

# Deepening Economic Responsibility Auditing of Local State-owned Enterprise Leaders: A Strategic Framework for Governance Modernization and Sustainable Value Creation

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## Abstract

This paper presents a constructive analysis and a forward-looking enhancement framework for the Economic Responsibility Audit (ERA) system as applied to leading cadres of local state-owned enterprises (LSOEs) in China. As a distinctive and integral component of China's state assets supervision mechanism, the ERA plays a crucial role in ensuring accountability and promoting the healthy development of the state sector. Focusing on LSOEs, which serve as key instruments for regional development under the socialist market economy, this paper explores pathways to refine the ERA's effectiveness in line with the national objectives of deepening reform and modernizing state asset governance. We propose a strategic evolution from a primarily compliance-focused audit towards a more comprehensive, value-oriented "governance - value audit" model. This paper introduces an innovative, five-pillar framework: (1) Strengthening institutional design and developing differentiated audit standards responsive to the diverse missions of LSOEs. (2) Expanding the audit scope to a holistic assessment integrating strategic decision-making quality, innovation drivers, and Environmental, Social, and Governance (ESG) performance. (3) Modernizing methodologies through risk-based planning and data analytics. (4) Institutionalizing consequential and constructive utilization of audit findings within cadre management and governance improvement processes. (5) Fostering professional audit capacity building. By aligning contemporary performance audit principles with the specific context of China's state-owned economy, this framework aims to enhance the ERA's role in safeguarding state assets, guiding sound decision-making, and fostering sustainable, high-quality development of LSOEs, thereby contributing to the broader national governance framework.

## Keywords

Economic Responsibility Audit, Local state-owned enterprises, Corporate governance, Performance audit, Strategic decision-making, Accountability, State-owned assets supervision

## Introduction

The role and evolution of ERA in the context of SOE Reform are analyzed, as China's state-owned sector operates within the framework of the socialist market economy and comprises both centrally-administered state-owned enterprises and local state-owned enterprises. LSOEs are vital entities entrusted with significant state assets and charged with important responsibilities. They contribute to regional economic stability, implement industrial policies, deliver public services, and drive local development, all while adapting to market dynamics. The leaders of these enterprises bear substantial responsibility for their stewardship and performance [1].

The Economic Responsibility Audit (ERA) is a cornerstone institution within China's state assets supervision and anti-corruption frameworks [2]. The ERA is systematically conducted upon the appointment, during the tenure, and upon the departure of SOE leaders. It serves critical functions by evaluating the fulfillment of economic and managerial duties, verifying the legality and regularity of financial and operational activities, and assessing leadership integrity. It is a key mechanism for enforcing accountability and promoting the lawful, compliant, and efficient operation of state capital.

As China continues to deepen reforms of its

state-owned sector and advance the modernization of its national governance system, the ERA system itself is subject to ongoing refinement and enhancement. In the context of LSOEs, which often operate under dual mandates of public service and market performance, there is a recognized opportunity to further strengthen the ERA's effectiveness. The aim is to ensure it comprehensively and accurately reflects a leader's performance across all dimensions of their responsibility. This paper proceeds from the premise that the ongoing development of the ERA is a constructive and necessary process. It seeks to contribute by exploring how the audit can evolve to better serve its core functions. These functions include safeguarding state assets, improving governance, and guiding LSOEs toward sustainable, high-quality development in line with contemporary requirements. The proposed evolution is not a departure from the system's foundations, but a strategic enhancement to increase its precision, relevance, and impact.

### **Literature review: Theoretical perspectives and institutional context**

#### ***The principal - agent framework and the Chinese context***

From a theoretical standpoint, the ERA can be analyzed through the lens of principal-agent theory, which addresses the challenges of aligning the interests of an owner (principal) with those of a manager (agent) [3]. In the context of state ownership, this framework highlights the importance of monitoring mechanisms to ensure that agents (SOE cadres) act in the best interests of the principal (the state, representing public ownership). The ERA functions as such a critical monitoring and verification tool.

It is important to situate this theory within China's unique institutional environment. The governance of SOEs involves a multi-faceted set of objectives that balance economic efficiency with strategic, social, and policy goals. Therefore, while the principal-agent model provides a foundational understanding of the need for accountability, the application of the ERA must account for this broader set of responsibilities embedded in the socialist market economy.

#### ***Performance auditing and stakeholder considerations***

Globally, the field of public sector auditing has evolved from strict financial compliance checking towards

performance auditing, which assesses the economy, efficiency, and effectiveness (3Es) of programs and resource use. Scholars have examined the broader societal role of auditing. In the specific context of Chinese SOE reform, researchers have discussed the potential for the ERA to contribute more directly to value creation and governance improvement [4,5].

Furthermore, stakeholder theory broadens the perspective on organizational accountability [6]. For an LSOE, key stakeholders extend beyond the immediate government shareholder to include employees, customers, local communities, and the environment. This implies that a comprehensive evaluation of leadership performance should consider impacts on these groups, aligning with concepts of sustainable development and social responsibility.

#### ***Research focus: Enhancing ERA for LSOEs***

Existing literature has established the ERA's role and identified general areas for development. However, there is a distinct need for focused research that addresses the specific operational context of LSOEs. Their close ties to local government, diverse operational profiles (from public utilities to competitive industries), and specific reform challenges necessitate tailored approaches. This paper aims to address this gap by developing a structured, practical framework for enhancing the ERA's design and execution specifically for LSOE leaders, integrating relevant theoretical insights with the practical demands of China's state sector governance.

#### **An enhancement framework: A five-pillar model**

To systematically address the objective of enhancing the ERA for LSOEs, this paper proposes an integrated framework built upon five interdependent pillars. The strength of the overall framework relies on the simultaneous advancement of all components:

- (1) Strengthening institutional design and context appropriate standard-setting: Ensuring robust audit governance and relevant evaluation criteria.
- (2) Evolving towards a holistic "governance - value" audit scope: Encompassing financial, strategic, innovative, and social/environmental performance.
- (3) Modernizing methodologies with risk awareness and technological tools: Employing dynamic planning and data-driven techniques.
- (4) Strengthening the constructive utilization of audit

outcomes: Ensuring findings lead to tangible governance improvements and informed personnel evaluations.

(5) Fostering professional audit capacity and systemic learning: Building the expertise and knowledge systems needed to execute advanced audits.

The following sections elaborate on each pillar.

### **Strengthening institutional design and context-appropriate standard-setting**

#### ***Upholding audit objectivity and tailoring approaches***

The credibility and effectiveness of the ERA depend fundamentally on its objectivity and the relevance of its criteria. Institutional arrangements should be designed to support audit independence and mitigate potential conflicts of interest. Furthermore, applying a uniform audit checklist to all LSOEs is impractical and can lead to misaligned evaluations. A city's public transportation company and a local high-tech manufacturing firm have fundamentally different primary missions and success metrics.

#### ***Approaches: Governance refinements and typology-based standards***

To support objectivity, the governance of high-stakes LSOE audits can benefit from clear protocols, including appropriate levels of oversight and review. More importantly, audit standard-setters should develop a categorized framework for LSOEs [7]. Enterprises could be classified into mission-based typologies such as:

(1) Public service and utility providers: Focusing on service quality, reliability, safety, affordability, and operational efficiency. Financial performance is assessed in the context of these primary duties.

(2) Competitive market entities: Emphasizing market performance, profitability, competitiveness, and strategic positioning, while also considering state-assigned strategic tasks.

(3) Infrastructure and development entities: Prioritizing project governance, long-term asset viability, debt sustainability, and contribution to regional development goals.

For each typology, a customized set of key performance indicators (KPIs) should guide the audit process, ensuring it evaluates what truly matters for that specific type of enterprise.

#### ***Illustrative application: Mission-driven audit planning***

Auditing a regional water supply company (a Public Service entity) under this framework would shift focus. Beyond basic financial checks, the audit would be carefully examined. (1) Service delivery: water quality compliance rates, supply continuity, and customer service responsiveness. (2) Social equity: coverage in underserved areas and tariff structures for vulnerable populations. (3) Resource efficiency and sustainability: network leakage rates, energy consumption, and plans for infrastructure renewal. This approach ensures the audit evaluates the leader's performance against the entity's core public service mission.

#### ***Evolving towards a holistic “governance - value” audit scope***

#### ***Complementing financial accountability***

Financial integrity remains a bedrock of the ERA. However, a leader's economic responsibility encompasses more than accounting accuracy. The “governance - value” concept advocates for a balanced assessment that captures the leader's overall contribution to the enterprise's health and its alignment with broader state objectives [8].

#### ***Evaluating strategic decision-making processes and outcomes***

A critical enhancement is the structured evaluation of major strategic decisions (e.g., significant investments, mergers and acquisitions). This involves a two-part analysis:

(1) Process quality: Assessing the rigor of the decision-making process itself - feasibility studies, due diligence, risk assessment, and adherence to internal governance rules (board reviews and approvals).

(2) Outcome analysis with context: Examining the results of decisions against their stated objectives. Crucially, auditors should seek to understand the strategic rationale and context at the time of the decision. This allows for a more nuanced judgment that distinguishes between well-reasoned strategies that face unforeseen market challenges and decisions flawed by poor process or judgment.

#### ***Assessing contributions to innovation and long-term competitiveness***

For LSOEs in competitive or technologically driven sectors, the audit should consider the leader's role in fostering innovation and building capabilities for the

future. This includes reviewing investments in research and development (R&D), talent cultivation and retention programs, partnerships with research institutions, and the adoption of digital technologies to enhance efficiency and innovation capacity. This dimension measures investment in the enterprise's long-term vitality.

#### ***Incorporating comprehensive performance indicators including ESG***

Integrating Environmental, Social, and Governance (ESG) factors provide a structured way to assess an enterprise's broader impact and sustainability [9]. This aligns the ERA with national priorities like ecological civilization and social harmony.

(1) Environmental (E): Reviewing compliance with environmental regulations, energy and resource efficiency, pollution control, and management of environmental risks. The quality of environmental information disclosure is directly related to the economic consequences of enterprises [10].

(2) Social (S): Evaluating labor practices (safety, fair wages), product/service quality and safety, community relations, and supply chain responsibility.

(3) Governance (G): Assessing the effectiveness of internal controls, risk management systems, board structure and practices, and transparency.

Incorporating these elements ensures the audit captures the full spectrum of an LSOE's responsibilities to its stakeholders and society.

#### **Modernizing methodologies with risk awareness and technological tools**

##### ***Implementing dynamic and risk-informed audit planning***

Audit plans should be driven by a current understanding of the enterprise's key risks. Instead of a static template, auditors should conduct a dynamic risk assessment considering industry trends, regulatory changes, the LSOE's financial and operational vulnerabilities, and internal control weaknesses. This risk profile then determines the allocation of audit resources, directing more effort towards areas of highest potential risk, such as major projects, overseas operations, or procurement.

##### ***Integrating data analytics to enhance audit depth and breadth***

The use of data analytics (DA) represents a significant

methodological advancement. DA allows auditors to analyze entire datasets (e.g., all procurement transactions, all sales entries) rather than relying solely on samples. It can identify patterns, anomalies, and relationships that may indicate errors, inefficiencies, or non-compliance. For example, DA can detect unusual payment patterns, contracts just below approval thresholds, or inconsistencies in inventory records, thereby increasing the scope, speed, and detection capability of the audit.

##### ***Combining quantitative analysis with qualitative insights***

A robust ERA methodology blends technological tools with human judgment. Structured interviews and surveys with a range of stakeholders - management, employees, board members, business partners - provide essential context. They help auditors understand organizational culture, leadership style, ethical climate, and the reasoning behind decisions, thereby enriching the interpretation of quantitative data.

#### **Strengthening the constructive utilization of audit outcomes**

##### ***From reporting to governance enhancement***

The ultimate value of an audit lies in its ability to drive improvement. The process must extend beyond the production of a report to ensure that findings lead to constructive change.

##### ***Systematically linking audit results to cadre evaluation and development***

To reinforce accountability, ERA results should be a formal, substantive, and clearly weighted component of the comprehensive evaluation of leading cadres conducted by relevant Party and state personnel departments. This creates a direct and meaningful link between audit outcomes and leadership assessment, incentivizing responsible management.

##### ***Establishing effective follow-up and rectification tracking mechanisms***

A formal process should require the LSOE's board and management to develop a detailed rectification plan addressing the audit's recommendations. The implementation status of this plan should be monitored. Crucially, follow-up audits should be conducted after a reasonable period (e.g., 12-18 months) to independently verify that deficiencies have been corrected and controls strengthened. This "close-the-loop" mechanism is

essential for transforming audit findings into lasting governance improvements.

### **Fostering professional audit capacity and systemic learning**

#### ***Addressing evolving competency requirements***

Implementing the enhanced framework demands auditors with a broader skill set, combining traditional audit expertise with knowledge in data analysis, specific industries, ESG standards, and strategic management.

#### ***Developing specialized expertise and collaborative audit models***

Sustained investment in professional development is crucial. This includes training in data analytics, sector-specific risks, and sustainability metrics. Furthermore, audit institutions should establish formal protocols for collaboration with external experts. In highly specialized areas, bringing in external specialists can ensure the necessary depth and credibility of the audit work. Building a shared repository of knowledge, case studies, and best practices across the audit system can also foster consistent quality and continuous learning.

### **Discussion: Implementation considerations, pathways, and future research**

#### ***Navigating practical challenges within the reform context***

Implementing this framework will involve practical challenges, including the need for resource investment (technology, training), the development of new audit standards, and the integration of new practices into established systems. These are typical challenges associated with meaningful reform and can be addressed through careful planning and phased execution, consistent with the broader, ongoing process of SOE reform and institutional refinement.

#### ***A proposed phased approach for framework implementation***

A gradual, evidence-based implementation strategy is advisable:

- (1) Phase 1 (pilot and design): Selecting a limited number of representative LSOEs and regions to pilot key components of the framework. Focusing on learning, tool development, and process refinement.
- (2) Phase 2 (refinement and gradual expansion): Based

on pilot evaluations, refining the methodologies and guidance. Expanding application to a broader set of LSOEs, prioritizing sectors of strategic importance.

- (3) Phase 3 (system integration and institutionalization): Incorporating successful practices and refined standards into formal audit guidelines and quality control systems, ensuring sustainability and broad adoption.

### **Conclusion**

The Economic Responsibility Audit is a vital institution in China's governance landscape. This paper has proposed a comprehensive, five-pillar framework for its strategic enhancement, particularly concerning local state-owned enterprises. The ERA can be strengthened through optimized design, expanded scope, modernized methodologies, enhanced impact, and built professional capacities. It can then more effectively fulfill its role in safeguarding state assets, guiding high-quality decision-making, and promoting the sustainable development of LSOEs. This contributes to the important goals of optimizing state capital management and advancing national governance system modernization. Future research could fruitfully focus on developing specific metrics for the holistic audit scope, conducting empirical studies on the outcomes of enhanced ERA practices, and exploring comparative insights from international public sector performance auditing.

### **Funding**

This work was not supported by any funds.

### **Acknowledgements**

The author would like to show sincere thanks to those techniques who have contributed to this research.

### **Conflicts of Interest**

The author declares no conflict of interest.

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