

NEW RISK ALERT: (SQ)

Square Flips Bitcoin to Drive Revenue, Not Profits

Latest 10-K reveals Bitcoin as single greatest driver of Squares's revenue but a low margin endeavor.

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This alert compares the language used in the company's latest filing with the period before. [Research](#) suggests changes in language, particularly in the risk factor section, is a powerful indicator of future performance. Companies that change filing language, according to research, underperform those that don't by 30-50 basis points per month for the following year.

Square Flips Bitcoin to Cash App Customers

Square, a digital payment, ecommerce, and point-of-sale solutions provider that is also now a bitcoin proxy, recently purchased a total of \$220 million in bitcoin. The company purchased \$50 million in October 2020 and \$170 million in February 2021.

Square buys bitcoin from private broker dealers or from Cash App customers and marks it up before selling it to customers. In accounting for the transactions, the sale amounts received from customers are recorded as revenue on a gross basis and the associated bitcoin cost as cost of revenues.

In its 2020 [10-K](#), Square includes new language detailing its risk in these transactions:

*"We have determined we are the principal because we control the bitcoin before delivery to the customer, we are primarily responsible for the delivery of the bitcoin to the customer, **we are exposed to risks arising from fluctuations of the market price of bitcoin before delivery to the customer, and we have discretion in setting prices charged to the customer.** Bitcoin revenue may fluctuate as a result of changes in customer demand or the market price of bitcoin."*

Square says it purchases bitcoin to provide customers access to bitcoin. The altruism is evident in the slim margins bitcoin produces, but the company's bitcoin purchases also expose it to significant risk and potentially unfavorable accounting treatment that may adversely impact financial results.

Nearly Half of Square's Revenue is Bitcoin

Our analysis reveals Bitcoin accounted for nearly half of Square's revenue in 2020 and nearly all of the company's revenue growth. In 2020, Square's revenue increased by \$4.8 billion, or 101%, compared to the previous year.

Bitcoin revenue increased by \$4.1 billion, and represented 85% of the increase in total net revenue. If we exclude bitcoin revenue, total net revenue increased by \$729 million, or 17%, in 2020, compared to the previous year.

Revenue (in thousands, except for percentages)

	Year Ended December 31,			
	2020	2019	\$ Change	% Change
Transaction-based revenue	\$ 3,294,978	\$ 3,081,074	\$ 213,904	7 %
Subscription and services-based revenue	1,539,403	1,031,456	507,947	49 %
Hardware revenue	91,654	84,505	7,149	8 %
Bitcoin revenue	4,571,543	516,465	4,055,078	785 %
Total net revenue	\$ 9,497,578	\$ 4,713,500	\$ 4,784,078	101 %

In its latest annual report, Square attributed the growth to the following:

"The increase was due to the market price of bitcoin, growth in the number of active bitcoin customers, as well as volume per customer. The amount of bitcoin revenue recognized will fluctuate depending on customer demand as well as changes in the market price of bitcoin."

Though bitcoin is a significant portion of Square's revenue, it's just a sliver of the company's gross margin. Bitcoin costs—the amount Square pays to purchase Bitcoin before marking it up and selling it to customers—rose by \$4 billion or 780% versus the year prior. Gross margin generated from bitcoin was just 3.5% of Square's total gross margin.

It means bitcoin accounts for just \$95.6 million of Square's \$2.7 billion gross profit. The bitcoin gross profit contribution, albeit relatively small, did provide a cushion against Square's \$18.8 million operating loss in 2020. The reason Square posted net income of \$213 million in 2020, was due in large part to the company's equity stake in DoorDash, which resulted in a post-IPO mark-to-market gain of \$276.3 million.

Bitcoin Exposure May Result in Unfavorable Accounting Results

The \$50 million in bitcoin Square purchased in November was worth \$136.5 million when the company closed its books on December 31, 2020. Square did not disclose in its latest annual report the market value of the \$170 million in bitcoin purchased in February 2021. So long as bitcoin remains above the price Square paid for it, investors have little to worry about.

However, the company did outline the risk to investors should the price of bitcoin reverse:

“If the market value of the bitcoin we hold decreases relative to the purchase prices, our financial condition may be adversely impacted.”

Unlike its equity stake in DoorDash, Square can't simply account for bitcoin by marking it to market. Under current accounting rules, bitcoin is classified as an indefinite-lived intangible asset. If bitcoin falls below its book value— the price Square paid for it— the company will have to recognize an impairment charge for the difference. Importantly, if bitcoin were to rise substantially after falling below Square's book value, the company cannot revise, mark-to-market, or recognize any gain until it sells the bitcoin.

“After an impairment loss is recognized, the adjusted carrying amount of bitcoin becomes its new accounting basis. A subsequent reversal of a previously recognized impairment loss is prohibited until the sale of the asset.”

Extreme volatility has been the norm for bitcoin recently. It means that the price of bitcoin on the dates Square closes its books each quarter may have an outsized impact on its reported results:

“As the number of customers who use our bitcoin product has increased and the value of bitcoins we hold on behalf of such customers has grown significantly, the risks and consequences of such adverse events have increased and could materially and adversely affect our business.”

Square purchased another \$170 million just before it filed its 2020 10-K in February 2021. The company says it may buy more and expects to hold it as a long term investment. For investors not in Square solely as a bitcoin proxy, it'll be vital to translate the company's accounting earnings into economic earnings.