

McGladrey & Pullen

Certified Public Accountants

June 18, 2003

McGladrey & Pullen, LLP
230 North Elm St., Ste. 1100, Greensboro, NC 27401-2436
P.O. Box 2470, Greensboro, NC 27402-2470
O 336.273.4461 F 336.274.2519
www.mcgladrey.com

The Honorable Mayor and
Members of Town Council
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, 2003. We ask that you either confirm or amend that understanding.

We will perform an audit of the Town's financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information as of and for the year ending June 30, 2003. 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, 2003 so as to satisfy the audit requirements imposed by the Single Audit Act of 1984, the U.S. Office of Management and Budget (OMB) Circular A-133 and the state of North Carolina single audit implementation act.

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 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. Accordingly, a 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.

Our audit will be conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Town's basic financial statements. The accompanying supplementary information, such as the introductory section, combining and individual nonmajor fund financial statements, statistical tables, as well as accompanying schedule of expenditures of federal and state awards as required by the U.S. Office of Management and Budget Circular A-133 and the State Single Audit Implementation Act, will be presented for purposes of additional analysis and are not a required part of the basic financial statements. The supplemental information and the accompanying schedule of expenditures of federal and state awards will be subjected to auditing procedures applied in the audit of the basic financial statements. The introductory section and the statistical tables will not be subjected to auditing procedures.

McGladrey & Pullen, LLP is an independent member firm of
RSM International, an affiliation of independent accounting
and consulting firms.

Mr. James M. Baker
June 18, 2003
Page 2

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, 2003.

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's Audit Committee relating to the conduct of the audit as required by *Government Auditing Standards*.

Applicable sections of the Data Collection Form.

The Town will determine and provide to us, a list of the Town's governmental activities, business-type activities, each major fund and the aggregate remaining fund information for the year ending June 30, 2003.

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.

The component unit whose financial statements you have told us are to be combined with and included as part of the Town's general purpose financial statements are the Orange Water and Sewer Authority (OWASA). This entity will be disclosed through discrete presentation as a component unit, as required by Governmental Accounting Standards Board (GASB) 14. Our firm as another separate engagement with OWASA audits this organization.

Our reports on internal control will include any reportable conditions and material structural 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 circulars identified above. Our reports on compliance will address material 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 or noncompliance 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,

6

Mr. James M. Baker
June 18, 2003
Page 3

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. has agreed to comply with Rule 301 of the AICPA Code of Professional Conduct, *Confidential Client Information*. 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 and accounting 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 or oversight agency or their 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.

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 is essential condition to our completion of the audit and issuance of our audit report.

Our fees are based on the time required by the individuals assigned to the engagement, plus direct expenses. 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 services described in this letter will not exceed \$56,000. 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/or 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 reproduction and/or release occurs. You also agree to provide us with a copy of the final reproduced material for our consent before it is distributed or released. Our fees for any

①

Mr. James M. Baker
June 18, 2003
Page 4

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 *Government Auditing Standards* a copy of our most recent peer review report has been provided to you, for your information

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

McGLADREY & PULLEN, LLP



Mark L. Snyder, Partner

MLS:ns
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