Cryptocurrency: The Top Things You Need to Know

Bitcoin and other cryptocurrencies are splashed across news headlines on a regular basis, charting a wild ride of extreme highs and lows. Once the sole domain of anti-establishment millennials burned by the 2008 recession, many institutional investors have shed their skepticism and are dipping their toes into the crypto market, adding exposure through crypto funds, futures, and other emerging investment options.

However, the world of crypto investing is still relatively uncharted territory. It is important to understand what cryptocurrencies are before investing or accounting for them. Organizations that take a step-by-step approach to due diligence and gain experience with small, low-risk projects involving cryptocurrencies may find they present exciting, new opportunities.

What is Cryptocurrency?
Cryptocurrency is a type of digital asset that is an intangible, digital currency that uses a highly sophisticated type of encryption called cryptography1 to secure and verify transactions as well as to control the creation of new units of currency. It is designed to work as a decentralized medium of exchange, independent of a financial institution or any other central authority. While Bitcoin is the most well-known cryptocurrency, it is not the only one. Other major types of cryptocurrencies include Ethereum, Ripple, Bitcoin Cash and Litecoin. There are also other digital assets (or “cryptoassets”).

These are commonly referred to as digital tokens. For example, a company can initiate a “token sale” or a “token launch” which is otherwise frequently referred to as an initial coin offering (ICO). In an ICO, a company is creating a new product and wants to build a user base who will benefit from purchasing the product early. The ICO also enables the company to raise proceeds to develop the product. It is attractive to companies because they can bypass the rigorous and regulated capital-raising process required by venture capitalists or banks. While this FAQ does not further explore ICOs or tokens, entities are encouraged to consult with their legal, accounting and tax advisors given the complexities and significant debate by regulators around such digital assets.

What is Bitcoin?
While there have been several attempts to create cryptocurrencies since the 1990’s tech boom, Bitcoin is the first to gain widespread public notoriety. Leveraging open-source peer-to-peer technology, the transaction and issuance of Bitcoin is collectively managed by the network, effectively cutting out the middleman.

Introduced by an anonymous programmer or group of programmers under the alias “Satoshi Nakamoto,” Bitcoin has consistently dominated the crypto market since it became available to the public in 2009. It has remained relatively unchallenged until the introduction of the Ethereum platform in 2016. Cryptocurrencies, including Bitcoin and Ethereum, are more volatile than traditional fiat currencies. Fiat currencies are declared to be legal tender by a government and are not backed by physical commodities.

1 Cryptography relates to the process of converting ordinary information to encrypted (or secure) information.
WHAT IS BLOCKCHAIN AND HOW IS IT CONNECTED TO CRYPTOCURRENCY?
Blockchain technology is a type of distributed ledger technology (DLT) that facilitates peer-to-peer transactions in a secure and verifiable way without a centralized party. It is a single, incorruptible database that continuously records and timestamps transactions (or "blocks") chronologically. Every transaction must be verified through a process known as "consensus," requiring multiple-system participants to independently verify authenticity of the output of the algorithm creating the "block." Once a new entry has been agreed to (verified) and made in the blockchain, it is "locked", meaning it cannot be modified; it can only be updated by adding a new entry as an addendum.

The best-known use of blockchain to date is to support the transaction of cryptocurrencies such as Bitcoin and, while the two are often conjoined—and confused—Bitcoin is just one of many potential blockchain applications. Bitcoin is, in essence, a form of currency; blockchain is the database that enables its unique, secure transaction.

HOW ARE CRYPTOCURRENCIES CREATED?
The process of creating a new type of cryptocurrency coins requires either building a new blockchain or modifying an existing process to create a new variant, or "fork." The majority of these so-called "altcoins" are forks of the Bitcoin protocol.

The only way more coins of an existing crypto coin can be created is through a process called “mining" in which the miner is awarded a transaction fee (a new coin) in exchange for contributing to the underlying blockchain algorithm by being the first to solve a cryptographic puzzle. Mining is extremely competitive and requires significant computing power.

Some cryptocurrencies, like Bitcoin, are finite in supply, meaning that there is a maximum number of coins that will ever be in circulation. Others do not have a maximum cap, but limit the number of new coins that can be generated each year.

DOES U.S. GAAP ADDRESS THE ACCOUNTING FOR CRYPTOCURRENCIES?
Currently, U.S. GAAP does not specifically address the accounting for cryptocurrencies. However, given the increase in cryptocurrency transactions, questions are now being raised about how cryptocurrencies should be accounted for.

CAN CRYPTOCURRENCIES BE USED FOR PURCHASING AND INVESTING JUST LIKE TRADITIONAL PHYSICAL MONEY?
Cryptocurrencies can be used to pay for goods and services, as well as for investing in some areas around the world. In this respect, they are similar to physical currencies. However, unlike fiat money, cryptocurrencies have no physical form, they have not been declared to be legal tender in the United States, and the vast majority are not backed by a government or legal entity. In other words, the supply of a cryptocurrency is not determined by any central bank. Therefore, users participate in transactions directly without the involvement of any intermediary, which for fiat money, would typically be a bank. It should be noted that while cryptocurrencies may be used legally in many countries, there are others that hold transacting in cryptocurrencies to be restricted and still others to be illegal and may result in jail sentences for those doing so. These countries include (restricted): China, Saudi Arabia, Egypt, Zambia, and Mexico; (illegal): Bangladesh (jail), Vietnam, Morocco, Algeria, Bolivia (jail), Ecuador, and Nepal (jail).

DOES CRYPTOCURRENCY REPRESENT CASH, A CASH EQUIVALENT OR A FOREIGN CURRENCY?
Cryptocurrencies are not cash because they are not legal tender and are not backed by a government or other legal entity. For similar reasons, they are also not cash equivalents or foreign currencies under U.S. GAAP.

DOES CRYPTOCURRENCY REPRESENT INVENTORY?
Entities use cryptocurrencies as a medium of exchange or for speculative purposes. In these instances, cryptocurrencies are clearly not inventory. In other situations, entities purchase or mine cryptocurrencies with the intent to sell them in the ordinary course of business and therefore, might be considered inventory. However, cryptocurrencies do not represent “tangible personal property” and therefore do not meet the definition of inventory under U.S. GAAP.
IS A CRYPTOCURRENCY A FINANCIAL INSTRUMENT?
Cryptocurrencies are not financial instruments under U.S. GAAP because they do not represent cash or a contract establishing a right or obligation to deliver or receive cash or another financial instrument.

IS A CRYPTOCURRENCY AN INTANGIBLE ASSET?
In our experience, cryptocurrencies are generally accounted for as indefinite-lived intangible assets, except in a few specific situations whereby they are held as an investment by investment companies – in which case fair value accounting is applied.

Intangible assets under U.S. GAAP are “assets (not including financial assets) that lack physical substance.” Further, financial assets are cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to receive cash or another financial instrument, or a right to exchange other financial instruments on potentially favorable terms.

Cryptocurrencies are not financial assets. They also lack physical substance. Therefore, they meet the definition of an intangible asset and would be recorded at acquisition cost (i.e. price paid or consideration given). Intangible assets are subject to an impairment test. Any recognized impairment losses cannot be subsequently reversed. Some believe the intangible model does not properly reflect the economics of cryptocurrencies because they can potentially be written down for impairment but never written up when they appreciate in value. This outcome could be less than helpful for financial statement users when significant volatility exists.

Unlike a direct purchase, additional complexity arises if cryptocurrencies are obtained through mining activities, as described above. In such instances, questions arise as to whether the transaction fees should be recognized as revenue or some other form of income. Additionally, miners incur costs for computer equipment, electricity and overhead. They must determine whether such costs can be capitalized based on existing U.S. GAAP, such as the guidance for internally developed intangible assets or other areas of U.S. GAAP.

HOW IS CRYPTOCURRENCY TAXED?
The Internal Revenue Service has released very little guidance on the taxation of cryptocurrency. However, it did issue a 2014 notice in which they stated that cryptocurrency will be treated as property for federal income tax purposes. Depending on how the cryptocurrency is held, it could be classified as business property, investment property or personal property.

In addition to the character of the gain, it is critical that owners of cryptocurrency track their basis. Every time cryptocurrency is used for the exchange of goods or services, a taxable transaction occurs. For example, events that are considered taxable events include a coin to fiat sale, a coin to coin swap, purchases made by the cryptocurrency and the receipt of cryptocurrency for services. Other complexities around taxation of cryptocurrency exist and it is very important that individuals and businesses continue to monitor future guidance.

BDO INSIGHTS
As cryptocurrencies continue to mature and evolve, unique regulatory, due diligence, tax and accounting challenges will continue to emerge. Without clear guidance from key regulators, industry innovation may get delayed. However, new financial products are already in the marketplace and mainstream industry acceptance continues to accelerate. While the cryptocurrency market continues to expand, service providers such as BDO are dedicated to staying on the cutting edge of regulatory pronouncements and rules governing the industry to serve our clients who are involved with this disruptive digital asset.

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2 See our BDO Asset Management Insights: Digital Currency Fund Preparation for Initial Year Audit and Tax Compliance, and Evolving Cryptocurrency Framework.