UHY LLP
Certified Public Accountants

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In This Issue:

ACCOUNTING IMPACT OF TARIFFS

Introduction

Governments use tariffs, a tax on imports or exports, as a source of government income; and to protect domestic industries from foreign competition. Title 19 of the Code of Federal Regulations, Section 141.1 authorizes the levying tariffs on the importer of record at the time of import. The US Customs and Border Protection office is responsible for enforcing the tariffs and collecting the duties. The tariff rates vary depending on the product classification and origin as defined in the Harmonized Tariff Schedule of the United States. It is the responsibility of the importer to exercise reasonable care to ensure that the imported item is properly classified based on the product attributes and origin.

Mitigating impact of tariffs

Importers have several options to mitigate the impact of tariffs on their profitability. One option is to renegotiate pricing with the foreign exporter to lower the selling price to offset the additional cost of the tariff. An importer may also request an exemption from the tariff. The exemption can be based on an insufficient quality or quantity being available from a US source or on the basis of national security.
To avoid the tariff altogether, an importer can identify an alternative source or reconfigure the items being imported to warrant a different classification not subject to the tariff. Ultimately, the importer may be unable to avoid the tariff. Ideally the importer will be able to pass along some of the cost to the customer but due to the competitive environment or contractual obligations may have to absorb at least some of the cost of the tariff. The following are some potential impacts tariffs may have on a company's accounting.

Inventory and cost of goods sold

The cost of the tariff is reflected in the inventory value and cost of goods sold of the importer, as a necessary expense to directly or indirectly bring the item to its existing condition and location. Companies using a standard costing system will need to update their product costs impacted by the tariffs. In addition, Accounting Standards Update (ASU) 2015-11 requires inventory to be recorded at the lower of cost or net realizable value. Net realizable value is defined as the expected selling price in the ordinary course of business less the cost of completion, disposal, and transportation. If value recorded in inventory exceeds the net realizable value as a result of the new tariffs, the inventory value of those products will need to be written down in the current period.

Continued on Page 2...

The next level of service

Continued from Page 2...

Transfer pricing

Tariffs can also have an impact on transfer pricing. The tariffs can affect the comparability and validity of benchmarking data used to demonstrate an arm's-length transaction value. The financial data used for such analyses may not reflect the latest tariffs because of the time lag in reporting and the general lack of specific country-to-country data. If the changes in tariffs result in transfer pricing adjustments to qualify as an arm's-length transaction then the values used to determine the duties owed may be affected. Customs agencies consider transfer pricing adjustments to be part of the value of the imported goods. Any transfer pricing adjustment should be evaluated for reporting which may result in additional customs duties to be paid or refunded depending on the direction of the adjustment.

Revenue recognition

If a company is party to a variable price contract which includes an enforceable right to adjust prices for tariff increases, Accounting Standards Codification (ASC 606) requires companies to estimate the impact of the pricing changes when determining the transaction price. In the case of a long-term contract with one performance obligation the tariff would be immediately reflected in both the revenue and cost estimates expected over the life of the contract. If there are multiple performance obligations the revised pricing reflecting the tariff costs would be recognized as each performance obligation is satisfied. Furthermore, if the company has entered a contract that does not include an enforceable right to increase prices to offset new tariffs and the cost now exceeds the contracted price; the company may now be in a loss-contract for which the entire loss attributable to the contract must be recognized in the current financial reporting period.

Long-term assets

Decreased profit margins resulting from the inability to pass along the additional customs duties to customers may impact the valuation of long-term assets such as goodwill, property, plant and equipment, and customer lists. According to ASC 360-10 companies are required to perform an impairment test when there is a change in events or circumstances that indicate the carrying amount is not recoverable. A decrease in cash flows generated from the asset caused by an increase in tariff costs could trigger the need to test for impairment. Typically, companies perform this testing annually. Complicating matters with any impairment analysis will be how to estimate the future changes in tariffs. The impairment loss resulting from the tariffs would need to be recognized in the current period.

Conclusion

The costs of tariffs impact the value of a company's inventory and cost of goods. Inventory values may need to be written down if the cost exceeds the net realizable value of the inventory. Tariffs also affect the ability to justify transfer prices as an arms-length transaction and may result in additional adjustments to customs duties. Under the new revenue recognition standards price increases may need to be recorded based on the number of performance obligations and if the new tariffs increase the cost above the price that can be charged may result in large write-off for a loss-contract. All together the additional costs of tariffs may also result in the impairment of assets and have a dramatic effect on the bottom line.

By Gregory Herbster, Senior Manager (St. Louis, Missouri)

CURRENT STATE OF THE MANUFACTURING INDUSTRY

According to a new Standard & Poor's report, there are two key indicators that will tell you what kind of shape the manufacturing industry is in. The first is the Institute for Supply Management's Purchasing Manager's Index and the second is the Federal Reserve's Capacity Utilization Index for motor vehicles and parts. A reading above 50 percent for the ISM index indicates that manufacturing is expanding in the US, and below 50 means that it is contracting. History shows that each time since 1983 that the index fell below 43 percent "speculative grade" automotive companies began to panic. Similarly any time the Fed's utilization rate dropped below 72 percent during that period, it caused stress to automotive companies. Let's take a look back at the trend over the past year:

RECENT TREND

AS OF **DEC '19**

ISM Purchasing Manager's Index: 47.2%

Fed Capacity Utilization Rate: 75.2%

AS OF **AUG '19**

ISM Purchasing Manager's Index: 48.1%

Fed Capacity Utilization Rate: 75.7%

AS OF **JUN '19**

ISM Purchasing Manager's Index: 49.1%

Fed Capacity Utilization Rate: 75.7%

AS OF **FEB '19**

ISM Purchasing Manager's Index: 51.7%

Fed Capacity Utilization Rate: 78.1%

MANUFACTURING INDUSTRY INSIGHT

UHY LLP recognizes that manufacturing companies require their auditors, tax specialists and business advisors to add value to financial reporting activities. That is why we combine the strength of business and financial expertise with a hands-on, "shop floor" approach to solving complex business decisions in these key segments:

- Aerospace & Defense
- Distribution
- Automotive Suppliers
- Industrial Manufacturing
- Consumer Products

Our professionals are leaders in the industry and take the steps necessary to ensure our client's future success by identifying and addressing new trends, accounting requirements and regulations.

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