The Effect Of Internal Control Weakness On Investment Efficiency

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ABSTRACT

This paper examines whether material weakness in internal accounting control is negatively associated with investment efficiency in Korea. Since internal accounting control weakness drives poor accounting quality and poor accounting quality exacerbates information asymmetry between firms and outside capital suppliers, managerial investment cannot be monitored effectively which result in over- and/or under- investment. Since internal accounting system is closely related to corporate governance, weak internal accounting control is often associated with poor corporate governance, and this control environment makes it hard to monitor managerial opportunistic behavior, causing abnormal investment such as over- and/or under- investment.

We find that firms with internal accounting control weakness tend to make over- and under- investment. We also find the number of weakness in internal accounting control is negatively related to investment efficiency. In addition, three types of qualified review opinion - overall company level weakness, account-specific weakness and disclaimer review opinion due to scope limitation - are differentially affected to investment efficiency; disclaimer review opinion is present the most severe problem in internal accounting control that drives over- and under-investment. Our findings suggest weak internal accounting control provides poor monitoring to manager and cannot restrain managerial inefficient investment decision.

Keywords: Investment Efficiency; Over-Investment; Under-Investment; Information Asymmetry

I. INTRODUCTION

In this paper, we examine the relation between internal accounting control weakness and investment efficiency among Korean firms. According to Internal Accounting Management System Sample Criteria in Korea, material weakness is "a significant deficiency, or combination of significant deficiencies that results in more than reasonably possible that a material misstatement of the annual or interim financial statement will not be prevented or detected". Internal accounting management system is one of internal control system, which is designed and operated by all members of the firm including manager and board of directors to enhance reliability of financial reporting.

Investment activity is a crucial driver for business growth and future outcome of a company. Generally, large amounts of resources are spent for capital investment and thus sometimes the life of companies depends on the degree of investment efficiency. If firms make over-investment, they even take negative net present value project, which will lead to exacerbating of liquidity and profitability, and in this reason even companies' business could be threatened at times. If firms make under-investment, they don't invest even they have positive net present value opportunity, resulting that long-term growth of company cannot be guaranteed. In this paper, we consider both over- and under-investment as inefficient investment behavior, i.e. discrepancy from optimal level of investment, and hereafter we can also mention them as abnormal investments.

To link internal accounting control weakness and investment inefficiency, we consider accounting quality produced in weak internal control system. Conceptually, it makes sense that a poor internal accounting control system is the basis for low-quality financial reporting, since weak internal controls cannot prevent both procedural and estimation errors, as well as manager's opportunistic earnings management. In this context, prior research documents the