Crypto as an asset class

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Crypto as an Asset Class: What Asset Managers Should Know Before Going Crypto

Even with ongoing market volatility, digital assets, particularly cryptocurrencies, are in the midst of a transformational moment. Crypto native funds have grown significantly, and hedge funds and other investors are launching new vehicles devoted to digital assets, with funds investing in cryptocurrencies leading all hedge funds in performance in 2021 with a 215% return. Institutional investors such as university endowments and public pensions have also made inroads. Overall, in January 2022, cryptocurrencies reached a market capitalization of $1.7 trillion, with non-fungible tokens (NFTs) comprising $23 billion. We see emerging opportunities and potential pitfalls, and asset managers contemplating this new asset class should understand the implications of accounting for digital assets.

Investment Companies

Investment company accounting for digital assets is relatively straightforward, but there are some important nuances to consider. Under ASC 946, investment companies must decide whether the asset is an equity security, a debt security, or an "other asset," meaning the initial measurement is at the transaction price plus the cost to transact, and subsequent measurement is at fair value.

Questions to consider:

- How do you define your principal market for estimating the fair value of digital assets?
- Have you considered the reliability and sufficiency of market information? Matrix pricing emerged as a common fair value technique in financial statements of many early crypto funds. However, matrix pricing is considered a non-GAAP accounting policy and has come under SEC scrutiny.
- What is the cutoff timing for your fair value estimates in the 24-hour market for digital assets?

Operating Companies

Some funds obtain exposure to crypto by investing in operating companies whose business models are closely associated with crypto – e.g., exchanges, data providers, miners, or protocol or token sponsors. An investor looking at the financial statements of an operating company that holds digital assets may be surprised to see that the financial performance per the financial statements may be divorced from market signals.

There is no GAAP designed specifically for digital assets, and operating companies must evaluate the underlying nature of each digital asset they hold, including any associated rights or obligations. That analysis is critical in determining how to classify the assets for accounting purposes. Many digital assets end up being accounted for as intangible assets, which means that they are initially recorded at cost and are written down for impairment whenever the digital asset trades for less than the carrying amount.

Emerging Considerations

As the crypto ecosystem evolves, staking, decentralized finance (DeFi) and non-fungible tokens (NFTs) raise additional new accounting considerations for asset managers.

Staking

Most funds currently stake through a third-party custodian, which simplifies the accounting process. Involvements with third parties require an additional level of analysis to understand whether the fund owns the digital assets (and they are just being custodied by the third party on the fund's behalf) or whether the fund has a contractual receivable or other right from the third party that is tied to the value of a digital asset but does not represent current ownership of the digital asset itself.[1] Funds need to understand the contractual terms and conditions for staking arrangements and analogize to relevant GAAP when necessary.

DeFi

In the case of DeFi, users can lend, swap, and lease assets all without an intermediary. Asset managers must keep track of what assets are being reported on their balance sheet and include relevant disclosures in the financial statements. If one of their investment companies starts with Bitcoin on the balance sheet, for example, it might exchange that asset on a decentralized platform for a token that represents its interests in that investment.

NFTs

When considering investments in NFTs—associated with digital or real-world assets—it is imperative to be equipped with up-to-date market and technical knowledge and to understand the treatment of NFTs from accounting, tax, and regulatory perspectives. While NFTs may present an innovative solution for tokenizing ownership and property, accounting and valuation issues can be complex.

Know Before You Go…

Because most institutions custody their digital assets with a third party, it's important to select a custodian with appropriate internal controls around the creation, maintenance, security, and integrity of the private keys used to access the digital assets. Asset managers should also set expectations with custodians regarding timeliness of responding to confirmations sent from auditors. And management should also have processes to monitor blockchain transaction data to identify any discrepancies between their books and records and what is recorded on the blockchain.

Digital assets present opportunities and risks for both operating companies and investment companies. Knowing how to account for and invest in digital assets will help asset managers manage, account for and navigate the risks and rewards that come with this evolving asset class. As the accounting and regulatory

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[1] What to know before you go crypto (kpmg.us)

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landscape evolves, it will be important for asset managers to remain current with accounting and regulatory developments to ensure proper compliance with new requirements.

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