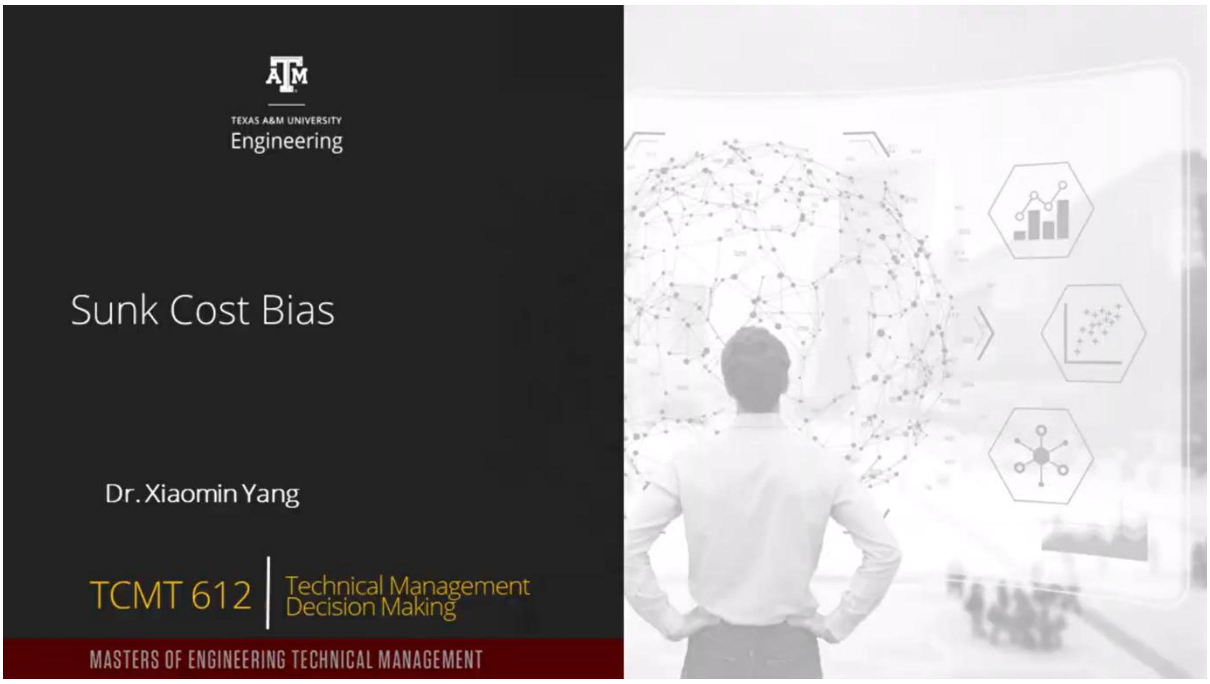
M2L21. Sunk Cost Bias

Slide #1



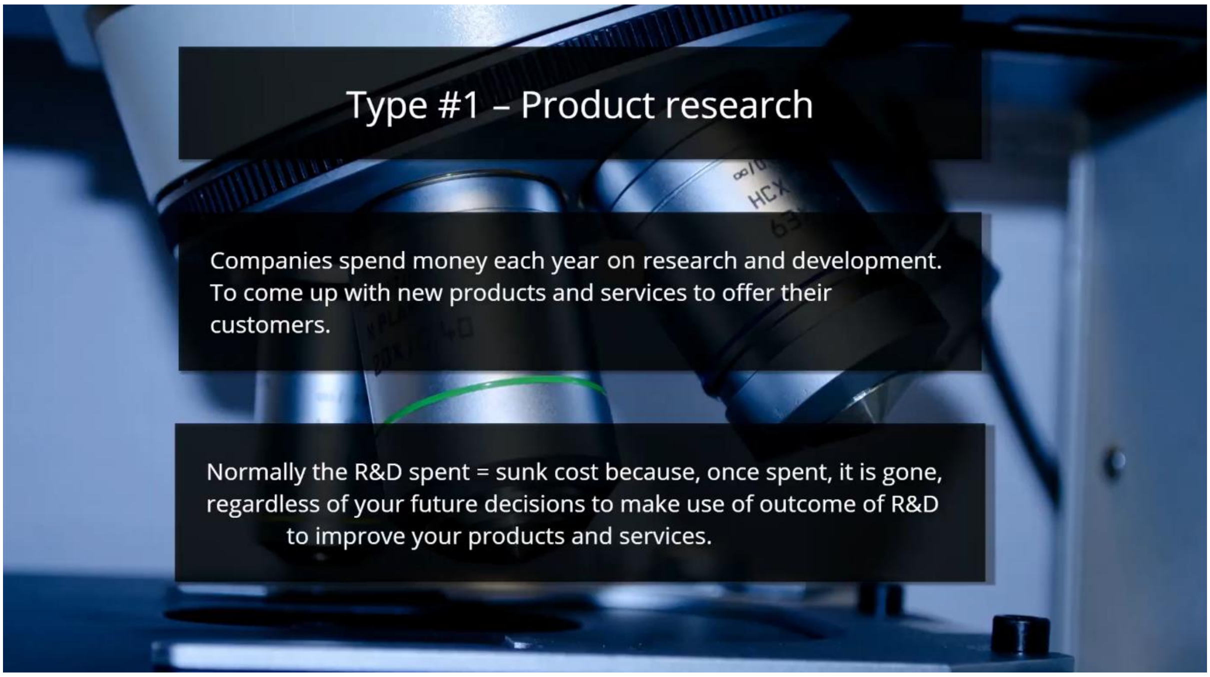
In this topic, we will discuss sunk cost bias.

Slide #2

A complicating factor that keeps us staying in the course of a failing project is how we look at and deal with sunk cost in our decision-making process.

A sunk cost is a cost that has been incurred and cannot be recovered.

Slide #3



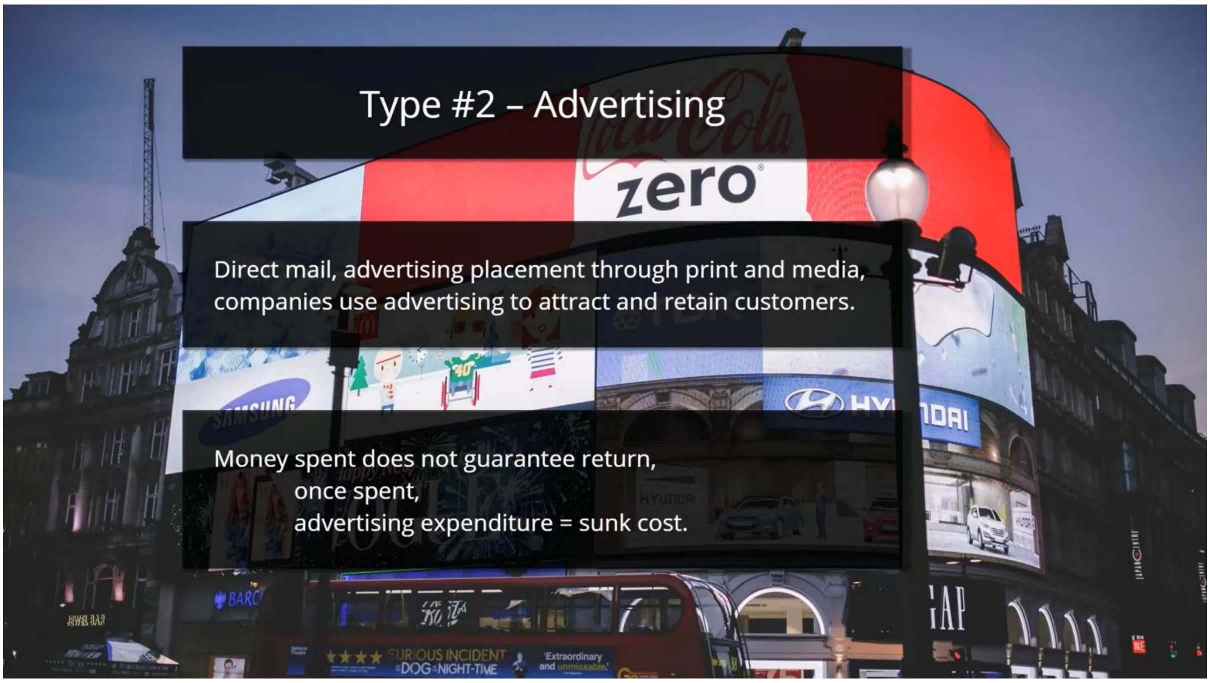
Some examples of sunk cost are product research.

Companies spend money each year on research and development.

They work to come up with new products and services to offer their customers.

Normally, the R&D spent is recognized as a sunk cost since once the R&D money is spent, it is gone regardless of your future decisions to make use of the outcome of research and development efforts to improve your products and services.

Slide #4

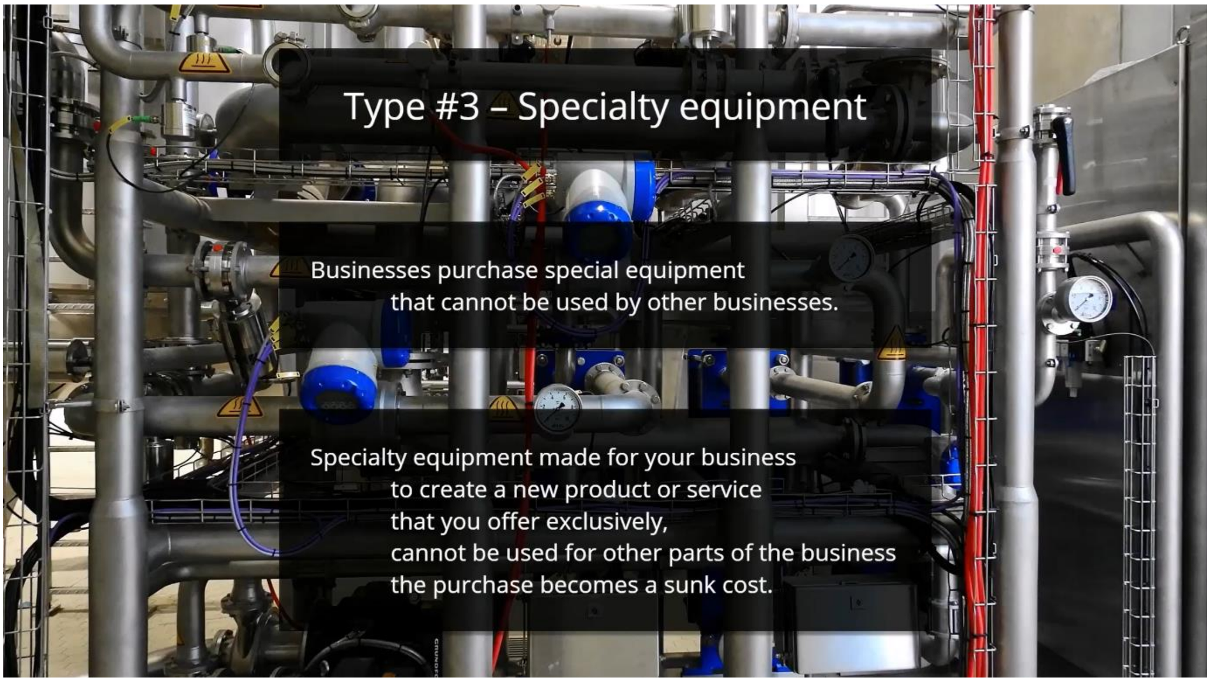


The second type of sunk costs is advertising.

From direct mail marketing to purchasing advertising placement through print and media, companies use advertising to attract and retain customers.

Money spent on advertising does not guarantee a return, but once the money is spent, the advertisement expenditure should be considered as sunk costs.

Slide #5

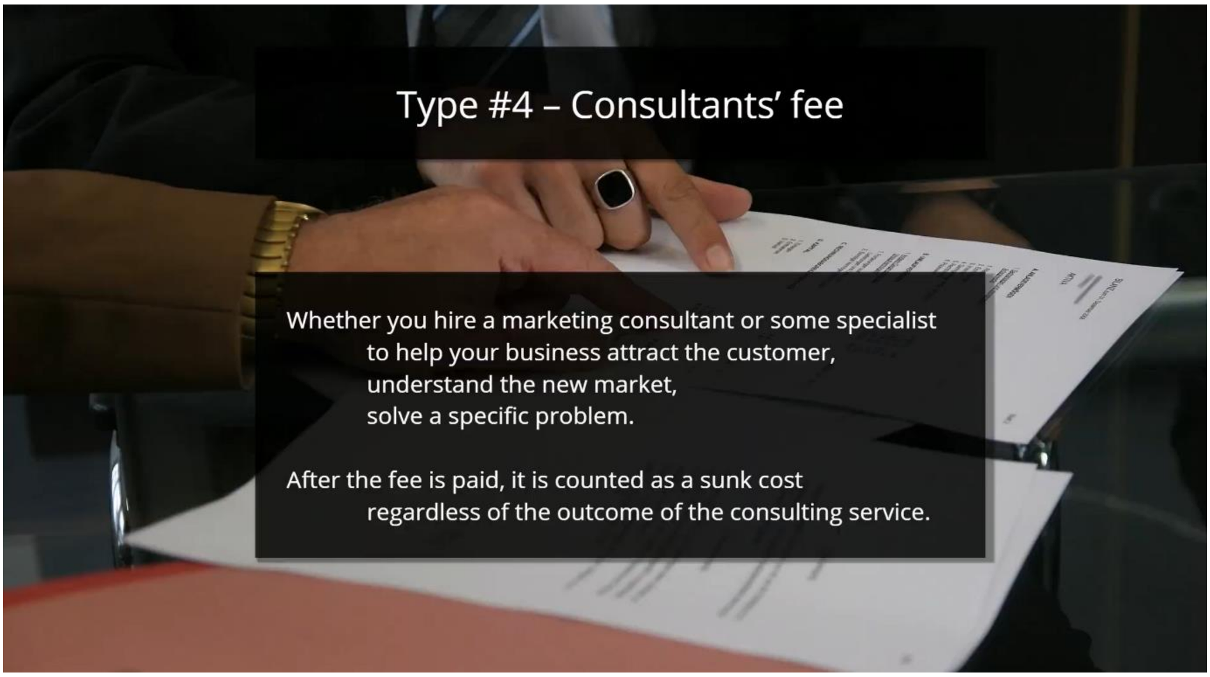


The third type of sunk cost is specialty equipment.

Businesses purchase special equipment that cannot be used by other businesses.

If you have specialty equipment made for your business to create a new product and service that you are offering exclusively and the equipment cannot be used for other parts of the business, the purchase becomes a sunk cost.

Slide #6

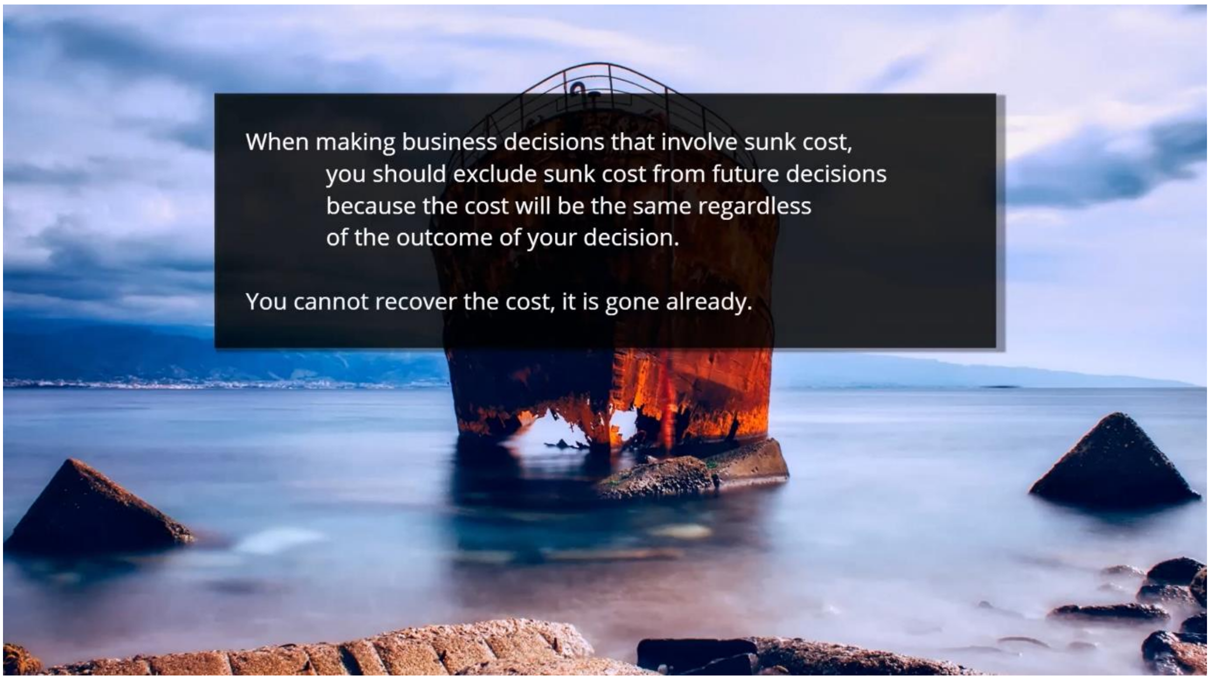


Another type of sunk cost is consultant's fee.

You hire a marketing consultant or some specialist to help your business attract customers, understand the new market, or solve a specific problem.

After the consulting fee is paid, it is counted as a sunk cost, regardless of the outcome of your consulting service.

Slide #7



When you are making business decisions that involve sunk cost, you should exclude the sunk cost from your future decisions because the cost will be the same regardless of the outcome of your decision.

You cannot recover the cost, it is gone already.

Slide #8

Mitigate Sunk Cost Fallacy (1)

- Adopt a forward-looking approach to decision-making.
- Focus on the potential future benefits and costs of a decision, rather than being influenced by past expenditures.
- Encourages the reassessment of ongoing projects based on current and anticipated outcomes.

All the tactics for avoiding the escalation of commitment are applicable to mitigating the sunk cost fallacy.

There are some practices particularly effective in addressing sunk cost misjudgment.

Here are a few.

To mitigate the sunk cost fallacy, businesses must adopt a forward-looking approach to decision making, emphasizing the evaluation of potential future benefits and costs, rather than being influenced by past expenditures.

This strategic shift requires a clear understanding that previous investments, whether in time, money, or resources, are irretrievable and should not dictate the course of future actions.

By focusing on prospective gains and losses, companies can make more rational and effective decisions that align with their long-term goals and objectives.

This mindset encourages the reassessment of ongoing projects based on current and anticipated outcomes, ensuring resources are allocated efficiently and strategically.

Embracing this forward-looking perspective helps avoid the pitfalls of continuing unproductive ventures solely because of the resources already committed, leading to more sustainable and profitable business practices.

Slide #9

Mitigate Sunk Cost Fallacy (2)

Encourage
flexibility

Re-evaluate
decisions

Respond
to changing circumstances
and market dynamics

Additionally, businesses need to encourage a culture of flexibility and openness to change.

This cultural shift involves fostering an environment where employees and leaders are comfortable re-evaluating decisions and altering course, when necessary, without fear of blame or repercussions.

By promoting adaptability and a willingness to embrace new information, companies can avoid the trap of persisting with failing projects simply because of prior investment.

This mindset encourages continuous learning and innovation, allowing businesses to pivot strategically in response to changing circumstances and market dynamics.

Slide #10

Furthermore, mitigating the sunk cost fallacy involves regularly reviewing projects and being willing to pivot or abandon them when they are no longer viable.

This process requires businesses to implement systematic evaluation checkpoints, where the progress, costs, and potential outcomes of projects are critically assessed.

By establishing clear criteria for continuation or termination, organizations can make objective decisions based on the current and projected value rather than past investment.

Encouraging a mindset that values learning and adaptation and recognizing that stopping a project is not a failure but a strategic decision is crucial.

This approach ensures that resources are not wasted on unproductive endeavors and can be redirected to more promising opportunities, ultimately fostering a more efficient and agile business environment.