

3 Essential Steps for Startups to Keep Enough Cash in the Bank

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Until your startup is profitable and generating positive cash flow, there is one fundamental question you should be able to answer at any time: How much runway do you have left? Many founders think this question refers to when their cash balance hits zero. Unfortunately, you'll be in trouble well before then.

As your cash balance approaches the danger zone, your auditors may issue a "going concern" memo. Your bank might get nervous, restricting access to critical debt facilities. Key vendors will become worried when you start stretching out payments, tightening credit terms or even requiring cash up front before they ship that next order.

You need to know the point at which your cash balance gets so low that you risk losing control of your company. Here are three essential steps to ensure you always have enough cash in the bank:

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1. Calculate how many months of cash you have

From the early days of Microsoft, Bill Gates insisted on

having at least enough cash in the bank to keep the company alive for 12 months if revenue dropped to zero. Gates understood that cash equals control, and he never wanted to find himself in a position where he NEEDED money from someone else to ensure the company's survival.

When considering how much of a cash balance you need to maintain, use your forward-looking monthly forecast for operating expenses, inventory purchases and capital expenditures. Don't rely on historical spending patterns. Most startups are on a growth trajectory that regularly ramps costs and investments, which means your forward-looking targets will be higher.

2. Review these two simple ratios each month

Just looking at your cash balance as an indication of financial health ignores the state of the rest of your balance sheet. Most importantly, how do your current assets compare to your current liabilities, defined as liabilities that must be settled in the next 12 months? Two simple ratios should be a consistent part of your monthly reporting: the quick and current ratios.

The quick ratio measures your company's ability to cover current liabilities with your most liquid assets, such as cash, marketable securities and net accounts receivable ("quick assets"). The formula for the quick ratio is: $\text{Quick Assets} / \text{Current Liabilities}$.

The current ratio, a less conservative measure, compares all of your current assets, including inventory and prepaid expenses, to your current liabilities. The formula for the current ratio is: $\text{Current Assets} / \text{Current Liabilities}$.

These ratios help uncover hidden problems that a seemingly

healthy cash balance might mask. For example, when your business starts to miss sales targets, you will likely begin to stretch out payments to vendors to maintain your target cash balance. The current and quick ratios can let you know when those deferred payments are creating a risk level in current liabilities that could soon get out of hand.

The target for these ratios will vary from company to company. Big red warning lights should flash if you have a ratio under 1.0. Your Board of Directors might want you to maintain a certain ratio to avoid triggering a fundraise or sale process. There might be industry averages that you can use to benchmark your company against peers.

Assuming you have debt facilities in place, your bank might also have a point of view – which leads us to the third step.

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3. Keep an eye on your bank covenants and “Events of Default”

Another reason that simply relying on your monthly cash balance is a mistake is that you likely have debt facilities that you've used to strengthen your cash position. Triggering a default with your lenders can leave your company in a precarious position.

First, be aware of your financial bank covenants. Often these covenants include a quick or current ratio target that you must maintain throughout the term of the loan. This is the bank's way of ensuring you have enough liquidity to stay current on payments and eventually pay off your debt.

Also, be aware that insolvency can trigger a default condition, which allows your bank to call your debt and demand full repayment. This provision is usually tucked away deep in

your loan agreement, under the section called “Events of Default.” Insolvency is a technical term meaning that your total liabilities exceed your total assets. You can have cash in the bank, make your debt payments on time and still be technically insolvent.

Maintaining adequate cash and liquidity levels is the key to always staying in control of your company’s prospects. With so much to think about as a founder, it’s easy to get lost in the weeds of weekly reporting and performance metrics. When all is said and done, spend a little extra time each month taking these steps to reassess your company’s financial health, and you’ll avoid nasty surprises that suddenly narrow your future options.

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