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THE INSTITUTE OF  
**CHARTERED** ACCOUNTANTS  
OF SRI LANKA

# **SUGGESTED SOLUTIONS**

## **03104 – Management and Business Economics**

Certificate in Accounting and Business I Examination  
September 2014

**THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA**

## Examiners' General Comment

### Paper A

Performance of candidates in Paper A was satisfactory. However some of the candidates could not select the correct answer to following questions in Paper A perhaps due to poor preparation for the exam:

Q4, Q7, Q10, Q11, Q20

### Paper A

#### Answers for multiple choice questions

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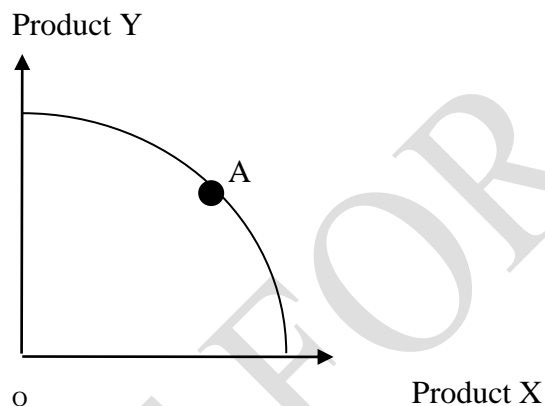
## Examiners' General Comment

### Paper B

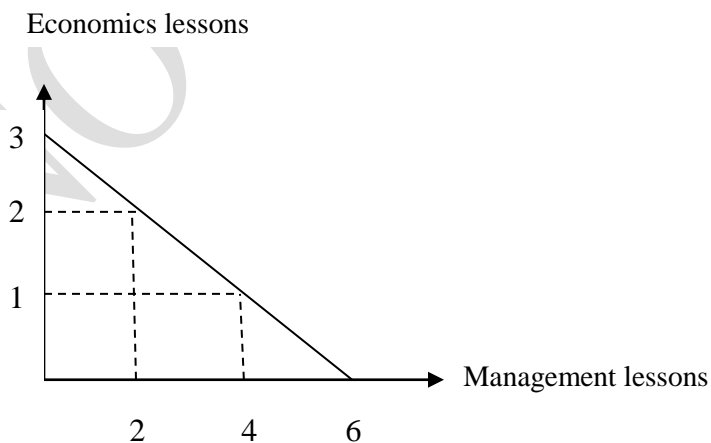
Overall performance of candidates was satisfactory. Nevertheless the common mistakes made by the candidates are given below, question-wise.

#### Answer No. 01

- (a) The concept of rationalising emerges because of the scarcity of resources. In economics, it is assumed that consumers and producers use the best information available to them to make correct choices. Accordingly, consumers try to maximise their satisfaction while producers try to maximise profits.
- (b) In PPC, moving down the curve, each additional unit of Product X can be manufactured only by giving up increasing units of Product Y. This is the principle of increasing opportunity cost. If the producers choose any point on the curve such as A, they can produce the maximum by effective utilisation of the available resources or factors of production.



- (c) (i)



- (ii) Opportunity cost =  $\frac{\text{Quantity forgone}}{\text{Quantity gained}}$   
=  $\frac{6}{3}$   
= 2 management lessons

**Examiners' comments**

Part (a) - Under rational behavior it is assumed that consumers and producers use the best information available for maximisation of satisfaction and profits by consumers and producers respectively. The concept of rationalising emerges because of the scarcity of resources according to some candidates who earned the full marks allocated. Some explained the basic economic problems that arise due to the scarcity of resources which earned only a few marks.

Part (b) - Some candidates had drawn production possibility curves concave to the origin and concluded that any combination (point) on the line will result in effective, utilisation of the available resources which earned marks allocated. Some had explained the concept of opportunity cost sans any mention about optional resource allocation.

Part (c) (i) - Most of the candidates had correctly drawn the production possibility curve (PPC) assuming constant opportunity cost and marked the axes correctly with given values. Some had not drawn the PPC correctly where the curve was kept open, without the curve touching the two axes, vertical and horizontal.

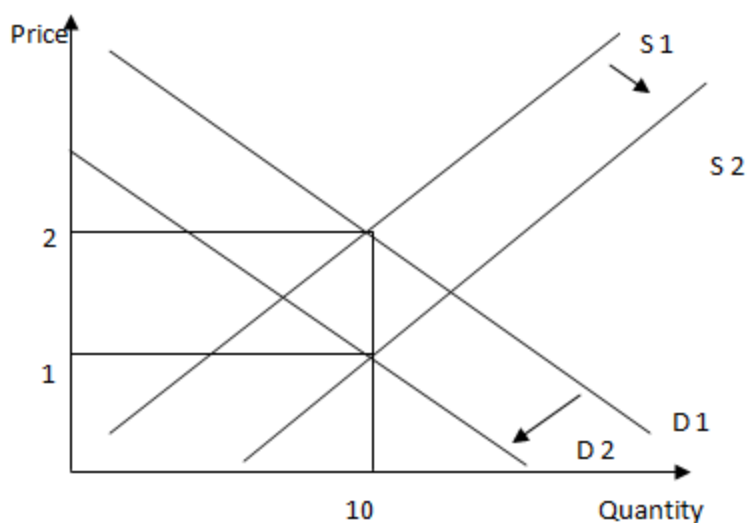
(ii) - Most of the candidates arrived at the correct answer of 2 (i.e. the opportunity cost of an Economics lesson in terms of a Management lesson). A few students ended up with the incorrect answer of 0.5.

## Answer No. 02

- (a) (i) Prices of related goods or services - These are either complementary, which are things that are usually bought along with the product in demand, or they could also be substitutes for the product in demand. If it is a complementary good, the relationship is negative. When the price of a complementary good increases while all other factors remain unchanged, demand for the commodity under consideration will decrease. E.g. electricity price and demand for electrical appliances. Relationship between two substitutes will be positive. When price of one substitute is increased, demand for the other will increase. E.g. relationship between price of bread and demand for rice.
- (i) Income of those with the demand - Relationship between income and demand depends on the nature of the good. If it is a normal good, the relationship will be positive. Higher the income, consumers buy more of a normal good.
- (ii) Tastes or preferences of those with the demand - Tastes and preferences can change the demand for a certain good. Through advertisements or demonstration effects, consumers may change their demand.
- (iii) Expectations - These are usually about whether the price will go up. This is important for consumer durables and non-perishable goods. If the consumer knows that the price of such goods will increase, they tend to buy more of it.
- (iv) Seasonal factors - Demand for some good is also related with seasonal factors. E.g. demand for umbrellas increases in the rainy season, demand for alcohol increases during festival seasons.
- (v) Demographic factors - Some goods are consumed by particular demographic groups. E.g. families with more babies demand baby foods items.
- (b) The imposition of taxes on imported goods will increase its price. The price elasticity of demand for imported goods would determine the outcome of taxes imposed on them. The outcome could be vastly different depending on whether the demand for the particular good is price sensitive or not.

If the demand for the imported product is price sensitive, the intended outcome of the government could be achieved, as the quantity demanded would significantly reduce, thereby reducing the outflow of foreign exchange by curtailing the expenditure on imports.

(c)



The increase in consumer income combined with the introduction of a low cost technology in production is said to have caused the price to fall, while the equilibrium quantity remained unchanged. The introduction of low cost technology would always result in an increase in supply of the product. However in this case, since the quantity remains unchanged, it implies that the increase in income of the consumer has resulted in a reduction in demand. **Thereby, it could be concluded that the particular product is an “inferior good”.**

#### Examiners' comments

- Part (a) – Most of the candidates had correctly described prices of related goods/services, income of those with demand, preferences of those with demand etc. Some had just named the factors but did not describe them, which earned only half the marks allocated. Some candidates had confused the term complementary goods with substitute goods.
- Part (b) – Some candidates had correctly stated that if tax is imposed on the imported product, which is price sensitive, the intended outcome of the government could be achieved since the quantity demanded would significantly reduce, thereby reducing the outflow of foreign exchange. Some candidates just explained five types of price sensitivity without the answer being related to the question. Some candidates were confused over inelastic demand and elastic demand and ended up with the wrong conclusion.
- Part (c) - Some candidates had correctly drafted the demand-supply sketch to represent the situation, and concluded that the product under reference is an inferior good since increase in income of the consumer base has resulted in an increase in demand. Some candidates were unable to draw the diagram in line with the given situation, and as a result they had ended up with the wrong conclusion. Some candidates had drawn a perfectly-elastic demand curve. Some candidates were also unable to indicate the shift in the demand curve to the left.

**Answer No. 03**

(a) The common sources of economies of scale are purchasing (bulk buying of materials through long-term contracts), managerial (increasing the specialisation of managers), financial (obtaining lower-interest charges when borrowing from banks including access to a greater range of financial instruments), marketing (spreading the cost of advertising over a greater range of output), and technological.

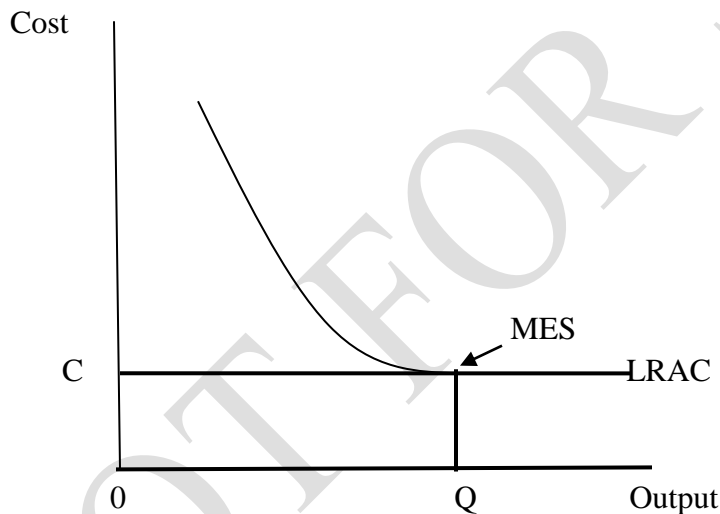
(b) (i) The production function shows the technically optimal (efficient) relationship between the inputs and outputs of a firm.

(ii) - Short run production function shows the relationship between output and the firm's variable inputs. This implies that some factors are constant in the short run.

- Long run production function shows the relationship between output and the firm's variable inputs only. In the long run, all inputs are variable.

(c) **Minimum Efficient Scale (MES)**

The lowest production point at which long-run total average costs (LRAC) are minimised. Plants below this size are at a competitive disadvantage.



(d) (i) The level of technology is constant

(ii) There is at least one factor which is fixed in supply

**Examiners' comments**

Part (a) - Economies of scale happen when bulk purchasing, increasing specialisation of managers, borrowing at low interest rates, spreading cost of advertising over greater range of output, as per some candidates who earned the marks allocated. Some candidates stated that efficiency is the source of economies of scale without the efficiencies being specified, which earned no marks.

Part (b) (i) - The production function is the technically optimal relationship between the inputs and outputs of a firm, as per some students who earned the marks allocated. Some candidates just mentioned the relationship between the inputs and outputs of a firm as the production function. The production function is the processing of inputs to arrive at outputs, according to some candidates who were unable to earn the allocated marks.

(ii) - Some candidates had correctly stated that one or more factors is fixed in supply in the short run and in the long run all factors become variable. Some candidates incorrectly stated that only variable inputs are used in the short run.

Part (c) - Minimum efficient scale refers to the lowest production point at which the long run average costs are minimised as per some candidates who earned the marks allocated. Production scale that minimises the efficiency of the production process is the minimum efficient scale as per some candidates who earned no marks.

Part (d) - Most of the candidates had correctly mentioned that there is at least one factor which is fixed in supply to cause the law of diminishing returns. However, they had ignored the assumption that the level of technology is constant. Some candidates stated that management inefficiencies cause the law of diminishing returns.



**Answer No. 04**

- (a) Certain items of GDP (GNP) leak out and certain items are added to the circular flow of GDP (GNP). In a simple closed economy Savings (S) leaks out of the flow and Investments (I) are added.

Leakage in the simple closed economy is Savings (S).

Injection is the Investment (I).

In the equilibrium, Injections are equal to Savings. ( $I = S$ ).

(b) (i)  $C = 200 + 0.8 Y_d$

(ii)  $C = 200 + 0.8 Y_d$   
 $C = 200 + 0.8 (Y - T)$   
 $C = 200 + 0.8 (1000 - 100)$   
 $C = 200 + 720$   
 $C = 920$

(iii)  $Y = C + I + G$   
 $Y = 200 + 0.8Y + 50 + 50$   
 $Y = 200 + 0.8Y + 50 + 50$   
 $Y = 300 + 0.8Y$   
 $0.2Y = 300$   
 $Y = 1,500$

(iv) Increase of equilibrium income due to increase of Investment by Rs. 25 is  $(25)/(1 - MPC)$   
 $K \equiv \frac{1}{1 - MPC}$

$$\Delta Y = K \times \Delta I$$

$$(25) / 0.2 = 125.$$

Without using the multiplier students can arrive at the answer by using the equation  $Y = C + I + G$

### Examiners' comments

- Part (a) - Having identified savings and investments as leakages and injection respectively some candidates correctly identified “Investments = Savings” at the equilibrium level of income in a single closed economy. Some candidates incorrectly identified expenditure and income as leakages and injections respectively. Some candidates stated when “Input = Output”, equilibrium level is achieved. In a simple closed economy equilibrium point is  $T + S = I + G$ , according to some students who did not earn marks.
- Part (b) (i) - Some candidates had correctly derived the consumption function as,  $C = 200 + 0.8Y_d$ . Some candidates stated the function in terms of  $Y$  rather than  $Y_d$  which earned no marks.
- (ii) - Some candidates had correctly arrived at the level of consumption as Rs.920. Some ended up with wrong answer since they ignored the fact that disposal income is taken after deducting the tax amount from total national income.
- (iii) - Some candidates had correctly arrived at the level of equilibrium income as Rs. 1,500. Some candidates had done arithmetic mistakes and ended up with wrong answers, and some were unable to write the correct equation i.e.  $Y = C + I + G$
- (iv) - Some candidates indicated the correct equation i.e.  $\Delta Y = \Delta I \times K$  (change in income = change in investment x multiplier) and ended up the correct answer as Rs. 125. Some candidates calculated total national income with the data given under this part of the question and compared it with the national income arrived under the previous part of the question and arrived at the correct increase of national income of Rs. 125, which earned the allocated marks. Some candidates could not arrive at the correct multiplier effect i.e. they used  $k = 1/1-MPS$  rather than  $k = 1/1-MPC$ .

**Answer No. 05**

- (a) Fiscal policy relates to government policy on taxation, public borrowing and spending. Monetary policy relates to government policy on the money supply, interest and exchange rates and the availability of credit.

Fiscal policy is executed largely through the government and governmental institutions. Monetary policy is largely executed by the Central Bank, through banks and other financial institutions.

- (b) (i)
- High but sustainable rate of economic growth
  - Full employment
  - Balance of payment equilibrium
  - Price stability
- (ii) The policies implemented by the government to stimulate or stabilise the economy by changing aggregate demand of the economy.
- (c) Expansionary (eased) monetary policy stance.
- Interest rates - the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) have been reduced.
  - The Statutory Reserve Requirement (SRR) on rupee deposit liabilities of commercial banks being reduced during the period.
  - Both market lending and deposit interest rates have adjusted downwards substantially, although there is further room for downward adjustment in long term lending rates.

***Alternative Answer***

*“Recently the Central Bank of Sri Lanka has taken a stance of expansionary monetary policy, by reducing interest rates to increase spending and investments and ultimately the aggregate demand of the economy. The reduction in interest rates would imply a lower cost for borrowing, enabling individuals and businesses to increase their consumption and investments through borrowed funds.*

*This in turn is expected to lead to a higher economic growth through increasing the GDP to match the increase in aggregate demand”.*

**Examiners' comments**

Part (a) - Fiscal policy relates to government policy on taxation, public borrowing and spending and monetary policy on money supply, interest rate and exchange rate and the availability credit, according to some candidates who earned the allocated marks. Some candidates were of the view that monetary policy is exercised through government institutions like General Treasury, which earned no marks.

Part (b) (i) - Sustainable rate of economic growth, full employment, price stability etc. were identified by some candidates as macro-economic objectives, which the earned allocated marks. Rather than "full employment" being mentioned, some candidates stated "protection of employees". Globalisation was identified as a macro economic objective which earned no marks.

(ii) - Demand management polices stabilise the economy by changing the aggregate demand of the economy as per some candidates who earned the allocated marks. Policies relating to promoting exports and discouraging imports are demand management policies according to some candidates who earned no marks.

Part (c) - Reduction of interest rates (SDFR and SLFR) and statutory reserves requirement (SRR) and adjustment of market lending rates and deposit rates downwards are the recent monitory policy stances accordingly to some candidates who earned the allocated marks. Some candidates were of the wrong view that interest rates and SRR were increased recently.

## Answer No. 06

- (a)
- (i) A good leader should be **trustworthy** to lead others.
  - (ii) A good leader is **enthusiastic** about their work and also about their role as leader. Leaders need to be able to be a **source of inspiration**, and be a **motivator** towards the required action.
  - (iii) In order to lead and set direction, a leader needs to be **confident**.
  - (iv) A leader also needs to function in an **orderly and purposeful manner** in situations of uncertainty.
  - (v) A good leader keeps the main goal in focus and is **able to think analytically**.
  - (vi) A good leader is **committed** to excellence.

(b) Theory X assumptions

- Average person dislikes work and will try to avoid it.
- Most people need to be corrected, controlled, directed, and threatened with punishment to get them to work towards organisational goals.
- Average person wants to be directed, shuns responsibility, has little ambition, and seeks security above all.

Theory Y assumptions

- Most people do not inherently dislike work; the physical and mental effort involved is as natural as play or rest.
- People will exercise self-direction and self-control to reach goals to which they are committed; external control and threat of punishment are not the only means for ensuring effort toward goals.
- Commitment to goals is a function of the rewards available, particularly rewards that satisfy esteem and self-actualisation needs.
- When conditions are favourable, the average person learns not only to accept but also to seek responsibility.
- Many people have the capacity to exercise a high degree of creativity and innovation in solving organisational problems.
- Intellectual potential of most individuals is only partially utilised in most organisations.

(c) Similarities

- Both leaders and managers **provide guidance** to followers/subordinates.
- Both should be **able to motivate** the followers/subordinates.

Differences

- A leader creates a vision to give direction to the organisation's activities. In contrast, the key function of the manager is to implement a set of activities that help to accomplish the vision/mission. The manager chooses the means to achieve the end that the leader formulates.
- Managers are mainly concerned with order and maintaining the status quo, focusing on the decision making processes within the organisation. Leaders, in contrast are committed to change and constantly search out opportunities to change. Effective leaders are likely to transform their organisations whereas managers just manage organisations.

### Examiners' comments

Part (a) - Some candidates came out with acceptable attributes of a good leader as trustworthy, enthusiastic, source of inspiration, confident, commitment to excellence etc. Some candidates stated that the leader should be democratic, feasible and open minded, which earned no marks.

Part (b) - Some candidates had correctly mentioned that the average person dislikes work and will try to avoid it, most people need to be corrected, controlled, directed and threatened with punishments to get work done and the average person seeks security, as assumptions of Theory X.

Theory Y assumptions were mentioned as follows:

- Most people do not inherently dislike work; people will exercise self-direction and self-control to reach goals.
- Commitment to goals is a function of the rewards available.

Most of the candidates mentioned incomplete assumptions e.g. the average person dislikes work sans the other part of the assumption (i.e. and will try avoid work).

Part (c) - Both leaders and managers provide guidance to followers/subordinates. A leader creates a vision and managers help to accomplish the vision, according to some candidates who earned the allocated marks. Some candidates gave unacceptable answers e.g. a leader works with others whereas managers get work done by others, a leader is not innovative.

**Answer No. 07**

(a)

- Assign duties - The delegator first tries to define the task and duties to the subordinate. He also has to define the result expected from the subordinates. Accordingly, clarity of the duty as well as the result expected has to be the first step in delegation.
- Extend authority - Subdivision of authority takes place when a superior divides and shares his authority with the subordinate.
- Clearly defined responsibility and accountability - Responsibility is said to be the factor or obligation of an individual to carry out his duties to best of his ability as per the directions of a superior. Accountability, is the obligation of the individual to carry out his duties as per the standards of performance.

(b)

- Reluctance to delegate authority by managers.
- Fear of subordinates because managers think that the subordinate may pose challenge to the manager.
- Managers may lack confidence or trust of subordinates.
- Incompetence of subordinates.
- Subordinates may not show any interest to accept authority because of lack of sufficient reward.

(c)

<b>Line functions</b>	<b>Staff functions</b>
Functions contribute directly to the provision of goods and services to the customer	Functions contribute indirectly to goods and services by supporting the line
Typical line functions are production and sales	Typical staff functions include purchasing, accounts, legal and personnel
Seen as primary functions of the organisation	Seen as the secondary functions of the organisation
Line functions act	Staff functions think

**Examiners' comments**

Part (a) - The delegator needs to define the task and duties and the results expected. Authority needs to be extended to the subordinate, and the delegator must assign the tasks to the subordinate and define responsibility and accountability according to some candidates who earned the allocated marks. Most of the candidates were unable to mention the needs of defining the results expected from the subordinates. Some stated that power is also to be granted for effective delegation of authority, which earned no marks.

Part (b) - Some managers are reluctant to delegate and have fear of subordinates, incompetence of subordinates and their unwillingness to accept authority are some barriers to effective delegation of authority according to some candidates who earned the allocated. Some candidates came out with irrelevant answers e.g. Nature of business, business size, technology, higher administrative cost as barriers to delegation.

Part (c) - Line functions directly contribute to the provision of goods and services to the customers whereas staff function indirectly contribute. Typical line functions are production and sales. Staff functions include purchasing, accounting, legal etc. as per some candidates who earned the allocated marks. Some provided unacceptable answers e.g. Line managers give orders to subordinates whereas staff managers do not. Some candidates were of the wrong view that line function thinks and staff functions act.

NOT FOR





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