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THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

KE5 – Commercial Insight for Management

March 2017

SECTION 1

Answer 01

1.1

Learning Outcome/s: 1.2. Nature of market offerings
<i>Study text reference: page 13</i>
Correct answer: B

1.2

Learning Outcome/s: 1.4 Future directions of businesses
<i>Study text reference: page 22</i>
Correct answer: C

1.3

Learning Outcome/s: 2.4 Managerial roles
<i>Study text reference: page 63</i>
Correct answer: B

1.4

Learning Outcome/s: 2.8.1 Identify the economic resources and their remuneration
<i>Study text reference: page 84</i>
Correct answer: C

1.5

Learning Outcome/s: 2.7.1 Discuss the concept of opportunity cost and scarcity and their relevance to economic choice.
<i>Study text reference: page 89</i>
Correct answer: A

1.6

Learning Outcome/s: 3.9 Competitive forces
<i>Study text reference: page 163</i>
Correct answer: A

1.7

Learning Outcome/s: 6.5.1 Discuss the concepts of economies of scale and economies of scope in business.
<i>Study text reference: page 412</i>
Correct answer: C

1.8

Learning Outcome/s: 6.11 Elements of a marketing programme
<i>Study text reference: page 450</i>
Correct answer: D

1.9

Learning Outcome/s: 4.4.3 Discuss the inter-relationship among supply, inflation and interest rates in an economy.
<i>Study text reference: page 281</i>
Correct answer: B

1.10

Learning Outcome/s: 6.7 Production concepts in businesses
<i>Study text reference: page 425</i>
Correct answer: A

(2x10=Total: 20 marks)

Answer 02

2.1

Learning Outcome/s: 6.6.1 Define the main production methods (job production, batch production and flow production)

Study text reference: page 420

Characteristics of job production

- Products are non-standard
- Products are made to customer orders
- Range of products will be highly diverse
- Produce one-off items and in small quantities

Characteristics of batch production

- Produce in some volume
- Items are standard within batches
- Products will be less diverse in range

2.2

Learning Outcome/s: 2.2 Efficiency and effectiveness

Study text reference: page 72

Efficiency means “doing things right”.

Efficiency measures the relationship between costs and attainment. An improvement in what is achieved at no extra cost, or a reduction in cost for no reduction in performance, or a combination of the two, are all improvements in efficiency.

However productivity is narrower in its definition, as it is the relationship of tangible output to resources input or the rate of production over time.

Effectiveness is concerned with how well an activity is achieving its objectives or other intended effects. It means, “doing the right thing”.

2.3

Learning Outcome/s: 2.8.2 Explain the types of economic goods (including normal goods, Giffen goods, inferior goods, Veblen goods and public goods)

Study text reference: page 87

- (a) Public good are non-exclusive, which means that anyone can get the benefit of these goods without paying for them. This is known as the free-rider problem. As a result, there would normally be no economic incentive for organisations to make these goods, because they would not get any revenue for it.
- (b) How to overcome the free-rider problem:
- Compulsory payment – introduce licences and issue tickets to use roads and highways.
 - Exclusion of non-payers – use smart cards to allow decoding of satellite television.
 - Public provision – governments can provide the service directly and charge the public via taxation.

2.4

Learning Outcome/s: 3.4.1 Identify the behaviour of rational consumers using cardinal and ordinal utility theories

Study text reference: page 109

Consumers attempt to maximise the total utility attainable with a limited income. When the consumer decides to buy one unit of a good, he is deciding that its marginal utility exceeds the marginal utility that would be yielded by any other alternative use of the price he pays.

Any example that is linked to the rational behaviour of a consumer.

Assume a customer has Rs. 500 and he wants to buy breakfast with that money. He has different options including rice and curry, string hoppers and short eats. He will decide to buy one of these items that will give him the highest marginal utility when compared to the alternative use of the price he pays.

2.5

Learning Outcome/s: 3.13 Suppliers and distributors

Study text reference: page 193

- Stronger relationship with the supplier
- Facilitates better communication
- Possible source of competitive advantage
- Possible source of superior quality due to increased opportunity for a supplier quality assurance programme.
- Facilitates confidentiality
- Economies of scale

2.6

Learning Outcome/s: 4.3.2 Define the concepts of national income (including GDP, nominal and real GNP and NNP)

Study text reference: page 274

- Gross domestic product means the total value of income/production from economic activities **within** Sri Lanka ($C + I + G + X - M$).
- Gross national product is arrived at after adjusting the gross domestic product for the net property income from abroad.
- Net national product is arrived at after adjusting the gross national product for the depreciation of fixed capital and depletion of national resources.

2.7

Learning Outcome/s: 4.4.2 Explain how demand management and supply management policies can be used to control inflation

Study text reference: page 285

- Spending more money on creating jobs
- Encouraging growth in the private sector of the economy
- Encouraging training on job skills
- Offering grant assistance to employers
- Encouraging labour mobility

2.8

Learning Outcome/s: 6.16.1 Identify the basic concepts of change management

Study text reference: page 547

- Changes in the environment such as changes in what competitors are doing, what customers are buying, the law, social behaviour, economy etc.
- Changes in the products the organisation makes or the service it provides in response to changes in customer demands, new technology etc.
- Changes in technology on working methods.
- Changes in management and working relationships such as changes in leadership style.
- Changes in the organisation structure or size.
- Post-acquisition – incoming management will wish to improve and integrate the firm into the new parent's structure and systems.

2.9

Learning Outcome/s: 6.1.1 Identify the main functions of a business and their relationship with the management process

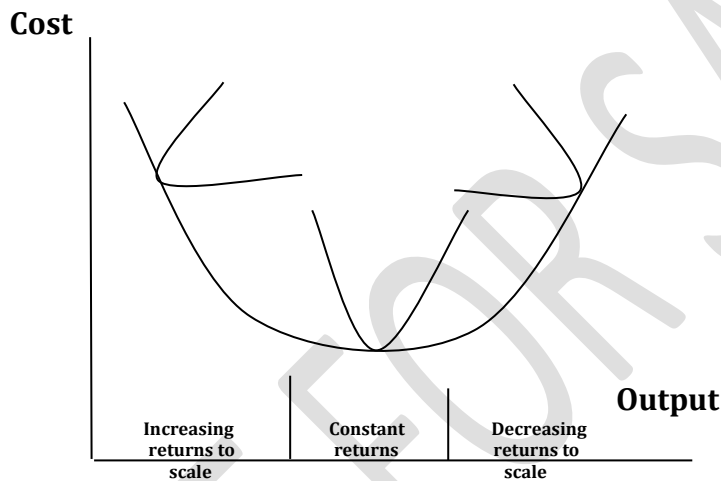
Study text reference: page 390

- **Operations**– responsible for fulfilling customer orders. Requests the production of the goods and services, and the delivery of them to the customer.
- **Marketing and sales**– responsible for identifying customer needs and perhaps more significantly for communicating information about the organisation's products to customers so as to procure sales orders.
- **Product and service development**– responsible for designing new products that will meet customer needs to generate sales orders.

Learning Outcome/s: 6.3 Cost concepts in businesses*Study text reference: page 398*

Since in the long-run all inputs, including capital equipment, can be altered, the relevant concept governing the shape of the long-run average cost curve is that of returns to scale.

Returns to scale increase with the initial increase in output and after remaining constant for a while, the returns to scale decrease. It is because of the increasing returns to scale in the beginning that the long-run average cost of production falls as output is increased and likewise, it is because of the decreasing returns to scale that the long-run average cost of production rises beyond a certain point.

**(Total: 30 marks)**

SECTION 2

Answer 03

Learning outcome/s: 4.5 Importance of exchanges rates on businesses
<i>Study text reference: page 306</i>

(a)

- Rate of inflation compared with the rate of inflation in other countries
- Interest rates compared with interest rates in other countries
- Balance of payments
- Speculation
- Government policy on intervention to influence the exchange rate

(2 marks)

(b) **Advantages**

- Governments do not have to spend or even hold foreign currency reserves.
- Balance of payments deficits and surpluses are automatically corrected. A deficit will result in the exchange rate falling; this will improve competitiveness, raise exports and restore equilibrium.
- Governments need not adopt economic policies that may be undesirable for other reasons just to maintain exchange rates.
- It encourages efficient allocation of resources since exchange rates will reflect economic conditions.

Disadvantages

- If the exchange rate appreciates too much under a floating exchange rate system, then the international competitiveness of firms may reduce, and output and employment could fall across the economy.
- Uncertainty surrounding fluctuations in the exchange rate could deter trade.
- If exchange rates fall too much, import prices will go up and cause inflation to rise.
- Currency risk will be maximised under a floating exchange rate system.

(4 marks)

(c)

- Domestic goods will become cheaper in foreign markets; thus exporting firms will benefit.
- Foreign goods will become more expensive, therefore the demand for imports will fall leading to an increase in demand for locally produced goods.
- Firms importing raw materials will face higher costs of imports, which will increase the cost of production.
- The above depends on elasticity of exports and imports.

(4 marks)

(Total: 10 marks)

Answer 04

Learning Outcome/s: 5.2 Organising and organisation structure 5.3 Authority, responsibility and power

<i>Study text reference: page 352, 359</i>
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(a)

- Inhibits delegation.
- Rigid supervision may be imposed, blocking initiative.
- The same work passes through too many hands.
- Increases administration and overhead costs.
- Slow decision-making and responses as the strategic apex is further away

(2 marks)

(b) (i) De-layering is the reduction of the number of management layers from bottom to top.

(ii)

- Information technology – reduces the need for middle managers to process information.
- Empowerment – many organisations, especially service businesses, are keen to delegate authority down the line to the lowest possible level. Front-line workers in the operating core are allowed to take decisions in order to increase responsiveness to customer demands.
- Economical – delayering reduces managerial/supervisory costs.
- Fashion – delayering is fashionable; if senior managers believe that tall structures are inherently inflexible, they might cut the numbers of management levels.

(3 marks)

(c)

- There are physical and mental limitations to the workload of any individual or group in authority.
- Managers are freed up to concentrate on higher-level tasks such as planning.
- The increasing size and complexity of some organisations calls for specialisation; both managerial and technical.
- Delegated authority contributes to job satisfaction and development of lower-level employees.
- Delegation shortens the chain of decision-making and brings decision makers closer to the situations that require them.

(4 marks)

(Total: 10 marks)

Answer 05

Learning Outcome/s: 6.12 Nature and scope of human resource management 6.13 Wage determination in competitive factor market

<i>Study text reference: page 481, 488, 514</i>

(a)

- Increased productivity – developing employee skills might make employees more productive.
- Enhanced group learning – employees work increasingly well in multi-skilled teams. Each employee has to be competent at several tasks. Some employees have to be trained to work together.
- Reduced staff turnover – training and developing staff often reduces turnover rates. This increases the effectiveness of operations and profitability as staff become more experienced.
- Encourage initiative – organisations can gain a significant advantage from encouraging and exploiting the present and potential abilities of the people working for them.

(2 marks)

(b) **Dealing with a staff shortage**

- Internal transfers and promotions, training
- External recruitment
- Reduce labour turnover by reviewing possible causes
- Work overtime
- Obtain new equipment and provide training to improve productivity, thus reduce the need for more people

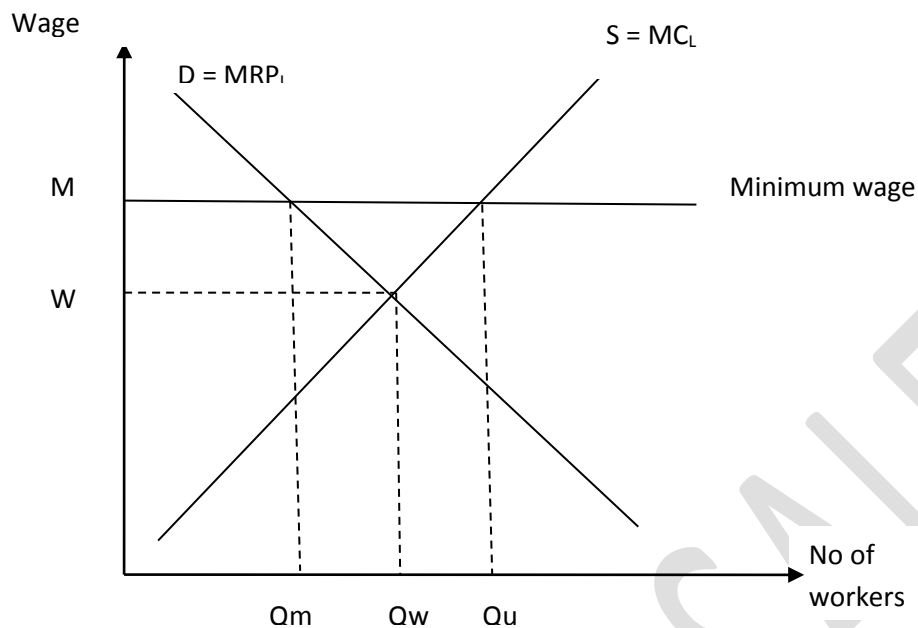
Dealing with a staff surplus

- Allow employee numbers to reduce
- Restrict recruitment
- Introduce part-time working for previously full time employees
- Redundancies – as a last resort and with careful planning

(4 marks)

(c) The purpose of a minimum wage is to ensure that low-paid workers earn enough to have an acceptable standard of living. The minimum wage is often above the current wage determined by the market forces.

The consequences of a minimum wage can be illustrated as follows.



Without the minimum wage, Q_w workers would be employed at wage rate W .

As a result of the minimum wage (M) there will be an excess supply of labour leading to unemployment, which is the difference between Q_u and Q_m (i.e. $Q_u - Q_m$). The demand for labour also reduces, resulting in job losses.

However, there is evidence that the imposition of a minimum wage can actually increase the numbers employed. This can occur with monopoly purchasers of labour, and is particularly apparent in markets for lower-grade labour, where employers hold wages to a low level. These employers will generally have vacancies since employment with them is unattractive. When a higher wage is imposed by law, the employers will find it easier to recruit and their numbers on payroll may actually rise. Their need for labour outweighs the market forces, which would have otherwise led to reductions in the numbers employed.

(4 marks)

(Total: 10 marks)

Answer 06

Learning Outcome/s 3.11 Theoretical dimensions of market structures
3.12 Optimal output, price and profit decisions in competitive market structures

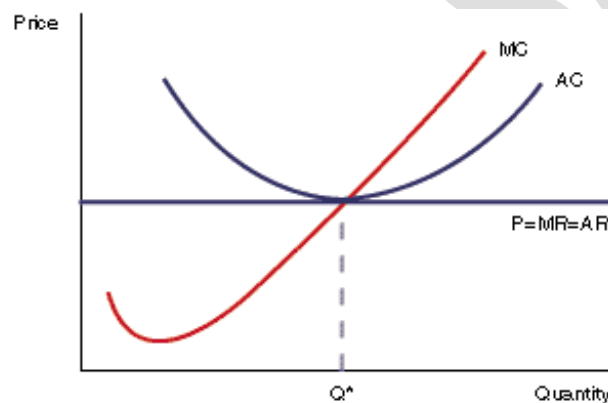
Study text reference: page 168

(a)

- Products are differentiated. This can be real or imaginary.
- Firms will try to avoid competition on price in order to preserve their position as a price-maker (non-price competition).
- No significant barriers to entry – there is free entry and free exit of firms in the market. There are also no restrictions on the mobility of factors of production.
- Large number of firms in the industry.

(3 marks)

(b) The long-run equilibrium of a perfectly competitive market can be illustrated as follows.



It is evident from the above diagram that the firm is operating at its most cost-effective point (the lowest point on the AC curve). This is known as productive efficiency. (lowest cost)

Further, at this point, the price equals marginal cost, which signifies allocative efficiency ($P = MC$)

The long-run equilibrium position under perfect competition is unique because it is the only market condition that achieves allocative efficiency. In the long-run all firms in the industry have $MR=MC=AC=AR=\text{price}$ at Q_m . Since both productive and allocative efficiency are achieved at the long-run equilibrium, perfect competition is referred to as the most desirable market structure.

(4 marks)

- (c) According to the facts given, the breakfast cereal industry operates under monopolistic competition market conditions.

Wastage of resources occurs due to the following reasons:

- The profit maximising output under monopolistic competition is lower than it would be under perfect competition, and it is at a point where average costs are not minimised (i.e. monopolistic competition firms are productively **inefficient**).
- It is wasteful to produce a wide variety of differentiated versions of the same product. If a single version of the same product is made, firms might be able to achieve economies of scale with large volume production.
- Some methods that are used to create product differentiation are a waste of resources. Methods such as advertising that are used to differentiate products can also be taken as a waste of resources since it does not add value to the products.

(3 marks)

(Total: 10 marks)

SECTION 3

Answer 07

Learning Outcome/s:

- 3.5 Demand, supply and market equilibrium in a competitive market
- 3.6 The concept of elasticity
- 3.7 Impact of government intervention on competitive markets
- 3.8 Competitors and their impact on organisations
- 4.2 Political and economic environment

(a) $100,000 - 140P = 20,000 + 20P$
 $80,000 = 160P$
 $\text{Rs. } 500 = P$

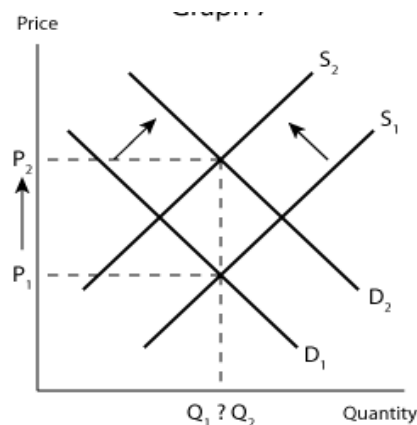
$100,000 - 140 \times 500 = Q_d$
 $30,000 \text{ metric tons} = Q_d$

(2 marks)

- (b) Prevailing conditions in the world market have had an impact on the demand for rubber:
- Increase in living standards has led to an increase in demand for automobiles.
 - Fluctuation of prices in synthetic rubber in relation to change in world oil prices.
 - Speculative demand for natural rubber due to a predicted shortfall in rubber production.

As a result, demand for natural rubber will increase from D_1 to D_2 .

Further, the supply of rubber will decrease due to poor weather conditions and difficulties in finding labour. The supply will decrease from S_1 to S_2 . As a result the price of natural rubber will go up.

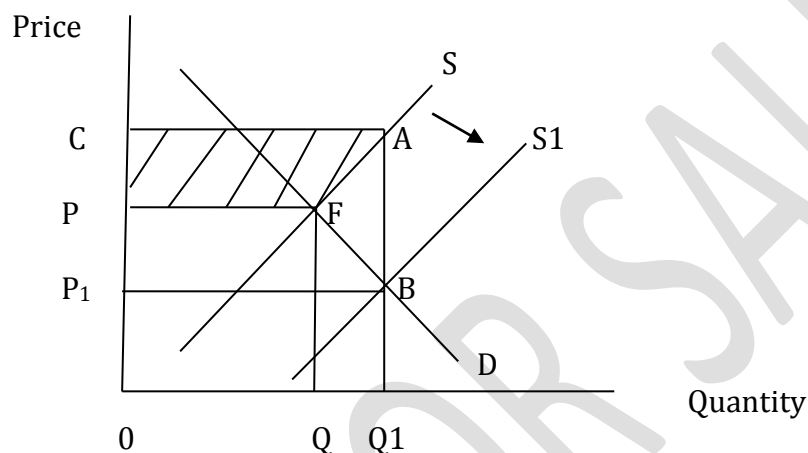


(5 marks)

- (c) (i) Natural rubber and synthetic rubber are substitutes and thus the cross price elasticity of demand is positive
- (ii) Automobiles and tyres are complements and thus the cross price elasticity of demand is negative

(2 marks)

- (d) (i) A subsidy is a payment to the supplier of a good by the government. It is made either to encourage more production of the good or to protect a vital industry. The effects of implementing a subsidy can be shown as follows.



The equilibrium price and quantity before the subsidy are P and Q respectively. Payment of a subsidy moves the supply curve downward to S_1 . As a result the suppliers would now be willing to produce Q_1 at a lower price of P_1 .

Due to the subsidy the benefit to the consumer is P_1PFB , and the benefit to the producer is $PCAF$. The subsidy, once successfully implemented, will improve the standard of living of the people of the country.

However the extent to which the benefit falls to the consumer and producer depends on the relative elasticity.

(5 marks)

- (ii) Minimum price needs to be set above the equilibrium price. The quantity demanded falls, but the quantity supplied increases because the higher price encourages more supply. There is excess supply. More goods will be produced than can be sold at the minimum price, so surplus quantities will build up. As a result of this, the over-supply can be exported to international markets, subject to price elasticity of demand for exports.

(3 marks)

- (e) A political environment can affect the businesses in a number of ways.

- Preparing a basic legal framework for their existence.

- The government can take a particular stance on an issue of direct relevance to a business.
- The government's overall conduct of economic policy is also relevant to the business.
- Government policy can encourage firms to increase their capacity. E.g. exports are not taxable. They can also offer capital allowances to encourage investment in equipment.
- The government can also influence demand by legislation, tax relief and subsidies.
- The government can promote the industry as a whole.
- The government can introduce regulations and controls.

(3 marks)

(Total: 20 marks)

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