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## **WEEKLY COMMENT: FRIDAY 9 SEPTEMBER 2022**

1. This is week 5 of my review of the taxation of cryptoassets (the term used by Inland Revenue to refer to virtual currencies) in New Zealand. I am taking a break from tax this week to look at the accounting implications of cryptoassets.
2. The information below on accounting for cryptoassets has been obtained from a variety of sources including:
  - (a) OECD (2020) Taxing Virtual Currencies – An Overview of Tax Treatments and Emerging Tax Policy Issues, OECD, Paris;
  - (b) EY: Accounting by holders of crypto-assets (Updated October 2021) 2021 EYGM Limited ey.com; and
  - (c) PwC In depth No. 2019-05 Cryptographic assets and related transactions: accounting considerations under IFRS, PwC December 2019.

### **Accounting classification of cryptoassets**

3. The OECD noted that as at mid- to late-2020, there was no formal guidance available that indicates how crypto-assets should be classified for accounting purposes. Therefore, it is necessary to apply the existing general accounting principles, which require that assets are classified based on their economic properties. In order to correctly classify cryptoassets, their economic purpose, the rights and liabilities associated with the assets, and the way the assets derive their inherent value are all relevant. Crypto-assets can be broadly categorised as ‘virtual currencies’, ‘security tokens’ or ‘utility tokens’, based on the above-mentioned criteria.
4. Different types of tokens will require a different type of classification for accounting purposes and tax purposes. For example, a security token, which provides the owner with a contractual right to cash or another financial asset, could be considered as a financial asset subject to NZ IFRS 9 Financial Instruments, while utility tokens, which represent a right to receive future goods or services, can be considered as a prepayment for those goods and services, and could therefore be treated as such under NZ IFRS 15 Revenue from Contracts with Customers.
5. In relation to classification and measurement, EY states that:

“Crypto-assets have diverse terms and conditions, and the purpose for holding them also differs among holders. Hence, holders of a crypto-asset will need to evaluate their own facts and circumstances in order to determine which accounting classification and measurement

under current IFRS should be applied. Depending on the standard, the holder may also need to assess its business model in order to determine the appropriate classification and measurement.”

### **Cryptoassets in the statement of cash flows**

6. The general conclusion is that cryptoassets are not cash or cash equivalents:
  - (a) The International Financial Reporting Interpretations Committee (IFRIC) notes that virtual currencies should not be classified as financial assets or cash, because:
    - (i) These assets are neither equity nor do they give rise to contractual rights for its holder to receive cash or to exchange financial assets or financial liabilities with another entity; and
    - (ii) While some virtual currencies can be used in exchange for goods and services, they cannot be classified as cash, because no virtual currency “is used as a medium of exchange and as the monetary unit in pricing goods or services to such an extent that it would be the basis on which all transactions are measured and recognised in financial statements.”;
  - (b) EY similarly concludes that cryptoassets would not currently be considered to be cash because transactions in which cryptoassets are used as a medium of exchange is quite low and some cryptoassets are not used as a medium of exchange at all, and the price is highly volatile when compared to a basket of fiat currencies;
  - (c) Cryptoassets also do not meet the definition of cash equivalents because they are generally not convertible into known amounts of cash, and there is a significant risk of change in value.
7. Therefore, as far as the implications for NZ IAS 7 Statement of Cash Flows is concerned:
  - (a) Cash transactions relating to cryptoassets that are not considered cash or cash equivalents will be presented as operating, investing or financing activities, depending on their nature;
  - (b) A holder would also be required to disclose significant non-cash transactions where crypto-assets are used in payment for other goods or services.

### **Cryptoassets as financial instruments**

8. NZ IAS 32 defines a financial instrument as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.
9. EY notes that as the use of a blockchain or distributed ledger does not automatically give rise to a contractual relationship between parties, it is necessary to first consider whether a contract arises:
  - (a) Cryptoassets that entitle the holder to underlying goods, services or financial instruments provided by an identifiable counterparty could meet the definition of a contract;
  - (b) Cryptoassets that do not entitle the holder to underlying goods, services or financial instruments and have no identifiable counterparty would not meet the definition of a

contract (for example, by holding a bitcoin, a holder does not have an enforceable claim on miners, exchanges, holders, or any other party, and economic benefits from holding the bitcoin can only be realized by finding a willing buyer);

(c) Agreements entered into “off the chain” to buy or sell cryptoassets could be contracts.

10. Second, EY notes that it is necessary to consider whether a financial asset arises through cryptoassets entitling the holder to a right to cash or another financial asset:

(a) Cryptoassets that entitle the holder to a cash payment or the delivery of bonds or shares would meet the definition of a financial asset, and would be subject to NZ IFRS 9 classification and measurement requirements (however, cryptoassets that entitle the holder to goods and services are not financial assets, but may be prepayments or intangible assets – see paragraph 16 onwards below);

(b) Cryptoassets that embody a contractual right to a residual interest in the net assets of an entity may be equity instruments, initially recorded at fair value, without adjusting for transaction fees, and, subsequently, measured as at fair value through profit or loss under NZ IFRS 9 (however, a constructive obligation on the part of the issuer, such as a right to a royalty stream on an online game, or a correlation to the popularity of an underlying platform, will not represent a contractual right to a residual interest);

(c) A contractual right to buy or sell cryptoassets that can be settled net or where the underlying cryptoasset is readily convertible into cash should be accounted for as a derivative within the scope of NZ IFRS 9 (however, a gross-settled contract to buy or sell a non-financial cryptoasset, which is not traded in an active market, would not be in the scope of NZ IFRS 9 because the cryptoasset would not be readily convertible into cash).

11. Holders of crypto-assets that qualify as financial instruments (e.g., financial assets, equity instruments or derivatives) will need to comply with the requirements of NZ IFRS 7 Financial Instruments: Disclosures, including the risk disclosures and the disclosures required by NZ IFRS 13 Fair Value Measurement for recurring fair value measurements.

### **Cryptoassets as inventory**

12. IFRIC notes that cryptoassets assets should be accounted for as inventory in accordance with NZ IAS 2 when an entity holds these assets for sale in the ‘ordinary course of business’. This would apply in particular for brokers and traders of cryptoassets.

13. Cryptoasset inventories would normally be measured at the lower of cost or net realisable value, for which the following considerations are relevant:

(a) The costs of purchased cryptoasset inventories would typically comprise the purchase price, irrecoverable taxes and other costs directly attributable to the acquisition of the inventory (e.g., blockchain processing fees);

(b) Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the crypto-asset inventories to their present location and condition;

(c) The cost of inventory excludes anticipated selling costs as well as storage expenses (e.g., costs of holding a wallet or other crypto-account);

- (d) Net realisable value may be lower than cost if cryptoassets have become wholly or partially obsolete (due to declining interest in the cryptoasset or its application), their selling prices have declined, or the estimated costs to sell them have increased;
- (e) Commodity broker-traders may measure their commodity inventories at fair value less costs to sell.

14. Entities that classify crypto-assets as inventory would need to disclose:

- (a) The carrying amount by class;
- (b) The entity's accounting policy for measuring inventory;
- (c) The amount of inventory recognised as an expense in the period, any write-downs and reversal of write downs to net realisable value that were recognised in profit or loss; and the reason for the reversal.

15. Commodity broker-traders holding crypto-assets as inventory at fair value less costs to sell will need to disclose the carrying amount of such inventories carried at fair value less costs to sell, in addition to the general NZ IAS 2 requirements, and the disclosure requirements under NZ IFRS 13 Fair Value Measurement would also apply.

### **Cryptoassets as prepayments**

- 16. A cryptoasset that entitles the holder to future goods or services should be accounted for as a prepayment, providing that the entity expects to realise the subsequent delivery of the underlying goods or services (however, if the entity expects to trade the cryptoasset, it should not be accounted for as a prepayment).
- 17. There are no specific disclosure requirements for prepayments in IFRS, and the holder of crypto-assets classified as prepayments should look to the general guidance provided in NZ IAS 1 in order to determine the appropriate level of disclosure that would be required in the circumstances.

### **Cryptoassets as intangible assets**

- 18. The OECD notes that cryptoassets are generally considered to be intangible assets. While they might not fit perfectly into existing asset classes, a number of major accountancy firms proposed to classify these assets as 'intangible assets other than goodwill', instead of creating a new asset class. This approach corresponds to the one adopted by most tax administrations, which have so far not created specific and ring-fenced tax regimes to tax the creation, mining, exchange and storage of virtual currencies.
- 19. IFRIC notes that cryptoassets meet the definition of an intangible asset under NZ IAS 38, which defines an intangible asset as "an identifiable non-monetary asset without physical substance". According to IFRIC, a virtual currency fits the definition of an intangible asset as "(a) it is capable of being separated from the holder and sold or transferred individually; and (b) it does not give the holder a right to receive a fixed or determinable number of units of currency." (International Financial Reporting Interpretations Committee, 2019)
- 20. EY notes that Crypto-assets generally meet the relatively wide definition of an intangible asset, as they are identifiable, lack physical substance, are controlled by the holder and give

rise to future economic benefits for the holder. Therefore, they should be accounted for under NZ IAS 38, except when they are within the scope of another standard.

21. Intangible assets are initially measured at cost. The cost of acquiring cryptoassets would typically include the purchase price (after deducting trade discounts and rebates, if any) and the related transaction costs, which could include blockchain processing fees. Where an intangible asset is acquired in exchange for another non-monetary asset, the cost is measured at fair value, unless the transaction lacks commercial substance or the fair value of neither the asset acquired nor the asset given up can be measured reliably. In such instances, the cost of the intangible asset is measured as the carrying amount of the asset given up.
22. Subsequent measurement of cryptoassets may be under either the cost model or the revaluation model:
  - (a) Under the cost method, subsequent measurement is at cost less amortisation or impairment:
    - (i) Many cryptoassets have no expiry date and there may be no limit to the period over which they could be expected to generate cash inflows, in which case, no amortisation is required;
    - (ii) Such cryptoassets are subject to NZ IAS 36 impairment testing if there is any indication of impairment;
    - (iii) Holders of crypto-assets classified as intangible assets under NZ IAS 38 will need to disclose, by class, a reconciliation between the opening and closing carrying amounts, whether the useful life is assessed as indefinite, and, if so, the reasons supporting the indefinite useful life assessment, and a description of individually material holdings;
  - (b) Under the revaluation model, fair value is determined by reference to an active market applying NZ IFRS 13:
    - (i) There are no provisions in NZ IAS 38 that allow for the fair value of an intangible asset to be determined indirectly;
    - (ii) If no observable price in an active market for an identical asset exists, the holder will have to apply the cost method the cryptoassets held;
    - (iii) Entities that measure intangibles under the revaluation model will need to disclose, by class, the effective date of the revaluation, a reconciliation of the opening and closing balance of the related revaluation surplus and the carrying amount that would have been recognised had the cost model been applied, and adhere to the disclosure requirements in NZ IFRS 13.

### **Own accounting policy under NZ IAS 8**

23. EY notes that where no other standard applies and an entity develops its own accounting policy for a crypto-asset held under the NZ IAS 8 hierarchy, the entity needs to consider if the guidance in IFRS dealing with similar and related issues and the relevant definitions and recognition criteria in the Conceptual Framework would preclude it from being recognised

as an asset. In that case, the cost incurred in obtaining the crypto-asset should be expensed as incurred.

24. EY also notes that when an entity measures its crypto-assets at fair value (or based on fair value), it needs to carefully evaluate the comprehensive guidance under NZ IFRS 13, including that related to the definition of fair value, application of valuation techniques and inputs to valuation techniques.

### **Cryptoassets held by a custodian**

25. The terms and conditions for custodian arrangements can vary widely. Some exchanges retain all client crypto-assets in central wallets and only allow for clients to realise their crypto holdings through sale in exchange for a fiat currency. Other custodian service providers keep the client's cryptoassets in a unique cold storage wallet for which the entity retains the private key. Alternatively, crypto-wallet providers may simply facilitate movement of crypto-assets between clients' wallets and the private key for each client is retained on the client's device.
26. EY notes that, therefore, it is impossible to generalize as to the appropriate accounting treatment. The terms and conditions of the arrangement and the legal and regulatory environment in which the custodian operates will help to determine the appropriate accounting treatment for the client cryptoassets held.

### **Conclusion**

27. The OECD notes that these considerations provide some direction on how crypto-assets are classified for accounting purposes. Nevertheless, no internationally agreed guidance has yet been issued and several areas require further exploration, especially with regard to 'hybrid tokens', meaning tokens combining features of payment, security and utility tokens.
28. EY concludes that holders need to use judgement in providing sufficiently detailed quantitative and qualitative disclosures to enable users of financial statements to understand the impact of holding crypto-assets on their financial position, financial performance and cash flows.



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