

Chapter 8

Perceptions and Framing of Risk, Uncertainty, Loss, and Failure in Entrepreneurship

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ABSTRACT

Research indicates that perceptions of risk and loss affect decision-making. Entrepreneurship presents a context in which risk, failure, and loss frequently frame decisions. This paper presents a review of the entrepreneurship literature that is grounded in Kahneman and Tversky's 1979 article on prospect theory. The theory's contribution to the understanding of how the framing of losses affects decisions offers a useful foundation for considering streams of research in entrepreneurship and small business, given that the prospects for loss and failure are high in these endeavors. This review identifies 79 articles and organizes them into four broad themes: risk-taking perspectives of the entrepreneur and stakeholders, aspirations and reference points, organizational innovation and change, and learning from failure. The review concludes by considering the future research potential in the topics of regret, mental accounting, and an understanding of competitors.

INTRODUCTION

Entrepreneurship is a risky undertaking in which failure and loss are not unexpected outcomes. An entrepreneur's response not only to a realized failure but also to the potential for failure has implications for the willingness to engage in the risk-taking behavior that is a hallmark of entrepreneurship.

Approximately 35 years ago, Daniel Kahneman and Amos Tversky (1979) demonstrated that deci-

sions framed as situations of potential loss were evaluated differently than decisions framed as situations of potential gain. Demonstrating behavior that these researchers explained in prospect theory, decision-makers will tend to pursue risk-seeking alternatives in an effort to avoid a loss.

The influence of Kahneman and Tversky's research (Evans & Over, 1997; Kahneman, 2003) in the bounded rationality and cognitive biases of decision-makers has been widely felt in various disciplines and research streams. Prospect theory

is one facet in that body of work that highlights the role of loss, offering a useful foundation from which to consider how entrepreneurs' behavior is affected by the prospects of loss and failure.

Given that entrepreneurship is known to carry a high risk of failure, researchers have considered how those prospects in general affect entrepreneurs' behavior. Further, they have examined how experiencing actual losing or failing performance may lead entrepreneurs to opt for a high-risk choice among what is considered a risky set of options. This paper presents a review of the entrepreneurship literature based on Kahneman and Tversky's 1979 article and sets this entrepreneurship research within the broader set of work derived from that original theoretical foundation. Other disciplines have taken different turns and investigated different research questions that may fruitfully inform future entrepreneurship research, and this review closes by making these ties in identifying future research possibilities.

LITERATURE SEARCH

Because this review is focused on entrepreneurs' perspectives on loss and failure, the findings of prospect theory (Kahneman & Tversky, 1979) serve as a key foundation. In short, prospect theory suggests that a decision-maker faced with losing prospects will pursue a risky alternative in an effort to avoid the loss. This cognitive bias toward risk-taking is an example of the bounded rationality of decision-makers. The entrepreneurship research that is covered in this review indicates that there are different ways in which the outcome of "loss" or "failure" can be manifest. Of course, a business can suffer a financial loss or a series of financial losses severe enough to cause the business to close.

Some businesses, however, close without experiencing an actual financial loss, but they were not sufficiently successful to be sustainable and survive. A part of a business – such as a unit or a product line – may fail while the rest continues.

The business may fail to meet an objective set by the entrepreneur, falling short of growth or profit expectations, for example. In addition to the business-specific losses, the business owner may experience some psychological or emotional loss since an owner's identity or reputation may be closely tied to the business. Or the owner may close the business because more highly-valued alternatives exist and the business represents an opportunity cost.

Kahneman and Tversky (1979) examined the prospects for failure, referring to a future outcome. But research in prospect theory also considers that we look at future prospects based on current conditions and our past experiences. For instance, research covered in this review examines behaviors of entrepreneurs making decisions about businesses that are currently under-performing but have not failed yet. Thus, in addition to having application to entrepreneurs contemplating the gamble on starting a new business that may fail, the research covered in this review is relevant to a broad set of entrepreneurs. For instance, serial entrepreneurs may be making a decision about a new undertaking in light of a recently failed business. Individuals may not have a failed business or losses in their own past, but perhaps they are considering partnering with an entrepreneur who has overseen a failed or poorly performing business.

The body of work by Kahneman and Tversky, which garnered a Nobel Prize in 2002, has been a foundational reference for much research. The 1979 paper, specifically, has been cited extensively. A search of the EBSCO Business Source Complete database indicates that over 3,000 articles have cited this paper "Prospect theory: an analysis of decision under risk" that was published in *Econometrica*. Each of the business disciplines are represented in this article count including economics (approximately 25% of the publications), marketing (25%), management (25%), finance and accounting (15%), and other miscellaneous topics (e.g., law, communications) making up

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