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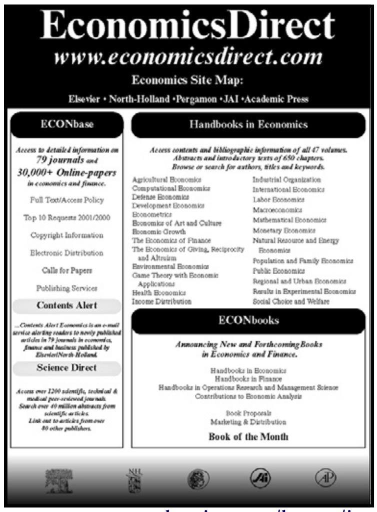

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On the persistence and pricing of industry-wide and firm-specific earnings, cash flows, and accruals

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1. Introduction

This paper examines the relation between industry-wide and firm-specific information contained in earnings and the extent to which this information is reflected in stock prices. Economic theory suggests that firm performance determined by industry fundamentals (e.g., consumer taste, production technology, and regulatory environment) is relatively long-lasting. On the other hand, performance that deviates from industry norms tends to dissipate more quickly because learning and imitation improve industry losers' performance but erode industry winners' competitive edge (e.g., Mueller, 1977, 1986, 1990; Waring, 1996). To the extent that accounting earnings are a (noisy) measure of economic profits, we expect the industry-wide component of earnings to be more persistent than the firm-specific component. Prior research suggests that investors tend to fixate on reported earnings, however, not fully recognizing differences in the persistence of its components (e.g., Sloan 1996). As a result, we expect the market to underreact to the higher persistence of the industry-wide component of earnings.

Predicting greater persistence of the industry-wide component of earnings inherently assumes industry homogeneity and stationarity. Firms in homogeneous industries face relatively similar economic forces, and thus industry-wide earnings should be more persistent than in heterogeneous industries. Earnings components should also be more persistent in stable industries than in those disrupted by business shocks. The effect of business shocks, however, should be smaller on industry-wide earnings than on firm-specific earnings if, as expected, industry-wide earnings are more stationary in general. Investors that underestimate the persistence of industry-wide earnings are thus more