Accounting for Cryptocurrency

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When you look up 'cryptocurrency' you will typically find the following: "is a digital asset designed to work as a medium of exchange that uses cryptography (which use decentralised control) to secure its transactions, to control the creation of additional units, and to verify the transfer of assets."

Cryptocurrency is generally accepted to be a form of digital currency. Bitcoin was the first decentralised cryptocurrency, which was created in 2009, and is one of the best-known cryptocurrencies, and since we have seen many more such as Ethereum, Ripple, Litecoin and IOTA to name few.

Cryptocurrency has no intrinsic value in that it is not redeemable for another commodity (such as gold), has no physical form (such as physical coins), is not legal tender and is not currently backed by the government or a legal entity.

Transactions are performed and validated by the users of the system on a peer-to-peer basis without an intermediary (such as a bank) facilitating these functions, using public-key cryptography. The cryptocurrency model introduced 'blockchain' technology, which is likely to revolutionise many industries. A blockchain is a continuous record, using an open distributed ledger (effectively many copies of the ledger held on many computers, and as such you would need to change many records on many different computers at the same time to alter it) that can record transactions between two parties in a verifiable and permanent way, and avoids retroactive alterations. In fact, this open distributed ledger and blockchain technology makes it so difficult to hack, that the hacker would more likely go after the computer that holds the digital currency.

Blockchain technology provides efficiency by eliminating the intermediaries (such as banks), avoiding many regulations that would normally apply to financial transactions, and security by means of cryptography and the open distributed ledger. While this brings efficiency, avoiding bank fees and other costs, it also removes a go-to person. When something goes wrong, or you want to dispute a payment, or someone stole your Bitcoins, you have little recourse or assistance.

Your cryptocurrency is not held by a bank or other entity; it's stored in your 'wallet' on your computer, cellphone or in the cloud. Cryptocurrency, such as Bitcoin, is pseudonymous in that the cryptocurrency is not tied to a person, but rather one or more specific keys, and thereby the owner is not identifiable, while all transactions are publicly available in the blockchain.

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Cryptocurrency is increasingly being used to pay for goods or services, as well as for investment purposes. Transaction volumes are growing exponentially, without specific guidance in IFRS on how to account. You can purchase clothes, food, stationery, health products, appliances and many more from both online and bricks-and-mortar retailers.

We know that cryptocurrencies are a type of exchange that only exist in digital form and are thus volatile. It is not linked to any physical currency or underlying asset or commodity. It may be quoted on an exchange against other currencies, even exchanges for physical currency.

The South African Reserve Bank (SARB) issued a Position Paper on Virtual Currencies (December 2014) in which it confirmed that it is not a recognised currency, nor backed or regulated by National Treasury or SARB. Furthermore, it expressed the view that "there are many legal uncertainties regarding virtual currency schemes… The lack of proper regulatory and legal framework substantially exacerbates the other risks, especially the enforcement of the principle of finality and irrevocability in the payment system". However, SARB issued a media statement on 13 February 2018 regarding the establishment of the Financial Technology (FinTech) Programme with its first objective to review SARB's position on cryptocurrencies to inform appropriate policy framework and regulatory regime.

There is also some uncertainty as to the correct taxing of gains and losses, and VAT treatment, regarding the trading or holding cryptocurrencies. The South African Revenue Service (SARS) confirmed that it will clarify its position on the tax treatment early in 2018. This is likely to be in the form of a binding ruling or interpretation note.

Given that cryptocurrencies are not controlled by a centralised entity it raises several concerns with law enforcement agencies and tax authorities around the world because of its anonymity and lack of a reporting entity. Cryptocurrency can be used for money laundering, evasion of exchange controls, and other illicit activities. One of the greatest challenges facing cryptocurrencies is around transparency. A tax authority, such as SARS, is very dependent on information provided by third parties to verify taxpayer disclosure and to manage tax risks and compliance. Without a third party to hold to account to provide information, SARS can only rely on the taxpayer's disclosure, or audits that are resource intense. To introduce regulations, you need to identify accountable entities that will be required to report, such as the banks acting as authorised dealers for the SARB.

The value of cryptocurrencies, such as Bitcoin, has fluctuated significantly since it was released. Some of the volatility is inherent as various countries are struggling with regulatory environment, and new cryptocurrencies are introduced. Also, it is possible that some volatility is due to its infancy or even could be indicative of inherent weaknesses.

Cryptocurrencies are susceptible to being lost or stolen either due to the device/computer on which they are stored being lost, or by the device being hacked. At present there is no legislation, regulation, or even centralised entity in place to provide some protection for those who have had their cryptocurrency stolen or their digital wallets hacked.

HOW MIGHT CRYPTOCURRENCIES BE ACCOUNTED FOR?

The IASB issued Conceptual Framework for Financial Reporting defines an asset as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity", and that "physical form is not essential to the existence of an asset". While there are some that hold the view that the uncertainty around whether future economic benefits are expected to flow from a cryptocurrency to the entity, means that an asset does not exist, it is generally been accepted that a cryptocurrency is an asset (on the grounds that there is sufficient control and certainty of future economic benefit). It appears that the real issue is with classification and measurement.

- Cryptocurrencies are not 'cash' and are not issued or backed by government.

- Due to its volatility there is a significant risk of changes in value, and it cannot be 'cash equivalent'.

- As cryptocurrencies do not give the holder a contractual right or obligation to receive cash or another financial asset, it can't be a 'financial instrument'.

- Also, is not land and building, and has no physical form, excluding 'PPE or Investment Property'.

COULD A CRYPTOCURRENCY BE 'INVENTORY'?

Inventories do not need to be in physical form but must be held for sale in the ordinary course of business. However, cryptocurrencies must be traded frequently enough so that such trading activity could be an entity's 'ordinary course of business'. Where a company accepts payment or makes payments for goods and services using cryptocurrencies, the company will not meet the test. If the company is a trader in cryptocurrencies, it could be argued that the definition of 'inventory' has been met but would need to be measured at cost.

An 'intangible asset' [IAS 38] is an identifiable non-monetary asset without physical substance/form. So, cryptocurrencies appear to meet the definition of an intangible asset, as they are identifiable, can be sold, exchanged or transferred individually, are not cash, a non-monetary asset and have no physical form.

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Intangible assets have traditionally been assets held for use in the production process, such as patents, trademarks, copyrights and other intellectual property. An intangible asset's primary objective is to generate revenue from the company's ordinary course of business. Cryptocurrencies are used to pay/exchange for goods or services, to incentivise or promote, and for investment purposes. An intangible asset feels very different from the use of cryptocurrencies.

It is generally accepted that fair value measurement is the most relevant measurement basis for a cryptocurrency, because it's being used as a currency-equivalent or alternative investment vehicle. An intangible asset can be measured at fair value, but only if there is an active market. Fair value movements must be recognised in 'Other Comprehensive Income'.

CONCLUSION

With the increasing popularity and use of cryptocurrencies, and its volatility, we must consider what shareholders and other users of financial statements need to know about the companies that hold cryptocurrencies. Until new guidance is issued, disclosure is of high importance to explain how cryptocurrency is classified and measured. Accounting for cryptocurrency is going to become a major concern for small and large companies alike.