Ready?
Or not.

The next phase of IFRS

A major new initiative of the International Financial Reporting Standards (IFRS) demands knowledge, effort and resources for effective implementation.

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## Ready? Or not.

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"The current phase of IFRS implementation introduces an unprecedented level of change. Because they’re so complex and the changes required so fundamental, each of these four standards will have a significant lead time in terms of implementation. Regardless of your resources, it’s going to be a long journey to get where you need to be. Implementing new technologies? Developing new systems? Renegotiating contracts and covenants? Everybody should be thinking about this now."

– Kristy Carscallen
The next phase of IFRS

The latest standards will take knowledge, effort and resources to implement.

Within the next two years, a major IFRS initiative involving four new standards will come to fruition. These standards cut a broad swath across the business world and will not be limited in their application or impact to any particular size or type of company, or—if IFRS 17 excepted—to any one industry or sector.

IFRS 9 Financial Instruments, IFRS 15 Revenue from Contracts with Customers, IFRS 16 Leases and IFRS 17 Insurance Contracts—all of which come into effect in the next five years (most sooner)—will have major and often far-ranging impacts on companies as diverse as banks, telecommunication companies, retailers, utilities, construction and manufacturing. IFRS 17 is set to radically alter the way insurance companies report their performance.

Importantly, companies—excepting those following Accounting Standards for Private Enterprises (ASPE)—will not be able to avoid assessing the impact of these new standards and their readiness to adopt them, even if they initially believe they won’t be impacted. The complexity of the new standards means there is no way to truly know the impact on results without some form of analysis. Moreover, companies will have to disclose information about how they are proceeding with their implementation plans and the impact that the adoption of the standards will have on their financial reporting. Regulators are expecting expanded disclosures in 2017.

For some companies, the current phase of IFRS implementation may be more challenging than the initial Canadian IFRS implementation in 2011. That makes it absolutely critical for companies to prepare. With this level of change in the offing, companies must not underestimate the work required in advance of adopting each of the standards. Developed to raise awareness around scope—as well as implementation and governance considerations—this report covers the elements of each standard; outlines which industries may be most affected; looks at specific impacts that go beyond financial reporting (e.g., tax, IT and HR/compensation); and considers what management, boards and audit committees should be doing to prepare for, oversee and facilitate implementation and compliance.

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IFRS 9 – Financial instruments

“Companies that hedge commodities or hedge with options can benefit most from early adoption of IFRS 9 as it simplifies hedge accounting and can help reduce volatility on the profit and loss statement. Some companies were able to significantly increase their net income in the first quarter (from $40M to $80M in one case) by early adopting.”

– Sylvie Monette

In full effect: January 1, 2018¹ (annual periods beginning on or after January 1, 2018; early adoption is allowed)

Most prominently affects:
financial institutions; companies with large global operations and complex financial strategies using hedging and derivatives; commodity-based businesses, such as mining, transportation and O&G

IFRS 9 represents a fundamental shift in accounting for financial instruments and will have enormous impact on all financial institutions (FIs)—banks, insurance companies, finance companies—as well non-FI companies that use hedging to manage risk. Changes will be seen in three major areas: classification and measurement; hedge accounting; and impairment provisions, where the biggest impact will be seen.

With respect to classification and measurement, the criteria used to determine how financial instruments are classified are changing. Organizations with many financial instruments will have the biggest task, as they must determine if and how classification has changed for each one. Banks will obviously be the most affected by these provisions.

The news around hedge accounting is probably better in several respects. For example, some of the stricter hedge accounting principles have been eased and are now more aligned with risk management principles. As well, non-FIs may see more opportunities; for instance, those companies heavily affected by commodity prices may choose early adoption of IFRS 9, opening up more hedging options. Having noted these positives, IFRS 9 does introduce some new complexities, so organizations need to look at current hedging strategies and exposures to ensure existing hedge relationships meet—or are adapted to meet—IFRS 9 requirements by January 2018.

¹ Amendments to IFRS 4 permit many insurers to defer adoption of IFRS 9 until the implementation of IFRS 17 or January 1, 2021 at the latest, although certain disclosures are required from 2018 onward.
New impairment rules for calculating the allowance for credit losses on loans or investments are by far the most significant change brought by IFRS 9. The incurred loss model is being replaced by an expected loss model (i.e., instead of only setting loan provisions for losses actually incurred, companies will have to provide against losses they can reasonably expect to incur). Essentially, companies no longer wait until something goes wrong to recognize a loss. Rather, by following credit deterioration on every loan that goes on the books, companies can classify them as either having the same risk today as they did at origination (classified as stage 1) or having significantly greater risk than at origination (stage 2) and make loan provisions according to that risk.

Historically, risk management has focused on loan risk in absolute terms; IFRS 9 looks at changing risk over the life of the loan—which is a fundamental change in thinking.

FIs and any company that will potentially be affected must ensure they fully understand these principles and their repercussions, which means conducting gap analyses and impact assessments. Moreover, they must address the need to implement predictive models that can effectively render IFRS 9 relevant results—either by developing them in-house or buying from service providers.

In an unusual measure, the Global Public Policy Committee—comprising KPMG, BDO, Deloitte, EY, Grant Thornton and PwC—issued a joint paper to help audit committees meet their IFRS 9 responsibilities. Specifically addressing the topics of “increased complexity,” “diverse range approaches and outcomes” and “the time and effort involved in implementation,” the paper speaks to the seriousness and difficulty surrounding IFRS 9 implementation.

Assess the impacts and develop a plan to mitigate any negative consequences. The implementation plan should involve discussions with analysts, shareholders, regulators and providers of finance.
IFRS 15 - Revenue from contracts with customers

"Along with the challenges companies will have to generate financial reports under the new standards, users of those reports will have to adjust as well. IFRS 15, for example, changes how revenue is recognized, but cash flows—which indicate the underlying health of the business—won’t change. Analysts and the investors who heed them will need to consider things like these impacts.” – Karyn Brooks

In effect: January 1, 2018
(for year ends beginning on or after January 1, 2018, earlier application is permitted)

Most prominently affects: telecommunications and technology industries, as well as companies party to long-term contracts with customers

This new standard is a major change from the old and will affect almost all companies (since almost every company has revenue) and virtually every industry (though specific impacts will vary). The new five-step model requires a different way of thinking about revenue that could impact both the amount and timing of revenue recognition.

The model not only requires significant judgements and estimates to be made, but it also disconnects revenue from cash flows, which may have an effect on key metrics. In addition, the new standard includes specific guidance on costs incurred to obtain and fulfil contracts, which may change some current accounting practices. It also requires detailed disclosures about revenues, which have not been required in the past.

IFRS 15 could impact: timing of revenue recognition; profile of margin on contracts; systems and processes, including data collection; contract negotiations with customers; revenue-based metrics; debt covenants and employee-reward schemes; and disclosures in financial statements.

Many companies that have started their IFRS 15 project have identified three areas that need further analysis, even if their initial assessment indicated they would not be impacted by the standard.

1. Change management

The new revenue standard differs significantly from that of the first IFRS adoption. The initial changeover to IFRS was, in many respects, largely a corporate initiative that resulted in some changes to the numbers, but did not have a huge impact on the business. IFRS 15, however, could have substantial impact, as it reaches farther into the business and will affect companies’ top lines. Once the ramifications reach operations, implementation becomes a much bigger change management event.

5-step model for revenue recognition

1. Identify the contract with a customer
2. Identify the performance obligations
3. Determine the transaction price
4. Allocate the transaction price
5. Recognize revenue
2. **Timing of revenue recognition**

Different industries may be affected in different ways by changes to the timing of revenue recognition. Some may go from recognizing revenue at a point in time to recognizing it over time; in other industries, it may be vice versa. In contract manufacturing, for instance, revenue is currently recognized when the products are shipped to the customer. However, because those products have value only to a specific customer, the revenue—even if amounts don’t change—may be recognized over time under the new standard, rather than when shipped. This change also may impact the balance sheet.

3. **New revenue items**

Depending on whether they are material or not, some new items may now be included as revenue for some companies. For instance, consider a company that offers a free product to customers for signing a new contract. Today that product is considered a marketing expense. Under IFRS 15, it will be considered a promise to the customer, meaning some revenue must be attributed to the free product and recorded as such.

To comply with IFRS 15 before January 1, 2018, companies will need to analyze contractual arrangements using the five-step model; review existing accounting policies, practices, contracts, processes and IT systems to make whatever changes are necessary; then report effectively and accurately under the new standard. Since many contracts contain non-standard terms and conditions, implementation can be a time-consuming effort and impacted companies should be well on their way. If not, there should be a sense of urgency, including new controls that will affect internal controls certification.

Companies will have to choose between certain options as they transition to IFRS 15. These may depend on data availability and the amount of time they have left themselves to determine what constitutes revenue under the new standard. The different transition options and choices made should be carefully analyzed and understood so companies can explain their results in the marketplace.
IFRS 16 - Leases

In effect: January 1, 2019
(early adoption is allowed in conjunction with IFRS 15)

Most prominently affects:
retail, power and utilities, banks,
telecommunications, transportation—or any
lessee companies with a significant number
of operating leases

Today, operating leases are accounted for
off-balance sheet. With the introduction of IFRS
16, companies will recognize operating leases on
balance sheet—a major change. This standard is
data and calculation-heavy and companies with
many leases will need robust IT systems to
ensure effective implementation and
compliance. Many companies will have to
upgrade or change those systems to get the job
done, so IT projects may result. Although the
standard isn’t immediately in effect, IT work and
resource allocation should be considered now as
implementation may be both time-intensive and
costly.

Determining the right transition approach can in
itself require significant analysis. There are
several approaches available, as well as
individual options and practical expedients that
can be chosen as needed, some on a lease-
by-lease basis. Large companies will have a huge
number of potential permutations to consider.

Along with the calculation requirements, the
standard will involve significant new judgement
thresholds that will affect the identification,
classification and measurement of lease
transactions, as well as new required
reassessments throughout the lease term.
IT systems may need to be upgraded or
modified to ensure all leases are captured and
appropriate data accumulated.

Companies should begin inventorying their
leases soon. Information gathering is the key
starting point. There are also many decisions to
be made related to the standard. Several tactical
exemptions were added in the last stages of the
standard’s development and companies will
need to fully understand them to leverage them
effectively. For example, transition is an area
where companies have been given several
options that may reduce the cost of
implementing the standard. It will also be
important for companies signing and negotiating
new leases to consider how they will be affected
after IFRS 16 implementation.

Two practical expedients:
a lessee can elect not to apply the IFRS 16
lessee accounting model to short-term leases
(lease terms less than 12 months) or
low-value leases (under $5,000).
In effect: January 1, 2021
(annual periods beginning on or after January 1, 2021; early adoption is allowed)

Most prominently affects: recognition, measurement, disclosure and presentation of insurance contracts within the scope of the standard, significantly impacting all insurance and reinsurance companies

Slated for issue in May 2017, IFRS 17 (currently in draft form but substantially complete) will mark wholesale change for insurance companies, affecting insurers both big and small. It will not only change financial statements—for example, in terms of how profit is recognized, key financial metrics and disclosures—but also things like data management, IT systems, processes, level of analysis and projections. Planning for implementation will require thoughtful change management, in particular, given that insurers will need to address these changes hand in glove with the changes to accounting for financial instruments.

These changes are more deep seated for insurance companies than was the adoption of IFRS in 2011 since IFRS 4 grandfathered existing Canadian accounting methods for insurance contracts. This will not be the case with the forthcoming IFRS 17; the changes will significantly affect all insurers headquartered in Canada, as well as resident foreign insurers.

While the level of impact will depend to some degree on what products a company sells, there will unquestionably be across-the-board changes regarding the data gathered in relation to those products, the systems used to analyze and process that data and the financial statements themselves, including their look and feel, transparency and amount of analysis required.

A good example of the extent of change on the way can be seen in the profit recognition calculation. Historically, insurance companies in Canada have been able to recognize profit as soon as a product is sold. There is now a new concept around the contractual service margin that requires insurers to amortize profits over the period in which they deliver their services—a completely new calculation.

*Currently in draft form

The more lines of business and product versions you have, the more time you’re likely to need to implement.
IFRS impacts beyond financial reporting

While the impact on financial reporting as a result of the new standards is the most obvious of the relevant impacts, certain areas beyond financial reporting should not be overlooked.

Information Technology
In the early days of IFRS, some companies tried to get by with patch-work solutions, adapting legacy systems and making the necessary adjustments on spreadsheets. To accommodate new IFRS requirements, however, many will need or want to make more substantive changes to their IT processes and systems, from reconfiguring data collection parameters, to developing new analytical models, to implementing entirely new financial modules or systems. Recognizing the need, however, is just the beginning. If a large technology change is required, companies also need to get that process underway. Where there are significant changes as a result of implementing the new standards, an Excel “fix-up” now may mean trouble later. Rather, forward-thinking organizations are investing in technology solutions, bringing on technical accounting advisers and expanding technology risk management processes.

The new standards will require some companies to change the way they not only gather data, but the way they group, cut and analyze it, which has wide-ranging system implications. Since entirely different calculations will be required for some standards, for example IFRS 15 and 17, the technology employed must be able to access the right data and transform it to suit new reporting requirements in a sustainable way. Compared to 2011, many new data requirements and system-based calculations necessitate a more seamless interaction with ERP systems—an integration process that can be very complicated to work out. Multiple systems may have to be updated or changed out entirely.

And of course, the bigger the company and the more globalized the industry, the bigger the challenge. Some industries where significant IT change is required, for example telecommunications, are concerned they won’t be able to get everything done in time—even some that have been working on the transition for years. Moreover, as new systems are implemented to execute on new business processes, an appropriate IT control environment must also eventually be built, tested and evaluated. The point is, there’s a very real risk that appropriate systems won’t be in place if IT needs are not properly scoped early on.

“The goal is to build an overall solution that integrates close cycles with technological processes and systems that will be sustainable as future IFRS changes are made.” – Dilshad Hassen
Tax
Depending on the tax jurisdiction, each standard could have significant specific impacts. For example, under IFRS 16, a number of assets and liabilities will now be on the balance sheet that weren’t there before, which in turn means new tax balances. Multinationals may be particularly affected. Also, types of tax beyond income tax may be impacted—for example, commodity tax, which may not immediately be considered by all companies. To address this, it is important to get tax specialists involved early to discuss the changes and ensure the proper analysis is done for income tax, commodity tax and any other affected areas.

HR/compensation
Implementation of the new standards could alter metrics currently used in some compensation plans. To the extent those metrics shift, compensation payouts may also change. For example, the new revenue standard may move revenue earlier or later and may result in different revenue allocations across products, divisions, segments or groups. As a result, companies will have to look at their plans’ performance tracking and incentive compensation metrics to see if they need to be changed. Absent any adjustment to those metrics, people may find their compensation to be drastically different than before the adoption of IFRS 15.

Covenant renegotiation
The implementation of IFRS 16 may require the renegotiation of certain bank covenants, so it is important to begin the process now. Since covenants generally specify ratios of assets to liabilities that must be maintained, changing the recognized asset base—which will happen once all operating leases are moved to the balance sheet—will change those ratios and may put borrowers offside their covenants. As a result, agreements may have to be renegotiated—a time-consuming effort that should not be ignored. Determining the impact of IFRS 16 is the first step.

Investor relations
Once the four standards are in place, companies will be providing substantially more disclosure in the notes to the financial statements. This will have an impact on investors, analysts, competitors and anyone else using the statements. Investor confidence needs to be maintained during the entire change cycle, meaning they need to be kept up to date and educated on the changes underway—for example, why and how revenues and debt ratios are changing and how management is arriving at key estimates. Investors will want to be reassured that cash flows do not change. To this end, the board needs to exercise oversight over all investor-related aspects of the change process.

“We’ve been encouraging companies to talk to their tax group early. There will certainly be some tax fallout associated with upcoming IFRS adoption. Any change to the financial statements will drive tax changes. It’s important to monitor and consider to what extent tax authorities may try to align with the new standards or implement specific standards-based changes—or whether impacts will arise more from existing rules around deferred tax.”

– Jeff King
Management, boards and audit committees

We conducted multiple interviews with KPMG partners and professionals who deal directly with IFRS conversion and implementation issues. This yielded a strong core of key questions that executive management, boards and audit committees should be asking about their companies’ implementation strategies.

Key questions for management

- Have gap analyses and impact assessments been done to understand what IFRS changes will mean to the business overall?
- Where significant changes have been identified:
  - Is IFRS transition a top item on the C-suite agenda?
  - Is there a fully fleshed out, company-wide implementation plan in place, with a detailed timeline that includes controls design and testing?
  - What changes to IT systems/capabilities, controls and business processes will be required? Is IT at the table to help facilitate the process from the beginning?
  - Has a change management plan been considered to help educate people throughout the business as to what these changes will mean for them and their function?
- Is there a communication plan in place to educate the board and audit committee on the new standards and to update them on transition progress, results and issues? Is there a plan to similarly manage investor relations?
- Are the resources and the right people in place to ensure implementation goes smoothly? Has the need for additional resources been considered?
- Are the new standards and models being applied in test cases?
- Is the company monitoring its transition plan? If progress stalls, what has to happen to get back on track? Is progress being tracked against that of peers?
- Are all needed functional areas (e.g., Tax, IT and HR) fully engaged and participating?
You’re facing the accounting changes in nearly a decade. Your stakeholders are already in the mood for asking questions. They will expect to be kept informed, so it will pay to be prepared on all fronts.

Key questions for boards and audit committees to ask management

☐ Is the company planning to implement new models and requirements on a level that is robust, but aligned with the size and maturity of the organization?

☐ With different data being required and different estimates and judgements being made, is there confidence in the accuracy and relevance of those accounting outcomes?

☐ Are the right internal groups—such as tax, IT, treasury and risk—at the table, engaged and collaborating on the overall effort?

☐ Are the right questions being asked around what’s not being done and why?

☐ What is the expected cost of the implementation effort?

☐ Is IFRS transition on the board and audit committee agendas as well as that of the risk committee?

☐ Is there a core understanding of the standards applicable to the organization as well as the extent of the changes and the work effort involved?

☐ Is there an understanding of management’s project plan, including impact and gap analyses, responsibilities, documentation of procedures, key milestones and overall timelines? Are those timelines realistic?

☐ What resources are currently in place and what steps is management taking to ensure any gaps are being filled?

☐ Is the company overseeing the right risks, monitoring changes to internal controls and doing so on an organization-wide basis?
“The board has a major role to play in IFRS, starting with fully understanding the standards and asking hard questions of management about their impact: Do we have the right resources? How does the timeframe look? What are some of our peers doing? And the audit committee needs to be on top of the process as well, as they will wear some of the pain if there’s a restatement after the fact. Start asking questions to management now; simply saying ‘this doesn’t apply to us’ isn’t sufficient.” – Todd Buchanan
Everybody has work to do

Ready or not, change is coming. And while IFRS impacts will be different for everybody, it’s critical that no company underestimate the potential challenges this complex process will bring.

Some companies will say they won’t be significantly impacted by the new standards. That may be true in some cases, but work must be done to confirm that assertion and to document all accounting decisions. Certainly, the less complex operations are, the simpler implementation becomes. However, it will be necessary to demonstrate to regulators that the requirements of the new standards have been implemented and internal controls are robust. The company must also document the impact of any work-arounds or materiality decisions taken when assessing the internal controls environment.

Public companies that will be affected by any of the four new standards discussed above should be sure to communicate regularly and meaningfully with investors about expected change. The board also needs to exercise strong governance over the change process.

Insurance companies, in particular, have not seen this magnitude of change in a long time, so no stone should be left unturned to ensure successful transition.

No company wants to face regulatory or business challenges because the transition has morphed into a crisis scenario. IFRS impacts are different for each company, so it is important to take the time to analyze what the changes mean for you.

Experience shows that many companies will underestimate the work required, especially given that multiple IFRS adoptions will be required in a compact time period. Don’t be caught short. Leave enough time to allocate and engage the appropriate resources, develop the processes and build the systems needed to successfully transition to—and thrive within—the new IFRS.

“Companies are trying to figure out the best, most efficient, most business-aligned way to adopt multiple standards. Do you take the big bang approach and try to adopt all at once, or spread things out and adopt as required? That decision affects everything else. For instance, how quickly do you need your budget to reflect the new standards? How will compensation and measurement be affected? What impact will this have on technology spend? Questions beget questions; everybody has work to do.”

– Sebastian Distefano
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What do online consumers really want? This global survey asks 18,430 consumers about their most recent online shopping experiences. http://bit.ly/2jl0YGt

Stay informed on recent developments in a number of areas of interest at kpmg.ca, and bookmark the Canadian IFRS webpage (kpmg.ca/ifrs) to gain access to need-to-know information on international standards in the accounting and regulatory space.
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