

Leases - New Generation Technology Driving Accuracy

WHITEPAPER

Leases in Financial Reporting has grown over the years to be more than just an arrangement under which a lessor agrees to allow a lessee to control the use of an identified property. The complex permutation and combinations within the contract agreements today, leave a wide scope for errors, when calculations are undertaken over a wider range of data and time.

In IFRS 16*, leased subjects have shown an impact on lessee's balance sheet and they need to be reported with associated financials. Currently, a Single accounting model is in effect for all leases with a few exemptions, including short term (<12 months) and low valued assets.

| Several things in the process are complex including:

- ▶ Identification of Leases
- ▶ Impact of Leases on Balance Sheet

| Complexity in Identification of Leases

It is no more a compulsion to explicitly define the term 'lease' in contracts. However, assets that are 'physically distinct' may be qualified as 'lease'. In addition, substitution rights and 'right to control the use' of the assets need to be determined.

For instance, a Data Center contract with an IT company where 'Dedicated Servers' are used for the Lessee may be qualified as a 'Lease', while the term 'lease' is not explicitly defined in the contract.



Complexity in Assessing the Impact of Leases on Balance Sheet

Here, Lease and Payment Terms are used for 'Accounting' calculations. Lease Terms can be:



Non-cancellable



Extendable



Terminable

Liability calculations involve different components, which could be:



Fixed payments



Calculation of Residual Value



Penalties or Variable payments based on external Index.

How can New-Gen Technology help the overall process?

Extraction of possible lease clauses from 'existing' contracts is the typical first step of the process. AI/ML models can extract relevant clauses from contracts. The extraction process would require NLP** to pick up clauses in right context from the contract.

Once extracted, classification can also be done by the AI/ML model. At this point, the output (extracted and classified clauses) can be fed into a deterministic algorithm to accurately 'identify' the lease, where final step is a deterministic algorithm, which will help in driving higher accuracy.

***IFRS 16** is an International Financial Reporting Standard (IFRS)

**** NLP:** Natural Language Processing



In addition, output of the deterministic algorithm can be fed into the classification model as a feedback loop to drive higher accuracy.

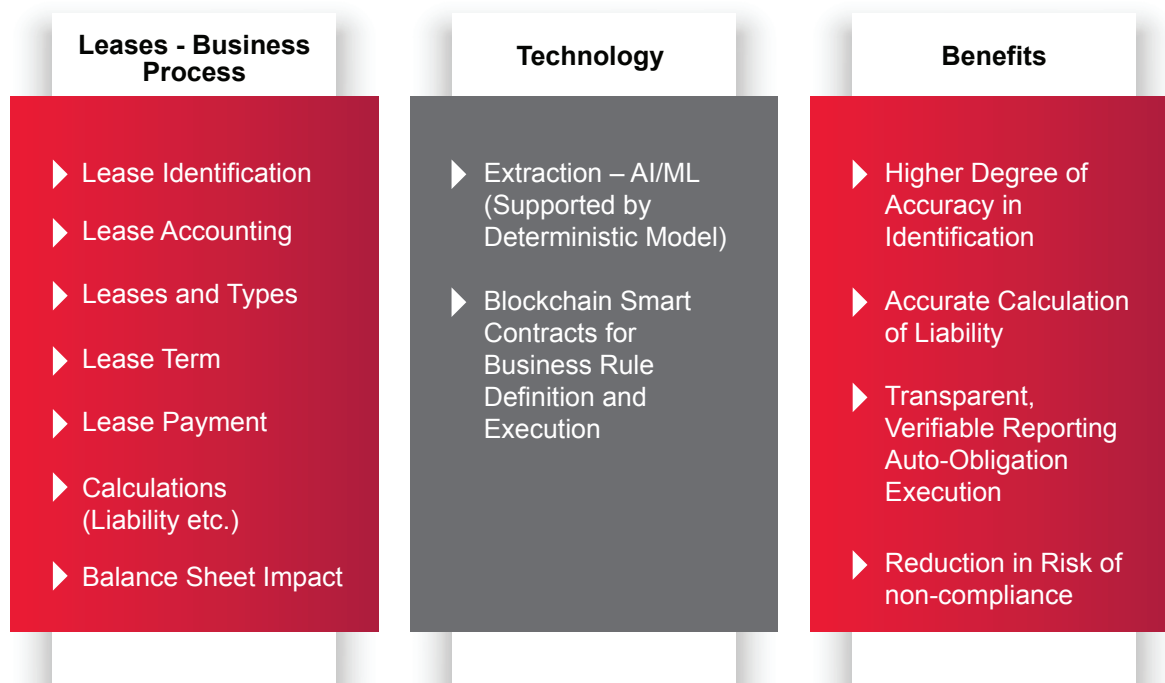
‘Smart Contracts’ in Blockchain can help enforce obligations based on contract clauses. Smart Contracts can be defined between Lessee and Lessor with pre-defined rules including terms and actions. Terms related to Cancellation, Extension and Termination could be a pre-set by rules and associated action.

As the lease term is reached, external triggers or a trigger from Lessee or Lessor can execute the Smart contract, and the associated action for the lease can be auto-executed.

Blockchain Smart Contracts can also auto-execute liability calculation, leveraging predefined clauses and external inputs including ‘actual payments made’ and external index rates: Calculated Liability, including complete traceability from ‘Contract Definition to Payment Terms – Execution’ upon reaching a Lease Term can be verified by the Auditor and Regulator. At this point, Auditor and Regulators just need to verify the sources and digital identity of sources in Blockchain.

In new contracts, AI/ML models can help in assessing potential lease exposure, to make decisions on contractual clauses. Once decided, contractual clauses can be defined directly as Smart Contracts in a Blockchain.

How can New-Gen Technology help the overall process?



TechM is now driving new-gen technology adoption in Audit/Assurance including IFRS/Leases space at a rapid pace, and we as one of the leading firms delivering solutions, make sure that what we produce is of utmost quality and class before delivering our services to the clients.

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Suresh has over 20 Years of experience in Consulting, Technology and Software Services Industry. His focus has been Technology Transformation (with Focus on Blockchain, AI/ML Models/Algorithms, Cloud (IaaS/PaaS/SaaS) and IoT. He has worked extensively on Platform/Product/Asset based Services Strategy with a proven experience managing \$250 Million Multiyear Strategic Global Accounts. His experience includes developing and Defining and executing Business Strategy and consulting.



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