Sunk Costs

Be prepared to write off these losses when upgrading technology.

BY JON A. HULTMAN, DPM, MBA

When making financial decisions, be wary of being swayed by sunk costs. These are different from overhead costs in that they are those which will not be changed as a result of a new financial or strategic decision. Because they will not change, they should never be a factor when making strategic practice decisions. For example, assume that you purchase a computer system at a cost of $32,000—a major investment. Four years later, that system now needs upgrading—at a rather steep cost of $16,000. Rather than upgrading the old system, another option is a brand-new system which will have the same capabilities as the old upgraded one. This new system can be purchased for $9,000. Your decision—should you purchase the new system at $9,000 and scrap the old one; or, should you upgrade the old one at a cost of $16,000? Knowing the costs, the answer to this question should be obvious.

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At a time like this, some very intelligent people choose to upgrade their old systems, arguing that they do not want to "lose" the money that they had already invested. They should, however, be aware at this point that the $32,000 is a *sunk cost*

Continued on page 154

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Sunk Costs *(from page 153)*

and should be considered irrelevant when making the decision. This is like solving an algebraic equation that has the $32,000 amount on each side of the equal sign—amounts which cancel each other out when solving the equation. Assuming that a computer upgrade is essential to the practice, the relevant decision comes down to whether it would be better to spend $9,000 (the completely new system) or $16,000 (the upgrade). Each essentially achieves the same result—a fully functioning computer system that can meet the practice's current demands.

The answer to the above problem might seem obvious; however, this type of problem is often difficult to recognize. Doctors frequently make poor financial decisions when a similar choice is presented. For instance, in this example, assume that the original $32,000 used to purchase the computer system had been borrowed, employing a ten-year bank note with an annual interest rate of 9%. The payments are $405.36 a month, and there are six years remaining on the loan payments. Over the next six years the doctor will need to pay out $29,185.92 ($405.36 x 12 x 6 = $29,185.92). Should this change the decision being made? Such irrelevant issues often cloud the decision-making process. To the doctor, these loan payments might seem like a game changer; yet, stop and think about this. The loan and the monthly payments are actually irrelevant to the decision and should not be considered when making it. The payments on this loan are a sunk cost; the loan must be paid, regardless of the ultimate choice made. The amount of this loan is on both sides of the equation—repayment is common to both decisions. What the loan payments are relevant to is cash flow planning, but not strategic, financial decision-making.

When sunk costs are involved, emotion often enters the picture and confuses the decision-making process. Someone who has invested a great deal of time or money—usually both—in an idea or a process has difficulty "letting go" of that idea or process. This is the issue that makes it difficult to sell a losing stock and replace it with a winner. There is plenty of room in clinical medicine for emotion but no place for emotion when making strategic financial decisions.

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Andy Grove, former CEO of Intel, has put forth an interesting strategy of "firing yourself" to remove the emotional component surrounding sunk costs. In his 1996 book, *Only the Paranoid Survive*, Grove tells the story of a time when Intel was losing market share of its business to Asian competitors. At the time, memory chips were the mainstay of Intel's business, and the company was setting out to "beat the competition at their own game." They were going to make a better chip and sell it for less. It soon became clear that this strategy was not working for them and that it probably never would.

The reality was that the time and effort they had invested in producing memory chips was a sunk cost. Grove realized that he and his management team carried too much baggage to think this situation through logically and unemotionally and asked his colleague, Gordon Moore, "If we got kicked out and the board brought in a new CEO, what do you think he would do?" Moore's answer, "He would get us out of the memory chip business." Grove responded by asking, "Why shouldn't you and I walk out the door, come back and do that ourselves?" This is precisely what they did, and Intel soon began focusing on the production of microprocessors, which reignited the company's growth and led to even greater success. Since the publication of Grove's book, many CEOs have adopted this approach to strategic planning.

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We constantly hear that change is difficult, and one reason that we hold on to old ideas is that the things that typically need to be changed are the ones we have spent years creating, implementing, and perfecting—our sunk costs. While "firing and re-hiring yourself" may sound effortless, this way of thinking offers a powerful approach to strategic planning. In most companies, new CEOs and management teams come in and make the changes that their predecessors had already known needed to be made. A wise sage once said, "It is hard to see the writing on the wall when your back is up against it." "Firing yourself" frees you from past baggage—your sunk costs—and forces you to turn around and read that writing on the wall.

Be brave enough to try this strategy when you seek to implement significant changes in your practice. Once you see what needs to be done, appropriate strategies will soon follow. **PM**

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