THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

03104 – Management and Business Economics

Certificate in Accounting and Business I Examination
September 2012

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

PAPER ‘A’

ANSWERS FOR MULTIPLE CHOICE QUESTIONS

1.	**2**	11.	**2**
2.	**2**	12.	**3**
3.	**1**	13.	**4**
4.	**3**	14.	**3**
5.	**2**	15.	**1**
6.	**4**	16.	**4**
7.	**2**	17.	**1**
8.	**2**	18.	**2**
9.	**3**	19.	**4**
10.	**1**	20.	**1**

PAPER 'B'

Answer No. 01

(a) **Names of different types of economic systems prevailing in the world**

i. Free enterprise or Market economic systems; Capitalist systems.

ii. Centrally planned or Command economic systems; Socialist systems.

iii. Mixed economies

Basis for such categorization; taking i, ii and iii above respectively.

i. Supply and prices are regulated by market forces / price mechanism; economic decision making with regard to that how to produce, what to produce, to whom it is to be produced, their pricing etc. are solely guided by the interaction of market forces / price mechanism ; government intervention or central planning is minimum or virtually nil.

ii. Supply and prices are regulated by the government rather than market forces; government planners decide which goods and services are produced, what prices they should be charged and how they are distributed (i. e. central planning);

iii. Economic decisions are made partly by the free market forces of demand and supply and partly by the government.

(b) Sri Lanka is classified as a mixed economy.

Possible advantages, Sri Lanka could have for having a mixed economy.

In a mixed economy, both the Government and the private sector jointly control the economic system. The advantages of a mixed economy are;

i. Provide fair competition. The presence of private enterprise ensures that there is fair competition in the market and the quality of products and services are not compromised.

ii. The market prices are well regulated. The Government with regulatory bodies ensures that the market price do not go beyond the actual price.

iii. Optimum utilization of national resources. In a mixed economy, the resources are utilized efficiently, as both government and private enterprises are utilizing them.

iv. People are given more freedom. The average people have more say when it comes to the quality and the prices of products and services.

v. It does not allow monopoly at all. A mixed economy does not allow any monopoly as both Government and private enterprises enter every sector for business.

(c) (i) **Normative Economics**

A perspective on economics that incorporates subjectivity within its analyses. It is the study or presentation of "**what ought to be**" rather than "**what actually is**". Normative economics deals heavily in **value judgments** e.g. government should have controlled the inflation.

(ii) **Positive Economics**

Positive economics is the opposite of it. Positive statements are statements of facts. It studies **"what is", "what was"** or, **"what will be"** e.g. average inflation rate is 8% this year.

(d) **The impact of the decline of National Savings in Sri Lanka, as a percentage to GDP, form its 2010 level of 25.4% to 22.1% in 2011felt on economic development**

i. Decline in capital formation / availability of resources for investments,

ii. Actual level of investments in the economy would come down.

iii As a result, growth rate of the economy would become lower than the expectation.

iv. Under employment of resources in the economy.

v. Economic development would be slowed down.

Answer No. 02

(a) $Q(d) = 600 - 15P$

$Q(s) = -275 + 20P$

(i) Price at market equilibrium; i. e. P at when, Q (d) = Q (s)

i.e. $600 - 15P = -275 + 20P$

$600 + 275 = 20P + 15P$

$35P = 875$

$P = 875/35 =$ **Rs. 25**

Now **Q** value is to be determined by substituting **P** value for any one of the two equations.

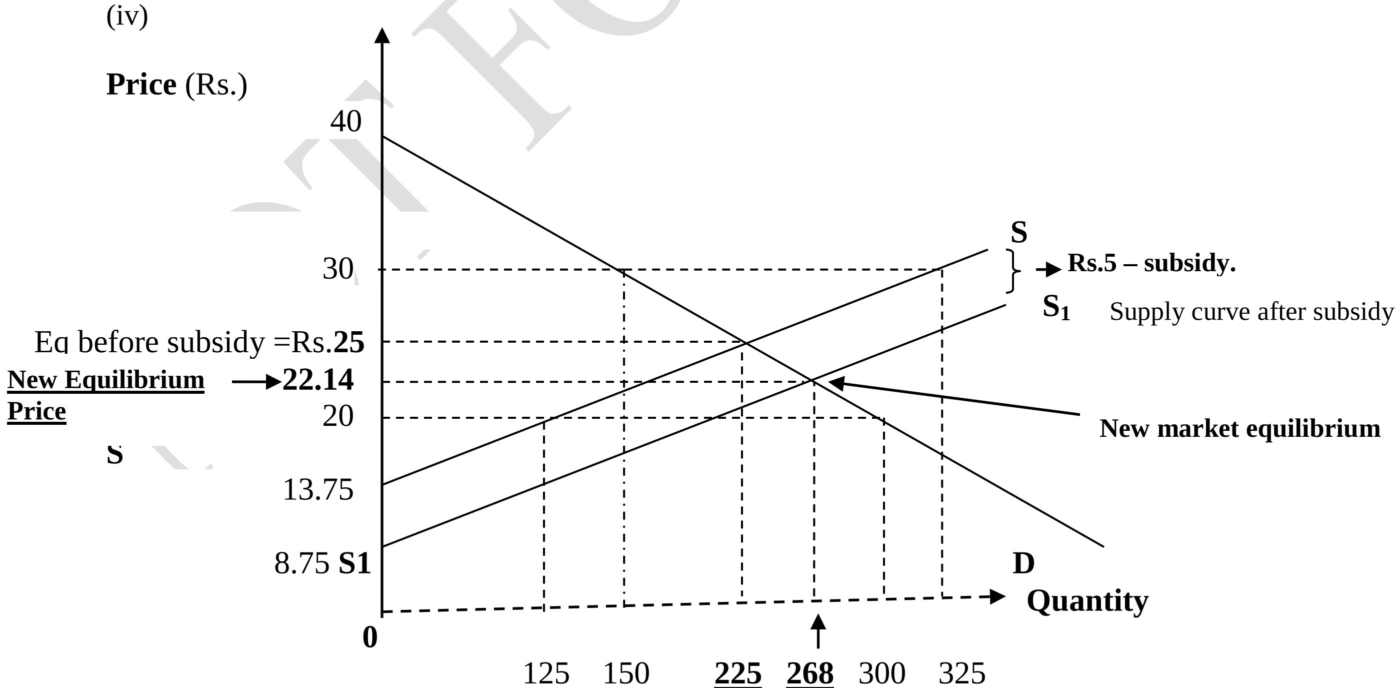
$Q = 600 - 15P = 600 - 15(25) =$ **225 Units**.

(ii) Schedule of quantities demanded and supplied, at P= Rs. 20/= and Rs. 30/=

Price (P) (Rs.)	**Q Demanded.**	**Q Supplied.**
20.00	300	125
30.00	150	325

(iii) Market Demand and Supply Curve;

(iv)



<u>Calculation of new equilibrium, when the government introduced the subsidy for each unit sold</u>;

Q (d) = 600 – 15P (**No change**)

Q (s) = -275 + 20P (**Before subsidy**)

Q_{S_1} = -175 + 20P (**After subsidy of Rs. 5/= for each unit sold**)

<u>Price at new equilibrium</u>; 600 – 15 P = - 175 + 20 P
600 + 175 = 15 P + 20 P
775 = 35 P
P = **<u>Rs. 22.14</u>** (Approximately)

<u>Quantity at new equilibrium</u>; Q = 600 – 15P = 600 – 15(22.14) = 600 – 332 = **<u>268 Units</u>**

New equilibrium price = Rs. 22.14
New equilibrium quantity = 268 units

(a) Consumer surplus = (268) (40.00 -22.14)
= **<u>Rs. 2,393.24</u>**

(b) Producer surplus = (268) (22.14 - 8.75)) + (**subsidy**)
= (1,794.26) + (5.00 * 268)
= **<u>Rs. 3,134.26</u>**

Note: (i) Rs. 40.00 = price at which quantity demanded becomes zero
(ii) Rs. 8.75 = price at which quantity supplied becomes zero, after subsidy
(iii) At above (a) and (b), is used to calculate the square area of a triangle, as applicable.

(b) When a price of a commodity comes down, say from Rs. 10 per unit to Rs. 8 per unit, the quantity demanded at the new price of Rs. 8 would be much higher, say 12 units, than that for at Rs. 10 per unit, say 8 units, under normal circumstances.

This increase in quantity demanded in 4 units would be caused due to two combined effects, namely:

i. Income effect and
ii. Substitution effect.

Income Effect.

As a result of the price reduction, first thing to happen would be the increase of the **real income** of the consumer. E.g. If the total income of the consumer is Rs. 200/=, prior to the decrease of the price, total units that could be purchased would be 200 / 10 = 20 units; now at the reduced price it would be 200 / 8 = 25 units. The real income, i.e. quantity that could be purchased, has gone up from 20 to 25 units or by 25%. As a result of this increase of the real income or real purchasing power increase takes place, the consumer tempts to demand more from the commodity concerned. This increase in the quantity demanded is considered as **"income effect" as it takes place in view of the increase in the real income.**

Substitution Effect.

The second thing that would happen is that due to this price reduction, the commodity concerned would become cheaper compared to the prices of substitute goods available for this commodity. Now the price of the commodity concerned is relatively low. Due to this happening, the consumer concerned would tempt to demand more from this commodity, in place of the substitutes that he used to buy earlier, prior to the price reduction of this commodity. This increase takes place in the quantity demanded is considered as due to "**substitution effect**" as it takes place in view of the increase in demand **due to the substitution that would take place.**

(c) **Accounting Profit vs. Economic profit.**

Profit is defined as the **residual value gained from any business operation**. However, the exact method of calculation differs between accountants and economists.

Economists usually define profits as" revenues **less** the **opportunity** cost of land, labour, capital and materials used for its production". This surplus is the economic profit that economists see as the incentive for firms to enter or leave the market / industry.
Therefore, **Economic profit = Revenue – Total opportunity cost involved.**

In the accounting sense of the term, net profit (before tax) is the residual after deduction of all money costs such as; **wages, rent, fuel, raw materials, interest on loans and depreciation.**

Another definition of accounting profit is the "**total revenue less costs properly chargeable against the goods sold".**

In calculating economic profit, **opportunity costs** are deducted from revenues earned. **Opportunity costs of inputs** are the alternative best returns foregone due to using the chosen inputs for the current operation. As a result, there may be a situation with a significant accounting profit but with little to no economic profit.

For example, say, for an investment of Rs. 100,000 to start a business, somebody earns Rs. 120,000/=. Then the accounting profit earned would be Rs. 20,000. However, say, that in the same year, if he could have earned an income of Rs. 45,000 some other way, his **economic loss** under this situation would be Rs. 25,000. i.e (120,000 - 100,000 - 45,000).

Answer No. 03

(a) **Internal and external price stability**

Internally, the **Price Stability** is a situation where there are **no wide fluctuations in the general price level** in an economy which helps to achieve sustainable economic growth.

When the prices fluctuate at a low rate, there would **not** have any significant influence on economic decisions of participants of an economy, viz. households and firms. Therefore, stable prices **would not distort the economic decisions** regarding what to produce and how to produce etc., thus enabling, efficient allocation of resources in the economy leading to economic stability.

Similarly, **External Price Stability** is a situation where there are no wide fluctuations in the **exchange rate** and that situation helps to achieve **sustainable level of external trading and a balance of payment situation**, in dealing with the outside world.

Therefore, the price stability, **internally and externally** is very vital for the achievement of sustainable economic development for the economy.

(b) **Monetary Policy instruments of the central Bank;**

The Central Bank possesses a wide range of tools to be used as instruments of monetary policy. The main monetary policy instruments currently used are;

(a) Policy interest rates and open market operations (OMO) and
(b) The statutory reserve requirement (SRR) on commercial bank deposit liabilities.

(c) (i) **Policy interest rates and open market operations (OMO)**

The key elements of this instrument are (i) an interest rate corridor formed by the main policy rates of the Bank i.e. the **repurchase rate** and the **reverse repurchase rate**, (ii) a **daily auction** either to **absorb or inject** liquidity.

These main policy instruments of repurchase rate and reverse repurchase rate of the Central bank form the lower and upper bounds for the comparable overnight interest rates in money markets. These rates are reviewed on a regular basis by the Central Bank, usually once a month, and revised if necessary.

A daily auction / open market operations are conducted either to absorb liquidity through repurchase transactions, if there is excess liquidity, or to inject liquidity through reverse repurchase transactions, if there is a shortage of liquidity and thereby to maintain overnight interest rates stable around a level considered consistent with the reserve money targets.

There also exists another policy rate known as the **Bank Rate**. It is the rate at which, the Central Bank provides credits to commercial banks as lender of last resort.

(ii) **Statutory Reserve Requirement (SRR).**

The Statutory Reserve Ratio, the percentage (portion) of the deposit liabilities that commercial banks are required to keep as cash deposit with the Central Bank, had been widely used to influence money supply in the past.

However, the reliance on SRR as a day to day monetary management measure has been gradually reduced with a view to enhancing market orientation of monetary policy and also reducing the implicit cost of funds with the SRR would entail on commercial banks.

Under Monetary Law Act, commercial banks are required maintain reserves with the Central Bank at rates determined by the Central Bank. At present, demand, time and savings deposits of commercial banks are subject to SRR.

(d) (i) **GDP at Factor Cost Prices;**

Gross domestic product (GDP) is the aggregate value of-all final goods and services produced within the domestic territory of a country during a year.

The term "**factor cost**" or basic price is used in the national accounts to refer to the prices of products **as received by producers**.

Accordingly **GDP at factor cost = Total factor cost of production of all final goods and services including the profit = total salaries, wages & employee earnings, total rent, total interest and total corporate profit.**

In other words, factor income earned by all four factors of production in the process of production of goods and services.

(ii) **GDP at market price;**

This is the money value of all domestic final gross output or product of a nation. The term domestic output refers to the output exclusively produced within the domestic territory of a country. "By gross domestic product we mean value of all the final goods and services produced in any given period usually in a year in the domestic territory of a country".

In 'order to calculate GDP **at market price**, all goods and services produced domestically are **multiplied** by their respective **market prices**. Market prices are the **prices as paid by consumers**. Thus, factor cost or basic prices are equal to market prices **minus** taxes on products **plus** subsidies on products.

GDP at market prices = (GDP at factor cost prices) + (Indirect taxes or taxes on products) – (subsidies on products).

<u>Answer No. 04</u>

(a) **<u>Inflation</u>**;

In economics, **inflation** is a rise in the **general level of prices of goods and services** in an economy **over a period of time** **<u>or</u>** the **rate at which the general level of prices** for goods and services is rising in an economy.

(b) Colombo Consumer Price Index is the index used to measure the rate of inflation in Sri Lanka

(c) (i) **Demand Pull Inflation**;
This is a term used in Keynesian economics to describe the scenario that occurs **when price levels rise** because of an **imbalance** in the **aggregate supply and aggregate demand**. When the aggregate demand in an economy strongly outweighs the aggregate supply, prices increase. Economists will often say that demand-pull inflation is a result of too many dollars chasing too few goods.

(ii) **Cost Push Inflation;**
This is a phenomenon in which the general price levels rise (inflation) due to increases mainly in the **cost of wages and raw materials of goods or services produced.**

(d) **<u>GDP Deflator</u>**;
In most systems of national income accounts, GDP deflator measures the **ratio of nominal (or current-price) GDP to the real (or volume) measure of GDP**. The formula used to calculate the deflator is:

$$\text{GDP deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$$

Here the Real GDP is GDP at constant prices.

Dividing the nominal GDP by the Real GDP and multiplying it by 100 would give the figure for real GDP, hence deflating the nominal GDP into a real measure. This measure helps to ascertain the real growth in GDP over the years.

(e) (i) **Improved domestic supply conditions;**

This means the situations contributed to increase the **aggregate supply** caused by say, **improved weather conditions** as regards the agricultural products, **improved productivity** due to **enhanced technology, higher investments** etc. This situation has helped to maintain the **internal price stability** by **minimizing the inflationary pressure** due to **heavy demand.**

(ii) **Prudent Liquidity Management in the economy;**
This means the **effective implementation of monetary policy measures** by the Central Bank **to maintain the money supply and aggregate deman**d in the economy at an optimum level **to minimize the inflationary pressure due to possible increased aggregate market demand** due to **excessive money supply/excessive liquidity** in the economy.

Answer No. 05

(a) **"Balance of Payments" (BOP)**

A record of all transactions made **between one particular country** and **all other countries** during a **specified period of time**. BOP compares the dollar difference of the amount of exports and imports, including all financial exports and imports. A negative balance of payments means that more money is flowing out of the country than coming in, and vice versa. Persistent negative balance of payments situation will contribute to experience adverse external disability.

(b) **Main Components of a Balance of payments Account.**

I. Current Account	
(A) Goods	General merchandise, goods for processing, repairs on goods produced in ports by carries and non-monetary gold.
(B) Services	Transportation, travel, communications, construction, financial and computer services, royalties and license fees, other professional and business services.
(C) Income	Direct investment income, portfolio investment income, and compensation of employees
(D) Current Transfers	Government current transfers, workers' remittances and other current transfers.
II. Capital and Financial Account	
1. Capital Account	
(A) Capital transfers	Government and private transfers of fixed assets and forgiveness of liabilities.
(B) Non-produced and Non-financial assets	Land and subsoil assets, patents, copyrights, trademarks, franchises.
2. Financial Account	
(C) Direct Investment	External investments with lasting interest in enterprises.
(D) Portfolio Investment	External investments in securities and financial derivatives.
(E) Other investment	External investments other than reserves, direct and portfolio investments. For example, short- and long-terms loans, trade credits, currency holdings and deposits, other accounts receivable and payable.
(F) Reserve Assets	Monetary gold, foreign exchange assets and other claims.

(c) **<u>Reasons for experiencing a persistent BOP Problem;</u>**

Over the last two to three years, Sri Lanka has been experiencing **a progressive increase of imports coupled with gradual decrease of exports or increase of exports**, **but not at the rate of increase of imports** to enable **to outweigh the exchange outflow taken place** in the external trade. This was aggravated by the **deteriorating terms of trade** experienced by the country, especially **due to increasing fuel prices** in the world market.

(d) **<u>Root causes for BOP problem;</u>**

i. Worldwide economic recession taken place.
ii. Gradual decrease in prices of certain agricultural exports, e.g. Tea.
iii. Not receiving certain export duty concessions, as Sri Lanka is a middle income economy.
iv. Not taking the export proceeds back to the country by exporters and instead, retaining them outside the country, expecting further depreciation of Sri Lankan Rupee.
v. Increase in fuel prices causing to have an increase of foreign exchange outflow.
vi. Heavy demand for imported consumer items, including automobiles.

(e) **<u>Remedial measures taken;</u>**

(i) Devaluate the Sri Lankan rupee against foreign currencies and thereafter allowing to float the Sri Lankan Rupee.
(ii) Introduce certain monetary policy measures, mainly the increase of interest rates, to curtail the excess liquidity in the economy which had been causing to increase the demand for imports.
(ii) Increase import duties of certain selected items like automobiles, to reduce the import demand to minimize the exchange outflow.
(iii) Increase the selling price of fuel to control the consumption and reduce the pressure on its import bill.
(iv) Encourage the commercial banks to minimize the loans given for imports.
(v) Persuade exporters to bring back their export proceeds to Sri Lanka.

Answer No. 06

(a) **Management Process**;

The process of **planning, implementing and controlling** activities of any task / project that involve **using human, financial and material resources**, **in order to achieve set goals and objectives.**

(b) **If no proper planning taken place, there would not be any effective control;**

A typical process for management "**control"** includes the following steps: (**1**) actual performance is compared with **planned performance**, **(2**) the difference between the two is measured, (**3**) causes contributing to the difference are identified, and (**4**) corrective action is taken to eliminate or minimize the difference.

Accordingly, if there is no proper planning, **no proper comparison could be made** for the purpose of **control** as there would not be such **pre determined targets** and if that is the case, no proper investigation also could be made to **ascertain the contributing reasons** for such adverse variations /differences, **in order take corrective actions**.

Therefore, there would not be an effective control **to take place,** if there is no any plan to be compared with the real achievement.

(c) **Delegation of authority;**

Delegation is the **assignment of authority and responsibility** to another person (normally from a manager to a subordinate) to carry out **specific activities**. However the person who delegated the work remains **accountable for the outcome of the delegated work.** Delegation **empowers** a subordinate to make decisions, i.e. it is a **shif**t of decision-making authority **from one organizational level to a lower one**.

(d.) **Pre-requisites for successful delegation;**

i. Correctly identify the right task to be delegated.
ii. Correctly identify the right person (a competent person) to whom the task should be delegated.
iii. Provide necessary training to the delegate to undertake the task.
iv. Provide the necessary resources, including the necessary authority, to the delegate to carry out the task.
vi. Availability of the superior on the scene to give guidance and advice to the delegate when it is required.
vii. The superior must monitor the progress of the work by way of regular feedback, but without closely controlling the subordinate.
viii. The subordinate must be rewarded for successfully carrying out the assigned task.

Answer No. 07

(a) **Effective Communication**;

Communication is the process of **sharing information**, **thoughts and feelings** between people through **speaking, writing or body language**. Effective communication extends the concept to require that **transmitted content is received and understood by someone in the way it was intended**. The goals of effective communication include creating a common perception, changing behaviors and acquiring information.

(b) **Why Effective communication is significant for managers to perform their jobs?**

Effective communication is important in an organization because it creates mutual understanding environment between the managers and employees. Directly, it also helps in increasing the employee's productivity.

Therefore, clear speech is important so the other person / people can understand what the manager is saying. If it is written information, it should include facts as well as opinions so it is not biased. It should be formal and simple to read. People who will read this so think of how they would see it and work from there. It gives a sense of direction to the workers as they now understand what they are to achieve through good communication.

(c) **Esteem needs of human beings are considered very important for employee motivation;**

All humans have a need to be respected and to have self-esteem and self-respect. Esteem presents the normal human desire to be accepted and valued by others. People need to engage themselves to gain recognition and have an activity or activities that give the person a sense of contribution, to feel self-valued. Imbalances at this level can result in low self-esteem or an inferiority complex. People with low self-esteem need respect from others. They may seek fame or glory, which again depends on others.

Most people have a need for a stable self-respect and self-esteem. Maslow noted **two versions of esteem needs**, a lower one and a higher one. **The lower one is the need for the respect of others, the need for status, recognition, fame, prestige, and attention. The higher one is the need for self-respect, the need for strength, competence, mastery, self-confidence, independence and freedom.** Deprivation of these needs can lead to an inferiority complex, weakness and helplessness. That is why, recognition of esteem needs is considered more important for employee motivation.

(d) **Hygiene or maintenance factors;**

Hygiene factors are the situations related to the **environment in which employees do their work**. **Presence of hygiene factors in a poor condition causes job dissatisfact**ion. However, maintaining hygiene factors in an optimum level does not necessarily increase the job satisfaction level like in the case of the presence of motivational factors, which **influences to enhance the job satisfaction level.**

Some examples of hygiene factors:

i. Company Policy.
ii. Working Conditions.
iii. Salary.
iv. Benefits.
v. Supervision.
vi. Administration.

Notice of Disclaimer

The answers given are entirely by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) and you accept the answers on an "as is" basis.

They are not intended as "Model answers', but rather as suggested solutions.

The answers have two fundamental purposes, namely:

1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) makes no warranties with respect to the suggested solutions and as such there should be no reason for you to bring any grievance against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka). However, if you do bring any action, claim, suit, threat or demand against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka), and you do not substantially prevail, you shall pay the Institute of Chartered Accountants of Sri Lanka's (CA Sri Lanka's) entire legal fees and costs attached to such action. In the same token, if the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) is forced to take legal action to enforce this right or any of its rights described herein or under the laws of Sri Lanka, you will pay the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) legal fees and costs.