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ENTREPRENEURIAL RISK AND LOSS AVERSION IN THE EVALUATION OF VENTURE FORMATION OPPORTUNITIES

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Principal Topic

For venture formation to occur, entrepreneurs must recognize an opportunity and decide to act (Venkataraman, 1997). The decision to act follows careful evaluation of a recognized opportunity (Krueger et al., 2000). During opportunity evaluation, entrepreneurs screen recognized opportunities to judge their attractiveness for exploitation. Explaining this evaluation is critical to entrepreneurship theory. Although risk is central to evaluation, our understanding of risk in this context is incomplete, leading some to call for more rigorous theorizing (Mullins & Forlani, 2005). Further, despite mounting evidence of loss aversion (Kahneman & Tversky, 1979), a striking feature of venture formation research is the continued emphasis on risk aversion. In response, we build on risk literature and entrepreneurship theory to develop a theoretical framework for understanding the influence of entrepreneurial risk, focusing attention on three dimensions essential to explaining the evaluation of venture formation opportunities.

Theoretical Framework

Opportunity recognition represents the process through which entrepreneurs discover an opportunity while exploitation involves deliberate actions that expose entrepreneurs to significant financial and non-financial outcomes. Given such consequences, an entrepreneur evaluates venture formation opportunities before deciding to act. Central to our theory is that such judgments depend importantly on risk perceptions in the entrepreneur's evaluation of recognized opportunities (Palich & Bagby, 1995). Such risk is determined by expected utility estimates of the outcomes of venture formation, the entrepreneur's confidence in these estimates (i.e., uncertainty), and the position of these estimates relative to a reference point. During evaluation, entrepreneurs collect and analyze information, enabling them to revise these estimates. Thus, as entrepreneurs evaluate an opportunity, their perception of the risk associated with that opportunity changes. In shaping responses to these perceptions, loss aversion dominates the determination of an opportunity's attractiveness. In theory describing these dynamics, we include propositions that codify our arguments.

Implications

We provide new theory to explain the influence of risk perceptions on the evaluation of venture formation opportunities. In doing so, we (a) develop a multidimensional model of entrepreneurial risk, (b) extend loss aversion to the venture formation context, and (c) use our model and the loss aversion concept to explain the evaluation of venture formation opportunities.

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