



DEPARTMENT OF GENERAL SERVICES' BUREAU OF REAL ESTATE SERVICES

REPORT ON AUDIT FOR THE YEAR ENDED JUNE 30, 2020

Auditor of Public Accounts
Martha S. Mavredes, CPA
www.apa.virginia.gov
(804) 225-3350



AUDIT SUMMARY

Our audit of the operating and capital leases administered by the Department of General Services' Bureau of Real Estate Services for the fiscal year ended June 30, 2020, found:

- proper recording and reporting of all transactions, in all material respects, in Real Estate Service's real estate management system, the Commonwealth's lease accounting system, and the Department of Accounts' Attachment 11;
- one matter involving internal control and its operation 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 FINDING AND RECOMMENDATION

Improve Lease Policies and Procedures and Review of Lease Classifications

Type: Internal Control

Severity: Significant Deficiency

Repeat: No

The Bureau of Real Estate Services (Real Estate Services) did not properly classify two new leases during fiscal year 2020. This understated capital lease future obligations and overstated the operating lease future obligations by \$6.6 million for fiscal year 2020. In addition, Real Estate Services inaccurately interpreted and implemented Financial Accounting Standards Board (FASB) accounting standards for lease classification, as set out in their policies, instead of using Governmental Accounting Standards Board (GASB) accounting standards.

Real Estate Services inaccurately assessed one lease, which included an entire building and portion of a parking lot and land surrounding the building, as a lease of a portion of a property and automatically classified the lease as operating. The inaccurate assessment of the lease occurred because Real Estate Services misunderstood that a portion of a property meant a portion of a building, such as an office or a floor, not a building and a portion of a piece of land. In addition, Real Estate Services did not consider whether there were renovations that extended or restarted the life of another leased asset and inaccurately determined the remaining economic useful life of the leased asset. The inaccurate assessment of whether the renovation extends or restarts the useful life of the leased property occurred because Real Estate Services has an inadequate understanding about which types of major renovations extend the useful life of a leased property and does not have a policy that addresses it.

GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, outlines the capital lease tests required for leases involving land and buildings and leases involving a portion of a building. Leases involving only a portion of a building are classified as operating leases; however, leases involving land and buildings must have the capital lease tests applied to determine classification. All lease classifications are dependent upon determining the estimated useful life of the building. The Commonwealth Accounting Policies and Procedures Manual Topic 30405 states that it is possible to add years to the useful life of a building; however, determining the increase in useful life is somewhat subjective. Agency personnel must review transactions on a case-by-case basis to determine the economic benefit received. Real Estate Services' policy assumes the total asset useful life is thirty years from the date of construction or major renovation for a typical office building.

Real Estate Services should update their internal policies and procedures to ensure compliance with GASB not FASB. These policies and procedures should include guidance for determining whether renovations performed increase the remaining useful life of a leased property. Real Estate Services should document support for the decision to extend or restart the remaining economic useful life of the leased asset. Real Estate Services should perform the capital lease tests in compliance with these updated internal policies and procedures. With GASB Statement No. 87, *Leases*, becoming effective for fiscal year 2022, determination of the useful life of the underlying asset will still be important since the new standard requires leased assets to be amortized over the shorter of the lease term or the useful life of the underlying asset.

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 buying, selling, leasing, and conveying real estate interests of the Commonwealth;
- transactional documentation preparation; and
- real estate information database maintenance, reporting, and enhancement.

Real Estate Services is a division of General Services. Real Estate Services leases over 4.37 million square feet of rental space. In fiscal year 2020, Real Estate Services managed seven master capital leases and 501 master operating leases. Real Estate Services makes all lease payments to the lessor on behalf of the state agencies. In fiscal year 2020, Real Estate Services paid \$65.3 million in lease payments and had \$348.6 million in future obligations.

Lease Payments and Future Obligations

Type of Lease	Fiscal Year 2020 Payments	Future Obligations (2021-2045)
Operating	\$62,605,467	\$315,353,034
Capital	2,712,293	33,286,342

Source: Real Estate Services' real estate management system and Commonwealth's lease accounting system

In 2017, the GASB issued Statement No. 87, *Leases*. The effective date of this accounting standard was postponed by 18 months by Statement No. 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*. It will become effective for fiscal year 2022 and will significantly change the way governments account for leases. Under the new model, operating and capital leases no longer exist. All leases will be reported as financing transactions, which results in recording an intangible asset and a liability for every lease except short term leases (less than 12 months). GASB Statement No. 87 requires that existing leases be recognized and measured using the facts and circumstances that exist at the beginning of the period of implementation, not the inception of the lease. Real Estate Services has begun to develop new policies and procedures and has implemented changes to its real estate management system to prepare for the new standard. We are monitoring Real Estate Services implementation of GASB Statement No. 87 and will issue status reports as needed.



Martha S. Mavredes, CPA
Auditor of Public Accounts

Commonwealth of Virginia

Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

October 27, 2020

The Honorable Ralph S. Northam
Governor of Virginia

The Honorable Kenneth R. Plum
Chairman, Joint Legislative Audit
and Review Commission

We have audited the financial records and operations of the **Department of General Services' Bureau of Real Estate Services** for the year ended June 30, 2020. 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 Annual Financial Report and Single Audit. 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 in support of the Comprehensive Annual Financial Report for the Commonwealth of Virginia for the year ended June 30, 2020. In support of this objective, we evaluated the accuracy of recorded financial transactions in Real Estate Services' real estate management system, the Commonwealth's 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 grant agreements.

Audit Scope and Methodology

Real Estate Services' management has responsibility for establishing and maintaining internal control and complying with applicable laws, regulations, contracts, and grant agreements. 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 grant 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

- Information system security over Real Estate Services' real estate management system

- System access controls over Real Estate Services' real estate management system

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 grant agreements. Our audit procedures included inquiries of appropriate personnel, inspection of documents, records, and contracts, and observation of Real Estate Services' operations. We tested details of lease classification and performed analytical procedures to achieve our objectives.

A nonstatistical sampling approach was used. Our samples were designed to support conclusions about our audit objectives. An appropriate sampling methodology was used to ensure the samples selected were representative of the population and provided sufficient, appropriate evidence. We identified specific attributes for testing each of the samples and when appropriate, we projected our results to the population.

Our consideration of internal control over financial reporting (internal control) was for the limited purpose described in the section "Audit Objectives" and 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. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify a deficiency in internal control entitled "Improve Lease Policies and Procedures and Review of Lease Classifications," which is described in the section titled "Audit Finding and Recommendation," that we consider to be a significant deficiency.

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 statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Conclusions

We found that Real Estate Services' properly stated, in all material respects, the amounts recorded and reported in Real Estate Services' real estate management system, the Commonwealth's lease accounting system, and Department of Accounts' Attachment 11. The financial information presented in this report came directly from the Commonwealth's lease accounting system and Real Estate Services' real estate management system.

We noted a matter involving internal control and its operation that requires management's attention and corrective action. This matter is described in the section entitled "Audit Finding and Recommendation." The results of our tests of compliance with applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

Since the finding noted above has been identified as a significant deficiency, it will be reported as such in the "Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance with Government Auditing Standards," which is included in the Commonwealth of Virginia's Single Audit Report for the year ended June 30, 2020. The Single Audit Report will be available at www.apa.virginia.gov in February 2020.

Exit Conference and Report Distribution

We discussed this report with management on December 1, 2020. 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.

Martha S. Mavredes
AUDITOR OF PUBLIC ACCOUNTS

DBC/clj



COMMONWEALTH of VIRGINIA
Department of General Services

Joseph F. Damico
Director

Sandra Gill,
Deputy Director

Matthew James,
Deputy Director

1100 Bank Street
Suite 420
Richmond, Virginia 23219
Phone (804) 786-3311
FAX (804) 371-8305

December 1, 2020

Martha S. Mavredes
Auditor of Public Accounts
P.O. Box 1295
Richmond, VA 23218

Dear Ms. Mavredes:

Thank you for the opportunity to respond to the Auditor of Public Accounts' Review of the Department of General Services' Bureau of Real Estate Services for the fiscal year ended June 30, 2020. Overall we agree with the report's findings regarding our agency.

The Department of General Services will take necessary actions to address the internal control deficiencies identified in the audit report. We will work to update our internal policies and procedures in accordance with your recommendations.

We appreciate the professionalism of your staff and thank you for working with us.

Sincerely,

A handwritten signature in black ink, appearing to read "J. Damico", written over the word "Sincerely,".
Joseph F. Damico

**DEPARTMENT OF GENERAL SERVICES
BUREAU OF REAL ESTATE SERVICES**

As of June 30, 2020

Joseph Damico
Director, Department of General Services

Sandra Gill
Deputy Director, Department of General Services

Bryan Wagner
Controller, Department of General Services

Holly Eve
Director, Division of Real Estate and Facilities Management

Karl Saimre
Director, Bureau of Real Estate Services