

Effect of R&D investments on persistence of abnormal earnings



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Purpose

This paper sets out to test the effects of firms' and industry's R&D intensity on persistence of abnormal earnings.

Design/methodology/approach

Ohlson's valuation model is used with pooled regressions along with Fama–Macbeth methodology on yearly regressions and partitioning on Herfindahl index to conduct the tests.

Findings

It was found that firms' and industries' R&D intensities are both positively correlated with persistence of abnormal earnings. The evidence suggests that the positive effect on earnings persistence caused by R&D's effectiveness in mitigating competition dominates the negative effect brought by more risk from R&D projects

Practical implications

The fact that the firm's own R&D investment leads to incremental earnings persistence beyond that of the industry suggests the importance of incorporating both industry and firm's R&D intensity in earnings persistence. While industry R&D investment leads to competition mitigation via creation of entry barriers, a firm's own investment in R&D differentiates its products from those of its competitors, and thereby results in further competition mitigation by creating replacement barriers.

Originality/value

Finally, since R&D intensity is correlated with earnings persistence, inclusion of R&D intensity in future earnings persistence studies may lead to better model specification by reducing the problem of correlated omitted variables.

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