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By Michael C. Davids

Imperfect Boards Make Common Errors

Although many people strive for perfection in many fields, few achieve it.

Perfection is said to be found in many of the impeccable art works created by world renowned masters of painting and sculpture like Michelangelo, Rembrandt, Picasso and Monet. Some Olympics athletes such as gymnasts and divers have scored the coveted perfect score in their best efforts.

Other observers could point to examples of what they consider to be flawlessness, but near perfection is about as close as anyone comes in human performance. The world of community associations is no exception. Although some may be exemplars in how their boards run them, there probably aren't any that can claim to always doing the right thing- adhering without deviation to the law and their governing documents as well as

following sound business practices in every conceivable situation. They will all stray from the path of correctness at some point. But that is to be expected because to err is human- it is part of our nature.

The failures of boards of directors are more readily perceived by outside parties who work with them and see where they go astray- managers, lawyers, accountants and others. We inquired about common errors by community association boards with three such professionals recently to discuss from their own experiences where they have seen directors stumble in their decision-making, policies and actions. Each highlighted several areas where boards commonly misstep and provided direction for getting on the right track.

Let's hear first from Thomas Skweres of ACM Community Management, who talked about general administration and management. He has seen his share of errors in the way boards operate.

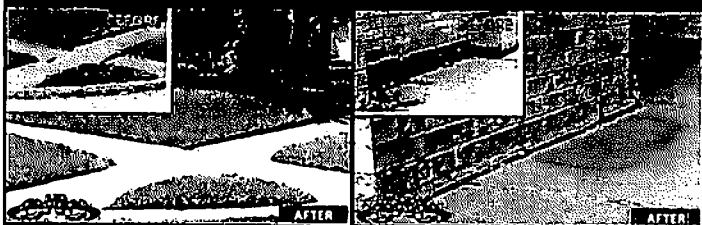
Associations are not run like Businesses.

That became evident, he has found, because:

- Board meetings are not well planned in advance and with an agenda. Directors fail to read materials given them before a meeting. "Nothing is more frustrating than to have someone come to a meeting and not be prepared," said Skweres.
- Meetings are run without regard to time and functional procedures such as Roberts Rules of Order.
- Job descriptions are not provided for all board members, the manager and other staff. "Everybody should know what they

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have to do," said Skweres, adding that sample descriptions can be obtained from CAI.

- Boards do not develop strategic, long-term plans for the association. "You have a fiduciary duty to plan for the longevity of the association- 3, 5, 10 years down the road," he said. "It should be a vision and a team effort, short, simple, with a set of time sensitive goals, and be flexible to respond to changing conditions. Management can help in drafting a plan.
- Boards do not enforce their covenants and rules fairly and consistently.
- Boards fail to set up procedures for the bidding, awarding and monitoring of contracts.

When boards have to go into "executive sessions" there are often leaks about what is discussed. As Skweres put it, "what goes on behind closed doors, needs to stay behind closed doors."

Some board members tend to try to dominate associations, squeezing out other voices so that only they dictate what is to be done. In a board setting, said Skweres, "individuals do not make decisions; you make decisions as a group."

- Boards fail to understand the proper role of Management and that they should operate together as a team.

They sometimes downplay the possible contribution that the management company can make and don't recognize that the agent is a professional organization whose main goal is to assure the success of the association. Each has their respective roles in this process. It should be understood, but often, isn't, that the board establishes policies and procedures and management implements them. Boards should not be hesitant to call on management for assistance in almost any association matter and make use of its experience, knowledge and contacts. When selecting a management company or a replacement for one, a board should assure itself that the candidate chosen is a good fit with the association in its strength and personality.

As Skweres noted, "a good relationship between the board and management is a win/win situation for the association."

- Boards too often try to operate on their own, ignoring the potential benefits in using committees and volunteers.

With regard to this all too common omission, Skweres urged boards to consider the following issues. Committees do research and analysis and make recommendations to boards; they do not make final decisions. That authority always remains with the directors. Committees are great training grounds for later leadership roles. "It is important to have a succession plan for future board members," Skweres said. Committees can make the lives of board members easier and reduce potential burn out. They can bring more owners into the operation and give the board the opportunity to take advantage of various skills and talents that can be put into service for the association.

- Boards fail to communicate adequately with their constituents.

This can make controversial decisions by a board a tough sell to unit owners when the latter have been kept in the dark until told what is to be done, especially when an action will require some self sacrifice such as paying increased or separate assessments. Resistance can be surmounted or at least significantly mitigated by keeping owners informed at all stages in the decision making process about the problems that need to be addressed and why they must be as well as the best approaches to resolve them. "People will cooperate better if they understand why they are being asked to do things," explained Skweres. "If

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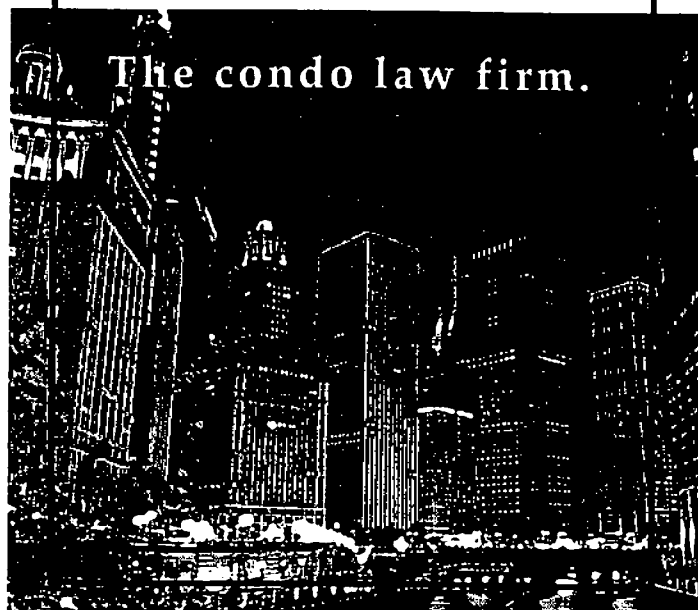
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you give people as much information as to what you are doing, your job will be a lot easier." This is one of the keys to running an association effectively.

And directors should not be reluctant to entertain suggestions from those not on the board about how to improve their plans or approaches on issues. Communication should be a two way process with the ideas going back and forth, especially on complicated matters. Communication is not just words from the leaders, nor is it just hearing what others have to say. "It is actually listening to what is said," said Skweres, and giving weight to helpful ideas and recommendations. Meetings with owners, newsletters, websites and the use of e-mail are a great means to facilitate communication.

Attorney's Perspective

Lara Anderson of Fullett Rosenlund & Anderson, P.C. offered some thoughts on what she has experienced as some of the major weaknesses of boards.

Failure to consult with professionals.

Many sources exist to assist associations with guidance on how to proceed on numerous issues that are too complex for them to wrestle with alone, but still many prefer to proceed independently, frequently guessing about what has to be done rather than knowing for sure. Directors do this because expert advice doesn't come free of charge. "Too often a board is concerned with cost and does not spend the money on advice from professionals," said Anderson, who cited property managers, accountants, architects and attorneys as among those who should be involved with boards in a team approach to solve problems. "The benefit (for them) is really worth the cost."

Anderson pointed to Section 18.4(r) of the Illinois Condominium Act, which dictates that officers and members of the board exercise the care required of a fiduciary of the unit owners. That means they, "must act with the best interests of the association and with informed decisions," she said, noting that important decisions can often only be made

competently with the advice and consultation of professionals. Failing to obtain it where necessary and appropriate could be construed as a breach of fiduciary duty. The business judgment rule applies to a board's decision making and courts will not generally second guess the actions of a board if they act in good faith and with informed judgment. Therefore to better assure favorable judicial review of what they do in the event of owner lawsuits challenging their actions, "it's extremely important that boards spend the money to hire the experts to get the best information to make the best decisions," Anderson reiterated.

Failure to have contracts reviewed.

In an effort to save money, many boards do not send contracts to their attorney for review. Some attempt to use generic terms or riders prepared for other contracts not realizing that such riders are not sufficient for every contract. Anderson noted that in her experience, "the cost to an association when there is a breach or other problem with a con-



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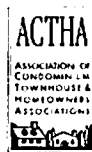
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tract and there are not adequate protections in the contract far exceed the cost the association would have incurred to have the contract reviewed up front."

Failure to aggressively seek the collection of delinquent assessments

Associations are often not as aggressive as they should be in this aspect of their operations, preferring to give delinquent unit owners too much time to catch up on back assessments rather than pushing ahead with legal action before the debt gets out of hand. Anderson strongly recommends that boards turn over collection to an attorney when an owner's payments are 45 to 60 days behind or total over \$500. "This is my guideline, it's not written anywhere," she said. But most attorneys handling collections for associations follow a similar timetable. The higher the debt becomes the harder it will be to recover. "When collecting assessments, it's a lot easier for a person to come up with \$500 rather than \$5000."

Some boards are reluctant to pursue collections when a foreclosure has been filed against a property. Due to the length of time

many foreclosures now take, Anderson explained, it is often an advantage for boards to pursue collections even if a foreclosure is pending. In many cases, the association will be able to take possession of the property and rent it to recover delinquent assessments before there is a foreclosure sale. If they do not pursue collections after a foreclosure is filed, Condo boards should at least monitor foreclosures to take advantage of the law which allows them to collect up to six months of delinquent assessments and legal fees from the purchaser of a unit if they take appropriate steps to protect their interests. (These procedures have been covered in previous issues of Condo Lifestyles.)

Failure to maintain the corporate status and to designate a proper registered agent.

This is a serious mistake for a board because under Section 107.85 of the Illinois General Not for Profit Corporation Act creditors cannot go after members of the corporation for any debt or obligation of the corporation. Incorporation, "protects the membership

(unit owners) and the board from personal liability," explained Anderson, who also advised that boards get a professional- either an attorney or its management company to serve as their registered agents. "This is a key position because papers regarding a foreclosure or other legal matters are served on the registered agent." If they only go to a board member designated as the agent, he/she might not understand their significance or respond within necessary time frames.

Once an association incorporates it must take action annually to maintain its corporate status by filing an annual report with the Illinois Secretary of State on forms prescribed by that office and meet any other requirements, duties which can more reliably be performed by a party that is familiar with the procedures and their timing.

Anderson also noted that Section 108.75 of the Not for Profit Act provides that an association may indemnify the directors and officers of a board against causes of action, "if such person acted in good faith and in a manner he or she reasonably believed to be in, or not opposed to, the best interests of the



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association." In this litigious society, board members need all the protection they can get.

Failure to reasonably accommodate the needs of the disabled.

Many associations are unaware of or ignore their legal responsibilities under the Fair Housing Act, which, in part, prohibits discrimination in housing by associations against the handicapped and disabled, whether physically or mentally challenged. That means associations must be willing to make reasonable

structural changes by modifying their existing premises and common areas to permit access and use by the disadvantaged and must be agreeable to changing certain rules or practices to make allowances for special needs. Not doing so has led to a number of lawsuits around the Country resulting in associations being ordered to comply with the law and forced to pay attorney's fees for both plaintiffs and themselves.

"Right now," said Anderson, "a lot of litigation is going on regarding emotional sup-

port pets," recommended by a doctor to alleviate their patients' conditions such as depression. Another example of accommodation would be the removal of carpeting in a unit that has sound deadening properties because the occupant is allergic to the material.

More such demands can be expected to be made of associations to alter their physical environments or their rules and they should be prepared to meet them to avoid the high legal costs associated with resisting the changes. Anderson encouraged their compliance.

Failure to raise assessments or pass special assessments when necessary.


Due to the economy, this is becoming more of a problem. Anderson explained that Boards are often reluctant to increase assessments or pass a special assessment when necessary for repairs or other items because such may cause a financial hardship on some unit owners. However, boards need to keep in mind that they have a fiduciary duty to maintain, repair and replace the common elements as necessary. While an increase in assessments or special assessment may be unpopular, boards must be motivated by doing what is in the best interest of the association. Plus, deferring certain expenses, such as maintenance and repairs, may result in greater costs in the future.

Accountant's Perspective

CPA Steven Silberman of Frost, Ruttenberg & Rothblatt, PC, added his comments in areas where he has found boards to deviate from sound operational practices, although, as with Skweres and Anderson, the lapses he pointed out didn't constitute an all inclusive list of slipups.


Reserve studies not being done or updated if they are on file.

The Illinois Condominium Act mandates that condo associations amass a reserve unless their governing documents contain no such requirement and two thirds of the owners vote to waive setting such funds aside for critical capital improvements. A reserve study is one of the factors a board should take into consideration in determining how large the amount should be and how much to regularly assess to grow it. It is part of a board's responsibility to do due diligence in creating a plan to fund capital expenditures and without a reserve study that would be very difficult.




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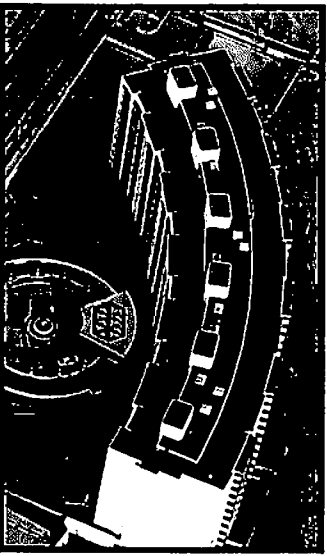
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Due to the economic climate, potential buyers do not want to buy a unit in an association where they may have to pay a special assessment in a year or two after purchasing their dream home. Potential buyers are now looking to see if an association has

reserves and if it has a reserve study. Silberman says "They are asking me, as their accountant, not only to see if there is a study but is the study prepared by a professional and is the association following the reserve study." Furthermore, lending institutions will be less likely to lend money to associations for expensive improvements if they do not have a reserve study since they do not know if the association will have funds available for future projects and when these projects will have to be done.

Cost is often a reason that some boards are negligent in this area. "We're finding a lot of small associations are not doing professional reserve studies because they're too expensive or the Board may prepare their own study and just set aside funds for one or two future projects," said Silberman. Despite that hindrance, however, having such a long term planning tool available for guidance in the gradual funding of a reserve makes good business sense. But, then, even when an association has a reserve study completed the board may ignore it, which leads to the following problem.

- Associations are not funding a reserve according to a reserve study and do not account for expenditures properly.

Due to the economic climate, potential buyers do not want to buy a unit in an association where they may have to pay a special assessment in a year or two after purchasing their dream home.

Boards that have reserve studies completed are often remiss in not setting aside sufficient funds because the studies were not completed by a person or firm competent to produce a comprehensive and quality product or because they choose to ignore one that

is a realistic projection of future capital needs. In the first case, the scope of the analysis would likely be inadequate to permit a reasonably accurate forecasting of need. In the second, assessments will not truly reflect the amount needed to provide for funding future work and the common elements will suffer as a result. Silberman has also found that boards are not reviewing their reserve study. "So many things happen each year that may lead to a departure from what is in the reserve study. The Boards should review and update the study annually when they are preparing their budget and it should be reviewed every three to five years by a professional."

Non-Fund Accounting

Many associations fail to properly account for their reserves. They use what is called non-fund accounting in which all the money of an association is lumped together. The association budgeted to have a certain amount of assessments transferred to reserves, so if you are using non-fund accounting you will not know if the assessments were transferred to reserves and you will not know if the budgeted reserve expenses were paid out of reserves.

Associations that use non-fund accounting do so because the system is easier to understand than the alternative of fund accounting but a disadvantage in doing so is that the IRS won't permit an association to file tax form 1120. The association can only file IRS income tax form 1120-H if they are using non-fund accounting. (More on IRS filings below.) Associations that do use non-fund accounting and are co-mingling their funds may be violating their governing documents as some actually provide for using the fund method of accounting, according to Silberman.

- Boards not understanding or reviewing the management company's financial reports or the CPA's year end financial statements.

Board members have to run their association like a business so they need to have some understanding of general accounting principles and practices even if someone else compiles the numbers. They are responsible for the financial information of the association. They should know whether the monthly statements from the preparer- usually management- are constructed on a cash basis, reflecting actual money in and money out or on an accrual basis, indicating in addition to what is actually received and disbursed, amounts that are due to be received or to be paid later. They should also know how to distinguish fund from non-fund accounting described above. And it is essential that someone- but preferably everyone- on the board actually review the monthly or quarterly reports, whatever the frequency of preparation. "You must do due diligence by looking over the financial package given you by management," said Silberman. That's the only way to make sure that your association is financially successful. Also, it is possible that fraud can occur when you do not have an active Board.

As far as years end financial statements are concerned, a board is required by law to furnish unit owners with an annual accounting of income and expenses for the common elements. A CPA is not required to prepare year-end financial statements, but it is a good idea to have a professional undertake the work for a few reasons. It may be required by the governing documents or a lending institution may request that a CPA prepared

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financial report be provided for a loan. It is also prudent and part of your due diligence to have an independent entity provide a check on the day to day accounting records kept by management or the Board treasurer. The cost and the procedures performed will vary depending upon whether the association decides to have a CPA firm prepare a compilation, review or audit report. A compilation does not express an opinion. A review expresses the opinion that we are not aware of any material modifications that should be made. An audit, the most costly report, expresses the opinion that the financial statements present fairly the financial position of the association and results of the operations and cash flows.

Filing income tax returns without understanding IRS procedures.

Silberman has found that some small associations are not filing income tax returns since they think that not for profit associations do not have to file income tax returns, which of course, is incorrect. Some associations file IRS income tax form 1120-H because it is shorter, cheaper and simpler than IRS form 1120, ignoring the fact that they could save income taxes (depending upon the circumstances) since the association could pay tax at a 15% income tax rate instead of a 30% income tax rate on a non-membership income. The decision is critical for those associations that earn a lot of non-assessment income from interest, user fees and rental

Board members have to run their association like a business so they need to have some understanding of general accounting principles and practices even if someone else compiles the numbers.

income. To be eligible to file the 1120 and take advantage of the lower tax rate, an association must meet a number of requirements imposed by the IRS, including, as noted previously, using fund accounting, having a reserve study that supports the amount of reserves deposited and withdrawn in a year, having a budget that also conforms to the reserve study in terms of the amount assessed for the reserve and avoiding inter-fund borrowing, but, if necessary, documenting it with repayment terms.

Regarding the mandated consistency between a reserve study and the annual deposits to the reserve, "if the contributions are different, the IRS may say that excess contributions are taxable," said Silberman. So care is necessary to ensure that the study clearly supports the reserve fund accumulation.

Some associations overlook another requirement of the IRS when form 1120 is filed. The unit owners have to annually approve the association's election under Revenue Ruling 70-604 concerning what to do with any excess income to avoid it being taxed. A decision has to be made whether the overage is to be carried forward to the next year or be refunded to the owners. In this election, no specific dollar amount must be stated and it should ideally be made before the end of the tax year, preferably at the annual meeting. ■■

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