

Rt Hon Nicky Morgan MP
Chair, Treasury Select Committee
House of Commons
London
SW1A 0AA

13 April 2018

Dear Ms Morgan

FRC submission to the Treasury Select Committee Digital Currencies Inquiry

The Financial Reporting Council (FRC) is the UK's independent regulator for accounting, audit and actuarial practice. Our mission is to promote transparency and integrity in business, which we do through a variety of activities including the UK Corporate Governance and Stewardship Codes that we set and maintain; through the standards for company accounts we implement; through monitoring of corporate reports, and through enforcement action when audit standards fall short.

The growth and development of cryptocurrencies has potential implications for company accounting and reporting. As such, we have been monitoring developments in respect of digital currencies and the underlying blockchain technology closely to understand the opportunities, risks and challenges its growing use presents.

Accounting for cryptocurrencies

While there are currently more than 1,500 different cryptocurrencies being traded to some degree, this is not yet a material accounting issue for major UK financial institutions and large corporates. The appropriate accounting for different variants of cryptocurrencies or other tokenised assets is still unclear, as the instruments may confer different benefits and employ different structures. A variety of accounting treatments may also apply because cryptocurrency units may be held for different purposes by various parties (cryptocurrency units may be held for trading, investment or as a medium of exchange). For example, the most appropriate measurement basis for 'mining' companies would probably be cost, whereas for a trader, measurement at fair value would arguably be the most appropriate.

The broad range of cryptocurrencies and related business models means that diverse accounting approaches are emerging. Some stakeholders consider that cryptocurrencies held as investments should be measured at fair value through profit or loss, as this would provide the most useful information to investors. However, the current IFRS accounting framework

would not support that treatment. To be accounted for at fair value the cryptocurrency would need to meet the definition of a financial asset, which it arguably does not. Accordingly, depending on the circumstances, such cryptocurrencies could be accounted for as either inventory or intangible assets and, therefore, probably be measured at cost. The accounting treatments adopted may have different impacts on regulatory capital where financial institutions are concerned, which may require further consideration.

Some accounting specialists consider that cryptocurrencies have the same characteristics as commodities and, therefore, the accounting treatment applied to commodities such as gold should be applied. Therefore, a potential solution would be for the International Accounting Standards Board (IASB) to amend paragraph 2.5 of IFRS 9 to specifically incorporate cryptocurrencies into the scope of assets measured at fair value through profit or loss. However, the matter is not currently on the IASB's standard-setting agenda and will probably need to become more significant before a specific solution is considered by the IASB. In the absence of specific guidance, there is a risk that diverse accounting practices will develop and become entrenched before authoritative guidance is issued.

We will continue to monitor accounting practice but will seek only to intervene if we observe significant divergence of practice or there is a lack of clarity in any material judgements made by directors in preparing accounts.

FRC Financial Reporting Lab

The FRC's Financial Reporting Lab, launched in 2011 to bring together investors and companies to develop pragmatic and innovative solutions to today's reporting needs, has been conducting research into the potential impact of blockchain on company reporting. As part of which, the Lab is due to recommend the creation of a Reporting, Accounting and Auditing on the Blockchain Forum. Further information can be found in our response to specific questions overleaf.

We have focused our response to the Committee's inquiry on those questions most relevant to our regulatory role and remit. We would be happy to expand on any of these or provide additional information should the Committee find it useful.

Yours sincerely

Paul George

Executive Director
Corporate Governance & Reporting Division

Responses to specific questions

What work has the Government (and its associated bodies) done to understand, prepare for and, where relevant, encourage changes that may be brought about by increased adoption of digital currencies?

We recognise both the risks and opportunities posed by increased adoption of cryptocurrencies, and, as a result, have been undertaking a number of activities to develop our own understanding, as well as that of companies, accountants and investors, in relation to their growth.

We engage regularly with UK and international regulators to better understand, share learning with and coordinate the development of policy related to cryptocurrencies and accounting. This has included discussions with other accounting standard setters through participation in a Multi-Lateral Network (of the US, Japanese, Canadian and German accounting standards setters) and considering emerging accounting issues tabled at European Enforcers Common Sessions (EECS) arranged by the European Securities and Markets Authority (ESMA).

We have also sought to improve our level of understanding within the FRC. We have established an internal Artificial Intelligence and Technology Working Group. This Group routinely considers the impact of new technology such as blockchain and cryptocurrency on our areas of regulatory remit. It also arranges related training and provides an internal forum to share information about latest related technological and market developments and considers the adaptation of FRC policy accordingly.

Financial Reporting Lab project – blockchain and company reporting

Through our Financial Reporting Lab, we are undertaking a project considering the potential for blockchain to be used in the production, distribution and consumption of corporate reporting. This report is expected to be released in May, which we will provide to the Committee.

As part of which, we expect to recommend the creation of a forum of professional bodies, standard setters and others with a relevant interest. This Reporting, Accounting and Auditing on the Blockchain Forum would be UK-focused and seek to connect with other similar forums worldwide.

The Forum would:

1. provide a space to discuss ideas, risks and opportunities related to blockchain and company reporting;
2. support participants' education and learning about blockchain;
3. form a focal point for relevant opinion supporting the Government or other appropriate consultation activity;
4. encourage innovation and experimentation, and
5. support standardisation efforts where relevant.

How might the Government's processes adapt should digital currencies be adopted more widely (e.g. tax implications, anti-money laundering measures?).

The use of digital currency and blockchain potentially has some significant impacts on Government processes. These include:

- the taxation of cryptocurrency transactions and new business models based on cryptocurrencies;
- accounting for cryptocurrency transactions;
- the incorporation of blockchain as part of business, government and regulatory infrastructure; and
- jurisdictional issues related to the regulation of blockchains when operated outside of the UK.

Blockchain technologies remain at an early stage of development; balancing innovation with appropriate regulation, therefore, is a difficult to achieve but ultimately would be in the interest of the UK in order to ensure financial stability. Monitoring and responding to developments in the cryptocurrencies market is an essential element of ensuring that government policies, processes and legal frameworks are adapted to reflect the new environment. In order to be effective, any adaptations would have to be developed in collaboration with other governments or, as a minimum, developed with a view of ensuring that actions are consistent across different jurisdictions.

How are governments and regulators in other countries approaching digital currencies and what lessons can the UK learn from overseas?

The following recent international examples may be useful for the UK's approach to cryptocurrencies in relation to accounting and reporting.

1. The European Commission has proposed a European Financial Transparency Gateway¹ to facilitate investor and other stakeholder access to company information, and launched an EU Blockchain Observatory and Forum.² The UK has also recently become a signatory to the Declaration on the establishment of a European Blockchain Partnership.³
2. In 2016, Japan amended the Payment Services Act to define virtual currencies and to introduce a registration system for virtual currency dealers. This drove a need for accounting guidance. As a response on December 6, 2017, the Accounting Standards Board of Japan (ASBJ) issued for public comment an Exposure Draft on *Practical Solution on the Accounting for Virtual Currencies under the Payment Services Act*. The comment period ended on February 6, 2018.

¹ <http://www.europarl.europa.eu/sides/getAllAnswers.do?reference=P-2017-004573&language=EN>

² http://europa.eu/rapid/press-release_IP-18-521_en.htm

³ <https://ec.europa.eu/digital-single-market/en/news/european-countries-join-blockchain-partnership>

3. In 2016, the Australian Accounting Standards Board (AASB) issued a paper analysing the accounting for cryptocurrencies in the context of current accounting standards. The paper concluded that current International Financial Reporting Standards (IFRSs) do not provide adequate guidance and recommended that the IASB should consider adding the matter to its standard-setting agenda.⁴
4. In its January 2018 meeting, the IFRS Discussion Group (an advisory group of the Accounting Standards Board (AcSB) in Canada) discussed the challenges of accounting for cryptocurrencies. It observed that, under the confines of current IFRSs, it is difficult to provide relevant and faithfully representative information on cryptocurrencies. The Group recommended that the issue should be discussed with the AcSB to determine whether it should be further escalated to the IASB or the IFRS Interpretations Committee.⁵

The above actions illustrate that standard-setters, such as Japan, which operate accounting frameworks outside of IFRS are pressing ahead with the development of relevant guidance. Other standard-setters are using their influence to encourage the IASB to develop the required accounting guidance.

⁴ http://www.aasb.gov.au/admin/file/content102/c3/AASB_ASAF_DigitalCurrency.pdf

⁵ <http://www.frscanada.ca/international-financial-reporting-standards/ifrs-discussion-group/search-past-meeting-topics/item85451.pdf>