



A Guide to Digital Asset Accounting

**Corporate Crypto
Accounting, Simplified**



Introduction

Fourteen years ago, Satoshi Nakamoto, the mysterious inventor of Bitcoin created a “... peer-to-peer version of electronic cash that would allow online payments to be sent directly from one party to another without going through a financial institution.” Over a decade later, the asset class of cryptocurrency had grown to over a trillion dollar market capitalization.

With use cases extending far beyond currency and despite their historic volatility, digital assets continue to be embraced by leaders across a wide array of industries. Payment giants such as Visa, Mastercard, and Paypal have been actively investing in crypto companies, enabling digital asset payments, or facilitating trading. Meanwhile, financial magnates such as Fidelity, Blackrock, State Street, BNY Mellon, and others continue to hit key milestones in enabling crypto custody, investing in crypto companies, or facilitating trading for clients.

In a December 2022 article via the Wall Street Journal, Goldman Sachs CEO David Solomon proclaimed that in the wake of the FTX collapse, “Regulated financial institutions are well positioned to harness the revolutionary technology.” Digital assets are poised to disrupt the financial system with the ability to transact value directly, near-instantly, 24/7/365, to anyone, anywhere in the world.

Or as the CEO of Blackrock, the world's largest asset manager, remarked at a New York Times conference in December: "I actually believe this technology is going to be very important... I believe the next generation for markets, the next generation for securities, will be tokenization of securities." Further, publicly traded corporations such as Tesla, Block (formerly Square), and Microstrategy continue to hold billions of dollars worth of Bitcoin on their balance sheets today – in spite of its historical accounting challenges.

Many obstacles remain but a key roadblock is eroding. In November, a Bloomberg survey found that the Majority of Investors Welcome Regulation. Regulatory clarity is finally emerging to the ultimate benefit of individuals and investors. In 2022, the SEC (U.S. Securities and Exchange Commission) and the FASB (Financial Accounting Standards Board) offered key guidelines toward promoting transparency for companies holding or transacting in digital assets – and the recent FASB decision is set to eliminate one of the most frustrating aspects of holding digital assets in corporate treasuries: impairment charges.



Whether you're already participating, investing, or just starting to explore, you'll want to assess your digital assets strategy from a holistic perspective, including robust risk management practices.

With new-found regulatory clarity, transparent accounting and enterprise compliance are key to restoring investor confidence – enabling the digital asset class to reach its full potential and position your business for success.

Executive Summary

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Regulatory scrutiny is increasing but so is clarity – thereby eroding a key concern for investors while promoting greater transparency and better accounting standards

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Recent decisions from the FASB will transform how digital assets are currently accounted for by allowing crypto assets to be accounted for at fair value – thus eliminating frustrating impairment charges that have deterred corporate crypto adoption

3

Further guidance from the FASB – adding to previous SEC guidance – promotes greater crypto financial transparency by requiring key disclosures on the face of both balance sheets and income statements

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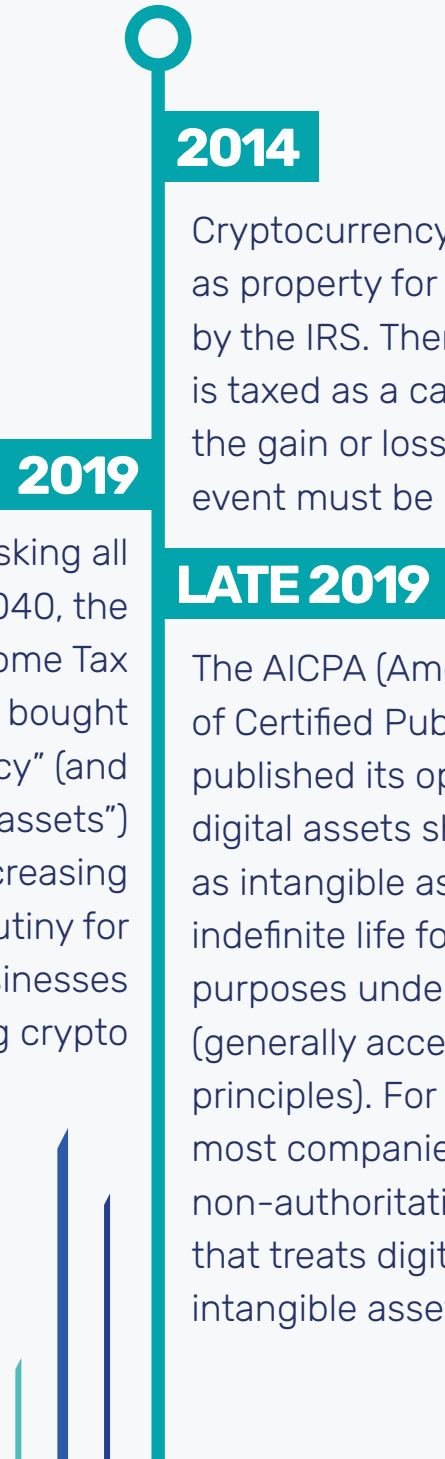
The fall of FTX has spotlighted the need for greater industry transparency, regulatory clarity, and better accounting practices

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Despite increasing regulatory clarity, digital asset accounting can still be exceptionally complex and challenging – and TaxBit has built the industry-leading solution to support your business in harnessing the full potential of the asset class

The path to regulatory clarity

As we consider how digital assets should be accounted for in the future, we can learn from the past.



2014

Cryptocurrency is determined as property for tax purposes by the IRS. Therefore, crypto is taxed as a capital asset and the gain or loss of every taxable event must be reported

2019

The IRS begins asking all taxpayers on Form 1040, the U.S. Individual Income Tax Return, whether they bought or sold “virtual currency” (and later called “digital assets”) – spotlighting the increasing regulatory scrutiny for individuals and businesses transacting crypto

LATE 2019

The AICPA (American Institute of Certified Public Accountants) published its opinion that digital assets should be treated as intangible assets with an indefinite life for accounting purposes under GAAP (generally accepted accounting principles). For years thereafter, most companies adopted this non-authoritative guidance that treats digital assets as intangible assets



2021

Congress passed the Infrastructure Investment and Jobs Act (IIJA), which included provisions relating to how brokers should conduct tax information reporting on “digital assets.” The IIJA introduced the term “digital assets” to encompass any kind of asset built on blockchain technology that may not necessarily be “currency” (such as NFTs, for example)

MARCH 2022

The SEC Staff Accounting Bulletin (SAB) 121 is released
– reflecting a departure from certain aspects of the AICPA’s guidance by requiring companies who custody assets for their users to report a safeguarding liability and asset on their balance sheet

DECEMBER 2022

Adding to recent guidance regarding fair value treatment, the FASB votes to require certain disclosures for cryptocurrency activity, along with its distinct presentation on the face of both the balance sheet and income statement

OCTOBER 2022

The FASB votes to require companies to account for crypto assets at their fair value
– setting the stage to put an end to frustrating impairment charges that have hindered corporate crypto adoption



Current accounting framework

While there is currently no authoritative guidance that is tailored for digital assets under GAAP, current practice – supported by the AICPA – is to treat digital assets as “intangible assets”. This is based on how the FASB defines as intangible assets: “assets (not including financial assets) that lack physical substance.” Further, digital assets are generally treated as intangible assets with an “indefinite life” – meaning they should not be amortized or depreciated, and are subject to [impairment](#).

In other words, businesses must track intraday price movements across their entire digital asset portfolio so they can identify price dips the instant they drop below the current book value. Digital assets should be reported on the balance sheet at initial acquisition cost, less any impairment due to price dips, and can’t be written back up again, even if the market price rebounds. The asset must remain on the balance sheet at its impaired book value until it’s sold or otherwise disposed of, at which point a realized gain or loss is recognized.

As impairment charges weigh on public earnings reports, this current paradigm has been a significant deterrent for corporate crypto adoption. In addition, the ambiguity of current accounting rules for digital assets generally fails to promote financial transparency.

Tracking by lot

Each time a company acquires a new unit, multiple units, or a fraction of a unit of cryptocurrency, those new units acquired are defined as a lot. A lot doesn't have to equal one whole unit – it is simply a batch of units, or divisible fractions of units, with the same acquisition date and the same acquisition price.

Digital asset transactions can create significant difficulty when tracking activity at the lot level. Acquisition and disposition dates, cost basis, and transaction size for each digital asset lot in your portfolio must be granularly tracked, which can become a burdensome task.

Future accounting framework

Fortunately, the FASB, which sets authoritative accounting guidance under US GAAP, recently voted on a series of provisions to increase transparency and end frustrating impairment charges – two key initiatives that can promote digital asset investor trust.

For each asset conforming to the scoping requirements (see section below), companies will be required to report assets held at fair value at the end of each reporting period. Companies will be required to produce new robust disclosures, including significant holdings on an asset-by-asset basis – including the quantity, cost basis, and fair value of assets held (see disclosures section below for a detailed breakdown).

While the recent vote is not yet authoritative, in the coming months the FASB will issue a public Exposure Draft outlining its new proposed guidance. Stakeholders throughout the industry will have the opportunity to comment on the Exposure Draft, after which the Board will make it's final deliberations before the issuing a new Accounting Standards Update (ASU).

FASB scope for fair value treatment

It's important to note that the FASB's updated fair value treatment would only apply to crypto assets that meet the scope requirements. These crypto assets must meet the following criteria:

- Meet the definition of "intangible asset" as defined in the Master Glossary of the Codification (i.e. "an asset that lacks physical substance")
- Do not provide the asset holder with enforceable rights to, or claims on, underlying goods, services, or other assets
- Are created or reside on a distributed ledger or "blockchain"
- Are secured through cryptography
- Are fungible (i.e. "able to replace or be replaced by another identical item; mutually interchangeable")

These scope requirements essentially mean that most cryptocurrencies will be eligible for fair value treatment. Notable exceptions would include NFTs (which are explicitly scoped out in criteria number 5), tokenized equities or other traditional asset-backed tokens, issuer tokens or those created by a related party to the reporting entity, wrapped tokens, and certain stablecoins. As a result, impairment may still be required for any of the above exceptions, including NFTs held by a corporation.

Financial statement presentation of crypto assets

As a result of recent FASB votes, companies should present crypto holdings separate from other intangible assets (such as patents or trademarks, or other non-physical assets) on the face of key financial statements.

Balance sheets will have a separate line item specifically dedicated to crypto holdings and, as previously discussed, those holdings will be reflected at their fair value at the end of the reporting period. Any changes in fair value on income statements will be reflected as a component of net income and broken out as a separate line item.

These presentation decisions will significantly increase financial transparency about the holdings and earnings impact of specific crypto assets – tracking the assets held, the quantity of assets held, and the cost basis and fair value of those assets at the time of the reporting. The FASB's series of new decisions herald a significant positive change for companies interested in digital assets and for investors seeking greater transparency.

Here is an example of a company's balance sheet and income statement under the future rules:

Consolidated Balance Sheet (in thousands)

Assets	September 30, 2022
Cash	\$ 18,431.00
Accounts Receivable, net	\$ 894.00
Inventory	\$ 2,698.00
Intangible Assets, net	\$ 322.00
Crypto Assets	\$ 1,964.43
Total Assets	\$ 24,309.43

Consolidated Statement of Operations (in thousands)

	September 30, 2022
Revenue	\$ 62,397.00
Cost of Revenue	\$ (12,894.00)
Gross Profit	\$ 49,503.00
Operating Expense	\$ (30,341.00)
Net Gain / Loss from Crypto Activity	\$ (24,094.55)
Net Income	\$ (4,932.55)

In addition to the critical decisions regarding digital asset accounting on balance sheets and income statements, the FASB also made a series of other decisions. Specifically, the FASB clarified how certain cryptocurrency activities should be classified within the statement of cash flows.

For example, most cryptocurrency activity would normally be classified under the investing section of the statement of cash flows. That classification may not be appropriate for companies that receive crypto as revenue and immediately convert those assets to cash – this is especially true for mining companies that immediately sell their mining proceeds. In that case, under the current interpretation, a company would be generating income without classifying the cash generated as part of its operating cash flows.

At the time of writing, Bitcoin miners comprise a large proportion of the top corporations valued by their crypto holdings:

Public companies with Bitcoin treasuries

Microstrategy		\$2.74B
Marathon Digital		\$208.21M
Tesla		\$201.27M
Hut 8 Mining		\$173.69M
Block (Formerly Square)		\$166.22M
Riot Blockchain		\$135.34M
Coinbase		\$92.91M
Hive Blockchain		\$83.49M
Galaxy Digital		\$82.83M
Bitfarms Ltd.		\$63.67M

Source: BitcoinTreasuries.net as of Jan. 8, 2023

The FASB clarified that in those cases, it would be more appropriate to classify those cash flows related to asset dispositions as part of the operating section of the statement of cash flows.

Additional financial disclosures of crypto assets and activities

Further, the FASB has determined that companies will be required to disclose a series of specific items regarding their crypto holdings and activity:

- **Significant holdings:** A company would provide a listing of the specific assets they hold (with a focus on those assets that are deemed to be significant, or material) and would disclose the asset name, the quantity held, along with the cost basis and fair value of holdings
- **A reconciliation or roll-forward of crypto assets for the respective period:** This would include beginning balances, along with additions, dispositions, gains/losses (whether realized or unrealized), etc. that have occurred during the period to arrive at the ending balance at the end of the period. The FASB may also require that companies provide supplemental information stating the cumulative gains/losses of a company's current holdings
- **The fair value of restricted assets and the nature of those restrictions:** A company may have tokens that are locked up and otherwise inaccessible to them. In that case, the company would need to disclose this in the disclosures so users of financial statements are able to gain an understanding of which assets are liquid
- **Follow the existing disclosure requirements outlined in ASC 820 for fair value measurements more broadly:** This would specifically include classification levels within the fair value hierarchy and disclosures of related party transactions

Here are a series of example disclosures based on the FASB's preliminary decisions:

Crypto Assets Significant Holdings

Assets	Number of Units	Cost Basis	Fair Value
BTC			
Coinbase	43.0078	\$ 712,854.29	\$ 838,652.10
Binance	20.9761	\$ 347,678.86	\$ 409,033.95
ETH			
Coinbase	493.3422	\$ 545,143.13	\$ 641,344.86
ETH Wallet	57.9998	\$ 64,089.78	\$ 75,399.74
Total Assets Held		\$ 1,669,766.05	\$ 1,964,430.65

Crypto Asset Roll Forward

Assets	Fair Value
Total Fair Value as of June 30, 2022	\$ 1,866,312.91
Asset Acquired	\$ 275,001.93
Asset Disposed	\$ (152,789.64)
Gains (Realized and Unrealized)	\$ 89,000.72
Losses (Realized and Unrealized)	\$ (113,095.27)
Total Fair Value as of September 30, 2022	\$ 1,964,430.65

Realized vs. Unrealized Gains and Losses

(\$ in thousands)	Fair Value
Realized Gain / Loss	\$ 40,561.72
Unrealized Gain / Loss	\$ (64,656.27)
Net Gain/Loss for the period ending September 30, 2022	\$ (24,094.55)

Challenges of holding crypto on your balance sheet

In addition to the increased array of reporting requirements, there are other unique challenges with respect to holding digital assets on a balance sheet.

Determining fair value according to principal markets

In order to satisfy regulatory accounting standards and determine fair value for digital assets, asset prices should be tracked according to their so-called principal market. To do so, you should answer the following questions for each given asset held: Which actively traded markets do you have access to? Of the markets you have access to, which has the greatest trading volume for the given asset?

As a simple example, let's assume you hold Bitcoin on your balance sheet which requires fair value measurement. Let's also assume you have access to trade Bitcoin on five U.S. exchanges: Coinbase, Binance, FTX, Gemini, and Kraken.

In this example, even if you do a majority of your Bitcoin trading on the Kraken exchange, if Coinbase may be deemed to be the principal market due to it having the highest trade volume, then you would likely be required to use pricing from Coinbase for your Bitcoin fair value measurements.

While the above example is very simple, this gets more complicated when you hold multiple assets that each have a different principal market. For example, assume you also hold some Dogecoin in addition to your Bitcoin holdings.

If the exchange with the highest trading volume for Dogecoin is Binance, but the exchange with the highest volume for Bitcoin is Coinbase, then you would have to collect fair value price information from Binance for your Dogecoin fair value measurement, and Coinbase for your Bitcoin fair value measurement.

Due to the number of available assets and trading markets in the crypto space, it is likely that the principal market for one asset in your holdings will differ from another. It is also likely that the principal market for some assets will change from time to time. And given the historic volatility of crypto assets, tracking these changing variables can quickly become difficult and costly for enterprises.

In the ASC 820 guidance, fair value determination methods are divided into a hierarchy based on the level of information available to determine the fair value of an asset:

-
- **Level 1** valuations are supported by quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date
-
- **Level 2** valuations are supported by observable market inputs other than Level 1 inputs
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- **Level 3** valuations are supported by unobservable market inputs

In the current digital asset landscape, it is likely that most enterprises are primarily dealing in Level 1 assets; however, it should be noted that there are also many types of digital assets that do not actively trade on an open market and therefore lack observable price inputs.

It is also not uncommon for assets to switch back and forth from active trading on an open market with readily available pricing to suddenly being unavailable to trade on an open market and requiring Level 3 inputs for valuation, and vice versa. In the absence of Level 1 observable price inputs, enterprises are required to deploy other valuation methods.

Additional considerations for digital asset brokers and custodians

An SEC Staff Accounting Bulletin (SAB) 121 was released in 2022 that requires companies who custody assets for their users to report a safeguarding liability and asset on their balance sheet. In SAB 121, the SEC clarifies their standing that companies who are responsible for safeguarding customer assets must do the following:

- Report the obligation associated with these custody arrangements as liabilities on their balance sheet
- Recognize a corresponding asset “similar in nature to an indemnification asset” as outlined in FASB ASC 805
- Measure the liability and asset – upon initial recognition and at each reporting date thereafter – at the fair value of the assets under custody
- Disclose risks related to these custody arrangements to their investors

Traditional ERP systems don't account for digital assets

Traditional enterprise resource planning (ERP) systems aren't equipped to deal with the complex and unique nature of digital assets. While these systems are adept for traditional accounting transactions, companies are in need of a more tailored solution that's fit for purpose and ready to manage the unique challenges that digital assets present.

As a result, most finance and accounting departments manage their holdings and transactions via inefficient manual reports, which makes information difficult to track in real-time, less secure, and less controlled. Companies and their auditors need solutions that provide a robust control environment to identify errors and prevent them from occurring prior to publishing financial reports.

The fall of FTX and how transparent accounting can restore crypto's future

Many questions remain unanswered, and facts are still emerging, but the recent downfall of FTX will likely go down in history as Crypto's Great Financial Crisis. While the industry continues to reel from the unfolding event, the overwhelming need to prevent future crises has become top-of-mind for regulators and investors alike. Regulatory clarity, on-chain transparency, and better accounting can provide a path forward.

What happened to FTX

On Friday, November 11, 2022, Sam Bankman-Fried – the previous CEO of the firm – filed for the bankruptcies of FTX, FTX US, and 134 other affiliated companies, including his investment company, Alameda Research. FTX had grown to become the second largest crypto exchange in the world – valued at \$32 billion.

FTX investments throughout the digital-asset ecosystem were vast, and the complexity of its structure was highly convoluted. Most ominously, FTX had attracted consumer funds of approximately \$16 billion to its platform. In a handful of days, FTX went from one of the kingpins in the market to becoming completely insolvent, resulting in billions of dollars worth of lost value for consumers and investors alike.

How it happened

On November 2, CoinDesk reported a leak of FTX financial statements, which raised serious doubts about the stability of FTX. Specifically, CoinDesk reported that the leaked statements showed that the quantity and quality of the assets on FTX's books were not aligned with its liabilities, leaving FTX exposed to substantial risk, most notably because of an over-reliance on its own crypto token, FTT.

FTT token market capitalization



As word of this exposure spread throughout the crypto market, investors began dumping the FTT token, collapsing its value, and ultimately exposing a hole in FTX's balance sheet leading to its insolvency. While it is true that FTX experienced a market-driven run, it is also becoming increasingly clear that a much larger problem existed at FTX, including the misappropriation of customer assets and apparently fraudulent business practices.

While there were many key aspects that enabled FTX to perpetuate this fraud-like activity (such as undisclosed related-party transactions, the commingling of customer and corporate assets, and the lack of governance and internal controls), it was also a critical failure of accounting.

One of the ways FTX (and indirectly Alameda) made it look like they had more assets than they actually did was via the creation of FTT and other incubated tokens. In short, FTX created its own token and then grossed up its balance sheet to the value of the tokens it created but had not circulated.

As a simple illustration, if a company creates one million of its own tokens and sells 100,000 of them in the market, the company should not recognize an asset on its balance sheet equal to the price of the tokens in circulation multiplied by the 900,000 still-uncirculated tokens.

This accounting treatment created the mirage that FTX had substantial holding value in FTT (and other tokens). In reality, however, if FTX would have tried to liquidate its FTT position during this time, it would have flooded the market and collapsed FTT's price. Without these FTT "assets" on its balance sheet, FTX would have shown a very large negative equity balance because its liabilities outweighed its assets by a significant margin.

The path forward for crypto as an asset class

In October 2022, Aaron Jacob, Head of Accounting Solutions at TaxBit noted in Bloomberg Tax:

"Similar to what traditional asset classes experienced in 2008, cryptocurrency recently experienced its own high-profile Lehman-like bankruptcies. In the wake of the 2008 financial crisis, a speech by SEC Commissioner Kathleen Casey homed in on the need for accounting standards to promote transparency... After a chaotic crypto winter, regulatory clarity, transparency, and better accounting will let spring finally emerge again."

Effective accounting rules demanded by investors and enforced by regulators can help prevent companies such as FTX from being able to leverage themselves using self-created tokens. The FASB, for example, which plans to implement new and improved accounting rules for digital assets in the next year, should also consider crafting guidance for exchange-created tokens such as FTT.

Proof of reserves and liabilities

One of the great ironies of FTX's collapse is that blockchain was originally created to prevent this type of meltdown. In the wake of the financial crisis, Satoshi Nakamoto, Bitcoin's mysterious inventor wrote in 2009: "The root problem with conventional currency is all the trust that's required to make it work... Banks must be trusted to hold our money and transfer it electronically, but they lend it out in waves of credit bubbles with barely a fraction in reserve."

In recent months, many industry participants have encouraged on-chain transparency in order to help prevent similar meltdowns in the future. Venture capitalist Nic Carter, for example, recently explained a technique called Proof of Reserves via Coindesk (the same publication that broke the initial news of FTX's fragility):

"Requiring exchanges to show they have assets to match their liabilities would improve transparency and help to win back public trust in crypto... Post-FTX, a new enthusiasm for proofs of reserve has emerged. A number of exchanges – at a minimum Binance, Gate.io, KuCoin, Poloniex, Bitget, Huobi, OKX, Deribit, and Bybit – have indicated their intention to publish proofs of reserve. A few such as Crypto.com, Bitfinex, and Binance have taken the intermediate step of releasing wallet addresses as crude proof of assets. But this is incomplete without corresponding liabilities."

To be fair, auditing the liabilities side of the equation still requires a trusted third party that can potentially be negligent. In addition, fraudsters can potentially find innovative ways to evade discerning eyes.

FTX entities were supposedly audited by two firms, but at the same time bankruptcy filings reported that FTX held zero bitcoin on its balance sheet (despite having over a billion dollars in BTC liabilities). If FTX had been actively publishing on-chain proof of reserves, this would have been a blazing red flag for the public to transparently see.

The future of crypto requires better accounting via a combination of reputable auditors and on-chain transparency. But as an added complexity, very few firms are equipped to perform audits of companies that deal with digital assets. New firms and existing Big 4 auditors, supported by innovative software solutions, are emerging to fill this void.

The future of crypto accounting

Regulatory clarity, increased transparency, and better accounting can help restore the future of digital assets. Recent and future developments from the FASB and other regulators will mark critical milestones toward this end. Companies should therefore be preparing for this future – and focus on restoring investor trust.

At TaxBit, we are building pioneering solutions for digital asset accounting. Our technology is trusted by some of the world's largest regulatory agencies, accounting firms, and crypto enterprises as we enable the following:



Scalability to handle tens of millions of transactions



Seamless integration with traditional accounting platforms



A highly secure environment that supports robust control frameworks such as ISO 27001 or SOC 1 & 2 audits



Support for FASB and SEC-compliant journal entry and asset tracking



Audit support that is built with your auditors in mind



Transparency into transaction and accounting details



Industry thought leaders with technical accounting expertise; former FASB/AICPA/Big4 employees working in national offices as your partners

