

## **Engagement Letters: Why Use One?**

Statistics gathered by the AICPA Professional Liability Insurance Program provide dramatic evidence of the importance of engagement letters. In approximately 25% of all claims made in the Program, the client alleged the scope of the engagement went beyond those services which the CPA believed he or she had agreed to perform. The resulting claim then alleged that when performed, these disputed services were performed negligently. Although such misperceptions are often the cause of liability suits, there are in fact, a variety of reasons a CPA should utilize engagement letters. Broadly defined, these reasons fall within three general categories:

- Enhanced Client Communications
- Professional Standards
- Protection from Legal Liability

### **Enhanced Client Communications**

An important requirement in the establishment of long-term professional relationships with clients is the consistent presentation of detailed, but understandable information about the services being performed. Additionally, explaining how the resulting information is intended to be used is necessary to further clarify what services will be performed. The importance of verbally discussing and explaining proposed services with clients is commonly recognized; however, many CPAs neglect to memorialize in writing, the agreement between CPA and client regarding the scope and limitations of an engagement. This step is critical in minimizing future misunderstandings and lawsuits.

Enhanced client communications, such as regularly-issued engagement letters, help to avoid expectation gaps for services to be rendered. By re-emphasizing both the value and the scope of services in advance, CPAs can improve clients' overall satisfaction with professional services rendered. The satisfied customer is more likely to continue or expand a relationship with a CPA, as well as to provide valuable referrals to associates. Taking steps to establish clear expectations promotes this positive word-of-mouth and expands business accordingly.

Engagement letters can also be an effective marketing tool for clients and prospects. A CPA can easily promote related accounting and other consulting services by mentioning them in his or her engagement letters. For example, do clients know that when their annual individual tax returns are prepared, tax planning or other related services are not being performed? More importantly, do clients recognize they could in fact benefit from such advice? An engagement letter issued to a client for whom tax returns are prepared could clarify the services included, as well as distinguish those related services which are not included in the engagement under its present terms. Further, the CPA could emphasize that these supplementary services will not be included unless they are both discussed with the CPA and specifically identified in a new, signed engagement letter.

Engagement letters are most effective in improving client communications when they are used consistently, and when information is presented in a format that is clear, concise, and immediately understandable to the client. Don't miss this valuable opportunity to create a positive and professional image by memorializing the understanding with the client regarding those services to be rendered as well as clarifying the related services which could be beneficial, but which are not included under the present terms of the engagement agreement.

### **Professional Standards**

AICPA Professional Standards governing various practice areas discuss establishing an understanding of services with clients. AU Sections 622.11 and 722.07 of the Statements on Auditing Standards and AR Section 100.08 of the Statement on Standards for Accounting and

Review Services offer more details in this area. While AICPA Professional Standards do not require CPAs to issue engagement letters, proposed standards would require documentation of the undertaking with the client, preferably with a written communication. Engagement letters can meet these standards by providing advanced documentation of exact services to be performed, assessment of fees, responsibilities of both CPA and client, and limitations of information delivered.

### **Protection From Legal Liability**

While a signed engagement letter cannot shield a CPA from malpractice claims, it can form the basis of an effective defense in the event of a claim. Clients who might entertain the idea of pursuing a claim when faced with an unexpected business expense or tax liability, view their personal responsibility differently when they have signed an engagement letter identifying the mutual responsibilities of both CPA and client, a detailed description of the services to be performed, and any limitations inherent to the engagement. In certain states, an engagement letter which specifically identifies the client and any intended users of the CPA's work product can also effectively bar unintended third party users from suing for negligence.

Trial juries typically do not have a sophisticated understanding of the variety and precise features of services performed by CPAs. In rendering their judgments, they must therefore heavily rely on documentation and live testimony evidencing communications between the CPA and the client. In the absence of an engagement letter, decisions regarding disputes concerning level of service tend to favor clients more often than CPAs. Since the CPA's profession is accounting services, the CPA is viewed as the documentation expert, and considered to be responsible to clearly and accurately communicate with the client. Without an engagement letter, there is a danger that the jury may be inclined to make its judgement based on the credibility of the witnesses and its own, perhaps inexperienced and inaccurate expectations of exactly what services the accountant should have provided.

Engagement letters clearly can help CPAs establish a positive basis for communication with clients, provide new marketing opportunities, and assist both in preventing claims which arise from disputes regarding engagement scope and defending malpractice claims at trial.

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