TESTBANK: CHAPTER 2
Goals, Values and Performance

True/False Questions

1. The entrepreneurs who create business enterprises are motivated primarily by the desire for personal wealth.
[See p. 37]
a. T
*b. F

2. “Value” refers to the estimated monetary worth of a product or asset.
[See p.37]
*a. T
b. F

3. A firm’s Value Added is the difference between the value of its outputs and the costs of the inputs purchased by the firm to provide these outputs.
[See p.38]
a. T
*b. F

4. For a firm to pursue stakeholder interests rather than shareholder interests requires that it maximizes value for all stakeholders rather than maximizes value for shareholders alone. The tools of stakeholder analysis mean that this is not a major problem for management.
[See p.39]
a. T
*b. F

5. Because profit is defined by accounting rules and measured in financial statements, profit maximization is an unambiguous performance goal for a firm.
[See p.40]
a. T
b. F*

6. Economic profit is a better indicator of a firm’s performance than accounting profit because economic profit takes into account the normal expected return to capital.
[See pp.40-41]
*a. T
b. F

7. Firms are often constrained from pursing goals other than profit maximization by the pressure of competition and threat of acquisition.
[See p.39]
*a. T
b. F

8. Maximizing profit over the life of the firm bears no relationship to the goal of maximizing shareholder value.
[See pp. 42-43]
a. T

*b. F

9. In practice, pursuing stakeholder interests and pursuing shareholder interests are identical since in order to make profits a firm must satisfy all its stakeholders.
[See p.39]
a. T
*b. F

10. Basing management decisions on economic profit (e.g. Economic Value Added) rather than accounting profit is more important for companies with few fixed assets (such as software companies and consulting firms) than capital-intensive companies such as chemical companies and vehicle manufacturers.
[See p.41]
a. T
*b. F

11. Stock market capitalization offers the best available indicator of the net present value of a firm's future free cash flows.
[See pp.42-43]
*a. T
b. F

12. Estimating a firm's future cash flows is a fairly straightforward task.
[See pp.43-44]
a. T
*b. F

13. To assess the profitability of a company it is usually better to use profitability ratios based upon balance sheet items (such as return on equity or return on capital employed) than portability ratios based upon sales (such as operating margin or net margin).
[See Table 2.3, p. 45]
a. T
*b. F

14. Disaggregating return on capital employed into sales margin and capital turnover offers a useful stating point for diagnosing firm performance.
[See pp.45-46]
*a. T
b. F

15. Since the long term is a series of short terms, short term profit maximization will always lead to long term profit maximization.
[See pp.48-49]
a. T
*b. F

16. The main difficulty of selecting performance targets for a firm is that performance goals tend to be long term, but effective monitoring must be short term.
[See p.49]
*a. T
b. F

17. The balanced scorecard is primarily a tool for implementing the stakeholder view of the firm.
[See p.48]
a. T
*b. F

18. If a firm is to achieve superior profit performance, it is essential that profitability targets are set for managers. If managers focus on the drivers of profitability rather than profitability itself, their efforts will be diffused.
[See pp.49-51]
a. T
*b. F

19. Adam Smith's notion of the "invisible hand" refers to the ability of the price mechanism to align the interests of individuals with those of society—by pursuing their own interests self-interested individuals also further the overall good of society.
[See p.51]
a. T
*b. F

20. According to Milton Friedman, the social purpose of a business is to make profit.
[See p.51]
*a. T
b. F

21. Empirical research shows that firms that are committed to values and ethical principles are significantly less profitable over the long run than those committed to the pursuit of profit.
[See p.53]
a. T
*b. F

22. Michael Porter and Mark Kramer's concept of shared value is based upon the notion that business enterprises should focus, first, on creating value and, second, on distributing that value among different participants (including shareholders and society-at-large).
[See p.54]
a. T
*b. F

23. One implication of real option analysis is that when pursuing a new strategic initiative, there is value in a firm making an irreversible commitment to continuing that initiative.
[See p.56]
a. T
*b. F

24. A "phases and gates" approach to new product development is an example of a business process designed to create option value.
[See p.56]
*a. T
b. F

25. Real options are an important tool for thinking about strategic decisions under uncertainty, however, quantitative techniques designed to value financial options (e.g. the Black-Scholes option pricing model) cannot be applied to real options.

[See p.57]
a. T
*b. F

Multiple Choice Questions

26. Every business enterprise has a distinct purpose; however, common to all businesses is the goal of:
[See p.37]
a. Making customers satisfied.
*b. Creating value.
c. Satisfying stakeholders.
d. Maximizing shareholder value.

27. For the purposes of strategy analysis, it is convenient to view business strategy is primarily a quest for:
[See p.39]
a. Attractive markets
*b. Profit
c. Customer loyalty
d. Motivated and talented personnel

28. A major impediment to the stakeholder view of the firm is:
[See p.39]
a. The inevitable conflicts between the interests of different stakeholders
b. The fact that customers and employees are likely to be even more short-term oriented than shareholders
*c. The difficulties of quantifying the performance of the stakeholder-focused firm
d. The difficulty of constituting a board of directors that represents the interests of all stakeholders

29. For a value for the firm requires that a firm:
[See p.37]
a. Earns profits for shareholders, then uses these profits to satisfy the interests of other stakeholders.
b. Creates customer loyalty, that can then be converted into profit through increasing prices.
*c. Creates value for customers, then appropriate some of that value as profit.
d. Creates value for employees through attractive pay, benefits, and working conditions, then relying upon employees to drive customer satisfaction and, eventually, profits.

30. The firms create value through production—transforming less valuable inputs into more valuable outputs—and also through:
[See p.37]
a. Entrepreneurship: creating new businesses.
b. Restructuring: turning around, and selling off divisions or units.
*c. Commerce: transferring products across space and time from where they are valued less to where they are valued.
d. Marketing: presenting products in a way that makes them more valuable to customers.

31. Value added can be defined as:
[See p.38]
a. The difference between sales and expenses
b. The difference between the sales value of a firm's output and the cost of physical inputs used to produce that output
c. The difference between the sales value of a firm's output and the direct costs of producing it

d. EBITDA (earnings before interest, tax, depreciation, and amortization)

32. Although firms may pursue a variety of goals, the assumption that primary goal of strategy is to maximize profits over the long term may be justified by:
[See p.39]
a. The fact that in today's intensely competitive markets, firms must focus on profit maximization in order to survive.
*b. The external pressures on firms for profitability that arises from (i) strong competition in product markets and (ii) the threat that firms that do not maximize profits will be acquired by forms that do.
c. The legal requirement on Boards of Directors to ensure that companies are operated in the interests of their shareholders.
d. Shareholder pressure on CEOs to maximizing profits.

33. The principal difference between accounting profit and economic profit is:
[See p.40]
a. Accounting profit is distorted by the arbitrary treatment of depreciation and unusual items.
*b. Accounting profit includes both economic profit and the normal return on capital to the providers of equity capital.
c. Economic profit is cash flow based and is, hence, less subject to manipulation that accounting profit.
d. Economic profit is endorsed by economists who tend to be more rigorous than accountants.

34. The divergence between accounting profit and economic profit is likely to:
[See p.41]
a. Greater for highly leveraged firms than for equity-financed firms
b. Greater for labor-intensive firms than for capital-intensive firms
*c. Greater for capital-intensive firms than for labor-intensive firms
d. Greater for technology-based firms than firms in mature industries

35. Profit and value of the firm are two concepts which are:
[See pp.41-42]
a. Unrelated because cash flow not profit is the main determinant of firm value
*b. Closely linked because the present value of a firm's future profits approximates to the market value of its securities
c. Closely linked because dividends are paid out of profits and it is dividends that determine the market value of a firm's shares
d. Closely linked because the market value of a firm is determined by its profits multiplied by the price-earnings ratio of its shares

36. The main difference between accounting measures of firm performance and stock-market measures of firm performance is:
[See pp.43-44]
a. Accounting measures are less reliable because of firms' discretion over how they apply accounting conventions
b. Stock market measures are less reliable because share prices are so volatile
c. Accounting data offers a sound basis for forecasting future performance
*d. Accounting measures are backward looking; stock market measures are forward looking

37. Maximizing enterprise value and maximizing shareholder value are closely linked because:
[See p.40]
a. Enterprise value and shareholder value are the same thing
b. Shareholder value is calculated by adding debt and other non-equity financial claims to the DCF value of the firm

*c. Shareholder value is calculated by subtracting debt and other non-equity financial claims from the enterprise value of the firm
d. It is obvious that they must be linked

38. To assess the adequacy of the return on capital employed (ROCE) that a firm earned in its most recent financial year, which of the following would not be an appropriate benchmark:
[See pp.44-45]
a. The ROCE earned by the same firm in previous years
b. The ROCE earned by competitors during the same period
*c. The firm's cost of equity capital
d. The firm's weighted average cost of capital

39. To assess whether or not a firm is earning an adequate rate of profit, return on capital employed (ROCE) is a better indicator than return on sales because:
[See p.45]
a. Sales are more variable than capital employed
*b. Return on sales varies between industries according to their capital intensity
c. A firm's return on sales depends upon the choice between gross margin, operating margin, and net margin
d. ROCE is based upon cash flow

40. To diagnose the sources of a firm's poor financial performance, it is useful to:
[See pp.45-46]
a. Focus on the firm's cash flow statement rather than its income statement and balance sheet
b. Concentrate on sales growth and market share rather than profit data
c. Adopt a forward-looking approach through analyzing share price performance rather than looking at backward-looking accounting statements
*d. Disaggregate overall return on capital into its component items

41. In using accounting ratios to appraise a firm's performance, it is helpful to use:
[See pp.42-43]
a. Benchmarks
b. Trends in these ratios over the past 5 years or more
c. Multiple indicators
*d. All of these

42. In appraising a firm's profit performance:
[See pp.41-42]
a. Return on sales is a better indicator than return on invested capital.
*b. Return on invested capital is a better indicator than return on sales.
c. Net margin is a better indicator than operating margin.
d. Narrow measures of profit (such as after-tax net income) are better indicators than broad-based measures (such as EBITDA—earnings before interest, tax, depreciation and amortization).

43. The biggest problem in designing a performance management system arises as a result of:
[See pp.45-46]
a. The tendency for performance management systems to be based entirely on financial targets
*b. A performance management system needs short-term indicators to monitor performance, yet the ultimate goal is to enhance the long-term performance of the firm
c. Performance targets are always ineffective because individuals will "game the system"
d. The personal interests of organizational members need to be taken into account

44. The Balanced Scorecard is a technique of performance management that establishes and monitors four dimensions of performance:
[See p.49]
a. Financial, strategic, operational, and ethical performance
*b. Financial, customer, internal, and learning/innovation performance
c. Profit, sales, productivity, and asset management performance
d. Shareholder, customer, employee, supplier, and social performance

45. The main problem of a company establishing shareholder value creation as its primary performance goal is:
[See pp.49-51]
a. Shareholder value maximization is appropriate only for financial service companies
b. Pursuing shareholder value inevitably leads to unethical behavior by senior managers
*c. Focusing on shareholder value does not necessarily encourage managers to concentrate on the actions and activities that create the profits that are the source of shareholder value
d. Pursuing shareholder value is likely to be detrimental to employee morale and customer satisfaction

46. Influential scholars such as Milton Friedman, Charles Handy, Michael Porter and CK Prahalad:
[See p.49]
a. Agree that CSR is an essential "moral imperative"
*b. Have fundamental disagreements about the justification for CSR
c. Believe that the capitalist system would operate better if all firms adopted CSR
d. Regard most firms' CSR initiatives as primarily exercises in public relations

47. Michael Porter and Mark Kramer's notion of "shared value" reconceptualises CSR (corporate social responsibility) by emphasizing:
[See p.50]
*a. CSR as a value creating activity.
b. CSR as a source of legitimacy for a company.
c. CSR a means of transferring value from shareholders to less fortunate members of society.
d. CSR as a counterweight to greed and amorality among managers and investors.

48. Which of the following activities by Starbucks Inc. is least likely to be an example of Michael Porter and Mark Kramer's "shared value creation"?
[See p.54]
*a. The 2015 "Race Together" initiative to combat racism and promote racial harmony
b. The introduction in 2014 of college tuition benefits to employees
c. Participating in the Coffee and Farm Equity program to benefit growers
d. Financial and media support for American Red Cross efforts to aid refugees

49. In new product development, a "phases and gates" approach means that:
[See p.56]
a. A firm's market is divided into specific segments (or "phases") linked by "gates" which allow synergies to be exploited
b. A firm's product development relies on time segments that must be linked through gates
*c. The process is divided into consecutive stages, at the end of each a decision is made as to whether to continue to the next stage of development
d. The product is divided into separate modules where the interface between them are viewed as gates

50. Viewing strategy as a portfolio of options rather than a portfolio of investments relies upon the rationale that:
[See pp.55-56]

a. Uncertainty means that flexibility is valuable
b. Committing to a long-term program of investment can be disastrous if circumstances change
c. Most investment projects can be divided into a sequence of stages where, at any point of time, it is only necessary to decide the next stage
*d. All of these

51. The value of a real option can be calculated using:
[See p.56]
a. The Black-Scholes option pricing model
b. Binomial options pricing model
c. Discounted cash flow analysis
*d. The Black-Scholes option pricing model OR Binomial options pricing model

52. The two main categories of real options are growth options and flexibility options. Which of the following investments is not a growth option?
[See pp.56-57]
*a. Ford’s acquisition of programmable robots that allow different models of car to be produced on a single assembly line
b. Facebook’s acquisition of WhatsApp 2014
c. Apple’s program of research into virtual reality
d. Callaway Golf’s strategic alliance with Automobili Lamborghini to develop new composite materials