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QUESTION NO: 1

A firm is considering replacing an existing machine with a more efficient model. The old machine could be sold today for \$18,000. The new machine costs \$120,000 and requires \$7,000 in installation costs. The firm has already spent \$5,000 on a feasibility study for the replacement.

What amount should the firm use as the net initial investment for the replacement decision, ignoring taxes?

- A. \$102,000
- B. \$109,000
- C. \$114,000
- D. \$132,000

ANSWER: B

Explanation:

\$109,000 is correct. The relevant initial outlay includes the \$120,000 purchase price and \$7,000 installation cost, less the \$18,000 cash received from selling the existing machine: $\$120,000 + \$7,000 - \$18,000 = \$109,000$. The \$5,000 feasibility study is a sunk cost because it has already been incurred and will not change regardless of whether the replacement occurs.

QUESTION NO: 2

What is a potential drawback of lowering the annual dividend payment?

- A. It can lead to an immediate increase in the company's stock price.
- B. It could possibly increase the company's net margin.
- C. It might lead to higher sales growth for the company.
- D. It may cause the company's stockholders to react negatively.

ANSWER: D

Explanation:

It may cause the company's stockholders to react negatively. Dividend payments commonly convey information to investors about management's expectations for sustainable earnings and cash flow. Because dividends are generally set with attention to whether the firm can maintain them over time, a reduction can be interpreted as a signal that management anticipates weaker financial performance, reduced cash availability, or greater uncertainty. This interpretation can diminish investor confidence and prompt shareholders to sell, creating downward pressure on the market price of the company's stock. A dividend reduction may be a prudent decision when retaining cash supports operations, debt service, or valuable investment opportunities; however, the market reaction remains a meaningful potential drawback. Management should therefore evaluate both the cash-flow benefits of a lower payout and the likely signaling effect on current and prospective owners, while communicating the strategic rationale clearly. The dividend-signaling concept and the importance investors place on dividend changes are discussed in [Investopedia's overview of dividend signaling](#) and in [Corporate Finance Institute's dividend-policy guidance](#).

QUESTION NO: 3

What does a beta of less than 1 signify in the capital asset pricing model (CAPM)?

- A. The investment has higher risk than the market.
- B. The investment has lower risk than the market.
- C. The investment has a return that is independent of the market.

D. The investment is risk-free.

ANSWER: B

Explanation:

The investment has lower risk than the market. In CAPM, beta measures a security's systematic risk: its sensitivity to changes in the overall market portfolio. The market portfolio is assigned a beta of 1. A beta below 1 means that, on average, the investment's returns are expected to move by a smaller percentage than the market's returns. For example, an asset with a beta of 0.70 would be expected to rise or fall by about 0.70% for a 1% market movement, although actual returns can differ from that estimate.

Because CAPM compensates investors for nondiversifiable market risk, a lower beta produces a lower required return than an otherwise comparable investment with a beta of 1 or greater. This relationship is represented by the CAPM equation: expected return equals the risk-free rate plus beta times the market risk premium. Beta does not measure all possible risk in isolation; company-specific risk may still affect the investment, but that risk can generally be reduced through diversification. The U.S. Securities and Exchange Commission discusses beta as a measure of volatility relative to the market in its [risk guidance](#). CAPM's beta-based expected-return relationship is also summarized by [NYU Stern's finance definitions](#).

QUESTION NO: 4

Alliah Company produces vaccines at its pharmaceutical facility near a river. It is considering expanding its operations by building a second facility next to the first. The company holds a public hearing to discuss an extra investment it will make to minimize pollution and keep the river clean and thriving for the native wildlife.

How does this effort support the overall goal of the firm?

- A.** Alliah Company is seeking to focus initially on maximizing value to the shareholders—or owners—of the firm, and the extra costs to prevent pollution will increase the immediate earnings available for owners.
- B.** Alliah Company is focusing on consumers first and foremost to create the greatest value for the company. Reducing this pollution will directly improve the quality of products the company creates.
- C.** Alliah Company is considering the long-term impact on shareholder value and the company's social responsibility to all stakeholders—including the environment and local community.
- D.** Alliah Company is ensuring this action will reduce immediate costs to maximize employee engagement and earnings—because the ultimate goal of a company is employee-oriented.

ANSWER: C

Explanation:

Alliah Company is considering the long-term impact on shareholder value and the company's social responsibility to all stakeholders—including the environment and local community. This is correct because a firm's overall financial objective is to maximize the long-term value of the owners' investment. Value depends on sustainable future cash flows and the risks associated with producing those cash flows, rather than on a single period's reported earnings. Spending on pollution prevention can protect operating continuity and reduce exposure to environmental cleanup obligations, regulatory actions, litigation, and reputational damage. Those effects can preserve expected cash flows and reduce the uncertainty surrounding the company's future operations.

The public hearing also recognizes that local residents, regulators, and environmental interests materially affect the firm's ability to operate and expand. Addressing their concerns supports the firm's social responsibility while also helping maintain community trust and its practical license to operate. This approach therefore connects responsible environmental decision-making with durable shareholder value creation. The U.S. Securities and Exchange Commission describes environmental matters as potentially material business risks requiring disclosure, illustrating why environmental risk can affect financial decisions and firm value. See the [SEC climate-related disclosure rule](#) and the [Business Roundtable statement on stakeholder commitments](#).

QUESTION NO: 5

A firm expects to receive £4 million from a customer in 60 days. The firm reports its financial results in U.S. dollars and is concerned that the British pound will depreciate before the customer pays.

Which transaction most directly hedges the firm's transaction exposure?

- A. Buying British pounds forward
- B. Selling British pounds forward
- C. Borrowing U.S. dollars for 60 days
- D. Purchasing additional shares of the customer's stock

ANSWER: B

Explanation:

Selling British pounds forward is correct. The firm will receive pounds in the future and therefore faces a loss in U.S.-dollar value if the pound depreciates. By entering a forward contract to sell pounds at a predetermined exchange rate, the firm locks in the dollar value of the anticipated pound receipt. Buying pounds forward would be appropriate for a firm that must make a future payment denominated in pounds.

QUESTION NO: 6

A company forecasts sales growth that will require \$900,000 in total assets next year. Projected spontaneous liabilities are \$270,000. The company expects to retain \$90,000 of earnings, and its current equity balance is \$480,000.

What is the company's discretionary financing need for next year?

- A. \$30,000
- B. \$60,000
- C. \$90,000
- D. \$150,000

ANSWER: B

Explanation:

\$60,000 is correct. The projected asset requirement must be financed by projected liabilities and projected equity. Projected equity equals the existing \$480,000 equity plus \$90,000 of retained earnings, or \$570,000. Total available financing is $\$270,000 + \$570,000 = \$840,000$. The discretionary financing need is therefore $\$900,000 - \$840,000 = \$60,000$.

QUESTION NO: 7

A building owner is undertaking a weatherization project. The owner will make a one-time investment of \$410,000 for caulking, sunshades, and smart thermostats. Annual utility savings are projected to be:

- Year 1: \$125,000
- Year 2: \$125,000
- Year 3: \$140,000
- Year 4: \$140,000
- Year 5: \$160,000

What is the **payback period**, in years? (Round up)

- A. 2
- B. 3
- C. 4
- D. 5

ANSWER: C

Explanation:

4 is correct because the payback period is the time required for cumulative cash inflows to recover the project's initial cash outlay. The building owner invests \$410,000 at the beginning of the project. Savings total \$125,000 after the first year, \$250,000 after the second year, and \$390,000 after the third year. Thus, at the end of year 3, \$20,000 of the initial investment remains unrecovered.

During year 4, the project produces an additional \$140,000 in utility savings. The exact recovery point is therefore 3 years plus \$20,000 divided by \$140,000, or approximately 3.14 years. Because the question specifically directs that the result be rounded up, the reported payback period is 4 years. This approach uses undiscounted annual savings, as is standard for a basic payback-period calculation; it focuses on how quickly the original investment is recovered rather than on the time value of money or benefits received after payback. For background on the payback method in capital-budgeting decisions, see [OpenStax: The Payback Period Method](#) and [AccountingCoach: Payback Period](#).

QUESTION NO: 8

Kretsmart anticipates its sales will grow by **10% each year for the next two years** . Information from the company's current income statement is given below, and **Cost of Goods Sold (COGS) is assumed to be a spontaneous account** .

Kretsmart Income Statement Current Year	
Sales	\$100
Cost of Goods Sold	\$45
Gross Margin	\$55

What would the company's **projected gross margin for Year 2** ?

- A. \$59.45
- B. \$66.55
- C. \$71.25
- D. \$76.00

ANSWER: B

Explanation:

\$66.55 is the projected gross margin for Year 2. The current income statement shows sales of \$100 and gross margin of \$55, so the current gross-margin percentage is 55% of sales. Equivalently, COGS is \$45, or 45% of sales. Because COGS

is identified as a spontaneous account, the percentage-of-sales forecasting assumption applies: COGS will continue to equal 45% of projected sales, absent any stated change in costs or operating efficiency.

Sales increase by 10% in each of two successive years, so Year 2 sales are calculated using compound growth: $\$100 \times 1.10 \times 1.10 = \121 . COGS for Year 2 is therefore $\$121 \times 45\% = \54.45 . Subtracting projected COGS from projected sales gives gross margin of $\$121 - \$54.45 = \$66.55$. The same result can be obtained by applying the unchanged 55% gross-margin ratio directly to Year 2 sales: $\$121 \times 55\% = \66.55 .

This reflects the standard percentage-of-sales approach used in pro forma financial-statement forecasting, where accounts that vary directly with sales are projected as a stable proportion of sales. For additional background, see the [OpenStax financial forecasting overview](#) and the [Corporate Finance Institute's gross-margin definition](#).

QUESTION NO: 9

A stock has a beta of 1.3. The risk-free rate is 4%, and the expected market return is 10%.

Using the capital asset pricing model (CAPM), what is the stock's required return?

- A. 7.8%
- B. 10.0%
- C. 11.8%
- D. 17.8%

ANSWER: C

Explanation:

11.8% is correct. CAPM calculates the required return as the risk-free rate plus beta multiplied by the market risk premium. The market risk premium is $10\% - 4\% = 6\%$. Therefore, the required return is $4\% + 1.3(6\%) = 11.8\%$. The beta applies to the market risk premium, not to the entire expected market return.

QUESTION NO: 10

A company is expected to pay a dividend of \$2 next year, and dividends are expected to grow at 5% per year indefinitely. The required rate of return on the company's stock is 10%.

What is the value of the stock using the Gordon growth model?

- A. \$15
- B. \$20
- C. \$40
- D. \$61

ANSWER: C

Explanation:

The correct value is **\$40**. The Gordon growth model, also called the dividend discount model for constant growth, estimates a stock's intrinsic value when dividends are expected to grow at a stable rate forever. Its formula is $P_0 = D_1 \div (r - g)$, where D_1 is the dividend expected one period from now, r is the required return, and g is the constant dividend-growth rate. Here, the expected next-year dividend is \$2, the required return is 10% (0.10), and the growth rate is 5% (0.05). Therefore, the value is $\$2 \div (0.10 - 0.05)$, or $\$2 \div 0.05$, which equals \$40. The model's required condition is met because the required return exceeds the perpetual growth rate; this creates a positive denominator and a finite present value. Since the stated dividend is explicitly the dividend expected next year, it is used directly as D_1 rather than being grown first. For a discussion

of the constant-growth dividend discount model and its inputs, see [NYU Stern's dividend discount model materials](#) and [Investopedia's Gordon Growth Model overview](#).