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**Extending the Disciplines on Domestic
Regulation for Accounting to other
Professional Services**

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**Extending the Disciplines on Domestic Regulation for Accounting
to other Professional Services**

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Introduction

1. GATS Article VI.4 calls for the development of disciplines to ensure “that measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services.” In accordance with this mandate, the former Working Party on Professional Services developed such disciplines for accountancy services. The purpose of this note is to discuss the feasibility of extending these disciplines to professional services more generally.
2. In referring to professional services the note addresses accredited professions such as accountants, architects, auditors, doctors, engineers, lawyers, teachers and veterinaries.
3. Whether the disciplines on domestic regulation for accounting can be extended to other accredited professions is assessed on the basis of issues such as the rationale for regulation, the type of regulations that apply in each case and the type of barriers to trade that arise in each case.

Case for Regulating Professional Services

4. The economic case for regulating economic sectors stems essentially from three types of market failure: market power, asymmetries of information and externalities. The social case for regulation is motivated by distributional concerns, such as universal access.
5. Asymmetries of information arise in professional services because consumers are unable to assess the quality of the service provided. This is mainly the case in accredited professions, such as accountants, architects, doctors, engineers, lawyers, veterinaries and teachers. In other professional services such as consulting or advertising the quality of the service is either less critical or easily observable. This note addresses the former type of professional services.
6. Unobservability of the quality of the service may occur ex-ante and/or ex-post. For instance, in the case of architectural, engineering, medical and legal services the client/patient observes the quality of the service after it was provided. In

auditing/accounting services, the consumer –i.e. shareholders and other third parties– cannot tell, even after the fact, if the auditor/accountant provided quality services.¹

7. A number of market-based mechanisms exist to deal with information asymmetries. These include reputation, contractual guarantees of performance quality, performance bonds, or third-party accreditation or quality rating. All of these mechanisms, as well as civil liability rules (as opposed to direct government intervention), provide an incentive for providers to maintain higher quality. For instance, providers of professional services will find it beneficial to invest in reputation for providing high quality services if ex-post observation is feasible, consumers make purchases repeatedly or information about quality is easily spread amongst consumers. This may be the case of all accredited professions listed above except for auditors/accountants. With very low failure rates, and the absence of contact and observability by customers, it is not possible for auditors/accountants to develop meaningful and accurate reputation with shareholders in any reasonable length of time (Sunder, 2000).
8. Where observability (ex-ante and ex-post) of the quality of the service is not feasible, competition is weak, purchases are rare (i.e. reputation effects are not applicable), assigning responsibility for outcomes is difficult or any consequences are irreversible² market-based mechanisms are less effective. Private medical surgery and auditing services may be examples of some of these categories.
9. When market-based mechanisms or horizontal civil liability rules do not adequately address information asymmetries, direct domestic regulation becomes essential. Good domestic regulation in professional services should find a balance between increasing the contestability of the markets and ensuring the quality of the service. Where the purchase of professional services is mandated in order to promote other objectives (for instance mandatory auditing of corporate accounts in order to protect small shareholders), regulation of the quality of the service is necessary to offset the incentive to purchase low-quality services.

Domestic Regulation in Professional Services

10. The scope and form of regulation varies widely between professions and between countries. In most cases regulation includes the service provider, extending from qualification requirements for professionals to licensing requirements for firms. In other cases regulation also includes the service itself by setting mandatory standards. An example of the latter is accounting services.
11. Some countries limit the activities that can be performed by professionals. For instance, some countries allow accountants to provide taxation services or management consultancy services, while others restrict these services to entirely

¹ Consumers are unable to determine the quality of auditing services ex-post for three reasons: 1) the rate of audit failure is less than 1%, 2) the customers never see the auditors do their work and 3) Firm's decisions on hiring the auditor are made by managers who are the subject of the audit (Sunder, 2002).

² See OECD, 2000.

separate professions. Likewise, in some countries engineers are allowed to provide design services, while in others such activities are limited to architects.³

12. Professional services are regulated at the national or sub-national level by governments and/or by delegating regulatory powers to self-regulatory organizations such as professional bodies. Sub-national regulations are common in accountancy and legal services (e.g. bar associations in the United States).
13. The responsibilities of professional bodies vary widely across professions and countries (and in some cases within countries) and membership of a professional body may be mandatory or voluntary. Professional associations usually play an important role in the accounting, legal and medical professions.

Trade in Professional Services

14. Many of the regulations (or their absence) that affect professional services may become impediments to competition and international trade in professional services. Concerns have been raised that certain regulations may restrict competition (and trade) more than is necessary, raising the price and limiting innovation in the provision of professional services.
15. Impediments to trade in professional services include nationality requirements, residence/establishment requirements, professional certification/entry requirements, compartmentalization/scope of practice limitations, restrictions on advertising, solicitation and fee-setting, quantitative restrictions on the provision of services, differences in quality standards, restrictions on business structures, and restrictions on international relationships/use of firms names.⁴
16. Asymmetries in regulatory regimes between countries may also constitute barriers to trade in professional services, for instance, when qualification requirements in one country are more stringent than in the partner country, or when the host country does not allow the same array of activities to be developed by a certain profession as the foreign country.
17. Similarly, differences in the powers delegated to professional associations between countries may also constitute important barriers to trade. For example, when a professional association is delegated the power to discipline its members, concerns have arisen that these associations may use this powers to excessively restrict entry, fix prices and enforce anti-competitive co-operation between its members. In some cases, studies have found that restricting entry to the most highly qualified providers may lower service quality overall as consumers forgo professional services or seek to provide the services for themselves (OECD, 2000).
18. The lack of regulatory harmonization and mutual recognition procedures – which reduce regulatory asymmetries between countries- can act as a major barrier to international trade. For instance, adapting to local training and certification requirements may be excessively costly for foreign professionals, whereas local conduct rules may be less costly to comply with. Permanent establishment may

³ The annex to the template attached to this document lists the activities that each of four types of professionals may be allowed to perform.

⁴ See template attached for a complete list of limitations of trade in each of four professional services.

justify greater adaptation effort than sporadic cross-border provision of services. In this context, lack of harmonization or mutual recognition can preclude certain types of international transactions entirely, at least through the means of cross-border trade as opposed to permanent local establishment.

19. Regulatory harmonization is however not feasible in every services sector. It must be noted that regulatory asymmetries usually reflect legitimate differences between countries in taste, income distribution, market culture, geography, risk aversion and more generally, prevailing patterns of state-society relationships (Nicolaodis, 2002). For instance, where consumers have a low risk tolerance it might not be justifiable to harmonize regulations of medical services with a jurisdiction where regulations are less stringent. Even if countries agree on the objectives of regulation of medical services, confidence in compliance verification methods may differ. On the other hand, a higher degree of harmonization may be justified in auditing services, as risk probability is low and the quality of the service is not observable ex-post (so that the quality of the service does not depend on consumer characteristics).
20. Mutual recognition agreements (MRAs) in professional services are likely to magnify information asymmetries, as observability of the quality of the service becomes less feasible between consumers and suppliers from different countries. Hence, they are more suitable for sectors where ex-post observation is feasible.
21. An approximation to regulatory harmonization, which facilitates MRAs, has been the development of international quality standards. However, these have been legitimised for a limited number of professional services and their incorporation into domestic regulations is not contractually binding. International standards have been developed for the accountancy profession (IASB), auditing profession (IFAC), engineering profession (ISO).
22. Professions also differ in their organizational structure and the preferred means to supply services internationally. Such differences may also constitute a barrier to international trade. They usually respond to the extent to which information asymmetries are magnified through international trade, which increases the relevance of issues such as client relations, knowledge of host country business customs and regulations and the need to balance local expertise with international coordination. Some of these issues may be attenuated by the development of international rules on domestic regulation.
23. Accounting and auditing, for example, in most countries is largely practiced at the level of firms or partnerships rather than individuals, with small-scale firms predominant. Law firms operate offices in foreign countries generally to provide host country clients with advice on laws and regulations concerning the law firms' home country. Architects and engineers usually work as independent professionals based in either the home or the foreign country.

GATS Disciplines on Domestic Regulation in the Accountancy Sector

24. Pursuant to GATS Article VI.4 the Council for Trade in Services developed disciplines to ensure that qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade in accounting services.

25. The disciplines adopted⁵ contain provisions on transparency requirements, administration of licensing requirements, qualification requirements and procedures, and technical standards for the accountancy profession. The disciplines do not address measures subject to GATS Articles XVI and XVII, which restrict access to the domestic market or limit the application of national treatment to foreign suppliers. Such measures are addressed in the GATS through the negotiation and scheduling of specific commitments.
26. A key provision is the general requirement that measures taken for the purposes above “are not more trade-restrictive than necessary to fulfil a legitimate objective. Legitimate objectives are, *inter alia*, the protection of consumers (which includes all users of accounting services and the public generally), the quality of the service, professional competence, and the integrity of the profession.” The objectives are further qualified by obligations to: 1) inform another Member of the rationale behind domestic regulatory measures in relation to the legitimate objectives (Transparency provision); 2) ensure that, when membership of a professional organization is required, the terms for membership are reasonable, and do not include conditions or pre-conditions unrelated to the fulfilment of a legitimate objective (Licensing Requirements provision); and 3) in determining whether a measure relating to technical standards is not excessively restrictive, take account of internationally recognized standards of relevant international organizations applied by a Member (Technical Standards provision).⁶
27. The transparency provision requires that members make publicly available contact information of competent authorities (governmental and non-governmental), as well as information describing the activities and professional titles which are regulated or which must comply with technical standards; requirements and procedures to obtain, renew or retain any licenses or professional qualifications and the regulator’s procedures for monitoring compliance; information on technical standards; and confirmation that a particular professional or firm is licensed to practise within their jurisdiction. Members should also endeavour to provide opportunity for comment before adoption of new measures and make public details of procedures for the review of administrative procedures.
28. Licensing requirements and procedures shall be pre-established, publicly available and objective, and shall not in themselves constitute a restriction on the supply of the service. Where residency requirements not subject to scheduling under GATS Article XVII exist, Members shall consider whether less trade restrictive means could be employed to achieve the purposes for which these requirements were set, taking into account costs and local conditions. Use of firm names may not be restricted, save in fulfilment of a legitimate objective. Requirements regarding professional indemnity insurance for foreign applicants must take into account any existing insurance coverage and fees charged by the competent authorities shall not represent an impediment in themselves to practising the relevant activity. Application procedures and the related documentation shall be not more burdensome than necessary to ensure

⁵ See WTO document S/L/64.

⁶ The term “relevant international organizations” refers to international bodies whose membership is open to the relevant bodies of at least all Members of the WTO.

that applicants fulfil qualification and licensing requirements. A license, once granted, shall enter into effect immediately.

29. In respect to qualification requirements, competent authorities must take account of qualifications acquired in the territory of another Member, on the basis of equivalency of education, experience and/or examination requirements. The scope of examinations and of any other qualification requirements shall be limited to subjects relevant to the activities for which authorization is sought. Qualification requirements may include education, examinations, practical training, experience and language skills. The importance of mutual recognition agreements is explicitly acknowledged regarding the process of verification of qualifications and/or in establishing equivalency of education.
30. Qualification procedures must expedite the verification of qualifications acquired in the partner country and, when additional qualifications are necessary, this must be identified. Examinations shall be open to all eligible applicants, including foreign and foreign-qualified applicants, and must be scheduled at reasonably frequent intervals. Fees charged by competent authorities shall not represent in themselves an impediment to practising the relevant activity. Residency requirements not subject to scheduling under GATS Article XVII shall not be required for sitting examinations.
31. Measures related to technical standards must be prepared, adopted and applied only to fulfil legitimate objectives.

Extending the Disciplines on Domestic Regulation in Accounting to other Professions

32. This section analyses whether the disciplines on domestic regulation developed for the accountancy profession in GATS can be extended to other accredited professions. The rationale for stating this premise is that given that the case for regulating accredited professions stems from the existence of a common market failure, it should be possible to devise a common set of disciplines aimed at reducing barriers to trade in such services. The underlying principle suggests that economic sectors can be grouped according to the market failure(s) affecting them, and that regulatory disciplines in trade agreements should target the market failure itself, rather than developing specific regulations for specific sectors.
33. Hence, the issue of whether the regulatory provisions developed for the accounting sector in GATS can be extended to other professions depends on whether the magnitude and impact of the information asymmetry differ between professions and across countries. It also depends on idiosyncratic factors such as taste, income distribution, market culture, geography, risk aversion and prevailing patterns of state-society relations.
34. As regards the necessity test developed for the accountancy sector, consumer protection should be a common regulatory objective to all professions as it addresses the source of the problem, i.e. the market failure. The other three “objectives” - quality of the service, professional competence, and the integrity of the profession-constitute instruments to achieve the overall objective of consumer protection. The relevant question then is not whether or not these objectives are also legitimate in

other professions, which they are, but whether it is possible to develop generic criteria to determine if a measure is excessively restrictive with respect to legitimate objectives defined in such general terms.

35. For instance, the concept of consumer protection (and also quality of the service, professional competence and integrity of the profession) may not only differ across countries, but also across professions as it depends on issues such as consumer type (individuals v/s firms), the effectiveness of market-based mechanisms and direct government intervention to address the information asymmetry problem, as well as idiosyncratic factors like risk aversion, tastes and market culture.
36. Similarly, the issue of whether a measure is necessary to guarantee a “desired” quality of a service is directly related to the observability of the service. Where the quality of the service is not observable ex-ante and ex-post, measures to achieve the “desired” quality may need to be much more stringent than in cases where it is observable ex-post. This would require, for example, that the criteria to assess the restrictiveness of measures affecting doctors should be less stringent than those affecting auditors. A residency requirement may hence be justified for doctors and not for auditors.
37. Both professional competence and integrity of the profession may be interpreted as ex-ante indicators of the quality of the service. Should these be highly correlated with ex-post quality the criteria to assess the restrictiveness of the related measures should be in line with those established for the quality of the service. Should this not be the case more stringent temporary measures should be allowed to ensure that competence and integrity increase the observability, at least ex-ante, of the quality of the service.
38. Other provisions developed for the accounting sector –transparency, licensing requirements and procedures, qualification requirements and procedures– are also stated in very general terms and may thus be extended to all other professions. It is possible however to develop more specialized provisions should the different professions be grouped according to common characteristics. For instance, in the architecture, engineering and law professional bodies play an important role, reputation creation is viable and assigning responsibility for outcomes is feasible. In medical and veterinary services ex-post observability and irreversibility of the consequences of the service may be the basis for common regulatory principles.
39. The technical standards provision developed for accounting services is a special case. The necessity test in this case is importantly dependent of the existence of internationally recognized standards. As mentioned above, such standards have only been developed for a limited number of professional services, so the provision has limited applicability in other professions. Moreover, internationally accepted standards may be seen as a second best solution to harmonization and it was mentioned above that not all professions require such a high degree of regulatory integration. Only where observability of the quality of the service ex-post is not feasible, a common set of regulations is critical internationally. In sectors where observability ex-post is more probable, mutual recognition agreements may be a better solution, as these not only allow regulatory competition and replace host country control (i.e. enforcement capacity) by recognition of home country control, but they also take into account idiosyncratic factors.

40. The chart below groups professions according to common characteristics and identifies the provisions that could be extended to them.

**Types of Regulatory Disciplines that may be applied to
Various Categories of Professional Services**

Category of Professional Service	Common disciplines on transparency, licensing requirements and procedures, qualification requirements and procedures	Common necessity test	Harmonization recommended (technical standards developed)	Mutual Recognition recommended
Legal Services, Architectural Services, Engineering Services	X	X		X
Accounting/Auditing	X	X	X	
Medical and Veterinary services	X	X		X

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