

Regulation on the Rise as Bitcoin Gains Popularity

By Rick Barlin

Over the past eight years, financial professionals' interest in bitcoin and other digital currencies has increased, and now regulators have taken notice. The federal government has enacted controversial legislation regarding how to account for digital currencies on financial statements, as well as for tax purposes. Further complicating matters is the fact that these currencies are defined differently, depending upon how they are used. Aside from the accounting problems, investors,

consumers, and merchants must also deal with digital currencies' extreme volatility. The use of digital currencies is supposed to make shopping easier, but payment methods such as bitcoin can be a double-edged sword. The increasing use of bitcoin and other digital currencies will lead to new regulations and accounting standards.

What Is Bitcoin?

Bitcoin is a type of virtual currency. Certain merchants accept it as a form of payment, and investors can acquire it on exchanges. Bitcoin was created in 2009, allegedly, by a man using the pseudonym of "Satoshi Nakamoto," whose true identity has yet to be discovered (Mark Reijman, "Bitcoin: Fast Lane To Billions or Bankruptcy," *Star Online*, Feb. 4, 2017, <http://bit.ly/2qG0BKj>). Virtual currencies are essentially computer-generated data; in order to be used, they must be

retrieved. Technically, bitcoins are not made, but mined. Mining is the process of having a computer solve a complicated math problem to "earn" a bitcoin. With digital currencies, the computers are the miners, the math problems are the pick-axes, and the bitcoins are the gold.

Luckily, interested consumers do not have to do the mining themselves. Bitcoins already on the market may be acquired via exchanges, such as Coinbase and Blockchain.info. In order to receive bitcoins, however, one must have a digital wallet, which can also be acquired through those same exchanges. A digital wallet is like an app that allows the user to send and receive bitcoins. Some of the more popular businesses that accept bitcoins are Overstock.com, OKCupid, Virgin Galactic, and Subway (Ofir Beigel, "How to Use Bitcoin? A Quick Start Guide," *99 Bitcoins*, Jan. 24, 2017, <http://bit.ly/2rmmOjg>). Bitcoins also need a bitcoin address, which comes with the wallet. A bitcoin address consists of approximately 33 random characters that are password protected (Gail Liberman, "Palm Beach Discussion Group Purchases Single Bitcoin," *Palm Beach Daily News*, Jan. 12, 2014, <http://bit.ly/2q4yy5a>).

Overstock.com was the first merchant to accept bitcoin at checkout, in January 2014. The site uses Coinbase to convert the bitcoins it receives into U.S. dollars. Overstock receives payment equivalent to that of the item purchased, while Coinbase keeps the bitcoins (Chris Gaetano, "Newsmakers: Overstock.com's Chairman of the Board Jonathan Johnson and CFO Robert Hughes," *The Trusted Professional*, June 2014). Such a strategy has proved successful; acceptance of bitcoin has resulted in new customers, increased revenue, and lower merchant fees than credit cards.

The success or failure of investing in virtual currency largely depends on the market. Bitcoin finished 2016 on a high note, as 459 million bitcoins were traded

in the fourth quarter alone, a more than 200% increase from the previous quarter and the final quarter of 2015 (Bradley Miles, "459 Million Bitcoins: Exchange Volume Reached Peak Levels in Q4 2016," *CoinDesk Research*, Feb. 2, 2017, <http://bit.ly/2rAt9F2>). In the first week of February 2017, the value of bitcoin increased 11.5%, to \$1,024.14 (Charles Bovaird, "Bullish Sentiment Fuels Bitcoin's Return to \$1,000," *CoinDesk*, Feb. 4, 2017, <http://bit.ly/2rAHvo7>). Bitcoin does tend to follow the market, however, which means an economic downturn would affect the digital currency's value as well.

Drawbacks and Risks

The surging popularity of bitcoin may prove to be its downfall. Like any type of data, bitcoin requires hard disk space, and such space is becoming scant. In February, \$1 billion worth of bitcoins were stuck in a transaction backlog due to limited capacity (Andrew Quentson, "Almost \$1 Billion Worth of Bitcoins Stuck in Transaction Log," *Cryptocoins News*, Apr. 2, 2017, <http://bit.ly/2q1wJXp>). This dilemma is turning one of the digital currencies' advantages into just the opposite. Bitcoin costs less in fees to merchants than credit cards; however, those fees may increase if there is less room to store the currency.

In addition to the technical issues, there are privacy and fraud concerns as well. The whole point of a cryptocurrency is to protect the user's privacy; however, the randomly generated bitcoin addresses may not be safe enough. According to the Open Bitcoin Privacy Project, an advocacy group that focuses on security issues, a bitcoin address may be able to be traced back to the network it came from (Stan Higgins, "Bitcoin's Privacy Gets 'Failing Grade' in 2016 Threat Report," *CoinDesk*, Feb. 2, 2017, <http://bit.ly/2qA8pPj>). Even if a new address is generated for separate transactions, the original source may still be found through those very transactions. A more



sophisticated network is needed to prevent the data from being tracked.

Combining new technologies with a new type of currency will inevitably lead to new risks, particularly fraud. Texas financier Trendon T. Shavers created a Bitcoin Investment Trust, only to defraud his clients in a Ponzi scheme costing tens of millions of dollars. Shavers would entice new investors via online forums, then use their investments to pay old clients. Some of those funds were taken to pay his personal expenses, including rent and food ("SEC Charges Texas Man with Running Bitcoin Denominated Ponzi Scheme," SEC press release, Jul. 23, 2013, <http://bit.ly/2q1Ayfk>). Bitcoin is so volatile that its rising price over a year caused those victims to lose 12 times more than their initial investment.

Regulation of Digital Currencies

The SEC, the Financial Crimes Enforcement Network (FinCEN), and the IRS have all issued some form of regulation regarding digital currencies in the last few years. The main problem with regulating currencies such as bitcoin is that it is treated as both a method of payment and an investment property. FinCEN's Guidance FIN-2013-G001 declared that "virtual currency does not have legal tender in any jurisdiction" ("Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," Mar. 18, 2013, <http://bit.ly/2q4JOyG>). The way to get around this is by converting the bitcoin into legal tender, just as Overstock.com does when it accepts bitcoin from its customer. The consumer is essentially using an investment, bitcoins, to buy a product, but rather than treating it like an exchange of property, the third party's conversion of the virtual currency makes it an ordinary business transaction. This leads to major reporting issues for bookkeeping and tax purposes.

If virtual currency is not real currency,

the IRS says, then it must be treated as property for tax purposes. That means a capital gain or loss should be recorded as if it were an exchange involving property. It should be treated like inventory if it is held for resale, and therefore an ordinary gain or loss recorded. If it is used as payment, it should be treated like currency, but must be converted and its fair market value checked on an exchange (Chris Gaetano, "IRS: Treat Virtual Currency as Property, Not Currency, For Tax Purposes," *The Trusted Professional*, Apr. 22, 2014, <http://bit.ly/2qG1PoE>). This ruling is also contradictory; it states that virtual currencies can be treated like real currencies in certain circumstances. Bitcoins received as payment to an employee would be considered wages; payment to an independent contractor would be subject to self-employment tax. If a bitcoin is bought on an exchange and then used to buy a product, the sale is treated like a barter transaction, and the gain or loss is the difference in basis between the value of the product received and the value of the bitcoin at that time.

From the perspective of a corporate officer, the situation is even more complicated. Unlike with taxes, where an asset must be sold before it is recognized, the receipt of a bitcoin or other virtual currency must be recorded. Furthermore, because bitcoins are treated like real currency, their exchange rate at the balance sheet date must be considered and adjusting entries must be made to reflect conversion to U.S. dollars (Pierre Rochard, "Bitcoin for Accountants," *Live and Learn: MPA Student Life Blog*, Feb. 6, 2013, <http://bit.ly/2q1vO9L>).

Virtual currency transactions are also creating new challenges for auditors. The technological complexities can affect a company's internal controls, as well as increase the risk of material misstatement on the financial statements. This was indi-

cated by AU section 314.27, "The Standards of Fieldwork, Appendix C: Conditions and Events": "Inconsistencies between information technology and the business as well as changes to the IT environment may indicate a risk of material misstatement in the company's financial statements." Evidence of a bitcoin transaction is recorded on a digital public ledger called a blockchain; this can get very technical, depending on how many transactions there are and the number of addresses for each. Regarding the value of these bitcoin transactions, auditors may compare the balances of the digital currencies the company holds in reserves to actual customer balances. This method is known as the Merkle Tree Technique and was created by Greg Maxwell, a bitcoin developer, specifically to audit bitcoins (Nermin Begovic, "Kraken Bitcoin Exchange Passes 'Proof of Reserves' Cryptography Audit," *CoinDesk*, Mar. 24, 2014, <http://bit.ly/2r19CAn>).

A New Complication

The advent of bitcoin and other virtual currencies is forcing both consumers and merchants to become more tech-savvy. Investors can further diversify their portfolios by investing in bitcoin. While the currency is supposed to be more secure and cheaper than credit cards or cash, it is only as strong as the market it's traded in. Virtual currencies have been subjected to large swings in price over the years, not to mention fraud. Federal agencies have issued guidance on how to treat these currencies, but despite this, tax and financial statement treatments are at odds. Auditors also face new challenges regarding information technology and account balance accuracy. The future of bitcoin is unclear, but it will surely be a roller-coaster ride for the business community. □

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