

True or false questions

1. Value refers to the estimated monetary worth of a product or asset

@ Pages and References: p35

*a. T

b. F

2. A firm's Value Added is the difference between the value of its outputs and the total costs of the inputs purchased by the firm to provide these outputs

@ Pages and References: p36

*a. T

b. F

3. One type of value creating activity is commerce, which transforms raw material and intermediate products into final products

@ Pages and References: p35

a. T

*b. F

4. Most of the tools used by decision-makers in the corporate world are based upon the central assumption of profit maximization

@ Pages and References: p35

*a. T

b. F

5. Profit maximization is an unambiguous performance goal for a firm.

@ Pages and References: p38

a. T

*b. F

6. Economic profit is a better indicator of firms' performance than accounting profit because economic profit takes into account the normal expected return to capital

@ Pages and References: p 38

*a. T

b. F

7. Profit can only be measured in relation to a specified time period.

@ Pages and References: p39

*a. T

b. F

8. The maximization of profit over the life of the firm equates to the maximization of the firm's value

@ Pages and References: p39

*a. T

b. F

9. In practice, valuing firms by discounting economic profits leads to the same result as by discounting the firm's net cash flows

@ Pages and References: p40

*a. T

b. F

10. Shareholder value is the value of a firm's equity; enterprise value is the value of its debt.

@ Pages and References: p40

a. T

*b. F

11. A firm's stock market capitalization offers the best available indicator of the net present value of its future free cash flows.

@ Pages and References: p41

*a. T

b. F

13. Estimating a firm's future cash flows is an easy task

@ Pages and References: p41

a. T

*b. F

14. The DuPont formula offers a useful starting point for diagnosing firm performance by disaggregating return on invested capital into sales turnover and capital margin.

@ Pages and References: p43

a. T

*b. F

15. Short term maximization of profit will always lead to long term profit maximization and, therefore, to the maximization of a firm's value

@ Pages and References: pp40-41

a. T

*b. F

16. The balanced scorecard method developed by Kaplan and Norton provides an integrated framework for balancing financial and strategic goals.

@ Pages and References: p47

*a. T

b. F

17. The balanced scorecard is primarily a tool for reconciling stakeholder interests.

@ Pages and References: p47

a. T

*b. F

18. Most successful firms were founded by entrepreneurs whose primary goal was to become wealthy.

@ Pages and References: p35

a. T

*b. F

19. If a firm is to achieve superior profit performance it is often better for management to focus on the drivers of profitability—such as innovation or customer satisfaction—rather than on profitability itself.

@ Pages and References: p48

*a. T

b. F

20. According to Milton Friedman, the social purpose of a business is to make profit.

@ Pages and References: p49

*a. T

b. F

21. Empirical research shows that firms that are committed to values and ethical principles tend to be less profitable over the long run than those committed to the pursuit of profit.

@ Pages and References: p50

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 the distribution of that value among different participants (including shareholders and society-at-large).

@ Pages and References: p52

- a. T
- *b. F

23. One implication of real option analysis is that when pursuing a new strategic initiatives, there is value in a firm making an irreversible commitment to continuing that initiative.

@ Pages and References: p53

- 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.

@ Pages and References: p53

- *a. T
- b. F

Multiple choice questions

25. Every business enterprise has a distinct purpose, however, common to all businesses is the goal of:

@ Pages and References: p35

- a. Making customers satisfied and happy
- *b. Creating value
- c. Satisfying as many stakeholders as possible
- d. Maximizing dividend payments to shareholders over the long term.

26. Business strategy is primarily a quest for:

@ Pages and References: p35

- a. Attractive markets
- *b. Profit
- c. Superior technology
- d. Motivated and talented personnel

27. A major impediment to the stakeholder view of the firm is:

@ Pages and References: p36

- *a. The practical problem of taking account of multiple goals in strategic decision making
- 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 need to represent each stakeholder group on the board of directors.

28. To survive and prosper over the long run requires a firm to:

@ Pages and References: p37

- a. Commit itself to growing its sales
- *b. Be responsive to its external environment—including its social, political, and natural environment
- c. Pursue simultaneously strategies of low cost and differentiation
- d. Ensure the ethical conduct of executives

29. For a firm to create value involves:

@ Pages and References: p35

- a. Earning profits for shareholders, then using these profits to fund lower prices for customers
- b. Creating strong customer loyalty, and then to progressively increase prices, thereby creating extra value
- *c. Creating value for customers, and appropriate some of that value as then extracting some of that customer value as profit
- d. Creating value for employees through attractive pay, benefits, and work conditions, then relying upon employees to drive customer satisfaction and, eventually, profits.

30. The principal means by which firms create value is through production: transforming less valuable inputs into more valuable outputs. Firms can also create value through:

@ Pages and References: p35

- a. Entrepreneurship: creating new businesses
- b. Restructuring: turning around, and selling off divisions or units
- *c. Commerce
- d. Advertising which increases consumer's perception of a product's value.

31. Commerce creates value by:

@ Pages and References: p35

- a. Physically transforming products
- b. Repositioning products in space
- c. Repositioning products in time
- *d. Repositioning products in space and time

32. Value added can be defined as:

@ Pages and References: p35

- a. The difference between sales and expenses
- *b. The difference between the money values of a firm's output and physical inputs
- c. The difference between sales and wages
- d. The retained profits

33. The primary justification for the assumption that primary goal of strategy is to maximize profits over the long term is:

@ Pages and References: p37

- *a. The fact that in today's intensely competitive markets, firms must focus on profit maximization in order to survive
- b. The legal requirement on Boards of Directors to ensure that companies are operated in the interests of their shareholders
- c. In order to earn profits over the long run, firms must attend to the interests of all their stakeholders
- d. Shareholders will oust CEOs that are not effective at maximizing profits.

34. The principal difference between accounting profit and economic profit is:

@ Pages and References: p38

- a. Accounting profit is distorted by the arbitrary treatment of depreciation and unusual items
- *b. Economic profit is pure surplus; accounting profit includes the normal return to the providers of equity capital.
- c. Economic profit is cash flow based and is less subject to manipulation than accounting profit
- d.. Economic profit is endorsed by economists who tend to be more rigorous than accountants.

35. There are two main concepts of profit:

@ Pages and References: p38

- a. The normal return to capital and the abnormal return of capital
- b. Return on capital and return on sales
- *c. Accounting profit and the economic profit
- d. Economic rent and the economic profit

36. Profit maximization and value of the firm are two concepts which are:

@ Pages and References: p39

- a. Unrelated because cash flow is only one component of a firm's value
- *b. Closely linked because profit maximization translates into maximizing a firm's value
- c. Unrelated because the Net Present Value is used to assess the value of a firm
- d. Closely linked because the value of a firm is the sum of its free cash flows in each year discounted at the firm's interest rate

37. The value of a firm can be defined as:

@ Pages and References: p39

- *a. The sum of its free cash flows in each year, discounted at the firm's weighted average cost of capital (WACC)

- b. The sum of the firm's operating cash flows in each year, discounted at the firm's cost of capital
- c. The sum of its free cash flows in each year, discounted at the cost of equity
- d. The sum of its cash flows in each year, discounted at the risk-free rate of interest

38. Maximizing enterprise value and maximizing shareholder value are linked because:

@ Pages and References: p40

- 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

39. To use the Discounted Cash Flow method, the future cash flows have to be forecasted. To determine these estimates management will:

@ Pages and References: p40

- *a. Make justified assumptions about income, expenses, profit and all other significant figures
- b. Use a benchmarking approach to align the firm's cash flows with its rivals' cash flows
- c. Use accounting data and directly extrapolate from the past the future cash flows
- d. Reach consensus by discussion with a group of external experts such as stockbrokers

40. A key merit of long-term profit maximization as a prime goal is its:

@ Pages and References: p41

- a. simplicity
- b. consistency over time
- c. tendency to optimize long-term survival
- *d. All of the above

41. To diagnose the sources of a firm's poor financial performance, it is useful to:

@ Pages and References: p43

- 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.

42. Using accounting ratios to analyze firm performance:

@ Pages and References: pp42-43

- a. Benchmarks
- b. Analyzing trends over at least 5 years
- c. Multiple indicators
- *d. All of the above

43. In appraising a firm's profit performance:

@ Pages and References: pp41-42

- 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).

44. The fundamental problem of any type of performance management system is:

@ Pages and References: pp45-46

- a. The tendency for performance management systems to be based entirely on financial targets
- *b. A performance management systems needs short-term measures to assess performance, yet the ultimate goal is to enhance the long-term performance of the firm

c. Performance targets always lead to unintended consequences because individuals always “game the system”

d. Managerial, political and personal interests need to be taken into account

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

@ Pages and References: p46

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

46. The main lesson to be drawn from Boeing’s deteriorating performance during the late 1990s when top management emphasized the pursuit of profit and shareholder value is:

@ Pages and References: p48

a. Shareholder value maximization is only appropriate to financial service companies

b. Pursuing profit and shareholder value will inevitably lead to damaging ethical problems

c. Focusing on the interests of shareholders is detrimental to employee morale and customer satisfaction

d. Management should focus upon the factors that drive profitability and shareholder value rather than profitability and shareholder value themselves.

47. Influential scholars such as Milton Friedman, Charles Handy, Michael Porter and CK Prahalad:

@ Pages and References: p49

a. Agree that CSR is an essential “moral imperative”

*b. Disagree widely 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

48. Michael Porter and Mark Kramer’s notion of “shared value” reconceptualises CSR (corporate social responsibility) by emphasizing:

@ Pages and References: p50

*a. CSR as a value creating activity

b. CSR as advantageous to the firm by conferring reputational and legitimacy benefits

c. CSR as a means of transferring value from shareholders to less fortunate members of society

d. CSR as a counterweight to greed and amorality among managers.

49. The field of “real option analysis” emerged in:

@ Pages and References: p50

a. Industrial economics

*b. Corporate finance

c. Systems theory

d. Strategic management

50. In formulating strategies under uncertainty, real option analysis is a valuable strategic tool because:

@ Pages and References: p52

*a. It allows firms to create value from flexibility and a wider range of growth opportunities

b. It can assist firms in using complex financial derivatives to hedge risk

c. It allows firms to make investment decisions without the need to forecast cash flows long into the future

d. It renders obsolete most conventional tools and techniques of strategy analysis.

51. For product development, a “phases and gates” approach means that:

@ Pages and References: p52

a. a firm’s market is divided into specific phases separated by gates, which must be crossed to establish synergies across segments

b. a firm’s product development relies on time segments that must be linked through gates

*c. product development is split into several consecutive phases, at the end of each the product is reassessed to continue (go through the “gate”) or discontinue

d. For each gate, the value of each product is assessed, and some are abandoned until there is only one left.

52. Viewing strategy as a portfolio of options rather than a portfolio of investments, relies upon the central idea that:

@ Pages and References: p52

a. strategy needs to reconcile direction and flexibility in an uncertain environment

b. "all or nothing" strategic projects can be such costly mistakes as to be fatal to the firm

c. the advantage of an option follows from the potential to amend or stop a strategic project during the development

*d. All of the above

Essay questions

53. Although free cash flow is theoretically the best and most appropriate measure of net present value of the firm, in practice economic profit may be a better indicator of performance. Why?

Answer: Free cash flow integrates the "consumed" capital by the firm at the time of the expenditure whereas economic profit deducts capital along the life of assets by charging depreciation.

For assessing the firm's performance in a single year or a finite number of years, economic profit (such as the EVA measure) is usually preferable to free cash flow, which depends on managerial choices about capital expenditures. In comparison, economic surplus represents the surplus being generated by the firm in each year.

References: p39

54. What is economic profit?

Answer: Economic profit (also referred to as economic rent or rent) represents a better and more reliable measure of profit and, therefore, of performance because it is defined as the surplus available once all inputs have been paid for (including capital). A common measure of economic profit is Economic Added Value (EVA) which represents the Net Profit After Tax (NOPAT) less the firm's Weighted Average Cost of Capital (WACC).

References: p37

55. The "finance-inspired" theory of Real Options has emerged in strategic management and is used by strategy analysts. Why? What is its contribution?

Answer: The ability of preserving flexibility and adaptation in the strategic management process is a huge challenge because investments and actions are almost irreversible and have consequences in the long run. Moreover, determinant information emerges during the process life. Because of these characteristics, viewing strategic orientations as "projects" on which the firm may have an option is valuable since it focuses on this property of flexibility for those projects. This emphasis on flexibility appears critical because it concentrates on the possibility at any time during the process before any final decision is made, to improve, amend, rescale or stop a project.

References: p42

56. The Discounted Cash Flow method is a function of three variables. What are these three variables?

Answer: The DCF assesses the value of future projects. It uses historical data and relies also on assumptions about the future. The three variables are: 1/ Return on the firm's invested capital ROIC, 2/ Weighted average cost of capital and 3/ Rate of growth of the operating profit.

References: p45

57. What is the most important for strategic management: preserving stability, or maintaining flexibility to allow change and adaptation?

Answer: Both are important because a firm needs a stable framework for progressing and some stable strategic directions, even if not extremely detailed. However, the ability to alter strategies for adaptation to an ever changing environment is a requirement. The speed and depth of change are key variables and vary with the industry. These conflicting requirements represent a huge challenge for top managers.

References: p50

58. To what extent is a firm's value approach helpful in assessing performance from an external point of view?

Answer: This approach provides managers with a guide to understanding the complexity of this topic. Value, in a broad sense, refers to the money customers are willing to pay for a product or service. Then, the challenge for business is to create value for customers and to extract some of that value in the form of profit for the firm.

This profit can be measured in different ways but the overall profit maximization translates into maximization of the value of the firm. From an external point of view, assessing performance is a daunting task because of the complexity of the organization, of emergent strategies, and of pressures from the environment. Using profit is convenient, because this proxy can be easily quantified, proves to be reliable in measuring performance, and has fiscal and financial implications. Profit is at the root of the fundamental and simplifying assumption that firms operate in the interests of their owners to maximize long term profits.

References: p35

59. Is it possible for managers to manipulate their firm's value for stakeholders' interests or for self-serving reasons?

Answer: It is likely that this type of endeavor takes place. We can make a distinction between illegal behavior and "only" unethical behavior, although the line between the two is becoming blurred. Illegal behaviors can be punished by law enforcement authorities and send the perpetrators behind bars. "Cooking the books" or lying in official business documents or hearings belongs in this category. Unethical behavior refers to actions that are legally, financially and technically possible; however, they may not be ethical because they induce a biased evaluation of the firm. Accounting offers possibilities in that field.

Just hiding important information or presenting that information differently may fit into that category, for example when a manager reports to the higher managerial level. The trend in the business world is to increase control and accountability for top managers and accounting firms (Sarbanes Oxley Act, 2002) and to punish violators severely. Many studies show that ethical behavior, respect for stakeholders, and excellent "corporate citizenship" pays-off for the firm in the long term.

References: p35

60. Theory explains that corporate strategy and corporate social responsibility must be aligned for better performance and long term success within all the firm's constituencies. Do situations exist where they absolutely conflict in a win-lose game?

Answer: The social entity conception of the firm looks at the organization as a community of individuals that is sustained and supported by its relationship with its social, political, economic, and natural environment. In this approach, there is a double relationship between the survival and prosperity of the firm and the coexistence with the external environment. In other words, the prosperity of the owners of the firm cannot in the long term take place in an environment characterized by poverty and misery. The firm and its context should rely on each other to increase the quality of life, in general, on both levels.

In the short term, there are situations where the value of internal prosperity and external sharing may conflict (e.g. Body Shop looking for natural products; Patagonia and its environmentally friendly raw materials; and state agencies providing more benefits than the average in their industry, then increasing costs and shrinking returns). However, in the long term, firms are "condemned" to find a "strategic compromise".

References: p52

61. If a corporation is a living organization with social responsibilities, how would the players in the defense or tobacco industries justify their corporate goals, and their mission, and balance them with human values?

Answer: These industries experience difficulties in justifying some aspects of their mission and values. Justifying the contribution to their shareholders seems to be easy because they generate profits. However, their role in the community at large may be more questionable.

For the tobacco industry, products are clearly harming health and do not provide any benefit. One contribution they may claim is that the use of tobacco may avoid the use of worse substances and drugs; this argument is hardly convincing. The only solution for these firms is diversification to other non-harmless products and to educate people to quit smoking before quitting that industry themselves.

The defense industry is a more complex question. Its role is not directly to make profit but to build and maintain the country's resources and capabilities to protect itself against any aggression, and to act abroad to protect the outside interests of the country.

Morally, the use of force and violence is reprehensible but can be justified in certain cases. Justifying their mission is easier and can be positively complemented by the humanitarian role that armed forces may have in some countries.

References: p52

62. What happens if the Key success factors of an industry are misunderstood? Does the disaggregation of the profit into components allow analysts to capture the causes of the misunderstanding and to fix it?

Answer: If KSF are misunderstood, bad consequences can occur because the strategic process may start on an incorrect basis. If the requirements to be successful are misunderstood the firm will probably not be able to satisfy them. If the firm uses a strong analytical capability, it may be able, afterwards, to identify the right KSF and fix the problem.

The disaggregation of profit into components provides analysts with a useful tool to identify the antecedents and determinants of profit. However, a qualitative analysis often proves to be necessary to capture the entirety of the phenomenon. Another approach, such as the Resource-based view or the Balanced score card can be extremely valuable as well.

References: p35