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Financial Audit Supervision: Theoretical Interpretation of Advantages

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Abstract: *This article starts from the perspectives of market failure and regulatory failure, elaborating on the theoretical logic of financial supervision through the analysis of dimensions such as monopoly, information asymmetry, and externalities. Simultaneously, it conducts an in-depth analysis of the reasons for regulatory failure, including lack of intention, lack of capability, and pro-cyclical effects. Therefore, to ensure the effectiveness of regulation, third-party organizations need to independently constrain it. As an integral part of the party and state supervision system, the National Audit Office, with its unique governance advantages, effectively plays the role of a financial guardian through independent functional design, routine supervision mechanisms, and cross-cutting supervision content. This research provides a theoretical interpretation of the functions of the National Audit Office in economic examinations.*

Keywords: *Financial Audit, financial supervision*

1. Introduction

The overlapping of market failure and regulatory failure is an undeniable factor leading to financial crises. To effectively resolve financial crises, an independent supervisory system must be established as an effective complement to dual failures in the market and regulation. James R. Barth introduced the concept of a financial guardian, pointing out the lack of independent overseers in the U.S. financial markets. In China, the National Audit Office, as a crucial component of the party and state supervision system [1], has become a vital entity undertaking the role of a financial guardian, thanks to its unique governance advantages.

2. Market Failure Requires Financial Regulation

In the course of the development of financial markets, recurring financial crises have revealed that market mechanisms are often ineffective in resource allocation, leading to the phenomenon of "market failure." The main causes of market failure include imperfect competition, external influences, public goods, and unsafe information. This article delves into the aspects of monopoly, information asymmetry, and externalities, coupled with China's economic characteristics.

2.1. Financial Market Monopoly and Financial Regulation

According to the theory of imperfect competition, monopoly is a factor influencing the failure of financial markets. Financial monopolies not only exist globally but also played a significant role in the U.S. financial crisis. It is also a characteristic of China's financial market structure, despite differences. Traditional theories suggest that monopolies may lead to a loss of overall social welfare, resulting in unreasonable resource allocation, reduced economic efficiency, and difficulty achieving Pareto optimality in society [2]. According to rent-seeking theory, financial institutions in financial markets may incur greater costs to pursue and maintain a monopoly position, which is a pure net loss for overall social welfare. Monopoly manifests as the presence of massive organizational structures in the financial market, with these institutions holding significant positions in the industry but often facing difficulties in adjustment and violating consumer rights through unilateral contract terms. However, monopoly also has some positive effects, particularly in China's financial industry. In China, the economies of scale formed under monopoly help reduce transaction costs in the financial market. The large human, financial, and material resources, coupled with strong professional skills, governance capabilities, and institutional development, aid financial institutions in resisting the impact of financial risks. Large

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state-owned financial institutions in China's management have dual goals of political performance and performance, actively responding to national policies and playing a positive role in supporting small and micro enterprises, rural areas, green finance, and other areas.

2.2. Financial Market Information Asymmetry and Financial Regulation

Information is a highly valuable resource, especially in financial markets where its significance is prominent. The fundamental economic function of financial markets is to transfer funds from one party (households, businesses, and governments) with surplus funds to another party facing a shortage of funds due to expenditures exceeding income. In this intermediation process, information asymmetry becomes a key factor for arbitrage[3]. Information asymmetry is a significant manifestation of financial market failure, implying that investors may face adverse selection and moral hazards, hindering the effective functioning of financial markets.

Firstly, information asymmetry may lead to moral hazards. In financial markets, moral hazards manifest in the transfer of the right to use funds, where contributors must ensure the repayment ability of funds and pay subsidies for the transfer of usage rights. Meanwhile, recipients of funds need to provide information about their repayment capabilities and pay the costs of using funds. In the process of providing funding channels and guarantees, financial intermediaries face the issue of rigid redemption behind financial products. Moral hazards primarily arise from the concealment of the recipient's repayment ability, such as the manipulation of financial statements, false information disclosure in the stock market, and debt defaults in the bond market. The root cause of these problems is the moral hazard under information asymmetry, representing the manifestation of financial market failure.

Secondly, information asymmetry may lead to adverse selection[4]. In financial markets, the insurance market is often used to illustrate adverse selection, i.e., the phenomenon of bad money driving out good money. This phenomenon is also prevalent in stock markets, bond markets, and credit markets. Information asymmetry caused by moral hazards and adverse selection increases transaction costs and information costs in financial markets. One of the reasons for financial regulation is to alleviate information asymmetry under financial market failure. In China, due to the large proportion of small and medium-sized investors in the stock market and their lack of professional competence, the information asymmetry issue is exacerbated. With the advancement of the registration system reform, regulations not only focus on enhancing the disclosure level of information providers but also emphasize improving the education level of small and medium-sized investors.

2.3. Financial Market Externalities and Financial Regulation

Externality refers to the impact of the actions of economic entities on the welfare of other entities, which may lead to external economies and external diseconomies [5]. In financial markets, financial activities exhibit obvious externalities, mainly reflected in the negative externalities of financial risks, leading to the occurrence of financial and economic crises. Externalities in financial markets manifest in various ways, including the impact of financial activities on the financial market, the impact of the financial market on the national economy, and the impact on the macroeconomy. Without measures to correct market failures, market mechanisms cannot function effectively, causing adverse effects on the overall economy. Therefore, regulatory intervention in financial markets becomes a necessary means to address the problem of financial market failure. The government's regulation of financial markets aims primarily to promote information disclosure and ensure the stability of the financial system.

3. Regulatory Failure Requires Independent Supervision

If financial market intervention is necessary due to market failure, is regulation always effective? The answer is negative. Whether subjectively, regulatory intentions deviate, or objectively, regulatory capabilities are lacking, regulatory failure may occur. Therefore, the market also needs an independent overseer separate from regulation.

3.1. Lack of Will and Regulatory Failure

Will refers to one's desires or wishes. Lack of will implies that the regulatory subject's behavior goals are no longer aimed at correcting market failures but are more inclined toward personal interests.

From the perspective of regulatory capture theory, companies, driven by rent-seeking motives to pursue and maintain a monopoly, lead to a desire for government support. In China, the monopoly status of financial institutions is rooted in their historical origins. State-owned financial institutions naturally seek government support, while private enterprises pursue a certain degree of monopoly through political connections. The motive behind these political connections, achieved through ownership transfers, direct interest transfers, and regulatory lobbying, gradually diminishes the regulatory officials' will. Acemoglu revealed that the process of relaxing financial regulations in the United States over the past 30 years was a lobbying-driven process [6]. Audit reports reveal the existence of regulatory hunting and independence risks, as well as shortcomings in the Federal Reserve's policy-making process. On the other hand, the phenomenon of the "revolving door" between financial regulation and financial institutions further strengthens the motive for resignation. Imperfect incentive systems, including monetary compensation, limited promotion opportunities, and career development restrictions, make regulatory personnel more inclined to pursue personal interests, thereby weakening the regulatory will. Inadequate policy measures, industry development pressures, and obstacles to innovation by regulation also intensify the motivation for regulatory personnel to resign. These issues have attracted attention from relevant authorities, attempting to restrict the resignation behavior of financial regulatory personnel through documents such as "Opinions on Regulating the Post-Resignation Employment Behavior of Civil Servants." The existence of default costs further weakens the willingness of regulatory personnel to take effective actions. Regulatory personnel may believe that even if violations occur, they may not be discovered, or even if exposed, the costs may be low. This kind of luck mentality, coupled with actions taken to avoid risks, leads to delayed regulation, harming financial order. Under the pressure of industry development, regulation becomes a constraint on the system, but overly strict regulation may become a barrier to financial innovation, forming an obstacle to industry development. The real solution to the problem of lack of regulatory will requires regulatory authorities to focus on regulation rather than industry development, reducing the possibility of lack of will.

3.2. Lack of Capability and Regulatory Failure

Professional competence is a crucial factor for effective regulation, and financial regulation, due to its difficulty and depth, demands higher requirements from practitioners. Financial regulatory personnel need to possess professional competence levels higher than financial institutions, combining theoretical knowledge with practical skills. This is because financial institutions and regulation have been in a game of innovation and regulation. If regulatory authorities cannot have a higher professional level, they will find it difficult to discover the innovative models and potential motives of financial institutions. Professional competence in the cross-disciplinary field of finance is also indispensable. Financial institutions engage in various means of fund operations, and regulation needs to comprehensively grasp financial theories and practical knowledge to identify problems during on-site and off-site inspections. At the same time, maintaining proactive learning capabilities is crucial. The continuous development of financial innovation and regulation requires regulatory personnel to continuously learn new knowledge, understand new systems, models, and developments at home and abroad. Although there is a learning curve effect for regulators, the rapid development of the financial field requires regulators to continuously increase their learning costs. In this regard, auditing can leverage its advantages through organizational models and big data analysis to promote the improvement of regulatory personnel's professional competence.

Secondly, professional competence is required in the cross-disciplinary field of finance. Financial institutions interconnect through fund operations. Starting from the banking sector, they can directly lend to those in need of funds, enter the stock market through securities investments, engage in buying and selling corporate bonds and enterprise bonds in the bond market, and utilize trust plans and asset management plans. The financial field involves cross-domain integration, continuously concealing the direction of fund operations and the transfer of usage rights through various agreements, such as repurchase agreements, drawer agreements, and additional terms [7]. If regulatory actions need to be implemented on these behaviors or even more complex financial activities, comprehensive knowledge of financial theory and practice is required. Regulatory personnel must address problems during on-site inspections and have a clear data analysis approach during off-site inspections, posing a challenge for financial regulatory personnel.Thirdly, maintaining proactive learning competence is essential. Financial innovation is ongoing, and regulation is continuously progressing, requiring a corresponding increase in learning capabilities. However, learning comes with associated costs, not only in terms of later-stage training but also in mastering and understanding new systems, models, and developments domestically and internationally during the same period. Although regulators may have a certain

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learning curve effect, meaning that with repeated occurrences of regulatory matters, the time required for each execution becomes less, continuous financial innovation makes it difficult to maintain the same regulatory approach and mindset. For example, facing recent financial technology innovation, the development of cryptocurrencies, and the deepening of internet finance, regulations are continuously introducing new systems. Therefore, whether in terms of willingness or capability, government regulation after market failure also has the possibility of failure. In organizational settings, a supervisory role for regulators is needed. Supervisory systems include various forms such as state agency supervision, democratic supervision, judicial supervision, public supervision, and media supervision. As an important part of the party and state supervision system, national audit, in undertaking the role of a supervisor for financial regulation, possesses its own advantages [7]. Of course, regarding the lack of willingness and capability, the independence of audit personnel is crucial. With a willingness advantage, audit personnel can play a key role. In terms of professional competence, leveraging the organizational model of audit projects can utilize the advantages of teamwork, allowing talents from different professional fields to complement each other and form a joint force. Additionally, harnessing the power of big data analysis, integrating cross-market and cross-domain data, and finding audit advantages through analysis can also be beneficial.

3.3. Pro-cyclical Effects and Regulatory Failure

From the perspective of financial regulation, the role of pro-cyclicality cannot be ignored. From an audit perspective, aligned with regulatory goals of preventing financial risks and maintaining financial security, promoting the better play of the countercyclical regulatory role is also a crucial step in achieving financial security.

Firstly, in the process of formulating economic policies, the timeliness of considering the effectiveness of policies is required. The introduction of financial regulatory policies has cyclicality. Policies primarily regulate behaviors and markets, and from the proposal of policy intentions to policy formulation, soliciting opinions, trial implementation, and finalization, a relatively long cycle is needed. For dealing with some emergencies and problems, policy effects often have timeliness [8]. Therefore, when the economy is booming, consideration should be given not only to countermeasures against economic overheating but also to how to adjust policies in a timely manner when the economy is declining after policy issuance.

Secondly, under the segmented regulatory model, the realization of countercyclical regulation by different departments needs to be promoted. Different regulatory departments, due to different functions and closely monitoring different regulatory targets, may have regulatory frictions, increasing the cost of institutional coordination. On the one hand, there may be mutual shirking among cross-sector regulatory departments, with unclear regulatory subjects leading to regulatory gaps. On the other hand, there may be policy conflicts during the same period based on different goals, resulting in conflicting policy offset effects. The advantage of national audit lies in considering the context through the policy transmission mechanism, observing policy implementation effects, revealing problems in policy execution, and providing feedback to policy-making institutions [9]. It can also promptly reveal areas of regulatory overlap and regulatory gaps in the face of regulatory friction among different departments, objectively evaluate, promptly discover, accurately reveal, and promote regulation, starting from the overall perspective of high-quality development of the macroeconomy. It is important to note that the need for financial regulation does not arise solely because of market failure, and the need for audit supervision does not arise solely because of regulatory failure. This is just one of the theoretical foundations for audit to supervise financial regulatory authorities.

4. Governance Advantages of Independent Oversight

Markets are not always effective, and the same holds true for regulation[10]. Who watches the watchdogs? Barth J.R. et al. introduced the concept of financial guardianship, suggesting that the financial supervision system could serve as an effective complement in cases of market and regulatory failure, while maintaining a clear distinction from regulators. National auditing, as a crucial component of the oversight system, is well-suited to assume this responsibility due to its independent functional design, regular oversight mechanisms, and comprehensive oversight content.

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4.1. Independent Auditing Oversight Functions

According to national system design, the greatest strength of national auditing lies in its independence, a critical requirement for the concept of financial guardianship.

Independence in Legal Status: Independence is a focal point in auditing, and national auditing must maintain dual independence both in form and substance. As per the regulations on auditing independence in Article 5, Article 6, Article 12, and Article 12 of the Auditing Law, "Audit institutions independently exercise auditing oversight in accordance with the law, free from interference by other administrative organs, social organizations, and individuals. Audit institutions and auditors shall not participate in activities that may affect their independent performance of auditing oversight duties, and they shall not intervene in or interfere with the normal production, operation, and management activities of audited entities and their related units." National auditing possesses independent auditing oversight rights as defined by law and is free from interference. Maintaining independence is the linchpin of national auditing. Articles 14, 16, 17, 18, 19, and 21 of the National Auditing Standards delineate the regulations related to independence in national auditing. Independence is a professional requirement for national auditing and is the essence of objective fairness in the auditing profession.

Independence in Oversight Functions: Financial regulatory authorities possess dual authorities in management and oversight. In the process of considering industry development, regulatory bodies may inadvertently overlook regulatory issues within the industry. National auditing, with its sole oversight function, can effectively complement regulatory failures. For example, between 1995 and 2022, China's insurance industry experienced rapid growth, and the emergence of cross-border financial products complicated the development of the financial industry. However, issues such as regulatory gaps and redundancy were prevalent. The dual attributes of regulatory departments may result in considerable hesitancy during the punitive oversight process. However, national auditing, with its independent oversight function, is better positioned to address regulatory failures. Therefore, an independent auditing oversight system can effectively overcome the phenomenon of intention deficiency in regulatory failures.

4.2. Normalized Audit Oversight System

At the current stage, China has a well-established oversight system. Compared to functional departments such as inspections, discipline inspection, and supervision, the advantage of national auditing lies in its normalized oversight system. This normalization is evident in institutional design and project implementation.

Firstly, institutional design normalization is primarily demonstrated in the vertical management of China's audit entities. China implements a dual vertical management system with the Audit Office and local audit institutions. The full-dimensional audit supervision system at both central and local levels enables a better top-down understanding of policy effectiveness and issues, while also allowing for a bottom-up grasp of the development of individual economic entities, acquiring the most authentic economic data. This vertical audit management system, especially in addressing issues of capability deficiency in regulatory failure, regulatory conflicts, and regulatory gaps, has institutional advantages.

In the field of financial auditing, the Audit Office has a specialized Financial Audit Bureau deployed within audited entities, overseeing different markets. This establishment, compared to other oversight mechanisms, is more favorable for fulfilling the role of economic check-ups.

Secondly, the normalization of project implementation is another crucial aspect. For example, regular projects such as budget execution audits and audits of the economic responsibilities of leading cadres are more conducive to constructing effective oversight mechanisms. These projects facilitate the periodic discovery of audit leads, focusing on abnormal fluctuations and significant risks in financial markets, issuing timely warnings. Conversely, temporary special audits are advantageous for concentrating efforts on key areas, stabilizing the financial system, preventing systemic financial risks, and maintaining financial security.

4.3. Cross-Dimensional Audit Oversight Content

National auditing can audit both financial institutions and regulatory departments, forming a dual-dimensional oversight approach that is more macroscopic and comprehensive than that of regulatory bodies. Firstly, it focuses on correcting the regulatory effects of financial supervision, intervening when regulatory failure occurs. National auditing can supervise and guide financial regulatory agencies in correctly performing their functions, becoming a supervisor of their functional execution. On the other hand, it focuses on the financial market failure itself. In the context of regulatory failure, where regulation cannot effectively control market failure[11], national auditing, through the implementation of audit projects, can directly observe financial market failure behaviors, aiming to maintain financial security and perform some functions of financial supervision. These two dimensions together constitute the mainline of national auditing in safeguarding financial security.

5. Conclusion

Due to the influence of monopolies, information asymmetry, and externalities, market failures are prevalent, necessitating timely correction through financial supervision. However, regulation is not omnipotent, and driven by intention deficiency, capability deficiency, and pro-cyclical effects, regulatory failures exist, requiring an independent supervisory mechanism for constraint. National auditing, as an essential component of the Party and state supervisory system, endowed with rich audit objects and extensive audit powers under its institutional advantages, can effectively address the issue of regulatory capability deficiency. As one of the ways to conduct economic check-ups, the position of national auditing is more macroscopic and comprehensive, enabling better identification of crisis clues. Therefore, in the realm of supervisory governance, national auditing has certain advantages and qualifies as a financial guardian. It should be clarified that while national auditing cannot replace the functions of financial regulatory agencies, it can act as a supervisor of their functional execution. Additionally, national auditing focuses on the financial market failure itself. In the case of regulatory failure, through the implementation of audit projects, it helps directly observe and manage the failure behaviors in the financial market, further safeguarding financial security.

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