

The importance of engagement letters for small firms

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November 1, 2018

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Tax issues are the most common source of malpractice claims against CPA firms, accounting for 72% of total claims in 2016, according to CNA Financial Corporation, the carrier for the AICPA's professional liability insurance program. Common reasons for those claims often include issues that arise from misunderstandings between firms and their clients. According to CNA Financial and discussions with Kevin M. Murphy, partner and managing attorney at Carr Maloney PC, during the AICPA Tax Practice Responsibilities Committee meeting on May 9, 2018, among those reasons are:

- Failure to advise clients or providing improper advice;
- Filing errors such as late elections, underreporting revenue, overstating deductions, and math and clerical errors;
- Errors related to specific transactions such as Sec. 1031 exchanges and mergers and acquisitions;
- Defalcations by client personnel;
- Conflict claims in divorces or business separations;
- Tax return identity theft;
- Actions against a CPA or firm by a state board or other agency;
- Lack of disclosure when there is a questionable basis for a deduction; and
- Foreign asset disclosure forms (e.g., FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR)).

Failure to advise clients (or providing improper advice) is the most frequent cause of claims in the AICPA Professional Liability Insurance Program. Often, these disputes are a result of scope-of-service disagreements between firms and their clients. Engagement letters are the first and most critical line of defense against scope-of-service claims, helping to prevent claims by establishing clear responsibilities and managing client expectations as well as defending against claims by defining the scope of services and establishing limitations on the services to be provided to a client. Using engagement letters is also associated with reducing the severity, i.e., the dollar amount, of claims (see Ference, "[Professional Liability Spotlight: Setting Expectations](https://www.journalofaccountancy.com/issues/2017/oct/engagement-letters-cpa-firms.html)" (2017), 224-4 *Journal of Accountancy* 16 (October 2017)). Unfortunately, small firms and sole practitioners are the least likely to regularly use engagement letters (id.).

While firms may be reluctant to send multiple-page engagement letters to clients (the sample AICPA letter for individual clients is eight pages, with an additional eight-page addendum of terms and documents) and may have difficulty getting clients to sign and return the letters, best practice standards in Section 10.33 of Circular 230, *Regulations Governing*

Practice Before the Internal Revenue Service (31 C.F.R. Part 10), require "[c]ommunicating clearly with the client regarding the terms of the engagement."

Limiting scope of service with engagement letters

Engagement letters should be used to limit the scope of services by specifying the returns and other services for which the firm is responsible. It is just as important to specify the services for which the firm is *not* responsible. For example, a firm may want to include language regarding whether bookkeeping services required to prepare a tax return are included in the engagement, or whether the firm will prepare partner or shareholder basis schedules as part of an engagement. Firms should generally exclude from a compliance engagement any tax consulting and tax planning, as well as correspondence with taxing authorities, and use separate letters for those services if a client requests them.

Care should be taken to specify the client taxpayer or taxpayers to which the engagement services are being provided, particularly if an individual taxpayer has an ownership interest in business entities or trusts. Separate letters should be used for business engagements and individual engagements, as well as for adult children of clients, and should specifically include or exclude filing responsibilities for minor children.

Model engagement letters available to AICPA Tax Section members (available at www.aicpa.org (<https://www.aicpa.org/interestareas/tax/resources/compliance/annualcompliancekit.html>), as part of the Annual Tax Compliance Kit) suggest specifically noting not only which federal and state returns will be prepared as part of the engagement but also the specific tax years involved. Using form numbers and years (e.g., "2018 Form 1040 and applicable schedules") is an effective way to clearly articulate the firm's responsibilities. Responsibility for filing the returns and the subsequent termination of the engagement should also be discussed in the letter. For electronically filed returns, language should typically specify that firm responsibilities end with the electronic filing of the return (and subsequent acknowledgment by the taxing authorities). For paper-filed returns, it is critical to note whether the client or the firm is responsible for mailing the returns.

Firms should avoid using engagement letters that do not require a client's signature but instead specify an automatic acceptance by a client when a client provides tax information to the firm. Instead, engagement letters should be updated and signed by clients annually. This is important in limiting potential liability resulting from clients' allegations of continuous representation by a firm. Annual letters also are beneficial in starting the running of the statute of limitation for claims.

State, local, and international filing obligations

For state and local tax returns, engagement letters should list the state and local income tax returns to be prepared and whether the engagement includes other non—income-based taxes (e.g., excise, franchise, or sales and use tax) that may be due. Letters should specifically list which state returns and form numbers are included in an engagement rather than just saying "all required state returns."

With the inherent difficulties in determining state tax nexus and filing requirements for clients, firms should consider language that puts the onus on the client to determine state and local filing obligations rather than on the firm. If clients want the firm to undertake a nexus study to determine return filing obligations, a separate engagement letter should be used to specify those services.

Likewise, an engagement letter should specify responsibility for determining filing requirements for non-U.S. returns and, unless otherwise agreed to, exclude foreign filing obligations from the scope of the engagement.

Filing obligations related to foreign financial assets

Engagement letters should note that individual clients are responsible for reporting the values of certain foreign financial assets as part of their tax reporting obligations and that they may need to file Form 8938, *Statement of Specified Foreign Financial Assets*, with Form 1040, *U.S. Individual Income Tax Return*, or separately, an FBAR. While a client organizer will often include questions and request information about ownership of foreign assets and their maximum values and so

on, the engagement letter should clearly state whether the firm's services will include preparing and filing such forms. An engagement letter for an income tax compliance engagement should normally exclude responsibility for filing an FBAR, since it is not filed as part of the Form 1040.

Other scope of service issues

Specifically mentioning other services that are *not* included can be an effective way to limit misunderstandings and subsequent claims, particularly if such services have been provided to a client as part of a previous engagement. Accordingly, it may be necessary to customize engagement letters for specific clients, taking into account the firm's previous relationship with the client as well as the risks that a specific client brings to an engagement.

Care should be taken to prevent an unintentional expansion of scope (see Ference, "Professional Liability Spotlight: Don't Let Scope Creep Lead You Out of Bounds," 220-3 *Journal of Accountancy* 18 (September 2015)). This can happen when a tax adviser informally responds in an email or a phone call to a client question about the tax consequences of a sale or other transaction that is not part of the original engagement. What the firm considers to be an "unofficial" response based on incomplete information might be considered more formal advice by the client, leading to misunderstandings as well as future liability claims.

Firms can also create an unintentional expansion of scope by providing services that are not part of the original engagement. For example, preparing a state tax return not included in the original engagement letter may cause the client to assume that the CPA has done a nexus study and has concluded that no other state returns are required. New engagement letters should be used anytime additional services are identified.

Terms and conditions

A "terms and conditions" addendum should generally be referred to in the engagement letter and attached to the document. (As an alternative, a firm might consider modifying the engagement letter for specific clients to include critical terms and conditions language within the letter rather than as an addendum.) A sample terms and conditions document can be found online as part of the AICPA Tax Section's Annual Tax Compliance Toolkit. As noted in the sample document, some state boards of accountancy or governmental bodies may prohibit a CPA from limiting the rights of clients in an engagement letter or addendum. Accordingly, a CPA should consult with an attorney on how best to draft such a document to effectively limit liability.

With respect to limiting claims, a well-drafted terms and conditions document can help to clarify additional responsibilities of the client such as classification of workers and related payroll tax and withholding requirements, and billing and payment terms (helping to limit misunderstandings about fees).

In addition, this document should typically contain language regarding data storage and data transfer practices and limit the firm's liability for data breaches and hacks (as long as reasonable security provisions are in place). This document may also include language limiting liability for claims from third parties and overall liability for claims to fees paid in the engagement, or more commonly, some multiple of those fees.

Finally, a terms and conditions document should include language limiting the commencement of claims by the client to a reasonable period (if allowed by state law) following delivery of the work product and termination of the engagement. As mentioned earlier, updating engagement letters annually and making sure they are signed annually is key to commencing the running of a statute of limitation for claims.

Other risk management considerations

Liability claims sometimes arise when clients sue firms when deductions are disallowed by the IRS or other taxing authorities for lack of documentation. An effective way to reduce these types of claims is to include a one-page signature form as part of the tax organizer, requiring the client to affirm the accuracy of written contemporaneous records of charitable contributions, business mileage, ownership of foreign financial accounts, and other key documents.

At the end of an engagement, particularly one providing tax planning services or specific tax advice, the CPA should consider using informed consent letters to summarize the advice provided and request that the client sign and return a copy of the letter indicating his or her understanding and acceptance. The letter should note that any actions taken by the client are ultimately those of the client and not the tax practitioner or firm.

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