

Agency Theory in Auditing: Review of Past and Present

Adeusi Amos Sunday

Adekunle Ajasin University, Nigeria

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ABSTRACT

Agency theory is a widely recognized framework used to explain the relationship between principals (capital owners or shareholders) and agents (capital users or managers) in modern corporate entities. This study reviews the past and present perspectives of agency theory in auditing and examines how the theory explains the demand for independent and statutory auditing as a monitoring mechanism in corporate entities. The separation of ownership and control in modern companies often creates conflicts of interest because capital users may pursue personal goals that differ from those of capital users. These conflicts are commonly associated with information asymmetry, incomplete contracts, and differing risk preferences between principals and agents. As a result, auditing has emerged as a fundamental governance mechanism designed to enhance accountability, transparency, and reliability in financial reporting. The study adopts a conceptual research design based on an extensive review of secondary sources, including academic journals, professional publications, and relevant literature on agency theory and auditing. The literature review highlights the evolution of agency theory from its early foundations to its modern applications in auditing and corporate governance. Historically, auditing was influenced by the police theory of auditing, which emphasized fraud detection. However, as corporate entities became larger and more complex, auditing practices evolved to focus more on providing assurance on financial statements, strengthening internal controls, and supporting corporate governance structures. The findings reveal that agency theory provides a strong justification for the existence of auditing because it helps reduce agency costs, mitigate information asymmetry, and improve the credibility of financial information. Independent auditors play a crucial role in verifying financial statements and ensuring that management actions align with the interests of capital owners. The study also highlights criticisms of agency theory, including its emphasis on self-interest and its limited focus on capital owners while overlooking other stakeholders. Summarily, the review concludes that agency theory remains highly relevant in contemporary auditing and corporate governance. The study recommends strengthening governance mechanisms, promoting auditor independence, and encouraging future empirical research to explore the impact of technological developments and evolving governance systems on auditing practices.

Keywords: Academic journals, capital owners, capital users, conflict of interests, opportunist behavior.

JEL Classification: M42, M41, G34, D82, D86

INTRODUCTION

Agency theory explains the relationship between owners (principals) and managers (agents) in organizations and why auditing is important in that relationship. In many companies, especially large corporations, the capital owners or shareholders are not directly involved in the daily management of the business. Instead, they appoint capital users to run the company on their behalf. This separation of ownership and control creates a possibility that capital users may act in their own interests rather than in the interests of the capital owners (Brioschi, et al., 1989). As a result, there is a need for mechanisms that help ensure accountability and transparency. One of the most important mechanisms developed to address this issue is auditing. Historically, Cheffins, (2021) opines that the concept of agency theory gained prominence in the 20th century, particularly after the work of scholars like Michael C. Jensen and William H. Meckling in 1976, who formally explained the principal-agent

relationship in modern corporations. Their work highlighted how information asymmetry where capital users have more information about the company than capital owners can lead to conflicts of interest. Auditing emerged as an independent verification process designed to reduce these conflicts by providing assurance that financial statements are reliable and fairly presented (Boynton, & Johnson, 2005).

In the present day, agency theory continues to play a significant role in auditing practices. Auditors act as independent professionals who examine financial records and provide assurance to stakeholders that management has reported financial information honestly (Gray, et al., 2011). Turley, and Willekens, (2008) point out that the growth of global businesses, stricter regulations, and increased stakeholder expectations, auditing has become an essential tool for strengthening corporate governance and maintaining trust between principals and agents. Agency theory explains the relationship between capital owners (principals) and capital users (agents) in organizations and why auditing is important in that relationship. In many companies, especially large corporations, the capital owners or shareholders are not directly involved in the daily management of the business (Adams, 1994; Panda, & Leepsa, 2017). Instead, they appoint capital users to run the company on their behalf. This separation of ownership and control creates a possibility that capital users may act in their own interests rather than in the interests of the capital owners. As a result, there is a need for mechanisms that help ensure accountability and transparency. One of the most important mechanisms developed to address this issue is auditing.

In the present day, agency theory continues to play a significant role in auditing practices. Auditors act as independent professionals who examine financial records and provide assurance to stakeholders that management has reported financial information honestly. With the growth of global businesses, stricter regulations, and increased stakeholder expectations, auditing has become an essential tool for strengthening corporate governance and maintaining trust between principals and agents.

LITERATURE REVIEW

Agency Theory of Auditing

Watts, and Zimmerman, (1986) explain that agency theory is one of the most influential theoretical frameworks used to explain the demand for auditing in modern organizations. The theory was formally developed by Michael C. Jensen and William H. Meckling in their seminal 1976 paper “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure.” Agency theory examines the relationship between principals (such as capital owners) and agents (such as capital users) who are hired to manage the organization on behalf of the capital owners (Panda, & Leepsa, 2017). According to Lane, and Kivisto, (2008) view that agency theory, conflicts of interest can arise because agents may pursue personal goals that do not always align with the interests of the principals. In addition Bosse, and Phillips, (2016) pin point information asymmetry often exists because managers typically possess more detailed knowledge about the company’s operations than shareholders. This imbalance creates uncertainty and the risk that managers may manipulate financial information to present a more favorable picture of the firm’s performance (Einhorn, & Ziv, 2007). As a result, independent auditing emerges as a monitoring mechanism designed to reduce these agency problems.

Several scholars have emphasized that external auditing helps to minimize agency costs by enhancing the credibility and reliability of financial statements (Augustine, 2025; Celestin, 2015 Ramírez, & Tejada, 2018).. For example, Watts and Zimmerman (1986) argue that auditing plays a critical role in ensuring that capital users’ report financial information faithfully, thereby protecting the interests of capital owners and other stakeholders. By providing an independent verification of financial reports, auditors help reduce the risk of misrepresentation and increase investor confidence (Yahaya, 2025). Furthermore, empirical studies suggest that strong audit mechanisms can improve corporate governance by strengthening accountability and transparency Babalola, et al., 2025; La Rosa, Caserio, & Bernini, 2019; Yahaya, 2026).. When shareholders are assured that financial statements have been independently examined, they are more likely to trust management decisions and invest in the firm. Consequently, auditing is viewed within agency theory as an essential governance tool that aligns the interests of managers with those of owners and reduces the potential for opportunistic behavior.

In summary, the literature concludes that agency theory provides a strong justification for the existence of auditing, as it helps mitigate information asymmetry, reduce agency costs, and enhance the reliability of financial reporting in organizations.

Agency Theory: Review of Past and Present

Agency theory is a fundamental concept in economics, finance, and auditing that explains the relationship between principals (capital owners or shareholders) and agents (capital users or employees) who are delegated authority to act on behalf of the principals. The development of agency theory is largely attributed to the influential work of Michael C. Jensen and William H. Meckling in their 1976 study, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure." (Jensen, & Meckling, 2019). Their work established the foundation for understanding how conflicts of interest arise when ownership and control are separated in modern corporations. Historically, Jensen, and Meckling, (2019) origins of agency theory can be traced to earlier discussions about corporate ownership and managerial control. For instance, Adolf A. Berle and Gardiner C. Means highlighted this separation in their 1932 book *The Modern Corporation and Private Property* (Means, 2017). They argued that as companies grew larger, shareholders increasingly relied on professional managers to run the business, creating potential conflicts between owners and managers (Bo, & Driver, 2012; McColgan, 2001).

In the past, agency theory primarily focused on identifying the problems associated with these conflicts, such as information asymmetry and opportunistic behavior by managers (Bendickson, 2019; Eisenhardt, 1989). Information asymmetry occurs when managers possess more information about the firm's activities than shareholders (Steinle, Schiele, & Ernst, 2014). This imbalance may allow managers to pursue personal interests, such as excessive compensation or risk-averse strategies, rather than maximizing shareholder wealth. To address these challenges, mechanisms such as monitoring systems, incentive contracts, and independent audits were introduced to reduce agency costs (Dalton, et al., 2007; Huu Cuong, 2011).

In the present era, agency theory has expanded beyond its traditional focus on capital owners and capital users. Modern research now examines multiple agency relationships involving stakeholders such as creditors, regulators, and employees (Armour, et al., 2021; Child, & Rodrigues, 2003; Kamara, & Bendu, 2026). Dey, (2008) point out that corporate governance mechanisms including independent boards, audit committees, and regulatory frameworks are widely used to mitigate agency conflicts and promote transparency. Major corporate scandals, including the collapse of companies like Enron and WorldCom, have further emphasized the importance of effective monitoring and governance structures in controlling agency problems (Aror Tina, & Naphtali, 2025; Arnold, & De Lange, 2004; Çakalı, 2022; Elson, & Gyves, 2003; Yahaya, 2026). Today, Kamara, and Bendu, (2026) opine that agency theory remains highly relevant in fields such as corporate governance, auditing, and financial management. Contemporary scholars continue to refine the theory by integrating perspectives from behavioral economics and organizational theory (Bo, & Driver, 2012). These developments acknowledge that agents may not always act purely out of self-interest but may also be influenced by ethical considerations, social norms, and institutional pressures (Hindriks, & De Haan, 2025; Singh, et al., 2017)

Largely, the evolution of agency theory from its early foundations to modern applications demonstrates its enduring significance in explaining managerial behavior, organizational control, and the need for accountability mechanisms within corporations.

Assumptions of Agency Theory

Agency theory is based on a set of fundamental assumptions that explain the relationship between principals (capital owners) and agents (capital users) in organizations. Understanding these assumptions is critical because they underpin why monitoring mechanisms, such as auditing, are necessary. The first key assumption is that individuals are rational and self-interested. Principals and agents are assumed to act in ways that maximize their own utility. For agents, this may mean pursuing personal benefits such as higher salaries, perks, or job security

even when these goals conflict with the interests of the principals. Principals, similarly, seek to maximize returns on their investment. This inherent potential for conflict is the core of the principal-agent problem (Forbes-Pitt, 2011; Spremann, 1987; Wright, et al., 2001; Worsham, et al., 1997).

A second assumption is the presence of information asymmetry. Agents typically have more detailed and timely knowledge about the firm's operations, performance, and risk exposure than principal (McIntyre, 2025; Steinle, et al., 2014). Because principals cannot directly observe all managerial actions, they face uncertainty regarding whether agents are acting in the organization's best interests. This asymmetry creates opportunities for agents to act opportunistically, intentionally or unintentionally. The third assumption is that contracts are incomplete. It is impossible to specify every action, decision, or contingency in a formal agreement between principals and agents (Al-Najjar, 1995; Hart, & Holmström, 1987; Nilakant, & Rao, 1994). Therefore, even well-designed contracts cannot fully prevent deviations from expected behavior. This leads to the need for monitoring mechanisms, including audits, to reduce agency risk.

Fourth, agency theory assumes the existence of agency costs. These include monitoring costs (e.g., auditing fees), bonding costs (e.g., guarantees or incentives to align agent behavior), and residual costs that result from any remaining misalignment (Jensen, & Meckling, 2019; Panda, & Leepsa, 2017). Agency costs are a necessary consequence of the principal-agent relationship and provide a measurable rationale for governance mechanisms. Finally, the theory assumes that aligning incentives can mitigate conflicts. Mechanisms such as performance-based compensation, stock options, and independent audits are assumed to reduce the divergence between agent and principal interests (Ajaegbu, & Mmayie, 2025).

In summary, agency theory relies on assumptions of rational self-interest, information asymmetry, incomplete contracts, and measurable agency costs. These assumptions explain why organizations implement monitoring and control mechanisms, such as auditing, to ensure that agents act in ways that protect the interests of principals. This framework highlights the practical relevance of governance tools in mitigating conflicts and promoting accountability.

Relevance of Agency Theory in Auditing

Agency theory is highly relevant in auditing because it explains why independent audits are necessary in modern organizations. The theory, developed by Michael C. Jensen and William H. Meckling, focuses on the relationship between principals (owners or shareholders) and agents (managers) (Jensen, & Meckling, 2019). In most companies, shareholders delegate the responsibility of running the business to managers. However, because managers control daily operations, they often possess more information about the company than the owners. This situation creates information asymmetry, which can lead to conflicts of interest. The relevance of agency theory lies in its explanation of how auditing helps to reduce these conflicts. Capital users may sometimes act in their own interests rather than in the interests of capital owners. For instance, they may manipulate financial statements to hide poor performance or to secure bonuses and other personal benefits (Carasu, 2015). Independent auditing helps address this issue by verifying the accuracy and reliability of financial reports prepared by management. Through this verification process, auditors provide assurance that financial statements present a true and fair view of the company's financial position (Wolnizer, 2006).

Agency theory is also relevant because it highlights the importance of accountability and monitoring within organizations. Wolnizer, (2006) explains that auditors act as an independent third party that monitors management's financial reporting practices. This monitoring function helps to reduce the risk of fraud, errors, and financial misstatements. As a result, capital owners and other stakeholders gain greater confidence in the financial information disclosed by companies. Furthermore, agency theory supports the development of strong corporate governance systems. Effective auditing practices encourage transparency, discipline, and responsible decision-making among capital users. Researchers such as Watts and Zimmerman (1986) emphasize that auditing reduces agency costs and improves trust between management and investors.

In conclusion, agency theory is relevant to auditing because it explains the need for independent verification of financial information, helps reduce conflicts between managers and owners, strengthens corporate governance, and enhances the credibility of financial reporting in organizations.

Applications of Agency Theory

Agency theory has wide applications in accounting, auditing, corporate governance, and financial management (Bonazzi, & Islam, 2007). The theory explains how relationships between principals (capital owners or shareholders) and agents (capital users) can create conflicts of interest and how various mechanisms are used to control these conflicts.

One major application of agency theory is in auditing. Because managers control company resources and prepare financial statements, shareholders require independent auditors to verify the accuracy and fairness of financial reports. Ojo, (2009) ascertains that the External auditors act as monitoring agents who reduce information asymmetry between management and shareholders. By examining financial statements and internal controls, auditors help ensure that managers do not manipulate financial information for personal benefit. Another important application is in corporate governance. Schöndube-Pirchegger, and Schöndube, (2010) point out that agency theory helps explain the need for governance mechanisms such as boards of directors, audit committees, and performance-based compensation. These mechanisms are designed to monitor managerial actions and align the interests of managers with those of shareholders. For example, boards of directors supervise management decisions, while audit committees oversee financial reporting and the audit process to ensure transparency and accountability.

Agency theory is also applied in executive compensation and incentive systems. Corporate entities often design compensation packages that include bonuses, stock options, or profit-sharing schemes to motivate managers to act in the best interests of shareholders (Wang, 2004; Nuttall, & Hoffmire, 2026). By linking managerial rewards to organizational performance, firms attempt to reduce conflicts of interest and encourage managers to focus on long-term value creation. In addition, agency theory is used in contract design and performance evaluation. Contracts between owners and managers often specify responsibilities, reporting requirements, and performance targets (Murphy, 2000; Simpson, 2013). These contracts help minimize opportunistic behavior and establish clear accountability. Conclusively, agency theory provides a useful framework for understanding how corporate entity design monitoring systems, governance structures, and incentive mechanisms to manage conflicts between principals (capital owners) and agents (capital users). Through agency's applications in auditing, governance, compensation, and contractual arrangements, the theory helps improve transparency, accountability, and organizational efficiency (Ajaegbu, & Mmayie, 2025; Moldoveanu, & Martin, 2001).

Criticisms of Agency Theory

Al-Faryan, (2024) opines that although agency theory is widely used to explain the role of auditing and corporate governance, several scholars have criticized its assumptions and limitations. One major criticism is that the theory assumes individuals are primarily motivated by self-interest and opportunistic behavior (Panda, & Leepsa, 2017). The framework developed by Michael C. Jensen and William H. Meckling portrays managers as agents who may act against the interests of shareholders unless closely monitored. Critics argue that this assumption oversimplifies human behavior and ignores the possibility that managers may act ethically, professionally, or in the long-term interest of the organization (Ramaul, et al., 2026). According to Freeman, (2023) explains that another criticism is that agency theory focuses mainly on the Modern organizations interact with employees, customers, governments, and the wider society. Scholars such as R. Edward Freeman argue through stakeholder theory that businesses should consider the interests of all stakeholders rather than focusing solely on shareholders (Freeman, 1998). As a result, agency theory may provide a narrow perspective on corporate governance and accountability.

Additionally, critics argue that agency theory places excessive emphasis on monitoring and control mechanisms, such as auditing and performance incentives (Watts, & Zimmerman, 1983; Kamara, & Bendu, 2026). While

these mechanisms may reduce agency costs, they can also create high administrative expenses and lead to distrust between principals and agents. Overreliance on strict monitoring may discourage cooperation, creativity, and long-term strategic thinking within organizations. Furthermore, agency theory assumes that contracts between principals and agents can effectively regulate behavior (Keser, & Willinger, 2007). However, in reality, contracts are often incomplete due to uncertainty and the complexity of business environments. This means that not all possible actions or outcomes can be specified in advance, limiting the effectiveness of contractual controls (Shapiro, 2005). Finally, some scholars argue that agency theory does not adequately account for organizational culture, ethical values, and social norms that influence managerial behavior (Heath, 2009). These factors play a significant role in shaping decision-making within firms but are largely overlooked in the traditional agency framework (Shailer, 2023).

In summary, while agency theory provides useful insights into the need for auditing and monitoring, its assumptions about human behavior, narrow focus on shareholders, and limited consideration of social and organizational factors have led to significant criticisms in the literature.

Agency theory adapts to digital-era auditing: conflict of interests

Agency theory explains conflicts of interest that arise when principals (capital owners) delegate decision-making authority to agents (capital users). In traditional corporate settings, these conflicts occur because capital users may pursue personal interests that do not fully align with the goals of capital owners (Ingley, & Van Der Walt, 2004). According to Rahman, et al., (2021) point out that in the digital era, however, auditing practices and governance mechanisms are evolving, allowing agency theory to adapt through technological innovations that help reduce these conflicts and improve monitoring (Syed, 2025). One of the fundamental ways conflict of interest challenges can be minimized is through enhanced transparency using digital technologies. Radhasharan, (2026) mention that tools such as real-time data analytics and continuous auditing systems allow auditors and stakeholders to monitor financial transactions more closely and frequently Adekunle, et al., 2023; Dako, et al., 2025). Continuous auditing enables auditors to examine financial data throughout the reporting period rather than only at the end of the financial year. This ongoing monitoring reduces the opportunity for capital users to manipulate financial information or engage in opportunistic behavior (Radhasharan, 2026).

Ariciu, et al., (2026) opine that another important development is the use of blockchain technology in financial reporting and auditing. Blockchain creates immutable and transparent records of transactions, which makes it more difficult for agents to alter financial data without detection (Yahaya, 2026b). By ensuring that financial records are traceable and verifiable, blockchain strengthens trust between principals and agents and significantly lowers agency costs associated with monitoring and verification. The application of artificial intelligence (AI) and machine learning also plays a crucial role in digital-era auditing (Dawood, & ALmagtome, 2025). AI-driven systems can analyze large volumes of financial data, identify unusual patterns, and flag potential risks or irregularities for further investigation. These automated systems enhance auditors' ability to detect errors or fraud more efficiently and reduce information asymmetry between capital users and capital owners.

Furthermore, digital platforms improve corporate governance and reporting practices by enabling faster communication and better access to financial information. Stakeholders can receive timely reports and insights, allowing them to evaluate managerial performance more effectively. In conclusion, agency theory continues to remain relevant in the digital age by incorporating modern auditing technologies that strengthen monitoring, transparency, and accountability. By leveraging tools such as continuous auditing, blockchain, and artificial intelligence, companies can significantly minimize conflicts of interest and enhance trust between principals and agents in contemporary corporate environments.

Agency Theory Adapts to Digital-Era Auditing: Information Asymmetry

Information asymmetry occurs when capital users (agents) possess more information about the company's activities and financial condition than capital owners (principals). This imbalance can lead to opportunistic behavior, inaccurate financial reporting, and higher agency costs. In the context of auditing, agency theory

provides mechanisms that help reduce these information gaps and improve transparency between principals and agents. As companies increasingly adopt digital technologies, agency theory has also evolved to incorporate digital-era auditing practices that strengthen monitoring and accountability. One major way information asymmetry can be minimized is through enhanced monitoring systems supported by digital technologies. Modern auditing increasingly relies on tools such as data analytics, artificial intelligence (AI), and automated audit systems (Al-Omush, et al., 2025). These technologies enable auditors to analyze large volumes of financial and operational data in real time, making it easier to detect irregularities, unusual transactions, or potential fraud (Hasibuan, & Nasution, 2025). Continuous auditing systems allow auditors to monitor financial activities regularly rather than only during periodic audits, thereby improving transparency and reducing the chances of managerial opportunism. Continuous auditing systems allow auditors to monitor financial activities regularly rather than only during periodic audits, thereby improving transparency and reducing the chances of managerial opportunism (Hasibuan, & Nasution, 2025; Rezaee, et al., 2002).

Another important mechanism is the improvement of corporate governance and internal control systems. Digital platforms can support stronger governance by improving documentation, communication, and reporting processes within organizations (Putro, 2023). For example, integrated enterprise systems allow both management and auditors to access accurate financial information quickly, reducing the delay or manipulation of information. This helps principals gain more reliable insights into the firm's performance and financial position. Additionally, emerging technologies such as blockchain have the potential to significantly reduce information asymmetry in auditing (Han, et al., 2023; Yang, & Son, 2025). Blockchain creates immutable and transparent transaction records that cannot easily be altered, ensuring the reliability and traceability of financial information (Adewale, et al., 2022; Rane, et al., 2023). When auditors and stakeholders have access to such verified records, the risk of manipulation or hidden information is reduced.

Generally, the adaptation of agency theory to digital-era auditing highlights the importance of combining traditional monitoring mechanisms with advanced technological tools. By enhancing transparency, strengthening governance structures, and enabling continuous monitoring, digital auditing practices help minimize information asymmetry and align the interests of managers and shareholders more effectively.

Statutory Primary Responsibilities of Auditors

The statutory primary responsibilities of auditors are defined by company laws and professional auditing standards to ensure transparency, accountability, and reliability in financial reporting (Babalola, et al., 2025; Friday, et al., 2024). Auditors are appointed to independently examine the financial statements of an organization and provide assurance that these statements present a true and fair view of the company's financial position. Their responsibilities are generally guided by legislation such as the Companies Act 2020 as amended and professional standards issued by bodies like the International Auditing and Assurance Standards Board. According to Mähönen, (2022) point out that one of the key statutory responsibilities of auditors is to examine and report on the financial statements of a company. This includes reviewing the balance sheet, income statement, cash flow statement, and related notes to ensure they are prepared in accordance with applicable accounting standards. The auditor must determine whether the financial statements provide a true and fair view of the company's financial performance and position.

Another important responsibility is the verification of accounting records and internal controls. Auditors are required to obtain sufficient and appropriate audit evidence to support their opinion (Babalola, et al., 2025; Mähönen, 2022). This involves assessing the adequacy of internal control systems, testing transactions, and verifying assets and liabilities. By doing so, auditors help ensure that financial records are accurate and free from material misstatements. Auditors also have a statutory duty to detect and report fraud, errors, or irregularities that may materially affect the financial statements (Babalola, et al., 2025; Dimitrov, 2024). While auditors are not primarily responsible for preventing fraud, they must exercise professional skepticism and perform procedures that may reveal fraudulent activities or misrepresentations in the financial records.

In addition, Setiawan, et al., (2023) confirm that auditors must maintain independence and objectivity throughout the audit process. Independence ensures that the auditor's opinion is unbiased and reliable. Auditors are also required to prepare an audit report that communicates their findings to shareholders and other stakeholders (Sihombing, et al., 2026). In conclusive, the statutory responsibilities of auditors play a vital role in promoting financial integrity, enhancing corporate governance, and protecting the interests of shareholders and the public by ensuring that financial information presented by organizations is credible and trustworthy.

THEORETICAL REVIEW

Police Theory of Auditing (Past and Present)

The Police Theory of Auditing is one of the earliest theories explaining the purpose of auditing. Historically, this theory viewed auditors as watchdogs whose main responsibility was to detect and prevent fraud, errors, and misappropriation of funds (Halbouni, 2015). In the early development of auditing, especially during the 19th and early 20th centuries, businesses were smaller and owners were directly involved in management (Jiao, 1999). Because of this, owners relied on auditors mainly to investigate financial records and uncover dishonest activities by employees or managers (Rezaee, 2005).

Under the police theory, auditors were expected to act almost like financial detectives. Their primary task was to examine accounting records thoroughly, verify transactions, and ensure that no fraud had occurred (Singleton, et al., 2006). If fraud or irregularities were discovered, the auditor would report them to the capital owners or stakeholders (Arens, 2025). Therefore, the focus of auditing at that time was fraud detection rather than providing assurance on financial statements. However, Farras, et al., (2025) argue that as businesses grew larger and more complex during the industrial expansion and the rise of corporations, the expectations of auditing began to change. It became practically impossible for auditors to check every transaction in large organizations. This led to the development of modern auditing practices that emphasize sampling, internal controls, and risk assessment rather than detailed investigation of all records (Tanbour, et al., 2025)

In the present-day auditing environment, Economou, and Kyriazis, (2025) opine that the police theory is considered outdated but still relevant in a limited sense. Modern auditing standards state that the primary objective of auditors is to express an independent opinion on whether financial statements present a true and fair view of the company's financial position (Ayyoobi, 2025). Detecting fraud is no longer the sole purpose of auditing, although auditors are still required to maintain professional skepticism and consider the risk of fraud during an audit (Martua, Al Hafidz, & Angelica, 2025).

In summary, while the police theory played a significant role in the early development of auditing, modern auditing has evolved beyond it. Today, auditing focuses more on assurance, transparency, and reliability of financial reporting, though the expectation that auditors help detect fraud still partially reflects the influence of the police theory.

EMPIRICAL REVIEW

Watts and Zimmerman, (1983) examine the key ideas, perspectives, problems, and issues associated with the theory. The review explains that agency problems arise mainly from the separation of ownership and control, differences in risk preferences between owners and managers, information asymmetry, and moral hazard. These factors often lead to conflicts of interest and increased agency costs within organizations. The literature identifies several mechanisms that can help reduce these costs, including strong ownership monitoring, managerial shareholding, independent board members, and specialized board committees. Overall, the survey provides useful insights for researchers and practitioners, helping them better understand agency conflicts and identify effective governance practices for minimizing agency problems in organizations.

Adams, (1994) pinpoints that agency theory is widely used in accounting research to explain and predict why organizations appoint external auditors and how they perform their duties. It also offers a valuable framework for understanding the internal auditing function within organizations. According to this theory, internal auditing exists to help reduce conflicts of interest between management and owners by monitoring activities and ensuring accountability. Agency theory further explains the roles and responsibilities given to internal auditors by organizations and how these roles support effective oversight and control. In addition, the theory suggests that changes in an organization's structure or operations can influence the internal audit function. Overall, agency theory provides a strong foundation for further research that can support both academic studies and the development of the internal auditing profession.

Mihret, (2014) uses labor process theory (LPT) to explain how the development of capitalism created the need for internal auditing. During the twentieth century, as capitalism evolved, organizations introduced stronger structural controls over labor to manage conflicts between capital and labor. In this environment, employees, management, and boards of directors are expected to work toward achieving the desired return on capital. The paper argues that existing literature has not fully explained the role of internal auditing in this system. It proposes that internal auditing functions as a control mechanism used by management and boards to monitor and regulate work processes involved in generating value. Through assurance and advisory services, internal auditing helps ensure activities follow management's plans and improve efficiency, supporting the organization's goal of maximizing returns on invested capital.

Bendickson, et al., (2016) revisits the agency theory literature to extend historical perspectives and identify four key influences on its development: Weber and Simon's ideas, the Great Depression, cooperation theory, and the Chicago School. Understanding these historical foundations is important because they shape how agency theory is applied to explain different organizational and economic phenomena. Using archival sources and an influence-mapping approach commonly applied in management history research, the study synthesizes historical records to clarify the origins of agency theory. The findings highlight additional influences often overlooked in earlier studies, including the industrial revolution, unionization, stock exchange growth, and evolving management practices, which collectively contributed to the development of agency theory's central principles.

Safrihana, et al., (2019) review existing literature to examine factors influencing voluntary Public Accounting Firm (PAF) switching, using contract theory within the framework of agency theory proposed by Watts and Zimmerman (1986). PAF switching can occur due to regulations requiring companies to change auditors (mandatory switching) or through a company's own decision outside regulatory requirements (voluntary switching). The study finds that about 23.9% of companies change PAFs voluntarily, mainly due to management changes, financial distress, PAF size, changes in return on assets, client size, and auditor opinion. Contract theory helps explain auditing practices related to auditor reputation, professionalism, environment, firm size, and industry specialization. Larger PAFs often have stronger reputations and are viewed as more independent than smaller firms. Agency theory explains the need for auditors to monitor information asymmetry between principals and agents.

Antwi, (2021) conducts a bibliometric review of agency theory in accounting, covering both financial and management accounting research. Using literature from the Scopus database between 1999 and 2019, the analysis examines scientific output, subject categories, journals, and author keywords to identify major research trends and hotspots. The findings indicate a steady increase in publications over the period studied. Critical Perspectives on Accounting emerges as the most productive journal, while Accounting, Auditing and Accountability Journal is the most influential. Many leading institutions are based in the United Kingdom, whereas the United States leads in the number of publications and citations. The study highlights the value of bibliometric analysis for understanding research development.

Al-Faryan, (2024) revisits the separation of ownership and control by reviewing literature on agency theory, corporate governance, and corruption. Using an integrative literature review, it examines arguments and counterarguments from existing research to create a thematic inventory. It addresses a gap, as prior studies have not explored the interconnections between agency theory, governance, and corruption. Findings indicate a shift

from diffuse to concentrated ownership, contributing to corruption and deepening the agency problem. The study highlights the focus on applied research in existing literature and emphasizes practical implications of agency theory, building on Berle and Means' concept to extend its real-world relevance.

Ajaegbu, and Mmayie, (2025) explain the relationship between principals (capital owners) and agents (capital users), where conflicts often occur because of different goals, information imbalance, and varying risk preferences. These conflicts can increase monitoring costs, weaken accountability, and negatively affect organizational performance. This study uses a conceptual research approach based on secondary sources such as academic literature, regulatory frameworks, professional standards, and case studies from global and Nigerian contexts. Through thematic analysis, it examines how agency theory has evolved and highlights the important role of internal audit in reducing information asymmetry and improving transparency. Cases like Enron, WorldCom, and Cadbury Nigeria show that weak internal audit systems can worsen agency problems.

Devita, et al., (2026) examine the development of financial management concepts from the perspective of agency theory and corporate value using a literature review approach. The study shows that agency theory has progressed from the traditional principal-agent conflict to digital agency theory, which uses AI monitoring, blockchain transparency, and real-time analytics to reduce agency costs and improve firm value measured by Tobin's Q and the market-to-book ratio. Digital transformation enhances corporate value through operational efficiency, governance transparency, and intangible asset creation, though it may reduce profitability in capital-intensive industries like Indonesian mining. The study suggests hybrid governance, optimized capital structures, and further research on digital agency theory in ASEAN markets.

METHODOLOGY

The study uses conceptual research design which means a framework used in research to outline the key concepts, relationships, and variables that a study will examine, without necessarily collecting new empirical data. It focuses on theoretical analysis, literature review, and logical reasoning to explore, explain, or develop ideas. Data were extracted from secondary sources, which involving a comprehensive review of relevant and related existing literature. The literature reviewed consist academic journals, professional journals, industrial publication, government reports that provide insightful and valuable knowledge, these provide findings on agency theory. The study provides a basis for understanding the current research environment while also highlighting gaps in existing literature that the present research aims to address. This method enables a wider comprehension of the topic and supports the development of well-informed hypotheses and conclusions grounded in previous studies and established research findings. the study not only establishes a foundation for understanding the current research context but also identifies gaps in the literature that the current investigation seeks to address. This approach allows for a broader understanding of the subject matter and facilitates the development of informed hypotheses and conclusions based on established research.

RESULTS AND DISCUSSION

Summary of Agency Theory in Auditing

Agency theory is a fundamental concept used to explain the relationship between capital owners (principals) and capital users or managers (agents) in organizations. In modern corporations, capital owners typically delegate the responsibility of managing the business to professional capital users. This separation of ownership and control creates the possibility that managers may pursue personal interests rather than the interests of the owners. As a result, conflicts of interest may arise, commonly referred to as the principal-agent problem. According to the literature, agency theory provides a strong explanation for the existence and importance of auditing as a monitoring mechanism designed to reduce such conflicts and improve accountability.

The theory gained prominence through the influential work of Jensen and Meckling (1976), who explained how agency relationships lead to information asymmetry, where managers possess more information about the firm's

operations than shareholders. Because capital owners cannot directly observe all managerial actions, there is a risk that capital users may manipulate financial information or make decisions that benefit themselves rather than the company. In order to address this issue, company implement monitoring and control mechanisms such as independent auditing, incentive contracts, and governance structures. Independent and statutory auditors play a key role in verifying the accuracy and reliability of financial statements, thereby reducing information asymmetry and increasing investor confidence.

Historically, the origins of agency theory can be traced to earlier discussions about corporate ownership and managerial control, particularly in the study of (Berle & Means, 1932). They highlighted how the growth of large corporations increased the separation between capital owners and capital users, making it necessary to develop systems that ensure accountability. Over time, agency theory evolved to become one of the most influential frameworks in fields such as accounting, auditing, corporate governance, and financial management. The theory explains how monitoring systems, incentive structures, and contractual arrangements are designed to align the interests of capital users with those of capital owners and reduce agency costs.

Agency theory is based on several fundamental assumptions. First, it assumes that individuals are rational and self-interested, meaning both principals and agents seek to maximize their own benefits. Second, the theory recognizes the existence of information asymmetry, which gives agents an informational advantage over principals. Third, it assumes that contracts between principals and agents are often incomplete, making it impossible to specify every possible action or contingency. Finally, agency theory acknowledges the existence of agency costs, which include monitoring costs (such as audit fees), bonding costs, and residual losses arising from conflicts of interest. These assumptions explain reason corporate entities adopt governance mechanisms like auditing to protect the interests of shareholders.

Ramaul, et al., (2026) point out that despite its widespread application, agency theory has also faced several criticisms. Critics argue that the theory overly emphasizes self-interest and opportunistic behavior, ignoring the possibility that managers may act ethically or in the long-term interest of the organization. Others note that the theory focuses mainly on shareholders while neglecting other stakeholders such as employees, customers, and society. Additionally, heavy reliance on monitoring and control mechanisms may increase administrative costs and reduce trust within organizations.

In summary, agency theory remains highly relevant in auditing because it explains the need for independent verification of financial information, enhances corporate governance, and reduces conflicts between managers and shareholders. Although the theory has evolved and faced criticism, it continues to provide a strong foundation for understanding the role of auditing in promoting transparency, accountability, and trust in modern organizations.

CONCLUSION AND RECOMMENDATIONS

Conclusion

This study examined the concept of agency theory in auditing by reviewing its past and present perspectives. Agency theory explains the relationship between principals (capital owners or shareholders) and agents (capital users or managers) who are entrusted with the responsibility of managing corporate entities. The divorce of ownership and control in modern rations often creates conflicts of interest because managers may pursue personal goals that do not always align with the interests of shareholders. As highlighted in the literature, these conflicts are mainly driven by information asymmetry, self-interest, incomplete contracts, and differences in risk preferences between principals and agents.

The study shows that auditing plays a vital role in reducing these agency problems. Independent and statutory auditors serve as monitoring mechanisms that help ensure the credibility and reliability of financial information prepared by management. By examining financial statements and evaluating internal control systems, auditors

provide assurance that financial reports present a true and fair view of a company's financial position. This assurance helps reduce agency costs, improve accountability, and increase investor confidence.

The review also reveals that agency theory has evolved over time. Historically, auditing was influenced by the police theory of auditing, which focused mainly on fraud detection. However, as organizations became larger and more complex, auditing practices shifted toward providing assurance on financial statements, strengthening corporate governance, and enhancing transparency. Modern auditing now emphasizes risk assessment, internal control evaluation, and professional skepticism rather than checking every transaction. The adaptation of agency theory to digital-era auditing plays a significant role in minimizing conflicts of interest and information asymmetry between capital owners and capital users. The integration of advanced technologies such as continuous auditing, blockchain, artificial intelligence, and data analytics enhances transparency, strengthens monitoring mechanisms, and improves the reliability of financial information. These developments help reduce agency costs and increase trust between principals and agents.

Furthermore, the study highlights that agency theory remains highly relevant in contemporary auditing, particularly in supporting governance structures such as boards of directors, audit committees, and regulatory oversight. Despite its usefulness, the theory has also faced criticism for assuming that individuals are purely self-interested and for focusing mainly on shareholders while neglecting other stakeholders. Nevertheless, the framework continues to provide a strong theoretical basis for understanding the demand for auditing and the role of monitoring mechanisms in organizations.

Conclusively, the findings demonstrate that agency theory continues to be an important foundation for auditing practices, corporate governance, and financial accountability in modern organizations.

Recommendations

Following from the findings of this study, several recommendations are hereby proposed. Firstly, corporate entity should instill governance structures such as audit committees, independent boards, and internal audit systems to effectively monitor management activities and reduce agency conflicts. Secondly, regulatory bodies and professional bodies should enforce strict rules that ensure the independence and objectivity of auditors. Independent auditors are essential for maintaining trust in financial reporting. Thirdly, Companies should adopt transparent financial reporting practices and provide adequate disclosure of financial information to reduce information asymmetry between management and shareholders. Moreover, company should promote ethical values and professional integrity among managers and employees. Ethical behavior can reduce opportunistic actions and complement formal monitoring mechanisms. Additionally, it is therefore recommended that companies adopt modern digital auditing tools, strengthen corporate governance structures, and promote auditor independence. Also, regulators and firms should invest in technological capacity and training to ensure effective implementation of digital auditing practices.

Lastly, researchers should conduct empirical studies to examine how agency theory applies in modern environments, especially with the emergence of digital technologies, evolving governance systems, and increasing stakeholder expectations.

Policy Implications and Future Research

The findings of this study have important policy implications for regulators, corporate entities, and auditing professionals. First, regulatory bodies should strengthen corporate governance frameworks by promoting independent auditing, effective audit committees, and transparent financial reporting systems. Since agency theory highlights the risks arising from information asymmetry between capital owners and capital users, policies that enhance disclosure requirements and auditor independence can help reduce agency conflicts. Governments and professional accounting bodies should also enforce strict auditing standards and ethical guidelines to improve accountability and investor confidence. Additionally, companies should implement strong internal control systems and monitoring mechanisms to minimize agency costs and ensure that management actions align

with capital owners' interests. Encouraging the use of modern technologies in auditing, such as data analytics and digital reporting systems, can further enhance audit effectiveness and transparency.

For future research, empirical studies are needed to examine how agency theory operates in different institutional and economic environments, particularly in developing and emerging markets. Researchers may also investigate the impact of digital technologies, such as artificial intelligence and blockchain, on auditing practices and agency cost reduction. Furthermore, future studies could explore the relationship between agency theory and other governance frameworks, such as stakeholder theory, to provide a broader perspective on managerial accountability. Comparative studies across industries may also offer deeper insights into how auditing mechanisms influence corporate performance and governance outcomes.

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