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The Importance of Opportunity Costs in Financial Management in Connection to the Economic Profit

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ABSTRACT

The main goal of the paper is to present the position of opportunity costs in the analysis of financial management. The article discusses the costs of lost opportunities, explains their importance for the financial management of business entities and, based on a theoretical basis, points to the need to consider these costs in relation to economic profit. The individual parts of the article provide a description of individual financial analysis, economic profit, alternative costs and their interconnection and the importance of their interconnection. The article also provides an in-depth search, which is a secondary basis for pointing out the importance and significance of the interconnection of the mentioned economic variables and phenomena.

Keywords: *Financial management, economic profit, accounting profit, opportunity costs, alternative costs, financial analysis*

1. INTRODUCTION

Globalization is a concept that resonates in almost all areas of life. This is also the case in business economics too. The interconnection of economies, markets, banking systems and the resulting interconnection of capital are far beyond the borders of neighboring countries. In such an integrating business environment, it is important to know and use transparent and comparable methodological procedures and tools. This is particularly effective in the current turbulent development of the world economy and in cyclical changes in the economy. From this point of view, a necessary part of every company is financial management and its part a financial analysis, which looks at economic profit. For many years, accounting profit was considered a suitable indicator of profit, but the modern trend of profit is economic profit [1].

Economic profit is conditioned by achieving profit after deducting alternative costs of capital. Alternative costs are a basic but illusory concept in economics. The general idea is easy to understand - all relevant costs must be taken into account when making a decision. However, the exact meaning of "all relevant costs" and how to measure these relevant costs is not straightforward. Alternative costs can therefore be defined as lost revenue, which the company is deprived of by not implementing one alternative but preferring another. Complications in measuring alternative costs are mainly due to the fact that they are not recorded in accounting, they have an implicit character and their quantification is possible only if we consider two or more variants [2].

2. LITERATURE REVIEW

Financial management is an integral part of every business entity, whether larger or smaller. After all, all companies want to know how they stand in the business environment [3-5]. The basic activity is financial analysis, which includes a number of quantities and their mutual comparison and interconnection. This article deals with the connection of alternative costs with economic profit, which is in its essence an elementary apparatus of financial analysis and an aspect of value creation of a company, i.e. the goal of financial management. Incentives to point out the differences between accounting and economic profit can be spoken of in connection with past centuries. The concept of residual profit was mentioned in a work by the famous economist Alfred Marshall as early as 1890 [6]. This concept was related to the basis of economic added value. Residual profit, as the older term for economic profit, has been explained as the actual profit that a company makes when, in addition to various operating costs, the cost of invested capital (equity and debt) is covered [7].

The theory of alternative costs in relation to economic profit has been discussed by scientists Dluhosova [8] and Colander [9], who both argued that economic profit is conditioned by making a profit after deducting alternative costs of capital. According to them, alternative costs are a basic but illusory concept in the economy.

3. METHODOLOGY

Due to the theoretical character of the scientific article, we dealt mainly with the literature search and description of the variables in question. For the elaboration of the work, book publications from domestic and foreign authors mostly served as elementary sources of information. At the same time, knowledge from scientific articles and contributions, published in scientific journals and conference proceedings, as well as information from web portals focused on value-oriented management, the concept of economic profit, financial management and opportunity costs were incorporated. In order to fulfill both the main goal of the work and the above-mentioned partial goals, it was necessary to build on theoretical knowledge acquired through a detailed study of information sources. Given the current state of processing of the issue, the methods of formal logic mainly analysis, synthesis and description were used. The analysis was carried out mainly in accordance with the available theoretical knowledge from the above sources, which were subsequently transformed into a synthesis of the knowledge in question from available information sources.

4. RESULTS

Economic profit is thus the total income (yield), which is reduced by economic (actual, relevant) costs. Economic costs consist of the sum of implicit and explicit costs. Unlike accounting profit, implicit costs are also taken into account here, which, however, are not included in corporate accounting and are not expressed in monetary terms, and are therefore difficult to quantify. To calculate them, the costs of sacrificed opportunities (alternative costs, opportunity costs, lost opportunity costs) are used, which represent monetary amounts lost due to the fact that production factors were not used to the best extent [10].
Various other equivalents of economic profit are also used in the professional literature. In domestic as well as in foreign literature we can find the given issue under terms such as residual income, surplus value, residual income, abnormal income, surplus profit, super-profit. The basic idea of all these terms is basically the same, namely to produce a company's income in excess of the cost of capital. The equivalent "residual profit" is used because it takes into account the cost of the opportunity which was sacrificed. This term is also related to residual income. The main idea is to produce such revenue for the owners to cover the cost of the sacrificed opportunity. The terms surplus-value, surplus-profit, or super-profit are used to denote returns in excess of the cost of total capital. Abnormal income expresses a profit which, after deducting the cost of equity, is positive.
This positive result is no longer the normal profit produced by the company, but it is the so-called abnormal income of business owners. For the purposes of work, we will unify these terms into the concept of economic profit, which we will consider a profit exceeding the total cost of capital.

Alternative costs mean the best feasible opportunity, which has not yet been realized. Due to the limited economic resources, it is not possible to implement all the variants that are available on the market. For the highest achievable benefit, it is necessary to reject those variants where a lower benefit is achieved. The company has several options on the market and decides between several alternatives. By choosing one alternative, the company gives up the implementation of the other. Opportunity costs represent the value of the profit from the opportunities that must be sacrificed in favor of another alternative. Thus, opportunity costs do not represent the realized activities of the company, but the potential profit from the implementation of the second alternative. They are also defined as lost revenue that the company did not achieve because it preferred another alternative [11].

$$\text{Economic profit} = \text{accounting profit} - \text{implicit costs} \quad (1)$$

$$\text{Ec. profit} = \text{total return on capital} - \text{cost of capital} \quad (2)$$

$$\text{Ec. profit} = \text{revenues} - \text{explicit costs} - \text{implicit costs} \quad (3)$$

In connection with the economic concept of costs, the quantification of the so-called opportunity costs or lost opportunity costs based on the general consideration that a particular expense of an asset for the purpose of valuing it in a particular business activity makes it impossible to use it in another, alternative way [12].
The limited economic resources do not allow the company to realize all the possibilities, but only some of them. In order for the alternatives with the highest effect to be accepted, it is necessary that the rejected alternatives bring lower benefits. Opportunity costs are thus characterized as "lost" revenues, for which the company is deprived of the fact that it does not implement a certain alternative of further development. On the contrary, opportunity revenues represent costs that the company avoids by not implementing some alternative of further development [13].
Where resources are not limited, an enterprise doesn´t need to consider choosing an alternative to use those resources. The cost of lost opportunity is absolutely important for managerial accounting and financial management. Unless there is another option to use resources, then the cost of the lost opportunity is zero. But if resources have alternative uses and are limited, then there are also opportunity costs [14].

5. CONCLUSION

The manager may make the wrong decision in certain situations if he takes the wrong costs into account in the decision-making process. When management evaluates the financial benefits of different alternatives, they may be skewed in certain situations by taking into account irrelevant costs for the situation. Then it is necessary to distinguish which costs to include in the decision-making and which not. This cost concept represents cash outflows that will arise in the future as a result of a decision made. The concept of relevant costs can be used for decisions of various kinds, such as decisions on the continuation of an already started investment or project, decisions on own production versus purchase, etc. These are the expected future costs that differ in the possibilities of the activities considered. The cost of lost opportunity can be defined as the difference between the chosen investment and the one we necessarily sacrifice. It is a value that we must give up expressed in the value of another activity carried out. Their analysis helps managers make better decisions.

Opportunity costs are an important economic concept that has application in a wide range of business decisions. Their evaluation has many practical applications in business because they will exist as long as there is a lack of resources. The value of the best alternative must be taken into account when choosing between production options, calculating the cost of capital, analyzing comparative advantages, but also when deciding which product to buy or how to spend time.

It is important for managers to know that the cost of a missed opportunity is real even though it is not explicitly recognized in the balance sheet or income statement. Many times they are difficult to quantify because they are often associated with future activities. The big problem is that opportunity costs are often overlooked by many managers.

Most financial managers work with a set budget and pre-set goals, so they may miss out on growth opportunities. Without consulting the operations manager, the largest number of decisions is made. As a result, operations managers are convinced by CFOs that the search for opportunities that maximize the value of the organization should be avoided if the budget does not allow it.

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