

How to Create a Cash Reserve

GAS TO AN AIRPLANE IS LIKE CASH TO A BUSINESS

WE IN BUSINESS HAVE TO ACCUMULATE AN ADEQUATE RESERVE OF
CASH AND WE HAVE TO HAVE THE DISCIPLINE TO MAINTAIN IT.

HOW TO CREATE A CASH RESERVE

Just after I graduated from college and long before I fully understood the need for a cash reserve, I learned to fly small airplanes. At the time, I had enough money to rent an airplane, but not enough to rent the airplane AND pay for a full tank of gas.

One afternoon my former instructor approached after overhearing me order a half-tank of fuel. "It's okay to fly on a half tank," she said, "so long as you fly out of the top half of the tank, not the bottom."

Her point, of course, was that by flying out of the top half, I would always have the bottom half as a reserve to get out of trouble.

Her logic made obvious sense, but also presented me with a couple of problems.

First, I had to come up with the money to pay for the first full tank, and second, I had to maintain the discipline to top it off when it was half empty, even though I didn't "have to."

Easy to say, not so easy to do.

I often quote my instructor to business coaching clients because gas to an airplane is like cash to a business. An otherwise functioning airplane that runs out of fuel is in big trouble as is an otherwise functioning business that runs out of cash.

The problem is the same and so is the solution.

We in business have to accumulate an adequate reserve of cash and we have to have the discipline to maintain it.

Easy to say, not so easy to do.

DEFINING AN ADEQUATE CASH RESERVE

We all know what a half tank is, but what's an adequate cash reserve for a business?

A good start is a reserve sufficient to fully meet the company's cash obligations for one month. That means enough cash to pay one month's **overhead expenses** plus one month's **debt service**. We can find our average monthly overhead by looking at our past **income statements**.

Debt service is not that easy. Debt service is the amount we have to pay, on average, to stay current on our accounts payable, bank and credit card debt, and any other regular debt payments we may have.

Although the information is there, monthly debt service is not as easy to locate on financial statements as expense. However, we can get a good idea of what's due each month by looking at past check registers and bank statements.

CREATING A CASH RESERVE ACCOUNT

Once we have a reserve amount targeted, the next step is to create a reserve account. Most of us will do best by accumulating our reserve in an account separate from our regular operating account, preferably in a separate bank.

The funds should be available, but more difficult to access than by just clicking a transfer button on our bank's web page. The idea is to build barriers to protect our cash and ourselves from those inevitable moments of weakness that would wreck our plan.

HOW TO FUND YOUR CASH RESERVE

Now that we have a target amount and a separate banking account, we have to come up with the cash to fund the reserve. For the majority of us, cash is tight, and even the idea of carving out a month's reserve is daunting.

How are we supposed to do it?

By paying attention to where our cash goes and tightening our belts. If we are making a good profit, but having a tough time with cash, there are only **three possible reasons**:

- 1) We haven't been paid yet (which means our cash is tied up in receivables),
- 2) We spent it buying assets or paying down debt, or
- 3) We took it as owner draws.

That's where cash goes, so that's where our reserves must come from. We have to create our own rules to impose discipline in those three areas. We have to improve our collections, limit our spending on inventory and other assets, modify our debt repayment and/or not take as much cash out of the business.

Think of building a reserve as damming a river. A dam reduces flow. Once the lake is full the flow returns to normal, but with a lake in reserve. Our cash reserve account is our lake and we must resolve to endure reduced flows, at least until it is full.

Once we've built our reserve, we treat it as the "the bottom half of our tank," the same way we used to treat a zero cash balance. If the reserve falls below the target amount, we re-impose the rules we used to create it. No inventory expansion, no new assets, no hiring, no draws and no new overhead expense until the reserve is replenished.

BENEFITS OF A CASH RESERVE

There are good reasons beyond mere survival to build and maintain a cash reserve.

Cash reserves provide:

1. Peace of mind,
2. Confidence,
3. Discipline, and
4. Opportunity.

We don't have to experience it ourselves to imagine that a pilot who is lost and running near empty suffers an entirely different experience than a lost pilot who has half a tank of fuel remaining.

It's the same with business owners.

The stresses of business are easier to bear, our thinking is more clear, our judgment is more refined, and we sleep better when we are not consumed by cash worries.

Cash provides confidence that affects every facet of our businesses. We are more likely to make sales on our terms, to be better leaders and managers, and to make better decisions when we are not stressed by the urgency of a cash shortage.

Once we've built our reserve, we treat it as the "the bottom half of our tank," the same way we used to treat a zero cash balance. If the reserve falls below the target amount, we re-impose the rules we used to create it. No inventory expansion, no new assets, no hiring, no draws and no new overhead expense until the reserve is replenished.

BENEFITS OF A CASH RESERVE

There are good reasons beyond mere survival to build and maintain a cash reserve.

Cash reserves provide:

1. Peace of mind,
2. Confidence,
3. Discipline, and
4. Opportunity.

We don't have to experience it ourselves to imagine that a pilot who is lost and running near empty suffers an entirely different experience than a lost pilot who has half a tank of fuel remaining.

It's the same with business owners.

- The stresses of business are easier to bear, our thinking is more clear, our judgment is more refined, and we sleep better when we are not consumed by cash worries.
- Cash provides confidence that affects every facet of our businesses. We are more likely to make sales on our terms, to be better leaders and managers, and to make better decisions when we are not stressed by the urgency of a cash shortage.

- We will make fewer impulsive choices when we discipline ourselves with a cash reserve. By creating and living by the objective rules of a cash reserve, we are less likely to give in to the impetuous decisions we have all made, such as a December 30 decision to buy assets to on save taxes, or a capricious decision to increase inventory based on a customer's offhand comment. The rules of a cash reserve impose discipline and good practices on our behavior and give us an objective standard to measure our results.
- Businesses with cash can take advantage of more opportunities than businesses without cash. Where a business with cash reserves completes jobs based on an efficient schedule, a cash strapped business completes jobs according to who will pay first.
- Businesses with cash have lower percentage cost of sales because they buy in economic order quantities and take advantage of early payment discounts. A cash strapped business buys from whoever offers the longest payment terms, regardless of price.
- Businesses with cash reserves can move quickly into new markets because they have the resources to fund opportunities when they arise (such as buying out a cash-poor competitor).

The cumulative effects of having a cash reserve work like compound interest. Businesses with cash tend to make more and more money and accumulate more and more cash while those without cash fall further and further behind. This is due not only to the cash itself, but also to the discipline imposed by a cash reserve requirement.

STEPS TO CREATING A CASH RESERVE

To get it done:

1. Determine the amount.
2. Set up a reserve account.
3. Create the rules that allow us to accumulate cash.
4. Treat the reserve amount as our new zero.

HOW ABOUT YOU?

Do you have a cash reserve? Do you have rules regulating your decisions? How would your life change if you had adequate cash reserves? What decisions have you made that were driven by cash issues rather than economic issues?

If you have any further questions, please don't hesitate to mail me at Martin@annealbc.com or visit www.annealbc.com



Martin Holland

Martin Holland is the son of a successful entrepreneur. He grew up hearing about margins and markets, R&D and sales, risk and return on investment. He learned to love the language and rigors of business and grew to believe that business is both the most human of all endeavors and the highest calling. After selling a company in 2011, Martin became a coach in order to help other owners build profitable businesses that do not require their day-to-day involvement.

A native of Norman, Martin earned a B.A. degree from Hastings College in Hastings, Nebraska and a Masters in Business Administration degree from the University of Oklahoma. Over the past 7 years he has written business plans that have raised over \$52.4 million in bank and investor financing. He has helped 157 (and counting) business owners reduce stress and increase performance through clarity of purpose, better marriages, more money, and more free time away from the business.