

The Engagement Letter: An Accountant's First and Best Defense Against a Malpractice Claim

Article By:

Kevin Shaftan

Shirley S. Karasick

Best practice dictates that accountants memorialize the professional services that they will perform on behalf of clients in a written engagement letter, regardless of the service being performed.

The purpose of the engagement letter is to set out the professional relationship and expectations undertaken between the accountant and the client. Among other things, a well-conceived engagement letter should (1) detail the scope of the work to be performed, (2) define the respective responsibilities of the parties, (3) disclose the fees to be charged, and (4) set parameters as to the commencement and completion of the services. At its best, the engagement letter will serve to minimize the risk of misunderstandings between the accountant and the client and help to protect the accountant against a complaint or a claim of professional negligence.

Stating the Case for the Engagement Letter

According to a 2021 study from *The Journal of Accountancy*, malpractice claims against accountants with engagement letters can be up to 71 percent less severe or expensive to settle than malpractice claims against accountants who do not have engagement letters with their clients. Indeed, according to the National Association of State Boards of Accountancy, the first question when investigating a complaint filed against a CPA is, "What does your engagement letter say?"

Many legal and disciplinary complaints filed against accountants arise from or relate to a communication breakdown between client and accountant. A well-written engagement letter, by clearly stating the terms of engagement, serves to limit the expectation gap that results in misunderstandings and leads to complaints.

Elements of a Successful Engagement Letter

A good engagement letter should include the following key provisions:

- The scope of the work to be completed
- The accountant's responsibilities and the client's responsibilities
- Limitations on liability clauses
- Dispute resolution provisions

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- Waiver of a jury trial
 - Time limits, if allowable, for claims to be brought
 - Any caps on the monetary limits of liability, if allowable in the state
 - The fees to be charged.

One of the first areas of concern that should be addressed in the engagement letter is to provide a description of the types of services that will be performed by the accountant during the course of the engagement.

Bear in mind that every provision in an engagement letter should serve the purpose of managing risk. If the client, after reviewing the engagement letter, wants to make any edits, consider how such edits impact the accountant's risk tolerance. Consider why the client may be interested in making edits that shift risk back to the accountant, and whether accepting such edits would place the accountant in a position where accepting the engagement may no longer be advantageous.

Concern about exposure is why setting out in the engagement letter exactly what each party is responsible for is so important. Be clear as to what information and level of cooperation is expected from the client in each engagement and make sure those expectations are set forth in the engagement letter. In addition, risk allocation provisions should be included in every engagement letter. Risk allocation simply means sharing or allocating the risk between parties to an agreement.

For non-attest engagements, limitations of liability provisions in the engagement letter are a useful tool to shift risk exposure resulting from the engagement to the accountant. A limitation on damages clause is by design intended to limit the maximum dollar exposure the accountant would have in the event the client is successful in bringing a claim. Typically, such provisions are stated in terms of a multiplier of the professional fees associated with the engagement. There also can be a provision that limits the types of damages a party can seek, whether they are direct damages, lost profits, punitive damages or consequential damages

Another key element of every engagement letter is some type of alternative dispute resolution (ADR) clause, which also can include a provision waiving a jury trial. Including a provision for either mediation or arbitration in the situation where a dispute arises generally tends to result in overall lower costs, as it is generally a quicker path to resolution. Mediation and arbitration are considered expeditious tools for resolving disputes rather than proceeding in court, which typically can be protracted and overall more costly. Significantly, professionals tend to favor ADR provisions in an engagement letter as these proceedings are confidential in nature as opposed to proceeding in a court setting that becomes public record.

Additional Considerations

The inclusion of indemnification clauses also should be considered for non-attest service engagements. For example, in tax preparation engagements in which the accountant does not perform attest services for the same client, the inclusion of an indemnification clause can be a useful tool in managing risk should the client, for example, fail to provide a Form 1099 or fail to report foreign income, resulting in the client being assessed with a penalty from the IRS upon filing the tax return. The inclusion of an indemnification clause may help tax preparers insulate themselves from their client's faulty reporting of information that led to the penalty.

As accountants and tax professionals are often the recipients of third-party requests for the provision of their clients' documents, it is advisable that the engagement letter include a carefully worded subpoena reimbursement clause that is not overbroad, especially for attest services, or the

professional runs the risk of a regulator or fact finder considering them to be an impermissible indemnity provision. The subpoena reimbursement clauses in an engagement letter are quite valuable as responses to subpoena requests can be costly to the professional.

In addition to outlining the accountant's responsibilities, the engagement letter should communicate clearly to the client what their responsibilities are related to the engagement. Critically, the client has a responsibility to provide the accountant with all requested or necessary documentation in a timely manner. To mitigate delays, the accountant might consider stating a deadline by which the client must provide all necessary documents and information before the professional begins the engagement. Language should be included in the engagement letter that would relieve the accountant/tax professional from continuing with the engagement if the client is uncooperative.

Similarly, the engagement letter should clearly articulate the client's responsibility to be responsive to the professional's continued requests throughout the course of the engagement and be able to provide complete and accurate information upon request. Including language in the engagement letter that makes clear that the client is ultimately responsible for the engagement, whether it be the accuracy of a filed tax return or the fair presentation of financial statements, and that the accountant/tax professional is not being engaged to guarantee any particular result.

Failures and Fees

The engagement letter should specifically state when the engagement concludes. For example, an engagement could conclude upon the delivery of a tax return or audit report.

Equally important is the inclusion of language in the engagement letter that provides for instances that would require the accountant or tax professional to disengage from the engagement. Common situations that could warrant the professional to disengage include but are not limited to:

- The professional being asked to take an unreasonable or unsupported tax position
- The professional is not provided with information requested for timely completion of work
- The client refuses to cooperate
- The client has provided misrepresentations
- The client has not paid for services rendered.

Last but certainly not least, clearly outline the fees to be charged for the engagement and clearly set forth expectations as to payment terms and timing. It is critical to include an explicit statement that the services to be performed under the engagement shall halt in the event of failure of payment.

A carefully crafted engagement letter will be the accountant's first line of defense when faced with a complaint. Of course, as with any critical business document designed to mitigate risk, consulting a trusted legal adviser is recommended.

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