



Helping You Run Your Condo or Homeowners Association Legally and Efficiently

SPECIAL ISSUE

FEATURE

Take business management stance to protect association's financial health.

Use Audit to Test Association's Financial Health

Association living requires a collaborative effort to ensure safety, uniform aesthetics, shared common amenities and activities, and maintenance that make the community a desirable place to call home. The day-to-day focus of homeowners, the community association manager, and the board might center on their roles in keeping the community running smoothly—abiding by the governing documents, quickly dealing with problems that pop up, and making decisions that affect the community, respectively.

Finances, however, are what really enable the community to run in the first place. That's sometimes forgotten when associations are in the thick of daily operations. But it's important for associations to treat themselves as businesses. And that means carving out some of their budget to pay for an audit or other audit alternative to confirm that their finances are on track. Using an independent, third-party to assess the health of the association can ensure that it continues to run smoothly—or get it back on track if it's in trouble.

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Reasons to Take Stock of Finances

Boards have felt more pressure than ever from members who are pushing for audits as they read an increasing number of headlines about fraud or embezzlement by directors or managers. The surge in audit requests could be attributed to reports of fraud or mismanagement of association funds, but audits have always been a part of good business management, notes certified public accountant Neal Bach, whose accounting firm regularly performs homeowners association audits and audit alternatives. Bach says the difference is that, now, homeowners have begun to push for audits as they read these headlines, and boards and property management companies have become more cautious.

Audits are also useful for several situations that have nothing to do with suspected misdoings in an association. An improved economy has sparked new construction, resulting in developer turnovers; an audit can uncover underfunded reserves. Some covenants specify

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Use Audit

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that an audit must be performed. An influx of cash from improved assessment collections means that there is more money for associations to spend—and be accounted for at year’s end. And an increase in debit card usage to pay for association costs is a big concern for Bach. It’s hard to track whether resources paid for by a debit card are actually for personal use by a manager or board member. An audit or audit alternative like an agreed-upon procedures engagement can assess that type of situation.

Determine Need for Specific Type of Review

A full audit is sometimes not necessary for an association, which can opt to use an audit alternative, like an agreed-upon procedures engagement. To determine which type of accounting is best for the association you manage, familiarize yourself with the details and objectives of each method:

Audit. A financial audit is an independent, objective evaluation of an association’s financial reports and financial reporting processes. Audit requirements are set by the American Institute of Certified Public Accountants (AICPA) and follow Generally Accepted Accounting Procedures (GAAP) and Generally Accepted Auditing Standards (GAAS). “That’s the technical way of saying that the certified public accountant tests financial procedures of the association to verify that the association’s financial statements are accurate and complete,” Bach explains.

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Use Audit

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Bach notes that an association would specifically want an audit in certain situations. “We are called when there’s a major change to association management, like a developer, board, or property manager turnover,” he says. In that scenario, an audit helps the board and community to confirm the financial health so they can start fresh, he adds. Bach also notes that annual audits are typically required when associations have bank loans.

“Not all boards can have a CPA as their treasurer, so an audit can also help make up for a board’s lack of financial experience,” Bach says.

Agreed-upon procedures engagement. This is a targeted examination, since it is a very detailed look at specific financial areas more prone to errors or issues, Bach explains.

“Many people use the term ‘audit’ but they don’t necessarily mean a formal financial audit. Many associations really don’t want—or, need—that type of engagement. Audits can be expensive, and may be overkill when you can focus just on a few areas,” Bach says.

Sometimes, a traditional audit is specifically mentioned in the covenants. But if it’s not, Bach recommends considering an agreed-upon procedures engagement. That way, the CPA can focus efforts on specific areas where there is the greatest chance of an issue or error. “Why spend extra money on a traditional audit if you don’t need to?” Bach says. A better approach would be to schedule an agreed-upon procedures engagement with greater frequency, he advises.

Every association has unique aspects to it; your association’s accounting firm can help tailor an audit or audit alternative to fit its needs. If your association doesn’t have an accounting firm, call experienced CPAs in the area to get opinions. The main factor to take into account when choosing an accounting firm to perform an audit is experience—specifically working with community associations. “These are much different than traditional businesses,” Bach warns.

Beware of asking a board member with financial experience to conduct the audit, which requires a licensed, neutral CPA. Even if the board member is a CPA, he or she is not independent and, therefore, probably doesn’t meet AICPA ethical standards, says Bach. He also reminds managers that many people won’t take the audit results seriously unless they are presented by a neutral third party.

PRACTICAL POINTER: There are two other types of audit alternatives, but in most circumstances, there’s limited value in a “compilation,” which is basically a restatement of the association’s financial statements on an accounting firm’s letterhead. A “review” is more of a cursory look at financial statements to ensure they conform with standard accounting procedures. But there aren’t many tests in a review. An audit or agreed-upon procedures engagement provides much more insight than a compilation or review, but you still should ask your CPA about the best options for your particular association.

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Use Audit

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Help CPA Focus on Crucial Areas

Audits and agreed-upon engagement letters focus on specific areas that are more likely to uncover issues and errors. Be prepared for your CPA to do the following:

- Confirm that incoming funds like member assessments are accounted for, and outgoing funds (like bills and petty cash) have appropriate backup.
- Review actual revenue and expenses against the association's budget to ensure that all variances can be explained.
- Make sure that the checkbook and other bank account balances match the amounts on the financial reports.
- Make sure that the reserve account is adequately funded based on the reserve study. This is very important to check during developer turnover.
- Verify that contracts, especially larger and long-term contracts, match payments.
- Confirm that the association has adequate insurance coverage. That includes several policies, like property & casualty, general liability, directors & officers (D&O), and fidelity bond coverage.

Once your association decides that an audit or engagement is necessary, association managers and management companies typically are asked to help prepare for it. Bach's firm has a questionnaire that it uses to help associations prepare and gather the right information ahead of time, but managers, and especially those who haven't been part of an audit before, might be unsure about their overall role in the process. Bach explains that, although an accounting firm is hired by the board, the property manager and property management company, if there

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► **Take Next Steps to Plug Loopholes**

Sometimes audits reveal that costly mistakes or fraud could have been discovered through simple oversight like reviewing bank statements. Other times, it's more difficult to ascertain why things don't add up. Regardless of how and why they've happened, you can expose errors or crimes by performing an audit or other engagement every couple of years, says Bach.

If the audit or other engagement uncovers irregularities, you'll want to respond to the situation. A certified public accountant's report should point out specific errors and issues that need to be corrected. You or your management company and the association should then go down the list and decide whether and how to address each item. Bach recommends also documenting the reason that any item is not addressed.

Managers don't have to handle the fallout from an audit alone, though. Some accounting firms that perform audits can also help associations to get back on track if irregularities are uncovered. When Bach's firm gives a report to the association, it recommends financial process enhancements, which the firm can help implement, if needed. "If we perform a follow-up audit, we can make sure that the association has complied with our recommendations," notes Bach.

Finally, don't be afraid to ask the CPA if she can recommend vendors for larger maintenance contracts, insurance, reserve studies, and other initiatives, if you feel you need guidance.

Use Audit

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is one, are usually providing all of the information the firm needs for the audit or other engagement. So be prepared to answer questions as the CPA conducts the audit, and provide follow-up documentation. Keep in mind that, with board approval, you could have a role later in correcting any issues or implementing any procedural enhancements that are recommended.

You can help make the process more efficient by doing the following:

- Organize financial records, including financial and bank statements, and possibly other documentation for an agreed-upon procedures engagement, as soon as you know an audit or engagement has been scheduled;
- Give developers, the property management company, and other stakeholders plenty of advanced notice;
- Provide the information the CPA requests on a timely basis, and let the CPA know if specific documentation is not available;
- Let the CPA have “read-only” access from the records, so he can get necessary information; and
- Be reasonably available for follow-up questions.

An audit or other engagement can be nerve-racking for managers who haven't gone through one before. Bach assures managers whose association has planned an audit that they can relax. “This is a great way to prove that you and your management company have sound financial management practices,” Bach says. “If we do find anything that requires attention, we're just helping to make your reporting more accurate in the future.” ♦

Insider Source

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RECENT COURT RULINGS

► Special Assessment for Roadwork Wasn't Deceptive

FACTS: A homeowners association used funds from a special assessment to complete roadwork in a subdivision of the planned community. Each homeowner was asked to pay \$7,500. One of the homeowners paid his portion on time but later sued the association, seeking to recoup that amount and alleging that, among several other illegal activities, the association had engaged in fraud by requiring payment of the assessment. A trial court ruled in favor of the association. The homeowner appealed.

DECISION: An Illinois appeals court upheld the trial court's decision.

REASONING: The homeowner had alleged that the association violated the Illinois Consumer Fraud Act and the Illinois Deceptive Practices Act by failing to follow all procedures outlined in the declaration and required by Illinois law regarding

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Recent Court Rulings

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special assessments. He argued that the board of directors had a fiduciary duty to association members that it violated. In particular, he focused on the notice sent for the special assessment meeting, and the procedures followed at the meeting itself.

The homeowner argued that the notice caused confusion because it didn't specifically refer to a special assessment vote or spell the association's name correctly. He also argued that the vote and subsequent special assessment were in "questionable" compliance with the necessary procedures.

The appeals court pointed out that, to state a cause of action under the Consumer Fraud Act, the homeowner must establish five elements:

1. A deceptive act or practice by the association;
2. The association's intent that the homeowner rely on the deception;
3. The deception occur in the course of conduct involving trade or commerce;
4. Actual damage to the homeowner; and
5. Proximate—that is, direct—cause between the deception and the damage.

The association argued that the homeowner didn't show a deceptive act, proximate cause, or that it was engaged in "trade or commerce."

The appeals court noted that the Consumer Fraud Act defines a deceptive act as "the use or employment of any deception, fraud, false pretense, false promise, misrepresentation, or the concealment, suppression, or omission of any material fact." An omission or concealment of a material fact is actionable where it is employed as a device to mislead. Here, the misspelling of the name of the association (by including an apostrophe) is simply not deceptive, even if it was confusing to the homeowner, said the appeals court. While the homeowner argued that the meeting didn't refer to a "special assessment" vote, he admitted that the meeting was called to discuss road repair and resurfacing. The meeting notice listed road repair as a meeting topic. The homeowner hadn't alleged anything resembling a misrepresentation, an omission of material fact, or a false pretense or promise, the appeals court determined. Rather, he alleged only that the association made a typo in its meeting notice and the notice of the meeting, which he didn't attend, and didn't specifically refer to a special assessment for road construction but only that the meeting would address the topic of road construction, it added. "These are not deceptive acts," concluded the appeals court.

- Goldberg v. Glenstone Homeowners Assn., November 2015

➤ Association Recorded Improper Lien on Townhouses

FACTS: The owner of two townhouse units performed renovations that were not permissible under the association's governing documents. The association charged the owner several thousand dollars in penalties and fines. When the owner didn't pay, the association imposed a lien on the properties. The owner sued the association, alleging, among several other claims, that it had negligently placed an improper lien.

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Recent Court Rulings

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The association asked for a judgment in its favor without a trial. A trial court ruled in favor of the association. The owner appealed.

DECISION: A Louisiana appeals court reversed the decision regarding the recording of improper liens.

REASONING: The appeals court noted that, based on the language of the Louisiana Homeowners Association Act, it was apparent that the association was entitled to assert a privilege—or lien—which may be recorded against the lots of owners, for any owner’s nonpayment of assessments, charges, dues, and expenses. The exception is a lien made “in bad faith” or “with malice.”

The owner asserted that the association had an obligation to deal fairly and in good faith with him because he was a member of the association. He claimed that the association improperly recorded the liens. That was because, over many years, the whole plan of restrictions created by the initial declaration had been abandoned, and therefore terminated, as there had been a great number of violations by other members of all or most of the restrictions specified within that initial declaration.

The owner alleged that the association acted in bad faith in placing a lien on the properties stemming from fines assessed for impermissible renovations when the restrictions on renovations were no longer active.

The appeals court agreed that the association wrongfully recorded an improper lien on the owner’s property and was acting in bad faith because it was attempting to enforce invalid restrictions and rules. The appeals court sent the case back to the lower court for further proceedings consistent with its opinion. ♦

- Tchefuncte Harbour Townhome Assn. v. Costanza, November 2015

RISK MANAGEMENT

Avoid Falling Victim to Oil-Shorting Scams

If your condominium building uses heating oil as a fuel for furnaces or boilers, you should take steps to ensure that you aren’t paying for more oil than is being delivered to the building. Don’t fall prey to an unscrupulous oil company that might try to trick you or your management company about the amount of fuel that’s delivered to the building. A New York City commission recently found widespread heating oil fraud, with nine companies and 44 individuals indicted on multiple felony counts. According to authorities, the defendants shorted oil deliveries for nine years but charged customers full price. They say in some cases they then sold the stolen oil at below-market costs elsewhere. Based on interviews with employees of the indicted delivery companies, recorded conversations, and other intelligence gathered during the investigation, it is believed that the aggregate theft amounted to at least \$18 million annually.

Here’s the low-down on four common oil delivery scams, and advice on how to stop paying for oil you don’t get for your building.

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Risk Management

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Delivery Process Basics

To figure out how the oil-shorting scams work, you need to understand how the oil delivery process works.

The oil meter. Home heating oil is sold by volume. Your city or municipality should have a weights and measures agency that routinely inspects all oil meters for accuracy. Most oil delivery trucks are equipped with oil meters. Like a gasoline pump, an oil meter registers, in gallons, the amount of oil that passes from the truck into your building's oil tank. The meters on these trucks should be sealed by your city's Bureau of Weights and Measures, or by a city-approved oil meter repair contractor, to ensure that nobody has tampered with them.

The delivery ticket. Unless arrangements are made in writing and prior to the sale, when this product is delivered to your building, the seller should give you a "delivery ticket" at the time of delivery. Check the delivery ticket for the following information:

- Serial number.
- Date of delivery.
- Name and address of seller legibly recorded.
- Name of and address of buyer legibly recorded.
- The quantity of oil delivered mechanically printed on the ticket.
- A sales sequence number mechanically printed.
- The price per gallon.
- The identity of the person making the delivery (this may be driver's name, initials, or code number).

The delivery truck is supposed to insert the ticket into the oil meter before pumping oil into your tank. When the delivery is completed, the meter prints the amount of oil that was pumped from the truck into your tank. The driver is supposed to remove the ticket from the meter, and give one copy to you. But that's not what happens when you're subjected to oil-shorting scams.

Watch Out for Four Oil-Shorting Rip-Offs

The four oil delivery scams described below are the most common.

Scam #1: Add-on sales. After delivering 500 gallons of oil to someone else, the delivery truck arrives at your building with a ticket already in the meter. The driver starts your delivery on the same ticket at 501 gallons instead of zero. And the result is that you pay for 500 gallons of oil that were delivered to someone else.

A driver should insert a *fresh* ticket when he arrives at your building and should *remove* the ticket from the printer at the end of the delivery.

Scam #2: Switching tickets. After completing your oil delivery, the driver makes some excuse to take your delivery ticket in the truck's cab, where he switches it for another ticket that's been preprinted with more gallons than were actually delivered. As a result, you're paying for phantom oil.

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Be aware that delivery drivers should not have preprinted amounts for undelivered oil or delivery tickets that show different quantities of oil for the same delivery.

Scam #3: Air in the oil. Every fuel truck is supposed to have an air eliminator—a device that removes air bubbles from the oil before they pass through the meter. If the air eliminator is broken or shut off, air bubbles in the oil will pass through the meter and get registered as delivered oil. As a result, you pay for air.

Scam #4: Heated oil. The oil company delivers oil that's too hot, but doesn't adjust the bill to account for the temperature. As a result, you end up paying for more oil than you actually got. To make the oil flow faster, fuel companies heat the oil before loading it onto delivery trucks. Since oil expands when it's heated, the oil company is supposed to record the temperature of delivered oil on a loading ticket—and reduce your oil bill to adjust for the expansion factor when the oil is above a certain temperature.

Beat Scams by Monitoring Oil Deliveries

The best way to beat oil-shorting scams is to have your oil company make deliveries only when someone from your maintenance staff can closely monitor the process. You can have your staff watch every phase of every oil delivery from start to finish. You can have them check the trucks, oil meters, delivery tickets, and receipts. Here are some monitoring steps you can utilize. We've also provided a *Model Form: Give Oil Delivery Checklist to Maintenance Staff* covering these steps. Give it to your staff to use for each delivery.

1. Check oil level before delivery begins. Use one of three commonly used devices to check how much oil is in your tank before an oil delivery. And record the amount. Here are the three devices:

◆ **Dipsticks.** Dipsticks are inexpensive and highly accurate (often within five to 10 gallons). The dipstick works in your building's tank like a smaller version works in the oil tank in your car. To use the stick, get to the opening on top of the tank and sink the stick in until it touches the bottom. (Be prepared to get dirty, and make sure you have enough headroom to lower the stick—dipsticks are often 12 feet long). When you withdraw the stick, read the level reached by the oil. To get an accurate reading, you must buy a dipstick that's specially designed for your tank's size and shape. Your tank manufacturer can supply you with the tank's dimensions, and suggest the correct dipstick.

◆ **Petrometers.** A petrometer is a pressurized gauge with a wire going into the tank. When the petrometer is pumped up, a colored liquid inside a glass tube rises to tell you the level of oil in your tank, usually in increments of 50 gallons. Although many owners use them, the less expensive hand-pumped petrometers are accurate only within 50 to 75 gallons. Also, the pressure created by the hand pump doesn't hold the liquid at the reading level for very long, so you have to work fast to take the reading before the liquid in the gauge goes down.

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If you own a large building, you might want to buy a petrometer with a built-in air compressor that keeps the liquid at the right level. This type of petrometer is generally accurate, but is more expensive.

◆ **Fuel gauge.** If your maintenance staff can't reliably monitor oil deliveries with a dipstick or petrometer, there are fuel gauges that use sonar to keep track of the amount of oil in your tank. A fuel gauge also records the date, time, quantity, and temperature of any oil that's delivered to the building. And the data from the gauge can be delivered remotely.

2. Check delivery truck's oil meter seal. Make sure the meter's seal and the wire it's attached to are intact. This assures you that the meter is measuring oil properly. If the wire and seal are broken, don't accept a delivery unless it's an emergency.

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MODEL FORM

Give Oil Delivery Checklist to Maintenance Staff

The best way to defeat oil-shorting scams is to be vigilant. Your vigilance will act as a deterrent to oil companies tempted to overcharge you for deliveries. Have a designated staff member closely monitor the delivery process with the help of the following checklist.

OIL DELIVERY CHECKLIST

Complete this checklist for each oil delivery.

1. Record delivery date: _____
2. Read oil tank before fuel delivery and record reading: _____ gallons.
3. Check seal on delivery truck's oil meter. If wire or seal is broken, refuse delivery unless there's an emergency.
4. Check truck's oil meter reading when the driver inserts the delivery ticket into the meter. It should read "0." If meter doesn't read "0," instruct driver to turn the meter back to "0" before he puts the ticket into the meter.
5. Check delivery ticket before it goes into the truck's oil meter. Make sure ticket is fresh and that it's not preprinted with a certain number of gallons.
6. Check for Red Flags during delivery:
 - a. Does the flow of oil, as indicated by the speed with which the truck meter reading increases, seem to be steady? YES NO
 - b. Does the truck hose through which the oil is being pumped "jump" at all during the delivery (may indicate that air rather than oil is passing through)? YES NO
7. Check delivery ticket when it's removed from the oil meter. Make sure the ticket reading matches the reading on meter. Don't let driver take ticket into the truck's cab and switch it for a preprinted ticket.
8. Check driver's loading ticket and record oil temperature: _____ degrees Fahrenheit.
9. Read oil tank after delivery and record reading: _____ gallons.
10. Re-measure 30 minutes after delivery: _____ gallons.
11. Give completed checklist to manager.

Risk Management

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3. Make sure truck's oil meter reads "0" when driver inserts ticket into meter. If the meter isn't at "0," make sure the driver turns it back to "0" before he puts the ticket into the meter. This stymies the "add-on sales" scam.

4. Inspect delivery ticket before and after it goes into meter. Make sure the meter contains a clean, unused ticket. This prevents a driver from falsely inflating the amount of oil actually delivered by using a meter ticket from a prior, larger delivery. The driver must start out with a fresh delivery ticket that's not preprinted with a fuel quantity before he puts it into the oil meter. When the delivery is finished, make sure the reading on the delivery ticket matches the reading on the meter. Get the ticket as soon as the driver takes it out of the meter. Don't let the driver take the ticket into his truck cab where he could switch it for another. This will thwart the "switching tickets scam."

5. Look for red flags during delivery. During the delivery, have a staff member position himself at the back of the truck and continuously observe the delivery and the appearance of any "red flags." The main observations to make are: (1) whether the flow of the oil, as indicated by the speed with which the truck meter reading increases, seems to be steady; and (2) whether the truck hose through which the oil is being pumped "jumps" at all during the delivery, which is an indication that air rather than oil is passing through. If the oil flow is erratic or the hose jumps, the building representative should question the driver.

6. Recheck your oil level twice. Immediately after an oil delivery, take a follow-up reading of your tank. Subtract the pre-delivery reading from the post-delivery reading. This number should roughly match the number of gallons on your delivery ticket. (Keep in mind that some hand-pumped petrometers can be off by 50 to 75 gallons.) However, if air was mixed in with the fuel and permitted to flow into the tank, the bubbles could cause a false reading, making it appear that more fuel was delivered than in actuality. Also, the fuel delivery vendor could have heated the fuel so that the quantity expands prior to pumping, thereby causing the quantity delivered to appear inflated. To combat both of these schemes, take a measurement directly after the delivery as well as 30 minutes later to allow time for the air to settle and the fuel to contract.

7. Compare bill to delivery tickets. Keep copies of your readings and tickets. Compare your calculation with the bill you get in the mail. Check to see that you're not being charged for more oil than was delivered, and that any necessary temperature adjustments were made for heated oil.

If you suspect that you're being shorted on oil deliveries or have any questions, reach out to your city's agency responsible for inspecting fuel delivery trucks. ♦