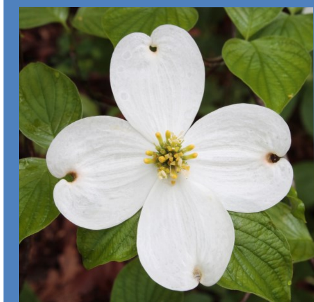

REVIEW OF THE DEPARTMENT OF GENERAL SERVICES' CAPITAL OUTLAY AND MAINTENANCE RESERVE PROJECT ACCOUNTING

NOVEMBER 2019

Auditor of Public Accounts
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AUDIT SUMMARY

During the 2018 audit of the Commonwealth's Comprehensive Annual Financial Report, the Auditor of Public Accounts identified several issues with the Department of General Services' accounting and reporting of capital assets resulting from capital outlay and maintenance reserve projects. Subsequently, we performed a more thorough review of such activity for the fiscal years 2015 through 2018, which is the focus of this report.

Our review of capital outlay and maintenance reserve costs at the Department of General Services (General Services) found the following results:

- General Services improperly did not capitalize $37.9 million in construction and improvement costs incurred from capital outlay and maintenance reserve projects for fiscal years 2015 through 2018.

- General Services does not have adequate documented policies and procedures over accounting for and reporting capital assets.

- General Services does not have an evaluation process to determine if costs should be capitalized.

- General Services' Office of Fiscal Services (Fiscal Services) does not maintain a detailed schedule of changes to construction in progress.

- General Services was unable to provide evidence of construction in progress reconciliations.

- General Services does not capitalize construction projects at the point recommended by the Commonwealth Accounting Policies and Procedures Manual, and Fiscal Services does not monitor the status of internally developed software projects to ensure they are capitalized when substantially complete.

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INTRODUCTION

The Auditor of Public Accounts reviewed the Department of General Services' (General Services) accounting for its capital outlay and maintenance reserve costs. We conducted this review after identifying significant concerns with the capital asset financial information related to the Capital Square Complex and Infrastructure Security project that General Services submitted to the Department of Accounts for preparation of the Commonwealth's Comprehensive Annual Financial Report for fiscal year 2018. The Capital Square Complex and Infrastructure Security project is a massive $300 million project with multiple parts, including demolition and abatement of the old General Assembly building; foundation, sitework, and construction of the new General Assembly building; construction of a new parking structure; renovation of Old City Hall; and renovation of space in the James Monroe building, Pocahontas building, and Main Street Centre for relocation of tenants throughout the project.

Objectives

The objectives of this review are to:

- Evaluate General Services' policies and practices to account for capital outlay and maintenance reserve expenses.
- Determine whether General Services is properly recording capital assets resulting from capital outlay and maintenance reserve expenses.

Scope and Methodology

Our review was limited to General Services' capital outlay and maintenance expenses for fiscal years 2015 through 2018. In addition, we reviewed expenses related to internally generated software projects during the same period. We reviewed policies in the Commonwealth Accounting Policies and Procedures (CAPP) Manual, Department of Accounts Fiscal Year-End Closing Procedures, and Governmental Accounting Standards Board standards to gain an understanding of accounting and reporting requirements over capital assets.

We obtained and reviewed the policies of General Services over accounting for construction and improvement costs. We compared capital outlay expenses to amounts recorded in the Commonwealth capital asset system and year-end reporting submissions. We also tested to ensure capital project expenses were capitalized timely upon substantial completion. Finally, we tested reconciliations between the Commonwealth financial accounting and reporting system and the Commonwealth capital asset system, insofar as they related to capital outlay costs during the period.

BACKGROUND

The term capital assets includes land, improvements to land, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period. Because capital assets provide benefits over multiple periods, they are capitalized as assets and subsequently expensed over their useful lives to properly match the reported costs with the benefits derived from such assets. If assets are not properly capitalized, this can significantly overstate the expenses in one period, while potentially understating them in later periods, as well as understating assets.

Construction projects in the Commonwealth generally fall into two categories from a budgetary perspective: capital outlay projects and maintenance reserve projects.

Capital outlay projects include, but are not limited to, the following:

- Acquisition of real property;
- New construction projects with a total project cost exceeding $3 million;
- Improvements, renovations, repairs, replacement, maintenance, or combination projects for a single building with a total project cost exceeding $3 million; and
- Umbrella projects, which contain a series of identical or similar tasks for multiple facilities.

A maintenance reserve project is a major repair or replacement to plant, property, or equipment that is intended to extend its useful life. Each project should cost between $25,000 and $1.5 million.

As shown in Table 1, General Services has significant expenses of both capital outlay and maintenance reserve funds; therefore, it is important for the agency to properly capitalize qualifying construction and improvement costs from these funds.

Capital Outlay and Maintenance Reserve Expenses

Table 1

	Fiscal Year 2015	Fiscal Year 2016	Fiscal Year 2017	Fiscal Year 2018	Total
Capital Outlay	$39,912,328	$36,455,934	$23,401,984	$22,924,042	$122,694,288
Maintenance Reserve	7,437,028	6,689,408	8,293,907	9,938,517	32,358,860
Total	**$47,349,356**	**$43,145,342**	**$31,695,891**	**$32,862,559**	**$155,053,148**

Source: Commonwealth Accounting and Reporting System

Table 2 includes a list of General Services' capital outlay projects that were active during the period audited.

Capital Outlay Budget to Actual Expenses

Table 2

	Budget	Life to Date Expenses as of June 30, 2018
Renovation of the 9th Street Office Building and Parking Deck	$ 66,426,082	$ 66,202,053
Renovate Exterior and Interior of the Supreme Court Building	3,387,342	3,387,342
Monroe Exterior Repairs and Jefferson Building Window Replacement	4,906,000	4,728,815
Capitol Complex Infrastructure and Security	285,963,502	38,890,107
Make Critical Repairs and Improvements to Consolidated Lab	11,551,323	4,353,960
Replace Roof on General Services' Westmoreland Plaza Building	3,722,000	3,275,068
Renovate and Repair Fort Monroe	22,500,000	866,506
Repair the Exterior Envelope of Main Street Centre	2,500,000	2,500,000
New Alcoholic Beverage Control Central Office and Warehouse Facility	91,878,400	17,850
Total	**$492,834,649**	**$124,221,701**

Source: Commonwealth Accounting and Reporting System

AUDIT RESULTS

Policies and Procedures

The CAPP Manual states that "State agencies and institutions must have policies and procedures in place to ensure that assets that meet the criteria contained in this topic are properly recorded in FAACS." (CAPP Manual Topic 30105 – Introduction) These policies and procedures, in relation to capital outlay and maintenance reserve projects, should include the following topics:

- Determining types of costs included in the acquisition value of a constructed or renovated asset or intangible asset;
- Tracking of construction in progress costs during construction;
- Timing for capitalization of completed projects;
- Establishing useful lives and depreciation;
- Accounting for software and other intangible assets; and
- Determining whether additions, renovations, and repairs are capitalizable.

Our review found that General Services does not have adequate documented policies and procedures over accounting and reporting of capital assets. Instead, General Services relies on the experience of staff to guide their current processes. This contributed to several findings within this report, which cover instances of misstatements of capital assets and non-compliance with the CAPP Manual. Without proper procedures that are documented, reviewed, and implemented, General Services is not able to ensure compliance with the CAPP Manual or proper accounting and reporting of capital assets.

Recommendation 1: Develop and Implement a Capital Asset Policy

General Services should update, create, and implement existing and new policies and procedures over accounting and reporting of capital assets. General Services should document and review these policies to ensure the policies are sufficient to maintain compliance with the CAPP Manual and submission of financial information to the Department of Accounts for year-end financial reporting. General Services should specifically ensure that policies and procedures address the following areas to support the findings throughout the rest of this report:

- Criteria for capitalization of construction and improvement costs, including those from maintenance reserve projects;
- Reconciliation of capital outlay program expenses to amounts capitalized in the capital asset system;
- Tracking of construction in progress; and
- Monitoring to ensure timely capitalization of assets when construction is complete.

Determining Costs to Be Capitalized

Determining what costs should be capitalized is important to ensure proper valuation and completeness of reported capital assets. The acquisition cost of a capital asset includes the purchase price or construction cost, as well as costs incurred to place an asset in its intended location and in an operable condition. (CAPP Manual Topic 30210 – Acquisition Valuation) These include:

- Freight and transportation charges;
- Installation costs;
- Site preparation expenses;
- Professional fees (including title costs and surveying fees if appropriate);

- Legal costs directly attributable to asset acquisition; and
- Cost of necessary easements and right-of-ways.

Improvements to capital assets should be capitalized if they increase the economic benefits to be derived from the asset by:

- Extending the useful life of the asset;
- Increasing the capacity of the asset; and
- Improving the efficiency of the asset. (CAPP Manual Topic 30405 – Additions, Renovations, and Repairs)

Fiscal Services did not demonstrate a sufficient understanding of certain types of costs that should be capitalized and does not have updated policies over this area. Largely because of these issues, Fiscal Services improperly did not capitalize $37.9 million in capital outlay and maintenance reserve costs from fiscal years 2015 to 2018.

Fiscal Services' practice is not to capitalize any maintenance reserve costs and instead simply expenses these costs. However, many maintenance reserve projects do meet the criteria for capitalization, often increasing the useful life, efficiency, or service capacity of the assets being repaired or renovated as part of these projects. Even the definition of maintenance reserve projects, as defined by the Department of Planning and Budget, implies that these projects include costs that would meet the criteria for capitalization, stating that a maintenance reserve project is a "major repair or replacement to plant, property, or equipment that is intended to extend its useful life." General Services had $32.4 million in maintenance reserve expenses from fiscal years 2015 through 2018. We excluded $4.3 million of these expenses from testing because they were for projects that General Services is managing for other agencies and will not capitalize. We reviewed 21 maintenance reserve projects with expenses totaling $18.5 million, with a bias towards projects that appeared to be capitalizable. Fiscal Services did not capitalize $10.7 million related to 14 projects, which should have been capitalized and represented 58 percent of expenses selected for testing. We did not test the remaining $9.6 in maintenance reserve costs from the period; therefore, these may include additional amounts that Fiscal Services should have capitalized.

Fiscal Services also does not have a consistent or documented process to determine which capital outlay costs they should capitalize. Fiscal Services did not sufficiently research or consider whether certain types of costs should be capitalized, which led to Fiscal Services not capitalizing costs for several subprojects within the Capital Square Complex and Infrastructure Security Project. These included demolition costs to prepare for construction of the new General Assembly Building and other large scale renovations, such as those to the Pocahontas Building, Main Street Centre, James Monroe Building, and other locations. We reviewed all of General Services' capital outlay projects that were active during the period audited, as detailed in Table 2. We compared activity within construction in progress and compared to actual capital outlay project expenses for reasonableness with the expectation that all capital outlay expenses should be capitalized. We investigated any project with activity that did not meet our expectations. In total, Fiscal Services did not capitalize $27.2 million in capital outlay costs from fiscal years 2015 to 2018, which should have been capitalized.

Because of the lack of consistent or documented processes of the capitalization criteria, Fiscal Services' process to prepare and review the capital asset submission to the Department of Accounts for use in compiling the Commonwealth's Comprehensive Annual Financial Report is ineffective. The capital asset submissions had significant errors, specifically in the reconciliation of construction in progress expenses.

It is important for agencies to have a sufficient understanding of which costs meet the criteria for capitalization so that they can properly report the assets of the Commonwealth. As part of year-end reporting, agencies are required to have sufficient review, so that submissions are accurate and complete. By not reporting all capital asset additions, Fiscal Services is understating reported assets of the Commonwealth as well as overstating current expenses.

Recommendation 2: Capitalize Construction and Improvement Costs

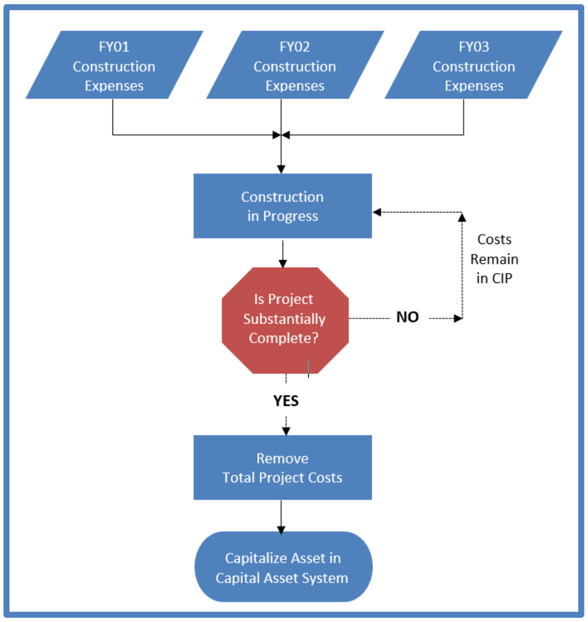
Fiscal Services should properly record all costs meeting the criteria for capitalization as assets in the capital asset system and on the year-end capital asset submissions. To ensure capital assets are properly reported, Fiscal Services should develop and document a policy and process to evaluate each maintenance reserve project and all capital outlay costs against the capitalization criteria to determine whether the costs are capitalizable. Fiscal Services should track the capitalizable costs in construction in progress and then capitalize the total cost as an asset when it is complete. The Controller should ensure that all Fiscal Services staff involved in the capital asset reporting process have a sufficient understanding of the capitalization criteria to evaluate costs effectively. The reviewer of the capital asset submission should have adequate knowledge of capital asset accounting standards so that the reviewer can identify errors and ensure the accuracy of the submission. Finally, Fiscal Services should review the remaining $9.6 million in maintenance reserve costs from the audit period that we did not review as part of the audit to determine any additional amounts to capitalize.

Construction in Progress

Construction in progress is a temporary capitalization of labor, materials, and equipment of buildings or other capital assets under construction. Construction in progress costs are capitalized; however, the assets therein are not depreciated until they are placed in service or substantially complete. When construction is complete, the costs are removed from construction in progress, capitalized specifically by asset, and subsequently depreciated based on the useful lives of the assets. (CAPP Manual Topic 30205 - Acquisition Method) See Chart 1 for an illustration of this process.

Process Flowchart for Capitalization of Construction Projects

Chart 1



CAPP Manual Topic 30310 - Asset Categorization requires agencies to maintain sufficient internal documentation to support changes made to construction in progress balances, including maintaining a construction in progress spreadsheet that tracks the costs for each project. The comprehensive spreadsheet should include each invoice with at least the following levels of detail: project number, project name, date paid, fund code, department or cost center, vendor name, a breakdown of the payment showing amounts expensed and capitalized (listed separately), and asset category (if capitalized).

CAPP Manual Topic 30905 – Reconciliation & Error Correction states that agencies, as part of their construction in progress reviews, should review records from their internal accounting system or the Commonwealth's accounting and financial reporting system for potential construction in progress expenses. Additionally, CAPP Manual Topic 30905 states that agencies should enter additions to construction in progress into the capital asset system at least quarterly, and reconcile all differences between project expenses, capital asset additions, and construction in progress additions at this time.

Fiscal Services does not maintain a detailed schedule of construction in progress. Fiscal Services also does not have a policy to track construction in progress changes in detail and instead only tracks changes in summary form by project, without sufficient distinction for subproject or other required levels of detail. At the time of our audit, Fiscal Services was unable to provide a detailed schedule of amounts added to construction in progress for the Capital Square Complex and Infrastructure Security project because they did not retain this information in the necessary level of detail. Maintaining a proper construction in progress schedule is important for tracking and reconciliation of construction in progress costs, as well as to provide a sufficient audit trail.

Recommendation 3: Maintain Schedule of Construction in Progress

Fiscal Services should create and maintain a tracking sheet showing construction in progress additions, deletions, and balances at a transactional level by project and sub-project that includes the level of detail required by the CAPP Manual and the level necessary to capitalize the resulting individual assets at the proper amount.

Fiscal Services does not maintain documentation of quarterly reconciliations of capital outlay expenses to capital asset system additions for construction in progress. Because Fiscal Services does not maintain reconciliation documentation, we were unable to determine whether they perform reconciliations regularly or timely. Additionally, Fiscal Services did not capitalize significant capital outlay expenses in the capital asset system or on year-end reporting submissions as noted throughout this report, which indicates that if they are performing reconciliations, the process is ineffective. Without proper reconciliation of capital outlay expenses to additions in the capital asset system, Fiscal Services cannot ensure that all capital assets are properly recorded and reported.

Recommendation 4: Properly Perform and Document Construction in Progress Reconciliations

Fiscal Services should develop and document a detailed policy to perform quarterly reconciliations of capital outlay expenses to construction in progress additions. The policy should include information on documentation, timing, and retention of the reconciliations. In addition, the policy should include a requirement for a review of the reconciliation by someone with the proper knowledge of requirements. As part of documentation, Fiscal Services should ensure that they document and properly address all variances between capital outlay project expenses and corresponding additions in the capital asset system.

<u>Timing of Capitalization for Completed Projects</u>

CAPP Manual Topic 30205 – Acquisition Method states that constructed assets are transferred from the construction in progress account to the related building, infrastructure, or equipment accounts when they become operational. The CAPP Manual Topic goes on to say that constructed assets should be considered operational, and thus should be capitalized, when the certificate of occupancy is obtained, even if subsequent costs will be incurred for the project.

Regarding intangible software development projects, CAPP Manual Topic 30325 – Software and Other Intangible Assets states that upon the conclusion of a software development project, construction in progress should be reversed and the internally generated software asset should be recorded as a separate asset. The department responsible for recording capital assets will often need to collaborate with a separate department, such as the information technology department, to monitor when internally developed software projects are substantially complete and should be capitalized.

Fiscal Services did not capitalize several projects for periods exceeding 18 months after substantial completion of the project; instead, Fiscal Services left the costs in construction in progress during this time. One of these projects, the renovation of the Ninth Street office building, had total costs exceeding $66 million, which Fiscal Services did not capitalize until nearly two years after the project was substantially complete. This resulted in an understatement of depreciation expense by an estimated $1.1 million and $1.6 million for the fiscal years 2017 and 2018, respectively. Fiscal Services uses the project completion report as the point at which they capitalize construction projects, instead of the certificate of occupancy, as recommended by the CAPP Manual. A certificate of occupancy is issued when the building has passed the inspection necessary to be occupied; however, a project completion report is issued after all costs have occurred on the project. There is often considerable time between these two reports, which can cause a significant impact on depreciation expenses. Once a building is substantially complete and occupied, it physically starts to depreciate; therefore, the accounting records should attempt to mirror actuality.

Four projects were intangible software development projects with a total value of $2.4 million, which Fiscal Services had not capitalized at the time of our inquiry, despite the projects having been complete for periods exceeding 18 months. At the time of our audit, Fiscal Services did not know the exact point at which each of the four projects was complete and was working with the Office of Information Systems and Services (Information Systems) to determine this. Fiscal Services does not have a process for regularly following up with Information Systems regarding the status of ongoing projects, and instead typically relies on Information Systems to inform them when projects are complete and can be capitalized.

By not capitalizing projects timely, Fiscal Services may be inaccurately reporting expenses and assets of the Commonwealth.

Recommendation 5: Capitalize Assets Upon Substantial Completion

Fiscal Services should develop and document processes to ensure that they remove substantially completed projects timely from construction in progress and appropriately capitalize the costs as assets in the capital asset system. Specifically, Fiscal Services should capitalize construction project costs when they obtain a certificate of occupancy, if applicable, rather than waiting for the project completion report to capitalize these costs. Additionally, Fiscal Services should develop a process to monitor the status of intangible asset projects, which should involve regular and proactive communication between Fiscal Services and Information Systems, to ensure applicable costs are capitalized timely when such assets are substantially complete or in use.

General Services regularly oversees or manages large construction projects for the Commonwealth. Given the significance of these expenses and assets, it is critical that General Services implement appropriate internal controls and processes to account for them accurately and timely.

Commonwealth of Virginia

Auditor of Public Accounts

Martha S. Mavredes, CPA
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

October 24, 2019

The Honorable Ralph S. Northam
Governor of Virginia

The Honorable Thomas K. Norment, Jr.
Chairman, Joint Legislative Audit
and Review Commission

We have reviewed the Department of General Services' accounting for its capital outlay and maintenance reserve costs and are pleased to submit our report entitled **Review of General Services' Capital Outlay and Maintenance Reserve Project Accounting**. We conducted this performance audit in accordance with generally accepted government auditing standards. 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.

We obtained and reviewed the policies of General Services over accounting for construction and improvement costs. We compared capital outlay expenses to amounts recorded in the Commonwealth capital asset system and year-end reporting submissions. We also tested to ensure capital project expenses were capitalized timely upon substantial completion. Finally, we tested reconciliations between the Commonwealth financial accounting and reporting system and the Commonwealth capital asset system, insofar as they related to capital outlay costs during the period.

<u>Conclusion</u>

Our review found that General Services has several internal control deficiencies over accounting for capital outlay and maintenance reserve expenses. These deficiencies included:

- General Services improperly did not capitalize $37.9 million in construction and improvement costs incurred from capital outlay and maintenance reserve projects for fiscal years 2015 through 2018.

- General Services does not have adequate documented policies and procedures over accounting for and reporting capital assets.

- General Services does not have an evaluation process to determine if costs should be capitalized.

- Fiscal Services does not maintain a detailed schedule of changes to construction in progress.

- General Services was unable to provide evidence of construction in progress reconciliations.

- General Services does not capitalize construction projects at the point recommended by the CAPP Manual, and Fiscal Services does not monitor the status of internally developed software projects to ensure they are capitalized when substantially complete.

Exit Conference and Report Distribution

We discussed this report with management on October 24, 2019. Management's response to the findings identified in our audit is included in the section titled "Management's 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

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APPENDIX A
Recommendations

Recommendation 1: Develop and Implement a Capital Asset Policy

General Services should update, create, and implement existing and new policies and procedures over accounting and reporting of capital assets. General Services should document and review these policies to ensure the policies are sufficient to maintain compliance with the CAPP Manual and submission of financial information to the Department of Accounts for year-end financial reporting. General Services should specifically ensure that policies and procedures address the following areas to support the findings throughout the rest of this report:

- Criteria for capitalization of construction and improvement costs, including those from maintenance reserve projects;
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Recommendation 3: Maintain Schedule of Construction in Progress

Fiscal Services should create and maintain a tracking sheet showing construction in progress additions, deletions, and balances at a transactional level by project and sub-project that includes the level of detail required by the CAPP Manual and the level necessary to capitalize the resulting individual assets at the proper amount.

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Fiscal Services should develop and document a detailed policy to perform quarterly reconciliations of capital outlay expenses to construction in progress additions. The policy should include information on documentation, timing, and retention of the reconciliations. In addition, the policy should include a requirement for a review of the reconciliation by someone with the proper knowledge of requirements. As part of documentation, Fiscal Services should ensure that they document and properly address all variances between capital outlay project expenses and corresponding additions in the capital asset system.

Recommendation 5: Capitalize Assets Upon Substantial Completion

Fiscal Services should develop and document processes to ensure that they remove substantially completed projects timely from construction in progress and appropriately capitalize the costs as assets in the capital asset system. Specifically, Fiscal Services should capitalize construction project costs when they obtain a certificate of occupancy, if applicable, rather than waiting for the project completion report to capitalize these costs. Additionally, Fiscal Services should develop a process to monitor the status of intangible asset projects, which should involve regular and proactive communication between Fiscal Services and Information Systems, to ensure applicable costs are capitalized timely when such assets are substantially complete or in use.

COMMONWEALTH *of* VIRGINIA
Department of General Services

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October 28, 2019

Martha S. Mavredes, CPA
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P. O. Box 1295
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Dear Ms. Mavredes:

Thank you for the opportunity to respond to the Auditor of Public Accounts' Review of General Services' Capital Outlay and Maintenance Reserve Project Accounting for the audit period of July 1, 2014 through June 30, 2019. Overall, we agree with the report's findings regarding our agency.

The Department will continue to take the necessary actions to address the findings contained in the audit report. We will work to establish appropriate policies, processes, and procedures discussed in this report.

As always, we appreciate the professionalism of your staff and thank you for working with us. Thank you for working with us and seeking our input.

Sincerely,

Joseph F. Damico

Consolidated Laboratory • Engineering & Buildings • Fleet • Graphics • Purchases & Supply • Real Estate & Facilities • Surplus• Mail

DEPARTMENT OF GENERAL SERVICES

As of June 30, 2018

Joseph Damico
Director

Sandra Gill
Deputy Director

Bryan W. Wagner
Controller

Tim Bishton
Assistant Controller