TEST BANK: CHAPTER 2

Goals, Values and Performance

True or false questions

1. The entrepreneurs who create business enterprises are motivated primarily by the desire for personal wealth.
[See p. 31]
a. T
*b. F

2. “Value” refers to the monetary worth of a product or asset.
[See p.31]
*a. T
b. F

3. The value created by a firm is the value received by the customers for that firm’s products, minus the real cost of producing these products.
[See p.32]
* a. T
b. F

4. If a firm to pursue stakeholder interests rather than shareholder interests, it means that it maximizes value received by all stakeholders rather than the value received by shareholders alone.
[See pp.32-33]
* a. T
b. F

5. Implementing stakeholder value maximization is inherently more difficult than implementing shareholder value maximization because of the difficulties of measuring total value creation.
[See p.33]
*a. T
b. F

6. In most continental European countries, company law requires boards of directors to ensure that their companies operate primarily in the interests of shareholders, while in most English-speaking countries are required to take account of employees, society, and the interests of the company as a whole.
{See p.33]
a. T
*b. F

7. The tendency for stakeholder interests and shareholder interests to converge means that stakeholder value maximization and shareholder value maximization leads to identical corporate behavior. stakeholders.
[See p.34]
a. T
*b. F

8. Firms are often constrained from pursing goals other than profit maximization by the pressure of competition and threat of acquisition.
[See p.34]
*a. T
b. F

9. Because profit is defined by accounting rules and measured in financial statements, profit maximization is an unambiguous performance goal for a firm.
[See p.35]
a. T
*b. F

10. Economic profit is a better indicator of a firm's performance than accounting profit because economic profit takes account of the normal, expected return to capital.
[See pp.35-36]
*a. T
b. F

11. 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.36]
a. T
*b. F

12. Maximizing profit over the life of the firm bears no relationship to the goal of maximizing shareholder value.
[See pp.36-37]
a. T
*b. F

13. Stock market capitalization offers the best available indicator of the net present value of a firm's future free cash flows.
[See p.38]
*a. T
b. F

14. Estimating a firm's future cash flows is a fairly straightforward task.
[See p.38]
a. T
*b. F

15. When comparing the profitability of firms in different industries, it is better to use profit margins on sales rather than profitability ratios based upon balance sheet items (such as return on equity or return on capital employed)?
[See pp. 40-40]
a. T
*b. F

16. Disaggregating return on capital employed into sales margin and capital turnover offers a useful starting point for diagnosing firm performance.
[See pp.39-40]
*a. T
b. F

17. Since the long term is a series of short terms, short-term profit maximization will always lead to long-term profit maximization.
[See pp.43-45]
a. T
*b. F

18. A major difficulty in selecting performance targets for a firm is that performance goals tend to be long term, but effective monitoring must be short term.

[See pp.44-45]
*a. T
b. F

19. The balanced scorecard is a useful tool for setting and monitoring performance targets for firms that pursue stakeholder goals; it is less useful for firms that seek to maximize profits over the long term.
[See p.43]
a. T
*b. F

20. 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.43-45]
a. T
*b. F

21. A major problem encountered by firms that adopt the goal of maximizing shareholder value is the tendency to concentrate on increasing short-term profits at the expense of long-term profits.
[See pp.39, 43]
*a. T
b. F

22. According to Milton Friedman, the social purpose of a business is to make profit.
[See p.45]
*a. T
b. F

23. Values and ethical principles can complement a firm's strategy through creating a sense of identity and supporting cohesion.
[See pp.45-46]
*a. T
b. F

24. 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.47]
a. T
*b. F

25. "Bottom of the pyramid" initiatives embody the notion that multinational corporations should use a portion of their profits on community-based projects in developing countries.
[See p.48]
a. T
*b. F

26. 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 pp.49-50]
a. T
*b. F

27. A "phases and gates" approach to new product development is an example of a business process designed to create option value.
[See p.49]
*a. T
b. F

28. Real options are a useful 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.50]
a. T
*b. F

Multiple choice questions

1. A major challenge of establishing the goal of business firms is that:
[See p.31]
a. Flexibility of accounting rules allow different firms to measure profit in different ways
b. Each firm has different set of stakeholders, hence will define stakeholder value differently
*c. Each firm has a distinct business purpose
d. The goal of the firm is not directly observable

2. Every business enterprise has a distinct purpose, however, common to all businesses is the goal of:
[See p.31]
a. Satisfying customers
*b. Creating value
c. Satisfying stakeholders
d. Maximizing shareholder value.

3. The two processes through which firms create value are:
[See p.31]
a. Restructuring existing businesses and creating new businesses through entrepreneurship
b. Increases prices and reducing costs
*c. Production and commerce
d. Production to create real value and marketing to create perceived value

4. The total value created by a firm is equal to:
[See p.32]
a. The total revenue the firm receives for the products it sells
b. The total revenue the firm receives less the cost of bought-in materials and components
*c. The sum of producer surplus and consumer surplus the firm creates
d. None of the above

5. Consumer surplus is equal to :
[See p.32]
a. The amount consumers pay for a product
*b. The difference between the amount consumers would be willing to pay for a product and what they actually pay
c. The difference between the sales value of a firm's output and the direct costs of producing it
d. The amount consumers pay for a product adjusted for the social costs and benefits of the product.

6. For the purposes of strategy analysis, it is convenient to view business strategy is primarily a quest for:
[See p.34]
a. Attractive markets
*b. Profit over the long term
c. Customer loyalty
d. Motivated and talented personnel

7. The main problems in implementing stakeholder value maximization are:
[See pp.33-34]
a. Adjudicating conflicts between different stakeholders
b. The propensity for customers and employees to be even more short-term oriented than shareholders

*c. The difficulties of quantifying value creation and creating a governance system to manage the trade-offs among the interests of different stakeholders.
 d. The legal obligation of boards of directors to operate companies in the interests of their shareholders.

8. For a firm to survive over the long term it must:
[See p.34]
 a. Pay a satisfactory level of dividends to its shareholders
 b. Create customer loyalty, that can then be converted into profit through increasing prices
*c. Earn as rate of return that covers its cost of capital
 d. Balance the interests of all its stakeholders.

9. 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.34]
 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 that arise from (i) strong competition in product markets and (ii) the threat that firms that do not maximize profits will be acquired by firms 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 maximize profits.

10. The principal difference between accounting profit and economic profit is:
[See pp.35-36]
 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.

11. The divergence between accounting profit and economic profit is likely to be:
[See pp.35-36]
 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

12. Profit and value of the firm are two concepts which are:
[See p.37]
 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 expected 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

13. The main difference between accounting measures of firm performance and stock-market measures of firm performance is:
[See pp.38-39]
 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

14. Maximizing enterprise value and maximizing shareholder value are closely linked because:

[See p.37]
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. A business enterprise is owned by its shareholders.

15. In using accounting ratios to appraise a firm's performance, it is helpful to use:
[See p.39
a. Benchmarks
b. Trends in these ratios over the past 5 years or more
c. Multiple indicators
*d. All of the above

16. 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 <u>not</u> be an appropriate benchmark:
[See pp.39-40]
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

17. In appraising a firm's profit performance:
[See pp.39-40]
a. Return on sales is a better indicator than return on invested capital
*b. Return on capital employed 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).

18. 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 pp.39-40]
a. Sales are more variable than capital employed
*b. Return on sales vary 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

19. To diagnose the sources of a firm's poor financial performance, it is useful to:
[See pp.40-41]
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

20. The biggest problem in designing a performance management system arises as a result of:
[See pp.41, 43]
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

21. The Balanced Scorecard is a technique of performance management that establishes and monitors four dimensions of performance:

[See pp.43-44]
 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

22. The main problem of a company establishing shareholder value creation as its primary performance goal is:
[See pp.43-45]
 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

23. In relation to the social responsibilities of firms, leading economists and management theorists:
[See pp.46-47]
 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

24. Michael Porter and Mark Kramer's notion of "shared value" reconceptualizes CSR (corporate social responsibility) by emphasizing:
[See p.47]
*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.

25. Which of the following activities by Starbucks Inc. is <u>least likely</u> to be an example of Michael Porter and Mark Kramer's "shared value creation":
[See pp.46-48]
*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. Setting targets for reducing energy utilization and increasing recycling.

26. In new product development, a "phases and gates" approach means that:
[See p.49]
 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

27. Viewing strategy as a portfolio of options rather than a portfolio of investments, relies upon the rationale that:
[See pp.49-51]
 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 the above

28. The value of a real option can be calculated using:
[See p.50]

a. The Black-Scholes option pricing model
b. Binomial options pricing model
c. Discounted cash flow analysis
*d. (a) or (b)

29. 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.49-51]
*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