# Introduction

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**Abstract:** This paper introduces the special issue on risk and accounting and provides a brief review of the papers within the issue. Each of the articles takes a very different look at the relationship between accounting and risk, from the perspectives of risk reporting, derivative disclosure, option assessment and risk liabilities. This introduction compares and contextualises the contributions, finding that the papers further our knowledge of risk and accounting where limited research has been done.

**Biographical notes:** Simon S. Gao is Professor of Accounting and Finance at Napier University Edinburgh, UK. He holds a PhD in Accounting and Finance from Erasmus University Rotterdam. He has authored three books and published over 40 articles on leasing finance, accounting in developing countries, insurance and risk management, social and environmental accounting and public-sector risk management.

In the past decades, risk was shown to be an inescapable reality of modern business in both developed and developing countries. Evidence has shown that the straightforward failure to identify, manage and monitor risks can shrink shareholder value, prevent achievement of business objectives and lead to significant financial losses or business failure. Following the Cadbury Report (1992) and the Turnbull report (1999) in the UK and the Sarbanes-Oxley Act (2002) in the US, businesses have recognised the importance of risk management. Today, driven by the increasing dynamism, globalisation and complexity of modern business environments, there is a high and continually increasing attention to the need to manage risks effectively and efficiently.

Risk has emerged as an area of attracting increasing interest in the literature. Much recent research has focused upon the identification and evaluation of financial risks and risk compliance in the banking and financial services sector (Chavez-Demoulin et al., 2006; Iannotta et al., 2007; Lehar, 2005). Many perspectives of risk have not been studied in the field of accounting.

To some extent risk, in particular financial risk, has been associated with the abuse of financial derivatives with the evidence of a dramatic rise in reported scandals attributed to the misuse of financial derivatives (Dunne and Helliar, 2002; Hogan, 1997; Overdahl and Schachter, 1995). The number of scandals and the funds 'lost' from unauthorised derivative transactions associated with these scandals have undoubtedly contributed to calls for greater disclosure of derivatives activities (Blankley et al., 2002; Bodnar et al., 1998; Grant and Marshall, 1997). The lack of information (both internally and externally) about the usage of derivative instruments is frequently cited as a reason for many of the scandals associated with these innovative products over the last decade.

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Accountants play an important role in risk management (Curtis and Turley, 2007). In recent years, there has been an increasing public demand for firms to disclose more information related to derivatives as a result of a series of high profile scandals. It is widely recognised that substantial financial risks which endanger the existence of a firm need to be identified and reported at an early stage. A number of countries have established accounting and reporting standards for derivative instruments. Limited research on the usefulness and quality of derivative related disclosures are predominantly based on the case of the US (e.g. Ahmed et al., 2004; Skinner, 1996). In this special issue, three articles are largely concerned with the disclosure of derivatives and risk reporting in non-US environments.

Each of the three articles in this special issue takes a very different look at derivatives disclosure. The first article in the issue, by Dunne, Fox and Helliar, provides an empirical investigation into the disclosure of information concerning the use of derivatives and other financial instruments in corporate annual reports of UK firms following the introduction of Financial Reporting Standard 13 (FRS 13) 'Derivatives and other financial instruments – disclosures'. Their results indicate that the implementation of this standard was associated with a substantial increase in derivatives-related information available in corporate annual reports. They argue that this increase in disclosure has implications for the corporate governance and internal control mechanisms of the reporting companies.

Li and Gao examine the usefulness of derivative related disclosure in the Australian banking sector and test whether derivative disclosures are associated with annual stock returns of the banks over the period of 1998–2004. Their preliminary results reveal that the disclosures of fair gains and losses for both trading and non-trading derivatives are significant to the stock returns but the disclosure of principal amounts and credit disclosure are generally insignificant to stock returns. The disclosures of fair value gains and losses on trading and non-trading derivatives provide significant information for the stock returns, which might suggest that these disclosures contain new and useful information not incorporated in earnings and market beta.

Based on the sample of one hundred non-financial companies in Japan, Konishi and Ali examine the relations between Japanese corporate characteristics and level of risk reporting and discuss the impact of issuing regulatory guidelines on risk reporting in annual reports. They find the size of the company and the number of risk disclosures are positively correlated but no significant relationship exists between the number of risk disclosures and other corporate characteristics. In the case of Japan, most companies disclose descriptive risk information but are reluctant to quantify risk. However, their study shows that the level of risk, cross-corporate shareholding pattern, ownership distribution pattern and average profitability of the company do not have a significant relationship with risk disclosure level.

Two further studies within this special issue are concerned with the more technical sides of the themes related to risk and accounting. Papanastasopoulos uses option based measures of financial performance to examine informational context and properties of the measures as distress indicators and to estimate default probabilities for listed firms. His results suggest that adding accounting information to market information can improve both in sample fitting and out of sample predictability of defaults. In his view, option theory does not generate sufficient statistics of the actual default frequency. While market information can be extremely valuable, it is most useful when coupled with accounting information in assessing the default risk of listed firms.

O'Brien examines accounting for risky liabilities and presents evidence from UK pension plans. Risky liabilities such as pensions are usually calculated from deterministic estimates of future cashflows. However, different approaches have been adopted by different types of pension provider. The study examines the reporting of UK pension arrangements and O'Brien finds that there are differences between the reporting of the state scheme, life insurers' pension arrangements and occupational pension schemes. In particular, occupational schemes have poor disclosure of the assumptions they make when assessing liabilities, with underestimates of likely future changes in mortality.

I am very pleased to have been able to select from sixteen submissions five very substantial papers for this special issue, each written by experts in their fields and each, in their own way, furthering our knowledge in relation to risk and accounting. I hope you will enjoy reading the articles in this special issue as much as I have enjoyed putting it together.

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