Cristal Advocates

Accounts Receivable Financing in Uganda

The Legal and Commercial Issues

Cristal Thought Leadership Series

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1. Introduction

This publication provides an overview of the legal and commercial issues relevant to the technique of accounts receivable financing that some business enterprises in Uganda use to raise funds for their operations.

Accounts receivable represent the balance of funds due to a business for goods and services provided but not yet paid for by customers.

Accounts receivable (also known as trade receivables) are recorded as part of the current assets of a business in its balance sheet or statement of financial position. Accounts receivable financing enables traders to receive early payment on their outstanding invoices.

A business using accounts receivable financing commits some or all of its outstanding invoices to a funder for early payment. The funder earns a fee for the finances advanced.

2. Accounts receivable financing

There are two categories of accounts receivable financing namely invoice discounting and debt factoring. Both are transitional sources of finances that can carry a business through a time when it does not qualify for traditional bank financing (e.g. a start-up or temporary business downturn) until its balance sheet is strengthened sufficiently to become bankable.

(a) Invoice discounting

Invoice discounting is a secured borrowing transaction more like a traditional bank loan but with some differences. Bank loans are secured by collateral that can include though not limited to fixed assets while invoice discounting is backed by a pledge of the unpaid invoices.

Under the invoice discounting arrangement, typically over 70% of the business qualifying receivables establish the base against which money is borrowed. The financing entity charges a collateral monthly management against the outstanding invoice amount. Interest is also imposed by the funding institution on the actual amount of money borrowed against the qualifying receivables base. To count towards the receivables borrowing base, an invoice must be evaluated as collectible and creditworthy by the financing company.

Invoice discounting is generally cheaper than debt factoring and it is also easier to move to a traditional bank line of credit when the business becomes bankable again for traditional financing.

(b) Debt factoring

Debt factoring is an arrangement where the funder or factor purchases the business trade receivables outright and is entitled to the full proceeds of the settlement of the receivables acquired.

Normally, the funder advances to the business finances in excess of 70% of the value of the receivables purchased. The funder earns a factoring fee which is based on the total value of the purchased invoices commercially determined by reference to the assessment of the collection risk. The balance, less the factoring fee, is paid to the business when the invoice is collected.

The business can choose the invoices to sell under the debt factoring arrangement. Once the invoices are purchased, the factor manages the receivables including following up on payment. By determining which invoices to sell to a factor, debt factoring offers more flexibility than accounts receivable financing.

3. Legal considerations

It is important that the legal form of the envisaged receivables financing transaction meets the expectations and intention of the parties. Though both are classified as receivable financing transactions, the legal substance of invoice discounting and debt factoring differs given that the former represents a secured borrowing transaction and the latter an outright sale of receivables. Below are some of the legal issues to take into account while reviewing accounts receivable financing arrangements.

a) Formal legal contract

Trade receivables arise on the sale of goods or services by a business to a buyer originating a debt that is booked as an asset by the business. It is therefore important to have in place a properly executed contract

between the parties to the transaction. In the absence of this, it is difficult to establish the contractual terms of the transaction purportedly crystallising a trade receivable.

b) Receivables due diligence

Given the risk of fraud, a proper due diligence should be carried out on the receivables in question the basis of the proposed financing.

c) Assignment of receivables restriction

Some sale contracts restrict the transfer or assignment of rights held by the supplier to any other party without the consent of the buyer. If the supplier purports to transfer and assign the receivable to the financier in breach of such a restriction, the transfer or assignment is not valid against the buyer.

d) Dillution of receivables

Receivables may be subject to set-off rights, rebates, discounts, or penalties that may erode the value of the receivables that the financing company is purchasing.

e) Contracting parties

It is important to ensure that the receivable is bought from the correct entity, i.e. the one which owns the receivable otherwise the underlying transaction may be void from outset.

4. Accounting considerations

The accounting treatment of trade receivable financing arrangements depends on whether the transaction is an outright purchase or secured borrowing. This is a determination that is made on the basis of all facts, circumstances and economics of the transaction.

Revisions to accounting standards have significantly altered the accounting analysis of receivables financing making it more likely that common structures used are to be accounted for as secured borrowing or invoice discounting.

Accounting for trade receivable financing as outright sale or debt factoring has become more difficult but not impossible.

Whether a transfer of receivables is accounted for as a sale or secured borrowing is therefore premised on who controls the asset after the transfer is complete. A key consideration of control is whether the transferred assets have been isolated beyond the reach of the transferor and its creditors. The evaluation of whether this requirement has been met is generally based on an analysis of the legal implications of the terms of the receivables transfer.

(a) Outright sale

An outright sale of trade receivables requires that the seller surrenders control over the receivables. Specific guidance is provided by accounting guidelines to determine if the seller has indeed surrendered control. If these requirements of surrendering control are met, then the receivables are removed from the seller's books and a gain or loss is recognised. The buyer then records the receivables received on its books at fair value.

The direct sales or transfers of receivables to third parties with no continuing involvement by the transferor are generally straightforward and easily qualify as an outright sale provided control has been surrendered. Whether the control of receivables has been surrendered is mainly a legal determination and not an accounting one.

(b) Secured borrowing

In case of a secured borrowing, the business maintains the receivables on its books, records a liability, and recognises interest expense over the term of the loan. Transfers of receivables with continuing involvement by the transferor present challenges and usually require a much more detailed analysis to confirm that the transferor has ceded control.

Continuing involvement refers to any involvement by the business after the receivables have been transferred and includes any involvement that permits the seller to receive cash flows or other benefits that arise from the purportedly sold receivables. The usual approach based on accounting standards is to treat such transactions as secured borrowing. Involvement with respect to transferred receivables can include: obtaining servicing of the financial assets, pledges of collateral, commitment to transfer more financial assets; representations and warranties with respect to the transferred receivables.

5. Tax considerations

Tax accounting ordinarily follows the rules of generally accepted accounting principles though there are instances when the tax and accounting position can differ.

(a) **Secured Borrowing transaction**

As already highlighted above, invoice discounting is classified as a secured borrowing transaction following from which the tax consequences set out below:

- A secured borrowing transaction is a financial transaction. Financial services in Uganda are exempt from Value Added Tax ("VAT"). Financial services are defined under the VAT Act to include amongst others the granting, negotiating and dealing with loans, creditors, credit guarantees and any security for money including management of loans, credit or credit guarantees by the grantor;
- The interest repayment on the funds advanced to the borrower is potentially subject to withholding tax ("WHT);
- Stamp duty is chargeable on the instruments executed to perfect the transaction.

(b) **Outright sale**

Debt factoring transactions are typically treated as outright sales following from which the following tax consequences below:

- Debt factoring arrangements attract VAT in Uganda at the standard rate of 18%;
- On assignment of the receivables as an outright sale, the seller recognises a loss or gain on disposal. It is unlikely a gain can arise on a debt factoring transaction but if it does, the gain is taxable for corporate income tax purposes while the loss on disposal is deductible for corporate income tax purposes;
- Stamp duty is chargeable on the instruments executed to perfect the transaction.

6. Conclusion

It is not surprising that accounts receivable financing is gaining popularity in Uganda considering it gives business the opportunity to convert credit sales into immediate cash flow easing operational working capital requirements. It frees up valuable time previously spent on chasing debtors that can be devoted towards building the business. ■

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At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

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From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

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Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

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Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

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