**Episode Title:**

Engagement Letters: Foundational Best Practices

**Episode Notes:**

In this podcast from the [*Modernizing Your Practice*](https://www.cpa.com/modernizing-your-practice) mini-series, you’ll hear from Stan Sterna, JD from Aon and Sarah Ference from CNA, as they discuss challenges around liability risk in engagement letters and engagement letter scope. Stan and Sarah will share key insights and data around the most common reasons a firm faces a lawsuit in this area as well as steps firms can take to minimize this risk.

OUR GUESTS

Stan Sterna, JD, Vice President, Aon Insurance Services | Professional Firms

Sarah Ference, CPA, Risk Control Director, Accountants Professional Liability, CNA

INTERVIEWER

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**Transcript:**

Engagement Letters - Foundational Best Practices

**SUMMARY KEYWORDS**

engagement letter, client, firm, scope, claim, professional liability, service, expectations, aicpa, tax return, services, dispute

**SPEAKERS**

Stan Sterna, Sarah Ference, Matt Towers,

**Matt Towers**

Hello and welcome to the Modernizing Your Practice mini podcast series brought to you by CPA.COM. CPA.COM is the technology subsidiary of the AICPA and is tasked with helping bring the profession forward into the digital age through relevant learning opportunities and technology solutions. I'm your host, Matt Towers, Product Lead for Assurance Services with CPA.COM. Our goal with this podcast series is to bring relevant and actionable insight around ways that you can modernize your firm in the context of today's most common areas of liability and risk for public accounting firms. With me today is Stan Sterna, JD and Vice President of the Professional Firms division of Aon Affinity, and Sarah Ference, CPA and Risk Control Director at CNA. Stan, Sarah, welcome to the podcast.

**Sarah Ference**

Thanks, Matt.

**Stan Sterna**

Glad to be here.

**Matt Towers**

Today, Stan, Sarah and I are going to be discussing foundational best practices with engagement letters to help mitigate professional liability risk. To begin the conversation, we should really dig into why this is an important issue to tackle. So, what elements of engagement letters are the key areas of focus to get right, to help mitigate a firm's liability risk?

**Sarah Ference**

There's a lot of things that can be included in an engagement letter. But I think from a professional liability risk management perspective, there are three key areas that firms want to make sure they get right when drafting their engagement letters. The first one is the scope of service, which is what you have been engaged to do and what services you are going to be delivering to the client. You may think that this is an obvious area for the engagement letter, but we do see a lot of disputes when it comes to identification of scope and misalignment of expectations regarding what the client thinks is being delivered, and what the firm thinks it's delivering. The more specificity and clarity you can provide in the scope of service within an engagement letter really just helps align those expectations.

**Sarah Ference**

I'll give you an example. Your engagement letter might say that you are engaged to prepare a client's tax returns. Well, what kind of return is that? Is it an income tax return? Is it a sales and use tax return? Is it a gift tax return? So, identifying even the type of tax return is important. And then the question is "For what jurisdiction is it for? Is it the federal return only, or is it a certain state? And if it's federal and state, well, which state/s?" Getting as detailed as you can and putting a box around the scope of your service is only going to help align expectations, and then if there is a dispute down the road, the firm can pull out its engagement letter and work with the client and say, "Look, this is what I was engaged to do."

**Sarah Ference**

The second area of importance in an engagement letter is laying out the professional standards that the firm is going to follow when delivering the service. This helps extend expectations regarding what that level of service is. For example, are you engaged to deliver a compilation service, or is it an audit? Those two levels of standards are very different in terms of what kind of assurance or no assurance that is being provided by the firm. So, laying out and identifying the professional standards that the firm is going to follow. Closely aligned with that is the limitations of that service. So, for the vast majority of services that a CPA firm delivers, there is no responsibility to detect the theft or fraud at a client organization, yet we see that kind of claim in all areas of practice that a CPA firm performs. So, making sure there's clarity in the engagement letter and the fact that the engagement isn't designed to detect fraud at the client's organization or isn’t designed to, and the firm has no responsibility, to detect a weakness in the client's internal controls. Or the fact that, in preparing client's tax return, they're not going to audit or verify the information that's provided to the client or provided by the client. So it’s kind of setting forth the limitations of that service in the engagement letter, again, just helps align expectations.

**Sarah Ference**

And finally, laying out what are the client's responsibilities in the engagement letter. You know, it's to provide information timely, and maybe even is there a certain deadline the client needs to provide their information by, so that the firm can actually prepare the return on a timely basis. You don't want to get information on April 13 for an April 15 deadline. Maybe advancing that deadline by which the client needs to provide information to the end of March perhaps, or even earlier. And that allows the firm to manage their time.

**Sarah Ference**

Other things with regards to the client responsibilities, if it's advice and recommendations the firm is providing in a consulting engagement, for example, laying out the fact that it's the client’s responsibility to make decisions and to implement or respond to any advice or recommendations provided by the firm. So, I think those are evolving engagement letter provisions that there are, that are important from a professional liability risk management perspective. Managing that, and providing clarity on scope of service, laying out the standards that the firm is going to follow, including the limitations of that service, and then articulating the client responsibilities.

**Matt Towers**

Great. Thanks, Sara. That's extremely helpful, and I appreciate you providing the details around some examples there. So, Stan, with your background in managing claim defense, how does engagement letter construct come into play when a firm finds themselves facing potential legal action?

**Stan Sterna**

Matt, many, many claims deal with scope issues. Scope issues in terms of the engagement, expectations maybe aren't clearly defined, or there is maybe that a difference in opinion, or maybe there's a difference of opinion between the client and the CPA with regard to what was going to be done, and unless you are being diligent, making sure there is a robust engagement letter process and procedure within a firm, as Sarah noted, you're going to find yourself sort of behind the eight ball when you're dealing with a claim, especially when the scope of the service is being disputed. So ineffective engagement scope management is going to obviously adversely impact the defense of a claim so, whenever I'm dealing with a claim, or whenever one of our defense counsels assisting in defense of a claim, the first thing that we look at, or want to look at, is the documentation regarding the scope of the engagement and what the parties agreed to. What the parties agreed to at a time when there wasn't a dispute between those parties. I mean, that's a key point because, you know, hindsight is always 20/20. And people, especially attorneys, are going to parse words and try to draw different inferences for different things that were said or done. But when you have an engagement letter that was entered into between the parties at a time when there was a meeting of the minds, and no disputes with regard to the engagement letter, that becomes a very, very powerful tool when defending a claim.

**Stan Sterna**

So, the engagement letter is sort of the first documentary evidence that we're going to look for, in order to determine how we're going to defend this claim. And if the claim centers on, or are a hallmark of the claim is based upon, scope issues, obviously, a document that memorializes the expectations of the parties, the scope of the services, the limitations of the services, is going to be central to our defense of a claim. So, I cannot emphasize more the importance of having an engagement letter documenting the scope of the engagement in terms of defending an account’s professional liability claim. Because what you can do with an effective engagement letter, especially in a claim that is primarily focused on a scope issue, somebody saying, for instance, "Yeah, you're my tax advisor or my tax preparer, but I asked you about investment advice, and you gave me a thumbs up on an investment vehicle, and I lost a lot of money in that investment." You know the accountant will be sitting there and saying, "Well, we never agreed to enter into that kind of engagement. I was never engaged to provide you with investment advice."- You'd be able to take an engagement letter and say, "Here's the scope of the engagement. This is what you agreed to."- And there's no other documentation out there with regard to investment advice in either the bills, or in any sort of ancillary correspondence. I mean, that's going to be a powerful, powerful defense tool to respond to a claim and you can really take the wind out of the sails of a claimant at the outset of a claim by having an effective and thorough engagement letter that memorializes the service agreed to. So, I can't underestimate the importance of proper engagement letter procedures and having a proper engagement letter with all the necessary or the required elements that Sarah talked about, when defending accounts professional liability.

**Matt Towers**

I really appreciate that response and I think you both have hit on two really key areas… what should be in the letter, and why is it so important from a standpoint of defending a claim. I think the last piece I'd like to dig into a little bit here, is there any kind of recommendation you might have, or what you might consider to be the most important next step, or a critical step, that a firm should be taking today, if they're not already.

**Stan Sterna**

Yeah Matt, I have three takeaways that I'd like to provide to the listeners. One, obviously get an engagement letter. And get an engagement [letter] no matter what the service. A lot of professionals that I talked to will say, "Well, it's difficult to do that on a 1040 tax return." The expectation that your clients, you can have hundreds of these types of clients are going to issue or sign engagement letters. You know, I would say that's not completely accurate, if you're explaining to the client what you need, why you need it, why it's good for them why it's good for the accounts. Level-set the expectation so, in other words, implement a procedure in your firm to obtain annual signed engagement letters with all the relevant elements that Sarah noted when she was describing what you should include in the engagement letter. So that would be number one. Obviously get engagement letters, getting annual engagement letters from the client.

**Stan Sterna**

Takeaway number two, review those engagement letters annually. So, each year you're getting a new engagement letter. By having an annual engagement review process, you're sort of triggering yourself each year to not only evaluate the scope of the engagement, making sure that the engagement letter corresponds to what you may have agreed to during the course of the year with the client with regard to the scope, with regard to the limitations. And by doing this each year, you're sort of forcing yourself to review the engagement and you can do it as part of your annual client continuance due diligence. Reviewing the scope of the services, reviewing the communications you've had with the client through the course of the year, and making sure that engagement letter each year accurately defines the scope of the engagement.

**Stan Sterna**

And last, and this is I think a very, very key takeaway with regards, especially with regards, to defending scope issues, and accounts professional liability claims, amend the engagement agreement when it needs to be amended. So, whenever the scope of the services change, document that change. If you're agreeing to take on additional services, then either issue a new engagement letter, or amend the existing engagement letter, by maybe including an addendum to the engagement letter describing what the changes are. At the very, very least, if you don't do those first two, document in writing. I don't care if it’s a person who has defended claims for over 20 years. I don't care if it's via email, whether it's via a written letter, it can even be a text. You should document in some written form the changes in the scope, because when we're defending professional liability claims, there's nothing more powerful that documentary evidence. I mean, when you have one individual saying, "No, you agreed to do this." and the CPA may be saying, "No, I didn't agree to do that". When there's no documentation with regard to what the meetings of the minds were, with regard to the scope, the claim will devolve into a what we call a "swearing contest." So, it's going to be, more or less one, "he said, she said." One person saying one side of the story, the other person having another story. Then it comes down to credibility. And sometimes a jury finds one person believable, even though that person could be the person who is misrepresenting the truth. When you could bring in documentation, documentation at the time the engagement was going on, as I noted earlier, at a time when the parties wouldn't dispute, that's powerful evidence of the claim, to say "Now you're mistaken. This is what we agreed to, and what we agreed to was not what you're complaining that I did not do or should have done." So again, the three takeaways that I would have, get engagement letters, have a process in place to get them, review them annually, and amend them accordingly.

**Sarah Ference**

And I would also add it's very easy for us to say all these things, and it's harder to implement them when you've got the demands of delivering the service, growing the business, managing your practice. But having a good engagement letter in place is also incredibly beneficial from a business perspective for a CPA firm. If there are amendments or changes to the scope, well, that's additional service. and that could be an additional revenue stream for the firm. So, in addition to helping manage the firm's risk, it also might generate some fee opportunities for the client and articulating what the service is, and what the firm is going to provide, and managing those expectations with the client, well, that's actually a very good thing from a client service perspective. And revisiting the scope of service every year allows you to not only manage your professional liability risk, but also help manage that client relationship as well.

**Sarah Ference**

So, understanding that implementing and updating engagement letters is incredibly onerous and could be perceived as an administrative task. There's a lot of resources out there to help firms. You know, we as the professional liability carrier for the AICPA insurance program do provide sample engagement letters to our policyholders, that we update on an annual basis. We have over 30 of them, including sample Terms and Conditions, which get you to 90% of the way to creating your own engagement letters. So that's a resource for you. The AICPA, certain sections, also offer sample engagement letters. There's a wide variety of resources out there to support firms. What we would say, is create something that's going to work for your firm and your client base. You know what your firm can do to implement. You know your clients, and but as Stan said, get something in place with those clients, and for every engagement. Because at the end of the day, it's not only going to help the firm manage its professional liability risk, it’s also good to help the firm deliver excellent client service as well.

**Matt Towers**

Those are some really good suggestions and practical advice for people to take. I really appreciate your time today Stan and Sarah. Thank you so much. And I'm sure everyone listening appreciates having a bit more awareness around some best practices for engagement letter creation and scope.

**Matt Towers**

I'm Matt Towers, at CPA.COM, and I want to thank everyone for listening in today. We hope you glean some useful insight from the podcast. And until next time, I encourage you to check out CPA.COM for more useful information to help you and your firm win in the digital age. Take care.

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