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Resolving Principal Agent Conflicts: Revisiting Agency Theory Through the Lens of Internal Audit

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Abstract: Agency theory provides a critical framework for analysing the contractual relationship between principals, such as shareholders, and agents, including managers and executives. While agents are entrusted to act in the best interests of principals, conflicts frequently arise due to divergent objectives, information asymmetry, and differing risk appetites. These agency conflicts generate monitoring costs, reduce accountability, and threaten organisational performance.

This paper adopts a conceptual research design, drawing on secondary sources including academic literature, regulatory frameworks, professional standards, and case studies from global and Nigerian contexts. Through a thematic analysis, it explores the evolution of agency theory, examines mechanisms traditionally used to mitigate principal–agent conflicts, and emphasises the unique role of internal audit as a governance safeguard.

The findings highlight that internal audit reduces information asymmetry, lowers monitoring costs, and enhances transparency and accountability, thereby aligning managerial actions with shareholder interests. Case illustrations, such as Enron, WorldCom, and Cadbury Nigeria, demonstrate how weak internal audit functions exacerbate agency problems.

The paper contributes by integrating internal audit directly into the agency theory framework and concludes with recommendations for strengthening audit independence, embedding risk management practices, and adapting audit functions to emerging governance challenges.

Keywords: *Agency Theory, Principal Agent Conflict, Internal Audit, Corporate Governance, Agency Costs, Information Asymmetry, Stakeholder Confidence.*

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I. INTRODUCTION

The separation of ownership and control is a key characteristic of modern corporations. Shareholders, investors, or owners provide the capital needed to establish and grow a business but delegate the power to make operational and strategic decisions to professional managers. This arrangement is practical, especially in large and complex organisations where the dispersed ownership makes direct involvement by the owners impossible. However, this delegation introduces an inherent tension: while owners expect managers to act in their best interest, managers may pursue personal goals that do not align with those of the shareholders. This tension, known as the principal agent conflict, is central to agency theory (Jensen & Meckling, 1976).

Agency theory offers a framework for understanding the relationship between two parties: the principal, who delegates responsibility, and the agent, who performs duties on the principal's behalf. Although such contracts are designed to ensure mutual benefit, they often suffer from information asymmetry, differing interests, and variations in risk preferences (Eisenhardt, 1989). Principals typically aim

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to maximise long term value and ensure efficient use of resources, while agents may be driven by short term performance metrics, compensation packages, personal reputation, or job security. This misalignment can result in significant costs and, in extreme cases, even lead to organisational failure.

The consequences of agency problems are evident in corporate scandals worldwide. In the United States, the collapse of Enron and WorldCom in the early 2000s demonstrated how managers manipulated financial statements and concealed risks for personal gain, leaving shareholders to bear the losses. Similarly, in Nigeria, the Cadbury Nigeria financial reporting scandal in 2006 revealed that executives inflated earnings to meet market expectations and secure performance related incentives, eroding investor confidence and damaging the firm's reputation. These incidents illustrate not only the widespread nature of principal agent conflicts but also their destructive potential if left unaddressed.

To mitigate these conflicts, organisations employ various mechanisms, such as incentive contracts, independent boards of directors, and external audits. While these mechanisms are valuable, they have limitations. Poorly designed or manipulated incentive contracts can fail; boards of directors may lack sufficient independence or expertise for effective oversight; and external audits, typically conducted annually, often provide assurance only retrospectively rather than continuously (Fama & Jensen, 1983). These limitations underscore the essential role of internal audit, which serves as an independent and objective assurance function embedded within the organisation.

Internal audit has evolved over the past few decades. Initially focused on financial compliance and verification, it is now widely recognised as a core governance mechanism that contributes to risk management, internal control, and strategic advisory functions (IIA, 2020). Unlike external auditors, internal auditors provide continuous monitoring, evaluate operational effectiveness, and offer independent assurance directly to the board and the audit committee. This unique positioning allows internal audit to effectively address the agency problem by reducing information asymmetry, monitoring managerial behaviour, and assuring principals that resources are used efficiently and ethically.

Moreover, the rise of globalisation, digital transformation, and complex financial instruments has broadened the scope and urgency of agency related risks. Executives may engage in aggressive earnings management to meet short term market pressures, approve risky loans to achieve sales targets, or pursue prestige driven projects that enhance their personal reputation without delivering value to shareholders. In the public sector, politicians (acting as agents) may prioritise their personal or party agendas over the needs of the citizens (the principals) who elected them. In each instance, the misalignment of interests highlights the importance of mechanisms, such as internal audit, which promote accountability and transparency.

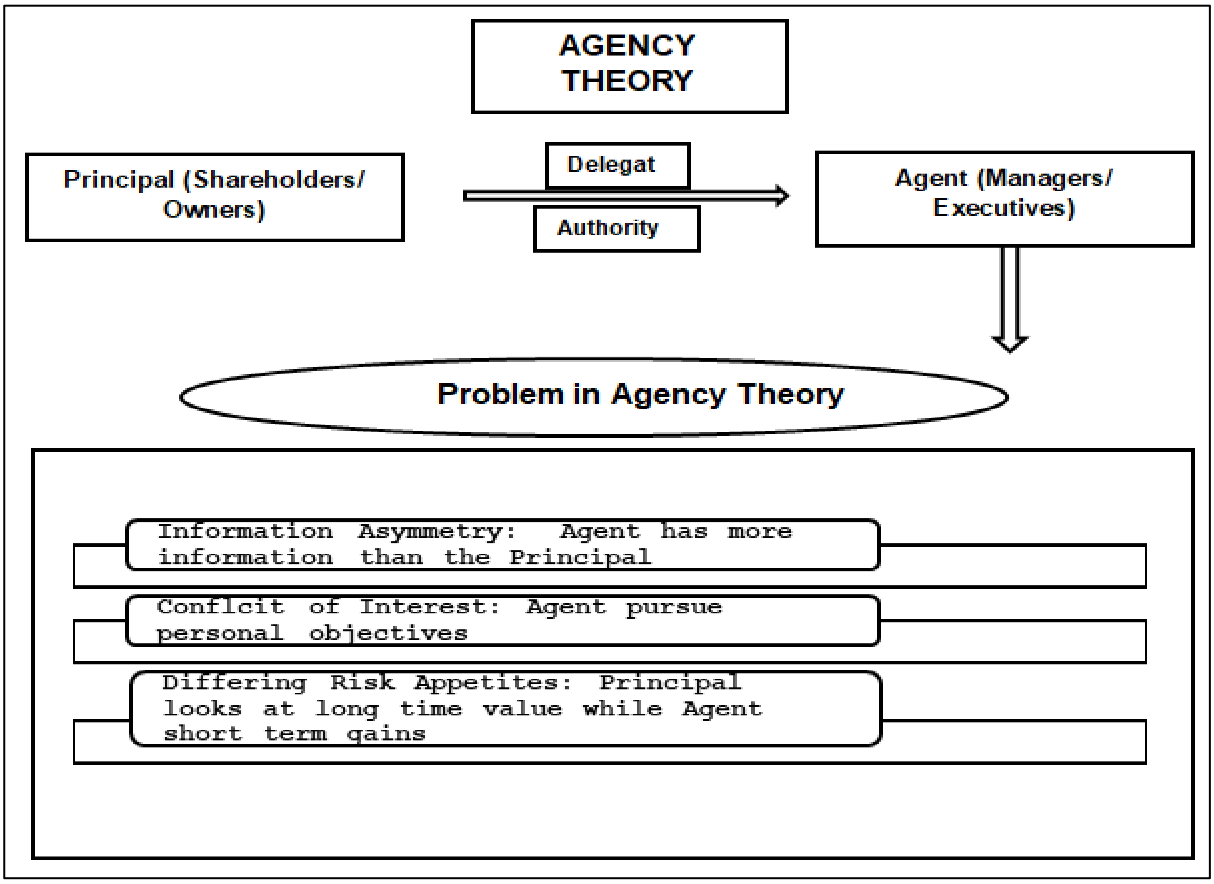

Fig 1: Problems in Agency Theory Relationship between Principals and Agents

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The study of agency theory and its application to governance is vital for both scholars and practitioners. Academically, agency theory has been one of the most influential frameworks for analysing corporate behaviour, organisational structures, and financial decision making. It has fuelled discussions in the fields of accounting, economics, and management, while also sparking critiques and calls for broader theoretical perspectives, like stewardship theory and stakeholder theory. Practically, understanding the conflict between principals and agents provides a foundation for designing effective governance mechanisms, especially in environments where investor confidence, regulatory compliance, and ethical conduct are crucial to an organisation's survival.

This article aims to contribute to the literature by revisiting agency theory through the lens of the internal audit's role in mitigating conflicts between principals and agents. Specifically, it seeks to address three guiding questions:

- How does agency theory explain the conflict between principals and agents in organisations?
- What mechanisms have traditionally been developed to mitigate such conflicts, and what are their limitations?
- How does an internal audit strengthen governance and accountability by providing assurance and reducing agency costs?

To address these inquiries, the article employs a conceptual framework firmly rooted in a thorough review of both theoretical and practical literature. The discussion is enhanced with case examples that reflect experiences from both global and Nigerian contexts, focusing particularly on the financial and corporate sectors, where agency problems are most evident.

The structure of this paper is as follows: Section 2 offers an in-depth review of the literature pertaining to agency theory, the conflicts between principals and agents, and potential mitigation strategies. Section 3 details the methodology utilised in this conceptual analysis. Section 4 presents a discussion and analysis, showcasing case studies that demonstrate the practical occurrences of agency conflicts and the significant role of internal audit. Section 5 examines the wider implications for corporate governance, while Section 6 concludes with recommendations and suggestions for future research.

II. LITERATURE REVIEW

A. Evolution and Foundations of Agency Theory

Agency theory emerged as one of the most influential frameworks in corporate governance, organisational economics, and finance. The seminal work of Jensen and Meckling (1976) is widely credited with formalising the theory by conceptualising the firm as a “nexus of contracts” between principals (owners) and agents (managers). The essence of their argument is that principals delegate decision making authority to agents under the assumption that agents will act in the best interest of principals. However, because both parties are self interested and utility maximising, this assumption is often violated.

Early discussions of agency theory can be traced to Berle and Means (1932), who highlighted the separation of ownership and control in modern corporations. They argued that as firms grow larger and ownership becomes dispersed among numerous shareholders, professional managers acquire significant discretionary power. This dispersion creates opportunities for managerial opportunism, which Jensen and Meckling later codified as the principal agent problem.

Over time, agency theory evolved into two primary streams:

- Positive Agency Theory (PAT): Seeks to explain and predict the existence of agency relationships and their consequences within organisations (e.g., conflict of interest, risk preferences).
- Principal and Agent Theory: Focuses more on the contractual design of relationships, particularly how incentive structures and monitoring mechanisms can align interests between principals and agents.

Both streams underscore the importance of governance mechanisms that minimise conflict, reduce agency costs, and enhance accountability.

B. The Principal and Agent Conflict

The central conflict between principals and agents arises because their objectives are not always aligned. Principals aim to maximise returns on their investments, ensure long term organisational sustainability, and manage risks prudently. Agents, on the other hand, may prioritise compensation, job security, prestige, or personal utility, which can diverge from the principal’s goals.

This conflict is exacerbated by information asymmetry, where agents have superior access to information about the firm’s operations compared to principals. Because principals cannot perfectly observe or verify all managerial actions, they face challenges in holding agents fully accountable.

Principal and agent conflicts manifest in several ways:

- Moral Hazard: Agents may shirk responsibilities or take hidden actions that are not in the principal’s interest. For instance, a manager might overstate revenue or conceal losses.
- Adverse Selection: Principals may be unable to distinguish between competent and incompetent agents before entering a contractual relationship, resulting in suboptimal hiring or investment decisions.
- Risk Preference Divergence: Principals may favour conservative strategies to preserve capital, while agents, whose careers are tied to performance metrics, may pursue high risk ventures for short term gains.

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These conflicts generate agency costs, which Jensen and Meckling (1976) categorised into three components:

- Monitoring Costs: Expenses borne by the principal to oversee agent performance (e.g., audits, performance reviews).
- Bonding Costs: Costs incurred by agents to assure principals of their commitment (e.g., contractual guarantees, reporting).
- Residual Loss: The cost of value lost when agent actions still diverge from principal interests despite monitoring and bonding efforts.

C. Mechanisms for Mitigating Agency Conflicts

Over the years, scholars and practitioners have identified several governance mechanisms designed to reduce agency problems. These include:

- Boards of Directors: Tasked with overseeing management on behalf of shareholders. Effective boards provide strategic oversight and act as a check on managerial discretion. However, board independence and capacity often limit their effectiveness.
- Executive Compensation Schemes: Aligning managerial incentives with shareholder interests through performance-based pay, stock options, or profit sharing. While theoretically sound, poorly designed compensation can encourage short termism or excessive risk taking.
- Market for Corporate Control: Takeovers and mergers act as external discipline mechanisms by threatening underperforming managers with replacement. Nonetheless, these mechanisms are influenced by market inefficiencies and regulatory environments.
- External Auditing: Provides independent assurance on the fairness of financial reporting. Yet, external audits are periodic and may not capture emerging risks or management manipulation in real time.
- Regulation and Legal Frameworks: Laws and regulatory bodies establish standards for transparency and accountability. However, compliance is often reactive, and enforcement can be inconsistent, especially in developing economies.

While each of these mechanisms contributes to mitigating agency problems, they share a common limitation: they are either intermittent, backward looking, or limited in scope. This reality has elevated the importance of internal auditing as a proactive and continuous assurance function.

D. Internal Audit in Agency Theory Literature

The internal audit function has gained increasing recognition as a key mechanism in addressing agency conflicts within organisations. Internal auditors provide independent and objective assurance that organisational operations are conducted efficiently, risks are managed effectively, and controls are functioning as intended.

From an agency theory perspective, the internal audit performs several roles:

- Reducing Information Asymmetry: By continuously monitoring operations and reporting directly to audit committees or boards, internal auditors give principals a clearer picture of agent activities.
- Lowering Monitoring Costs: Instead of relying solely on costly external audits, internal audit provides ongoing assurance that reduces the overall cost of supervision.
- Enhancing Accountability: By evaluating compliance with laws, regulations, and policies, internal audit constrains managerial opportunism.
- Strengthening Risk Management: Internal audit plays a proactive role in identifying risks that may threaten shareholder value and advising management on mitigation strategies.

Recent studies reinforce this perspective. For example, Alzeban (2020) found that effective internal audit functions improve financial reporting quality, thereby directly reducing agency costs. Similarly, Allegrini and Greco (2021) provided evidence from European firms that strong corporate governance combined with a robust internal audit significantly enhances organisational performance. In the public sector, Kabuye et al. (2021) demonstrated that internal audit strengthens accountability through its interaction with audit committees, a finding particularly relevant for emerging economies such as Nigeria.

E. Critiques and Alternative Perspectives

While agency theory remains a dominant framework, it is not without criticism. Some scholars argue that its assumptions of self interest and rationality are overly simplistic and fail to capture the complex motivations of agents, such as ethics, loyalty, or professional values. Alternative theories have been proposed to address these limitations, including:

- Stewardship Theory: Suggests that managers may act as stewards who prioritise organisational success over personal gain.
- Stakeholder Theory: Expands the principal and agent model by recognising multiple stakeholders (employees, customers, society) rather than just shareholders.
- Resource Dependency Theory: Emphasises the role of managers in securing and managing external resources rather than merely acting as opportunistic agents.

Despite these critiques, agency theory continues to provide a robust foundation for understanding the conflicts inherent in principal and agent relationships. Its integration with internal audit literature has enriched governance research, offering practical pathways to reduce costs, enhance transparency, and align interests.

III. METHODOLOGY

A. Research Design

This study adopts a conceptual research design, appropriate for examining theoretical frameworks and their applications to practice. The objective is not to collect or analyse primary data but rather to synthesize and extend existing knowledge on agency theory, principal agent

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conflicts, and the role of internal audit within corporate governance. Conceptual research is particularly suitable for addressing gaps in theory and offering new perspectives grounded in secondary data and case evidence (Eisenhardt, 1989).

B. Data Sources

The analysis is based on a comprehensive review of secondary data drawn from:

- Peer reviewed academic journals in the fields of accounting, finance, corporate governance, and auditing.
- Foundational texts on agency theory, particularly Jensen and Meckling (1976), Berle and Means (1932), and subsequent works that extended the theory.
- Professional standards and guidelines, including the International Professional Practices Framework (IPPF) of the Institute of Internal Auditors (IIA).
- Corporate governance codes and regulatory documents, particularly the Nigerian Code of Corporate Governance (NCCG, 2018), the Companies and Allied Matters Act (CAMA, 2020), and guidelines issued by the Central Bank of Nigeria (CBN).
- Case studies and reports of corporate scandals (e.g., Enron, WorldCom, and Cadbury Nigeria) that illustrate agency conflicts in practice.

This multi source approach ensures that the paper draws from both global and local contexts, providing balanced insights relevant to diverse stakeholders.

C. Analytical Approach

The analysis employs a thematic synthesis approach, where literature and case examples are organised around the study's guiding questions:

- How does agency theory explain principal agent conflicts?
- What governance mechanisms have been used to mitigate such conflicts?
- What unique role does internal audit play in reducing agency costs and enhancing accountability?

By clustering the literature under these themes, the paper develops an integrated conceptual framework that connects agency theory to internal audit practice in both global and Nigerian contexts.

D. Scope and Limitations

As a conceptual paper, the scope is limited to theoretical discussion and secondary evidence. The absence of primary data means the findings cannot be generalised empirically across all organisations. Additionally, case illustrations, while informative, may not capture the full diversity of contexts in which agency conflicts arise. Nevertheless, the conceptual approach provides theoretical clarity, contextual richness, and practical insights, and establishes a foundation for future empirical research in corporate governance and internal auditing.

IV. ANALYSIS AND DISCUSSION

A. Agency Theory and the Reality of Principal Agent Conflicts

At the heart of agency theory lies the recognition that principals and agents often pursue divergent objectives. Principals, such as shareholders or investors, typically focus on wealth maximisation, efficient resource allocation, and sustainable growth. Agents, however, may prioritise personal goals such as career advancement, financial rewards, prestige, or even risk avoidance. Because principals cannot perfectly observe or verify every action taken by agents, the resulting information asymmetry gives agents room to act in ways that may not align with the principal's interests.

This misalignment of objectives translates into what Jensen and Meckling (1976) termed agency costs. Principals may attempt to reduce these costs through monitoring (e.g., boards, audits), while agents may try to bond themselves to principals through contracts or reporting. Nevertheless, residual loss often remains because complete alignment is impossible.

In practice, principal and agent conflicts are not abstract phenomena; they are observable in everyday corporate decisions, such as:

- Investment strategies: Managers may reject profitable long-term investments because they do not yield immediate returns linked to their performance bonuses.
- Financing choices: Executives may prefer debt financing to boost short term earnings, ignoring long term solvency risks.
- Operational policies: Managers may underinvest in internal controls or compliance because these do not directly contribute to short term profit figures.

Without effective oversight, these conflicts can escalate into large scale governance failures with devastating financial, reputational, and social consequences.

B. Case Examples of Agency Conflicts

➢ *Global Cases*

- Enron (2001): Enron epitomises the dangers of unchecked managerial opportunism. Executives exploited complex accounting loopholes and off-balance sheet entities to inflate profits and hide debt. Shareholders were misled, employees lost their pensions, and the company collapsed. From an agency theory perspective, managers acted in their own interest, securing bonuses and stock options, while concealing the true financial health of the company. The absence of effective internal audit oversight exacerbated the problem, as the function was marginalised and unable to challenge management practices.
- WorldCom (2002): At WorldCom, management fraudulently capitalised operating expenses to overstate earnings by more than $11 billion. Like Enron, agency conflicts were evident: executives prioritised stock price manipulation and personal enrichment over shareholder interests. Weak internal audit allowed the

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misclassification to persist until whistleblowers and external scrutiny revealed the fraud.

Both cases illustrate that external audits and boards of directors, while necessary, are not sufficient. The scandals catalysed global reforms, including the Sarbanes Oxley Act of 2002 (SOX), which emphasised stronger internal controls and elevated the role of internal audit.

➢ *Nigerian Cases*

- Cadbury Nigeria Plc (2006): Cadbury's management overstated financial results over several years, misleading shareholders and damaging trust in Nigeria's capital markets. Investigations revealed weak internal controls and ineffective oversight, with the internal audit function failing to detect or report irregularities in time. This highlighted the vulnerability of emerging markets to agency conflicts, particularly where enforcement and investor protection are weaker than in developed economies.
- Oceanic Bank and Intercontinental Bank (2009): The Nigerian banking crisis exposed deep rooted agency problems. Executives engaged in insider lending, granting loans to themselves and related parties without adequate collateral. Shareholders and depositors bore the losses when the banks collapsed. Inadequate internal audit reporting lines and weak board oversight allowed such practices to continue unchecked.

These Nigerian cases show how agency conflicts are compounded by institutional weaknesses such as regulatory inefficiencies, lack of board independence, and cultural factors that may prioritise loyalty over accountability. They underscore the need for stronger internal audit practices tailored to the local governance environment.

C. The Role of Internal Audit in Mitigating Agency Conflicts

Agency theory predicts that principals will incur monitoring costs to oversee agents. Internal audit directly addresses this prediction by acting as a built-in monitoring mechanism within organisations. Its role can be understood along several dimensions:

➢ *Reducing Information Asymmetry*

Internal audit provides principals (via the board and audit committee) with independent and reliable information about the organisation's operations. By conducting regular reviews of financial statements, operational processes, and risk exposures, the internal audit reduces the knowledge gap between principals and agents. For example, in financial institutions, continuous auditing of loan approvals and credit risk assessments prevents management from concealing bad loans, thus protecting shareholder value.

➢ *Lowering Monitoring Costs*

Rather than relying solely on costly external audits or investigative processes after problems emerge, internal audit delivers ongoing assurance. This lowers overall monitoring expenses while improving efficiency. In multinational corporations, internal audit often uses data analytics and automated monitoring tools to track transactions in real time, thereby reducing the cost of traditional manual oversight.

➢ *Enhancing Accountability and Compliance*

Internal audit enforces accountability by ensuring agents comply with internal policies, industry standards, and regulatory requirements. For example, in Nigeria, the Central Bank of Nigeria (CBN) mandates that banks maintain strong internal audit functions to comply with prudential guidelines. By flagging noncompliance early, internal auditors limit management's ability to pursue personal or opportunistic strategies.

➢ *Strengthening Risk Management*

A modern internal audit function is not limited to compliance but is risk focused. By identifying emerging risks, whether operational, financial, technological, or reputational, internal audit ensures management strategies are aligned with the risk appetite defined by the board. This is critical in industries such as banking and insurance, where excessive risk taking by managers can destabilise entire systems.

➢ *Providing Independent Assurance*

The most key role of internal audit in the agency framework is its independence. Internal auditors who report functionally to the board or audit committee (rather than to management) provide unbiased insights into management performance. This reporting structure reduces the risk of management interference and strengthens principal confidence in organisational governance.

D. Challenges Facing Internal Audit in Addressing Agency Conflicts

Despite its potential, the internal audit faces several challenges that limit its effectiveness in resolving agency conflicts:

- Independence Threats: In many organisations, internal auditors report administratively to the Chief Executive Officer (CEO) or Chief Financial Officer (CFO). This creates conflicts of interest, as auditors may hesitate to challenge those to whom they report.
- Resource Constraints: Effective auditing requires adequate staffing, funding, and technology. In developing economies, internal audit departments are often underfunded, limiting their coverage and ability to apply advanced tools such as continuous auditing and data analytics.
- Management Override: Even when internal auditors detect irregularities, management may override controls or downplay audit findings, especially if boards are passive or lack independence.
- Regulatory Weaknesses: In countries like Nigeria, weak enforcement of corporate governance codes and limited shareholder activism reduce the pressure on management to implement audit recommendations.
- Cultural Barriers: In some contexts, cultural values such as loyalty, hierarchy, or fear of confrontation may discourage internal auditors from challenging senior

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management aggressively, thereby weakening the monitoring role.

E. Integrating Internal Audit into Agency Theory

The discussion above suggests that internal audit should be integrated directly into the agency theory framework as a core mechanism for resolving conflicts. Internal audit addresses the three central issues of agency theory:

- Information asymmetry: by providing principals with accurate and timely insights.
- Monitoring costs: by offering continuous assurance at a lower cost compared to external or reactive measures.
- Residual loss: by reducing, though never fully eliminating, the divergence between principal and agent interests. In this sense, internal audit is not merely a compliance or support function; it is a governance mechanism on par with boards, regulation, and external audits. Its strength lies in its continuous, embedded, and forward-looking orientation, which distinguishes it from other mechanisms that are either periodic (external audits) or limited in capacity (boards).

F. Emerging Trends and the Future Role of Internal Audit

The agency theory framework must also evolve to account for emerging challenges in corporate governance:

- Digital Transformation: As organisations digitise operations, internal auditors must develop skills in cybersecurity, data analytics, and artificial intelligence auditing. Failure to adapt could widen the information asymmetry between managers (who adopt modern technologies) and boards (who may lack technical expertise).
- ESG (Environmental, Social, and Governance) Expectations: Stakeholders now demand accountability beyond financial results. Internal audit is increasingly expected to review sustainability reporting, ethical practices, and social impact, expanding its role in agency conflict mitigation.
- Globalisation and Complex Structures: Multinational corporations face cross border risks, transfer pricing issues, and regulatory complexity. Internal audit provides assurance that management decisions in one jurisdiction do not harm global shareholder interests.
- Regulatory Reforms: In Nigeria and other emerging economies, regulators are strengthening governance codes, placing greater emphasis on internal audit independence and capacity. This trend reinforces the centrality of internal audit in governance frameworks.

V. IMPLICATIONS FOR CORPORATE GOVERNANCE

A. The Centrality of Governance in Resolving Agency Conflicts

Corporate governance is fundamentally about ensuring that organisations are directed, controlled, and held accountable in a manner that balances the interests of diverse stakeholders. Within the context of agency theory, governance serves as the platform for aligning principal and agent interests and reducing the inefficiencies that arise from divergent goals.

Agency conflicts remind us that no matter how well structured an organisation may appear, power asymmetries exist: managers typically control resources and decision-making processes, while shareholders, creditors, regulators, and other stakeholders rely on reporting and disclosures to assess performance. Without robust governance mechanisms, these asymmetries can quickly escalate into opportunistic behaviours, such as earnings manipulation, self dealing, or excessive risk taking.

Thus, corporate governance acts as a mediator between principals and agents, while internal audit functions as a tool of enforcement and assurance within the governance architecture.

B. Internal Audit as a Pillar of Governance

In modern governance frameworks, internal audit has evolved from being a purely financial control function to becoming a strategic governance mechanism. The Institute of Internal Auditors (IIA) defines internal audit as an “independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. When viewed through an agency theory lens, internal audit strengthens governance in the following ways:

- Providing Assurance to the Board: Internal audit ensures that the board and audit committee receive independent insights into whether management’s actions align with shareholder objectives.
- Safeguarding Shareholder Interests: By evaluating controls over financial reporting, risk management, and compliance, the internal audit protects investors from the consequences of managerial opportunism.
- Facilitating Transparency: Regular internal audit reviews reduce the opacity that typically benefits agents but disadvantages principals. Transparency fosters trust, accountability, and informed decision making.

In effect, internal audit becomes not just a compliance tool but a governance safeguard that protects long term organizational sustainability.

C. Corporate Governance Codes and Regulatory Expectations

Globally, governance codes (e.g., the UK Corporate Governance Code, OECD Principles of Corporate Governance, Sarbanes Oxley Act in the US) emphasise the role of audit committees, risk management, and internal control frameworks in reducing agency problems.

In Nigeria, the Financial Reporting Council’s Nigerian Code of Corporate Governance (NCCG, 2018) highlights internal audit as a key governance mechanism, requiring that:

- Every board establishes an independent internal audit function.
- Internal auditors report functionally to the audit committee, not management.

- Internal audit provides assurance on the effectiveness of risk management, control, and governance processes.

These requirements reflect a global consensus: without an internal audit, corporate governance frameworks remain incomplete. The Nigerian experience with Cadbury, Oceanic Bank, and Intercontinental Bank reinforces how weak governance, particularly ineffective internal audit, can accelerate corporate failure.

D. Practical Implications for Boards and Management

➢ *For Boards of Directors*

- Strengthen Oversight: Boards must empower internal audit by granting direct access to the audit committee, adequate resources, and authority to investigate without interference.
- Foster a Culture of Accountability: Internal audit findings should be treated seriously, with corrective actions tracked and enforced.
- Integrate Risk Management and Audit: Governance effectiveness improves when internal audit is aligned with enterprise risk management (ERM) frameworks, ensuring risk oversight is proactive rather than reactive.

➢ *For Management (Agents)*

- Embrace Internal Audit as a Partner: Rather than seeing internal audit as a policing function, managers should recognize its role in improving efficiency, reducing risks, and safeguarding reputations.
- Ensure Transparency in Reporting: Timely provision of accurate information to auditors fosters trust with shareholders and regulators.
- Avoid Management Override: Respecting audit recommendations and control structures strengthens both governance credibility and investor confidence.

➢ *For Regulators*

- Regulatory bodies such as the CBN, SEC Nigeria, and FRC should consistently enforce compliance with governance codes.
- Promote Whistleblowing and Audit Independence: Strong protections for auditors and whistleblowers help prevent suppression of critical findings.
- Encourage Capacity Building: Regulators should push for continuous professional development for internal auditors to ensure they can handle evolving risks such as cyber threats, fintech innovations, and ESG (environmental, social, governance) challenges.

E. Broader Implications for Stakeholders

Corporate governance extends beyond shareholders and managers. Other stakeholders, creditors, employees, customers, regulators, and society at large also depend on governance structures for protection. Internal audit's role in this ecosystem includes:

- Protecting Creditors: By ensuring prudent financial management and compliance with lending covenants.
- Safeguarding Employees: By ensuring fair labour practices and reducing the risks associated with the mismanagement or collapse of firms.
- Building Investor Confidence: Investors, both domestic and international, are more likely to invest where robust governance and effective internal audit are evident.
- Enhancing National Stability: Corporate collapses (e.g., banks in Nigeria's 2009 crisis) often trigger systemic risks that affect the wider economy. Strengthening internal audit indirectly supports financial system stability.

F. Evolving Role of Internal Audit in Governance

As businesses become more complex, the scope of internal audit within governance must expand beyond traditional financial controls. Key evolving trends include:

- Integration with ESG Oversight: Boards now expect internal audit to assess sustainability reporting, environmental risk, and ethical compliance.
- Technology and Data Analytics: Internal audit must leverage big data and artificial intelligence to provide predictive insights rather than backward looking assurance.
- Globalization and Cross Border Risks: For multinational corporations, internal audit is increasingly tasked with ensuring compliance across jurisdictions.
- Third Line of Defence Model: Internal audit is firmly recognised as the third line of defence in governance frameworks, after management (first line) and risk/compliance functions (second line).

These shifts highlight that internal audit is no longer optional but a governance necessity for managing agency conflicts and ensuring organisational resilience.

VI. CONCLUSION AND RECOMMENDATIONS

A. Conclusion

This paper has explored agency theory, its relevance to modern corporate governance, and the role of internal audit in mitigating principal agent conflicts. The discussion highlighted that agency relationships are characterised by information asymmetry, moral hazard, risk appetite divergence, and monitoring costs, all of which create opportunities for agents (managers) to act in their own self interest at the expense of principals (shareholders).

Historical corporate failures, such as Enron, WorldCom, Cadbury Nigeria Plc, and the Nigerian banking crisis of 2009, serve as sobering reminders that without effective monitoring and governance, the agency problem can result in financial collapse, loss of investor confidence, and systemic economic instability.

Within this context, internal audit emerges as a vital governance mechanism. Beyond its traditional assurance role, internal audit helps reduce information asymmetry, lower monitoring costs, strengthen accountability, and align risk taking with shareholder interests. Its independence, objectivity, and direct reporting to the board make it

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uniquely positioned to address the shortcomings of the principal agent relationship.

However, the effectiveness of internal audit is often constrained by independence threats, inadequate resources, management override, and weak regulatory enforcement, particularly in developing economies. Strengthening internal audit is therefore essential for enhancing corporate governance and ensuring organisational resilience in the face of agency conflicts.

The findings of this paper align with recent evidence (e.g., Allegrini & Greco, 2021; Lenz et al., 2022) that internal audit is no longer a peripheral compliance activity but a central governance mechanism. Strengthening its independence and capacity is essential for reducing agency costs and enhancing accountability in both developed and emerging markets.

B. Recommendations

➢ *For Boards of Directors*

- Empower Internal Audit: Ensure that internal audit reports functionally to the audit committee and has unrestricted access to information, resources, and personnel.
- Monitor Implementation of Audit Findings: Establish clear follow up mechanisms to ensure audit recommendations are acted upon promptly.
- Adopt Risk Based Oversight: Align audit priorities with enterprise risk management to anticipate and mitigate emerging risks.

➢ *For Management (Agents)*

- View Internal Audit as a Value Adding Partner: Encourage collaboration with auditors rather than resistance, recognizing that strong controls enhance organizational sustainability.
- Promote Transparency: Share accurate and timely information with auditors and the board to foster accountability.
- Respect Governance Structures: Avoid management override of controls and ensure compliance with both internal and external governance frameworks.

➢ *For Regulators and Policymakers*

- Enforce Governance Codes: Strengthen monitoring of compliance with the Nigerian Code of Corporate Governance and similar international standards.
- Promote Auditor Independence: Introduce stricter safeguards to protect internal auditors from undue influence by management.
- Capacity Building: Encourage training, professional certification, and continuous development for internal auditors to address evolving risks, including cybersecurity, ESG, and financial innovation.
- Whistleblowing Mechanisms: Strengthen whistleblower protections to complement internal audit efforts in exposing misconduct.

➢ *For Researchers and Academics*

- Expand Empirical Research in Developing Economies: Investigate how internal audit functions in environments with weaker regulatory enforcement.
- Explore New Frontiers of Agency Theory: Extend the theory to cover emerging governance challenges, such as digital transformation and sustainability.
- Evaluate Internal Audit's Strategic Role: Assess how internal audit contributes to long term value creation beyond compliance.

C. Final Thoughts

Agency theory continues to provide a robust framework for understanding corporate governance challenges. However, theory alone is insufficient; practical mechanisms must be embedded within organisations to bridge the gap between principals and agents. Internal audit stands out as one of the most effective mechanisms for achieving this alignment.

As corporate environments grow more complex, the role of internal audit must evolve beyond compliance to become a strategic partner in governance, risk management, and accountability. By empowering internal auditors, enforcing governance codes, and promoting transparency, organisations can reduce agency costs, enhance trust, and build resilience.

Strong internal audit functions, supported by robust governance structures, are not just tools for preventing corporate scandals they are cornerstones for sustainable value creation, investor confidence, and national economic stability.

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