

# AICPA Professional Liability Insurance Program



Preparing and Using Engagement Letters

**CNA**

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## Executive Summary

- Engagement letters should be customized for each engagement based on the terms agreed upon with the client. This guide provides CPAs with examples of how common topics can be covered in engagement letters.
- The content of draft engagement letters should be discussed and agreed upon by the CPA firm and the client. If an engagement letter template is used for drafting individual letters, the letters should be tailored to each engagement to reflect the objectives, scope and limitations of the engagement, the responsibilities of the CPA firm and the client, and other terms and conditions as required by the firm.
- An engagement letter is often the controlling factor in determining the responsibilities of both parties in client-asserted professional liability claims against CPAs.
- Attorneys who specialize in defending CPAs facing professional liability claims agree that obtaining a signed engagement letter before services are rendered is an effective defense tool, especially if the scope of the engagement is disputed.
- Since statutes and case law addressing privity of contract vary from state to state, engagement letter language addressing third-party usage of the CPA's work product must be customized to the jurisdiction in which services are rendered.
- The statute of limitations begins upon discovery of the error or omission in some states. However, in many states, the statute of limitations for suits against CPAs alleging professional malpractice begins to run on the date the services are concluded. In order to help establish proof of this date, the engagement letter should indicate that the services will conclude with the delivery of the final work product or by a specific date. In an ongoing engagement, a new engagement letter should be issued each year, and whenever the scope of service changes.
- Certain courts view engagement letters as contracts, and local laws applicable to the matters included in engagement letters vary significantly. Certain governmental bodies, commissions, regulatory agencies, state boards of accountancy or professional organizations have established requirements that may prohibit entities subject to their regulation or professional standards from including engagement letter provisions that limit the rights of clients. Accordingly, before using an engagement letter, a competent attorney should carefully review it for conformity with applicable law.



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## Setting the Stage

Both large and small CPA firms continue to be subject to claims and lawsuits regarding work performed for clients. More than two-thirds of all professional liability claims in the AICPA Professional Liability Insurance Program (the Program) arise from allegations of malpractice against the CPA by the client (rather than third parties). In such disputes, the engagement letter (or lack thereof) is an important to determine the responsibilities of the CPA and the client. Expectation gap problems can often be mitigated through the use of



engagement letters that clearly define the scope of the engagement and the responsibilities of the client and CPA firm, especially in non-attest engagements.

As hypothetical examples, consider the following:

### Engagement Letter Used

A small CPA firm was engaged to compile a retail client's annual financial statements. The CPA responsible for the engagement prepared an engagement letter for signature by the client. The letter, in part, included disclosure language in the illustrative engagement letter in the AICPA *Statements on Standards for Accounting and Review Services* pertaining to the scope and limitations of the engagement. The signed engagement letter was placed in the CPA's work paper file.

Approximately six months after the CPA delivered the financial statements, the client discovered that its bookkeeper had embezzled more than \$100,000 by altering and forging checks. The bookkeeper was tried and convicted on criminal charges, but was unable to make restitution, as the stolen funds were lost supporting a gambling habit.

The client sued the CPA firm, alleging that the firm failed to discover the theft in connection with its "audit" of the client's books and records. However, the engagement letter clearly defined the scope of the CPA's work, as well as the CPA's responsibilities related to that scope. Therefore, the CPA firm's defense attorney was able to use the engagement letter as evidence that the CPA firm was not responsible for identifying the fraud while performing a compilation in accordance with AICPA professional standards. This evidence thus became a key element in the successful defense of the lawsuit.

## Engagement Letter Not Used

For several years, a CPA firm had been preparing state and federal corporate income tax returns for a client that performed restorations to antique ornamental ironwork and installed prefabricated ornamental ironwork. No engagement letters were issued.

During the fourth year of rendering services for the client, the client received a deficiency notice from the state of domicile, stating that the company owed sales tax on the sale of prefabricated ironwork. The state sought in excess of \$200,000 in penalties and interest in addition to the sales tax owed.

After losing on appeal to the state taxing authorities, the client sued the CPA firm. The client alleged that the CPA firm was engaged to provide ongoing advice on all tax-related matters, and that the firm was negligent in failing to advise the client of the requirement collect and remit sales tax to the state on the sale of prefabricated ironwork.

At trial, the CPA testified that the firm was only engaged to prepare the federal and state income tax returns for the client, and that the client never requested advice on sales tax issues. The client's bookkeeper refuted this testimony, countering that he relied upon the CPA to advise him on all tax-related matters, as did the owner of the company.

The jury awarded over \$250,000 to the client, including interest and attorney fees. In polling the jury after the trial, the defense attorney for the CPA firm learned that jurors found the client's version of what happened more credible than that of the CPA. Several jurors commented that in the absence of written evidence, they could not find that the client knew and understood that services would be limited to the preparation of the state and federal income tax returns. They believed that the client was not sophisticated in accounting and tax matters and that it was reasonable to assume that the client was relying on the CPA for all tax-related advice.

## Purpose of This Guide

The AICPA Professional and Personal Liability Insurance Program Committee (“PPLIP”) monitors the Program’s performance to understand and meet the needs of CPAs in public practice. PPLIP recognized a need for tools to assist CPA firms in drafting effective engagement letters, which can help CPAs avoid misunderstandings with clients and defend themselves in the event of a claim. As such, CNA risk control professionals developed this guide. CNA has also developed resources to supplement this guide, including *An Introduction to Engagement Letters* podcast and sample engagement letters for various client service engagements. These resources are available to CNA policyholders via the Policyholder Resource Center at [www.cpai.com](http://www.cpai.com).

This guide discusses and provides suggested language related to general use engagement letters. Specific types of services or engagements require engagement letters customized to the client situation. Any matters or terms unique to an engagement that are agreed upon between the CPA firm and the client in advance of rendering professional services should be documented in the engagement letter.

## When Should I Issue an Engagement Letter?

The accounting profession remains under significant scrutiny by regulatory agencies, businesses, and the general public. Much of this scrutiny has focused on the scope of accountants' responsibilities when rendering client services. The engagement letter can be an effective tool in defending claims where the engagement scope is in dispute. Professional standards promulgated by the AICPA, including AICPA *Ethics Interpretation 101-3*, and *Treasury Department Circular No. 230* also reinforce the importance of documenting the understanding between the accountant and the client.

It is recommended that CPA firms issue engagement letters for *all* engagements prior to rendering any services, even if an engagement letter is not required by the AICPA Professional Standards. A new engagement letter should be issued annually for recurring work. If the scope of an ongoing engagement changes during the year, depending on the significance of the changes, either an amendment to the existing letter or a new engagement letter should be issued. When a client requests either a change in services or additional services, the principal in charge of the engagement should discuss, clarify, and document the proposed changes with the client. Sending a follow-up letter to the client and including documentation in the client's work paper file are effective methods of memorializing changes to the engagement. Follow-up letters can explain and confirm the change in services and fees and refer the client back to the engagement letter, indicating that the change in services will continue to be governed by the terms of the engagement letter issued for that year.

If the CPA firm provides services to both a business entity and its owners, the services should be covered in separate engagement letters addressed to the entity and to the individual owners.

### Evergreen Engagement Letters

A well-drafted engagement letter defines the timing of the engagement. In the interest of saving time or reducing administrative burden, some CPA firms issue engagement letters that indicate services will continue until either party terminates the professional relationship. These types of engagement letters, which are often referred to as *self-renewing* or *evergreen* letters, either renew automatically or do not specify a time period for the performance of services.

Clients sometimes attempt to assert a claim several years after the service was rendered. In many cases, these claims would be time-barred based upon applicable state statutes of limitations. A successful statute of limitations defense may be dependent upon producing evidence that an engagement ended on a specific date. An engagement letter, which defines the timing of the engagement and is signed by both the client and the accounting firm, can serve as such evidence. In the event of a claim, evergreen letters have the potential to jeopardize a successful statute of limitations defense.

### Unilateral Engagement Letters

Some firms issue *unilateral* engagement letters that do not require a client signature. Unilateral engagement letters may be appropriate for comparatively low-risk engagements with standard terms (i.e., preparing individual income tax returns for wage earners with ordinary income). When unilateral engagement letters are used, there is a risk that the client will allege either that it did not consent to the arrangement or requested different or additional services, or that the terms and conditions were not fair or equitable and had they fully understood them, they would not have engaged the CPA firm. For these reasons, engagements with increased exposure, such as the preparation of returns for self-employed individuals and corporations, should be governed by engagement letters signed by both the CPA firm and

the client, not a unilateral engagement letter. If a unilateral letter is used, the firm should not start the work until the client has acknowledged receipt of the letter or acknowledged agreement of the terms of the engagement by actions such as providing a completed tax organizer to the CPA. The unilateral engagement letter may include the following language:

“To accept our firm’s offer to perform services on the terms set forth in this engagement letter, forward the tax organizer and/or other tax return information requested to us. By doing so, you agree to be bound by the terms and conditions set forth above.”

## Reviewing Engagement Letters with Clients

Managing client communications is a key element in a risk control program. Reviewing engagement letters with clients helps ensure the client understands the scope and limitations of services, and the respective responsibilities of the client and the CPA firm. This protocol is especially important when issuing an engagement letter to a client for the first time.

Whether being engaged by a new client or a longstanding client, the principal in charge of the engagement should discuss the engagement objectives and the content of the engagement letter with the client’s authorized representative prior to both having the client sign the engagement letter and commencing services. If the firm’s practice requires signed engagement letters, the client should be informed that the requirement applies equally to all clients.

When discussing the engagement letter with a client, the firm should think from the client’s perspective – what do they need to know in order to feel comfortable signing the letter? Clients should understand what an engagement letter is, why it is required, and what benefits it provides to the client and the CPA firm.

Some important topics to address include:

- Clarifying the objectives of the engagement;
- Defining the nature, scope, and timing of the services the CPA firm is being engaged to perform and the limitations of these services;
- Identifying the deliverables or work products to be issued, including any restrictions on the use or distribution of deliverables;
- Identifying the responsibilities of both the CPA firm and the client under the engagement, and potential consequences if either party fails to perform fulfill them;
- Explaining the cost of services as well as the billing and payment terms;
- Communicating the circumstances under which the CPA firm may withdraw or terminate the engagement without completing the work; and
- Requiring written acknowledgment of any change in scope of services – either by amending the existing engagement letter or issuing a new engagement letter.

## Client Communications Required by the AICPA

The CPA firm should establish an understanding with the client regarding the nature of the engagement. This should be documented in the engagement letter or in firm workpapers. For certain types of engagements, professional standards require this understanding to be memorialized in the form of a written communication. For other types of engagements, such as consulting and valuation, the AICPA professional standards require CPAs to obtain an understanding of the engagement with the client, but do not expressly require written communication with the client. Use of engagement letters is recommended, even if the standards do not require it.

AICPA Professional Standards do not require engagement letters to be signed by both the CPA firm and client (or, if applicable, those charged with governance). However, obtaining the client's signature on the engagement letter before commencing services is recommended. Doing so helps demonstrate the client's affirmative acknowledgement of the terms and conditions related to the services to be provided.

### Audit and Attestation Engagements

For audit and attestation engagements, *AICPA Statements on Auditing Standards (SAS) No. 122, Planning and Supervision* (AU-C Section 210) and *AICPA Statements on Standards for Attestation Engagements (SSAE) No. 10, Attest Engagements*, (AT Section 101.46), state that the practitioner should establish an understanding with the client regarding services to be performed. These Statements indicate that the understanding should include, for example, the nature and objectives of the engagement, management's responsibilities, the practitioner's responsibilities, and limitations of the engagement. Audit standards state that this understanding should be documented in the form of a written communication between the auditor and the client. For attest engagements, the standards indicate that the practitioner should document the understanding in the workpapers, preferably through a written communication with the client.

*AICPA Ethics Interpretation 101-3, Performance of Non-attest Services* (ET Section 101.05), requires written documentation of an understanding with an attest client when a member renders non-attest services to the client.

### Compilation and Review Engagements

For financial statement compilation and review engagements, *AICPA Statements on Standards for Accounting and Review Services (SSARS) No. 19, Compilation and Review Engagements* requires that an accountant document the establishment of an understanding with the client in an engagement letter, regardless of the level of service or the intended users. The understanding should include a description of the nature and limitations of the services to be provided and a description of the report the accountant expects to render.

### Tax Services

*U.S. Treasury Department Circular No. 230*, §10.33 promotes best practices for tax advisors, including communicating clearly with the client regarding the terms of an engagement (e.g., the form and scope of the advice or assistance to be rendered).

### Additional Guidance

The *AICPA Professional Standards*, practice guides, training materials, and other reference materials identify topics for inclusion in engagement letters and provide guidance regarding the content of engagement letters.

Sample engagement letters are also included in these materials. In addition to this engagement letter guidance and CNA's sample engagement letters, practitioners should review these sources for assistance in drafting engagement letters. Listings of selected AICPA professional standards and other reference materials relevant to establishing an understanding with a client are available in the Appendix.

## Third Parties and Engagement Letters

Third parties, such as lenders, investors, or client vendors sometimes assert professional liability claims against CPA firms alleging that in making a business decision, a third party relied in some way upon services performed for the client by the CPA firm, and that they suffered damages as a result.

Legal standards that establish who has standing to sue an accountant vary by state. Generally, four approaches have been taken by the courts regarding this issue: foreseeability, restatement, near-privacy, and privity.

### Foreseeability

Under the foreseeability approach, the CPA owes a duty to anyone whom the court subsequently determines the CPA should have reasonably foreseen as a recipient of his or her work product. Foreseeability represents the most expansive approach.

### Restatement

In the majority of states, the CPA owes a duty to a limited class of third parties that the CPA knew at the time services were being rendered were going to rely upon their work product for a specific purpose. This standard has been adopted in a treatise called the *Restatement of Torts* and is thus referred to as the Restatement approach.

### Near-Privacy

This approach sets forth a three-part test that must be met by third-party plaintiffs to establish standing to sue an accountant:

1. The accountant must have been aware that the work product would be used for a specific purpose;
2. The accountant must have known that a certain party or parties intended to rely on their work; and
3. There was conduct by the accountant linking the accountant to the party or parties, evidencing the accountant's understanding of their reliance.

### Strict Privity

Under this approach, only the accountant's client has standing to sue the accountant. Strict privity reflects the least expansive approach recognized by the courts but has only been adopted by a few states.



In many instances, accountants have the ability to affect the rights of third parties who may rely on their work. The engagement letter provides the accountant an opportunity to do this. Certain third parties can be named and acknowledged as recipients or users of the work product. Conversely, accountants may restrict the use of the work product to certain parties by noting this in the engagement letter and work product documents, such as the audit report.

Because the law varies from jurisdiction to jurisdiction, engagement letter language regarding this issue should be customized to the facts of each case and the jurisdiction in which services are being rendered. Both written communication and other contact between a CPA and third parties can significantly affect the rights of third parties to sue a CPA (e.g. attending a meeting with a client's lender). For more information on the legal standard applicable in a specific state, practitioners should consult with their state CPA society and local counsel for guidance. The AICPA also maintains relevant information on its website at <http://www.aicpa.org>. Because the law regarding who has standing to sue an accountant may change and CPAs often practice in multiple jurisdictions, it is important to keep abreast of the status of the law in this area and adapt your engagement letter practices to such changes.

## Identification of the Client and Description of Scope of Services to be Rendered

Identifying the client by name evidences that the engagement is between the CPA firm and the identified party. Without documentation of the client name, third parties may assert that the engagement was performed for their benefit. This issue can be particularly important in the event of disputes involving divorcing clients, partnerships, trusts, joint ventures, and closely held businesses. When services are being rendered to an entity, identify the entity as the client, rather than the individual who hired the CPA firm.

The engagement letter should define the scope of services a firm will perform for the client. The description of services should be clear and include sufficient details to avoid any possible misunderstanding or misinterpretation by the client. “Bookkeeping services,” “accounting services,” and “tax services” are examples of broad descriptions of services, which are subject to interpretation and do not sufficiently define the scope of services. Additionally, clients may assume that certain services are included in the scope of the engagement. For example, “We will prepare your U.S. Individual Income Tax Return (Form 1040) and California Resident Income Tax Return (Form 540)” is preferable to “We will prepare your federal and state tax returns.” The broader description can expose the firm to allegations of failure to prepare other tax returns (e.g., payroll, sales and use, property, excise, or transfer tax, etc.) or other state tax returns.

Engagement letters should separately address each service to be rendered. For each service, the scope, terms of service, applicable professional standards, limitations to services, laws, and regulations may vary. Depending on the extent and complexity of services to be rendered, consider issuing an annual engagement letter for each type of professional service.

### Additional Services

In many claims made against Program policyholders, plaintiffs have alleged that the CPA firm did not fulfill the expected scope of services. For example, the engagement letter may state that the client engaged the firm to prepare his or her federal individual income tax returns. The client may expect that this includes additional services such as preparing *all* federal and state tax returns, identifying and advising on tax planning strategies, and handling all inquiries from tax authorities. This “expectation gap” often develops as the relationship with the client matures. Additional services beyond the scope specified in an engagement letter may be addressed as follows:

“You may request that we perform additional services not contemplated by this engagement letter. If this occurs, we will communicate with you regarding the scope and estimated cost of these additional services. Engagements for additional services may necessitate that we issue a separate engagement letter or addendum to this engagement letter to reflect the obligations of both parties. In the absence of any other written communications from us documenting additional services, our services will be limited to and governed by the terms of this engagement letter.”

When clients request additional services, miscommunications may be avoided by having the engagement principal respond to such requests and follow-up on client discussions with a letter that recaps the discussion and details any agreed upon changes in services and fees. If the change is a minor deviation from an existing engagement, the letter may indicate that the additional services will continue to be governed by the terms and conditions of the previously issued engagement letter, a copy of which would be enclosed, with the changes identified in the new letter. If the additional services significantly expand the scope of engagement, or are completely unrelated to an existing engagement, the firm should consider issuing a new engagement letter to cover only the additional services.

## Restricting the Use and Distribution of Deliverables

CPA firms can limit their liability to third parties by restricting the use and distribution of the firm's report or work product to the client. If the report will also be used by known third parties, the use of the report can be restricted to the client and those specified parties. Several accounting and auditing standards apply to the restriction of the accountant/auditor's report.

- SAS No. 125, *Alert That Restricts the Use of the Auditor's Written Communication* (AU-C Section 905), SSARS No. 80, *Compilation of Financial Statements* (AR Section 80.30–38), and SSARS No. 90 *Review of Financial Statements* (AR Section 90.37–45) provide guidance about restricting the use of reports.
- In an attest engagement, the use of a report may require restrictions in certain circumstances. See SSAE No. 10, *Attest Engagements*, (AT Sections 101.78–83, 101.114–115), SSAE Nos. 10 and 11 *Agreed Upon Procedures* (AT Section 201.06) for further information.
- In an engagement to compile a client's financial statements for management's use only, the use of the compiled financial statements should be restricted to the client (AR Section 80.22–.24 and 80.63 (Compilation Exhibit A)).
- Under other professional standards, the CPA may consider restricting the use of the resulting report. See AICPA *Statements on Standards for Valuation Services* sections VS 100.12 and 100.49 and AICPA *Statement on Standard for Consulting Services* section CS 100.02.

Additionally, Practice Aid 04-1 *Engagement Letters for Litigation Services*, paragraph 46, provides guidance to restrict the use of work without authorization.

### Restriction on Use of Deliverables

After reaching an understanding with a client concerning the use of a report, this understanding should be documented in the engagement letter.

Such language might read as follows:

“The financial statements to be compiled are intended solely for the information and use of [include list of specified members of management] and are not intended for and should not be used by any other party.”

Or

“The deliverable(s) presented as part of this engagement are for the internal use of your management and the Board of Directors and are not to be distributed externally to third parties, in whole or in part, or used for any other purpose.”

### Restriction on Distribution of Deliverables

Except in cases where a client is subject to regulation requiring the distribution of a report to a third-party user (for example, in an audit engagement for a client receiving government funding), the use of any CPA firm report may be restricted to management-use only by including language in both the engagement letter and the report.

Consider the following sample language:

“You agree not to distribute, reproduce, or publish our report, or any portion of it to other parties not specified in this engagement letter without our consent. If we consent, you agree to provide us with copies of masters’ or printers’ proof of the entire document in sufficient time for our review and approval before distribution or print. You also agree to provide us a copy of the final reproduced or printed material for our approval before it is distributed.”

## Consent Considerations

In accepting the appointment as an auditor, CPA firms should consider restricting the use and distribution of the firm’s audit report to prevent use in connection with a private securities offering or SEC filing without the firm’s written consent.

The following sample language may be used for this purpose:

“[Client Name] may wish to include or incorporate by reference our audit report on the financial statements in a private offering or SEC filing by another party. You agree to not include our audit report or make any reference to our firm without first obtaining our written consent to same. Additional services may be required prior to providing such consent related to a private or public offering of securities, or inclusion in an SEC filing. Such services will be undertaken as a separate engagement at an additional fee.”

For further discussion of considerations when asked to consent to include the firms’ previously-issued report in a securities offering, please see *An Auditor’s Dilemma: To Consent or Not to Consent*,” at [www.cpai.com](http://www.cpai.com).



## Description of Client Responsibilities

While a CPA has specific responsibilities in an engagement, the client also has responsibilities, many of which are defined in the AICPA professional standards. For example, the client is responsible for establishing and maintaining a system of internal controls, making all management decisions, and performing all management functions. These responsibilities should be included in the engagement letter to illustrate clearly what the CPA firm expects from the client, and, conversely, what the client cannot and should not expect from the CPA firm. Additionally, AICPA Ethics Interpretation 101-3, *Performance of Non-attest Services*, requires that a CPA who performs non-attest services for an attest client establish and document their understanding with the client regarding, among other things, the client's acceptance of their responsibilities to perform all management functions and make all management decisions in connection with the CPA's non-attest services.

Sample language that could be used is:

“As a condition to our performing the services described above, you agree to:

- make all management decisions and perform all management functions, including determining account codings and approving all proposed journal entries;
- designate an individual who possesses suitable skill, knowledge, and/or experience, preferably within senior management, to oversee the services;
- evaluate the adequacy and results of the services performed;
- accept responsibility for the results of the services, including decisions regarding the implementation of any recommendations provided by us; and
- establish and maintain internal controls as well as monitoring ongoing activities.”

In certain engagements, such as consulting or bookkeeping engagements, consider stating that the CPA will not make any management decisions or perform any management functions. In these instances, the following language may be appropriate:

“[CPA Firm], in its sole professional judgment, reserves the right to refuse to take any action that may be construed as making management decisions or performing management functions.”

Additional client responsibilities are expected when performing audits of financial statements and should be communicated to the client in the engagement letter. Sample language that could be used is:

“Management is responsible for the following functions:

- establishing and maintaining effective internal control over financial reporting, including monitoring ongoing activities, including but not limited to supervision of your staff;
- Selection and application of an applicable and appropriate financial reporting framework;
- designing, implementing and maintaining programs and controls to prevent and detect fraud;
- identifying and ensuring that the company complies with the laws and regulations applicable to its activities;
- establishing and maintaining adequate records;
- making all financial records and related information available to us on a timely basis and assuring that the records and information are complete and accurate;
- selecting and applying accounting principles;
- safeguarding of assets;

- adjusting the financial statements to correct material misstatements and affirming to us in the management representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole;
- informing us about all known, alleged, or suspected thefts or fraud that involves company management, employees, former employees, or others where the thefts or fraud could have a material effect on the financial statements;
- confirming certain representations made to us in the management representation letter;
- reviewing and approving the financial statements prior to their issuance, and assuming responsibility for the fair presentation of financial statements, including all footnote disclosures; and
- [*Optional – if non-attest services are provided to the attest client*] assuming all management responsibilities; overseeing the service [specify the non-attest service(s)] by designating an individual, preferably within senior management, who possesses suitable skill, knowledge and/or experience; for evaluating the adequacy and results of those services, accepting responsibilities for the results of those services, and making significant judgments and decisions.”

The client typically must provide information needed by the CPA firm to render services. The engagement letter should specify the scope and timing of these responsibilities, and that the information must be provided in a format usable by the firm. Without such communication, frustration, service delays, and fee disputes may follow. Providing the client with specific guidelines may help avoid these problems.

The following examples could be utilized:

“We will provide you with an income tax organizer to help you compile and document the information we will need to prepare your income tax returns. It is your obligation to complete the tax organizer with accurate and complete information, including worldwide income.”

Or

“If the requested information you provide is not submitted in a timely manner, or they are incomplete or unusable, we reserve the right to charge additional fees and expenses for services required to correct the problem. If this occurs, we will contact your representative to discuss the matter and the anticipated delay in performing our services.”

See CNA sample tax engagement letters for additional responsibilities to include.

## Responsibility for Detecting Fraud and Illegal Acts

A CPA's responsibility for detecting financial statement misstatements or asset misappropriation caused by fraud and/or illegal acts varies depending on the level of services performed. No matter what type of service is performed, there is a risk that the client and/or a third party could misconstrue the CPA's responsibility for detecting fraud and illegal acts. For example, allegations of failure to detect theft or fraud have been made against accountants who provided tax compliance or bookkeeping services.

Engagement letter content regarding a CPA's responsibility for detecting fraud and illegal acts by client employees and others is an important element in the defense of such allegations. *All* engagement letters should reflect this critical issue regardless of the scope of services being provided.

### Audit Engagements

A CPA's responsibilities for detecting financial statement misstatements caused by fraud and for detecting illegal acts in connection with a financial statement audit have been the subject of study and discussion for many years. Professional standards and guidance on these matters are included in *AICPA Professional Standards*, AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* and AU-C Section 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. Although duty of auditors is limited to "...a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud" (AU-C Section *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards* 200.12), clients as well as the public-at-large increasingly expect auditors to detect any or all fraud and embezzlements regardless of the level of materiality. Therefore, the auditor must communicate his or her responsibilities related to fraud and illegal acts in the engagement letter with the client.

In an audit engagement letter, this communication may read as follows:

"We will conduct our audit in accordance with auditing standards generally accepted in the United States of America [*or the applicable auditing framework used*]. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud. Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, account balances, and disclosures, there is a risk that material misstatements, whether caused by error or fraud, may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements or incidents of fraud or illegal acts that do not have a direct and material effect on the financial statements. However, we will communicate to management and those charged with governance, any errors, fraud, or other illegal acts that come to our attention during the audit, unless clearly inconsequential."

### Compilation and Review Engagements

CPAs engaged to provide compilation and review services are often alleged to have failed to detect fraud and illegal acts despite the fact that the scope of these services is significantly less than that of an audit of financial statements. In many cases, clients sustaining fraud losses do not understand the nature and scope of these services and the limited responsibilities assumed by the CPA. In addition to educating clients about the scope of compilation and review services, CPA firms should incorporate a description of their responsibility for detecting fraud and illegal acts in engagement letters covering these services.

The following is a sample of such a disclosure:

“Our engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform the appropriate level of management of any material errors and of any evidence or information that comes to our attention during the performance of [compilation/review] procedures that fraud may have occurred. In addition, we will report to you any evidence or information that comes to our attention during the performance of our [compilation/review] procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.”

### Other Services

Engagements to provide other services such as tax, bookkeeping, business valuation, personal financial planning and consulting services (except certain specifically defined and detailed forensic and litigation services) do not generally include any procedures designed to detect fraud or illegal acts. Engagement letters for such services should disclaim any responsibility for detecting fraud and illegal acts. The following is an example of language that may be used:

“Our engagement does not include any procedures designed to detect errors, fraud, or theft. Therefore, our engagement cannot be relied upon to disclose such matters.”



## Timing of the Work

In most engagements, information deadlines, filing deadlines, and scheduling requirements affect the timing of services provided by the CPA firm. An explanation regarding when the work is expected to be performed may help reduce the risk of disputes with the client relating to the timing of the work. In some states, the statute of limitations period for a client or third party to file a claim for professional liability begins to accrue on the date that the professional services at issue were completed or reliance was placed on the work performed. In those jurisdictions, establishing proof of when services were completed is critical to determining the statute of limitations period. To address both issues, the CPA firm should document in the engagement letter the estimated starting date for professional services, as well as any filing or other deadlines. Explain when services will end, either by identifying the final work product and indicating that services are concluded when the work product is delivered to the client, or by providing an estimated date for the completion of services. If services are ongoing, such as monthly bookkeeping services, specify an end date, no longer than one year from the start date. Any services provided after that date should be governed by a new engagement letter.

The following language could be used:

“We are prepared to begin work upon receipt of a signed copy of this engagement letter and at a time mutually determined by you and [CPA Firm Name] and the information requested in the attached Schedule X. Our services will conclude with the delivery of our [report] to you, issuance of our closure letter to you,<sup>1</sup> or written notification by either party that the engagement is terminated, whichever occurs first. [Note: Limit timing of engagement to no longer than one year to allow the statute of limitations to begin to accrue.] Any extension of this engagement must be set forth in writing and signed by both parties.”

For audit services:

“We plan to begin our audit on approximately [Date] and currently plan to issue our report on approximately [Date]. The timing of our work is dependent on the timely receipt of the information we requested from you.”

For tax services:

“We expect to begin the preparation of your returns upon receipt of the completed 20XX tax organizer and all tax documents requested either in the organizer or by our office.

If your return is electronically filed, our services will conclude upon the earlier of the filing and acceptance of your 20XX tax returns by the appropriate taxing authorities or one year from the execution date of this letter. You will be required to verify and sign a completed Form 8879, IRS e-file Signature Authorization, and [state equivalent authorization form] before your returns can be filed electronically. You are responsible for reviewing the accuracy of all tax returns and any accompanying schedules and statements prior to filing.

If your return is filed by mail, our services will be concluded upon the earlier of delivery to you of your 20XX tax returns for your review and filing with the appropriate taxing authorities or one year from the execution date of this letter.”

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<sup>1</sup> See CNA sample engagement closure letter available via the Policyholder Resource Center at [www.cpai.com](http://www.cpai.com).

As statutes of limitation periods vary by state and by the type of legal action (e.g., tort, contract, fraud, etc.), local counsel should be consulted for guidance regarding their application to a specific engagement.

## Consequences of Extending Completion Deadlines

Clients should be informed of the possible consequences of extending the deadline to file a tax return or to extend the due date for other government filings. In the absence of evidence establishing that this occurred, clients may allege that the CPA firm failed to inform them of these potential consequences, and that any damages they suffered due to the extension of time (e.g., penalties, interest, lost benefits) should be attributable to the CPA firm. These problems may be avoided by including an explanation of the potential consequences of delayed filings:

Sample wording is as follows:

“The original filing due dates for your income tax returns are [month & date, 20XX] for federal and [month & date, 20XX] for [State]. [If a large number of returns are included, consider including this as an appendix].

It may become necessary to apply for an extension of the filing deadline if there are unresolved tax issues or delays in processing, or if we do not receive all of the necessary information from you on a timely basis. Applying for an extension of time to file may extend the time available for a government agency to undertake an audit of your return or may extend the statute of limitations. All taxes owed are due by the original filing due date. Additionally, extensions may affect your liability for penalties and interest or compliance with government or other deadlines.

**To the extent you wish to engage our firm to apply for extensions of time to file tax returns on your behalf, you must notify us of this in writing. Our firm will not file these applications unless we receive either a signed copy of this engagement letter or your express written authorization to do so. In some cases, your signature may be needed on such applications prior to filing. Failure to timely file for an extension of time to file can result in penalties for failure to file tax returns, which accrue from the original due date of the returns, and can be substantial.**

See CNA sample engagement letters for tax services for additional provisions regarding extensions of time to file tax returns.

## Fees and Billing

### Billing Policies and Payment Terms

Providing clear explanations regarding the firm’s policy on billing of fees and expenses is critical to avoiding client disputes regarding payment and the accumulation of receivables. The engagement letter should provide an estimate for anticipated client fees and expenses, and the method of billing (hourly rate or fixed fee, for example). In situations where a fee estimate is not determinable (litigation services, for example), a range of fees and/or how they will be calculated should be included in the engagement letter. If a CPA firm’s home state regulates client billing methods, verify that the firm’s methods comply with applicable regulations.



Sample language regarding fees and billing methods might include the following:

#### Time and Materials

“Our fee is based upon the complexity of the work to be performed and our professional time to complete the work. Based upon the estimated effort to complete the scope outlined above, we estimate that our total fees for this project will range between  $[\$XX]$  and  $[\$XX]$  excluding out-of-pocket expenses. Circumstances encountered during the engagement or scope changes may require additional time and expense. We will notify you of such circumstances as they arise, and we will obtain your approval before proceeding.

Resource	Hourly Rate	Estimated Hours	Estimated Fees
Partner	\$ xxx		
Director	\$ xxx		
Manager	\$ xxx		
Senior Associate	\$ xxx		
Associate	\$ xxx		
<b>Total</b>		<b>XXX</b>	<b>\$XXX</b>

Our fees are not contingent on an action or event resulting from the analyses or conclusions in, or the use of, our report deliverable.

Fees for the services outlined above will be billed monthly at the standard billing rate for each of the professionals performing the work, plus out-of-pocket expenses. Invoices are due *[upon receipt or within XX days of the date on the billing statement.]*”

### Fixed Fee

“Our professional fee for the services outlined above is estimated to be \$[XXX]. This fee is based upon the complexity of the work to be performed and our professional time to complete the work. Additionally, this fee depends upon the availability, quality, and completeness of your records. You agree that you will deliver all records requested by our staff to complete this engagement on a timely basis.

In the event your records are not submitted in a timely manner, or are incomplete or unusable, we reserve the right to charge additional fees and expenses for services required to correct the problem. If this occurs, we will contact you to discuss the matter and the anticipated delay in completing our engagement prior to rendering further services.”

### **Retainers**

For new clients, clients with a history of payment problems, or high-risk engagements (clients with delinquent tax obligations or litigation services engagements, for example), CPA firms should consider obtaining a retainer prior to commencing services. Doing so helps avoid the accumulation of receivables and minimizes the risk of uncollectibility.

Sample language regarding retainers is as follows:

“Our firm’s practice is to obtain a retainer upon execution of this agreement. The required retainer amount is \$XXX. This will be applied to the final billings and any unused retainer will be refunded immediately at the end of the engagement.”

Or

“\$XXX is due as a retainer upon execution of this agreement. The retainer paid will be applied to the final billing.”

Or

“We require an advance payment of 50% of our estimated fee before beginning our work. Please submit your payment with the completed tax organizer and related materials.”

### **Consequences of Non-payment**

Clients understand that there are specific consequences for failing to pay vendors and lenders in a timely manner; payments for professional services are no different. Clients should be informed of the CPA firm’s policy regarding non-payment. CPAs who fail to do this may place themselves in the difficult position of having to complete an engagement for which future payment is questionable, rather than risk the threat of legal action from the client for damages allegedly suffered due to missed deadlines, for example. Addressing the consequences of non-payment in the engagement letter helps position the CPA firm to suspend or terminate the engagement, if warranted:

“If payment is not received by the due date, you will be assessed interest charges of XX% per month on the unpaid balance. We reserve the right to suspend or terminate our work for non-payment of fees. If our work is suspended or terminated, you agree that we will not be responsible for your failure to meet government and other deadlines, for any penalties or interest that may be assessed against you resulting from your failure to meet such deadlines, and for any other damages (including but not limited to consequential, indirect, lost profits, or punitive damages) incurred as a result of the suspension or termination of our service.”

In litigation service engagements, CPAs may require payment of fees before providing deposition or trial testimony. There may be a concern that the parties will resolve their dispute and the CPA will not get paid. A large outstanding fee at the time of testimony also may result in a credibility challenge by opposing counsel.

Accordingly, the following language could be incorporated into the engagement letter:

“If you request that we testify, we will require payment in full prior to such testimony for all work performed to date.”



## Alternative Dispute Resolution

Alternative dispute resolution (ADR,) is increasingly being used by CPA firms to resolve client disputes. The primary methods of ADR are *arbitration* and *mediation*. Some CPA firms include provisions in engagement letters requiring the use of ADR to resolve disputes that arise related to the engagement. However, for reasons discussed below, some types of ADR are preferable to others.

### Mediation

Mediation involves a skilled facilitator (mediator) who assists the parties in attempting to reach a mutually acceptable resolution to their dispute. It can be an effective and efficient means of resolving disputes that would otherwise result in complex, expensive, and protracted litigation.

Before the mediation, the parties usually exchange documents and other information that they believe is relevant and supports their position and also provide a summary of their case to the mediator and possibly, to the other side. The mediator may confidentially share his or her opinions on certain aspects of each party's case but the mediator does not issue a decision on any particular issue or the case in general. If a resolution is not reached in mediation, the parties are free to litigate if they so choose.

Typical engagement letter mediation provisions require the case to be mediated before litigation can proceed. If the client files a lawsuit without first mediating the case, the CPA firm's defense counsel can file a motion to dismiss until the case is mediated. Early mediation can be an effective tool for dispute resolution, and use of mandatory mediation provisions is recommended. Sample language is as follows:

“If a dispute arises out of or relates to this contract or engagement letter, or the breach thereof, and if the dispute cannot be settled through negotiation, the parties agree first to try in good faith to settle the dispute by mediation administered by the American Arbitration Association under the *Dispute Resolution Rules for Professional Accounting Services Dispute Resolution Rules* before resorting to arbitration, litigation, or some other dispute resolution procedure. The costs of any mediation proceedings shall be shared equally by all parties.”

### Arbitration

Arbitration is a non-courtroom hearing in which an arbitrator or arbitrators decide the outcome of a dispute. Arbitrators are typically lawyers or retired judges with expertise in the subject matter at issue. Arbitration has several advantages including the following:

- The case is decided by finders of fact who are usually more knowledgeable regarding the CPA's standard of care than a typical jury.
- Decisions are generally produced sooner than litigation.
- The contents and results of arbitration proceedings may be kept confidential if stipulated by the parties.

The type and amount of evidence (documents, deposition testimony, and expert reports) introduced in an arbitration is determined by the rules of the arbitration, which are agreed to by the parties, and to some extent is within the discretion of the arbitrator. Arbitrations are generally performed in accordance with the rules established by the American Arbitration Association (AAA).

The rules of the arbitration may limit evidence to be considered. While this can reduce costs, it may also cause certain documents or testimony to be excluded. The arbitrator or arbitrators are paid by the parties, unlike a judge

and jury, who are paid by the government. The award of the arbitrators is usually binding on the parties and generally cannot be vacated or appealed unless the award was obtained as a result of fraud, or either arbitrator misconduct or abuse of discretion. As judicial decisions regarding arbitration vary, consult with legal counsel to determine relevant guidelines in your jurisdiction.

Third parties cannot be forced to participate in an arbitration proceeding between a CPA firm and their client because they are not a party to the agreement to arbitrate (i.e. the engagement letter). However, they may bear at least a portion of the responsibility for the damages being claimed by the client. Thus, arbitration without all potential parties may not entirely resolve the dispute. This may result in post-arbitration litigation between the client and the third party, or the CPA firm and the third party. Because of these reasons, and the fact that arbitration may not be appropriate in all cases, the use of *mandatory* arbitration provisions in engagement letters is not recommended.

### **Alternative Dispute Resolution and the Impact on Independence**

Ethics Ruling Nos. 95 and 96 of the AICPA Code of Professional Conduct, *Agreement With Attest Client to Use ADR Techniques* and *Commencement of ADR Proceedings*, (ET Sections 191.190-.194), address ADR and the impact on independence of a CPA. AICPA ethics rulings indicate that the *existence* of an agreement with a client to use ADR to resolve future disputes regarding past services does not impair independence. However, the commencement of ADR proceedings which are sufficiently similar to litigation would impair independence. The existence of *binding* arbitration is considered sufficiently similar to litigation. As such, the existence of a binding arbitration clause for ADR would impair independence of the CPA firm.

A CPA firm considering the use of ADR provisions in its engagement letters should first consult with its attorney and professional liability insurer regarding their recommendations and with its professional liability insurance agent or broker regarding insurance coverage considerations. Professional liability insurance policies generally require claims to be immediately reported to the carrier. If a claim is made, ADR should only be pursued with the advice and consent of the insurance carrier representative and legal counsel.

## Loss-Limiting and Indemnification Provisions

CPA firms can further manage the risks associated with professional liability litigation by including loss-limiting or indemnification clauses in engagement letters.

Loss-limiting clauses attempt to limit the liability of the CPA firm to its client in connection with services rendered. This may help minimize the damages that could arise from a client claim and may reduce the likelihood of a claim. An example of such a clause may read as follows:

“[CPA Firm’s] liability for all claims, damages, and costs of [Client Name] arising from this engagement is limited to X times the total amount of fees paid by [Client Name] to [CPA Firm] for services rendered under this agreement.”

Many CPA firms also include engagement letter clauses that provide for indemnification of the CPA firm by the client for claims made against the CPA by third parties in the event that client management knowingly makes misrepresentations to the firm, withholds or conceals information from the firm, or participates in a fraud.

### Indemnification and Attest Clients, including Audit

The AICPA *Code of Professional Conduct* has issued several Ethics Rulings and Interpretations on the subject of indemnification provisions.

Ethics Ruling No. 94, *Indemnification Clause in Engagement Letters* (ET Section 191.188 - .189), indicates that the use of an indemnification clause whereby the client indemnifies the CPA firm against all liabilities and costs resulting from knowing misrepresentation by management does not impair the CPA firm’s independence.

However, Ethics Ruling No. 102, *Indemnification of a Client*, (ET Section 191.204-.205), indicates that if an attest client requests the CPA firm to indemnify the client for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to client acts, independence would be impaired.

With respect to indemnity and limitation of liability provisions for audit and other attest service engagements for certain governmental bodies, commissions, or other regulatory agencies, the AICPA Professional Ethics Executive Committee issued Ethics Interpretation 501-8. ET 501-8 states that use of indemnification and liability limitation clauses that are prohibited by regulators of the client entity would be considered an act discreditable in violation of this guidance, and provides that “...for example, federal banking regulators, state insurance commissions and the Securities and Exchange Commission have established such requirements.”

As a result, when considering the use of indemnification and liability limitation clauses in an attest engagement letter, if the client is in a regulated industry, such as banking or insurance and/or is regulated by the Securities and Exchange Commission, the CPA firm should review the applicable regulatory rules for prohibitions regarding the use of these clauses as well as the AICPA ethics rules. If indemnification clauses are consistent with AICPA ethics rulings and are not prohibited by regulation, they are permissible in engagement letters for attest services.

Firms that audit federally regulated financial institutions should review the *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters*, Financial Institution Letter No. 13-2006. This provides specific guidance to financial institutions regarding audit engagement letter provisions.

The Securities and Exchange Commission's *Codification of Financial Reporting Policies*, provides that auditor independence is impaired "...when an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission..."

Where permitted for an attest client, sample language that could be used is:

"[*Client Name*] agrees to hold [*CPA Firm*] harmless from any and all claims of [*Client Name*] which arise from knowing misrepresentations to [*CPA firm*] by the management/employees of [*Client Name*], or the intentional withholding or concealment of information from [*CPA Firm*] by the management/employees of [*Client Name*]. [*Client Name*] also agrees to indemnify [*CPA Firm*] for any claims made against [*CPA Firm*] by third parties which arise from any of these actions by the management/employees of [*Client Name*]. The provisions of this paragraph shall apply regardless of the nature of the claim, including the negligence of any party."

### **Indemnification and Non-Attest Clients**

For non-attest services, there are typically no restrictions on the use of indemnification and liability limitation clauses in engagement letters. The terms in those clauses are subject to negotiation between the CPA and client. An example of an engagement letter provision that may be used is as follows:

"[*Client Name*] agrees to indemnify, defend, and hold [*CPA Firm*] and any of its partners, principals, shareholders, officers, directors, members, employees, agents or assigns harmless with respect to any and all claims arising from this engagement, regardless of the nature of the claim, and including the negligence of any party, but not to the extent caused by the gross negligence or intentional acts by the firm."

### **Enforceability**

The enforceability of loss-limiting and indemnification clauses depends upon the law in the relevant jurisdiction where the professional liability claim and fee dispute is asserted against the CPA firm. Where permissible, the use of loss-limiting and indemnification provisions in engagement letters covering CPA services is encouraged. No single provision or wording is appropriate in all situations. Before incorporating loss limiting or indemnification provisions in engagement letters, consult with local legal counsel in the state where services are being rendered for guidance on specific wording that complies with applicable law.

## Designation of Venue and Jurisdiction

Many CPA firms serve clients located in or with operations in multiple states. Laws governing professional liability lawsuits and issues such as privity and statutes of limitations differ substantially by jurisdiction and are subject to change. Trial outcomes also vary by jurisdiction based upon the orientation of judges and juries, as well as other factors. Accordingly, some firms have stipulated in the engagement letter the venue for resolution of any disputes. For example, the following language could be used:

“We agree that the courts of the state of [*State Name*] have jurisdiction over the parties and all disputes between us, and we agree to submit all disputes to the [*Name of State of Federal Court Desired*], which is the proper and most convenient venue for resolution. We also agree that the law of the state of [*State Name*] shall govern all such disputes.”

An attorney may advise on the use of such a provision and the specific wording necessary to meet local requirements. A CPA firm’s insurance agent also can assist in providing information regarding potential insurance coverage issues that this may raise under the accountant’s professional liability policy.

## Statute of Limitations Clauses

A statute of limitations clause purports to change the statute of limitations, which would apply to litigation arising out of the engagement. Thus, a three year statute of limitations could be changed to a one year statute of limitations. In addition, many statute of limitations laws provide that the statute begin running when the party knew or should have known they had a claim, also known as the "discovery rule." Under limited circumstances, the "discovery rule" may be eliminated by agreement via the engagement letter. For example, the engagement letter agreement could provide that:

"You agree that any claim arising out of this engagement letter shall be commenced within one year of the delivery of the work product to you, regardless of any longer period of time for commencing such claim as may be set by law."

Courts may not always enforce agreements to waive the "discovery rule." Before using such provisions, consult with local legal counsel.

## Severability Clauses

In the event of litigation, some courts may view certain engagement letter provisions as void, which could lead the court to invalidate the entire agreement in the absence of a severability or savings clause. Sample language for such a clause is as follows:



“If any portion of this agreement is deemed to be invalid or unenforceable, said finding shall not invalidate the remainder of the terms set forth in this engagement letter.”

## Withdrawal and Termination

In some circumstances, it may be impossible for the CPA firm to complete the engagement. AICPA professional standards governing compilations, reviews, audits and tax services discuss the following specific situations in which the CPA may be unable to complete the engagement and issue a report. The following are examples of situations requiring a practitioner's consideration of withdrawal from an engagement. However, situations requiring withdrawal consideration are not limited to the following:

- SSARS No. 19 *Compilation and Review Engagements* (AR Section 80.13) indicates that when an accountant becomes aware, during the course of performing compilation procedures, of information that is incorrect, incomplete or otherwise unsatisfactory, or that, fraud or illegal acts may have occurred that could materially affect the financial statements that is not properly addressed by management, the accountant should consider withdrawing from the engagement. The same requirement exists for review engagements and can be found at AR Section 90.21.
- SSARS No. 19 *Compilation and Review Engagements* (AR Sections 80.29 and 90.36) states that when the accountant determines that there is a material departure from GAAP in the financial statements that the accountant has been engaged to compile or review, and management is not willing to make appropriate disclosures, and modification of the accountant's report is not sufficient, the accountant should consider withdrawing from the engagement and provide no additional services related to this engagement.
- SAS No. 122 *Consideration of Fraud in a Financial Statement Audit* (AU-C Section 240.38) notes that an auditor should "consider whether it is appropriate to withdraw from the engagement" in the event of identified or suspected fraud. If withdrawal is deemed appropriate, reasons for withdrawal should be communicated to those charged with governance. AU-C Section 240.63 further addresses factors for consideration of withdrawal as it relates to fraud and management's response to the identified or suspected fraud.
- SAS No. 122 *Consideration of Laws and Regulations in an Audit of Financial Statements* (AU-C Section 250.A24-A25) states that when the auditor identifies instances of noncompliance with laws and regulations and determines that management or those charged with governance has not taken appropriate remedial actions that the auditor considers appropriate in the circumstances, no matter how material, the auditor may consider withdrawing from the engagement. However, withdrawal may not be possible under application law and regulation and the auditor should consider such laws and regulations when determining whether or not to withdraw. AU-C Section 250.A27 indicates that withdrawal is possible when management does not accept a modified report due to identified or suspected noncompliance with laws and regulations.
- AICPA *Statements on Standards for Tax Services* (SSTS) No. 6 *Knowledge of Error: Return Preparation and Administrative Proceedings* (TS Sections 600.05-06, and 600.08) states that if a tax preparer is aware of an error on a prior year return and the taxpayer has not taken appropriate action to correct the error, the tax preparer should consider whether withdrawal from the current year engagement and the professional relationship with the client is appropriate. If the tax preparer is representing a client in an administrative proceeding, and is aware of an error in the return being reviewed, the tax preparer should obtain the taxpayer's permission to disclose that error to the taxing authority. If the taxpayer refuses to grant permission, the tax preparer should consider withdrawal from the engagement. TS Section 600.10 cautions that a conflict of interest between the accountant and the client may arise due to the potential adverse impact on the client by the accountant's withdrawal from the engagement and the professional relationship. Therefore, the accountant should consult with his or her legal counsel when deciding whether or not to continue with the professional relationship.

- SSTS No. 6 *Knowledge of Error: Return Preparation and Administrative Proceedings* (TS Section 600.12) states that an accountant may be placed in the position of preparing a return that carries forward an error made in prior years. In this situation, the accountant should take reasonable steps to ensure that the same error does not recur. If it is not possible to correct the error in the current year, the accountant should consider withdrawal from the engagement.

In all circumstances in which the firm is considering withdrawal prior to completion of an engagement, consult with legal counsel and the firm's professional liability insurer for additional guidance.

The following paragraph is an example of how withdrawal situations may be preemptively addressed in an engagement letter:

“We reserve the right to withdraw from this engagement without completing our services for any reason, including, but not limited to, if you fail to comply with the terms of this engagement letter or as we determine professional standards require.”

## Staffing of the Engagement

Client misunderstandings and discontent with the performance of the CPA firm can develop when the client learns that firm staff rather than principals or partners will complete portions of the engagement. To avoid such problems, the following explanatory paragraph could be utilized:

“[XXX] and [YYY] will lead the teams assigned to service your account and will serve as the primary contacts with you for this engagement. The team will include professional staff or other members of the firm.”

If the individuals who will render the services or direct the engagement are identified in the engagement letter, be prepared to follow through on this commitment and monitor your firm’s compliance with this plan. If circumstances arise requiring assignment of other personnel, discuss this with the client beforehand, and document this change in a follow-up communication to the client.

## Addressing Potential and Actual Conflicts

If a potential or actual conflict of interest is identified prior to commencing services, the CPA firm should discuss this with the client and address the conflict in the engagement letter. Depending on the circumstances, the CPA firm may be prohibited from rendering the service.

Conflicts of interest arise when a CPA performs a service for a client and the CPA has a relationship with another person, entity, product, or service that could be perceived by the client or third parties as compromising objectivity. For engagements that do not require independence, if a conflict of interest exists and the CPA believes that the service can be performed with objectivity, ET Section 102.03 of the *AICPA Professional Standards* does not prohibit the performance of the service if the conflict is disclosed and consent is obtained from the client. Engagement letter wording should be customized based upon applicable facts and circumstances.



The following is an example of such wording:

“Per our discussion with (XXX) of your company, (YYY), a partner in our firm, is married to (ZZZ), the controller of (AAA), which is a principal supplier to your firm. While we have concluded that no conflict of interest exists, you acknowledge that you are aware of this fact and have no objection to engaging our firm to perform these services.”

For engagements that require independence, such as audits, reviews and other attest services, disclosure and consent by the client will not eliminate an independence impairment resulting from a conflict of interest.

Treasury Department Circular *No. 230*, §10.29, *Conflicting Interest*, prohibits representing a client before the IRS if the representation involves a conflict of interest, except if:

- The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;
- The representation is not prohibited by law; and
- Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.

Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the IRS on request.

## **Conflict Waiver Considerations**

Language considered appropriate to waive a conflict of interest and provide consent under AICPA professional standards or Circular No. 230 may not establish a legally binding waiver of the conflict of interest. Consult with legal counsel when drafting a conflict of interest waiver provision for inclusion in the engagement letter to ensure that it would be considered valid in a court of law. Additionally, consult with counsel on the parties required to sign the engagement letter to acknowledge the disclosure and consent. Do not initiate services prior to receiving the signed engagement letter.

Rendering professional services when a conflict of interest exists presents elevated risk to the CPA firm, irrespective of obtaining conflict waivers. Firms should consider this prior to agreeing to render services in such circumstances.

## **Conflicts of Interest Arising Subsequent to Service Commencement**

Despite stringent client screening procedures, potential or actual conflicts of interest may arise after engagements begin. To avoid conflict of interest allegations by clients, it is helpful to explain in the engagement letter the circumstances under which the firm may be required to suspend services or resign from an engagement due to such conflicts:

“If we, in our sole discretion, believe a conflict has arisen affecting our ability to deliver services to you in accordance with either the ethical standards of our firm or the ethical standards of our profession, we may be required to suspend or terminate our services without issuing a report.”

## Electronic Data Communication and Storage and Use of Third Party Service Provider

Most CPA firms use electronic software applications and devices as well as the internet to communicate with and exchange information with their clients, to maintain data electronically, and to assist in the delivery of professional services. Despite efforts to improve internet and electronic security, there is always a potential risk that information may be intercepted, used, or corrupted by unauthorized persons, which raises privacy and data security issues. CPAs should address the resulting risks in the engagement letter.

Software applications, devices, and other tools are often provided by third-party service providers. Under AICPA *Ethics Ruling No. 112* under *Rule 102, Integrity and Objectivity* (ET section 191.224-.225), AICPA members are required to inform their client, preferably in writing, that the member may use a third-party service provider to assist the firm in providing professional services prior to disclosing confidential client information to the provider. AICPA members are not required to inform the client when the third-party service provider is utilized to provide administrative support services to the member, but it is considered a good practice to do so.

AICPA *Ethics Ruling No. 1* under *Rule 301, Responsibilities to Clients* (ET section 391.001-.002) also discusses the use of third party service organizations by AICPA members. This ruling states that client consent is not required for a member to disclose confidential client information to a third party service provider used to assist the member in providing professional services to clients or to perform administrative support services to the member *as long as* the following occurs before using the service provider:

- The member enters into a contractual agreement with the third party service provider to maintain the confidentiality of such information.
- The member is reasonably assured that the third party service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information to others.

If the member does not enter into a contractual confidentiality agreement with the provider and is unable to obtain the necessary assurance, the member should obtain specific client consent before releasing confidential client data to the third party.

The following sample language informs clients of the risks of electronic communications and the use of third-party service providers that will have access to confidential client information, and seeks client consent to disclose such information to these service providers:

“In the interest of facilitating our services to your company, we may send data over the Internet, store electronic data via computer software applications hosted remotely on the Internet, or allow access to data through third-party vendors’ secured portals or clouds. Electronic data that is confidential to your company may be transmitted or stored using these methods. We may use third-party service providers to store or transmit this data, such as providers of tax return preparation software. In using these data communication and storage methods, our firm employs measures designed to maintain data security. We use reasonable efforts to keep such communications and data access secure in accordance with our obligations under applicable laws and professional standards. We also require all of our third-party vendors to do the same.

You recognize and accept that we have no control over the unauthorized interception or breach of any communications or data once it has been sent or has been subject to unauthorized access, notwithstanding all reasonable security measures employed by us or our third-party vendors. You

consent to our use of these electronic devices and applications and submission of confidential client information to third-party service providers during this engagement.”

## Client Portals

If the firm uses a portal for communicating and exchanging files with clients and for other purposes, consult with an attorney who is familiar with electronic privacy and security issues and applicable law. Portal providers typically require users to acknowledge and agree to the terms and conditions of an end user license agreement (EULA) prior to providing access to the portal. Both the agreement between the firm and the portal provider as well as the EULA should be reviewed by the firm’s legal counsel prior to entering into any engagements that will utilize the portal.

In addition, a portal agreement should be drafted by the firm’s legal counsel. As part of the portal registration process integrated to the firm’s website, the agreement should require the client’s acknowledgement and agreement with its terms and conditions prior to providing the client with access to the portal. Portal agreements should, at a minimum, address service availability, portal security and information protection, user password and security, and termination of logon accounts.



Sample language regarding portals to include in an engagement letter is as follows:

“To enhance our services to you, we will use [*Portal Name*], a collaborative, virtual workspace in a protected, online environment. [*Portal Name*] allows for real-time collaboration across geographic boundaries and time zones and allows [*CPA Firm*] and you to share data, engagement information, knowledge, and deliverables in a protected environment. In order to use [*Portal Name*], you will be required to execute a client portal agreement and agree to be bound by the terms, conditions and limitations of such agreement. You agree that [*CPA Firm*] has no responsibility for the activities of [*Portal Provider*] and agree to indemnify and hold [*CPA Firm*] harmless with respect to any and all claims arising from or related to the operation of [*Portal Name*]. While [*Portal Provider Name*] backs up your files to a third party server, we recommend that you also maintain your own backup files of these records.”

## Other Third-Party Service Providers

If a CPA firm engages a specialist or other service provider to assist the firm in the delivery of professional services, sample engagement letter wording to inform the client and obtain consent is as follows:

“In the interest of enhancing our availability to meet your professional service needs while maintaining service quality and timeliness, we may use a third-party service provider to assist us in the preparation of your [*insert applicable service, work product, etc. here*]. This provider has established procedures and

controls designed to protect client confidentiality and maintain data security. As the paid provider of professional services, our firm remains responsible for exercising reasonable care in providing such service(s), and our work product will be subjected to our firm's normal quality control procedures. If you have any questions or concerns about this arrangement, please contact our office.”

## **Considerations for Tax Engagements**

Practitioners preparing U.S. income tax returns should be familiar with IRC § 7216, *Disclosure or Use of Information by Preparers of Returns*, and related IRS pronouncements and guidance. This provision specifies the content, format, transmission and signature requirements for required paper or electronic forms providing taxpayer consent to disclose or consent to use tax return information. In engagements which do *not* consist solely of tax return preparation or auxiliary services (as defined in applicable guidance), taxpayers must complete and return the consent form before tax return information can be disclosed to third parties.

Before preparing client consent forms, including related engagement letter language, practitioners should consult the Section 7216 Information Center (available at [www.irs.gov](http://www.irs.gov)) for current guidance.

## **Other Privacy and Security Considerations**

Firms should remain cognizant of applicable state and federal privacy and security laws that may stipulate methods by which client information can be transmitted. Some states require that all transmissions of client data be encrypted, and most states have laws containing specific notification requirements in the event of a breach of confidential data maintained by the firm.

A number of states and other regulators have either enacted laws or are considering legislation and regulations imposing specific privacy obligations on businesses that outsource services or disclose information to third-party service providers. These measures contemplate a required signed acknowledgment from the client concerning the firm's use of third parties prior to the start of the engagement. Check with your state CPA society and applicable state boards of accountancy for current guidance. Although substantial equivalency rules under the Uniform Accountancy Act have been adopted by many states allowing CPAs to practice in jurisdictions other than their home state, state board of accountancy regulations and state privacy laws for that jurisdiction apply, and may differ from those of their home state.

## Records – Retention, Requests, and Ownership

Designing, implementing, and monitoring the consistent application of a record retention policy and responding to requests for records are an important risk control procedures for all CPA firms. Improperly documented, incomplete, disorganized, or tampered work papers, whether paper or electronic, can be detrimental to the defense of a CPA firm in a professional liability claim. For additional information on record retention and responding to requests for records, see CNA’s publications located at [www.cpai.com](http://www.cpai.com).

### Record Retention Policies

Records retention policies vary widely among CPA firms based upon many factors, including legal jurisdiction, type of client, services performed, government regulations, and the firm’s practice. Clients need to understand and agree to be bound by the CPA firm’s policy regarding retention of firm work papers and copies of client records.

Engagement letters should separately address access to and responsibility for both firm work papers and client-provided records. Client-provided records should be returned to the client no later than at the conclusion of each engagement to avoid assuming a continuing responsibility for maintaining them. Whenever possible, CPA firms should avoid taking possession of original records. Whatever the firm’s record retention policy, it should be clearly stated. Here is an example providing such disclosure:

“Our records retention policy requires us to return all original records and documents that you have given us to you at the conclusion of the engagement. Your records are the primary records for your operations and comprise the backup and support for your financial reports and tax returns. Our records and files are our property and are not a substitute for your own records. A copy of our record retention policy is attached for your reference (*or, is available upon request*). Our firm destroys our engagement files and workpapers after a period of X years. Catastrophic events or physical deterioration may result in our firm’s records being unavailable before the expiration of the above retention period.”

For an individual or a corporate tax client, additional wording regarding records is as follows:

“You should retain all documents that provide evidence and support for reported income, expenses, credits, and deductions on your returns as required under tax law. You are responsible for the adequacy of all such documents. You represent that you have such documentation and can produce it if needed to respond to any audit or inquiry by taxing authorities.”

### Responding to Subpoenas and Requests for Records

Due to client business disputes, divorces, regulatory investigations and other similar matters, CPA firms receive court orders, subpoenas, summonses, and informal requests from a variety of sources to produce documents, give depositions, or testify in court.

It is advisable to promptly report the receipt of court orders, subpoenas, summonses and requests to produce documents to the firm’s professional liability carrier and consult with legal counsel prior to either contacting the client regarding the inquiry or responding to it.

While the duty to respond to such inquiries varies depending upon the situation and legal jurisdiction, the client should be advised of the CPA firm's position on this issue in the engagement letter. The following is an example of wording that could be used to inform a client about the firm's policy on responding to a subpoena or summons:

"All information you provide to us in connection with this engagement will be maintained by us on a strictly confidential basis. If we receive a summons or subpoena requesting that we produce documents from this engagement or testify about this engagement and we are not prohibited from doing so by law or regulation, we agree to inform you of such requests as soon as practicable. You may, within the time permitted for our firm to respond to any request, initiate such legal action as you deem appropriate to protect information from discovery. If you take no action within the time permitted for us to respond, or if your action does not result in a judicial order protecting us from supplying requested information, we may construe your inaction or failure as consent to comply with the request. As long as we are not a party to the proceeding in which the information is sought, you agree to reimburse us for our professional time and expenses, as well as the fees and expenses of our counsel, incurred in responding to such requests."

Requests for records may also come from a regulator, successor accountant or other party. Sample engagement letter language addressing such requests is as follows.

"We may be requested to make certain work papers available to [*state, federal and foreign regulators*] pursuant to authority provided by law or regulation. If requested, access to such work papers will be provided under the supervision of firm personnel. Furthermore, upon request, we may provide photocopies of selected work papers to [*state, federal and foreign regulators*]. Such regulators may intend, or decide, to distribute the photocopies or information contained therein to others, including other government agencies."

*AICPA Professional Standards*, ET Sections 501.02 and 591.377-.378 defines several types of records utilized or created in the delivery of services by a AICPA member and describe the member's responsibilities related to responding to requests for records. *Treasury Department Circular No. 230, §10.28*, describes a tax practitioner's responsibilities in responding to requests for return of client records. State boards of accountancy regulations also govern responses to such requests. CPAs should familiarize themselves with these standards and regulations when responding to requests for records.

## Ownership of Records

Ownership of CPA firm working papers and the handling of client-provided records may be addressed in the engagement letter as follows:

"At the completion of our engagement, the original source documents will be returned to you. Workpapers and other documents created by us are our property. Such original workpapers will remain in our control, and copies are not to be distributed without our prior written consent."

## Client Signature and Date

A well-drafted engagement letter that memorializes the service agreement between the CPA firm and its client may be of limited use in avoiding or defending professional liability claims if it is unsigned. Engagement letters should be signed and dated by firm and client representatives prior to commencing *any* services. For a discussion on the issuance of unilateral or unsigned engagement letters, please refer to the section of this guide titled *When Should I Issue an Engagement Letter*.

### Who Should Sign?

For engagements provided to a married couple, both parties should sign. With respect to business entities, only those individuals who are authorized under the entity's by-laws, resolutions, operating agreements, or other governance records should sign the engagement letter. This authority is affected by the form the entity takes, such as a corporation, partnership, trust, limited liability company, or joint venture. To the extent the engagement letter is signed by an individual whose authority to enter into a binding business agreement on behalf of the client business entity cannot be verified, consult with an attorney prior to accepting the engagement letter, and do not commence services until this issue has been resolved.

Whenever possible, the engagement letter should be delivered to the individual(s) authorized to sign it. A request for the client's signature may be addressed as follows:

“We appreciate the opportunity to be of service to you. Please date and sign the enclosed copy of this engagement letter and return it to us to acknowledge your agreement with the terms of this engagement. It is our policy to initiate services only after we receive the executed engagement letter.”

### When Should it be Signed?

Over the years, numerous CPA firms have experienced claims involving scope disputes. Such claims have alleged the CPA firm's failure to render certain services, or a failure to detect and communicate regarding weaknesses in internal controls, fraud, and theft. In many cases, these claims pertained to services related to a continuing client relationship rather than a new client, and the firm initiated services before obtaining a signed engagement letter. The client later disputed the timing and the scope of the services rendered. To mitigate liability exposures, CPA firms should not initiate *any* services until the signed engagement letter has been received from the client.

## Closure Letters

When the services as memorialized in an engagement letter are concluded, issuing a closure letter to the client may help to limit a CPA firm's liability exposure, even if there is a continuing client relationship and an expectation that the client will engage the CPA firm to perform additional services at a later date. Issuing a closure letter helps to establish proof of the date services were completed and helps to define the statute of limitations period. The letter may be used to direct the client to follow-up on any activity required by governmental authorities (e.g., complying with tax filing deadlines) or suggested by the firm during the course of the engagement (e.g. taking action on recommendations noted in a consulting engagement). Closure letters should be used at the end of an engagement where completion may be difficult to determine, including most consulting engagements. A sample closure letter is available in the Policyholder Resource Center at [www.cpai.com](http://www.cpai.com).



## Summary

While engagement letters are not a “magic shield” to protect CPA firms from professional liability claims, the consistent use of engagement letters helps provide clients with accurate information regarding the services the CPA firm will perform, the limitations of those services, and the responsibilities of both the CPA firm and the client arising from the engagement. By clearly defining these terms prior to the start of the engagement, the CPA firm promotes open communication with clients. This protocol also provides the client with the opportunity to request and receive clarification of any specific issues referenced in or omitted from the letter which helps to minimize the risk of fee and scope disputes. Establishing and reinforcing this type of up-front communication with clients is a critical element in avoiding “expectation gap” problems that can lead to professional liability claims.

If a CPA firm does not fulfill its own obligations as agreed to in the engagement letter and offers advice or performs services beyond the defined engagement scope of services, such practice or patterns may destroy the protections offered by engagement letters.



## Appendix

### Selected AICPA Professional Standards

- Statement on Auditing Standards No. 122, *Terms of Engagement* (AU-C Section 210.09-.10) provides that “The auditor should agree upon the terms of the audit engagement with management or those charged with governance,” and “The agreed-upon terms of the engagement should be documented in an audit engagement letter or other suitable form of written agreement...” *Statement on Standards for Attestation Engagements* No. 10 (AT Section 101.46) provides that “the practitioner should establish an understanding with the client regarding the services to be performed for each engagement,” and that “the practitioner should document the understanding in the workpapers, preferably through a written communication with the client.”
- Statement on Auditing Standards 122, *Interim Financial Information* (AU-C Section 930.10), which applies to reviews of interim financial information and states, “The auditor should agree upon the terms of the engagement with management or those charged with governance, as appropriate. The agreed-upon terms of the engagement should be recorded in an engagement letter or other suitable form or written agreement...” This statement also sets forth items to include in the engagement letter.
- Statements on Standards for Attest Services No. 10, *Agreed Upon Procedures* (AT Section 201.10) states “The practitioner should establish an understanding with the client regarding the services to be performed. When the practitioner documents the understanding through a written communication with the client (an engagement letter) the communication should be addressed to the client, and, in some circumstances, also to all specified parties.”
- Statements on Standards for Accounting and Review Services No 19, *Compilation and Review Engagements* (AR Section 80.02-.05 and 90.03-.06) states that “The accountant should establish an understanding with management regarding the services to be performed for the engagement and should document the understanding through a written communication with management.” Also see Appendix A of AR Section 80 and Appendix, A of AR Section 90 for sample engagement letters.
- Statement on Quality Control Standards, *A Firm’s System of Quality Control* (QC Section 10.29) states that a firm’s policies and procedures should provide for obtaining an understanding with the client regarding the nature, scope, and limitations of services to be performed. This statement also indicates that professional standards applicable to an engagement may contain requirements for obtaining a written understanding with the client.
- The AICPA Statements on Standards for Valuations Services establishes standards for CPAs who perform valuations of businesses, business ownership interests, securities, or intangible assets. Section VS Section 100.16-.17 of these standards state that “The valuation analyst should establish an understanding with the client, preferably in writing, regarding the engagement to be performed.”
- The AICPA Statement on Standards for Consulting Services establishes additional general standards for all consulting services. Section CS Section 100.07 of this standard includes a requirement to “Establish with the client a written or oral understanding about the responsibilities of the parties and the nature, scope, and limitations of services to be performed, and modify the understanding if circumstances require a significant change during the engagement.”

- Section 100.21 of the AICPA Statements on Responsibilities in Personal Financial Planning Practice states that “The CPA should document his or her understanding of the scope and nature of the services to be provided. Such documentation could be in the form of an engagement letter or other written communication to the client, or if there is an oral understanding, a memo to the file.” These Statements are not currently enforceable standards under the *AICPA Code of Professional Conduct*. However, the proposed AICPA Statement on Standards in Personal Financial Planning Services would make such standards enforceable. The proposed standard also includes a provision for the member to “document and communicate to the client the scope and nature of services to be provided...”

### **Additional AICPA Reference Materials**

The AICPA has sample engagement letters for various services to AICPA section members. Practice management guides are also available to members.

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For more information on the AICPA Professional Liability Insurance Program, contact AON Insurance services at 1-800-221-3023 or go to [www.cpai.com](http://www.cpai.com).

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