



Accountants

Risk Management Newsletter

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Reducing Your Liability Risk: How accountants build protective walls using well- crafted engagement letters

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The accounting profession is under fire. As an attorney whose clients predominately include accountants and lawyers, I have witnessed the number of accounting malpractice claims grow considerably in the last few years. Many claims are undoubtedly by-products of the recession. Individuals and businesses struck by these economic times are seeking new and inventive ways to recover lost money. While lawyers and financial advisors are regular victims of the disgruntled client's lawsuit, accountants are now in good company. It's a blame-game with significant risk implications for the practicing accountant, and no one is safe. Or are they?

Some lawsuits against accounting firms are completely baseless; others are merited beyond question. All of the cases, however, are defensible in some way. Cases are not won because of some supreme legal skill or courtroom drama. They are won, many times, because of what the accountants did to protect themselves long before something went wrong. The strength of the defense is often a function of

the accountant's internal risk management. The accountants who have clearly spelled out the terms of their retention *in written form* before commencing any work for the client have built a protective wall against a myriad of claims. I am talking about the engagement letter, which is perhaps the most important document an accountant may use as evidence against baseless claims for professional services never initially contemplated.

This article will briefly discuss the makings of a superior engagement letter. We will also examine the equally important, yet often overlooked closing correspondence which helps to solidify the proverbial wall built by the initial correspondence. Further, we'll discuss the importance of preserving the writings in an increasingly digital world, and we'll conclude the article with a true story of one accountant saved by the engagement letter.

What Makes the Best Engagement Letter?

The best engagement letter clearly and robustly defines the accountant's role. While deceptively simple, engagement letters should be drafted for *any* type of service to be performed, regardless of how straightforward or menial the scope of the service. In the letter, the accountant should let the client know what she will be doing and how it will be done. For example, if the engagement calls for tax preparation, *say that in the letter*, and outline what

it will entail. Even though the scope of service may be obvious to you and your client, it won't be obvious to a court when the client accuses you of not performing an "audit" or not delivering "sound financial advice" when you thought you were just retained to file a tax return.

If you are hired to conduct some higher level of service, such as a review or an audit, spell out what you will be doing. Also explain what you will *not* be doing. The benefit of that is twofold: you protect your firm and at the same time market your services by identifying those services you are not providing, but could.

Moreover, establishing the fee schedule in the engagement letter will help to avoid disputes later. The accountant should also include alternative dispute resolution (mediation or arbitration) language to the letter to mitigate the potential severity of any claims that do arise. This can also be effective in maintaining client relationships.

Finally, the client should agree to the terms of the engagement letter by signing and returning the document, such to avoid any potential questions that may arise as to its validity and status as an enforceable contract.

Of course, the accountant should strictly adhere to the terms of the engagement or risk exposure to claims that exceed that of ordinary negligence. Alarming, we are seeing an increase in claims sounding in breach of fiduciary duty which are appended to the more traditional claims for negligence. Claims as such often arise out of business advisory relationships that go beyond the scope of basic accounting services. A plaintiff cannot sustain a claim for breach of fiduciary duty if the accountant did not contract for the types of things that will give rise for such a duty.¹ The engagement letter protects against this by setting forth the terms of the retainer.

Whenever a new assignment arises, even with a long standing client, drawing up a fresh engagement letter is good practice. If circumstances require the existing scope to be modified, simply draft a new letter.

The Overlooked Closing Correspondence

A good engagement letter spells out the length of retention and sets a clear end-date for the project. In addition, I always recommend the use of a closing letter or report which reaffirms that a project has concluded. It can simply read, for example, "*With the issuance of this report, our audit of your company's 2010 financial statements has concluded. It was a pleasure working you with you and we look forward to our next engagement.*" Unlike, a *disengagement* letter, which is designed to permanently sever the relationship with the client,² a closing correspondence simply marks the date and time of the project's conclusion.

I understand that sometimes the "end" of a project is not clearly defined, especially for the accountant employed by clients with complex tax issues. Thus, it is up to the accountant to determine the right time to send a closing letter. But it should not be ignored. In this challenging time for the profession, it's amazing how taking two minutes to write a two-line letter can save what is potentially years' worth of headache (not to mention money).

Keeping Letters Preserved in a Digital World

A clear engagement letter, often very helpful in shielding the accountant against specious claims, is only useful if it is preserved for evidence. As we move toward a paperless society I see my accountant-clients increasingly using emails in lieu of formal letters. This is apparently a universal trend, as courts are now scrutinizing emails more than ever and finding that emails may establish contractual relationships like any traditional writing.³ I typically advise that an emailed retention "letter" is acceptable, but bear in mind that communicating via email tends to de-formalize the written content therein. This raises a red flag, because the accountant should never spare the key language used in a formal letter. She must render the terms clear and unassailable—which automatically begets formal language.

And one must remember that emails are only useful if preserved. I often advise clients and colleague that "digital files *do not exist* unless they exist in two places." Email servers crash frequently. For example,

Google's popular Gmail recently deleted the emails of 150,000 of its users.⁴ The lesson here is simple: print the email and keep it in a safe place.

True Story: Saved by the Engagement Letter

In a case that I personally handled, a malpractice claim against my client was outright dismissed due to a well-drafted engagement letter. The facts of the case were certainly interesting: the board of a research company employed by "big tobacco" sued its accountant claiming that an audit for the 2001 tax year was negligently performed. Allegedly, the accountant failed to detect that an officer had used corporate checks to purchase a \$1 million sport fishing boat as well as \$50,000 worth of dental implants. Weighty allegations, for sure, but I won't discuss the (frankly scary) merits of the claims because the court didn't even bother with it, instead holding *ab initio* that the claim was *barred* by New York's three-year statute of limitations.

The board of the research company, in opposition to our motion to dismiss, argued that because the relationship with the accountant continued for nearly a decade after the 2001 audit, there was one long, continuing engagement which "tolled" the statute of limitations. The court didn't see it that way, and focused sharply on the 2001 audit engagement—separate and distinct from the many subsequent services performed. Fatal to the case was the court's finding that the allegedly negligent actions performed by the accountant in 2001 were too old to be actionable.⁵

How did the court reach that conclusion? It looked to the multiple engagement letters that we produced as evidence. The accountant was in the good habit of drafting fresh engagement letters each year for its client—for each specific audit or review that he was hired to perform. Once a service was completed, the engagement was effectively over, and a new one began. When the client was asked to perform the same service in a subsequent year, he simply mailed a newly-minted engagement letter. Clearly, our client was "saved" by the engagement letters. Case dismissed.

In conclusion, we note that every engagement is unique, and accountants owe a duty to themselves, as well as to their clients, to express the terms of retention clearly. In this era when accountants are likely targets for economy-driven claims, the accountant should define her role as sharply as possible, and stick to it. That is solid risk management. Your lawyer and liability insurance carrier will thank you. More importantly, you will thank yourself.

¹ Saracino, Gregory R. "The Dangers of Fiduciary Duty." *Accounting Today*. Vol. 24, No. 10. August 16, 2010.

² Lambert, Joyce C. *et al.* "Disengagement Letters: Crafting Documentation for a Variety of Scenarios." *CPA Journal*. Vol. 79, No. 7. July 2009.

³ *See Newmark & Co. Real Estate v. 2615 East 17 Street Realty*, 80 A.D.3d 476, 914 N.Y.S.2d 162 (1st Dep't 2011)

⁴ Bosker, Bianca. "Gmail Reset Erases Messages? Users Report All Emails DELETED." *Huffington Post*. February 27, 2011.

⁵ The judge cited *Williamson v. Pricewaterhouse* (2007), where New York's highest court examined the question of whether there is one "long" engagement or separate, distinct engagements for purposes of applying a statute of limitations defense. The Court of Appeals held that "*the nature and scope of the parties' retainer agreement (engagement) play a key role in determining whether 'continuous representation' was contemplated by the parties.*" The statute of limitations was not tolled by continuous representation because each annual engagement letter between the parties contemplated separate and discrete auditing services each year, and once the defendant had preformed the services for a particular year, no further work on that year was undertaken.

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