge is not only to predict revenue flows accurately but also to diversify sources and manage cash flow effectively amid uncertainty. In Part II of our series, we delve into revenue risk assessments, exploring how to evaluate revenue streams, forecast future revenues, and mitigate risks associated with revenue volatility.

UNDERSTANDING BUDGETARY RISK

Revenue risk encompasses uncertainties related to the reliability, predictability, and timing of revenue. This includes:

- ▶ **Revenue Concentration:** High dependency on a sole source, like federal funding or property taxes.
- ▶ **Timing Mismatches:** Differences between when revenue is expected versus when it is actually received.
- ▶ **External Factors:** Economic shifts, policy changes, and demographic trends that can influence revenue generation.

Example

Imagine a city that relies heavily on sales taxes. During an economic downturn, consumer spending might decrease, leading to lower-than-expected sales tax revenue. Without alternative revenue sources or sufficient reserves, this shortfall could force difficult budget cuts or service reductions.

APPROACHING A REVENUE RISK ASSESSMENT

1. Identify and Categorize Revenue Streams

Mapping Sources: Start by categorizing revenue into distinct streams:

- ▶ **Federal and State Funding (i.e., grants):** Often one of the largest sources but subject to political and economic variability.
- ▶ **Local Taxes and Fees:** Property, sales, or service taxes that provide a more stable base.
- ▶ **Contract Revenues and Service Fees:** Income from contracts or fee-for-service programs.

Items to Consider:

- ▶ What percentage of total revenue comes from each source?
- ▶ Which revenue sources are most volatile or subject to external pressures?
- ▶ Are there opportunities to broaden the revenue base?

Example

A local government might discover that 60% of its revenue is derived from property taxes, while federal funding only account for 20%. Recognizing this distribution helps in understanding which areas might be more susceptible to shortfalls and where diversification efforts should be focused.

2. Forecast Revenue with Precision

Historical Trend Analysis: Review historical revenue data to establish trends and identify seasonal or cyclical patterns. Historical analysis can reveal underlying patterns that help refine forecasts.

Items to Consider:

- ▶ What are the historical growth rates for each revenue stream?
- ▶ Are there seasonal variations that affect revenue collection?
- ▶ How have previous economic downturns affected revenue?

Scenario Forecasting: Develop different revenue scenarios to account for uncertainty:

- ▶ **Optimistic Scenario:** Based on favorable economic conditions and full appropriation of funds.
- ▶ **Base Scenario:** Reflects moderate growth consistent with historical trends.
- ▶ **Pessimistic Scenario:** Incorporates potential cuts or delays in revenue.

Example

A county government might use historical data to project a 3% annual increase in local tax revenue under normal conditions. However, by modeling a pessimistic scenario where an economic downturn leads to a 2% decline, the finance team can better prepare for cash flow challenges.

3. Monitor Revenue Realization and Manage Cash Flow

Regular Reporting and Reconciliation: Implement robust reporting processes that regularly compare forecasted revenue against actual collections. This involves setting up monthly or quarterly review cycles.

Items to Consider:

- ▶ Are revenue collection processes integrated with financial reporting systems?
- ▶ How frequently is revenue data reconciled against bank deposits and collection records?
- ▶ What mechanisms are in place to alert management when significant discrepancies occur?
- ▶ **Cash Flow Management:** Revenue timing is critical. Even if overall revenue targets are met, delays in cash inflows can create operational challenges.
- ▶ **Liquidity Reserves:** Maintain sufficient cash reserves to bridge gaps between revenue receipts and expenditure obligations.
- ▶ **Timing Strategies:** Consider measures such as accelerating collections or negotiating payment terms to better align revenue timing with expense schedules.

Example

A municipal finance department may notice that although annual revenue targets are met, monthly cash flow reports reveal recurring shortfalls during the first quarter of the fiscal year. By establishing a reserve fund and adjusting collection strategies (such as offering advance payment incentives), the department can mitigate cash flow issues.

4. Diversify Revenue Streams

Mitigate Concentration Risk: Diversification reduces the risk associated with dependence on a single revenue source. Explore new revenue opportunities or expand existing streams.

Items to Consider:

- ▶ Are there underutilized local assets that could generate additional income?
- ▶ Can fee-based services be expanded or enhanced to create steady revenue?
- ▶ What partnerships or innovative financing arrangements can be pursued?

Example

A state government that relies primarily on federal funding to fund infrastructure projects may consider developing public-private partnerships for infrastructure projects. These arrangements can generate additional revenue streams while sharing risk with private sector partners.

Effective revenue risk assessments require a comprehensive understanding of your revenue sources, accurate forecasting, and proactive cash flow management. By categorizing revenue streams, forecasting with scenario-based approaches, monitoring real-time performance, and diversifying revenue sources, state and local governments can build a more resilient financial foundation. The key is to remain vigilant and adaptable – ready to adjust strategies as external conditions change, to make sure revenue uncertainties do not compromise public services or fiscal stability.





What's Next in the Series

With budget and revenue risks addressed, the final article in our series turns to compliance—an area that directly affects financial integrity and public trust. We will examine how to prevent improper payments and manage regulatory risk through internal controls, continuous monitoring, and a culture of compliance.

CONTACT US

LEE KLUMPP

Assurance National Technical Principal
lklumpp@bdo.com

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