Sunk Cost Vs Opportunity Cost: What’s The Difference?

In business decisions, organizations often focus too much on *Sunk Costs,* ignoring the *Opportunity Costs*. Sunk Costs are explicit and appear on financial statements so it is understandable why these costs are honed in on. Opportunity Costs are implicit and unseen, so they are often overlooked. The nature of these costs generates confusion around which to consider when making business decisions.

Understanding sunk costs and opportunity costs and their relevance to your business is essential. Smarter business decisions increase savings and cut costs, setting your business up for success.

Business Costs

It is inevitable that businesses will incur costs in their day-to-day operations. Some of these costs are discretionary and can be identified and reduced. Managing both your direct and indirect spend with a centralized procurement software solution makes it easy to track costs and automate business procedures, eliminating nonessential spending. Understanding your business's costs is the first step to making savings.

Managers with a solid grasp of sunk costs and opportunity costs can help achieve realized savings that match your business's targets.

> *Understanding sunk costs and opportunity costs gives companies the leverage to make educated business decisions; minimizing costs, saving money, and ultimately setting themselves up for success.*

What is a Sunk Cost?

A sunk cost refers to a cost that has already occurred and has no potential for recovery in the future. Given sunk costs have already occurred, the cost will remain the same regardless of the outcome of a decision, and so they should not be considered in capital budgeting.

It is easy to get hung up on sunk costs, especially when they are explicit costs. *Explicit costs* are direct payments made to others in the course of running a business, such as wages, rent and, materials. Explicit costs which have already been incurred are sunk and are irrelevant to future decision-making. Explicit costs which will occur in the future, however, are relevant to business decisions as they will be direct costs to the company that could be avoided.

Sunk Cost Fallacy

One trap managers should be aware of when it comes to sunk costs is the sunk cost fallacy. The Sunk Cost Fallacy describes our tendency to follow through on an endeavor if we have already invested time, effort or money into it, whether or not the current costs outweigh the benefits. Economists tell us we should avoid falling into this trap in the decision-making process that justifies a bad decision based on previously incurred costs that no longer bear relevance to the decision at hand.

Examples of Sunk Costs

Some examples of sunk costs are salaries, depreciation, or rental leases. Consider the following scenario: Your business has spent $2 million building a state-of-the-art printer. Your buyers then decide they want to stop printing and publish their content online only. Your company must consider the relevant costs. They can either decide to finish building the printer which would cost another $1 million, or they could decide to build out their online publication system for $2 million. The sunk cost in this scenario is the $2 million already incurred on building the printer. To continue building the printer would be falling into the sunk cost fallacy. It does not make sense to spend a further $1 million on the printer which you would ultimately have no use for, irrespective of the $2 million already spent.

Challenges with Sunk Costs

It is important to note that while all sunk costs are fixed costs, not all fixed costs are sunk costs. Sunk costs are, by definition, those which cannot be recovered by any means. Some previously incurred costs *can* be sold on for their purchase price and therefore are not considered sunk.

Take the following scenario: Imagine your company is considering ceasing operation. Management must compare the revenue they would lose with the costs they would eliminate, should they shut down. In this scenario, fixed costs such as the factory lease and machinery must also be considered as eliminated expenses as the lease has an end date and the machinery could be sold on (accounting for depreciation). These costs now become relevant and are therefore no longer considered sunk costs. Any variable costs that can be reduced by a decision will also be important to factor in.

What is Opportunity Cost?

An Opportunity Cost is the loss of other alternatives when one option is chosen or no action is taken. Opportunity costs are unseen, not included in financial reports, and can often be forgotten about in capital budgeting. Part of the reason opportunity costs are unseen is because they consider *Implicit Costs*. An implicit cost is any cost that has already occurred but is not necessarily shown or reported as a separate expense. These costs are much harder to measure as they are not always quantitative. Being aware of trade-offs will allow managers to make better-educated investment decisions. The costs and benefits of every other potential alternative must be examined and weighed in order to properly calculate opportunity costs.

Examples of Opportunity Costs

Consider the following scenario: Your business is deciding between investing money into the stock market to generate returns or investing money back into the company. Historically, the average stock market return is 10%. A manager at your company has calculated that investing money back into the business has an expected ROI of 8%. To calculate opportunity cost, use the formula:

Opportunity Cost = Return on most profitable foregone option – Return on the chosen option

The opportunity cost of investing money back into the business would be (10%-8%), which equals 2% foregone returns. Therefore, should your company choose to invest money back into the business, their opportunity cost is sacrificing higher profitability.

Challenges with Opportunity Cost

The main challenge with opportunity costs is that they are hard to accurately calculate. Returns on investments are often estimates rather than hard-set figures. It is also not always easy to define non-monetary factors like risk, time, skills, or effort. This is not to say trade-offs should not be estimated and considered in business decision-making, but rather that it is only after a choice has been made that managers will have the hindsight to see how each investment decision compared.

Similarly, opportunity costs often include implicit costs that are also hard to calculate. Opting for one alternative over another may mean sacrificing time, energy, even happiness, all of which are hard to place a quantitative value on.

For example, imagine you are looking for a new job. You have job A which pays very well but demands long hours and is not a role you will be happy in. Job B, on the other hand, is one in which you will be very happy, with shorter hours, but lower pay. It is easy to compare the opportunity costs of the salaries between the two jobs. It is much harder to calculate the levels of happiness you will experience or consider what you could do with extra time in the job with fewer working hours.

Finally, comparing opportunity costs gets harder when the returns may come in different forms or at different times. For example, a business is deciding between 2 investment options. Option A will see returns of $2 million but ties up the company's cash for 2 years. Option B will see returns of $10 million but ties up the company's cash for 7 years. In this case, part of the opportunity cost is how important the timeline of returns is and how badly the business needs liquid assets. Tying up the company's money for a longer period of time, while producing higher returns, also creates the possibility for a missed opportunity down the line as liquid resources are lacking.

What's the Difference between Sunk Costs and Opportunity Costs?

Meaning

- Sunk costs have already been incurred and cannot be recovered by any means
- Opportunity costs represent forgone returns of alternative opportunities

Implicit or Explicit

- Sunk costs are explicit as they are the result of actual cash flows
- Opportunity costs are generally implicit as they are notional in nature and do not come in the form of cash outflow

Estimation of Cost

- Sunk costs can be accurately estimated as they have actual purchase prices that have been incurred
- Opportunity costs are harder to estimate as they are often notional and their value is more subjective

Reporting

- Sunk costs have already been paid for and are reflected on balance sheets and financial statements

- Opportunity costs are not shown on financial statements, though they may be included in managerial reports

Role in Decision Making

- Sunk costs have already been incurred and are therefore no longer relevant to future business decisions
- Opportunity costs are very important to future business decision-making as they represent the potential benefits a business misses out on when choosing one alternative over another.

How can Considering these Costs Improve how your Company Does Business?

Every business wants to save money, and understanding both sunk and opportunity costs allow them to do just that. The cost management process helps identified savings match realized savings by controlling business costs. In the cost management process, decision-makers determine the business's budget, estimate costs, and then manage these costs over the duration of the project or investment.

Take the following scenario and see how considering sunk and opportunity costs can improve decision-making and how your company does business.

Imagine your business has spent $50,000 training employees in your new CRM system. A year into training, the employees still do not fully understand the new system. Your procurement team has identified an opportunity to save 40% over the next fiscal year by switching to an alternative training program that costs $30,000. Some managers in your company are wary of switching as they have already committed $50,000 to a training program and should just continue with it. Your newest manager, who understands sunk costs, explains the sunk cost fallacy to them. The training has proven to be ineffective so continuing with it would be a poor business decision, irrespective of the $50,000 spent. He explains the opportunity cost of sticking with the current program is not only more expensive but also means sacrificing higher-quality training the new system offers. All things considered, it is a better business decision to switch to the new CRM training system.

By having a solid grasp of both sunk costs and opportunity costs, managers can better estimate the costs associated with potential investments and projects and identify the best course of action to go with, ultimately saving your business money and improving its performance.

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