

Institute of Certified Public Accountants
F1.3 Economics and Business Environment
Model Answers

SECTION A- Question 1

1)

1	D	11	C
2	C	12	D
3	A	13	C
4	D	14	D
5	B	15	C
6	C	16	C
7	C	17	D
8	B	18	D
9	B	19	D
10	D	20	C

Total: 40 Marks

SECTION B- ANSWERS

2) (a)

The factors that affect supply include:

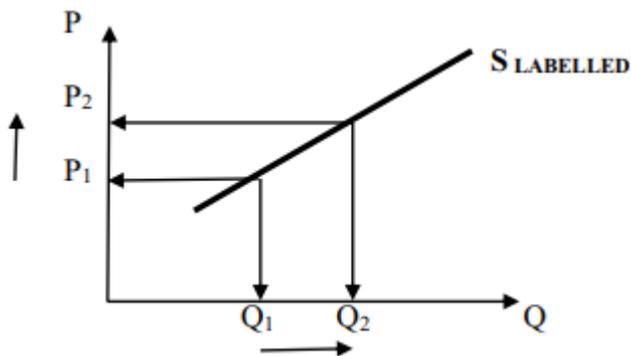
- ✓ Price of the good itself
- ✓ Price of related goods
- ✓ Cost of inputs / cost of production
- ✓ The introduction of new technologies
- ✓ Unplanned events / changes in expectations
- ✓ Indirect taxes / Government subsidies

(6 Marks)

(b)

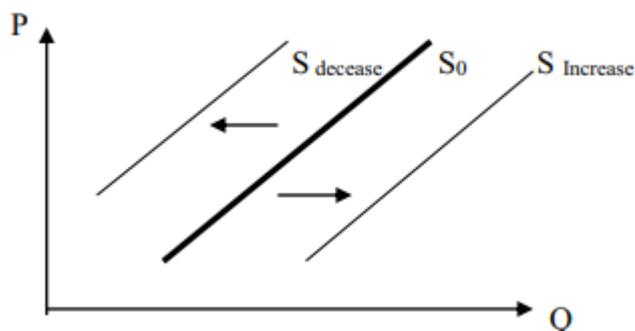
Movement along a supply curve

A change in the selling price of the good itself will cause a movement along the supply curve and we term this a change in the quantity supplied.



Shift in a supply curve.

A change in any of the factors other than price will cause the supply curve to shift to the right (an increase in supply) or to the left (a fall in supply). In this case we say that there has been a change in supply at any given price



(6 Marks)

(c)

(i) The cross price elasticity of demand for substitute goods has a negative value- FALSE

The cross price elasticity of demand for substitute goods is positive / An increase in the price of one good will lead to an increase in the demand for its substitute. Substitute goods are goods that are interchangeable. For example, Toyota and VW are substitute goods. If the price of Toyota cars increases, then the demand for VW is also likely to increase.

(ii) PED tends to be more elastic in the long run than in the short run.- TRUE

In general, for many goods, demand is more elastic in the long run than in the short run because it takes time for consumers to adjust their patterns of consumption to changes in price. Over the longer term consumers are better able to switch from one product to another and demand for original product becomes more price elastic.

(iii) When demand is price inelastic, a fall in price will increase total sales revenue.- FALSE

If demand is inelastic it means that buyers are not sensitive to changes in prices. Thus the increase in demand in percentage terms is smaller relative to the price change in percentage terms. Therefore, the fall in price won't increase sales revenue, rather it will lower it.

(iv) Income elasticity of demand (YED) for luxury goods is positive. -TRUE

As income rises consumers spend proportionately more on normal goods. As luxury goods are normal goods this statement is true. Consumers will buy more of these goods as income rises therefore YED is positive/A luxury good is a normal good for which income elasticity of demand is positive and greater than 1.

(8 Marks)
Total: 20 Marks

3.) (a)

I. In Economics resources are limited / finite / scarce and have alternative uses while wants are unlimited / infinite. As a result choices must be made and these choices involve an opportunity cost.

(2 Marks)

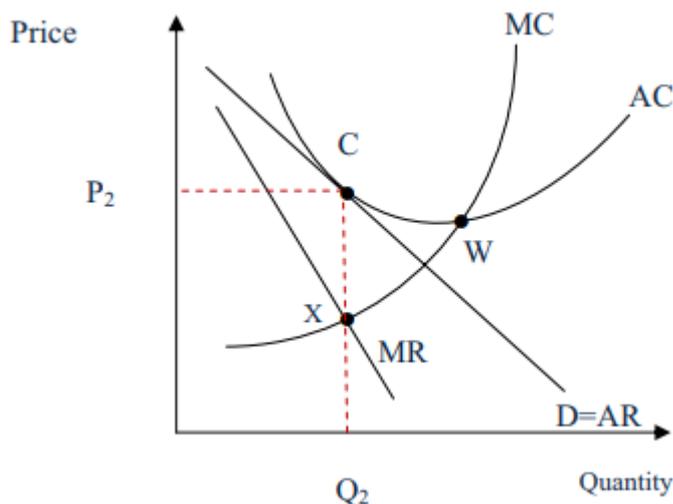
II.

- ✓ There are many buyers- An individual buyer, by his/her own actions, can not influence the market price of the goods.
- ✓ There are many sellers in the industry- An individual seller can influence the quantity sold by the price it charges for its output.
- ✓ Product differentiation exists- The goods supplied by the firm are not homogenous but are close substitutes. Firms use branding to distinguish their products from one another.
- ✓ Freedom of entry and exit-No barriers to entry exist within the industry. It is possible for firms to enter/leave the industry as they wish.

- ✓ Reasonable knowledge- Within the industry each firm has reasonable knowledge of profits made by other firms. Consumers have a reasonable knowledge of the prices being charged for different products.
- ✓ Each firm attempts to maximise profits- Firms produce where $MC = MR$. Each firm will attempt to minimise costs of production.

(4 Marks)

(b)



Explanation of long run equilibrium:

Equilibrium / profit maximisation occurs (at point X) where $MC = MR$
(MC is rising and cuts MR from below).

- x The level of output produced is Q_2 and the price the firm sells this output at is P_2 .
- x The average cost of production is shown at point C / not producing at lowest point of AC.
- x This firm is earning normal profits because $AR = AC$.

(6 Marks)

(c)

Market Structure: Oligopoly

Explanation:

The Sri Lankan markets is dominated by a few large sellers- The industry is dominated by a few large retailers, who hold a major share of the market / high concentration ratio. The large multiples dominate the trade in Sri Lanka.

Barriers to entry exist- New firms may find it difficult to enter due to high barriers to entry such as economies of scale, brand proliferation and control by existing firms of the channels of distribution. Limit Pricing may also be used by the existing firms, so future entrants to the market are discouraged.

Mutual interdependence between the large retailers- Firms interact by taking account of each other's marketing/pricing strategies.

The products sold are close substitutes / product differentiation- Competitive advertising is very important as is heavy 'product loyalty' promotions in-store e.g. loyalty cards etc. Large multiples also use 'brand names' to maintain consumer loyalty. The multiple may also use advertising and marketing campaigns to create differentiation in the mind of consumers, even though its product is more or less identical to the products of rivals/ positioning strategies attempt to increase brand recognition and loyalty. The multiples engage in extensive advertising on TV and newspapers.

Non price competition- The large retailers that have a tacit understanding not to compete on price often engage in intense non price competition using advertising and other means to try and increase their sales.

(8 Marks)

Total: 20 Marks

4)

(a)

A surplus on the current account means that the money value of imports is less than the money value of exports. A current account surplus indicates that a nation is a net lender to the rest of the world.

A BOP surplus implies that a country is exporting more than it is importing. It is necessary to know the size of the current account surplus what is driving the surplus.

- ✓ BOP Surplus due to weak domestic demand / unbalanced economy / relying too heavily on exports -A country may have a large current account surplus because of relatively weak domestic demand. Weak domestic demand leads to lower consumer spending and as a result employment might suffer. It may indicate that a country is relying too heavily on exports and consumer spending is relatively low.
- ✓ Current account surpluses finance current account deficits- A country can only enjoy a trading surplus if at least another country has a deficit. The country with a deficit may introduce protectionist measures. The surplus being enjoyed by the developed countries may be at the expense of the developing world.
- ✓ Manipulating the value of the currency- To make their exports more competitive a country can keep its currency undervalued / stop the appreciation of their currency. This makes their exports more competitive and the imports more expensive. However, such policies carry the risk of allowing an economy to grow too quickly and cause a boom and bust.
- ✓ A current account surplus must be running a financial/capital account deficit- A country is in effect lending to the rest of the world. This is not a problem for an economy if there is no global economic upheaval but could pose a problem for a country that is lending. China lends to the USA. It lends in US \$s. If the \$ falls in value then this will pose a problem for China.

- ✓ Current account surpluses could cause demand-pull inflation. Aggregate demand in an economy will grow due to an injection into the circular flow of income-if an economy is close to full employment this can lead to demand-pull inflation.

(6 Marks)

(b)

- ✓ Borrowing discouraged-Borrowing is more expensive resulting in higher loan repayments, which will reduce spending power, resulting in a lower standard of living.
- ✓ Savings encouraged- With a higher rate of return people may find it more attractive to save, and so they will reduce their spending.
- ✓ Increased mortgage repayments- The cost of monthly repayments increases, resulting in reduced disposable income and a lower standard of living.
- ✓ Increased cost of servicing the National Debt- With higher domestic interest rates the cost of repaying the internal portion of the national debt rises.
- ✓ Increased costs of production / reduced competitiveness-Cost of production will increase resulting in higher domestic prices. This will reduce the competitiveness of exports and may lead to reduction in sales.
- ✓ Economic Growth hindered-With possible lower investment, future economic growth may be damaged.
- ✓ Increases in Unemployment-Lower consumer spending, falling demand for exports, a reduction in investment and a decline in economic growth may result in an increase in the numbers unemployed.

(6

Marks)

(c)

- ✓ To protect domestic jobs from “cheap” labor abroad. Wages in industrialized countries are higher because their output per worker is higher than developing country.
- ✓ To improve a trade deficit.
- ✓ To protect “infant industries.
- ✓ Protection from “dumping.
- ✓ To earn more revenue.

(8 Marks)

Total: 20 Marks

5) (a)

Business environment is the sum total of all external and internal factors that influence a business. For example, a health and safety regulation is an external factor that influences the internal environment of business operations

Importance (Explain the following)

- ✓ Enables to Identify Business Opportunities

- ✓ Helps in Tapping Useful Resources
- ✓ Coping with Changes
- ✓ Assistance in Planning
- ✓ Helps in Improving Performance

(6 Marks)

(b)

- **Economic Environment**:- Economic Environment consists of factors like inflation rates, interest rates, consumers' incomes, economic policies, market conditions etc. which affect the performance of a business firm.
- **Social Environment**:-Social environment implies traditions, literacy rates, educational levels, values, customs, lifestyle, demographic distribution and other characteristics of the society in which the organization exists.
- **Technological Environment**:-The forces related to scientific improvements and innovations for improving quality of goods and services and new techniques for operating the business, are all part of technological environment. It includes new approaches, new procedures and new equipments to transform inputs into outputs. It facilitates an organization's efficiency and effectiveness so that it can try to remain at par with the best in the world.
- **Political Environment**:-Political Environment consists of forces such as political stability and peace in the country and attitude of the ruling party and its representatives towards business. These forces significantly affect the functioning of business.
- **Legal Environment**:-Legal environment consists of rules and regulations, framed by the Parliament, under which business must operate. To exist and grow, business is required to follow all the rules and regulations that constitute this environment.

(6 Marks)

c)

Social responsibility is the obligation of decision-makers to take actions, which protect and improve the welfare of society as a whole along with their own interests. Every decision the businessman takes and every action he contemplates have social implications.

ARGUMENTS FOR SOCIAL RESPONSIBILITY

- ✓ Business has to respond to the needs and expectations of society.
- ✓ Improvement of the social environment benefits both society and business.
- ✓ Social responsibility discourages additional governmental regulation and intervention.
- ✓ Business has a great deal of power, which should be accompanied by an equal amount of responsibility.
- ✓ Internal activities of the enterprise have an impact on the external environment.
- ✓ The concept of social responsibility protects interests of stockholders.
- ✓ Social responsibility creates a favourable public image.
- ✓ Business has the resources to solve some of society's problems.
- ✓ It is better to prevent social problems through business involvement than to cure them.

ARGUMENTS AGAINST SOCIAL RESPONSIBILITY

- ✓ Social responsibilities could reduce economic efficiency.
- ✓ Social responsibility would create excessive costs for business.
- ✓ Weakened international balance of payments
- ✓ Business has enough power, and social involvement would further increase its power and influence.
- ✓ Business people lack the social skills necessary to deal with the problems of society.

(8 Marks)
Total: 20 Marks