

How Stablecoin Implementation Can Lead to Increased Accounting Clarity and Standardization

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Abstract

Stablecoins represent the current iteration of cryptoasset development and implementation but remain an area in which further development and research is necessary to improve the reporting and accounting codification conversation. Although the various iterations of stablecoins do purport to address some of the significant problems and issues preventing wide adoption and implementation of cryptocurrencies there is also some debate around the future of these cryptoassets. Accounting and reporting guidelines for cryptoassets overall, including stablecoins, remain fragmented due to regulatory misunderstanding as well regulatory scrutiny over proposed stablecoin projects. What this research does is present both an analysis of stablecoins as well as put forth a number of suggestions as to how stablecoins can help drive the accounting classification dialogue forward. Written with both a practitioner and academic audience in mind this research can be used to pursue further implementation and research projects moving forward.

Keywords: Stablecoins, cryptoassets, accounting, financial reporting, codification

1. Introduction

Stablecoins continue to generate conversation and analysis both in the blockchain and broader financial services marketplace, but there does seem to still be a level of uncertainty and confusion related to just what these assets represent. Depending on the specific stablecoin in question there do appear to be several appropriate or relevant definitions that are applicable and important to further the professional conversation. Taking these definitions into account, however, merely is the first step in the process of understanding and analyzing just what these types of cryptoassets mean for the blockchain and cryptoasset space at large. Bitcoin and more traditionally decentralized cryptocurrencies may have led to the conversation and adoption of blockchain technology, but institutional interest and investment continues to increase. Specifically as incumbent financial institutions continue to invest both financial and human capital into the development and implementation of blockchain platforms, it seems logical to predict that stablecoins will fill an important role moving forward. Such increased adoption and utilization may ultimately also lead to increased clarity with regards to accounting taxonomy, but prior to a broader analysis it seems logical to revisit just what the core characteristics of stablecoins represent.

2. Stablecoin Analysis

The development of stablecoins has been characterized by some market actors as an inevitable result and implication of how traditionally decentralized and distributed cryptocurrencies interact with the broader economic landscape (Kharif, 2019). Specifically the price volatility commonly associated with bitcoin and other cryptocurrencies seems to have played a prominent role in the rise of stablecoins for both individual and institutional utilization. Stablecoins as an asset class attempt to resolve and address this price volatility that undermines many institutional projects. While this position certainly has merit and should be considered as a part of any stablecoin analysis it is also worth taking into account the accounting and financial reporting implications of cryptocurrencies. Price volatility did play a role in the rise of stablecoins, but the continued uncertainty and ambiguity with regards to accounting classification and reporting also represents a factor that should be included as a part of any comprehensive analysis (R.F, B.H., & T.R., 2019). Cryptocurrencies in the United States are not classified as currency, despite the currency labeling, and are instead classified as property for tax purposes. Compounding this ambiguity is the fact that different market regulators, including both the SEC and CFTC, have issued guidance and comments on how these various cryptoassets should be treated and classified (Thursfield, 2019). Such ambiguity means that, despite the numerous comments and opinions, the appropriate classification and reporting of cryptocurrencies remains uncertain. Organizations, including those in the financial services field, and those operating in other industry verticals, require certainty to make longer term decisions and investments. In this context, and keeping in mind the uncertainty that continues to exist in the cryptoasset space, defining core characteristics of stablecoins is a logical next step.

First and perhaps most obviously is the fact that stablecoins purport to have lower levels of volatility than other types of decentralized cryptocurrencies. Said stabilization can be achieved in any number of ways, but there do seem to be several areas leading the space forward as

stablecoins continue to develop and mature in response to institutional interest. These categories are not meant to be all-inclusive nor exhaustive, but rather should form the basis for comprehensive conversation moving forward. Said categories of stablecoins include, but are not limited to, the following:

1. Stabilized by fiat currencies. Perhaps the most popular and simple to understand in the context of traditional financial instruments, stablecoins that are stabilized by connecting these cryptoassets to a fiat currency also appear to be the most popular iteration. While it is true that the majority of fiat linked stablecoins are connected to the US Dollar the potential for other fiat linked stablecoins continues to increase. Interestingly enough, and while the Libra project – spearheaded by Facebook but including an array of other organizations – has obtained massive amounts of coverage, this concept may not be as unique as initially thought.

- a. The SDR, launched by the IMF several decades ago, has many of the same characteristics of Libra (Waller, 2019). The SDR, like Libra, is backed and supported by a basket of currencies in a certain ratio, and can be used to settle international transactions. It remains to be seen what ultimately happens with the Libra initiative, but the similarities between the SDR and Libra are both worth mentioning and intriguing.

2. Stabilized by commodities. If a particular government or institution does not have a significant appetite for creating a cryptoasset or cryptocurrency supported or pegged by a fiat currency, developing a cryptoasset supported by a commodity appears to represent a legitimate alternative. Gold possibly represents the most obvious and initial choice of commodity to choose for stabilization initiatives, but there are other options that may be as useful depending on the content in question. Oil, other commodities, or a blend of external commodities may serve as a useful alternative, but such a structure raises the following question.

- a. If a stablecoin is supported or backed by a commodity, what exactly does that entail for the users of this cryptoasset? For example, if an investor wishes to exchange or redeem a stablecoin backed by gold, what does that investor receive? An investor may assume that a stablecoin supported by gold will be redeemable for gold itself, but that may not be the case. Instead the investor may only be eligible to receive a Gold ETF or other type of derivative instrument, which in addition to representing a surprise may also undermine some of the usefulness of investing in such a stablecoin.

3. Stablecoins backed or supported by a basket of fiat currencies. Returning to Libra for illustrative purposes, the development and implementation of stablecoins backed and supported by an array of cryptocurrencies seems to be gaining steam going forward. Reasons for this may be a combination of purely financial as well as political in nature, but the message is the same; reducing exposure and affiliation to any one single fiat currency does appear to make sense in a global economic landscape characterized by political uncertainty and increasing competition on an economic basis. Although these basket backed cryptoassets may indeed reduce the exposure of cryptoasset holders to any one specific currency, this scenario also raises an array of questions.

- a. As an example, if an investor has converted \$100 USD into an equivalent amount of stablecoins but at some point in the future wants to redeem these stablecoins for fiat, how does

that process actually function? Expanded upon below, the questions of redemption and redeemability remain open items for many stablecoin issuers

There is also a subset of stablecoins that are stabilized by other cryptocurrencies, with the most high-profile example of such an arrangement represented by the DAI stablecoin handled by MakerDAO. In addition to the stabilization that is a byproduct of the cryptoasset structure, a cryptoasset such as this also has perhaps the strongest connection to the concept of decentralized cryptocurrencies. While technically complex to execute and scale, such a scenario does hold potential as the broader blockchain and cryptoasset ecosystem continues to develop and mature. As of this research there does not appear to be broad institutional support for such a stabilized cryptoasset, but it remains interesting to see where such an arrangement or structure fits into the wider conversation moving forward.

4. Exchange and Redeemability

Redeeming or exchanging specific cryptoassets, including stablecoins, for either the underlying asset supporting the cryptoasset in question remains an issue that needs to be addressed by issuers and practitioners seeking to facilitate increased mainstream adoption of these cryptoassets (Lee, 2018). While various stablecoins will be underpinned or supported by different assets or categories of assets, the redemption process and considerations do appear to be consistent across the range of stablecoin assets. Seemingly an academic or theoretical question, the process by which individual or institutional investors can both enter into, and exit, investments into cryptoassets is a consideration that is worthy of future analysis. More to the point, and linking back to the core point of this research, if an asset or purported medium or exchange is not redeemable or is not redeemable in a liquid manner, the argument for classifying and treating these assets as currency equivalents is weakened. Focusing on the current regulations and guidance, including the late 2019 release of additional information from the IRS, the debate and analysis around how cryptoassets can be construed as a legitimate currency equivalent appears to hinge on how liquid and free flowing stablecoins become.

4.1 The Current Equivalent Question

Cryptocurrencies, ranging from traditional decentralized options such as bitcoin to centralized and stabilized options including Libra, were initially developed and marketed as technologically superior alternatives to fiat currencies. That said, in order to truly replace fiat options that currently exist it is required, somewhat obviously, that these cryptoassets be classified as treated as currency equivalents. As of this research the current treatment of these assets remains varied, with the United States classifying these items as property. What this truly means is that every time a cryptoasset – regardless of whether it is stabilized by an external asset or not – generates a taxable event and item every time it changes hands (Browning & Davison, 2019). Whether or not a cryptocurrency is used to pay for goods and services, received in exchange for goods and services provided, or paid to employees in lieu of wages, there are additional reporting and compliance considerations that must be taken into account. In addition to these reporting items there is also the reality that income taxes will be owed on the change in fair market value of cryptocurrencies, illustrated by the following scenario.

- Option 1 – A U.S. consumer uses USD to purchase a pizza for \$15, and pays \$15 for this food product. Sales tax in this jurisdiction are not applied to food, so that is not a consideration.

- Option 2 – A U.S. consumer uses a cryptoasset to purchase a pizza that is still priced in \$15 USD. Assuming that the merchant accepts cryptocurrency as a valid payment option (which is not guaranteed), there are several other complicating factors that need to be taken into account. Most notably are the tax reporting and payment aspects of using cryptocurrencies to purchase goods or services under the current regulatory structure. If that individual had purchased that cryptocurrency for \$5,000 and used it to pay for pizza when the fair market value was at \$7,500 would owe taxes on the \$2,500 increase in value.

No matter what specific asset underpins or supports the stablecoin itself there does appear to be a connection between the redeemability and liquidity of a specific cryptoasset and the ability of proponents to argue for treatment as a currency equivalent (Parashar & Rasiwata, 2019). Stated another way, in order for cryptoassets – including stablecoins – to gain broader adoption and utilization by consumers as legitimate currency options it seems reasonable for consumers to expect that these items can be redeemed or transformed into fiat options with relative ease. This is where a stablecoin can attempt to bridge the gap between decentralized and distributed cryptocurrencies and the current fiat options that exist in the marketplace. While no stablecoin as of this research have been able to successfully change the classification as property to one of a currency equivalent, there does appear to be a case to made that this would be possible. At this point in time this remains a theoretical conversation and analysis, but the continued and increasing investment into this space by some of the largest financial institutions in the world it is not unreasonable to expect this conversation to move the forefront in the near term.

4.1.1 Headwinds

Given the pace of development and refinement of the stablecoin subset of the cryptoasset space it might seem unusual that no single stablecoin has managed to successfully push the conversation forward. Upon closer examination, however, there are several pain points and open items that need to be resolved prior to the ability of any product or organization to close the loops on these items (Robertson, 2019). Stablecoins do, in theory, represent the next stage of the tools underpinning financial transactions so it is not entirely unreasonable to expect these cryptoassets to come under some level of scrutiny. Acknowledging this reality, however, is just one aspect of the stablecoin analysis, and is compounded by the fact that many stablecoin options appear to be trying to enact an alternative financial system to rival established financial markets. The scrutiny and backlash that the Libra initiative and Association has generated since its initial launch is indicative of this structural headwind that continues to present challenges to other stablecoins oriented and designed to either augment or entirely replace existing financial infrastructure and systems.

Viewed strictly through a technical or crypto-related lens it might seem unusual to see such robust and publish criticism, but that only represents a partial view that misses the bigger point. Taking a step back and viewing this analysis and evolution from the perspective of financial policy makes and legislators the rise of stablecoins and decentralized financial systems creates a potential systemic risk to the current financial order. These risks are routinely cited by lawmakers in any number of countries as a core issue and problem connected to stablecoin development (Cox, 2019). Taking a look at Libra this concern and feedback does seem to have some validity to it; the structure of the Libra Association and authorized resellers does seem to mirror the current version of the U.S. Federal Reserve system. Libra reserves are going to be

held and managed by a governing body, and the only methods by which Libra cryptoassets can be converted or exchanged for fiat currencies is via a designated list of wholesale institutions. Such a setup seems to closely track and mirror the current setup and structure of the Federal Reserve (located in Washington D.C.), and the regional Fed banks located in the districts throughout the country.

Governments across the global have any number of responsibilities, duties, and obligations, but arguably the most sacrosanct is the right of a government to control and manage the currency used within its sovereign borders. Much of the discourse and debate that routinely takes place in the European Union is directly linked to the fact that the nations that have adopted the Euro have – in effect – given up financial control over their economies. Framed in that context it becomes readily apparent why regulators and lawmakers have appeared so reticent to embrace the rise of private sector stablecoins. If these cryptoassets do launch and function even partially as advertised it could potentially undermine the financial strength and sovereignty of the nation in question. These concerns are compounded by the fact that the layers of financial compliance and regulation have been developed, implemented, and tweaked based on the assumption that only financial institutions will be involved in the conversation and debate (Berson & Berson, 2019). Technology institutions, or organizations wholly constructed to deal with cryptoassets, Facebook and Paxos come to mind as respective examples, simply do not have the background or expertise to contend with these thickets of compliance inherent to the financial services space.

Proponents of stablecoins argue that this differentiation represents a strength of the idea; financial institutions have become too inflexible, and in some cases too big to fail; fresh ideas are required to reinvigorate the financial sector (Marsh, 2019). What these arguments fail to take into account, however, is that while the financial services sector continues to be augmented by technology, the financial sector plays a critical role in the global economy. Financial services, and the markets at large, play an important role in allocating capital, pairing investors and content producers, and allows companies to achieve the scale necessary to compete and thrive in a global economy. Privatizing such a critical component of governmental authority and enforcement, rather obviously, does not appear to be a course of action many of those in governmental positions are interested in seeing come to fruition. Such resistance aside it is increasingly apparent that private or consortia based alternatives to currency and fiat capital are emerging as priorities at a number of different locations on a global basis. In order to such proposals to succeed, however, there are a number of components and factors that will have to be incorporated into any cryptoasset truly seeking to supplant crypto.

5. Proposed Stablecoin Requirements

In order for this conversation to move from a theoretical or abstract item to one that is tangible and realistic to expect from market actors there appear to be several components that will be required. This listing and factor list should not be considered to be an all-inclusive listing, nor one that is exhaustive in nature, but items that should form the basis for a robust and comprehensive ongoing conversation. Said factors include the following:

1. Assets that can be documented and reported to external stakeholders on a consistent and continuous basis. Most notably highlighted by the saga that unfolded in 2019 that eventually looped in Tether, Bitfinex, and Crypto Capital Corp, the importance of being able to verify and attest to reserves cannot be overstated. By the very nature of the cryptoasset itself, stablecoins imply a stabilization factor derived from association with an underlying asset. Confidence in said stabilization, however, is at least partially dependent on external verification regardless of the asset in question.
2. Proof that the stabilization actually functions as advertised. Stating that a particular coin or token is stabilized or is redeemable or otherwise connected to an underlying asset is one matter; actually having it work in the marketplace is a different matter entirely. Financial instruments that may include hedges, futures, forwards, or simply a commitment to buy or burn (destroy) tokens to maintain a certain level or parity of ratio of value need to be published and documented. In addition to documenting these tools it should also be expected that the financial costs associated with said tools are disclosed and reported in a transparent manner.
3. Custody and custodial services are provided in a manner that is both secure and does not violate the decentralized and distributed nature of blockchain and cryptoasset technologies. Constructing such custodial services continues to be an area of interest and investment for institutional players, but there is one underlying consideration that remains a variable across current offerings. How does an asset holder, be they individual or institutional in nature, verify and prove the custody and provenance of a specific cryptoasset? In the case of bitcoin the ultimate proof of ownership is also the way in which an unethical actor could redirect said funds; private keys. Stablecoins may have different ownership structures, but establishing how these can be held in a custodial fashion is imperative.
4. A corollary to the first necessary component is the fact that in order for any asset, stablecoin or otherwise, to be effectively used as a medium or exchange, is that these assets have a verifiable external value of this asset. In essence what this mean is that in order for the proposed stablecoin to have any lasting value in the marketplace it must be able to be used for an intended purpose. While it is unlikely that a newly issued stablecoin will have a deep and liquid marketplace that does not mean that the valuation conversation should not occur, or should only happen periodically. Much like traditional assets have different levels of value depending on how liquid and transparent the marketplace is, the valuation prospect for stablecoins will need to evolve and transition over time.
5. Functionality must be understood and communicated to the proposed stakeholder groups, including financial actors as well as consumer groups. As highlighted by the multiple 2019 hearings convened by the U.S. Congress it is also important to ensure that information and data is communicated to regulators and various oversight bodies that are going to be involved in the regulatory and legal conversation. Ensuring that information is produced and communicated to the different regulators and stakeholder groups are going to obviously occupy a large amount of initial time and energy for management professionals, but this is one that cannot be overstated. Being in compliance with the different legal and other regulatory compliance mechanisms is something that must be completed. Financial markets and financial services do tend to have large amounts of compliance for the simple reason that financial services have a

large impact on the economy. Compliance by its nature can restrict growth and innovation, but also serves an opportunity to safeguard the financial assets and rights of the users.

6. Accounting Considerations and Clarifications

Mentioned above one of the largest open items and considerations that still remains unaddressed in the current marketplace is the lack of accounting standards and codification in the broader cryptoasset landscape. Until these issues are resolved in one way or another, but ideally in a manner that does not burden users and financial actors with undue compliance requirements such as those that currently exist with the treatment and classification as tax property, adoption does seem posed to accelerate (Bruno & Gift, 2019). Accounting, reporting, and taxation requirements still do occupy large amounts of professional time in financial services circles, and that is because of the importance of having financial and accounting information that is useable to external parties. At the core of the idea as it connects to accounting and financial markets is the importance of accounting information to be consistent, clear, and comparable to other asset classes and information.

Accounting information systems as they connect to cryptoassets and financial information must be able to produce clear, concise, and comparable information. As it connects to the reporting of cryptoasset information it is also important to recognize the fact that a core component of how data is communicated is, in turn, based on the functionality and use cases connected to different financial markets and information. While certain cryptoassets and other cryptocurrency information may be labeled and thought of as currency alternatives they do not function nor are they currently treated as such under current market guidelines and information. Many of the current tools including the broader cryptoasset class are, although labeled as currency, are not treated as such from a financial reporting or taxation point of view. This paradox poses a substantial headwind to broader adoption and implementation.

Stablecoins, especially ones that are created and organized to operate legitimately as currency alternatives, may provide a realistic option to assist with making the case for an accounting classification. Depending on the use case or application of these stablecoins, such clarification might also highlight the applicable and usability of stablecoins for other purposes such as charitable giving (Searing & MacLeod, 2019). Linking back to the to the necessary components for a stablecoin to operate as advertised there are a few statements or points that should be communicated in order for this conversation and position to make sense.

First and foremost the stablecoin must actually operate as advertised and be stabilized, regardless of what specific asset in question is used as the stabilizing agent. The peg itself, nor the asset used to stabilize the coin, is as important as the fact that the pegging or stabilizing functionality performs correctly. If a cryptoasset is meant to be developed and ultimately utilized as a legitimate currency alternative it must be able to be exchanged, redeemed, or otherwise linked to the asset in question. One of the largest arguments against the adoption and utilization of cryptoassets for the purchasing of goods and services is the price volatility so commonly associated with bitcoin and other cryptocurrencies. This very price volatility and action is also a leading reason as to why cryptocurrency products such as ETFs have faced such severe headwinds toward adoption and acceptance. Addressing this issue and doing so on a consistent basis is a critical structural aspect that must be solved.

A second argument that could be made for reporting and classifying specific stablecoins as different classes of assets is to determine how these assets are to be used, or what the use case for the specific asset tends to be. Different organizations will hold and use certain types of cryptocurrencies and cryptoassets for different uses so it does tend to make sense that different types of stablecoins will be developed as a result. This trend is already beginning to emerge represented by the development and implementation of utility and security token classifications. Without delving into unnecessary technical details, the difference between the utility and security tokens can be distilled into the following. Utility tokens, in essence, operate as an equivalent to coupons or other types of native tokens that grant the token holders access to the goods and services of the organization. Security tokens, contrastingly, operate as close equivalents to equity securities in so much as they tend to be traded externally, have external value, and often are linked to the profits and management rights of the organization.

Different classes of stablecoins, including some of which might indeed remain classified as intangible assets may not be as radical an idea or concept as it might initially appear. Assets are classified, including cash, inventory, and prepaid equipment, already presented and classified dependent both linked to how the assets are used at the business itself. Stablecoins and different versions of stablecoins could just as easily grow and be differentiated as the ecosystem matures. They need not all be classified as currencies, and may very well be judged and classified by how they function in addition to whether the stabilization functions as advertised.

7. Forward Directions

Ultimately the case for stablecoins to lead the conversation forward is based on a number of factors and the flexibility that the cryptoasset model creates. Coins and cryptoassets can be created stabilized by any number of external assets, or even other cryptocurrencies themselves, and this inherent complexity also can simplify the debate moving forward. Stablecoins address, simultaneously, two of the biggest problems that have continued to plague the broader cryptoasset ecosystem; price volatility and uncertainty with regards to business use. Stablecoins or asset backed coins – whichever label ultimately succeeds – by the very nature of being stabilized can assist in addressing the price volatility that continues to prevent broader consumer and commercial adoption. Building on this ability to address the price volatility linked to many cryptocurrencies also assists in developing and refining the specific use cases for these assets, including the accounting classification and codification of cryptoassets at large. Whatever the outcome of these conversations are, it will remain an intriguing and important are for both practitioners and academics to continue examining for the foreseeable future.

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