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Navigating Tariffs: Accounting and Financial Reporting Considerations

Background

Although tariffs are not new to the global economic landscape, their prominence and impact have grown significantly in recent months as a result of rapid increases in tariff rates and shifting trade patterns. The introduction or modification of import taxes can significantly alter existing cost structures, disrupt supply chains, and create new operational and compliance challenges, which can, in turn, lead to significant accounting and financial reporting implications. Tariff rate changes may necessitate a review of existing business controls to ensure compliance with trade regulations and mitigate new financial risks.

Understanding the impacts of tariffs is crucial for maintaining accurate financial reporting and effective business management in this evolving trade environment. Accordingly, this *Accounting Spotlight* discusses accounting and financial reporting considerations related to assessing the practical effects of tariffs on an entity, including the entity's internal controls. These considerations are not all-inclusive; an entity may also need to use judgment in its assessment.

ICFR Considerations

Because tariffs introduce new risks and complexities, entities that are subject to them must thoroughly review their internal controls over financial reporting (ICFR) to ensure that their financial statements are accurate and compliant and that their existing controls adequately address the impact of tariffs on financial reporting. If necessary, entities should modify their existing controls or implement new ones in response to emergent financial reporting risks. Entities should evaluate controls related to their compliance with tariff regulations as well as those associated with the identification, measurement, and disclosure of tariff-related impacts in the financial statements. Depending on the nature of the tariffs, key considerations related to this evaluation may include:

- *Identification* — Given the rapid pace of change, organizations should have processes in place for monitoring and adapting to changes in trade regulations and trade agreements within and between countries and for various product categories.
- *Measurement* — Tariffs can have various measurement and valuation impacts on the financial statements, as further discussed below. Entities may need to reevaluate the level of precision of their mitigating controls when determining whether such controls are appropriately designed, including controls related to estimates that are affected by tariffs. Moreover, entities should evaluate their controls over the associated tariff obligations or offsets. This evaluation may include considerations such as:
  - *Country of origin* — Entities must accurately determine and document the country of origin for all imported goods, since this affects tariff rates and compliance requirements.
  - *Product value* — Accurate valuation of imported goods is critical, since tariffs are often calculated as a percentage of a product's value. Entities should ensure that their valuation methods are consistent with regulatory requirements. In addition, they should evaluate the allocation of both direct costs (i.e., imported products) and indirect costs (e.g., transportation, warranty, and other indirect costs) when applicable (e.g., in accordance with the United States-Mexico-Canada Agreement).
  - *Product classification* — To properly classify goods under the Harmonized Tariff Schedule, an entity will need to determine the applicable tariff rates and may be required to use significant judgment. Misclassification can lead to compliance issues and financial misstatements.
- *Compliance* — An entity may need to consider compliance with laws or regulations and related controls. Inadequate processes or controls may lead to underreporting of tariffs, exposing businesses to penalties, fines, and reputational risks.
- *Disclosure* — SEC registrants may need to assess whether to include disclosures about material ICFR changes in quarterly or annual filings.

Companies should also consider establishing robust controls and procedures related to ensuring that timely and relevant information about tariffs and the current economic environment is communicated to those responsible for accounting and reporting judgments.

Accounting Considerations

The effects of tariffs on an entity's financial reporting may be broad or may be limited to certain accounts, transactions, or disclosures. As a result of current conditions and future uncertainty, entities may also face significant forecasting challenges. Such challenges may be compounded by other macroeconomic factors such as inflation and global supply-chain issues. The accounting and financial reporting implications of tariffs can be significant for some businesses, particularly given the uncertainty and volatility they introduce, which can increase the complexity of management's process for making reliable accounting estimates. Such complexity could lead to accounting and financial reporting challenges in areas such as inventory valuation, nonfinancial asset impairment, revenue recognition, tax estimates, and forecasting liquidity.

Because the tariffs have been levied on various occasions and have been subject to change or negotiation, the accounting and disclosure considerations associated with them may vary, in part, on the basis of whether the executive orders or other actions announcing the tariffs occurred during the reporting period under audit or review or after it. Both announced and expected tariffs could affect the cost of acquired goods for many companies, which could in turn affect such companies' accounting and reporting when they are required to estimate future costs. Additional evaluation and disclosure considerations are necessary for tariffs that were announced via executive orders or other actions taken after the reporting period.

Impairment of Nonfinancial Assets

Inventory Valuation

Under U.S. GAAP, most inventory must be measured at the lower of its cost or (1) market value (for inventory measured by using the last-in, first-out method or the retail inventory method) or (2) net realizable value (for all other inventory). The ASC master glossary defines net realizable value as "estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation." Any trade measures that affect the cost of inventory should be reflected in the acquisition cost of those goods. That is, any tariffs levied on inventory purchases would be considered part of the cost of such inventory. In a volatile economic environment, especially if goods are purchased in future periods at a higher cost as a result of tariffs, it may be particularly important for entities to determine whether their inventory on hand has become impaired as a result of their inability to increase prices to customers. Assumptions related to the current macroeconomic environment, as well as the effect of those assumptions on the net realizable value of inventory, should be included in the calculations of net realizable value as part of management's inventory impairment analysis. Further, entities with noncancelable, unhedged firm purchase commitments for inventory should recognize expected net losses to the extent that they are unable to recover such costs through sales.

Further, if supply-chain disruptions affect an entity's ability to operate its manufacturing facilities at normal capacity, management should consider the accounting guidance on inventory to determine which costs may be capitalized. For example, certain manufacturers with facilities that may be operating at abnormally low production levels would be required to expense abnormal overhead costs as incurred rather than capitalize them into inventory.

Long-Lived Assets

Long-lived assets (or asset groups) such as property, equipment, assets under construction, finite-lived intangibles, or right-of-use assets are tested for impairment upon the occurrence of triggering events, which are events or circumstances that make it more likely than not that the carrying amount of the asset (or asset group) is not recoverable. Therefore, management may need to consider whether factors such as rising costs attributable to tariffs have resulted in a triggering event. If so, the entity would first assess whether the asset is recoverable on an undiscounted-cash-flow basis. If the entity determines that the carrying amount of the assets is not recoverable, it would calculate the fair value and measure any subsequent impairment of the assets' carrying value. Regardless of whether the entity recognizes an impairment loss, it should consider whether there has been a change in the remaining useful life or salvage value because of the triggering event that occurred.

Management will need to assess whether historical assumptions about market participants are still sustainable and how its conclusions about such assumptions may affect the price or other aspects of determining fair value. Such an assessment would include consideration of the characteristics of market participants as well as the assumptions they would use when pricing an asset. Assumptions associated with forward-looking estimates or projections related to the long-lived asset impairment process should include reasonable macroeconomic factors that are known or knowable as of the end of the reporting period.

Moreover, an entity may choose to abandon assets (e.g., because of geopolitical crises abroad or decisions to shift supply chains). If so, the entity should assess whether it needs to test the relevant asset groups for impairment and consider whether it must revise estimates that may result in an acceleration of depreciation.

For additional considerations related to impairment or abandonment of long-lived assets, see Deloitte's Roadmap *Impairments and Disposals of Long-Lived Assets and Discontinued Operations*.

Indefinite-Lived Intangible Assets, Including Goodwill

Indefinite-lived intangible assets (such as trade names), as well as reporting units that include goodwill, should be tested for impairment at least annually or more frequently if a triggering event has occurred (i.e., an event or change in circumstances that indicates that it is more likely than not that the assets or reporting units are impaired). If a triggering event has occurred, the entity would compare the fair value of such assets (or reporting units that include goodwill) with their carrying value. For indefinite-lived intangible assets other than goodwill, management should consider whether events and circumstances continue to support its conclusion that an asset has an indefinite useful life in addition to determining whether it must perform an interim impairment test. An entity might perform an interim impairment test if its expected use of the asset changes as a result of certain conditions.

In addition, in such circumstances, public companies should consider their disclosures about critical accounting estimates, including whether these disclosures need to be updated or any early-warning disclosures should be included (e.g., when there is no significant cushion of estimated fair value over carrying value for goodwill reporting units or other material long-lived assets). Such disclosures may include the carrying value of the reporting unit or asset at risk, the key assumptions used in the registrant's most significant estimates, and the sensitivity of such estimates to changes that could reasonably occur as events continue to unfold.

For additional considerations related to impairment of indefinite-lived intangible assets and goodwill, see Deloitte's Roadmap *Goodwill and Intangible Assets*.

Revenue Recognition

Trade policies may affect contracts with customers. Accordingly, entities may need to review the terms and conditions of those contracts to determine any potential impacts on revenue recognition and other related accounting effects. In addition, costs associated with satisfying performance obligations may be affected by tariffs, and entities, particularly those that recognize revenue over time, may need to use significant judgment in determining whether cost increases resulting from tariffs should be incorporated into the estimate-at-completion cost of the contract. This determination could affect the amount of revenue that is recognized in a given period (e.g., for entities using a cost-to-cost measure of progress) and could result in onerous contract losses if anticipated costs to be incurred exceed the remaining consideration under the contract.

Management's Estimates of Cost

In a manner similar to management's consideration of other potential changes in cost over a contract term, the anticipated impact of a proposed or expected change in tariff policy should typically be factored into an entity's estimated costs to be incurred under a contract. That is, when an entity estimates costs related to satisfying performance obligations in a contract with a customer, that estimate, which is made as of the balance sheet date, would take into account the expected impact of tariffs and whether such tariffs will be increased, lowered, or removed. The actual effect of announced tariffs that differ from those used in management's estimates would typically be considered a nonrecognizable (or Type 2) subsequent event. In other words, management's estimates of costs to be incurred under a contract as of the balance sheet date would not be adjusted to reflect the impact of actual tariffs announced after the balance sheet date. It will be important for management to disclose significant judgments and estimates related to its contracts with customers, including significant judgments and estimates associated with the impact of anticipated tariffs.

Economic Price Adjustments

Some contracts may have economic pricing adjustment clauses that automatically allow for the cost increase to be mirrored in a price increase, but many may not contain such a provision. When a contract does not include a mechanism for addressing changing input pricing, potential price increases should not be accounted for until the conditions in ASC 606 for a contract modification are met — that is, an expected price increase passed on to a customer should not be accounted for until it is enforceable. Price increases that an entity passes on to its customers would be considered as part of the transaction price and therefore as additional revenue when or as the associated performance obligation(s) are satisfied. For more information, see Chapter 9 of Deloitte's Roadmap *Revenue Recognition*.

Tariffs that are passed on to customers as increases in the contract price are not considered taxes that are both imposed on and concurrent with a specific revenue-producing transaction. Therefore, additional amounts billed as a result of tariffs would not be eligible for the accounting policy election in ASC 606-10-32-2A under which certain taxes billed to customers can be excluded from the ASC 606 transaction price.

Other Considerations

Tariffs may also affect the ability of an entity's customer to pay amounts due under the contract. As a result, expected credit losses may be affected (and allowances may be required) and entities may need to consider whether a customer's inability to pay affects their conclusion that a revenue contract exists. In such cases, further revenue recognition may be precluded. In addition, many entities may renegotiate contracts, grant concessions, or cancel contracts and may need to consider the accounting requirements for contract modifications and price concessions. For further discussion, see Chapter 4 (on identifying a contract), Chapter 6 (on determining the transaction price), and Chapter 9 (on contract modifications) of Deloitte's Roadmap *Revenue Recognition*.

Revenue Disclosure Considerations

In accordance with ASC 606, entities should remember to disclose the following information related to their estimates made and conclusions reached (this list is not all-inclusive):

- Significant judgments and changes in judgments (ASC 606-10-50-17).
- Revenue recognized in the current period for performance obligations satisfied (or partially satisfied) in a prior period (ASC 606-10-50-12A).
- Methods used to recognize revenue over time (ASC 606-10-50-18).

See Chapter 15 of Deloitte's Roadmap *Revenue Recognition* for further discussion.

Income Tax Implications

Entities should consider how potential profitability, liquidity, and impairment concerns associated with the tariffs might also influence income tax accounting under ASC 740 in affected jurisdictions. For example, a reduction in a jurisdiction's current-period income or the actual incurrence of losses, a decrease in forecasted income or a forecast of future losses, or both could lead an entity to reassess whether (1) it is more likely than not that some or all of the jurisdiction's deferred tax assets are realizable and, in some cases, (2) recognition of a valuation allowance is needed in that jurisdiction. Similarly, changes in profitability or liquidity due to rising costs or intercompany transfer pricing might also result in changes in an entity's assessment of whether certain foreign earnings can remain indefinitely reinvested.

Adjustments to forecasted income (like those assumed for other impairment analyses) may also need to be factored into an entity's estimated annual effective tax rate (AETR). Uncertainty regarding an entity's forecasted income, or a forecasted reduction in an entity's income as a result of changing macroeconomic conditions, might hinder management's ability to reliably estimate its AETR, either because the entity cannot reliably estimate its ordinary income or because the entity's AETR is highly sensitive to changes in estimated ordinary income for the year (e.g., in situations in which ordinary income is closer to breakeven and permanent items do not "scale" with ordinary income). In either case, the actual effective tax rate for the year to date may be the best estimate of the AETR.

Other Financial Reporting Considerations

A tariff that is announced in an executive order issued or other action taken after the balance sheet date typically would not be expected to result in the recognition of an adjustment to the financial statements that is attributable to that tariff as of the balance sheet date (i.e., the executive order or other action would generally be a Type 2 subsequent event [nonrecognized]). However, the impact of proposed or expected tariffs on accounting estimates that are based on projected or forecasted information as of the balance sheet date would generally be considered in a manner similar to other macroeconomic conditions. In such cases, the estimates would typically not be "trued up" to reflect the specifics of the executive order or other action until the period that includes it. See the Disclosures section below for more information.

Subsequent Events

Entities whose reporting periods end before the issuance of executive orders or other actions announcing the tariffs, and that have not issued their financial statements, will need to consider the subsequent-event guidance in ASC 855 to determine the appropriate treatment of their interim or annual financial statements. Such entities will need to evaluate the tariffs' effects on their financial statements and whether the tariffs meet the definition of a Type 1 or Type 2 subsequent event.

As discussed above, we would typically expect tariffs that are announced after the balance sheet date to be a Type 2 (or nonrecognized) subsequent event. For such an event, ASC 855-10-50-2 requires entities to disclose both "[t]he nature of the event" and "[a]n estimate of its financial effect, or a statement that such an estimate cannot be made" if the absence of such disclosures would result in misleading financial statements.

Going Concern

As a result of the tariffs' effects on an entity's operations and forecasted future cash flows, engagement teams may need to inquire whether management has properly reevaluated whether the entity has the ability to continue as a going concern within one year after the date on which the interim or annual financial statements are issued (or available to be issued, when applicable). Management is required to provide comprehensive disclosures in its annual and interim financial statements when events and conditions are identified that raise substantial doubt about the entity's ability to continue as a going concern, even when management's plans alleviate such doubt.

Disclosures

Entities may need to include disclosures about the impact of tariffs in the footnotes to their financial statements (e.g., see ASC 275-10-50-6 through 50-8) as well as in other areas of their SEC filings, such as in MD&A or the risk factors section. The extent of such disclosures would be based on the potential materiality of the impact. For more information about disclosure considerations related to macroeconomic events, see Deloitte's December 1, 2022, *Financial Reporting Alert*.

Risk and Forward-Looking Information

Management may need to discuss with legal counsel whether disclosures related to risk factors, MD&A, and forward-looking information must be updated to reflect the impact of the tariffs either in periodic reports on Forms 10-K, 10-Q, and 8-K or in registration statements that do not automatically incorporate such periodic reports by reference (e.g., Forms S-1 or S-4). For example, risk factors might need to be updated to reflect that these tariffs are likely to affect a company's cost structures, profitability, and consumer demand and that strategic adjustments may need to be made to avoid potential issues with global supply chains. Further, companies that are materially affected by tariffs may consider whether such effects would represent a material known trend that should be disclosed and quantified, to the extent practicable, in MD&A.

Non-GAAP Measures

Quantifying the impact of tariffs may provide financial statement users with valuable insights; however, we believe that the SEC staff may question the use of non-GAAP measures that remove the impact of tariffs. For example, such adjustments might be questioned because:

- Increased costs due to tariffs might be recovered through price increases and adjustments for cost impacts only could be viewed as "cherry-picking."
- Given the uncertainty, it may be difficult to establish that the costs are nonrecurring as opposed to representing the "new normal."
- The SEC staff has previously objected to "normalizing" input costs in commodity industries because of the challenges associated with ascertaining a "normal" market price.

Contacts

This is a rapidly evolving situation, and we encourage entities to monitor the associated impacts on the accounting and reporting conclusions discussed above. Questions about this *Accounting Spotlight* should be directed to the following Deloitte professionals:

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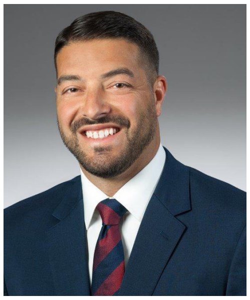
For information about Deloitte's offerings on the accounting and internal control considerations related to tariffs, please reach out to:



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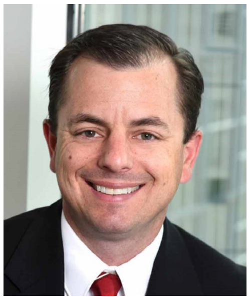

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