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**McGLADREY & PULLEN, LLP**
**Certified Public Accountants**
**RSM**  
 international

February 6, 2002

The Honorable Mayor and Members  
 of the Town Council  
 Town of Chapel Hill  
 306 North Columbia Street  
 Chapel Hill, North Carolina 27516

Attention: Mr. James M. Baker, Finance Director

This letter is to explain our understanding of the arrangements for the services we are to perform for the Town of Chapel Hill, North Carolina for the year ending June 30, 2002. We ask that you either confirm or amend that understanding.

We will perform an audit of the Town's general-purpose financial statements as of and for the year ending June 30, 2002. We understand that these financial statements will be prepared in accordance with accounting principles generally accepted in the United States of America.

We will also perform the audit of the Town as of June 30, 2002 so as to satisfy the audit requirements imposed by the Single Audit Act and the U.S. Office of Management and Budget (OMB) Circular No. A-133.

We will conduct the audit in accordance with auditing standards generally accepted in the United States of America; *Government Auditing Standards* issued by the Comptroller General of the United States; the provisions of the Single Audit Act, OMB Circular A-133 and OMB's Compliance Supplement and the State Single Audit Implementation Act. Those standards, circulars, supplements and/or guides require that we plan and perform the audit to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement whether caused by error, fraudulent financial reporting or misappropriation of assets, may remain undetected. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. As a result, an audit is not designed to detect errors or fraud that are immaterial to the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our reports.

In addition to our report on the Town's financial statements, we will also issue the following reports or types of reports:

A report on the fairness of the presentation of the Town's schedule of expenditures of Federal and State awards for the year ending June 30, 2002.

Reports on internal control related to the financial statements, and major programs. These reports will describe the scope of testing of internal control and the results of our tests of internal controls.

Reports on compliance with laws, regulations, and the provision of contracts or grant agreements. We will report on any noncompliance which could have a material effect on the financial statements and any noncompliance which could have a direct and material effect on each major program.

A schedule of findings and questioned costs.

Communication with the Town Council relating to the conduct of the audit as required by *Government Auditing Standards*.

Applicable sections of the Data Collection Form.

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The funds and account groups that you have told us are maintained by the Town and that are to be included as part of our audit are those listed below:

General Fund  
Special Revenue Funds  
Debt Service Fund  
Capital Project Funds  
Enterprise Funds  
Fiduciary Funds  
General Fixed Assets Account Group  
General Long-Term Debt Account Group

The federal and state financial assistance programs that you have told us that the Town participates in and that are to be included as part of the single audit compliance examination are listed in the attachment.

In accordance with our audit, we agree on the following:

- a) The Town's Finance Director will be responsible for the preparation of the Schedule of Expenditures of Federal and State Awards to be submitted to the North Carolina State Treasurer's Department.
- b) The Town's Finance Director will be responsible for the timely preparation of the normal "client assistance package" of schedules, confirmations, and other items that support the financial statements and compliance reports and assist the auditor in efficiently executing the engagement.
- c) The Town will identify all sources of federal and state awards prior to the beginning of fieldwork and will prepare, as required by OMB Circular A-133, the supplementary schedule of expenditures or federal and state awards; identifying each program (normally by program or grant title, including the federal agency and federal CFDA number) and indicating whether the federal and state financial assistance is direct or pass-through. This will enable McGladrey & Pullen, LLP to plan and execute the single audit effectively and efficiently and will keep the Town in compliance with OMB Circular A-133 and the State Single Audit Implementation Act. Nonperformance of this responsibility will be an impediment to timely delivery of the statements. If McGladrey & Pullen, LLP performs the work, standard rates reduced by 20% will apply. If major programs exist which have not been identified prior to the beginning of the single audit fieldwork, McGladrey and Pullen, LLP will perform the work at standard rates reduced by 20%, not to exceed \$2,500 per program.
- d) If the Town cannot perform its responsibilities in a timely manner, the McGladrey "partner/senior manager responsible" will consult with the Finance Director for his decision as to whether McGladrey personnel will complete the work. This arrangement protects the Town and McGladrey from unforeseen time and expense and provides the Town with a means, through increased efficiency and/or assistance by Town personnel, to lower the total hours and, therefore, reduce the fee charged. The rates for "non-normal" hours will be at standard rates reduced by 20% and will apply to such work as extended procedures in the event of fraud.
- e) Previously identified component unit is Orange Water and Sewer Authority (OWASA) that will be reported as discretely presented component unit of the Town as required under GASB No. 14. This organization is audited by our firm as another separate engagement with OWASA.

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Our reports on internal control will include any reportable conditions and material structural or operational weaknesses in the system of which we become aware as a result of obtaining an understanding of internal control and performing tests of internal control consistent with requirements of the standards and circular identified above. Our reports on compliance will address errors, fraud, violations of compliance requirements and other responsibilities imposed by state and federal statutes and regulations and assumed by contracts; and any state or federal grant, entitlement or loan program questioned costs of which we become aware, consistent with requirements of the standards and circulars identified above.

If circumstances relating to the condition of your records, the availability of sufficient, competent evidential matter, or indications of a significant risk of material misstatement of the financial statements because of error, fraudulent financial reporting, or misappropriation of assets which in our professional judgment prevent us from completing the audit, we retain the unilateral right to take any course of action permitted by professional standards, including withdrawal from the engagement.

As you know, management is responsible for (1) the preparation of the Town's financial statements, (2) establishing and maintaining effective internal control over financial reporting and safeguarding assets, (3) properly recording transactions in the records, (4) identifying and ensuring that the Town complies with the laws and regulations applicable to its activities and (5) making all financial records and related information available to us and (6) for adjusting the financial statements to correct material misstatements. At the conclusions of our audit, we will request certain written representations from management about the financial statements and matters related thereto. We will also require that you affirm to us that the effects of any uncorrected misstatements brought to your attention by us, are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

The Town of Chapel Hill. acknowledges that McGladrey & Pullen, LLP, at its discretion, will use employees of RSM McGladrey, Inc., an indirect wholly owned subsidiary of H&R Block, Inc. for certain administrative support, marketing and professional services relating to The Town of Chapel Hill. To facilitate the delivery of these services, The Town of Chapel Hill. authorizes McGladrey & Pullen, LLP to allow employees of RSM McGladrey, Inc. access to The Town of Chapel Hill. files, financial information and other confidential information as determined by McGladrey & Pullen, LLP. RSM McGladrey, Inc. is not a licensed certified public accounting firm and will not offer or perform public accounting services.

You have informed us that you intend to prepare a comprehensive annual financial report (CAFR) and submit it for evaluation by the Government Finance Officers Association's Certificate of Achievement for Excellence in Financial Reporting. Our participation in the preparation of the CAFR is to consist of having the audit report reviewed by a person who is also a reviewer for the GFOA Certificate Program and have him involved in the resolution of any accounting or reporting questions that arise during the engagement.

The working papers for this engagement are the property of McGladrey & Pullen, LLP. However, you acknowledge and grant your assent that representatives of the cognizant agency or its designee, other government audit staffs and the U.S. General Accounting Office shall have access to the audit working papers upon their request; and that we shall maintain the working papers for a period of at least three years after the date of the report, or for a longer period if we are requested to do so by the cognizant or oversight agency. Access to requested workpapers will be provided under the supervision of McGladrey & Pullen, LLP audit personnel and at a location designated by our Firm.

During the course of our engagement, we may accumulate records containing data which should be reflected in your books and records. You will determine that all such data, if necessary, will be so reflected. Accordingly, you will not expect us to maintain copies of such records in our possession.

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The assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, has been discussed and coordinated with Ms. Kay Johnson. The timely completion of this work will assist us in performing our work efficiently.

Our fees are based on the time required by the individuals assigned to the engagement, plus direct expenses. Individual hourly rates vary according to the degree of responsibility involved and the skill required. Interim billings will be submitted as work progresses and as expenses are incurred. We will submit our final bill for these services promptly upon delivering the reports. Our fee for the audit services described in this letter will not exceed \$38,500. If the assistance to which the Town has agreed to furnish is not provided, or unexpected conditions are encountered, we will discuss the situation with you before proceeding, if agreed to by the Town by an amendment to the Contract. Any services performed in addition to normal audit procedures will be charged at standard rates less 20%. All other provisions of this letter will survive any fee adjustment.

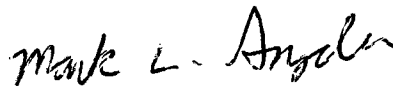
In the event we are requested or authorized by the Town or are required by government regulation, subpoena, or other legal process to produce our documents or our personnel as witnesses with respect to our engagements for the Town, the Town will, so long as we are not a party to the proceeding in which the information is sought, reimburse us for our professional time and expenses, as well as the fees and expenses of our counsel, incurred in responding to such requests.

Our report on the financial statements is not to be included in an official statement or other document involved with the sale of debt instruments without our prior consent. Additionally, if you intend to publish or otherwise reproduce the financial statements and make reference by name to us or our audit, you agree to provide us with printer's proofs or masters for our review and consent before printing. You also agree to provide us with a copy of the final reproduced material for our consent before it is distributed. Our fees for any additional services that may be required under our quality assurance system as a result of the above will be established with you at the time such services are determined to be necessary.

In accordance with the 1994 revision of *Government Auditing Standards* a copy of our most recent peer review report has been filed with the State Treasurer's Office for your review.

If this letter defines the arrangements, as you understand them, please sign the enclosed copy and return it to us. Thank you for this opportunity to be of assistance. We appreciate your business.

McGLADREY & PULLEN, LLP



Mark L. Snyder, Partner

MLS:vb  
Enclosure

Confirmed on behalf of the addressee:

\_\_\_\_\_  
Town Manager

This instrument has been preaudited in the manner required by the Local Government Budget and Fiscal Control Act.

\_\_\_\_\_  
Finance Director