SRI LANKA

Association of Accounting Technicians of Sri Lanka

July 2015 Examination - AA1 Level

Questions and Suggested Answers
(AA13)

ECONOMICS FOR BUSINESS AND ACCOUNTING
(EBA)

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

EDUCATION AND TRAINING DIVISION

AA1 Level Examination - July 2015
(13) Economics for Business and Accounting

SUGGESTED ANSWERS

SECTION – A

Answers to ALL the questions are expected.

Suggested Answers to Question One:

Question No	Answer
1.1	3
1.2	2
1.3	2
1.4	1
1.5	3

Consumer Surplus $= \dfrac{\left\{\text{Maximum Demand Price} - \text{Equilibrium Price}\right\} \times \text{Equilibrium Quantity}}{2}$

$= \dfrac{(20-10) \times 15}{2}$

$= \underline{\underline{\text{Rs. } 75/-}}$

Question No	Answer
1.6	3
1.7	3
1.8	2
1.9	3
1.10	2
1.11	TRUE
1.12	TRUE
1.13	FALSE
1.14	FALSE
1.15	TRUE

1.16	Curve shifts to the left or right
1.17	Giffen Goods
1.18	Progressive
1.19	05 units
	Profit Maximization under Perfect Competition
	Marginal Profit (MP) = Marginal Cost (MC)
1.20	Rs 25/-
	Supper normal Profit = (Price- Average Cost) x Quantity
	= (45-40) x 5
	= **Rs.25/-**

End of Section A

SECTION –B

Answers to ALL the questions are expected.

Suggested Answers to Question Two:

(a) **Human Needs**

1. Human needs are essential physical and mental conditions or requirements that must be satisfied by a person for the survival of life.
   Examples: Food, Shelter, Clothing and medical facilities etc..
2. Human needs are common to all. Needs do not differ from person to person.
3. Human needs are limited in numbers (human needs are limited)
4. Human needs cannot be changed. in other words, there are no alternatives for human needs.

Human Wants

1. Human wants arise from human needs. The different means or methods that can be used to satisfy human needs are known as human wants. Human wants can be created or people can obtain human wants.
   Example: Food: Bread, Rice, curries, String hoppers etc.. Cloths: Shirts, T-shirt, Trousers and others.
2. There private wants and common wants. Wants differ from person to person.
3. Human wants are unlimited.
4. Human wants vary over time. They are affected by advertising, attitudes, innovations etc..

(b) Scarcity refers to the insufficiency of resources to produce goods and services to satisfy all human needs and wants of human beings. The concept of Scarcity arises when human wants are compared with the resources available to satisfy them. No economy can produce all goods and services that the society wants. No matter how rich or poor, large or small, developed or developing, located in the east or the west, every society inevitably encounters the problem of scarcity. There are competing and conflicting uses of scaree economic resources. As a result, decision must be made regarding the use of resources and the production of goods and services. Thus, economics is the study of the allocation of scaree resources among competing uses, in other words, economics studies scarcity. Scarcity is the key economic principle on which the entire study of economics is based on.

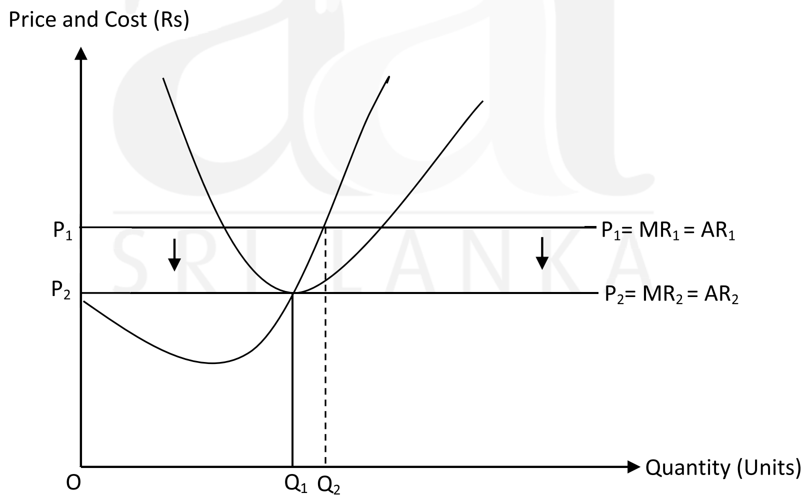
Suggested Answers to Question Three:

(a) Perfect competition is a highly competitive hypothetical market model which comprises of a large number of sellers and buyers that sells a standardized or homogeneous product at a given price.

It will attract more firms into the industry where the firms earn super normal profits in the short-run because of the perfect market knowledge and lack of entry barriers of the industry. As a result of the free entry into the market, market supply rises and supply curve shifts to the right leading to a fall in price of the product. The fall in price eventually leads to the disappearance of the super normal profits in the long-run.

If the firm incurs a loss in the short-run, it will leave from the market under the free-exit condition. Thus, the supply of the product decreases and supply curve shifts to the left pushing the price up until the loss disappears. Competitive firms are able to earn normal profit in this situation.

When competitive firms earn super normal profits in the short-run new firms come to the market. It will result in a decrease in market supply and fall in price of the product provided the firms earn only normal profits in the long-run.



The competitive firm earns super normal profits at P1. As a result of increase in market supply price declines to P2 and firm earns only normal profits at this price as Total Revenue (TR) equals Total Cost (TC).

(b) Any four characteristics out of the following features,

1. There is a single seller in the market. (There is no difference between industry and the firm).
2. A unique product or heterogeneous product (there are no close substitutes)
3. There are entry barriers (extremely difficult to enter into the market)
4. Firm is a price maker.
5. Imperfect market information and difficult to obtain perfect information without cost.
6. Firm's demand curve is a downward sloping demand curve.

Suggested Answers to Question Four:

(a) Following two factors should be taken into consideration in determining the value of money.

1. **The Internal Value (Domestic value) of Money.**

   Internal value of money can be categorized into two,

   The Internal Real Value of Money.

   The Internal real value means the quantity of goods and services that can be purchased in the domestic market with a unit of money. Generally the value of money refers to the Internal Real value of money.

   The Internal Official Value of Money.

   The Internal official value refers to the face value of money which is stated on the face of the notes or coins.

2. **The external value of money**

   The external value of money can also be categorized into two,

   The Real External Value of money

   The Real External Value of money is the quantity of goods and services which could be purchased in a foreign market with a unit of the domestic currency. It is the external purchasing power of domestic currency.

   The official external value of money

   The official external value of money is the exchange rate of the economy in terms of foreign currency. It is the number of foreign currency units that will be exchanged with a unit of domestic currency.

(b) Any four facts out of the following items

- Redistribution of income in ways which may be undesirable .Pensioners will be worse affected as they do not have the bargaining power, while variable income earners would be better off as they could bargain.
- Inflation gives disadvantages to the lenders and creditors while debtors get advantages in an inflationary situation. Thus, re-distribution of income is taking place among the creditors and debtors.
- Decision making process is adversely affected by the inflation.
- Depreciation of exchange rate.
- Absolute poverty level increases.
- Long-term investments are discouraged due to uncertainty of future price in the market and funds would be allocated in the short-term investments.
- Export competition is adversely affected by inflation and current account deficit increases
- An uncertainty economic situation is created due to trade union activities.

Suggested Answers to Question Five :

(a) Balance of Payment (BOP) statement is the systematic record of all transactions made between residents of one particular country and foreigners of all other countries during a specified period of time. Balance of payment consists of two main accounts,

1. Current and Capital Account
2. Financial Account

(b) Balance of Current Account of BOP in Sri Lanka has been reported as an unfavorable balance over past periods and various steps have been taken to reduce the negative balance.

Any five items out of the following steps,

- Product differentiations through innovations
- Expansion of export market (traditional markets have been shifted to the new Asian markets)
- Increase in foreign remittance through the expansion of foreign employment opportunities.
- Decrease in interest on foreign debts through the efficient foreign debt management.
- Stabilization of external value of currency in terms of significant trading partners.
- Implementation of import substitutions in order to control food and garment imports.
- Encouraging and increasing the global competition.
- Increase in investment on research and development.
- Enhancing Bi-lateral and multilateral trade agreements

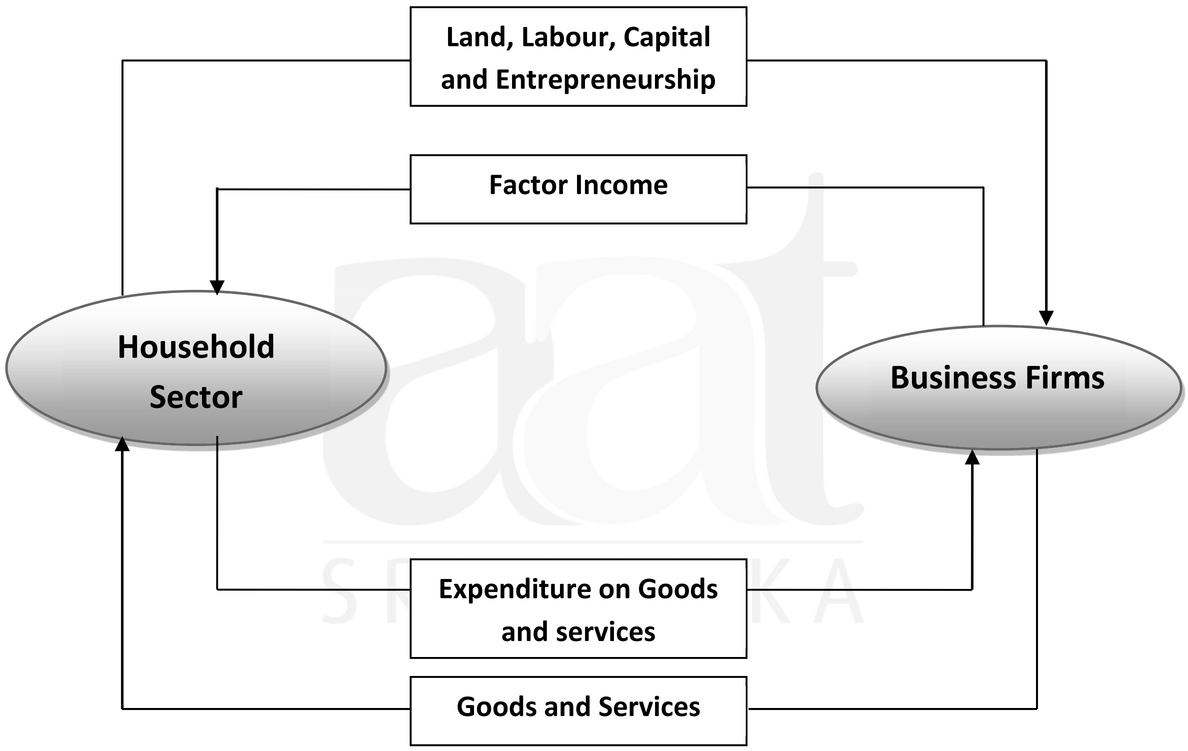
End of Section B

SECTION –C

Answers to ALL the questions are expected.

Suggested Answers to Question Six:

(a) Circular Flow of National income is the continuous process of circulation of income and expenditure derived from production of the economy among the economic agents such as Household and Business firms etc. The Circular Flow shows the relationship between Production, Income and Expenditure of the economy in a given period.



(b) The value of goods and services produced by the economy in a year, or the GDP calculated based on the prevailing market price, or the value of GDP for a particular year using the actual market prices of that year is known as GDP at current Prices. This is also known as NOMINAL GDP. It includes the following components,

- Changes in price level of the economy(inflation effect)
- Changes in quantity of output (real effect)

GDP at Constant prices (Real GDP) refers to the value of GDP of an economy in a particular year which is calculated by tracking the volume (quantity) of production after removing the influence of changing prices or inflation. GDP at constant prices shows the real change in the production activities or production of the economy in a given period. Thus, Real GDP is used to measure the economic growth as it shows the real change in production of the economy during two periods. . GDP at Constant prices (Real GDP) can be calculated as follows,

$$\text{GDP at Constant prices (Real GDP)} = \frac{\text{Nominal GDP (GDP at current prices)}}{\text{GDP deflator}} \times 100$$

(c) (i)

Sectors and items	Rs.(Millions)
Agriculture	
Agriculture, livestock and Forestry	150
Fishing	50
Industry	
Mining and Quarrying	89
Manufacturing	75
Electricity ,Gas and water	40
Construction	58
Service	
Wholesale and retail trade	70
Hotel and restaurants	20
Transport and communication	60
Banking, Insurance and Real Estate	40
Ownership of dwelling	10
Government Services	10
Private services	13
Gross Domestic Product at Factor Cost	**685**
Add	
Net Factor Income from Abroad	**(10)**
Gross National Product at factor cost price	**675**

(ii)

	Rs.(Millions)
Gross National Product at factor price	675
Add	
Indirect Taxes	30
Less	
Production subsidies	(20)
Gross National Product at market price	**685**

Suggested Answers to Question Seven:

(a) **Difference between Economic Growth and Economic Development**

Economic growth refers to the expansion of an economy's production possibility of potential output of the economy over time. That is the increase in real GDP of an economy continuously over time. Economic growth results a shift in production possibility curve to the right.

Economic development is the process of improvement in quantity and quality of production of an economy over time. Economic growth is not the only requirement in the development process. Improvement in social, cultural and other structural changes are required with the economic growth to meet the economic development.

(b) **Following factors contribute in the economic growth of an economy (any four factors)**

- Increase in resources endowment
- Increase in productivity
- Macroeconomic stability (Control over inflation)
- Availability of favorable incentive system in the economy
- Skill developments of entrepreneurs
- Good governance
- Political stability
- Economic freedom

(c) **Government can intervene in economic and social welfare as follows (different forms of government interference in economic and social welfare)**

- Provision of public goods and services
- Provision of welfare goods and services
- Encouraging consumption and production activities which generate external benefits and discouraging consumption and production activities which generate external costs
- Provisions of house hold subsidies to the low income earners.
- The Government provides infrastructure facilities to the economy.
- Provision of favorable incentive system to encourage the local producers.
- Intervention to the market through maximum price policy, minimum price policy and subsidies.
- Providing necessary facilities to protect and retain foreign investments.

End of Section C