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Cryptocurrencies and the Auditor's Dilemma

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Abstract

Insurance companies want to diversify their holdings to include cryptocurrencies. Under the principles of statutory accounting, cryptocurrencies should be cash or cash equivalents. Cash or cash equivalents are, by definition, admitted assets. When cryptocurrencies are adopted as admitted assets, auditors will face a dilemma. Current guidance suggesting treatment of cryptocurrencies as intangible assets results in misleading financial statements. Intangible assets are generally not depreciated or amortized, and are impaired without a corresponding mark to market. This results in a negative valuation feedback loop undermining the ability for an auditor to issue a non-qualified opinion since the cryptocurrencies' fair market value would be materially misstated. Treating cryptocurrencies as tangible assets resolves the dilemma for both industry and the users of financial statements.

Keywords: *Cryptocurrency, Financial statements, Intangible assets, Auditors*

1. Introduction

1.1. The Future of the NAIC and Cryptocurrencies

States' departments of insurance generally follow guidance issued by the not-for-profit organization known as the National Associated of Insurance Commissioners (NAIC)[1]. The NAIC promulgates best practices regarding statutory accounting principles governing insurance carriers. Unlike Generally Accepted Accounting Principles (GAAP), which focuses on a matching principle, statutory accounting focuses on solvency. Statutory accounting bifurcates assets into two classes: (1) admitted assets; and (2) nonadmitted assets. If an asset is nonadmitted it is charged directly against surplus thereby reducing the equity of the insurance carrier. This system injects a high degree of conservatism into financial statements in order to ensure that insurance carriers maintain enough liquidity to pay claims. This serves the policyholders by lowering the probability of insolvency and reduces the burden to the state by lowering the chances of a carrier falling into receivership.

Statement of Statutory Accounting Principles (SSAP) No. 4 – Assets and Nonadmitted Assets defines an asset as: "probable future economic benefits obtained or controlled by a particular entity as a result of past

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[1] NAIC Statutory Issue Paper No. 4 (March 16, 1998).

transactions or events." Assets share three traits: (a) they embody a future benefit contributing to future net cash inflows; (b) an entity can obtain that benefit and control others' access thereto; and (c) the transaction giving rise to the benefit already occurred. Paragraph 3 of the SSAP No. 4 states that assets which are not specifically identified in the NAIC's Accounting Practices and Procedures Manual (AP&P) are classified as nonadmitted.

The Statutory Accounting Principles Working Group released INT 21-01: Accounting for Cryptocurrencies providing that "directly held cryptocurrencies are nonadmitted assets for statutory accounting." This position largely rests on the faulty syllogism that since cryptocurrencies are not identified in the AP&P as an admitted asset and do not meet the definition of any other admitted assets, therefore cryptocurrencies are nonadmitted assets. This position is untenable as cryptocurrencies meet the definition of cash or cash equivalent.

Regardless, the NAIC argues that cryptocurrencies are not cash. SSAP No. 2R: Cash, Cash Equivalents, Drafts, and Short-Term Investments describes cash as a "medium of exchange that a bank or other similar financial institution will accept for deposit." The NAIC argues that cryptocurrencies are not accepted by major banks; consequently, cryptocurrencies do not meet the definition of cash. This position overlooks the SSAP No. 2R's operative language "or other similar financial institution."

Cryptocurrencies are accepted for deposit by Paypal and Paypal is a bank by any colloquial understanding of a bank. Paypal offers the ability to conduct financial transactions in dozens of currencies, offers debit cards, credit cards, and offers lines of credit. Most notably, Paypal's Cash Card allows users to store money in their Paypal account with FDIC insurance in the same manner as a bank account. The only meaningful differences between a bank and Paypal are legalistic. Given that Paypal can accept deposits and offer FDIC insurance, extend credit, and function in every common sense understanding as a bank, Paypal's acceptance of Bitcoin satisfies the "similar financial institution" clause of SSAP No. 2R. The NAIC's contrary position is inconsistent with the plain meaning of "similar financial institution." This definition encompasses non-banks that function like banks.

Given that Paypal is a bank or similar financial institution, and that cryptocurrencies are accepted by Paypal, cryptocurrencies are a "medium of exchange that a bank of other similar financial institution will accept for deposit." Thus, cryptocurrencies qualify as cash. Cash is, by definition, an admitted asset pursuant to the NAIC's AP&P. Consequently, cryptocurrencies should be admitted assets.

Given the volatility of cryptocurrencies, the assets should be discounted pursuant to the NAIC's Investment RBC Charges spreadsheet. The Investment RBC Charges spreadsheet provides for a discount to the value of an asset relative to the asset's perceived volatility. NAIC 01, reserved for low-risk assets such as government bonds, provides for a 0.00% discount. NAIC 06 class assets provide for a 30% charge against the asset's fair market value. The Investment RBC Charges spreadsheet provides the following charges against cash:

Table 1: Spreadsheet of Investment RBC Charges

Miscellaneous Assets			
Cash	0.40%	0.30%	0.30%
Cash Equivalents	0.40%	0.30%	0.30%
Short-Term Investment	0.40%	0.30%	0.30%
Premium Notes	6.80%	5.02%	N/A
Receivable for Securities	0.14%	0.10%	2.30%
Aggregate Write-ins for Invested Assets	6.80%	5.02%	5.00%

The third column shows the charges against cash, cash equivalents, and similar assets for property and casualty carriers. The 0.30% charge accounts for cash's general stability with the historically low loss of value due to inflation.

Cryptocurrency volatility is trending lower over time but still remains volatile by comparison to the US dollar.

Given the volatility of cryptocurrency and its logical status as either cash or cash equivalent, the NAIC should adopt a new Investment RBC Charge to accommodate cryptocurrency. Cryptocurrencies held as admitted assets by insurance carriers should command a significant charge against the cryptocurrency's acquisition price.

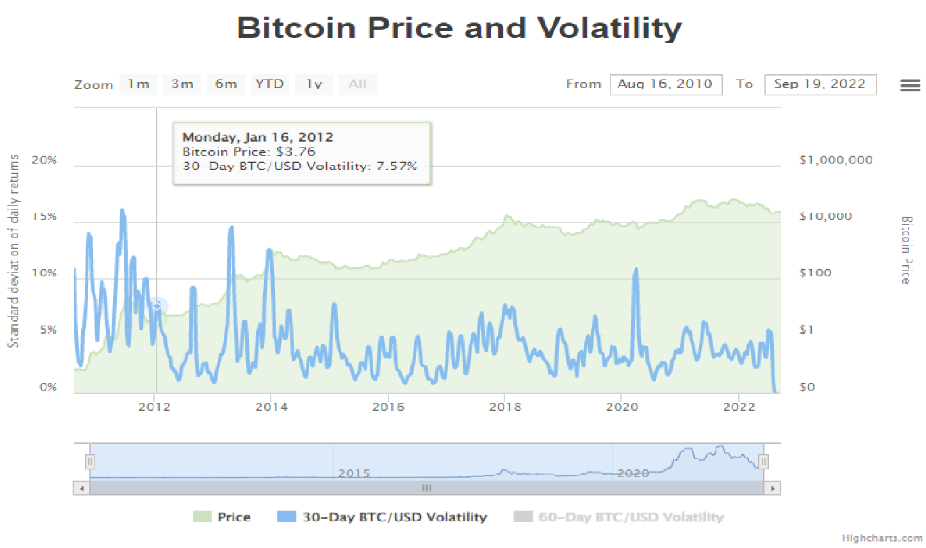

Figure 1: Bitcoin Volatility Time Series Charts

Source: https://buybitcoinworldwide.com/volatility-index/

Table 2: Bitcoin's Historical Volatility

Year	Average 30-Day BTC/USD Volatility
2010	6.21
2011	8.26
2012	4.50
2013	5.50
2014	5.06
2015	4.26
2016	2.49
2017	4.13
2018	4.58
2019	4.06
2020	5.17
2021	4.56

Source: https://buybitcoinworldwide.com/volatility-index/ last checked August 22, 2022

In addition, if the cryptocurrency experiences a decline of more than 10% of its carrying value at the time of issuance of the financial statement, then a Subsequent Event Footnote should be added outlining the clear impact on the financial statements.

Cryptocurrencies are cash or cash equivalent. Cash is an admitted asset. Recognition as such is an eventuality that shall come to pass in the foreseeable future. When the NAIC concedes that cryptocurrency is cash or a cash equivalent then this will force the FASB to formalize treatment of cryptocurrencies.

2. FASB and the Auditor's Dilemma

FASB takes no position on how to account for cryptocurrencies. However, the American Institute of Certified Public Accountants (AICPA) and other non-authoritative institutions consider cryptocurrencies intangible assets. FASB's[2] Accounting Standards Codification Master Glossary (ASC)[3] states that intangible assets are assets lacking physical substance. This definition excludes financial assets. The AICPA[4] and others argue that cryptocurrencies meet the definition of intangible assets since they are:

1. A medium of exchange;
2. They are not issued by a jurisdictional authority;
3. They do not give rise to a contract between the holder and any counter party; and finally,
4. Are not considered a security.

Alas, this position overlooks the FASB ASC definitions of an "asset" and of "cash" and "cash equivalents".

Auditors are charged with showing whether the financial statements present the financial position and operations of the auditee so that a user of the statements has enough information on which reliance may be place.

Cryptocurrencies are assets. The FASB ASC does not define the term "asset." However, the Statement of Financial Accounting Concepts (SFAC) No. 6 Elements of Financial Statements[5] defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." SFAC No. 6 states an asset has three characteristics:

1. It embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows;
2. A particular entity can obtain the benefit and control others' access to it; and
3. The transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

Bitcoins or other cryptocurrencies received as payment for the sale of goods to a customer or transferred as payment for the purchase of goods from a supplier meet the definition of an asset and possess all three required characteristics of an asset. There is widespread agreement that cryptocurrencies constitute an asset under SFAC No. 6. However, debate exists as to whether the asset should be considered cash or cash equivalent, or an intangible asset.

Cash is defined in the FASB ASC as: "…currency on hand, demand deposits with banks or other financial institutions…" Cash equivalents are short-term, highly liquid investments that are (1) readily convertible to known amounts of cash; and (2) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Given that the FASB's definition of cash specifically includes currency on hand, there is strong evidence supporting the position that cryptocurrencies should be treated as cash if cryptocurrencies meet the legal definition of a "currency."

The full weight of the US federal courts supports the position that cryptocurrencies constitute both currency and money. *See SEC v. Shavers*[6], No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018 (E.D. Tex. August 6, 2013) *defining Bitcoin as currency. See also,* U.S. vs. Harmon, 474 F. Supp. 3d 76, 88 (D.D.C. 2020), reconsideration denied, 514 F. Supp. 3d 47 (D.D.C. 2020) holding that Bitcoin is "money" under the District of Columbia Money Transmitters Act. *But see United States v. Petix,* No. 15-cr-227A, 2016 WL 7017919, at *5 (W.D.N.Y. December 1, 2016) (concluding, in a magistrate judge report and recommendation never adopted by the district court, that the ordinary meaning of money contemplates a connection to a sovereign [this holding did not apply to the term "currency"). The IRS takes a similar position in noting that "Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and / or a store of value." IRS

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2 FASB ASC Master Glossary

3 ASC Master Glossary 805-20 defines intangible assets as assets (other than goodwill) that lack physical substance, whereas assets are defined as probable future economic benefits obtained as a result of past transactions.

4 AICPA & CIMA Practice Aid: Accounting for and auditing of digital assets, December 2019.

5 Statement of Financial Accounting Concepts (SFAC) No. 6 Elements of Financial Statements.

6 *See SEC v. Shavers,* No. 4:13-CV-416, 2013 U.S. Dist. LEXIS 110018 (E.D. Tex. August 6, 2013) *defining Bitcoin as currency. See also, U.S. v. Harmon*, 474 F. Supp. 3d 76, 88 (D.D.C. 2020), reconsideration denied, 514 F. Supp. 3d 47 (D.D.C. 2020) holding that Bitcoin is "money" under the District of Columbia Money Transmitters Act. *But see* HYPERLINK "https://1.next.westlaw.com/Link/Document/FullText?findType=Y&serNum=2040430931&pubNum=0000999&originatingDoc=I33c12700ce0b11ea90f3cef67f2ea235&refType=RP&originationContext=document&transitionType=DocumentItem&ppcid=b63f4b54fa9c4ce4bc1f2f85cff270df&contextData=(sc.Keycite)" *United States v. Petix*, No. 15-cr-227A, 2016 WL 7017919, at *5 (W.D.N.Y. December 1, 2016) (concluding, in a magistrate judge report and recommendation never adopted by the district court, that the ordinary meaning of money contemplates a connection to a sovereign [this holding did not apply to the term "currency").

Virtual Currency Guidance. Notice 2014-21, 2014-16 I.R.B 938 (2014). In every case presented before a federal court or agency, each published opinion confirms that cryptocurrencies are a form of currency.

The AICPA and others advocate for the FASB to treat cryptocurrencies as an intangible asset. This treatment is improper and creates negative valuation feedback loop effectively banning cryptocurrencies from insurance carriers' balance sheets and mislead the users of the financial statements. Intangible assets can only be impaired. There is no ability to mark to market. This means that if a cryptocurrency's value drops by 50% in a period and the auditors impair the intangible asset by 50%, then an insurance carrier holding cryptocurrency may be rendered insolvent or in violation of their premium to surplus ratio. Since there is no ability to mark to market if the cryptocurrency returns to its previous price or exceeds it, this means that cryptocurrencies' values will always trend toward $0. In addition, impairment of an intangible asset creates a capital loss which can only offset capital gains. Thus, an insurance carrier would receive less beneficial tax treatment to accommodate the loss.

Further, most intangible assets are depreciated or amortized to account for the loss of value over time, with few exceptions. Example of the exceptions include patents, trademarks, and non-compete agreements. Cryptocurrencies do not resemble intellectual property or contracts. Cryptocurrencies are currencies. Currencies are treated as cash. In addition, cryptocurrencies are readily convertible to cash at any given time.

3. Legal Tender Non-Sequitur

The AICPA further notes that cryptocurrencies are not cash or cash equivalents because cryptocurrencies do not constitute legal tender. Legal tender is defined by the *Money and Finance, US Code* Title 31, Section 5103 as "US coins and currency (including federal reserve notes and circulating notes of Federal reserve banks and national banks) as legal tender for all debts, public charges, taxes, and dues."

"Legal tender" refers to the coin, paper money, or circulating medium that the law compels a creditor to accept in payment of a debt when tendered by the debtor. 53A Am. Jur. 2d Money § 11. *See also*, *Seidman v. Insurance Com'r of Com.,* 110 Pa. Commw2. 401, 532 A.2d 217 (1987). A medium of exchange does not need to be legal tender to be classified as money. State v. Finnegean, 127 Iowa 286, 103 N.W. 155 (1905); Vick v. Howard, 136 Va. 101, 116 S.E. 465, 31 A.L.R. 240 (1923). Nonetheless, where an obligation is in general terms made payable in money, it is by implication payable in the legal tender of the country. 53A Am. Jur. 2d Money § 11. *See also*, Cohn v. Tucson Elec. Power Co., 138 Ariz. 136, 673 P.2d 334 (Ct. App. Div. 2 1983).

Although cryptocurrencies do not qualify as legal tender, this analysis is ultimately fruitless. Cryptocurrency is a currency and is classified as money. An asset does not need to be legal tender to be a currency or money. Virtual currencies may act as a substitute for a real currency and function as convertible virtual currency. Bitcoin is one example of a convertible virtual currency. From an accounting standpoint, there is no justification for classifying cryptocurrency as an intangible asset because it does not qualify as legal tender. This is a logical fallacy with no relation to the underlying asset.

4. Conclusion

Cryptocurrencies should be treated as cash or cash equivalents under the statutory accounting guidelines. Treatment as cash or cash equivalents renders cryptocurrencies as an admitted asset. When cryptocurrencies are considered admitted assets, insurance carriers will purchase cryptocurrencies *en masse*. Broad scale purchasing of cryptocurrencies by insurance carriers creates an auditor's dilemma. The role of the auditor is to provide an opinion that financial statements are correct and not misleading. Recognition of cryptocurrencies as intangible assets without any ability to depreciate or amortize results in a balance sheet is fundamentally misleading. The negative valuation feedback loop of intangible assets challenges the ability for any auditor to issue a non-qualified opinion because cryptocurrencies' fair market value would be materially misstated in the event of a bull market for cryptocurrencies.

The sole resolution to this dilemma is to account for cryptocurrencies as tangible assets. In this manner, the fair market value of the cryptocurrencies is maintained with subsequent events indicating a decline of more than 10% of the fair market value of the cryptocurrency from the issuance of the financial statement. This better informs the users of the financial statements of the carrier's solvency, and follows the matching principle.

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