SRI LANKA

Association of Accounting Technicians of Sri Lanka

January 2016 Examination - AA1 Level

Questions and Suggested Answers
Subject No : 13

ECONOMICS FOR BUSINESS & ACCOUNTING (EBA)

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

EDUCATION AND TRAINING DIVISION

AA1 Examination - January 2016
(13) Economics for Business & Accounting

SUGGESTED ANSWERS

SECTION – A

Objective Test Questions (OTQs)

Answers to ALL questions are expected.

(Total 40 marks)

Suggested Answers to Question One:

Question No	Answer
1.1	3
1.2	2
1.3	3
1.4	2
1.5	3
1.6	-
1.7	2 (4.7%)
1.8	2 ($M_2 = C_p + DD + TSD$)
1.9	2
1.10	4
1.11	TRUE
1.12	FALSE
1.13	TRUE
1.14	FALSE
1.15	TRUE
1.16	Economic Development
1.17	Real
1.18	Substitutes
1.19	a. UK (United Kingdom)
	b. UK (United Kingdom)

1.20 a. UK (United Kingdom)

b. Japan

a. Comparative Advantages for Potatoes

UK ; Pepper/Potatoes

6/12=0.5

Japan ; Pepper/Potatoes

4/2= 2

UK has comparative advantage in the production of Potatoes

b. Comparative Advantages for Pepper

UK ; Potatoes/Pepper

12/6 = 2

Japan ; Potatoes /Pepper

2/4 = 0.5

Japan has comparative advantage in the production of Pepper

End of Section A

SECTION –B

All four (04) questions of this section to be answered.
(Total 40 marks)

Suggested Answers to Question Two:

(a) **Economic Resources**

Economic resources are anything which can be used to produce goods and services to satisfy human needs and wants and which are limited in supply or scarce and associated with opportunity cost in utilizing in the production process. Availability of a price and transact in the market, individual ownership and economic resources are not freely available. It has a price.

Examples: Labour used in the production, Raw Materials, Land and Buildings, mineral resources etc

If at least one of the following features is included in a particular resource it is knwon as a economic resource

- Limited in supply (Scaricity)
- Opportunity cost
- Availability of a resource and transact in the market
- Individual ownership

Economic resources can be categorized into four (04) categories as Land, Labour, Capital and Entrepreneurship (05 Marks)

(b) i. **Opportunity Cost :**

Opportunity cost refers to the value of the best forgone next alternative of an economic activity as a selection of an opportunity due to scarcity of recourses and alternative uses of resources.

- Opportunity cost is a real concept which may or may not include monetary value. The opportunity cost is taken into consideration in calculating the economic profit.

Accounting Cost:

The finance cost incurred by a firm to purchase factors of production from the outside is known as Accounting Cost. Accounting Cost includes only explicit cost but it does not include implicit cost of the production. Accounting Cost is taken into consideration in calculating the accounting profit. (03 Marks)

ii. a) **Examples for Opportunity Cost.**

If a person utilizes his personal labour and assets for a business, the opportunity cost is the returns or benefits that could have been derived from his labour and assets by utilizing them in other opportunities.

b) **Examples for Accounting Cost.**

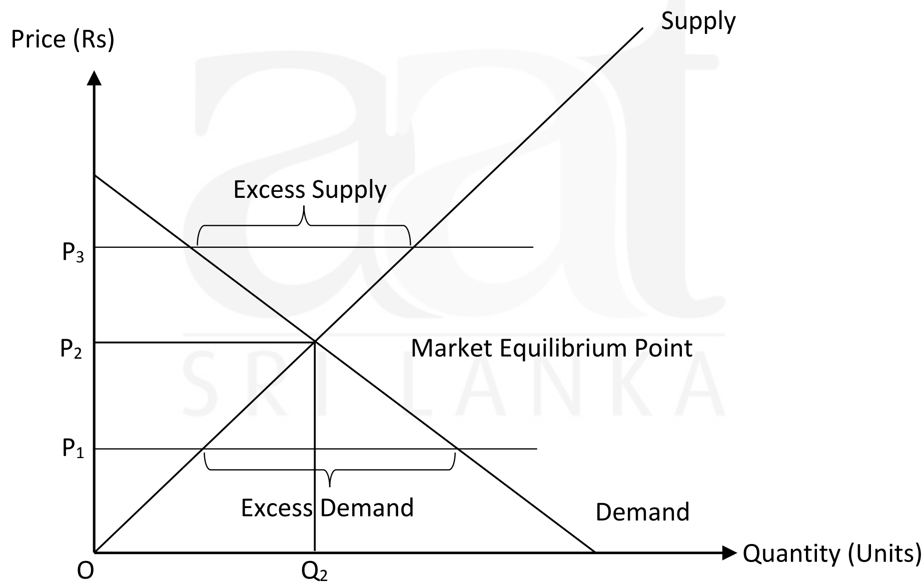
If a business organization has recruited employees from the outside and purchased raw materials from the outside, the cost incurred by the firm for labour and raw materials is considered as Accounting Cost. (02 Marks)

Suggested Answers to Question Three:

(a) The market economy is driven by 'Price'. Basic economic problems and other economic issues are solved by the price system in the economy. Price of a product or factor is determined by demand force and supply force in the market. Demand represents the behaviour of buyers whereas supply shows the behaviour of sellers in the market.

Market equilibrium is the situation where the market demand equals market supply and the state at which two opposite forces balanced at the same time. The price which is determined at the equilibrium is known as equilibrium price and the quantity is known as equilibrium quantity. Equilibrium price and quantity change as a result of change in market demand and market supply. Therefore equilibrium shows the direction of price change caused by the changes in demand and supply.

(06 Marks)



At price P_1 the excess demand cause to increase price. At P_3 the excess sypply cause to reduce the price.

At the inter section point of the demand and supply curves, the equilibrium is determined. The equilibrium price is P_2, equilibrium quantity is Q_2. At this point demand equals to supply.

(b)

1. Demand and supply concepts are fundamental to business operations.
2. Firms produce goods and services and supply to the market if demand for such goods and services is exist in the market.
3. The demand and supply of the goods or services affects the revenue attainable from the market.

4. Knowledge in supply and demand concepts can help the firm for the following decisions.

   - Sales forecasting - Forecast the impact of a change in price.
   - Pricing policy - Helps to decide whether to raise or reduce the price.
   - Non pricing policy - When the demand is highly elastic, can use advertising and other promotional techniques.
   - Diversification - Can diversify and offer a range of goods with different income elasticity conditions.
   - Income elasticity - Changes in income tend to change in demand.
   - Business Cycles - Changes in real national income tend to result in cyclical changes in demand.

(04 Marks)

Suggested Answers to Question Four:

(a) Characteristics of a Monopolistic competition can be stated as follows,

1. Existence of large number of firms - These firms do not produce perfect subsitutes. But the products are close substitutes.
2. Product differentiation- Differentiation is done through differences in materials used, design, colour, etc..
3. Some influence over the price- a monopolistic firm can change the price of the product up to certain extent.
4. Absence of firm's interdependence- each firm formulates its own price - output policy upon its own demand.
5. High advertising- firms incur a considerable expenditure on advertising and sales related expenses so as to win the consumers.
6. Freedom of entry and exit - Easy for new firms to enter to existing firm to leave the industry.

(04 Marks)

(b) 1. **Transaction Motive**

This is the interest that people have to hold money in the form of currency for the purpose finance day today transactions. The transaction motive for demanding money arises from the fact that most transactions involve an exchange of money. Because it is necessary to have money available for transactions, money will be demanded. The main determinant for transaction demand for money is real income and it is positively related.

2. **Precautionary Motive**
This is the interest that people have to hold money in the form of currency for the purpose finance unexpected (uncertain) transactions. Unexpected expenses, such as medical or car repair bills often require immediate payment. Similar to the transaction demand for money, precautionary demand for money is positively related with real income.

3. **Speculative Motive**
Speculative demand for money refers the interest that people have to hold money in the form of currency in order to generate a return in the future. The speculative motive for demanding money arises in situations where holding money is perceived to be less risky than the alternative of lending the money or investing. The main determinant of speculative demand for money is interest rate as it indicates the opportunity cost of holding money. Interest rate is negatively related with speculative demand for money.

(06 Marks)

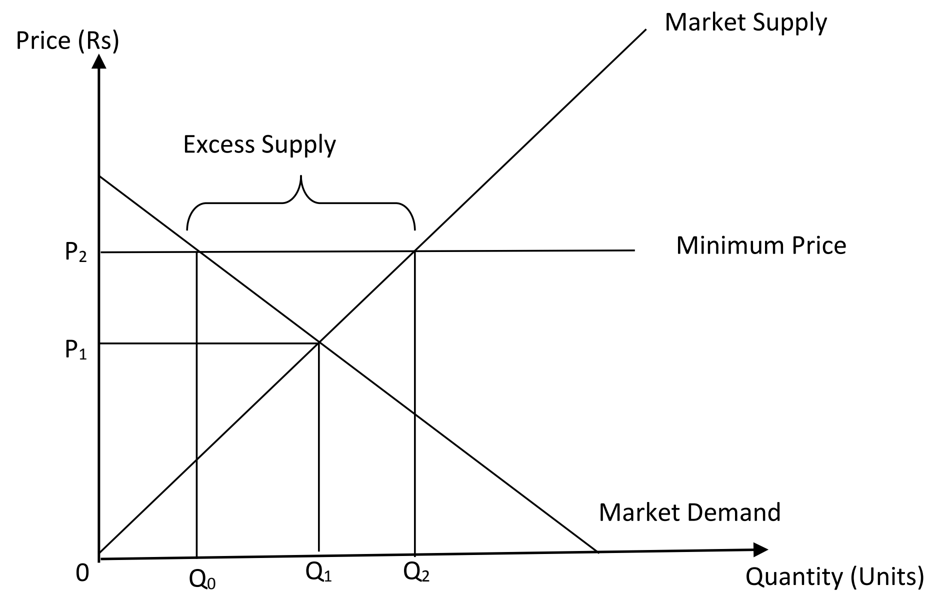
Suggested Answers to Question Five:

(a) The main objectives of a government budget can be listed out as follows,

1. Effective allocation of limited resources
2. Redistribution of income
3. Promotion of economic growth and development
4. Provision of infrastructure facilities
5. Maintenance of Economic Stability
6. Attainment of political objectives

(04 Marks)

(b) price floor can be illustrated as follows,



1. Minimum purchasing prices are used to protect producers. The objective is to fix a reasonable price to producers and safeguard their income.
2. Minimum price will create an excess supply in the market.
3. If necessary measures are not taken to eliminate the excess supply, it is possible to reduce the market price to a very low level causing more difficulties for the producers.
4. Government need to take the following measures to eliminate the excess supply in the market.
   - Purchasing the excess supply and store it for future use.
   - Export the excess supply.
   - Encourage firm to produce subsitute goods using the excess supply.
5. If this excess supply cannot be used and could not find purchasers, there will be an inefficient allocation of resources.
6. There will be possibilities for intermediate to purchase the product, specially from small producers at a lower price and sell at the floor price.
7. It bumper harvest arise storage problems, will occur.

(06 Marks)

End of Section B

SECTION –C

One question of this section to be answered.
(Total 20 marks)

Suggested Answers to Question Six:

(a) i. **Uses**

1. National Income is the main indicator of the performance of the overall economic activities. It helps to understood the total value of the goods and servicess produced by a country's resources during a period of time, usually a year.
2. National Income can be used to measure the performance of different sectors in the economy.
3. It can be used for the comparisons between years, in order ro make meaningful comparisions between years, allowance is made for inflation.
4. National Income, specially per-capita income can be used for comparison with other countries.
5. It helps to understood the pattern of utilization of resources and also to identify if any misuse of resources.
6. Can be used to measure the standard of living of the country and for the comparison between years.
7. Can be used to estimate the amount of expenditure for consumption and investment and the amount of savings in the country.
8. Used for the preparation of economic plans and for the evaluation.
9. It is used to measure the economic growth of the country.

(03 Marks)

ii. **Limitations of NIA**

- National income measures value of domestic economic output but not social welfare
- National income figures ignore the distribution of income. It does not take disparity in incomes between the rich and poor into account.
- Errors in measurements. National income statistics do not include black market activities, underground economic activities, some direct production activities etc..
- National income does not measure leisure, work satisfaction, product quality etc
- National income does not accurately reflect the impact to the environment such as pollution.
- Problem of depreciation and different methods applicable in calculation of depreciation.
- Double counting errors in national accounting.

(05 Marks)

(b) (i) **Gross Domestic Product (GDP) at a factor cost price**

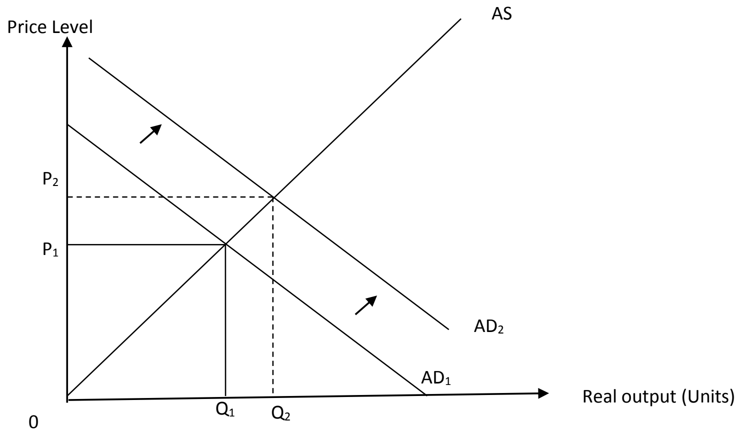
Item		Rs. (Millions)
Private Consumption		30
Public consumption		07
Gross Domestic Capital Formation		08
Gross Domestic Expenditure		**45**
Add - Net Export	- Exports 10	
	- Imports (12)	(02)
Gross Domestic Product at Market Price		43
Less		
Indirect Taxes		(06)
add		
Subsidies		02
Gross Domestic Product at Factor Cost Prices		**39**

(ii) **Gross National Product (GNP) at a factor cost price**

		Rs. (Millions)
Gross Domestic Product market prices		43
Add - Net factor Income from abroad		(1)
Gross National Product at Market Prices		**42**
Less - Taxes on expenditure	6	
Add - Subsidies	2	(4)
Gross National Product (GNP) at factor cost prices		**38**

(c) . **Demand - Pull Inflation**

1. Demand - pull inflation refers to a situation where prices tend to rise continuously when the aggregate demand increases faster than the aggregate supply.
2. The aggregate demand can rise due to increase either in aggregate consumption, aggregate investment, government expenditure or combination of all. The availability of money is behind increase demand by individuals.
3.

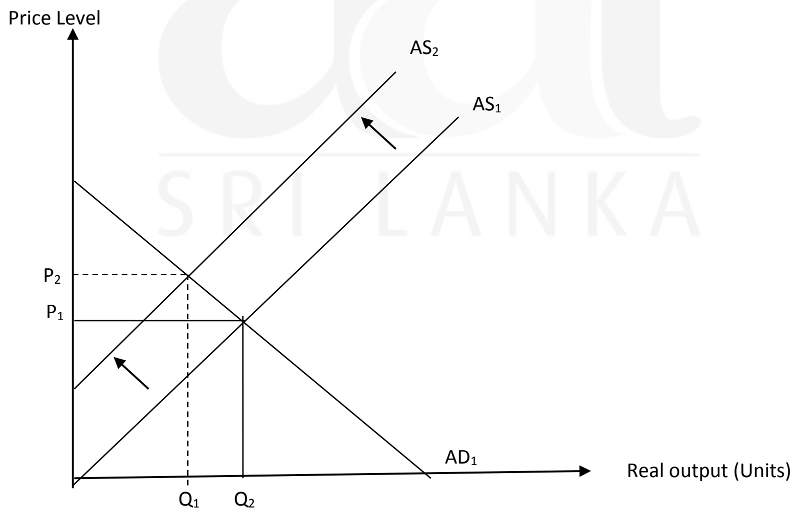


AD = Aggregate Demand
AS = Aggregate Supply

At **AD**$_1$ curve the price is at **P**$_1$. With the increase in aggregate demand, the **AD**$_1$ curve shifts to **AD**$_2$ and the price increases to **P**$_2$.

<u>Cost - Push Inflation</u>

1. Cost - Push Inflation originates from the supply side and it is usually the result increase in the cost of production.
2. The possible reasons for the supply side inflation;
   - i. Wide spread droughts of floods that affect aggregate supply, specially in agricultural sector.
   - ii. Wide spread labour strikes affect the production and distributors.
   - iii. Higher wages resulting from trade union activity.
   - iv. Increase in prices of raw materials supplied by domestic sources.
   - v. Increase in international commodity prices or depreciation of the domestic currency could push prices of imported inputs and final goods.
3. The aggregate supply curve shifts inward from AS1 to AS2, no change in demand. Therefore the price of good increases from P1 to P2.



End of Section C

Notice :

These answers complied and issued by the Education and Training Division of AAT Sri Lanka constitute part and parcel of study material for AAT students.

These should be understood as Suggested Answers to question set at AAT Examinations and should not be construed as the “Only” answers, or, for that matter even as “Model Answers”.

The fundamental objective of this publication is to add completeness to its series of study texts, designs especially for the benefit of those students who are engaged in self-studies. These are intended to assist them with the exploration of the relevant subject matter and further enhance their understanding as well as stay relevant in the art of answering questions at examination level.