EFRAG WEBINAR: ACCOUNTING FOR CRYPTO-ASSETS (LIABILITIES)

KEY CHALLENGES AND THE WAY FORWARD

SUMMARY REPORT

WEBINAR – 6 JULY 2021

This report has been prepared for the convenience of European constituents by the EFRAG Secretariat and has not been subject to review or discussion by neither the EFRAG Board nor the EFRAG Technical Expert Group. It has been reviewed by the speakers at the event.
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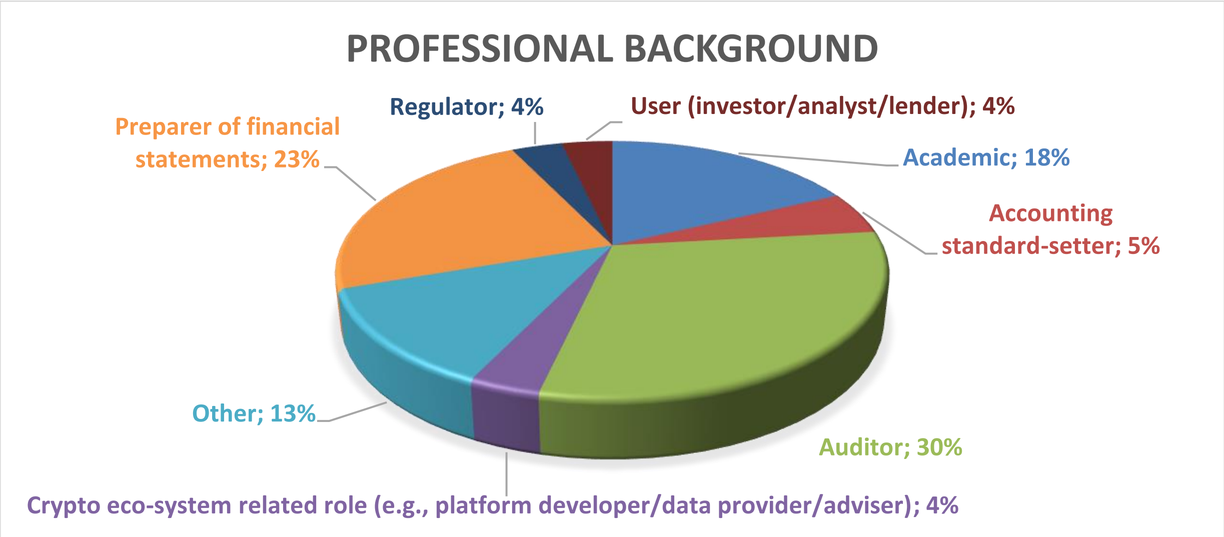
Background

On 6 July 2021, EFRAG organised an online webinar *Accounting for Crypto-Assets (Liabilities) – Key Challenges and the Way Forward*. The aim of the outreach event was to highlight the key market developments, key findings of the EFRAG's *Discussion Paper – Accounting for Crypto-Assets (Liabilities)* ('the EFRAG DP'), the IASB activity and thinking on the way forward, and key accounting challenges from a preparer, user and auditor perspective. This report has been prepared for the convenience of European constituents to summarise the event.

The following supporting documents are available:

- the program of the event: here
- the bios of the speakers and panellists: here
- the slide-deck, presented by the IASB's: here

The below chart represents the functional profile of the webinar participants



The webinar featured an opening speech by Chiara del Prete, EFRAG TEG Chairwoman, followed by presentations from Flora Camp, partner at PwC France, a presentation on the EFRAG DP, and by IASB Board member Bruce McKenzie. Following the presentations, there was a panel discussion on the key accounting challenges and the way forward in developing requirements for accounting for crypto-assets (liabilities).

Setting the scene

Olivier Scherer, EFRAG Board member and IFRS Technical leader at PwC France, who moderated the session welcomed the participants and panellists and emphasised the important contribution of the EFRAG DP.

In setting the scene, **Chiara del Prete, EFRAG TEG Chairwoman,** highlighted that the crypto-asset (liability) market is developing strongly and the interest from various stakeholders is increasing.

She added that the level of crypto-asset holdings was low albeit increasing strongly and there is an increased focus by regulators. Central banks around the world are researching Central Bank Digital Currencies (CBDCs) as a response to the emergence of private stable coins and to meet the need of a digitalised economy. She explained that the European Central Bank (ECB) is continuing its research on a digital Euro after its consultation phase. All these developments show how important the topic is around the world. She emphasised that it is important to clarify the accounting for such a class of assets and be ready for it becoming mainstream.

Related to the accounting, she referred to the IFRIC agenda decision on cryptocurrencies and noted that crypto-assets are not really intangible assets, therefore IAS 38 *Intangible Assets* seems to have shortcomings as crypto-assets (liabilities) have more in common with cash and cash equivalents and therefore financial instruments. However, she acknowledged that determining an active market, and with that, the valuation of the crypto-assets (liabilities) is still a challenge as there is not (yet) a regulated market.

She noted that the outcome of the EFRAG DP will provide valuable educational input for all interested parties and provide a good starting point for the IASB should the topic be included in its agenda.

Presentations

To give an overall view of market developments**, Flora Camp, Partner at PwC France,** presented the six key trends and challenges in 2021 related to the crypto-market:

1) **Developments in the crypto-market -** Crypto-assets were a niche market two to three years ago but in 2020 the market massively increased. The expectation is that crypto-assets will become mainstream in the coming years. The products and services are becoming more diverse, several large companies from various industries are investing in the products and services and there is a lot of media attention.

2) **A 'respectable' class of assets? -** Although the current exposure to crypto-assets (liabilities) by large companies that apply IFRS is relatively low, there is a trend of increasing potential for further investments. PwC observes that an increasing number of their large clients indicate that their appetite for issuing or investing in crypto-assets is increasing or even unavoidable. There seems to be even an increasing appetite for accepting and organising payments using crypto-assets in the market. She noted that the crypto-assets are becoming a respectable asset class as their image and reputation is enhancing.

3) **Stablecoins –** stable coins are crypto-assets that are linked to an existing currency or even commodity (such as gold) and used to mitigate the risk of volatility in the crypto-market. In 2020, stable coins have experienced significant growth.

4) **Central Bank Digital Currencies -** Another development is the increase of the CBDCs which has been researched by more than 60 central banks since 2014. Some of these CBDC programs are entering into the implementation phase, like in China.

5) **Decentralised Finance (DeFi) –** DeFi, which consists of lending and financing products without any centralised intermediary, but instead is based on decentralised blockchain technology. Even

though the application of DeFi is still in infancy, it offers an alternative form of financing of activities on a decentralised basis.

6) **Non-Fungible Tokens (NFTs) -** NFTs are digital assets representing existing assets in real life as well as other digital assets. These tokens are mostly used in the art, sports and gaming industries. The use of these tokens has strongly increased in 2020.

She also presented the five key factors that will influence the scalability and mainstreaming of crypto-assets:

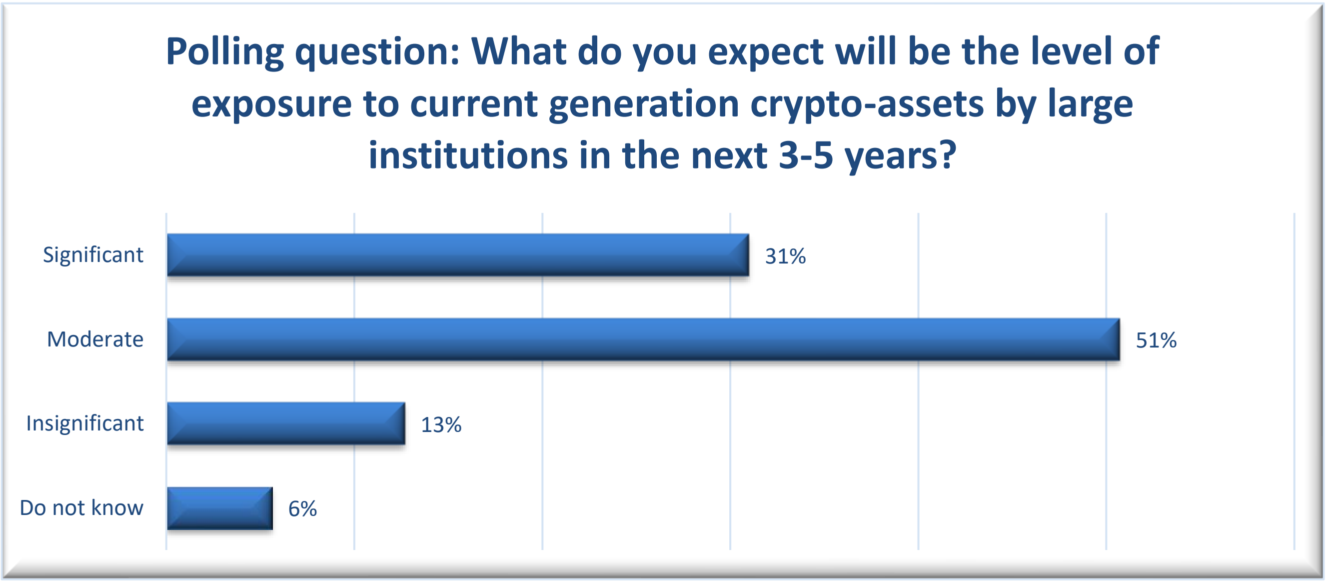
1) **Technological infrastructure -** The technological infrastructure should enable a fast-processing speed as the (high) price volatility of crypto-assets could result in a mismatch between the value of the product and the value transferred due to delays.

2) **Price volatility -** The price volatility of crypto-assets is currently a factor that limits wide-scale adoption. However, stable coins and CBDCs could be a response to that challenge.

3) **Sustainability -** The first generation of crypto-assets such as bitcoin, which use the 'proof-of-work' mechanism to validate transactions use much more energy than several new-generation crypto-assets such as tezos, which use the 'proof-of-stake' mechanism.

4) **Trust -** She noted that based on feedback from clients, more trust and assurance is expected from the crypto-market as it is decentralised compared with non-crypto-markets where third party institutions such as banks have a central role in confirming the number and ownership of assets. She confirmed that the auditors could play a role here.

5) **Regulation -** She explained that companies, not being pure players, are interested in using crypto-assets and blockchain technology in a regulated market to avoid any risks.



Vincent Papa, EFRAG Associate Director, introduced the approach and background of the EFRAG DP emphasising that it includes both an extensive research on the current accounting standards and proposals for the way forward. He noted the current guidance lacks explicit guidance for crypto-assets that are non-financial assets and held as investments and the limitations of IAS 2 *Inventories* and IAS 38 as these do not capture the investment characteristics of crypto-assets.

A possible solution could be the update of the definition of financial assets for some security tokens that have functional equivalence to equity securities but do not meet the IAS 32 *Financial Instruments: Presentation*. Another possible solution could be to update the definition of cash and cash equivalents in light of the proliferation of CBDCs and some fiat-currency pegged stable coins. He also highlighted some of the stakeholders' responses to the DP where preference is expressed for an approach whereby crypto-assets are scoped into IFRS 9 *Financial Instruments* allowing the crypto-assets to pass the 'Solely Payments of Principal and Interest'-test (SPPI). Alternatively, some stakeholders prefer a broader approach where a new asset Standard is developed including an accounting principle for a broader range of assets that currently lack accounting guidance. He highlighted the need for further guidance on accounting for intermediary holders (e.g., custodians, brokers, exchanges) particularly regarding who controls the asset.

Isabel Batista, EFRAG Senior Technical Manager, presented the highlights of the EFRAG DP on issuer accounting. She explained that in the absence of specific guidance for Initial Coin Offerings (ICO) entities might apply several IFRS Standards by analogy. For example, IFRS 9 for financial liabilities resulting from the issuance of (some) security and asset-based tokens. IAS 32 for equity instruments resulting from the issuance of (some) security and asset-based tokens. Another option is to apply IFRS 15 *Revenue from Contracts with Customers* for prepayments for future goods or services (for example access to a platform) for issuance of utility tokens to holders that can be considered potential customers and IAS 37 *Provisions* for contracts that could lead to a constructive obligation. She added that if no obligation exists, the ICO issuing entity could recognise a gain/income in profit or loss. Other areas that need further clarification are ICO tokens exchanged for employee services or third-party services. Other areas that need further clarification are ICO tokens exchanged for employee services or third-party services.

On valuation, she explained that the unique and/or multiple element characteristics of different crypto-assets (liabilities) such as the early stage of its development, high intra-day volatility and absence of an active market can make valuation complex. She pointed to a research paper by the Chartered Business Valuators Institute (CBV Institute) in which three valuation approaches are mentioned, namely: Cost of Production, Equation of Exchange and Network Value to Transactions Ratio.

Finally, she presented the three options on the way forward included in the EFRAG DP (1) do nothing, (2) clarify and/or amend existing IFRS requirements and (3) develop a new standard on crypto-assets (liabilities) or a broader category of digital assets.

Bruce Mackenzie, IASB Board Member, expressed his interest in the highlights of the EFRAG DP and confirmed that the accounting for crypto-assets (liabilities) currently raises many questions. He noted that the crypto market has the potential to have an evolutionary impact on global commerce, however, the current hype needs to end and some level of regulation is needed before it moves to the mainstream. He pointed out that there is little guidance on this matter and the IASB might not ignore the developments any longer. However, whether the IASB will address this and to what extent will depend on the stakeholders. He provided an overview of the discussions held at the IASB, which started in 2016 and subsequently in 2018 and 2019, based on the findings of low prevalence, the IASB decided not to undertake related standard-setting.

Current accounting approach: He noted that the existing standards are not developed having crypto-assets in mind. He summarised the considerations of the IFRIC (International Financial Reporting Interpretations Committee) back in 2019 where it was concluded that crypto-assets are not considered as cash as it was not a medium of exchange and also did not meet the definition of financial instruments as it does not give a contractual right to cash flows. The IFRIC also concluded that the application of IAS 38 (if not held in the ordinary course of business) and IAS 2 (if held in the ordinary course of business) was the most appropriate.

In his view, both the IAS 38 impairment treatment and revaluation approach may in some circumstances fail to portray the economic reality of the crypto-assets. He added that an entity needs to identify the obligations arising from issuing the crypto-assets which determines whether IFRS 9, IAS 32, IFRS 15, IAS 38 or IAS 37 applies. In some cases, when none of the Standards are applicable, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* can be applied.

Way Forward possibilities: He emphasised the importance of the recent IASB Request for Information (RFI) on the IASB Third Agenda Consultation which will determine, amongst others, the new financial reporting issues that could be given priority in the IASB's work plan for the upcoming five years. He informed that the crypto-assets (liabilities) are one of the potential financial reporting issues as identified in the RFI with the following suggested scopes:

- developing educational materials;
- amendments to IAS 38 by developing additional disclosure requirements about the fair value of cryptocurrencies or permit more intangible assets to be measured at fair value and consider whether recognising changes in fair value in the statement of profit or loss is appropriate in some circumstances;
- amendments to IFRS 9 or to develop a new standard. He repeated the importance of the RFI invited respondents to respond to the RFI on this matter.

Panel discussion

Accounting challenges from a preparer perspective

Olivier Scherer asked Renate Szkoda how digital assets play a role in the business activities of Galaxy Digital and what accounting challenges are identified.

Renata Szkoda, Board Member Global Digital Assets and Cryptocurrencies Association and CFO/COO at Blue Fire Capital, first noted that the EFRAG DP provides insight into the possible accounting treatment for various products and from different perspectives after summarising Galaxy Digital's business model, she explained that the entity currently applies IAS 2 for the broker activities which allows for fair value accounting. She emphasised that these crypto-assets are mostly held for investment purposes, they have cash like applications and experience market volatility. Therefore, she supports enabling fair value accounting for these types of assets which are held for investment purposes but are non-financial. Considering these assets as intangible assets is not appropriate as the fair value movements are not captured like regular investment assets.

She added that another main challenge relates to identifying accounting evidence to determine the obligations and rights of holders and issuers of crypto-assets (liabilities). Accountants are used to reviewing legal documents to determine these rights and obligations. However, in the digital ecosystem, these legal documents are not always available. Therefore, when a new token is issued the following three key documents are likely to be available, namely the smart contract code, white paper and in most cases an audit report. However, these are not legal documents and this makes it challenging to identify the legal rights and obligations.

She explained that challenges also exist relating to the valuation and referred to the valuation methodology mentioned in the EFRAG DP which included the definition of an active market which includes digital assets that trade against fiat currency. She explained that the market for digital assets that trade against fiat currency is currently a very small portion of the actual market for crypto-assets. However, she added that almost all crypto-assets trade against stable coins. When the definition of an active market only considers crypto-assets against fiat currency, the majority of the market will be neglected. In addition, especially under increased volatility, the fiat currency does not appropriately represent the value of the market. Furthermore, she noted that certain crypto-assets, such as Polka Dot and TRX Tron with a market capitalisation of billions of dollars do not trade in exchange for fiat currency. For these crypto-assets, it would not be appropriate to state that there is no active market. Finally, she pointed that the crypto-market does not have an 'end of day' concept as it is continuously active and this could lead to different valuations based on different cut-off times.

Olivier Scherer asked Maria Erviti Legarra what accounting challenges were encountered when BBVA introduced the custodial services for crypto-assets to its clients.

Maria Erviti Legarra, Member of EFRAG Financial Instruments Working Group and Director of Accounting & Prudential Policies at BBVA explained that BBVA recently started to provide custodial services for crypto-assets to private banking clients in Switzerland. However, this specific custodial service is limited to Switzerland instead since a clear and widespread regulation is available in that jurisdiction. The accounting analysis performed for these services related to whether the bank controlled the crypto-assets held for the client or not. If the bank controls the asset it would need to recognise the crypto-assets and if not, the bank would only provide a service triggering the application of IFRS 15.

She stated that the main challenge in performing this analysis related to identifying the rights and obligations embedded in the custodial and trading services for crypto-assets. It involved an analysis of the traditional risks related to these activities such as liquidity risk, market risk, credit risk, counterparty risk. In addition, non-financial risks also needed to be considered such as operational risk, cyber risk, legal risk and third-party risk. She informed that the main factor that led to the conclusion that the bank did not control the crypto-assets related to the personal wallets that clients used to keep the crypto-assets.

Secondly, the bank serves as an intermediary between the broker and the clients and always follows clients' instructions. Even if the client loses the key to the wallet and the bank is the one that has access, the bank has no right over the crypto-assets in the wallet and can only act based on the instructions of the client.

Thirdly, clients bear all the risks relating to the transactions, including the counterparty risk where the broker does not fulfil its obligations under the transaction or any risk related to fraud, loss of keys and cyber-attacks. She added that although the fees received by the bank for the custodial services is (partly) dependent on the value of the crypto-asset portfolio, the bank is not able to influence the activities of the client or the value of the portfolio as the bank does not provide investment advice. She summarised that the main challenge was not related to applying the accounting Standards but lay instead in identifying and understanding the rights and obligations of the custodial service providers in respect of the crypto-assets held on behalf of clients.

In response to a question on whether any factor was determinative to conclude that no control exists, **Maria Erviti Legarra** highlighted that all the factors were relevant and that the legal environment and regulation in the jurisdiction together with the legal documentation were important to identify and conclude on the rights and obligations relating to the custodial services.

Accounting considerations from a user perspective

Olivier Scherer asked Dennis Jullens to explain which areas are the most concerning when using financial statements of entities that hold or issue crypto-assets (liabilities) and whether those concerns result in the use of non-GAAP measures.

Dennis Jullens, EFRAG TEG member and lecturer at the University of Amsterdam, noted the main question was around what information users need to assess the performance of entities with crypto-assets exposure. He explained that normally an enterprise value is derived for the business as a whole by deducting the liabilities and add the value of the investments of which the earnings are not captured in the value of the business as a whole. He noted that the crypto-assets are considered an investment and need to be taken into account in deriving the enterprise value which means that the fair value of the crypto-assets and the crypto-liabilities needs to be determined.

The fact that IAS 38 is applied does not always be a limitation to determine the fair value of these digital assets but it does feel counterintuitive to have a different valuation method for digital assets and liabilities which have the characteristics of financial instruments. Therefore, many investors would prefer to account for these digital assets and liabilities as financial instruments. He added that non-GAAP measures are not necessarily applicable and used as long as there is sufficient disaggregation of the income and expense items in the financial statements that enable users to derive the fair value and to determine whether these income and expenses are included in performance measures and are relevant for forecasting.

Olivier Scherer asked Maria Erviti Legarra to explain the reasons behind the current level of crypto-assets within the banking industry.

Maria Erviti Legarra referred to a recent preliminary proposal of the Basel Committee relating to the prudential treatment of crypto-assets. In that report, the Committee acknowledges the recent growth and development of the crypto market. However, the exposure of banks to crypto-assets remain limited. The main reason for this is that the legal and regulatory framework is not developed yet in most jurisdictions. She stated that in general financial institutions are not comfortable operating in an environment that lacks sufficient regulation. She added that the high volatility of crypto-assets, not being stable coins, also contribute to the reason why banks have low levels of direct exposure. Other factors that have an impact are the lack of transparency regarding the ownership and responsibilities and issues relating to convertibility to fiat currency.

She also informed that the European regulator and central bank have a conservative approach to the crypto market which also impacts the approach by banks. Furthermore, she noted that as the regulation within Europe will take significant time to process any significant increase in the exposure by banks is not expected in the short term. Finally, she stated that it will be interesting to see how the different types of crypto-assets will evolve, in particular the development of the CBDCs. She noted that those could rather facilitate international transactions and increase transparency.

Auditability perspective

Olivier Scherer asked Flora Camp to explain the accounting challenges from an audit perspective.

Flora Camp confirmed that the crypto-assets (liabilities) are a very complex audit area and presented six areas of challenges:

1) **Awareness and general education of executive management, including CFOs -** The lack of awareness and general education of executive management regarding the crypto transactions could result in a misstated accounting or disclosure due to a wrong understanding of the substance of transactions.

2) **Ownership and completeness of crypto-assets -** Since the crypto market is decentralised and deregulated there is no regulated institution such as banks to confirm the (sole) ownership and completeness of the assets by confirming the number and the value of the assets. She

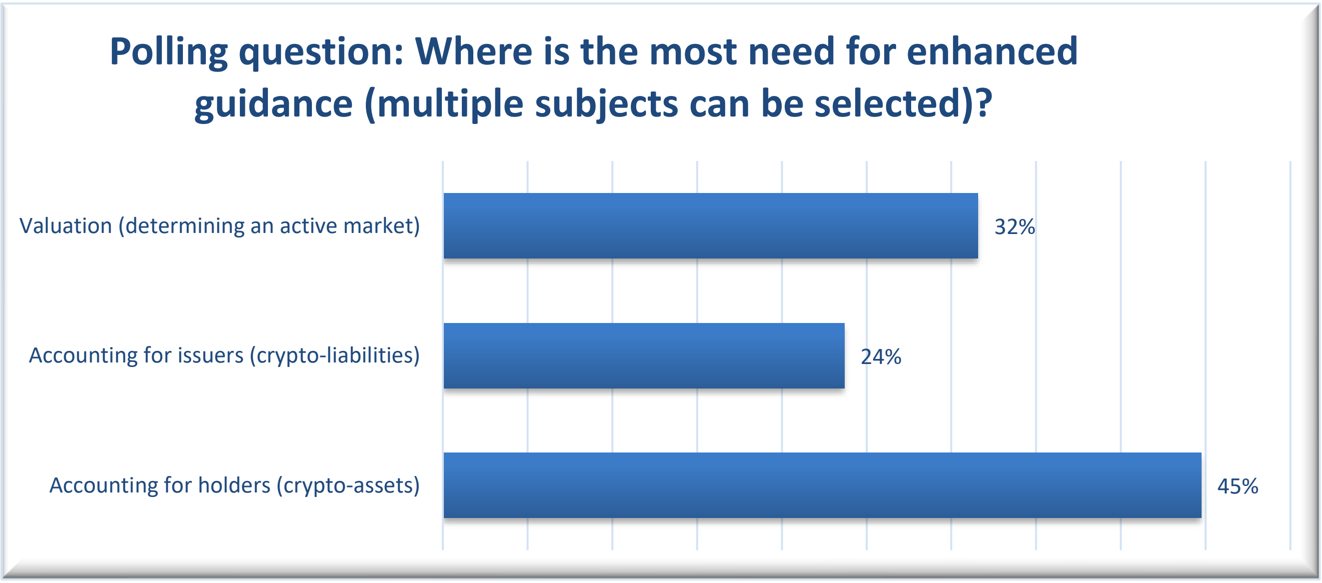
noted that PwC has developed its own confirmatory crypto-asset tool to assess the ownership and completeness of the crypto-assets for audit evidence.

3) **Governance and internal control -** The governance and internal control environment around the crypto-activities of the entities needs to be robust to avoid and diminish risks such as losing keys or inserting wrong keys.

4) **Valuation -** She repeated the challenge around the valuation as discussed earlier in this webinar and emphasised especially the assumptions and data used within the valuation model.

5) **Underlying rights and obligations -** The lack of legal documentation and the variety of available supporting documents between various crypto-assets results in challenges to determine the rights and obligations.

6) **Disclosures to financial statements -** Lastly, as the accounting for crypto-assets (liabilities) is very complex and judgmental, the completeness of the disclosures is very relevant for users.



Olivier Scherer asked the panel to express their views regarding the three options on developing IFRS requirements (1. Do nothing, 2. Amend existing IFRS Standards, 3. Develop a new digital asset Standard) as presented in the EFRAG DP as a way forward.

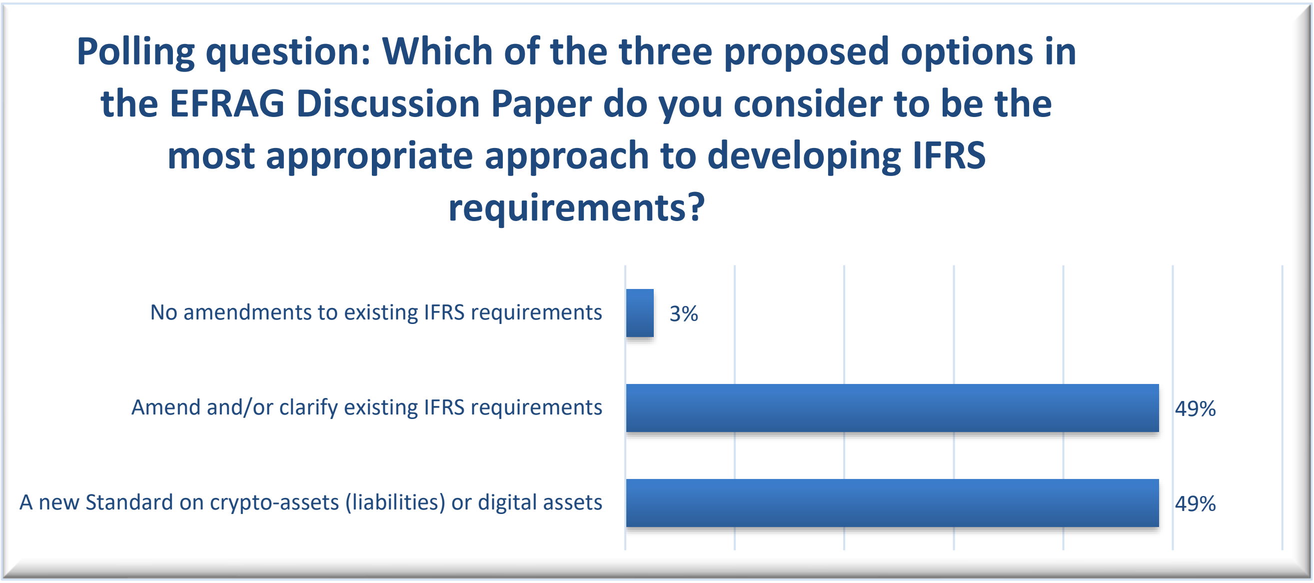
Dennis Jullens confirmed that from a user perspective the valuation of crypto-assets (liabilities) should be based on the fair value which naturally suggests a financial instruments approach. He added that he was intrigued by the IASB Board members' presentation around the option to allow more assets to be measured ar fair value under IAS 38 possibly by changes accounted for through the statement of profit or loss, but questioned whether that would not trigger more subjectivity into the existing Standard.

Maria Erviti Legarra noted that the first option to do nothing is not appropriate as currently, the Standards lack guidance. Regarding the third option to develop a completely new Standard she expressed her doubts on whether this is possible and suitable since the rapid evolution and developments in the crypto market. Therefore, she expressed her preference for option two to amend existing Standards. Specifically, she supports the application of the fair value through profit or loss to crypto-assets (liabilities) complemented by sufficient disclosures around the nature of the asset, the business model, the applied valuation model and the volatility.

She reiterated that measurement based on cost or revaluation through OCI does not fit the economic substance of the crypto-assets (liabilities). She added that the current option for fair value through OCI which is allowed under IFRS 9, should not be considered as it is already controversial and might be a potential issue for the upcoming Post-Implementation Review of IFRS 9. She also stated that the definition of cash and cash equivalents needs an update to include also the CBDCs and stable coins.

Renata Szkoda agreed with the views expressed by Dennis and Maria regarding the amendment of existing Standards on the need to allow fair value through profit or loss recognition and measurement. However, she suggested the development of a new Standard for mining transactions due to their specific characteristics that are not covered by any accounting Standard.

In response to a question, **Chiara del Prete** noted that the FASB is currently monitoring this topic and it might be added to their agenda as it is also part of their recently initiated agenda consultation. She noted that both the IASB and the FASB probably need to monitor each other's work and aim for a consistent approach.



In his closing remarks, Olivier Scherer pinpointed the fast and ongoing developments of the crypto market and noted the challenges arising from an operational, regulatory and financial reporting perspective. He mentioned that some of these challenges should be addressed by standard-setting activities and observed that stakeholders seem to expect that the IASB will undertake some standard-setting regarding the accounting for crypto-assets (liabilities).

To conclude, he invited stakeholders to respond to the EFRAG DP and the IASB's Third Agenda Consultation through the EFRAG consultation process which will help the IASB to determine the scope of a possible standard-setting project.