THE ACCOUNTING REVIEW
Vol. 87, No. 5
2012
pp. 1555–1588

American Accounting Association
DOI: 10.2308/accr-50196

Influence Activities and Favoritism in Subjective Performance Evaluation: Evidence from Chinese State-Owned Enterprises

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ABSTRACT: This study addresses the two-way process in which a subordinate and a superior engage in influence activities (bottom-up) and favoritism (top-down) in subjective Performance Evaluation. The research context is the Chinese government's evaluation of Chinese state-owned enterprises (SOEs) by the State-Owned Assets Supervision and Administration Commission of China (SASAC). We analyze archival records of the government's evaluation scores, score adjustments, and evaluation ratings given to 63 SOEs between 2005 and 2007. These analyses are also interpreted based on insights gained from in-depth field interviews with SASAC officials and chief financial officers (CFOs) of SOEs. Results indicate that the political connection of SOE CFOs, the geographic proximity of SOE headquarters to the SASAC central office, and political rank of the firm affect the SASAC's evaluations.

Keywords: *subjective Performance Evaluation; favoritism; influence activities; political connections; geographic proximity; State-Owned Asset Supervision and Administration Council (SASAC); Chinese State-Owned Enterprises (SOEs).*

Data Availability: *Data used in this study cannot be made public due to a confidentiality agreement.*

We greatly appreciate the helpful comments and suggestions from two reviewers, Rajani Krishnan (editor), John Harry Evans III (senior editor), Jasmijn Bol, Clara (Xiaoling) Chen, Lei Chen, Francisco de Asis Martinez-Jerez, Kelsey Dworkis, David Erkens, Chris Ittner, Charles Lee, Joan Luft, Neale O'Connor, Joe Piotroski, Claudia (Zhen) Qi, Tatiana Sandino, Wim Van der Stede, Feng Tian, and participants in the 2010 MAS Conference. We also gratefully acknowledge the research assistance of Jiaxiang Chen and Xi Yan.

Editor's note: Accepted by Ranjani Krishnan.

Submitted: August 2010
Accepted: April 2012
Published Online: April 2012

I. INTRODUCTION

The purpose of Subjective Performance Evaluation (SPE) is to allow a superior to include information relevant to subordinate's work performance that is not incorporated in objective performance measures (Holmstrom 1979; Prendergast and Topel 1996). Studies by Gibbs et al. (2004) and Nisar (2007) suggest that including subjectivity in Performance Evaluation increases subordinate pay satisfaction, sales productivity, and trust between superiors and subordinates. While SPE allows a superior to include more information in subordinate Performance Evaluation, it also increases the likelihood of influence activities, since it provides more opportunities for subordinates to affect superior evaluation decisions and for superiors to make discretionary judgments by playing favorites (Gibbs et al. 2004).

Empirical studies in this area have emphasized the decision-influencing behavior of subordinates' activities, while focusing less on the role of favoritism on the part of the superiors.[1] This study empirically assesses the two-way relationship in a subjective Performance Evaluation process by determining how subordinates attempt to influence their evaluations and how superiors engage in favoritism with particular subordinates (Prendergast and Topel 1996).

Our research setting is the Chinese government's evaluations of 63 state-owned enterprises (SOEs—the subordinates) by the State-Owned Assets Supervision and Administration Commission of the State Council of China (SASAC—the superior). The study draws on the archival records of the Chinese government's evaluation scores, score adjustments, and evaluation ratings of 63 SOEs between 2005 and 2007, as well as in-depth field interviews with chief financial officers (CFOs) of 6 SOEs. We identify the factors that influence governmental evaluations of SOEs in addition to the financial performance indicators that the SASAC claims to use when evaluating SOEs. To address this research question, we use a database prepared by the SASAC that contains several levels of our dependent variables—the scores, ratings, the assignment of cutoff scores, and the *ex post* adjustments in scores/ratings.

Chinese SOEs play a critical role in the Chinese and world economies. At the end of 2007, the SASAC list of supervised firms contained 152 of the largest firms owned by the Chinese central government, whose asset size totaled 14.9 trillion RMB (US$2.1 trillion), and whose annual earnings totaled 1 trillion RMB (US$140 billion), accounting for 4 percent of China's annual gross domestic product (GDP). As of December 2007, 16 Chinese central government controlled SOEs were on the *Fortune* 500 list. By the end of 2011, this number has increased to 38. Each year the SASAC evaluates the performance of each central government controlled SOE in China, giving it a score based on three metrics: (1) the levels of budgetary targets on key financial indicators; (2) actual performance on the same set of key financial indicators; and (3) the degree of target difficulty as predetermined by the SASAC. Of relevance to our study is that the SASAC engages in *ex post* subjective adjustments of evaluation scores on a case-by-case basis. The SASAC makes personnel and compensation decisions based on these final evaluation scores and ratings.

Evidence from our field interviews illustrates the two-way process in which subordinates (using a bottom-up approach) and superiors (using a top-down approach) can affect subjective Performance Evaluation. From the SOE (subordinate) perspective, Performance Evaluation influences SOE executives' compensation and their political advancement, and executives are motivated to maximize performance on measures in the official evaluation formula. When subjectivity is included in the appraisal process, SOE executives have the opportunity to engage in influence activities with superiors by privately communicating information to the SASAC, engaging in joint social activities with SASAC officials, and attempting to manipulate the SASAC's

[1] Bol et al.'s (2010) study, while not directly related to ours, is the first empirical study to look at how superiors adjust sales targets to promote fairness.

perceptions of their performance in order to appear more competent (Milgrom and Roberts 1992). We assess the level of influence activities on the part of SOEs by looking at the effects of two factors on the SASAC's evaluations—the political connections of top executives of the SOEs and the geographic proximity between SOE headquarters and the central SASAC office. Further, we study how two other factors related to favoritism affect the SASAC's evaluation scores and ratings of SOEs—the SASAC's determination of whether an SOE is fulfilling strategic government objectives, and the political rank of an SOE.[2]

Results suggest that both CFO connections, an executive identity variable that proxies for influence activities, and SOE political rank, a firm identity variable that proxies for government favoritism, affect evaluation scores, ratings, and *ex post* score adjustment. To better understand whether these factors influence how governmental discretion is used to apply favoritism, we further test their role in the target-setting process and cutoff scores assignment. Results indicate that highly ranked SOEs and SOEs that compete in strategic industries obtain fewer points in achieving targets based on common measures, and obtain more points in achieving targets based on firm-specific measures than less highly ranked SOEs or SOEs not in strategic industries. The government assigns cutoff scores to the benefit of high-ranked SOEs, which is consistent with the government playing favorites with a certain set of SOEs.

Our paper proceeds as follows. In Section II we present institutional details relating to the development of the SASAC and how it conducts Performance Evaluations of SOEs. In-depth field interviews conducted with SOE CFOs and high-ranking officials of the SASAC also informed this and the following section. Section III provides the theoretical framework motivating our investigation and presents our research hypotheses. In Section IV we test our hypotheses using archival data and present our results. Section V concludes the paper with a summary, discussion, and suggestions for future research.

II. INSTITUTIONAL BACKGROUND

The state-owned enterprise (SOE) system in China has undergone enormous changes in the last three decades. SOEs were initially part of the Chinese government, but reforms gave them increasing autonomy so that, by the early 1990s, many SOEs had become independent production and management entities. The State-Owned Assets Supervision and Administration Commission (SASAC) was created in November 2002, and charged with establishing a "new state asset management system in which authority, duty, and responsibilities are united, and in which management of assets, personnel, and affairs is unified" (SASAC 2006). The SASAC represents the scaling back of government authority through the creation of an arm's-length regulatory body, and is designed to be a powerful and authoritative board of directors. The roles of the SASAC include monitoring enterprise operations to protect the rights of the government owner; dispatching supervisors to audit and monitor the enterprise; appointing members of boards of directors and establishing procedures for appointing managers; approving major decisions in enterprise operations, including mergers, bankruptcies, and the issuance of new securities; and reporting on enterprise performance and revenues to the appropriate level of government. The SASAC also issues guidelines to direct strategic pathways for the SOEs.

To understand the evaluation timeline and procedures better, we conducted in-depth interviews with two high-ranking officials from the Performance Evaluation bureau of the SASAC and with

[2]In this research setting, the government evaluator (the SASAC) is the sole decision maker that decides which industries are strategic industries, and assigns political rank to these SOEs. An SOE is not able to influence its own industry or its political rank. These two measures allow us to disentangle governmental favoritism from influence activities.

CFOs of six central government controlled SOEs in July 2009. We use insights gained from these interviews to increase our knowledge of the institutional aspects of the paper and to clarify particular findings in the results section. The interviews included a broad range of companies in different industries, including equipment manufacturing, military supply, metallurgy, commercial trade, petroleum, and a large investment holding company. We conducted three interviews in person at companies in Beijing and three others via conference calls to companies headquartered outside Beijing. We conducted all interviews in Mandarin with two of the co-authors present. We followed a strict interview protocol asking the same set of open-ended questions in the same order across all six firms and obtained insights into whether SPE, SOE influence activities, or governmental favoritism exist in the Performance Evaluation of SOEs managed by the SASAC. More specifically, we were interested in how different aspects of SPE may have affected the SASAC's Performance Evaluation scores and ratings of SOEs, and the potential factors that may have led to more favorable governmental ratings. Each interview lasted approximately three hours. By the sixth interview we did not learn anything that was significantly different from previous interviews and, thus, terminated the interview process.

Five Stages of the SASAC's Performance Evaluation Process

In this section we describe the five stages that the SASAC goes through to determine an SOE's Performance Evaluation score.

Stage 1: Operational Target Setting

In the fourth quarter of each year, the SASAC begins a Performance Evaluation process for the following year by setting performance targets for SOEs. Target setting is a bottom-up process in which the SOEs propose annual operational targets, and the SASAC either approves or adjusts those targets. Setting an operational target that is either lower than last year's actual performance or lower than the average of the last three years precludes an SOE from getting a top rating in the next annual Performance Evaluation. At the end of March, after the SASAC and SOEs have reached consensus regarding targets, an SASAC representative signs a performance responsibility contract with the so-called "Persons in Charge" of each SOE.

Each SOE sets targets based on four measures as shown in Appendix A. The first two measures are mandatory: earnings before tax and extraordinary items (EBT), and return on equity (ROE). Each SOE must also choose two of the following three other measures: inventory turnover, accounts receivable turnover, or sales growth. Details of the scoring are discussed below.

Stage 2: Operational Results Verification

Before the end of April each year, CFOs of the SOEs prepare annual performance reports, which include a budget variance analysis and an operational performance summary based on audited annual financial statements for the previous year. These mandatory reports are submitted to the SASAC and its supervising committee. The SASAC verifies and evaluates each SOE's performance in relation to its annual operational targets. SOEs may voluntarily disclose additional information to the SASAC when they submit the performance reports. For example, if unfavorable variances occur, they can provide a detailed explanation for the variances.

Stage 3: Raw Score Calculation

The SASAC verifies the operational results of the SOEs and calculates their raw evaluation scores. The raw scores range from a minimum of 72 to a maximum of 120 points. The comprehensive score for each SOE's annual Performance Evaluation is the sum of the points

awarded for target achievement on each measure, multiplied by the degree of operational difficulty given that an SOE meets all performance targets. When an SOE achieves a specific target measure, points earned on that measure are multiplied by the degree of difficulty parameter, a parameter > 1 for every SOE as shown in Appendix A.

The degree of operational difficulty is a subjectively determined parameter based on assets, revenue, total profit, return on equity, number of employees, and ratio of retired employees to total employees. This parameter varies across years for different firms. The degree of operational difficulty parameter is assigned to each SOE after all SOE audited financial statements have been submitted to the SASAC. The SASAC then compiles a list that ranks all SOEs based on the current-year assets, revenue, total profit, return on equity, number of employees, and ratio of retired employees to total employees. Using this rank, the SASAC then subjectively assigns the degree of difficulty parameter to each SOE.[3]

Stage 4: Ex Post *Discretionary Adjustment*

After calculating the raw scores of all SOEs, the SASAC makes *ex post* discretionary adjustments to each SOE's score based on subjective criteria. The SASAC indicates that they deduct punishment points from raw scores if enterprises have severe safety incidents or have been involved in financial fraud or other scandals. Enterprises that have acquired financially distressed enterprises out of political concerns receive bonus points (SASAC 2008). The SASAC makes *ex post* discretionary adjustments to SOE Performance Evaluation scores on a case-by-case basis, and all such adjustments publicly available online.

Stage 5: Ratings Assignment

The Performance Evaluation Bureau prepares a comprehensive working document that includes all SOE fulfillment or non-fulfillment of targets, degrees of difficulty, raw scores, subjective adjustment scores, and final scores sorted from the highest to the lowest final score. Based on this document, SASAC directors determine cutoff scores with which to assign each SOE to one of five classes: A, B, C, D, and E. A score of "C" or above is considered acceptable and SOE executives in D- and E-ranked firms may be asked to step down from their current positions by SASAC officials.

SOE executives are motivated to influence the perceptions of government superiors and engage in private communication with government superiors because evaluation ratings affect their performance-based bonuses and their career advancement.[4]

The SASAC notifies the executive of each SOE of their confirmed evaluation scores and ratings. An executive can appeal the rating to the SASAC. The SASAC reports the Performance Evaluation results to the State Council of China, and makes bonus and personnel decisions based on Performance Evaluation results. Our field interviews suggest that firms care more about the ratings (A–E) than their scores *per se*. All of the CFOs and SASAC officials we interviewed agreed that

[3] We were unable to obtain further details regarding the specific formula used by the SASAC to calculate the degree of difficulty parameter of individual SOEs.

[4] Performance-based bonuses are influenced by evaluation rank in a piece-linear manner: SOE executives of A-ranked firms can get bonuses of 2 to 3 times their base salaries; SOE executives of B-ranked firms can get bonuses of 1.5 to 2 times their base salaries; SOE executives of C-ranked firms can get bonuses of 1 to 1.5 times their base salaries; SOE executives of D-ranked firms can get bonuses of 0 to 1 times their base salaries; and SOE executives of E-ranked firms get 0 bonuses. In addition, part of the bonuses of SOE executives of D- and E-ranked firms are deducted as punishment, depending on how large the gaps are between their evaluation scores and the minimum scores of C-ranked firms.

SOE executives carefully monitor the ratings assigned to them by the SASAC, in part because of economic concerns, but primarily because of issues of face and honor.

III. THEORETICAL FRAMEWORK

Subjective Performance Evaluation of State-Owned Enterprises (SOEs)

SOEs differ from their private counterparts because of their roles as business entities and agents of the government. As governmental agents, they are responsible for achieving multiple objectives, including creating jobs, promoting industrialization, advancing technologies, defending national security, and subsidizing underdeveloped areas of the country. Since the SOEs work toward multiple goals, the government uses multiple measures to evaluate both the economic efficiency and the social effectiveness of these SOEs. Some of these measures may be contradictory with one another and may be difficult to quantify. Subjective Performance Evaluation is a mechanism used by the Chinese government and individual politicians to focus SOEs on the goals and objectives important to the government and to individual politicians.

Influence Activities and Tactics Used by SOEs to Influence the SASAC

Influence activities occur when agents attempt to affect a superior's decisions for their own private benefit (Milgrom 1988; Milgrom and Roberts 1988, 1992; Meyer et al. 1992). In organizations where individuals have discretion over decisions that have distributional implications, influence activities inevitably arise (Inderst et al. 2005). Since subjective Performance Evaluation directly affects the compensation and promotion of SOE executives, they are motivated to engage in influence activities in the subjective evaluation process. While the SASAC centralizes authority over SOEs, CFOs have private information regarding their own performance, which exacerbates the potential for costly efforts to influence the SASAC evaluation decisions. The costs of engaging in influence activities include wasted subordinate effort and time, inefficient decision-making, and deadweight losses in firm value (Milgrom 1988; MacLeod 2003).

More specifically, influence activities include direct personal appeals, offers of reciprocity, and the use of rational persuasion and consultation (Ciadini 1984; Yukl et al. 1993). Higgins et al. (2003) suggest that these types of ingratiation activities have positive effects on work outcomes. SOE executives may attempt to manage perceptions regarding their own performance to make themselves look more competent in the eyes of supervisors. They may also be motivated to create a generally good impression with supervisors to gain higher evaluation scores (Milgrom and Roberts 1988). The CFOs we interviewed confirmed that SOEs are likely to actively communicate with the SASAC during the Performance Evaluation process. They suggested that such SOE initiated communication should include "an early start," "a timely follow-up," and "a creative mentality."

Our field interviews suggest that SOE executives frequently use two types of influence tactics when communicating with SASAC officials. The first tactic is persuasion, which is the use of logical arguments and factual evidence to persuade others that their proposals or special requests are viable, reasonable, and may aid long-term sustainable growth of their firms (Yukl et al. 1993). One commercial trade company successfully convinced the SASAC to adjust their operational targets during the evaluation period. The company's CFO believed that the persuasion strategy was very effective:

> A 2 percent Renminbi appreciation can immediately cause exchange losses of 40 million U.S. dollars in our company. By no means could we foresee our central government reforming the Renminbi exchange rate system on July 21, 2005. (We were) considering which would be the most effective way to communicate with the SASAC about our difficult situation and to ask them for special treatment. We decided to hold a seminar; we

> invited all commercial trade companies in Beijing to discuss how Renminbi appreciation would influence exchange losses in 2005, and of course, we invited officials from the SASAC to attend our seminar. Using this strategy, we were able to convey our message clearly to the SASAC and successfully convince them to upwardly adjust our profit number by 31 million U.S. dollars in that evaluation period.

The second tactic used by SOEs is consultation. The SOEs proactively consult with SASAC officials and solicit the participation of the SASAC in planning strategy, activity, or change, showing the SASAC their willingness to modify a proposal in response to concerns and suggestions. One CFO remarked:

> It would be way too late if we waited until operational results are submitted to the SASAC to start communicating with the SASAC. We have to strategically set targets to better fulfill our promise to the SASAC as specified in our performance responsibility contract.

Another CFO explained:

> We call SASAC officials who are assigned to calculate the score for our firm once a week during the evaluation period.

Political Connections, Geographic Proximity, and SOE Influence Activities

According to social identity theory (Tajfel and Turner 1986), people are attracted to those who belong to the same social categories (an in-group identity), and this attraction has real economic consequences. For example, research on Performance Evaluation has found that older employees are rated lower on task performance and citizenship behavior by younger supervisors than by older supervisors (Tsui and Egan 1994). People have multiple sources of identity, and those sources vary in their salience depending on the social context.

In our setting, one likely social identity category is the political connections of executives in the SOEs to those members of the SASAC. SOE executives with a prior career history in the government are more familiar with the bureaucratic systems, administrative procedures, and macro-perspectives taken by government officials when making decisions. SOE executives with previous government experience often share similar ideologies and aspirations with SASAC officials, understand the inner workings of the bureaucracies, and can better use the language of the Chinese Communist Party when communicating with SASAC officials. As noted by an SASAC official:

> Former governmental officials think like governmental officials even after joining boards of directors of big SOEs. They tend to approach questions from a macro-economic perspective, and from the industry-wide perspective. They understand to what extent the government wants to regulate the industry and why. This is a unique difference between politically connected SOE executives and internally promoted executives in SOEs.

Another CFO explained:

> The experience of serving as governmental officials facilitates communication of SOE executives with SASAC officials.

Politically connected executives share a higher level of in-group identity with SASAC officials than do less-connected executives. A shared group identity facilitates the influence tactics of persuasion and consultation. In addition, levels of trust and reciprocity are higher and friendships and a sense of loyalty are stronger among in-group members. All of these factors can facilitate successful influence activities.

This discussion is summarized in our first hypothesis:

H1 (The Political Connection Hypothesis): SOEs with executives having stronger political connections with the Chinese government receive more favorable evaluation scores from the SASAC than do SOEs whose executives have weaker political connections with the Chinese government.

Another social identity category is the geographic proximity between superiors and subordinates. Geographic proximity implies common dialects (Farh et al. 1998) and similar alumni networks (Faccio 2006), both of which facilitate social relations among people. More frequent business and social interactions between officials and business executives through leisure and social activities are likely to provide more favorable views of each other and easier communication. A study by Landier et al. (2009) of more than 250 firms with approximately five divisions within each firm showed that business divisions that were closer to headquarters were less likely to face layoffs and to be divested. SASAC officials may feel a higher level of social pressure for giving a low rating to a geographically proximate SOE, since they are more likely to know local individuals, be members of the same regional business community, and observe more directly how an individuals' personal welfare is affected.

Geographic proximity, or "home bias" as coined by Covrig et al. (2007), also implies lower communication costs and information advantages (Schultz 2003), which may influence a variety of economic behaviors. These include holding a higher proportion of local stocks in investment portfolios (Grinblatt and Keloharju 2001), higher returns of fund investors on their investments in local firms (Coval and Moskowitz 2001), more accurate forecasts by analysts about firms in closer proximity to their own brokerage firms (Malloy 2005), and higher acquirer returns for acquisitions within closer geographic proximity (Uysal et al. 2008). Incurring higher information-gathering costs can cause supervisors to be less willing to invest the required time in information collection and it is possible that SOEs with headquarters located closer to the central SASAC office in Beijing will have a greater likelihood of receiving a more accurate adjustment from the SASAC central office. Our interviews indicated how geographic proximity helps communication between SOE executives and SASAC officials. As one CFO observed:

> SOEs located in Beijing enjoy great information sharing and knowledge exchange with SASAC officials. First of all, the SASAC invites CEOs of excellent-performing SOEs to come visit their central office in Beijing and give lectures on various management topics such as Economic Value Added (EVAs), budgetary management, continuous improvements, or balance scorecards. We always attend these lectures.

Another CFO put it this way:

> The most frequent communication between the SASAC and us does not take the form of letters, emails, or telephone calls. We believe walk-in visits show more commitment, and we always bring supporting documentation that explains our operational situation in detail when visiting the SASAC office.

This discussion leads to our second hypothesis:

H2 (The Geographic Proximity Hypothesis): SOEs with headquarters located closer to the SASAC central office receive more favorable evaluation scores from the SASAC than SOEs with headquarters located farther from the SASAC central office.

SPE and Governmental Favoritism

Favoritism occurs when superiors, acting on personal preferences, show partiality to some subordinates over others (Prendergast and Topel 1996). Subjectivity in Performance Evaluation

facilitates favoritism because it provides superiors with the discretion to adjust performance ratings based on subjective factors that they observe. Like all Performance Evaluation processes, favoritism can have both positive and negative consequences depending on the superior's motivations. Some superiors may use their power to adjust evaluations based on having better information, but others may simply use their power for personal gain or satisfaction. Favoritism can be demoralizing to subordinates if the perception of credibility and fairness of the Performance Evaluation system is diminished. One way of reducing the possibility of favoritism is to install a system of accountability such that higher-level executives review all Performance Evaluations. This solution does not appear to be viable in our research setting. Officials in the Performance Evaluation Bureau of the SASAC are government bureaucrats for whom seniority plays a key role in compensation and promotion decisions, and these officials are not motivated to invest effort to gather information to make accurate subjective evaluations. Thus, we expect subjectivity to lead to favoritism in the annual Performance Evaluation of SOEs.

Our interviews suggest that SASAC officials want SOEs to perform well, to fulfill social goals, and to perform in a manner that can advance the official's own career. Thus, we expect the government to favorably rate those SOEs that assume more social responsibility than those that do not, a preference that can be revealed in analyzing subjective Performance Evaluation scores assigned by the SASAC. For example, the SASAC may favorably rate those who compete in strategic industries such as the military and petroleum industries and those companies that provide more employment opportunities. Consistent with the social responsibility argument, is this statement from a CEO:

> We believe getting A ratings bolsters employee morale, and distinguishes our firm from average performers. We contribute greatly to our nation's basic industries; we provide a tremendous amount of jobs, especially in minority areas. We deserve to get A's no matter how the SASAC weights economic profits versus social benefits.

A CFO from another large SOE told us that:

> There are 460,000 employees in our firm. We have taken such and such steps in creating job opportunities, and have contributed greatly to the central government's call to reduce unemployment. Of course, the SASAC should favor us and reward us for taking on social responsibility in addition to creating economic value.

These observations lead us to our third hypothesis:

> **H3 (The Social Responsibility Hypothesis):** SOEs that assume more social responsibilities receive more favorable evaluation scores from the SASAC than SOEs that assume fewer social responsibilities.

Politicians act out of self-interest and are likely to intervene in firm activities to fulfill their personal agendas. Typically, politicians need money, information, and votes to advance their careers. To advance their careers, politicians would treat firms with more assets that can afford larger campaign contributions, firms with more employees that provide a larger constituency, and firms located in political centers with politically influential CEOs, that provide richer information content and broader information channels, more favorably. We expect government officials to favorably rate SOEs that are willing to return the favor by helping to advance these officials' careers.[5] SOEs with higher political rank are likely to have more strategic allies and partners in critical political circles than SOEs of lower political rank. As a result, we speculate that the SASAC

[5] In China, officials are selected through a top-down process initiated every five years by the Organization Department of the CPC Central Committee. Central government officials are elected, followed by elections of provincial, city, county, and township officials. In this process, catering to the desires of high-ranking politicians may be just as important as fulfilling the will of the populace.

officials in charge of subjective evaluations will be more likely to evaluate those SOEs with higher political rank more favorably. One CFO noted:

> SASAC officials value networking with SOE managers, especially with those CEOs who have potential to be promoted to provincial directors. For example, Mr. W, the former CEO of CNOOC has now been promoted to secretary of the Hainan Provincial Committee of the Communist Party of China (CPC) Committee.

An SASAC official noted that the SASAC is "unfair" when setting cutoff scores and that the SASAC shows favoritism, especially to firms with higher political rank:

> Let's say that the Performance Evaluation bureau finishes summarizing all final performance scores ranked in order from highest to lowest. The director's office decides that 20 percent of the SOEs can be rated as A-level firms. By mechanical calculation, we know that the critical value should be 132. However, if a vice-ministerial-level petroleum firm gets a score of 131.5, chances are that the SASAC will finally lower the cutoff score to 131 to make room for the petroleum firm on the A-list.

This discussion leads to our fourth hypothesis:

> **H4 (The Political Rank Hypothesis):** SOEs with higher political rank receive more favorable evaluation scores from the SASAC than SOEs with lower political rank.

IV. SAMPLE, ANALYSES, AND RESULTS

Data

The data we use in our tests are derived from the following data sources: (1) a proprietary database of annual Performance Evaluation results assigned to central government controlled SOEs prepared by the SASAC from 2005 to 2007; (2) audited financial reports of 63 SOEs from the initial issuance statements of firm bonds from 2005 to 2007; and (3) complete personnel records of the top management teams of 63 SOEs from the initial issuance of firm bonds or from rating agency reports from 2005 to 2007. We obtained the remaining resumes from websites of individual companies. Our final sample consists of 63 state-owned enterprises and 189 firm-year observations.

Measurement of Variables

SOE Executives' Political Connections

Political connections considered in our study derive from career histories of SOE executives as officials in the Chinese government. The first measure of CEO political connections is *CEOConnection*, which is based on scores assigned to the highest bureaucratic positions held by CEOs before they joined the top management teams of their SOEs. We assign the highest level of political connections to those executives who have held top positions in the central government, followed by individuals in the provincial and the municipal governments. The corresponding *CFOConnection* measure is coded in the same way.[6]

[6] We improve on previous measures of political connections that treated political connections as a dichotomous variable. We manually collected detailed resume data of top management team members of Chinese SOEs, and coded the political connection measures as the sum of the score on an individual's highest career title earned in his or her previous political career before joining the boards of directors of SOEs and the score on the individual's highest-ranking government position.

Geographic Proximity from SOE Headquarters to the SASAC Central Office

We measured geographic proximities using *Distance*,[7] the log transformation of the exact physical distance between headquarters of SOEs and the SASAC central office. This is consistent with Landier et al.'s (2009) approach that calculates the log transformation of spherical distance as the number of miles between the longitude and latitude of two different locations.

Social Responsibility of SOEs

Social responsibility is proxied by two measures. The first measure is the log transformation of employees (*Employees*) scaled by the total assets of each SOE. This number includes retired employees. The second measure reflects the industry in which individual SOE competes (*StrategicIndustry*). *StrategicIndustry* is coded as 1 in those industries in which the Chinese government seeks to retain greater power, including the military, electric power, petroleum and petrochemical, telecom, coal, civil aviation, and shipping and transportation industries. Panel B of Table 1 shows the distribution of industries in which SOEs compete in our sample. Twenty-seven SOEs are categorized into strategic industry groups and 36 SOEs are categorized into non-strategic industry groups, according to the industry classification standard prepared by the SASAC.

Political Rank of SOEs

Political rank (*SOEPoliticalRank*) means the "bureaucratic rank"[8] of the firm. We use two criteria to code the political rank of individual SOEs: whether a SOE is a "vice-ministerial level" firm[9] or whether the CEO of the SOE is assigned by the Organization Department of the CPC Central Committee. Political rank is coded as 2 for the largest 13 "vice-ministry level" firms whose CEOs are appointed by the Organization Department of the CPC Central Committee. Political rank is coded as 1 for the next tier of 40 firms whose CEOs are appointed by the Organization Department of the CPC Central Committee. Political rank of all other central government controlled SOEs is coded as 0, and the CEOs of these SOEs are appointed by the SASAC, which reports to the State Council and the CPC Central Committee.

Control Variables

Earnings before tax and extraordinary items (*EBT*), return on equity (*ROE*), the inventory turnover rate (*INTurnover*), the accounts receivable turnover rate (*ARTurnover*), and sales growth (*SalesGrowth*) serve as control variables as all SOEs are evaluated based on these measures, and the raw evaluation score of each SOE is the sum of the points granted for achieving targets based on these measures.

We use the degree of operational difficulty (*DegreeofDifficulty*) as a control variable in our empirical tests. The SASAC subjectively assigns to each SOE a parameter called the degree of operational difficulty based on assets, revenue, total profit, return on equity, number of employees, and ratio of retired employees to total employees. The comprehensive score of each SOE is a raw evaluation score multiplied by the degree of operational difficulty parameter.

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[7] As a robustness check, we use a dummy indicator, *Local*, that takes the value of 1 if the headquarters of a SOE is located in Beijing, where the central SASAC office is located. Results remain the same.

[8] SOEs have political rank for two reasons. First, before the reform separating state-owned enterprises from the government, all SOEs used the same coding system of political rank as the one used by the Chinese government. Chinese SOEs would follow the wording of government administrative rank with "section chief," "head of the department," or "head of the bureau," to distinguish the administrative rank of firm employees. Second, some SOEs were directly converted from governmental ministries during reforms that streamlined and merged governmental ministries.

[9] "Vice-ministry level" central government controlled SOEs means that their CEOs have the same political rank as vice-ministers of central government ministries.

We use organizational size as an additional control variable since our field observations suggest that size may be related to higher evaluation scores and ratings.[10] Variable measurements are described in Appendix B.

Summary Statistics

Panel A of Figure 1 shows the population distribution of SASAC evaluation scores for all 152 central government owned SOEs from 2005 to 2007. Among all 152 SOEs, we were able to extract the personnel information and complete financial indicators of 63 SOEs, whose distribution of SASAC evaluation scores is reported in Panel B of Figure 1. Panel C of Figure 1 shows the cutoff scores in the SASAC ratings assignment. Panel D of Figure 1 shows the number of SOEs that were in each class from 2005 to 2007 for the population of all 152 central government controlled SOEs. As shown in Panel D of Figure 1, the percentage of SOEs obtaining a Performance Evaluation of A increased from 18.1 percent in 2005, to 26.3 percent in 2007. The percentage of SOEs obtaining a Performance Evaluation of C decreased from 26.3 percent in 2005, to 18.4 percent in 2007. The sample distribution in Panel E of Figure 1 is consistent with this data pattern, showing that the percentage of SOEs obtaining a Performance Evaluation of A increased from 28.6 percent in 2005 to 46.0 percent in 2007, and that the percentage of SOE obtaining a Performance Evaluation of C decreased from 14.3 percent in 2005 to 3.2 percent in 2007. Thus, it appears that the SASAC has issued more lenient ratings over time.

Table 2 shows the summary statistics for our sample of 63 SOEs from 2005 to 2007. The 25th percentile of SASAC scores is 125.7, which coincides with the cutoff score for B rated firms in 2007. The 75th percentile of SASAC scores is 132.0, which coincides with the cutoff score for A rated firms in 2007.

Empirical Models

Our hypotheses are summarized in Figure 2.

To test whether a positive association exists between the variables of interest and the SASAC evaluation results, we perform a set of regressions in which the dependent variables are the SASAC evaluation results. Evaluation results measures include evaluation scores, evaluation ratings, points earned on common measures, points earned on firm-specific measures, cutoff scores, upward adjustment of raw evaluation scores, and upward adjustment of evaluation ratings. We examine whether our political connection measures, geographic proximity measures, social responsibility measures, and political rank measures load significantly in addition to the control variables when explaining the variation of SASAC evaluation results. The general model specification is as follows:[11]

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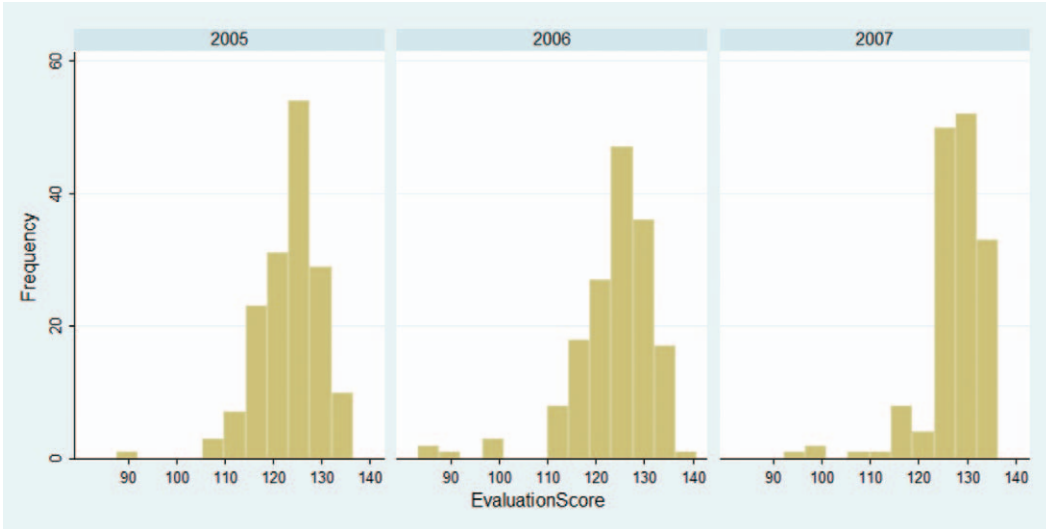
[10] A SASAC official told us that "[t]he SASAC shows favoritism to big firms due to strategic concerns, and having a larger asset base leads to a mechanical advantage when calculating the degree of operational difficulty, and thus large SOEs tend to get A's as long as they do OK jobs." The CFOs of relatively large SOEs mentioned that the SASAC has "done a great job" in giving big firms special opportunities, while the CFOs of relatively small SOEs said that the system is "unfair" knowing that largest firms are more likely to be leniently treated by the SASAC in the Performance Evaluation process. A CFO from a relatively small SOE mentioned that "A-ratings are reserved for those largest SOEs."

[11] The condition number generated from the Collin test of multicollinearity is 36.1684, which suggests the possibility of multicollinearity. The small sample size ($n = 168$) may exacerbate the multicollinearity concern for this study. Thus, we chose to introduce the independent variables one at a time instead of including all independent variables in the same regression. We also investigated whether a single common factor better reflects the underlying processes that created the correlations among our variables of interest. To this end, we performed principal factors extraction with varimax rotation in our research sample. Three factors were extracted with eigenvalues higher than 1. Consistent with our results, the social responsibility measures (*Employees*, *StrategicIndustry*) and SOE political rank measure load on the same factor, which we label Factor_Favoritism. *CFOConnection* and *Distance* load on a common factor, which we label Factor_Influence. *CEOConnection* loads on a factor, which we label Factor_CEO. We replaced the original independent variables with the factor scores in the regression models and the results are consistent with our original analyses.

FIGURE 1
Scores and Ratings Comparison of Sample Central Government Owned SOEs to the Population Central SOEs in 2005–2007[a]

Panel A: Population Distribution of Evaluation Scores of All 152 Central Government Owned SOEs in 2005–2007



[a] Figure 1 is excerpted and summarized from the *Report Regarding the Annual Performance Evaluation Results* of central government controlled SOEs issued by the Performance Evaluation Bureau of the SASAC in 2005–2007. The SASAC evaluated 160 central government controlled SOEs in 2005 and 2006, and evaluated 152 central government controlled SOEs in 2007.

(continued on next page)

$$\begin{aligned} \textit{Evaluation Results}_{i,t} = {} & \alpha_0 + \beta_1 \textit{Variable of Interest}_{i,t} + \beta_2 \textit{DegreeofDifficulty}_{i,t} + \beta_3 \textit{Assets}_{i,t} \\ & + \beta_4 \textit{EBT}_{i,t} + \beta_5 \textit{ROE}_{i,t} + \beta_6 \textit{INTurnover}_{i,t} + \beta_7 \textit{ARTurnover}_{i,t} \\ & + \beta_8 \textit{SalesGrowth}_{i,t} + \varepsilon_{i,t}. \end{aligned}$$

We use OLS regression models and ordinal logit analyses to test whether our variables of interest lead to more lenient evaluation results. We use the OLS regressions to examine the effect that the variables of interest have on higher evaluation scores. We use the ordinal logit analyses to assess the effect of the variables of interest on the likelihood that SOEs belong to higher rating categories, and the likelihood that the SASAC upwardly adjusts SOEs scores and ratings.

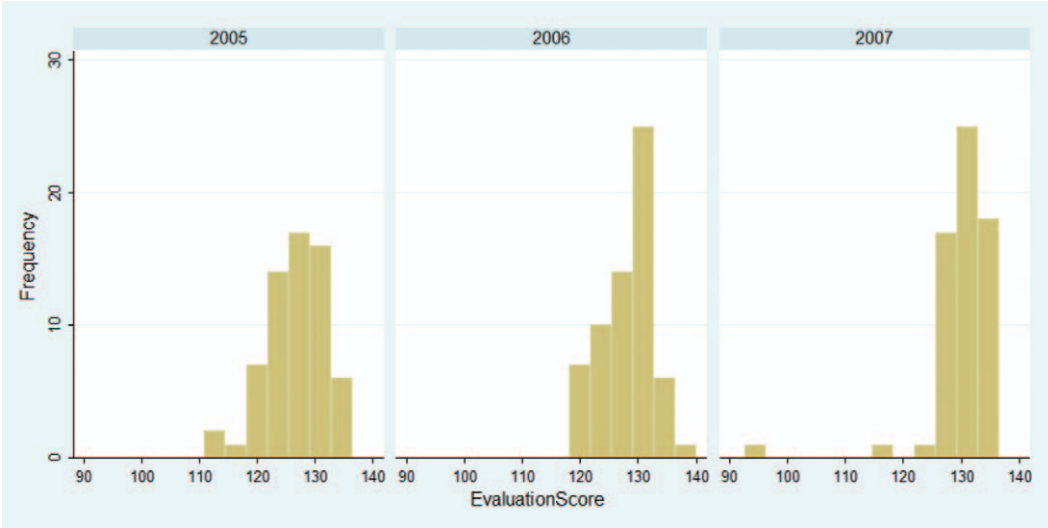
Hypotheses Tests

Test of the Political Connections Hypothesis

Results for Model 1 in Column (1) of Tables 3 and 4 show that the CEO political connection measure (*CEOConnection*) is not significant. Results for Model 2 in Column (2) of Tables 3 and 4

FIGURE 1 (continued)

Panel B: Sample Distribution of Evaluation Scores of 63 out of 152 Central Government Owned SOEs in 2005–2007



Panel C: Cut-off Scores in Rating Assignments Issued to SOEs by the SASAC in 2005–2007

	A	B	C	D	E
2007	>=132	[126,132)	[100,126)	<100	Not Available
2006	>=130	[121,130)	[100,121)	<100	Not Available
2005	>=130	[120.02,130)	[110.32,120.02)	<110.32	Not Available

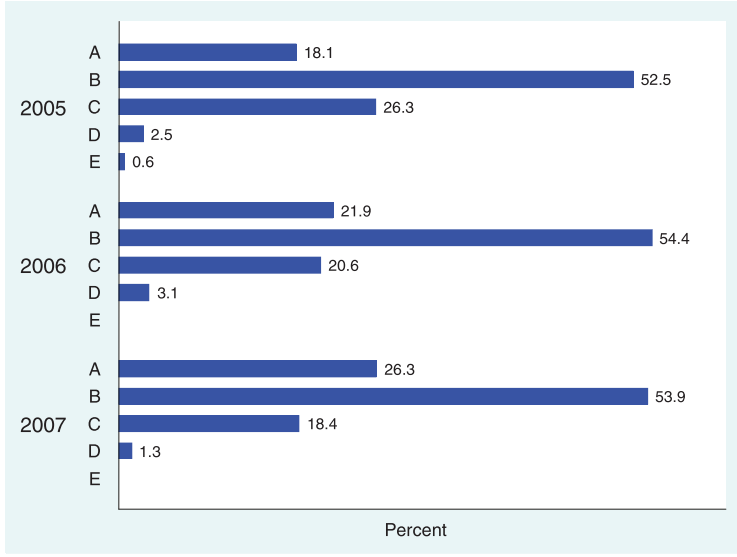
(continued on next page)

show that SOEs with politically connected CFOs are more likely to get higher evaluation scores (coefficient = 0.363; t-statistic = 2.49) and to get higher evaluation ratings (coefficient = 0.238; t-statistic = 1.99).[12] In terms of percentage change, there is a 27 percent increase in the odds of a SOE getting a higher evaluation rating for a one unit increase in the CFO political connection measure. These results provide partial support for the Political Connections Hypothesis (H1) that SOEs with politically connected executives are more likely to get higher evaluation scores (ratings). This finding is consistent with remarks made by interviewees that CFOs are the major firm representatives in communication with the SASAC, and that CEOs play lesser a role in influencing the SASAC evaluation results. For example, a SASAC official mentioned that CFOs typically take the responsibility for calling, visiting, and following up with the SASAC officials. Key inputs in the SASAC Performance Evaluation process include budgetary targets and financial statement bottom-line items, and CFOs often have specific knowledge about the generation of these numbers. This

[12] We use the degree of difficulty assigned to SOEs by the SASAC as a control variable because higher degree of operational difficulty parameters mechanically translate into higher evaluation scores/ratings in this research setting. Results do not change if this control is added or dropped.

FIGURE 1 (continued)

Panel D: Population Distribution of Evaluation Ratings of All 152 Central Government Controlled SOEs in 2005–2007[b]



[b] Percentage of central government controlled SOE sorted into Classes A through E by the SASAC in 2005–2007. Percentages of SOEs that are sorted into a certain rating class in a year are listed on the right-hand side of the bars.

Panel E: Sample Distribution of Evaluation Ratings of 63 out of 152 Central Government Controlled SOEs in 2005–2007

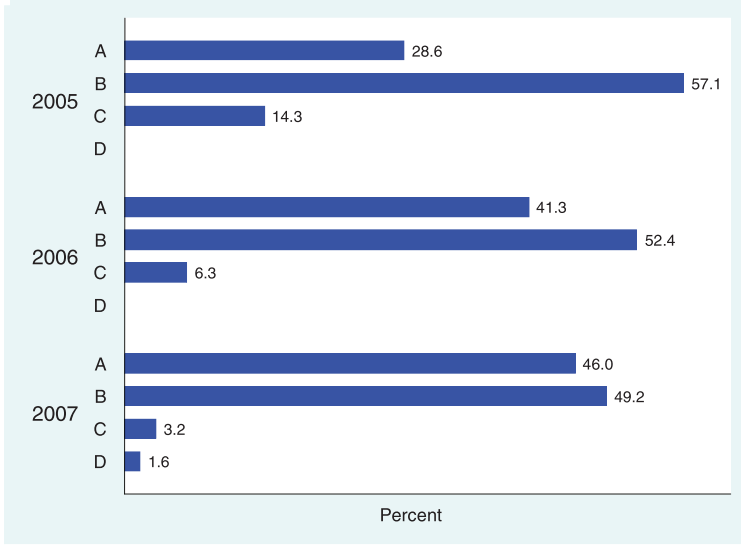


TABLE 1

Sample Statistics of SOEs Characteristics in 2005–2007

Panel A: By Headquarters Location

	% of the Total Sample by Headquarters Location/Industries	Number of SOEs by Headquarters Location/Industries
Beijing	79.37	50
An'Shan	1.59	1
Guangzhou	3.17	2
Pan Zhihua	1.59	1
Shanghai	1.59	1
Shenzhen	4.76	3
Wuhan	6.35	4
Xi'an	1.59	1
Total		63

Panel B: By Industry

	Percentage of the Total Sample by Headquarters Location/Industries	Number of SOEs by Headquarters Location/Industries
Coal	1.59	1
Military	9.52	6
Petroleum	3.17	2
Power	14.29	9
Telecom	6.35	4
Transportation	7.94	5
Strategic Industries	42.86	
Subtotal		27
Electronics	3.17	2
Infrastructure	9.52	6
Investment	4.76	3
Manufacturing	7.94	5
Materials	3.17	2
Metallurgical	7.94	5
Real Estate	3.17	2
Research	1.59	1
Trade	14.29	9
Travels	1.59	1
Non-Strategic Industries	57.14	
Subtotal		36
Total		63

Table 1 shows the distribution of geographic locations of SOE headquarters in our research sample in Panel A and the distribution of industries where SOEs compete in our research sample in Panel B. Columns 1 and 2 report the percentage of SOEs and the number of SOEs. Panel A reports the sample by headquarters location. Panel B reports the sample by industry sector.

TABLE 2

Summary Statistics of the Sample SOEs from 2005 to 2007

Variable	Mean	Std.	Min.	Lower Quartile	Median	Higher Quartile	Max.
EvaluationScore	128.42	5.21	92.60	125.70	129.38	132.03	136.52
EvaluationRating	2.30	0.63	0	2	2	3	3
CEOConnection	1.87	2.31	0	0	0	4	6
CFOConnection	1.06	1.85	0	0	0	2	5
Local	0.79	0.41	0.00	1.00	1.00	1.00	1.00
Distance	3.10	2.20	0.18	1.76	2.42	2.82	7.84
Employees	11.11	1.16	8.11	10.41	11.28	11.8	14.25
StrategicIndustry	0.42	0.5	0	0	0	1	1
SOEPoliticRank	0.67	0.69	0	0	1	1	2
DegreeofDifficulty	1.10	0.02	1.05	1.09	1.10	1.11	1.14
EBT	0.05	0.04	−0.02	0.02	0.03	0.06	0.24
ROE	0.10	0.07	−0.18	0.05	0.09	0.14	0.36
INTurnover	12.84	24.89	0.39	3.61	6.57	13.87	244.71
ARTurnover	18.34	18.97	1.56	7.2	10.28	22.36	126.24
SalesGrowth	0.29	0.22	−0.17	0.16	0.25	0.36	1.06
Assets	6.55	1.19	3.84	5.71	6.64	7.3	9.52

Table 2 describes the summary statistics of the main variables. See Appendix B for variable definitions. *Distance*, *Employees*, and *Assets* are presented after log transformation.

FIGURE 2
Summary of Hypotheses

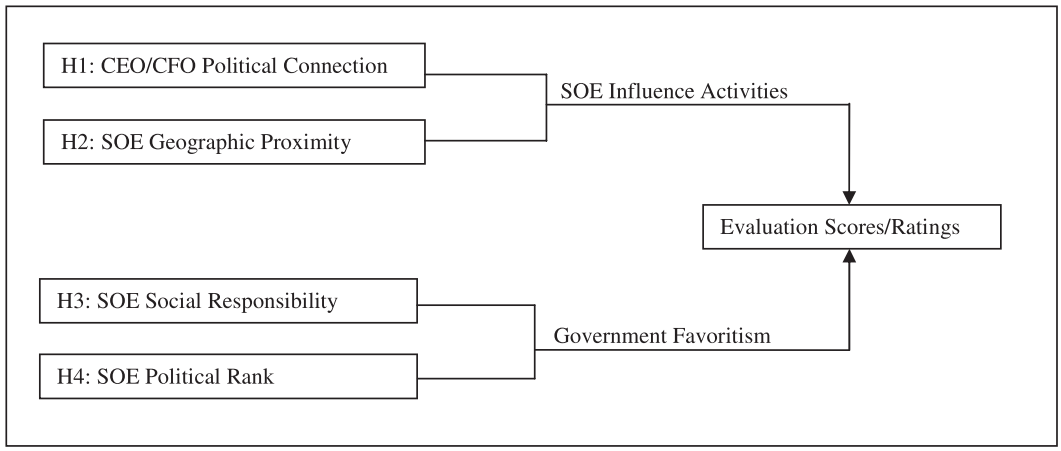


Figure 2 illustrates the hypotheses in this study. H1 is the political connections hypothesis: SOEs with executives with stronger political connections are more likely to get higher evaluation scores (ratings). H2 is the geographic proximity hypothesis: SOEs with headquarters located proximate to the SASAC central office are more likely to get higher evaluation scores (ratings). H3 is the social responsibility hypothesis: SOEs that assume more social responsibilities are more likely to get higher evaluation scores (ratings). H4 is the political rank hypothesis: SOEs with higher political ranks are more likely to get higher evaluation scores (ratings).

TABLE 3

Associations between Political Connections, Geographic Proximity, Social Responsibility, SOE Political Rank, and SASAC Evaluation Scores

$$EvaluationScore_{i,t} = \alpha_0 + \beta_1 Variable\ of\ Interest_{i,t} + \beta_2 DegreeofDifficulty_{i,t} + \beta_3 Assets_{i,t} + \beta_4 EBT_{i,t} + \beta_5 ROE_{i,t} + \beta_6 INTurnover_{i,t} + \beta_7 ARTurnover_{i,t} + \beta_8 SalesGrowth_{i,t} + \varepsilon_{i,t}.$$

	(1) Evaluation Score	(2) Evaluation Score	(3) Evaluation Score	(4) Evaluation Score	(5) Evaluation Score	(6) Evaluation Score
CEOConnection	0.092					
	(0.69)					
CFOConnection		0.363**				
		(2.49)				
Distance			−0.225*			
			(−1.84)			
Employees				0.043		
				(0.08)		
StrategicIndustry					1.065	
					(1.26)	
SOEPoliticalRank						2.074***
						(4.29)
DegreeofDifficulty	168.6***	164.5***	164.1***	165.3***	172.7***	158.4***
	(3.14)	(3.26)	(3.24)	(2.84)	(3.27)	(3.27)
Assets	0.263	0.195	0.221	0.309	−0.069	−0.444
	(0.39)	(0.30)	(0.35)	(0.46)	(−0.09)	(−0.67)
EBT	29.33***	26.21***	30.29***	28.60**	30.11***	24.62**
	(2.84)	(2.72)	(2.91)	(2.51)	(2.83)	(2.49)
ROE	−1.098	0.269	−0.477	−0.668	−1.008	2.865
	(−0.34)	(0.08)	(−0.15)	(−0.20)	(−0.32)	(0.87)
INTurnover	−0.033***	−0.032***	−0.032***	−0.030***	−0.034***	−0.019***
	(−4.67)	(−4.24)	(−5.09)	(−5.02)	(−5.49)	(−3.08)
ARTurnover	−0.034	−0.030	−0.026	−0.028	−0.028	−0.030
	(−1.37)	(−1.44)	(−1.21)	(−1.17)	(−1.17)	(−1.33)
SalesGrowth	0.164	0.111	−0.320	0.441	0.0734	−0.162
	(0.12)	(0.08)	(−0.24)	(0.36)	(0.06)	(−0.12)
Year Indicator	Yes	Yes	Yes	Yes	Yes	Yes
Adj. R^2	0.544	0.558	0.551	0.545	0.548	0.577
n	168	168	168	156	168	168

*, **, *** Indicate two-tailed statistical significance of coefficient estimates at the 0.10, 0.05, and 0.01 levels, respectively.

Table 3 reports the regression results for the effect of executive political connections, geographic proximity, SOE social responsibility, and SOE political rank on SOE evaluation scores. Columns (1)–(6) report results when *CEOConnection*, *CFOConnection*, *Distance* between the SASAC and SOE headquarters, SOE's number of employees, and SOE political rank are used respectively as independent variables. To ensure that our inferences are not artifacts of a few extreme values, all variables are winsorized at the top and bottom 1 percent. Regressions are performed with clustered robust standard errors (Rogers 1993) to control for within firm correlation. t-statistics are in parentheses.

TABLE 4

Associations between Political Connections, Geographic Proximity, Social Responsibility, SOE Political Rank, and SASAC Evaluation Ratings

$$EvaluationRating_{i,t} = \alpha_0 + \beta_1 Variable\ of\ Interest_{i,t} + \beta_2 DegreeofDifficulty_{i,t} + \beta_3 Assets_{i,t} + \beta_4 EBT_{i,t} + \beta_5 ROE_{i,t} + \beta_6 INTurnover_{i,t} + \beta_7 ARTurnover_{i,t} + \beta_8 SalesGrowth_{i,t} + \varepsilon_{i,t}.$$

	(1) Evaluation Rating	(2) Evaluation Rating	(3) Evaluation Rating	(4) Evaluation Rating	(5) Evaluation Rating	(6) Evaluation Rating
CEOConnection	0.003					
	(0.04)					
CFOConnection		0.238**				
		(1.99)				
Distance			−0.170*			
			(−1.84)			
Employees				0.021		
				(0.08)		
StrategicIndustry					1.479***	
					(2.67)	
SOEPoliticalRank						3.596***
						(4.49)
DegreeofDifficulty	40.58*	42.60**	42.73**	35.88	56.21**	46.39**
	(1.84)	(1.99)	(2.01)	(1.61)	(2.49)	(2.02)
Assets	1.442***	1.391***	1.369***	1.432***	0.893**	0.501
	(4.04)	(3.93)	(3.94)	(3.68)	(2.22)	(1.24)
EBT	20.76***	16.09**	22.46***	22.36***	21.62***	15.76*
	(2.62)	(2.00)	(2.80)	(2.71)	(2.66)	(1.79)
ROE	−1.957	−1.098	−1.758	−1.393	−1.816	3.386
	(−0.72)	(−0.39)	(−0.64)	(−0.51)	(−0.65)	(0.99)
INTurnover	−0.024***	−0.023***	−0.024***	−0.023***	−0.028***	−0.009
	(−2.90)	(−2.83)	(−3.01)	(−2.87)	(−3.39)	(−0.80)
ARTurnover	0.006	0.007	0.012	0.006	0.014	0.006
	(0.43)	(0.46)	(0.78)	(0.40)	(0.88)	(0.35)
SalesGrowth	0.476	0.256	0.185	0.525	0.399	0.192
	(0.55)	(0.29)	(0.21)	(0.58)	(0.45)	(0.18)
Year Indicator	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R^2	0.388	0.401	0.399	0.390	0.412	0.525
n	168	168	168	156	168	168

*, **, *** Indicate two-tailed statistical significance of coefficient estimates at the 0.10, 0.05, and 0.01 levels, respectively.

Table 4 reports the regression results for the effect of executive political connections, geographic proximity, SOE social responsibility, and SOE political rank on SOE evaluation ratings. Columns (1)–(6) report results when *CEOConnection*, *CFOConnection*, *Distance* between the SASAC and SOE headquarters, SOE's number of employees, and SOE political rank are used respectively as independent variables. To ensure that our inferences are not artifacts of a few extreme values, all variables are winsorized at the top and bottom 1 percent. Regressions are performed with clustered robust standard errors (Rogers 1993) to control for within firm correlation. t-statistics are in parentheses.

result suggests that CFOs with strong political connections can successfully influence the SASAC's assignment of evaluation scores to their own advantage.

Test of the Geographic Proximity Hypothesis

Results for Model 3 in Column (3) of Tables 3 and 4 report that SOEs with headquarters located closer to the SASAC central office are more likely to get higher evaluation scores (ratings) with marginal significance ($p < 0.10$). These results are consistent with the prediction of the Geographic Proximity Hypothesis (H2), that SOEs with headquarters located closer to the SASAC central office are more successful in influencing the SASAC's decision in granting higher evaluation scores (ratings).

Test of the Social Responsibility Hypothesis

Results for Model 4 in Column (4) of Tables 3 and 4 show that the number of employees is not significantly related to evaluation scores or evaluation ratings. These results are not consistent with the Social Responsibility Hypothesis (H3). Results for Model 5 in Column (5) of Tables 3 and 4 suggest that firms competing in strategic industries do not receive higher evaluation scores for competing in strategic industries, as shown in Model 5, Table 3, but are more likely to belong to higher rating categories (coefficient = 1.479; t-statistic = 2.67) as shown in Model 5, Table 4. These results are consistent with the Chinese government not rewarding those SOEs that provide more employment opportunities with higher evaluation scores or ratings, but assigning higher evaluation ratings to SOEs in strategic industries.

Test of the Political Rank Hypothesis

Results for Model 6 shown in Column (6) of Table 3 show that SOEs with higher political rank are more likely to get higher evaluation scores (coefficient = 2.074; t-statistic = 4.29). Results for Model 6 in Column (6) of Table 4 show that SOEs with higher political rank are more likely to get higher evaluation ratings (coefficient = 3.596; t-statistic = 4.49). The results suggest that SOEs with higher political rank enjoy favorable treatment by obtaining higher degrees of difficulty, and can exert incremental influence in bargaining for higher evaluation scores after the parameter of degree of difficulty is set. In terms of economic significance, a one-unit increase in SOE political rank measure is associated with an increase of 2.0 points in the total evaluation score and a 3.6 increase in the log odds of being in a higher rating category. The results support the Political Rank Hypothesis, indicating that the SASAC favorably rates SOEs that help fulfill government officials' personal agendas.

Additional Analyses

In this section we conduct some additional analyses related to the how influence activities and favoritism could influence the target-setting process, the cutoff score assignment, and the *ex post* adjustments in evaluation scores and ratings.

The Association between Variables of Interest and the Target-Setting Process

Favoritism and influence costs can potentially occur at all five stages of the evaluation. In particular, it is possible that these variables affect the setting of the target in the first place. The target-setting process is a bottom-up process in which the SOEs propose annual operational targets and the SASAC either approves or adjusts those targets. Since the SASAC uses the difference between targeted amounts and actual budgeted amounts as a main parameter in score calculation,

firms try to bargain for lower targets in the performance responsibility contract; a lower target assigned would mechanically lead to higher points earned.

To investigate the possibility that influence activities and government favoritism affect the target-setting process, we obtain detailed data regarding individual SOEs' points earned for achieving profit targets, points earned for achieving ROE targets, and points earned for achieving firm-specific targets. Profit targets and ROE targets, are common measures used by the SASAC to evaluate SOEs, while firm-specific targets may vary across firms. Previous research has found that only common measures affect superiors' holistic evaluations when both common measures and firm-specific measures are used in the Performance Evaluation process (Lipe and Salterio 2000). This occurs because common measures facilitate cross-sectional comparison and benchmarking. Superiors derive utility from power by favoring preferred subordinates (Prendergast and Topel 1996). At the same time, the psychological costs of confrontation inevitably arise when superiors are questioned by less-favored employees about the fairness of the evaluation system (Harris 1994; Bol et al. 2010). In our research setting, if the SASAC assigns a lower ROE common measure target to favored SOEs, then less-favored peer SOEs may question the fairness in target setting. One way for superiors to retain power and reduce the fairness concern is by setting lower targets for favored subordinates on specific measures but not on common measures. If this argument holds, then we expect to see that the variables of interest should load significantly on points earned by achieving firm-specific targets, and should not be significant when explaining the variation in points earned by achieving profit targets and points earned by achieving ROE targets.

The results in Panel A of Table 5 suggest that SOEs competing in strategic industries and having high political rank obtain fewer points on achieving targets based on common measures. On the other hand, the results in Panel B of Table 5 show that SOEs competing in strategic industries and having high political rank obtain more points on achieving targets based on firm-specific measures. This finding supports our conjecture that government favoritism leads to more slack in the target-setting process, but only in the target setting for firm-specific measures. Results are consistent with it being more difficult to manipulate the points earned on common measures rather than the points earned on SOE-specific measures. Common measures are comparable across different SOEs, making it more difficult (easier) for the government evaluator to favor a SOE by assigning lower targets on common (firm-specific) measures. Results also show that firms with high political rank are not necessarily those firms that are more profitable; rather, the data suggest that high-ranked firms have lower profitability compared to those SOEs with lower political rank. These results help to rule out the alternative explanation that the highly ranked SOEs get higher ratings because of their superior ability and performance.

The Association between Variables of Interest and Cutoff Score Assignment

We include SASAC scores as an additional control variable to examine whether the variables of interest influence the SASAC's decision of setting the cutoff scores to the advantage of individual SOEs, holding the evaluation scores constant. As shown in Model 2 in Column (2) of Table 6, the CFO political connections measure leads to a higher evaluation rating after controlling for the evaluation score (coefficient = 0.235; t-statistic = 1.82), suggesting that connected CFOs are better at bargaining with the SASAC for more advantageous cutoff scores for their own firms. SOEs whose headquarters are located closer to the central SASAC office get higher SASAC evaluation ratings, but this relation does not hold when SASAC evaluation scores are controlled for, implying that the geographic proximity does not contribute to effective manipulation of the SASAC's assignment of cutoff scores to the advantage of individual firms. Firms that compete in strategic industries receive higher SASAC evaluation ratings, and this relationship holds when evaluation scores are controlled for (coefficient = 1.390, t-statistic = 2.79), indicating that SOEs operating in

TABLE 5

Associations between Political Connections, Geographic Proximity, Social Responsibility, SOE Political Rank, and Points Earned Based on Common/Specific Measures (Target-Setting Process)

$$Points\ Earned\ Based\ on\ Common/Specific\ Measures_{i,t} = \alpha_0 + \beta_1 Variable\ of\ Interest_{i,t} + \beta_2 EBT_{i,t} + \beta_3 ROE_{i,t} + \beta_4 INTurnover_{i,t} + \beta_5 ARTurnover_{i,t} + \beta_6 SalesGrowth_{i,t} + \varepsilon_{i,t}.$$

Panel A: Points Earned Based on Common Measures (*ROE* and *EBT*)

	(1) Points Earned on Common Measures	(2) Points Earned on Common Measures	(3) Points Earned on Common Measures	(4) Points Earned on Common Measures	(5) Points Earned on Common Measures	(6) Points Earned on Common Measures
CEOConnection	−0.0204					
	(−0.12)					
CFOConnection		−0.114				
		(−0.40)				
Distance			0.106			
			(0.68)			
Employees				−0.654		
				(−1.37)		
StrategicIndustry					−2.889***	
					(−2.83)	
SOEPoliticalRank						−2.767***
						(−3.84)
EBT	25.20**	26.39**	25.34**	22.83*	28.29**	40.58***
	(2.13)	(2.11)	(2.20)	(1.89)	(2.57)	(3.29)
ROE	14.21**	13.79**	13.97**	13.33*	12.45*	8.168
	(2.18)	(2.00)	(2.09)	(1.90)	(2.00)	(1.42)
INTurnover	−0.002	−0.002	−0.002	0.004	0.012	−0.008
	(−0.25)	(−0.26)	(−0.19)	(0.37)	(0.85)	(−0.84)

(continued on next page)

TABLE 5 (continued)

	(1) Points Earned on Common Measures	(2) Points Earned on Common Measures	(3) Points Earned on Common Measures	(4) Points Earned on Common Measures	(5) Points Earned on Common Measures	(6) Points Earned on Common Measures
ARTurnover	0.015	0.014	0.013	0.028	0.010	0.021
	(0.85)	(0.77)	(0.69)	(1.25)	(0.52)	(0.94)
SalesGrowth	−0.818	−0.824	−0.619	−0.599	0.124	0.0768
	(−0.45)	(−0.45)	(−0.33)	(−0.33)	(0.07)	(0.05)
Year Indicator	Yes	Yes	Yes	Yes	Yes	Yes
Adj. R^2	0.165	0.167	0.168	0.185	0.283	0.370
n	113	113	113	105	113	113

Panel B: Points Earned Based on Firm-Specific Measures

	(1) Points Earned on Specific Measures	(2) Points Earned on Specific Measures	(3) Points Earned on Specific Measures	(4) Points Earned on Specific Measures	(5) Points Earned on Specific Measures	(6) Points Earned on Specific Measures
CEOConnection	−0.112					
	(−0.43)					
CFOConnection		0.208				
		(0.47)				
Distance			−0.256			
			(−1.14)			
Employees				1.645**		
				(2.28)		
StrategicIndustry					4.710***	
					(3.08)	
SOEPoliticalRank						5.456***
						(5.16)
EBT	−7.093	−10.42	−8.588	−5.573	−13.27	−39.24***
	(−0.61)	(−0.78)	(−0.77)	(−0.47)	(−1.10)	(−2.93)

(continued on next page)

TABLE 5 (continued)

	(1) Points Earned on Specific Measures	(2) Points Earned on Specific Measures	(3) Points Earned on Specific Measures	(4) Points Earned on Specific Measures	(5) Points Earned on Specific Measures	(6) Points Earned on Specific Measures
ROE	−28.74***	−28.33***	−28.29***	−28.50***	−26.56***	−16.97**
	(−2.92)	(−2.67)	(−2.83)	(−2.90)	(−3.13)	(−2.52)
INTurnover	−0.020	−0.022	−0.023	−0.035**	−0.044*	−0.009
	(−1.53)	(−1.47)	(−1.62)	(−2.09)	(−1.81)	(−0.51)
ARTurnover	−0.039	−0.039	−0.035	−0.064*	−0.029	−0.046
	(−1.64)	(−1.57)	(−1.47)	(−2.00)	(−1.19)	(−1.48)
SalesGrowth	1.718	1.619	1.091	1.233	0.155	0.060
	(0.75)	(0.69)	(0.45)	(0.59)	(0.07)	(0.04)
Year Indicator	Yes	Yes	Yes	Yes	Yes	Yes
Adj. R^2	0.156	0.159	0.164	0.254	0.308	0.550
n	106	106	106	98	106	106

*, **, *** Indicate two-tailed statistical significance of coefficient estimates at the 0.10, 0.05, and 0.01 levels, respectively.

Panel A of Table 5 reports the regression results for the effect of executive political connections, geographic proximity, SOE social responsibility, and SOE political rank on points earned based on common measures including *EBT* and *ROE*. Panel B of Table 5 reports the regression results for the effect of executive political connections, geographic proximity, SOE social responsibility, and SOE political rank on points earned based on firm-specific measures. Columns (1)–(6) report results when *CEOConnection*, *CFOConnection*, *Distance* between the SASAC and SOE headquarters, SOE's number of employees, and SOE political rank are used respectively as independent variables. To ensure that our inferences are not artifacts of a few extreme values, all variables are winsorized at the top and bottom 1 percent. Regressions are performed with clustered robust standard errors (Rogers 1993) to control for within firm correlation. t-statistics are in parentheses.

TABLE 6

Associations between Political Connections, Geographic Proximity, Social Responsibility, SOE Political Rank, and Cutoff Scores

$$EvaluationRating_{i,t} = \alpha_0 + \beta_1 CEOConnection_{i,t} + \beta_2 CFOConnection_{i,t} + \beta_3 Local_{i,t} + \beta_4 Distance_{i,t} + \beta_5 Employees_{i,t} + \beta_6 StrategicIndustry_{i,t} + \beta_7 SOEPoliticalRank_{i,t} + \beta_8 EvaluationScore_{i,t} + \varepsilon_{i,t}.$$

	(1) Evaluation Rating	(2) Evaluation Rating	(3) Evaluation Rating	(4) Evaluation Rating	(5) Evaluation Rating	(6) Evaluation Rating
CEOConnection	0.0597					
	(0.60)					
CFOConnection		0.235*				
		(1.82)				
Distance			−0.108			
			(−1.04)			
Employees				0.139		
				(0.55)		
StrategicIndustry					1.390**	
					(2.79)	
SOEPoliticalRank						2.724***
						(4.13)
EvaluationScore	1.025***	1.009***	1.022***	0.975***	0.976***	0.897***
	(7.50)	(7.26)	(7.53)	(6.78)	(7.26)	(6.55)
Pseudo R^2	0.630	0.640	0.634	0.631	0.654	0.710
n	186	186	189	174	189	189

*, **, *** Indicate two-tailed statistical significance of coefficient estimates at the 0.10, 0.05, and 0.01 levels, respectively.

Table 6 reports the regression results for the effect of executive political connections, geographic proximity, SOE social responsibility, and SOE political rank on evaluation ratings after controlling for evaluation scores. To ensure that our inferences are not artifacts of a few extreme values, all variables are winsorized at the top and bottom 1 percent. Regressions are performed with clustered robust standard errors (Rogers 1993) to control for within firm correlation. t-statistics are in parentheses.

strategic industries may effectively influencing the SASAC's decision when setting cutoff scores to their own advantage. Political rank of SOEs (coefficient = 2.724, t-statistic = 4.13) remains positively and significantly related to higher evaluation ratings, suggesting that these firms can get more favorable ratings by influencing the determination of cutoff scores.

To address the question of how political connections and geographic proximity influence the assignment of cutoff scores, we ran a t-test between two subsamples of SOEs: the "just-above" SOEs and the "just-below" SOEs. A firm is included in the "just-above" subsample if it is among the five firms that received evaluation scores that are just higher than the cutoff score for a specific rating category. A firm is included in the "just-below" subsample if it is among the five firms that received evaluation scores that are just lower than the cutoff score for a specific rating category. Results (not tabulated) show that "just-above" SOEs have significantly higher level of

political connections than "just-below" SOEs, indicating that political connections influence the SASAC's decision in assigning cutoff scores. An ordinal logit analysis (not tabulated) suggests that SOE political rank leads to a higher chance that an SOE belongs to the "just-above" cutoff score group.

Ex Post *Discretionary Adjustments in Evaluation Scores and Evaluation Ratings*

We investigate whether our variables of interest influence the *ex post* discretionary adjustment in evaluation scores and evaluation ratings after controlling for financial performance indicators. Recall from Section II that punishment points are deducted from raw scores if SOEs have severe safety-related incidents or if they are involved in financial fraud or scandals. Further, bonus points are awarded to those SOEs that have acquired financially distressed SOEs out of political concern. Since we do not have objective measurements of safety-related incidents, financial frauds or financial scandals, and political mergers and acquisitions, we only control for financial performance indicators. This limits the inferences we can draw from the results reported in Table 7 and Table 8.

Results for Model 2 shown in Column (2) of Tables 7 and 8 show that SOEs with strongly connected CFOs are more likely to receive upward score adjustments from the SASAC but not upward ratings adjustments. Results for Model 6 in Column (6) of Tables 7 and 8 suggest that SOEs with higher political rank are more likely to receive upward ratings adjustments but not upward scores adjustments.

Results for Model 4 detailed in Column (4) of Table 7 and Model 4 shown in Column (4) of Table 8 suggest that firms with more employees are less likely to get upward adjustment in scores and ratings. This observed negative association between employee number and *ex post* score/rating adjustment may occur because SOEs with more employees are harder to manage and more likely to evince safety-related incidents and financial fraud. When safety-related incidents and financial fraud do occur, SOEs with more employees receive more public attention and more media coverage, and it is more difficult for the SASAC to cover up these events in the Performance Evaluation process. Further, we use the domestic-listing status and cross-listing status as instrumental variables to proxy for organizational salience. We use the operational scope and the firm internal Herfindahl indices as instrumental variables to proxy for organizational complexity. Results (untabulated) show that even after controlling for these instrumental variables, the measure of employee number remains negatively and significantly related to ratings adjustments, possibly indicating that the Chinese government is rewarding SOEs for reducing extra manpower, but not for creating redundant job opportunities.

The Association between Variables of Interest and Future Financial Performance of SOEs

An alternative explanation that may account for the positive association between variables of interest and evaluation results is that political connections are unique resources, and that politically connected executives bring real benefits to these SOEs. Stronger political connections may reflect more formal and informal social ties and a higher level of legitimacy, capability, and social status. It is possible that the SASAC has specific knowledge regarding SOEs' political connections and makes reasonable adjustments by giving bonus points to those companies that make best use of their political connections in creating firm value. A lead-lag performance analysis (untabulated) shows that executive political connections and firm political rank are significantly and positively related to future evaluation scores, but are not significantly related to contemporaneous or future sales growth, ROE, and EVA. Thus, our data do not support the argument that political connections create value for SOEs or that the SASAC takes into consideration the real benefit of political connections of SOEs when granting evaluation scores and assigning evaluation ratings.

TABLE 7

Associations between Political Connections, Geographic Proximity, Social Responsibility, SOE Political Rank, and Upward Adjustments in Evaluation Scores

$$DScoreAdj_{i,t} = \alpha_0 + \beta_1 Variable\ of\ Interest_{i,t} + \beta_2 DegreeofDifficulty_{i,t} + \beta_3 Assets_{i,t} + \beta_4 EBT_{i,t} + \beta_5 ROE_{i,t} + \beta_6 INTurnover_{i,t} + \beta_7 ARTurnover_{i,t} + \beta_8 SalesGrowth_{i,t} + \varepsilon_{i,t}.$$

	(1) *DScoreAdj*	(2) *DScoreAdj*	(3) *DScoreAdj*	(4) *DScoreAdj*	(5) *DScoreAdj*	(6) *DScoreAdj*
CEOConnection	0.0133					
	(0.14)					
CFOConnection		0.416***				
		(3.18)				
Distance			0.003			
			(0.03)			
Employees				−0.566*		
				(−1.84)		
StrategicIndustry					−0.492	
					(−0.85)	
SOEPoliticalRank						0.640
						(1.50)
DegreeofDifficulty	−7.124	−6.051	−7.948	0.141	−12.51	−9.419
	(−0.32)	(−0.28)	(−0.37)	(0.01)	(−0.57)	(−0.44)
Assets	−0.257	−0.421	−0.241	0.134	−0.045	−0.484
	(−0.77)	(−1.26)	(−0.75)	(0.36)	(−0.12)	(−1.36)
EBT	−1.734	−3.968	−1.655	−5.264	−1.724	−3.453
	(−0.26)	(−0.55)	(−0.25)	(−0.76)	(−0.26)	(−0.51)
ROE	3.737	5.526*	3.770	3.424	3.797	4.997
	(1.25)	(1.72)	(1.26)	(1.15)	(1.27)	(1.61)
INTurnover	0.001	0.000	0.001	0.002	0.002	0.005
	(0.14)	(0.02)	(0.16)	(0.30)	(0.27)	(0.61)
ARTurnover	−0.012	−0.011	−0.012	−0.007	−0.014	−0.011
	(−0.89)	(−0.78)	(−0.87)	(−0.54)	(−1.03)	(−0.84)
SalesGrowth	−1.427*	−1.572*	−1.417	−1.328	−1.389	−1.535*
	(−1.68)	(−1.79)	(−1.63)	(−1.52)	(−1.62)	(−1.82)
Year Indicator	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R^2	0.062	0.120	0.062	0.078	0.066	0.073
n	168	168	168	156	168	168

*, **, *** Indicate two-tailed statistical significance of coefficient estimates at the 0.10, 0.05, and 0.01 levels, respectively.

Table 7 reports the regression results for the effect of executive political connections, geographic proximity, SOE social responsibility, and SOE political rank on upward adjustments in evaluation scores. Columns (1)–(6) report results when *CEOConnection*, *CFOConnection*, *Distance* between the SASAC and SOE headquarters, SOE's number of employees, and SOE political rank are used respectively as independent variables. To ensure that our inferences are not artifacts of a few extreme values, all variables are winsorized at the top and bottom 1 percent. Regressions are performed with clustered robust standard errors (Rogers 1993) to control for within firm correlation. t-statistics are in parentheses.

TABLE 8

Associations between Political Connections, Geographic Proximity, Social Responsibility, SOE Political Rank, and Upward Adjustments in Evaluation Ratings

$$DRatingAdj_{i,t} = \alpha_0 + \beta_1 Variable\ of\ Interest_{i,t} + \beta_2 DegreeofDifficulty_{i,t} + \beta_3 Assets_{i,t} + \beta_4 EBT_{i,t} + \beta_5 ROE_{i,t} + \beta_6 INTurnover_{i,t} + \beta_7 ARTurnover_{i,t} + \beta_8 SalesGrowth_{i,t} + \varepsilon_{i,t}.$$

	(1) *DRatingAdj*	(2) *DRatingAdj*	(3) *DRatingAdj*	(4) *DRatingAdj*	(5) *DRatingAdj*	(6) *DRatingAdj*
CEOConnection	0.254					
	(1.08)					
CFOConnection		0.251				
		(1.02)				
Distance			−0.141			
			(−0.72)			
Employees				−1.481**		
				(−2.27)		
StrategicIndustry					1.711	
					(1.55)	
SOEPoliticalRank						3.122***
						(2.79)
DegreeofDifficulty	−15.95	−24.65	−27.26	−8.367	−8.709	−12.50
	(−0.38)	(−0.59)	(−0.66)	(−0.19)	(−0.19)	(−0.32)
Assets	−0.226	−0.070	−0.079	0.729	−0.730	−1.524*
	(−0.34)	(−0.11)	(−0.12)	(1.00)	(−0.90)	(−1.77)
EBT	3.682	1.680	5.833	−4.865	5.134	−7.963
	(0.23)	(0.10)	(0.38)	(−0.30)	(0.32)	(−0.45)
ROE	2.824	5.770	4.160	4.289	5.182	11.09*
	(0.57)	(1.10)	(0.88)	(0.84)	(1.03)	(1.71)
INTurnover	−0.004	−0.002	−0.001	0.004	−0.005	0.016
	(−0.23)	(−0.08)	(−0.08)	(0.29)	(−0.35)	(0.68)
ARTurnover	0.049	0.049	0.051*	0.070*	0.053*	0.062*
	(1.44)	(1.56)	(1.66)	(1.95)	(1.69)	(1.80)
SalesGrowth	−2.138*	−2.116	−2.253*	−1.480	−2.472*	−3.074**
	(−1.66)	(−1.62)	(−1.72)	(−1.04)	(−1.89)	(−2.21)
Year Indicator	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R^2	0.138	0.136	0.127	0.198	0.153	0.266
n	168	168	168	156	168	168

*, **, *** Indicate two-tailed statistical significance of coefficient estimates at the 0.10, 0.05, and 0.01 level, respectively.

Table 8 reports the regression results for the effect of executive political connections, geographic proximity, SOE social responsibility, and SOE political rank on upward adjustments in evaluation ratings. Columns (1)–(6) report results when *CEOConnection*, *CFOConnection*, *Distance* between the SASAC and SOE headquarters, SOE's number of employees, and SOE political rank are used respectively as independent variables. To ensure that our inferences are not artifacts of a few extreme values, all variables are winsorized at the top, and bottom 1 percent. Regressions are performed with clustered robust standard errors (Rogers 1993) to control for within firm correlation. t-statistics are in parentheses.

V. CONCLUSION AND DISCUSSION

The main objective of this study is to investigate the two-way process in which a subordinate and a superior engage in influence activities and favoritism, respectively, in subjective Performance Evaluation. To study this process we employ a database that contains information of economic importance from China, one of the world's largest economies. Our study suggests that the use of subjectivity in Performance Evaluation leads to influence activities, consistent with evaluators hesitating to use subjective evaluation even when objective measures are less than perfect. Furthermore, our interviews suggest that social interaction and unofficial communication between superiors and subordinates influence the level and direction of the subjective adjustment of Performance Evaluation scores. These results enrich our understanding of the complexity of social behavior in the Performance Evaluation process beyond the simple dichotomy of using objective versus subjective measures. Insights from the field also allow us to examine subjectivity in more detail. Subjectivity manifests itself in bargaining for lower operational targets, bargaining for upward adjustment of actual performance because of uncontrollable factors, bargaining for upward adjustment of raw scores, and by affecting the SASAC's determination of cutoff scores of ratings assignments.

We use social identity theory to identify factors that we expect to contribute to the effectiveness of influence activities such as persuasion and consultation in the subjective evaluation setting. Having CFOs with career histories as governmental officials and locating headquarters in geographical proximity to the evaluator (the SASAC office) facilitate the communication between the SOEs and the SASAC and, thus, lead to higher evaluation scores and ratings. This result contributes to the influence literature by demonstrating how subordinates' political connections and geographic proximity contributes to their SOEs' ability to influence the evaluation outcomes. We investigate the firm characteristics that lead to favorable governmental treatments in evaluation scores/ratings. Results indicate that the political rank of SOEs is positively and significantly related to the evaluation scores/ratings.

This study also addresses a puzzling question in the literature regarding why SEOs that receive more favorable governmental treatment perform worse than their counterparts in the private sector. Prior research has focused on the relationship between state ownership and firm value (Sapienza 2004; Dinc 2005), but has rarely discussed the mechanism used by the government that could distract SOEs from making value-maximizing decisions. Our empirical findings suggest that SOEs must balance multiple goals and make trade-offs between social responsibility and economic benefits, which leads to the use of multiple-measure Performance Evaluation when SOEs are evaluated. These social objective measures are hard to quantify and may conflict with one another. Subjectivity is then employed to strengthen incentives by incorporating additional information not included in objective measures. Given that the performance appraisal results influence SOE executives' compensation, promotion, and political career advancement, there are clear incentives for SOE executives to maximize measures officially included in the evaluation formula. However, when subjectivity is included in the appraisal process and when governmental officials are granted discretion in adjusting the evaluation scores/ratings, governmental evaluators can provide more favorable evaluation scores to those SOEs that comply. In addition, officials can treat larger SOEs with politically influential executives more favorably and, in return, hope for reciprocity from these executives who may later wish to advance their careers. Facing unfair treatment under subjective evaluation supervised by the government officials, SOE executives may divert their time and effort from maximizing firm value to pleasing government officials and, in the process, forgo business opportunities.

Our study has some limitations that may lead to future research. First, we follow Ittner et al. (2003) and Hoppe and Moers (2011) in trying to separate different types of subjectivity. We also

show that subjectivity is manifested in several forms and is embedded in the Performance Evaluation system and in the target-setting process. Even though we distinguish our study by examining both influence activities and favoritism simultaneously, the correlation among the empirical proxies is likely to limit the study's ability to isolate these two constructs. Second, while our database derives from the Chinese government's evaluation of SOEs, future studies could be extended to the private sector in situations where the firm headquarters evaluates the performance of multiple business divisions.

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APPENDIX A

SASAC Performance Evaluation System[a]

Measures	Base Points for Achieving Target	Range of Points	Points Granted	Degree of Difficulty (DoD)	Scores
Earnings before Tax and Extraordinary Items[b]	30	[24, 36]	P_EBT	[1.01, 1.14]	S_EBT = P_EBT × DoD when the preset target on EBT is achieved. Otherwise, the SOE just gets the points with no multiplier effect.
Return on Equity[c]	40	[32, 48]	P_ROE	[1.01, 1.14]	S_ROE = P_ROE × DoD when the preset target on ROE is achieved. Otherwise, the SOE just gets the points with no multiplier effect.
Inventory Turnover	15	[12, 18]	P_INTurn	[1.01, 1.14]	S_INTurn = P_ INTurn × DoD when the preset target on inventory turnover is achieved. Otherwise, the SOE just gets the points with no multiplier effect.
Accounts Receivable Turnover	15	[12, 18]	P_ARTurn	[1.01, 1.14]	S_ARTurn = P_ ARTurn × DoD when the preset target on accounts receivable turnover is achieved. Otherwise, the SOE just gets the points with no multiplier effect.
Sales Growth	15	[12, 18]	P_Growth	[1.01, 1.14]	S_Growth = P_Growth × DoD when the preset target on sales growth is achieved. Otherwise, the SOE just gets the points with no multiplier effect.
Subtotal: Objective	100	80–120			
Occurrence of Safety Incidents	0	(−∞, 0]	P_Incidents		S_Incidents = P_S Incidents
Occurrence of Financial Frauds and Scandals	0	(−∞, 0]	P_Frauds		S_Frauds = P_Frauds
Acquisition of Financially Distressed Firms Out of Political Concern	0	[0, +∞)	P_Acquisition		S_Acquisition = P_Acquisition
Subtotal: Adjustments	0	(−∞, +∞)			
EvaluationScore	*Scores Based on Objective Measures + Scores Based on Discretionary Adjustments*				

[a] Appendix A is excerpted and summarized from the *Report Regarding the Annual Performance Evaluation* of central government controlled SOEs issued by the Performance Evaluation Bureau of the SASAC in 2003.

[b] An SOE can get one additional point when exceeding the preset EBT target by 3 percent.

[c] Additional points granted for exceeding the ROE target depend on the level of the preset target for ROE. When the preset target is lower than the historical record and the industry record, an SOE can get one additional point when exceeding the preset target by 4 percent. When the target is higher than or equal to the historical record or the industry record, an SOE can get one additional point when exceeding the preset target by 3 percent.

APPENDIX B
VARIABLE DEFINITIONS

Dependent Variables

$EvaluationScore_{it}$ = comprehensive Performance Evaluation score prepared by the SASAC assigned to SOE i in fiscal year t;

$EvaluationRating_{it}$ = rating assigned by the SASAC to SOE i. Evaluation ratings are 3 when SOEs are rated A, 2 when they are rated B, 1 when they are rated C, and 0 when they are rated D or E;

$Cutoff_{it}$ = dummy indicator that SOE i belongs to the "just-above" group of SOEs. An SOE is included in the "just-above" group if it is among the five firms that received evaluation scores that are just higher than the cutoff scores for the specific rating;

$DScoreAdj_{it}$ = *ex post* discretionary adjustment in evaluation scores. *DScoreAdj* is 2 if an SOE's final evaluation score is higher than the raw score, 1 if an SOE's final evaluation score equals the raw score, and 0 if an SOE's final evaluation score is lower than the raw score; and

$DRatingAdj_{it}$ = *ex post* discretionary adjustment in evaluation ratings. *DRatingAdj* is 2 if the SASAC adjust upward an SOE's rating based on discretionary adjustment in evaluation scores, 1 if the SASAC does not adjust an SOE's rating, and 0 if the SASAC adjust downward an SOE's rating.

Control Variables

$DegreeofDifficulty_{it}$ = degree of operational difficulties assigned by the SASAC to SOE i. This parameter, when multiplied by points earned, converts scores on separate financial performance measures of an individual SOE into its final comprehensive evaluation score;

$Assets_{it}$ = natural log of total assets of SOE i at the end of year t;

EBT_{it} = earnings before tax and extraordinary items of SOE i in year t scaled by total assets of SOE i in year t;

ROE_{it} = return on equity of SOE i in year t;

$INTurnover_{it}$ = operational cost divided by average inventory of SOE i in year t;

$ARTurnover_{it}$ = operational revenue divided by average accounts receivable of SOE i in year t; and

$SalesGrowth_{it} = (Sales_t - Sales_{t-1})$ divided by $Sales_{t-1}$ of SOE i in year t.

Political Connections

$CEOConnection_{it}$ = highest bureaucracy position a CEO occupied before joining an SOE top management team. The position is manually coded into two dimensions of categorical measures: the rank of the bureau in which the CEO had served, and the rank of the political title the CEO held. The ranking of the bureau is sorted into three categories: central government (= 3), provincial government (= 2), and municipal government (= 1). The ranking of the political title is also sorted into three levels, ministerial/provincial level (= 3), board/regional level (= 2), and unit level (= 1); and

$CFOConnection_{it}$ = coded as above for *CEOConnection*.

Geographic Proximity

$Distance_{it}$ = log transformation of distance between SOE headquarters and SASAC central office.

Social Responsibility

$Employees_{it}$ = natural log of the number of employee of SOE *i* scaled by *Assets* in fiscal year *t*; and

$StrategicIndustry_{it}$ = dummy of industry in which SOE *i* competes in year *t*. *StrategicIndustry* is coded as 1 when an SOE competes in industries in which the government wants to retain absolute control power, including the military, electric power, petroleum and petrochemicals, telecom, coal, civil aviation, and shipping and transportation; *StrategicIndustry* is coded as 0 when an SOE competes in industries not mentioned above.

Political Rank

$SOEPoliticalRank_{it}$ = political rank of the SOE *i* is located in fiscal year *t*. The SASAC sorts Chinese SOEs into three levels of administrative rank. *SOEPoliticalRank* is coded as 2 if an SOE is sorted into the highest administrative rank, coded as 1 if an SOE is sorted into the second highest administrative rank, and coded as 0 if an SOE is sorted into the third highest administrative rank.