



DEPARTMENT OF GENERAL SERVICES' DIVISION OF REAL ESTATE SERVICES

REPORT ON AUDIT FOR THE YEAR ENDED JUNE 30, 2015

Auditor of Public Accounts
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AUDIT SUMMARY

Our audit of operating and capital leases administered by the Department of General Services' Division of Real Estate Services for the fiscal year ended June 30, 2015, found:

- proper recording and reporting of all transactions, in all material respects, in the Integrated Real Estate Management System, Lease Accounting System, and Department of Accounts Attachment 11, except as noted in the finding "Improve Internal Controls over Lease Reporting;"
- a matter considered to be a material weakness involving internal control over financial reporting necessary to bring to management's attention; and
- no instances of noncompliance with applicable laws and regulations or other matters that are required to be reported.

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AUDIT FINDINGS AND RECOMMENDATIONS

Improve Internal Controls over Lease Reporting

Type of Finding: Internal Control

Degree of Finding: Material Weakness

The Department of General Services improperly reported an operating lease to Department of Accounts (Accounts) for fiscal year 2015 that does not begin until fiscal year 2016, resulting in a \$23 million overstatement in future commitments. In addition, the information in the Lease Accounting System (LAS) for two capital leases contained inaccurate information related to dates, payments, and salvage values resulting in an understatement of \$4 million.

The CAPP Manual Topic 31215 “LAS Transactions” states, “All financial information related to property, plant, and equipment lease agreements must be properly recorded and accounted for on the books of the Commonwealth with appropriate reporting and disclosure in agency and Commonwealth financial statements in accordance with generally accepted accounting principles.”

The Division of Real Estate Services (Real Estate Services) does not have anyone within the lease classification and documentation process that understands the financial reporting implications of the lease classification process and the importance of the accuracy of the information that goes into the determination. As a result, Real Estate Services gave the Office of Fiscal Services (Fiscal Services) operating lease data from the Integrated Real Estate Management System (IREMS) containing future commencing leases to complete the current year commitments and subsequent event information in Accounts attachments without the ability to identify the future leases and properly classify them as a subsequent event versus a commitment. In addition, Real Estate Services provided Fiscal Services information, such as dates, payments, and estimated salvage values, to enter into LAS for two capital leases that was not consistent with IREMS data or lease documentation. Fiscal Services expects the information provided to them to be accurate, current, and in agreement with IREMS and lease documentation for the respective reporting period. As a result, this finding is a material weakness.

Real Estate Services should communicate with Fiscal Services when submitting information to Fiscal Services for use in preparing Accounts’ attachments and performing LAS entry. Real Estate Services and Fiscal Services should ensure that the leases with future fiscal year commencement dates are not included in current year commitments, but instead are reported as a subsequent event. In addition, Real Estate Services should ensure that they properly report future capital leases to Accounts through attachments and LAS.

AGENCY HIGHLIGHTS

Real Estate Services is the Commonwealth of Virginia's provider of real estate services to state agencies. Some of Real Estate Services responsibilities include:

- management of the Commonwealth's real estate portfolio;
- comprehensive transactional support for negotiating, leasing, and acquiring space;
- transactional documentation guidance; and
- real estate information database maintenance and enhancement.

Real Estate Services is a division of Department of General Services. Real Estate Services leases about 13 million square feet of rental space in over 1,500 locations. In fiscal year 2015, Real Estate Services managed 13 master capital leases and 461 master operating leases. Real Estate Services makes all lease payments to the lessor on behalf of the state agencies. In fiscal year 2015, Real Estate Services paid \$60.9 million in lease payments and had \$280.7 million in future obligations.

Lease Payments and Future Obligations

Type of Lease	Fiscal Year 2015 Payments	Future Obligations (2016 – 2045)
Capital	\$ 4,861,665	\$ 36,140,851
Operating	\$ 56,125,325	\$ 244,594,530

Source: Lease Accounting System and Integrated Real Estate Management System

In support of the Commonwealth's Comprehensive Annual Financial Report, Fiscal Services completes financial reporting information and submits it to Accounts for Real Estate Services. Real Estate Services provides Fiscal Services information at the time of lease commencement to enter into LAS, which determines lease classification as operating or capital based on the information entered. During the year, Real Estate Services retains capital leases in LAS for financial reporting purposes; however, Real Estate Services uses the Integrated Real Estate Management System (IREMS) to make lease payments and track capital and operating leases. Real Estate Services provides Fiscal Services with financial reporting data for operating leases from IREMS to report to Accounts. However, for capital leases, Fiscal Services uses LAS to complete the capital lease financial reporting section.



Martha S. Mavredes, CPA
Auditor of Public Accounts

Commonwealth of Virginia

Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

November 20, 2015

The Honorable Terence R. McAuliffe
Governor of Virginia

The Honorable John C. Watkins
Chairman, Joint Legislative Audit
and Review Commission

We have audited the operating and capital leases administered by the **Department of General Services' Division of Real Estate Services** for the year ended June 30, 2015. We conducted this audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States, in support of the Commonwealth's Comprehensive Annual Financial Report. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Objectives

Our audit's primary objective was to evaluate the accuracy of Real Estate Services' financial transactions related to operating and capital leases that they administer as reported in the Comprehensive Annual Financial Report for the Commonwealth of Virginia for the year ended June 30, 2015. In support of this objective, we evaluated the accuracy of recorded financial transactions in the Integrated Real Estate Management System, Lease Accounting System, and Department of Accounts Attachment 11, reviewed the adequacy of Real Estate Services' internal control, and tested for compliance with applicable laws, regulations, contracts, and lease agreements.

Audit Scope and Methodology

Real Estate Services' management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws, regulations, contracts, and lease agreements.

We gained an understanding of the overall internal controls, both automated and manual, sufficient to plan the audit. We considered materiality and risk in determining the nature and extent of our audit procedures. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances.

- Capital leases
- Operating leases
- Rent, insurance, and other related charges
- System access controls

We performed audit tests to determine whether Real Estate Services' controls were adequate, had been placed in operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws, regulations, contracts, and lease agreements. Our audit procedures included inquiries of appropriate personnel, inspection of documents, records, and contracts, and observation of Real Estate Services' operations. We tested transactions and performed analytical procedures.

Conclusions

We found that Real Estate Services properly stated, in all material respects, the amounts recorded and reported in the Integrated Real Estate Management System, Lease Accounting System, and Department of Accounts Attachment 11, except as noted in the finding "Improve Internal Controls over Lease Reporting." The financial information presented in this report came directly from the Lease Accounting System and the Integrated Real Estate Management System.

Our consideration of internal control was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the section entitled "Audit Findings and Recommendations," we identified a deficiency in internal control that we consider to be a material weakness.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial information will not be prevented, or detected and corrected on a timely basis. We consider the deficiency entitled "Improve Internal Controls over Lease Reporting," which is described in the section titled "Audit Findings and Recommendations," to be a material weakness.

The results of our tests of compliance with applicable laws, regulations, contracts, and lease agreements disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

The results for the Commonwealth's Comprehensive Annual Financial Report for the year ended June 30, 2015, are contained in the Single Audit Report, which serves to communicate not only findings related to federal compliance testing, but also internal control and compliance matters related to the CAFR audit. The Single Audit Report will be available on the APA's website at www.apa.virginia.gov in February 2016.

Exit Conference and Report Distribution

We discussed this report with management on November 23, 2015. Management's response to the findings identified in our audit is included in the section titled "Agency Response." We did not audit management's response and, accordingly, we express no opinion on it.

This report is intended for the information and use of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

DBC/clj



COMMONWEALTH *of* VIRGINIA

Department of General Services

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Director

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Deputy Director

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December 3, 2015

Martha Mavredes
Auditor of Public Accounts
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Richmond, Virginia 23218

Dear Ms. Mavredes:

I am providing this letter in response to the management point contained in the audit of operating and capital leases administered by the Department of General Services, Division of Real Estate Services. The classification of the lease in question was made based on our understanding that the lease was a renewal and we were not considering it a "new" lease with a future fiscal year commencement date. But, based on discussions with your audit staff, we understand that our interpretation may not have been correct.

Since the end of the audit, we have identified a significant number of one year leases that all renew on July 1 of each fiscal year and end on June 30. Since these leases potentially fall into the same category as the lease identified in the audit, I have tasked our Controller to obtain guidance from the Department of Accounts (DOA) regarding reporting of these leases on our future year-end financial statements and establish the necessary reporting processes with the Division of Real Estate Services to ensure our lease transactions are reported in accordance with DOA guidance prior to preparing our next year-end financial statements.

Sincerely,

Christopher L. Beschler

AGENCY OFFICIALS

As of June 30, 2015

Department of General Services
Division of Real Estate Services

Richard F. Sliwoski, P.E.
Director, Department of General Services

Joseph Damico
Deputy Director, Department of General Services

Bryan W. Wagner
Controller, Department of General Services

Holly L. Eve
Director, Division of Real Estate Services