

CHAPTER 4

Preshipment inspection

Summary

Since about the second half of the twentieth century importers have used the services of independent inspection companies to certify the quality and quantity of products they want to import. These inspections, which are conducted in most cases prior to shipment and in the country of exportation, assure the importer that the goods conform to the technical specifications and the quality standards laid down in the contract and that the quantities exported are accurate. The services of such inspection companies are utilized not only by private business firms, but also by State-owned enterprises and government departments. In fact, the regulations in many countries require goods procured by government departments to be inspected and certified for quality and quantity by independent and competent inspection companies.

Since the mid-1960s, the governments of some developing countries have also been using the services of preshipment inspection (PSI) companies to inspect goods to be imported and to verify their prices, prior to shipment and in the exporting countries. Their basic purpose in doing so is to bring under control the under- or over-invoicing of imported goods and other unfair or improper practices. Today, over 30 countries in Africa, Asia and Latin America use these services:

- To carry out physical inspection of the goods to be imported in order to ensure that they conform to the terms of the contract;*
- To verify their prices; and*
- To ensure that they are classified by the exporter under the correct tariff classification of the importing country.*

The physical inspection of goods is an integral part of the procedures adopted by PSI companies to ensure that the prices indicated by the exporter in the invoice reflect the true value of the goods and that there is no under- or over-invoicing. Such inspections assure importers that the goods they have ordered meet contractual specifications and quality standards, thereby reducing possibilities for dispute after the goods arrive at destination. These inspections also prevent the import of products that are considered harmful to health and therefore cannot be sold (e.g. banned chemicals and pharmaceutical products, substandard food products) in the exporting countries.

In most PSI-using countries, physical inspection and price verification of almost all goods prior to exportation is obligatory for imports to be permitted. In one country, the system is voluntary and importers using PSI services are entitled to have their goods cleared through Customs without further scrutiny of the value recommended by the companies concerned.

Almost all PSI-using countries exempt goods valued below a specified threshold from preshipment inspection.

Objectives for using PSI services

Contracts for mandatory preshipment inspections can be grouped into two broad categories according to the purpose for which the services of PSI companies are employed. In the terminology used by PSI companies, these are *foreign exchange contracts (forex)* and *customs contracts*. The first is usually employed to designate contracts whose basic objective (and that of the government requiring them) is to prevent the flight of capital through over-invoicing. The second is used for contracts undertaken when the governments' main aim is to prevent slippage of customs revenue as a result of undervaluation or deliberate misclassification by traders of goods to be imported under low-duty headings.

Until about a few years ago, the predominant government objective was to prevent the overvaluation of imports. Traders tend to overvalue imports when the import trade and foreign exchange transactions are subject to restrictions. As a result of the steps which developing countries have taken to liberalize their trade and foreign exchange regimes, traders do not generally have at present any incentive to overvalue imported goods. The result has been that, as box 13 shows, the majority of the PSI contracts are now customs contracts; their main aim is to detect the undervaluation of imported goods, with a view to ensuring that revenue due is fully collected and to controlling customs-related corruption.

While PSI services are mainly used for the preshipment inspection of imports, a few governments also utilize them to control the flight of capital through the undervaluation of exports.

There are currently five PSI companies providing preshipment inspection services on a worldwide or a regional basis. The largest among them is the Société générale de surveillance (SGS) of Geneva. It has over 130 affiliated companies, with a presence in more than 140 countries and a staff of over 30,000. The other four companies are BIVAC International of Paris, COTECNA of Geneva, Inchape Testing Services International (ITSI) of London, and the Inspectorate of the United States. They are all members of the Preshipment Inspection Committee of the International Federation of Inspection Agencies (IFIA). There are indications that other companies providing either the same or more or less similar services may enter the market in the near future.

Background to the negotiations on the PSI Agreement

The extension of PSI services to the mandatory verification of the prices agreed between importer and exporter was viewed with concern by business and industry, especially in some developed countries. They were particularly worried by the fact that they were asked to revise their prices downward when the PSI companies found contractual prices to be overvalued. They argued that the criteria used by PSI companies for price comparison was not always known to the exporters. The lack of transparency not only created uncertainty about the acceptability of prices negotiated with buyers but also put exporters in a disadvantageous position, as there were no procedures for appealing to independent bodies against the decisions of PSI companies. The delays in carrying out physical inspections and price verifications also delayed shipment, adding to the exporters' costs.

The Agreement on Preshipment Inspection, negotiated in the Uruguay Round, attempts to strike a balance between the concerns expressed by exporting enterprises in developed countries and the need to safeguard the essential interests of developing countries that consider PSI services useful. It clarifies

Box 13**Countries/areas using PSI services**

Country/area	Type of PSI contract
Argentina	Customs
Bangladesh	Customs
Benin	Customs/Forex
Bolivia	Forex
Burkina Faso	Customs/Forex
Burundi	Forex
Cameroon	Customs/Forex
Central African Republic	Customs/Forex
Colombia	Customs
Comoros	Customs/Forex
Côte d'Ivoire	Customs
Democratic Republic of the Congo	Customs
Ecuador	Customs
Ghana	Customs/Forex
Guinea	Customs/Forex
Iran, Islamic Republic of	Quality/Quantity
Kenya	Customs
Liberia	Customs
Madagascar	Customs/Forex
Malawi	Customs/Forex
Mali	Customs
Mauritania	Customs/Forex
Mexico	Customs
Mozambique	Customs/Forex
Niger	Customs/Forex
Nigeria	Customs/Forex
Paraguay	Customs
Peru	Customs
Philippines	Customs
Rwanda	Customs/Forex
Senegal	Customs/Forex
Sierra Leone	Customs/Forex
Togo	Customs
Uganda	Customs
United Republic of Tanzania	Customs/Forex
Uzbekistan	Forex
Zanzibar	Forex

that its provisions apply only to preshipment activities carried out in exporting countries that are “contracted or mandated by the government”. The term ‘preshipment inspection’ is defined as “all activities relating to the verification of the quality, the quantity, the price, including currency exchange rate and financial terms and/or the customs classification of goods to be exported”.

Main provisions of the Agreement

Agreement on PSI,
Preamble

The Agreement further recognizes that a number of developing countries use PSI services, and allows their use “for as long as and in so far as” they are “necessary to verify the quality, quantity or price of imported goods”. The basic aim of the Agreement is to lay down a set of principles and rules which countries using PSI services and exporting countries have to follow in order to ensure that their activities do not cause barriers to trade.

Obligations of PSI-using countries

The obligations which the Agreement imposes on countries using PSI services aim at ensuring the reduction or elimination of the practical problems encountered by exporters as a result of delays by PSI companies in carrying out physical inspections and price verifications, the lack of transparency in the procedures they follow, and the treatment of confidential information. Towards this end, the Agreement contains provisions covering, *inter alia*:

- ❑ Extension of MFN and national treatment,
- ❑ Protection of confidential business information,
- ❑ Avoidance of unreasonable delays, and
- ❑ The use of specific guidelines for conducting price verification.

Box 14 describes the main features of the obligations which the Agreement imposes on PSI-using countries.

Box 14

Main obligations of PSI-using countries

Non-discrimination. Procedures and criteria should be applied on an equal basis to all exporters. There should be uniform performance of inspection by all inspectors. [Agreement on Preshipment Inspection, Article 2.1]

National treatment. Countries using PSI services should not apply national regulations in a manner that will result in less favourable treatment of the goods being inspected in comparison to the like domestic product. [Agreement on Preshipment Inspection, Article 2.2]

Inspection site. Physical inspection should be carried out in the exporting country and, only if this is not feasible, in the country of manufacture. [Agreement on Preshipment Inspection, Article 2.3]

Standards. Quality and quantity inspections should be conducted according to the standards agreed between buyer and seller or, in their absence, international standards. [Agreement on Preshipment Inspection, Article 2.4]

Transparency. Transparency should be ensured by providing exporters with information, *inter alia*, on the laws and regulations of user countries on PSI activities, and the procedures and criteria used for inspection. [Agreement on Preshipment Inspection, Article 2.5 to 2.8]

Protection of confidential information. Confidential information should not be divulged to third parties. [Agreement on Preshipment Inspection, Article 2.5 to 2.13]

Delays. Unreasonable delays should be avoided. [Agreement on Preshipment Inspection, Article 2.15 to 19]

Price verification. See box 15.

Guidelines for conducting price verification

The Agreement stipulates that in order to determine whether the export price reflects the correct value of the goods, PSI companies could compare this price with the prices of identical or similar goods offered for export from the same country of exportation

- to the country of importation, or
- to other markets.

However, where for price comparison purposes the prices charged for export to countries other than the country of importation are used, the economic and other factors that influence the prices charged to different countries should be

taken into account. In other words, the rules recognize that firms often charge varying prices for different markets, taking into account demand and growth potential as well as factors such as per capita income and standards of living in these markets. An exporting firm may thus charge higher prices for its exports of, say, shirts to Europe than it does for exports to Africa. The Agreement stipulates that when third-country prices are used for price-comparison purposes, the factors responsible for variations in the prices charged to importers in different countries should be taken into account and PSI companies should not “arbitrarily impose the lowest price upon the shipment”. In addition, it states that PSI companies should make appropriate allowances for certain “applicable adjusting factors” in regard to the export price of the goods being inspected and the prices of identical or similar goods being used for price comparison. (See box 15 for details.)

Box 15

Agreement on Preshipment Inspection: Provisions on price verification

(the text of Article 2:20)

User Members shall ensure that, in order to prevent over- and under-invoicing and fraud, preshipment inspection entities conduct price verification according to the following guidelines:

(a) preshipment inspection entities shall only reject a contract price agreed between an exporter and an importer if they can demonstrate that their findings of an unsatisfactory price are based on a verification process which is in conformity with the criteria set out in subparagraphs (b) through (e);

(b) the preshipment inspection entity shall base its price comparison for the verification of the export price on the price(s) of identical or similar goods offered for export from the same country of exportation at or about the same time, under competitive and comparable conditions of sale, in conformity with customary commercial practices and net of any applicable standard discounts. Such comparison shall be based on the following:

(i) only prices providing a valid basis of comparison shall be used, taking into account the relevant economic factors pertaining to the country of importation and a country or countries used for price comparison;

(ii) the preshipment inspection entity shall not rely upon the price of goods offered for export to different countries of importation to arbitrarily impose the lowest price upon the shipment;

(iii) the preshipment inspection entity shall take into account the specific elements listed in subparagraph (c);

(iv) at any stage in the process described above, the preshipment inspection entity shall provide the exporter with an opportunity to explain the price;

(c) when conducting price verification, preshipment inspection entities shall make appropriate allowances for the terms of the sales contract and generally applicable adjusting factors pertaining to the transaction; these factors shall include but not be limited to the commercial level and quantity of the sale, delivery periods and conditions, price escalation clauses, quality specifications, special design features, special shipping or packing specifications, order size, spot sales, seasonal influences, licence or other intellectual property fees, and services rendered as part of the contract if these are not customarily invoiced separately; they shall also include certain elements relating to the exporter's price, such as the contractual relationship between the exporter and importer;

(d) the verification of transportation charges shall relate only to the agreed price of the mode of transport in the country of exportation as indicated in the sales contract;

(e) the following shall not be used for price verification purposes:

(i) the selling price in the country of importation of goods produced in such country;

(ii) the price of goods for export from a country other than the country of exportation;

(iii) the cost of production;

(iv) arbitrary or fictitious prices or values.

Differing rules on the verification of prices in the Agreement on PSI and on the valuation of goods in the Agreement on Customs Valuation

The main differences in the provisions of the two Agreements

Since one of the main aims of governments in using PSI services is to prevent the loss of customs revenue from undervaluation of goods, the question arises of how Customs should use the prices recommended by PSI companies in determining value for customs purposes. The issue is of importance since under the Brussels Definition of Value, the system current in all PSI-using countries, customs authorities have considerable flexibility to use the prices recommended by the PSI companies in determining customs value. However, these countries are obliged to change to the system prescribed by the Agreement on Customs Valuation when the delay period available to developing countries for its implementation expires on 1 January 2000.

The stricter disciplines which the Agreement on Customs Valuation imposes considerably restrains the rights of Customs to use the price recommendations of PSI companies. Moreover, the Agreement prohibits countries from using prices charged by the same exporters to their third markets as a basis for valuation. By contrast, the PSI Agreement permits them to use such prices but, as noted earlier, lays down certain guidelines which they must take into account in recommending prices. (See box 15.) Taking this situation into account, the Agreement on Customs Valuation clarifies the role of Customs by stating that the obligations of user member countries “with respect to the services of preshipment inspection entities (in connection with customs valuation) shall be the obligations which they have accepted” under the Agreement on Customs Valuation.

Practical implications of the differences

The aim of the above clarification is to ensure that customs administrations in countries having recourse to PSI services use the prices recommended by them only as test values or advisory opinions when checking the truth or accuracy of the importer’s declared value. Customs could use such recommended prices as test values even when the recommended prices are arrived at on the basis of the prices charged by exporters to third-country markets.

Customs however cannot automatically determine dutiable value for levying customs duties on the basis of prices recommended by a PSI company. An examination has to be carried out in each case. If on the basis of the

examination and a comparison of the price declared by the importer and the one recommended by the PSI company, it finds that the latter reflects the correct price and the importer does not contest it, the value can be determined on the basis of that price. In all such cases, it will be necessary to ensure that in arriving at the recommended price, the PSI company has followed the rules on adjustments for various elements (e.g. buying commissions and sole agency commissions) laid down by the Agreement on Customs Valuation.

There will always be a few importers who will contest the PSI-recommended prices that are acceptable to Customs, and maintain that the prices they have declared reflect the true value of goods. Such importers have a right to expect Customs to give them the opportunity to produce documentary and other evidence to justify their declared price. If, after examining the evidence, Customs still maintains that the price declared by the importer involves either under- or over-valuation, it cannot under the provisions of the Agreement on Customs Valuation determine value on the basis of the PSI-recommended price.⁸ It will have to determine it by using the methods laid down in the Agreement for the determination of value when the transaction value declared by the importer is not acceptable. These methods, *inter alia*, provide for the determination of the value of imported goods on the basis of the value determined in earlier transactions involving identical or similar goods. When the value cannot be determined under these methods, it has to be determined on the basis of price of the imported goods in the domestic market of the importing country (deductive value) or on the basis of cost of production (computed value).

Obligations of exporting countries

So far the discussion has centred on the obligation which the Agreement on PSI imposes on countries using PSI services with a view to ensuring that practices followed and actions taken by PSI companies do not cause barriers to trade. The Agreement also imposes certain obligations on countries which export to PSI-using countries. These are designated in the Agreement as 'exporting countries'. The main obligations which the Agreement imposes on these countries are summarized below:

Agreement on PSI,
Article 3:1

☐ *Non-discrimination.* Laws and regulations that may have been adopted to govern the operation of PSI services should be applied on a non-discriminatory basis.

Agreement on PSI,
Article 3:2

☐ *Transparency.* All such laws and regulations should be published.

Agreement on PSI,
Article 3:3.

As noted earlier, the Agreement visualizes the use of preshipment inspection by developing countries only on the short term. For the long term, the objective of these countries should be to reduce reliance on the use of PSI services to detect customs malpractices and fraud by gradually developing the technical capacities of their customs administrations to deal with such practices. To assist PSI-using countries in building up such capacities, the Agreement calls on exporting countries to provide them with technical assistance, with a view to gradually reducing their reliance on PSI services for verifying prices.

⁸ This applies even when the PSI company has arrived at the price by adhering to the rules of the Agreement on Customs Valuation.

Consideration of complaints and settlement of disputes

Agreement on PSI,
Article 2:21; Article 4

One of the major criticisms made by exporters of PSI activities was the absence of an institutional mechanism for considering complaints on arbitrary or wrong decisions. To facilitate the consideration of such grievances, the Agreement establishes a three-tier mechanism.

First, the Agreement calls on PSI entities to designate officials to whom exporters can appeal against the decisions of PSI entities.

Second, it establishes an independent review entity (IE) to which both exporters and PSI entities can submit grievances. The IE is constituted jointly by WTO, the International Chamber of Commerce (ICC, which represents the interests of exporters), and the International Federation of Inspection Agencies (IFIA, which represents the interests of PSI companies). WTO is responsible for the administration of the IE.

Third, the Agreement recognizes the right of the governments of countries using PSI services and of the exporting countries to invoke WTO dispute settlement procedures, if they consider that the rules of the Agreement are not being adhered to.

A complaint can be submitted to the IE by an exporting enterprise or by a PSI company. Once a complaint is filed, the IE is expected to appoint, with the agreement of the parties to the complaint, either a single trade expert or a three-member panel. Where a panel is constituted, one member is nominated by ICC, the second by IFIA and the third, who should be a trade expert and who will act as chairman, by the IE itself. The panel is required to make a decision, by a majority vote, within eight working days from the filing of the dispute. Both parties to the dispute are required to make financial deposits to cover expenditures incurred by the panel.

These procedures have, however, not been so far invoked either by exporters or by PSI companies.

Review of the provisions of the Agreement

Agreement on PSI,
Article 6

Recommendations adopted to clarify the rules of the Agreement

The Agreement provides that its provisions should be reviewed at the end of the second year of its operation. To carry out such a review the General Council has appointed a Working Party on Preshipment Inspection.

The work done by the Party has resulted in the adoption of recommendations clarifying and improving the provisions in the Agreement. These are set out below.⁹

- *Responsibility for determining dutiable value should rest with Customs.* Price verification by PSI entities for customs purposes should be limited to providing technical advice to facilitate the determination of customs value by the user Member. In this regard, the ultimate responsibility for customs valuation and revenue collection should rest with user Members. All activities of PSI entities should be monitored by user Members who should be encouraged to reflect this in national legislation or administrative regulations.

⁹ Source: "Report of the Working Party on Preshipment Inspection to the General Council", 2 December 1997 (WTO document G/L/214).

- *Making publicly available price verification criteria.* A user Member should be required to:

- Make publicly available a single set of price verification criteria, and
- Inform exporters and importers of the applicable valuation methodology.

The price verification criteria should include the customs valuation methodology, as specified in user Members' national legislation or administrative regulations, used when providing technical advice on customs valuation. In this regard, user Members should encourage PSI entities to utilize electronic means for purposes of providing the required information to exporters and importers.

User Members should ensure that requests for information do not go beyond that required by the provisions of the Agreement on Preshipment Inspection. Reciprocally, exporter members should inform user Members when they become aware that the PSI entities' requests for information go beyond these Articles.

- *Site for inspection.* User Members should ensure that PSI entities are encouraged to establish local focal points in countries where they do not have physical, on-site representation.

- *Use of electronic means of communication.* The establishment of Web sites by IFIA and by PSI entities with on-line services would enhance the efficiency of PSI operations in such areas as procedures, methods, inspection criteria, responses to enquiries, and dissemination of other usable, essential information by importers and exporters. In addition to providing hard copies, PSI entities should be encouraged to communicate Clean Reports of Findings (CRFs) to importers and exporters through electronic means.

- *Avoidance of delays.* User Members should ensure that PSI entities issue CRFs to importers and exporters immediately on receipt of the final documents and completion of inspection. In no case should the issue of a CRF exceed five working days after an inspection. If a CRF has not been issued, the user Member should ensure that the PSI entity puts out a detailed written explanation specifying the reasons for non-issuance.

- *Protection of confidential information.* User Members should ensure that contracts with PSI entities or national implementing legislation or administrative regulations specify procedures to be undertaken by such entities to limit the confidential business information they seek from exporters to that provided for under the Agreement and to ensure that any such information obtained by PSI entities is not used for any other purpose than PSI activities for the user Members. Any breach of the rule of confidentiality by the PSI entity is an action that may be brought against the PSI entity in the appropriate judicial or administrative forum of the user Member.

- *Fee structures.* User Members should ensure that contracts with PSI entities or national implementing legislation or administrative regulations provide for fee structures that do not create incentives for potential conflicts of interest in any way that may be inconsistent with the objectives of the Agreement. Additionally, contracts with PSI entities or national implementing legislation or administrative regulations should specify that PSI entities should not inspect transactions involving products in which a PSI entity or its related company may have a commercial interest.

- *Consideration of complaints from exporters.* Members should ensure that the PSI entity, when responding to a dispute on price verification, provides a detailed written explanation within 10 days of receipt of the complaint, setting forth the basis of its opinion of value by reference to the specific applicable elements of the price verification criteria.

- ❑ *Use of a model contract.* Members must ensure that contracts are in conformity with the provisions of the PSI Agreement and are encouraged to consider following wherever possible the model contract that has been developed by the Working Party.
- ❑ *Selectivity and risk assessment.* Members should examine incorporating the principles of selectivity and risk assessment in their contracts.
- ❑ *PSI auditing.* Members considering having their PSI programmes audited should be guided by the principles that have been developed by the Working Party or ensure that, when alternative criteria are used, the principles of the PSI Agreement are respected.
- ❑ *Technical assistance.* Developed countries must ensure that developing countries receive the necessary technical assistance for domestic capacity building in order that the transition from PSI can be made.

Future monitoring

Future monitoring of the Agreement on PSI will be undertaken initially by the Committee on Customs Valuation, where PSI will be a standing agenda item.

Business implications

It is important to note that the Agreement provides that countries using the services of PSI companies for verification of prices should do so only for temporary periods of time. The long-term objective should be gradually to reduce their dependence on the use of these services, by developing the capacities of their customs officials to detect cases of undervaluation and other customs malpractices.

The clarifications of the rules of the PSI Agreement described above seek to reduce further, if not completely eliminate, the difficulties enterprises experience in exporting to countries using PSI services. In addition, the Agreement has created a mechanism for the consideration of complaints. This will enable exporters who believe that their prices have been revised arbitrarily by the verifying inspector to complain to a designated senior official of the inspecting company and, if they are not satisfied, to bring the matter up for consideration by the independent review entity, which has been established under the Agreement.

Governments of PSI-using countries benefit from the increased customs revenue resulting from the detection of undervaluation and from the decline in the flight of capital through overvaluation. The employment of PSI services also brings indirect benefits to business enterprises. First, it speeds up the clearance of goods. Second, the use of PSI services lowers the level of customs-related corruption, thereby reducing demands for under-the-table payments for imported goods to be cleared. As has been said, one of the objectives of governments using PSI services is to bring customs-related corruption under control. Third, when verifying prices, PSI companies carry out physical inspections of goods to be imported in order to ensure that they conform to the conditions stipulated in contracts between importers and exporters in regard to quality and quantity. Except therefore in cases of low-value imports, which are not inspected, importers obtain an assurance that the goods they will receive will be in conformity with the terms of their contracts. However, as PSI companies enter into contracts with governments, importers have no right of recourse to these companies if they (the importers) ultimately find that the imported goods do not, in fact, meet the terms of their contracts.