TRUE/FALSE

1. In 2006 U.S. airlines performed nearly identically in terms of financial results.

   ANS: F PTS: 1 DIF: Easy REF: pp. 35-36
   OBJ: 1 NAT: AACSB Analytic | AACSB Strategy, Environmental Influence

2. Customary performance measures for assessing a strategy should reflect the company's efforts as a whole, be comparable with measures from other companies, and reflect long-term commitments.

   ANS: T PTS: 1 DIF: Easy REF: p. 37
   OBJ: 1 NAT: AACSB Reflective Thinking | AACSB Strategy

3. Emerging attributes by which we might assess a company's performance go beyond financial measures and include things like environmental sustainability in company operations and societal contributions by the firm.

   ANS: T PTS: 1 DIF: Easy REF: pp. 38-39
   OBJ: 1
   NAT: AACSB Reflective Thinking | AACSB Strategy, Environmental Influence

4. Stakeholders are individuals and groups who receive or have the potential to receive direct payments from an organization.

   ANS: F PTS: 1 DIF: Medium REF: p. 39
   OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

5. The increasing adoption of strategic management principles by organizations in the non-profit and government sectors of the economy means that these types of organizations must identify financial measures of their performance to gauge whether their strategies are working or not.

   ANS: F PTS: 1 DIF: Medium REF: p. 40
   OBJ: 1 NAT: AACSB Reflective Thinking | AACSB Strategy

6. One measure by which a non-profit might assess the effectiveness of its strategy is by looking at how well its stakeholders are served.

   ANS: T PTS: 1 DIF: Easy REF: p. 41
   OBJ: 1 NAT: AACSB Reflective Thinking | AACSB Strategy

7. Strategic performance should be assessed by a balance of customary financial measures and emerging, non-financial measures.

   ANS: T PTS: 1 DIF: Easy REF: p. 41
   OBJ: 1 NAT: AACSB Reflective Thinking | AACSB Strategy

8. A normal profit is the minimum return earned by a firm that is necessary to attract and secure the owners' inputs.

ANS: T PTS: 1 DIF: Easy REF: p. 41
OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

9. Economic profit is the residual income above normal profit that accrues to those firms in an industry who choose to use a capital structure without any long-term debt.

ANS: F PTS: 1 DIF: Medium REF: p. 41
OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

10. Return on equity (ROE) is one of the key performance indicators used by the senior managers of organizations.

ANS: T PTS: 1 DIF: Easy REF: p. 42
OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

11. Return on equity (ROE) can be broken down into three other financial measures of performance: Profitability, asset productivity, and financial leverage.

ANS: T PTS: 1 DIF: Medium REF: p. 42
OBJ: 1 NAT: AACSB Analytic | AACSB Strategy, Creation of Value

12. Revenue growth is a direct indicator of a firm's ability to pare costs from its operations.

ANS: F PTS: 1 DIF: Medium REF: pp. 43-44
OBJ: 2 NAT: AACSB Analytic | AACSB Strategy

13. As a measure of performance, revenue growth typically occurs in lockstep with growth in profitability; i.e., as revenues increase dramatically so does profitability for nearly all firms.

ANS: F PTS: 1 DIF: Hard REF: p. 44
OBJ: 1 NAT: AACSB Reflective Thinking | AACSB Strategy

14. We define common stock returns--a common measure of performance--as the dividend paid per share of stock divided by the price of the stock at a given time.

ANS: F PTS: 1 DIF: Hard REF: p. 44
OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

15. Market capitalization is calculated as the number of shares outstanding times the current market price per share of stock.

ANS: T PTS: 1 DIF: Easy REF: p. 44
OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

16. Strategic financial analysis is able to show us what companies are really doing regardless of what they *say* they are doing.

ANS: T PTS: 1 DIF: Medium REF: p. 45
OBJ: 3 NAT: AACSB Analytic | AACSB Strategy

17. Common-sized financial statements have been reworked (using the original entries) to fit a standard format that has been developed by a major accounting firm.

ANS: F PTS: 1 DIF: Medium REF: p. 46
OBJ: 3 NAT: AACSB Analytic | AACSB Strategy

18. A fine-grained examination of financial statements can illustrate different approaches to the marketplace.

ANS: T PTS: 1 DIF: Easy REF: p. 48
OBJ: 3 NAT: AACSB Analytic | AACSB Strategy

19. Amazon's decision to build its own warehouses is evident upon close analysis of the trend in its balance sheets.

ANS: T PTS: 1 DIF: Easy REF: p. 50
OBJ: 3 NAT: AACSB Analytic | AACSB Strategy

20. Economic logic is the means by which a company seeks to generate a return that is greater than its cost of capital and greater than the returns earned by rivals.

ANS: T PTS: 1 DIF: Easy REF: p. 51
OBJ: 4 NAT: AACSB Reflective Thinking | AACSB Strategy

21. Once a given economic logic has been proven to generate superior returns, all firms in the industry adopt that logic; we do not see a variety of logics being used in any industry that has existed for a reasonable period of time.

ANS: F PTS: 1 DIF: Medium REF: p. 51
OBJ: 4 NAT: AACSB Reflective Thinking | AACSB Strategy

22. An economic logic dictates nearly all of the details of a strategy for any firm that chooses to operate under that logic.

ANS: F PTS: 1 DIF: Medium REF: p. 52
OBJ: 4 NAT: AACSB Reflective Thinking | AACSB Strategy

23. Every industry has developed measures of operating characteristics, or metrics, that show how competitors are faring.

ANS: T PTS: 1 DIF: Medium REF: p. 52
OBJ: 4 NAT: AACSB Reflective Thinking | AACSB Strategy

24. Strategy involves a pattern of asset allocations and inter-related activities that manifests itself in financial results.

ANS: T PTS: 1 DIF: Easy REF: p. 53
OBJ: 5 NAT: AACSB Reflective Thinking | AACSB Strategy

25. It is typically a mistake for managers to forecast financial results as part of the strategy formulation process. There are simply too many assumptions necessary and a high probability that the environment will change in significant ways, rendering financial forecasts inaccurate.

ANS: F PTS: 1 DIF: Hard REF: p. 54
OBJ: 5 NAT: AACSB Reflective Thinking | AACSB Strategy

MULTIPLE CHOICE

1. Which of the following statements is true about the U.S. airline industry as described in the opening vignette for Chapter 2 of the text?
   a. All airlines confront identical industry conditions.
   b. Financial performance of the U.S. airlines was mixed during 2006.
   c. Many airlines were considering mergers in response to tough industry conditions.
   d. All of the above statements are true.

   ANS: D PTS: 1 DIF: Easy REF: pp. 35-36
   OBJ: 2 NAT: AACSB Analytic | AACSB Strategy, Environmental Influence

2. The critical outcome measure of strategy is
   a. customer retention.
   b. performance.
   c. employee turnover.
   d. environmental sustainability.

   ANS: B PTS: 1 DIF: Easy REF: p. 36
   OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

3. Performance measures of interest to those involved with an organization's strategy should reflect
   a. marketing outcomes.
   b. human resource recruiting and staffing results.
   c. the company's efforts as a whole.
   d. the interpretation of external analyses.

   ANS: C PTS: 1 DIF: Easy REF: p. 37
   OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

4. Studies show that average industry performance varies greatly as does the performance of companies within industries. Thus, one must pay attention to performance measures that
   a. can easily be compared to other firms in the same industry.
   b. express commonalities across firms in different industries.
   c. are unique to the firm of interest.
   d. illustrate the risks of doing business in one industry versus another.

   ANS: A PTS: 1 DIF: Easy REF: p. 37
   OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

5. Which of the following is most likely to measure performance that results from a company's long-term commitments?
   a. a financial measure such as return on equity (ROE)
   b. a company's stock price at the close of trading on a given day
   c. a cell phone service provider's customer "churn" for the most recent quarter
   d. a grocer's coupon redemption rate for the most recent fiscal year

   ANS: A PTS: 1 DIF: Medium REF: pp. 37-38
   OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

6. Which of the following is **not** an aspect of measuring performance that is important to consider from a strategic point of view?
   a. The performance measure reflects the company's efforts as a whole.
   b. The performance measure can be compared to the same measure from rivals.
   c. The performance measure is easily calculated and interpreted.
   d. The performance measure reflects a company's long-term commitments.

   ANS: C PTS: 1 DIF: Easy REF: pp. 37-38
   OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

7. The financial performance of a firm
   a. should be the only consideration when assessing a strategy.
   b. should be used along with other measures, including some that are qualitative, to assess a strategy.
   c. is not likely to be reported accurately in its financial statements, as can be seen with Enron and WorldCom, so it is of little use when assessing a strategy.
   d. is more easily deduced by outsiders when the firm is privately held rather than publicly traded.

   ANS: B PTS: 1 DIF: Medium REF: p. 38
   OBJ: 1 NAT: AACSB Reflective Thinking | AACSB Strategy

8. Value creation by companies can take many forms. Which of the following is **not** a type of value that might be created by a company?
   a. economic
   b. cultural
   c. social
   d. instrumental

   ANS: D PTS: 1 DIF: Easy REF: p. 38
   OBJ: 1 NAT: AACSB Analytic | AACSB Strategy, Creation of Value

9. Eliminating waste, selling products that are produced with sustainable methods, and installing natural power generation illustrate what approach to achieving a competitive advantage and creating value?
   a. a purely economic approach
   b. a "green" or environmentally sustainable approach
   c. a knowledge-based approach
   d. a politically correct approach

   ANS: B PTS: 1 DIF: Easy REF: p. 38
   OBJ: 1 NAT: AACSB Reflective Thinking | AACSB Strategy, Creation of Value

10. A key element of the emergent view of the appropriate dimensions for assessing company performance is that the interests of ________ should be taken into account.
   a. various stakeholders
   b. only stockholders
   c. capital providers, including debt holders,
   d. employees

   ANS: A PTS: 1 DIF: Easy REF: p. 39
   OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

11. Individuals or groups who have an interest in or influence on the operations of a company are called
   a. external operatives.

b. moral agents.
c. stakeholders.
d. special interests.

ANS: C PTS: 1 DIF: Easy REF: p. 39
OBJ: 1 NAT: AACSB Analytic | AACSB Strategy, Environmental Influence

12. Employees, managers and officers, boards of directors, and stockholders are all ________ of a company.
a. external stakeholders
b. indirect beneficiaries
c. internal stakeholders
d. fiduciary agents

ANS: C PTS: 1 DIF: Medium REF: p. 39
OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

13. Suppliers, creditors, customers, communities, and governments are all ________ of a company.
a. internal stakeholders
b. participatory agents
c. informal auditors
d. external stakeholders

ANS: D PTS: 1 DIF: Easy REF: p. 39
OBJ: 1 NAT: AACSB Analytic | AACSB Strategy

14. Newman's Own and Ben & Jerry's are two examples of companies that began their business operations with
a. funding from friends and family.
b. explicit social objectives.
c. the desire to be the most profitable firms in their respective industries.
d. a wish to employ as many people as possible.

ANS: B PTS: 1 DIF: Hard REF: p. 39
OBJ: 1 NAT: AACSB Reflective Thinking | AACSB Strategy

15. When strategic management principles are applied in non-profit and governmental organizations there is a need for ________ measures of performance.
a. human resource-based
b. non-financial
c. public accounting
d. few, if any,

ANS: B PTS: 1 DIF: Medium REF: p. 40
OBJ: 1 NAT: AACSB Reflective Thinking | AACSB Strategy

16. Strategy should be assessed by combination of _______ and ________ measures.
a. financial; environmental
b. financial; governmental
c. non-financial; legal
d. financial; non-financial

ANS: D PTS: 1 DIF: Easy REF: p. 41
OBJ: 2 NAT: AACSB Analytic | AACSB Strategy

17. The minimum return earned by a company that is necessary to attract capital is known as
   a. normal profit.
   b. its internal rate of return.
   c. external profit.
   d. the hurdle rate.

ANS: A PTS: 1 DIF: Easy REF: p. 41
OBJ: 2 NAT: AACSB Analytic | AACSB Strategy

18. The residual income above that from normal profit that derives from the efforts of management is known as
   a. excess rent.
   b. windfall profit.
   c. economic profit.
   d. return on investment.

ANS: C PTS: 1 DIF: Easy REF: p. 41
OBJ: 2 NAT: AACSB Analytic | AACSB Strategy

19. Which of the following is not a component of the key performance indicator return on equity (ROE)?
   a. profitability
   b. asset productivity
   c. financial leverage
   d. market capitalization

ANS: D PTS: 1 DIF: Medium REF: p. 42
OBJ: 2 NAT: AACSB Analytic | AACSB Strategy

20. A company that achieves a higher return on equity (ROE) than the industry average earns
   a. the disdain of its peers.
   b. normal rents.
   c. the Malcolm Baldrige award.
   d. economic profit.

ANS: D PTS: 1 DIF: Easy REF: p. 42
OBJ: 2 NAT: AACSB Analytic | AACSB Strategy

21. For 2006 Continental Airlines was able to report ROE of 106% compared to 7.3% for Southwest Airlines. While Southwest achieved higher profitability, Continental had a much higher level of
   a. operating leverage.
   b. financial leverage.
   c. receivables turnover.
   d. working capital.

ANS: B PTS: 1 DIF: Hard REF: p. 42
OBJ: 2 NAT: AACSB Analytic | AACSB Strategy

22. Aside from return on equity (ROE), which of the following is commonly used as a measure of performance?
   a. sales revenue growth
   b. returns to common stock
   c. measures of a company's market value such as market capitalization
   d. all of the above are commonly used.

ANS: D PTS: 1 DIF: Easy REF: p. 43

OBJ: 3 NAT: AACSB Analytic | AACSB Strategy

23. The advantage of common-sized financial statements is that they
   a. offer a clear comparison between companies of different sizes.
   b. are more accurate than the unconverted source statements.
   c. have all figures in U.S. dollars for comparative purposes.
   d. have been subject to a final audit by one public accounting firm.

ANS: A PTS: 1 DIF: Medium REF: p. 46
OBJ: 3 NAT: AACSB Analytic | AACSB Strategy

24. The detailed analysis of the financial statements of retail chains A (Safeway), B (CVS Caremark), and C (Kohl's) best illustrates the idea that
   a. drugstores always have a lower return on equity than grocers or department stores.
   b. retail chains carry little cash and near-cash equivalents on their balance sheets compared to other types of businesses.
   c. different businesses have operating characteristics that can be discerned by way of a thorough investigation of their financial and operating data.
   d. grocers typically operate at low levels of overhead expense.

ANS: C PTS: 1 DIF: Hard REF: pp. 47-48
OBJ: 3 NAT: AACSB Analytic | AACSB Strategy

25. An examination of a company's financial statements from a period of several years allows the analyst to
   a. extrapolate the company's likely future stock price from its past investments.
   b. estimate accurately the size and quality of the company's pipeline of products that are to be introduced in the near future.
   c. identify changes in strategy as well as gain insight into the higher-level thinking that guides the company.
   d. forecast the company's market capitalization for the next five- to ten-year period.

ANS: C PTS: 1 DIF: Medium REF: pp. 50-51
OBJ: 3 NAT: AACSB Analytic | AACSB Strategy

26. The means by which a company seeks to generate returns greater than those that rivals earn and that are greater than its cost of capital is called
   a. capital restructuring.
   b. economic logic.
   c. business process re-engineering.
   d. structuring for strategic change.

ANS: B PTS: 1 DIF: Easy REF: p. 51
OBJ: 4 NAT: AACSB Reflective Thinking | AACSB Strategy, Creation of Value

27. Once we understand the economic logics of an industry, we have a better chance of
   a. accurately diagnosing the strategy of a particular company in the industry.
   b. successful entry with a business model unlike any currently used by incumbents.
   c. using that knowledge to drive competitors from markets where we have significant interests.
   d. creating first-mover advantages.

ANS: A PTS: 1 DIF: Medium REF: p. 52
OBJ: 4 NAT: AACSB Reflective Thinking | AACSB Strategy, Creation of Value

SHORT ANSWER

1. Why should firms use non-financial measures of performance to assess their strategies?

   ANS:
   Performance should be measured wherever value is created. As the Whole Foods example shows, value can be created outside of the economic sphere. Whole Foods has created value for its suppliers and the communities in which it operates. This kind of value cannot be accounted for by typical financial measures.

   Furthermore, non-profits and governmental entities must be able to measure the success of their strategies. By definition, however, they do not earn profits and profits underpin nearly all financial assessments of strategies. These organizations must identify and use alternatives to financial measures of performance, such as how well stakeholders are served.

   Finally, society may be coming to expect a broader definition of firm performance given the range of undesirable outcomes that corporations, especially larger ones, may create in the course of normal operations. For instance, the evolving social contract may make some level of overall employment a measure of the success of the strategies of many corporations.

   PTS: 1 DIF: Medium REF: pp. 38-41 OBJ: 1
   NAT: AACSB Reflective Thinking | AACSB Strategy

2. How do financial statements help us determine whether or not a firm holds a sustainable competitive advantage in the marketplace?

   ANS:
   A firm holds a sustainable competitive advantage if it, for some longer period of time, is able to earn economic profits. Economic profits are profits in excess of the cost of capital and are earned as a result of skillful management decisions.

   One of the key indicators of the presence of economic profits is a firm's return on equity (ROE). If the firm's ROE is above the industry average and it incurs no risk above the norm for the industry the firm is producing economic profits. A firm that produces a superior ROE for one or two measurement periods (whether quarters or years) may not hold a *sustainable* competitive advantage.

   Additional measures used to determine whether a firm holds a sustainable competitive advantage include revenue growth, common stock returns, and market capitalization. These measures should be used in concert with return on equity when assessing the nature of a firm's competitive advantage.

   ROE and revenue growth can be directly calculated from the firm's own financial statements, while common stock returns and market capitalization require additional information.

   PTS: 1 DIF: Medium REF: pp. 41-44 OBJ: 2
   NAT: AACSB Reflective Thinking | AACSB Strategy, Creation of Value

3. Give some specific examples of how you might use the income statements for two rivals in a comparison of their strategies.

   ANS:

First, one should make the comparison clearer by common-sizing the income statements. This requires that revenues for each firm be set to 100% and the statement expense and income items be expressed in percentages of revenue.

One might initially examine the gross profit margins for each competitor. A rival with a higher gross profit margin could be charging higher prices (perhaps because customers perceive the products to have more value). Or it could command lower prices from suppliers due to high volumes of purchases. If the rivals are manufacturers, the direct raw materials and labor costs for the higher profit margin firm might be lower for any number of reasons, including the use of non-union labor.

A comparison of SGA expenses might reveal one firm to do a better job of controlling overhead expenses. Employees who travel may be required to fly coach rather than business class. Or employees who travel in teams may be asked to share hotel rooms under the appropriate circumstances (as Wal-Mart employees do).

Lower interest expenses for one rival probably indicate less debt for that firm. This can be confirmed with data from the balance sheet. However, lower interest expenses might be offset by higher dividend payouts. Too, the use of debt in relation to equity is one component in the makeup of ROE. A lower percentage of debt in a firm's capital structure (and, by extension, a higher level of shareholder equity) will lower its ROE, all else held constant.

One should compare return on sales (ROS) for each firm. This is indicated by net income as a percent of revenues. One rival with a higher ROS for an extended period of time is a good indicator of a firm with a competitive advantage and an effective strategy. The rivals' ROEs should also be calculated to confirm the relative effectiveness of each strategy.

PTS: 1 DIF: Hard REF: pp. 44-51 OBJ: 3
NAT: AACSB Reflective Thinking | AACSB Strategy, Creation of Value

4. What is meant when we say that one or more economic logics exist in an industry?

ANS:
The text defines an economic logic as "The means by which the successful company seeks to generate a return that is greater than what competitors earn and greater than its cost of capital." That is, an economic logic is the method used by firms to produce economic profits. A close synonym for an economic logic is a business model.

The firms in an industry may employ a variety of economic logics, each of which is capable of earning economic profits. Or an industry may support just one economic logic at a given time.
Retailers of clothing, for example, use both high-margin, low-volume logics and low-margin, high-volume logics with success.

Going back to the Sirius XM Satellite Radio example we can see two economic logics at work in radio broadcasting. Land-based broadcasters rely solely on advertising revenues. Sirius XM derives revenues both from subscription fees and advertising. In the case of Sirius XM it is not yet clear whether its economic logic will be able to produce economic profits so the industry's dominant logic is that of advertising as the source of revenues.

The makers of video game consoles follow a "razors and blades" economic logic. Little, if any, money is made from the sales of game console hardware (the razor). However, significant profits can be earned from the sales of popular games (the razor blades). The manufacturers of inkjet printers employ this logic, too. These are industries in which a single economic logic exists.

One of the problems that plagued the early dot.com startups was the absence of a clear economic logic for many web ventures. On-line advertising was in its infancy. How were dot.coms to earn economic (or normal, for that matter) profits?

PTS: 1 DIF: Hard REF: pp. 51-53 OBJ: 4
NAT: AACSB Reflective Thinking | AACSB Strategy, Creation of Value

5. Briefly describe the relationship between strategy formulation and the analysis of financial statements.

ANS:
A thoughtful, rigorous analysis of a firm's financial statements is a window - translucent though it may be - into the strategy formulated and implemented by the company. It reveals a pattern of resource allocations and activities that are meaningful indicators of a strategy. Financial statements can show information about a firm's strategy that is largely left unspoken.

Internally, the projected success of a newly formulated strategy is evaluated by its likely financial (and other, as noted in the emerging measures of performance section) results. The typical goals for a strategy are expressed in terms of financial and market-based ratios.

Thus the relationship between strategy formulation and financial analysis is a two-way street. Or perhaps we might think of it as a roundabout. Strategies are formulated to create results which are then used to evaluate the strategies.

PTS: 1 DIF: Medium REF: pp. 53-54 OBJ: 5
NAT: AACSB Reflective Thinking | AACSB Strategy