Paper Type: Original Article

Does Audit Quality Moderate the Relationship Between Audit Fee Stickiness and Financial Reporting Quality?

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Citation:

Abstract

Financial statements provide much information a company's investors and creditors need. Because of this reliance on financial statements, the role of auditors is so important. The audit of Ameri's financial statements is necessary because audited financial statements can provide investors and creditors with the assurance that they are receiving valid and reliable information. According to the mentioned cases, this research aims to investigate the effect of audit quality on the relationship between Audit Fee Stickiness (AFS) and Financial Reporting Quality (FRQ). The method of this applied research is the statistical population of companies listed on the Tehran Stock Exchange from 2017 to 2021. The statistical sample also includes 114 companies selected by systematic exclusion. The software used was Excel and Eviews. Finally, the results indicated the rejection of both hypotheses of this research. Based on the first hypothesis, there is no significant relationship between AFS and FRQ. Based on the second hypothesis, audit quality does not affect the relationship between AFS and FRQ.

Keywords: Financial reporting quality, Audit fee, Audit fee stickiness, Audit quality.

1 | Introduction

Financial reports are one of the most essential products of the accounting system, one of the main objectives of which is to provide the necessary information to assess the performance and profitability of an economic entity [1]. The primary purpose of financial reporting is to express the economic effects of financial events and transactions on the financial position and performance of the entity to assist actual and potential users in making financial decisions about the entity.

However, various factors can influence this report [2]. The background of research on the appropriateness of audit fees and their impact on the quality of financial reporting shows mixed results. A detailed analysis of

audit fees can determine the reason for these different results, although according to theoretical foundations and previous research, it is assumed that auditor's price low-quality accounting information with higher audit fees. That is, they charge higher fees to companies with low accounting quality. Therefore, the higher the residual in the fee model, the lower the quality of the hiring firm [3].

According to Chen et al. [4], the structure of public companies is very diverse. Therefore, the quality of monitoring the activities of managers varies from company to company. With the increasing competition in the profession, audit firms have realized the need to provide better quality services at a lower price to the market.

To compete on a basis other than quality and service differentiation, audit firms seek to optimize their fees and the best bids for them. This way, they can maximize their revenues and avoid losing business in a competitive environment. To this end, knowledge of the effects of AFS can be beneficial. Independent auditors are under increasing pressure to control and reduce audit fees. To facilitate this issue, the factors affecting audit fees can be divided into two general groups. The first group consists of the characteristics of the audit firm, and the second group consists of the characteristics of the employer or the company that hires the audit firm [5].

In this context, the most critical aspect of audit quality control and management can also be seen as the stickiness of the audit fee. AFS is a necessary condition for ensuring audit quality. Although the higher stickiness of the audit fee does not always indicate the cost of a higher quality audit, in addition to the appropriate audit quality, audit firms consider a standard fee for performing their work, which is naturally higher than these fees [6].

Investigating the factors that affect AFS is essential because of its impact on financial reporting. Low audit quality reduces the confidence of financial statement users, which leads to the failure to achieve the audit objectives and also reduces the credibility of the audit process on a large scale, preventing the optimal allocation of capital in the stock market and increasing the cost of capital and financing. Although the audit fee does not always reflect the cost of a higher quality audit, audit firms consider a standard fee for their work in addition to the right quality, which is naturally higher than these fees [7].

Therefore, this research questions whether there is a significant relationship between the stickiness of audit fees and the quality of financial reporting. Does audit quality influence this relationship?

2 | Theoretical Literature

2.1 | The Concept of Financial Reporting

Attracting stagnant savings and transferring them to production units, and creating opportunities for the public to participate in the development of industries and to share in the earnings of factories are considered to be the main objectives of the stock exchange of any country so that the said organization can act as a lever in controlling the inflation rate and increasing the investment rate plays a decisive role in society. Therefore, to achieve this goal, the said organization should be able to gain the confidence of investors to invest in the capital market.

This also depends on the existence of a clear and transparent capital market. The transparency of the capital market depends on the correct and timely financial reporting of the companies listed on the stock exchange. Such information is necessary for users to promptly recognize investment opportunities and risks [8]. Financial reports are the end product of the accounting system.

Because of their importance to users, especially shareholders, they have grown and have always been the focus of various accounting associations. Before establishing the Securities and Exchange Commission (SEC), most institutions and business entities voluntarily prepared and published their financial reports. This voluntary disclosure can be seen as gaining public confidence, introducing the institution to the public and investors, and ultimately attracting capital and investors. Still, after the crisis of 1929 and the establishment of the SEC

in 1933, financial reporting became a legal requirement for revenue institutions. Regarding financial reporting requirements, it is also important to note that in addition to the requirements of the SEC, there are other requirements for financial reporting, which are known as market requirements and include capital market requirements and labor market requirements [9].

2.2 | Financial Reporting Quality

Companies decide on the quality level of their financial reporting based on the cost-benefit of disclosing quality information. It may be assumed that companies choose to provide information of the highest possible quality regardless of the costs of disclosing such information. But in reality, this fact does not happen because information disclosure imposes costs such as direct (non-proprietary) costs, legal and judicial costs, and proprietary costs, which are considered indirect costs of disclosure, to the company.

Given these costs, companies choose an internal strategy for the quality of their financial reporting. Companies disclose information about their performance, results, and financial position in financial statements. Disclosure refers to the communication and presentation of economic information, both financial and non-financial, quantitative or other forms of information relating to the financial position and performance of the company. Disclosure is mandatory when required by regulations and laws and voluntary when not required by specific rules.

Quality financial reporting and disclosure is a necessity. The quality of financial reporting enables investors and other users of financial statements to predict the company's future cash flows better. Given that accounting and economics influence each other, the level of quality of financial reporting has economic implications. The usefulness of financial statements or other financial reports is influenced by the quality of financial reporting, where the stability of the process and the accuracy of the information are critical aspects of quality. The quality of financial reporting is the criteria that separates valuable and useful information from other information and promotes the usefulness of financial information. Legislators and investors agree on the need for high-quality financial reporting. This is because the general belief is that the quality of financial reporting directly impacts capital markets [10].

2.3 | Audit Fees

Accountability to the public is a prerequisite for implementing the democratic process. Still, it is one of the main accountability tools in economic activities, auditing, and accounting. Auditing and accountability are part of the monitoring dimension of any system. They are widely used from the highest level of the country's administration to the smallest business unit because every system needs monitoring and feedback to be sustainable. Still, despite the scope, audit work is not based on a scientific model due to the need to determine the fee for this service in our country. Considering the unit's characteristics, It is impossible to say on a logical and defensible basis at what cost this work can be done. The audit fee reflects the economic cost of efficient auditors.

From the auditor's perspective, the auditor seeks to minimize total costs by balancing the cost of its resources (the cost of performing more audit work) and the future losses caused by legal liability. Doing more audit work reduces the probability of liability losses, and the auditor provides a volume of audit work that minimizes total costs [11]. Audit fees reflect audit quality for external users of financial statements. Independent audit is an integral part of the financial reporting system. The independent auditor's report can indicate the fulfillment of the employer's management's obligations to investors, and the audit fee can be seen as a cost paid by the employer to the auditor in exchange for fulfilling these obligations. The audit fee depends on several factors, the importance of which varies from country to country.

One of the main controversies in the audit profession is determining the lowest audit fee rate and the break-even rate of some audit firms. Still, the view of audit as a homogeneous product and its non-competitive pricing threatens the independence and quality of audit services. It should also be noted that independent

auditing is the basis for economic transparency, people's trust in the capital market, and government responsiveness to the people. Therefore, it should not be treated like ordinary goods and services [12].

2.4 | Audit Fee Stickiness

Research results in recent years indicate that costs increase when the level of activity increases more than they decrease when the level of activity decreases. This behaviour is known as cost stickiness.

It is expected that the audit cost will be correctly estimated according to the changes in the factors affecting the cost (either in the direction of increasing the cost or decreasing the cost). Still, the research results of researchers in recent years indicate that the amount of increase in the audit cost when expecting an increase in the audit fee is greater than the amount of decrease in the audit fee when expecting a reduction in the audit fee. This behaviour is known as audit cost stickiness. As for the stickiness of the audit fee, it puts forward two reasons, as follows:

I. The auditor determines the cost of the audit according to the amount of procedures and audit risk, and the amount of procedures and audit risk is determined during the audit, so the auditor, before planning the implementation of the work and determining the cost of the audit, it does not consider the issue. In cases where the amount of procedures and audit risk is significantly reduced due to the conclusion of the contract before the start of the work, the audit fee is not reduced in the year under review, and these changes are recognized with a delay in the next financial year. It is also expected that this issue will have a short-term impact and will be considered by the auditor in future years.

II. The size of the company is one of the main factors affecting the audit cost, and the decrease in the size of the company may have happened due to the existence of high-risk factors such as the deterioration of assets and the reduction of the company's credit. The auditor examines the level of; therefore, the audit cost does not decrease in proportion to the reduction of assets, which causes the audit cost to stick.

When sellers do not fully understand the market situation, economic theory predicts price changes. Price changes are essential in macroeconomics because they explain the reasons for the time-consuming effects of changes in monetary policy. With an understanding of the market situation, sellers are willing to lower the price through multiple corrections. In this respect, they have shown that sellers who do not have sufficient information about the market base their prices on cost and change them gradually and infrequently. Similarly, auditors need to gain enough knowledge of the reaction of business owners to changes in audit fees.

They, therefore, base their pricing on the cost price and change it gradually. Thus, the stickiness of audit fees can be predicted in this way. By examining the standard audit fee model, they showed that the explanatory power of the standard model is lower in the annual mode than in the long-term mode (for multi-year periods). These results indicate that audit fees do not change rapidly and according to the standard model's predictions. In the economic literature, when quality cannot be observed, the price is considered a measure of quality, and audit fees are also considered a measure of audit quality [13].

Competitive markets bring pricing closer to reality. For example, the seller cannot extract a higher price from the buyer. Market inefficiencies (imperfect information) lead to stickiness (prices do not change quickly), but competition forces sellers to lower prices over time. Price changes are negligible when the number of sellers is significant and there is no collusion between them. In other words, under competitive conditions, prices have slight stickiness. From the auditor's point of view, if the auditor overestimates the time to do the work, the audit fees will be higher in the current period, but it will be corrected in the following periods. Therefore, the stickiness is reversed in the subsequent periods. In the competitive audit market, opportunistic auditors have to change their opportunistic behaviour to keep the audit work (not to lose the employer).

On the other hand, if the auditors do not adjust the audit fee and the owners decide to change the auditors to reduce the fees, we will see the reversal of AFS in subsequent periods. Anderson and colleagues believe that the long-term periods (more than one year) complete the reform cycles in the sense that the stickiness is reduced in the long-term periods. Employers are expected to manage the fee reduction in the long term.

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Part of the stickiness is due to incomplete information. In this case, the seller needs to learn more about the buyer's reaction to the price change. For example, he does not know why the buyer has changed sellers. If the buyer chooses a new seller, the uncertainty is reduced because it is clear that the buyer intends to change the seller. Therefore, one of the factors of the gap in the market, which is the price stickiness factor, is removed, and the prices are expected to be closer to the expected level [14].

2.5 | Audit Quality

Audit quality is a multifaceted concept that can be examined from different perspectives. From one perspective, the auditor's report is viewed as a product, and the quality of this product indicates the quality of the audit through its compliance with established standards. In another view of audit quality, the audit is seen as a service to be provided by qualified persons, and the process of delivering this service and reporting its results is subject to specific rules and standards.

Therefore, if the service's provision, from the beginning to the end of the audit report, is carried out by the established norms and criteria, it has the required quality [15]. A literature review to date shows that audit quality is defined in different ways. In the applied literature, audit quality is often defined as compliance with auditing standards. On the other hand, accounting and auditing researchers have paid attention to the multiple dimensions of audit quality, and these dimensions have often led to different definitions. One of the most common definitions of audit quality is that provided by the Auditor General. He defined audit quality as the market's perception of the likelihood that the auditor will, 1) detect material misstatements in the company's financial statements using the company's accounting system, and 2) report the detected material misstatements.

3 | Methodology

3.1 | Statistical Population and Sample Size

The statistical population of this research includes all companies listed on the Tehran Stock Exchange during 2017-2021.

In this research, the purposive sampling method (systematic elimination) was used. For this purpose, all companies in the statistical society with the following conditions were selected as a sample, and the rest were excluded. The final number of companies surveyed is shown in *Table 1.a.*

Table 1.a. Sampling table.

The total number of companies that will be listed to the stock exchange by 2018	369
The number of companies that were investment, brokerage, insurance and banking companies	51
Companies listed on Tehran Stock Exchange after 2014	17
Number of companies with an ending date other than 29 March	34
The number of enterprises that have been inactive during the period of the study	110
Number of companies dropping the symbol for more than three months	27
Number of enterprises for which no information was available	16
The remaining enterprises in the statistical sample	114

3.2 | Research Regression Model

In this research, the following regression model was used to test the hypotheses. First hypothesis model:

$$FRQ = \alpha_0 + \alpha_1\,AFS + \alpha_2\,SIZE + \alpha_3\,GO + \alpha_4\,LEV + \varepsilon$$

The second hypothesis model:

$$FRQ = \alpha_0 + \alpha_1\,AFS + \alpha_2\,AQ + \alpha_3\,(AFS*AQ) + \alpha_4\,SIZE + \alpha_5\,GO + \alpha_6\,LEV + \varepsilon$$

Dependent variable

FRQ: in this research, in order to measure the quality of financial reporting, the calculation of the quality of accruals has been used as follows:

In this research, the calculation of the quality of accruals has been used to measure the quality of financial reporting [16].

$$TCA_{j,t} = \beta_0 + \beta_1\ CFO_{i,t-1} + \beta_2\ CFO_{i,t} + \beta_3\ CFO_{i,t+1} + \beta_4\ \Delta REV_{i,t} + \beta_5\ PPE_{i,t} + \varepsilon_{i,t}$$

TCA: all current provisions for the company i in year t.

$\Delta REV_{i,t}$: change in net turnover from t-1 to t.

$PPE_{i,t}$: gross value of property, plant, and equipment in year t.

$CFO_{i,t}$: operating cash flow turnover.

$TCA = \Delta CA - \Delta CL - \Delta CASH + \Delta DEBT$.

$\Delta CA_{i,t}$: change in working capital.

$\Delta CL_{i,t}$: change in current liabilities.

$\Delta STDEBT_{i,t}$: change in the proportion of long-term debt.

$\Delta CASH_{i,t}$: change in liquid assets.

Independent variable

AFS: the presented model is used to calculate AFS. In this way, the following relationship will be estimated using the rolling stock regression, and then the 2β coefficient will be calculated for each year-the company will be considered a proxy for AFS.

$$Ln\ (AF_t/AF_{t-1}) = \beta_0 + \beta_1\ Ln\ (EAF_t/EAF_{t-1}) + \beta_2\ Decrease\_Dummy \times Ln\ (EAF_t/EAF_{t-1}) + \varepsilon$$

In which: AF is the actual audit fee. EAF is the expected audit fee calculated using the following relationship.

$$LogFee_{it} = \beta_0 + \beta_1\ DA_{it} + BIGN_{it} + SALE_{it} + LOGASSET_{it} + ROA_{it} + LEV_{it} + \varepsilon_{it}$$

Decrease-Dummy is an artificial variable (zero and a dummy variable), if $Ln\ (EAF_t/EAF_{t-1})$ becomes negative it is equal to 1, otherwise it is equal to 0.

In other words, we assign this variable a value of 1 if the expected audit fee is reduced and a value of 0 if it is increased [17].

Modifier variable

If the auditor is an audit organisation, the number is 1, otherwise the number is 0 [17].

Control variables

Firm Size (SIZE): the logarithm of the firm's total assets.

Growth Opportunity (GO) rate: the ratio of market value to book value of equity.

Financial leverage (LEV) is the result of dividing long-term liabilities at the end of the period by total assets.

4 | Findings of the Research

4.1 | Descriptive Statistics

Considering that all the information and data in this research are quantitative, descriptive statistics were used in the first stage to analyse the collected data. In testing the research hypotheses, the descriptive statistics are shown in *Table 1.b*. The time period of the data related to the assumptions of this research is from 1397 to 1400 and the number of companies in the sample is 114 companies.

Table 1.b. Descriptive statistics.

Variables	Average	Median	Max	Min	SD
Quality of financial reporting	0.038	0.037	0.761	-1.172	0.122
AFS	-0.005	-0.003	0.127	-0.141	0.073
Audit quality	0.247	0.000	000.1	0.000	0.431
Company size	13.757	13.648	16.257	11.816	1.191
Growth opportunities rate	3.703	2.627	56.794	-100.842	6.652
Financial leverage	0.683	0.671	1.063	0.316	0.196

The maximum and minimum audit quality is 1.000. It is 0.000. The minimum and maximum values of the company size variable indicate the diversity of the companies in the sample in terms of size. The mean of the financial leverage variable for the sampled companies is 0.683, and its median is 0.671. These values show that many companies' capitals structure consists of debt. The minimum and maximum values of this variable are 0.316 and 1.063 respectively. The amount of financial leverage is more than one due to the accumulated losses in the equity part of some enterprises, which makes its value negative. The Durbin-Watson statistic is equal to 2.317, indicating that there is no serial autocorrelation between the residuals. The adjusted coefficient of determination is equal to 0.413, indicating that the independent variables in the model explain approximately 41% of the variation in FRQ. In addition, considering that the probability of Fisher's statistic for this model is (0.000), it can be said that this model is meaningful and highly reliable at the 99% confidence level.

Table 2. Results of the first hypothesis test.

Variables	Coeffs	SD	T Stats	Sig
C	0.041	0.093	0.442	0.658
AFS	0.002	0.005	0.404	0.686
Company size	0.267	0.123	2.176	0.029
Growth opportunities rate	0.024	0.022	1.056	0.290
Financial leverage	2.199	0.115	18.995	0.000
Adjusted coefficient of determination 0.431			Fisher's statistic 4.464	
Durbin-Watson stats 2.317			Fisher's probability stats [***]0.000	
Dependent variable: FRQ				

The results of the second hypothesis test are presented in *Table 3*. As can be seen in the table, the AFS's probability of audit quality variable is equal to 0.281, which indicates the lack of impact of the audit quality modifier variable on the relationship between AFS and FRQ.

The Durbin-Watson statistic was used for the serial autocorrelation test. The Watson camera statistic is 2.274. As the value of Watson's camera statistic is between 1.5 and 2.5, there is no serial autocorrelation between the residuals. The adjusted coefficient of determination is 0.363, indicating that the independent variables in the model explain approximately 36% of the quality of financial reporting. In addition, considering that the probability of the Fisher's statistic of this model is (0.000), it can be said that this model is meaningful and highly reliable at the 99% confidence level.

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Table 3. Results of the second hypothesis test.
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Variables	Coeffs	SD	T Stats	Sign
C	0.097	0.097	000.1	0.317
FRQ	0.003	0.005	0.581	0.561
AFS	0.522	0.087	5.956	0.000
Audit quality	-0.050	0.046	-1.078	0.281
Company size	0.246	0.128	1.924	0.054
Growth opportunities rate	0.021	0.025	0.847	0.397
Financial leverage	2.017	0.128	15.699	0.000
Adjusted coefficient of etermination 0.363			Fisher's statistics 3.778	
Durbin-Watson stats 2.274			Fisher's probability stats ***0.000	
Dependent variable: FRQ				

5 | Discussion and Recommendations

5.1 | Discussion of the Results of the First Research Hypothesis

The results of the tests of the first hypothesis of this research stated as follows: the stickiness of audit fees affects the quality of financial reporting in companies listed on the Tehran Stock Exchange; it has shown its rejection. Therefore, it can be said that the first hypothesis of this research has been rejected. The results indicate that the independent variable does not affect the dependent variable, i.e., no matter how low or high the AFS is, the quality of financial reporting will not change. According to the definition of the independent variable of this hypothesis in the third chapter, it can be interpreted in such a way that the more the audit fee increases or grows in consecutive years, i.e., the lower the AFS is, the more the quality of financial reporting does not change.

That is, no matter how much the audit fee, which can measure the auditor's motivation, effort, or enthusiasm to perform high-quality and accurate audits, increases in successive years, the quality of financial reporting does not change. In line with this hypothesis, they found that the unexpected audit fee negatively and significantly affects the quality of the company's financial reporting. There is a significant and negative relationship between audit fees, earnings quality, and financial reporting of companies listed in Tehran Stock Exchange. Rashidi Baghi [13] found that AFS follows a different trend. In the early years, audit firms do not change their requested fees, but in the following years, they adjust their fees according to the knowledge they get from their employers. Do The banking industry can obtain quality audit services at lower audit fees. Hartlib and Levy [18] also showed that cost stickiness primarily limits opportunistic income smoothing and that this relationship depends on other factors, such as adjustment costs. The results of the tests in the first hypothesis of this research in the relationship between the control variables and the dependent variable show a significant and positive relationship between company size and financial leverage with the quality of financial reporting. Still, there is no significant relationship between the rate of growth opportunities and the quality of financial reporting.

5.2 | Discussion of the Results of the Second Research Hypothesis

The results of the second hypothesis test this research, and this hypothesis has been proposed: audit quality affects the relationship between AFS and quality of financial reporting in companies listed in the Tehran Stock Exchange. It has indicated its rejection. This means that the second hypothesis of this research was rejected. The results showed that audit quality does not affect the relationship between AFS and FRQ. This means that the high audit quality or audit by an audit organisation will not cause AFS to affect FRQ more or less. The comparability of financial statements improves the quality of financial reporting, but the moderating role of audit quality does not affect this relationship. The audit fee discount has a negative (and positive) effect on the disclosure of material misstatements by auditors (and the possibility of fraud by company

managers). Also, their results show the relationship between the use of quality audit firms and the disclosure of material misstatements by auditors. The possibility of fraud by company managers, as well as confirming the moderating effect of this variable on the relationship between fee discount and audit on the disclosure of material misstatements by auditors and the possibility of fraud by company managers. As the level of the interactive effect between audit quality and the rank of the audit firm according to the classification of the official accounting society changes, the quality of the company's financial reporting also fluctuates and changes. Azizpour Shirsawar [19] also concluded that there is a positive and significant relationship between audit quality and FRQ. The findings of Vaez et al. [7] showed that there is a negative and significant relationship between audit firm expertise and audit fees. The results of this research also show that the factors of auditor continuity and audit firm size have a positive and significant relationship with audit fees. Mansour et al. [20] found no significant relationship between audit fees and audit quality without an intermediary. The results also showed that, after using five mediators (total assets, origin of a company, size of audit firm, complexity of operations, auditor's industry), there is a significant relationship between audit fees and audit quality from the audit firm's perspective. The findings of Chang et al. [21] also show that upward (downward) fee stickiness has a negative (positive) relationship with audit quality, as measured by earnings management and conservatism of the auditor's report. When accepting new work, they reduce the audit fee to obtain new job, and the fee reduction may also be due to the structure of the audit fee market. The results of the tests in the second hypothesis of this research in the relationship between the control variables and the dependent variable show that; there is no significant relationship between the size of the company and the rate of growth opportunities with the quality of financial reporting, but there is a significant and positive relationship between financial leverage and the quality of financial reporting.

Suggestions

I. The researchers are suggested that due to the importance of the pharmaceutical and automotive industries in the country, this issue should be specifically investigated in the statistical population of these two industries.

II. Researchers are suggested to investigate this issue in family businesses.

III. Researchers are encouraged to investigate the mediating role of audit quality in the relationship between audit fees and FRQ.

Author Contributaion

Mohammadreza Pourali conceptualized and designed the research, and Pour Habibi performed data analysis and manuscript preparation.

Funding

Data Availability

The data used in this study are derived from publicly available financial reports of companies listed on the Tehran Stock Exchange. Further details can be requested from the author.

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