In brief

Tariffs: the price tag of global trade on financial reporting

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Key Points

- The imposition of new or increased tariffs introduces complexities for businesses that might affect operating results, liquidity and financial reporting.
- Management should consider the relevant impacts on financial reporting, including cost capitalisation, contracts with customers, impairment of non-financial assets and income taxes.
- Disclosures about an entity’s liquidity, going concern and risks and uncertainties arising from tariffs are crucial.

What is the issue?

As part of international trade policy, many countries have historically imposed tariffs on imported goods. The implementation of new tariffs and increases to existing tariffs, along with the possibility of reciprocal tariffs, has heightened the potential impact on businesses across many industries. Entities might face complex operational and compliance challenges due to the number of items potentially subject to tariffs and ongoing uncertainty surrounding tariff policies. These complexities give rise to a number of accounting implications and disclosure considerations. As entities navigate this shifting landscape, management should collaborate closely with their legal, compliance and operations teams to proactively identify and assess additional risks related to tariffs that could affect operating results, liquidity and financial reporting. It should be noted that this In brief is dated 03 April and therefore only represents the latest status as of this date. This in brief does not reflect any supposed changes after this date.

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What is the impact and for whom?

Tariffs could impact entities in a variety of different ways. Entities that directly purchase goods impacted by tariffs for their operations are likely to experience an increase in costs. Even if an entity does not directly purchase such goods, prices of goods or services increase because of the tariffs, so the entity's costs might still increase if its supply chain is negatively impacted by tariffs. Revenues of entities that sell goods subject to tariffs might also be impacted. Consequently, related financial ratios such as gross margin would also be impacted.

These impacts could result in wide-ranging consequences for financial reporting. Entities will need to evaluate a broad range of factors when assessing the potential impact of tariffs on their financial reporting. The main accounting implications are discussed in this publication.

1. **Cost capitalisation**

Entities might face increases in the costs of purchasing assets subject to tariffs, such as items of inventory or property, plant and equipment. Such an increase in costs of acquisition of the assets does not represent 'abnormal costs'. Therefore, the additional cost arising from new tariffs or increases in tariff rates should be considered directly attributable costs to be included in the cost of the purchased asset [chapter 25 para 19 of the Manual of accounting – IFRS] [chapter 22 para 19 of the Manual of accounting – IFRS]. For example, entities applying the weighted average cost method will need to adjust the cost of existing inventory for the higher cost of newly purchased items.

Inventory is typically recognised as an expense in the statement of profit or loss when sold. Entities would therefore experience an increase in expenses for inventory sold, due to the higher inventory cost from the tariffs [chapter 25 para 42 of the Manual of accounting – IFRS]. Higher cost of property, plant and equipment would also result in higher expenses, in the statement of profit or loss, from the depreciation of the asset cost over its useful life [chapter 22 para 79 of the Manual of accounting – IFRS].

2. **Contracts with customers**

Because tariffs are paid by the importer (or purchaser) of the goods, it is unlikely that there will be a direct accounting implication for a seller of goods subject to a tariff. However, tariffs will almost certainly impact the market dynamics for those goods, and they could require entities to rethink their pricing or distribution model. Whether an entity can pass on the increased cost of tariffs to its customers will depend on the market environment. In some markets, competitive pressures might limit the recovery of incremental tariff costs, resulting in margin compression, which could have broader ramifications for the business.

While some contracts with customers might have price adjustment clauses that automatically allow for an increase in price for an increase in tariffs, many will not. In either case, any changes in pricing precipitated by a change in tariffs will be accounted for like any other price change under IFRS 15. If the price change is contractually specified, it would be subject to the variable consideration guidance [chapter 11 para 77 of the Manual of accounting – IFRS]. If the price change is separately negotiated, it will be treated as a contract modification [chapter 11 para 44 of the Manual of accounting – IFRS].

For entities that measure the progress of performance obligations satisfied over time using costs incurred as an input method, new or increased tariffs introduce additional costs that should be estimated as part of the total estimated costs to complete the performance obligation [chapter 11 para 182 of the Manual of accounting – IFRS]. This might be complex, due to uncertainty regarding the timing, scope and duration of the tariffs. The increase in the total estimated costs might reduce the percentage of completion of the performance obligation, potentially leading to a decrease in the total cumulative revenue that should be recognised.

3. **Impairment of non-financial assets**

Depending on the industry and the significance of the impact, changes in tariffs might increase costs, constrain demand for products, or otherwise disrupt the market dynamics in an industry, any of which might result in reduced future cash flows. These factors could result in entities having to recognise an impairment loss on their non-financial assets.

Some impairment considerations for non-financial assets are as follows:

- *Inventory*

  Inventory is measured at the lower of cost and net realisable value (NRV) [chapter 25 para 34 of the Manual of accounting – IFRS]. Costs are defined in IAS 2; but, for the impairment test, especially for work-in-progress inventory, future tariffs might impact the estimation of costs of completion. For the NRV, an entity should evaluate whether the resulting higher inventory costs affect the 'lower of cost or NRV' assessment and would result in an impairment loss on the inventory. An important part of that assessment might be the entity's expectation about whether it will be able to implement price increases to offset the increased cost from tariffs.

- *Goodwill and other non-financial assets*

  If an entity is significantly exposed to tariffs, the increase in costs, the prospect of decreasing revenues, and reconsideration of investment plans or restructurings might provide an indication that a non-financial asset (for example, property, plant and equipment, investment property or definite-life intangible asset) or a cash-generating unit might be impaired. An impairment test should be performed on such non-financial assets if an impairment indicator is present [chapter 24 para 9 of the Manual of accounting – IFRS]. Similarly, goodwill and indefinite-life intangible assets should be tested for impairment annually [chapter 24 para 10 of the Manual of accounting – IFRS]. Management will need to consider inputs into the impairment test (such as sales volumes, production volumes and margins) to determine how they will be impacted by the tariffs. For example, higher tariffs are likely to lead to increased input costs, lower margins and possibly lower sales volumes, which would result in a higher risk of an impairment. Another key assumption might be any expected new tariffs or changes to existing tariffs, and whether entities think that tariffs will be in place indefinitely or might be subject to change in the future.

4. **Income taxes**

Unexpected costs and the potential for long-term impact on an entity's operations arising from new or increased tariffs should be considered when determining the recoverability of deferred tax assets.

In addition, the tariffs could create other accounting impacts that an entity will need to assess for related income tax consequences. For example, the impairment of non-financial assets or goodwill might have an impact on an entity's deferred taxes.

Companies should also consider whether the introduction of new tariffs has an impact on existing transfer pricing arrangements, or whether any changes to transfer pricing arrangements to attempt to mitigate the impact of tariffs could give rise to any new uncertain tax positions under IFRIC 23 [chapter 14 para 146.1 of the Manual of accounting – IFRS].

5. Disclosures and going concern

Companies should consider disclosure requirements, including those related to risks and uncertainties arising from new or increased tariffs. IAS 1 [IFRS 18] also requires an entity to disclose information regarding its use of judgements, assumptions and sources of estimation uncertainty [chapter 4 para 152 of the Manual of accounting – IFRS] [chapter 4 para 155 of the Manual of accounting – IFRS] [chapter 3 para 50.4 of the Manual of accounting – IFRS] [chapter 3 para 50.7 of the Manual of accounting – IFRS].

For example, an entity should consider providing disclosure of the effects of the tariffs on:

- significant assumptions or sources of significant estimation uncertainty applied in impairment assessments of non-financial assets;
- assumptions made in relation to forward-looking information used in expected credit loss (ECL) estimates;
- the recoverability of deferred tax assets; or
- the liquidity risk of the entity.

FAQ 4.157.1 – Which areas could require disclosure in respect of estimation uncertainty?
FAQ 4.158.1 – How should an entity disclose estimation uncertainty for assets and liabilities carried at fair value that might be subject to significant market fluctuations in the following year?
FAQ 47.94.1 – What are the disclosure requirements for ECL model adjustments?

If new or increased tariffs are expected to have a significant impact on an entity's operations, that could translate to an impact on liquidity and, in turn, the entity's going concern assessment. Even if an entity's financial statements continue to be prepared on a going concern basis, disclosures are required where there are significant doubts or material uncertainties about the entity's ability to continue as a going concern. [chapter 4 para 27 of the Manual of accounting – IFRS]. [chapter 3 para 2.16 of the Manual of accounting – IFRS].

What else do I need to be mindful of?

As tariff policies (including retaliatory tariff policies) evolve, entities need to continue to monitor legislative and regulatory developments for potential accounting and reporting implications. Depending on when changes are announced or implemented relative to an entity's reporting end date, the entity might need to consider IAS 10, 'Events after the reporting period', possibly resulting in changes to measurements or disclosures [chapter 9 para 1 of the Manual of accounting – IFRS].

FAQ 9.5.5 – How should events after the reporting date affecting impairment calculations related to non-financial assets with a measurement basis other than fair value be accounted for?
FAQ 9.5.6 – How should events after the reporting period affecting remeasurement/impairment calculations related to assets with a measurement basis of fair value be accounted for?
FAQ 45.64.2 – To what extent should additional information after the reporting date be included in the ECL estimate?

Where do I get more details?

For more information, contact Christoph Wimmer or Ulf Kuehle.

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