Compliance and Internal Control

Guam Housing Corporation
(A Component Unit of the Government of Guam)

September 30, 2010

Ernst & Young

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Reports on Compliance and Internal Control

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Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Board of Directors
Guam Housing Corporation

We have audited the financial statements of the Guam Housing Corporation (the Corporation) as of and for the year ended September 30, 2010, and have issued our report thereon dated March 3, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Corporation's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Corporation's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying schedule of findings and responses, we identified certain deficiencies in internal control that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

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 deficiencies described the accompanying schedule of findings and responses, as items 2010-1 and 2010-2 to be material weaknesses.

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. We consider the deficiencies described in the accompanying schedule of findings and responses, as items 2010-3, 2010-4 and 2010-5 to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain other matters that we reported to management of the Corporation in a separate letter dated March 3, 2011.

The Corporation's responses to the finding identified in our audit are described in the accompanying schedule of findings and responses. We did not audit the Corporation's responses and accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Board of Directors and management of the Guam Housing Corporation, the Office of Public Accountability, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties. However, this report is also a matter of public information.

Ernst + Young LLP

March 3, 2011

Material Weaknesses

Finding Number 2010-1
Impairment of Long-lived Assets

Condition:

The Corporation's Lada Estates Project (Lada Estates) has experienced theft and physical damage to its infrastructure and has been a site of illegal dumping of trash and refuse for the past several years. In addition, construction activity necessary to complete the Lada Estates has ceased since 2002. Because of these situations, an impairment loss should have been recognized in previous year's financial statements in accordance with Government Accounting Standard Board Statement 42 *"Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries"*. Accordingly, a prior period adjustment to reduce net assets as of October 1, 2009 by approximately $5.2 million to account for impairment loss to the Lada Estates has been recorded in the financial statements.

Recommendation:

We recommend that the Corporation continue to evaluate the Lada Estates for future possible impairment loss.

Management's response:

The $5.2 million impairment loss was incurred for the Lada Estates Project from fiscal years 1991 through 2002. This cost may not be recoverable and was written off as a prior year adjustments. It may be difficult for the Corporation to evaluate possible impairment loss while in litigation.

Finding Number 2010-2
Allowance for Loan and Lease Losses (ALLL)

Condition:

In accordance with its loan portfolio policy, the Corporation should maintain an ALLL of no less than 3% of the gross loan portfolio. The Corporation has no documentation that supports the basis for the aforementioned minimum ALLL policy. In prior years, the ALLL totaled approximately $3.4 million, which is more than the average total delinquent loan balance (more than 30 days in arrears or more) of approximately $2.9 million at September 30, 2008 and 2009. A majority of these delinquent loans are fully secured by a first lien position on single family residential units. However, in determining the ALLL, the Corporation did not measure the loss allowance as the difference between the carrying value of the loan and the fair value of the collateral less cost to sell as required by generally accepted accounting principles. As a result, the Corporation concluded that its ALLL was overstated by approximately $2.3 million as of October 1, 2009. Accordingly, an adjustment to increase net assets as of October 1, 2009 by approximately $2.3 million has been recorded in the financial statements.

Recommendation:

We recommend that management document its basis and rationalize to maintain a 3% minimum ALLL based on the gross loan portfolio. Additionally, we recommend that the Corporation consider fair value of collateral less cost to sell in determining the specific allowance to be provided on delinquent loans or loans near foreclosure.

Management's response:

We agree that the loan loss reserve was overstated however this was at the recommendation of the previous Auditor. GHC has reduced that amount with a prior year adjustment down to 3% of the loan portfolio pursuant to the loan policy. We will recommend to the Board of Directors to make an amendment to the loan policy to reflect the fair value of the collateral plus expenses.

Significant Deficiencies

Finding Number 2010-3
Merit Bonus

Condition:

In accordance with Title 4 of the Guam Code Annotated, Chapter 6, §6203, "superior performance by a classified employee in Grades A through V shall be rewarded by a lump sum bonus based on an amount equivalent to 3.5% of the employee's base salary. The merit bonus shall be automatic upon a superior rating evaluation conducted for increment purposes. The merit bonus is in addition to the increment provided under §6102 and is limited to the fiscal year in which superior performance is rendered".

Subsequent to September 30, 2010, the Corporation made a $174,203 gross lump-sum payment of merit bonuses to employees for fiscal years 1991 through 2010. A post-trial balance adjustment was made to accrue the $174,023 merit bonuses as of September 30, 2010. However, there was no evidence indicating that the Corporation's board of directors had approved payment of the merit bonuses.

Recommendation:

We recommend that the Corporation's management obtain authorization and approval from the board of directors prior to executing major decisions especially those involving significant or unusual disbursements.

Management's response:

The action taken is consistent with the provisions of P.L. 21-59:7 (4GCA CH. 6 § 6203), GHC's statutes and bylaws of the Corporation. It has been and remains the intent of the Corporation to garner Board acknowledgement/ratification of this action.

Significant Deficiencies, continued

Finding Number 2010-4
Evaluation of Collateral

Condition:

The Corporation's policy is to secure all loans with a first lien position on single family residential units. We noted in July 1999, the Corporation foreclosed on a loan that was collateralized by a wetland. The carrying cost of the aforementioned acquired asset, as of September 30, 2010, totals $95,526. Accordingly, this situation is a deviation from the Corporation's policy and results in the Corporation having inadequate collateral to minimize its loan loss upon foreclosure.

Recommendation:

We recommend that the Corporation evaluate its loan portfolio to identify other similar situations where inadequate collateral was obtained to secure loans disbursed. If further discoveries are made, then management should investigate the root causes of the breach in the Corporation's lending policy.

Management's response:

The loan was in compliance at the time it was written. The policy has been changed to prevent this type of loan from reoccurring.

Finding Number 2010-5
Loan Approval

Condition:

The Corporation's lending policy states that a loan applicant would be ineligible for a loan if the applicant had filed for bankruptcy protection within the past five years. However, this general rule can be overcome provided that the Corporation's board of directors approves the applicant's loan filing. We noted that a loan applicant, with a history of bankruptcy within the past five years, was granted a loan, but there was no evidence that the Corporation's board of directors had approved the loan. However, it is unclear if the five year period lapses at the date of application or date of loan approval.

Significant Deficiencies, continued

Finding Number 2010-5, continued
Loan Approval

Recommendation:

We recommend that the Corporation clarify its loan approval policy to minimize the credit risk of its loan portfolio.

Management's response:

At the time the loan was approved the applicant did meet the five year requirement, thus complying with the loan policy. The loan is current and is performing in accordance with the loan documents. We will revisit this part of the loan policy to ensure it is adequate as well as review other loans initiated under similar circumstances and make changes if warranted.