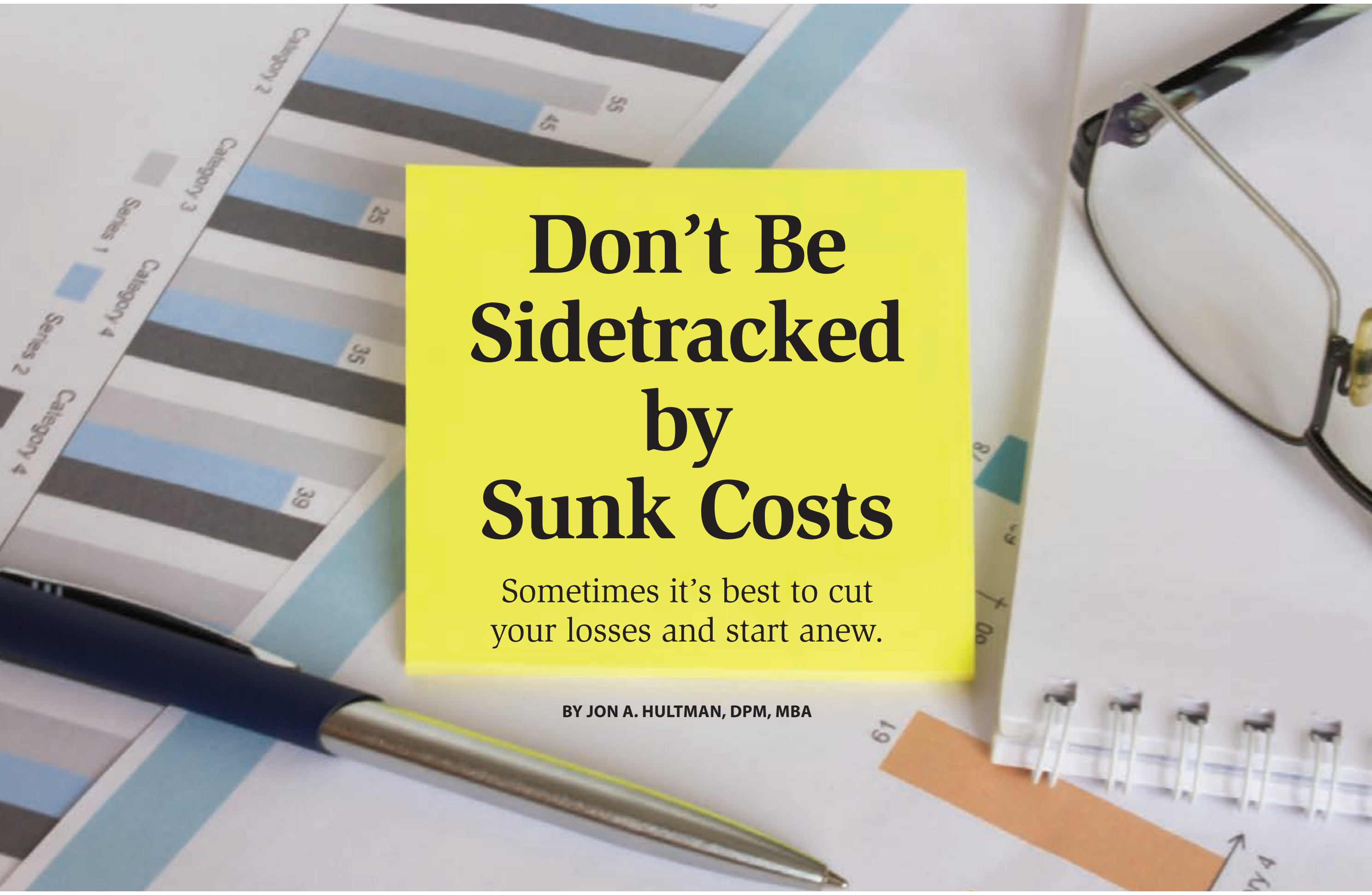

Don't Be Sidetracked by Sunk Costs

Sometimes it's best to cut your losses and start anew.

BY JON A. HULTMAN, DPM, MBA

Be wary of being swayed by sunk costs when making financial decisions. These are costs which are not a part of ongoing overhead. They are, instead, past costs which have already been accounted for and should not affect any new financial or strategic decisions. Holding on to "the old"—being afraid to "let go" or make changes because "sunk costs" are being included in the decision-making process will only lead to sub-optimal decisions.

While we have covered this topic before, we think it is worth revisiting now—especially if you are planning your practice budget for 2025.

The following is an example of sunk costs. Assume that, in the past, you made a major investment—purchasing a computer system at a cost of $32,000. Four years later, that system now needs upgrading—at a rather steep cost of $16,000. Rather than upgrading the old system, an option would be to purchase a brand-new one which would have the same capabilities as the old one following an upgrade. This new system can be purchased for $9,000. The decision—should you scrap the old one and purchase a new one at $9,000?; or should you upgrade the old one at an additional cost of $16,000? Knowing the costs, the answer to this question should be obvious. You should not allow your previous substantial investment to cloud your judgment.

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At times like this, some very intelligent people choose the "upgrade" option, arguing that they did 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* and should be irrelevant to making a decision going forward. This is like solving an algebraic equation that has the $32,000 amount on both sides of the equal sign—amounts which cancel each other out when solving the problem. 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). In this case,

Continued on page 122

Sunk Costs (from page 121)

each achieves the same result—a fully functioning computer system that can meet the practice's current demands. One should also consider that the quality of new technology is likely to be even better than that of an upgraded system. Being swayed by sunk costs when making this decision is the wrong path to go down.

As obvious as the answer to this quandary might seem, it is often difficult to recognize when you are considering irrelevant costs. Doctors frequently make poor financial decisions when such a choice is presented. For instance, assume that in this example the original $32,000 used to purchase the system had been borrowed. To do this, a down payment was made, and a ten-year bank note with an annual interest rate of 9% was employed. The payments on this note are $405.36 a month, with six years remaining. Over the next six years, total payments amount to an additional $29,185.92 ($405.36 x 12 x 6 = $29,185.92). Should this change the decision being made? Looking at this unemotionally, you recognize that this is actually an irrelevant issue; yet it clouds the decision-making process.

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To the doctor, these loan payments might seem like a game changer; yet, stop and think. These 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 and must be paid, regardless of the ultimate decision made. The down payment of this loan is also a sunk cost—one that is on both sides of the equation. What the loan payments are relevant to is planning for future cash flow—not strategic, financial decision-making.

Emotion often enters the picture and confuses the decision-making process when sunk costs are involved. 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 potential winner. There is plenty of room in clinical medicine for emotion, but no place for emotion when making strategic financial decisions.

Andy Grove, former CEO of Intel, has put forth an interesting strategy for removing the emotional component surrounding sunk costs. He calls this strategy "Firing Yourself." In his 1996 book, *Only the Paranoid Survive*, Grove tells the story of a time when Intel was losing its 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 answered, "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. This re-ignited 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 need to be changed are typically the ones we have spent years creating, implementing, and perfecting—our sunk costs. While "firing and re-hiring yourself" may sound effortless, this is not easy to execute; however, this approach is a powerful tool for strategic planning. Successful new CEOs and management teams often 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. It forces you to turn around and read that writing on the wall. My suggestion? Be open enough to recognize which of your costs are sunk costs, and implement this strategy when you seek to make significant changes in your practice. Once you see what is actually irrelevant to your needs going forward, appropriate strategies will soon follow. **PM**

Dr. Hultman is Executive Director, California Podiatric Medical Association and President, Medical Business Advisors, specializing in practice evaluations, valuations, and mergers. He is the author of *Reengineering the Medical Practice* and *Medical Practitioner's Survival Handbook.*