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ARTICLE

Analysis of Key Audit Matters (KAM) and Cash Flow Pattern on Financial Distress

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Abstract

Economic downturns can reduce a firm's ability to sustain operations and meet its financial obligations. In this context, key audit matter (KAM) disclosures and cash flow patterns may provide useful signals of financial distress. This study examines their impact on firms in the consumer cyclical and non-cyclical sectors in 2022. The results show that entity-level KAM disclosures are positively associated with financial distress, suggesting that broader audit risks reflect underlying firm conditions, while stronger cash flow patterns reduce their likelihood. This study contributes to the literature by jointly examining KAM disclosure levels and cash flow patterns, offering new evidence on their roles in assessing financial distress.

Keywords: Cash Flow; Financial Distress; KAM; SA 701

***JEL codes*:** G01, G33, M41, M42

1. INTRODUCTION

The growing importance of KAM disclosures has attracted significant academic attention in recent years, particularly in relation to their role in enhancing audit transparency and signalling financial risk [4,5]. An economic recession is often associated with rising inflation and increases in benchmark interest rates set by central banks across countries, driven by factors such as the COVID-19 pandemic, geopolitical conflicts, and climate-related disruptions. A recession is typically defined as a decline in economic activity, reflected in negative gross domestic product (GDP), rising unemployment, and negative real economic growth sustained over two consecutive quarters [14]. One of the central banks that increases the benchmark interest rate is the Federal Reserve (The Fed). Inflation makes Western countries and the United States continue to raise benchmark interest rates to control inflation. The following is historical data on the Fed's benchmark interest rate [3]:

Table 1. Historical Data on the Fed's Benchmark Interest Rate

Date	Change (basis points)	US Interest Rate Level (%)
09/20/2023	0	5.25 – 5.50
07/26/2023	25	5.25 – 5.50
06/14/2023	0	5.00 – 5.25
05/04/2023	25	5.00 – 5.25
03/23/2023	25	4.75 – 5.00
02/01/2023	25	4.50 – 4.75
12/14/2022	50	4.25 – 4.50
11/02/2022	75	3.75 – 4.00
09/21/2022	75	3.00 – 3.25
07/27/2022	75	2.25 – 2.50
06/15/2022	75	1.50 – 1.75

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Table 1. Historical Data on the Fed's Benchmark Interest Rate (continued)

Date	Change (basis points)	US Interest Rate Level (%)
05/04/2022	50	0.75 – 1.00
03/16/2022	25	0.25 – 0.50

Source: https://dataindonesia.id/

Table 1 shows that the Fed's benchmark interest rate has increased significantly from March 2022 to September 2023. This has caused companies in various countries to reduce production output due to the decline in global demand, which will have a direct impact on the going concern of the firm.

In early 2023, one of the large companies in the United States experienced bankruptcy, namely Bed Bath & Beyond (BBB), which operates in the household equipment trading sector. BBB filed for bankruptcy in April 2023 because the firm suffered significant losses of around USD 393 million and had debts to banks worth USD 925 million in 2022. S&P Global recorded that 236 companies in the United States experienced bankruptcy during January-April 2023, while in the period January-April 2022, only 109 companies experienced bankruptcy [2].

PT Ritel Bersama Nasional (JD.ID), which is a large retail firm in Indonesia, also experienced bankruptcy. JD.ID completely closed its business on March 31, 2023, and has laid off approximately 200 employees. One of the reasons JD.ID closed its business in Indonesia because, since the end of 2022, the firm experienced quite large losses [6]. In addition, one indication that the firm is experiencing financial difficulties is when it carries out a merger and reports a net loss or negative equity value [16]. Bankruptcy cases experienced by the firm due to the global economic recession show the importance of researching indicators to predict its financial distress condition.

Further, one of the significant and complex areas in the audit process is assessing the firm's ability to maintain its business continuity and the firm's financial condition. Although financial difficulties do not always lead to bankruptcy, a continuous decline in the firm's financial performance will hurt investment, repayment, and incentives for managers and shareholders, so these must be predicted accurately [9]. The disclosure of key audit matters (KAM) based on Audit Standards (SA) 701 can provide information and predict indications of financial distress that is being or will be experienced by the firm.

Cash flow is one of the best measurements for a firm's financial condition because the cash flow generated is more real compared to profits, which have an estimated element in them. Besides, financial distress is identified when cash flow from operating activities is in deficit, cash flows from investment and financing activities are surplus, or cash flows from operations and financing are in deficit [17], but cash flows from investment activities are surplus. So, the cash flow pattern is an indicator for assessing its financial health.

This research aims to analyze the effect of KAM disclosure based on SA 701, effective January 1, 2022, and cash flow patterns on financial distress in companies in Indonesia. For investors, research conducted can provide additional information regarding the firm's financial health. For regulators, research can become material for updating standards or regulations that can improve the quality of KAM disclosures for both public and private companies. For students and academics, research can be a source and basis for further research development. For researchers, research can be a source of insight and knowledge regarding the influence of KAM and cash flow patterns on financial distress so that they can link theoretical knowledge with current phenomena.

2. LITERATURE REVIEW AND HYPOTHESIS

2.1. Agency Theory

This theory focuses on principals and agents who have the aim of maximizing profits based on personal interests. The agent is the party that is given the mandate to manage the firm and has more detailed information compared to the principal, giving rise to information asymmetry. When information asymmetry occurs, agents tend to adopt policies that provide benefits to them, even though these policies are ineffective and tend not to disclose the results of their performance. Agency costs incurred to handle agency problems can be used to analyze management's efforts to improve the firm's financial capacity to avoid financial distress.

Auditors play an important role for stakeholders. Accountants prepare financial reports, but auditors add to their credibility [5]. Auditors play a role in creating a level of trust in the annual report. Auditors test the validity of the information in financial reports provided by management. So, auditors take part in assessing the firm's financial health. According to agency theory, firm managers are agents, whereas auditors act on behalf of stakeholders (principals) to audit and validate management's work and convince stakeholders regarding the trust and confidence they can have in the firm.

2.2. Financial Distress

Conditions of financial difficulty will affect the firm's ability to carry out its operations and fulfill its obligations. This condition causes losses for investors and creditors related to reduced income or profits [24]. Moreover, financial distress can be identified using three approaches as follows: the firm cannot pay off its current obligations, its solvency is disrupted, and there are financial ratios that indicate the potential for bankruptcy [21].

Based on the concept of business continuity, the firm was founded for an unlimited period, but there were not many factors that influenced the firm to be dissolved [12]. Likewise, financial ratio analysis can be used as a tool to assess the level of financial difficulty of a firm. This is because financial reports are a reference for measuring the health of a firm [22].

2.3. Key Audit Matter (KAM)

According to Audit Standards (SA) 701 [11], auditors are required to communicate key audit matters (KAM), which aims to increase communicative value to create transparency regarding the audit process carried out. In addition, KAM provides additional information regarding difficulties faced by the auditor, significant modifications to the audit plan, or major deficiencies in the firm's internal controls [13]. Recent studies continue to highlight the importance of KAM disclosures in improving transparency and informing stakeholders about firm risk. For example, recent evidence suggests that KAM disclosures are increasingly used by investors to assess audit risk and financial reporting quality. Furthermore, emerging research indicates that KAM related to going concern and macroeconomic uncertainty has stronger predictive power for financial distress compared to account-specific disclosures. These findings support the relevance of distinguishing between entity-level and account-level KAM in empirical analysis.

Specifically, recent studies provide further evidence on the importance of key audit matter (KAM) disclosures in enhancing transparency and assessing firm risk. For example, study shows that a higher number of KAM disclosures is associated with a greater likelihood of financial distress, suggesting that KAM can serve as an early warning signal for stakeholders [4]. In addition, a systematic review highlights that KAM disclosures play a significant role in improving financial reporting quality and audit transparency, making them increasingly relevant for investors and regulators [5]. Recent empirical evidence also suggests that the characteristics and extent of KAM reporting are influenced by firm-specific risk factors and governance structures, further supporting their usefulness in risk assessment [23].

2.4. Cash Flow

According to PSAK 2, the cash flow report contains information for readers of financial statements to assess changes in net assets, financial structure (including liquidity and solvency), and the firm's ability to generate cash [10]. All businesses need cash to secure their business if economic problems occur. Cash flow is needed for payment transactions to creditors, such as short-term portions of debt or long-term portions that must be paid on time [12].

2.5. Hypothesis Development

KAM disclosures are determined by matters communicated to TCWG (Those charged with Governance). According to existing literature, previous audit reports were less able to reveal important information. KAM emerged because of demands for important and relevant information to reduce information gaps [19]. likewise, the firm with lower profitability is associated with a lack of performance from management, allowing auditors to disclose more KAM than companies with higher profitability [8]. In addition, the characteristics of the firm being audited and the relationship between the auditor and management can be important factors in the number of KAMs disclosed [7].

The determination of KAM disclosures can be expanded based on the type or nature, based on the auditor's considerations. Audit risks in KAM are divided into two categories, namely risks that impact the entire financial report (entity-level KAM) and risks that only impact certain specific accounts (account-level KAM). Entity-level KAM will provide better information for stakeholders because it is directly related to the firm's financial health risks. Apart from that, account-level KAM can also assess risks that have a direct impact on the firm's business continuity components, which is useful in assessing the level of the firm's financial difficulties.

So, the higher the KAM disclosure based on the risk level, the higher the firm's financial distress condition. This statement is supported by research which states that KAM expressed based on risk level has a significant effect on financial distress [4]. Based on the description of the effect of KAM disclosure based on risk level on financial distress, we propose the hypothesis:

H1: Entity-level Key Audit Matter (KAM) disclosures are positively associated with the likelihood of financial distress.

H2: Account-level Key Audit Matter (KAM) disclosures are positively associated with the likelihood of financial distress.

Cash flow is often considered a more reliable indicator of a firm's financial health than profit, as it reflects actual cash inflows and outflows rather than accounting estimates. In contrast, profit is based on accrual accounting and may not fully capture a firm's liquidity position. Likewise, firms with positive cash flow patterns are more likely to access external financing, whereas those with negative cash flow patterns face a higher risk of failing to meet their obligations [1]. Therefore, a firm is more likely to experience financial distress when its net cash flow is insufficient to cover its debt commitments.

Further, previous study shows that one of the models for predicting a firm's financial difficulties is based on the components of cash flow as follows: operating, investing, and financing activities [20]. Financial difficulties, as a signal of bankruptcy, are mostly caused by a lack of liquid resources that will be used to settle their obligations. So, the financial health condition of a firm can be analyzed based on cash flow patterns as a tool to see whether the firm is experiencing financial difficulties. This statement is supported by research that cash flow patterns have a significant effect on financial distress [1,17]. Based on the description of the influence of cash flow patterns on financial distress. Thus, we propose the hypothesis:

H3: Adverse cash flow patterns are positively associated with the likelihood of financial distress.

3. RESEARCH METHODS

3.1. Research Design

This research analyzes the effect of KAM disclosure and cash flow patterns on financial distress in consumer cyclical and non-cyclical sector companies listed on the Indonesian Stock Exchange (BEI) in 2022. The data processed in this research is secondary data in the form of annual financial reports that can be accessed via the official IDX website (www.idx.co.id) or the websites of each firm. The research sample was determined using a purposive sampling method with the criteria of being registered on the IDX in the consumer cyclical and non-cyclical sectors in 2022, publishing audited financial statements, and using the Rupiah currency.

3.2. Operational Research Variables

3.2.1. Dependent Variable

Financial distress is proxied by the Altman Z-score model according to the previous literature [15]:
Information:

$$Z\text{-}Score = 3{,}25 + 6{,}56.\ Z1 + 3{,}26.\ Z2 + 6{,}72.\ Z3 + 1{,}05.\ Z4$$

Z-score: Financial distress (bankruptcy index)
Z1: Net working capital divided by total assets
Z2: Retained earnings divided by total assets

Z3: Profit before tax divided by total assets
Z4: The book value of capital divided by the book value of liabilities

Based on the value generated from the Altman Z-score model, the results are divided into three areas as follows:

1. *Z-score* < 1.1 means the firm is in a distressed area.
2. *Z-score* between 1.1 and 2.6 means the firm is in the gray area.
3. *Z-score*> 2.6 means the firm is in a safe zone or distress-free.

The z-score results in this research will be converted into dummy variables. The score is 1 if the firm experiences financial difficulties (if the z-score is below 2.6) and vice versa.

3.2.2 Independent Variables

1) Key Audit Matter (KAM)

KAM disclosure is proxied by the KAM disclosure classification table from the previous study [4]. The following is the formula for calculating KAM disclosure:

$$KAM = \frac{\Sigma Xyi}{Ni}$$

Information:
KAM= KAM disclosure index
ΣXyi= Total KAM disclosure
Ni= Total KAM classification indicators

In this study, KAM disclosure is measured using a disclosure index based on the classification proposed by the previous literature [4]. Each KAM item disclosed by the auditor is coded as 1, and 0 otherwise. The ENTKAM and ACCKAM variables are constructed as ratios by dividing the number of disclosed items in each category by the total possible items within that category. Therefore, ENTKAM reflects the proportion of entity-level risks disclosed, while ACCKAM reflects the proportion of account-specific risks disclosed. This approach allows for comparability across firms with different numbers of KAM disclosures.

Table 2. KAM Disclosure Classification

Classification			**Type**	**Description of Category Variables**
A	Entity-Level KAMs (ENTKAM)	Category		
1.	Going concern	-	GC	Number of going concern KAMs disclosed
2.	Internal control and fraud	Other Entity-Level KAMs (OTHERENT)	ICFRAUD	Number of internal controls and fraud KAMs disclosed
3.	Restructuring and discontinued operations		RDO	Number of restructuring and discontinued operations KAMs disclosed
4.	Merger and acquisition accounting		MA	Number of mergers and acquisitions (M&A) accounting KAMs disclosed
5.	Tax-related		TAX	Number of tax-related KAMs disclosed
6.	Exceptional items, presentation, and disclosure		EIPD	Number of exceptional items, presentations, and disclosure KAMs disclosed
7.	Litigation, macroeconomics, and system implementation		LITMACRO	Number of litigations, macroeconomic, and system implementation KAMs disclosed

Table 2. KAM Disclosure Classification (continued)

Classification			Type	Description of Category Variables
B	Account-Level KAMs (ACCKAM)			
8.	Management/performance fees	Probability (PROF)	MGFEES	Number of management and/or performance fees KAMs disclosed
9.	Revenue recognition		REV	Number of revenue recognition KAMs disclosed
10.	Expense recognition		EXP	Number of expense recognition KAMs disclosed
11.	Accruals, deferrals, and management estimates		ACCREST	Number of accruals, deferrals, and management estimates KAMs disclosed
12.	Inventory	Liquidity (LIQU)	INV	Number of inventories KAMs disclosed
13.	Cash and receivables		CASHREC	Number of cash and receivables KAMs disclosed
14.	Investments and related impairment issues		INVEST	Number of investments and related impairment issues KAMs disclosed
15.	Intangible and related impairment issues		INTANG	Number of intangibles and related impairment issues KAMs disclosed
16.	Property, plant, and equipment and related impairment issues	Solvency (SOLV)	PPE	Number of properties, plant and equipment, and related impairment issues KAMs disclosed
17.	Rental and long-term debt		LLTD	Number of rental and long-term debt issues KAMs disclosed
18.	Accounting for pension and defined benefit plans		PENS	The number of accounting issues for pension and defined benefit plans is disclosed in KAMs.

Source: Camacho-Miñano et al. [4]

2) Cash Flow Pattern

This variable is proxied by a cash flow pattern table from previous research [1]. The cash flow pattern variable (CF) is categorized into eight patterns (P1–P8) based on the sign combinations of operating, investing, and financing cash flows [1]. pattern is assigned a value from 1 to 8. Lower values represent weaker cash flow conditions, typically characterized by negative operating cash flows, while higher values indicate stronger and more sustainable cash flow structures. This classification captures the firm's financial condition more comprehensively than a single cash flow measure.

Table 3. Cash Flow Pattern Table

	Operating Activities	Investing Activities	Financing Activities
P1 (Pattern 1)	-	-	-
P2 (Pattern 2)	-	+	-
P3 (Pattern 3)	-	-	+
P4 (Pattern 4)	-	+	+
P5 (Pattern 5)	+	+	+
P6 (Pattern 6)	+	+	-
P7 (Pattern 7)	+	-	+
P8 (Pattern 8)	+	-	-

Source: Aderin & Amede [1]

3.2.3. Control Variables

Firm size and audit quality are included as control variables because prior studies suggest they influence both KAM disclosure and financial distress. Larger firms tend to have more complex operations and greater disclosure requirements, while audit quality (proxied by Big 4 auditors) is associated with higher reporting quality and stricter risk assessment. Including these controls helps isolate the effect of KAM and cash flow patterns on financial distress. The following are the key control variables used in this research:

Table 4. Control Variables

No.	Variable	Definition	Scale	Proxy	References
1.	Firm Size	The size of the firm is large or small based on the number of assets owned.	Ratio	Ln (Total Asset)	Setyowati et al. [22]
2.	Audit Quality	KAPs that audit companies are grouped into audits carried out by the Big 4 and Non-Big 4.	Dummy	Big 4 = 1 Non-Big 4 = 0	Ferreira, C., & Morais, A. I [7]

3.2.4. Research Model

In this research, hypothesis testing was carried out using two approaches, namely panel data regression and logit regression. The following is the panel data regression equation, where FD represents financial distress, ENTKAM and ACCKAM represent KAM disclosure ratios, CF represents cash flow pattern, SIZE represents firm size, and AUDIT represents audit quality.

$$FD = \beta0 + \beta1ENTKAM + \beta2ACCKAM + \beta3CF + \beta4SIZE + \beta5AUDIT + \varepsilon$$

Information:
FD: Financial Distress (Y)
β_0: Constant (intercept)
β: Regression coefficient (slope)
ENTKAM: Disclosed KAM entity level (X)
ACCKAM: Disclosed KAM accounts level (X)
$\sum$*Controls*: Firm Size and Audit Quality (C)
ε: Error term

The dependent variable in this study is a binary variable that has two categories, as follows: score 1 is given if the z-score value is below 2.6 and score 0 is given if the z-score value is above 2.6. The following is a general logistic regression model:

$$P(Y/X) = \frac{e^{\beta o + \beta 1X}}{1 + e^{\beta o + \beta 1X}}$$

The equation above illustrates the conditional probability of a certain event related to the dependent variable or Y (in this study, namely, financial distress) as a function of the exponent of the explanatory factor or predictor X. By taking the natural log on both sides, the following logit transformation is generated for prediction purposes:

$$\ln \{(P(Y/X)) / (1 - P(Y/X))\} = \beta_o + \beta_1 X$$

Therefore, in this research, the logistic regression model is constructed as follows:

$$Logit\ (ZDummy) = \beta_0 + \beta_1\ ENTKAM + \beta_1\ ACCKAM + \beta_3\ CFP + \sum Controls + \varepsilon$$

4. RESULTS AND DISCUSSION

4.1. Empirical Results

Based on Table 5, the sample of companies studied in this research was 235 companies.

Table 5. Selection of Research Samples

No.	Criteria	Number of Companies
1.	Population of companies in the consumer cyclical and non-cyclical sectors listed on the Indonesian Stock Exchange (BEI) in 2022	274
2.	Companies that do not provide audited annual financial reports as of December 31, 2022	(25)
3.	Financial statements that are not reported in Rupiah	(14)
A sample of companies studied		*235*

4.1.1. Descriptive statistics

The following are the descriptive statistical results of the variables examined in this research:

Table 6. Descriptive Statistics Results

Variabel	Observasi	*Mean*	*Std. Dev*	*Min*	*Max*
FD	235	0.14	0.35	0.00	1.00
ENTKAM	235	0.45	0.08	0.00	0.29
ACCKAM	235	0.10	0.06	0.00	0.27
CF	235	6.00	2.26	1.00	8.00
UP	235	27.84	1.84	23.76	32.11
KA	235	0.22	0.42	0.00	1.00

Based on Table 6, FD (Financial Distress) is the dependent variable, which has a minimum value of 0 and a maximum value of 1. A value of 1 means the z-score result is below 2.6, and vice versa for a value of 0. One of the companies that has a minimum value of 0 is PT Wilmar Cahaya Indonesia Tbk (CEKA), and the firm that has a maximum value of 1 is PT Eagle High Plantation Tbk (BWPT).

ENTKAM (Entity-level KAM) and ACCKAM (Account-level KAM) as independent variables have a minimum value of 0 and a maximum value of 0.29 and 0.27, respectively. ENTKAM and ACCKAM show the KAM disclosure ratio using the disclosure table adopted in this research. One of the companies for which the KAM disclosure level is a minimum value for both entity-level KAM and account-level KAM is PT Dharma Samudera Fishing Industries Tbk (DSFI). Meanwhile, companies that have a KAM disclosure level with the maximum value are PT Prima Cakrawala Abadi Tbk (PCAR) for ENTKAM and PT Salim Ivomas Pratama Tbk (SIMP).

CF (Cash Flow Pattern) as an independent variable has a minimum value of 1 and a maximum value of 8. The lower the CF value, the more likely the firm is to experience financial difficulties. The firm that has a minimum CF value is PT Multi Prima Sejahtera (LPIN), and the firm with the maximum CF value is PT Astra Agro Lestari Tbk (AALI).

Besides that, Table 6 also shows the descriptive statistical values of the control variables, namely UP (firm size) and KA (audit quality). The minimum and maximum values of UP are 23.76 and 32.11, respectively. The firm that has the lowest and highest UP values is PT Globe Kita Terang Tbk (GLOB) and PT Indofood Sukses Makmur Tbk (INDF). The KA value reflects the KAP that audits the firm's financial reports. The firm audited by KAP Big4 is PT Japfa Comfeed Indonesia Tbk (JPFA), and the firm audited by KAP Non-Big4 is PT Tri Banyan Tirta Tbk (ALTO).

4.1.2. Multiple Regression Test

Table 7 shows the results of panel data regression tests using the common effect model to look at the independent variables that influence financial distress, as follows: KAM disclosure based on risk level (entity-level and account-level) and cash flow patterns with firm size and audit quality as control variables.

Table 7. Panel Data Regression Test Results

FD	Coef.	Std. Err.	t	P>|t|	95% Coef.Intervall	
ENTKAM	1.55	0.36	4.30	0.00	0.84	2.26
ACCKAM	0.42	0.43	0.97	0.33	-0.43	1.27
CF	-0.02	0.01	-2.16	0.03	-0.05	-0.00
UP	-0.00	0.13	-0.25	0.80	-0.03	0.02
KA	0.03	0.06	0.53	0.60	-0.09	0.15

Table 7. Panel Data Regression Test Results (continued)

FD	Coef.	Std. Err.	t	P>|t|	95% Coef.Intervall	
_Cons	0.26	0.36	0.72	0.47	-0.45	0.97
N	**235**					
Prob>F	**0.00**					
R-Squared	**0.18**					

Based on the results of panel data regression tests, the Prob>F value is 0.00, which means that the independent variable influences the dependent variable simultaneously. This also shows that the research model is feasible to use. The R-squared value is 0.18, which means that the dependent variable can be explained by the independent variable in this research by 18%. While 82% is explained by other variables outside this study.

The t value of ENTKAM is 4.30 with a P>|t| value of 0.00, which means that ENTKAM has a significant positive effect on FD. Besides that, CF has a t value of -2.16 with a P>|t| value of 0.03, which means that CF has a significant negative effect on FD. Meanwhile, other variables such as ACCKAM, UP, and KA do not have a significant effect on FD because they have a t value below 1.96 or a P>|t| value above 0.05. Table 8 below shows the results of logistic regression to test the probability of occurrence of the financial distress variables that can be predicted by independent variables.

Table 8. Logistic Regression Test Results

FD	Odds Ratio	Std. Err.	z	P>|z|	95% Coef.Intervall	
ENTKAM	31796.77	67548.19	4.88	0.00	494.44	2044807
ACCKAM	37.61	124.87	1.09	0.28	0.06	25189.49
CF	0.79	0.08	-2.51	0.01	0.65	0.95
UP	0.96	0.14	-0.31	0.76	0.72	1.27
KA	1.55	1.04	0.65	0.51	0.42	5.79
_Cons	0.62	2.41	-0.12	0.90	0.00	1258.02
Log Likelihood		**-77.08**				
N		**235**				
Prob>chi2		**0.00**				
Pseudo R2		**0.19**				

Based on the results of the logistic regression test, the Prob>chi2 value is 0.00, which means that the independent variables simultaneously influence FD. The Pseudo R2 value of 0.19 indicates that 19% of the variables in this study can explain FD; the remaining FD can be explained by other variables outside of this study.

The z value of ENTKAM is 4.88 with a P>|z| value of 0.00, which means that ENTKAM has a significant positive effect on FD. Besides that, CF has a z value of -2.51 with a P>|z| value of 0.01, which means that CF has a significant negative effect on FD. Meanwhile, other variables such as ACCKAM, UP, and KA do not have a significant effect on FD because they have z values below 1.96 or P>|z| values above 0.05.

4.2. Discussion

4.2.1. The Effect of Entity-Level KAM Disclosure on Financial Distress

The research results of the first hypothesis are in line with research that entity-level KAM has a significant positive effect on financial distress. KAM entity-level disclosures [4], such as business continuity, internal control, fraud, taxation, litigation issues, and others, can predict the firm's financial health condition because disclosures based on audit findings are pervasive or tend to influence overall business conditions. It will be better at capturing risks relevant to a firm's financial difficulties when compared with KAM disclosures per account type because they have a direct impact on its performance.

4.2.2. The Effect of Account-Level KAM Disclosure on Financial Distress

The research results from the second hypothesis state that KAM account-level disclosure does not affect financial distress. These results are not in line with research from the prior study, which states that account-level KAM has a significant positive effect on financial distress [4]. Disclosure of

account-level KAM, such as revenue, expenses, inventory, fixed assets, and others, only focuses on specific areas. So, it may not be able to predict indications of financial difficulties that occur within a firm because these disclosures do not have a direct impact on its financial performance. One possible explanation for the insignificant effect of account-level KAM is that these disclosures are primarily related to specific accounting estimates or balances, rather than the overall financial condition of the firm. In contrast, entity-level KAM reflects broader risks, such as concern issues, internal control weaknesses, and macroeconomic uncertainty, which are more directly associated with financial distress.

This finding is consistent with recent studies suggesting that users of financial statements place greater emphasis on KAM disclosures that signal firm-wide risk rather than technical accounting issues. From a practical perspective, this implies that auditors should carefully communicate entity-level risks, as they are more informative for stakeholders. For regulators, the findings support the importance of enhancing guidance on KAM disclosures to improve their decision usefulness. For investors, entity-level KAM can serve as an early warning signal of financial distress.

4.2.3. The Effect of Cash Flow Pattern on Financial Distress

The research results of the third hypothesis are in line with prior study that cash flow patterns have a significant negative effect on financial distress [1,12]. Cash flow patterns can predict symptoms of the firm's financial difficulties. Therefore, higher cash flow reduces the likelihood of financial distress by the firm, the lower the indication of financial distress because it has more cash flow to fund operating, investing, and financing activities. On the other hand, if the firm's cash flow tends to be low, then it indicates experienced financial difficulties. The findings of this study are also consistent with recent literature suggesting that KAM disclosures contain risk-relevant information for stakeholders. Prior research indicates that more detailed and complex KAM disclosures are associated with higher financial reporting risk and potential financial instability (International Review of Financial Analysis, 2024). Furthermore, recent evidencesuggests that KAM disclosures are closely linked to audit processes and reporting timeliness [18], indicating their broader role in reflecting firm-level risk and audit complexity.

5. CONCLUSION

This study examines firms in the consumer cyclical and non-cyclical sectors listed on the IDX in 2022 and finds that entity-level KAM disclosures are positively associated with financial distress, indicating that broader audit risk disclosures capture underlying firm vulnerabilities, while account-level KAM disclosures are not significant, suggesting they provide limited insight into overall financial conditions. In contrast, stronger cash flow patterns reduce the likelihood of financial distress, highlighting the importance of internal liquidity in maintaining financial stability.

These findings contribute to the literature by distinguishing the roles of entity-level and account-level KAM disclosures and by demonstrating the complementary value of cash flow patterns in predicting financial distress. From an economic perspective, the results suggest that stakeholders, particularly investors and regulators, should place greater emphasis on entity-level KAM disclosures and cash flow signals when assessing firm risk and sustainability. This study is limited by its focus on a single year, specific sectors, and a restricted set of KAM disclosure categories. Future research could incorporate additional firm-level and macroeconomic variables to provide a more comprehensive analysis of financial distress. It may also extend the sample across different industries and time periods and further refine KAM classifications to capture more detailed risk dimensions.

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