



Association of Accounting Technicians of Sri Lanka

July 2020 Examination –Level I

Suggested Answers (103)

(103) ECONOMICS

Association of Accounting Technicians of Sri Lanka

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

Level I Examination-July2020

(103) ECONOMICS

SUGGESTED ANSWERS

(Total 40 Marks)

SECTION - A

Suggested Answers to Question One:

1.1 (4)

1.2 (3)

1.3 (3)

1.4 (2)

1.5 (3)

1.6 (2)

1.7 (1)

1.8 (4)

1.9 (2)

1.10 (1)

1.11 Average Cost

1.12 Higher

1.13 False

1.14 True

1.15 False

1.16 1. What to produce and in what quantities?
2. How to produce?
3. For whom to produce?

1.17 This is the situation where the Marginal Production decreases when more and more variable inputs are used after a certain level of production in the short-run production process.

Diminishing marginal returns occur in the short-run when one factor is fixed. If the variable factor of production is increased, there is a point where it becomes less productive and therefore, there will eventually be decreasing marginal returns and then average cost.

The law of diminishing marginal returns states that in any production process, adding one more production unit while keeping the others constant will cause the overall output to decrease.

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- 1.18**
1. There is a single seller in the market
 2. Product is unique (No close substitutes)
 3. There's only a single firm engages in the production
 4. Price maker since it can determine the price in the market
 5. Price discrimination can be seen
 6. Barriers to entry
 7. Profit maximizer
 8. Imperfect and incomplete information is available and not possible to obtain the information at free cost.
- 1.19**
1. Non-inclusion of productive activities taking place in informal economy
 2. Non-inclusion of dependent economic activities in national production
 3. Non-inclusion of services provided by housewives in national production
 4. Non-inclusion of interest paid on public debts in national production calculations
 5. Non consideration of damage to environment due to production activities
 6. Non consideration of changes of productivity in public services
 7. Inclusion of expenditure on defense and wars under productive activities
 8. Non-inclusion of some consumer goods with long lifespan in national production by categorizing them as investments.
- 1.20**
1. Price stability
 2. Full employment
 3. Equilibrium in Balance of Payment
 4. Fair distribution of income
 5. Sustainable development
 6. Economic growth

(02 marks each, Total 20 marks)

Suggested Answers to Question Two:***Chapter 01-Economic Concepts and Systems related to Business Environment*****(a) Economic Goods and Non-economic Goods.**

Economic Goods are anything which can be used to satisfy human needs and wants and which are limited in supply or scarce and associated with opportunity cost in consumption or production.

Examples: Food, Clothing, Vehicles, educational services etc.

Non-economic Goods refer to the goods which can be used in unlimited quantities when there is a supply and do not associate with opportunity cost in consumption or production

Examples: natural air, rain water and natural environment.

(03 Marks)

(b) The characteristics of a planned economy

1. Solving of fundamental economic problems according to a planned mechanism.
2. Property ownership/ Means of production lie with the government.
3. Existence of state entrepreneurial system.
4. The guiding factor of economic activities is the social welfare.
5. Non-existence of consumer sovereignty.
6. Existence of fair income distribution.
7. Absence of freedom of choice.
8. There is no producer sovereignty.
9. Low level employment.

(04 Marks)

(c) Concept of opportunity cost in Economics

- Opportunity Cost refers to the value of the next best alternative forgone of an economic activity as a selection of an opportunity due to scarcity of resources and alternative uses of resources. Opportunity cost is a real concept which may or may not include monetary value in the decision making. It is the main cost which is considered in the decision making in economics.
- Example; If a person has commenced owned business by using his labour, capital and other assets, the opportunity cost of this business is the returns, incomes or benefits that could have been earned from his labour, invested capital and other assets by utilizing them elsewhere in other opportunities.

(03 Marks)

(Total 10 Marks)

Suggested Answers to Question Three:

Chapter 02-Demand, Supply, Equilibrium and Ways of Government Intervention

(a) (i) $Q_d = 180 - 4p$
 $Q_s = -20 + 6p$

At equilibrium ; $Q_d = Q_s$

$$\begin{aligned} 180 - 4p &= -20 + 6p \\ 200 &= 10p \\ 200/10 &= p \\ \underline{\underline{20}} &= \underline{\underline{P}} \end{aligned}$$

Equilibrium Price - Rs. 20/-

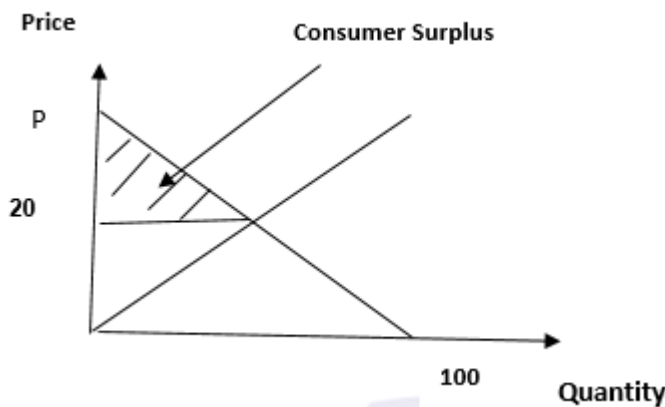
$P = 20$ is substituted to the Q_d equation,

$$\begin{aligned} Q_d &= 180 - 4p \\ Q_d &= 180 - (4 \times 20) \\ Q_d &= 180 - 80 \\ \underline{\underline{Q_d}} &= \underline{\underline{100}} \end{aligned}$$

Equilibrium Quantity – 100 Units

(03 Marks)

(ii)



$$\begin{aligned} \text{Consumer Surplus} &= \frac{(\text{Maximum Price} - \text{Equilibrium Price}) \times \text{Quantity}}{2} \\ &= \frac{(45-20) \times 100}{2} \\ &= \underline{\underline{\text{Rs. 1,250/-}}} \end{aligned}$$

(02 Marks)

(b) Price elasticity of demand is determined by following factors

- Number of close substitutes available
- Nature of the good
- Share of consumer's budget (percentage of income allocated for the product)
- Passage of time need to adapt to the change in price
- Habit forming goods
- Whether the relevant good is necessary or luxury
- The number of the alternative usage of the given period

(02 arks)

(c) Ways by which the government intervene in the market economy.

The government can intervene market in different ways.

- **Imposition of tax**

The government imposes taxes on consumers and producers to intervene in the freely functioning markets. Accordingly, the government can impose as a fixed rupee amount on the unit of item consumed or as a percentage.

- **Providing subsidies**

Providing subsidies to consumers and producers can be considered as another method by which the government intervene in the free market. For producers it will help to increase the production by minimizing cost.

- **Price controls**

Government can introduce the maximum price and minimum price to control the price of the goods and services. Government imposes the maximum price to protect consumers and imposes

Minimum price to protect producers.

- **Government Enterprises**

A government enterprise is a legal entity created by a government to undertake commercial or business activities on behalf of the government. Government enterprises help to avoid adverse market conditions.

- **Provision of public goods**

When the market fails to provide certain goods and services there is a clear necessity for the government to intervene to the market in order to eliminate adverse economic conditions. Therefore, the government provides those goods.

(03 Marks)
(Total 10 Marks)

Suggested Answers to Question Four:

Chapter 05 – Financial System, Money and General Price Level

(a) (i) Characteristics of Money

1. General Acceptability- The material of which money is made should be acceptable to all without any hesitation.
2. Portability- Money should be easily carried or transferred from one place to another.
3. Durability- Money material must last for a long time without losing its value.
4. Divisibility- Money must be easily sub-divided to allow for the purchase of smaller units of the commodities.
5. Uniformity- Money should be homogeneous. Its units should be identical;
6. Cognoscibility- Money should easily be recognized, Convenience to identify
7. Limited Supply-Relative Scarcity
8. Stability of value- The value of money should remain stable and should not change for a long period of time.
9. Intrinsic value is not greater than face value
10. Difficult to counterfeit

(02 Marks)

(ii) Reasons for using electronic money

There are various reasons for using electronic money.

- More convenient method since easy and quick settlement method (Can be used anytime, anywhere)
- Any amount can be transferred.
- Speed payment method.
- Safety and secured payment method than using currency.
- Each transaction is recorded.
- Consumer's convenience.
- Can be linked to intranet of banks
- Competition among commercial institutions
- Development of the financial sector.

(02 Marks)

(b) Functions of the Central Bank can be stated under different categories as follows

Core Functions

- Economic and Price Stability
- Financial System stability

Other functions

- Currency issue and management
- Employees' provident fund management
- Foreign Exchange management

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- Public debt management
 - Regional Development
 - Relationship with commercial banks and controlling commercial banks (banker of the banks)
 - Micro Finance and Regional Development
 - Financial Intelligence
 - Economic and Price Stability
 - Management of the monetary policy
 - Management of the official foreign reserves
 - Management of the issuance of currencies

(02 Marks)

(c)

1. **Transaction Motive**

This is the interest that people have to hold money in the form of currency for the purpose of financing day today transactions. The transaction motive for demanding money arises from the fact that most transactions involve an exchange of money. Since 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 of financing 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**

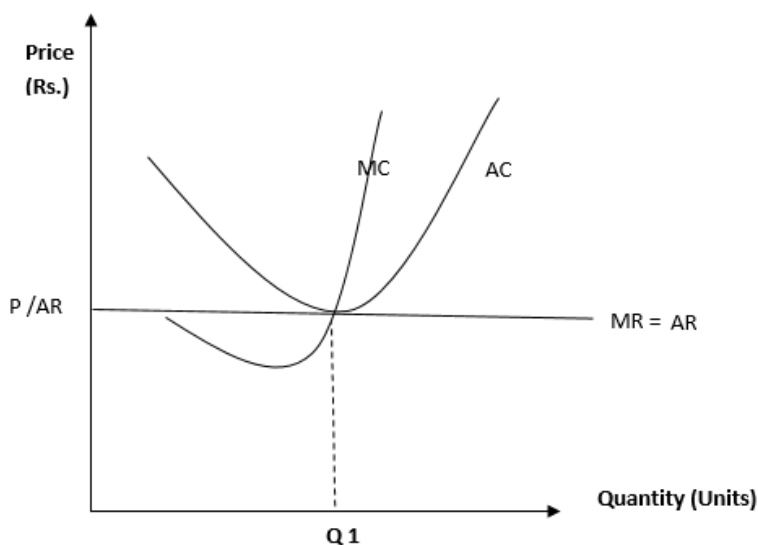
Speculative demand for money refers the interest that people have to hold money in the form of currency in order to generate a return in the future. The speculative motive for demanding money arises in situations where holding money is perceived to be less risky than the alternative of lending the money 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.

(04 Marks)

Suggested Answers to Question Five:

Chapter 03 – Behavior of Production Process and Different Market Structures

(a)



Profit maximizing output level is Q1 where MC=MR

Perfectly competitive firms achieve the equilibrium at the point where its marginal cost is equal to marginal revenue.

Therefore, the output produced at the point where its marginal cost is equal to marginal revenue. Therefore, the output produced at the point where the firms marginal cost equals the marginal revenue is the firms optimum output and this output maximizes the firm's profit.

(04 Marks)

(b) **Consequences of COVID-19**

- 1. Withdrawal of foreign investment both direct and financial (portfolio) investment.**
This will increase in deficit of balance payment account and to fill the gap the government will have to take more loans and that increases the borrowings of the country.
- 2. Downturn of the tourism industry in the country**
Sri Lanka earns a lot from tourism industry and due to COVID-19 it is severely affected. Employees of the industry have lost their jobs.
- 3. Unemployment and underutilization of economic resources of the country.**
Lockdown and COVID-19 prevention measures have resulted in observable decrease in Sri Lanka's national output or income and directly affects employment. Specially there's a high risk to self-employed workers of losing their jobs.
- 4. Expansion of IT industry**
The work from home concept increased the use of IT equipment and internet facilities.
- 5. Drop in business income of the economy**
Lockdown resulted in bankruptcy of some of the business in the country. Since export barriers were imposed to stop the spread of virus, businesses engaged in those activities had to close down their businesses because there was no income generation.

6. New opportunities were created

Due to COVID-19, new innovations and entrepreneurs developed since people began to think in new ways.

More consequences would be as below.

- Drop in share market
- Decrease in income of people and living standard.
- Decrease in confidence of the public regarding the economic situation of the country.
- Other economic and social problems

(06 Marks)
(Total 10 Marks)

*Suggested Answers to Question Six:***Chapter 06 – International Trade and Foreign Exchange Market****(A) (a) Advantages of international trade.**

- Increased production: free trade permits countries to specialize in the production of those commodities in which they have a comparative advantage. With specialization, countries are able to take advantage of efficiencies generated from economies of scale and increase in output.
- Maximum utilization of resources: international trade helps a country to utilize its resources to the maximum limit. If a country does not take up imports and exports then some of its resources may not be utilized. Thus it helps to eliminate the wastage of resources.
- Benefits to consumers: consumers are benefited by using high quality goods and services through international trade.
- Promote international relationship
- Increase in production
- Reduce trade fluctuations
- Utilization of surplus production
- Promote international relationships
- More employment opportunities will be created
- Transfer of technology and knowledge
- Non-economic advantages in relation to areas like political, social and cultural to be gained by foster in trade in international organizations
- Greater variety of goods available for consumption

- (b)** Fixed exchange rate system refers to the determination of amount of local currency which is exchanged with one unit of foreign currency by the financial authority of an economy. Under this system, a country keeps a constant rate for the period as predetermined.

Floating Exchange Rate System is where the exchange rate which is determined by the interaction of demand for foreign currency and supply of foreign currency in the foreign currency market without the involvement of financial authority of an economy.

(03 Marks)

Chapter 04 – National Accounting and Role of the Government

(B) Importance of preparing national Accounts

- To assess economic performance
- To make comparison with other countries in the world
- To measure economic growth
- To understand the economic structure of the economy
- To estimate per-capita national income
- To have an understanding about exposure to resource composition and utilization
- To forecast behavior of national macroeconomic variables.
- To forecast the behavior of macroeconomic variables
- To identify functional relationships between economic factors

(03 Marks)

(C.) (a) Gross Domestic Expenditure (GDE) at market price

	Rs.Million
Private consumption expenditure	2,000
Government consumption expenditure	1,500
Gross domestic capital formation	<u>1,200</u>
Gross Domestic Expenditure (GDE) at market price.	<u>4,700</u>

(b) Gross Domestic Product (GDP) at market price

Gross Domestic Expenditure (GDE) at market price.	4,700
Add: Export	1,800
Less: Imports	<u>(1,250)</u>
Gross Domestic Product (GDP) at market price.	<u>5,250</u>

(b) Gross National Income (GNI) at market price

Gross Domestic Product (GDP) at market price.	5,250
Net foreign primary income	<u>(800)</u>
Gross National Income (GNI) at market price	<u>4,450</u>

(10Marks)
(Total 20 Marks)

End of Section C

Notice:

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