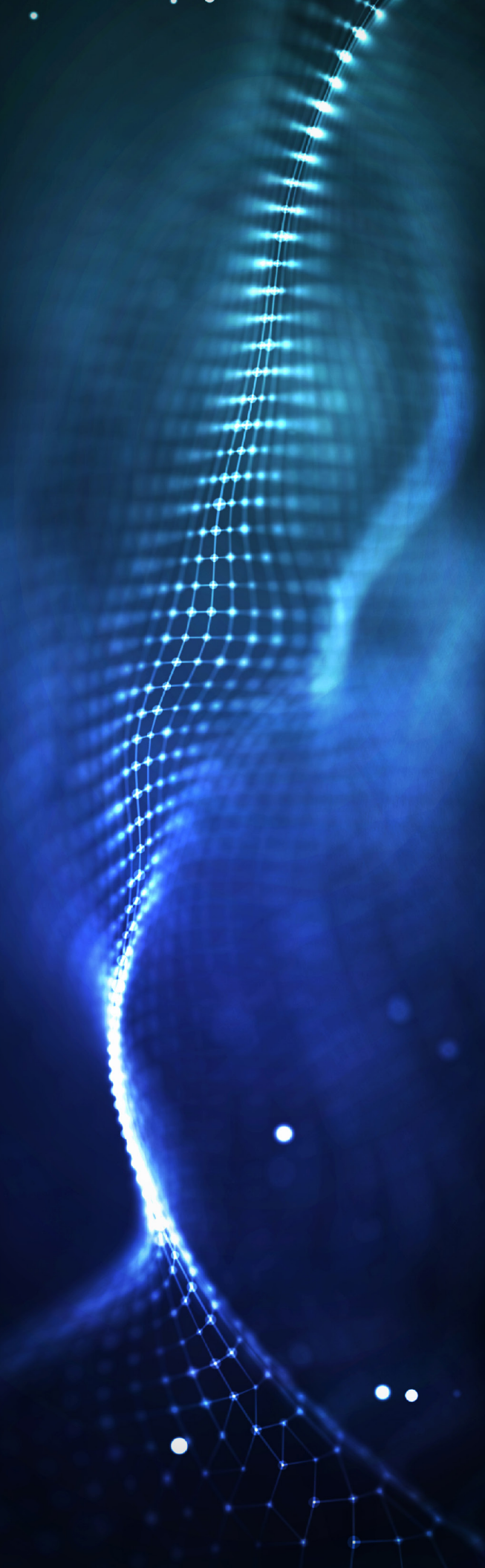


Deloitte.



Corporates investing in crypto

**Considerations regarding allocations
to digital assets**



The terrain of digital assets is a new frontier of possibilities, so it requires that each corporate department, and its external party, rethink the application of the rules and policies of its core competency.

Table of contents

Introduction	4
The high-level view from treasury	6
Accounting and tax: Potential opportunities for alignment, challenges of divergence	7
Controls	11
Conclusion: The need for cross-organization collaboration	13
Get in touch	14

Introduction

In 2020, more operating companies began allocating cash to digital assets and cryptocurrencies. This is a new dynamic and a departure from more conventional investing by funds and others in this space. One telling example is MicroStrategy Inc., which announced, last December, that it had made more than \$1B in total Bitcoin purchases in 2020, a move that it characterized as an investment that would “provide the opportunity for better returns and preserve the value of our capital over time compared to holding cash.”¹ Some companies have followed suit, and others may now be wondering how to invest in Bitcoin and other digital assets. There are a variety of reasons for adding digital assets to a company’s balance sheet, whether it’s seeking asymmetric risk return observed over previous years or as a natural hedge against fluctuating fiat currencies; whether it’s part of a corporate strategy to embrace modern, open technologies; or as a complement to an operational strategy that includes accepting digital assets as payments.

This paper focuses largely on Bitcoin investments, considering recent increased investments in Bitcoin, and its common reference as a store of value. It should be noted that there are numerous types of digital assets, each having their own unique characteristics. Ethereum is also viewed as a store of value, with the added use of enabling transactions on Ethereum-based decentralized applications. These contrast with central bank digital currencies (CBDCs) and stablecoins, which are digital representations of fiat currency. Their value is derived from an actual currency in circulation, and they are issued by a central bank. Equity and derivative tokens are digital assets whose value may represent actual corporate stock or a legal right to another asset or financial instrument. Some digital assets have additional attributes, such as voting

rights on a protocol, or they may provide a level of access for participation in a decentralized application. These may provide some commercial or economic benefit to the holder. Prior to investing in any digital asset, it is important to understand the specific terms, conditions, and characteristics of the investment since those will affect accounting, tax, risk, controls, and legal considerations, among others.

What follows here, then, is some guidance on what undergirds any corporate decision to invest in digital assets like Bitcoin. In addition, we set out the ongoing actions that teams across a company should undertake to monitor and go forward with a long-term investment. In other words, our goal is to answer the question “How would you do that?” rather than “Why do it?”

Before proceeding, we want to make one point absolutely clear: There is no playbook or foolproof approach for these kinds of bold moves. There is only painstaking effort, disciplined analysis, fresh thinking and rethinking, dedicated collaboration across competencies, and, above all, rigorous execution. What follows, then, is not a step-by-step prescription, but instead a high-level guided tour of the wide terrain companies should cover when they are considering investing in Bitcoin. Additionally, note that what is stated here cannot necessarily be extrapolated to all digital assets, given that they have many different characteristics.

1. <https://www.microstrategy.com/en/company/company-videos/microstrategy-announces-over-1b-in-total-bitcoin-purchases-in-2020>.

$$\sum_{x=0}^{45-4a-3} (5+x+k+2a+21) \cdot \lim_{h \rightarrow 0} \frac{1+x+y+2a+21}{h} > 0$$

$$\left[\frac{(1+x+y+2a) - (3a+3g+x)}{5+x+k+2a+21} \right] \cdot \lim_{h \rightarrow 0} \frac{1+x+y+2a+21}{h} > 0$$

$E=mc^2$

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The high-level view from treasury

The main purpose of the treasury function is risk management and the preservation of capital. When deciding and executing on an investment in digital assets, governance is key to all activities. More than creating a policy, governance begins with understanding the types of investment the company is making and where this alternative investment vehicle—digital assets like Bitcoin—fits within the broader investment strategy. Leaders also need to be comfortable with the characteristics and nature of the vehicle. (More on this below in the discussion on controls.) Given that it's a financial investment, it's imperative that the treasurer, CRO, CEO, CTO, and board of directors all have a clear assessment and understanding of the asset's risk profile, the company's tolerance for risk, and how these two may align or diverge. Ultimately, governance is all about monitoring and assuring that the conditions and requirements set by the organization are maintained.

Tolerance for risk, depending on the stake and type of digital asset, may well have to be modified and periodically adjusted. Risk tolerance takes several forms and requires decisions on issues such as the following:

- What percentage of the cash on hand, after accounting for operating costs, will be assigned to alternative investments in digital assets?
- What range of risk is the company comfortable with? Governing risk is rarely a matter of "set it and forget it."

Risk is a constantly moving target, and adjustments frequently need to be made within an agreed-upon band of risk tolerance.

- With digital assets, treasury needs to consider not just the investment side, but also how these assets may figure into daily operations such as payments, debt management, raising funds, IPOs, etc.
- How can treasury be more strategic in using these assets to advance efficiencies in payroll, vendor payment, trade, customer interactions, and cross-border transactions with subsidiaries and others? (More on this last point when we discuss accounting and tax implications, as well as controls, below.)

Of course, the first and final refrain for treasury must always be that the governance of digital assets is a living and adaptive process. It constantly follows and must adjust to market and risk realities.

"Global macroeconomic, monetary, and digital evolutions have converged, requiring all forward-thinking corporations to consider alternative assets on their balance sheet. The ecosystem and the regulatory environment for digital assets, especially Bitcoin, have matured to the point that this strategy is becoming approachable and mainstream."

Phong Le, President and CFO, MicroStrategy, Inc.

Liquidity is not necessarily a major issue, especially if the company is adopting a longer-term investment mindset. Nevertheless, there needs to be appropriate provision for extra cash on hand. And assuming investments are layered in progressively over time, liquidity is likely to be less of an issue.

Yet, in the event of the need to liquidate assets, the company needs to know if the facility to do so is available without a premium penalty or if the transaction can be executed without a depreciation of the assets' value.

Accounting and tax: Potential opportunities for alignment, challenges of divergence

Accounting for digital assets under US Generally Accepted Accounting Principles (US GAAP)

US GAAP does not offer specific guidance for the treatment of digital assets, and, to date, the Financial Accounting Standards Board (FASB) has decided not to add a project on accounting for cryptocurrencies.² For those reasons, a company's accounting function must draw on various pertinent sections of US GAAP to facilitate accounting for digital assets. First, the accounting will be determined by what the company is accounting for. What is it investing in? Practice has settled on accounting for certain digital assets, like Bitcoin, as an "indefinite-lived intangible asset."³ That means it does not meet the accounting definition of cash or a cash equivalent, financial instrument, or inventory. Needless to say, the accounting principles prevailing today were largely established at a time when digital assets were not yet even contemplated.

Now here's the accounting challenge with digital assets being reflected as intangible assets: According to US GAAP, acquired digital assets (intangibles) should be accounted for at cost, subject to subsequent impairment, as appropriate. That means that when the asset is impaired, the company must write down the value on its books. The converse is not true. The value of the asset cannot be written up when, and

if, the price goes up or a previously written-down asset subsequently recovers. As a consequence, for accounting purposes, it is virtually impossible to book any ROI on digital assets held as investments. Clearly then, the rules and framework for digital assets present certain important constraints: It is not possible for the company's accounting function to reflect the economics of how it may value its digital assets.

Absent the ability to mark up the value of a company's digital asset holdings, if the company believes fair value to be more reflective of the economics of its investment, it has the flexibility to provide disclosures that it believes are meaningful to its investors. For example, the company can provide investors with information about the value of one digital asset (say, a Bitcoin), by flagging the price of one Bitcoin at a given time on a given exchange. But then again, unlike equities, Bitcoins are typically traded on multiple exchanges, and around the clock, seven days a week. Hence, any snapshot of the price can only provide rough guidance. But with the knowledge of the number of coins or other digital assets held, investors can arrive at an approximate determination of the valuation of the company's digital asset holdings. Note that companies should be mindful of non-GAAP measures when preparing these disclosures.



MicroStrategy's 70,469 Bitcoins held as of December 31, 2020 were acquired for \$1.125B and reflected in its financial statements at \$1.054B. If the price of a Bitcoin on an exchange was \$29,000 at December 31, 2020, MicroStrategy may view its 70,469 Bitcoins economically to be worth \$2.044B, rather than the \$1.054B on its balance sheet.

Perhaps investors understand MicroStrategy's accounting treatment by looking at the company's disclosures and (based on its stock price performance) appear to be valuing a company's digital assets based on the current price rather than the book value.

2. The FASB decided at its October 21, 2020, meeting not to add a project on digital currencies to its agenda.
3. That assumes that the company is not required to apply specialized industry guidance, such as the guidance in ASC 946 *Financial Services – Investment Companies*.

SEC reporting

As we've seen, absent standard-setting on specific accounting for digital assets, the accounting function draws on various rules and frameworks under the US GAAP rubric of intangible assets. Similarly, the related disclosures need to be drawn from various sections within US GAAP to align with the accounting, resulting in a patchwork of disclosures. For example, the disclosure requirements within [ASC 350, Intangibles – Goodwill and Other](#), apply to the digital assets held as an investment. And additional disclosures under [ASC 820, Fair Value Measurement](#), would be required for the nonrecurring fair value measurement used to determine impairment of those digital assets. To the extent the company sells digital assets or uses them in its business transactions, additional disclosures would be required.

These disclosures, drawn from various areas of US GAAP, should articulate the accounting to an investor and explain why the digital assets, and related transactions, are presented the way they are in the financial statements. A reader should be able to understand the company's investment in digital assets. That includes where it is presented on the financial statements and the overall investment strategy. When considering the presentation in the financial statement, there are plenty of potential pitfalls, and mere logic does not suffice. For example, one may be tempted to conclude that write-downs on a digital asset are akin to a loss on an investment and hence should be classified as nonoperating income. But

because of their treatment as intangible assets, that presentation may not be appropriate or allowed.

Tax treatment and challenges from an investment perspective

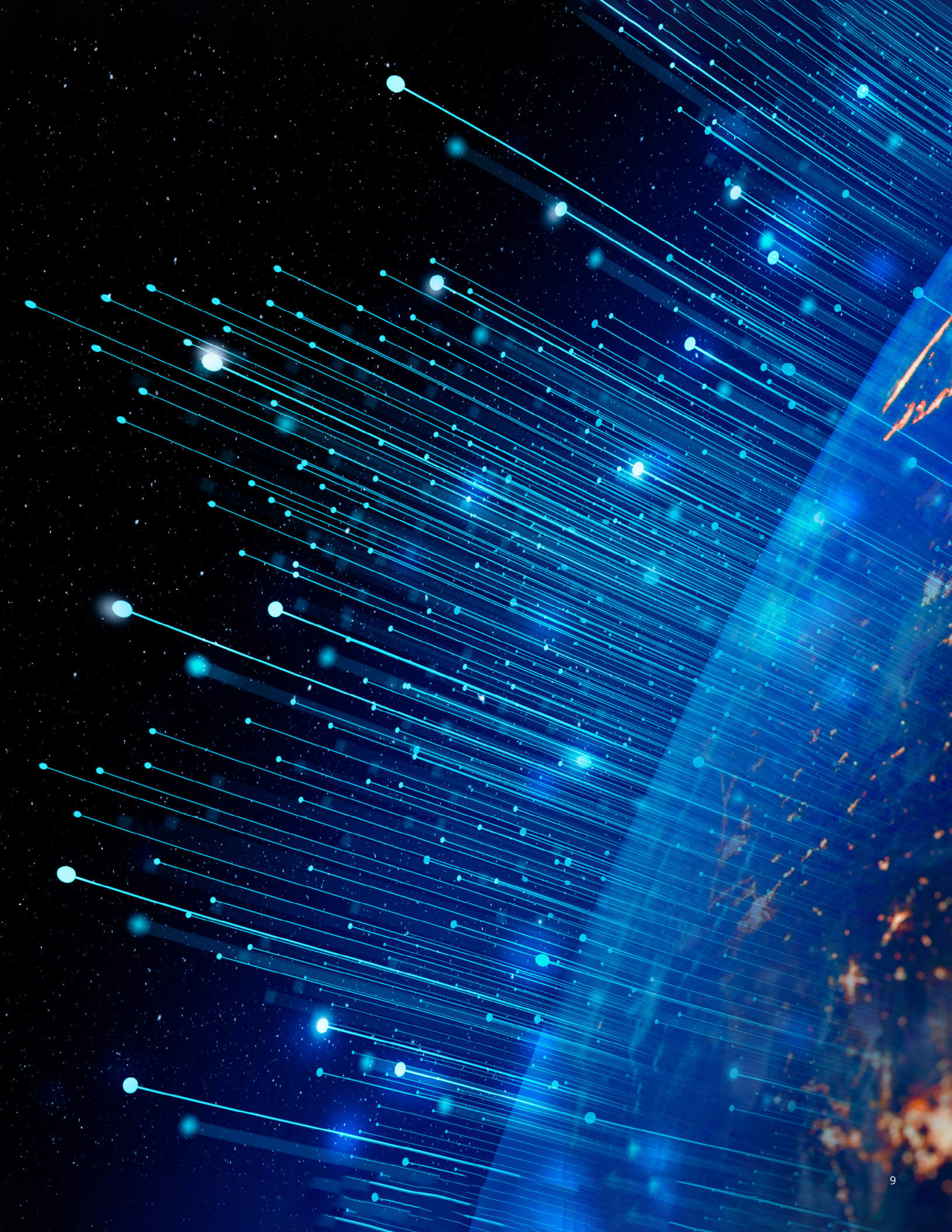
The rules governing tax treatment of digital assets do not depend on US GAAP accounting rules and frameworks. One key difference: In accounting, digital assets can only be marked down when impaired (impairment accounting) and not marked up when their value increases; but in tax, such a move only results from an election that may be available to dealers or traders whereby the tax function can mark up or down to fair value. For tax purposes, gain or loss is normally recognized only when a digital asset is sold or exchanged.

In the United States, there are two tax accounting methods or treatments that can help account for gains and losses: specific identification (ID) and first in, first out (FIFO). The specific ID method can be used to determine the cost basis of each digital asset the company is selling or exchanging. That means that every time the company disposes of such an asset, it is specifically identifying the exact units it is selling or exchanging. So how does one specifically identify a digital asset like Bitcoin that is deemed to be a fungible asset? By segregating tranches into distinct wallets. It's common for investors to develop wallet structures to house different tranches of their digital assets with different cost bases and holding periods. Hence, when it comes time to sell, a given wallet or tranche is readily distinguishable from another, and the relevant information is at hand—date

Regarding partnerships: The accounting and tax treatments for digital assets may change if a company invests in these alternative vehicles using a fund versus holding the assets outright.

and time each unit was acquired or wallet created, basis cost and fair market value of each unit at the time it was acquired or wallet created; and finally the fair market value of each unit when it was sold or exchanged.

Absent the use of the specific ID method and wallet structures, there are very limited ways to distinguish the different assets. Hence, taxpayers are likely bound to use a FIFO approach. In other words, absent the specific ID information (time, date, cost basis at time of purchase) and an adequately segregated and identified asset, each time a company disposes of a digital asset, the presumption is that the company is disposing of the oldest asset or coin(s) it holds. While complex and sometimes messy, tracking the cost basis versus the current market price is important for both tax and accounting.



From a tax standpoint, digital assets held for investment purposes are normally deemed a capital asset. In corporate solution, capital losses can only be used to offset capital gains. So while a company may mark down to fair value for accounting purposes, tax does not follow that methodology (except in certain limited circumstances relating to an election to mark to market as a dealer or trader in digital assets). Rather, it's a matter of layering in a deferred tax asset (DTA), which may require a valuation allowance if there are no other sources of capital gains.

So how does this play out in a set of financial statements? Members of a company's tax function must live and abide by the rules and framework of US GAAP first, and then layer on the tax treatment in terms of deferred taxes.

Tax treatment and challenges from a business transactions perspective

Let's move now from the investment angle to consider the use of digital assets in business transactions, such as fund transfers, paying vendors, and as an accepted form of payment from customers. When used for such transactions, digital assets should be segregated into separate wallets to maintain a clear distinction between digital assets used in the operation of the business (ordinary assets) and digital assets held for investment (capital assets). Naturally, if digital assets are being used in place of fiat, such actions will generate a gain/loss recognition event for tax purposes under the

umbrella of a barter transaction. That's the case every time digital assets are used in a business transaction. This has a related impact on accounting as well, and the process can become very complex on both fronts.

Accounting for digital assets used for business transactions

When companies use digital assets that are accounted for as intangibles for business transactions, such as paying vendors, these transactions will require a different accounting treatment, which is more complex. That is a consequence of the intangible asset now being used as a tangible one—i.e., a financial versus nonfinancial asset. The resulting financial reporting oftentimes doesn't align or "make sense." Many have expressed concerns that the financial reporting may be misleading, rather than useful, to investors. That said, more and more mainstream financial services and fintech companies are now offering customers the possibility of holding or exchanging Bitcoin.

Cross-border transactions

So far, we've applied a US-centric view to digital assets from both an accounting and tax perspective. Outside of the United States, the treatment of digital assets varies substantially. Accounting under International Financial Reporting Standards (IFRS) may similarly view digital assets, like Bitcoin, as intangible assets. However, the intangible asset guidance under IFRS differs from US GAAP. When a company uses digital assets like Bitcoin to transfer funds

across borders—say, to a foreign subsidiary in Europe—it encounters complexities in other jurisdictions.

The transfer process may well involve a number of steps: converting fiat to a cryptocurrency, transferring the cryptocurrency, then reconverting the cryptocurrency to fiat. The benefit, of course, is that such a process avoids bank transfer fees. Yet the act of transferring funds may well have triggered an unrealized gain or loss. And since the subsidiary may not be subject to the same tax and accounting rules as the US parent company, there may be implications in the following areas:

- Gain recognition rules
- Cost basis tracking methods
- Indirect taxes, such as VAT
- Withholding taxes that may apply upon transfer

The bottom line is this: The tax and accounting rules surrounding digital assets are still evolving. This evolution is occurring simultaneously around the world, but with inconsistent conclusions being reached across jurisdictions.

Wallets are typically structured according to the different cost bases at which the digital assets were acquired. Differentials can be set by a range of dollar denominated cost basis (say, at \$100 or \$1,000), or a new wallet can be created every time a new tranche is purchased.

Controls

It should be obvious from our discussion that risk and controls are at the very foundation of any investment project in digital assets. Let's quickly review the main areas that should be on the radar.

Risks unique to each digital asset

The risks underlying digital assets, including cryptocurrencies, vary considerably. Consequently, companies need to conduct rigorous due diligence about how the given asset or coin operates and related market vulnerabilities, as well as terms and conditions. From a technical perspective, companies need to understand the blockchain supporting each asset and how the associated governance system works, as this may have a direct bearing on the resilience of the coin system. This will also help to identify the types of events for which companies should be monitoring.

For example, the computer code that enables the Bitcoin network to process transactions is fundamentally different from the Ethereum code base. Further, as many blockchains enable extensibility in the form of smart contracts (e.g., ERC-20 tokens), mechanisms that allow for the taking of unilateral actions can have a negative impact on the holder of the assets. Other instances where assets can be lost include proof-of-stake blockchains, where assets can be "slashed" for violating network rules. That will result in a reduction of the amount of assets held in a given address. A full appreciation of the technical and business risks associated with each digital asset, and their dimensions, may warrant the

assistance of third-party technical help and evaluation.

Custody

Custody raises a number of important questions. Will the company custody the asset itself, or will it rely on third-party vendors? Self-custody may provide easy access to the assets, but it also presents additional risk in terms of accidental loss, who conducts transactions, and how transactions are monitored and recorded. Given the inherent complexity and risk associated with self-custody, more and more companies are resorting to third-party custodians. Then, it's a matter of evaluating the strengths and weaknesses of different custody processes and procedures.

If the company chooses to rely on an exchange or custodian to store its digital assets, careful consideration of a large number of potential risk issues and questions is in order. Some of these include:

- How does the third-party exchange or custodian secure private key material?
- Can the company trust the accuracy of account statements furnished by the third-party vendor?
- What plans are in place in the event of a liquidation of the custodial services?
- How does the exchange handle market anomalies, such as flash crashes?
- What is the vendor's hard-fork policy

in supporting new digital assets?

- What occurs if private keys and passwords are lost or stolen?

A great way to start addressing these potential issues would be to obtain and review the SOC 1 and/or SOC 2 reports of any potential exchange or custodian.

Authorization risks

Authorizing and executing transactions and transfers (such as the cross-border transfers to subsidiaries discussed above) may well create a host of risks. That's why it is vital for companies to segregate duties in such a way that there is a clear chain of command and documentation regarding who has access to the keys of the accounts and what transaction each person can or cannot undertake. That effort includes the timely monitoring of transactions that are committed to the blockchain and ensuring, independently—there are third-party tailored custodial solutions that employ, among other devices, automatic alerts—that those transactions were, in fact, authorized. Given that there is no FDIC insurance for digital asset holdings, it's important that a company ensure that its holdings are segregated from other participants rather than being part of a commingled account in an omnibus fashion; and that the custodian carry adequate insurance. That becomes very important if an exchange or custodian suddenly goes offline for a time or ultimately fails.

Regulatory compliance

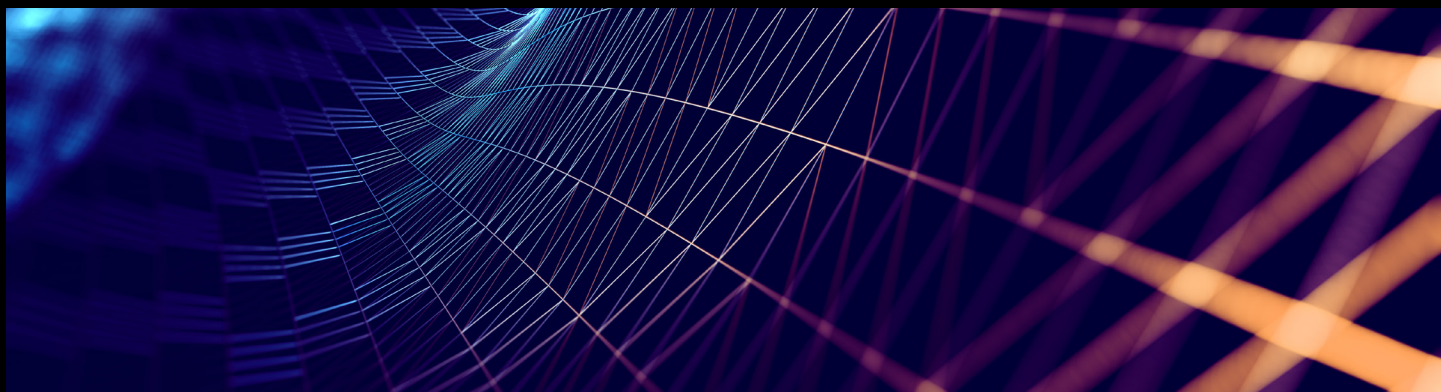
It's critical that the company be able to ascertain that the exchange or custodian in question is abiding by all appropriate laws and regulations. Items on the regulatory radar for exchanges and custodians include, among others, compliance with all anti-money laundering and know-your-customer regulations, measures related to counterterrorism, and rules set by the Office of Foreign Assets Control. As with accounting and tax, the rules and regulations vary by jurisdiction. Hence, to ensure compliance, it would be wise to seek advice from informed legal counsel.

"What has pleasantly surprised us in the process is how encouraging and welcoming the digital asset community has been. Longtime Bitcoin enthusiasts, macroeconomists, and luminaries; blockchain and technology fans; financial institutions, exchanges, and custodians; accounting, tax, and legal experts; and retail and institutional investors and shareholders have all emerged at scale to support and champion our efforts. The combination of these groups' support, as well as our own internal vision, strategy, and teamwork have led to our initial successes."

Phong Le, President and CFO, MicroStrategy, Inc.



Conclusion: The need for cross-organization collaboration



Any sizable investment in digital assets presents more than just technical issues related to treasury, accounting, reporting, tax, and controls. It also involves a significant cultural realignment—internal and external—among the many different groups and departments, including, but not limited to, the board of directors, the audit committee, risk, corporate reporting, finance, tax, internal audit, operations, controls, technology, and investor relations. Since many of these departments interact with external parties, such as the external auditor, tax and legal counsel, etc., it is vital that there be a corresponding realignment in thinking when dealing with these external groups.

What does that realignment entail? Typically, the various functions and departments of a company establish procedures and assumptions for collaborating across and outside the organization based on normal-course, well-understood transactions. The terrain of digital assets is a new frontier of possibilities, so it requires

that each corporate department, and its external party, rethink the application of the rules and policies of its core competency. Few of the norms associated with legacy investments in securities, fiat currency, or treasuries may apply. Once each group gains a level of comfort with the application of the rules to digital assets, they then need to actively listen to one another, gain an understanding of the sensitivities, evaluate any operational or technical dependencies, and finally rethink how they collaborate and tackle challenges together.

Many more operating companies are beginning to evaluate the potential benefits of investing in digital assets like Bitcoin. And as their cumulative experience grows and sparks further interest, the more likely strategic investments in digital assets are to become more routine realities. That said, companies must have the right risk measures in place, as well as the right risk tolerance levels, for it to be worthwhile pursuing this type of investment. For certain, the realities

facing operating companies interested in investing in such assets are complex and in flux. But they are navigable with the right level of commitment from all departments and external parties. And with appropriate attention to issues of process, procedures, and risk all along the decision spectrum, digital assets can offer innovative, bold, and dynamic alternatives to traditional investments.

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