



IFRS Today

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EPISODE 8 TRANSCRIPT

Crypto-assets – Risk and governance: Questions for audit committees to ask

Speakers

- Andrew Schofield
- Charlotte Lo
- James Bowe (Host)

Host

Hi – and welcome to Episode 8 of *IFRS Today*.

The development of blockchain technologies continues to gather pace. Yes, there has been volatility in the markets, but the tech is edging closer to the mainstream. People are even using bitcoin to buy foreign currency for their holidays these days!

At the same time, companies are finding their interactions with crypto-assets are on the up. But legal and regulatory protections in this space are still evolving, which means companies – and of course audit committees – need to balance the potential benefits with the risks they might bring.

In this episode, we look at some of the risk and governance issues that management and audit committees need to bear in mind.

Today, I'm pleased to have with me two KPMG colleagues, who both field great first-hand experience of the issues around crypto-assets.

First, Andrew Schofield – an audit partner in the Cayman Islands firm, who leads their digital asset practice. He's joined by Charlotte Lo – a director who provides accounting advice to financial institutions in the UK.

Andrew, to start, we can see that blockchain technology is potentially transformative. Should any alarm bells be ringing for audit committees?

Andrew

Thanks, James. I think that blockchain technology and crypto is not only transformative but it has the potential to disrupt existing business models.

I don't think there need to be alarm bells, but audit committees should be asking questions to ensure that the business is well positioned to take advantage of opportunities and that the risks are understood and managed.

Charlotte

That's right, Andrew – and the accounting for crypto assets is really challenging the traditional financial reporting boundaries and gives rise to a number of unique considerations when preparing financial statements – such as:

- **valuation**;
- **classification**;
- **existence and ownership**;
- **tax**;
- **legal** and
- for banks – **capital implications**.

Andrew

Okay – so, if we take each of those in turn, and start with **valuation** – we can split crypto-assets between liquid and illiquid assets.

Bitcoin would be an example of a liquid asset and these types of assets are often characterised by significant volatility and the potential for arbitrage across different markets, and so an assessment of the principal market is really important.

It's also critical to have a valuation policy that is tailored for the business and is consistently applied.

If there's not a price available in a liquid market, the valuation for crypto is a challenge, as crypto-assets don't typically represent a claim on future cash flows in the same way as a debt or an equity security does and there aren't established valuation methodologies to value these types of assets.

This means that each illiquid asset needs to be considered on a case-by-case basis and audit committees should challenge management on the valuation methods that they apply.

Charlotte

Yes – and for the other consideration, which is **classification**, digital assets are typically classified as intangibles. But accounting standards such as IAS 38 weren't designed with crypto-assets in mind. For example, Andrew, your fellow countrymen at the Australian Accounting Standards Board asserted that digital currencies are not financial instruments as defined under IAS 32.

So, really, audit committees need to consider whether the accounting policies applied are appropriate.

Andrew

One of the critical issues that we see from an audit and operational perspective is around the **existence** and the **ownership** of assets.

Crypto-assets are effectively bearer instruments, so anyone with access to the private keys can transact those assets. It's critical that management has a system of processes and internal controls in place to restrict access to those private keys.

Charlotte

That's a really good point, Andrew, and there are key questions that audit committees and management should be asking, such as:

- How is physical access to the private keys restricted?
- Are multiple signatures required to transact?
- How are risks of cyber-attack and theft mitigated?
- In the case of a third party custodian, how are they regulated and what is the extent of counterparty risk?
- Lastly: What additional independent assurance will the business require to validate the ownership and existence of digital assets?

Andrew

Thanks, Charlotte. Another area that management and audit committees should consider is how digital assets are **taxed**:

- in particular, whether or not there's clarity on the tax treatment or whether judgement needs to be exercised;
- whether there are appropriate systems in place in the organisation to correctly account for the digital assets; and
- the nature and the extent of information that's available from counterparties such as exchanges.

Charlotte

Makes sense. And Andrew – what's your take on the **legal** aspects around this?

Andrew

It's fair to say that the legal environment for digital assets is evolving rapidly and it differs by jurisdiction.

For issuers of digital assets in particular, it's vital to make sure that they're obtaining appropriate legal advice and that all relevant securities laws are complied with.

It is particularly important as digital assets can be transferred quickly and without friction across international boundaries.

Charlotte

As I mentioned just now about the regulated entities, such as banks and insurers, the **capital implications** will need to be considered.

You'll be interested to know, Andrew, that the Financial Times reported in July this year that the Basel Committee on Banking Supervision is carrying out an initial stock-take on the materiality of banks' direct and indirect exposures to crypto-assets. Basel will also be assessing the national rules on crypto-assets.

Once Basel completes this exercise it will consider whether to formally clarify the prudential treatment of crypto-assets across the set of risk categories. This has a big implication for financial institutions that are either trading or holding crypto-assets as custodial assets, or intend to do so.

James

Okay, thanks Charlotte and Andrew, that's been a really helpful discussion. So – moving forward – what are the key takeaways for management and audit committees?

Andrew

Thanks, James. First and foremost, it's that digital assets present unique risks and challenges and it's critical that these risks are not only understood and assessed by management but that they're adequately disclosed to stakeholders.

Charlotte

And audit committee and non-executive directors should be asking questions such as:

- Does the organisation plan to embark on any large technological transformation? If so, do these require the holding of crypto-assets?
- Are there any products being developed that appear to be traditional financial assets such as bonds or equity-like instruments but have underlyings that are crypto-assets?
- Does the organisation intend to provide new services that involve activities around valuation and/or custody of crypto-assets?

Andrew

That's right, Charlotte. Blockchain and crypto are potentially transformative and disruptive technologies and all organisations need to consider how to position themselves to take advantage of the opportunities and not get left behind.

If I summarise, the headline points for audit committees are:

- that crypto markets continue to evolve really rapidly;
- that digital assets present a unique set of risks and challenges;
- that audit committees should be challenging management to implement an appropriate set of processes and internal controls around crypto-assets; and finally
- I'd encourage audit committees to invest some time and educate yourself around the issues.

James

Thank you, Andrew and Charlotte.

We'll be returning to this topic in future episodes – when we'll look in some more detail at the accounting implications of some of the points touched on today.

And if you're looking for a recap on the basics, you might want to revisit [Episode 4](#) in this series, in which we dealt with some of the key concepts around blockchain.

But for now, thank you all very much for taking the time to listen to this edition of *IFRS Today*. And look out for our next episode, which will be released in the coming weeks...

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