

ACCOUNTING AND AUDITING OF DIGITAL ASSETS



March 19, 2020

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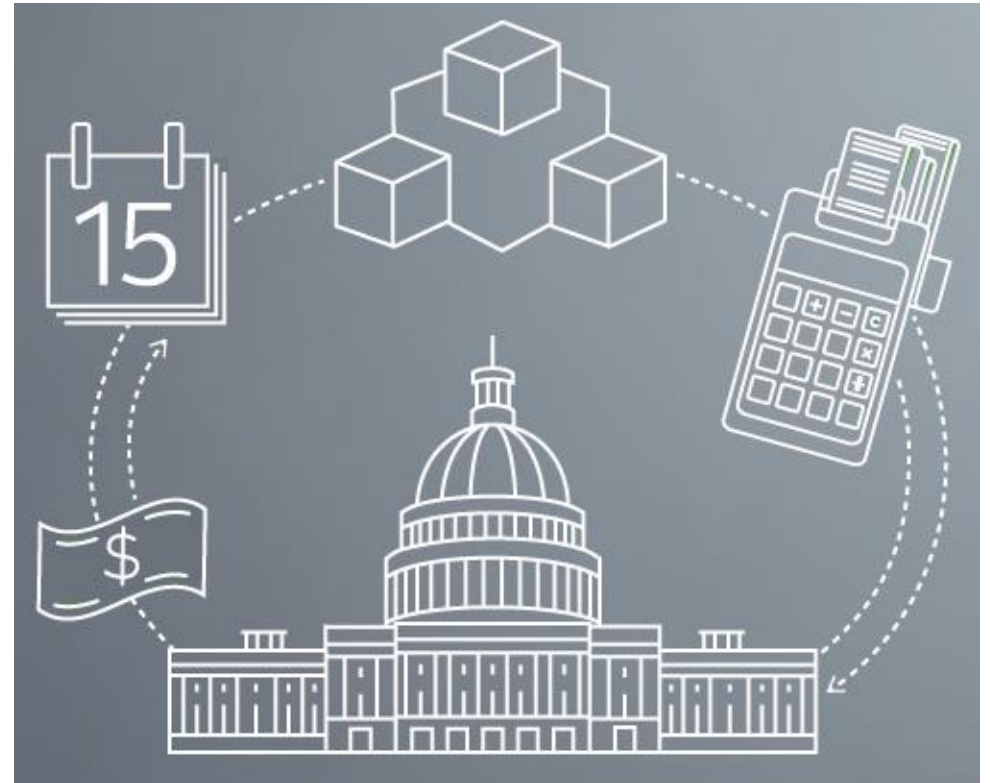
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Agenda

- Background
- AICPA Audit and Accounting Working Group Guidance
- Accounting Challenges
- Audit Challenges

Our vision

To enable our clients to accept, use and invest in digital assets while maintaining compliance with applicable regulatory, tax, accounting and audit frameworks.



Expansion of the use of digital assets



- The evolution of widely accepted alternatives to fiat currency is well underway
- Developments in blockchain technology are pushing the acceptance of digital assets as settlement for “traditional” transactions and allowing for tracking of transactions in ways not previously available

Digital assets: An application of blockchain technology

Digital asset types

- Crypto assets
- Bitcoin, ether, litecoin
- Stable coin
- Asset-backed token
- Crypto commodity
- Utility token
- Security token
- Privacy centric token

“Blockchain is to Bitcoin, what the internet is to email.

A big electronic system, on top of which you can build applications.

Currency is just one.”

What are we seeing today?

Smart contracts

Trade confirmation

Securities settlement

Tracking collateral in asset-based lending

Insurance claims processing

Derivatives consensus pricing

Food traceability

- Organic certification
- Fair trade

Supply chain

- Sustainability
- Labor force

Digital identify

Challenges of using blockchain and digital assets

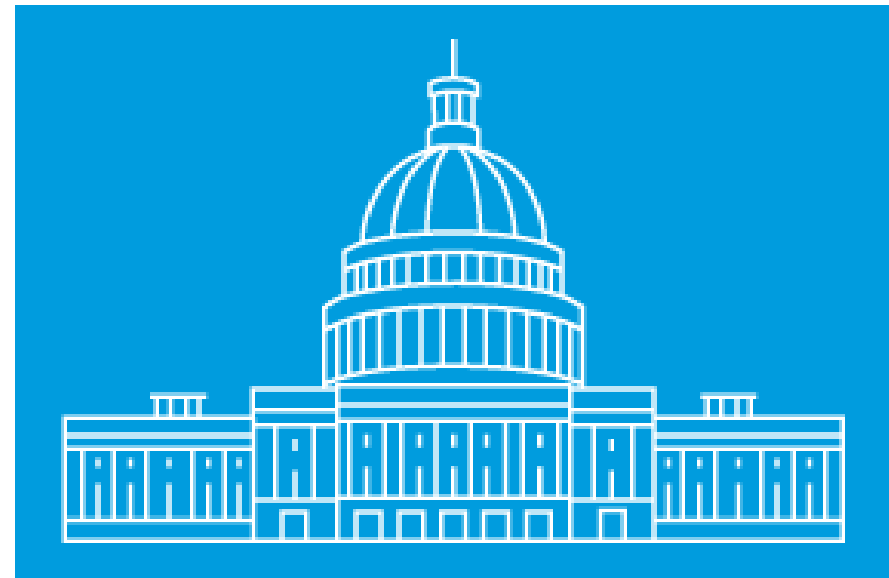


The use of blockchain and digital assets has wide implications for entities, including in the areas of:

- Governance, regulatory and risk considerations
- Income tax, state and local taxes
- Information systems
- Internal controls and processes
- Skillset of management and other service providers, including auditors

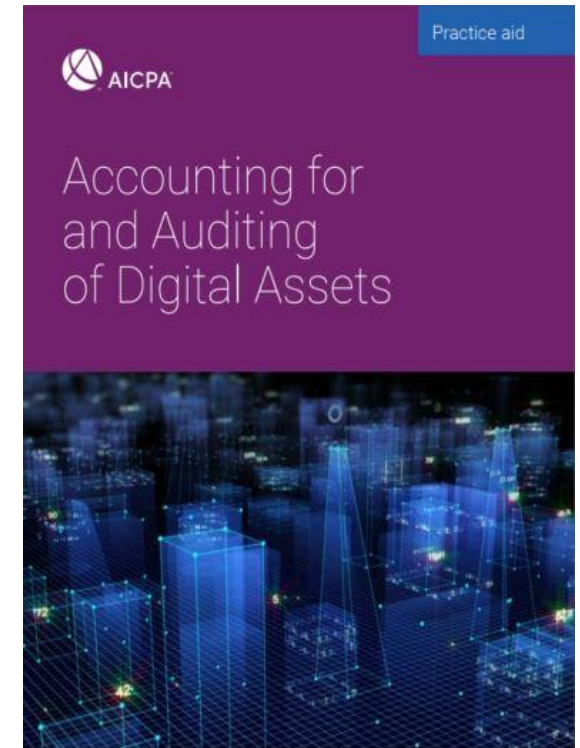
Regulatory bodies commonly associated with digital assets

- IRS
 - Updated guidance in Oct 2019
 - Further updates expected
- SEC
 - Regulates digital asset securities
- CFTC
 - Regulates digital asset commodities (bitcoin, ether, and their derivatives)
- FINRA
- FinCEN
- State regulators, e.g. NYDFS
- AICPA
 - Digital Asset Working Group



Challenges in accounting for digital assets

- No new accounting standards issued by FASB or IASB focusing on accounting for digital assets
- Research studies & working groups have been formed by FASB, IASB, AICPA, and similar institutes across the world
- AICPA's Digital Asset Working Group published [Accounting for and Auditing of Digital Assets](#) in December 2019



Agenda for AICPA's Digital Asset Working Group

Auditing

- Client Acceptance
 - Final review
- Risk Acceptance
 - Final review
- Process and Controls
 - In progress
- Illegal Acts and Related Parties
 - In progress

Accounting

- Q&A format
- First round published in December
- Second round in progress
- Will soon address:
 - Specialized industry guidance
 - Broker-dealers
 - Principle market
 - Cut-off
 - Fair value

Contents of the AICPA Accounting Practice Aid

Classification and Measurement When an Entity Purchases Crypto Assets

Recognition and Initial Measurement When an Entity Receives Digital Assets that are Classified as Indefinite-Lived Intangible Assets

Accounting for Digital Assets Classified as Indefinite-Lived Intangible Assets

Measurement of Cost Basis of Digital Assets that are Classified as Indefinite-Lived Intangible Assets

Derecognition of Digital Asset Holdings that are Classified as Indefinite-Lived Intangible Assets

Recognition of Digital Assets When an Entity Uses a Third-Party Hosted Wallet Service

Measurement basis

- Practice Aid provides accounting guidance for entities buying, selling and holding digital assets:
 - Entities will generally classify digital assets as indefinite-lived intangible assets, subject to impairment testing. These entities will not subsequently measure digital assets at fair value.
- Entities applying specialized industry guidance likely to classify and measure digital assets in accordance with such guidance

Implications of receiving digital assets

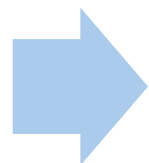
Whether an entity plans to immediately exchange digital assets into fiat currency, hold, or transact further in digital assets, the entity will need to determine:

- How the digital assets will be received
- With whom they will be exchanging the digital assets and/or how they will be transacting in digital assets in the future
- Whether to use a custodian and/or a trading platform
- Governance and risk management
- Changes to internal controls and processes
- Accounting policy

Accounting for a transaction settled in digital assets

When an entity agrees to settle a transaction in digital assets, it must consider the terms of the transaction carefully.

- For example, if Company A (not an investment company) sells a tangible good to Company B for 10,000 units of digital assets, what are the implications to revenue recognition if (1) Company B pays 10,000 units upon the change in control of the tangible good; or (2) Company B pays 10,000 units 30 days after the change in control of the tangible good?



How is revenue recognized? (Assuming point in time upon change in control of the tangible good.)

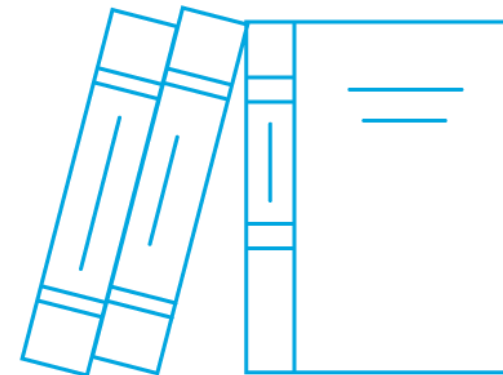


What are the implications of the 30-day payment terms?

Accounting for a transaction settled in digital assets – Revenue considerations

ASC 606, *Revenue from Contracts with Customers*

- Digital assets are expected to meet the definition of intangible assets, and will therefore be viewed as non-cash consideration
- When measuring the transaction price, value the digital asset on the contract inception date, assuming all criteria in FASB ASC 606-10-25-1 have been met
- Changes in the value of the digital asset after contract inception will not impact the transaction price, unless the variation is related to something other than the form of the consideration (e.g. entity performance). If the value is changing related to something other than the form of the consideration, this need to follow the variable consideration rules under FASB ASC 606-10-32-5 to 14.



Accounting for a transaction settled in digital assets - Subsequent accounting

- Digital assets accounted for as intangible assets are indefinite-lived, and thus, subject to impairment
- There are many considerations for how to track impairment indicators for these assets
- Subsequent use of digital assets also raises the need for policies and controls regarding how to track these assets in and out of the entity's wallets, how to attribute cost bases, etc.
 - Sales of digital assets must be assessed to determine if the transaction is within the scope of FASB ASC 606, *Revenue from Contracts with Customers*, FASB ASC 610-20, *Other Income: Gains and Losses from the Derecognition of Nonfinancial Assets*, or FASB ASC 845, *Nonmonetary Transactions*.

Accounting for a transaction settled in digital assets – Custody considerations

- If the entity receives the digital asset upon the change of control of the tangible asset (generally delivery), then the entity should consider the following:
 - Does the entity have custody of the digital asset?
 - Yes – the entity should consider the appropriate classification. For a non-investment company, digital assets will likely be classified as non-amortizing intangible assets, subject to impairment.
 - No – the entity should consider whether it has a receivable, derivative or hybrid contract with an embedded derivative from the custodial party.

Accounting for a transaction settled in digital assets – Custody considerations (cont.)

- In addition to considering the nature of the digital asset and how to classify it on the balance sheet, entities must consider whether they have custody
- When entities are transacting via agents, trading platforms, or custodians, care must be taken to determine who has custody at each stage of the transaction cycle

Auditing Standards Board

- Extracts from the AICPA [Proposed Statement on Auditing Standards \(SAS\) *Audit Evidence*](#) discussed at the ASB Meeting (January 13-16, 2020)

A24. Some sources of electronic information may provide a central location from which the auditor may obtain audit evidence. For example, a record maintained in a **distributed ledger**, such as a **blockchain**, may include information that is internal or external to the entity, which, among other factors, may affect the auditor's consideration of the reliability of the information in a **blockchain**.

A25. In certain circumstances, the source of information may be a combination of management and external parties. For example, if an entity develops a **distributed ledger** to capture transactions, there may be few or many other external parties participating in the transactions and contributing to the information included in the **distributed ledger**, including the entity. Therefore, when considering the source of the **distributed ledger**, the source is not solely management (that is, the information provided by management), but also includes information from external parties. In such circumstances, professional judgment is used by the auditor to assess the relevance and reliability of the audit evidence.

A51. Some electronic information (for example, records maintained on a **blockchain**) is available on a continuous basis during the audit. In such cases, auditors may develop procedures using automated tools and techniques to obtain information about transactions on a real-time basis.

- Proposed SAS is effective for periods beginning on or after December 15, 2021

Audit challenges

- Audits of entities receiving digital assets will be significantly impacted
- Auditors need to understand the new technology and the nature of the transactions:
 - Ownership, related parties
 - Custody – self or third-party service provider
 - Off chain; on chain
 - Use of third party trading platforms for transactions
 - New market risks

Audit challenges (cont.)

- Need to be flowing these considerations into risk assessment and appropriate audit responses
- Fundamental changes to the risk assessment of the audit – existence, completeness, rights & obligations, valuation
- Determining reliability of the blockchain
- New policies and internal controls
- New accounting policies requiring significant judgment
- Custody considerations
- Impairment considerations (for non-investment companies)

Blockchain – Impact on the financial statement audit

- “The acceptance of a transaction into a reliable blockchain may constitute sufficient appropriate audit evidence for certain financial statement assertions such as the occurrence of the transaction (e.g., that an asset recorded on the blockchain has transferred from a seller to a buyer)
 - For example, in a bitcoin transaction for a product, the transfer of bitcoin is recorded on the blockchain
- However, the auditor may or may not be able to determine the product that was delivered by solely evaluating information on the Bitcoin blockchain.”

Source: Blockchain Technology and Its Potential Impact on the Audit and Assurance Profession

Blockchain – Impact on the financial statement audit (cont.)

- “Therefore, recording a transaction in a blockchain may or may not provide sufficient appropriate audit evidence related to the nature of the transaction. In other words, a transaction recorded in a blockchain may still be:
 - unauthorized, fraudulent or illegal
 - executed between related parties
 - linked to a side agreement that is “off-chain”
 - incorrectly classified in the financial statements
- Furthermore, many transactions recorded in the financial statements reflect estimated values that differ from historical cost.
- Auditors will still need to consider and perform audit procedures on management’s estimates, even if the underlying transactions are recorded in a blockchain.” [Emphasis added]

Source: Blockchain Technology and Its Potential Impact on the Audit and Assurance Profession

Blockchain – Impact on the financial statement audit (cont.)

- Use of blockchains may provide centralized audit data
- Audit procedures related to data sourced from the blockchain must address the risk of fraud or error
- Auditor must be able to extract data from the blockchain
- Must consider the reliability of the data, including assessment of information technology general controls (ITGCs)
- Need to “understand and assess the reliability of the consensus protocol for the specific blockchain”
- Remember, the entities may be using multiple different blockchains

Evolution of audit and assurance

As blockchain technology is more widely adopted, companies and auditors will need to adapt

As entities begin to adopt this technology, care must be taken to ensure that data is being appropriately captured and considered within the financial statement close process

Data from the blockchain must be considered if it contains evidence related to the financial statements

Auditors must consider disconfirming evidence, whether on or off the blockchain

Companies need to reconsider their internal processes and controls to ensure that all evidence is being captured

Let's look at another example

1. Bitcoin transaction for a product - the transfer of bitcoin is recorded on the blockchain
 - The seller of the product receives bitcoin as payment for the product
 - For the seller, this is a revenue transaction and the auditor will be looking for evidence regarding the revenue recognition criteria, as well as the receipt of bitcoin as payment
 - If the blockchain tracks the delivery of the product, then that information needs to feed into the revenue recognition cycle as it provides evidence of the timing of the delivery – a key input into the timing of revenue recognition. If not, evidence of delivery must be obtained off the blockchain.

Digital assets - A few challenges that need to be considered

Valuation

How does the entity determine and capture the impairment or fair value of the digital assets?

Security

How are the private keys and digital assets kept secure?

Existence

How will the entity prove its ownership of the digital assets?

Regulations

How does the entity ensure compliance with all laws and regulations, e.g. AML?

Third-party controls

Has the third-party (custodian / trading platform) considered controls to ensure security of the digital assets?

Tax treatment

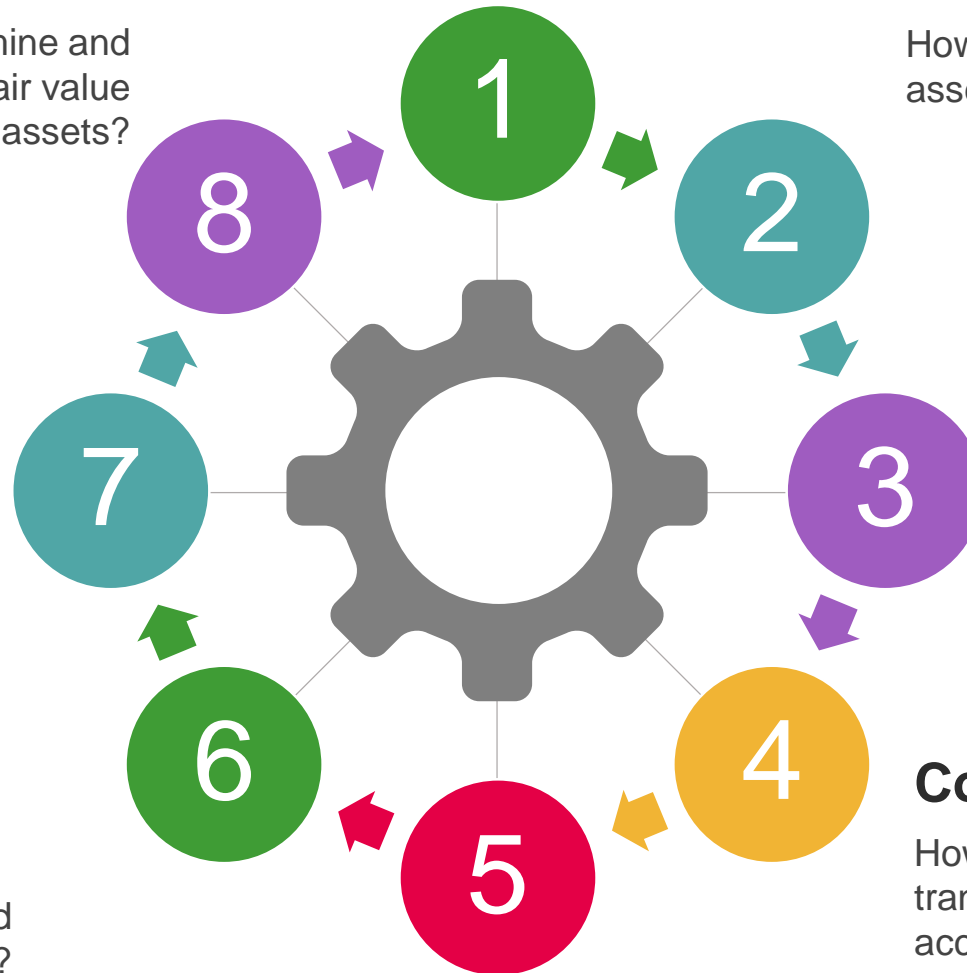
How does the entity comply with the tax treatment of various digital asset transactions?

Completeness

How does the entity ensure all transactions are captured and accounted for?

Know your customer (KYC)

How is the entity collecting and maintaining their KYC database?



Next steps

- In future webinars, we plan to cover:
 - AICPA Audit Guidance

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Leveraging emerging technologies to bridge critical trust and transparency gaps

In the simplest sense, a blockchain is a ledger that cryptographically signs and secures transaction records. The technology can be utilized for payments, securities issuance, contract automation and data transfers of all types.

In a fundamental way, this disruptive technology will change how companies operate. Major companies have launched blockchain initiatives to track shipments of cargo from manufacturer to distributor to retailer, trace food products to their source in times of contamination, and create smart contracts that execute provisions automatically using workflow and scanning technology.

We have an integrated team of audit, tax and consulting professionals committed to serving the blockchain industry. As the rules of the game change, we can provide middle market companies with the guidance they need to make blockchain technology work to their advantage.

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QUESTIONS AND ANSWERS

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