

THE REAL TRADE-OFF BETWEEN OPPORTUNITY COST AND UNCERTAIN PROFIT

Tshering Dema,
PG Student- Management
Royal University of Bhutan
Thimpu, BHUTAN.

ABSTRACT

The literatures have shown that there is a trade-off between the uncertainty and the profit in economic parlance. The empirical studies have shown the existence of the trade-off between the two. Opportunity cost is the other economic fact which is co studied with the uncertainty and profit. The opportunity cost is the cost which is exposed to the uncertainty and profitable avenues. This study shows that not only there exists a relation between the opportunity cost, uncertainty and profits but there also exists a trade-off between them. The study shows that the opportunity cost is always of the real consideration when determining the impact of the uncertainty over the profits.

KEYWORDS: Economic Analysis, Opportunity Cost, Trade-off, Uncertainty, Risk, Profits.

INTRODUCTION

Opportunity cost has always been considered while evaluating the alternative opportunities regarding any business investment decision. The opportunity cost is based on the concept of scarcity of resources and their multiple applications and usage. The principle of scarcity of resources says that the resources available to any economic activity are limited. And multiple usage theory says that all that scarce resources can be put to use in multiple circumstances and places. While selecting any particular usage the certainty of profits and the minimum risk coupled with the uncertainty is considered. There are various economic theories which say that the cost effective resources generating higher revenues should be opted for while going for any investment decision. The economists

have put forward their judgements regarding these economic theories. As per these theories when these scarce resources are put to the application generating a particular income, the other prospective applications are sacrificed. In this way the cost of the first application is the real cost of the resource plus the sacrificed revenues from the applications which were left out while making the investment decision.

DISCUSSION**OPPORTUNITY COST**

The opportunity cost is the income or revenue expected from the missed investment opportunities which were sacrificed for earning the revenues from the selected investment opportunity. The opportunity cost is also known as the cost of alternative (alternative cost).

UNCERTAINTY

Uncertainty is the level of occurrence of profits and losses. The uncertainty always comes with the printable avenues. It means where there is risk, there is profit and vice versa. The level of uncertainty has directly related with the level of profits, there exists a direct relation between the uncertainty (risk) and profit. It means higher the risk, higher the profits.

ECONOMIC PROFIT

The economic profits are those profits which are left out while deducting cost of revenues and the related resources. This can be described as a following equation:-

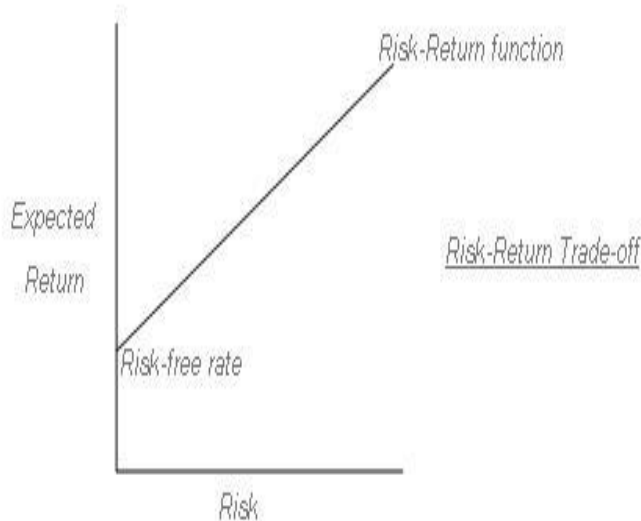
$$EP = TR - TC + OC$$

The EP is the economic profit, TR is total revenues, TC is total cost and OC is the opportunity cost. The above mentioned concept of economic profits clearly shows a relation between the opportunity cost and economic profits. The economic profits are not the balance sheet profits instead these are the profits which are calculated by the management while making a decision for any economic investment.

The opportunity cost has become vital issue while calculating the economic profits. The

opportunity cost is based on the concept of earning the profit while sacrificing the other one. The expected profit is purely based upon the future to come. The expected profit may or may not occur at a given future date. It means the opportunity cost has a direct bearing on the expected profit which is exposed to the uncertain future involving a degree of risk. This relation is to be called as the trade-off between the opportunity cost, uncertainty and economic profit.

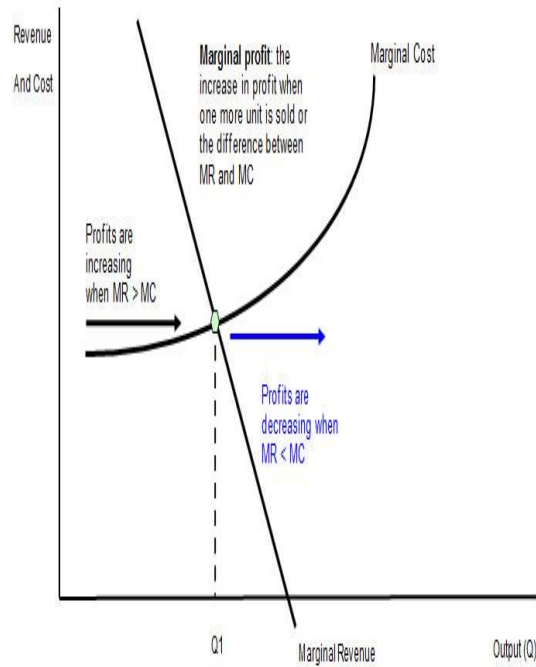
The following figure shows the trade-off between the risk and return in the first place:-



In the above figure, the risk free return is the trade-off between the risk and the expected return. The influence of risk over the expected return determines the degree of the actual profits. The risk free return and the degree of risk prepare the trade-off. This trade-off directly establishes a complimentary relation between the risk and the return on a given portfolio. The

risk free rate prescribes the optimum performance level of a give investment opportunity which justifies the sacrifice of the opportunity cost. Upto a level of activity, the return stays risk free but as the level of activity increases the risk factor comes to impact the profitability.

The following figure shows the relation between the opportunity cost and economic profit:-



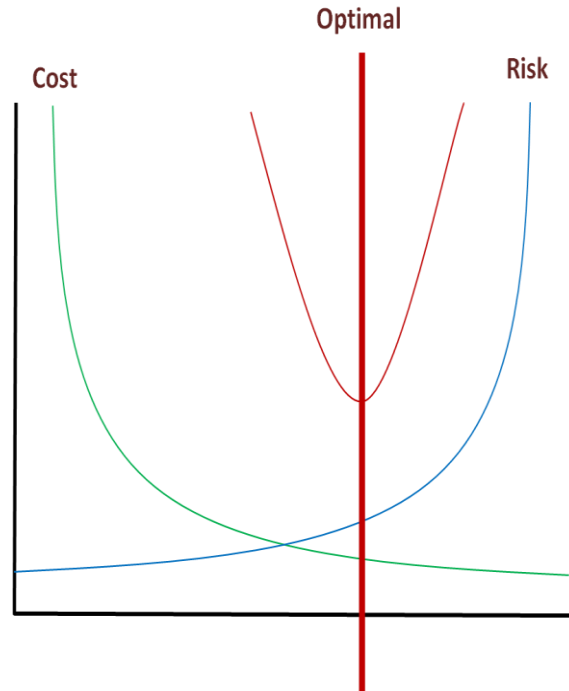
As depicted above, the economic profit decreases when the marginal opportunity cost increases. As the marginal revenue increases, the level of borne opportunity cost tends to decrease. The figure clearly shows that there is an inverse relation between the opportunity cost and the level of economic profit. The marginal cost coupled with the opportunity cost has the profit diminishing properties.

In economic parlance, it is always assumed that the as the cost increases, the profit decreases at a given level of revenue. The resources which are allocated to some productive usage will not be put to use to any other use as the principle of

scarcity of resources prevails. The above figure provides an opinion that the opportunity cost as included in the marginal cost. The total cost while including opportunity cost will bring down the economic profit to the decreased level.

The same holds good for the increasing risk and the likelihood of exposed to risk profits. The impending relation between the risk, marginal opportunity cost and economic profits exist irrespective of the conceptual trade-off is found only between the risk and return.

The following figure clarifies and depicts the trade-off between the opportunity cost, economic profit and the risk factor:-



As stated above, the opportunity cost exists at the bottom of the curve line as Y shaped. The impact of the opportunity cost is hidden at the bottom but it gives the basis to the cost and risk. Both risk and cost have their own impacts for the calculation of the optimum level of risk and return called as trade-off between the opportunity cost, the level of risk as well as the scarcity and multiplicity of the usage of the resources.

CONCLUSION

The imbining effect of the opportunity cost over the economic profit in uncertain circumstances has been proved by the above discussion the real trade-off between the risk and the return is now to be refined as the real trade-off between the lost profits (opportunity cost) and the real profits (Economic profit) and the uncertainty factors. The discussion has shown the interrelations between the three economic concepts covering the cost, revenue with the presence of risk. As a conclusion it is to be shown that whatever the amount of opportunity cost is, the proportion amount has a direct bearing on the future expected returns after considering the risk factors.

REFERENCES

- I. Anand, M. (2001). Working Capital performance of corporate India: An empirical survey, *Management & Accounting Research*, Vol. 4, pp. 35-65.
- II. Bhunia, A. (2010). A trend analysis of liquidity management efficiency in selected private sector India steel industry, *International Journal of Research in Commerce and Management*, Volume-1, Issue-5 (Sep, 2010), pp. 9-21.
- III. Deloof, M. (2003). "Does Working Capital Management affects Profitability of Belgian Firms?", *Journal of Business Finance & Accounting*, Vol.30 No. 3 & 4, pp. 573-587.
- IV. Eljelly, A. (2004) "Liquidity-Profitability Tradeoff: An Empirical Investigation in an Emerging Market." *International Journal of Commerce & Management*. Vol. 14, No 2, pp. 48-61.
- V. Kothari, C.R. (2004). *Research Methodology: Methods & Techniques*, p.55.
- VI. Krzikowski, G.A. (1963), "Quality control and quality costs within the mechanical industry", *Proceedings of the 7th European Organization for Quality Conference*, Copenhagen, p.129
- VII. Machowski, F. And Dale, B.G. (1998), "Quality Costing: An examination of

- knowledge, attitudes and perceptions”, Quality Management Journal, Vol.5, No.3, p.84
- VIII. Malchi, G. and McGurk, H. (2001), “Increasing value through the measurement of the cost of quality (CoQ) – A practical approach”, Pharmaceutical Engineering, Vol.21, No.3, p.92
- IX. Mandel, B.J. (1972), “Quality costing systems”, Quality Progress, Vol.5, No.12, p.11
- X. Marcellus, R.L. and Dada, M. (1991), “Interactive process quality improvement”, Management Science, November, Vol.37, No.11, p.1367
- XI. Marsh, J. (1989), “Process modeling for quality improvement”, Proceedings of the Second International Conference on Total Quality Management, p.111.
- XII. Narware, P.C. (2004). “Working Capital and Profitability - An Empirical Analysis”, The Management Accountant, Vol. 39(6), pp. 120-127.
- XIII. Rahmen, A. & Nasr, M. (2007). Working capital management and Profitability - Case of Pakistani Firms. International Review of Business Research Papers, Vol. 3, No. 1, pp. 279-300.
- XIV. Ricci, C. and Vito, N.D. (2000). International Working Capital Practices in the UK, European Financial Management, Vol. 6 No. 1, pp. 69-84.
- XV. Samiloglu, F. and Demirgunes, K. (2008). The Effect of Working Capital Management on Firm Profitability: Evidence from Turkey. International Research Journal of Applied Economics and Finance, Vol. 2(1), pp. 44-50.
- XVI. Singh, J.P. and Pandey, S. (2008), “Impact of Working Capital Management in the Profitability of Hindalco Industries Limited”, The ICFAI University Journal of Financial Economics, Vol. 36, pp. 64-79.
- XVII. Vishnani, S. and Bhupesh, K.S. (2007). “Impact of Working Capital Management Policies on Corporate Performance: An Empirical Study.” Global Business Review 8, p.267.