

FOUNDATION COURSE EXAMINATION

SUGGESTED ANSWER TO QUESTIONS

DECEMBER 2011

PAPER-3: ECONOMICS AND BUSINESS FUNDAMENTALS

Time Allowed : 3 Hours

Full Marks: 100

The figures in the margin on the right side indicate full marks.

Section I (60 Marks)

Answer Question No 1 which is compulsory and answer any two from the rest.

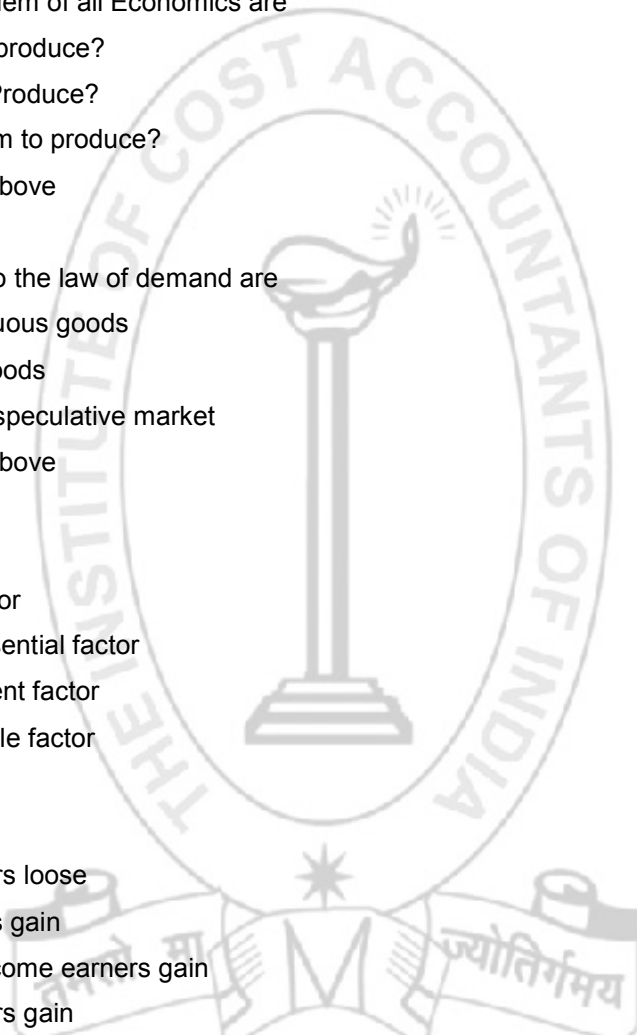
Question

1. (a) Answer the following :

[1×9=9]

- (i) Effective demand is
- (a) Demand exceeds supply
 - (b) Aggregate demand is equal to aggregate supply
 - (c) Elasticity of demand for a product is high
 - (d) Difference between actual and forecast demand.
- (ii) Progressive taxation means
- (a) Tax burden decreases with income
 - (b) Tax burden increases with income
 - (c) Large quantity of tax evasion
 - (d) Large quantity of tax avoidance.
- (iii) Cross elasticity of demand relates
- (a) Price of one commodity and demand for another commodity
 - (b) Substitutes and complementary goods
 - (c) Market and supply
 - (d) Production and cost

- (iv) Average variable cost is
- (a) L shaped
 - (b) U shaped
 - (c) Dish Shaped
 - (d) Horizontal straight line
- (v) Central Problem of all Economics are
- (a) What to produce?
 - (b) How to Produce?
 - (c) For whom to produce?
 - (d) All the above
- (vi) Exceptions to the law of demand are
- (a) Conspicuous goods
 - (b) Giffen goods
 - (c) Shares' speculative market
 - (d) All the above
- (vii) Labour is a
- (a) Vital factor
 - (b) Non- essential factor
 - (c) Permanent factor
 - (d) Perishable factor
- (viii) In inflation
- (a) Producers loose
 - (b) Creditors gain
 - (c) Fixed income earners gain
 - (d) Borrowers gain



(ix) Marginal Revenue is calculated as

(a) $\frac{\Delta TR}{\Delta Q}$

(b) $\frac{\Delta TC}{Q}$

(c) $\frac{\Delta TC}{\Delta AC}$

(d) $\frac{\Delta TC}{\Delta S}$

(b) **Fill in the blanks:**

[1×12=12]

- (i) The goal of all firms in perfect competition ismaximisation.
- (ii)helps on economy to earn income from world market.
- (iii) Whiletax is one whose burden cannot be shifted, Incase tax, the burden is shifted.
- (iv) Pricing to products is one of the problems of estimating.....
- (v) According to Malthus production of food grains increases at an arithmetical.....
- (vi) Fisher's quantity theory of money is also called cash transaction.....
- (vii) Deflation is an economic.....
- (viii) The level of Planned Investment isrelated to Interest rate.
- (ix) The growth rate of GDP at constant price is callednational income.
- (x) Time utility of making a product available at thewhen it is required.
- (xi) Disequilibrium in Balance of payments means deficit inaccount.
- (xii) During inflation Bank rate should be.....

(c) **State which of the following statements is 'True' and which is 'False':**

[1×9=9]

- (i) Whether savings a virtue or a vice depends upon its use and its effects on income.
- (ii) In public finance, the government cuts its coat according to its cloth.
- (iii) One of the limitations of credit creation is the size of the cash reserve ratio.
- (iv) Industrial Finance Corporation of India is a Development Bank
- (v) Balance of Payments is wider than Balance of Trade.
- (vi) The easiest way to tide over deficit in budget is to print more currency.
- (vii) Group equilibrium is a concept relevant to perfect competition.

(viii) Adding value of all goods and services produced to arrive at national income of a country is called income method.

(ix) Ratio of consumption to income is called marginal propensity to consumer.

(d) Define the following terms in not more than two lines:

[1×6=6]

- (i) Canon of Economy
- (ii) Indirect Tax
- (iii) Repressed inflation
- (iv) Taxable capacity
- (v) Credit Creation
- (vi) Bank rate.

Answer to Question No 1(a)

- (i) b (ii) b (iii) a (iv) b (v) d
- (vi) d (vii) d (viii) d (ix) a

Answer to Question No 1(b)

- (i) Profit (ii) Exports (iii) Direct, Indirect (iv) National Income
- (v) Progression (vi) Approach (vii) Phenomenon (viii) Inversely
- (ix) Real (x) Time (xi) Current (xii) Raised

Answer to Question No 1(c)

- (i) True (ii) False (iii) True (iv) True]
- (v) True (vi) False (vii) False (viii) False
- (ix) False

Answer to Question No 1(d)

- (i) **Canon of Economy** – Smith suggested that tax system be so framed “as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasure”.

- (ii) **Indirect Tax** – When the impact and incidence of a tax fall on different persons. The burden of tax can be shifted on others. For example VAT.
- (iii) **Repressed Inflation** – Repressed inflation is where excess demand is prevented from increasing price level through government action.
- (iv) **Taxable Capacity** – Taxable capacity is the tax paying ability of the society.
- (v) **Credit creation** – A process of creating more credit money with initial deposit by commercial banks is called credit creation.
- (vi) **Bank rate** – The rate at which the Central Bank of a country rediscount eligible bill from Commercial banks is called bank rate.

Question

2. **Define inflation. Discuss the causes of inflation.**

[2+10=12]

Answer to Question No 2

Inflation – When there is continuous rise in price level and the value of money is falling it is called inflation.

Causes of Inflation – The primary causes of inflation may arise from demand side or supply side. The various factors causing inflation are as given below :

- (i) Increase in public spending.
- (ii) Deficit financing of government spending.
- (iii) Increased velocity of circulation of money.
- (iv) Increase in population.
- (v) Hoarding of goods and services.
- (vi) Shortage of goods and services due to less production.
- (vii) Exports leading to shortages in domestic economy.
- (viii) Trade unions demanding more wages.
- (ix) Tax reduction and revision of pay scales.
- (x) Imposition of Indirect taxes.
- (xi) Price rise in the international market.
- (xii) Non-economic factors such as natural calamities.

Question

3. Discuss merits and demerits of direct taxes.

[12]

Answer to Question No 3.

Merits of Direct Taxes – The following are the merits of direct taxes.

- (i) Progressive in character as the rate of tax increases with the increase in income or value of property.
- (ii) They help in the redistribution of income and wealth.
- (iii) They are economical and easy to collect.
- (iv) They are paid consciously.
- (v) They contribute more to the Public authorities.

Demerits of Direct Taxes- The following are the demerits of direct taxes.

- (i) They adversely affect the work, income and savings of tax payees.
- (ii) They generate black money and wealth as they cannot be shifted.
- (iii) They fall more on salaried class.

Question

4. Critically examine Ricardo's theory of comparative cost.

[12]

Answer to Question No 4.

Ricardo's Theory of Comparative Advantage or Comparative Cost

It is obvious that if one country has an absolute advantage over the other country in one line of production and the other country has an absolute advantage over the first country in a second line of production, both countries can gain by trading. But what if one country is more productive than another country in all lines of production? If country A can produce all goods with less labour cost than country B, does it still benefit the countries to trade? Ricardo's answer was yes. For this, Ricardo gave the theory of comparative advantage (or the theory of comparative cost) of international trade. According to him, comparative advantage explains the existence of international trade. A detailed explanation of the theory of comparative advantage is given below:

Assumptions

Ricardo's theory of comparative advantage is based on the following assumptions:

- (i) It is assumed that there are only two countries in the world, and each country can produce two goods. Thus, this theory is carried out only in two country-two commodity model.
- (ii) There is perfect competition both in the commodity market and the factor market.
- (iii) There is only one factor of production and that is labour. It implies that the cost is expressed in terms of labour only and the value of the commodity depends only on its labour cost.
- (iv) Factors of production are assumed to be perfectly mobile within the country but perfectly immobile between different countries.
- (v) The law of constant returns to scale prevails in the economy.
- (vi) There are no transport costs between the two countries.

Criticisms of Ricardian Theory of Comparative cost

The theory of comparative cost has been attacked on many fronts by many economists from time to time.

Some of the important criticism are given below :

- (i) Wrong assumption of labour cost.
- (ii) Unrealistic model of two countries two commodities.
- (iii) Unrealistic assumption of the law of constant cost.
- (iv) Unrealistic assumption of full employment.
- (v) Wrong imagination regarding factor mobility.
- (vi) Transport costs ignored.
- (vii) One sided theory of international trade.
- (viii) Unrealistic.
- (ix) The theory is static in nature.
- (x) Not applicable in underdeveloped economies.

Despite these limitations the theory has a stand. It has narrated the truth that comparative advantage is definitely as advantage which should be gainfully exploited in international trade.

Section II (40 Marks)

Answer Question No 5 which is compulsory and answer any two from the rest.

Question

5. (a) Answer the following:

[1×6=6]

- (i) A bull is
 - (a) A speculator who expects price to fall
 - (b) A speculator who expects price to rise

- (c) A speculator who invests in mutual fund
 - (d) A speculator who invests in government bonds.
- (ii) One share one vote is applicable to
- (a) Joint stock company
 - (b) Co-operative society
 - (c) Partnership firm
 - (d) Joint Hindu family
- (iii) Liability clause is contained in
- (a) Articles of Association
 - (b) Prospectus
 - (c) Memorandum of Association
 - (d) Special Resolution
- (iv) Listing in stock exchange is
- (a) Mandatory
 - (b) Optional
 - (c) Desirable
 - (d) Publishing the details
- (v) The SWOT analysis stands for
- (a) Strength, Weaknesses, Opportunities, Threats
 - (b) Science, Wisdom, Opportunities, Triumph
 - (c) Success, Wisdom, Opportunities, truth
 - (d) Simple, Weakness, Opportunities, Threats
- (vi) Which of the following is not an advantage of verbal communication?
- (a) Easily understandable
 - (b) Less expensive and quicker
 - (c) Removes distances and barriers in communication
 - (d) Difficult to act on it due to missing details.

(b) Fill in the blanks:

[1×6=6]

- (i) The prescribed minimum number of qualified persons authorised to transact the business at meeting is called.....
- (ii) A stock market deals insecurities.
- (iii) A person who just lends his name and reputation for the benefit of the firm without taking active part is called.....
- (iv) involves sending written message through telecommunication links.
- (v) Acceptance of objectives after the superiors and subordinates sitting together is

called

(vi) When the liability of a person covers both business and personal property, it is called..... liability.

(c) State whether the following are 'True' and which are 'False'

[1×6=6]

- (i) Economic Systems and Economic Policies are studied under Economic Environment.
- (ii) Stock Exchange facilitate regular valuation of securities
- (iii) For communication to be effective it must be receiver oriented.
- (iv) Registered partnership enjoys perpetual existence.
- (v) Decoding refers to delivery of communication.
- (vi) Social responsibility is an indication of business ethics.

(d) Define the following terms in not more than two lines

[1×6=6]

- (i) Unlimited liability
- (ii) Special resolution
- (iii) Called up capital
- (iv) Partner by estoppel
- (v) Statement of lieu of prospectus
- (vi) Forward delivery contract

Answer to Question No 5 (a)

- (i) b (ii) a (iii) c (iv) b (v) a (vi) d

Answer to Question No 5 (b)

- (i) Quorum (ii) listed (iii) sleeping partner (iv) E-mail
(v) management by objective (vi) unlimited

Answer to Question No 5 (c)

- (i) True (ii) True (iii) True (iv) False (v) False
(vi) True

Answer to Question No 5 (d)

- (i) **Unlimited liability** – Unlimited liability implies that the liability of partners extends beyond their organizational property and include personal property.
- (ii) **Special resolution** – Special resolution is a type of resolution which is passed in a meeting as

spelt out by the Companies Act. Special resolution is passed by a majority of at least 75% of votes of members present in person or by proxy and notice of meeting should mention it as special and should be given at least 21 days before the date of meeting.

- (iii) **Called up capital** – Called up capital is that part of the capital which is called up by the company at the time of requirement.
- (iv) **Partner by estoppel** – A partner by estoppel is a person who has neither contributed any Capital nor takes any part in the management of the firm. If a person styles the character of a partner in a business before third party by his words or acts, he is stopped from denying this fact who believes in him and acts accordingly.
- (v) **Statement in lieu of a prospectus** – If a public company does not issue a prospectus, it can Issue a statement in lieu of prospectus. It contains almost the same information as is contained in the prospectus.
- (iv) **Forward Delivery contracts** – These dealings are for account and settlement takes place at the end of every fortnight through clearing house only and such transaction can have carry over facilities also. The speculators are the main parties in these dealing.

Question

5. **Discuss the functions of Stock Exchange and explain the method of trading in Stock Exchange.** [4+4=8]

Answer to Question No 6

Functions of Stock Exchanges

Stock exchanges play an important role in capitalistic countries. It is indispensable for the proper functioning of joint stock companies. The importance of a stock exchange will be clear from the study of its functions and services.

A stock exchange performs the following economic functions:

- (i) Provides ready and continuous market.
- (ii) Facilitates regular valuation of securities.
- (iii) Encourages capital formation.
- (iv) Provides proper direction to invest capital.
- (v) Ensures wide ownership of securities.

- (vi) Facilitates distribution of new securities.
- (vii) Ensures safety of funds.
- (viii) Regulates company management and performance.
- (ix) Disseminates information.
- (x) Facilitates speculation.
- (xi) Mirror of business cycle.

Method of Trading : The way in which the securities are transacted in a stock exchange is much different from trading in ordinary goods. A person who wants to purchase or sell securities cannot do it himself. He is not allowed to enter into the hall of the stock exchange and thus he cannot carry on transaction personally. He has to depend upon the brokers.

There are two types of trading on the stock exchange viz.

1. Ready delivery contracts, and
2. Forward delivery contracts.

Trading Procedure : Following are various steps involved in completing a transaction through stock exchange brokers:

1. Choice of a broker
2. Placing the order
 - (i) Fixed Price order
 - (ii) Limit price order
 - (iii) Bargain price order
3. Executing the order
4. Settlement of Transactions

Question

7. Explain the steps involved in the incorporation of a Joint Stock Company.

[8]

Answer to Question No 7

Incorporation of a Company

The following documents are to be filed with the Registrar of Companies of the State in which the registered office of the company is to be situated:

- (i) Memorandum of Association
- (ii) Articles of Association
- (iii) List of persons agreeing to act as Directors (their full address and occupations)

- (iv) Statement of consent signed by each Director
- (v) A statement of Authorized Capital
- (vi) Address of the company's registered office
- (vii) An undertaking by each Director to hold and pay for the qualification shares
- (viii) A statutory declaration by a chartered accountant or an advocate that all the Legal requirements of the Companies Act have been complied with. The Registrar of Companies scrutinizes the above documents. If the documents are found to be in order, the name of the company is entered in the register. Then the Registrar issues a 'Certificate of Incorporation' in favour of the company. This certificate gives birth to a company with a separate legal entity. A private company can commence its business just after getting an incorporation certificate.

Raising of capital (for public companies only)

Capital subscription (i.e., raising of capital) is the third stage of formation of the company. A private limited company does not require this stage as it does not collect funds by selling shares to the public.

A capital subscription stage is required for public companies as they are to collect funds from the members of the public at large by selling its shares and securities. So, with a view to raising funds, a public company, soon after its incorporation, has to arrange a meeting to deal with the following matters:

- (i) Issue of a prospectus or a statement in lieu of prospectus;
- (ii) Appointment of bankers;
- (iii) Appointment of a brokers for underwriting shares;
- (iv) Appointment of a pro tem secretary;
- (v) Conform to the guidelines issued by SEBI from time to time.

Commencement of business of a public company

A public company cannot start the business without having a 'certificate of commencement' from the Registrar. A 'certificate of commencement' is issued in favour of a public company by the Registrar when the following conditions are fulfilled:

- (i) A declaration that a prospectus or a statement in lieu of prospectus been filed with the Registrar.
- (ii) A declaration that the amount of minimum subscription (as specified in the prospectus) has been received.
- (iii) A declaration that the Directors of the company have paid for their qualification shares.
- (iv) A certificate by a Director or the secretary of the company that all the formalities relating to the commencement of the business have been fulfilled.

If the Registrar is satisfied that all the conditions have been fulfilled, he issues a 'certificate of commencement' in favour of the public company. No public company can start its operations without obtaining a 'commencement certificate'.

Question

8. Describe the essential elements in the process of an effective communication system. [8]

Answer to Question No 8

Essential elements in the process of an effective communication.

- (i) Clarity of message.
- (ii) Unbiasedness.
- (iii) Reciprocal communication.
- (iv) Consistency.
- (v) Correct channel.
- (vi) Speed.
- (vii) Accuracy.
- (viii) Safety.
- (ix) Flexibility.
- (x) Human and physical conditions.
- (xi) Sense of understanding.
- (xii) Feedback.
- (xiii) Listening carefully.
- (xiv) Restraint over emotions.

