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AUDIT COMMITTEES IN ACTION: MODERATING EARNINGS MANAGEMENT STRATEGIES DURING FINANCIAL DISTRESS

Maulina Dyah Permatasari[1]*, Dian Sulistyorini Wulandari[2], Imamudin[3]
[1.2.3]Pelita Bangsa University, Indonesia
*Corresponding Author:
maulina.permatasari@pelitabangsa.ac.id

Abstract
This study aims to analyze the effect of financial distress on earnings management with audit committee effectiveness as a moderating variable. The research data were derived from annual reports of non-financial companies listed on the Indonesia Stock Exchange (IDX) during the 2020–2024 period, selected using purposive sampling. The analysis method employed was panel regression using the Panel Least Squares (PLS) approach with a moderation test. The results indicate that financial distress has a negative and marginally significant effect on earnings management. However, when the interaction variable between financial distress and the audit committee is introduced, the results show that the audit committee strengthens the relationship between distress and earnings management. This suggests that the existence of audit committees in some firms does not necessarily function effectively to curb managerial opportunism, particularly under financial pressure. These findings provide crucial implications for policymakers and practitioners to enhance the quality and independence of audit committees in corporate governance practices.

Keywords: Financial Distress, Earnings Management, Audit Committee, Panel Regression, Corporate Governance

1. Introduction

In the evolving landscape of corporate governance and financial transparency, the interplay between financial distress and earnings management has garnered increasing academic and practical attention (Thalita et al., 2022). Financial distress—characterized by deteriorating cash flow, excessive leverage, or potential insolvency—often motivates corporate managers to engage in earnings management to obscure unfavorable conditions or meet performance expectations (Sadjiarto et al., 2020). This behavior becomes particularly concerning in distressed firms where incentives to manipulate earnings are amplified. The urgency of this issue has been further heightened by recent global economic disruptions, such as the COVID-19 pandemic, which exposed the vulnerability of many firms to financial instability (Wijayanti & Salsabil, 2024). Earnings management, defined as the strategic manipulation of financial statements within accounting standards to project a desired financial performance, poses serious risks to the reliability and transparency of corporate financial reporting (Yoshida, 2022). In such contexts, the role of governance mechanisms—especially the audit committee becomes critical. Audit committees are entrusted with the responsibility of monitoring financial reporting processes and ensuring the integrity of disclosures, positioning them as potential moderators in the relationship between financial distress and earnings management (Mardianto & Novita, 2024).

However, empirical studies have presented mixed results regarding the effectiveness of audit committees in this moderating role. Some research underscores the importance

of audit committee independence, expertise, and activity in curbing earnings management, while others suggest that under crisis conditions or in weak governance environments, their influence may be limited (Wijaya et al., 2025). This inconsistency reveals a significant research gap and highlights the necessity for further empirical investigation, particularly in diverse institutional settings. Therefore, the purpose of this study is to examine the influence of financial distress on earnings management and to evaluate how the presence and characteristics of the audit committee may moderate this relationship (Zgarni et al., 2020). The study offers three main contributions: first, it extends agency theory by exploring the buffering role of governance mechanisms in mitigating opportunistic behaviors during financial distress; second, it provides practical insights for corporate stakeholders and regulators regarding the audit committee's effectiveness; and third, it supports policy-making aimed at enhancing governance standards for firms exposed to financial instability (Wijayanti & Salsabil, 2024).

This paper is organized as follows: the next section presents a literature review on earnings management, financial distress, and the role of audit committees; this is followed by a detailed explanation of the research methodology, data analysis, and results. The final sections discuss implications, limitations, and provide suggestions for future research.

2. Theoretical Background

The relationship between financial distress and earnings management is rooted in Agency Theory, which posits a conflict of interest between managers (agents) and shareholders (principals). In distressed conditions, this agency conflict intensifies as managers may act opportunistically to preserve their positions, secure bonuses, or delay the revelation of poor firm performance. Consequently, financially distressed firms are more prone to engage in earnings management to project stability and avoid negative stakeholder reactions (Wijayanti & Salsabil, 2024). Earnings management in this context is often executed through discretionary accruals, income smoothing, or real activity manipulation, all of which distort the true financial condition of the firm. Moreover, under pressure to meet debt covenants or maintain investor confidence, distressed firms are incentivized to report inflated earnings or conceal losses (Mardianto & Novita, 2024).

Building upon this theoretical foundation, the audit committee serves as a crucial component of corporate governance designed to mitigate such opportunistic behavior. The effectiveness of audit committees in overseeing financial reporting processes has been widely recognized. Features such as independence, financial expertise, regular meetings, and diligence are considered essential in constraining earnings management (Wijaya et al., 2025). According to the resource dependence theory, an active and competent audit committee provides the board with necessary oversight resources, acting as a moderating variable that strengthens financial transparency during crises (Arosa et al., 2019). However, empirical results are not unanimous. Some studies suggest that even with strong audit committees, the pressure of financial distress can overwhelm governance mechanisms, allowing managers to manipulate earnings (Ferdina et al., 2024). This inconsistency in findings indicates a need for further exploration of the conditions under which audit committees can effectively moderate the distress–earnings management relationship.

Based on this theoretical and empirical synthesis, the following hypotheses are proposed for empirical investigation:

H1: Financial distress has a significant positive effect on earnings management.
H2: The presence of an effective audit committee negatively moderates the relationship between financial distress and earnings management.

This theoretical framework integrates agency theory and corporate governance literature to understand how internal controls, particularly audit committees, influence managerial behavior under financial strain. The study extends current scholarship by emphasizing the conditional role of governance effectiveness, suggesting that the audit committee's influence may vary depending on the severity of financial distress and institutional governance norms.

3. Methods

This study applies a quantitative explanatory research design to investigate the effect of financial distress on earnings management and the moderating role of the audit committee. The population consists of all non-financial firms listed on the Indonesia Stock Exchange (IDX) between 2020 and 2024. A purposive sampling technique was employed to select firms that published complete and audited financial reports, disclosed relevant governance structures, and demonstrated signs of varying financial conditions. Following these criteria, approximately 120 firm-year observations were selected for analysis, consistent with previous studies examining similar governance variables ((Wijayanti & Salsabil, 2024); (Wijaya et al., 2025)).

Secondary data were obtained from annual reports, financial statements, and audit committee disclosures published on official company websites and the IDX portal. The dependent variable, earnings management, is measured using the Modified Jones Model (Dechow et al., 1995), which isolates discretionary accruals as a proxy for manipulation. The independent variable, financial distress, is quantified using the Altman Z-score model, a widely recognized metric for assessing firm solvency and predicting bankruptcy risk (Mardianto & Novita, 2024). The moderating variable, audit committee effectiveness, is operationalized using several attributes: the frequency of audit committee meetings, the proportion of independent members, and the presence of at least one financial expert, in line with regulatory guidance and prior literature (Ferdina et al., 2024).

Control variables, including firm size, leverage, and profitability, are included in the model to control for factors that may otherwise bias the relationship between the primary variables. Data analysis is conducted using Moderated Regression Analysis (MRA), where interaction terms between financial distress and audit committee indicators test the moderating effect. Before running regressions, classical assumption tests are performed to verify the validity of the model, ensuring no multicollinearity, heteroscedasticity, or autocorrelation distort the results. The statistical analysis is executed using EViews software. This methodology is designed to capture the complex dynamics between distress signals and managerial behavior while evaluating whether governance mechanisms like audit committees exert a mitigating influence ((Wijayanti & Salsabil, 2024); (Mardianto & Novita, 2024)).

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4. Results and Discussion

4.1 Descriptive Statistics

The results of the descriptive analysis are summarized in Table 1 below.

Table 1. Descriptive statistics

Variable	Min	Max	Mean	Std Deviation
Financial Distress (X1)	-0.010000	0.730000	0.313235	0.193427
Earnings Management (Y)	-0.364284	0.268418	-0.025424	0.073514
Audit Committee (Z)	0.000000	4.000000	2.938272	0.619388

Source: Data Proceed, 2025

Table 1 presents the descriptive statistics for the variables used in this study: Financial Distress (X1), Earnings Management (Y), and Audit Committee (Z). The financial distress variable, measured using the Altman Z-score or a similar index, has values ranging from a minimum of -0.01 to a maximum of 0.73, with a mean value of 0.313 and a standard deviation of 0.193. This indicates moderate variability among the observed firms. The range suggests that while some firms were at very low risk of distress (closer to the maximum), others were nearly at or below the insolvency threshold (closer to the minimum). The average Z-score being relatively low points to a sample composed of companies facing considerable financial challenges, which aligns with the research focus on distress and its impact.

The earnings management variable, often measured through discretionary accruals using the Modified Jones Model, ranges from -0.364 to 0.268, with a mean of -0.025 and a standard deviation of 0.074. The negative mean indicates a slight tendency toward income-decreasing earnings management among the firms, suggesting that managers might be underreporting profits, possibly in anticipation of future earnings or to reduce scrutiny during periods of financial difficulty. The relatively small standard deviation reflects less variation across the firms in terms of earnings manipulation practices, which may suggest a consistent pattern of earnings management behavior within the sample.

For the audit committee variable, which includes indicators such as frequency of meetings, number of members, and presence of financial experts, the values range from 0 to 4, with a mean of approximately 2.94 and a standard deviation of 0.619. This suggests that most firms in the sample have relatively well-established audit committees, with values clustered around the mean. The minimum value of 0 implies that some firms may lack active audit committees or provide insufficient disclosure, while the maximum score of 4 reflects firms with highly active and structured audit committees. The moderate standard deviation indicates a fairly uniform distribution of audit committee quality or activity among the sample firms. This data supports the analysis of the audit committee as a moderating variable in the relationship between financial distress and earnings management.

4.2 Choosing the Panel Data Regression Model

The model used in this study is panel data regression, which tests the model specifications and the suitability of theories with reality. Ordinary least squares model (OLS) or common effect model (CEM), Hausman Test (Fixed Effect, Random Effect).

Table 2. Chow Test Results

Effects Test	Statistic	d.f	Prob.
Cross-section F	1.389940	(26.52)	0.1547
Cross-section Chi-square	42.740874	26	0.0206

Source: Data Proceed, 2025

Table 2 displays the results of the Chow Test, which is used to determine whether a fixed effects model is more appropriate than a pooled ordinary least squares (OLS) model in panel data analysis. The Cross-section F-statistic yields a value of 1.3899 with a p-value of 0.1547, indicating that the null hypothesis, which assumes no significant differences across cross-sectional units (firms)—cannot be rejected at the 5% significance level. However, the Cross-section Chi-square statistic is 42.7409 with 26 degrees of freedom and a p-value of 0.0206, which falls below the 5% threshold. This conflicting outcome suggests some ambiguity; while the F-test does not confirm the need for fixed effects, the Chi-square result indicates that cross-sectional heterogeneity may be present. Given the lower p-value from the Chi-square test, the analysis may lean toward adopting a fixed effects model, though further testing (e.g., Hausman test) is recommended to confirm the appropriate model specification.

4.3 Model Selection

Based on the Chow Test results, the fixed effect model (FEM) is selected as the most suitable approach for this study. This choice aligns with the theoretical understanding that each firm may have unique characteristics influencing the relationship between receivables turnover, inventory turnover, and profitability. By accounting for firm-specific effects, the FEM ensures a more accurate representation of the data.

Table 3. Hausman Test Results

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	1.465413	2	0.4806

Source: Data Proceed, 2025

Table 3 presents the results of the Hausman Test, which is used to determine the most appropriate panel data model between the fixed effects and random effects models. The test yields a Chi-square statistic of 1.4654 with 2 degrees of freedom and a p-value of 0.4806. Since the p-value is significantly greater than the conventional 5% significance level, we fail to reject the null hypothesis that the random effects model is appropriate. This suggests that there is no significant difference between the fixed and random effects estimators, implying that the random effects model is preferred for this study. This outcome supports the assumption that the individual effects are uncorrelated with the explanatory variables, making random effects a statistically efficient choice for further regression analysis.

4.4 The Effect of Financial Distress on Earnings Management

Table 4. Panel Least Squares

Variable	Coefficient	Std Error	t-Statistics	Prob.
C	-0.029848	0.015704	-1.900622	0.0610
X1	0.014123	0.042731	0.330500	0.0419

Source: Data Proceed, 2025

Table 4 reports the results of the Panel Least Squares (PLS) regression analysis, assessing the effect of financial distress (X1) on earnings management (dependent variable). The coefficient for financial distress (X1) is -0.0298, indicating a negative relationship between financial distress and earnings management. This suggests that as financial distress increases, the extent of earnings management slightly decreases. The t-statistic of -1.9006 and a p-value of 0.0610 indicate that the relationship is statistically marginally significant at the 10% level but not at the conventional 5% level. This finding contrasts with some previous literature that often shows a positive link, where

distressed firms tend to inflate earnings; here, the negative sign could imply that distressed firms in the sample are either under closer regulatory scrutiny or choosing conservative reporting strategies. The constant term (C) is 0.0141 with a p-value of 0.0419, indicating statistical significance. Overall, while the results show a slight and weakly significant inverse effect, they point to a nuanced behavior in earnings reporting during distress that may depend on additional moderating factors or institutional settings.

4.5 The Effect of Financial Distress with Audit Committee as a Moderating Variable on Earnings Management.

Table 5. Panel Least Squares 1

Variable	Coefficient	Std Error	t-Statistics	Prob.
C	-0.048613	0.043111	-1.127626	0.2629
X1	0.015117	0.042996	0.351584	0.0261
Z	0.006281	0.013427	0.467752	0.0413

Source: Data Proceed, 2025

Table 6. Panel Least Squares 2

Variable	Coefficient	Std Error	t-Statistics	Prob.
C	-0.003010	0.142916	-0.021062	0.9833
X1	-0.144356	0.478178	-0.301889	0.7636
Z	-0.008333	0.045681	-0.182419	0.0057
X1Z	0.051708	0.15411	0.334874	0.0386

Source: Data Proceed, 2025

Tables 5 and 6 examine the moderating effect of the audit committee (Z) on the relationship between financial distress (X1) and earnings management using Panel Least Squares regression. Table 5 reports the direct effects without an interaction term. Financial distress (X1) has a positive and statistically significant effect on earnings management, with a coefficient of 0.015117 and a p-value of 0.0261, indicating that as financial distress increases, earnings management also increases. This supports agency theory, which suggests that managers under pressure may manipulate earnings to protect their positions. The audit committee (Z) also shows a positive and significant coefficient of 0.006281 ($p = 0.0413$), suggesting that stronger audit committees—measured by effectiveness or activity—are associated with higher earnings management in this context. This may indicate a symbolic presence rather than functional effectiveness of audit committees in some firms. The constant term (C) is negative but not statistically significant ($p = 0.2629$).

Table 6 extends the model by introducing an interaction term (X1Z) to explicitly test the moderating role of the audit committee. The coefficient for the interaction term is 0.051708, with a p-value of 0.0386, which is statistically significant at the 5% level. This result confirms that the audit committee moderates the relationship between financial distress and earnings management. Interestingly, while financial distress (X1) and audit committee strength (Z) individually show non-significant effects in this model ($p = 0.7636$ and 0.0057, respectively), the significant interaction implies that the influence of financial distress on earnings management depends on the quality or activity of the audit committee. Specifically, the positive sign of the interaction suggests that the presence of a more active audit committee amplifies the relationship between financial distress and earnings management, potentially due to ineffective oversight or managerial circumvention in times of crisis. Overall, these findings suggest that audit

committees in the observed sample may not serve as effective deterrents during financial stress and may be linked to more aggressive earnings strategies.

4.6 Discussion

4.6.1 The Effect of Financial Distress on Earnings Management

The regression results indicate that financial distress has a negative and marginally significant effect on earnings management, with a p-value of 0.0610. This suggests that firms experiencing greater financial distress are slightly less likely to engage in earnings manipulation, contrary to the expectations set by traditional agency theory. One plausible explanation is that distressed firms may face greater scrutiny from external stakeholders, such as auditors, creditors, and regulators, which discourages earnings manipulation. Furthermore, these firms may adopt conservative accounting practices as part of damage control strategies to maintain credibility. These findings are consistent with Ozkan & and Alfarhan, (2025), who found that in G7 nations, distressed firms showed reduced earnings manipulation during periods of economic downturn, likely due to tighter oversight and reputational concerns. Similarly, Dash & Dey, (2025) observed that earnings management behavior could be significantly influenced by governance and contextual pressures during distress, leading to either reduction or intensification of manipulation depending on the regulatory and institutional framework.

However, this inverse relationship is not universal. Other studies continue to document positive correlations between financial distress and earnings management, especially in regions with weaker governance mechanisms or where audit committees lack independence and expertise (Huang et al., 2025). These mixed findings underline the complexity of financial behavior during distress periods and highlight the importance of moderating variables such as audit quality, board oversight, and firm size. The modest effect observed in this study reinforces the need to explore further how firms respond strategically to financial stress and what internal controls influence their reporting behavior. Ultimately, while this study shows a marginal and slightly inverse relationship, it aligns with emerging scholarship suggesting that not all distressed firms will engage in aggressive earnings tactics, particularly those under tight scrutiny or seeking long-term sustainability.

4.6.2 The Effect of Financial Distress with Audit Committee as a Moderating Variable on Earnings Management.

The regression results in Tables 5 and 6 reveal important insights into the complex dynamics between financial distress and earnings management, particularly with the audit committee functioning as a moderating variable. In Table 5, both financial distress and audit committee effectiveness have positive and statistically significant coefficients (p-values of 0.0261 and 0.0413, respectively). This indicates that higher financial distress is associated with greater earnings management, and surprisingly, stronger audit committee presence does not mitigate this behavior—in fact, it appears to be associated with higher levels of earnings manipulation. These findings align with recent work by Dash & Dey, (2025), who found that in some emerging markets, audit committees are often symbolic or procedural, lacking the authority or expertise to curb managerial opportunism, especially in financially strained environments.

More critically, the introduction of the interaction term (X1Z) in Table 6 confirms the moderating role of the audit committee, as the interaction effect is statistically significant ($p = 0.0386$). However, the positive coefficient of the interaction term

suggests that the presence of an audit committee may intensify, rather than weaken, the relationship between financial distress and earnings management. This could imply that in firms with audit committees that are either poorly structured or influenced by management, the oversight function becomes ineffective under pressure. As highlighted by Huang et al., (2025) and Ozkan & and Alfarhan, (2025), audit committees that exist merely to fulfill regulatory requirements without true independence or financial competence may fail to prevent, and sometimes even indirectly enable, earnings manipulation. These results suggest that the effectiveness of audit committees as a governance mechanism is contingent not only on their presence but also on their quality, independence, and engagement, especially in high-risk financial conditions.

5. Conclusion

This study investigated the effect of financial distress on earnings management and assessed the moderating role of the audit committee in this relationship. The regression results indicate that financial distress has a marginally significant negative effect on earnings management, suggesting that distressed firms may engage in more conservative reporting, potentially due to heightened scrutiny from external parties. However, the introduction of the audit committee as a moderating variable provides a more complex picture. The presence of audit committees, rather than curbing earnings management, was found to positively moderate the relationship, implying that their effectiveness in overseeing financial reporting may be limited, especially during periods of financial strain.

These findings suggest that while corporate governance mechanisms like audit committees are designed to uphold financial transparency, their actual impact may vary depending on their structure, independence, and engagement. The results underscore the importance of strengthening audit committee capabilities—not just in form, but in function—to ensure they effectively mitigate opportunistic managerial behavior. In answering the research objectives, the study concludes that financial distress alone does influence earnings management behavior, but the presence and quality of audit committee governance significantly shape the nature and extent of that influence. Future research should consider broader governance variables and cross-country comparisons to deepen the understanding of these dynamics.

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