Chapter 2

Practice Problems

1. What is the term for the situation when a firm fails to meet its debt obligations?
2. What are the two types of payments that firms make to their bondholders? Hint: one is a repayment of the amount borrowed, and the other is compensation for the use of the money over time.
3. (Fill in the blank) Shareholders are often known as ________________ claimants, which means that they have the right to receive the leftover resources after a firm's contractual promises have been met.
4. What are the two sources of return that shareholders earn by investing in a firm's stock?
5. What financial institution facilitates the transfer of securities from firms to investors?
6. What are the two steps the this institution takes to facilitate the transfer?
7. What are the benefits an initial public offering to the issuing firm?
8. What type of markets are the NYSE and NASDAQ?
9. What are some benefits of secondary markets?
10. What four factors influence a firm's cost of raising capital?
11. Which of these factors is embedded in the risk-free rate?
12. How do you calculate the risk premium on a bond if you know the bond's yield?
13. What does a credit rating generally indicate?
14. What is the lowest investment grade bond rating (using S&P's rating scale)?
15. What is another term used for "speculative grade" debt?

Chapter 2

Practice Problems (w/ answers)

1. What is the term for the situation when a firm fails to meet its debt obligations? **Default**
2. What are the two types of payments that firms make to their bondholders? Hint: one is a repayment of the amount borrowed, and the other is compensation for the use of the money over time. **Principal and interest**
3. (Fill in the blank) Shareholders are often known as _______________ claimants, which means that they have the right to receive the leftover resources after a firm's contractual promises have been met. **Residual**
4. What are the two sources of return that shareholders earn by investing in a firm's stock? **Dividends and capital gains**
5. What financial institution facilitates the transfer of securities from firms to investors? **Investment bank**
6. What are the two steps the this institution takes to facilitate the transfer? **It buys the securities from the firm and it then turns around and sells the securities to investors.**
7. What are the benefits an initial public offering to the issuing firm? **The primary benefit is that it allows the firm to raise a large amount of capital.**
8. What type of markets are the NYSE and NASDAQ? **Secondary markets**
9. What are some benefits of secondary markets? **They provide investors with liquidity and firms with information about their value (through their share price).**
10. What four factors influence a firm's cost of raising capital? **Production opportunities, consumption opportunities, inflation and risk.**
11. Which of these factors is embedded in the risk-free rate? **Production opportunities, consumption opportunities, and inflation.**
12. How do you calculate the risk premium on a bond if you know the bond's yield? **Risk premium = Yield - Risk-free rate**
13. What does a credit rating generally indicate? **The likelihood that a bond's terms are met.**
14. What is the lowest investment grade bond rating (using S&P's rating scale)? **BBB-**
15. What is another term used for "speculative grade" debt? **"Junk" bonds**