SUGGESTED SOLUTIONS

03104 – Management and Business Economics

Certificate in Accounting and Business I Examination
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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

PAPER 'A'

ANSWERS FOR MULTIPLE CHOICE QUESTIONS

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

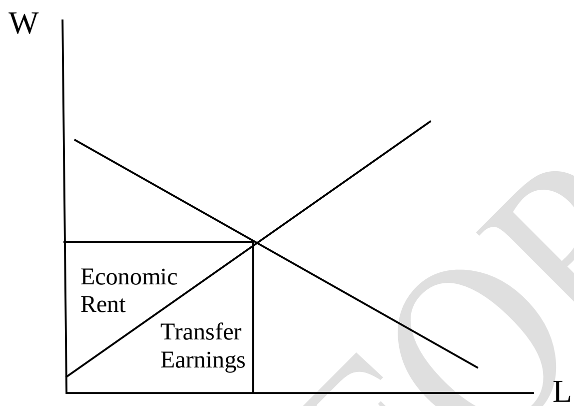
Answer No. 01

(a) Labour - provides human factors to a firm for a wage
- performs the task assigned

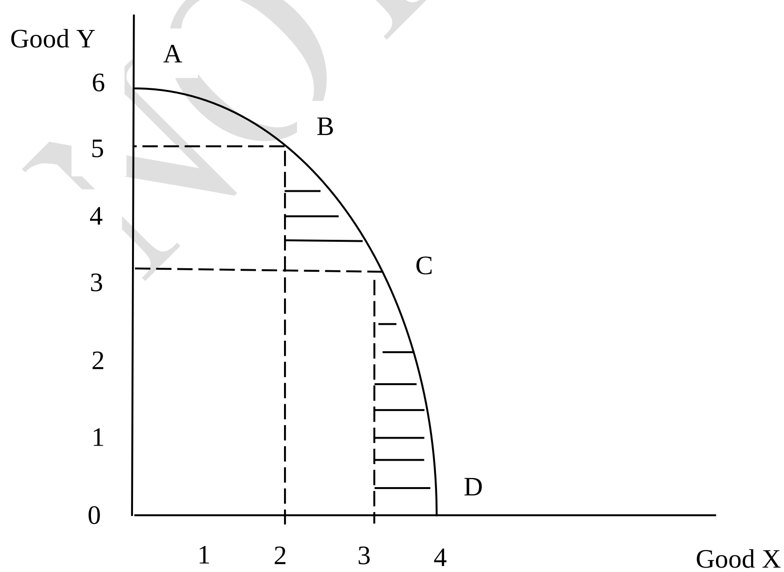
Entrepreneur - plans the business and does it for profit
- takes risk

(b) Transfer earnings – transfer earnings of a factor of production is the minimum payment required to prevent the factor from transferring to another employer or another occupation.

Economic rent - the amounts earned over and above transfer earnings



(c) A Production Possibility Curve (PPC) that is concave to the origin represents increasing opportunity cost. This is because when the production of one good increases, the quantity forgone from the other good becomes greater. This can be illustrated as follows;



The above PPC shows that as we move down the curve (from A to D), each additional unit of X can be only obtained by giving up increasing units of Y. This is the principle of increasing opportunity cost. Increasing opportunity cost arises as a result of resources not being homogenous.

(d) In a mixed economy, government intervention is required to;

- Control the market power of monopolies
- Correct inequalities of the free market system by redistributing wealth among individuals via taxes
- Provide goods and services that private enterprises are not willing to provide in adequate amounts and at acceptable prices. E.g. goods that are socially desirable but unprofitable for private enterprises.
- Provide services which are in the public interest. E.g. the judicial system and armed forces.
- Remove socially undesirable consequences of private production like pollution and regional imbalances in development
- Assist new industries and invest in research and development
- Manage inflation, employment levels, balance of payments and the rate of growth of the economy in accordance with social objectives
- Moderate fluctuations of the business cycle by stimulating economic activity during a recession and dampening demand during a period of high inflation.

Answer No. 02

(a) Total price effect = income effect + substitution effect.

All giffen goods are inferior goods. Therefore the income effect is positive. When the price of giffen goods rises, the quantity demanded also rises since more expensive items cannot be consumed by impoverished consumers who consider giffen goods as still cheaper. A giffen good is typically an inferior product that does not have existing available substitutes, as a result of which the income effect dominates the substitution effect.

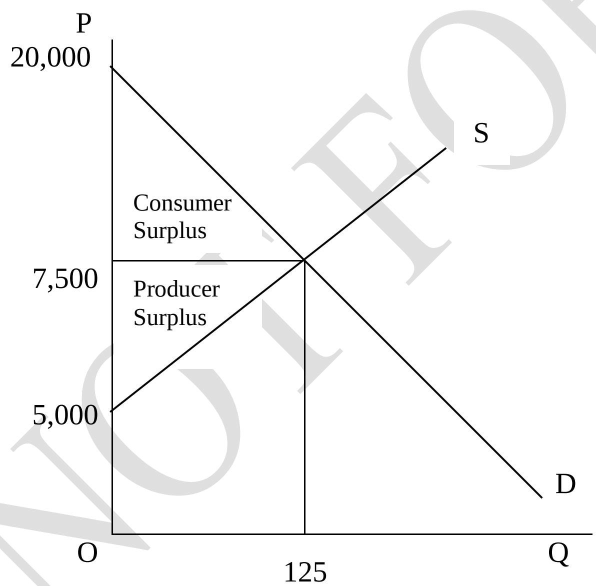
Substitution effect is negative.

The total price effect is positive because income effect > substitution effect for giffen goods.

(b)

$$
\begin{aligned}
Qd &= Qs \\
-100Q + 20{,}000 &= 20Q + 5{,}000 \\
120Q &= 15{,}000 \\
Q &= 125
\end{aligned}
$$

$$
\begin{aligned}
-100 \times 125 + 20{,}000 &= P \\
P &= 7{,}500
\end{aligned}
$$



(c) Economic profit - difference between revenue and opportunity cost
Accounting profit - difference between revenue and explicit costs

E.g. A person invested Rs. 100,000 and made a gain of Rs. 120, 000. Accounting profit would be Rs. 20,000. However, he would have made Rs. 150,000 if the money was invested in a different business. Accordingly, he has made an economic loss of Rs. 30,000.

Answer No. 03

(a) Factors that give rise to economies of scale are;

- Buying economies – price discounts can be obtained due to bulk buying
- Financial economies – large firms can raise capital more easily and at lower interest rates than a small firm
- Risk economies – greater ability to diversify and spread risks
- Research economies – more funds can be allocated to R&D and thereby firms can come up with better techniques and processes. This can help firms to increase their market share
- Marketing economies – a large firm can organize its distribution network better (i.e. with more sales outlets). It can spend more on advertising and provide bargain offers to increase sales
- Managerial economies – a large firm can employ specialist managers to handle each function. Thus, managerial capacity can be better utilized.
- Administrative economies – with large scale production, the administration overheads will be spread over more units of output
- Technical economies – it costs proportionately less to buy and maintain bigger machines. Machines come in standard sizes and there is a minimum efficiency scale of production. This minimum may be too large for a small firm to invest in and take advantage (principle of indivisibility of large machines)
- Labour economies – there can be better division of labour which leads to greater efficiency and productivity.

(b)
- Peak load pricing (electricity/telephone)
- Quantity discounts
- Service charge price discounts
- Students price for seminars
- Air ticket pricing
- Price differences in local and export markets

(c) Total fixed cost – part of total cost that does not change with the level of output

Total variable cost – part of total cost that changes directly with the level of output.

(d)

Monopoly	Oligopoly
1. Single seller	1. Few Sellers
2. Unique product	2. Relatively close substitutes
3. Barriers to entry	3. Barriers to entry
4. Price Makers	4. Price strategy varies as per the situation

Answer No. 04

(a) Reasons to justify the importance of reducing the government fiscal deficit:

- To reduce the borrowing requirement of the government and thereby reduce the public debt
- To ease out inflationary pressure
- To ensure funds are available for the private sector for investments
- To reduce interest rates and thereby induce investments
- Can lead to a favourabe impact on BOP
- To ensure macroeconomic stability and thereby promote economic growth
- To increase domestic savings

(b) Budget deficit - difference between projected government total revenue and projected expenditure (measured as a % of GDP).

Expenditure side measures:
- Reduce capital expenditure
- Reduce expenditure on social programmes

Revenue side measures:
- Increase tax revenue (e.g. increase tax base, eliminate tax evasion, phase out tax concessions)
- Increase non-tax revenue (e.g. increase fees and charges payable for services rendered by public institutions)

(c) If justified

For a developing country, a budget deficit can be justified as expenditure is mainly on; investment activities which will generate future revenue, enhancing welfare of poor people etc.

If not justified

A budget deficit will:
- have more burden on the poor due to financing through indirect taxes
- increase the indebtedness of the country

Question No. 05

(a)

- ***Bank rate*** – this is the official minimum rate at which the Central Bank discounts first class bills or lends to commercial banks. An increase in the bank rate will lead to an increase in the interest rates making borrowings expensive to the public, thus reducing the demand for bank loans. Likewise, a monetary expansion can be encouraged by reducing the bank rate.
- ***Open market operations*** – this refers to the sale and purchase of government securities in the open market in order to control the money supply. Sale of treasury bills in the open market would lead to a contraction of the money supply whereas purchase of securities by the Central Bank would lead to an expansion of the money supply.
- ***Statutory Reserve Requirement*** – this refers to the proportion of customer deposits that each commercial bank should hold as reserves. An increase in SRR would decrease the money supply whereas a reduction in SRR would expand the money supply.

- ***Quantitative and qualitative controls*** – Central Bank may impose ceilings on the total volume of bank credit (quantitative controls). The Central Bank can also discourage commercial bank lending to certain sectors of the economy such as the housing sector (qualitative controls).

- ***Moral suasion*** – The Central Bank can persuade commercial banks to adopt desired courses of action but these have no legal compulsion.

(b)

c = a + by
a = 525 (given)
APC @ Y = 100

$$APC = \frac{c}{y} = \frac{a+by}{y} = \frac{a}{y} + b$$

c = 600, when y = 100

$$APC = \frac{600}{100} = 6$$

$$\text{Then, } 6 = \frac{525}{100} + b = 5.25 + b$$

$$\Longrightarrow \quad b = 0.75 = MPC$$

$$\text{Multiplier is } \frac{1}{1 - 0.75} = \frac{1}{0.25} = 4$$

(c) Monetary policy is the policy instrument used by the Central Bank for demand management purposes through the money market using money supply or interest rates.

<u>Objectives:</u>

- Price stability
- Reduction of unemployment
- BOP control.

Answer No. 06

(a) **Legitimate power -** power derived from legal authority/position in a formal organization
Referent power - power derived from recognition by subordinates

(b) Barriers to communication are process barriers, personal barriers, physical barriers and semantic barriers.

(c) For an employee to perform his duties at the basic level of expectation, the management needs to ensure that the hygiene factors are met. However, to motivate the employee to perform beyond the basic level, motivation factors should be enhanced.

Answer No. 07

(a) Environment analysis involves appraisal of both the internal and external environment of the organization. The external environment in which an organization operates, such as the political, economical, socio cultural and technological environments, are dynamic in nature. This would influence the internal environment. The dynamic nature of the external environment forces an organization to keep up to date with the changes, failing of which will result in the loss of market position to competitors who adopt to the changes.

(b) There are three major types of organizational structures:
Functional – divides the company based on specialty(e.g. Production, Marketing, Finance etc)
Divisional – divides the compnay according to products, regions and customer groups
Matrix – hybrid of functional and other structures

Divisional structure	**Matrix structure**
Divides the company according to products, regions and customer	Hybrid of functional and other structures
Allows more control – employees report to the division/structure they are located in	Employees may have to report to two superiors

(c) A business organization has several stakeholders; shareholders, employees, the management, government, society in which it operates etc. Most organizations operate with a profit motive in order to satisfy its shareholder. However, this is only one segment of stakeholders. In the modern business context where consumers and society at large are well informed, organizations are under pressure not only to operate in an ethically acceptable way, but also to be socially responsible. Organizations which are found not to be socially responsible may lose customers and even shareholders who believe in investing in organizations with good values and those that positively contribute to the society.

(d) Efficiency – how well you do something i.e. doing something at the lowest cost within the least possible time

Effectiveness – how useful it is, i.e. the degree to which the organizational goals are achieved

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