

Accelerating Cash Flow: The Lockbox

Source: [The Business Owner](http://www.thebusinessowner.com) (<http://www.thebusinessowner.com>)

Businesses, by nature, tie-up cash. Capital is contributed, products and services are produced and delivered, and cash is collected from the customer... in that order. The total amount of capital tied-up in any enterprise is a function of:

- 1) The amount of cash consumed by each product or service that is created. For example, manufacturing a car would take up much more cash per unit than manufacturing a pencil.
- 2) The total number of goods or services simultaneously in process (between creation and collection). This is influenced significantly by the time that it takes for a product or service to be created and delivered.

Business owners seek to limit the amount of capital tied up in the business. This is the goal of short-term financial management. How can cash be wrung out of the system? One way is by using a lockbox.

What is a lock Box? A lockbox is a simple technique for speeding up the deposit of receipts. Customers send their payments directly to your bank, which deposits them immediately into your account. The bank then sends copies of the checks and deposit slips to you for recording. The result is that deposits are made more quickly and the business gains access to the cash at an earlier date. Many depository institutions provide this service.

Case Study

McGregor Co. fabricates large commercial grills. They sell \$10 million per year, all on net 30 terms. Most of their sales are to a few very large distribution companies who tend to pay slowly. On average, it takes McGregor 90 days to collect on billings. Would they benefit from a lockbox?

Analysis

McGregor has, on a typical day, \$2.5 million in outstanding receivables (\$10 million divided by 365 days per year, multiplied by 90 days.) After visiting with McGregor management and the lockbox experts at Pennsylvania National Bank, incoming payments could be deposited three days earlier by implementing the lockbox. Using the daily rate of \$27,397, (\$10 million divided by 365) \$82,000 could immediately and permanently be obtained, tax free, from implementing a lockbox.

Conclusion

A lockbox will not change the behavior of McGregor's suppliers, but it will help McGregor obtain the use of cash from customer payments more quickly. The immediate impact should be \$82,000.

Lockboxes are more popular during periods of high inflation when the time value of money is high. Lower profit margin businesses that churn large amounts of cash, such as insurance, collection, credit card and finance companies are heavy users of lockboxes as the benefits are greater.

Note: *The above analysis can be used to assess the cash benefit of any initiative that speeds up the cash conversion cycle. Future issues of The Business Owner will introduce other methods for wringing cash out of the system, and will provide examples of how to analyze the savings.*