IFRIC 12 in Nepal's Hydropower: Why Construction Profits Don't Mean What You Think

Imagine building a factory, reporting profits throughout construction, then watching those profits reverse once production begins. This is the financial reality for Nepal's hydropower companies under IFRIC 12—a standard that fundamentally changes how we interpret their financial performance.

What is IFRIC 12?

IFRIC 12 (Service Concession Arrangements) is an accounting standard that applies when a private company builds and operates infrastructure for a public entity under specific conditions. In Nepal's hydropower sector, this typically involves companies building power plants that will eventually be transferred to the government.

Key Parties in Concession Arrangements

- Operator: A private sector company responsible for building, improving, and maintaining the infrastructure used to provide a public service.
- Grantor: A public sector entity that represents the government and is responsible for managing the resources delivered to the private entity.

Three Accounting Models

IFRIC 12 identified two types of service concession arrangements: One in which the operator has a contractual right to receive cash or another financial asset from the government. One in which the operator has the right to charge for access to the service that it supplies.

1. Financial Asset Model

When to Apply: The operator has an unconditional contractual right to receive payments from the concession grantor, irrespective of the amount of use made of the infrastructure

Key Features:

- Operator receives guaranteed payments from the government
- Revenue comes from the grantor, not from users
- User fees (if any) are collected on behalf of the government
- Operator recognizes a financial receivable
- Asset is measured at fair value or cost plus margin

Accounting Treatment:

- Recognize financial asset during construction phase
- Apply effective interest method for subsequent measurement
- Interest income recognized over the concession period
- No infrastructure recorded as PPE

2. Intangible Asset Model

When to Apply: The grantor entity gives the operator the license to exploit the infrastructure built... The operator recognizes an intangible asset if it receives only a right to charge for the use of the public sector asset that it constructs or upgrades

Key Features:

- Operator has the right to charge users directly
- Revenue depends on actual usage of the infrastructure
- Demand risk is borne by the operator
- Operator recognizes an intangible asset

Accounting Treatment:

- Recognize intangible asset during construction phase
- Amortize over the concession period
- Revenue recognized from user charges under IFRS 15
- Borrowing costs can be capitalized under IAS 23

3. Bifurcated (Mixed) Model

When to Apply: IFRIC 12 allows for the possibility that both types of consideration may exist within a single contract

Key Conditions for IFRIC 12 Application in hydropower.

For IFRIC 12 to apply, two conditions must be met:

1. Grantor Control Over Services

- The government (grantor) determines what service must be provided (electricity generation)
- Who it's provided to (NEA - Nepal Electricity Authority)
- At what price (through Power Purchase Agreements)

2. Government Retains Ultimate Control

- After 35-50 years, the hydropower project must be handed over to the Nepalese government
- The government maintains significant residual interest in the asset

Accounting Impact During Construction

Traditional Accounting vs. IFRIC 12:

- Without IFRIC 12: Assets recorded as Property, Plant & Equipment (PPE)

- With IFRIC 12: Assets recorded as Intangible Assets, treated as construction contracts

Revenue Recognition:

- Companies act as contractors, not owners
- Revenue includes actual costs PLUS a "developer premium" (margin)
- This premium is often calculated using Internal Rate of Return (IRR) as a benchmark
- For example: If IRR is 15%, then 15% of costs incurred becomes the margin

Why This Matters for Investors

During Construction Phase:

- Companies show high profits that aren't real cash flows
- These profits get capitalized as intangible assets
- Can create misleading impressions of actual performance

During Operation Phase:

- The intangible assets are amortized over the project's life
- The construction-phase "profits" get reversed through amortization
- This balances out the inflated construction-phase earnings

Valuation Implications

For Investment Analysis:

- Construction-phase EPS includes artificial contract profits
- Better to use forward EPS from the operational phase
- Discount future operational earnings at risk-free rate for valuation
- Consider future amortization expenses in forecasts

Conclusion

IFRIC 12 creates a timing difference - profits are front-loaded during construction but then amortized during operations, creating a more complex but ultimately balanced accounting picture over the project's full lifecycle.

This standard essentially treats hydropower companies as contractors building assets for the government rather than as owners of power generation facilities.