

# Managerial Entrapment in losing projects

Statman and Caldwell FM 1987

# Project entrapment/refusal to abandon

- We have examined real options/flexibility
- Joyce: managers don't like flexibility
- Option to abandon
- Initial NPV +ve => take project
- Review project later: abandon project if termination value exceeds NPV of future cashflows from continuing
- Economic decision: Ignore sunk costs

# In reality

- Managers seem to hold on to losing projects too long (project entrapment)
- Statman and Caldwell explain as follows:
- Mental accounting (including sunk loss) rather than economic accounting
- Combined with prospect theory
- => managers chasing sunk losses
- Worsened by regret theory

# Numerical example

- Project has been going two years: already lost: -2000.
- Management can now abandon to get 1000 liquidation value.
- Or continue, with 50/50 chance of future (discounted) cashflows = 2000 or 0 (good or bad states)
- Ignoring sunk loss: risk aversion => abandon

# Mental Accounting/project entrapment

- But, mental accounting, including sunk loss
- => liquidation = -1000
- Continuation => 50/50 chance of 0 or -2000.
- Including sunk loss moves us from positive to negative domain => entrapment
- Worsened by regret aversion.