

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KE5 – Commercial Insight for Management

September 2016

SECTION 1

Answer 01

1.1

Learning Outcome/s: 1.1.1

Define the terms, 'business' and business organisation'

Correct answer: C

1.2

Learning Outcome/s: 5.3.1

Define the concepts of 'authority', 'responsibility', 'power' and 'accountability'.

Correct answer: A

1.3

Learning Outcome/s: 2.8.2

Explain the types of economics goods (including normal goods, Giffen goods, inferior goods, Veblen goods and public goods)
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Correct answer: A

1.4

Learning Outcome/s: 3.6.2

Compute the different types of elasticity.
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Correct answer: B

1.5

Learning Outcome/s: 3.8.1

Identify types of competitors under different classifications.
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Correct answer: B

1.6

Learning Outcome/s: 3.11.1

Explain characteristics of perfect competition, monopolistic competition, monopoly, oligopoly and their impact on businesses
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Correct answer: B

1.7

Learning Outcome/s: 6.3.1
Discuss the different cost concepts (total cost, marginal cost and average cost) in the short run and long run using graphical methods.
Correct answer: D

1.8

Learning Outcome/s: 6.7.1
Define short run and long run production concepts and related production measurements (total production, average production, marginal production) using graphical means.
Correct answer: C

1.9

Learning Outcome/s: 5.5.1
Define the concept of 'controlling'
Correct answer: B

1.10

Learning Outcome/s: 6.15.1
Identify the basic concepts of project management
Correct answer: D

(Total: 20 marks)

Answer 02

2.1

Learning Outcome/s: 1.6.1

Identify the volatile nature of modern work environment and its impact on the role of an accountant

- Providing more useful information on business units, projects, products and customers
- Supplying business cases for new investments
- Giving support in helping operational managers understand the information provided
- Collaborating in strategic planning and budgeting
- Designing information systems that provide greater support for operational managers.

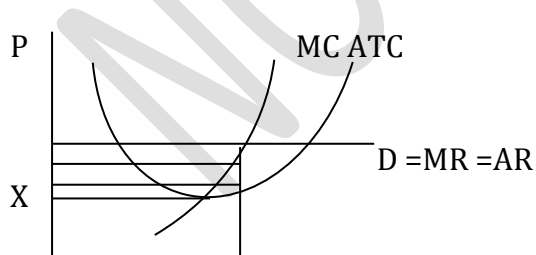
2.2

Learning Outcome/s: 3.10.1

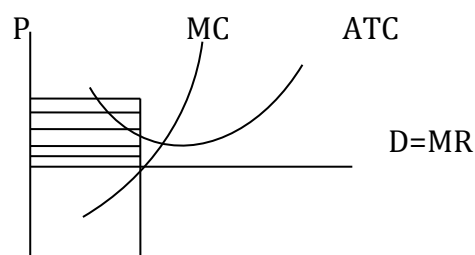
Explain the total revenue/total cost approach and marginal revenue/marginal cost approach in profit maximisation only using graphical means

In the short run, firms make supernormal profits since the average revenue is greater than the average cost (Graph 1) due to 'free entry and exit'; one of the main features in perfect competition. These profits attract new firms to the industry, causing price to go down. Hence instead of making profit the firm will start to incur losses. (Graph 2).

Therefore in the long run, firms will leave the industry due to losses.



Graph 1

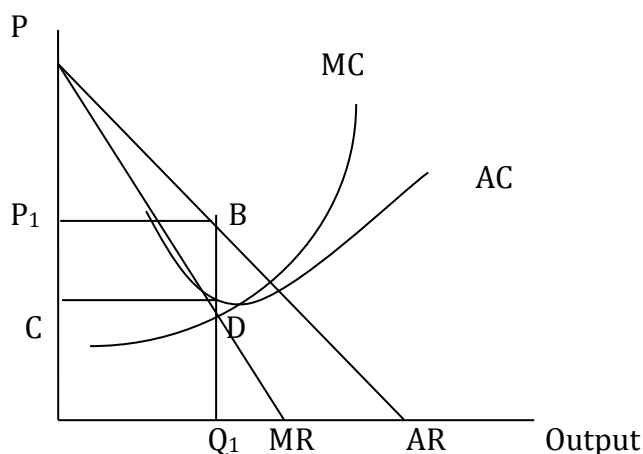


Graph 2

2.3

Learning Outcome/s: 3.12.1

Explain how businesses determine the optimum output, price and profit in the short and long run in different markets



A monopolist's profit is maximised at output level Q_1 , when marginal cost equals marginal revenue, and the price charged is the average revenue P_1 . The monopolist is earning supernormal profits and this is depicted in the rectangular area P_1BCD .

2.4

Learning Outcome/s: 4.3.1

Identify the circular flows of income and expenditure in the 'Four Sector Model'.

- (i) Tax, savings, import expenditure
- (ii) Tax will discourage investments. As a result economic growth will hinder.
Savings will reduce the circular flow and thereby reduce the aggregate demand.
Imports will increase the outflows from the country.

2.5

Learning Outcome/s: 4.5.2

Discuss the pros and cons of market vs. controlled exchange rates.

- Governments do not have to spend or even hold foreign currency reserves.
- Balance of payments deficits or surpluses are automatically corrected.
- Governments need not adopt economic policies that may be undesirable for other reasons to maintain exchange rates.
- A floating exchange rate system encourages efficient allocation of resources since exchange rates will reflect economic conditions.

2.6

Learning Outcome/s: 4.8.1

Discuss the nature of the prevailing socio cultural conditions and their impact on businesses

- Health and diet issues – there have been significant changes in the attitudes of some countries towards diet and health with people slowly moving to a healthier diet. In addition, there has been an increase in vegetarianism and green consumerism, including a move towards ‘organic food’.
- Women in work – due to increased participation of females in the workplace, there is a trend of shifting towards part-time working and flexible working.
- Environmentalism – as a result of growing concern over environmental sustainability and conservation, business organisations are moving towards more eco-friendly business practices.

2.7

Learning Outcome/s: 4.10.1

Discuss the new dynamics of the global environment and their impact on business

- Improved communication across the globe, including telecommunications and air transport
- Elimination of trade barriers between countries, as nations give up protectionist behaviour to enjoy the potential gains from trade
- Political change that has moved more economies away from tribal or state planned economies towards a market system
- Enhanced competitiveness
- Emergence of new growth markets
- Cross national business alliances and mergers

2.8

Learning Outcome/s: 6.5.1

Discuss the concepts of economics of scale and economies of scope in a business

- Reduced cost of material purchases through bulk purchase discounts
- More efficient inventory holding
- Bulk selling that enables a large firm to make relative savings in distribution and advertising costs
- Achieving economies of scope due to offering a wider range of products.

2.9

Learning Outcome/s: 6.13.1

Discuss wage determination in competitive factor markets, under demand and supply conditions (using labour leisure model)

Substitution effect – a rise in the wage rate increases the opportunity cost of leisure, as each hour spent not working involves a greater sacrifice in terms of the amount of income forgone. The substitution effect hence leads the individual to substitute work for leisure.

2.10

Learning Outcome/s: 6.14

Management information systems in organisation
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- Recording transactions – information systems assist an organisation to record information about each business transaction or event.
- Decision making – information systems enable organisations to make informed decisions
- Planning – information systems can provide a number of planning tools
- Performance measurement – information systems are useful in collection, analysis and presentation of data, which in turn is used for measuring performance
- Control – information systems can be used to monitor and control the outcomes of plans

(Total: 30 marks)

SECTION 02

Answer 03

Learning Outcome/s: 2.7 and 2.9
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2.7. Introduction to scarcity, choice and opportunity cost
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2.9. Economic vs. accounting profits

- (a)
- (i) Scarcity is the excess of human wants over what can actually be produced.
 - (ii) Opportunity cost represents the benefits of the best alternative given up/benefits foregone, when a decision is made.
 - (iii) Economic profit or loss is the difference between the revenue received from the sale of an output, and the opportunity cost of the inputs used.

- (b) In the presence of scarcity, in order to earn maximum profit from the investment, a decision-maker should not confine himself/herself to the financial profit of the investment, but should also pay attention to the opportunity cost of the investment i.e. the benefits of the best alternative given up/benefits foregone, when a decision is made.

In doing that, the investor could ascertain the economic profit of the investment by paying attention to the scarcity of the resources set apart for the investment.

Accordingly, the net benefit gained represents the actual benefit what he/she gains from the investment.

- (c) Economic profit = Revenue – (explicit cost + implicit cost).

	Project A	Project B
Initial capital	10,000,000	15,000,000
Annual rate of return	15%	18%
Income	1,500,000	2,700,000
Cost of additional capital	-	5,000,000
Interest rate	-	22%
Explicit cost	-	1,100,000
Accounting profit	1,500,000	1,600,000
Implicit cost (opportunity cost)	1,600,000	1,500,000
Economic profit	(100,000)	100,000

∴ the best project to select is Project B

(Total: 10 marks)

Answer 04

Learning Outcome/s: 4.4 and 4.6.2
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4.4 Role of inflation

4.6.2 Discuss the impact of monetary and fiscal policies on business
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- (a) Demand pull inflation occurs due to an excess of aggregate demand over the productive capacity of the economy (i.e. aggregate supply).

Example – an increase in aggregate demand due to increased income levels of consumers, increased government expenditure, increased demand for exports etc.

Cost push inflation results from an increase in the cost of production of goods and services that leads to a fall in aggregate supply.

Example – depreciation of the exchange rate that results in increased prices of imported raw materials, increased wage rates etc.

- (b) When the country has a high rate of inflation compared to other countries, its exports become relatively expensive and imports become relatively cheap.

As a result, demand for exports will fall and demand for imports will rise. Therefore this will affect the country's balance of payments negatively.

- (c)

- Contractionary fiscal policy by way of higher taxation and lower government expenditure.
- Contractionary monetary policy by way of increasing interest rates or decreasing money supply.
- Net effect of contractionary policies need to be stronger compared to the net effect of expansionary policies for controlling inflation effectively.

(Total: 10 marks)

Answer 05

Learning Outcome/s: 5.4

Nature and scope of leading as a management function
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(a)

- Entrepreneurship – the ability to spot business opportunities and mobilise resources to capitalise on them.
- Interpersonal skills – such as networking, rapport building, influencing, negotiating, conflict resolution, listening, counselling, coaching and communicating assertively.
- Decision-making and problem solving skills – which includes seeing the big picture
- Time management and personal organisation
- Self-development skills – the ability to learn continuously from experience, grow in self-awareness and exploit learning opportunities.

(b)

‘Leaders and born, not made’ is the underlying principle of trait theories of leadership, which suggest that there are certain personal qualities common to successful leaders.

However, this theory has been more or less discredited due to following reasons:

- The success of leaders also depends on the behaviour of the leader (style theories) as well as on the situation (contingency theories)
- The premise that certain qualities are absolutely necessary for effective leadership has never been substantiated
- The lists of traits proposed for leaders have been vast, varied and contradictory
- Trait theories ignore the complexities of the leadership situation and not everybody with leadership ‘traits’ turn out to be good leaders

(Total: 10 marks)

Answer 06

Learning Outcome/s: 6.11

Elements of marketing programmes

- (a) Market positioning refers to how customers perceive a brand or product relative to other brands or products.
- (b)
- Star Cola uses quality and premium prices as the positioning variable
 - Light Cola uses low prices as the positioning variable
- (c)
- **Advertising** – advertise on mass media to promote their products.
 - **Sales promotions** – use price promotions etc. for a particular period, organise competitions and provide loyalty incentives to increase sales.
 - **Public relations** – this helps to promote goodwill and mutual understanding between the company and the public, thereby promoting publicity and increasing sales.
 - **Direct marketing** – this will create a direct relationship between customers and the company to increase sales.

(Total: 10 marks)

SECTION 3

Answer 07

Learning Outcome/s: 3.5 and 3.7
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3.5 Demand, supply and market equilibrium in a competitive market

3.7 Impact of government intervention on competitive markets
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(a)

$$P_d = 160 - 0.625Q$$

$$P_s = 5 + 0.250Q$$

At the equilibrium point, $P_d = P_s$

$$\text{Quantity at the equilibrium point } (E_q) = 160 - 0.625Q = 5 + 0.250Q$$

$$155 = 0.875Q$$

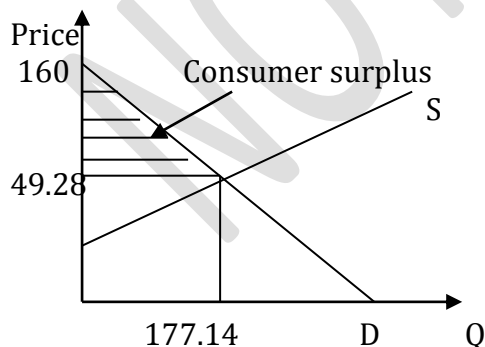
$$Q = 177.14 \text{ million barrels}$$

To find P (price at the market equilibrium), substitute the Q value, either to the demand or supply function.

$$\begin{aligned} P &= 160 - 0.625(177.14) \\ &= \text{USD } 49.28 \end{aligned}$$

(b) Under a demand curve that is sloping downward, there would always be a gap between the 'total price the consumer would be willing to pay for a number of units' and 'the total sum actually paid for the same number of units'.

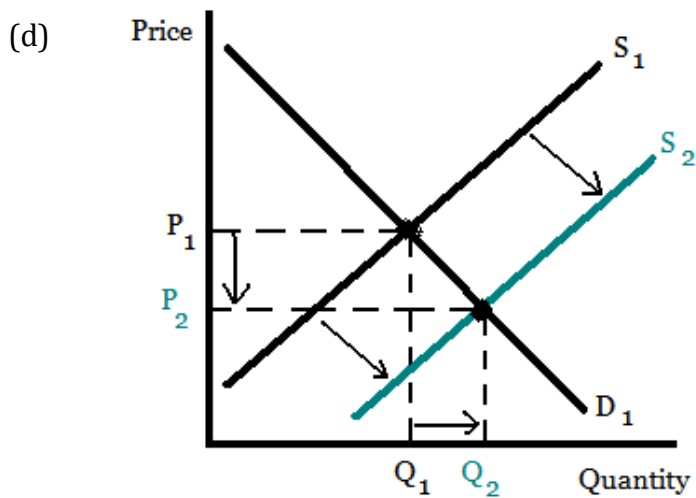
The marginal utility derived by different consumers, from the consumption of a unit will vary. Consumers may be able to buy the good at a prevailing market price lower than the price they were prepared to pay. This situation is called consumer surplus (CS).



The reason for the existence of CS is the varying relationship between 'market price' and 'quantity demanded'. This varying relationship could be seen only in relation to the downward sloping demand curve, as in the case of a monopoly (i.e. demand curve with price elasticity of demand between zero and infinity).

- (ii) Consumer surplus (CS)
 $CS = (\text{USD } 160.00 - \text{USD } 49.28) \times (177.14 \text{ million})/2$
 $= \text{USD } 9,806.47 \text{ million}$

- (c)
- Slowdown in global economic growth leading to a reduction in income levels of consumers. This in turn can reduce the consumption of crude oil.
 - Introduction of more fuel-efficient cars such as hybrid vehicles leading to a reduction in usage of crude oil.



Due to increased exploration of oil reserves there will be an increase in supply of crude oil shifting the supply curve from S_1 to S_2 .

As a result, the equilibrium price falls from P_1 to P_2 , while the equilibrium quantity increasing from Q_1 to Q_2 .

- (e)
- (i) **If the local retail selling prices of fuel continue to remain unchanged.**

Due to an increase of world market price, total cost of fuel importation would go up, widening the present unfavorable gap between import costs and export earnings. More pressure would be exerted on the country's balance of payment problem.

There would be pressure on the external value of the Sri Lankan rupee, due to the increase in demand for USD to meet higher import cost of fuel.

Basically, there would not be any impact on the consumer price index/inflation, as the retail price of fuel would continue to be unchanged.

- (ii) **If the local retail selling prices of fuel are adjusted by the government, depending on the possible change in the price of crude oil that takes place in the global market.**

The import bill on fuel for Sri Lanka would go up due to the increase of unit import costs. However, in view of the corresponding upward retail selling price adjustment to take place, a part or full amount of the crude oil price increase will have to be absorbed by the local consumer. If the full increase of unit import cost is passed on to the consumer, the indirect tax per unit would remain unchanged but due to the retail price increase, there would be a possibility of local consumption of fuel coming down, at least in the short run, causing a reduction in the total indirect tax revenue. Therefore, the ultimate impact to be felt on the total indirect tax revenue would depend on the size of the retail price adjustment made and the manner in which the local consumer would respond to the increase in fuel prices.

As the local retail price of fuel would be unchanged to meet the increase in import costs, there would be a corresponding increase in the consumption cost of fuel in relation to the cost of public and private transport, electricity generation, manufacturing etc.

Cost of production and cost of transportation of consumer goods like vegetables would definitely go up and due to the chain effects to occur, cost push inflation would take place affecting the consumer price index in a negative manner.

(Total: 20 marks)

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