Cryptocurrencies

Extract, IFRS® Discussion Group Report on the Meeting – January 10, 2018

The focus of the Group's discussion was on the accounting for investments in decentralized digital currencies (also referred to as cryptocurrencies). There are many different types of cryptocurrencies in the market (www.coinmarketcap.com). The terms and conditions of each type of cryptocurrency should be considered to determine the appropriate accounting.

In general, cryptocurrencies are a medium of exchange but differ from other currencies in that they only exist in virtual form. Similar to fiat currency, a cryptocurrency is not backed by any physical commodity. However, unlike fiat currency, it is not backed by a central bank, government or other entity, nor is it considered legal tender in Canada. As such, digital currency transactions are undertaken on a decentralized, peer-to-peer network. The peers in this network are the people that take part in digital currency transactions, and their computers make up the network. There is no middle party facilitating these transactions.

Issue 1: Is a cryptocurrency an asset?

In the existing *Conceptual Framework for Financial Reporting (Conceptual Framework)* issued by the IASB in September 2010, paragraph 4.4(a) defines an asset as follows:

> "An asset is 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."

The existing *Conceptual Framework* notes that the future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The definition embraces items that are not recognized as assets because they do not satisfy the recognition criteria. For example, the expectation for future economic benefits must be sufficiently certain to meet the probability criterion before an asset or liability is recognized.

View 1A – Yes, a cryptocurrency is an asset.

Paragraph 4.11 of the existing *Conceptual Framework* states, in part, that "physical form is not essential to the existence of an asset." Paragraph 4.12 of the existing *Conceptual Framework* further states, in part, that "although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control."

Proponents of this view note that investors control their investments in a cryptocurrency as they control its use through the mechanics of the public distributed ledger.

View 1B – No, a cryptocurrency is not an asset.

Proponents of this view consider the uncertainty around whether future economic benefits are expected to flow from a cryptocurrency to the entity to be sufficiently high that an asset does not exist.

The Group's Discussion

Group members agreed that a cryptocurrency is an asset (View 1A).

Issue 2: Assuming a cryptocurrency is an asset, what is the appropriate accounting model to apply?

There are various accounting models being considered for cryptocurrencies, each with differing views. Below are the discussion points relating to each accounting model. As mentioned earlier, it is important to note that the terms and conditions of each type of cryptocurrency should be considered to determine the appropriate accounting.

Hierarchy of Generally Accepted Accounting Principles (GAAP Heirarchy)

View 2A – The GAAP Hierarchy permits an entity to apply judgment in developing and applying an accounting policy.

In the absence of an IFRS Standard that specifically applies to a transaction, other event or condition, management should apply the GAAP Hierarchy described in paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

Management should apply its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. The financial statements should represent faithfully the financial position, financial performance and cash flows of the entity. They should also reflect the economic substance of transactions, other events and conditions, and not merely the legal form.

View 2B – The GAAP Hierarchy prohibits analogizing to other IFRS standards or applying judgment in determining an appropriate accounting policy (i.e., an entity needs to first consider the requirements in IFRS Standards dealing with similar or related issues).

Paragraph 11 of IAS 8 states the following:

> "In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:
> (a) the requirements in IFRSs dealing with similar and related issues; and
> (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework*."

Proponents of this view think that in applying paragraph 11 of IAS 8, an entity is directed to consider the requirements in IAS 38 *Intangible Assets*. A cryptocurrency has no physical substance and the accounting principles in IAS 38 deal with an identifiable non-monetary asset without physical substance.

Intangible asset

View 2C – A cryptocurrency is an intangible asset.

Proponents of this view think that either IAS 38 applies, or that that the GAAP Hierarchy directs an entity to IAS 38 as it provides sufficiently reliable and relevant accounting for a cryptocurrency given the asset is without physical substance. The asset is non-monetary because either (1) it is not a fiat currency and/or (2) it is not an asset to be received in a fixed or determinable number of units of currency in that it cannot be settled for a fiat currency. A currency is intended to encompass fiat currencies (i.e., those that are legal tenders).

View 2D – A cryptocurrency is not an intangible asset.

Proponents of this view think that IAS 38 does not apply because although a cryptocurrency has no physical substance, the accounting result of applying IAS 38 is not relevant. If IAS 38 was applied, a cryptocurrency would be carried at either cost or at its fair value at the date of the revaluation less any subsequent accumulated amortization and any subsequent accumulated impairment losses (i.e., the revaluation method). Under the revaluation method, only impairment losses are recognized in profit or loss. Gains are generally recognized in other comprehensive income.

In addition, IAS 38 only permits intangible assets to be revalued if there is an active market with sufficient frequency and transaction volume that takes place to provide pricing information on an ongoing basis. There are various exchanges through which cryptocurrency transactions are effected. However, the transaction values can be so volatile that a reliable value cannot be ascertained.

As a result, proponents think the more relevant measurement method is fair value through profit or loss given the nature of a cryptocurrency.

Financial asset

View 2E – A cryptocurrency is a financial asset.

Proponents of this view look to the definition of a financial asset in paragraph 11 of IAS 32 *Financial Instruments: Presentation*. They think that a cryptocurrency is virtual cash in that it is a medium of exchange that enables investors to purchase goods or services. Although a cryptocurrency is not a fiat currency and there is no one party standing ready to convert the investment into a fiat currency, these factors are not considered determinative.

View 2F – A cryptocurrency is not a financial asset.

Proponents of this view look to the definition of cash in paragraph 6 of IAS 7 *Statement of Cash Flows* to determine if cryptocurrencies are considered cash. Cash has the following meaning: "*Cash* comprises cash on hand and demand deposits."

Proponents of this view note that an investor of a cryptocurrency is not able to demand its cash back. The investor is only able to monetize its investment by either selling its cryptocurrency to another investor or by using it to purchase goods or services. Further, it is not cash on hand in the traditional sense. Other than for the impact of inflation, cash maintains its purchasing power. A cryptocurrency's value can be too volatile to be considered cash or analogous to cash.

To be a non-cash financial asset, an investor must have a contractual right to cash, or other assets, or a contract to be settled in equity instruments of an issuer. Proponents of this view note that a cryptocurrency is not an equity instrument of another party (i.e., it is not an interest in the net assets of any entity). In addition, holding a cryptocurrency does not give an investor any contractual right with any known party.

Inventory

View 2G – A cryptocurrency is inventory.

Proponents of this view think that IAS 2 *Inventories* acknowledges non-physical inventories because it recognizes commodity broker-traders have inventory. Paragraph 3(b) of IAS 2 (i.e., the scope exclusion from the measurement requirements of IAS 2 for commodity broker-traders) is relevant. Some proponents think cryptocurrency is a commodity, citing the commonly accepted definition of a commodity quoted on Investopedia as being "a basic good used in commerce that is interchangeable with other commodities of the same type."

Paragraph 3(b) of IAS 2 notes that the cost measurement basis does not apply to commodity broker-traders (i.e., those who buy or sell commodities for others or on their own account, and whose inventories are principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin). Paragraph 5 of IAS 2 indicates that such broker-traders measure their inventories at fair value less costs to sell. When these inventories are measured at fair value less costs to sell, any changes in fair value less costs to sell are recognized in profit or loss in the period of the change.

View 2H – A cryptocurrency is not inventory.

Proponents of this view think that a cryptocurrency is not within the scope of IAS 2 because it is not the type of asset described in paragraphs 3(b) or 6 of IAS 2. They think that cryptocurrencies are mediums of exchange. Similar to the exclusion of cash and other financial instruments from the scope of IAS 2, they think that cryptocurrencies should be excluded.

Investment property

View 2I – A cryptocurrency can be analogized to an investment property in IAS 40 Investment Property*.*

Proponents of this view think that the GAAP Hierarchy permits an entity to apply judgment in developing an accounting policy when an IFRS Standard does not specifically apply, or the consequence of applying a more specific standard would result in financial statements that are not relevant.

Investors in a cryptocurrency generally hold it for use as a medium of exchange, or for capital appreciation, or both. Therefore, proponents look toward the definition of investment property in paragraph 5 of IAS 40. The fair value model that is available to investment properties results in more relevant financial reporting. Unlike the revaluation model in IAS 38, changes in the fair value of investment properties are recognized in profit or loss. Proponents also note that some analogize to an investment property when accounting for a gold bullion that is held for capital appreciation.

View 2J – A cryptocurrency cannot be analogized to IAS 40 Investment Property *because it is neither permitted nor appropriate.*

Based on the definition of investment property, proponents of this view think that the scope of IAS 40 is limited to real properties (i.e., land and buildings).

The Group's Discussion

The Group discussed the applicability of the accounting models outlined above. Group members thought that an entity should first analyze whether the cryptocurrency it holds would be within the scope of an existing IFRS Standard before considering the GAAP Hierarchy.

Some Group members acknowledged that IAS 38 seems most applicable given the standard addresses assets without physical substance. However, some Group members noted that the accounting result produced under the revaluation method for intangible assets does not provide meaningful information to users when compared to a fair value through profit or loss measurement approach. One Group member noted that paragraph 7 of IAS 38 states, in part, "[e]xclusions from the scope of a Standard may occur if the activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way."

The Group discussed the fair value through profit or loss measurement approach under the financial instruments standard. However, there are challenges with applying the definition of a financial asset to a cryptocurrency because no identifiable contractual arrangement exists with another party. The only way to monetize the asset is to buy goods or services, or sell the interest in the cryptocurrency to another third party. From this perspective, a cryptocurrency is similar to gold bullion, which is not a financial instrument. One Group member raised the question of whether a cost less impairment model together with relevant disclosures provide more meaningful information as there is significant pricing volatility associated with some cryptocurrencies in the market.

The Group also discussed whether cryptocurrency is cash. The point of contention is whether the cryptocurrency can be viewed as a medium of exchange. Although the term "medium of exchange" is not defined in IFRS Standards, the Group discussed the notion of widespread acceptance and observed that it is difficult to compare cryptocurrencies to existing cash or cash equivalent products in today's marketplace. One Group member also thought another factor to consider is whether a cryptocurrency would ever be regarded as a functional currency for preparing financial statements.

One Group member commented on the IAS 2 and IAS 40 models. If the entity is a commodity broker-trader of cryptocurrencies, the IAS 2 model may work and allow for a fair value less costs to sell measurement approach. However, the difficulty with applying the IAS 40 model is that the standard is intended for physical assets.

Representatives from the Canadian Securities Administrators (CSA) observed that transactions involving cryptocurrencies are beginning to percolate in the market. CSA Staff Notice 46-307 "Cryptocurrency Offerings" was issued to assist reporting issuers to determine if such offerings would be considered a security under securities law. Although the definition of a security under securities law is not the same as the definition of a financial instrument under IAS 32 *Financial Instruments: Presentation*, considering the guidance in the staff notice may complement an entity's analysis on the accounting for cryptocurrencies. An entity's analysis should also consider whether there is an active market for the cryptocurrency it holds. Overall, the entity should clearly disclose the judgments applied in arriving at a certain accounting treatment.

The Group noted that IFRS Standards were designed before cryptocurrencies existed. As a result, providing financial information about a cryptocurrency that is relevant and faithfully representative within the existing confines of the IFRS Standards is difficult given the challenges pointed out with the various accounting models. The Group recommended that the issue be discussed with the AcSB to determine whether it should be raised to the IASB or the IFRS Interpretations Committee.

The IASB staff who observed the Group's discussion indicated that the IASB is actively monitoring the developments in this area.

(For a full understanding of the discussions and views expressed, listen to the audio clip).