ASAF Agenda Paper 2
December 2020

Highlights of EFRAG Discussion Paper-

Accounting for Crypto-assets (liabilities)

10 December 2020- Presentation to ASAF

European Financial Reporting Advisory Group

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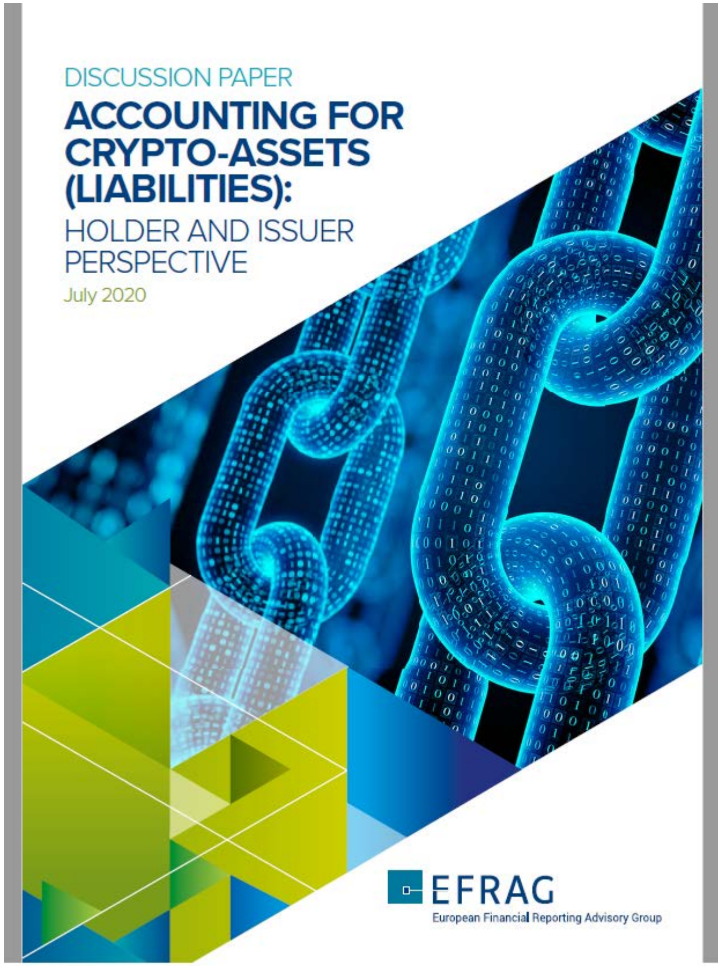
OVERVIEW & WAY FORWARD

Motivation for EFRAG research

- **Inform forthcoming IASB agenda consultation & IASB continued monitoring activities that begun with 2016 ASAF session**
- **Limited scope of the 2019 IFRIC agenda decision**
- **Stakeholders seek regulatory clarity including on accounting requirements** – need for accounting clarity at an international level was made in a 2019 OECD publication
- **Gaps or lack of clarity on existing accounting requirements** – Various NSS, accounting firms, accountancy professional bodies and a few academic papers have issued guidance
- **Contribute to opportunity to future proof IFRS requirements** – need to future-proof IFRS requirements by considering requirements for these emerging transactions; may need to go beyond thinking of current pervasiveness

Discussion Paper (Currently open for stakeholder comments until 31 July 2021)



- **DP open for 12-month consultation period taking account of Covid-19 circumstances**
- **Early comments highly welcome**
- **Outreaches commenced in Q4 2020**

Discussion Paper Overview

- Summary
- Questions for constituents
- Chapter 1: Introduction (background and motivation)
- Chapter 2: Overview of crypto-assets activities, economic characteristics and regulation
- **Chapter 3: Holders accounting**
- **Chapter 4: Issuers accounting**
- **Chapter 5: Crypto-assets valuation**
- **Chapter 6:Potential development of IFRS requirements**
- Chapter 7: Implications of potential market developments
- Appendices (activities; economic characteristics, rights and obligations; regulation)

Accounting issues contained in chapters 3,4, 5 and 6

Taxonomy of items in scope

- Private entity issued and CBDCs

- First generation and subsequent generation
  - Payment tokens
  - Utility tokens (rights to consume, access network goods or services)
  - Security and asset tokens- akin to investment securities
  - Hybrid tokens
  - Stable coins

WAY FORWARD

Proposed key principles

- Consider the development of a suitable (for accounting purposes) classification taxonomy as an initial step
- The following key considerations should underpin accounting requirements
  - **Emphasis on economic substance**: Emphasis should be on economic substance underlying rights and obligations (**what is in the container rather than the container**); need to be technology-neutral bearing in mind rapidly evolving ecosystem
  - **Holder business purpose:** the asset classification should be determined through a combined consideration of the business purpose for holding the crypto-asset and its economic characteristics and underlying rights
  - **Nature of issuer obligation:** accounting by issuers should be based on the determination of whether there is an obligation and on the nature of the obligation

Possible approaches to the clarification or development of IFRS requirements

- **Option 1: Do Nothing (No change in existing IFRS requirements)**
- **Option 2 (Enhancing implicit requirements): Clarify and/or amend existing IFRS requirements**
  - IAS 38/IAS 2 (Exclude crypto-assets from scope or possible amendment of requirements)
  - IAS 7 (Possible update of cash and cash equivalent definition)
  - IAS 32 (Possible update of definition of Financial instruments, financial assets, financial liabilities)
  - Clarification of requirements across various standards (IAS 37, IFRS 15, IFRS13)
- **Option 3 (Developing explicit requirements): Develop a new standard on crypto-assets (liabilities) or broader category of digital assets (liabilities)**

HOLDER ACCOUNTING

Existing guidance: 2019 IFRS Agenda Decision

- **Scope of 2019 IFRS IC agenda decision** is limited to cryptocurrencies with no claim on issuer
- The agenda decision clarified that IAS 38 *Intangible Assets* or IAS 2 *Inventories* are the applicable standards for cryptocurrencies with no claim on the issuer
- IAS 38 does not apply to intangible assets held for sale in the normal course of business and such intangible assets should be accounted for in accordance with IAS 2. The Committee observed that:
  - IAS 2 applies if an entity holds cryptocurrencies for sale in the ordinary course of business; and
  - If an entity is a broker-trader of cryptocurrencies, then it should consider the requirements of paragraph 3 (b) of IAS 2 for commodities broker-trader who measure their inventories at fair value less costs to sell

Holder accounting: Areas for possible update of IFRS

- **Lack of explicit IFRS guidance for when crypto-assets are non-financial assets held as investments**
  - Cross-cutting issue: Broader issue than the measurement of crypto-assets. Same gap is in place for the accounting of commodities, intangible assets held as investments (e.g. gold held by monetary authorities, water rights, emission rights)
  - Gap arose when IAS 25 *Accounting for Investments* was superceded by IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*
- **Need for relevant measurement for holders in all circumstances**
  - Feedback from outreach in respect of restrictions under IAS 38 towards applying FV measurement when there is no active market
  - Several publications (AASB) have argued that the characteristics of crypto-assets make the IAS 38, IAS 2 measurement approaches to be inappropriate

Holder accounting: Areas for possible update of IFRS

- **Need to ensure financial asset or similar classification where appropriate**
  - Some crypto-assets that are held as investments have functional equivalence to securities but do not meeting current definition of financial assets
  - Does IAS 32 *Financial Instruments Classification* need to be updated or is there a need for unique classification category for crypto-assets with financial instruments-like accounting?
  - Challenges arise in applying classification of financial instruments based on securities regulation (e.g. varied definitions at national level, differences in EU-MIFID versus US SEC requirements)

- **Cash or cash equivalent definition may need to be updated**
  - Will definition of cash or cash equivalent need to be updated to encompass CBDCs and stable coins pegged to fiat currencies(i.e. does IAS 7 definitions of cash equivalent need to be)?

Holder accounting: Areas for clarification

- **Accounting for holders of some utility and hybrid tokens may need clarification in several respects :**
  - Ongoing innovation has resulted in novel, atypical rights and obligations- particularly in relation to utility tokens (e.g. rights to: update network functionality; or contribute labour, effort, or resource to the system; launch of decentralised autonomous organisations)
  - It is likely to be difficult for holders to understand or readily analogise features of some utility tokens to more mainstream transactions
  - Utility tokens can be classified as prepayment assets but there is limited IFRS guidance on prepayment assets
  - Hybrid tokens: Is predominant characteristic or bifurcation the right accounting approach? If bifurcation, there is need for clarification of bifurcation principles for hybrid tokens
- **Accounting for holders due to mining transactions and barter exchanges**

Holder accounting: Areas for clarification

- **Accounting by holders on behalf of others**
  - Other than IAS 8- no IFRS guidance for holders on behalf of others
  - There is diversity of contractual arrangements and the existence and content of jurisdictional regulatory requirements in respect of third party holding of crypto-assets
  - There is need for IFRS clarification as follows:
    - Clarifying the application of indicative criteria to determine which party (depositor client versus intermediary holder) has economic control of the crypto-assets;
    - Clarifying which IFRS respectively applies for the depositor client that records an asset receivable and the intermediary holder (IAS 2, IAS 38, IFRS 9);
    - Clarifying whether the custodian credit risk exposure should be considered when determining the value of the receivable asset;
    - Special situations (Questions of ownership/rights of pre-forked asset holder that may arise when hard forks occur)

ISSUERS ACCOUNTING

Issuers (ICO's) overview

Initial Coin Offering (ICO) – a means of raising funds for an existing or future crypto-asset project by issuing tokens (digital tokens) to subscribers/potential investors

- Issuers accounting (such as an ICO and other initial offerings) **is not addressed under IFRS Standards**
- **Each ICO has unique terms and conditions** – which are generally set out in what is referred to as a "white paper"
- **A white paper should set out the rights** (of the holder) and obligations (of the issuer) - however because of lack of regulation they are often lacking information and their legal enforceability is unclear
- Tokens issued in an ICO (or similar offering) include:
  - Stable coins, Pre-functional tokens, Utility tokens, Security tokens (issued through Security Token Offering ('STO')
- Typically, a security token issued through an STO represents an investment contract into an underlying asset (like a share)

If and what type of obligations arise on crypto-assets issuance?

The question regarding the type of obligation only arises for the issuance of crypto-assets where the holder has a claim against the issuer

The Conceptual Framework defines a liability as:

> *A liability is a present obligation of the entity to transfer an economic resource as a result of past events.*

The type of obligations that arise from an ICO can be summarised as follows:

- **Obligations** that are either claims on issuer entities, issuer entities' constructive obligations or performance obligations.
- **No obligations** arising from the issuance of crypto-assets where there is no claim on the issuer or any counterparty (e.g. cryptocurrencies including payment-only tokens). Such issuance results in income for the issuing entity

Applicable IFRS Standards

Users will need information about the amount, timing and risks associated with an entity's crypto assets (liabilities)

- If no specific IFRS Standard applies an entity would develop an accounting policy under IAS 8 that results in information that is relevant to users
- When applying IAS 8 an entity would consider:
  - requirements in IFRSs dealing with similar and related issues; and
  - definitions, recognition and measurement concepts outlined in the *Conceptual Framework*
- In the absence of IFRS guidance an entity should also consider recent pronouncements of other standard-setting bodies that use a similar conceptual framework, other accounting literature and accepted industry practices

Existing accounting firm and NSS guidance (1)

- Accounting Firm publications and outreach with Firms informed that in the absence of specific IFRS guidance, ICO issuing entities can apply one or a combination of the following IFRS Standards:
  - IFRS 9 *Financial Instruments*– as a financial liability likely to be applicable for issuance of security and asset-based tokens;
  - IAS 32 – as an equity instrument likely to be applicable for issuance of security and asset-based tokens;
  - IFRS 15 *Revenue from Contracts with Customers*– as a prepayment for future goods or services (for example access to a platform) likely to be applicable for issuance of utility tokens to holders that can be considered potential customers; and
  - IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* – as an obligation leading to a provision (such as a constructive obligation)
- No commitment towards the holder or other party, an ICO issuing entity recognises a gain/ income in profit or loss

Existing accounting Firm and NSS guidance (2)

- Notable variation in accounting treatment by issuers across EU jurisdictions
- Some EU countries having developed specific ICO accounting guidance (following the development of local regulatory requirements for ICOs) – for example France and Lithuania
- Other EU jurisdictions recommending or requiring local GAAP accounting requirements which often follow tax accounting
- Japan also considering ICO and STO accounting guidance

Other issues related to ICO issuance (1)

- Other related ICO issues include:
  - Pre-sale agreements of pre-functional tokens (SAFTs) – does it represent a financial liability? For example if an ICO issuer must return amount invested (or part of) in the event of product/platform failure. Does it represent a pre-payment for future goods or services and if so does IFRS 15 apply?
  - Own ICO tokens exchanged for third party services - ICO tokens can be used as payment for acquired goods or services or employee payments – which IFRS Standard should apply (IAS 36, IFRS 15..)
  - Own tokens exchanged for employee services - some ICO entities might **reward their employees with** tokens generated through the ICO – if the token meets the definition of an equity instrument then IFRS 2 *Share-based Payments* could apply; otherwise could fall under IAS 19 *Employee Benefits*

Other issues related to ICO issuance (2)

- Additional specific issues that need further analysis include:
  - **ICO issue costs**: accounting for ICO issue costs incurred by the issuer including development costs related to the platform to launch the ICO. These are similar to IPO costs. Should they be capitalised or expensed?
  - **Own ICO tokens**: accounting for crypto-assets that remain the property of the ICO issuer (also often the founder of the crypto-asset) and are not placed in circulation
  - **Airdrops**: accounting for “airdrops” (i.e. crypto-assets given away for free/rewards in an ICO (or subsequent to the ICO)

CRYPTO-ASSETS (LIABILITIES) VALUATION

Valuation methodologies

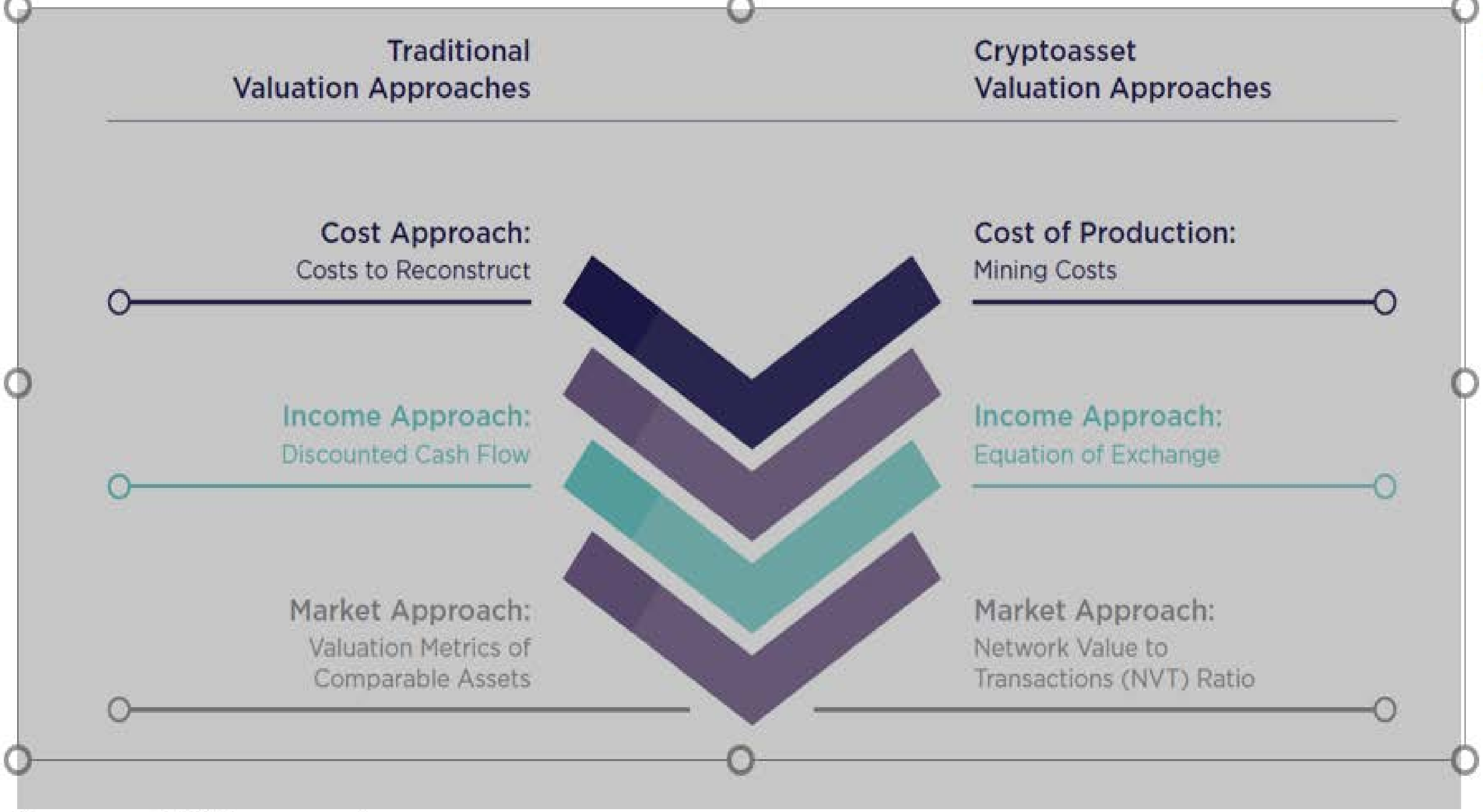
The unique and/or multiple element characteristics of different crypto-assets (liabilities) can make valuation complex

- Crypto-assets (liabilities) still in early stages of development making it hard to derive a robust methodology for their valuation – for example identifying active markets might be challenging
- Valuation methodologies indicate that three elements are important for crypto-asset value:
  - the current value of the crypto-asset to make payments (crypto-currencies);
  - the decision of forward-looking investors to buy crypto-assets, thereby effectively regulating its supply; and
  - the elements that jointly drive future consumer adoption of crypto-assets and merchant acceptance of crypto-currencies

CBV Institute research paper

- CBV Institute (professional association of Chartered Business Valuators in Canada) research paper published in 2019 provides an analysis of suitable valuation approaches for crypto-assets
- The CBV research paper examines three valuation approaches frequently included in the crypto-asset valuation:
  - Cost of Production;
  - Equation of Exchange; and
  - Network Value to Transactions Ratio.
- The CBV research paper highlights parallels between emergent crypto-asset valuation approaches and the traditional valuation approaches that are recognised within accounting literature including IFRS Standards (i.e. cost approach, income approach and market approach) – see next slide

CBV Institute research paper



Source: CBV research paper

Other valuation considerations for crypto-assets

Respondents to the EFRAG research noted the following valuation challenges

- Many crypto-assets show a high intra-day volatility of prices;
- Multiple markets for some crypto-assets (liabilities) and each of those markets might have different prices at the measurement date - determining the principal market for the asset might be challenging;
- Establishing whether an active market under IFRS 13 *Fair Value Measurement* exists might be challenging (crypto-assets are frequently traded primarily into other crypto-assets, as opposed to fiat currencies); and
- Some respondents to the EFRAG outreach viewed non-fiat exchange as a constraint to meeting the definition of an active market under IFRS 13

QUESTIONS FOR DISCUSSION

Questions for discussion

- Do you agree that there is need to address accounting topics not in scope of the IFRS IC agenda decision on cryptocurrencies with no claim on the issuer?

- Which of the three options put forward in the DP would be the most appropriate solution to address IFRS requirements? Are there other possible approaches towards addressing the accounting for crypto-assets (liabilities).

- If a new standard were to be developed, should its scope be only on crypto-assets (liabilities) or should it be broader category of digital assets (liabilities) including other use cases of blockchain?

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