

TIPS & TECHNIQUES

Sunk Costs Don't Matter*by Harvey A. Levine*

It's a message that you've heard since infancy. "Don't cry over spilled milk."

Now that you're full-grown and an executive, or in another leadership role, don't you think that it's time to pay more attention to this simple adage?

Common sense tells us that costs that we have already incurred should not figure into future calculations of value or benefits. But psychologically, we find it difficult to dismiss what we have already put into a project, in the way of costs.

Poker players know all about this. Joe sits down at the table with a hundred dollars. An hour later, he has doubled this to a cool two hundred. When the game breaks up, Joe comes away with \$125 dollars. If you ask Joe how he made out, he will sadly report that he lost seventy-five smackers. You can argue that this is preposterous. That he came out ahead by twenty-five bucks. Joe argues that, at one point in time, he had two hundred dollars. It was his money and he could have walked away with it. From that point, he lost seventy-five bucks.

Investors also get caught up in this sunk-costs quandary. Fran buys a bond at par, paying \$1000 per unit. The bond pays five percent interest, or \$50 per year. As interest rates decline, the bond value increases to \$1250. What interest rate is it now paying? Fran says that it's paying five percent. That's what it says on the coupon. But this is wrong. Her investment is currently worth \$1250 per unit, and Fran is currently earning four percent on the current value of her holding (\$50 on \$1250). As Fran evaluates her portfolio and investment options, she finds a bond that is currently paying 4.5%. She mistakenly passes this up, thinking that she is better off with her current holding. Wrong! She is earning \$50 per unit per year on the current bond. She can earn \$56.25 if she sells the current bond and invests the \$1250 at 4.5%.

Sunk Costs in Projects

What does this have to do with projects? A whole lot. We can put a lot of effort into tracking project cost metrics and evaluating cost performance. This writer has championed the use of Earned Value Analysis methods in support of this practice.

But this only helps us to look at the cost performance of a project, generating data relative to costs already incurred and perhaps forecasts of costs to complete. In an environment where a project essentially stands on its own, and is assumed to continue on to completion regardless of cost performance, this is important information for project performance evaluation.

Sunk Costs in Project Portfolio Management

The real message (that we should ignore sunk costs) is driven home when we consider alternatives for projects within a managed and changing portfolio. In Project Portfolio Management (PPM), we practice a structured project selection process. We select projects for the portfolio based on a multitude of factors, including value and benefits. The anticipated benefits are determined by considering risk-adjusted Return on Investment (ROI). Candidate projects are ranked for selection based on the benefits, plus criteria such as alignment with strategies, utilization of critical resources, risk parameters, and portfolio balance issues.

Portfolios, once established, are managed for both project performance and continuing portfolio analysis. Once a project is selected for the portfolio, should it remain there until completion? This question is addressed by Larry Leach in Chapter 8.1 of *Project Portfolio Management: A Practical Guide to Selecting Projects, Managing Portfolios and Maximizing Benefits*, Harvey A. Levine, Jossey-Bass, 2005. Writing about the Theory of Constraints (TOC) and Critical Chain Project Management (CCPM), Larry states:

Companies often assume that ongoing projects have higher priority than new project proposals. Sometimes they make this assumption implicitly by considering only new projects for addition to the portfolio and not considering elimination of ongoing projects at the same time. This is a version of the sunk-cost fallacy, wherein people judge additional investments based on how much they have invested so far. Sunk costs are in fact sunk and should not influence decisions going forward. It is very hard for most people to decouple their thinking from what has been spent to date, but unless there could be some way to recover the sunk investment, it truly has no direct relevance for decisions regarding future investment. This means that evaluations of ongoing projects need consider only the future investment, not the investment that has already been committed.

It logically follows that you can consider project portfolio decisions one new project at a time. The standard of comparison is the portfolio of ongoing projects, not the other projects proposed, coincidentally, at the same time. It's okay to have a periodic process to dream up and propose new projects in a bunch. But when you do so, you should compare them to ongoing projects on the basis of remaining investment or latest estimated impact on operating expense. It is equally okay to propose new projects one at a time, at any time, and compare them to the current portfolio.

When evaluating a new project proposal against the existing portfolio, it can be important to update the return on investment calculations for the existing portfolio. One reason is that the investment calculation need only consider the estimated remaining investment to complete the project; that is, it should not include the sunk cost.

In Chapter 4.3 of the aforementioned book, Jim Devlin writes about the Analytic Hierarchy Process (AHP), adding:

Although this process has been presented as discrete steps, a best practice approach to implementing an AHP-based PPM process is to consider a rolling

Published in PM World Today - January 2007 (Vol. IX, Issue I)

portfolio. Depending on the type of portfolio, it is fruitful to create a standard biweekly, monthly, or quarterly meeting to reassess the portfolio on an ongoing basis. During these portfolio “refresh” meetings, decision-makers consider the performance of the current project portfolio in conjunction with new projects in the pipeline to determine the new portfolio. Ideally, the portfolio undergoes regular refreshing and balancing in which it is tweaked and more tightly aligned with organizational objectives. This process entails reconsideration of sunk costs on the projects already begun, and it will certainly result in holding, continuing, or killing projects that are currently in the portfolio.

When writing about sunk costs, I am always reminded of a classic fallacy in accounting thinking. Here’s a fictionalized example, based on an actual case involving a major manufacturer.

In 1985, FrabCo invests in new equipment to machine frabistat widgets. The three manufacturing units, costing \$50,000 each, can produce the widgets at the rate of twelve units per hour per machine. In 1988, the company finds that it is losing market share to a competitor. Further investigation attributes the loss to a significant price differential. The competitor is operating out of a brand new facility. Their new equipment can produce widgets at the rate of 30 per hour, allowing them to price the widgets below the actual cost of manufacturing at FrabCo.

FrabCo’s Manager of Manufacturing suggests that the equipment be replaced by a new unit that will triple the rate of production. Accounting protests, asserting that the 1985 investment has not been fully amortized. This compulsion to bring sunk costs into the evaluation prohibits FrabCo from taking corrective action that would allow them to recapture their market share in frabistat widgets. The fact is that the 1985 investment has already been made. However, due to equipment advances, investment in newer equipment would generate improved benefits and ROI, and would allow the firm to remain competitive. What Accounting failed to recognize is that replacement of the equipment, at another \$50,000, would be paid back by the labor cost savings in less than a year. Pricing can be reduced, and increased capacity would be available for improved sales. Fussing over the sunk costs would accomplish nothing but loss of income, loss of market share, and eventual loss of jobs.

Summary

When evaluating retention of projects in the portfolio or substitution of newly proposed projects, it is important to conduct these evaluations using remaining costs and not sunk costs. As Larry Leach says: *“Sunk costs are in fact sunk and should not influence decisions going forward.”*

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*Harvey A. Levine, with 44 years of service to the project management industry, is founder of The Project Knowledge Group, a consulting firm specializing in the dissemination of PM knowledge through writing, training, mentoring and direct consulting. He has implemented or enhanced the project management capabilities of numerous firms, often combined with the selection or implementation of computerized project management tools. For more information on Harvey Levine or the Project Knowledge Group, please visit <http://home.earthlink.net/~halevine/>. Mr. Levine is the author of three books, and over 240 articles, whitepapers and videos on Project Management. His 2002 book, "Practical Project Management: Tips, Tactics, and Tools", is still available from John Wiley & Sons. Mr. Levine's latest book, "Project Portfolio Management, A Practical Guide to Selecting Projects, Managing Portfolios, and Maximizing Benefits", Jossey-Bass, was released in July, 2005. Mr. Levine is past president and chair of the Project Management Institute (PMI®), a recipient of PMI's 1989 Distinguished Contribution to Project Management award, and has been elected a Fellow of PMI. He was Contributing Editor to PMI's PM Network for thirteen years and has contributed to dozens of periodicals and websites dedicated to project management. He is a popular keynote speaker and panel chair, as well as presenter of workshops and problem solving sessions in the private and public sectors. Mr. Levine has been an early supporter of Project Portfolio Management practices and has promoted PPM through books, articles, presentations, and individual mentoring and consulting. Mr. Levine has offices in Saratoga Springs, New York and San Diego, California. Harvey can be contacted at [**halevine@earthlink.net**](mailto:halevine@earthlink.net).*

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