MACHAKOS UNIVERSITY

University Examinations for 2018/2019 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ACCOUNTING, FINANCE AND BANKING

SECOND YEAR SECOND SEMESTER EXAMINATION FOR

DOCTOR OF PHILOSOPHY IN BUSINESS ADMINSTRATION

BAC 905: THEORY OF FINANCE

DATE: 15/5/2019 **TIME: 9.00-12.00 PM**

INSTRUCTIONS

Attempt all questions

QUESTION ONE (10 MARKS)

The emergence of behavioral finance in the theory of finance questioned the traditional view of the rationality of the investors as postulated by the efficient market hypothesis. Critically examine, comparing and contrasting the efficient market hypothesis and the behavioral finance

QUESTION TWO (10 MARKS)

The term dividend usually refers to distribution of earning. Distributions from earnings are dividend and distribution from capital is liquidating dividend. Briefly discuss the following six theories of dividend.

Residual dividends theory

a) Tax differential theory

b) The signaling theory

c) The bird in the hand theory

d) The agency theory of dividend

QUESTION THREE (10 MARKS)

Introducing taxes into the initial proposition of Modigliani and Miller, debt becomes preferable as a source of financing. Discuss why and examine the reasons firms do not use 100% debt in their capital structure.

QUESTION FOUR (10 MARKS)

Arbitrage pricing theory rests of the perceived shortcomings of the capital pricing assets model. Examine some of the shortcomings; discuss the major propositions of arbitrage principle that provide different sets necessary and sufficient conditions for the absence of arbitrage opportunities.

QUESTION FIVE (10 MARKS)

Stock prices move in an 'irrational' manner and the investor may be unable to predict future prices from the past price movements. Rather implying a market following erratic spirits, the irrational movements are an indicator of an efficient market. Examine this in the light of efficient markets hypothesis.

QUESTION SIX (10 MARKS)

Modern theory of finance is no longer very modern dating back to the late 1950s. Discuss in details the major theoretical building blocks of financial economics in relation to development of theory of corporate finance.