

Understand "Sunk" Costs in Business Decisions

Once your business incurs costs that cannot be recovered those costs become irrelevant to subsequent business decisions. Such expenditures, known as sunk costs, can include money paid, time spent, or resources used that are no longer retrievable.

For example: You have invested \$20,000 in an expansion project, and it has become apparent that it will cost another \$10,000 to complete it. Regardless of what you do going forward, you will be unable to retrieve the initial \$20,000. Now an opportunity arises where you can buy an equivalent completed facility for \$6,000.

At this point, your only choice is whether to spend \$10,000 or \$6,000 for the same facility. Whatever you decide, the initial \$20,000 investment will be gone - a sunk cost. All else being equal, the rational choice is to buy the \$6,000 facility.

Now assume the same \$20,000 sunk cost with an additional \$6,000 needed for completion. An opportunity to buy a similar completed facility for \$8,000 arises. Obviously you will go forward with the \$6,000 completion costs, even though the total cost of the facility will be \$26,000 rather than \$8,000. The \$20,000 sunk cost remains irrelevant.

Another example: Your company has spent time and money developing an innovative new product, and you are justifiably proud of the result. However, when you test market the product on your customers, you learn that most of them have no interest in it and would not buy it at any feasible price. Clearly it is time to swallow your pride (along with the sunk development costs) and walk away from the product.

It is hard to disregard time and money you have already expended, but once such costs become irretrievable, it is simply counterproductive to factor them into any subsequent decision process. From that point forward, your choices should be based solely on expected future costs versus future benefits.