

Thinking ahead and
responding rapidly

BLOCKCHAIN AND THE EVOLUTION OF CRYPTOCURRENCIES IS STILL A WORK IN PROGRESS

Every day, the number of blockchain technologies, including 'cryptocurrencies', used in real world scenarios grows. From logistics to fine art, it is hard to find a sector that has not been touched by this transformative technology. We have reached a point where the technology has proven itself and global businesses can no longer afford to ignore it.

The 'World Economic Forum' anticipates that 10% of global GDP will be stored on the blockchain by 2025. That means Executives out there are preparing for this seismic shift and are ready to completely back its implementation. The impact of distributed ledger technology could be as grand as the internet revolution itself.

BLOCKCHAIN

Blockchain provides the ability to operate in a peer-to-peer business model, where individual members of a chain interact directly without the need for intermediaries. The blocks in a blockchain contain a cryptographic hash of the previous block and therefore are resistant to modification of data. This provides a significant level of security over the integrity of the data as the transactions recorded in the ledger cannot be altered retroactively without alteration of all subsequent blocks.

Having said that, the potential of collusion from members is still a risk that is present in transactions within the blockchain.

The use of blockchain technology is growing at different speeds, depending on the type of business and industry sector. However, the appealing idea to replace the current accounting of business transactions by means of accounting software with a blockchain system is something I personally do not see happening soon.

This is because it would require a multi-complex level of different blockchains, interconnecting thousands of members from different chains, with potential implications on privacy and confidentiality (e.g. it would result in anyone being able to see all transactions in the ledger).

CRYPTOCURRENCIES

It is difficult to talk about blockchain and to not talk about cryptocurrencies as this was initially invented to serve as the public transaction ledger of the cryptocurrency Bitcoin.

Cryptocurrencies are digital currency in which encryption techniques are used to regulate the generation of units of currency. These currencies operate independently of a central bank.

Since the genesis of Bitcoin (by far the most well-known cryptocurrency) other hundreds of cryptocurrencies have been created.

Recently, a matter that has been of public interest has been the volatility of its value. While on introduction in 2009 a Bitcoin's price amounted to US\$0, its price during the years 2014 to late 2016 was ranging between US\$200 to US\$400. Then, suddenly it rose to US\$1k by the end of January 2017 and reached US\$20k in December 2017 (now approx. US\$6k).

Why such appreciation?

This appreciation appears to be the combination of significant changes in demand, driven by the limited number of digital currencies in circulation, a peak demand from late technology/investors adopters and obviously speculation.

Another challenge that has emerged with cryptocurrencies is in relation to the accounting, classification and valuation of these assets for financial reporting purposes. At this stage, the International Accounting Standards Board (the IFRS) has held discussions regarding the accounting of digital currency, but it has not yet issued any standard or interpretation providing a clear guidance in accounting of cryptocurrencies. In fact, this issue is not even in their work plan of projects.

There are different views as to what class of assets they represent, whether they are financial instruments, inventory or intangible assets.

After doing further research, the best guidance available is perhaps the assessment prepared by the Australian Accounting Standards Board (the AASB) in its presentation to ASAF 2016 Meeting – Digital currency – A case for standard setting activity.

Below is a summary of the AASB's views:

CLASS OF ASSET – CASH

Cryptocurrencies are unlikely to represent 'Cash'.

The AASB conclusion is mainly based on the fact that, cryptocurrencies are not supported by a central bank, or recognised as legal tender. In addition, they argue other aspects, such as the relative small number of entities accepting digital currency as a medium of exchange and/or payment, to support this view.

CLASS OF ASSET – CASH EQUIVALENT

Cryptocurrencies fail the definition of 'cash equivalents'.

One of the arguments used by the AASB in its conclusion is that cash equivalents, by definition, are *assets subject to an insignificant risk of changes in value*. This, technically, is a clear and strong argument

CLASS OF ASSET – FINANCIAL ASSET

It fails the definition of a 'Financial asset'.

IAS 32 *Financial Instruments: Presentation* defines financial assets as *"a contractual right: (i) to receive cash or another financial asset from another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity"*.

There is neither such contractual rights to receive cash, nor to exchange financial assets or financial liabilities on Cryptocurrencies.

CLASS OF ASSET – PROPERTY, PLANT AND EQUIPMENT

They are not 'Property, plant and equipment' which in the definition in the accounting standards states it is "tangible", which criteria digital currencies obviously do not meet.

CLASS OF ASSET – INVESTMENT PROPERTY

No cryptocurrencies meet the definition of 'as this is defined as land or buildings'.

CLASS OF ASSET – INTANGIBLE ASSET (IA)

The AASB concluded that cryptocurrencies met the criteria of an IA. Cryptocurrencies are "Identifiable" as they are sold in units on an exchange. As mentioned above the AASB considered that digital currencies are not cash and therefore met the "Non-monetary" element of the criteria.

Also, it meets the "Without physical substance" criteria of the definition as cryptocurrencies have no physical substance.

However, the AASB concluded that entities trading with digital currencies would be considered to hold such digital currencies for sale in the ordinary course of business, and therefore will be excluded from the scope of IA in accordance with the applicable accounting standard.

Rather, these entities would have to account them as inventory in accordance with IAS 2 Inventory (IAS 2) – refer below.

CLASS OF ASSET – INVENTORY

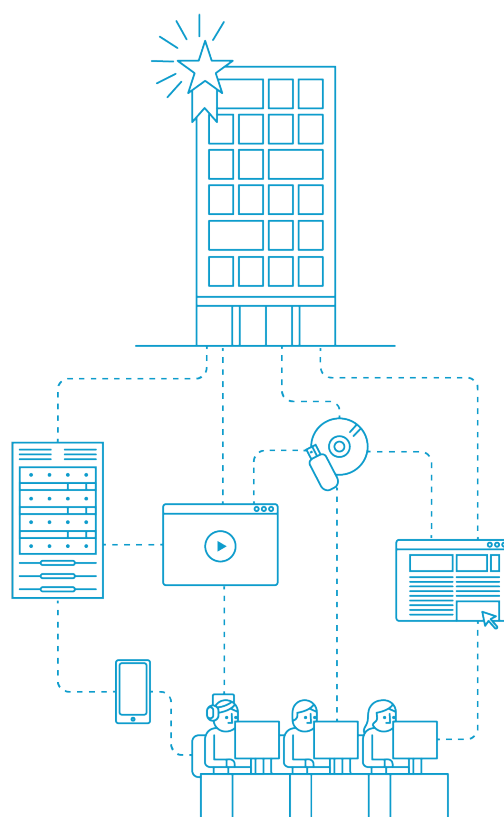
Further to the above commentary, the AASB outlines that if an entity determines that it is holding digital currency for sale in the ordinary course of business, it will need to determine if it is considered a 'commodity broker-trader' under the standard IAS 2. This is because this standard excludes commodity broker-traders from the measurement criteria of Inventory (i.e. at the lower of cost and net realisable value) but instead, requires commodity broker-traders to measure their assets at fair value less cost to sell, with changes in fair value recognised in profit or loss.



The AASB concluded that there is lack of guidance for accounting for these assets. In their opinion *"it is not necessarily clear in the context of digital currencies, when digital currencies should be accounted for under the scope of IAS 2 or IAS 38. Furthermore, it is also not clear if a digital currency should be considered a commodity for the purposes of IAS 2's measurement exemption for commodity broker-traders"*.

After reading and analysing all material available, the conclusion reached is as follows:

- Entities will need to develop their own accounting policy to deal with the initial recognition, classification and subsequent measurement of cryptocurrencies; and
- The accounting policy to be developed should provide guidance as how to account for the digital currencies, depending on the purpose of holding them. For example:
 - The treatment for classification and measurement of digital currencies held for investment purposes. These should be classified as IA measured at either the Cost model or under the fair value model (through other comprehensive income). Some people would argue that the fair value model, in accordance with IAS 38, will result in more useful information to any stakeholder.
 - The treatment of digital currencies accepted as means of payment for their goods or services and which potentially will be converted to cash in the short-term. In this scenario the currencies should be classified as an intangible asset – refer above for measurement.
 - The treatment of digital currencies held for sale in the ordinary course of business (i.e. effectively for trading). These should be accounted for as inventory but measured at fair value less cost to sell, with changes in fair value recognised through profit or loss.



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