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**THE PRODUCTION OF AUDIT SERVICES IN THE
NEW ZEALAND PUBLIC SECTOR: AN INVESTIGATION
INTO THE EFFECTS OF POLITICAL RISK AND
CORPORATE GOVERNANCE ON AUDIT EFFORT.**

By

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**A thesis submitted in partial fulfilment of the requirements
for the degree of**

DOCTOR OF PHILOSOPHY

in the

**School of Accountancy
College of Business**

Massey University

2004

This research is dedicated to all working mothers for their
courage and strength.



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CANDIDATE'S DECLARATION

This is to certify that the research carried out for my Doctoral Thesis entitled: "The Production of Audit Services in the New Zealand Public Sector: An Investigation into the Effects of Political Risk and Corporate Governance on Audit Effort" in the School of Accountancy, Massey University, Palmerston North Campus, New Zealand is my own work and that the thesis material has not been used in part or in whole for any other qualification.

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I verify that:

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Professor Steven Cahan

ABSTRACT

This study examines the effects of political risk and corporate governance on the production of audit services in the New Zealand public sector. It represents one of several studies that are classified as recent extensions of the research in the economics of auditing.

While the economics of auditing literature is extensive, most studies have focussed on audit fees as a means of explaining audit markets and audit services rather than audit production. Early audit production studies, however, found that audit fees are a noisy proxy for audit production as they are used by audit firms as a strategic tool for achieving a competitive position in an audit market.

This study extends the existing body of knowledge on audit production in two ways. Firstly, this study examines the determinants of audit effort for public sector corporate entities audits in New Zealand over a period of three years (1998-2000). Therefore, it follows the recommendation of previous audit production studies for research in audit production across auditors, additional industries, different auditing settings and time periods. Secondly, this study extends the existing body of knowledge in audit production by using two previously unused determinants of audit effort. It considers the effects of political risk and corporate governance on audit production/effort.

Whether political risks and political costs will affect the audit production in any setting has not been examined yet. In this study, it is expected that auditors will expend more audit effort in auditing public sector entities that have high levels of political risk.

The effect of corporate governance mechanisms (such as boards of directors) on audit effort has also received very little attention in professional standards or in the academic literature. The strength of corporate governance is expected to affect the audit risk of a current or potential audit client and to influence the auditors' risk assessments and audit production/effort.

To test the hypotheses in this study, I use a sample of 275 entity/year observations related to public sector companies in New Zealand for the years 1998-2000.

After controlling for other factors affecting audit effort, this study finds strong evidence supporting the political risk hypothesis as applied to the audit environment. This finding supports evidence from the empirical financial accounting research of political risk/cost and suggests that the implications of the political cost hypothesis are more widespread than previously believed.

This study also provides evidence that board effectiveness when measured by board size can have an impact on audit effort. However, there is no evidence of

a consistent relationship between other measures of board effectiveness – specifically, the presence of busy directors, the presence of the CEO on the board and the existence of an audit committee – and audit production.

While the evidence related to board effectiveness is mixed, this study is the first to link the corporate governance literature and the audit production research. This type of research is particularly important given that some recently enacted laws and regulatory requirements (e.g., the Sarbanes-Oxley Act in the US and new NZX listing requirements regarding audit committees in New Zealand) are based on the assumption that a more rigorous audit function is needed in the post-Enron environment.

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