Crypto Accounting Shenanigans: Why “Net Income” Has Become Even More Useless

Is That a DogeCoin on Your Balance Sheet?

This Tutorial: NOT My Personal Crypto Views

*This tutorial is **NOT** a “crypto bull” or “crypto bear” argument (I’m somewhere in between; I’ve bought and sold and still hold some, but less than before).*

Instead, I want to address another issue that has come up as major companies have been “adopting” crypto…

This Tutorial: NOT My Personal Crypto Views

*How do companies record **cryptocurrencies** on their financial statements? Should it count as a "security" or an "intangible asset"?*

And what are the implications? Are certain metrics and valuation methodologies more or less useful now?

Outline for This Tutorial:

Basics on the Statements

- **MSTR and TSLA:** Recording Bitcoin as "Digital Assets" and treating it like an **indefinite-lived intangible asset**

- **So:** No amortization, and under U.S. GAAP, no revaluing up…

- **But:** They'll still record **impairment losses** if/when the price of Bitcoin declines – even though these are Unrealized Losses!

- **And:** They'll record Realized Gains and Losses on the Income Statement if/when they finally sell these "Digital Assets"

- **Also:** There will be Deferred Taxes for many of these events (since Unrealized Losses are not immediately deductible)

Basics on the Statements

- **KEY PROBLEM(S):** Consistency! They’re recording *Unrealized Losses* but not Unrealized Gains? Actually, why record either? And why is Bitcoin considered an “Intangible Asset”?

- **Accounting Rules:** Companies now need to record Unrealized Gains and Losses on small investments in equity securities (Berkshire Hathaway affected by this)

- **So:** If TSLA and MSTR classified BTC as an “investment,” the treatment would be quite different

- **As Is:** Makes Net Income a highly deceptive metric because of Unrealized Losses, huge Realized Gains/Losses, etc.

Basics on the Statements

- **OTHER PROBLEM:** By calling Bitcoin an “intangible asset,” these companies are implying that Bitcoin is *core to their businesses*, i.e., it corresponds to Enterprise Value

- **But:** Are Tesla and MicroStrategy truly “crypto companies?”

- **Truth:** Seems like a stretch because they’re not operating exchanges, mining crypto, building related services, etc.

- **But, But, But:** Yeah, Tesla might accept Bitcoin for its cars now, but that still doesn’t make it a “core business asset”

- **So:** We believe it’s best to count crypto as *non-core* for both

A "Bank's" Crypto Treatment (Galaxy Digital)

- **Corporate Structure:** Galaxy Digital is a Limited Partnership that does "asset management for digital assets"

- **So:** Trading, asset management for high-net-worth individuals and institutions, investing, investment banking, and crypto mining

- **Here:** Much clearer case that crypto is a part of the firm's "core business" (though Enterprise Value isn't even used for banks)

- **Crypto:** Measured at fair value, with changes in fair value (Unrealized Gains and Losses) directly on the P&L

A "Bank's" Crypto Treatment (Galaxy Digital)

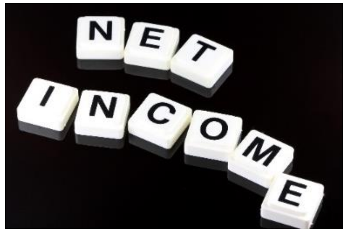
- **Overall:** Reasonable treatment on the statements, given the type of company and its other business lines

- **Only Quirk:** No taxes because it's a Limited Partnership – flow-through entity where the individual Partners pay taxes on their share of the profits

- **So:** No Deferred Tax impact from Unrealized Gains and Losses on crypto, either, because there are no corporate-level taxes to defer or eventually pay

Broader Issues with Net Income

- **Truth:** Net Income was never a great metric to use for valuation purposes because it's so easily distorted by capital structure, taxes, one-time items, etc.



- **But:** It has become even worse lately because of all these issues and other accounting rule changes (such as recording Unrealized Gains and Losses on the Income Statement)

- **Warren Buffett** has even pointed out some of these issues in his annual reports…

Broader Issues with Net Income

- Quotes from his 2017 shareholder letter:

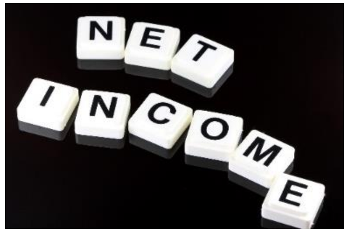
The new rule says that the net change in *unrealized* investment gains and losses in stocks we hold must be included in all net income figures we report to you. That requirement will produce some truly wild and capricious swings in our GAAP bottom-line. Berkshire owns $170 billion of marketable stocks (not including our shares of Kraft Heinz), and the value of these holdings can easily swing by $10 billion or more within a quarterly reporting period. Including gyrations of that magnitude in reported net income will swamp the truly important numbers that describe our operating performance. For analytical purposes, Berkshire's "bottom-line" will be useless.

With the new rule about unrealized gains exacerbating the distortion caused by the existing rules applying to realized gains, we will take pains every quarter to explain the adjustments you need in order to make sense of our numbers. But televised commentary on earnings releases is often instantaneous with their receipt, and newspaper headlines almost always focus on the year-over-year change in GAAP net income. Consequently, media reports sometimes highlight figures that unnecessarily frighten or encourage many readers or viewers.

- **So:** As more companies start using crypto and other "Digital Assets," these issues will get even worse – especially because they might record only Unrealized Losses!

Valuation Multiples and Methodologies

- **Net Income and P / E:** Far less useful than before for all the normal reasons, *plus* these Unrealized Gains and Losses distorting the numbers



- **Enterprise Value:** Must be very careful about what counts as a "core business Asset" – we don't think Bitcoin / Ethereum etc. should be in this category *for most companies*

- **DCF:** Not much changes because crypto doesn't generate cash flow, and even if it did, it would not count in Unlevered FCF

- **So:** Just be careful about the items in the Implied Enterprise Value to Implied Equity Value bridge at the end

Recap and Summary

- **Part 1:** The Basics on the Statements (MSTR and TSLA)

- **Part 2:** How a "Bank" (Galaxy Digital) Does It

- **Part 3:** The Broader Issue(s) with Net Income

- **Part 4:** Impact on Valuation Multiples and Methodologies