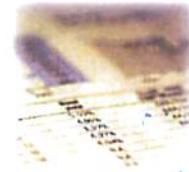


SHOULD YOUR ASSOCIATION HAVE FINANCIAL STATEMENTS PREPARED BY A CPA FIRM?



by
Steven Silberman, CPA
Frost, Ruttenberg & Rothblatt, P.C.



Many small associations (less than 50 units) and some larger associations feel that they do not need year-end financial statements prepared by a CPA firm. I recently spoke at a seminar where three board members shared the exact same feelings. One board member said, "We already pay our management company a fee to prepare our financial statements." Another board member said, "We have a financial statement from our management company, why should we pay for a second one?" Finally, an additional board member said, "They are too expensive!!" These board members need to be educated on the importance of CPA prepared financial statements.

When an association is making a decision on whether to have CPA prepared year-end financial statements, they have to answer the following questions:

1. Are CPA prepared financial statements required by the association's by-laws or declaration?

These are the association's most important documents. All associations must first review these documents before making any decision. These documents may require an independently prepared year end financial statement. The documents might even be more specific and require either a compilation, review or audit.

2. Are CPA prepared financial statements required by the association's lending institution?

Depending upon the amount the association may need to borrow, the lending institution may require a compilation, review or audit. The board should review the loan documents to see if there is a

requirement. Also, if the association already has financial statements prepared by a CPA firm when it approaches a lending institution for funds for a capital project, the lending institution may be more apt to approve the loan. They can rely more on independently prepared financial statements, especially if they are either reviewed or audited.

3. Is the Board of Directors performing the proper due diligence?

As part of the board members' due diligence, they should have an independent third party look over the records of the management company. If the board feels the management company is doing a good job, then these CPA prepared financial statements will reconfirm their feeling. If the CPA firm finds inconsistencies with the management company's financial statements, then you will know and can react appropriately. The same facts apply to self-managed associations where one board member controls the financial records of the association.

4. Is the management company's financial statements prepared in the format that the board prefers at year-end?

The association's management company may prepare cash basis financial statements while the board would prefer accrual basis so that they will know their true financial position at year end. Also, the management company may only prepare non fund (one single commingled fund) financial statements when the board prefers fund (separate operating and reserve funds) financial statements at year end, so they can get a better understanding of what income and expenses are in each fund. Are reserve assessments actually

deposited in the reserve fund? Are reserve expenses actually paid out of the reserve fund? A fund financial statement will tell you this but non fund financial statements will not since there is only one single commingled fund.

5. Will a potential buyer of an association unit feel comfortable relying on internally prepared management company financial statements?

Third party prepared financial statements, especially ones prepared by a CPA firm, will give more assurance to a potential buyer. The level of service (compilation, review or audit) will determine how much a potential buyer will be able to rely on these statements. Also, most financial statements prepared by a CPA firm will have notes to give a potential buyer additional information regarding the association – (for example, potential bad debts, lawsuits and reserve study funding).

6. Are CPA prepared financial statements actually too expensive?

The level of service (compilation, review or audit), the type of financial statement (cash vs. accrual and fund vs. non fund) and the activity (loans, special assessments or capital expenditures) will determine the cost of the financial statements. Cash basis, non fund financial statements will be the least expensive.

Some boards may feel any fee is too expensive, but the additional assurance that these statements give the board is worth the cost.

After answering these questions, does your association feel that year-end financial statements prepared by a CPA firm are still not needed?

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"WHICH FEDERAL INCOME TAX RETURN IS RIGHT FOR YOUR ASSOCIATION?"

By Steve M. Silberman, CPA

As a CPA, one of the most frequently asked questions I get from Board members (especially new Board members from associations just turned over from the developer) is: Are we a not-for-profit corporation and if we are, do we have to file an income tax return?

First of all, most associations are usually incorporated as not-for-profit corporations by the developer. If this did not happen to your association, I recommend hiring an attorney to incorporate your association as a not-for-profit corporation, even though you could go to the Secretary of State's website yourself to incorporate. Once incorporated, you must remember that each year your association has to file an annual report with the Illinois Secretary of State and pay an annual fee in order to stay incorporated.

Residential condominiums, townhomes, and homeowners' associations are not-for-profit corporations that generally do not qualify for Federal income tax-exempt status. Residential associations may be taxed under Internal Revenue Code (IRC) Section 277 or may elect to be taxed under IRC Section 528. Under IRC Section 277, associations file Federal Form 1120 and under IRC Section 528, associations file Federal Form 1120-H. An association can decide annually which form it would like to file. So let's discuss which form is right for your association and the differences between each form.

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FEDERAL FORM 1120-H

Federal Form 1120-H was developed so that associations would not be taxed for carrying out its main function of managing and maintaining the common elements. Commercial condominium associations cannot file Federal Form 1120-H. IRC Section 528 states that income and expenses must be allocated between exempt function activities and non-exempt function activities. Associations are only taxed on its net non-exempt function income at a Federal tax rate of 30%. (Timeshare Associations are taxed at a Federal tax rate of 32%). So what is exempt and non-exempt function income?

Exempt Function Income is: Operating income received as assessments from owners of condominium, townhome or homeowners' associations. They also can be assessments received from developers on unsold units or lots. These assessments must be assessed ratably to be exempt function income.

Non-exempt Function Income (or taxable income) is: 1) Income from non-association property - commercial operations and interest and dividends. 2) Income from non-members for use of association property. 3) User charges to association members for special services unless the user charge is

assessed once in a twelve month period and the benefit lasts for the entire twelve month period. An example of a user charge is laundry income.

The advantages of Federal Form 1120-H are as follows:

1. Associations are not taxed on exempt function income.
2. The tax form is a one page form, with supplementary schedules, so it costs less to prepare.
3. The form has less risk than Federal Form 1120. There are four tests that have to be met to file Federal Form 1120-H, but most residential associations will qualify.
4. Fund accounting is not required since capital or reserve assessments are not taxed.
5. No election forms are required like on Federal Form 1120.
6. As long as you keep filing Federal Form 1120-H, no estimated taxes are required.

FEDERAL FORM 1120

The key advantage of Federal Form 1120 is that an association could pay tax at a lower rate than Federal Form 1120-H. Income tax rates start out at 15% on the first \$50,000, however, the risk of compliance is far



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Continued from page 4

greater since an association must follow certain required procedures. Also, since the form is much longer and more complex it costs more to prepare than Federal Form 1120-H.

IRC Section 277 states that income for Federal Form 1120 should be allocated between membership and non-membership income. An association can be taxed on both if there is net income, however, an association can make an annual election to defer net membership income.

Revenue Ruling 70-604 allows associations to defer net membership income for one year but if the association has net membership income in the next year then the association would have to pay tax in the next year on the deferred income. An association can also make an election under Revenue Ruling 70-604 to refund net membership income, but in my thirty plus years of working with associations, I have never seen an association refund money. A question that I get asked about all the time is: Can our association transfer excess net membership income to reserves and then not have to pay taxes on this excess? The answer is NO if you are filing Federal Form 1120. IRC Section 118 states that an association cannot transfer excess net membership income to reserves to avoid paying taxes since you cannot re-characterize what the assessments were for originally. In order for Revenue Ruling 70-604 to be valid, the election has to be made annually by all members (usually at the annual meeting) and it should preferably be made before the end of the year. The dollar amount does not have to be specified.

Capital contributions (reserve assessments) will be treated as non-taxable on Federal Form 1120 if certain guidelines are followed:

1. The purpose of the assessment must be capital in nature. The reserve study supports the purpose of the capital assessment. However, painting, even if it was included in your reserve study, is an operating assessment, not a capital assessment.
2. Members must have advance notice. Distributing copies of the budget to the members is considered advance notice.
3. The assessment must be accounted for as a capital contribution and held for that purpose. The books and records, along with the budget should segregate operating and reserve (capital) activities. Therefore, the association should use fund accounting.
4. Reserve (capital) assessments should be deposited into a separate account and reserve expenditures should be paid out of this separate account. An association can pay

for capital expenditures out of the operating fund account as long as the reserve account reimburses the operating account in a relatively short period of time.

Now that you have a brief understanding of the two forms, you might be wondering which form should your association be using? This is a hard question to answer unless your CPA knows the facts and issues associated with your association.

Usually if your association has little interest income and no (or minimal) user fees you will file Federal Form 1120-H. As interest income grows, your association should look at filing Federal Form 1120 as an alternative. If your association has minimal interest income, but you have a net loss from your net membership (for example due to a painting project) you may want to file Federal Form 1120 since that loss gets carried forward. If your association files Federal Form 1120 because of the large amount of non-membership income, you want to make sure that you do tax planning ahead of time to minimize your net membership income.

You now should have a better understanding about the different types of Federal income tax returns and which Federal income tax return is right for your association.

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So You Think Your Association's Assets Are Safe - Are You Sure?

by STEVE SILBERMAN, CPA and KIM WAITE, CPA
Frost, Ruttenberg & Rothblatt, P.C.

Congratulations! You were elected to the Board of your Association. Did you hire a management company and say, "Thank goodness, now I don't have to worry about the financial records of the Association." Or, are you self-managed and said, "Thank goodness we have a treasurer who takes care of all of the finances, so I don't have to worry." If you said yes to either of these questions, you should read further to learn your responsibilities as a board member when it comes to safeguarding your Association's assets.



Reserve Funds – All reserve funds should be controlled by a member of the Board of Directors, which is usually the Treasurer.

RESERVE CASH RECEIPTS:

- Generally, the Board has an approved budget with monthly reserve transfers.
- Any other transfers including excess operating funds should be approved by the Board.

RESERVE CASH DISBURSEMENTS:

- Since the reserve funds are controlled by a member of the Board, all expenditures should be approved by the Board upon receipt of proper documentation.
- Dual signatures are recommended on checks written for reserve expenditures.
- All reserve activity should be reported to the person responsible for the Association's financial records.

Internal controls over cash are only one aspect in safeguarding the Association's assets. One of the most important things that a Board must do whether it is professionally managed or self-managed is to review the monthly financial package. This package should include the following: balance sheet, income and expense statement reporting actual versus budget, bank reconciliations, bank statements, check registers and cash receipts journals, an assessments receivable aging, and a detail of investments. Other reports that may be provided include a general ledger and an accounts payable listing.

So you might be wondering why you should be reviewing the monthly financial package, and you might be saying, "That's why I have a management company or that's why I have a treasurer?" Remember again, the Board is responsible for the financial information of the Association.

- As you review your monthly financial package, are you checking to see if the operating and reserve bank reconciliations agree with the amounts reflected on the balance sheet? If the amounts do not match, this could

The Board of Directors is responsible for the financial information of the Association whether it is professionally or self-managed. An important part of accurate financial reporting is internal controls and the Board plays a key role in the process. A board member has a fiduciary responsibility to make sure that the Association's operating and reserve funds are properly safeguarded. Proper segregation of duties leads to proper internal controls. As you know, cash is king, so it is important to have proper internal controls over cash. Here are some of the most important internal controls for cash that a Board needs to consider whether your Association is professionally managed or self-managed.

OPERATING CASH RECEIPTS:

- A lock box at a financial institution is a preferred internal control over cash receipts.
- If your Association does not use a lock box, the person opening the mail should endorse the checks "for deposit only" immediately and make a tape of the checks along with the deposit ticket.
- A second person should review the tape and deposit ticket while recording the deposits to the accounting records. This person should also bring the deposit to the bank on a frequent basis.
- The receipt for the deposit should be given to the person preparing the bank reconciliation. This person should be different from the individuals noted above.
- Bank reconciliations should be prepared each month as soon as possible.
- Operating Cash Disbursements:
- All requests for checks should have proper documentation.
- All invoices should be approved and categorized.
- Upon approval, checks can be written.
- The person writing the check should not have signature authority on the account.
- All written checks should be given to the signor with the appropriate documentation.
- The checks should not be mailed by the person who signs them.

be a sign that all of the activity is not being posted to your general ledger. Are there any old outstanding checks or old deposits in transit? If there are old outstanding checks or old deposits in transit, you will need to determine why they did not clear in a timely fashion.

- If your Association receives a printout of the cleared checks, these checks should be reviewed for proper signatures. Are you reviewing the monthly check register? A review of the check register could potentially uncover checks issued to unauthorized vendors or expenses that are incorrectly classified. Are you reviewing the cash receipts journal? A review of the cash receipts journal could disclose unit owners that are not paying timely.
- If you are on the accrual basis, does the assessments receivable on the aging report agree with the amount reflected on the balance sheet? These amounts must equal to ensure that proper revenues and receipts are being

recorded.

- Has your Association consistently followed its collection procedures? Assessments receivable should be reviewed monthly for delinquent amounts. If these are not reviewed timely, the Association could be losing out on potential collections.
- Have you reviewed the Association's investments and does the detail agree with the amounts reflected on the balance sheet? The investment detail should agree with the balance sheet, otherwise there could be activity missing in the Association's financial records.
- The Association should have an investment policy. Who approves the investments? Is the Association investing in insured investments? Are higher interest rates more important than liquidity? These are some of the questions that need to be addressed and answered in your investment policy.



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- BA, Summa Cum Laude, Lafayette College, Easton, PA
- JD, University of Chicago
- Formerly partner, Sachnoff & Weaver in real estate, and condominium law

• The balance sheet is a representation of the Association's financial position at a certain date. This report will differ if the Association prepares its reports on the cash basis, modified cash basis or accrual basis.

• We recommend that Associations prepare their year-end financial statements on the accrual basis to reflect their actual financial position on the balance sheet and their revenues earned and actual expenses incurred on the income statement for a specific period of time. Another reason to have the Association's income statement prepared on the accrual basis is that the Association's budget is prepared by this method. The Board should then be reviewing actual versus budgeted revenues and expenses and should investigate any variances immediately.

We have barely touched the surface of the Board's responsibilities regarding the safeguarding of the Association's assets. Hopefully you now know that every Association needs to have an active Board and make sure that proper internal controls are in place whether you are professionally managed or self-managed. Now, can you answer whether your Association's assets are safe? Are you sure?

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Assessment Collections: A Challenge For Associations

by **STEVEN M. SILBERMAN, C.P.A. & KIMBERLEY A. WAITE, C.P.A.** -
Frost, Ruttenberg & Rothblatt, P.C.

In these troubled and unusual economic times, we are seeing many community associations face new financial hardships due to slow or non payment of assessments by a growing number of unit owners. They have lost their jobs, had their salaries reduced or seen their retirement nest egg disappear. If that isn't bad enough, these same unit owners want to sell their units, but are having either a hard time selling their unit or have found out their unit is worth less than what they were anticipating. We have also seen speculators buy units as investment property with the intent of selling the units for a profit in a relatively short period of time. Unfortunately, they too have found out that the unit is worth less than the purchase price. As a result, they can neither afford to sell the unit for a loss nor can they afford to pay the assessments.

SO WHERE DOES THIS LEAVE ASSOCIATIONS?

Many associations that are having cash flow problems due to slow or non collection of assessments from unit owners end up borrowing from reserves. This is not a great idea! The Illinois Condominium Property Act states that associations shall provide for reasonable reserves for capital expenditures. One of the ways to provide for reasonable reserves is to obtain an independent professional reserve study. If the board continues to borrow from reserves, they may not be performing their proper due diligence to provide for reasonable reserves. If the board does decide to borrow on a short term basis, the Internal Revenue Service (IRS) has stated that you must do the following:

- The board minutes should state the reason and terms;
- Prepare a note with terms that agree with the board minutes;
- Notify unit owners; and
- Modify the reserve study. The association has altered its reserve funding cash flow, but will be able to continue to provide for reasonable reserves with a modified study.

In order for an association to combat its cash flow problems, we recommend several steps. First, each association should review its aged accounts receivable reports for delinquent accounts on a monthly basis. At year end, your accountant should review your aged accounts receivable listing and determine, based upon discussions with the board and management company, whether there needs to be a provision for bad debts.

If a certified audit is prepared, there are several procedures your accountant will perform. First, there will be a review of subsequent receipts. If after this review there are still several unit owners with large delinquent accounts, there will be inquiry of personnel at the management company or with the Board of Directors.



As mentioned earlier, both your management company and your Board of Directors should be keeping a close eye on potential delinquent accounts. A final step is a confirmation from the association's legal counsel. Although the representation from the attorney will not tell you whether a unit owner's assessments will be collected, it may provide valuable information as to the potential collection of the amount past due.

After all of those procedures are performed, a determination is made whether there should be a provision for bad debts on your association's financial statements. Generally, this provision will only be recorded if the association's financial statements are prepared either on the accrual basis or on the modified cash basis. Financial statements prepared on the accrual basis recognize revenues when they are billed to the unit owners and expenses when they are incurred. Financial statements prepared on the modified cash basis can be similar to the accrual basis in that assessments can be recorded when billed but expenses will be recorded when paid. The provision for bad debts will be shown as an offset to assessments receivable on the balance sheet. It is important to accurately reflect the association's assessments receivable so as to not overstate the assets on the balance sheet.

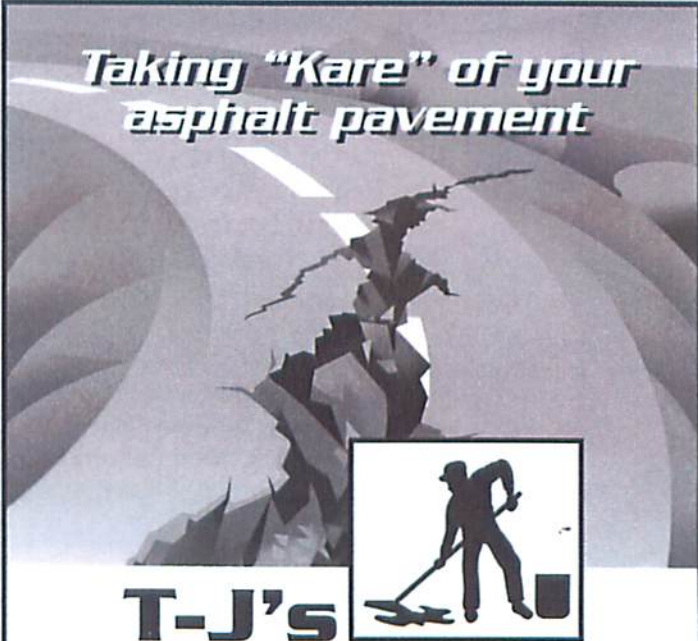
Another recommendation would be to adopt a policy regarding collection of assessments owed to the association, if there is not already one stated in the association's governing documents. Once the policy is adopted, it needs to be enforced without exception. Associations may get into trouble by giving breaks to individual unit owners, if they do not adhere to the written policies.

A final suggestion would be to start a contingency fund. We have been advising associations for years that they should have an operating contingency fund. We originally discussed starting a contingency fund to fund large periodic maintenance items like painting. Many associations believe that painting should be a reserve expenditure, especially since some reserve study consultants include painting in the reserve study. However, the IRS, through field audits and revenue rulings, has determined that painting is an operating maintenance expense. The contingency fund should also be used to fund unexpected operating expenses, like higher than expected snow plowing and heating costs during those extra snowy or frigid winters.

Because of the current economic conditions, we recommend that an association budget for contingency assessments, as well. There should be two separate line items for contingencies on the budget. One line item should be for the unexpected operating expenses and the other line item should be a provision for bad debts.

With the contingency built into the budget for potential uncollected assessments, the association may not feel the economic crunch that it might have felt without the contingency. In addition, the contingency amount should help prevent associations from borrowing from reserves.

In conclusion, these are tough economic times and associations have not been immune to them. Increasingly, associations are having problems collecting assessments from their unit owners. Associations are finding themselves short of cash and thus, borrowing from reserves to pay for its operating expenses. The Board of Directors and management company need to keep on top of potential delinquent accounts by reviewing the aged receivable reports on a monthly basis. If necessary, a provision for bad debts should be recorded. The association should also adopt a policy regarding the collection of assessments. This policy will aid in collection efforts and potentially get the Association its cash in a more timely fashion. Finally, an association should start a contingency fund and build contingencies for bad debts into its budget. With the contingencies, there will be extra cash available for the association to pay its operating expenses without borrowing from reserves. By following these steps, Associations can get through these tough economic times and keep their reserves at appropriate levels.



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