S&P Global
Ratings

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Summary:
Scio Township, Michigan; General Obligation

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Credit Profile		
Scio Twp downtown dev rfdg bnds (ltd tax GO)		
Long Term Rating	AA/Negative	Downgraded
Scio Twp GO (AGM)		
Unenhanced Rating	AA(SPUR)/Negative	Downgraded
Many issues are enhanced by bond insurance.		

Credit Highlights

- S&P Global Ratings lowered its long-term rating and underlying rating (SPUR) to 'AA' from 'AA+' on Scio Township, Mich.'s limited-tax general obligation (GO) debt.
- The outlook is negative.
- The rating action reflects our view that there is heightened risk of credit deterioration given operating challenges associated with governance structure concerns, including political discord; management turnover; risk management, culture, and oversight stemming from internal control findings; and a lapse in certain financial practices such as regular budget monitoring.
- We capture these credit risks associated with governance structure and risk management, culture, and oversight under environmental, social, and governance.
- Following the downgrade, our long-term rating on the township's series 2008 downtown development bonds now reflects a bond insurance rating of AA/Stable.

Security

The township's limited full-faith-and-credit pledge and agreement to levy ad valorem property taxes, within statutory and constitutional tax limits, secure the GO bonds. Despite the limitations, we rate the debt at the same level as our view of the township's general creditworthiness given the lack of limitations on the fungibility of resources available for debt service.

Credit overview

Scio Township's underlying credit fundamentals--including participation in the Ann Arbor economy, above-average wealth and income, extremely strong reserves, and a relatively low debt burden--remain strong. However, recent events indicate a somewhat unstable operating environment, which we believe could disrupt the track record of stable financial performance. These events include:

- Ongoing turnover, including prolonged vacancies in the township administrator and finance director positions;
- Several internal control findings in the township's audit;
- A lapse in regular financial reporting to the board; and

- Discord between township officials, including a lawsuit that the clerk filed against the board regarding a finance staffing contract.

We think these events could represent longer-term changes in the township's credit fundamentals and financial position, including difficulty maintaining operational balance as it faces a budget deficit in fiscal 2023.

Environmental, social, and governance

We view governance structure and risk management, culture, and oversight as governance factors under environmental, social, and governance as well as negative considerations in our credit rating analysis that led to the rating action. In our view, the political and management instability could inhibit the township's ability to maintain stable finances, as is evident in the current fiscal year's forecast for a budget deficit and lack of regular budget monitoring that could result in inability to make timely adjustments to maintain balance. We believe that should the township fail to address these governance risks, they could lead to further negative rating actions. We consider environmental and social factors neutral in our credit analysis.

Outlook

The negative outlook reflects our view that there is at least a one-in-three chance we could lower the rating over the next two years given ongoing governance challenges, which we believe could hinder the township's ability to maintain a strong financial profile.

Downside scenario

We could lower the rating, potentially by multiple notches, if governance and management conditions weaken further and the township is unable to maintain balanced operations and reserves deteriorate significantly, indicating ongoing financial pressures.

Upside scenario

We could revise the outlook to stable if the recent turmoil leading to challenges in financial operations is resolved, resulting in stabilized risk management and oversight.

Credit Opinion

Governance challenges threaten a track record of stable finances

Turnover and vacancies in key township positions have occurred over the past year. As a result of retirement and internal mobility, the township has been without a full-time finance director since November 2021. The township has had difficulty filling the position and is searching for an interim finance director. The board recently hired the township's retired assessor as the interim administrator following the resignation of an administrator who started in April 2022 and left less than five months into the position. Prior to this, the township operated without an administrator for two years.

In March 2022, in response to the turnover, the township clerk and treasurer approved an emergency contract with an accounting firm to help bridge the shortfall in finance staffing. However, the following month, the board voted to terminate this contract on the premise that the finance department had sufficient internal staffing. This action prompted the township clerk to file a lawsuit against the board alleging that they violated the clerk's emergency purchasing power, which is scheduled to go to court on Aug. 25. However, in the interim, a judge rejected the clerk's request for a restraining order against the board to prevent the contract cancellation.

Despite the turnover and claims of understaffing, we believe based on information we have received that the township has sufficient capacity to manage basic needs. That said, financial management shows signs of weakening. First, the township's 2021 audit contained several internal control findings, including a material weakness related to controls for determining its other postemployment benefit (OPEB) liability. (The auditors discovered one employee who was excluded from the data for the OPEB valuation.) The auditors also identified several instances of noncompliance with state regulations, including a failure to create an OPEB trust fund, failure to provide a quarterly investment report to the board, and a delay in the distribution of tax revenue to other taxing units. Last, the auditors noted some difficulty in performing and completing the audit given that officials did not provide all requested support by the audit deadline. The township has submitted a corrective action plan to address the audit findings.

The 2022 audit is not yet complete, though we foresee the possibility of additional findings. First, we understand that the township mistakenly excluded two Washtenaw County millages on its December 2021 tax bill. Because this related to county millages, the error created no cash flow issues for the township. There was a small impact to some county-captured tax increment financing revenue for the township's downtown development authority (DDA), but this did not affect the ability of the tax increment financing to support debt payments. The uncollected county millages will be placed on the 2022 winter tax roll, and we understand the township has strengthened its controls to prevent this from recurring. Second, budget reporting to the board has lapsed. The township clerk stopped providing monthly budget-to-actual reports to the board in the spring of 2022. In our view, this poses a risk in that the board may not be aware of significant budget variances that require timely action. Officials plan to review the budget six months into the fiscal year and make amendments if necessary. Last, earlier this year the township experienced a "phishing" incident in which an employee's direct deposit paycheck was misdirected. In response, the township has implemented more controls and employee training. In addition, there were other community and administrative concerns that could inform our view of management in the future.

We believe these issues, taken together, indicate a governance and management environment that is inconsistent with a higher rating, and the negative outlook reflects our view that should these credit risks persist, the rating could be downgraded by multiple notches.

In addition to the lack of budget and investment reporting, the township doesn't perform any long-term financial forecasting. Furthermore, the township uses a line-item approach to budgeting and about five years of historical data when forming revenue and expenditure assumptions. However, it maintains a five-year capital improvement plan that identifies cost estimates and funding sources. The township also has a formal debt policy with some affordability measures, and a formal reserve policy with a goal to maintain unrestricted general fund reserves above one year's expenditures for cash flow purposes. The township's reserves exceed this level, but we believe they could fall below this threshold during the outlook period given the ongoing governance weaknesses. Given that the relationship between the board and township officials has led to cessation of certain practices, we will monitor whether the township returns to adhering to them.

The institutional framework score for Michigan municipalities is strong.

Extremely strong reserves remain a credit strength, though an operating deficit in fiscal 2023 looms

As part of our analysis, we combined the general fund with the fire fund because fire operations represent a core function of the township. On a combined basis, the township has reported surplus operations in seven of the past 10 years, reflecting a fairly stable revenue and expenditure environment. In fiscal 2021 (ended March 31), the township reported a $427,000 drawdown in the general fund following a one-time transfer to the fire station renovation fund. Without this transfer, the general fund would have reported a surplus. In addition to the transfer, the general fund made a $1.5 million long-term advance to the fire station renovation fund that is classified as nonspendable fund balance in the audit. (Part of this was reclassified from committed fund balance.) The fire fund had a small surplus in 2021, after a one-time transfer to the fire station renovation fund. On net, available reserves decreased by about $1.4 million in 2021 because of the one-time transfers and advances.

On an unaudited basis, fiscal 2022 results depict another drawdown in the general fund of about $375,000, which management again attributes to one-time expenditures, including a land purchase. The fire fund reported a surplus of about $480,000. Therefore, on net, we estimate that total available reserves remained fairly flat.

The township's fiscal 2023 budget calls for a $1 million deficit in the general fund, though about half of this reflects various one-time expenditures, including another land purchase and culvert fix. The other half of the deficit reflects a structural gap between recurring revenue and expenditures. The fire fund budget shows a $92,000 surplus. If the township ends on target with the budget, we estimate that total available reserves would fall to about $6.7 million.

Based on projections, we estimate that the township will approach its 100% general fund reserve policy by the end of 2023. To address the deficit and maintain reserves above 100% after 2023, the township plans to increase its public safety special assessment millage. (It levies 1.3 mills against a 10-mill max.) In addition to the deficit in the general fund, costs in the fire fund are rising, partly because the township recently approved a three-year labor contract with the fire department that includes salary increases of 5.5%, 5.0%, and 5.0%. If governance and management conditions prevent the township from balancing the budget and sustaining reserves in adherence with its formal policy, the rating could come under pressure.

Liquidity remains very strong with no material contingent liquidity risks. The township has one private placement outstanding, with one more payment of $46,000 due in April 2023.

Very strong debt and contingent liability profile with low annual carrying charges

The township's limited-tax GO pledge secures approximately $5.6 million of DDA component unit debt, so we have included it in our calculation of the direct debt burden, although the annual debt service of approximately $1.1 million to $1.3 million is payable from tax increment revenue. Tax increment revenue has always been sufficient to cover the debt service, so we think that the DDA obligations will not likely need to be funded by the township's governmental funds. According to officials, the township could issue utility revenue debt in the near future.

Pension and OPEB liabilities

We do not consider pension and OPEB liabilities a credit pressure because costs are low relative to the budget.

Scio Township participated in the following plans as of Dec. 31, 2021:

- Municipal Employees' Retirement System (MERS), an agent multiple-employer defined benefit pension plan: 83.1% funded with a net pension liability of $843,000
- A single-employer defined benefit OPEB plan: 0% funded with a net OPEB liability of $1.2 million

Although the city funds 100% of its pension actuarially determined contributions, such contributions fell short of our minimum funding progress metric. However, they do exceed static funding, which implies positive but slow funding progress. In the near term, we believe the township can absorb increased costs given its very strong financial flexibility.

The township funds OPEB on a pay-as-you-go basis but plans to discuss establishing an OPEB trust fund to begin prefunding this liability.

Wealthy residential suburb of Ann Arbor

Scio township is located in Washtenaw County in the Ann Arbor, Mich., metropolitan statistical area. Wealth and income levels are very strong, and the tax base has exhibited moderate growth. In 2015, a village within the township achieved cityhood status, which led to a one-time drop in its tax base and population. Taxable value has grown since. We expect the local economy to remain strong.

Scio Township Key Credit Metrics

	Most recent	Historical information		
		2021	2020	2019
Strong economy				
Projected per capita EBI as % of U.S.	177			
Market value per capita ($)	161,059			
Population		21,878	22,031	21,796
County unemployment rate (%)		4.3		
Market value ($000s)	3,523,654	3,523,654	3,308,790	
Ten largest taxpayers as % of taxable value	5.6			
Adequate budgetary performance				
Operating fund result as % of expenditures		13.0	5.3	9.2
Total governmental funds result as % of expenditures		12.0	17.6	18.4
Very strong budgetary flexibility				
Available reserves as % of operating expenditures		144.7	182.9	181.8
Total available reserves ($000s)		7,568	8,946	8,574
Very strong liquidity				
Total government cash as % of governmental funds expenditures		505	610	602
Total government cash % of governmental funds debt service		49,274	44,678	42,098

Scio Township Key Credit Metrics (cont.)	Most recent	Historical information		
		2021	2020	2019
Adequate management				
Financial management assessment	Standard			
Very strong debt and long-term liabilities				
Debt service as % of governmental funds expenditures		1.0	1.4	1.4
Net direct debt as % of governmental funds revenue	75			
Overall net debt as % of market value	1.7			
Direct debt 10-year amortization (%)	75			
Required pension contribution as % of governmental funds expenditures		1.9		
OPEB actual contribution as % of governmental funds expenditures		0.2		
Strong institutional framework				

EBI--Effective buying income. OPEB--Other postemployment benefits. Data points and ratios may reflect analytical adjustments.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022
- 2021 Update Of Institutional Framework For U.S. Local Governments