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ENGAGEMENT LETTERS

by

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Bachelor of Science, University of North Dakota 1974



An Independent Study

Submitted to the Faculty

of the

University of North Dakota

in partial fulfillment of the requirements

for the degree of

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INTRODUCTION

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The topic of this engagement letter. It does not deal, as G. B. Hudson states, " . . . with marriage proposals . . . although they may attract more interest than . . . at hand." Rather, this study deals with the letter prepared . . .

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of these suits have arisen because of a lack of understanding between the accountant and his client or by third parties as to the exact nature or terms of the engagement. Special care is needed to avoid the problems which this type of situation creates.

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INTRODUCTION

The topic of this study is the engagement letter. It does not deal, as G. B. Hudson states, ". . . with marriage proposals or engagements, although they might attract more interest than the subject at hand."¹ Rather, this study deals with the letter prepared by a public accounting firm to confirm previous oral arrangements pertaining to the engagement of the firm to perform services for its client. Other names given to this written contract between an accountant and his client are the engagement confirmation letter, the letter of arrangement, letter of commitment, proposal letter, or appointment letter. The term, "engagement letter" will be used hereafter in this study.

In recent years, there has been a significant increase in the number of liability suits against public accountants. Many of these suits have arisen because of a lack of understanding between the accountant and his client or by third parties as to the exact nature or terms of the engagement. Special care is needed to avoid the problems which this type of situation creates.

The use of engagement letters is probably the best protection against liability which is available to the accountant. The objective of this study is to determine what topics should be covered in the engagement letter and what information should be

presented in order to enable the engagement letter to fulfill its primary purpose of maintaining good client relations and protecting the accounting firm against potential legal liability.

Chapter I will discuss the purpose of engagement letters and point out some of the situations which make the use of an engagement letter desirable. Several legal cases involving public accountants will illustrate ways in which engagement letters can be effectively utilized to avoid potential legal liability. In addition, there will be a discussion of the extent to which public accounting firms are currently using engagement letters.

Chapter II deals with the contents of engagement letters--the topics covered and the information presented. Since the contents of the engagement letter vary depending upon the type of engagement, this discussion will focus on engagement letters for various types of engagements--audit engagements, write-up engagements, and miscellaneous engagements such as management services or tax engagements.

Chapter III discusses some miscellaneous aspects of engagement letters and some modifications of or alternatives to the use of engagement letters. Finally, the Appendix contains some sample engagement letters for various types of engagements.

Introduction Endnotes

¹G.B. Hudson, "Proposals and Engagements," Canadian Chartered Accountant, Vol. XCVII (October, 1970), p. 275.

CHAPTER I

PURPOSE OF THE ENGAGEMENT LETTER

Maintenance of Good Client Relations

Most people think of the purpose of an engagement letter as being a means of protection against potential legal liability. While this may ultimately be true, it should be understood that most legal difficulties arise out of a misunderstanding between the client and the public accountant. Since a misunderstanding which leads to a liability suit against the accountant is obviously very damaging to the relationship between the client and the accounting firm, the basic purpose of the engagement letter should be the maintenance of good client relations -- through the avoidance of misunderstanding.

Much of the legal difficulty and public criticism which has been directed at the accounting profession is a result of a lack of understanding of the services which the CPA is qualified to perform and the responsibilities he is expected to assume. Charles Hellerson lists some of the problems and misunderstandings which may occur:

1. The client does not recognize the distinction between income tax requirements and generally accepted accounting principles.
2. The client thinks that accountants never make mistakes and that financial statements are "correct." He does not grasp the concept of "fairly present."
3. The client thinks that one-- if not the primary purpose of an examination is to disclose defalcations and other irregularities.
4. The client does not accept the concept that he has any responsibility for financial statements. As far as he is concerned, they are the CPA's-- he drafted them.
5. The client does not understand the distinction between unaudited statements, especially when some auditing is performed, and financial statements examined in accordance with generally accepted auditing standards resulting in an opinion. This situation is particularly acute where there is an examination with an unqualified opinion at year-end, but there are interim visits (whether quarterly or monthly) when some auditing is done and unaudited financial statements are prepared by the CPA. In my opinion, all financial statements are unaudited, regardless of the amount of auditing performed, unless the CPA was specifically engaged to make an examination of the financial statements in accordance with generally accepted auditing standards.
6. The client is uncertain about the amount and computation of the fee to be charged.¹

In many cases, the term "audit" is used loosely, and may mean different things to different people. Sometimes there may be restrictions placed upon the scope of the examination, so that it is not a true unrestricted audit. Often, the accounting firm will provide accounting services and prepare financial statements for a client, but does not perform an audit or render an opinion on the statements. In other instances, the accountant may merely provide tax services. These clients may all consider the accounting firm to be their auditors, and the work they do as an audit. Often, the corporate minutes will refer to the appointment of the accounting firm as "auditors." None of these circumstances, however, really constitutes an audit.

In situations such as the above, the engagement letter must

clearly define and clarify the true nature of the engagement. The client must be educated as to the distinction between an audit and the other types of engagements, and the engagement letter should spell out exactly what type of engagement is contemplated. This procedure can do much towards eliminating any misunderstanding between the client and the accountant.

Protection Against Legal Liability

Protection against lawsuits by third parties may also be provided by an engagement letter in this type of situation. Third parties may contend that the accounting firm was engaged to do an audit, and may seek to hold the accountants responsible for the standards applicable in an audit engagement. A well written engagement letter can quickly set the record straight. It is interesting to note that many insurance companies, in applications for malpractice insurance, ask questions about the use of engagement letters by the insured. Apparently, they feel that the use of such letters reduces their risk.

D.R. Carmichael offers the following observations regarding engagement letters:

When the CPA is engaged to prepare financial statements without audit, an engagement letter should always be used to clarify the nature of the services to be performed and to provide protection if, subsequently, the engagement becomes the subject of litigation or other disagreements.

Unfortunately, many people do not realize that CPAs commonly offer a wide range of services, including the accounting services involved in preparing unaudited financial statements. When a CPA's name is associated with financial statements, the implication of "audit" arises unless suffi-

cient care has been taken to indicate that the statements are unaudited. The transmittal letter accompanying the statements should contain the type of disclaimer illustrated in SAP No. 38 and each page of the statements should be marked "unaudited." These precautions are necessary for the benefit of potential users of the statements so that they will not be mistaken for audited financial statements.

The CPA should also take precautions for his own benefit so that no one can mistakenly believe that he agreed to perform an audit. SAP No. 38 was worded very carefully to identify any work in connection with unaudited financial statements as an accounting service. The CPA should be equally careful in arranging the engagement since he may have to prove in court that he was not engaged to perform an audit.²

The engagement letter can be an invaluable defense for the CPA who is involved in litigation. Through its use, the CPA can show exactly what the scope of the engagement and the intent of the parties were. As Earl F. Davis and James W. Kelley state:

Since the work undertaken by the accountant is based on a contract with his client, a letter clarifying the verbal agreements so as to eliminate later misunderstanding is in order. While the oral agreement is as binding as a subsequently written agreement, most contract litigation is not the result of contract content but of how the parties interpreted the contract. A written agreement does not depend on recollections of intent, and while it will not preclude litigation it should reduce the number of suits where intent of the parties must be determined.³

The 1136 Tenants' Case⁴

The 1136 Tenant's Case is a classic example of the danger inherent in the failure to use engagement letters. The defendant, Max Rothenberg & Co., was engaged in 1963 by Riker, the managing agent for the 1136 Tenants' Corp., a cooperative apartment corporation. Rothenberg prepared tax advice letters for the tenant-shareholders of the corporation in 1963, and prepared unaudited

financial statements for the year 1963 and for the six months ended June 30, 1964.

Riker, the managing agent, also managed several other cooperative apartment corporations. He maintained a single bank account in which he commingled maintenance payments from all the corporations and against which he drew checks in payment of the expenses of the corporations.

In March of 1965, it was discovered that Riker had been embezzling funds from the cooperatives, and suit was brought against the accountants. The plaintiff charged that Rothenberg had been engaged "to perform all necessary accounting and auditing services," and that they failed "to examine and audit the books, records, invoices, bank statements and cancelled check vouchers." Because of this breach of contract and failure to exercise due care, the accountants had failed to discover the defalcations which had taken place.

The defendant argued that it had been engaged to maintain the client's books and prepare tax returns and unaudited financial statements, and that it had no liability to perform auditing procedures. Unfortunately, the engagement was based on an oral agreement--there was no engagement letter, and the court found for the plaintiff. Thus, a judgment of approximately \$235,000 was assessed against the accountants--relative to an annual fee of \$600 which the accountants had agreed to charge.

This case points up the extreme need for engagement letters, even on the smallest of engagements. By spelling out in writing the terms of an engagement, the CPA can protect himself against

claims that he was engaged to do more than he contracted to do.

The Stephens Industries Case

The case of Stephens Industries v. Haskins and Sells also shows how protection against legal liability can be provided by a written clarification of the scope and terms of an engagement.

Haskins and Sells had been engaged to perform a purchase audit pursuant to the terms of a purchase agreement. One of the terms of this agreement was that "accounts receivable as shown by the records of such corporations, shall be used in determining net worth without adjustment to reflect the fact that the auditors may feel certain accounts are or may be uncollectible in whole or in part."

When the purchaser found that the accounts receivable were substantially overstated, he sued the accountants. In holding for the accountants, the court pointed to the clear, unambiguous and untechnical language of the purchase agreement, which stated that no adjustment for uncollectibility was to be made.

The analogy between the purchase agreement in this case and an engagement letter is that the accountant must not only state what is to be done in the engagement letter, but also, in many cases, what is not to be done. He must set forth the exact nature and terms of the engagement, including any restrictions upon the scope of the engagement, and he must do so in clear, untechnical language which is easily understood and not apt to

mislead anyone.

The Franklin Supply Case⁶

In the Franklin Supply Case, the accountants were engaged to perform a purchase audit for the plaintiff, which had agreed to purchase a subsidiary of a Venezuelan corporation. During the purchase negotiations, questions were raised regarding the value of the inventory. The parties had agreed that it would be valued on the financial statements on a replacement-cost basis.

As it developed, there were two markets in Venezuela in which replacement inventory could have been purchased, a market for new goods and a market for used goods. The accountants had used the former in the valuation, and were subsequently sued on the basis that they had overvalued the inventory. Although there were other factors which affected the court's decision, the result was that it was found that the accountants should have used the market for used goods in valuing the inventory, and judgment was entered against them.

The point which can be made regarding engagement letters is that the accountants, who should have been aware of the existence of two markets, should have obtained a written agreement clarifying the exact procedure to be used in the valuation of the inventory. By setting forth this information in an engagement letter, the accountants could have protected themselves from the type of liability incurred in this case. When accepting an engagement, the accountant should anticipate the types of

problems likely to be encountered under the existing circumstances. Then, in the engagement letter, he should clarify the scope of the engagement so that these possible points of conflict are covered. In this manner, he can protect himself against liability which might otherwise be incurred.

Current Use of Engagement Letters

In light of the reasons previously given for the use of engagement letters and the legal liability to which the accountant may be exposed by not using them, it would seem that the use of engagement letters would be a widespread practice. In this section it will be seen, however, that this is not the case.

In 1972, Dan M. Guy and Alan J. Winters took a survey of 235 public accounting partnerships in the state of Texas to determine the extent to which engagement letters were used.⁷ In order to correlate the data according to size of the firms involved, the firms selected in the sample were asked to indicate the amount of their total annual revenues and whether they were national, regional or local firms. Since this survey was directed towards the use of engagement letters where unaudited statements were involved, the firms were also asked to indicate the percentage of their business which involved the preparation of unaudited financial statements for their clients.

The results of the survey disclosed some rather startling information. Of the public accounting firms sampled, approx-

imately 48 per cent never employed engagement letters for unaudited financial statement engagements. Most of these firms stated that they felt their familiarity and long-standing relationships with their clients precluded the need for engagement letters. Many of the firms said they did not prepare engagement letters for existing clients but did prepare them for new clients. They felt that existing clients would be offended by the formality associated with engagement letters. The survey showed that the smaller firms, who were more likely to handle significant amounts of unaudited statement work, were the ones who were less likely to use engagement letters. The larger the firm, the more likely it was that engagement letters were used.

The firms in the sample were also asked to indicate their familiarity with the 1136 Tenants' Case, so that the sample results might be correlated with this factor. Again, the larger the size of the firm involved, the more likely it was that they were familiar with this case. Yet, 26 per cent of the firms who indicated they were "very familiar" with the case and 65 per cent of those indicating they were "somewhat familiar" with the case never used engagement letters. These findings are somewhat distressing, considering the importance of the use of engagement letters in light of the 1136 Tenants' Case. As Arthur P. Bartholomew said in discussing this case at the 1971 spring Council meeting of the AICPA: "One positive thing that could come from this case, I would hope, is that we could read from it the extreme need for engagement letters even on the smallest of engagements."⁸ Apparently, there is

still some progress to be made in this area.

CHAPTER II
Chapter I Endnotes

¹Charles B. Hellerson, "Client Engagement Letters Are in Your Best Interest," Journal of Accountancy, Vol. CXXIII (June, 1967), pp. 62-63.

²Douglas R. Carmichael, "An Engagement Letter for Un-audited Statements," Journal of Accountancy, Vol. CXXXI (March, 1971), p. 69.

³Earl F. Davis and James W. Kelley, "The Engagement Letter and Current Legal Developments," Journal of Accountancy, Vol. CXXXIV (December, 1972), p. 54.

⁴1136 Tenants' Corporation v. Max Rothenberg & Company, 36 AD 2d 804, 319 NYS 2d 1007 (1st Dept., 1971), aff'd, 30 NY 2d 585, 330 NYS 2d 800 (1972).

⁵Stephens Industries v. Haskins and Sells, 438 F. 2d 357(CA-10, 1971).

⁶Franklin Supply Co. v. Talman, 454 F. 2d 1059 (CA-9, 1971).

⁷Dan M. Guy and Alan J. Winters, "Unaudited Financial Statements: A Survey," Journal of Accountancy, Vol. CXXXIV (December, 1972), pp. 46-53.

⁸Ibid.

Basis for the Engagement Letter

The engagement letter should be merely a written record of what has previously been agreed upon. Therefore, before the letter is prepared, the CPA should discuss with the client, in detail, each of the points which he considers

to be significant in the particular engagement. When an inquiry is received from a prospective client, a member of the CPA firm should meet with the officers, board of directors, or other key employees of the client to discuss the groundwork for the engagement. At this time, the auditor should obtain general information about the client's firm, the type of services which the client desires.

CHAPTER II

CONTENTS OF THE ENGAGEMENT LETTER

This chapter will discuss the type of information and the topics which should be included in the engagement letter. Some of the contents may or may not change, depending on the type of engagement. Therefore, this discussion will take place in the context of some of the various types of engagements which may be encountered. First, a complete engagement letter for an audit situation will be discussed. Then, there will be a discussion of the variations which may be required for other types of engagements. Before embarking on this discussion, a brief look will be taken at the basis for the engagement letter.

1. Nature of the business.
2. Nature of auditing services desired (opinion audit, etc.).
3. Other services (tax, accounting or management services).
4. Date and period to be covered by report.
5. Addressee of report.
6. Number of copies of report.
7. Due date.
8. Extent of use of client personnel and facilities.
9. Fee arrangements.

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Douglas R. Carmichael and Thomas R. Hanley suggest the use of an "Arrangement Memorandum" to facilitate this conference with the client, to serve as a basis for the engagement letter, and to provide the auditor in charge of the field work with an introduction to the engagement. They suggest that it should contain information categories such as the following:

1. Client name, address, and telephone number.
2. Nature of the business.
3. Names and positions of key personnel.
4. Nature of auditing services desired (opinion audit, etc.).
5. Other services (tax, accounting or management services).
6. Date and period to be covered by report.
7. Addressee of report.
8. Number of copies of report.
9. Due date of report.
10. Extent of use of client personnel and facilities.
11. Fee arrangements.¹

Once the CPA firm has gathered the information pertinent to the engagement and has discussed all significant points with the client and reached a verbal understanding, the engagement letter can be prepared for the client's acceptance.

Engagement Letter for Audited Statements

This section will discuss the contents of an engagement letter prepared in connection with an engagement to audit and report upon the fairness of presentation of financial statements. The discussion will be centered on the information presented in various key sections of the letter.

To Whom Addressed

In general, the engagement letter should be addressed to whoever retained the accountant. If the client is a corporation, and the accountant is elected by the stockholders or the board of directors, the letter should be addressed to the chairman of the board or to the chief executive officer, depending on the arrangements. In cases where an audit committee appoints the accountant, the letter should be addressed to the committee. If the accountant is engaged by a high-ranking corporate official, the letter should go to him personally.

When the client is not a corporation, the letter should be addressed to the proprietor, partner, manager, or other person with whom the arrangements have been made.

In all cases, the accountant should consider who is in authority to bind the client under the circumstances. This will normally be a senior executive officer other than one responsible for control of the accounting system. Often, it is desirable to send copies of the engagement letter to persons

not directly involved in negotiations who are considered to be in positions of higher authority. This will assure that top management concurs with arrangements made by lesser officials.

Opening Section

In this section the accountant will summarize the events which led up to the retention of the accountant to perform services and will lead into the general purpose of the engagement. This information may prove helpful in defending actions taken to persons who were not directly involved in the negotiations.

Some firms also include general information about the accounting firm, its background, and other services which the firm is prepared to offer. This is a rare opportunity when the CPA can ethically advertise its services and expertise.

Scope Section

This section is one of the most important parts of the engagement letter. It is here that the CPA must set forth the exact nature of the engagement. By clarifying exactly what it is that he has been engaged to do, the CPA can avoid any misunderstanding with his client and add legal protection in case of future dispute.

Since, in an audit engagement, the purpose of the engagement is to express an opinion on the fairness of presentation of the financial statements in conformity with gener-

ally accepted accounting principles, the engagement letter should so state. Furthermore, the letter should explain what is meant by performance of an audit in accordance with generally accepted auditing standards. Some of the language and concepts of Statements on Auditing Procedure No. 33, "Auditing Standards and Procedures," might be used in this section. Some firms even include in the letter, or as an appendix to it, much or all of the language of Chapter 1 of the statement in which the responsibilities of the auditor and of management are defined.

Some auditors include in the letter a listing of the procedures which are contemplated in the scope of the examination. The extent of detail of this listing would be a matter of individual preference. Douglas R. Carmichael and Thomas R. Hanley propose that the engagement letter should stress these three points regarding the scope of the examination:

1. That an essential feature of an audit is a review and evaluation of the client's system of internal control.
2. That the audit tests to be made will be those that the auditor thinks are necessary in the circumstances.
3. That the extent of the tests will be influenced by the effectiveness of the system of internal control, which includes all aspects of the business.²

Regarding the reference to internal control and testing procedures in the scope of the examination, the letter should explain how these procedures pertain to the goal of expressing an opinion on the fairness of presentation of the financial statements. It should be made clear that these tests are not normally designed to offer conclusive evidence of such fairness

but that they are designed to achieve a balance between satisfactory conclusiveness and reasonable audit fees.

Consequently, it should be noted that the examination is not designed, and cannot be relied upon to detect fraud or other irregularities, although their discovery may result during the course of the examination. There is much misunderstanding concerning the responsibility of the auditor for uncovering defalcations. Therefore, it is extremely important that the engagement letter contain a disclaimer of such responsibility. Not only should the scope section of the letter show what the auditor is to do, but it must show what he is not to do also.

In an audit engagement, the auditor will likely agree to inform the client of any weaknesses or shortcomings existing in the client's system of internal control of which the auditor becomes aware during the course of his examination. If this is the case, then the scope section of the engagement letter should also make reference to this agreement.

Regardless of the type of engagement, the scope section of the engagement letter should specify exactly what it is that the accountant has been engaged to do. It is best to avoid vague generalizations. The more specific the accountant is in detailing the scope of the engagement, the greater the protection afforded by the engagement letter will be. Also, the use of technical terms and language should be avoided wherever possible. By using terms and language which the client can readily understand, the accountant can assure that there

will be less chance of misunderstanding. has imposed.

Special Circumstances or Limitations

If there are special circumstances, or limitations are placed upon the scope of the audit by the client, the engagement letter should disclose this fact. For example, if in an examination the auditor is not able to observe inventories and does not contemplate being able to satisfy himself by other means, or if the client requests that the auditor not confirm receivables, this should be noted. When any such restrictions are placed on the scope of the examination, the omitted procedures should be detailed in the engagement letter. of the client's accounting department.

In addition, the effect of these limitations on the auditor's opinion should be explained in the letter. The client should clearly understand that the auditor will have to disclaim an opinion and cannot issue a piecemeal opinion. Often, a brief explanation of the different types of opinions is worthwhile. Many accountants include in the engagement letter an example of the form and wording of the type of opinion which they expect to issue. including only the num-

bered By disclosing limitations in the engagement letter, the accountant will protect himself against claims that he was negligent in not performing required audit procedures. Also, disclosure of the effects of limitations will avoid misunderstanding and insure that the client is aware of the

consequences of the limitations which he has imposed. of his
prompt completion of the tasks which the client's staff is

Use of the Client's Staff

When the client's staff is to be used to perform tasks or to prepare schedules, the engagement letter should include a list of the tasks to be performed and the documents and schedules which are to be prepared before the start of field work. This information is sometimes included in a separate letter to the accounting department or discussed with a member of the client's accounting department. The engagement letter will then merely state that the use of the client's staff has been discussed and coordinated with that particular member of the client's accounting department.

The Tulsa, Oklahoma CPA firm of Sartain, Fischbein, Kurtz & Co. makes very effective use of a checklist in requesting the use of the client's staff.³ The checklist contains every conceivable task that the accounting firm may request the client to do. When planning the audit program, the auditor in charge numbers those paragraphs which pertain to the particular engagement. Then, a secretary types a letter on the CPA firm's stationery including only the numbered paragraphs, along with any other comments made by the in-charge auditor.

The applicable portions of the checklist might instead be included in the engagement letter or as an appendix to it. This may give it the appearance of being more "official" and

impress the client with the importance and necessity of his prompt completion of the tasks which the client's staff is to perform.

Agreement Concerning Fees

The engagement letter should also contain a section describing the basis upon which fees are computed and a description of the billing method (monthly, quarterly, progress billings, etc.). An estimate of the approximate total fees, or range of fees, for the engagement may also be given.

Clients are often confused regarding the fee arrangements and the use of auditing staff members with various levels of skill. When they engage an accounting firm to perform services, they often expect that a partner will be present in their office performing the services. They expect the best, and feel cheated when they find that a junior accountant is performing much of the work.

Carl S. Chilton, Jr. emphasizes the need for explaining fee arrangements to clients.⁴ His firm, in a newsletter sent to clients, explains that different kinds of accounting services require differing levels of skill. When the accounting firm is engaged to perform services for the client, it will assign personnel to the job who possess the necessary qualifications and skills to complete the job successfully. Since much of the work consists of routine procedures,

accounting personnel whose time is less valuable can be delegated to perform these tasks. Therefore, the fees which the client will be charged can be kept to a minimum.

Since most accounting firms base their fees upon the time spent on the engagement, an explanation in the engagement letter similar to that given above will insure that the client does not have a mistaken impression regarding fee arrangements. If, in addition, the client is to be charged for out-of-pocket expenses connected with the engagement, the engagement letter should also make this fact clear. Also, the client should be informed that if he request additional services, or if unexpected problems are encountered, additional fees will have to be charged, and the client will be consulted before the work is done.

Other Information

Some firms include a section in the engagement letter introducing the partner in charge of the engagement and indicating that he is responsible for insuring that the client receives good service. A statement that he will consult with other partners whenever another point of view or specialized assistance is needed will indicate to the client that the entire resources of the accounting firm are available for use on the engagement. The in-charge accountant or senior accountant in charge of the field work can also be introduced in this section.

The engagement letter should also set forth the accountant's understanding of any time limitations which are involved in the engagement. The letter may contain the complete audit schedule for the client's information, or merely the date set for completion of the audit and issuance of the auditor's report.

Closing Paragraph

The closing paragraph of the engagement letter should express the accounting firm's pleasure at having the opportunity to be of service to the client, and its readiness to assist the client in the future. The most important purpose of this paragraph, however, is to obtain protection against future liability. This is done by having the client indicate his understanding and acceptance of the terms of the engagement by signing the engagement letter and returning a copy to the accounting firm.

Engagement Letters for Other Engagements

Most sections of the engagement letter will remain basically unchanged, regardless of the nature of the engagement. Some sections, however, will vary depending upon the type of engagement. For certain types of engagements, information may be included which is necessitated by particular

characteristics of the engagement. This section will discuss the changes in the contents of the engagement letter discussed in the previous sections which would result from the differences in the nature of other engagements.

Unaudited Statements

The important thing to remember concerning the scope section of the engagement letter, regardless of the type of engagement, is to specify exactly what it is the accountant has been engaged to do. The more clearly and completely the nature of the engagement is described, the greater will be the protection against misunderstanding and potential legal liability.

In an engagement letter for unaudited statements, it should be emphasized that the purpose of the engagement is not to express an opinion on financial statements. The accountant has been engaged merely to prepare financial statements for the client's use, and an audit in accordance with generally accepted auditing standards is not contemplated. The engagement letter may state that the financial statements are being prepared from the general ledger and other information which the client has furnished, and although the accountant is preparing them, they are the representations of management. As such, management must accept the responsibility for their fairness.

Since the purpose of the engagement is not to express

an opinion on the statements, the engagement letter should state that the accountant will disclaim an opinion on the statements. It may be advisable to include an example of the wording of the disclaimer to prevent any misunderstanding by the client.

Although an audit is not contemplated in an engagement for unaudited statements, the accountant may find that the client's board of directors has recorded the engagement as an "audit" in the board's minutes. In litigation, this fact may be extremely damaging to the accountant's contention that he was not engaged to perform an audit, since it gives evidence of the intent of the parties.

For this reason, many accountants include in the engagement letter a paragraph which specifies that they have been engaged to perform accounting services, rather than an audit. A request is then made that the client does not record the engagement as an audit in the minutes, or that the client amend the minutes and verify that the accountant is not to perform an audit. This procedure will insure that there is no misunderstanding and will add protection in the event of litigation.

Since the statements which the accountant is preparing will be unaudited, care should be taken to insure that they are not reproduced or published in any manner which is out of context or which gives the appearance that the accountant has audited them. Therefore, the engagement letter for unaudited statements should contain a section which states

that if reproduction or publication of the financial statements, or any portion thereof, is intended, it is the accountant's policy that any masters or printer's proofs be submitted to him for review prior to reproduction or publication. The accountant can then be protected and maintain control over the way in which statements with which his name is associated are represented.

Tax Engagements

The scope section of an engagement letter for a tax engagement should specify the type of tax services to be performed. This information should include reference to the taxing authority, such as federal, state, or local, and the type of return to be filed, such as corporate, partnership information return, trust or estate, individual, etc.

The letter should state that the returns will be prepared on the basis of information provided by the client, based on the accountant's understanding of the tax laws and precedents, and that the accountant will take no responsibility for the correctness of the information supplied, other than to the extent he has expressed an opinion on any financial statements which may be attached to the returns. The client should be advised to examine the returns carefully when he has received them, and to file them by the due date.

Since it is possible that the Internal Revenue Service

may audit the returns and request changes in them, the client should be advised to preserve supporting records. The letter should indicate the limitation periods during which assessments may be made or claims for refund be filed.

Management Services Engagements

In the scope section of an engagement letter for a management services engagement, an attempt should be made to spell out exactly what is agreed upon. The objectives of the engagement should be clearly stated, and any limitations should be disclosed.

Charles Hellerson describes a situation encountered which can be prevented by use of an engagement letter:

... one executive wanted a new cost system installed, a second wanted the existing one revised, and a third wanted to know if the present system provided sufficient information for the establishment of realistic selling prices. In situations of this nature, the CPA's understanding of the engagement may be colored, depending upon which of the executives discussed the assignment with him. In this case, an engagement letter had been written in which the installation of a new cost system was specified as the objective of the engagement. Since that was not the desire of the principal executive concerned, the result was that the scope of the assignment was clarified prior to the commencement of any work, and subsequent possible unpleasantness was forestalled.

The above example illustrates the importance of clarifying the exact nature of the management services engagement. In addition, the engagement letter should stress that the accountant's services are those of a consultant, and that the implementation of any suggestions made is the responsibility of management.

Timing of the Letter

Chapter II Endnotes

The most effective practice is to mail the engagement letter to the client prior to the time that any work commences on the engagement. In the event that the accountant is asked to undertake an engagement without any advance notice, the engagement letter should be prepared as soon as possible. For clients who have not previously received engagement letters, one should be sent prior to the commencement of the next engagement.

It is desirable to send an engagement letter to each client every year. Some firms, however, only send engagement letters every second or third year. This may be an acceptable alternative in those cases where the scope of the engagement remains unchanged from the prior year. However, the letter should state that the terms of the engagement will remain in effect until amended. If there are any changes in the requirements of the engagement, or in the management, control, or ownership of the client organization, a new letter should be obtained.

In situations where a full engagement letter is not sent to existing clients every year, it still would seem to be desirable to update and reaffirm the scope of the work. In such a case, an abbreviated engagement letter may be sent to the client. Examples of such letters have been developed by the Washington Society of CPAs, and are included in the Appendix.

Chapter II Endnotes

¹Douglas R. Carmichael and Thomas R. Hanley, "Audit Arrangements and Engagement Letters," Journal of Accountancy, Vol. CXXIX (June, 1970), pp. 70-71.

²Ibid.

³Paul M. Katz, "Year-end Work to Be Done by the Client and Engagement Memo," Journal of Accountancy, Vol. CXXIX (January, 1970), p. 76.

⁴Carl S. Chilton, Jr., "Explaining Fees to Clients," Journal of Accountancy, Vol. CXXIX (January, 1970), p. 75.

⁵Charles B. Hellerson, "Client Engagement Letters Are in Your Best Interest," Journal of Accountancy, Vol. CXXIII (June, 1967), pp. 62-63.

Some accountants are against the use of engagement letters for various reasons. While they might agree in principle that a written clarification of the duties and responsibilities in an engagement is desirable, they feel that the use of engagement letters is not practical, may offend clients, or is an unnecessary formality.

One alternative which has been suggested is to combine the clarification aspects of the engagement letter with the other matters usually covered in a representation letter obtained from the client at the end of the engagement. Joe R. Fritzemeyer and Douglas R. Carmichael have prepared an example of such a letter, part of which is reproduced below:

In connection with your preparation of the unaudited financial statements of (client's name) as of the close of business on December 31, 1970, you have inquired whether we have knowledge of any significant facts not known by you

CHAPTER III

ALTERNATIVES TO THE USE
OF ENGAGEMENT LETTERS

Representation Letter

Some accountants are against the use of engagement letters for various reasons. While they might agree in principle that a written clarification of the duties and responsibilities in an engagement is desirable, they feel that the use of engagement letters is not practical, may offend clients, or is an unnecessary formality.

One alternative which has been suggested is to combine the clarification aspects of the engagement letter with the other matters usually covered in a representation letter obtained from the client at the end of the engagement. Joe R. Fritzemeyer and Douglas R. Carmichael have prepared an example of such a letter, part of which is reproduced below:

In connection with your preparation of the unaudited financial statements of (client's name) as of the close of business on December 31, 1970, you have inquired whether we have knowledge of any significant facts not known by you

concerning the matters mentioned below.

We understand that: (1) these matters have not necessarily been reviewed or checked by you because you are preparing our statements based on the information entered in our books of original entry and based on the other records and information which we are providing you, (2) you are not conducting an audit in accordance with generally accepted auditing standards and accordingly you will not be able to express an opinion on our financial statements except for noting any departure from generally accepted accounting principles of which you have knowledge, (3) the fair presentation of the statements is our responsibility and (4) the accounting work which you did perform is not specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result.

In addition, we give you our assurance¹

The letter then goes on to list the other items which would normally be included in a representation letter. It is initially prepared by the CPA on the client's letterhead stationery. An official of the client company would then sign the letter and return it to the CPA for inclusion in his working papers.

Although this alternative to the engagement letter would be better than none at all, it would appear that it would not meet some of the prime objectives of an engagement letter. Obviously, since the representation letter is prepared subsequent to the completion of the engagement, it would not prevent some of the misunderstandings concerning the engagement from occurring until it was too late. It would, however, seem to add some protection against subsequent legal liability.

1. Our firm cannot be expected to render an opinion as to whether your statements fairly present your financial position and results of operations in conformity with generally accepted accounting principles, which include adequate disclosures, and

2. Although our firm will have prepared, or assisted in preparing your financial statements, the statements

Letter of Understanding

Another alternative to the engagement letter is a "letter of understanding." It has the advantage over a representation letter of being sent to the client at the beginning of the engagement, rather than at the end, and its purpose is to clarify the responsibilities involved in the engagement. It is typically less lengthy than an engagement letter, and the title may make it more acceptable to clients than a "representation letter."

Joe R. Fritzemeyer and Douglas R. Carmichael suggest the following letter of understanding for an unaudited statements engagement:

Our engagement to perform services for your company includes the preparation of financial statements on an unaudited basis. The purpose of this letter is to obtain confirmation of your understanding with respect to the nature of unaudited financial statements and that an audit of such statements by our firm is not contemplated.

It is understood that our assignment is limited to an "accounting service" as described in the pronouncements of the American Institute of Certified Public Accountants and, therefore, does not include an audit of your financial statements in accordance with generally accepted auditing standards or any other auditing standards, expressed or implied.

Your financial statements will be prepared without audit and exclusively from your general ledger and other information furnished to us.

It is also understood that the nature of unaudited financial statements intended here shall be in accordance with the professional criteria of the American Institute of Certified Public Accountants which provides, in part, that:

1. Our firm cannot be expected to render an opinion as to whether your statements fairly present your financial position and results of operations in conformity with generally accepted accounting principles, which include adequate disclosures, and

2. Although our firm will have prepared, or assisted in preparing your financial statements, the statements

are representations of your management, as is the responsibility for the fairness of such representations.

In addition, it is understood that the accounting service involved here is not specifically designed, and cannot be relied upon, to disclose defalcations or similar irregularities.

Further, it is our policy to require that master or printer's proofs be submitted to us for review if the reproduction or publication of these financial statements, or any portion of them, is intended.

Please be sure that your company is in complete agreement with the matters set forth above before signing and returning to us the enclosed copy of this letter.²

A conventional closing and the signature of a member of the accounting firm would follow the above portion of the letter.

Then, the following section would be included for the client's acknowledgement:

We understand that the purpose of this letter is to clarify both the nature of your engagement with respect to our financial statements and the nature of the statements themselves. We hereby confirm to you that we understand and agree with the contents of this letter.³

Chapter III Endnotes

¹Joe R. Fritzemeyer and Douglas R. Carmichael, "An Alternative to the Engagement Letter for Unaudited Statements," Journal of Accountancy, Vol. CXXXII (July, 1971), pp. 73-74.

²Joe R. Fritzemeyer and Douglas R. Carmichael, "A 'Letter of Understanding' for Unaudited Statements," Journal of Accountancy, Vol. CXXXII (November, 1971), pp. 74-75.

³Ibid.

APPENDIX

Example of Engagement Letter for
Audited Financial Statement Engagements

Dear _____

This letter will confirm our understanding of the arrangements to make an examination of the financial statements of _____ Company for the year ended _____ for the purpose of expressing an opinion as to the fairness of presentation of such financial statements in conformity with generally accepted accounting principles.

We shall examine the Balance Sheet of _____ as of _____ and the related statements of income and retained earnings and changes in financial position.

or

We shall examine the financial statements of _____ as of _____ and provide such accounting, auditing and tax services as deemed necessary.

Our examination of the financial statements will be made in accordance with generally accepted auditing standards and will include such tests of the accounting records and such other procedures as we consider necessary in the circumstances and will be directed to the expression of our opinion on the fairness of presentation of the financial statements taken as a whole in conformity with generally accepted accounting principles.

or

Our examination will be made in accordance with generally accepted auditing standards of the American Institute of Certified Public Accountants, a listing (or copy) of which is attached.

An essential feature of our examination is the review and evaluation of your system of internal control upon which

the scope and extent of our audit tests will be determined. We will use audit procedures and tests deemed necessary in the circumstances.

Because we did not observe the physical inventory or confirm the accounts receivable as of _____, the beginning of the current fiscal year, and it is not contemplated that we will be able to satisfy ourselves as to these by other means, we will be unable to express an opinion on the Income Statement, Statement of Retained Earnings and Statement of Changes in Financial Position for the year ended _____ or on the consistency of the application of accounting principles with the preceding year.

or

If in the course of our examination we discover factors which would prevent us from issuing an unqualified opinion on these statements we will discuss the alternative with you and attempt to arrive at a resolution acceptable to both of us.

An examination directed to the expression of an opinion on the financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations or other similar irregularities should any exist, although their discovery may result.

or

It is not contemplated that we shall make a detailed examination of all transactions or that we shall necessarily discover fraud should any exist. We shall, however, inform you promptly of findings that appear to be unusual or abnormal.

Your accounting department will provide us with the necessary detailed trial balances and supporting schedules, a list of which is attached. It is also contemplated that your office personnel will assist us by locating and submitting to us invoices, vouchers, canceled checks and other corporate documents and records which we request.

or

Whenever possible, we will use the personnel of your firm as well as their schedules, reports and correspondence.

Our charge for this work will be at our regular per diem rates plus travel and other direct costs. Billings will be made monthly as the work progresses.

or

Our charges for the services discussed above will be completed at standard rates. Every effort will be made to keep our time at a minimum consistent with the engagement requirements.

We are pleased that you have selected us as your independent certified public accountants and look forward to a continuing pleasant relationship with you.

Please indicate your agreement with the arrangements discussed herein by signing and returning the enclosed copy of this letter.¹

Example of Full Engagement Letter
for Audited Financial Statements

(Date)

Board of Directors
and/or President

We are pleased to serve as independent accountants for _____ . The purpose of this letter is to review certain details of our engagement.

Our basic recurring engagement is to examine and report upon the annual financial statements. We are also available to assist the Board of Directors and management on business and tax problems which may arise.

The purpose of our examination is to express an unqualified opinion on the fairness of presentation of the corporation's financial statements for the year ended _____ , and their conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. If our opinion will be other than unqualified, the reasons will be discussed with you.

Our examination will be conducted in accordance with generally accepted auditing standards which will include a review of the system of internal control and test of transactions to the extent we believe necessary. Accordingly, it will not include a detailed audit of transactions to the extent which would be required if intended to disclose defalcations or other irregularities, although their discovery may result.

We direct your attention to the fact that management has the responsibility for proper recording of transactions in the books of account, for the safeguarding of assets, and for substantial accuracy of the financial statements.

Such statements are representations of management.

In addition to expressing the opinion on the financial statements, we will submit as a normal part of our examination a letter advising you of opportunities we observe for economies in operations or improvements in internal control.

In matters relating to federal income taxes, we will prepare the necessary federal income tax returns and supporting schedules, examine the assessment notices generally, and discuss any matters concerning your taxes with the IRS, when appropriate.

Our engagement will be scheduled as follows:

	<u>Begin</u>	<u>Complete</u>
Examination:		
Tests of transactions	_____	_____
Year-end work	_____	_____
Financial statements	_____	_____
Federal tax return	_____	_____

Assistance to be supplied by your personnel, including the preparation of schedules and analysis of accounts, has been discussed and coordinated with Mr. _____, (title). Timely completion of this work will facilitate achieving the best audit performance with the minimum time.

Our fees are based on the time required by the individuals assigned to the engagement plus direct expenses. Individual hourly rates vary according to the degree of responsibility involved and the skill required. Bills for services are due when rendered, and interim billings may be submitted as the work progresses and as expenses are incurred. We believe the fees for this engagement will range from \$_____ to \$_____.

Mr. _____ is the partner in charge of all work we will perform for you. It will be his responsibility to insure that your management receives good service. He will call upon other partners in the firm for a second point of view or a specialized knowledge, as necessary.

The audit this year will be supervised by _____, (title), and _____, (title). They will be assisted by other members of the staff as necessary.

We have enjoyed our past associations with you and your staff and appreciate the opportunity to continue serving _____. Please call if you have any questions about any aspect of our engagement.

Yours very truly,²

Example of Abbreviated Engagement Letter
for Audited Financial Statements

Board of Directors
and/or President

(Date)

This letter is to confirm our engagement with you for the year ended _____. The details of our engagement were outlined in our letter dated _____ (date of prior full engagement letter).

We agree to examine your financial statements for the year ended _____ and assist in the preparation of certain other reports and tax returns. Our examination will be performed in accordance with generally accepted auditing standards and accordingly will include such tests as we consider necessary in the circumstances. You understand that our examination is not designed to and will not necessarily disclose all irregularities should there be any.

We appreciate the opportunity to serve you and we are pleased with our continued association.

Yours very truly,³

Example of Engagement Letter
for Unaudited Statements

This letter is being written to confirm and specify the terms of our agreement, and to clarify the nature and extent of the accounting services we will provide.

We draw to your attention that our services will not satisfy any stockexchange or other requirements for an audit in accordance with generally accepted auditing standards. Since we are accepting this engagement as accountants, rather than as auditors, we request that you do not record this as an audit engagement in your minutes.

Our engagement will be designed to perform the following services: (1) To discuss such suggestions and recommendations concerning your accounting methods and financial affairs as we consider appropriate, with the officers/directors. (2) To prepare without audit financial statements for your use as arranged from time to time. To such statements we will append our report, which will probably

take the following form:

Disclaimer of Opinion

The accompanying balance sheet of X Company as of December 31, 19__ and the related statement(s) of income and retained earnings for the year then ended were not audited by us and accordingly we do not express an opinion on them.

(Signature and date)

(3) To carry out such bookkeeping as we find necessary preliminary to preparation of the financial statements, and any related work arranged with the officers/directors.

(4) To....(List other services which are to be rendered, as for example, to prepare the necessary federal (and state) income tax returns with supporting schedules; to examine assessment notices respecting them; to advise on income tax matters generally; and to discuss with the IRS any matters concerning your taxes (as arranged with you from time to time).)

We wish to emphasize that our engagement is not for the purpose of expressing an opinion on financial statements and is not primarily or specifically designed, and cannot be relied upon to disclose defalcations and other similar irregularities by your company's officers or staff, although their discovery may result.

If reproduction or publication of financial statements prepared by us, or any portion thereof, is intended, it is our policy that any masters or printer's proofs be submitted to us for review, if our firm's name will be mentioned.

The charges for our work are to be based on the time spent, and calculated at our regular hourly rates in effect, from time to time, plus direct expenses. Our rates vary according to the degree of responsibility involved and skill required. Bills for services are due when rendered. Interim bills may be submitted at periodic dates to cover charges and expenses incurred.

We shall be pleased to discuss this letter with you at any time, and to explain the reasons for any items.

If the above terms are acceptable to you, and the services outlined are in accordance with your requirements, please sign the copy of this letter in the space provided and return it to us.⁴

Example of Engagement Letter
for Unaudited Statements

Dear Sirs: (Should be addressed to the shareholders, board of directors or officers with whom engagement was contracted.)

It is the purpose of this letter to obtain confirmation of your understanding of our engagement concerning the nature and extent of the accounting services we will perform, especially with respect to the nature of unaudited financial statements and to the fact that an audit of your financial statements by our firm is not contemplated. Since this engagement does not include an audit of your financial statements, we request that you do not record this as an audit engagement in your minutes or other records.

Your statements will be prepared without audit exclusively from the general ledger and other information you have furnished us. Accordingly, we will not be in a position to express an opinion as to the fairness of your financial statements. Although our firm may prepare or assist in preparing your financial statements, the statements will be representations of your management, who must accept responsibility for the fairness of such representations. You should also understand that the accounting services involved in this engagement are not specifically designed and cannot be relied upon to disclose defalcations or other similar irregularities.

Our engagement will be designed to provide the following accounting services: (List services to be performed, such as (1) to discuss suggestions and recommendations regarding accounting methods and/or financial affairs, (2) to prepare federal income tax and other tax returns and/or handle other tax matters, (3) to perform such bookkeeping services as we find necessary prior to financial statement preparation, (4) to prepare for your use and without audit such financial statements as you may request.) To these financial statements we will append our report which will probably be of the following form:

Disclaimer of Opinion

The accompanying balance sheet of X Company as of December 31, 19__, and the related statement(s) of income and retained earnings and changes in financial position for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

(Signature and Date)

It is our policy concerning the publication or reproduction of all or any portion of the financial statements we have prepared, or assisted in preparing, to require that the master or printer's proofs be submitted to us for review prior to reproduction or publication.

Our fees for the accounting services we provide will be charged to you on the basis of time spent on the various jobs and in accordance with the levels of skill and responsibility required for these jobs. We will bill you at the end of each month for all work done during the month and request that remittance of the charges thereon be made upon receipt of such bill.

If the above statements concerning the scope of our engagement, the responsibilities we undertake, the distinction we have made regarding audited versus unaudited financial statements and the fee arrangement are satisfactory to you, please sign the attached copy of this letter and return it to us for our files.

Sincerely,
_____, CPA
Name

Accepted for Company X

Name

Title

Date 5

Example of Abbreviated Engagement Letter
for Unaudited Financial Statements

Based upon our discussions with you and conferences with operating management, our understanding of your objectives with regard to the accounting system of the ABC (Date) on are:
Board of Directors
and/or President

This letter is to confirm our engagement with you for the year ended _____. The details of our engagement were outlined in our letter dated _____ (date of prior full engagement letter).

We agree to prepare unaudited financial statements for your use (for the year ended _____ or/from time to time). The statements will be prepared from your books and records, without audit, and we will not be able to express an opinion as to the fairness of them. We also agree to assist in the preparation of certain other reports and tax returns. You understand that our engagement is not

designed to disclose defalcations or other similar irregularities.

We appreciate the opportunity to serve you and we are pleased with our continued association.

Yours very truly,⁶

Example of Engagement Letter for
Income Tax Engagements (Excerpts)

We have been engaged to prepare (or if in a transmittal letter, we have prepared) the federal income tax returns for _____ including all supplemental schedules and forms as well as the state of _____ return. The returns are based on information furnished by you and are based on our understanding of the governing tax laws and precedents.

It is possible that the Internal Revenue Service might request changes in the returns; thus, supporting records should be preserved. The normal limitation period with which an assessment may be made or in which a claim for refund may be filed will expire _____.⁷

Example of Engagement Letter for
Management Services Engagement

Based upon our discussions with you and conferences with operating management, our understanding of your objectives with regard to the accounting system of the ABC Division are:

1. Improvement in financial control reports
2. Current recognition of variances from standard costs
3. Strengthening of inventory controls
4. Internal control over reliability and accuracy of accounting data.

We understand that the division controller is currently recruiting two additional accounting personnel, one of whom will be assigned to the cost system modification program on a full-time basis and thereafter will be responsible for its operation. Until such time as additional personnel are available, we will initiate the improvement program and furnish the staff required to accomplish the detailed fact-finding and analyses.

In our opinion, the modification and improvement program can be divided into six segments, each of which can be further subdivided to make use of division personnel as they become available. The elapsed time for the program can be shortened by overlapping the operations required in various departments. Therefore, we plan to proceed in the following sequence:

1. Define the modification required in the financial reporting plan.
2. Select and review cost standards for revisions necessary to agree with current operations.
3. Define manufacturing reporting and variance identification plans.
4. Establish overhead accounting plan.
5. Establish accounting plan for shop supplies.
6. Document amended bookkeeping and operating procedures.

We have drafted a work program, a copy of which is enclosed, which will form the basis for estimating time and for making weekly reports of progress. The total time requirements will vary depending upon when a cost accountant is hired and the extent to which other division personnel can devote time to the improvement program. However, for planning purposes, we estimate the program will require approximately six to eight weeks. Our fees will be based upon the hours actually required at our daily rates for this work, plus out-of-pocket expenses.

If the foregoing is in accordance with your understanding of our discussions, kindly acknowledge your agreement by signing the duplicate of this letter in the space provided below and return it to us.

If we have misunderstood your objectives or particular interests, we will be glad to meet with you and make suitable revisions.⁸

Appendix Endnotes

¹Earl F. Davis and James W. Kelley, "The Engagement Letter and Current Legal Developments," Journal of Accountancy, Vol. CXXXIV (December, 1972), pp. 56-57.

²"How to Protect Against Malpractice Suits," The Practical Accountant, Vol. VI, No. 2 (March/April, 1973), p. 52.

³Ibid., p. 53.

⁴Joe R. Fritzemeyer and Douglas R. Carmichael, "An Engagement Letter for Unaudited Statements," Journal of Accountancy, Vol. CXXXI (March, 1971), p. 70.

⁵Dan M. Guy and Alan J. Winters, "Unaudited Financial Statements: A Survey," Journal of Accountancy, Vol. CXXXIV (December, 1972), pp. 52-53.

⁶"How to Protect...", Vol. VI, p. 52.

⁷Davis and Kelley, "The Engagement Letter...", Vol. CXXXIV, pp. 56-57.

⁸Charles B. Hellerson, "Client Engagement Letters Are in Your Best Interest," Journal of Accountancy, Vol. CXXIII (June, 1967), p. 64.

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