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Chinese Water Accounting Is Slippery When Wet

Accounting leeway has kept profits afloat for Beijing Enterprises Water

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A general view of Beijing's central business district. PHOTO: GETTY IMAGES

China's commitment to environmentalism isn't the only thing that has helped its sewage-treatment companies float. Accounting leeway, too, has done so in a way that could prove unsanitary for investors in Beijing Enterprises Water.

In the last three years, shares in Hong Kong-listed BEW almost tripled as local governments tapped it to build sewage plants. In many cases, the company builds the plants, operates them for 30 years and then transfers them back to the government.

Yet before the plants have begun operating, BEW promptly recognizes profits. This is permissible under international accounting rules for projects where governments have guaranteed the revenues once the plant is up and running.

The point of such treatment is to smooth out the profit picture over the life of a project. But smoothing can distort: it gives companies the chance to front-load profits. While critics of fair-value accounting have long derided what they say is an unfair impact it can have on losses, a bigger gripe is that companies can sometimes use it to make gains bigger.

Not only that, the process is subjective. It involves imagination on the company's part, and one way to do so is basing profit on capital expenditure for a project. While constructing a sewage plant, BEW derives a "fair value" construction revenue and gross margin.

BEW recognizes a receivable on its balance sheet equal to the construction revenue. Since the project's future revenues are guaranteed by the government, BEW acts as if it is lending money to the government for 30 years. So it declares interest income from the receivable, at a rate it estimates, as if the government were servicing the loan. This further pads profits.

The risk for investors is the leeway this allows in deciding how much profit to book in the early years. For instance, in 2014, BEW said its build-operate-transfer projects would earn a gross margin of 24% on construction. That was much higher than the 11% in 2013.

Why? The company attributed this in filings to "valuation parameters" changing.

Thanks to this accounting treatment, construction profits from such projects zoomed sevenfold in 2014 from the year before. These equated to about 26% of net profit attributable to shareholders during the year ending June, compared with 6% in all of 2013.

Such project construction is also heavily supporting the top line. In its latest filing for the first half of 2015, revenue from this source was higher than that from operating water-treatment projects. Meanwhile, receivables from such concession agreements were worth 112% of book value as of June.

But operating cash flow has been negative for most of the past decade. To fund projects, BEW relied mostly on borrowings. Net debt was 89% of equity in June, compared with 33% in 2013.

BEW's profits could decline in the years ahead. New projects in the first half of 2015 fell 71% from the year before. The market may have begun getting saturated since, by 2013, nine out of 10 Chinese cities were already treating their wastewater, according to Daiwa.

BEW is now buying other water companies and projects, another way to grow. But with some of the projects past their construction phase, BEW won't get to book the high construction margins that buoyed the top and bottom lines. It can book operating revenue from the acquired projects, but in a given year, this is likely smaller.

Expect BEW's revenue and earnings to eventually start hurting. Investors should take a close look before the sewage starts to smell.

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