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