

Tax Less Tips

CPA Protector Plan's Monthly Risk Management Newsletter

Diligence Now, Protection Later... Managing risk through use of an effective firm engagement letter.

An engagement letter can be a CPA's most effective shield. Regardless of the service provided, neglecting this shield is a penny-wise, pound-foolish approach that could result in misunderstandings, additional costs and even litigation. Taking the time to craft an effective engagement letter can save substantial time and expense in the future as well as protect against liability. An effective engagement letter clearly outlines the scope of the engagement, provides tools for resolving disputes and includes steps to avoid unnecessary expense.

Defining the Scope of the Engagement

It is crucial that an engagement letter clearly defines the scope of the engagement and the responsibilities of both the CPA firm and the client. An engagement letter should be tailored for each engagement and should include a thorough description of the services to be provided as well as a list of those that will not be provided. In today's litigious environment, it is important to avoid any misunderstanding as to the work to be performed by a CPA – misunderstandings can harm client relations and even lead to lawsuits.

Common claims arise from the client's mistaken belief that the engagement involves some aspect of fraud prevention or embezzlement discovery by the CPA. This is usually not the case. A specific caveat, such as "this engagement is not designed to and cannot be relied upon to detect fraud or embezzlement," may be appropriate in most circumstances.

Limiting Liability and Costs

It is possible to limit liability in an engagement letter. Potential lawsuits can be nipped in the bud or won because of what a CPA firm does to protect itself before an issue arises.

Depending on the CPA's jurisdiction, parties can even contractually shorten the period during which the client can bring a malpractice claim. For example, in New York, where accountant malpractice is governed by a three-year statute of limitations, such contractual provisions are usually proper as long as they are in writing, unambiguous and set a minimum time period of at least one year.

For example:

"Any and all claims by [Client] arising under this engagement must be commenced by [Client] within one (1) year following the date on which [Firm] delivered the [Anticipated Completed Work Product] associated with this engagement. If the completed work product is not delivered to the client, for any reason, any and all claims by [Client] arising under this engagement must be commenced by [Client] within one (1) year following the date [Client] is informed of the engagement's termination."

Additionally, for non-attest services, a CPA can use an indemnification clause that limits liability as there are no restrictions on the use of indemnification and liability-limitation clauses for non-attest services, and the arrangement is merely subject to negotiation between the CPA firm and the client. However, if met with resistance, the firm may point out to the client that without indemnification or liability-limitation clauses, fees may be higher to compensate for the increased risk associated with the engagement.

Regardless of the services provided, an engagement letter can protect against unnecessary expenses with an indemnification clause that addresses the costs associated with, for example, responding to subpoenas. Accounting firms are often subpoenaed and called to testify regarding a client's financial condition, regardless of the services performed. The costs associated with compliance can be substantial. It is important to ensure that the firm will be indemnified for all potential recoverable costs.

For example:

"You agree to indemnify [Firm Name], its successors and assigns, partners, principals and employees, to the fullest extent permitted by law for any expense, including compensation for our professional time and reimbursement for our out-of-pocket expenses and attorneys' fees, incurred in complying with or responding to any request (by subpoena or otherwise) for testimony, documents or other information concerning the [Company] by any governmental agency or investigative body or by a party in any litigation or dispute other than litigation or disputes involving claims by the [Client] against [Firm]. This indemnification will survive the termination of this engagement."

Fees and Dispute Resolution

From time to time, clients will attempt to avoid paying bills. An effective engagement letter can expedite the bill collection process by clearly outlining the payment system and the procedures that would be initiated in the case of a default.

Every engagement letter should detail how and when the client will be billed. Hourly billing rates, flat fees or other ways to compute fees should be clearly spelled out in the engagement letter, along with an accompanying payment schedule. Some firms charge a late fee for balances unpaid after 30 days, usually some amount of reasonable interest. Moreover, a firm can include a provision that explicitly permits the firm to stop all work or withdraw from the engagement until the client is up to date with its payments.

An engagement letter should contain a section outlining the dispute resolution process to be initiated in the case of a conflict. Many firms prefer alternative dispute resolution to avoid the potentially substantial costs associated with litigation. Additionally, a lawsuit for unpaid fees may trigger a malpractice counterclaim. Mediation or arbitration may help the firm pursue payment with a reduced risk of a counterclaim.

An engagement letter may provide for mediation and, if mediation fails, arbitration. By including a proper dispute resolution clause, a CPA firm can create the most desirable arbitration process. For example, the American Arbitration Association has specific rules for accountants in their Professional Accounting and Related Services Dispute Resolution Rules. Moreover, a dispute resolution clause will allow a firm to pick the venue, the law to be applied and other carefully tailored details of the arbitration.

Conclusion

Taking the time to draft an effective engagement letter can protect an accounting firm from expending time and money in the future. An engagement letter is a CPA's greatest defense and should be treated as such.

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