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On the Question of Transparency of Financial Reporting: Doctrine of "Piercing the Corporate Veil"

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The paper is dedicated to the memory of Professor of St. Petersburg State University V.V. Kovalev

ABSTRACT

In the context of the globalization of the world economy, the task of ensuring the transparency of information about the company's financial position remains relevant. The **purpose** of the paper is to recommend the transformation the economic entity principle in the doctrine of "piercing the corporate veil" formed in international legal practice, the essence of which is to identify the ultimate beneficial owners of a business. To achieve this purpose, the following **tasks** are performed: to identify the scope of the "corporate veil" concept in international practice, to establish the relationship of the described issues with the conceptual framework of international financial reporting, and also to propose ways to overcome the insufficiency of the principle of economic entity to ensure the transparency of financial reporting in the current economic conditions. The **object** of the research is represented by a set of economic and legal interpretations of the "economic entity" and "corporate veil" concepts in their historical development. The **subject** of the research is the impact of the "piercing the corporate veil" doctrine on the composition and structure of consolidated financial statements. The authors conducted a comparative analysis of legislative acts in different countries of the world aimed at increasing the transparency of financial reporting and the availability of information about beneficial owners of the business. The empirical basis of the research involves materials of court cases and journalistic investigations related to the veiling of the company's ownership structure, as well as the published reports of international, multinational public companies. The authors have identified the stages and described the logic of transformation of the principle of economic entity in the global accounting practice. The authors have developed **recommendations** for the application of the principle of additional liability to ensure transparency and reliability of information about the financial position of the company in the current economic conditions. The **results** of the paper can be used in the preparation of corporate legislation and the development of international and national financial reporting standards.

Keywords: financial reporting; economic entity principle; reporting entity concept; "piercing the corporate veil"; additional responsibility principle

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INTRODUCTION

The purpose of financial reporting — to provide users with an objective picture of the financial state and financial results of business. At the same time, the issue of transparency of financial reporting, i.e. its openness and accessibility, remains the focus of attention of both academics and practitioners. One aspect of this problem is the recognition of information about the ultimate beneficial owners of the business in the financial statements in the case of the formation of financial liabilities as a result of the company's activities harmful to individual counterparties or society as a whole. These situations, when there is a need "to look behind the curtain", behind which the real owners of the business are hidden, become the subject of litigation, key issues of analytical reviews of consulting agencies, topics of scientific publications. For example, such court cases of recent years as the bankruptcy of the company Parmalat (Italy, 2014), and the collapse of the chain of restaurants "Taras Bulba" (Russia, 2018) were widely resonated.

Actions on disclosure of information about real business owners are united by a rather unusual term — "piercing the corporate veil". Conditions remain debatable, in which such actions are possible, legitimate and perceived by society as fair. The problem of "penetration the corporate veil" is considered in the paper of domestic [1–10] and foreign researchers [11–17] in law.

In a globalizing world economy, it should be easy to provide transparent information on a company's financial situation: more information bases are being created, the Internet is becoming more widespread, analytical tools are becoming more complex. It may not be necessary to focus on the improvement of information processing techniques, but rather to review accounting concepts that have seemed to be intact for many years. An attempt is made to attract the attention of the professional accounting and finance community to the problem of developing new accounting principles that will increase the usefulness of the information presented in financial reports in the transformation of global economic environment. As a principle of proposed to use the principle of "additional responsibility" in financial reporting of companies in some situations.

REVIEW OF SCIENTIFIC PUBLICATIONS

The doctrine of "piercing the corporate veil" originated in the UK [7]. The term "piercing the corporate veil" was first used by Maurice Wormser, Professor of Law at the New York Law Institute in 1912, when he compared the managers and shareholders who used the "corporate veil" to hide the true owners of the business to "thieving wolves" [4]. In Russian literature the term is presented in various translations as "removal (tearing, puncturing, piercing) of corporate veil", "penetration the corporate curtain", which are used as synonyms.

Russian scientists dedicate their work to the comparative analysis of the norms of American, British and European law in the sphere of application of the concept of "piercing the corporate veil", identifying a list of conditions under which this becomes possible [3, 7, 10].

T. A. Filippova and M. V. Litskas [8] analyze approaches to the practical application of the doctrine in India and China and cite data that the number of cases in which the court makes a positive decision to penetration the corporate veil, increases in recent years exponentially. A. N. Vashchekin and K. A. Rostovtseva [1] suggest formalizing the process of developing criteria for the need to penetration the corporate veil through economic and mathematical modeling. V. G. Golubtsov analyzes the evolution of legislative approaches for accountability of controlling persons due to which the

company was bankrupt [2]. Tax aspects of the problem are investigated by I.A. Khavanova [9].

The publications of foreign researchers can be divided into two groups. Some authors focus on specific aspects of practical application of the concept of "piercing the corporate veil" in modern economic conditions. So, L. Wang [17] analyzes the impact of information about real business owners on the market price of shares. D. Lustig [15] considers the impact of "penetration through the corporate veil" on the global economic order. The second group of studies consists of publications on the application of the principle of "piercing the corporate veil" in selected countries. K. Alawamleh etc. [11] consider the Jordanian experience, A. Beebeejaun [13] — Court cases of environmental offences in the Republic of Mauritius. S. Sudiyana and D.P.B. Asri [16] analyze judicial precedents in Indonesia related to damage and search for the true perpetrators of forest fires. A. Auer and T. Papp [12] focused on the legal practice and professional opinions of auditors regarding caution and loyalty in managing a firm in Hungary. T. Fadi etc. [14] explore the opposition between "legal independence" and "economic dependence" of subsidiaries in Egypt.

This article is focused on the relationship of the concept with the principles of the formation of consolidated financial statements and the possibility of ensuring the usefulness of the information presented in it, as opposed to a large number of publications on the application of the doctrine of "piercing the corporate veil" and terms of its enforcement.

WHY NEED "PIERCING THE VEIL" TODAY?

Here are some examples from the financial scandals of the last two decades. One of them was the collapse of the transnational company Parmalat. In 2002, Parmalat was a huge company, which owned 148 plants in 31 countries of the world, with a total staff of 37 thous. people. However, in 2003, it was reported that Parmalat's money had disappeared in the bank accounts of numerous offshore companies. The investigation revealed,[1] that K. Tanci, the owner of Parmalat, hid the fact around 10 billion euros leakage, that equivalent to 1% of Italy's GDP. Fraudulent schemes hidden behind the corporate veil, led to huge losses 200 thousand shareholders of the company, negatively affected the results of many partners.

A significant attention in the Russian judicial practice of recent years received the case of the owner of the restaurant chain "Taras Bulba" Yu.A. Beloiwan. Business owner hid behind more than a dozen limited liability companies and individual entrepreneurs. All of them submitted individual reports on time, but during the tax audit, none of the legal entities could pay a fine to the Tax Inspectorate for concealment of revenues. The founder of the restaurant chain was attracted to subsidiary liability, as a result of which he was fined in favor of the tax inspection more than 4 million rubles.[2]

17 August 2020, the Chamber for Commercial Disputes of the Supreme Court of the Russian Federation considered an appeal in a case on prosecution for concluding a fictitious transaction on the manufacture of a civil aircraft YK-7UB.[3] The amount of the claim amounted to more than 19 million

[1] Landler M., Wakin D.J. The Rise and Fall of Parma's First Family. The New York Times, 11 January 2004. URL: https://www.nytimes.com/2004/01/11/business/the-rise-and-fall-of-parma-s-first-family.html (accessed on 19.12.2022).

[2] Decision of the Arbitration Court of the Moscow District No. 05–18580/2020 from25.11.2020 on the court case No. 40–136368/2018. URL: https://www.consultant.ru/cons/cgi/online.cgi?req=doc&base=AMS&n=366648 &ysclid=lffjae7jzp867381836#5wulxYTOUbjyHAaD 1 (accessed on 19.12.2022).

[3] Decision of the Chamber for Commercial Disputes of the Supreme Court of the Russian Federation No. 305-ЭС20–5422(1,2) from 24.08.2020 on the court case No. 40–232805/2017. URL https://legalacts.ru/sud/opredelenie-sudebnoi-kollegii-po-ekonomicheskim-sporam-verkhovnogo-suda-rossiiskoi-federatsii-ot-24082020-n-305-es20–542212-po-delu-n-a40–2328052017/?ysclid=lffje48tu569966579 (accessed on 19.12.2022).

rubles. Formally the sole owner of "Key" LLC was Missis K., but actually the transaction was planned, organized and controlled by someone M., married to her sister. In the course of the trial, the consistency of M. 's actions with the head of the design bureau of W., this organization was used by M. to create the appearance of aircraft assembly. Thus, Key" LLC became cover for concealing the true beneficiaries of the transaction, and only "piercing the veil" allowed to bring them to justice.

Thus, in domestic and international practice, the consideration of judicial disputes, the resolution of which is possible only in the case of an in-depth analysis of the structure of legal entities and individuals cooperating in business, as well as the delineation of their areas of responsibility. The doctrine of "piercing the corporate veil" has been developed in international legal practice to resolve such disputes. The essence of it consists in "put to shareholders or other legal entity member's liability for the company's debts, regardless of the principles of property autonomy and separate legal entity" [4, p. 88].

CONCEPT OF "PIERCING THE CORPORATE VEIL" IN LEGAL PRACTICE ABROAD

The root of the problem lies in the definition of "legal entity". At the end of the 20th century in the legal sphere two groups of theories of the company were formed, explaining the purpose of creation and essence of the company as a legal entity: fictional and realistic. The first group of theories represents a legal entity as a separate artificially created object. Supporters of this view were M.I. Brun, A.F. Brinz, M. Planiol. In 1881 the German scientist-lawyer R.F. Jhering put forward a different concept — he proposed to see behind the legal entity the beneficiaries of its activities — its owners [18].

At the end of the 19th century, the principle of economic entity's property was enshrined in regulations — in the laws on companies of various countries: Germany, Spain, France, the UK, the USA. As a result, the courts faced restrictions in bringing to justice those who really have an interest in the results of the company's activities and had to resort to the concept of "piercing the corporate veil". The term is found in various forms in French, German, Belgian and Dutch investment law (e.g., the Convention on the Settlement of Investment Disputes between States and Nationals of Other States of 18 March 1965). The doctrine of "piercing the corporate veil" is widely applied also in the law enforcement practice of the USA, it is beginning to find its application in recent years in Russia. The table shows examples of legal claims in recent years where the concept of "piercing the corporate veil" is used in making decisions.

In the sphere of legislative and judicial practice the concept of "piercing the corporate veil" is applied in various areas. First, bankruptcy cases in which those responsible for the actions that caused the firm to go bankrupt are identified, as it is possible to increase the insolvency estate at the expense of those persons and to satisfy more creditors. Second, these are cases of tax offenses, in which through "piercing the veil" determine those responsible for the non-payment of taxes and losses for the budget of the country. Third, often the responsibility of those hiding behind corporate veils is raised in the course of environmental investigations, as they usually have significant and tragic consequences for society. The fourth topical area of application of the concept of "piercing the corporate veil" is the search for end beneficiaries in the sphere of countering the laundering of criminal proceeds and the financing of terrorism.

THE CONCEPT OF "PIERCING THE CORPORATE VEIL" IN THE LEGAL FIELD OF RUSSIA

In a report prepared on the results of a study by the Russian Institute of Directors on the disclosure of information on

Table

Examples of Lawsuits in which Decisions were Made Using the Concept of "Piercing the Corporate Veil"

Parties to the lawsuit	Judicial body
United States v. Bestfoods	U.S. Supreme Court
Peterson Farms, Inc v. C&M Farming Limited	Commercial Court of the London Chambers of Commerce and Industry
Long v. Silver	4th USA Arbitration Court of Appeal
Decarel Inc. v. Concordia Project Mgmt Ltd	Quebec Court of Appeal (Canada)
Adams v Cape Industries plc	Court of Appeal (England and Wales)
Balwant Rai Saluja & Anr Etc.Etc. v. Air India	Supreme Court of India
Sukumar v. Secretary, ICAI & Ors., Special Leave Petition	Supreme Court of India
Office of the Federal Antimonopoly Service for the Novgorod region against PJSC "P" and LLC "TV"	Novgorod OFAS Russia
Bankruptcy manager of LLC "Dal'nya Doroga" vs LLC "HS-BC Bank (PP)" and HSBC Management Company	Chamber for Commercial Disputes of the Supreme Court of the Russian Federation
Yambulatova M.M. vs LLC "South Fuel Company" and LLC "Yzhnaya Havan'"	Arbitration Court of Krasnodar Krai

Source: Compiled by the authors on the basis of [1, 4–8].

corporate governance in the Russian Federation, concluded that there was a lack of transparency in the information provided by companies on the persons who actually control the business.[4] The study was conducted in 2011, but news agency publications confirm that the situation has not changed much now.[5]

In 2013–2014, the legal community attempted to incorporate the doctrine of "piercing the corporate veil" into the Russian legal field: article 53.1 of the Civil Code of the Russian Federation "responsibility ... of persons determining the actions of a legal entity" was introduced.[6] In 2017, the Federal Law of the Russian Federation "On insolvency (bankruptcy)"[7] was supplemented by Article 61.10 "debtor's controlling person".

[4] Research of the Russian Institute of Directors. Disclosure of information on corporate governance in the Russian Federation. URL: http://rid.ru/upload/resech/2010_CG_Russia_final.pdf (accessed on 19.12.2022).

[5] Official site of the Interfax Information Group. Demenkov A. Defamatory Connections. How the stock structure of Russian business changes. URL: https://spark-interfax.ru/articles/porochashchie-svyazi-21102022 (accessed on 19.12.2022).

[6] Civil Code of the Russian Federation (part one) No. 51 from 30.11.1994. URL: https: www.consultant.ru/ document/cons_doc_LAW_5142/?ysclid=lbwmdgjntb246209859 (accessed on 19.12.2022).

[7] Federal Law "On Insolvency (bankruptcy)" No. 127 from 26.10.2002. URL: https: www.consultant.ru/ document/cons_doc_LAW_39331/?ysclid=lbwno8gpba51534185 (accessed on 19.12.2022).

But to determine this controlling person, until the company becomes bankrupt or the directors face significant claims, is almost impossible. Also in the Russian Federation, numerous legal claims and proceedings to determine the ultimate beneficial owners of business are related to the specific area of State activity — Anti-Money Laundering and Combating the Financing of Terrorism (AML/FT). The criminal environment uses a chain of interconnected legal entities to conceal the proceeds of drug trafficking, arms trafficking, etc. The Central Bank, Rosfinmonitoring, FTS develop many documents, regulating the presentation of information on the final beneficiaries in this field.[8]

Thus, lawyers and tax authorities of all countries have been actively "piercing the veils" for the last 20–25 years, but, as a rule, shareholders and senior management are targeted only those companies that are already experiencing economic difficulties, show signs of insolvency or work to the detriment of the budget. These facts indicate the need to develop new semantic structures to meet the public demand for more transparent reporting on the financial situation of business units.

PRINCIPLE OF ECONOMIC ENTITY'S PROPERTY IN ACCOUNTING

Accountants-economists do not yet react very actively to the ongoing processes of "devaluation", adhering to the principle of economic entity's property. Follow the logic of the formation and evolutionary development of this principle in the field of accounting, Professor M.L. Pyatov consider that the source of this principle is the norms of Roman law [20]. In the Middle Ages, the principle of of economic entity's property in accounting has not yet been clearly formulated. This principle, expressed in a strict list of balance sheet items belonging to a company rather than its shareholders, was formed in accounting only at the end of the 19th century. "Accounting" interpretation of this principle, according to Y.V. Sokolov, belongs to H. Vannier, who in 1870 wrote that "accounting is always conducted on behalf of the estate, not the owner of this estate" [21, p. 147]. In the 20th century IFRS (International Financial Reporting Standards) were created, in which the principle of economic entity's property was universal for accounting systems of any countries.

The interpretation of major accounting categories was initially significantly influenced by the legal approach. As applied to the economic entity's property principle, this meant that the balance sheet initially reflected only property owned by the legal entity in the ownership. With the development of the world economy, the theoretical doctrine has evolved in the direction of the legal interpretation of the content of accounting reports to the economic. So, in the second half of the 20th century the concept of "The Reporting Entity" emerged, which proposes to consider the group of legal entities as a single economic mechanism. The term "consolidation perimeter" appeared in accounting practice, which can change depending on the professional judgment of the accountant [22].

In 21st century new forms of interaction of individual legal entities have appeared: strategic alliances, network companies, virtual structures, etc. which leads to blurring the boundaries of the concepts of "legal entity" and "reporting entity". The objective fact is the expansion of the meaningful content of accounting principles. As the scientists from the Saint Petersburg State University note, "the essence of the changes — is in the change of the functional purpose of accounting: the dominant control and analytical function ... replaced

[8] Letter from Rosfinmonitoring on UFO No. 21–4011/6731 from 23.10.2020. URL: https://dogma58.com/zakony/pismo-mru-rosfinmonitoringa-po-ufo-ot-23–10–2020-%E 2%84%96–21–4011–6731/?ysclid=lb717eb01w301534012 (accessed on 19.12.2022).

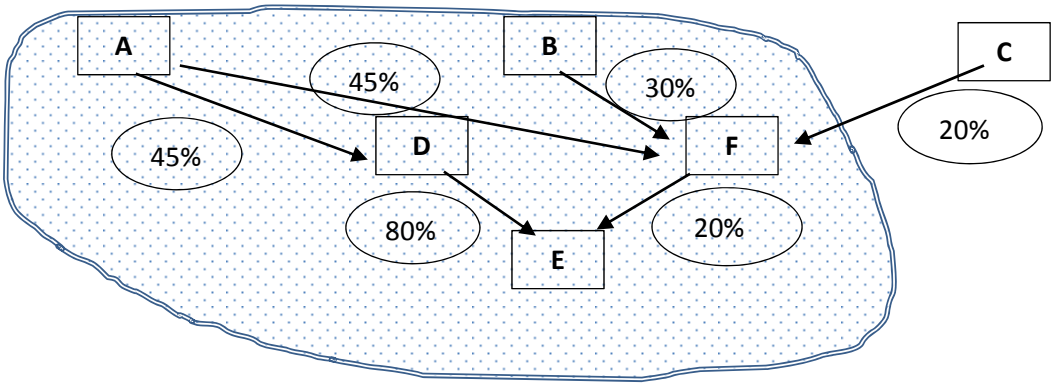

Fig. **Determination the Consolidation Perimeter for Indirect Ownership**

Source: Compiled by the authors.

by the dominant function of information-communicative" [23, p. 4]. The new version of the concept of "reporting entity", more flexible and informal, was adopted in 2010.[9] In 2013, the international standard IFRS 10 "Consolidated financial statements" was introduced, in which the content of consolidated reporting is expanded and based on the concept of "control". The *Figure* shows an example of a complex structure of uniting business entities through indirect ownership. On formal grounds (ownership of more than 50% of capital) only D and E companies would enter the consolidation perimeter.

In the case of individual reporting, the concept of control is implemented through the criteria of recognition of assets and liabilities in the balance sheet: the existence of control over the assets and the possibility of obtaining economic benefits from their use.

In the accounting practice of the Russian Federation, a legal approach to recognition of items in financial reporting was traditionally applied. Early version of the regulatory documents approved by 90s of 20th century[10] defined assets through ownership of the organization, with clear separation of the accounting rules for assets in balance sheet accounts and off-balance sheet accounts. Active convergence of domestic accounting standards with international standards in recent years leads to a predominance of economic approach. Regulations developed in 2000–2022 are formally based on the concept of control set out in IFRS.

However, domestic arbitration practice shows that unscrupulous business owners are comfortable with the principle of economic entity's property and limited liability for the obligations of companies. In this way, they try to avoid creditor claims in bankruptcy proceedings, organize the withdrawal of assets to dummy companies, which are the actual owners themselves. It is in such cases that attempts are made to hide the composition of the real owners behind the "corporate veil", and the concept of control turns out to be declared but unclaimed. Thus, despite the increasing volume of appendix and notes to financial statements, the level of transparency of financial reporting remains rather low.

CONCLUSION

There is an insufficiency of the principle of economic entity's property in the preparation of financial statements,

[9] Official website of the Ministry of Finance. URL: https://minfin.gov.ru/common/upload/library/2014/06/main/kontseptualnye_osnovy_na_sayt.pdf (accessed on 19.12.2022).

[10] Regulation on accounting and reporting in the Russian Federation, approved by the order of the Ministry of Finance of the Russian Federation No. 10 from 20.03.1992. URL: https://docs.cntd.ru/document/ 901608287?ysclid=lby4d2gcxq32899126 (accessed on 19.12.2022).

transparency of which is necessary for the formation of a civilized market space. Professional accounting community does not yet have a clear understanding of how to respond to this request. In these circumstances, it is proposed to start discussing the possibility of applying the principle of "additional responsibility", which is a logical consequence of the expansion of the content of the principle of economic entity's property in modern economic conditions.

Firstly, the additional responsibility of a certain group of persons having an actual influence on the activities of the business unit, including in some cases, the obligations of business owners, should be reflected in the financial statements. The professional judgement of the accountant as to how this information is to be reflected in the accounts is of particular importance. Options include both adding specific items to the balance sheet and creating a separate reporting form on comprehensive business equity. It is also relevant to include additional disclosures in the notes to the statement of financial position.

Secondly, the consolidation perimeter needs to be defined by identifying the controlling person(s). Regulator can set requirements of different severity for some situations. Normally, the consolidation perimeter is determined and declared by the organization itself on a voluntary basis, based on the professional judgment of the accountant. If there are some signs of bad faith or dysfunctional financial situation (for example, obtaining a qualified audit opinion, the presence of a large number of legal claims, etc.) in the perimeter of consolidation will fall all controlled enterprises, or separately disclose the group's transactions with controlling persons. A strong option of implementing the principle of additional responsibility implies disclosure of all controlling persons, which will ensure transparency and clarity of the governance structure of any business for users of published financial statements.

Thus, the shift from a legal to an economic approach to financial reporting leads to the need to revise fundamental accounting principles, including the transformation of the principle of economic entity's property.

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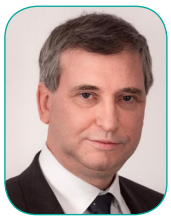

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