THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KE5 – Commercial Insight for Management

September 2015

SECTION 01

Answer 01

1.1.

Relevant Learning Outcome/s: 1.5.1 Explain the role of the accountant in a business (including risk management expert, business generalist/source of business intelligence and compliance).
Correct Answer: C Cost accounting comes within the scope of work of a management accountant & not a financial accountant.

1.2.

Relevant Learning Outcome/s: 2.2.1 Define efficiency and effectiveness with respect to productivity of an organisaiton.
Correct Answer: C Efficiency measures are ratios which relate inputs to outputs. It is linked to productivity. E.g. Minimize the wastage per unit of output. Effectiveness is about objectives or goals. E.g. Product quality is one of the goals in a common goal metric.

1.3.

Learning Outcome/s: 3.5.1 Identify the factors which influence market demand and supply
Correct Answer : C

1.4

Learning Outcome/s: 3.11.1 Explain characteristics of perfect competition, monopolistic competition, monopoly, oligopoly and their impact on businesses.
Correct Answer: C Market power means that the firm has control over the terms and conditions of exchange. In monopolistic competition (MC) firm has market power because it has relatively few competitors and the firm sells differentiated product. Market power also means that an MC firm faces a downward sloping demand curve. The demand curve is highly elastic although not "flat". MC firm can raise its prices without losing all its customers. The firm can also lower prices without triggering a potentially ruinous price war with competitors.

1.5

Learning Outcome/s: 4.4.1 Explain demand put/cost-push inflation and identify the cost of inflation on business and the national economy.
Correct Answer: D

1.6.

Relevant Learning Outcome/s: 4.4.3 Discuss the inter-relationship among money supply, inflation and interest rates in an economy.
Correct Answer: D An increase in the supply of money will have the same effect that the increase in the supply of anything would have. It causes the "**price of money**" to drop. i.e. Interest Rate is the price of money.

1.7.

Relevant Learning Outcome/s: 4.7.1 Identify financial markets, financial intermediation and their benefits to business.
Correct Answer: D Liquidity is the degree to which an asset or **security** can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Higher the rate under Option D, higher the level of liquidity.

1.8.

Relevant Learning Outcome/s: 6.2.1 Define "operations management"
Correct Answer: D Designing an effective reward system is to motivate employees. It does not come within the scope of operations management

1.9.

Relevant Learning Outcome/s: 6.5.1 Discuss the concepts of economies of scale and economies of scope in a business
Correct Answer: A B,C,D relate to economies of scale and not economies of scope.

1.10.

Relevant Learning Outcome/s: 6.6.1 To test the student's ability to distinguish between the main production methods
Correct Answer: A Letter B refers to continuous flow production Letter C refers to job production Letter D refers to batch production

(Total: 20 marks)

Answer 02

2.1

Relevant Learning Outcome/s:1.6.1. Identify the volatile nature of the modern work environment and its impact on the role of an accountant
• Skills in the use of tools that support data modelling and analysis • Skills in using technology to attract, develop and manage talent • Knowledge management skills • Project management skills • Change management skills

2.2

Relevant Learning Outcome/s: 3.1.1 Discuss the organisational environment (including internal task and general, direct and indirect action, micro and macro environment.
Internal environment of an organization refers to the interlinked sub systems of the organizational sub-systems. Generally speaking, internal environmental factors are easier to control than external environmental factors. E.g. Organisation's mission statement, leadership styles, its organizational culture, technology, employee morale etc. In making SWOT analysis, the strengths and weaknesses are based on internal environmental factors. Opportunities and threats are based on external environmental factors. (A SWOT analysis can be used to help a business to determine the advantages or disadvantages of changes they want to make based on internal and external factors. A SWOT analysis can be divided into two distinct parts. The strengths and weaknesses are based **on internal environmental factors.** Opportunities and threats are based on external environmental factors.)

2.3

Relevant Learning Outcome/s: 3.6.2 Compute the different types of elasticities.
Advertising elasticity of demand (**AED**) is a measure of an advertising campaign's effectiveness in generating new sales. It is calculated by dividing the percentage change in the quantity demanded by the percentage change in advertising expenditures. A positive advertising elasticity indicates that an increase in advertising leads to an increase in demand for the advertised good or service. The impact of an increase in advertising expenditure on sales varies according to the industry. Advertising a piece of jewelry may not see a payback for a period of time because the good is expensive and is less likely to be purchased hastily. Because a number of outside factors, such as the state of the economy and consumer tastes, may also result in a change in the quantity of a good demanded, the advertising elasticity of demand is not the most accurate predictor of advertising's effect on sales. Thus, a comparison of PED and AED can also be used to determine whether more advertising is the correct strategy to maximize profits or changing prices.

2.4

Relevant Learning Outcome/s:3.13.1
Identify the types of suppliers and distributors

- Some of the suppliers may produce better quality of products
- Suppliers are of different sizes, so can match order sizes to appropriate suppliers.
- Some suppliers may be cheaper on price
- Expertise varies between supplies, so can build relationships with number of suppliers and it will help to make more informed choices.
- Effective implementation of contingency plan.

2.5

Relevant Learning Outcome/s:4.1.1.
Explain the main dimensions of the general environment (PEST factors) and their influence on business.

- Interest rates
- Taxation rates
- Exchange rates
- Inflation
- Employment rate

2.6

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

- Increase tax (as given) (**a Fiscal Policy Measure**)
- Reduce Govt. Expenditure (as given)(**a Fiscal Policy Measure)**
- Forced savings. E.g. Introduction of Compulsory Provident Fund Schemes (**a Fiscal Policy Measure)**
- Surplus Budgets (**a Fiscal Policy Measure**)
- Raise Interest rates (**a Monetary Policy Measure**)
- CBSL sells securities in the open market to reduce the money supply (**a Monetary Policy Measure)**
- Introduction of selective credit control measures by CBSL E.g. Raise margin requirements to control consumer credit (**a Monetary Policy Measure**)
- Measures to increase Aggregate Supply and decrease Aggregate Demand (O**ther Measures**) E.g. Take measures to increase production of essential goods (e.g. Import rare raw material, Price Controls, Rationing)

2.7.

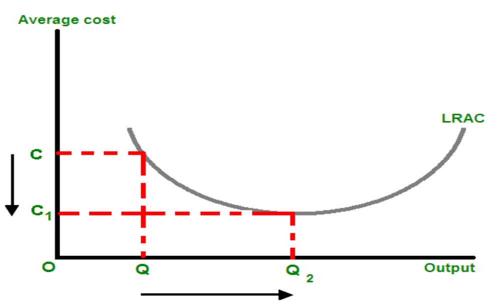
Relevant Learning Outcome/s: 5.3.3 Discuss the delegation of authority, its processes and the best practices.
• Assign the required authority and resources to enable a subordinate to carry out the given task. • Allow the subordinate to perform the task but be available to give him any help. • Review the progress made and give performance feed-back.

2.8.

Relevant 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.

Economies of scale are the advantages that an enterprise obtains in terms of cost, due to its size, level of output, or scale of operation, with cost per unit of output generally decreasing with increasing scale, as fixed costs are spread out over more units of output**.**

Often operational efficiency is also greater with increasing scale, leading to lower variable cost as well. As quantity of production increases from Q to Q2, the average cost of each unit decreases from C to C1.



However, economies of scale often have limits, such as passing the **optimum design point** (e.g. Q2 level of production) where costs per additional unit begin to increase.

Diseconomies of scale occur when a percentage increase in all factors of production results in a lower percent increase in output.

Diseconomies of scale can occur when firms become too big. The firms suffers from diseconomies of scale. At some point, the minimum of the Short Run Average Total Cost Curve (SRATC) will be at its lowest point where firm enjoys only constant returns to scale. After this point, increasing the inputs will result in diseconomies of scale and the LRAC slopes up i.e. after the Q2 level in the diagram.

2.9.

Learning Outcome/s:6.12.3 Discuss the major function of HRM
• Job analysis, job designing • Recruitment • Retention • Assessing future needs • Training and retaining to enhance the skill base • Budgeting and cost control

2.10.

Relevant Learning Outcome/s: 6.14.1 Identify basic information systems
• Management information system (MIS) – transform data from underlying transaction processing systems into summarized files. • Executive information system (EIS) – provide senior managers with easy access to key internal and external information. • Decision support system (DSS) – used by management to assist in making decisions. • Office automation system (OAS) – support the major activities performed in a typical office such as document management, facilitating communication and managing data. • Transaction processing system (TPS) – performs and records routine transactions.

(Total: 30 marks)

SECTION 2

Answer 03

Relevant Learning Outcome/s:
2.8.2 Explain the types of economic goods (including normal goods, Giffen goods, inferior goods, Veblen goods and public goods)
3.6.1 Explain the concepts of price elasticity of demand and supply, income elasticity, cross price elasticity and advertising elasticity on business decisions.

(a) Input, Process, Output

(b)

- Normal good: When consumer income increases, the demand for that good increases (e.g. clothing)
- Inferior good: When consumer income increases, the demand for that good decreases (e.g. a standard loaf of bread is an inferior good compared to whole meal bread)
- Veblen good: When price of the good increases, demand for that good also increases up to a point (e.g. luxury cars , designer wear, ostentatious good)

(c) The income effect can be defined as the change in consumption resulting from a change in real income.

Any increase or decrease in price correspondingly decreases or increases consumers' real income which, in turn, causes a lower or higher demand for the same or some other good or service. For example, if a consumer spends one-half of his or her income on bread alone, a fifty-percent decrease in the price of bread will increase the free money available to him or her by the same amount which he or she can spend in buying more bread or something else. It is one of the two effects caused by a price change: the other is substitution effect.
The substitution effect is one component of the total effect of a change in the price of a good upon the amount of that good demanded by a consumer, the other being the income effect.

The idea is that as price of a good falls, consumers will replace more expensive items with less costly alternatives. This movement from expensive items to cheaper items takes place due to the substitution effect, as the price reduction of the product has caused that product to be cheaper, compared to other products being purchased at comparatively higher prices.

Accordingly, a price reduction of a product would cause to increase its demand due to two effects, namely, (a) income effect caused due to increase in real income on account of the price reduction that has taken place and (b) substitution effect caused due to the substitution from expensive products to cheaper products due to the same price reduction.

(d)
(i) PED 1.5: Reduce the price to increase total revenue
(ii) PED 0.5: Increase the price to increase total revenue.

(Total: 10 marks)

Answer 04

Relevant Learning Outcome/s: 4.5
Importance of exchange rates on business

(a) Effects of depreciation of Sri Lankan rupee, on the business of FPL.

(i) Imported ladies shoes sold in Colombo.
A depreciation of Sri Lankan rupee means imports will become more expensive. This will cause to reduce demand for ladies shoes. However the total effect of depreciation depends on; Elasticity of demand for exports and imports. If the demand for ladies shoes is price elastic, the rise in the import price will lead to a substantial decrease in quantity sold. Therefore, the value of sales may actually fall.

If a firm cannot pass increased import costs onto consumers, firms may reduce their profit margins, at least in the short run.

Further, a rise in import prices would also cause to create an inflationary effect on the economy due to the heavy dependency on imports. That also would cause some negative impact on the sale of ladies shoes.

(ii) Export of garments.
A depreciation of the exchange rate will make exports more competitive and appear cheaper to foreigners. This will increase demand for garments. However the net effect would depend on the extent of Value Addition made locally, as certain components for garments are imported.

In this instance too the elasticity of demand for the said garment products would be a determining factor on the ultimate outcome.

However, in this regard, another factor to be taken into account is that the exports of FPL are priced in USD terms. Under that practice deprecation of Sri Lankan Rupee would not bring about an impact on exports, in terms of its export prices.

(iii) Since they are using imported inputs in their production process that will adversely affect their business as their cost of production will increase. Their products will be less competitive against local firms which are using local inputs for their production.

(iv) FPL is engaged in import and export business; therefore they are exposed to currency risk. But risk can be mitigated up to some extent.

- FYI can enter into forward contacts for their exports and imports and as a result

(b)

- FPL can enter into forward contacts for their exports and imports and as a result they can mitigate their risk of suffering losses on foreign transactions.
- They can outsource some of their activities to the local market. Buy locally manufactured raw material etc.
- Since they are in the business of export and import and all are priced in USD, they can automatically reduce the volatility of the exchange rate fluctuations.

(Total: 10 marks)

Answer 05

Relevant Learning Outcome/s: 5.1 Nature of planning and planning process

(a) Steps involved in a formal planning process

(i) Set out the goals to be achieved
(ii) Identify alternative strategies which can help to achieve the stated goals
(iii) Evaluate each strategy
(iv) Choose the best strategy
(v) Implement the strategy
(vi) Control and review (i.e. monitor progress & take corrective actions)

(b) Advantages of planning

- Planning provides direction to the entire organization as to what is sought to be achieved.
- It helps to achieve goal congruence and emphasizes the need to achieve congruence between corporate goals and department level goals.
- It helps the organization to adopt a long term (rather than a short term) view
- Provides a basis for top management to allocate resources rationally.
- Facilitates evaluation. It sets a standard against which the actual performance of the organization is measured and controlled.
- It comforts providers of finance in particular and encourages employees and suppliers to think in terms of a long term relationship

(Total: 10 marks)

Answer 06

Relevant Learning Outcome/s: 6.8
Nature and scope of marketing management

(a)

- Market segmentation is the process of sub-dividing a market into distinct and increasingly homogeneous sub-groups. These sub-groups share common characteristics.
- Market targeting is that part of the qualified market the company decides to serve with a distinct marketing mix.
- Market positioning refers to the way customers perceive a brand/product relative to other brands/products.

(b) Bases of segmentation are:

- Geographical area: The needs of potential customers in one geographic region may differ from the needs of customers in another geographic area e.g. urban vs. rural area.
- Demographic segmentation: We divide the market on the basis of variables such as age, gender, income, religion, social class etc. e.g. male vs. female customers; young vs. elderly groups.
- Psychographic segmentation: Buyers are divided into different groups on the basis of personality traits, life style, values and common interests. E.g. innovative and risk taking vs. conservative individuals
- Buyer Behavior: Buyers are divided into groups on the basis of their attitude toward, use of, or response to a product. E.g. the usage rate of a product.
- Benefit segmentation- dividing a market into sub groups according to the particular benefits they look for or will value in the product.
- End user – this refer to the context in which the product is used. Eg: office wear vs. casual wear.

(Total: 10 marks)

SECTION 3

Answer 07

Learning Outcome 3.5/3.7
3.5 Demand, supply and market equilibrium in a competitive market 3.7 Impact of government intervention on competitive markets

Suggested Detail Answer:

(a)

p = 160-0.35Q
P= 60 +0.15Q

160-0.35Q = 60 +0.15Q
100=0.5Q
200=Q

p = 160-0.35Q
P = 160 – (0.35*200)
P= 90

Therefore equilibrium quantity = 200,000
Equilibrium price = Rs. 90,000

(b) (i) 97 = 160-0.35Q
0.35Q = 160-97
Q = 180

$$\frac{\Delta Q}{\Delta P} * \frac{P}{Q}$$

$$= \frac{20}{7} * \frac{90}{200}$$

$$= 1.29$$

(ii) This product has an elastic demand.

(c) (i) percentage of income spent on the good – if larger % of consumer's income is spent on the good, then a change in the price of that good will have a strange impact on his overall income and will reduce the demand for the good.

(ii) Availability of substitute – if there are more substitutes in the market, the rise in the price will reduce the demand for the good in a greater proportion.

(iii) Necessity of the good – if the good is a luxury good, when the price increases, the demand will reduce., but if it is a necessary item, the consumer will continue to buy the product, without considering the price increment.

(iv) The time horizon.

(v) Habitual purchasing.

(d) When the government grants a supply-side subsidy to the suppliers of a product, the supply curve **shifts to the right**. **The demand curve remains unchanged**. Because the product is being subsidized, suppliers are encouraged to supply more of a product and are able to do so at a lower price. The price of personal computers would come down and more would be supplied. In practice, a supply-side subsidy will cause the demand for the product to increase.

Demand Equation re-stated, $P = 160 - 0.35Q$

New Supply Equation (i.e. after subsidy), $P = 60 + 0.15Q - \text{Subsidy}$

$P = 60 - 9 + 0.15Q$

New Market Equilibrium $160 - 0.35Q = 51 + 0.15Q$

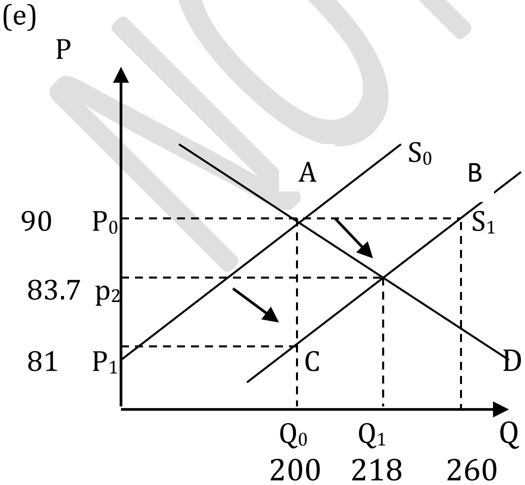
$0.5Q = 109$

$Q = 218$ i.e. **<u>218,000 units</u>**

New Market Equilibrium, Price. $P = 51 + 0.15(218) = \text{Rs } 83.7$ i.e. **<u>Rs. 83,700</u>**

The foreign exchange outflow also would get increased due to increased imports caused by the increase in the supply and the quantity demanded, at the equilibrium price.

(e)



The shift of the supply curve would cause an excess supply that eventually decreases the equilibrium price. At the initial price of Rs. 90,000 (i.e. at the equilibrium price with the initial supply curve), there will be an excess supply of 60,000 units. (i.e. as against the original equilibrium quantity of 200,000, new supply at Rs. 90,000 under new Supply Curve would be 260,000 units. i.e. Q= (90- 51) ÷ 0.15).

As indicated by points "A" and "B", suppliers are willing to sell 260,000 units (at point B), but users are willing to buy only 200,000 (at point A). Accordingly, suppliers want to sell 60,000 more units than computer users are willing to buy, and the excess supply of 60,000 units causes pressure to decrease the price of personal computers.

The equilibrium price is now at D=S1 or Rs. 83,700. Notice that the price actually paid by the computer users is Rs. 83,700 per unit.

The effect of the subsidy has been to increase the supply (shift the supply curve to the right from its original S0 to new S1) decreasing the equilibrium price from Rs. 90,000 per unit to Rs. 83,700 per unit and increasing the quantity demanded from its original equilibrium quantity of 200,000 units to the new equilibrium quantity of 218,000 units.

Finally, suppliers get a subsidy of Rs. 9,000 per unit (i.e. A to C in the graph) and users of computers also would get a price advantage of Rs. 6,300 per unit (i.e. Rs. 90,000 – 83,700). As a result, 18,000 new users who were not in a position or not willing to buy computers earlier, get an opportunity to buy personal computers.

(f) Advertising
Promotions
After sales services
Warranties
Cost reduction

(g) under pricing

(Total: 20 marks)

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