To Lockbox or Not to Lockbox?

Despite conventional wisdom, a lockbox is not always the optimal collection solution

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Despite the availability of bank lockbox services for almost forty years, many companies with geographically diverse customer bases still receive and process customer payments at their corporate headquarters or at dispersed subsidiary offices. A bank lockbox service is designed to accelerate check collections by reducing float and many companies view the lockbox as a natural step in the evolution of their collection system.

NLRussell Associates has worked with a number of mid-to large-sized U.S. companies that are seeking to improve their collection processes. We have found that conventional lockbox float analyses (often performed for companies by banks seeking to sell their lockbox services) almost always miss key issues essential to identifying a company's optimal collection solution. Because each company's profile and characteristics are unique, many factors come into play. The following two cases serve to illustrate this.

CASE ONE

Collection Overview

A multi-billion dollar U.S. company has extensive business operations in Latin America. It also manages a $250 million export division based in Miami, Florida, which sells products (billed in US Dollars) to companies located in the Caribbean and Central America. Export division customers remit payment by wire transfer, corporate check and cashier's check. Corporate checks are received by mail or overnight courier service. Other export division customers (those not eligible for credit terms) pay in person at the Miami office using cashier's checks. For an hour or two each afternoon, a clerk in the export division office processes the corporate and cashier's checks for pick up by a local courier service at 4 p.m. each business day. Deposits are made the next morning to a local bank. Among other things, the company wanted to accelerate its cash flow and reduce its days sales outstanding (DSO) and asked NLRussell Associates to evaluate the potential benefits of a lockbox.

Analysis

By sampling the company's top customers and actual collections, we calculated the current distribution of customer payment methods (see Table 1).

Based upon a sample of all corporate checks received during a two-week period in the Miami office, we calculated that approximately 60% ($74 million) were sent via overnight courier and 40% ($50 million) via U.S. mail. Of all corporate checks received by mail, about 58% were drawn on Florida bank accounts, many of them from Miami branches. We calculated that the current total collection float on these items averaged four days. An initial assessment projected that a Miami-based lockbox might reduce float by up to 2.5 days (see Table 2A).

To validate the benefits of using a lockbox, we evaluated several banks that offered lockbox services in Florida. We identified three key problem areas.

Table 1 - Estimated Annual Revenue by Customer Payment Method

Amount received via wire transfer	$ 65.5 million
Amount received via corporate check - office	$ 124.0 million
Amount received via cashier's check/money order - office	$ 60.0 million
Total amount (approximate annual sales revenue)	$ 249.5 million

Table 2A - Potential Float Savings with Lockbox

Collection Method	Mail Float	Processing Float	Availability Float	Total Float
Office (current)	2 days	1 day	1 day	4.0 days
Lockbox (assumed Miami)	1 day	0 days	0.5 days	1.5 days
Potential Float Savings with Lockbox	1 day	1 day	0.5 day	2.5 days

First, none of the banks actually offered a full-service lockbox in Miami; the closest full-service lockbox site was Orlando, FL. Based on the float studies provided by the banks, we calculated that using Orlando would add over one day to the company's current collection mail float. We determined this when, during the sampling of actual receipts, we found that more than 50% of U.S. mail received at the company's Miami office was postmarked from customer locations in Puerto Rico and Southern Florida. In fact, mail from Puerto Rico first enters mainland U.S. through the Miami post office.

Second, the bank lockbox services had internal cutoffs between 9:00 a.m. and 10:30 a.m. for the receipt and processing of items sent via overnight courier for same day credit. Since it is unlikely that the majority of checks sent by overnight courier would arrive before those early morning deadlines, the lockbox would be unable to process and deposit these items any faster than the company already does.

Third, over 50% of all checks received are drawn on Florida-based bank branches. Thus, the company was already receiving good funds availability on its deposits. Use of a lockbox would not improve that availability.

Recommendations

Considering all of the above factors, we estimated that a lockbox might improve collections by a half-day. However, the added expense of the lockbox service far exceeded a half-day improvement in collection float.

Table 2B - Actual Float Savings with Lockbox

Collection Method	Mail Float	Processing Float	Availability Float	Total Float
Office (current)	2 days	1 day	1 day	4.0 days
Lockbox (Orlando)	2 days	0.75 days	0.75 days	3.5 days
Actual Float Savings with Lockbox	0 days	0.25 days	0.25 days	0.5 days

As an alternative to a lockbox, we looked at the feasibility of the local office making its daily deposit to the bank earlier in the day. This would provide a one-day improvement over the current system. However, checks received at the office via U.S. mail and overnight courier typically arrived in the early afternoon and cashier's checks were received throughout the day. Given each of the local banks had a mid-afternoon ledger credit cut-off time, there would not be ample time to process the office receipts in time to meet this same-day deposit deadline.

Based on the characteristics of the company's receipts, we recommended the following solutions:

1. Establish wire transfer as the "preferred" method of payment for all Caribbean and Central American customers. This would greatly reduce (and potentially eliminate) the number of checks sent via overnight courier. For companies located in the Caribbean and Central America, wire transfer is a commonly accepted method of making US Dollar payments. Also, the cost of a wire transfer would not be more costly than what these customers were already spending to send checks using international overnight courier services.
2. Establish web-based information reporting to monitor incoming wire transfers and facilitate more timely posting of accounts receivable information.

The projected benefits from making these changes was a 4 to 5 day acceleration in payments received via overnight courier from Central American and Caribbean customers and more timely posting of accounts receivable information. Total collection float gain for the company on a dollar-weighted basis would exceed one day which equates to annual bottom-line benefits of approximately $75,000. Average DSO would also be reduced.

Had the company moved forward with a lockbox without a thorough evaluation of its collections, it would have incurred the additional cost of the lockbox, experienced no improvement in its cash flow and missed the opportunity to convert payments received by overnight courier to wire transfers.

CASE TWO

Collection Overview

This U.S. company, with over $500 million in annual sales, has more than 120 service centers in 40 states across the U.S. Some customer payments are mailed directly to the service centers for processing and deposit through a network of local depository banks. Other customer payments are mailed to the company's corporate headquarters where they are processed in-house and then deposited at the company's concentration bank.

In this situation, the company had been approached by banks offering wholesale lockbox services. It asked NLRussell Associates to determine if and to what extent a bank lockbox service might improve its current collection system. To address this question, we conducted a thorough evaluation of the company's current accounts receivable and collection systems.

Analysis

The company annually processed 325,000 checks worth $160 million at its corporate headquarters. A large percentage of checks were received on Saturdays and Mondays. Even with flexible accounts receivable staffing (day and night shifts), processing holdovers consistently occurred on Mondays, Tuesdays and most Wednesdays. After all checks were applied, they were batched, encoded, prepared for deposit and then picked up by a local courier for deposit to the company's concentration bank. Based upon a sample of all the mail received at corporate headquarters during a two-week period, float on these items totaled over seven days (see Table 3A).

During the review, we determined that many customers received bills generated by one of the local service centers. These customers are then to remit their payment to their respective local service center whose staff handles accounts receivables – cash application and past-due collection activities. Instead, we found that two-thirds of all checks received and processed at corporate headquarters should have been mailed to a local service center.

Table 3A - Current Check Float of Mail Received at Corporate Headquarters

Monthly Check Volume	Mail Float	Processing Float	Availability Float	Total Float
27,000	3 days	3 days	1.5 days	7.5 days

Our analysis determined that getting these customers to remit these payments to the designated local service center – not corporate headquarters – would reduce collection float by four days (see Table 3B). We also calculated that a change in the way the company collected and concentrated funds from the 120 local service center depository banks would reduce its current level of "idle" collected cash balances by more than $3 million.

The remaining one-third of all checks processed at corporate headquarters was received from customers who are centrally billed or managed by a centralized national accounts team. Collection at a central location for these customers was, therefore, appropriate. In this instance, we concluded that a bank lockbox service would perform the check collection tasks more efficiently and cost effectively than the company, especially for such activities as envelope opening, check copying, check encoding and deposit preparation. Additionally, for this group of customers, our analysis showed that a lockbox would accelerate mail delivery, processing and availability times by almost four days (see Table 3B). Additionally, the use of a lockbox would enable the company to reduce its centralized accounts receivable staff significantly.

Table 3B - Projected Float Savings from Re-directing
Customer Payments to either Local Service Centers or a Bank Lockbox

Monthly Check Volumes	Proposed Solution*	Mail Float	Processing Float	Availability Float	Total Float	Estimated Savings
27,000	Current System	3 days	3 days	1.5 days	7.5 days	
10,000	*Bank Lockbox	2.5 days		1.2 days	3.7 days	3.8 days
17,000	*Collect Locally	1.5 days	1.0 days	1.0 days	3.5 days	4.0 days

Recommendations

Clearly opportunities existed to significantly reduce collection float as well as the staffing expenses associated with collecting at corporate headquarters. Consequently, we recommended and worked with the company to undertake the following activities:

1. Aggressive review of all payments received at corporate headquarters to determine which customers needed to be notified to send payments to their local service center. This included a complete update of the company's accounts receivable "address book" which had not been reviewed for some time. Follow up was recommended for several months to ensure that customers mailed their payments to the correct "remit to" address printed on their invoices.
2. Evaluation and selection of a lockbox bank that would provide a high quality "plain-vanilla" wholesale lockbox service with optimal float reduction. All relevant customers were then notified to mail payments to this lockbox.
3. Retraining of the centralized accounts receivable staff to perform tasks in other areas of the company and elimination of the previously needed peak staffing.
4. Establishment of new regional depository bank and concentration system for local service centers to eliminate $3 million in idle collected balances.

Bottom-line savings from implementing these initiatives were almost $500,000 annually as shown in Table 4. They consisted of $300,000 from improvements in accounts receivable management and corporate collections plus $180,000 from changes in the local depository bank system.

Table 4 - Annual Savings from New Collection System

MeasureAnnual Savings	
Reductions in A/R staff	$ 240,000
Improved cash flow (3 days)	$ 127,000
Cost of lockbox	($ 66,000)
Net A/R and Corporate Collection Savings	**$ 301,000**
Elimination of idle cash balances	$ 180,000
Total Annual Savings	**$ 481,000**

CONCLUSION

A conventional bank lockbox analysis often fails to address the underlying and sometimes complex causes of a company's collection problems. In fact, a company that focuses just on a lockbox solution can miss significantly greater benefits than a lockbox can deliver on its own.

An independent review of a company's collection processes and associated cash flows to determine and quantify where the actual delays and costs are occurring can yield impressive benefits. NLRussell Associates has helped numerous companies improve their collection systems and cash flow by three to five days by re-engineering existing processes as well as taking advantage of both traditional and new bank collection services. While a lockbox may be part of the solution there are many other options available that can help a company construct a more cost effective and efficient collection system." ◆

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