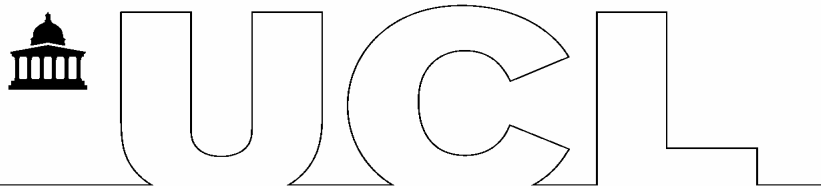
CENTRE FOR THE STUDY OF ECONOMIC AND
SOCIAL CHANGE IN EUROPE (CSESCE)



UCL SSEES
Centre for the Study of Economic and Social Change in Europe

GROWTH EXPECTATIONS AND FINANCIAL PERFORMANCE OF SMALL BUSINESSES. EVIDENCE FROM LATVIA.

Ruta Aidis,[a] Tomasz Mickiewicz [a] [b]

and

Arnis Sauka [c]

[a] UCL School of Slavonic and East European Studies
[b] Corresponding author: *t.mickiewicz@ucl.ac.uk*
[c] Stockholm School of Economics in Riga.

Economics Working Paper No. 85

January 2008

Centre for the Study of Economic and Social Change in Europe
UCL School of Slavonic and East European Studies
Gower Street, London, WC1E 6BT
Tel: +44 (0)20 7679 8519
Fax: +44 (0)20 7679 8777
Email: csesce@ssees.ucl.ac.uk

Growth Expectations and Financial Performance of Small Businesses.

Evidence from Latvia.

Ruta Aidis
University College London
Department of Social Sciences, SSEES
Gower Street
London, WC1E 6BT
United Kingdom
Tel.: +44 (0) 20 7679 8757
Fax: + 44 (0) 20 7679 8777
e-mail: r.aidis@ucl.ac.uk

Tomasz Mickiewicz
University College London
Department of Social Sciences, SSEES
Gower Street
London, WC1E 6BT
United Kingdom
Tel.: +44 (0) 20 7679 8757
Fax: + 44 (0) 20 7679 8777
e-mail: t.mickiewicz@ucl.ac.uk
(corresponding author)

Arnis Sauka
Stockholm School of Economics in Riga
The TeliaSonera Institute
Strelnieku street 4a
Riga, LV 1002
Latvia
Tel.: +371 26 043 567
Fax: +371 7830 249
e-mail: asauka@sseriga.edu.lv

Key Search Words: Entrepreneurial cognition, Expectations, Performance, Regulatory Focus Theory

Small Business Strategy and Organization

Biographical statements
(position and research interests)

Dr. Ruta Aidis is an honorary Research Fellow at University College London. Her main research interests include the influence of the institutional environment on entrepreneurship development, growth and performance. She is also interested in individual expectations, gender and migration as related to entrepreneurship.

Prof. Dr. Tomasz Mickiewicz holds a chair in comparative economics, at the University College London. His main research interests relate to entrepreneurship, corporate governance and privatisation, especially with reference to Central and Eastern Europe.

Dr. Arnis Sauka is a Research Fellow at the TeliaSonera Institute at the Stockholm School of Economics in Riga (Latvia). Prior to joining the doctoral program at the University of Siegen (Germany), he was a visiting PhD candidate at Jönköping International Business School (Sweden) and a teacher fellow at University College London (U.K.). His main research interests are related to productive and unproductive entrepreneurship, entrepreneurship policies and entrepreneurship in transition economies as well as business start-ups, performance and exits.

Growth Expectations and Financial Performance of Small Businesses. Evidence from Latvia.

Abstract

By applying regulatory focus theory, this paper investigates the impact of both initial confidence and of exactness of growth expectations on subsequent financial performance of the small firms. Drawing on the unique data set based on the repeated survey design, we make one of the first attempts to explore the complexity of this relationship empirically. Overall the findings suggest that controlling for other relevant factors, including actual growth, the entrepreneurs having higher growth expectations perform significantly better later on in terms of profitability. In addition, education has a strong modifying effect: the impact of high growth expectations on subsequent profit performance is stronger for entrepreneurs with lower level of education.

Growth Expectations and Financial Performance of Small Businesses.

Evidence from Latvia.

1. Introduction

The ability to collect and analyse information is of crucial importance when it comes to make strategic decisions and define the future growth of the company (e.g. West and Meyer 1997). While planning the direction of the firm and aiming to enhance its performance, entrepreneurs are involved in *cognitive processes* - "… the knowledge structures that people use to make assessments, judgments, or decisions involving opportunity evaluation, venture creation, and growth" (Mitchell et. al. 2002: 97).

Cognitive processes include creating mental models, shaping the way entrepreneurs organize their personal beliefs, memory of the past events, knowledge and intuition (e.g. Baron 2004). Mental processes occurring on the individual level has a direct effect on the entrepreneurship activities, which in turn helps to make further decisions as well as generate new business opportunities (e.g. Busenitz and Lau 1996; Shane and Venkatamaran 2000). Furthermore, mental models are used by entrepreneurs to define and understand cause-effects relationship between anticipations, actions and outcomes (Baron 2004).

With the help of mental models entrepreneurs make various anticipations[1], which are further adapted to decide on how to act in order to gain competitive

[1] Entrepreneurship literature refers to anticipations also as to expectations, predictions, or aspirations, often mixing these terms. In this paper, if not stated otherwise, we use terms anticipations and expectations as synonyms.

advantage in the market (e.g. Busenitz and Lau 1996). In this light, capacity to recognise, identify and respond to the existing set of opportunities and threats have been found to play a central role for successful entrepreneurship in the entrepreneurship literature (e.g. Baum and Locke 2004; Baron 2004; Brockner et al. 2004; De Corolis and Saparito 2006).

Furthermore, recent entrepreneurship literature emphasizes the importance of the accuracy of growth anticipations, especially when it comes to planning for financial performance. This is important since accuracy in anticipating the firm' sales growth performance can help to ensure optimal allocation of necessary resources which are needed to implement future strategies (Busenitz and Lau 1996; Gaglio and Katz 2001). As small firms usually command over limited financial resources compared to their larger counterparts (e.g. McIntyre 2001), their allocation is especially relevant when it comes to the management of small businesses.

In the context of this discussion, a research theme that is gaining interest in the entrepreneurship literature is the relationship between cognitive mechanisms such as 'entrepreneurial anticipation' and actual entrepreneurial outcomes. Moreover, the comparison of 'entrepreneurial anticipation' and 'actual entrepreneurial outcomes' is considered as an 'ideal measure of entrepreneurial cognitive bias (Wu and Knott 2006). Given the difficult nature of the latter process coupled with the difficulty in collecting adequate data, however, only a limited number of studies (e.g. Wiklund and Shepherd 2003) have attempted to empirically investigate the link between growth anticipations of entrepreneurs and actual growth outcomes. The aim of this paper is to broaden this empirical literature by further exploring the interaction between forward looking entrepreneurial beliefs shaping the growth strategies of entrepreneurs, their business's actual growth outcomes and financial performance.

By utilising a unique data set based on a repeated survey design collected specifically for this study, this paper contributes to the existing literature by providing empirical evidence as to the relationship between the exactness of entrepreneurial anticipations and business financial performance. Furthermore, we make one of the first attempts to address the complexity of this relationship by exploring the interacting effect of individual level characteristics within the expectations and performance relationship. Regulatory focus theory (Higgins 1997) and relevant amendments are used in order to develop testable empirical hypotheses and interpret our results.

The rest of the paper is structured as follows. Section two presents a conceptual framework. In section three we discuss methodology. Main results are presented in section four, whereas conclusions and implications are summarised in the section five.

2. Conceptual Framework

2.1 Cognitive strategies, anticipations and performance: the regulatory focus theory perspective

Individuals face a world that contains a set of threats and opportunities. An exact assessment of these is difficult as full information is never available, and additional information has to be acquired at a cost. To deal with this complexity, people adopt alternative cognitive (heuristic) strategies, the efficiency of which is conditional on the environmental characteristics (DellaVigna 2007). In this context, the contribution of regulatory focus theory (Higgins 1997) is to highlight the fact that

people may not attach the same weight to potential positive outcomes as to the to potential negative outcomes of their actions, often referred to as ‘opportunities’ and ‘risks’ in entrepreneurship literature (De Carolis and Saparito 2006).

In this light, the central contribution of the regulatory focus theory is to posit the identification of two stylised strategies of self-regulation aimed at achieving individual standards and goals: ’promotion focus’ and ‘prevention focus’ (Higgins 1997). The main difference is that individuals using the ‘promotion focus’ highlight the potential gains, while those individuals using ‘prevention focus’ concentrate on avoiding potential losses (Brockner et al. 2004). It is however impossible, to declare one of these strategies as superior a priori, as their efficiency is conditional on the nature of the task at hand (Baron 2004).

Moreover, empirical evidence suggests that both alertness to threats and the cognitive skills related to opportunity recognition may not necessary be substitutes; it is in fact likely that the winning combination lies where these two foci overlap. At this intersection we find individuals who can combine ‘promotion focus’ with some ‘prevention focus’, or those individuals who are flexible in modifying their approach depending on the circumstances. In the context of entrepreneurship, a ‘promotion focus’ may be of more critical value in an early phase of business start up when innovation is essential. On the other hand, a ‘prevention focus’ may be more useful during the business planning stage, where a reality check as well as the identification of business risks is of key importance (Brockner et al. 2004).

In addition, it is also important to acknowledge how different cognitive strategies affect the expectations. As Brockner et al. observe: “It is an advantage for people in a promotion focus to anticipate success because this positive expectancy will maintain their motivational intensity (high eagerness). (…) There is also evidence

that high promotion-pride individuals are optimists with high self-confidence." (Ibid., p. 215).[2]

The perspective presented above stresses the self-fulfilling features of people's beliefs. However, there are additional compelling arguments that highlight how higher performance expectancy may be beneficial for entrepreneurship.

Firstly, in the entrepreneurial context, opportunity recognition as related to promotion focus may be clearly seen as particularly beneficial (Baum et al. 2001; Baron 2004).

Secondly, shifting from a psychological to an economic argument, in an environment where most individuals are risk-averse, the willingness to take risks is rewarded (Parker 2004). Even if entrepreneurs do not differ in their tolerance for risk from the general population (Wu and Knott 2006), their actual risk-taking may be higher, being driven by entrepreneurial confidence (here understood as optimistic perceptions of opportunities). Thus, confidence can lead to better performance via its implications for risk taking.

And, thirdly, asymmetry may exist between failure and success. In particular, taking the resource perspective view, planning for success (associated with higher sales growth expectancy) may be more beneficial than an alternative strategy of planning to limit the impact of potential negative shocks (associated with lower sales growth expectancy), as the adjustment costs may differ in both cases. For example, while preparing for high sales growth, an entrepreneur may secure an open line of credit, which could be more difficult to obtain instantaneously later on, in case he/she would be surprised by unexpected high growth. In contrast, in case of securing initial finance when high growth does not materialise later on, the adjustment cost may be

[2] An important point to note is that here we talk about a cognitive bias (i.e. the difference in perceptions of risk), not about a different level of risk tolerance, as in the traditional theory (see discussion in: Baron 2004; De Carolis and Saparito 2006; Wu and Knott 2006).

smaller. Entrepreneurial opportunities are by definition of a transient nature and therefore the speed of response is a critical factor. Accordingly, the reward for an entrepreneur with higher growth expectations from having resources mobilised to meet a surge in demand (such as to secure an adequate level of finance or of employment with required skills) may be more than proportional when compared with the reward for a entrepreneur with lower growth expectations, that may result from potential savings from a decrease in the venture resource base in anticipation of the decrease in demand. Thus, the asymmetry between the gains from being prepared for the success versus the savings from being prepared for a downturn may explain why higher growth expectations may on average result in better performance than lower growth expectations.

It is for these reasons that the cognitive bias resulting in high growth expectations may be beneficial for entrepreneurial success as measured by financial performance. We apply this theoretical perspective to our first hypothesis:

H1: Entrepreneurial success[3] *is associated with the higher growth expectations.*

However, we posit that an alert and correct perception of the existing threats may also be a factor in entrepreneurial success. Recent entrepreneurship literature emphasizes the importance of the accuracy of growth anticipations. This is important since accuracy in anticipating the firm' growth can also help to ensure optimal allocation of necessary resources which are needed to implement future strategies (Busenitz and Lau 1996; Gaglio and Katz 2001). Therefore though high growth

[3] Though 'entrepreneurial success' can be conceptualised in a variety of ways including subjective as well as objective measures, this paper analyses 'entrepreneurial success' in terms of financial performance. See Section 3 below.

expectations may be beneficial for business success (as formulated in hypothesis 1), the impact of this factor may be mitigated by the negative influence of high discrepancy between anticipations and actual outcomes. Therefore the exactness of anticipation may also be important. This leads us to formulate our second hypothesis:

H2: Entrepreneurial success is positively affected by exactness of growth anticipations.

2.2. Addressing the complexity of anticipations and performance relationship

People's estimates may be incorrect due to various reasons. Underestimation of possible uncertainties of environment where the decision is made, inability to process new data and to acquire necessary knowledge, acting on the basis of inappropriate quantity or quality of information, and overall failure to understand the limits of own knowledge can be mentioned only as a few examples in this regard (e.g. Baron 2004; Sarasvathy 1999). Linking the correctness of such estimates, e.g. expectations, with the firms performance, entrepreneurship literature often refers to high expectations using the term 'confidence' or 'overconfidence'[4] (e.g. Baron and Markman 2003; Simon, et al. 2000). Thus, in the context of anticipations, overconfidence or simply confidence is defined as the case of cognitive bias where entrepreneurs systematically have too high expectations (e.g. Pohl 2004).

In this light, revealing the complex nature of expectations relationship with performance, existing empirical evidence highlights that high expectations (confidence) can have both positive and negative effect. In line with regulatory focus theory, for example, previous findings suggest that higher expectations not only have

[4] Although in such a way we do not capture the richness of the term 'overconfidence'; 'overconfidence' involves broader range of processes than 'high expectations'.

a positive relationship with the actual performance (e.g. Wiklund and Shepherd 2003) but are in fact one of the reasons why many entrepreneurs launch and expand their businesses in the first place. In particular, it is not an exception that somebody finds a good idea and works on it, having very limited information and/ or knowledge and confidence helps to start this process without thinking too much of whether such opportunity should be taken or not (e.g. Shane and Venkatamaran 2000; Bird 1989). As argued by Ma and Tan (2006: 712) "True entrepreneurs are hopelessly optimistic, amazingly resilient, and unwaveringly resolute, particularly when they are relatively unfamiliar with the problem and/or substantial uncertainty exists."

On the other hand, however, considerable empirical evidence exists highlighting that cognitive biases, such as overconfidence can as well have a negative effect on the firms performance, even to the extend that it increases the risk of business failure (e.g. Cooper, Woo, and Dunkelberg 1988; Busenitz and Barney 1997). In the light of the discussion, previous empirical studies reveal the importance of human capital related characteristics for confidence and performance relationship More specifically, existing empirical evidence highlights that firm performance is subject of the liabilities of newness – referring to both age and previous business experience of the entrepreneur. According to previous findings, while young entrepreneurs are more enthusiastic, confident and willing to experiment than older entrepreneurs, they are also much more likely to give up such intentions (e.g. Forbes 2005). In this context, entrepreneurs' age may also be associated with the exit from business, e.g. younger entrepreneurs are more likely to exit business than older

entrepreneurs, often as a result of earlier overconfidence (Blanchflower and Meyer 1994; Taylor 1999; Van Praag 2003)[5].

Apart from the age and previous business experience, the influence of education level on performance, has been addressed by a number of studies. In general, existing studies have shown that human capital as measured by education is not only an important characteristic of entrepreneurial capacity (Sexton and Upton 1985) but has a positive influence on firm survival, growth (Cooper et al. 1994; Aidis and Mickiewicz 2006) and financial performance (Cooper and Gimeno-Gascon 1992; Chandler and Hanks 1998; Watkins et. al. 2003). Furthermore, education seems to provide the knowledge base for analytical and problem-solving skills that foster more effective strategies for dealing with the demands of entrepreneurship. In the light of these arguments, we believe that higher education can have a positive influence on performance. In addition, there may exist some substitution effects between the human capital and the cognitive strategies. In particular, confidence may substitute for education. Lack of education implies limited knowledge and lower ability to understand and analyse the opportunities existing in the environment. In that situation, confidence may become a more decisive factor boosting entrepreneurial alertness and leading to entrepreneurial success. That leads us to formulate the following hypotheses:

H3. Higher level of education has positive effect on performance.

H4. Positive impact of confidence on performance is stronger for entrepreneurs with lower level of education.

[5] It is of importance to mention in this regards, that young entrepreneurs with less business management experience, however, can exit business also due to better access to alternative job opportunities in the market (Stam et. al. 2007)

2.3. Additional influences

Our analysis includes a number of control variables, which are well documented in the existing literature. To make sure that the estimated effects of owner- managers' education on performance are not due to an omitted variable bias, we also include a control for personal age, personal entrepreneurial experience and company age. We expect the actual growth of the entrepreneurial venture to be negatively correlated with its age as indicated by a number of studies (summarized in Parker 2004).

Gender and ethnicity have also been found to affect business growth. In particular, female businesses tend to be smaller and are less likely to grow than male-owned businesses (Cooper et al. 1994). Furthermore, a study by Cliff (1998) indicates that female business owners tend to have lower growth thresholds for their businesses than men, which not only can explain the tendency for women to have smaller businesses with lower turnovers, but also indicates the possible differences in cognitive processes, such as formation of expectations, amongst men and women. We therefore expect that, 'other things being equal', male entrepreneurs will achieve higher growth performance, but not necessarily higher financial performance than female entrepreneurs. Existing studies also indicate that minorities tend to perform better in entrepreneurship than the majority population (see Parker 2004 for further discussion). We would expect a similar trend to occur in our sample.

Finally, we also control for the initial size of the business and for sectoral affiliation. Figure 1 below summarises our framework for analysis.

Insert Figure 1 about here

---

3. Methodology

3.1 Summary Statistics

The data used in this paper is based on 133 strictly confidential face-to-face structured interviews with the owner-managers of SMEs in the summer of 2005 and a follow-up survey of the same owners-managers conducted a year later (in the summer of 2006). All interviews took place in Riga, Latvia. The initial interviews were randomly sampled using official statistics from the Company Register of Latvia, collected in the Lursoft database (see http://www.lursoft.lv). The sampling frame was limited to SMEs, i.e. firms with up to 250 employees registered in Riga, the capital city of Latvia, and operational at the time of the survey. Key descriptive statistics from this data are presented in Table 1.

Insert Table 1 about here

3.2. Mesurement of entrepreneurial success

There are many ways of interpreting 'entrepreneurial success'. Even though no consensus regarding the definition of small business performance exists, increase in sales, profitability and increase in market share are four ways in which business performance is typically measured (Chandler and Hanks 1993; Robinson 1999; Vesper 1996; Delmar et al. 2003; Watkins et al. 2003). Ultimately, however, it is financial performance that decides the future of any business venture.[6] In this paper, we take profits as our key measure of performance. We operationalise it as a short term (12 months) change in profitability (where profitability is defined as the ratio of profits to turnover). As in Baum et al. (2001), we prefer to focus on change in profitability rather than on the level of profitability to eliminate additional effects that we cannot control for, including where profits proxy for some elements of stable rents.

However, it is important to note that there are some limitations to this approach. Firstly, SMEs often rely on simplified accounting where the measures of profit are not clear-cut. Secondly, it is typical for many new firms to follow a period of low profitability in the initial phase of their existence, for which reason current profitability may not be a good indicator of the net present value of the venture. Thirdly, underreporting may be common.

Note however that our focus on change in profits alleviates both the second and the third difficulty. With respect to the second issue, even if some ventures are reporting low profits initially, the successful ones should experience a positive trend in profits that is possible to be captured by the direction of change, which is what we

[6] For further discussion of performance measures, see: Chandler and Hanks 1993; Robinson 1999; Vesper 1996; Watkins et al. 2003.

rely on. With respect to the third issue, a focus on dynamics may again be better, as long as the proportion of unreported profits remain stable. Moreover, the problem is not specific for profits as hiding some part of the entrepreneurial activity implies underreporting of all relevant information, including sales and employment. Interestingly, reliance on 'subjective' survey data (as in this paper) may have a clear cut advantage than the use of 'objective' financial data collected from the third party, as long as the respondents have little incentive to report incorrectly to the interviewers, conditional on their trust in the anonymity of the survey.

3.3. Dependent variables and estimators

We adopt the following estimation strategy. Our dependent variables measuring performance include two alternative measures of change in profitability. This situation enables us to verify if the results are sensitive to variation in measurement. According to the first of these measures, the respondents were asked to assess the change in profits using the 5-point Likert scale ranging from profits "decreased significantly" to profits "increased significantly". On the second measure, the respondents were given an ordered range of numerical intervals, ranging from high negative to high positive values. A detailed distribution of answers is given in Table 2. We compared the answers to both questions given by each respondent and we find an exact correspondence between the choices along both scales. That increases our confidence in the reliability of our results.[7]

[7] In the questionnaire design, the key motivation behind using ordered categorical responses instead of asking for exact figures is that the former method leads to higher response rate.

Insert Table 2 about here

We regress these two financial performance measures on the same set of explanatory variables using ordered probit estimators with robust standard errors.

3.4. Key explanatory variables

We operationalise the nature of the cognitive bias in expectations by introducing two explanatory variables:

1. a binary indicator distinguishing between strictly positive turnover growth anticipations (as declared in the 2005 survey, see Table 1 above) and
2. a binary indicator that captures exactness of anticipations, i.e. takes the value of one in the case either both expectations and actual growth were positive or both were negative, and the value of zero in case of a discrepancy between the expected and actual sign of the change in turnover (see Table 1).[8]

[8] As a robustness check, we explored the possible determinants of expectations of turnover. We found the estimated probit equations to have poor exploratory power regardless of specification (results available on request). That confirms the argument we made in Section 2.2: psychological variables affecting the entrepreneurial outcomes cannot be easily reduced to observable objective characteristics of the entrepreneurs. The only variable that had a significant impact was the indicator of 'opportunity entrepreneurship', a dummy variable that indicates that 'to respond to market opportunities' is chosen as one of the three most important reasons why the business was started. Clearly, 'entrepreneurial confidence' and 'opportunity entrepreneurship' are closely related phenomena. The simple correlation coefficient between the two variables is 0.22, which is significant (at 5% level). However, we leave this theme for future research.

In addition, we introduce an explanatory variable measuring entrepreneurial experience. Here the owner-manager respondent chooses the length of her/his experience using an ordered scale (distribution parameters of this variable are reported in Table 1). To test the hypothesis 3, we include a variable measuring higher education specifically investigating the difference between owner-managers who attained a university education as compared with those that did not. We also create an interactive effect between higher education and confidence to test the hypothesis 4.

In addition, we control for age of the entrepreneur and the age of business venture. Also we include dummy variables for gender and ethnicity of the entrepreneur. In terms of business activity, we control for exporting. We also control for the size of the company (captured by natural logarithm of turnover, as reported in 2005) and for sectoral affiliation (see Table 1 above for the sectoral distribution of the sample). And last but not least, we always include a control for actual growth in turnover, to eliminate a possibility that our variable capturing high growth anticipations (confidence) simply substitutes for actual growth, creating an omitted variable bias.

4. Results

The results are presented in four specific equations shown in tables 3 and 4 below.

Insert Table 3 about here

Insert Table 4 abut here

Table 3 presents two models where we take confidence (defined as positive turnover growth expectations measured *ex ante*) and exactness of anticipations (defined as consistence between *ex ante* expectations and *ex post* results) as two variables designed to test the hypotheses 1 and 2 correspondingly. While confidence has a strong positive impact on financial performance (significant at 1% level), the exactness of anticipations remains insignificant. Thus, based on this specification, we obtain strong support for hypothesis 1 and no support for hypothesis 2. Here, our evidence suggests that entrepreneurial success measured as financial performance is positively affected by entrepreneurial confidence and not by entrepreneurial exactness of anticipations.

To test hypothesis 4, we next run two models where we introduce an interactive term between the higher education variable and the confidence variable (Table 4). We find this effect significant at 1% level. Negative sign of this effect implies that the effect of confidence is weaker for entrepreneurs with higher education, consistent with hypothesis 4. In addition, the direct impact of confidence remains positive and significant on 1% level (hypothesis 1), and the direct impact of higher education is now positive and highly significant in support of the hypothesis 3 (in contrast to Table 3 results). The latter result suggest that the effect of education is sensitive to specification, yet proves important as soon as we account for interacting effect of confidence.

Thus, the results provide support for the notion that cognitive bias resulting from overconfidence and promotion focus has a positive impact on financial

performance. In other words, the result provides compelling evidence that entrepreneurial confidence results in better financial performance. This provides further strong support for hypothesis 1. In contrast, we found no support for hypothesis 2. Thus, we identify confidence as more important than exactness of anticipations for entrepreneurial success as measured by financial performance.

Further, we find evidence that generic human capital in the form of university education is beneficial for entrepreneurial success as measured by financial performance, provided we account for interacting effect (see Table 4). This provides support for hypothesis 3 and it is in line with existing research findings.

We also obtain support for hypothesis 4 investigating the interactive effects of entrepreneurial human capital and confidence on firm's financial performance (see Table 4, models a and b). The results suggest that the effect of confidence becomes less important for entrepreneurs with higher education.

In terms of our control variables, age is not a significant factor for financial performance, provided we include the direct measure of education (see H3 and H4 above). We performed other robustness checks[9] and found that the results for age were are also insignificant for other functional forms (quadratic, linear or log quadratic). We found however that business age has a significant negative impact on the dynamics of profitability, as expected.

Our results also show a puzzling result that exporting is associated with weaker dynamics of profitability, confirming that the role of exporting may be ambiguous and sensitive to the macroeconomic cycles. Interestingly, the male business owners perfomed significantly worse in terms of profitability than female business owners. This result may be contrasted with earlier findings in the literature

[9] Available from the authors upon request.

on the way gender affects growth (see discussion above in section 2.3). Our results may imply more subtle gender differences: while (relying on earlier results), male entrepreneurs may be more growth oriented, it is actually the female entrepreneurs that tend to obtain better results in terms of financial performance: our results suggest that the financial performance of firms run by male entrepreneurs is lower than for female entrepreneurs.

We fund no significant difference in performance between the businesses owned by ethnic Latvians (the majority members of the population) and the businesses owned by members of the ethnic minority (in this case Russians). To understand this phenomenon we explored also if there was any difference resulting from a possible influence of a form of institutionalised discrimination characterised by the fact that a sizeable portion of ethnic Russians living in Latvia do not have Latvian citizenship. Specifically, we wanted to test if the lack of Latvian citizenship played any role in our estimation results. To explore this factor, we replaced the ethnicity variable with a variable capturing citizenship, and also estimated the model where ethnicity and citizenship were introduced jointly. However, the latter variable turned out to be highly insignificant regardless of specification. We conclude that our results, which are not consistent with the literature based on ethnic minorities in other countries (Parker 2004), may be explained by the economic transition specific effects. It may be closely linked to informal institutions in general and cultural differences in particular. Those differences imply that unlike other studies, we see no positive performance premium related to businesses owned by ethnic minorities.[10]

[10] Another potential explanation is that results in the literature relate to the minorities, which are smaller in numbers, while in Latvia, both main ethnic groups are very large. Close to 30% of the population are ethnic Russians. About two thirds of these have no citizenship status (Paalzov et al. 2007). See also Hazans (2007).

5. Conclusions and Implications

In the light of our findings, we believe that this paper makes a number of important contributions to the existing literature. Our unique dataset which includes repeat sampling, allows us to empirically examine the relationship between growth anticipations and growth reality for 133 SME owner-managers. In doing so, we fill an existing knowledge gap in the firm performance literature.

Our results indicate a significant relationship between entrepreneurial confidence and entrepreneurial success in terms of actual firm growth and financial performance. In contrast, entrepreneurial exactness of anticipations which we define as a consistency between growth expectations and actual growth do not affect financial performance in a significant way. The impact of confidence dominates over the impact of exactness of anticipations.

Thus, even when we control for a standard set of performance determinants, and the actual growth, the initial high expectations of the owner-manager have a positive impact on the subsequent performance. In this sense it is legitimate to argue that the concept of entrepreneurial anticipations is closely related to the concept of 'aspirations' since these results are in line with studies focusing on 'entrepreneurial aspirations' (such as Wiklund and Shepherd 2003). Moreover, we believe that these results can also be seen as consistent with regulatory focus theory. In the context of entrepreneurship, the winning cognitive strategy may be the one that focuses predominantly on 'promotion' (defined as 'confidence' in our analysis). In addition we found that the positive effect of confidence is most important for the entrepreneurs with lower level of education, and matters little for those with university education.

At the same time, the direct effect of education on performance is positive and significant.

Our results are subject to several limitations. Firstly, our findings may be context specific. At time of the surveys (2005-2006), Latvia was a fast growing economy, where entrepreneurs who failed to identify the emerging opportunities correctly were paying a high price in terms of performance. Yet in a more stable, economic environment, the optimum balance between 'promotion' and 'prevention' cognitive strategies may be different. Further empirical research would be useful to explore the possible context specific characteristics on this relationship.

Secondly, our analysis incorporated a 12-month period in which to measure expectation versus reality in terms of business growth. Additional research that captures various time periods (such as an annual test up to a ten year period) may help distinguish other important effects.

Figure 1.

Framework for analysis.

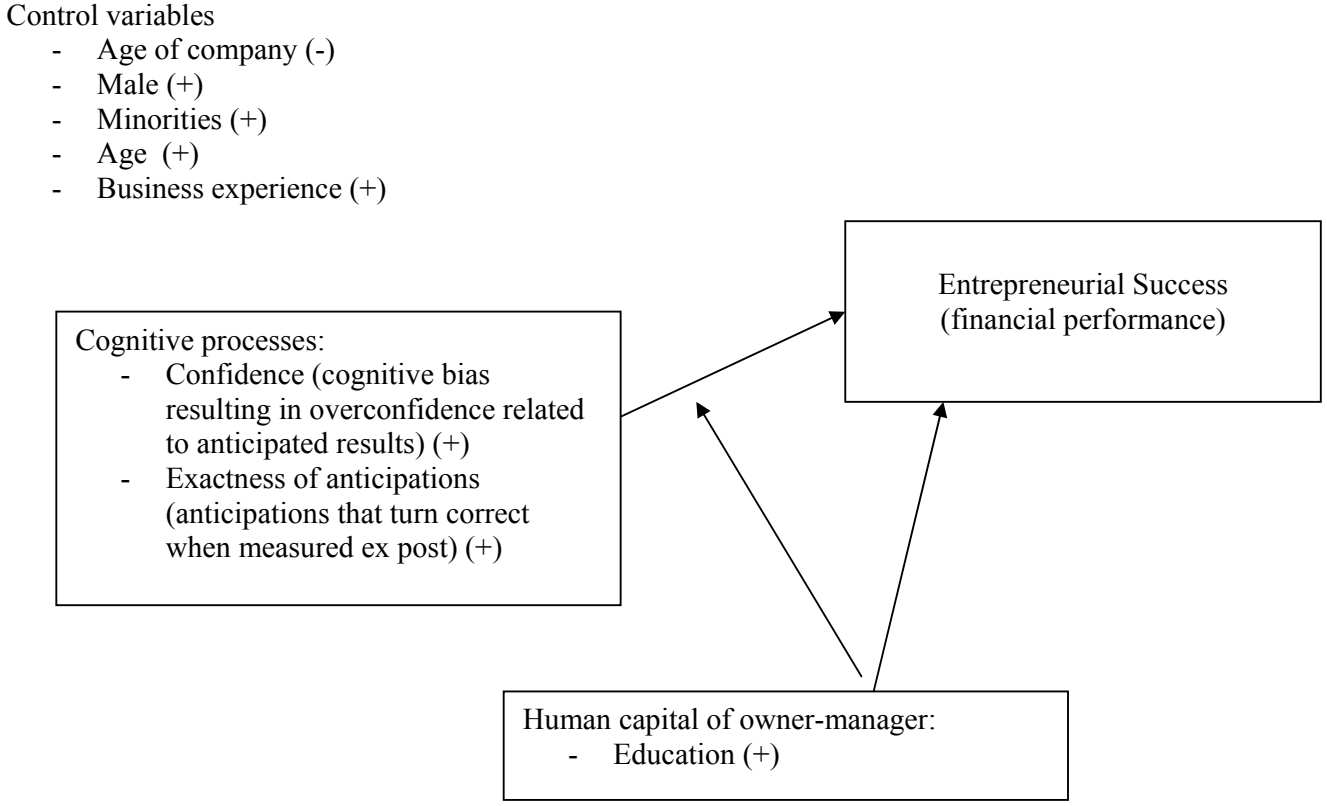


Table 1.

Descriptive statistics: independent variables.

Variable	Description	No of obs.	Mean	SD
Turnover [a]	Annual turnover as reported by the owner-manager in 2005.	123	345	565
Employment	Total employment as reported by the owner-manager in 2005.	126	20	31
Business's age	Business's age.	133	9	4
Respondent's age	The owner-manager's age.	133	45	11
University educ.	Dummy variable. One if the respondent has a university education, zero otherwise.	133	.60	.49
Experience				
Business exper. 1	Dummy variable. One if the business experience of the owner-manager was less than one year in 2005, zero otherwise.	133	.20	.40
Business exper. 1-7	Dummy variable. One if the business experience of the owner-manager was between one year and 7 years, zero otherwise.	133	.30	.46
Business exper. 8 – 15	Dummy variable. One if the business experience of the owner-manager was between 8 and 15 years, zero otherwise.	133	.19	.39
Business exper. 16	Dummy variable. One if the business experience of the owner-manager was over 16 years, zero otherwise.	133	.31	.46
Expectations	*Dummy variables*			
Confidence	One if the owner-manager expected their business's turnover to 'increase a lot' or 'increase' (in 2005), zero otherwise.	129	.71	.46
Exactness of anticipations	One if the sign of actual growth in turnover as reported in 2006 was consistent with the expected sign of turnover growth reported in 2005.	117	.70	.46
Other variables	Dummy variable. One if the business is in	133	.14	.35
Manufacturing	the manufacturing sector, zero otherwise.			
Trade	Dummy variable. One if the business is in	133	.37	.48

	the trade sector, zero otherwise.			
Services	Dummy variable. One if the business is in the service sector, zero otherwise.	133	.49	.50
Export	Dummy variable. One if the company was exporting in 2005, zero otherwise.	133	.18	.39
Male	Dummy variable. One if the owner-manager is male, zero if female.	133	.66	.47
Latvian	Dummy variable. One if the owner-manager is Latvian, zero if an ethnic minority.	133	.55	.50

Note: Turnover is reported in thousands of Lats. Applying appropriate exchange rate reported by Bank of Latvia results in the mean turnover expressed in Euro of 243 thousand.

Table 2.

Survey instruments measuring short-term growth in profits and in turnover (2006 compared with 2005).

(a) Likert scale **Change in profits (Likert)**	Freq.	Percent	Cum.	(b) Intervals **change in profits (value intevals)**	Freq.	Percent	Cum.
increased a lot	6	4.62	4.62	-40 to -1	14	10.77	10.77
increased	76	58.46	63.08	0	34	26.15	36.92
remained stable	34	26.15	89.23	1 to 20	63	48.46	85.38
decreased	14	10.77	100.00	more than 20	19	14.62	100.00
Total	130	10.00		Total	130	100.00	

change in turnover (value intervals)	Freq.	Percent	Cum.
-21% to less than -1%	3	2.31	2.31
-1% to less than 0%	12	9.23	11.54
remained stable	31	23.85	35.38
More than 0% to 20%	70	53.8	89.23
more than 20% to 40%	8	6.15	95.38
more than 40% to 60%	1	0.77	96.15
more than 60% to 80%	3	2.31	98.46
more than 80% to 100%	2	1.54	100.00
Total	130	100.00	

Note: Original survey instrument was based on intervals and Likert scale as reported above, in order to improve response rate. The categories we report here and utilise in our regressions correspond to those. Similarly, for other categorical variables, we employ the categories that result from the survey instruments.

Table 3.

Ordered probit regressions: determinants of profits growth

Dependent	**(a) change in profits (Likert scale)**		**(b) change in profits (Value intervals)**	
Independent variables:	Coef.	Robust Std. Err.	Coef.	Robust Std. Err.
Change in turnover (interv.)	3.33 ***	(0.60)	2.94 ***	(0.46)
Logarithm of turnover	-0.03	(0.07)	-0.06	(0.07)
Log. of respondent's age	0.58	(0.58)	1.06	(0.66)
Logarithm of business's age	-0.55	(0.30)	-0.74 ***	(0.35)
University education	0.49	(0.30)	0.36	(0.21)
Business experience 1_7years	0.17	(0.34)	0.28	(0.32)
Business experience 8_15y.	-0.22	(0.32)	-0.12	(0.47)
Business experience 16y.&more	-0.43	(0.38)	-0.15	(0.45)
Services	-0.42	(0.59)	-0.27	(0.43)
Trade	0.23	(0.49)	0.03	(0.36)
Export	-0.91 **	(0.35)	-0.50	(0.35)
Male	-0.56 ***	(0.24)	-0.35	(0.25)
Latvian	0.29	(0.34)	0.44	(0.30)
Exactness of anticipations	-0.10	(0.28)	-0.28	(0.27)
Confidence	0.85 **	(0.33)	0.11	(0.34)
Number of observations	117		117	
Wald chi2(17)	132.69***		112.94 ***	
Pseudo R2	0.81		0.64	

Note: *** significant at 0.001; ** significant at 0.01; * significant at 0.05; + significant at 0.10.

Table 4.

Ordered probit regressions: determinants of profits growth, with interactive effects between confidence and education

Dependent	**(a) change in profits (Likert scale)**		**(b) change in profits (Value intervals)**	
Independent variables:	Coef.	Robust Std. Err.	Coef.	Robust Std. Err.
Change in turnover (interv.)	3.50 ***	(0.68)	3.15 ***	(0.54)
Logarithm of turnover	-0.01	(0.07)	-0.07	(0.07)
Log. of respondent's age	0.64	(0.62)	1.07	(0.68)
Logarithm of business's age	-0.53	(0.32)	-0.77 ***	(0.37)
University education	1.33 ***	(0.61)	1.57 **	(0.52)
Business experience 1_7years	0.21	(0.36)	0.34	(0.32)
Business experience 8_15y.	-0.27	(0.36)	-0.09	(0.48)
Business experience 16y.&more	-0.37	(0.37)	-0.07	(0.46)
Services	-0.40	(0.57)	-0.14	(0.45)
Trade	0.33	(0.51)	0.17	(0.36)
Export	-1.02 **	(0.36)	-0.58	(0.35)
Male	-0.57 ***	(0.25)	-0.36	(0.26)
Latvian	0.28	(0.32)	0.46	(0.29)
Confidence	1.63 **	(0.62)	1.15 ***	(0.46)
Exactness of anticipations	-0.06	(0.32)	-0.16	(0.29)
Confidence x Univ.education	-1.32 ***	(0.67)	-1.67 **	(0.62)
Number of observations	117		117	
Wald chi2(17)	102.79***		105.70 ***	
Pseudo R2	0.82		0.66	

Note: *** significant at 0.001; ** significant at 0.01; * significant at 0.05; + significant at 0.10.

References

Aidis, R., and T. Mickiewicz (2006). "Why Entrepreneurs Do Not Expect to Expand Their Businesses: Lessons From Lithuania," *Europe Asia Studies*, 58, 855- 880.

Baron, R. (2004). "The Cognitive Perspective: A Valuable Tool for Answering Entrepreneurship's Basic "Why" Questions," *Journal of Business Venturing*, 19, 221-293.

Baron, R., and G. Markman, (2003). "Beyond Social Capital: The Role of Entrepreneurs' Social Competence in Their Financial Success," *Journal of Business Venturing*, 18, 41–60.

Batra, G., D. Kaufmann, and A. Stone (2003). *Investment Climate Around the World: Voices of the Firms From the World Business Environment Survey*. Washington DC: The World Bank.

Baum, R., E. Locke, and K. Smith (2001). "A Multidimensional Model of Venture Growth," *Academy of Management Journal*, 44 (2), 292-303.

Baum, J., and E. Locke (2004). "The Relationship of Entrepreneurial Traits, Skill, and Motivation to Subsequent Venture Growth," *Journal of Applied Psychology*, 89, 587-598.

Becchetti, L., and G. Trovato (2002). "The Determinants of Growth for Small and Medium Sized Firms. The Role and Availability of External Finance," *Small Business Economics*, 19, 291-306.

Beck, T., A. Demirguc-Kunt, and V. Maksimovic (2002). *Financial and Legal Constraints to Firm Growth. Does Size Matter? Mimeo*. Washington DC: The World Bank.

Begley, T., and D. Boyd (1987). "Psychological Characteristics Associated with Performance in Entrepreneurial Firms and Smaller Businesses," *Journal of Business Venturing*, 2, 79-93.

Bird, J. (1989). *Entrepreneurial Behavior*. IL: Scott, Foresman, Glenview.

Blanchflower, D., and B. Meyer (1994). "A Longitudinal Analysis of the Young Self-Employed in Australia and the United States," *Small Business Economics*, 6 (1), 1-19.

Brocker, J., E. Higgins, and M. Low (2004). "Regulatory Focus Theory and the Entrepreneurial Process," *Journal of Business Venturing*, 19, 203-220.

Busenitz, L., and J. Barney (1997). "Differences Between Entrepreneurs and Managers in Large Organizations: Biases and Heuristics in Strategic Decision-Making," *Journal of Business Venturing*, 12, 9-30.

Busenitz, L., and C. Lau, C (1996). "A Cross-cultural Cognitive Model of New Venture Creation," *Entrepreneurship Theory and Practice*, 20 (4), 25-39.

Chandler, G., and S. Hanks (1993). "Measuring the Performance of Emerging Businesses: A Validation Study," *Journal of Business Venturing*, 8, 391-408.

Cooper, A., C. Woo, and W. Dunkelberg (1988). „Entrepreneurs' Perceived Chances for Success," *Journal of Business Venturing*, 3(2), 97-108.

Davidsson, P. (1991). "Continued Entrepreneurship: Ability, Need and Opportunity as Determinants of Small Firm Growth," *Journal of Business Venturing*, 6, 405-429.

De Carolis, D., and P. Saparito (2006). "Social Capital, Cognition, and Entrepreneurial Opportunities: A Theoretical Framework," *Entrepreneurship Theory and Practice*, 30, 41-56.

DellaVigna, S. (2007). "Psychology and Economics: Evidence from the Field," *NBER Working Paper Series*, Working Paper 13420, National Bureau of Economic Research.

Delmar, F., P. Davidsson, and W. Gartner (2003). "Arriving at the High-growth Firm," *Journal of Business Venturing*, 18, 189-216.

Forbes, D. (2005). "Are Some Entrepreneurs More Overconfident Than Others", *Journal of Business Venturing*, 20 (5), 623-640.

Gaglio, C., and J. Katz (2001). „The Psychological Basis of Opportunity Identification: Entrepreneurial Alertness," *Small Business Economics,* 16 (2), 95-111.

Hazans, M. (2007). "Coping with Growth and Emigration: Latvian Labour Market Before and After EU Accession." <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=971198>. Accessed on March 2008.

Higgins, E. (1997). "Beyond Pleasure and Pain," *American Psychologist*, 52, 1280-1300.

Ma, H., and J. Tan (2006). "Key Components and Implications of Entrepreneurship: A 4-P Framework," *Journal of business venturing*, 21, 704-725.

Mitchell, R., S. Brock, E. Morse, K. Seawright, A. Peredo, and B. McKenzie (2002). "Are Entrepreneurial Cognitions Universal? : Assessing Entrepreneurial Cognitions Across Cultures, *Entrepreneurship Theory and Practice*, 26 (4), 9-32

McIntyre, R. (2001). *The Role of Small and Medium Enterprises in Transition: Growth and Entrepreneurship*, Research for Action 49, UNU world Institute for Development Economic Research (UNU-WIDER).

Parker, D. (2004). *Economics of Self-Employment and Entrepreneurship*. Cambridge: Cambridge University Press.

Parker, D. (2006). "Learning About the Unknown: How Fast Do Entrepreneurs Adjust Their Beliefs?," *Journal of Business Venturing*, 21, 1-26.

Paalzow, A., R. Kilis, V. Dombrovsky, D. Pauna, and A. Sauka (2007). *Riga: From a Hanseatic City to a Modern Metropolis. Pathways to Creative and Knowledge-Based Regions*. Amsterdam: University of Amsterdam.

Pohl, R. (2004). *Cognitive Illusions: A Handbook of Fallacies and Biases in Thinking, Judgment, and Memory*. Hove: Psychology Press.

Robinson, K. (1999). "An Examination of the Influence of Industry Structure on Eight Alternative Measures of New Venture Performance for High Potential Independent New Ventures," *Journal of Business Venturing*, 14, 165-187.

Sarasvathy, S. (1999). "Seminar on Research Perspectives in Entrepreneurship," *Journal of Business Venturing,* 15, 1-57.

Shane, S., and S. Venkataraman (2000). "The Promise of Entrepreneurship as a Field of Research," *Academy of Management Review,* 25 (1), 217-226.

Simon, M., S. Houghton, and K. Aquino (2000). "Cognitive Biases, Risk Perception, and Venture Formation: How Individuals Decide to Start Companies," *Journal of business venturing*, 15 (2), 113-134.

Stam, E. R. Thurik, and P. Van der Zwaan (2007). "Entrepreneurial Exit in Real and Imagined Markets." <http://www.tinbergen.nl/discussionpapers/08031.pdf>. Accessed on January 2008.

Taylor, M. (1999). "Survival of the Fittest? An Analysis of Self-Employed Duration in Britain," *Economic Journal*, 109 (454), C140-C155.

Van Praag, M. (2003). "Business Survival and Success of Young Small Business Owners," *Small Business Economics*, 21 (1), 1-17.

Vesper, K. (1996). *New Venture Experience*. Seattle WA: Vector Books.

West, P., and G. Meyer (1997). **"**Temporal Dimensions of Opportunistic Change in Technology-based Ventures,**"** *Entrepreneurship Theory and Practice*, 22 (2), 31-52.

Watson, W., W. Stewart Jr., and A. BarNir (2003). "The Effects of Human Capital, Organizational Demography and Interpersonal Processes on Venture Partner Perceptions of Firm Profit and Growth," *Journal of Business Venturing*, 18, 145-164.

Wiklund, J., and D. Shepherd (2003). "Aspiring For and Achieving Growth: The Moderating Role of Resources and Opportunities," *Journal of Management Studies*, 40, 1919-1941.

Wiklund, J., P. Davidsson, and F. Delmar (2003). "What Do They Think and Feel About Growth? An Expectancy-value Approach to Small Business Manager's Attitudes Toward Growth," *Entrepreneurship, Theory and Practice*, Spring 2003, 247–270.

Wu, B., and A. Knott (2006). "Entrepreneurial Risk and Market Entry," *Management Science*, 52, 1315-1330.

2007 CSESCE Working Papers

84 **The Sustainability of Russia's Energy Power: Implications for the Russian Economy** by Philip Hanson
83 **'Oligarchs', Business and Russian Foreign Policy: From El'tsin to Putin** by Peter J S Duncan
82 **Policies for promoting technological catching up: towards post-Washington approach** by Slavo Radosevic
81 **Entrepreneurship in Emerging Markets: Which Institutions Matter?** by Ruta Aidis, Saul Estrin and Tomasz Mickiewicz
80 **Oil and Gas: a Blessing for Few. Hydrocarbons and Within- Region Inequality in Russia** by Tullio Buccellato and Tomasz Mickiewicz
79 **Institutions and Entrepreneurship Development in Russia: A Comparative Perspective** by Ruta Aidis, Saul Estrin and Tomasz Mickiewicz
78 **Corporate Governance and Control in Russian Banks** by Andrei Vernikov
77 **Institutions, Infrastructure, and Trade** by Joseph Francois and Miriam Manchin
76 **The Great Divide: "Ruralisation" of Poverty in Russia** by Christopher J Gerry, Eugene Nivorozhkin and John A Rigg
75 **Research and Development and Competitiveness in South Eastern Europe: Asset or Liability for EU Integration?** by Slavo Radosevic
74 **Inequality, Democracy and Taxation: Lessons from the Post-Communist Transition** by Christopher J Gerry and Tomasz M Mickiewicz
73 **National Systems of Innovation and Entrepreneurship: In Search of a Missing Link** by Slavo Radosevic
72 **Convergence across Russian Regions: A Spatial Econometrics Approach** by Tullio Buccellato

2006 CSESCE Working Papers

71 **Knowledge Based Entrepreneurship in the Czech Republic and Hungary: Results from 4 case studies** by Kate Bishop
70 **Do Institutions Matter for Technological Change in Transition Economies? The Case of Russia's 89 regions and republics** by Brigitte Granville and Carol Leonard
69 **Growth, Integration and Spillovers in the Central and East European Software Industry** by Slavo Radošević
68 **Nature & determinants of productivity growth of Foreign subsidiaries in Central & East European countries** by Boris Majcen, Slavo Radošević & Matija Rojec
67 **Russia: Firm Entry and Survival.** by Ruta Aidis and Yuko Adachi
66 **Between Vision and Reality: Promoting Innovation through Technoparks in Kazahkstan.** by Slavo Radosevic and Marat Myrzakhmet
65 **Fiscal Policy and Policy Rules in Poland.** by Rafal Benecki, Jens Hölscher and Mariusz Jarmuzek
64 **Construction of Home by Polish and Lithuanian Migrants in the UK** by Violetta Parutis
63 **Ownership Structure and Development of Polish Life Insurance Companies: Evidence from 1991 to 2004** by Adam Sliwinski
62 **Corporate Governance, Managers' Independence, Exporting and Performance of Firms in Transition Economies** by Igor Filatotchev, Natalia Isachenkova and Tomasz Mickiewicz

2005 CSESCE Working Papers

61 **Entrepreneurship in Transition Economies: A Review** by Ruta Aidis
60 **New Estimates of the Risk and Duration of Registered Unemployment in Urban Russia** by Anton Nivorozhkin

59 **De-industrialisation and the Post-Communist Transition: Rowthorn and Well's Model Revisited** by Tomasz Mickiewicz and Anna Zalewska

58 **Upgrading Russian Enterprises from the Value Chain Perspective: the Case Study of Tube & Pipe, and Furniture Sectors**
Svetlana Avdasheva, Igor Budanov, Victoria Golikova and Andrei Yakovlev

57 **The Promotion of Innovation in Slovenia through Knowledge Transfer from Higher Education Institutions to SME's**
Will Bartlett and Vladimir Bukvič

56 **Reconstitution of Post-Soviet Ex-State Enterprises into Russian Business Firms under Institutional Weaknesses**
Yuko Adachi

55 **Post-Communist Recessions Re-examined**
Tomasz M. Mickiewicz

54 **Leadership and Corruption in Russia, 2000-2004**
Alena V. Ledeneva

53 **Foreign Direct Investment and Restructuring in the Automotive Industry in Central and East Europe**
Slavo Radosevic and Andrew Rozeik

52 **Financial Performance of Groups of Companies in Poland against the Background of Historical Determinants and Knowledge Management Procedures Applied**
Jan Chadam and Zbigniew Pastuszak

51 **Are the EU New Member States Fiscally Sustainable? An Empirical Analysis**
Mariusz Jarmuzek

50 **Growth Expectations of Business Owners: Impact of Human Capital, Firm Characteristics and Environmental Transition**
Ruta Aidis and Tomasz Mickiewicz

49 **Firms' capabilities related to the economic system: cases from Ukraine and Russia**
Gustavo Rinaldi

2004 CSESCE Working Papers

48 **Ambiguity of Social Networks in Post-Communist Contexts**
Alena V. Ledeneva

47 **Privatisation, Corporate Control and Employment Growth: Evidence from a Panel of Large Polish Firms, 1996-2002'**
Tomasz Mickiewicz, Christopher J Gerry and Kate Bishop

46 **Wage Bargaining, Privatisation, Ability to Pay, and Outside Options - Evidence from Hungary**
Janos Köllő and Tomasz Mickiewicz

45 **Informal Practices in Changing Societies: Comparing Chinese *Guanxi* and Russian *Blat***
Alena V. Ledeneva

44 **The Estonian Organizations - The Subjects of Transformation'**
Maaja Vadi and Harry Roots

43 **Revisiting Consumption Smoothing and the 1998 Russian Crisis**
Christopher J Gerry and Carmen A Li