

Engagement Letter Indemnification Clauses: Should You Use Them?

Many techniques are available to CPAs interested in managing the risk of litigation stemming from providing professional services. One such technique that has enjoyed some success is the use of an indemnification clause in an engagement letter.

An indemnification or hold harmless clause in an engagement letter typically provides that the client will indemnify or hold the CPA harmless in the event the CPA sustains a loss resulting from claims arising from the CPA's work on the subject engagement. Indemnification clauses are not intended to preclude the CPA from incurring liability for professional malpractice. Instead, such a clause is intended to preclude liability where the client knowingly makes misrepresentations to the CPA, causes or participates in a fraud, conceals information from the CPA, or otherwise leads the CPA astray.

While CPAs may view the use of an indemnification clause as attractive, clients may naturally have a differing opinion. The CPA can expect resistance from a client if such a clause is proposed to be included in an engagement letter. The use of such a clause then becomes a matter of negotiation with the client. The enforceability of indemnification clauses may be dependent upon the requirements of public policy and subject to the dictates of the controlling legal jurisdiction. Hence, the use of an indemnification clause may only provide false security to the CPA.

Nevertheless, where permitted, indemnification clauses may provide valuable benefits to the CPA. For example, the inclusion of an indemnification clause could prove to be a deterrent to a client considering a potential claim against a CPA firm. Recognizing the existence of the indemnification clause, the client may view an action against the CPA as being without potential benefit. Further, for the CPA and client desiring to keep the engagement risk and reward equation in balance, the use of an indemnification clause could provide support for the CPA's adjusting the fee for the subject services. Also, the upfront discussion and use of such a clause affords the parties the opportunity to address their specific risk management and risk allocation needs before the engagement commences and thereby provide both parties with knowledge of their individual limits and exposures.

For some time the position of the SEC with regard to the use of an indemnification provision by a CPA auditing a public company has been that an agreement that provides complete indemnification to an auditor impairs independence in attest engagements. The AICPA in an ethics ruling, however, has indicated that indemnification relating to liability and costs resulting from knowing misrepresentations by management would not impair a CPA's independence with respect to the client. An example of an engagement letter clause fitting this criteria could take the following form:

[Client company] agrees to release, indemnify, and hold [CPA firm] (its partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. (AICPA Audit and Accounting Manual As of June 1, 1997, American Institute of Certified Public Accountants, Inc., New York, NY, 1997, pg. 3402).

With the continuing focus on management fraud and an auditors' responsibility to detect fraud, some CPAs have expressed an interest in including an indemnification clause covering management fraud in engagement letters. Where management fraud is not detected by the auditor and litigation ensues, the success of this clause in protecting the CPA would be dependent, as noted above, upon the views of the governing jurisdiction.

Such an indemnification clause might take the following form:

[*Client company*] agrees to release, indemnify, and hold [CPA firm] (its partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from fraud caused by or participated in by management of [*Client company*].

Where permissible, CNA encourages the use of indemnification clauses in engagement letters covering CPA services. No single clause or wording is appropriate in all situations. Instead, the clause should be tailored to fit the individual client situation and the assessed risks involved. As noted above, the enforceability of indemnification and hold harmless clauses differs among legal jurisdictions. In certain locales, specific wording may need to be adhered to in order for the clause to be effective. It is, therefore, critical that CPAs contemplating the use of an indemnification clause in an engagement letter consult with local counsel to assess potential enforceability and to ensure compliance with the applicable local requirements.

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