MACHAKOS UNIVERSITY

University Examinations 2021/2022 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ACCOUNTING BANKING AND FINANCE

FIRST YEAR FIRST SEMESTER EXAMINATION FOR

DOCTOR OF PHILOSOPHY IN BUSINESS

BAC 905: THEORY OF FINANCE

DATE: 15/12/2021 **TIME: 9.00-12.00 PM**

INSTRUCTIONS

Attempt Question one and any other three Questions

QUESTION ONE (25 MARKS)

a) On September 26, 2019, the television company STV reported: "Housing and building materials company Monday warned that sales and operating income for the second quarter will be below market forecasts and year-earlier levels, blaming the soft housing market and campaign for cheaper building materials that culminated in property expo exhibition in Nairobi. The news cast also talked about rising raw material cost and inflation as the other factors" (www.STVstationnmedia.com). Further information relating to the STV announcement suggests that the price before the announcement was Kshs. 8. The Kenya premier property company said fully diluted earnings per share (EPS), before a charge of Kshs. 700 million to Kshs. 1 billion for interlocking brick-related liabilities, would be Kshs. 1. Actual EPS for the same quarter the previous year was Kshs. 0.77, and consensus analyst's estimates for September 2017 were Kshs.1.24 (the estimate had been falling for the previous 90 days following the downgrading of the company's short-term bond rating).

REQUIRED:

i. As a finance scholar, explain how you would expect the NSE market to respond to these news? (*Hint: be sure to state why, how and support your answer*) (9 marks)

ii. Explain the theoretical basis of the market reaction as per your explanation in (a) (7 marks)

iii. Explain the difference between Random walk theory and Momentum theory of portfolio returns; do you think the share price movements resulting after the TV announcement is a case of Momentum theory or Random walk theory and why? (9 marks)

QUESTION TWO (25 MARKS)

a) "FinTech", a contraction of "Financial technology", refers to technology enabled financial solutions. It is often seen today as the new marriage of financial services and information technology. However, the interlinkage of finance and technology poses challenges to the financial services sector".

REQUIRED:

i. Identify the possible challenges in the Kenyan Fintech market and suggest remedies for them to the Central Bank Governor (9 marks)

ii. "It is argued that financial inclusion can reduce poverty and increase economic growth, particularly for developing countries which have poor access to financial services".Discuss the concept of "financial inclusion" and how digital finance aids financial inclusion. (9 marks)

b) "Literature on Executive Compensation points to the fact that firm size largely influences executive pay". However, there are many arguments as to how executive pay, especially CEO pay is determined. Analyse based on empirical findings the determinants of CEO compensation. (7 marks)

QUESTION THREE (25 MARKS)

a) "A number of studies have established the same issue about dividend policy setting as Lintner (1965) and Back (1976) that whichever way you look at it; Dividend policy is a puzzle. In other words, its neither here nor there!!! Exactly, what managers consider is not what the text book or theory says. What researchers have agreed on is Managers don't want to change dividend; not reduce them, but would rather not pay as much as they do. They only increase them when they expect earnings to be maintained in future". Agree or disagree with this view, and Discuss why you think this is the case or not, and support your arguments with anecdotal evidence from research. (16 marks)

b) "Large firms engage only in defensive, unprofitable acquisitions, and these only occur when private benefits are high. Medium-sized firms engage in unprofitable defensive acquisitions when private benefits are high, but when private benefits are low, they engage in profitable positioning acquisitions. Finally, small firms typically engage in profitable acquisitions". Explaining the above quote, discuss the notion that firm size motivates mergers and race to increase firm size through mergers leads to managerial waste. (9 marks)

QUESTION FOUR (25 MARKS)

a) Professors and managers are divided, over which measure of value should be used- between profits and shareholder value (based on market share price). Reason being the argument trending that 'profit is an opinion, but market price is actuality'. Which view do you support as being a 'correct' measure of value? (12 marks)

b) "Internal governance can mitigate agency problems and ensure that firms have substantial value. Nonetheless, external governance, even if crude and uninformed, can complement internal governance and improve efficiency". What is the difference between internal governance and external governance, and which is effective in mitigating agency problem in corporate organizations. (6 marks)

c) Write short notes on working capital management policies likely to be pursued by SMEs. (5 marks)

QUESTION FIVE (25 MARKS)

a) Arguments for increased gender diversity (women on boards) fall into one of two categories: ethical or economic. Explain these arguments (9 marks)

b) Critically discuss the factors managers consider important in deciding on how much debt to carry. (6 marks)

c) "One of the most compelling and intriguing research questions of our time is how information is reflected in the price of stocks". Explain how this happens in real markets, and suggest how this is linked to the factors that drives stock market prices up and down (10 marks)