



Staking crypto assets

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Crypto as an asset class: Risks and opportunities of “staking” your claim

Notwithstanding current market volatility, staking activity is on the rise in the crypto ecosystem and is of considerable interest to asset managers. As funds have begun to invest, or expand their investments, in crypto assets that use a proof-of-stake consensus mechanism, staking has become, in general, an attractive means to earn passive investment income on a fund’s crypto assets.

Recently proposed federal legislation aims to address the regulatory landscape for crypto assets, including staking. Investment funds investing in crypto assets and involved in crypto staking should familiarize themselves with their underlying assets and the nuances of current frameworks to manage risk and regulatory compliance. And while regulators (e.g. the U.S. Securities and Exchange Commission) and the Financial Accounting Standards Board (FASB)¹ are beginning to address certain crypto asset accounting matters, there is no authoritative guidance on accounting for staking. Therefore, investment companies engaging in staking activities should thoughtfully consider what aspects of the current guidance in U.S. Generally Accepted Accounting Principles (U.S. GAAP) apply to their staking activities.

As we noted in our previous piece, *Crypto as an asset class*², the crypto ecosystem continues to evolve. Staking, as well as non-fungible tokens (NFTs) and decentralized finance (DeFi) more broadly, raise additional new accounting and regulatory considerations for asset managers. Consequently, asset managers should holistically consider the accounting and regulatory impacts of their investment activities.

What is staking?

Because blockchain networks are decentralized, they use consensus mechanisms such as proof-of-stake or proof-of-work to validate transactions. Solana and Polkadot are two examples of blockchains that operate on the proof-of-stake model, while Bitcoin is an example of a blockchain that operates on a proof-of-work model. On proof-of-stake blockchains, holders of the blockchain’s native crypto asset can bond, or stake, their tokens to the network. During the staking period, the tokens are restricted from being traded freely. In return, the asset owner (or its delegate) receives opportunities to validate transactions and earn staking rewards, which are typically newly minted tokens. Notably, staked assets are at a risk of loss, called slashing, which refers to the entity’s staked tokens being confiscated for not abiding by the blockchain’s requirements and either burned (i.e. removed from circulation) or redistributed to other entities staking on the network.

¹ KPMG US, *SAB 121: Questions & Answers*, April 2022, <https://frv.kpmg.us/reference-library/2022/sab-121-questions-and-answers.html>; *FASB takes on accounting for digital assets*, May 2022, <https://frv.kpmg.us/reference-library/2022/fasb-takes-on-accounting-for-digital-assets.html>.

² KPMG US, *Crypto as an Asset Class: What Asset Managers Should Know Before Going Crypto*, February 2022, <https://info.kpmg.us/news-perspectives/advancing-the-profession/crypto-as-an-asset-class.html>.

Staking through a third-party custodian

Most investment companies hold their crypto assets with third-party custodians and use those custodians to stake their tokens – i.e. they delegate their stake to the custodians, who then undertake the validation of blockchain transactions. Custodians often offer beneficial infrastructure, including technology and trained staff, provide the resources for staking activities and typically shoulder the risk of slashing.

Delegated staking gives rise to a host of questions for investment companies to consider, given the lack of authoritative guidance on accounting for staked crypto assets and staking activities. It is important to understand how accounting conclusions may differ based on the staking protocols of the specific blockchain and the provisions of the staking service agreement (or addendum) between the investment company and the custodian (or other party to whom it may have delegated its stake).

Investment company designation

Under U.S. GAAP, investment companies are defined as companies that do not have significant activities outside of investing. Staking activity must be considered in the assessment of whether a fund meets that definition. However, for the majority of funds who stake assets via a trusted validator (e.g. their third-party custodian), staking is likely a permissible investment activity under that definition, similar to securities lending.³

Accounting for the staked crypto assets

To begin with, when holding crypto assets with a third-party custodian, it is important to analyze whether, for accounting purposes, the fund owns and should record the crypto assets being custodied, or whether, instead, the fund has and should record a contractual receivable or other right from the third party that is tied to the value of a crypto asset but does not represent current ownership of the crypto asset itself. The determination of whether an investment company holds a crypto asset or a receivable is expected to affect how the investment is presented in the schedule of investments.⁴

If the investment company owns staked crypto assets, it generally will not derecognize those assets while they are staked. This is because neither the custodian, nor any other entity, obtains the right to direct the use of those staked assets during that time and, in any event, the investment company's right to de-stake the assets is akin to a call option thereon that would preclude derecognition.

Accounting for staking rewards⁵

It is crucial to carefully consider both the blockchain's staking protocols and the investment company's agreement with the custodian (i.e. the "validator" of blockchain transactions) to determine how to account for staking rewards earned. Typically, this will lead to a conclusion that the custodian is the principal to the blockchain validation activities, and therefore the investment company's staking revenue is net of the staking rewards remitted to the validator.

³ KPMG US, *Accounting for crypto assets by investment companies*, April 2022, <https://frv.kpmg.us/reference-library/2022/accounting-for-crypto-assets-by-investment-companies.html>.

⁴ KPMG US, *Accounting for crypto assets by investment companies*, April 2022, <https://frv.kpmg.us/reference-library/2022/accounting-for-crypto-assets-by-investment-companies.html>; *Evaluating custody of digital assets*, March 2022, <https://frv.kpmg.us/reference-library/2022/evaluating-custody-of-digital-assets.html>.

⁵ KPMG US, *Accounting for crypto assets by investment companies*, April 2022, <https://frv.kpmg.us/reference-library/2022/accounting-for-crypto-assets-by-investment-companies.html>; *Accounting for crypto staking rewards*, August 2022, <https://frv.kpmg.us/reference-library/2022/accounting-for-crypto-staking-rewards.html>

Staking, whether through a third-party or not, will typically meet the U.S. GAAP definition of “revenue.” And when staking through a third-party, as most investment companies do presently, staking rewards will typically qualify as revenue from a contract with a customer subject to Topic 606 (revenue from contracts with customers). Be particularly cognizant of Topic 606’s requirements on (1) non-cash consideration given that crypto assets accounted for as intangible assets constitute non-cash consideration and (2) contract inception and term. In our experience, investment companies generally classify staking revenue as a component of investment income.

Consider the following when staking through a third party:

- **The terms of the contract with the custodian.** Will the custodian take on the risk of slashing? What percentage of the rewards will be taken by the third-party provider, and is there an annual fee provision? Do the terms of the contract with the custodian refer to or deviate from the blockchain’s staking protocols (e.g. in terms of when and how the investment company can stake and de-stake its tokens)? Depending on the scale of expected staking activity and its possible effect on investment company status under Topic 946 (see Investment company designation section above), investment companies might consider procuring the human resources and hardware to conduct staking activities directly.
- **The staking protocols of the blockchain network.** Can the investment company de-stake at any time, or must it remain staked for a set period of time (e.g. an “epoch,” the term for a staking rewards cycle)? Does the blockchain have warm-up/cool-down and/or bonding/unbonding periods? This can affect how Topic 606 looks at contract inception and contract term, which can in turn affect how the non-cash staking rewards are measured for revenue recognition purposes.
- **Whether the custodian has a SOC report (usually a SOC I Type II attestation report), and if so, if it covers staking.** Without an appropriate attestation report, the investment manager may be required to perform additional procedures to validate that the custodian has appropriately handled fund assets.

Presenting staked crypto assets

Investment companies involved in staking crypto assets must closely analyze the nature of the underlying assets to present them on the balance sheet. Through different lenses, the asset could be presented as a coin/token, a contract, a receivable, or a derivative. Staked assets could be considered as separate from freely held assets or presented as a restricted asset, analogous to restricted securities in traditional finance. The presentation might also depend on whether the investment involves a smart contract run on the blockchain.

The 24/7/365 dynamic of the crypto market and the fact that staked tokens are temporarily unavailable to the asset holder also create unusual accounting scenarios. Careful consideration is necessary when preparing P&L statements and schedules of investments.

Disclosing risk to increase trust and transparency

Disclosure best practices are still emerging, and investment companies should consider what risk disclosures should be included in any discussion of staked assets and slashing. These may include:

- Disclosing events that lead to slashing (such as errors or malfeasance)
- Quantifying the potential effects of slashing
- Disclosing any contractual arrangements related to slashing

What to know before you go

The evolving regulatory environment and ongoing market volatility spotlight the need for investment companies considering investing in crypto assets to fully understand the current accounting frameworks and how to apply them to this emerging asset class.

Given that the accounting literature on staking has yet to be written, investment companies can put themselves in the best possible position by understanding the individual circumstances of their staking activities, which can differ by blockchain and by third-party validator.



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