



THE EXCHANGE

SEMINAR SERIES

MARKET INSIGHTS FOR PUBLIC COMPANIES

Digital Currencies – Accounting and Regulatory Update

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Wherever business takes you

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Agenda

- Accounting & Advisory Update
- Tax Update
- SOC

2021 – A Breakthrough Year

- Cryptocurrency has become institutional grade
- ETFs being approved or in the process of being approved by SEC and Canadian regulators
- Fidelity launched a digital currency division
- Morgan Stanley offers crypto funds to its wealth management clients
- Goldman Sachs relaunches crypto trading desk
- Some of Canada's largest investment banks are financing digital currency deals
- Seven in ten institutional investors expect to invest in or buy digital assets in the future
- Cryptocurrency has become mum and dad friendly
- The Pandemic

A Short History of Bitcoin



How Many Cryptocurrencies are there?

A LOT!

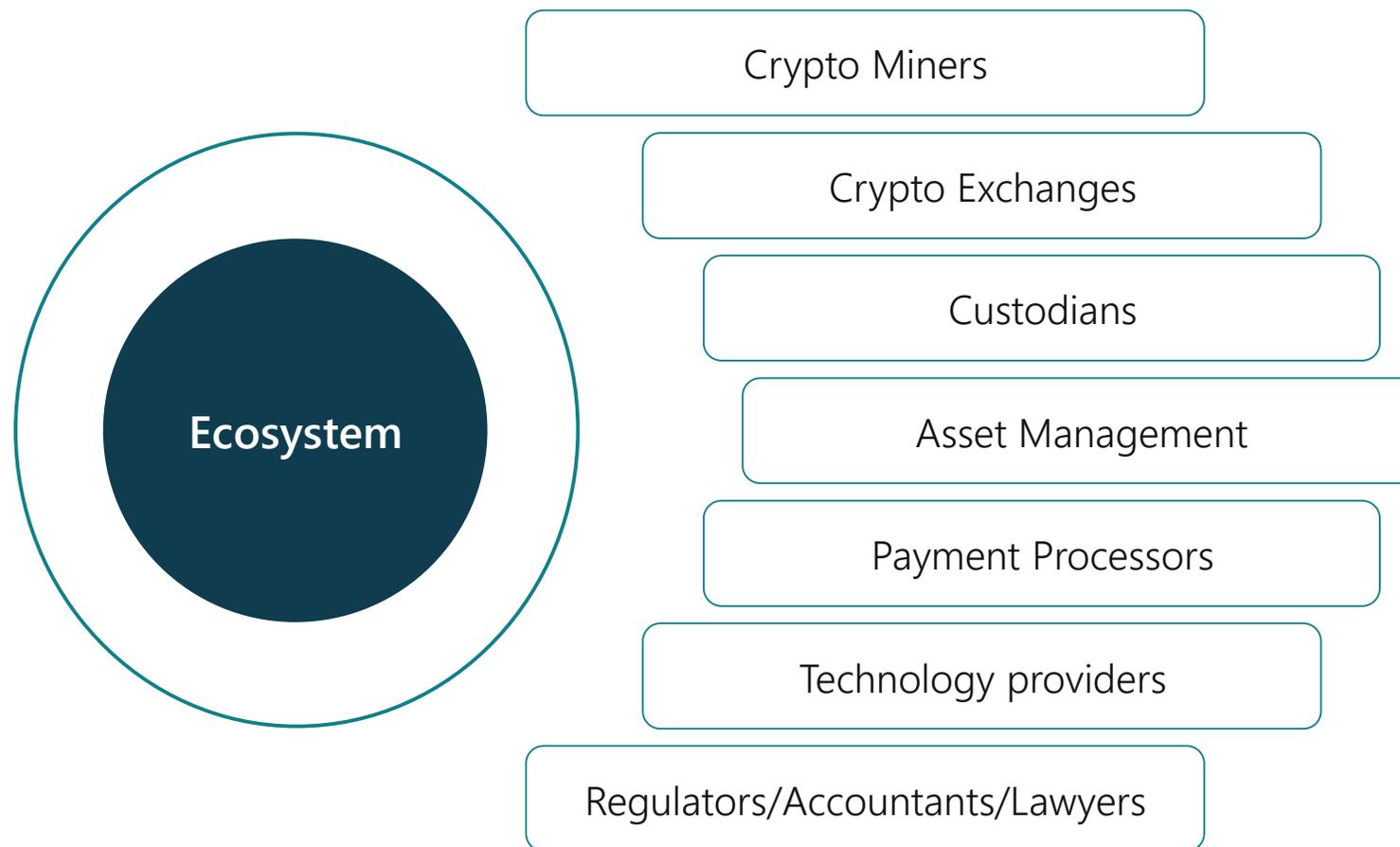


The Key Feature

It is powered by distributed ledgers via the blockchain that eliminate the need for central intermediaries to facilitate the value exchange.

- Blockchain vs Cryptocurrency
- Blockchain is the technology that enables the existence of cryptocurrency
- Blockchain also enables other uses beyond cryptocurrency

Cryptocurrency Ecosystem



What are the key issues we are going to face into the future?

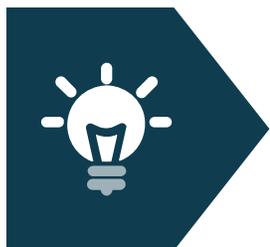


Continuing evolution of the legal landscape

2021 – China bans all crypto currency transactions while the SEC starts approving crypto backed ETFs



Volatility



New digital currencies

Large companies and countries

Accounting & Advisory Update

Agenda

- What is blockchain?
- What is cryptocurrency, tokens, SAFT/ICO contracts?
- Accounting treatment for digital assets
- Audit consideration for digital assets
- Recent developments

Overview of Blockchain

- Internet-based
- Peer-to-peer
- A decentralized public digital ledger
 - There is no single point where decisions are made
 - Captures transactions
 - Between parties in a network
- A distributed ledger
 - Includes all transactions since date of creation
- Transactions are secured by public-key encryption
- Systems use a “consensus algorithm”

What Are Cryptocurrencies?

- In March 2018, the word "cryptocurrency" was added to the Merriam-Webster Dictionary

"any form of currency that only exists digitally, that usually has no central issuing or regulating authority but instead uses a decentralized system to record transactions and manage the issuance of new units, and that relies on cryptography to prevent counterfeiting and fraudulent transactions"
- A type of digital asset that exists only on networks - not in physical form
- Cryptography is used in the generation, storing, transmittal and verification of transactions of these digital assets

Coins

Coins are cryptocurrencies operate on their own blockchains



Bitcoin (BTC)



Bitcoin Cash (BCH)



Litecoin (LTC)



Ethereum (ETH)



Ripple (XRP)



Cardano (ADA)



Stellar (XLM)



NEO (NEO)



Tokens

Tokens are used to interact with decentralized applications that are built on top of different blockchains.



Security Tokens – most tokens issued by ICO are security tokens. The person buying them is investing their money in the ICO with the expectation of profit. Under Swiss law, these are treated in the same way as traditional securities.



Equity Tokens – if a token represents some stock or equity in the company that issues it, it's an equity token. However, few companies have attempted such an ICO because there isn't much regulatory guidance about what is legal and what is not.



Utility Tokens – also called application tokens. They are used to provide people with access to either a product or service. They are also rare because most tokens are expected to gain in value based on their limited supply.



Payment Tokens – payment tokens have no other purpose than to pay for goods and services.

What is an ICO/ITO/SAFT?

- Initial Coin Offering (“ICO”) or Initial Token Offering (“ITO”) can be very similar to an Initial Public Offering (“IPO”) the public can purchase Tokens/Coins prior their release to crypto exchanges
- Simple Agreement for Future Tokens (“SAFT”) can be viewed the same as Simple Agreement for Future Equity (“SAFE”). Which are used frequently for institutional investors
- Similar to traditional shares of a company because their value may increase or decrease depending on the success of the business
- Capital is usually raised before a project commences and the project is then built on the amount of capital raised

Audit and Accounting Implications



Accounting treatment for Digital Assets



Audit considerations related to Digital Assets

IDG Jan 10, 2018 Meeting

Is Cryptocurrency an Asset?

The Conceptual Framework under IFRS:

“Asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity”

Criteria	How met?
Past event	Entity essentially buys, transacts with, or ‘mines’ a cryptocurrency (i.e., once the cryptocurrency is bought, traded, awarded or mined)
Control	Entity is able to control it, as it can decide when to sell it or use it as a medium of exchange
Future economic benefits	Ultimately, a sale or exchange of cryptocurrency for some other goods or services will result in benefits

IDG Jan 10, 2018 Meeting

Classification of Cryptocurrency Asset

Type	Factors supporting the classification	Factors not supporting the classification
Cash	Cryptocurrency represents a common medium of exchange and is widely accepted as a means of payment across the globe (similar to cash).	It is not issued or backed by any government or state.
Cash equivalent	Cryptocurrency is in the nature of a short-term, highly liquid investment that is readily convertible to known amounts of cash.	In recent history it has been extremely volatile, hence there is a significant risk of changes in value.
Financial asset	Cryptocurrency represents a right to receive cash or another financial asset, or to exchange financial assets with another entity under conditions that are potentially favourable.	It does not give the holder a contractual right to receive cash or another financial asset. There is no corresponding financial liability in the books of the party that would honour the value of the cryptocurrency.

IDG Jan 10, 2018 Meeting

Classification of Cryptocurrency Asset

Type	Factors supporting the classification	Factors not supporting the classification
Intangible asset	Cryptocurrency can be sold, exchanged or transferred individually; it is not cash, but a non-monetary asset, with no physical form.	Accounting results of applying IAS 38 might not be relevant (the cost method as well as the revaluation method).
Inventory	Cryptocurrency is viewed similar to a commodity held for trading purposes in the ordinary course of business.	It does not have any physical form. Further it may not be held for sale in the ordinary course of business.
Investment Property	Investors hold cryptocurrency for capital appreciation or as medium for exchange or both	IAS 40 is limited to real properties i.e. land and building

IDG Jan 10, 2018 Meeting

Measurement of Cryptocurrency Asset

Fair value through Profit or Loss (FVTPL)

- Pro is may reflect current value
- Pro is would reflect volatility
- Con is the recordkeeping and the volatility

Lower of cost or net realizable value

- Pro is would be simpler
- Con is would not reflect appreciation

Cost (less impairment)

- Depends on the business model

CPA Canada Position– Intangible Asset*

In May 2018, CPA Canada concluded:

- Not cash and cash equivalent
- Not inventory (unless broker-dealer)
- Not financial assets
- Not investment property

Conclusion: Many cryptocurrencies are likely to meet the definition of intangible assets and are therefore within the scope of IAS 38.

Recent Developments – Accounting treatment

Since 2018, at a high level, many standard setting boards are continuing to monitor the need for further accounting standard setting activity related to crypto-assets/digital assets, but there has been little actual published development when it comes to updated standards.

- Within Canada, the AcSB will continue to monitor the need for Crypto Asset guidance;
- IASB internationally has approved a project to address some of the challenges with intangibles under IAS 38 which could impact cryptocurrencies in the future, but decided not to add a project specific to crypto-assets on its workplan;
- Only the FASB has decided recently to proceed with further standard setting activities from an accounting standards perspective: AICPA published *Practice aid– Accounting for and auditing of digital assets – January 2022*

Accounting for and auditing of digital assets – January 2022

At a high level:

- Accounting for digital assets as other than intangible assets may not be appropriate
- Initially measured at costs and it should be tested for impairment annually or whenever impairment indicators arise
- When an entity uses a third-party hosted wallet service – Digital assets should be recognized on the F/S of the entity that has control over digital asset.
- Investment company holds digital assets as an investment – measured at fair value.

Conclusion: Diversity in practice!

Auditing considerations – common pitfalls

01

Whether the blockchain uses a robust cryptographic protocol or algorithm is susceptible to cause weakness in the blockchain.

02

Whether the blockchain is exposed to 51% attack or a consensus attack

03

Whether the auditor/specialist could operate its own node on a blockchain from which audit evidence can be obtained

04

Whether the IT application (Blockchain Explorer) is able to correctly display information on the blockchain

Auditing consideration – CPA Canada

- Audit considerations related to Cryptocurrency assets and transactions – July 2018
- Auditor's responses to assessed risks in audits of entities that hold crypto-assets – October 2018
- Auditing crypto-assets: relevance and reliability of the information obtained from a blockchain to be used as audit evidence – January 2020

New Guidance

CPA Canada and Auditing Assurance Standards Board (“AASB”)

Are test of controls needed regarding in the ownership assertion? (January 2020)

- Complexity of the entity’s business processes and IT environment
- Availability of evidence outside the blockchain
- Volume of transaction
- Other auditor risk assessment factors

Conclusion – It depends!

- Entities with only a small number of crypto-asset transactions, less complex IT and business processes, etc. – substantive sufficient.
- Many cases, substantive audit procedures might not be appropriate.

New Guidance

CPA Canada Crypto-Asset Auditing Working Group

Auditing financial statements of entities that engage with a third-party service provider in order to transact and/or hold crypto-assets (March 2021)

- System and Organization Controls (SOC) report may not be available. Even when it is available, it might not be able to address all concerns...
- Understanding the nature of the third party provided, including assessing a third party is a service organization: if so, auditors need to 1. identify and assess the risks of material misstatements; and 2. design and perform audit procedures responsive to those risks.
- Where a SOC report is not available or SOC report itself is not sufficient, auditors might need to perform your own testing of controls relevant to the audit at the service organization

New Guidance

CPA Canada Crypto-Asset Auditing Working Group

Control testing topics and risk scenarios such as:

- Cryptographic key management
- Custody, recordkeeping, order execution and customer transactions
- IT infrastructure security operations

Conclusion:

- Continue to update the understanding of the entity, and specifically its use of third parties as it relates to any crypto-asset holdings or trades, to inform the risk assessment and plan further audit procedures to obtain audit evidence to address identified risks of material misstatements.

Taxation of Digital Assets

Agenda

- Classification of digital assets
- Using digital assets as payment for goods and services
- Investing or trading in digital assets
- Mining or staking of digital assets
- Non-fungible tokens (“NFT’s”)
- Decentralized finance (“DEFI”)
- Foreign reporting
- Software solutions

Taxation of Digital Assets

Classification of Digital Assets

- 2013-051470117: *Bitcoins*
 - Virtual currencies not considered to be currency issued by a government of a country, as such treated as a commodity for purposes of ITA.
 - Use of Bitcoins on purchase of goods or services would be treated as a form of barter transaction.
- Generally most cryptocurrency (herein referred to as digital assets) are viewed as a commodity and not a currency in Canada; therefore, a transaction involving a digital asset is considered a barter transaction.
- Some digital assets could be considered securities; however, a discussion of those types of assets are beyond this presentation.

Taxation of Digital Assets

Using digital assets as payment for goods and services

- A payment for a good or service using a digital asset is a barter transaction. The FMV of the good or service will determine the proceeds of disposition for the digital asset.
 - Seller of good or service: generally, the FMV of the good or service is reported as income and is added to the cost basis for the digital asset received.
 - Buyer of good or service: generally, the FMV of the good or service purchased will be the proceeds of disposition for the digital asset given up.
 - Example: Buyer buys a car for 1 bitcoin and the FMV of car at the time is \$30,000.
 - Buyer has a disposition of bitcoin for \$30,000 – a gain or loss will be realized at this time depending on the Buyer's cost basis for bitcoin.
 - Seller has income of \$30,000 and a cost basis addition for bitcoin of \$30,000.
- Paying an employee in a digital asset rather than Canadian dollars:
 - Where an employee receives digital currency/assets as payment for salary or wages, the amount (computed in Canadian dollars) will be included in the employee's income.
 - An employer is still required to make all necessary source deductions as they would for an employee being paid in Canadian dollars.

Taxation of Digital Assets

Investing and trading digital assets

- Investors and traders in digital assets must track cost basis for tax purposes on a dollar cost average basis for each digital asset (exception – NFT's, discussed later).
- Purchasing the same digital asset you already own will change the cost basis per unit of account of the asset. Partially selling a digital asset will not impact the cost basis per unit of account.
- Any exchange of one digital asset for another is both a buy and sale event.
 - Example: Sell 1 Bitcoin for 10 Ethereum
 - Disposition of 1 Bitcoin at FMV = proceeds of disposition.
 - Cost basis addition for 10 Ethereum = proceeds of disposition.
- Capital gains vs. income:
 - Digital assets can be classified as capital property or inventory. Capital assets attract a half taxable rate on realized gains; whereas, inventory attracts a fully taxable rate on realized gains.
 - Whether someone is holding a capital asset (generally long-term investment) or inventory (frequent trading) is a factual analysis that depends on factors such as:
 - Are you investing in digital assets for the long-term or are you in the business of trading digital assets?
 - Do you have another job/business or are you in the business of digital assets?
 - Are the digital assets used in the day-to-day transactions of your business?

Taxation of Digital Assets

Mining and staking of digital assets

- Mining (proof-of-work validation) of digital assets:
 - The CRA clarified their position on the mining of Bitcoin in 2018.
 - 2018-077666117: *Bitcoin Mining*
 - Bitcoin received by a miner to validate transactions is consideration for services rendered by the miner. Where a taxpayer is in the business of Bitcoin mining, the Bitcoin received must be included in the taxpayer's income at the time it is earned.
 - Any digital asset mined through proof-of-work is considered business income and the FMV of the asset received is included in income.
- Staking (proof-of-stake validation) of digital assets:
 - Staking is an alternative validation method to proof-of-work whereby owners of a digital asset can stake their holdings rather than supply electricity and computing power.
 - While the CRA has clarified its position on proof-of-work validation (mining), we believe that staking should have the same taxable result in that any reward for staking digital assets is service income and should be included in income at the time earned.

Taxation of Digital Assets

Non-fungible tokens (“NFT’s”)

- Transactions involving NFT’s are considered barter transactions just like other digital assets such as Bitcoin.
- The key difference between other digital assets (such as Bitcoin) is that NFT’s as the name implies, are non-fungible meaning that one NFT is separately identifiable from another and therefore the cost basis of a NFT is tracked to the specific identify token.
- Individuals buying and selling NFT’s must track the cost basis per NFT including transaction fees such as exchange fees and network costs (e.g Ethereum gas fees).
- Whether NFT’s are held as capital property or inventory depends on the same factors discussed earlier regarding the trading of digital assets. If someone is in the business of trading/dealing NFT’s then they will be inventory.
- Holding NFT’s might also allow the holder to claim/receive airdrops or future utility – the taxation of airdrops or such utility will depend on the circumstances and facts regarding those specific situations.

Taxation of Digital Assets

Decentralized finance (“DEFI”)

- DEFI includes a wide range of digital asset transactions some of which are:
 - Trading digital assets via decentralized exchanges
 - Stablecoins
 - Lending or borrowing of digital assets
 - Wrapping digital assets
 - Decentralized gambling
- DEFI transactions that emulate any transaction involving an intermediary (e.g. centralized exchange) should have parallel taxation results. For example, trading of digital assets on a centralized exchange vs. a decentralized exchange will have the same taxation result.
- Where taxpayers enter DEFI transactions to earn a return (such as interest on lending) typically the income will be fully taxable like any simple interest one might earn; however, the complicated aspect of these DEFI transactions is whether the lending process is considered a disposition event of the digital asset lent out. To further complicate this, taxpayers who enter these sort of transactions will commonly compound DEFI transactions with other transactions further complicating the tax analysis.

Taxation of Digital Assets

Foreign reporting

- Section 233.3 of the ITA imposes requirement for reporting:
 - “specified Canada entity” to disclose ownership of “specified foreign property” if total cost of such property exceed \$100,000 at any time in a taxation year
 - “specified foreign property”: includes intangible property held outside of Canada that is not used or held exclusively in the course of carrying on active business.

CRA Views - 2014-0561061E5: *Digital currency would be funds or intangible property and would be specified foreign property ... if situated, deposited or held outside of Canada.*

- Location of cryptocurrency?
 - May exist simultaneously in several places
 - Where is the server located?
 - Hot wallet vs. cold wallet
- No additional commentary provided by CRA
- A taxpayer needs to closely consider the location of where their digital assets are held throughout the year to determine if they have a foreign reporting requirement.
- Development: the OECD is developing a new global tax transparency framework which provides for the automatic exchange of tax information on transactions in Crypto-Assets in a standardised manner

Taxation of Digital Assets

Software solutions

- There are a number of software solutions that exist today to help individuals determine their gains and losses due to transacting with digital assets.
- Most of these solutions work well where an individual has used a singular exchange or has limited the type of transactions; however, in our experience where users have complicated transactional history these programs often generate inaccurate results.
- Most taxpayers will need to manually determine their tax results to ensure accurate results. This can sometimes be extremely costly and time consuming due to digital asset exchanges having different methodologies for the accounting of transactions and the complexity involved with analyzing on-chain/off-chain transactions.

SOC

Chapter 1 Satoshi's project

Chapter 2 Community Managed Bitcoin

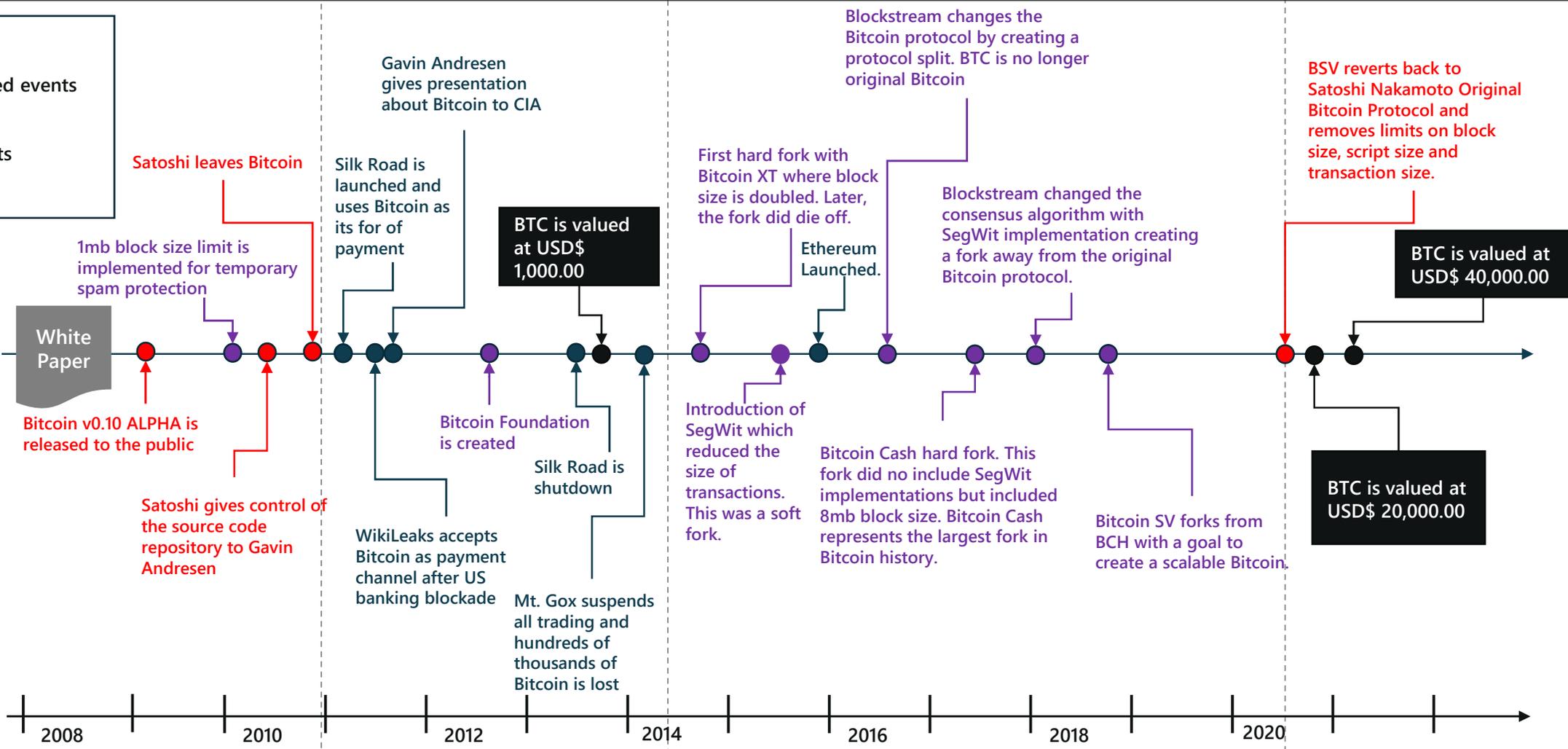
Chapter 3 Rise of Altcoins

Legend:

- Bitcoin forking related events
- External events
- Satoshi related events
- BTC price points

Protocols

Year



Adoption Challenges

Emerging technology

Blockchains are still an emerging technology

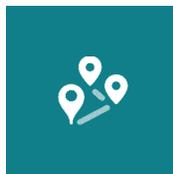


Lack of expertise

Lack of experts skilled in Blockchain technology

Lack of understanding

Lack of understanding just what Blockchain can do/is good for



Lack of industry standards

Use cases

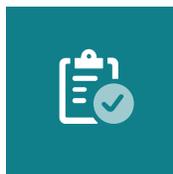
Identifying applicable use cases that are relevant, cost-effective, and practical to implement



Limited market

Limited market for available Blockchain solutions

Regulatory constraints



Privacy and security considerations

Planning Considerations

Some initial considerations...

1. What is the business purpose for using crypto?
2. How well does management understand risks related to crypto assets and crypto enabled transactions?
3. Has management established internal controls for its use of crypto?
4. Does the organization have the right competencies, knowledge, experience, etc.?
5. What is the degree of reliance on third party experts?
6. What are the external financial reporting/regulatory reporting implications?

SOC considerations for Crypto Currency?

What to think about when looking for service

- Service Organization Control Report
- What are the types of SOC reports:
 - SOC 1
 - SOC 2
 - TYPE 1 and TYPE 2

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