



**Association of Accounting Technicians of Sri Lanka**

**July 2018 Examination - AA1 Level**

**Questions and Suggested Answers**

**Subject No : AA13**

**ECONOMICS FOR BUSINESS & ACCOUNTING  
(EBA)**

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**A publication of the Education and Training Division**

THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA  
EDUCATION AND TRAINING DIVISION

**AA1 Examination - July 2018**  
**(AA13) 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         | - (1)                       |
| 1.2         | - (3)                       |
| 1.3         | - (3)                       |
| 1.4         | - (1)                       |
| 1.5         | - (1)                       |
| 1.6         | - (4)                       |
| 1.7         | - (3)                       |
| 1.8         | - (1)                       |
| 1.9         | - (4)                       |
| 1.10        | - (1)                       |
| 1.11        | - True                      |
| 1.12        | - False                     |
| 1.13        | - True                      |
| 1.14        | - False                     |
| 1.15        | - True                      |
| 1.16        | - entrepreneurship          |
| 1.17        | - no                        |
| 1.18        | - normal                    |
| 1.19        | - equilibrium interest rate |
| 1.20        | - economic development      |

(2 marks each, Total 40 marks)

*End of Section A*

Four (04) compulsory questions  
(Total 40 marks)

**Suggested Answers to Question Two:**

(a) **Three underlying assumptions of PPC**

(i) **Full employment of resources**

(The economy fully employs all its resources and producing the greatest output without waste or mismanagement.)

(ii) **The best available technology is used and it remains constant**

(Technology is the body of knowledge applied to the way goods and services are produced. Holding technology fixed put up a limit on the amounts and types of goods any economy can produce.)

(iii) **Only two types of goods are produced**

(It is assumed that the economy is producing only two categories of goods.  
(e.g. consumer goods and capital goods).)

(iv) **Factor endowments remains unchanged**

(v) **It is prepared for a given period of time**

(03 marks)

(b) **Differences between capitalist (Market) economy and socialist (Planned) Economy**

| Capitalist (Market) Economy   | Socialist (Planned) Economy  |
|---|--|
| Public sector is operating in the economy.                            | Government sector is operating in the economy.                         |
| Consumers have the sovereignty.                                       | There is no consumer sovereignty.                                      |
| There is a disparity among members of the society.                    | There is no disparity among members of the society.                    |
| Environment will be neglected by the private sector.                  | It is expected that the environment will be protected.                 |
| Prices of commodities determined through demand and supply of market. | The economic activities are handled by centralized planning committee. |
| Ownership of resources is with private sector.                        | Ownership of resources is with public sector.                          |
| All economic decisions are based on market prices.                    | Social welfare is considered when taking the decisions.                |

(03 marks)

(b) **Equilibrium Price**

(i) **Rs. 10;** At equilibrium,

$$\begin{aligned} Q_d &= Q_s \\ 80 - 6p &= -20 + 4p \\ 100 &= 10P \\ P &= 10 \end{aligned}$$

(02 marks)

(ii) **Rs:20** ( $Q_d = 80 - 6 * 10$ )

**OR**

$$(Q_s = -20 + 4p)$$

(02 marks)

(Total 10 marks)

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### *Suggested Answers to Question Three:*

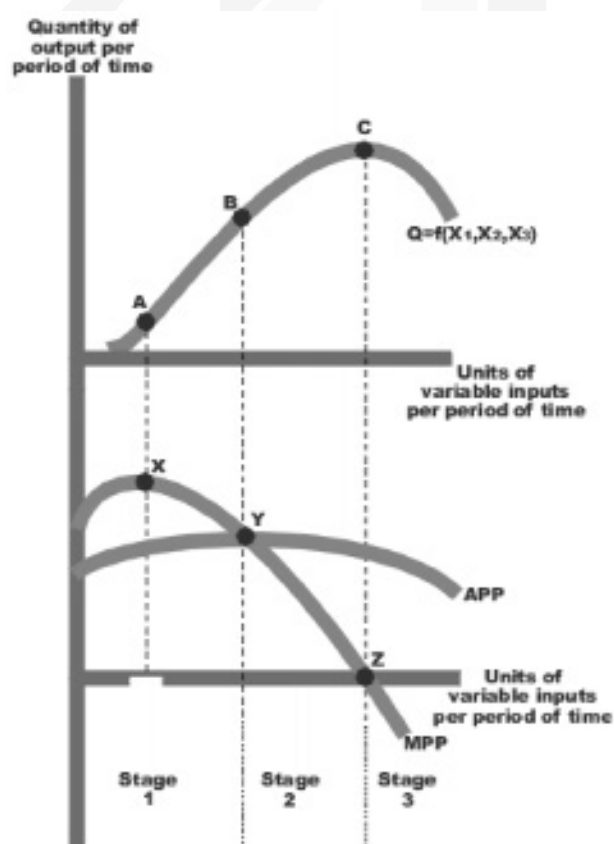
(A) **Relationship between TP, AP and MP**

Total production (TP) is the total number of units that can be produced for a given level of inputs. Average production (AP) is the production per unit of the input used and it is obtained by dividing TP by the number of inputs used (TP/L). Marginal production (MP) is the change in TP per unit change in the input used ( $\Delta TP/\Delta L$ ).

The production function for a product can be graphically illustrated as follows. It has been obtained by using various alternative quantities of labor within a specific period of time in a fixed area of land. Total production (TP), Average production (AP) and Marginal production (MP) curves for the above commodity will be shown as follows.

Two important relationships can be identified between these production curves.

- The MP becomes zero when the TP is maximized, and it is negative when the TP begins to decline.
- MP curve intersects the AP curve at the maximum point of the AP curve. Therefore, AP and MP of the firm are equal to each other when the AP of the firm is maximized.



(06 marks)

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(B) **4 differences between Monopoly and Monopolistic Competition**

**1. Type of products**

In a monopoly there is one unique product whereas in monopolistic competition the products are differentiated.

**2. Number of sellers**

In a monopoly there is only one seller whereas in monopolistic competition there are large number of competitors

**3. Entry conditions**

In a monopoly there are no entry barriers whereas in monopolistic competition it's easy to enter into the market.

**4. Competition**

In a monopoly, competition doesn't exist whereas in monopolistic competition stiff competition exist between the firms.

**5. Shape of the demand curve**

In the monopolistic competition the demand curve is negatively sloped but highly elastic whereas in a monopoly it is negatively sloped, but inelastic.

**6. Profitability in long equilibrium**

In monopolistic competition, only normal profits are earned but in a monopoly a firm can earn economic profits.

**7. Advertising**

In monopolistic competition advertising is present to some extent while in a monopoly products are not advertised.

*(04 marks)*

*(Total 10 marks)*

***Suggested Answers to Question Four:***

(a) **Consequences of granting a unit subsidy for a commodity**

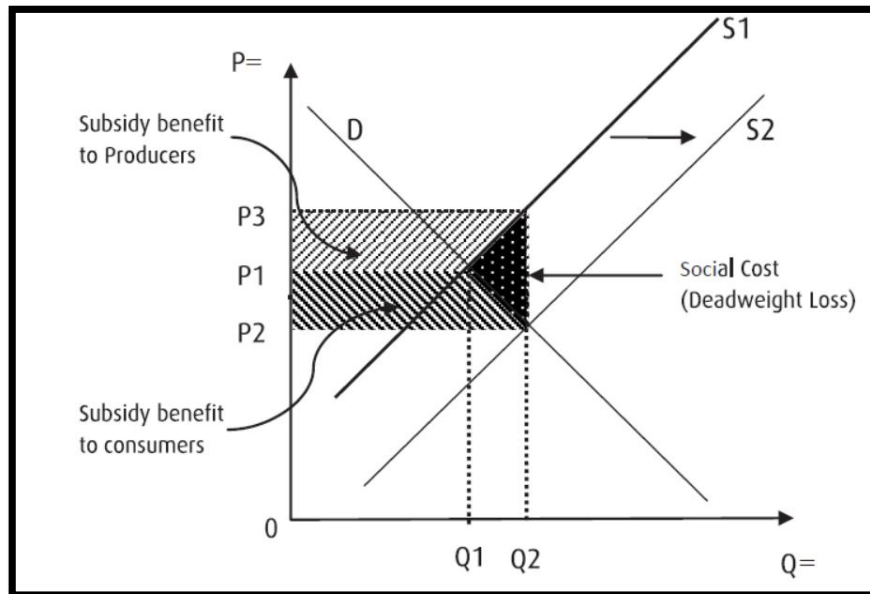
Government can grant subsidies for the benefit of either to producers or to consumers and accordingly, there are two types of subsidies namely, production subsidies and consumption subsidies.

A production subsidy is a payment by the government to suppliers that reduce their costs of production and encourages them to increase output.

When the price of a product in the market is too high, government can make a payment to producers requiring them to provide the said product to consumers at a concessionary price.

The effect of a government subsidy is to increase supply and (*ceteris paribus*) reduce the market equilibrium price. The subsidy causes the firm's supply curve to shift to the right. The amount spent on the subsidy is equal to the subsidy per unit multiplied by total output.

The decrease in price after the subsidy is the benefit available to consumers and the balance part of the subsidy which is not adjusted to the price of the product, is the subsidy benefit passed to producers.



(06 marks)

(b) (i) **Reasons for government to intervene in the market economy**

1. To correct the market failure.
2. To achieve a more fair distribution of income and wealth. (fair allocation of resources and distribution of income.)
3. To improve the performance of the economy.
4. Government intervention to provide infrastructure facilities.
5. Government intervention in activities which cause externalities.

(02 marks)

(ii) **Two ways of intervention in the market economy other than granting subsidies**

- Price controls
  - o Price ceilings
  - o Price floors
- Indirect taxes
- Government enterprises
- Provision of public goods

(02 marks)

(Total 10 marks)

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## ***Suggested Answers to Question Five:***

### ***Comparative advantage in the production***

As per the above table, A has the absolute advantage in producing both products.

Since B does not have absolute advantage in producing any product, one can argue that B cannot obtain any benefits from international trade by using specialization. But, that is not correct. Even if there is no absolute advantage any country can get the benefit from specialization, if there is comparative advantage. In order to identify whether a country has comparative advantage in producing a certain product, it is necessary to calculate the opportunity cost of producing respective products which is calculated as below.

Opportunity cost measures that number of units that should be sacrificed from one product, in order to produce one unit from the other product.

| <b>Country</b> | <b>Wheat (Kg)</b> | <b>Potatoes(kg)</b> |
|----------------|-------------------|---------------------|
| A              | 6                 | 4                   |
| B              | 1                 | 3                   |

Opportunity cost of producing 1 kg of wheat flour =  $\frac{\text{No of meters sacrificed from potatoes}}{\text{no of Kg produced from wheat flour}}$

Opportunity cost of producing 1 kg of Potatoes =  $\frac{\text{No of meters sacrificed from wheat flour}}{\text{no of Kg produced from potato}}$

| <b>Country</b> | <b>The opportunity cost of producing 1 kilogram of wheat flour</b> | <b>The opportunity cost of producing 1 kilogram of wheat flour 1 kilogram of potatoes</b> |
|----------------|--|---|
| A              | 0.67   | 1.50  |
| B              | 3.00   | 0.33  |

As per the above table, A country has the comparative advantage in producing wheat flour since the opportunity cost of producing that product is lower than B country. On the other hand B country has the comparative advantage in producing potatoes since the opportunity cost of producing that product is lower than A country.

***(06 marks)***

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**(b) Four consequences of devaluation of the SL rupee against US \$**

- Encourages the arrival of foreign tourists to Sri Lanka.
- It is beneficial for Exporters.
- Imports become more expensive due to rise in price
- Real income will reduce
- Increase in current account deficit since Sri Lanka's imports are higher than exports.
- Foreign currency debt will increase.
- Increase the prices of goods and services, therefore there will be an inflation.
- Purchasing power of currency goes down pressuring people to cut there essential expenses which ultimately challenge the living standards in the country.

*(04 marks)*

*(Total 10 marks)*



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*End of Section B*



**A compulsory question.**

**(Total 20 marks)**

***Suggested Answers to Question Six:***

(A) (i) **Qualitative controls of the monetary policy of the CBSL**

- Moral Suasion
- Fixing maturity periods for commercial bank credit
- Portfolio ceilings
- Fixing selective interest rates
- Provisions of refinance facilities

**(03 marks)**

(ii) **Banks face the challenge of maintaining a balance between the two conflicting objectives of liquidity and profitability.**

The intermediary process of commercial banks involves collecting funds from the surplus units as deposits and providing facilities to deficit units as loans and advances.

Therefore, commercial banks do their business with funds collected from others. The value of deposits that the bank can generate is depending on the confidence that people have about the financial soundness of such banks. To maintain that requirement, banks have to maintain liquidity. That is banks have to keep sufficient funds with them to maintain liquidity. On the other hand, banks have to generate profits through lending. They want to give more and more loans if they want to generate more profits.

Maximum safety can be attained only if the banks keep high amount of cash against the deposits they accept. But if they do this, this will not bring any profits for the banks. Thus, if the bank goes for maximum safety then they will have to sacrifice the profitability objective. Similarly if they go other way round that is they only keep on investing and trying to increase the profitability and they will have the problem if customer demands for cash. Therefore, it is very difficult for the banks to reconcile the twin objective of bringing the profitability factor and liquidity factor go hand in hand.

Accordingly, banks face the challenge of maintaining optimal balance between the two conflicting objectives of liquidity and profitability.

**(04 marks)**

(B)

(a) Gross domestic expenditure

$$\begin{aligned} E1 &= C + I + G \\ &= 1500 + 3000 + 1500 \\ &= \underline{\underline{6000}} \end{aligned}$$

**(04 marks)**

$$\begin{aligned}
 \text{(b) GDP at market price} & \\
 &= \text{GDE} + \text{net exports} \\
 &= 6000 + 2500 \\
 &= \underline{\underline{8500}}
 \end{aligned}$$

(02 marks)

(c) GNP at market price

$$\begin{aligned}
 \text{GDP at market price} &= 8500 \\
 \text{Net factor income from abroad} &= \underline{750} \\
 \text{GNP at market price} &= \underline{\underline{9250}}
 \end{aligned}$$

(02 marks)

$$\begin{aligned}
 \text{(d) NNP at market price} &= \text{GNP} - \text{Capital Depreciation} \\
 &= 9250 - 1000 \\
 &= \underline{\underline{8250}}
 \end{aligned}$$

(02 marks)

**(C) Macro Economic objectives of the government**

- **Price stability (low and stable inflation)**

(To achieve price stability it is necessary to manage the economy without inflationary or deflationary pressures. Average price level in the economy is considered as stable when economy experiences very lower rates of inflation.)

- **Full employment (low unemployment)**

(An economy achieves full employment level when all the resources in the economy are utilized in the full with maximum efficiency. When aiming at achieving full employment level it is necessary to minimize labour unemployment by increasing employment opportunities.)

- **Equilibrium in Balance of Payment**

(In order to achieve Balance of Payment equilibrium it is important to manage the economy without Balance of Payment crises when having exchanges across the boundaries.)

- **Fair distribution of income**

(Ensuring fair levels of income distribution among its population, a country is able to achieve equality. Income and wealth should be distributed in a way to ensure that every citizen of a country should have the ability to fulfill his/her wants and needs.)

- **High and sustainable economic growth.**

(Total 20 marks)

*End of Section C*

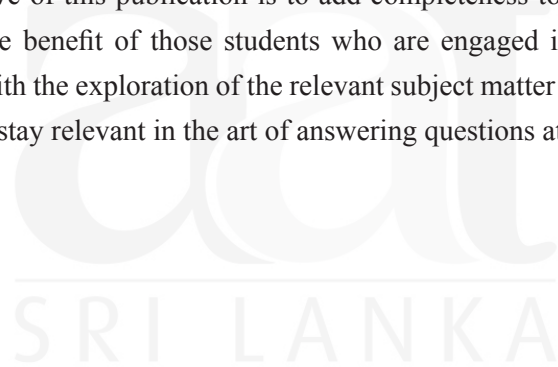
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***Notice :***

These answers compiled 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.



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