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Cryptocurrency framework

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Cryptocurrency framework

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With a lack of a consensus on the accounting treatment for cryptocurrencies, it's time the IASB took action

An interesting puzzle exists with respect to the accounting treatment of cryptocurrencies. The announcement in October 2020 that PayPal was launching its own cryptocurrency service suggests growing acceptability. However, there is no standard that deals with them specifically.

In November 2018, the International Accounting Standards Board (IASB) decided against adding a project on cryptocurrency holdings. In June 2019, the International Financial Reporting Interpretations Committee (IFRIC) concluded that cryptocurrencies are not financial assets and should be accounted for under International Accounting Standard (IAS) 38, Intangible Assets, or under IAS 2, Inventories, if they are held for sale in the ordinary course of business.

Cash classification

Prior research has considered the classification of cryptocurrencies as cash and cash equivalents. IAS 7, Statement of Cash Flows, defines cash as 'cash on hand and demand deposits'. Cash equivalents, on the other hand, are defined by IAS 7 as 'short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value'.

Clearly, a cryptocurrency would not meet the definition of a 'cash equivalent' because it is not 'subject to an insignificant risk of changes in value'. For it to be 'cash', it must qualify as an equivalent of a currency based on three attributes commonly agreed by economists:

1. It should function as a medium of exchange.
2. It should function as a unit of account.
3. It should function as a store of value.

David Yermack of New York University's Stern School of Business concludes, in his commentary in the Handbook of Digital Currency, that bitcoin should not be considered as a currency because it performs poorly on attributes two and three.

Some researchers support the cash classification. For example, in their paper in the Australian Accounting Review in 2017, Tan and Low recommend reporting bitcoin temporarily held by trading firms as cash and cash equivalent, comparing its acceptance and volatility with some legal currency.

However, most accountancy research concludes that cryptocurrency should not be considered as cash and cash equivalent because it lacks broad acceptance presently as a means of exchange and is not legal tender.

Financial assets

Some research advocates reporting bitcoin as a financial asset because it is held for investment purposes. Yermack concludes that ‘bitcoin resembles a speculative investment similar to the internet stocks of the late 1990s’, while Raiborn and Sivitanides, in their paper in the Journal of Corporate Accounting and Finance in 2015, classify it as a short- or long-term investment within a US GAAP framework.

Reporting cryptocurrency as investment aligns with the tax treatment in many countries (including the US). Raiborn and Sivitanides propose investment-related journal entries for both exchange and mining transactions, and deem other asset classification inappropriate.

However, more recent research, such as the Australian Accounting Standards Board (AASB) in its agenda paper of May 2018, suggests that cryptocurrency does not satisfy the definition of financial instrument due to the lack of contractual right for the holder. Cryptocurrency lacks the characteristic of issued equity or debt of another entity, as noted by Smith and Castonguay in their paper in Strategic Finance in November 2019.

> “A framework is needed to classify cryptocurrencies by underlying attributes and to require the appropriate accounting treatment for each classification”

Inventory

Some research supports reporting cryptocurrency as inventory for certain types of entities, such as bitcoin exchange (Tan and Low) and companies that mine or resell (Smith and Castonguay). However, the AASB argues that inventory is not an appropriate classification for such businesses because the lower of cost and net realisable value measurement in IFRS Standards reports only decreases in value and does not provide relevant information about cryptocurrency movements.

One exception is commodity broker-traders, who can report cryptocurrency as inventory measured at fair value less costs to sell through profit or loss, and thus provide relevant information, as noted by the AASB.

Intangible asset

Most researchers agree that cryptocurrency meets the definition of an intangible asset, although Tan and Low argue that bitcoin does not lead to future economic benefits other than being a medium of exchange or investment.

However, there is disagreement on the usefulness of this classification. On the one hand, Smith and Castonguay support applying existing intangible asset standards because they consider the fair value through profit or loss (FVTPL) model inconsistent with conservatism – a view consistent with opinions of the majority of Big Four audit firms in the US.

On the other hand, Smith, Petkov and Lahijani in their 2019 paper in the International Journal of Digital Accounting Research suggest that the different accounting treatments for externally acquired versus internally generated intangible assets present earnings management opportunities and increase concerns for audit risk. Furthermore, the AASB determines that neither the cost model nor the revaluation model in IAS 38 provides relevant information on cryptocurrencies.

The AASB concludes that cryptocurrency should be measured using the FVTPL model and recommend that the IASB develop a new standard for investments in intangible assets and commodities to address the gap left by the superseded IAS 25, Accounting for Investments.

Lack of consensus

Clearly, there is a lack of a consensus on the accounting classification and measurement of cryptocurrencies.

In its 2019 agenda paper, IFRIC posits that cryptocurrencies that are not held for sale in the ordinary course of business meet the definition of an intangible asset. IAS 38 defines an intangible asset as ‘an identifiable non-monetary asset without physical substance’.

We have two concerns about this. First, there is a wide range of cryptocurrencies with different uses, varying from transferring value (eg bitcoin) to providing programmable blockchain (eg ethereum). Subjecting them to the same measurement basis does not reflect their different functionalities. Second, the measurement basis of cost or revaluation of IAS 38 may not provide useful information on cryptocurrencies generally.

Broaden IFRS 9

An alternative approach is to broaden the existing standard IFRS 9, Financial Instruments, to include cryptocurrencies. Presently, IFRS 9 defines financial instruments categorically rather than conceptually.

Many cryptocurrencies have grown to be digital alternatives to fiat currency and investments, and are closer in nature to financial instruments than intangible assets such as patents or research and development. The accounting measurement of fair valuation in IFRS 9 is also better positioned to provide more relevant information than the cost or revaluation model of IAS 38.

We believe that the better option is to scope out cryptocurrencies from IAS 38. A framework is needed to classify cryptocurrencies by underlying attributes and to require the appropriate accounting treatment for each classification. We strongly believe that information on fair value through profit or loss remains a key consideration for cryptocurrencies.