

Stop Throwing Money Away!



One of the hardest things to do is to stop wasting money and resources on a losing proposition, emotions, biases and focusing on simple but irrelevant measures can all lead to bad decisions. A proper consideration of '*sunk costs*' can help eliminate these *always wrong* decisions.

The fact you have spent several months and \$thousands on a mission to accomplish something should not influence your thinking about expending more time and money (but it frequently does)! The past is past, and money spent is gone for ever – the costs and commitments have been 'sunk' and cannot be recovered. Making decisions about the future based on these 'sunk costs' simply distorts the decision and frequently leads to really bad outcomes.

There are basically three scenarios where sunk costs influence decision making:

1. There is very little prospect of ever achieving any return on the investment: the sensible option is to stop wasting resources and kill the endeavour regardless of the amount of cost and time already expended. Wasting more resources does not mitigate the waste to date.
2. The return on investment will be less than the additional resources that need to be expended to achieve the return: again the only sensible decision is to kill the endeavour regardless of the amount of cost and time already expended. Wasting more resources does not mitigate the waste to date.
3. The return on investment will be more than the additional resources that need to be expended to achieve the return, but will be insufficient to cover the overall cost of the work: in this situation, expending the additional resources to reduce the overall loss may be sensible.

The change from option 2 to option 3 above is time related. Consider a project that has suffered a major setback since initiation and the expected benefit is now only \$10 million from a total project cost of \$20 million – with perfect foresight, we know that if the project is completed, over its life there will be a net loss of \$10 million.

- If this situation is identified at the 25% stage, the expenditure to date will be \$5 million, cancelling the project results in a net loss of only \$5 million (the sunk costs). Spending the other \$15 million will allow the benefit of \$10 million to be realised, but increases the overall loss to \$10 million. The sensible option is to cancel the project, and minimise the overall loss.
- If the situation is identified at the 50% stage, the expenditure to date will be \$10 million, cancelling the project results in a net loss of \$10 million (the sunk costs). Spending the other \$10 million will allow the benefit of \$10 million to be realised, but the overall loss remains at \$10 million. The sensible option is to cancel the project – the extra capital and resources should be better used on a project with a positive return on investment.
- If the situation is identified at the 75% stage, the expenditure to date will be \$15 million, cancelling the project results in a net loss of \$15 million (the sunk costs). Spending the other \$5 million will allow the benefit of \$10 million to be realised, which will reduce the overall loss to \$10 million. The sensible option is to keep going and spend the money to reduce the overall loss from \$15 million if the project is cancelled now, to \$10 million if it is completed and the benefit realised.

The key factor affecting the above scenarios is that each decision is based on achieving the best overall outcome for the organisation, the planned project costs are not given or discussed – they are completely

irrelevant. The fact the project costs have increased from \$15 million to \$20 million should make absolutely no difference to the stop/go decision.

The major problem with this scenario is that the actual costs are known for certain; future costs and benefits are estimates and will always be uncertain (there are risks involved). This is compounded by time and control factors. The further into the future you try to predict costs or benefits, the greater the uncertainty. Similarly most organisations have significantly better understanding and control over their costs that over future unrealised benefits. These uncertainties should be part of the decision making process and adjustments made to the future estimates to allow for the uncertainty by using benefits from the lower end of the expected range and costs from the higher end.

From a rational perspective, it is highly desirable to fail early and fail cheaply - the 25% scenario above. The problem is that at this stage of the project's lifecycle, the ability to 'precisely foresee' the final total cost and benefits is significantly less than later in the project. The information available for decision making evolves over time and may change. The 'kill' decision needs good information, careful analysis, clear thinking and a degree of courage to act on the available data¹. Unfortunately this type of decision is rarely based on rational thinking, emotions and innate biases have a major effect.

Three Ways to Always Make the Wrong Decision

There are many factors affecting the kill/continue decision process, three of the most common and 'worst' are:

Focusing on easy to measure, irrelevant facts.

Killing a project because it is over spending its budget, or overrunning time is simplistic stupidity. Just because these two factors are easy to measure does not make them important or significant. The cost and time needed to complete the project is only part of the equation – the benefits expected as a result of completing the work complete the picture. Most of these bad decisions are made after the project has moved into the 'third' scenario above and completing the work minimises the overall loss. Similarly de-scoping the project to reduce the project costs and whilst destroying most of the benefits is highly unlikely to help².

Not killing because of an 'emotional attachment'.

Every project is loved by somebody..... The problem is emotional attachment rarely leads to pragmatic decisions. Good project managers and project team members are always emotionally committed to 'their project'. Very often sponsors and project champions have a similar attachment, either from a positive aspect, or from a desire not to have their 'reputation' tarnished from being associated with a failure.

Emotions are particularly significant when personal conflict, contractual claims and other forms of dispute are mixed up in the decision making process. As soon as there is a level of conflict, protagonists can quickly become emotionally committed to winning 'the fight' at the expense of all other considerations. Winning may be a grand objective, but Pyrrhic victories³ that damage the winner are of little practical value.

Generally the greater the person's level of input to the work (emotional, financial, personal effort, etc), the more attached they become to 'the cause' and their ability to step back and make a rational decision is

¹ For more on **decision making** see:

http://www.mosaicprojects.com.au/WhitePapers/WP1053_Decision_Making.pdf

² For more on benefits an value see **Value is in the eye of the stakeholder**.

<https://mosaicprojects.wordpress.com/2009/03/28/value-is-the-stakeholder>

³ A Pyrrhic victory is a victory that inflicts such a devastating toll on the victor that it is tantamount to defeat:

http://en.wikipedia.org/wiki/Pyrrhic_victory



severely diminished. This type of emotional commitment is highly desirable from the aspect of building a motivated team committed to achieving project success; but needs to be carefully managed when making the hard ‘kill’ decisions – usually by involving other authorities in the process.

Optimism, loss aversion, confirmation bias, hyperbolic discounting and other types of innate bias.

Everyone is biased. Some of the more dangerous include confirmation bias (only hearing ‘facts’ that support a predetermined belief), optimism, loss aversion and hyperbolic discounting (a focus on the near-term). These innate traits make taking a near-term loss to avoid the probability of a much greater loss in the longer term very difficult⁴.

Summary

Making a sensible decision to ‘kill’ an uneconomic project or to support an ‘over budget’ project that still has a viable return on investment is always difficult and requires access to reliable data. The decision making process requires a level of detachment that is hard to achieve in the absence of both an effective project controls system and a rigorous governance system focused on achieving the best outcome for the organisation. In the absence of these two factors, emotions and biases have unfettered opportunities to influence people to make bad decisions.

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to view and download a wide range of published papers and articles see:
http://www.mosaicprojects.com.au/PM-Knowledge_Index.html

⁴ For more on **biases** see: http://www.mosaicprojects.com.au/WhitePapers/WP1069_Bias.pdf

