Public version

Inventory Finance at Thales Nederland B.V.

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Public summary

This paper focuses on potential off-balance sheet inventory finance solutions entering the domain of working capital optimization. The purpose is not to enhance efficiency in the cash conversion cycle through more efficient operations, but to analyze aspects that come along with off-balance sheet inventory finance by involving a third party in this process, i.e. management of one of the working capital elements, being inventory and the accounting standards related to off-balance sheet inventory finance.

Thales NL as part of the French defense electronics concern is keen on investigating on this less common form of financing. Over the last years it has made considerable use of standard trade finance and balance sheet debt. However, the finance needed due to large inventory and work in progress remains. This is an additional burden on the already capital-intensive industry of Thales due to its lengthy and high value operations. Moreover, inventory finance could provide possibilities for off-balance sheet financing and consequently will have a positive effect on a company's solvency. This could positively contribute in maintaining access to external capital.

The central research question is: *Which aspects are relevant in off-balance sheet inventory finance accounting in general and specifically for Thales NL?* The central research question is divided into six sub-questions. The purpose of this paper is to come to a well funded theoretical and practical answer on the central research question.

The core working capital component in this paper is inventory. Other working capital components are accounts receivable, cash and accounts payable. Especially the type of inventory, the magnitude and cycle times of the inventory are aspects to take into account in off-balance sheet inventory finance. To measure inventory cycle times in an organization, the operating cycle as part of the cash conversion cycle is an appropriate instrument because of its dynamic measurement of liquidity (Hager, 1976). Working capital is a reflection of a company's liquidity. There is always money locked up in working capital. The extent of this locked liquidity is largely industry dependent. Thales as a group acts in a business with long operating cycle times, entailing a large claim on the company's working capital. Between 2005 and 2009, the operating cycle of Thales SA is around 190 days. A possibility to reduce working capital is to decrease the inventory and accounts receivable position of a company or to increase accounts payable, but this is not the domain of this paper. The focus is on inventory finance as a tool to manage working capital. In the literature, inventory finance is described as a form of asset-based finance in which inventory is used as collateral in a loan, ensuring that the lender is entitled to the goods if the borrower does not pay. Initially, it seems that IFRS

accounting standards simply forbid off-balance sheet inventory finance, but this paper demonstrates that there are possibilities to do this. An aspect for a transaction to be accounted off-balance is whether it is a true sale or not. When determining if a transaction is a true sale, recognition of assets and liabilities, and the risks and rewards of ownership are key aspects.

After analyzing the literature and accounting standards, there was no indication that inventory finance could be accounted off-balance sheet. At this point the case study regarding inventory finance possibilities at Thales NL started. Given the great diversity of inventory at Thales NL, the IFF component is selected to serve as benchmark for further application of inventory finance solutions at Thales NL.

A structure is designed that makes it possible for a company to come to an off-balance sheet inventory finance solution. The most important aspect is that the inventory will be bought directly from the supplier by a third party in the form of a financial institution, without creating a debt position on the balance sheet of the company. Contradictory to a repurchase agreement where the buy-and-sale back structure does not lead to the desired off-balance sheet structure, this structure could possibly be accounted off-balance sheet because the risks are completely for the third party during their period of ownership, a true sale analysis is justified and the financier will act as principal and not an agent. However, some IFRS fundamentals should always be taken into account in a financial transaction. Despite the fact that the legal form of the solution seems not to be a problem, interpretation of the substance of the transaction could give another view for a company's auditor to assess the transaction. IFRS requires substance over form, so a company's auditor will capture a key role in the decision process. Beside this, a company should consider if the financing costs of the off-balance sheet inventory finance structure does not exceed the opportunity costs of the company. The optimization of financing costs as strategic business objective is initially the primary goal, off-balance sheet inventory finance could serve as a mean to realize this.

The results of this case study are not exclusively applicable to Thales. They could also serve as starting point for other companies that are interested in the topic of working capital optimization through off-balance sheet inventory finance.