BNA

Accounting Policy & Practice Report®

VOL. 7, NO. 17 AUGUST 19, 2011

ANALYSIS & PERSPECTIVE

When Kovel Letters Spell Trouble for a CFO
Aaron Krauss, of Cozen O'Connor's Philadelphia office, writes that an outside accountant's work can be privileged if the accountant is providing new services at the direction of a lawyer under a specific engagement letter with the lawyer. He explains that if the accountant proceeds under a *Kovel* letter, the accountant will have done everything possible to protect the client's interests.
Page 623

CURRENT DEVELOPMENTS

For Instruments Gauged at Cost, FASB Opts for Reporting of Fair Values
Publicly-owned banks would have to disclose fair value amounts of loans along with cost amounts on the face of the balance sheet, the Financial Accounting Standards Board tentatively decides. **Page 626**

FASB to Call for Disclosure of Remeasured Amounts of Banks' Deposits
FASB decides that public companies must disclose in the footnotes to financial statements a present value amount for demand deposit liabilities.
Page 626

FASB to Issue Final Standard in Sept. on Testing Goodwill for Impairment
New guidance aimed at reducing complexity and cost related to accounting for goodwill impairment tests will be issued in September, FASB says. The guidance will allow an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. **Page 628**

PCAOB Announces Some Progress in Impasse Over Audit Oversight in China
The Public Company Accounting Oversight Board says that it may be a step closer to reaching an agreement with its Chinese counterparts that would enable Sino-U.S. cooperation on audit oversight of public companies. **Page 633**

FASB Drafting Final Disclosure Requirements for Balance Sheet Offsetting
FASB votes to move ahead with drafting final disclosure requirements related to balance sheet offsetting that is contingent on the—a narrower version of its initial efforts with the International Accounting Standards Board on that topic.
Page 627

IASB Will Relax Requirements For Hedging of Risk Components
The International Accounting Standards Board agrees to allow entities to designate risk components as eligible hedged items. The decision confirms a proposal set out in the board's October 2010 exposure draft on hedge accounting.
Page 629

ALSO IN THE NEWS

INTERNAL CONTROLS: Desperate employees facing unrealistic pressure to meet financial targets are turning to accounting fraud in greater numbers, according to a KPMG report.
Page 635

AUDITOR OVERSIGHT: PCAOB votes unanimously to seek public comment on a proposal to require public companies to change their auditing firms from time to time. **Page 634**

FINANCIAL INSTRUMENTS: The Municipal Securities Rulemaking Board urges the Securities and Exchange Commission to amend its municipal disclosure rule to impose "consequences" for issuers for not complying with their continuing disclosure responsibilities. **Page 636**

SECTION INDEX

Analysis & Perspective 623
Accounting & Disclosure 626
Audit Developments 633
Accounting Practice 635
Official Actions 643
Calendar
- **Financial Restatements** 644
- **Comment Deadlines** 645
- **Effective Dates** 646
- **Upcoming Meetings** 650

Copyright © 2011 by Tax Management Inc. ISSN 1558-6642

Analysis&Perspective

When Kovel Letters Spell Trouble for a CFO; Or 'What Do You Mean My Accountant's Work Isn't Privileged?'

BY AARON KRAUSS

Chief financial officers and in-house accounting staff are often asked to work with lawyers to gather or interpret information needed to evaluate a potential acquisition or address a legal problem. When CFOs and their staff are called upon to do so, it is common for them to ask outside accountants—either the company's auditors or another firm that can provide consulting services without raising independence issues—to provide assistance. When CFOs and their staff ask outside accountants to provide assistance, they usually assume that the work of the outside accountants will be privileged, just as a lawyer's work is privileged.

While that can be the case, a privilege usually applies only if the outside accountant's work was not part of the accountant's routine work for the client, but was instead done at the direction of the client's lawyer in an effort to "translate" accounting concepts into terms the lawyer could understand. The existence of a separate engagement letter—a *Kovel* letter—is often a prerequisite for a finding that the accountant's work is privileged.

Aaron Krauss is a commercial litigator who practices in Cozen O'Connor's Philadelphia office. His practice includes both the defense of accounting firms and the retention of accounting firms to assist him in representing companies in contract disputes and business torts. Aaron Krauss can be reached at (215) 665-4181 or akrauss@cozen.com. This article should not be construed as giving legal advice. If you would like to receive legal advice, call Aaron Krauss. The views expressed in this article are the views of Aaron Krauss alone, and are not necessarily the views of Cozen O'Connor.

Privilege. A privilege prevents an adversary—whether it is the government or a private party to a lawsuit —from gaining access to certain information. The attorney-client privilege is the oldest and best established of the privileges.

If the accountant proceeds under a *Kovel* letter, the accountant will have done everything possible to protect the client's interests.

It prevents third-parties from discovering what a client says to a lawyer for the purpose of seeking legal advice. The theory is that, absent the attorney-client privilege, clients could not communicate honestly with their lawyers and give their lawyers all the facts.

Without all the facts, lawyers could not give good legal advice, nor could they make informed decisions regarding what strategies to use in an attempt to achieve the client's goals. Similarly, if lawyers knew that an adversary could go through their files, they could not explore different potential strategies, or realistically and honestly evaluate the merits of the available strategies.

Not Robust for Accountants. Especially when compared to the attorney-client privilege, the accountant-client privilege is not particularly robust or well established. Although state statutes sometimes provide for some privilege, that privilege is often limited, and courts (especially federal courts) often find it is inapplicable. This is because accountants are not supposed to be advocates (whether they actually are or not is another story). An accountant-client privilege would suggest that, rather than "auditing the books," accountants were trying to reach preordained conclusions. Moreover, an accountant's conclusions are supposed to follow logically from the information given to the accountant. They should literally add up, and any other accountant should be able to "check the math" both proverbially and literally. This would not be possible if an accountant's workpapers were shielded from review.

Perhaps more importantly, the IRS has the right to examine a client's books during a tax audit. Facts, such as the amount of a particular expenditure, cannot be

privileged, even if they are communicated to an attorney.

The bottom line is that an outside accountant's work can be privileged if the accountant is providing new services at the direction of a lawyer under a specific engagement letter with the lawyer.

As a result, even the federal taxpayer communications act, 26 U.S.C. §7525, is limited. For example, it does not apply in criminal actions. Instead, it only shields accountant-client communications from the government's review in civil tax cases. It is also inapplicable if the communications involve tax shelters (an exception that may swallow the rule). More importantly, the federal taxpayer communications act can only shelter communications from the government. It cannot shelter them from a private party.

Kovel Letter. So what is a *Kovel* letter, and how does one allow an accountant's work to be privileged? *Kovel* was a case in which an accountant who worked for a law firm refused to answer questions put to him by a prosecutor who had convened a grand jury to investigate the client's potential tax liabilities. The accountant claimed that his work was protected by the attorney-client privilege because he worked for a law firm. The trial judge supervising the grand jury disagreed and jailed the accountant for contempt.

Fortunately for accountants everywhere, the appellate court reversed. While the appellate court explicitly stated that a lawyer could not make an accountant's work privileged by the simple expedient of putting the accountant on the lawyer's payroll, it observed that the attorney-client privilege had always extended to non-lawyers who were essential to the lawyer's ability to do his or her job. Classic examples of non-lawyers who were entitled to claim the privilege were secretaries, file clerks, and message clerks. The Court then noted that, if a lawyer hired a translator to allow him or her to communicate with a client who spoke another language, the translator would be entitled to claim the attorney-client privilege. More importantly, if the translator interviewed the client without the lawyer present, and then wrote a memo to the lawyer summarizing the interview, the communication would be privileged. The Court concluded that

> If the lawyer had directed the client, either in the specific case or generally, to tell his story in the first instance to an accountant engaged by the lawyer, who is then to interpret it so that the lawyer may better give legal advice, communications by the client reasonably related to that purpose ought to fall within the privilege; there can be no more virtue in requiring the lawyer to sit by while the client pursues these possibly tedious preliminary conversations with the accountant than in insisting on the lawyer's physical presence while the client dictates a statement to the layer's secretary or is interviewed by a clerk not yet admitted to practice.

Accountants' Work Must Benefit Lawyers. Aside from confirming that lawyers and accountants speak different languages (and that judges think accounting is tedious), the *Kovel* Court established the two touchstones that enable an accountant to claim the benefit of the attorney-client privilege. One is positive—the work has to be for the benefit of the lawyer, and has to be necessary for the lawyer to render legal advice. The other is negative—the work cannot be something that the accountant would have done even absent the lawyer's involvement.

What does it mean that the work has to be for the benefit of the lawyer? First, that the lawyer has to direct the work. If the accountant is directing the work, no privilege will apply. Although it may seem trite, courts often focus on which professional was consulted first. If the lawyer was consulted first, and then retained the accountant, the accountant's work is likely to be privileged. If, on the other hand, the accountant is consulted before the lawyer becomes involved, courts are likely to find that the accountant's work is not privileged.

Second, the legal, rather than the accounting, aspect of the work must predominate. If, for example, the end product is a fairness opinion, a court is not likely to find that the accountant's work is privileged. If, on the other hand, the end product is either an expert report or an opinion on the damages that might be awarded in a lawsuit, a court is likely to find the accountant's work is privileged.

While the appellate court explicitly stated that a lawyer could not make an accountant's work privileged by the simple expedient of putting the accountant on the lawyer's payroll, it observed that the attorney-client privilege had always extended to non-lawyers who were essential to the lawyer's ability to do his or her job.

As for the negative touchstone, courts often ask whether the accountant would have done the work anyway even if the lawyer had not been involved. If, for example, an accountant had been reviewing financial statements for years, a court is unlikely to find that the accountant's work is privileged even if a lawyer asked the accountant to review the financial statements. But what if the lawyer asks the accountant to perform different procedures than the accountant traditionally performed? This is where the *Kovel* letter comes into play.

Many outside accountants perform tasks directed by lawyers without issuing a separate engagement letter. Absent a separate engagement letter, courts usually assume that it is "business as usual," and that the accountant is continuing to provide routine accounting services to the client. If, however, there is a separate engagement letter between the accountant and the lawyer, and if the letter states that the accountant will provide separate services—services that the accountant has not previously provided to the client—to the lawyer

Copyright © 2011 by Tax Management Inc.
APPR ISSN 1558-6642

so that the lawyer can render legal advice, a court is likely to find that the advice is privileged. This is especially true if the accountant segregates the value of the services being provided to the lawyer and bills the lawyer separately.

When Privilege is Waived. A word of caution is in order, however. Even if advice or work is privileged, that privilege can be waived if the privileged material is disclosed to outsiders—including the government. Clients often have powerful incentives to disclose a report prepared by their accountant to third parties such as current or potential stockholders, banks, bonding companies, or even the IRS. If a client discloses an accountant's work product, any otherwise applicable privilege will be waived.

The privilege will be waived as to both the document that was disclosed as well as to any related documents. This is because courts do not allow selective waivers. A selective waiver would allow a client to release the "good stuff" that supports its position and use the privilege to shield from disclosure the "bad stuff" that harms its position. While courts will allow a privilege to shield information from disclosure, they will not allow it to be used as both a sword and a shield.

The bottom line is that an outside accountant's work can be privileged if the accountant is providing new services at the direction of a lawyer under a specific engagement letter with the lawyer. While the client can choose to waive the privilege by disclosing the accountant's work, that is the client's choice to make. If the accountant proceeds under a *Kovel* letter, the accountant will have done everything possible to protect the client's interests.