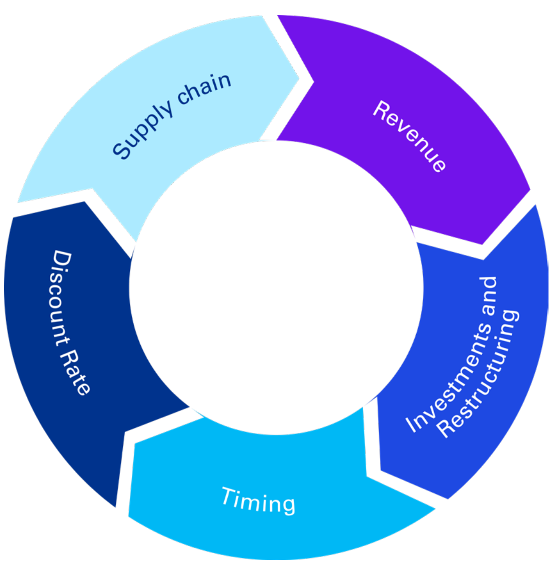
Tariffs and valuation

Recent updates to US tariffs on imports from Mexico, Canada and China, as well as reciprocal global tariffs on other countries, along with retaliatory tariffs, may cause supply chain disruptions and other uncertainty that significantly affects businesses. Tariffs can alter trade dynamics between countries and worldwide and potentially shift economic growth trajectories. As a result, tariffs can have a substantial effect on any valuation analysis.

The following steps can be used to assess rapidly changing policies and environments that are creating significant uncertainty which may need to be reflected in any valuation analysis.

What is happening?



Tariffs are nothing new – they have been part of international trade for centuries and companies know how to reflect them in their projected financial information (PFI). The challenge arises due to the pace of change and the level of uncertainty about the applicability and duration of tariffs and potential other retaliatory measures. Companies and their valuation specialist need to monitor these developments closely and reflect them in their analysis.

Supply Chain

Supply chains might need to be realigned, and production cost may increase due to tariffs increasing the cost of inputs

Revenue

Companies might have to increase prices to offset higher costs adversely affecting sales volume

Investments and Restructuring

Companies might have to consider investment decisions or restructure operations based on the shifting environment

Timing

Which tariffs to consider and when? Announced, proposed, enacted?

Discount Rate

What is the effect on the discount rate?

Consider cash flows risk and macroeconomic shifts (currency and country risk)

Scenario analysis might have to be considered

Step 1: Assess the effect of new tariffs and other measures on operations and projected financial information

New import tariffs and other measures may significantly change market conditions or a company's expectations about its performance.

For example, tariffs may:

- **Affect sales:** Tariffs may change the competitive environment and disrupt sales to key markets. Some companies (e.g. exporters) may decide to reduce the sales prices of products affected by the new tariffs. Others may decide to pass on the cost to their customers. The overall effect on future revenues will mainly depend on the sensitivity of demand for the company's products to price increases, the company's competitive position and exchange rate fluctuations.

- **Increase production costs:** A company may use imported components and raw materials that are subject to tariffs. This may result in lower profit margins if the company decides not to pass on the cost to its customers.

- **Affect investment or business plans:** If tariffs are expected to lower profits, then a company may reconsider its investment plans or decide to close or relocate its production facilities.

- **Affect a company's transfer pricing:** A company with a complex supply chain that crosses international borders may be affected by tariffs. In response, companies might realign their transfer pricing to the changes in the economic environment.

Step 2: Valuation considerations

Timing of the tariffs – Which tariffs to consider? Enacted, announced and proposed.

As part of a valuation analysis a company will have to consider a market participant or investor view when deciding which tariffs and other measures to reflect in the valuation analysis. In general, as of the valuation date, we recommend that tariffs reflect a market participant or investor perspective and therefore consider:

- Enacted and in force as of the valuation date,
- Announced, and
- Proposed and expected to become effective in the immediate future – if sufficient information is available and the effect is expected to be substantial.

Similar consideration should be given to retaliatory tariffs and other countermeasures.

What is the effect on cash flows?

Budgets and cash flow forecasts prepared by management generally serve as the starting point for estimating the future cash flows. Companies need to consider how tariffs change their strategy and/or business plans and reflect that in the projection of future cash flows. Significant assumptions, such as forecast sales, growth rates, inflation rates, profit margins and capital expenditures, need to be reassessed and updated.

How to consider tariffs in the valuation analysis

Broadly speaking a valuation analysis considers two approaches to project cash flows which theoretically are expected to result in the same outcome.

- **Single cash flow approach ('traditional approach')**: Under this approach, a company uses a single most likely cashflow projection.
- **Scenario analysis or expected cash flow approach ('ECF approach')**: Under this approach, a company uses multiple probability-weighted cash flow projections.

Although the traditional approach is more common, in some cases it may be more appropriate to use a scenario analysis approach to capture the effect of tariffs – e.g. if as a result of the tariffs significant downside scenarios are more likely and/or more severe than the upside scenarios or if there are a limited number of distinct outcomes to consider that a traditional approach is ill equipped to approximate.

What is the effect on the discount rate?

The discount rate reflects a market participant or investor's view of the risks embedded in the cash flows or projected financial information of an entity. The approach to reflecting the uncertainty about the future cash flows in the discount rate differs depending on the approach applied.

- Under the traditional approach: a company makes an adjustment to the discount rate for any cash flow uncertainty not captured in the single cash flow projection.
- Under the ECF or scenario approach: the uncertainty is considered in estimating the cash flows and the probabilities attached to them. Therefore, the discount rate should only consider risk elements not considered in the different scenarios.

Whichever approach a company uses, the rate used to discount cash flows should not reflect adjustments for factors that have been incorporated into the estimated cash flows and vice versa. Otherwise, the effect of some factors would be double counted.

Conclusion

The announcement and introduction of US import tariffs and responding actions by other countries have substantially increased market uncertainty that will need to be considered in any valuation analysis for valuation dates after the announcement. We believe considering the effect in the projected financial information to the extent that is feasible would be the preferred approach. This can be done either in a single cash flow forecast or as part of distinct cash flow scenarios.

In situations where inclusion of the effect in the cash flows is not feasible, a well supported adjustment to the discount rate may be warranted. Unless it is possible to show that the subject company is not significantly affected by the increase in uncertainty, it would not be appropriate to ignore the increased uncertainty in the discount rate or the projected financial information.

Regardless of how the effect is considered, detailed documentation of assumptions and significant judgments may be required. Developing a sensitivity analysis and ranges of possible outcomes may be useful tools to assess and document the effect.

Step 3: Financial Reporting considerations and additional resources

Impairment

Goodwill and long-lived assets: Increased costs, changes in customer demand or supply chain disruptions due to tariffs could give rise to an impairment triggering event. If a quantitative impairment test is required, it may be necessary to adjust previous assumptions used in financial projections, such as sales growth, supply costs, tariff costs and capital spending. See chapters 5 and 6 of **KPMG Handbook, Accounting for economic disruption.**

Additional resources

- **KPMG Handbook, Accounting for economic disruption**
- **KPMG Handbook, Impairment of nonfinancial assets**
- **KPMG Handbook, Going Concern**
- **KPMG Issues & Trends, Q1 2025 Quarterly Outlook**
- **KPMG IFRS Today, How will new import tariffs affect impairment testing of non-current assets?**
- **Digital Hub – Financial reporting in uncertain times**

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