

# EMPIRICAL RELATIONSHIP BETWEEN AUDIT FEES AND FINANCIAL PARAMETERS: AN INDICATOR OF CORPORATE GOVERNANCE IN INDIAN BANKS

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## Abstract

The auditors play a central role in fostering good Corporate Governance system in a corporate entity. Law vests the authority to appoint the auditors in shareholders and they take such decision at the general body meeting including their fees. Companies decide fees to be paid to auditors based on their reputation, their relationship with the company, market trends, quantum of audit work, the size of company's operations and its financial strength, etc. The paper seeks to identify an empirical relationship between the audit fees and relevant financial indicators of three categories of banks operating in India, i.e. the Public Sector Banks, New Private Sector Banks and Old Private Sector Banks. This study fills the gap in the literature by exploring an intriguing question of whether the quantum of audit fees paid by various bank groups in India is an indicator of good corporate governance or not.

**Keywords:** Auditors, Audit Fees, Corporate Governance, Financial Indicators, New Private Sector Banks, Old Private Sector Banks, Public Sector Banks

**JEL classification:** G28

## 1. INTRODUCTION

Corporate Governance has come on centre stage of the business world and is also marked by many corporate governance failures. Many of such wrongdoings

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have been found to be originated from inaction or wrongful actions on the part of board members or auditors. The Board and auditors both have been empowered to play a significant role in promoting Corporate Governance System in a corporate entity. Statutory auditors, in India, are responsible for certifying accuracy and fairness of financial accounts to investors and regulatory authorities and thereby contribute to promoting good corporate governance. Shareholders appoint these auditors at the general body meeting of the company, as per the recommendations of Audit Committee and Board of Directors. The shareholders also decide the fees to be paid by the company to auditors for discharging functions of statutory audit. The amount of audit fees is a major factor in the discharge of their duties and functions. Any disproportionate linkage of audit fees to relevant financial parameters of the company, when compared with industry practices, could be indicative of corporate governance compromise or vice versa.

## **2. AUDITOR AND CORPORATE GOVERNANCE**

A slew of legislative initiatives have been taken in various jurisdictions to facilitate auditors in the promotion of corporate governance. After the Enron scam, the US Government promulgated Sarbanes-Oxley Law (2002) aimed at regulating the audit function. This law envisaged constitution of Public Company Accounting Oversight Board (PCAOB) to oversee audit function in US listed companies. The law also incorporates provisions for monitoring of audit fees, rotation of auditors, audit committees, financial information of firms, all with the objective of overseeing the auditors' role in promoting better corporate governance. In India, Naresh Chandra Committee in 2002 made several recommendations, quite similar to the Sarbanes Law. The new Companies Act, 2013 has incorporated relevant provisions for the independence of audit which are necessary for ensuring investor confidence and aid corporate governance. These provisions are about fixing the tenure of an Auditor, and exclusion of certain interested persons for appointment as auditors, etc. (Companies Act, 2015). The Act also abstain auditors from undertaking non-audit services like investment banking, internal audit, management services, and actuarial function, etc. (Companies Act, 2015a). An external auditor is cast with a major responsibility to verify the genuine and accurate nature of financial statements and providing reasonable assurance to shareholders and other capital providers. There are many instances in various parts of the world which have revealed that an auditor could compromise his independent position owing to the incentives, direct or indirect, bestowed by the company. Thus it transpires that any disproportionate linkage of audit fees with the financial parameters of an organisation, not in line with the general industry trend, may be indicative of corporate governance compromise and vice versa.

### 3. LITERATURE REVIEW

The study bridges the gap in the literature by examining the relationship between audit fees and various financial parameters of different bank groups in India. A summary of few studies conducted in the past in other countries is mentioned below.

Voeller et al. (2013, p. 198) analysed the relationship between audit fees and governance mechanisms in Germany and pointed out that “performance-based management remuneration has a significant positive impact on audit fees”. The study further concluded a “complementary relation between audit fees and the formation of an audit committee”. Another important study by Geiger and Rama (2003), pp. 53 summarised “significant positive association between the magnitude of audit fees and the likelihood of receiving going-concern modified audit opinion”. Research on Malaysian companies by Hamid and Abdullah (2012), pp. 140 showed that “audit fees are positively and significantly related to board size, while not significantly related to other governance variables for government-linked companies”. Particularly on non-government linked companies, this study pointed that “board independence is positively and significantly associated with audit fees, while other governance variables present significant negative relationship with audit fees”. Another study by Hassan et al. (2014) on Pakistani companies brought out that corporate governance; firm size and leverage have a positive relationship with audit fees whereas audit firm size is insignificantly related to audit fees.

### 4. AUDIT FEES

Auditors receive audit fees for providing audit related services to the corporate entities. They have also been collecting fees for non-audit services if so provided by them though some checks and balances for performing this work are prescribed. Such regulation emanated mainly from the lessons learnt in many well-known cases of corporate governance failures like Enron and Satyam where reputed names of audit firms were discovered to have received disproportionate sums as fees not only in the name of audit services but also for a host of other nondescript services. The client hires the auditor and pays the fees presuming that the auditor will conduct the audit in an independent fashion by adhering to the professions of independence (Salehi, 2009). Independence of auditor function is critical. However, situations may arise that instead create a significant threat to auditor's independence, integrity and objectivity (Ahmad et al., 2006).

Fees of auditors often depend on their reputation, their relationship with the company, market trends, the quantum of audit work, and the size of company's operations and its financial strength, etc. The shareholders approve their fees based on recommendations by the Audit Committee of Directors/ Board. Unlike the USA, there is no overseeing authority in India to keep a watch on audit fees and expenses paid by the company. Over and above the audit fees, the auditors are reimbursed lucrative out of pocket expenditures in the form of travel charges, hotel

expenses, food and conveyance, etc. The quantum of fees paid to auditors has been an issue attracting critical attention after the emergence of many financial frauds involving inaction or palpable compromise by auditors in areas requiring serious attention by them. The audit fees have to bear some rational relationship to the size of financial transactions that are required to be verified by the auditors. The relevant parameters identified for this study are select balance sheet numbers viz. asset size, total expenses, and total income as they determine to a large extent the volume of audit work and the resultant audit fees. It is quite possible that some other factors also reckon in fixation of audit fees, but the parameters as stated above are considered most relevant for the purpose of this study.

## 5. OBJECTIVE OF STUDY

To examine the relationship between audit fees and financial parameters like asset size, total income and total expenses in various bank groups in India, viz. Public Sector Banks including State Bank of India, New Private Sector Banks and Old Private Sector Banks and analyse it from the point of view of corporate governance.

## 6. DATA AND METHODOLOGY

The sample of Indian banks selected for the study includes Public Sector Banks (including State Bank of India), New Private Sector Banks and Old Private Sector Banks. Though the classification of new Private Sector Banks and old Private Sector Banks does not officially exist, the same has been followed as both these segments have vast differences regarding the size of operations and financial parameters. The financial parameters of banks have been drawn from statements on RBI website for the year ending March 2015. Method of Ordinary Least Squares (OLS) is applied on this annual dataset to draw results for the analysis. The results are also verified regarding their residual diagnostics so as to formulate a model of best fit. E- Views Software Version 7.0 is used for applying and testing the financial econometric techniques.

## 7. MODEL SPECIFICATION

To examine the relationship between the dependent variable (Y) and the independent variables (X1- X3), we have estimated the following linear regression model:

$$Y_{it} = \alpha + \beta_1 X1_{it} + \beta_2 X2_{it} + \beta_3 X3_{it} + \mu_{it} \quad (1)$$

Where,

$Y_{it}$ = Dependent Variable: Auditors' fees and expenses

$X1_{it}$ = Independent Variable: Total expenditure

$X2_{it}$  = Independent Variable: Total income

$X3_{it}$  = Independent Variable: Total assets

$\mu_{it}$  = Stochastic disturbance term

$i$  = Categories of Indian Banks taken for the study viz. Public Sector Banks, New Private Sector Banks and Old Private Sector Banks

$t$  = Time period, Year 2015

**Hypothesis Testing**

H1= Total expenditure does not have a significant effect on Auditors’ fees and expenses of Bank  $i$  at time  $t$

H2= Total income does not have a significant effect on Auditors’ fees and expenses of Bank  $i$  at time  $t$

H3= Total assets do not have a significant effect on Auditors' fees and expenses of Bank  $i$  at time  $t$

**8. EMPIRICAL RESULTS AND DISCUSSIONS**

As a part of preliminary investigations, correlation matrix of the selected variables in the study is shown in Table 1

**Table 1:** Correlation Matrix of the selected variables in the study for the year 2015 (Public Sector Banks)

|    | Y        | X1       | X2       | X3       |
|----|----------|----------|----------|----------|
| Y  | 1.000000 | 0.971811 | 0.973023 | 0.972151 |
| X1 | 0.971811 | 1.000000 | 0.999201 | 0.994164 |
| X2 | 0.973023 | 0.999201 | 1.000000 | 0.995030 |
| X3 | 0.972151 | 0.994164 | 0.995030 | 1.000000 |

**Source:** Authors’ own compilation based on computations done on E-Views (Version 7.0)

From the above table, it is evident that there is a strong positive correlation between the variables across all the 21 Banks in this category.

**Table 2:** Correlation Matrix of the selected variables in the study for the year 2015 (New Private Sector Banks)

|    | Y        | X1       | X2       | X3       |
|----|----------|----------|----------|----------|
| Y  | 1.000000 | 0.643785 | 0.658523 | 0.665028 |
| X1 | 0.643785 | 1.000000 | 0.999686 | 0.998694 |
| X2 | 0.658523 | 0.999686 | 1.000000 | 0.999498 |
| X3 | 0.665028 | 0.998694 | 0.999498 | 1.000000 |

**Source:** Author’s own compilation based on computations done on E-Views (Version 7.0)

The above table affirms that there is a strong positive correlation between the variables across all the 7 new private sector banks in the sample.

**Table 3: Correlation Matrix of the selected variables in the study for the year 2015 (Old Private Sector Banks)**

|    | Y        | X1       | X2       | X3       |
|----|----------|----------|----------|----------|
| Y  | 1.000000 | 0.627312 | 0.671729 | 0.681025 |
| X1 | 0.627312 | 1.000000 | 0.996439 | 0.991860 |
| X2 | 0.671729 | 0.996439 | 1.000000 | 0.995658 |
| X3 | 0.681025 | 0.991860 | 0.995658 | 1.000000 |

**Source:** Author’s own compilation based on computations done on E-Views (Version 7.0)

From the above table, it is obvious that there is a strong positive correlation between the variables across all the 13 old private sector banks in the sample.

The strong correlation between all variables, in the case of all the bank groups is a clear indication of the inference that audit fees in banks has firm linkage to financial parameters like asset size, total income and total expenditure. This is also evident as these factors represent the quantum of audit work involved based on which audit fees is decided. The higher the quantum of these financial parameters, higher will be the fees of the audit function.

To understand the data in a better way, the descriptive statistics of all the selected variables for all the selected banks used in the study is presented below:

**Table 4: Descriptive Statistics of the selected variables in the study for the year 2015 (Public Sector Banks)**

|              | Y        | X1       | X2       | X3       |
|--------------|----------|----------|----------|----------|
| Mean         | 341.0321 | 270690.3 | 331864.4 | 3865881. |
| Median       | 224.3760 | 181361.4 | 220827.8 | 2459169. |
| Maximum      | 1789.993 | 1360595. | 1749730. | 20480798 |
| Minimum      | 21.86100 | 82418.50 | 90173.00 | 977534.0 |
| Std. Dev.    | 365.3859 | 271499.5 | 350687.1 | 4200376. |
| Skewness     | 3.119778 | 3.253303 | 3.328560 | 3.131080 |
| Kurtosis     | 13.06420 | 13.69439 | 14.08245 | 12.93039 |
| Sum          | 7161.675 | 5684495. | 6969153. | 81183492 |
| Observations | 21       | 21       | 21       | 21       |

**Source:** Author’s own compilation based on computations done on E-Views (Version 7.0)

**Table 5: Descriptive Statistics of the selected variables in the study for the year 2015 (New Private Sector Banks)**

|              | Y        | X1       | X2       | X3       |
|--------------|----------|----------|----------|----------|
| Mean         | 20.00400 | 202136.3 | 288039.9 | 2951422. |
| Median       | 14.50800 | 103688.8 | 136184.6 | 1361704. |
| Maximum      | 66.79300 | 415473.6 | 612672.7 | 6461293. |
| Minimum      | 6.317000 | 13106.91 | 15881.38 | 161323.1 |
| Std. Dev.    | 20.96645 | 166606.4 | 246405.6 | 2619617. |
| Skewness     | 1.902991 | 0.310566 | 0.335407 | 0.347538 |
| Kurtosis     | 4.883720 | 1.371636 | 1.371971 | 1.351687 |
| Sum          | 140.0280 | 1414954. | 2016279. | 20659955 |
| Observations | 7        | 7        | 7        | 7        |

**Source:** Author’s own compilation based on computations done on E-Views (Version 7.0)

**Table 6:** Descriptive Statistics of the selected variables in the study for the year 2015 (Old Private Sector Banks)

|              | Y        | X1       | X2       | X3       |
|--------------|----------|----------|----------|----------|
| Mean         | 27.14977 | 34432.80 | 41703.96 | 411347.8 |
| Median       | 11.66300 | 25200.47 | 31274.14 | 297494.5 |
| Maximum      | 136.7100 | 66699.92 | 82977.74 | 828504.8 |
| Minimum      | 3.790000 | 4513.442 | 5567.569 | 59779.26 |
| Std. Dev.    | 37.19618 | 20039.13 | 25421.45 | 250684.3 |
| Skewness     | 2.251933 | 0.149353 | 0.214599 | 0.274092 |
| Kurtosis     | 6.992632 | 1.614493 | 1.694980 | 1.753121 |
| Sum          | 352.9470 | 447626.4 | 542151.5 | 5347521. |
| Observations | 13       | 13       | 13       | 13       |

**Source:** Author’s own compilation based on computations done on E-Views (Version 7.0)

The estimation results of equation 1 about the Regression Model for all the selected banks are presented in Table 7 below:

**Table 7:** Regression Analysis of relationship between Auditors’ Fees and Expenses and other financial parameters

| <b>Dependent Variable: Auditors’ Fees and Expenses</b> |                                     |                                     |                                     |
|--|-------------------------------------|-------------------------------------|-------------------------------------|
| <b>Method: Ordinary Least Square (OLS)</b>             |                                     |                                     |                                     |
|  | <b>Public Sector Banks</b>          | <b>New Private Sector Banks</b>     | <b>Old Private Sector Banks</b>     |
| <b>Independent Variables</b>                           | <b>Coefficients (t- statistics)</b> | <b>Coefficients (t- statistics)</b> | <b>Coefficients (t- statistics)</b> |
| Intercept  | 12.45218<br>(0.328919)              | 24.48858<br>(1.945260)              | 4.062002<br>(0.284763)              |
| X1 (Total Expenditure)                                 | -0.000342<br>(-0.184395)            | -0.003622<br>(-2.212498)            | -0.010890<br>(-2.768433)**          |
| X2 (Total Income)                                      | 0.000866<br>(0.556656)              | 0.003120<br>(1.748104)              | 0.007732<br>(1.822954)              |
| X3 (Total Assets)                                      | 0.0000346<br>(0.719426)             | -0.0000579<br>(-0.703137)           | 0.000184<br>(0.645360)              |
| Adjusted R-squared                                     | 0.939366                            | 0.604950                            | 0.617215                            |
| F-statistic  | 104.2831*                           | 4.062655                            | 7.449727*                           |
| Corresponding p-value                                  | 0.000000                            | 0.139863                            | 0.008233                            |

**Notes:** 1. \*, \*\* and \*\*\* denote the significance at one, five and ten percent level, respectively.

2. Figures in parentheses are t-statistics.

Table 7 shows the estimation results of the OLS method applied on the Linear Regression Model as mentioned in equation 1 for all sample banks. The summary of analysis is as under:

***For Public Sector Banks***

1. The Adjusted  $R^2$  i.e. Coefficient of Determination is 0.939366 which implies that all variables largely account for variations in the dependent variable, audit fees.
2. None of the probability values of independent variables are significant at 0.05 significance level. So, we can say that none of these variables are individually significant to explain the variation in the audit fees and expenses.
3. The corresponding probability value of F- statistic is 0.000000. Since the p-value is less than 0.05, it means that all the independent variables are jointly influencing the variation in audit fees and expenses in Public Sector Banks.

***For New Private Sector Banks***

1. The Adjusted  $R^2$  i.e. Coefficient of Determination is 0.604950 which implies that all variables largely account for variations in the dependent variable, audit fees.
2. None of the probability values of independent variables are significant at 0.05 significance level. So, we can say that none of these variables are individually significant to explain the variation in the audit fees and expenses.
3. The corresponding probability value of F- statistic is 0.139863. Since the p-value is more than 0.05, it means that all the independent variables are not jointly influencing the variation in audit fees and expenses in new private sector banks. It implies that there are other factors also which are affecting the determination of audit fees in this category of banks.

***For Old Private Sector Banks***

1. The Adjusted  $R^2$  i.e. Coefficient of Determination is 0.617215 which implies that all variables largely account for variations in the dependent variable, audit fees.
2. The probability value of total expenditure is significant at 0.05 significance level. So, we can say that the total expenditure is significant to explain the variation in the audit fees and expenses.
3. The corresponding probability value of F- statistic is 0.008233. Since the p-value is less than 0.05, it means that all the independent variables are jointly influencing the variation in audit fees in old private sector banks. Thus, it can be inferred that any rise in expenditure value has a tendency to raise the audit fees in this category of banks.

**Percentage Relationship of audit fees with other financial parameters**

The above regression results are also substantiated by the following analytical presentation reflecting the percentage of audit fees in the sample banks in relation to financial parameters in the following tables:



**Table 8:** Percentage of audit fees with other financial parameters of Public Sector Banks for the year 2015

| S. No. | Bank                      | Percentage of audit fees to |              |              |
|--------|---------------------------|-----------------------------|--------------|--------------|
|        |                           | Total expenditure           | Total income | Total assets |
| 1.     | Allahabad Bank            | 0.109                       | 0.087        | 0.008        |
| 2.     | Andhra Bank               | 0.139                       | 0.114        | 0.011        |
| 3.     | Bank of Baroda            | 0.138                       | 0.109        | 0.007        |
| 4.     | Bank of India             | 0.128                       | 0.108        | 0.008        |
| 5.     | Bank of Maharashtra       | 0.166                       | 0.138        | 0.013        |
| 6.     | Canara Bank               | 0.124                       | 0.107        | 0.009        |
| 7.     | Central Bank of India     | 0.091                       | 0.079        | 0.007        |
| 8.     | Corporation Bank          | 0.122                       | 0.105        | 0.010        |
| 9.     | Dena Bank                 | 0.123                       | 0.108        | 0.010        |
| 10.    | IDBI Bank Limited         | 0.008                       | 0.007        | 0.001        |
| 11.    | Indian Bank               | 0.170                       | 0.140        | 0.012        |
| 12.    | Indian Overseas Bank      | 0.186                       | 0.162        | 0.015        |
| 13.    | Oriental Bank of Commerce | 0.113                       | 0.093        | 0.009        |
| 14.    | Punjab and Sind Bank      | 0.110                       | 0.100        | 0.009        |
| 15.    | Punjab National Bank      | 0.133                       | 0.103        | 0.009        |
| 16.    | Syndicate Bank            | 0.132                       | 0.110        | 0.009        |
| 17.    | UCO Bank                  | 0.182                       | 0.140        | 0.012        |
| 18.    | Union Bank of India       | 0.115                       | 0.096        | 0.009        |
| 19.    | United Bank of India      | 0.154                       | 0.122        | 0.012        |
| 20.    | Vijaya Bank               | 0.091                       | 0.082        | 0.008        |
| 21.    | State Bank of India       | 0.132                       | 0.102        | 0.009        |
|        | <b>Average</b>            | 0.127                       | 0.105        | 0.009        |
|        | <b>Standard Deviation</b> | 0.038                       | 0.031        | 0.003        |

**Source:** Authors' own compilation based on data of Nationalized Banks including State Bank of India, retrieved from RBI website (RBI, 2015)

**Table 9:** Percentage of audit fees with other financial parameters of New Private Sector Banks for the year 2015

| S. No. | Bank                      | Percentage of audit fees to |              |              |
|--------|---------------------------|-----------------------------|--------------|--------------|
|        |                           | Total expenditure           | Total income | Total assets |
| 1.     | Axis Bank                 | 0.005                       | 0.004        | 0.000        |
| 2.     | DCB Bank                  | 0.048                       | 0.040        | 0.004        |
| 3.     | HDFC Bank                 | 0.004                       | 0.003        | 0.000        |
| 4.     | ICICI Bank                | 0.016                       | 0.011        | 0.001        |
| 5.     | IndusInd Bank             | 0.015                       | 0.011        | 0.001        |
| 6.     | Kotak Mahindra Bank       | 0.018                       | 0.013        | 0.001        |
| 7.     | Yes Bank                  | 0.007                       | 0.006        | 0.001        |
|        | <b>Average</b>            | 0.016                       | 0.012        | 0.001        |
|        | <b>Standard Deviation</b> | 0.014                       | 0.012        | 0.001        |

**Source:** Authors' own compilation based on data of New Private Sector Banks, retrieved from RBI website (RBI, 2015)

**Table 10:** *Percentage of audit fees with other financial parameters of Old Private Sector Banks for the year March 2015*

| S. No. | Bank                      | Percentage of audit fees to |              |              |
|--------|---------------------------|-----------------------------|--------------|--------------|
|        |                           | Total expenditure           | Total income | Total assets |
| 1.     | Catholic Syrian Bank      | 0.108                       | 0.104        | 0.011        |
| 2.     | City Union Bank           | 0.049                       | 0.038        | 0.004        |
| 3.     | Dhanlaxmi Bank            | 0.045                       | 0.044        | 0.004        |
| 4.     | Federal Bank              | 0.104                       | 0.083        | 0.008        |
| 5.     | ING Vysya Bank            | 0.013                       | 0.011        | 0.001        |
| 6.     | Jammu & Kashmir Bank      | 0.235                       | 0.179        | 0.018        |
| 7.     | Karnataka Bank            | 0.049                       | 0.042        | 0.004        |
| 8.     | Karur Vysya Bank          | 0.038                       | 0.032        | 0.004        |
| 9.     | Lakshmi Vilas Bank        | 0.052                       | 0.044        | 0.004        |
| 10.    | Nainital Bank             | 0.084                       | 0.068        | 0.006        |
| 11.    | South Indian Bank         | 0.067                       | 0.057        | 0.006        |
| 12.    | Tamilnad Mercantile Bank  | 0.038                       | 0.031        | 0.003        |
| 13.    | The Ratnakar Bank         | 0.033                       | 0.028        | 0.002        |
|        | <b>Average</b>            | 0.070                       | 0.059        | 0.006        |
|        | <b>Standard Deviation</b> | 0.057                       | 0.044        | 0.004        |

**Source:** Authors' own compilation based on data of Old Private Sector Banks, retrieved from RBI website (RBI, 2015)

It emerges from above that the audit fees paid by various bank groups as a proportion of total expenditure; total income and total assets are quite similar in all the banks. There is no significant variation in any ratio. It signifies good corporate governance resulting from the absence of any disproportionate audit fees in the banks.

## 9. CONCLUSION

The audit fee is an important indicator of independence of auditors, and any excessive payment of audit fees is a possible sign of complicity. Such was the case that emanated from many well-known cases in India like Enron, Satyam, etc. As per a recently published article at Live Mint.com, “in the Satyam fraud case, the fees paid to PwC tripled during the period during which the fraud was perpetrated. Moreover, the auditors of Satyam were paid almost twice as much as what was paid to the auditors of Satyam’s peer companies”. The study of different bank groups in India viz. Public Sector Banks, New Private Sector Banks and Old Private Sector Banks has revealed an active corporate governance scenario on this account though there are variables other than those examined in the study, which may affect the quantum of audit fees. It reflects an active management attitude towards a pragmatic corporate governance signalling independence of audit

function. Both correlation and regression analysis has further substantiated the premise that audit fees has rational relation with other financial parameters, signifying a positive audit stance towards good corporate governance.

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