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Cash Basis Accounting Has a Muni Market Price for Issuers.

Issuers that use cash basis accounting pay a yield premium of three to five basis points in the primary market compared to those using generally accepted accounting principles, and their bonds are less likely to trade in the secondary market, a new research paper finds.

The paper, "Does GAAP Compliance Matter to Municipal Bond Investors?" looks at general obligation bonds issued by Illinois municipalities. It is currently under review at a peer-reviewed journal.

It further finds that bonds sold by cash basis issuers face an access penalty in the secondary market, and that audit oversight is tied to investor participation in the secondary market, with the likelihood that the bonds never trade dropping 34% if a municipality is subject to a mandatory audit by a certified public accountant.

One possible explanation for the difference in investor behavior is that "investors see bonds for cash basis issuers as just inherently less creditworthy," said Justin Marlowe, research professor at the University of Chicago's Harris School of Public Policy, director of the Center for Municipal Finance and the author of the paper. "I think there's some sense out there that you do cash basis accounting if you've got something to hide, and I don't find that to be the case."

Notably, for cash basis bonds that do trade in the secondary market, "there is no evidence of higher transaction costs," the paper finds.

The paper concludes that cash basis reporting primarily impacts who is willing to buy and hold a bond, not how investors price its underlying credit risk.

In the paper's comparison, the underlying financial health of the GAAP and cash basis issuers was largely similar, Marlowe said.

"If that's the case, then why is it that we might see this noticeable difference in any borrowing costs in the primary market?" he said. "Clearly, what's happening here is the buyer base for cash basis bonds is smaller, and there are some mechanical reasons for that."

For one, many mutual funds are not allowed to buy bonds from issuers who rely on cash basis statements. Portfolio managers are often under a strict mandate that forbids it, because cash basis accounting does not allow the kind of deep credit analysis that the funds require, he said.

Also, "when you talk to managers in the (separately managed account) world, in particular, there's a similar dynamic there," he said. "They're doing a lot of benchmarking and comparison; a lot of the marching orders that investors give to their SMA managers is to buy particular types of bonds, or buy bonds with certain characteristics."

SMA managers are often trying to maintain roughly the same credit profile across portfolios, but shift the portfolio in ways that prioritizes other kinds of risk besides credit, Marlowe said. "If you have some bonds that are cash basis and some bonds that are GAAP basis, it's very difficult to hold

credit constant because you don't exactly know what some of those longer-term financial concerns are from cash basis borrowers."

Marlowe completed his paper as it became clear that an audit standards bill in Illinois, HB 5391, would not pass during the session that ended Sunday.

Among other things, HB 5391 would allow more local governments to use cash basis rather than GAAP accounting, creating four financial reporting categories, with the three categories under the \$35 million in cash receipts threshold able to use cash basis.

The bill's proponents plan to pass it this year, according to Dan Nugent, assistant professor of accounting at the University of Wisconsin-Platteville, who said he is the bill's drafter.

The bill aims both to enable more timely audits and to incentivize CPAs to do more public sector work, Nugent told The Bond Buyer in an interview.

"The number of CPAs who are actually doing this work, if you look at the number of partners back when we pulled this data, you've got about 202 right now across Illinois," he said. "There were 461 back in 2010."

Particularly downstate, "as the quality control standards of the peer review process have increased, that has resulted in (firms) not performing local government audits," Nugent said. "They're stepping back from this, saying that local government audits are too risky.

"Untimely financial reporting of local governments is a nationwide problem," he said.

In a Monday outlook report, Municipal Market Analytics warned that "HB 5391's proposed solution is unlikely to deliver the relief expected for mid-sized local governments" and "switching the basis of accounting is not an effective solution in decreasing the audit burden."

MMA agreed with Nugent that the issues the bill tries to address - such as the shortage of CPAs doing government work and accountants' complaints about GAAP audits being comparatively onerous - are not unique to Illinois.

But HB 5391's potential status as a bellwether for other states is "concerning," MMA said.

"Normalizing a solution that reduces governmental transparency but fails to address the root causes of the timeliness and cost problem? is an undesirable outcome for not only market participants but also the governments and their citizens," MMA said.

Nugent rejected the solution arrived at in Texas, which tied property tax hikes to audit timeliness ? with audits filed within 180 days of fiscal year's end ? and saw its delinquent audits essentially cut in half.

"If you're not going to allow (local governments) to levy for what they need to operate, how are they going to be able to do what they're supposed to do?" he said. "I understand where Texas is coming from, but your flip side of that is what happens when they don't (complete audits on time)? That's why I believe this model is much better."

HB 5391 would give local governments seven months after the fiscal year's end to file their audits with the comptroller's office.

Two months after that, "the comptroller's office is to come in and start actively monitoring," he said.

Twenty-eight days after that, the comptroller's office would make a determination of whether a local government is taking sufficient action.

If the comptroller finds it is not, the matter would be referred to the state attorney general, who would then seek a judicial remedy, Nugent said.

He added that while the bill is a work in progress and he's still meeting with people to get feedback on the draft, the representative who is sponsoring the bill, Natalie Manley, D-Joliet, "has announced that there's going to be meetings throughout the summer, with the intention that as you get towards the fall veto session, there would be a bill that works."

Bills passed during Illinois' fall veto session typically require a three-fifths majority vote.

In his paper, Marlowe proposed one change that could make the bill more effective: preserve the mandatory CPA audit but relax GAAP accrual requirements.

"To be able to separate the effect of GAAP basis reporting as something the market responds to, as opposed to just having the assurance that an accounting professional reviewed the financial statements... that was a unique opportunity," he said. "To find that, in fact, yes, the market responds to some form of external oversight over financial reporting, independent of the substance of the reports, is I think an interesting finding in and of itself."

Still, MMA warned in its report that "rating agencies' methodologies rely on information that is not included in cash-based audits. Local governments with bond ratings will reasonably need to provide agencies with additional information included in GAAP-based audits to maintain their ratings.

"And if the information is not provided and the government's rating is withdrawn, that is likely to increase issuance costs in the future," MMA said.

Marlowe said cash basis issuers' bonds are more likely to be unrated, and "there's no doubt" that "unrated bonds just are not eligible for certain kinds of funds," resulting in a smaller buyer base.

By Jennifer Shea

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