



# DEPARTMENT OF GENERAL SERVICES' DIVISION OF REAL ESTATE SERVICES

## REPORT ON AUDIT FOR THE YEAR ENDED JUNE 30, 2018

Auditor of Public Accounts  
Martha S. Mavredes, CPA  
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## AUDIT SUMMARY

Our audit of the operating and capital leases administered by the Department of General Services' Division of Real Estate Services for the fiscal year ended June 30, 2018, found:

- proper recording and reporting of all transactions after adjustment, 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;
- two matters involving internal control and its operations 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

### **Properly Classify Lease Renewals and Establish Policies for Renovations**

**Type:** Internal Control

**Severity:** Significant Deficiency

**Repeat:** No

The Division of Real Estate Services (Real Estate Services) did not properly re-classify four leases that renewed in fiscal year 2017 in its real estate management system. This understated operating lease expenses by \$801,372 and understated the operating lease future obligations by \$3,026,002 for fiscal year 2018. When classifying another lease, Real Estate Services extended the remaining economic life of a renovated property past what appeared reasonable for the property's renovations. The leased property renovations would not have extended the economic life of the leased property past the original useful life.

The Commonwealth Accounting Policies and Procedures Manual (CAPP) Topic 31220 states that information in the lease accounting system, such as the fair market value, economic life, and other lease data, shall reflect the lease renewal term. Additionally, Real Estate Services has a policy outlining the capital lease test. The policy states that the capital lease test shall consider the proposed new term of the lease only. Prior term or length of time under a prior lease term is not considered. CAPP 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 economic life is fifty years from the date of construction or major renovation for a typical office building.

Real Estate Services did not review the leases' renewals and did not always re-perform the capital lease test based on the renewal term. The inaccurate assessment of whether the renovation extends or restarts the economic life of the leased property occurred because Real Estate Services has an inadequate understanding and does not have a policy that addresses which types of major renovations extend the economic life of a leased property.

Real Estate Services should review leases when they are close to the lease end date and analyze the lease renewal term. Real Estate Services should perform the capital lease test in compliance with Real Estate Services' internal policies and procedures. Real Estate Services should create policies and procedures that would provide guidance for determining whether renovations performed increase the remaining economic life of a leased property. Real Estate Services should document support for the decision to extend or restart the remaining economic useful life.

## **Improve Preparation Procedures for Attachment 11**

**Type:** Internal Control

**Severity:** Significant Deficiency

**Repeat:** No

The Department of General Services' (General Services) Office of Fiscal Services (Fiscal Services) reported incorrect amounts in its internal service fund financial statement template (Attachment 11) submission for fiscal year 2018 to the Department of Accounts (Accounts). Fiscal Services incorrectly reported gross capital assets and accumulated depreciation for buildings by not removing \$10.5 million in assets related to an expired lease, overstating gross assets and accumulated depreciation by \$10.5 million. Additionally, Fiscal Services understated the fiscal year 2018 operating rental expense by \$850,961.

Fiscal Services used the incorrect report from the Commonwealth's lease accounting system to calculate gross assets and accumulated depreciation, which resulted in the error. CAPP Topic 70610 states the balance sheet report is the correct lease accounting system report to use when determining the gross asset and associated accumulated depreciation amounts as of fiscal year end. We informed Fiscal Services' controller in the prior year that Fiscal Services was using the incorrect report and indicated the guidance and correct report to use. Inaccurate reporting of capital assets and accumulated depreciation occurred again in the current year due to lack of communication and guidance between Fiscal Services' staff in preparing Attachment 11.

In addition, to separate fiscal year 2018 total lease payments into capital and operating payments, Fiscal Services deducted estimated capital lease payments from the Commonwealth's lease accounting system from actual expenditures, rather than using the actual capital lease payments from their financial accounting system to calculate the amount for operating lease payments. Basic accounting principles dictate that in calculating actual expenses, actual expense data should be used to support the expenses of both capital and operating leases. Reporting incorrect amounts to Accounts in Attachment 11 could lead to inaccurate financial information reported in the Commonwealth's Comprehensive Annual Financial Report (CAFR).

Fiscal Services should follow the guidance provided in the CAPP manual and complete Attachment 11 accurately. Fiscal Services management should communicate with the Fiscal Services staff throughout the financial reporting process to ensure all staff are aware of the correct reporting process, use the proper reports, and use actual expense data to calculate operating and capital lease expenses. Fiscal Services should make certain that the calculation for the fiscal year operating rental expense is accurate prior to submitting to Accounts for use in the CAFR.

## 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 General Services. Real Estate Services leases over 4 million square feet of rental space. In fiscal year 2018, Real Estate Services managed six master capital leases and 495 master operating leases. Real Estate Services makes all lease payments to the lessor on behalf of the state agencies. In fiscal year 2018, Real Estate Services paid \$61.5 million in lease payments and had \$323.3 million in future obligations.

### Lease Payments and Future Obligations

| Type of Lease | Fiscal Year 2018<br>Payments | Future Obligations<br>(2019 – 2048) |
|---------------|------------------------------|-------------------------------------|
| Capital       | \$ 1,985,922                 | \$ 28,065,298                       |
| Operating     | 59,495,275                   | 295,191,203                         |

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

Fiscal Services maintains capital leases in the Commonwealth's lease accounting system and Real Estate Services maintains operating leases in its real estate management system. Real Estate Services provides Fiscal Services with financial reporting data for operating and capital leases from Real Estate Services' real estate management system to report to Accounts in support of the Commonwealth's Comprehensive Annual Financial Report.



Martha S. Mavredes, CPA  
Auditor of Public Accounts

# Commonwealth of Virginia

## *Auditor of Public Accounts*

P.O. Box 1295  
Richmond, Virginia 23218

October 10, 2018

The Honorable Ralph S. Northam  
Governor of Virginia

The Honorable Thomas K. Norment, Jr.  
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, 2018. 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.

### **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, 2018. 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 significance 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.

A non-statistical 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.

### **Conclusions**

We found that Real Estate Services properly stated, in all material respects, the amounts recorded and reported in the 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 certain matters involving internal control and its operation that require management's attention and corrective action. These matters are described in the section entitled "Audit Findings and Recommendations." 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.

### **Exit Conference and Report Distribution**

We discussed this report with management on October 10, 2018. 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*

Joseph F. Damico  
Director

Sandra Gill  
Deputy Director

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Richmond, Virginia 23219  
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October 31, 2018

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

Dear Ms. Mavredes:

Thank you for the opportunity to respond to the Auditor of Public Accounts' Review of the operating and capital leases administered by the Department of General Services' Division of Real Estate Services for the fiscal year ended June 30, 2018. 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 establish guidelines on determining the extended useful life of assets that undergo renovations. Additionally, our fiscal management staff will follow the guidance in the CAPP manual for completion of Attachment 11 which is submitted to the Department of Accounts.

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

Sincerely,

A handwritten signature in black ink, appearing to be "J. Damico", written over a horizontal line.

Joseph F. Damico

**DEPARTMENT OF GENERAL SERVICES  
DIVISION OF REAL ESTATE SERVICES**

As of June 30, 2018

Joseph Damico  
Director, Department of General Services

Sandra Gill  
Deputy Director, Department of General Services

Bryan W. Wagner  
Controller, Department of General Services

Holly L. Eve  
Director, Division of Real Estate Services