

Buckle Up: Crafting Effective Engagement Letters

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Imagine that you're leaving home to head to the office or a client site, or maybe you're just running out quickly to get a gallon of milk. You get in the car. What's the first thing you do before shifting into reverse and backing out of the driveway? You likely put on a seat belt. If you get into an accident, regardless of who is at fault, that seat belt could help prevent serious injury. Just as a seat belt helps mitigate the risk of bodily injury, using a well-crafted engagement letter may help mitigate the risk of a professional liability claim.

The value and importance of engagement letters have been espoused by many. Some professional liability insurers even provide incentives such as premium credits to customers who use engagement letters. Nevertheless, in one-third of all professional liability claims asserted in 2020 against CPA firms in the AICPA Professional Liability Insurance Program, there was no related engagement letter. In claims arising from tax and other non-attest engagements, this percentage increased to approximately 45%. These claims are more difficult to defend against if the practitioner did not use an engagement letter.

If your firm has never used engagement letters or perhaps has not implemented them consistently, where do you start? Here are some tips to help increase the efficiency and effectiveness of this critical tool.

View engagement letters as a tool, not a burden

At the beginning of the client relationship, you probably discussed the client's needs, the services to be provided, and what the client expected to receive from the firm. Rather than viewing an engagement letter as an administrative hassle or a non-value-added activity, consider it a tool that helps memorialize client discussions and manage expectations. This leaves more time for delivering billable services and means less time will be spent resolving misunderstandings related to scope of services or fees. The result is a win-win for the client and the CPA.

Create templates and leverage examples to gain efficiencies

While there is no one-size-fits-all engagement letter, it's likely that a significant portion of engagement letter content will apply to all clients in a specific service line. Create engagement letter templates for each service the firm provides. These templates can then be tailored to specific client needs and circumstances. Common engagement letter components for all services include:

- *Scope of services.* Clearly delineate the services included in the engagement. The description should be clear and include sufficient details to avoid misunderstanding or misinterpretation.
- *Professional standards by which the engagement will be governed.* Referring to the appropriate professional standards helps define and limit the CPA's professional responsibilities.
- *Deliverable or work product.* Even if the work product appears obvious (such as a completed income tax return in a tax compliance engagement), it is important to clearly define the work product to help avoid disagreements. Any restrictions on the use or distribution of the deliverable should also be articulated in the engagement letter.
- *Limitations of services.* Describe applicable limitations to the service. For example, most engagement letters should include a statement regarding the CPA's responsibility, or lack thereof, to detect and report on evidence of possible theft or fraud or to identify deficiencies in a client's internal controls.
- *CPA firm and management responsibilities.* A CPA's responsibilities are typically limited to the performance of services described in the engagement letter. A client has business operation and oversight responsibilities, including responsibility for making management decisions and performing other management functions.

Update the templates at least annually, or as necessary, to address changes in applicable professional standards, statutes, and regulations. The firm's attorney should review the engagement letters to ensure their provisions are enforceable in the applicable jurisdiction.

Many resources are available to help create engagement letter templates. Sample engagement letters are available from the AICPA and for-profit content providers, and may also be available from the firm's professional liability insurance carrier. Consult multiple sources when developing engagement letter templates to ensure those templates are appropriate and relevant for your firm.

Aim for 100% engagement letter use over time

If your firm has not historically required signed engagement letters on all engagements, doing so may seem overwhelming. A multiyear implementation plan may help ease the pain. Begin by grouping engagements into categories.

The first category should include engagements where applicable professional standards require the use of engagement letters, such as audits, reviews, and compilations. This part of the plan should be implemented immediately.

The second category includes clients or engagements that present elevated professional liability risk, such as high-net-worth individuals, complex engagements with multiple services, business tax clients, and clients raising capital or renegotiating loan terms. Consider implementing engagement letters for this category within one year to help manage the associated risks of these engagements.

The third category includes lower-risk engagements with standard terms, such as the preparation of income tax returns for individual clients with ordinary income reported via Forms W-2 and 1099. For these engagements, consider using a unilateral engagement letter that does not require a client signature and can be attached to the annual tax organizer.

Consider using a standard terms-and-conditions document

Often, client questions and pushback to engagement letters emanate not from the agreed-upon scope of service or work product to be issued but other terms and conditions of the engagement, such as billing practices, withdrawal provisions, indemnification, limitations of liability, or use of alternative dispute resolution. Consider placing these non-engagement-specific, cross-service terms and conditions in a stand-alone document that can be attached to all engagement letters and incorporated by reference. Any modifications to these terms may be made via agreement in the engagement letter. Use of a standard terms-and-conditions document may have the added benefit of appearing to shorten the engagement letter—something that is generally welcomed by most clients.

A final tip

Just like a seat belt, engagement letters can protect your firm only if they are used properly. Deliver services as described in the engagement letter. Well-intentioned actions that expand the scope of services, such as making adjusting journal entries to correct client errors to prepare a tax return, can be detrimental in the event of a professional liability claim. If additional services or scope modifications are required to complete an engagement, confirm this new understanding, including applicable limitations, with the client in writing, whether through an email or an amendment to the engagement letter. For new services, issue a new engagement letter.

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