



DEPARTMENT OF GENERAL SERVICES
DIVISION OF REAL ESTATE SERVICES
AND THE
OFFICE OF FISCAL SERVICES

REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2023

Auditor of Public Accounts
Staci A. Henshaw, CPA

www.apa.virginia.gov

(804) 225-3350



AUDIT SUMMARY

Our audit of the real estate leases administered by the Department of General Services' (General Services) Division of Real Estate Services (Real Estate Services) and accounted for by the Office of Fiscal Services (Fiscal Services) for the year ended June 30, 2023, found:

- proper recording and reporting of all transactions, in all material respects, in the Real Estate Services' real estate management system and the Department of Accounts' Attachment 11, after adjustment for the misstatements noted in the finding "Improve Internal Controls over Financial Reporting of Leases under GASB Statement No. 87;"
- 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.

In the section titled "Internal Control and Compliance Finding and Recommendation," we have included our assessment of the conditions and causes resulting in the internal control and compliance finding identified through our audit as well as a recommendation for addressing the finding. Our assessment does not remove management's responsibility to perform a thorough assessment of the conditions and causes of the finding and developing and appropriately implementing adequate corrective action to resolve the finding as required by the Department of Accounts in Section 10205 – Agency Response to APA Audit of the Commonwealth Accounting Policies and Procedures Manual. The corrective action may include additional items beyond our recommendation.

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INTERNAL CONTROL FINDING AND RECOMMENDATION

Improve Internal Controls over Financial Reporting of Leases under GASB Statement No. 87

Type: Internal Control

Severity: Material Weakness

First Issued: Fiscal Year 2022

As previously noted in our 2022 report, the Department of General Services' (General Services) Division of Real Estate Services (Real Estate Services) real estate management and leasing system is not fully compliant with Governmental Accounting Standards Board (GASB) Statement No. 87, Leases. Real Estate Services did not adequately involve Department of General Services' Office of Fiscal Services (Fiscal Services) during the design and implementation stage of the real estate management and leasing system upgrade, including designing the year-end financial reports to ensure the system would properly and accurately report all necessary financial information. The real estate management and leasing system continues to be deficient in the following areas:

- The system does not determine lease classification based on data inputs or have a field to record lease classification, such as short-term lease, long-term lease, finance purchases, and non-exchange like transactions. The Leased Real Property Team and Fiscal Services determine the lease classification manually outside of the system.
- The data from the system requires numerous manual manipulations outside the system to prepare the financial reporting information, which include:
 - Calculating the non-lease component of the total lease payment.
 - Applying the \$50,000 threshold to determine short-term leases.
 - Reversing and correcting previously remeasured leases when errors occur.
 - Correcting the liability and asset amount for remeasured leases that change lease classification.
 - Calculating and removing the asset and amortization for expired leases.
- The system does not record leases by asset categories, such as land and infrastructure associated with real estate leases.
- The system does not separate out and record multiple asset components within a lease, such as a split lease containing land and building assets. As a result, Fiscal Services inappropriately reported all right-to-use intangible assets as buildings in the capital assets footnote. Real Estate Services must re-evaluate their leases for multiple

components or components other than buildings to determine the impact within the footnote disclosure.

Furthermore, the length of time Real Estate Services takes to process contracts varies from a few days to several months, which results in inaccurate and untimely information reported in the real estate management and leasing system. Although directors and staff of Real Estate Services and Fiscal Services continued to improve communication and work together to obtain a complete understanding of the complex intricacies of GASB Statement No. 87 financial reporting requirements and finalize policies and procedures, they were unsuccessful. Real Estate Services has the knowledge and expertise surrounding the lease system, and Fiscal Services has the knowledge and expertise surrounding the preparation of the financial data reported in the Commonwealth's Annual Comprehensive Financial Report (ACFR). However, the two Divisions did not use this knowledge to collaborate on how to properly report leases, resulting in the following financial reporting errors:

- Fiscal Services incorrectly reported lease interest expense, totaling \$26.8 million, as an operating expense instead of a non-operating expense.
- Fiscal Services improperly excluded long-term principal payments in current year rent expense, which resulted in a \$25.0 million understatement. This exclusion also impacted the amounts reported in the current year activity associated with the right to use assets and liabilities as shown in the fourth bullet below.
- Fiscal Services improperly reported expired and remeasured leases as long-term instead of short-term, resulting in a \$23.9 million overstatement of right to use asset amortization. These misclassifications also impacted the amounts reported in the current year activity associated with the right to use assets and liabilities as shown in the fourth bullet below.
- Fiscal Services overstated liability and asset increases by \$14.3 million and \$16.1 million and overstated liability and asset reductions by \$19.0 million and \$19.8 million, respectively. In addition, they understated asset amortization's beginning balance and decreases by \$26.1 million and \$2.8 million, respectively, and overstated asset amortization's increases by \$24.1 million.
- Real Estate Services did not record the liability and asset for the future leases signed before year end in the system, which resulted in Fiscal Services not disclosing \$28.0 million in future commitments.
- Real Estate Services did not properly classify four leases under the financial reporting threshold of \$50,000 as short-term, resulting in an overstatement of \$138,000 in lease liability and assets. In addition, they did not properly classify 12 long-term leases, resulting in an understatement of \$1.6 million in lease liability and assets.

- Real Estate Services did not report eight leases to Fiscal Services for financial reporting, resulting in an understatement of \$5.8 million in lease liability and assets.

Real Estate Services and Fiscal Services made numerous misstatements throughout the various internal service fund financial statement template line items, including intangible right to use capital assets, long-term liabilities, amortization, rent expense, and interest expense as well as the associated footnote disclosures. We reported these same issues in the fiscal year 2022 audit report; however, General Services management did not implement corrective action to rectify the issues. Reporting incorrect amounts to Department of Accounts (Accounts) in the internal service fund financial statement template could lead to inaccurate financial information reported in the ACFR. We consider this to be a material weakness because the combination of issues noted create a reasonable possibility that a material misstatement of financial information will not be prevented, or detected and corrected, on a timely basis.

Management is responsible for designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of financial information that is free from material misstatement, whether due to fraud or error. GASB Statement No. 87 prescribes the applicable accounting standards surrounding the proper accounting and financial reporting for leases. Commonwealth Accounting Policies and Procedures (CAPP) Manual Topics 31205-31220 state all agencies must follow guidelines as required by GASB Statement No. 87.

Given the material nature of real estate leases in relation to the ACFR, General Services management should prioritize and emphasize the need for and importance of preparing accurate financial information in accordance with generally accepted accounting principles. Real Estate Services and Fiscal Services should develop, implement, and regularly update policies and procedures over their lease process to ensure accurate and complete reporting. Real Estate Services and Fiscal Services should collaborate to update the real estate management and leasing system fields to be compliant with GASB Statement No. 87 and to ensure the system enables reasonable and accurate reporting of lease financial information prior to the end of fiscal year 2024 to ensure proper reporting in the 2024 ACFR. Real Estate Services should re-evaluate all leases to ensure the non-lease components are reasonable and all asset types are recorded properly. Real Estate Services should ensure Fiscal Services has a thorough understanding of the lease system and has access to all the information it needs to prepare Accounts' attachments, such as the internal service fund financial statement template. Fiscal Services should maintain support for and make certain that the calculation for the fiscal year lease line items, footnotes, and disclosures are accurate prior to submitting this information to Accounts for use in the ACFR.

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 5.3 million square feet of rental space. In fiscal year 2023, Real Estate Services managed 325 master long-term leases and 218 master short-term leases. Real Estate Services makes all lease payments to the lessor on behalf of the state agencies. In fiscal year 2023, Real Estate Services paid \$61.7 million in lease principal and interest payments. Real Estate Services recorded a net of \$299.8 million in right-to-use assets and \$324.0 million in long-term lease liabilities, with \$16.7 million being due within one year. In addition, Real Estate Services has \$26.8 million in future commitments for leases starting in fiscal year 2024.

General Services implemented GASB Statement No. 87, Leases in fiscal year 2022. The accounting standard significantly changed the way governments account for leases. Real Estate Services uses its real estate management and leasing system to account for leases. Fiscal year 2023 is the second year under this new reporting model.

Real Estate Services provides Fiscal Services with lease data from its real estate management and leasing system. Fiscal Services uses the lease data to report the transactions and year end asset and liability balances related to short-term leases, long-term leases, and financed purchases on the internal service fund financial statement template, Attachment 11, in compliance with GASB Statement No. 87. Fiscal Services submits this to the Department of Accounts in support of the Commonwealth's Annual Comprehensive Financial Report.



Staci A. Henshaw, CPA
Auditor of Public Accounts

Commonwealth of Virginia

Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

December 5, 2023

The Honorable Glenn Youngkin
Governor of Virginia

Joint Legislative Audit
and Review Commission

Michael Bisogno
Department of General Services

We have audited the financial records and operations of the **Department of General Services' Division of Real Estate Services and the Office of Fiscal Services** for the year ended June 30, 2023. 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 Comprehensive Financial Report 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 General Services' financial transactions as reported in the Annual Comprehensive Financial Report for the Commonwealth of Virginia for the year ended June 30, 2023. In support of this objective, we evaluated the accuracy of recorded financial transactions in Real Estate Services' real estate management system and Department of Accounts' Attachment 11; reviewed the adequacy of Real Estate Services' and Fiscal Services' internal control; and tested for compliance with applicable laws, regulations, contracts, and grant agreements.

Audit Scope and Methodology

General 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.

Leases

Financed purchases

Rent, insurance, and other related charges

Interest expense

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 the Real Estate Services' and Fiscal 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 the Real Estate Services' and Fiscal Services' operations. We performed analytical procedures, including budgetary and trend analyses, and tested details of transactions to achieve our audit 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. However, as described in the section titled "Internal Control Finding and Recommendation," 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 statements will not be prevented or detected and corrected on a timely basis. We consider the deficiency titled "Improve Internal Controls over Financial Reporting of Leases under GASB Statement No. 87," which is described in the section titled "Internal Control Finding and Recommendation," to be a material weakness.

Conclusions

We found that Real Estate Services and Fiscal Services properly stated, in all material respects, the amounts recorded and reported in the Real Estate Services' real estate management system and Department of Accounts' Attachment 11, after adjustment for the misstatements noted in the finding "Improve Internal Controls over Financial Reporting of Leases under GASB Statement No. 87." The financial information presented in this report came directly from the 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 titled "Internal Control Finding and Recommendation."

Since the finding noted above has been identified as a material weakness, 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, 2023. The Single Audit Report will be available at www.apa.virginia.gov in February 2024.

Exit Conference and Report Distribution

We discussed this report with management at an exit conference held on February 2, 2024. Government Auditing Standards require the auditor to perform limited procedures on management's response to the findings identified in our audit, which is included in the accompanying section titled "Agency Response." Management's response was not subjected to the other auditing procedures applied in the audit and, accordingly, we express no opinion on the response.

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.

Staci A. Henshaw
AUDITOR OF PUBLIC ACCOUNTS

DBC/clj

FINDINGS SUMMARY

Finding Title	Status of Corrective Action	First Issued
Improve Internal Controls over Financial Reporting of Leases under GASB Statement No. 87	Ongoing	2022



COMMONWEALTH of VIRGINIA
Department of General Services

Michael Bisogno
Acting Director

Sandra Gill
Deputy Director

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

February 5, 2024

Staci Henshaw
Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

Dear Ms. Henshaw:

Thank you for the opportunity to respond to the Auditor of Public Accounts' Review of the Department of General Services' Division of Real Estate Services for the fiscal year ended June 30, 2023 and 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 "MB", written over a horizontal line.

Michael Bisogno