

McGladrey & Pullen

Certified Public Accountants



April 28, 2004

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

Attention: Ms. Kay Johnson, 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, 2004. We ask that you either confirm or amend this understanding.

We will perform an audit of the Town of Chapel Hill, North Carolina's governmental activities, business-type activities, discretely presented component unit, each major fund, and aggregate remaining fund information as of and for the year ending June 30, 2004 which collectively comprise the basic financial statements. We understand that these financial statements will be prepared in accordance with accounting principles generally accepted in the United States of America. The objective of an audit of financial statements is to express an opinion on those statements.

We will also perform the audit of the Town of Chapel Hill, North Carolina as of June 30, 2004 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 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.

In addition to our reports 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 awards for the year ending June 30, 2004.

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.

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A schedule of findings and questioned costs.

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

General Fund
Special Revenue Funds
Capital Project Funds
Debt Service Fund
Enterprise Funds
Internal Service Funds
Fiduciary Funds

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 are listed as an attachment.

The component unit whose financial statements you have told us are to be included as part of the Town's basic financial statements is the Orange Water and Sewer Authority.

Our reports on internal control will include any reportable conditions and material 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 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 of loan program questioned costs of which we become aware, consistent with requirements of the standards and circulars identified above.

If circumstances arise relating to the conditions 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, misappropriation of assets, or noncompliance which in our professional judgment prevent us from completing the audit or forming an opinion, we retain the unilateral right to take any course of action permitted by professional standards, including declining to express an opinion or issue a report, or withdrawal from the engagement.

As you know, management is responsible for 1) the preparation of the Town of Chapel Hill, North Carolina's financial statements and the schedule of federal awards, 2) establishing and maintaining effective internal control over financial reporting and safeguarding assets and internal control over compliance, and for informing us of all significant deficiencies in the design or operation of such controls of which it has knowledge, 3) properly recording transactions in the records, 4) identifying and ensuring that the Town of Chapel Hill, North Carolina complies with the laws and regulations applicable to its activities, and for informing us about all known material violations of such laws or regulations, 5) the design and implementation of programs and controls to prevent and detect fraud, and for informing us about all known or suspected fraud affecting the entity involving management, employees who have significant roles in internal control and others where the fraud could have a material effect on the financial statements, 6) informing us of its knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, regulators, or others, 7) making all financial records and related information available to us, and 8) for adjusting the financial statements to correct material misstatements and 9) following up and taking corrective action on audit findings, including the preparation of a summary schedule of prior audit findings, and a corrective action plan, and 10) submitting the reporting package. At the conclusion 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 aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

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The Town Council is responsible for informing us of its views about the risks of fraud within the entity, and its knowledge of any fraud or suspected fraud affecting the entity. We will also determine that certain matters related to the conduct of the audit are communicated to the Town Council including 1) fraud involving senior management and fraud whether caused by senior management or other employees that causes a material misstatement of the financial statements, 2) illegal acts that come to our attention unless they are clearly inconsequential, 3) disagreements with management and other serious difficulties encountered in performing the audit, and 4) various matters related to the entity's accounting policies and financial statements.

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 Program. Our participation in the preparation of the CAFR is to consist of reading and reviewing the CAFR for material misstatements and suggestions to comply with the programs reporting requirements.

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 organization personnel, including the preparation of schedules and analyses of accounts, has been discussed and coordinated with Ms. Jeanne Erwin. The timely and accurate completion of this work is an 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. Billings are due upon submission. Our fee for the services described in this letter will not exceed \$45,000 unless the scope of the engagement is changed, the assistance which the Town has agreed to furnish is not provided, or unexpected conditions are encountered, in which case we will discuss the situation with you before proceeding. All other provisions of this letter will survive any fee adjustment.

Our professional standards require that we perform certain additional procedures, on current and previous years engagements, whenever a partner or professional employee leaves the firm and is subsequently employed by or associated with a client. Accordingly, the Town of Chapel Hill, North Carolina agrees it will compensate McGladrey & Pullen, LLP for any additional costs incurred as a result of the employment of a partner or professional employee of McGladrey & Pullen, LLP.

In the event we are requested or authorized by the Town of Chapel Hill, North Carolina 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 of Chapel Hill, North Carolina, Town of Chapel Hill, North Carolina 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.

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Professional standards and our Firm policies require that we perform certain additional procedures whenever our reports are included, or we are named as accountants, auditors, or "experts" in a document used in a public offering of debt securities. 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 to us or our audit, you agree to provide us with printer's proofs or master 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 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.

It is agreed by the Town of Chapel Hill, North Carolina and McGladrey & Pullen, LLP or any successors in interest that no claim arising out of services rendered pursuant to this agreement by or on behalf the of Town of Chapel Hill, North Carolina shall be asserted more than two years after the date of the last audit report issued by McGladrey & Pullen, LLP.

This letter constitutes the complete and exclusive statement of agreement between McGladrey & Pullen, LLP and the Town of Chapel Hill, North Carolina, superseding all proposals oral or written and all other communication, with respect to the terms of the engagement between the parties.

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 and date the enclosed copy, and return it to us. We appreciate your business.

McGladrey & Pullen, LLP



John J. Gilberto, Director

Confirmed on behalf of
the addressee:

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TOWN OF CHAPEL HILL, NORTH CAROLINA

SCHEDULE OF EXPENDITURES OF FEDERAL AND STATE AWARDS (Continued)
FOR THE YEAR ENDED JUNE 30, 2003

Federal Grantor/Pass-Through Grantor/Program Title	Federal CFDA Number	Grantor's Number
Passed-Through City of Durham, North Carolina:		
Federal Transit Administration - Thoroughfare Planning, Section 5303	20.505	03-08-002
Federal Transit Administration - Highway Act of 1973 Section 104(f) Planning Grant	20.505	PL 104(F)
Total U.S. Department of Transportation		
Federal Emergency Management Agency		
FEMA Public Assistance Grants	83.544	135-11800-00
Flood Mitigation Grant	83.548	FMA-PJ-99-01
Total Federal Emergency Management Agency		
U.S. Department of Housing and Urban Development		
Direct Programs:		
Community Development Block Grant Entitlement Program income	14.218	MC-37-0016
Economic Development Initiative Grant	14.246	B-00-SPNC-0023
Disaster Recovery Initiative Grant	14.218	B-98-MU-37-0016
Public and Indian Housing Program - Operating	14.850	A-3963
Public and Indian Housing - Drug Elimination	14.854	NC-19DEP0460101
Public and Indian Housing Capital Fund	14.872	NC-19P04650100 NC-19P04650101 NC-19P04650102
Total U.S. Department of Housing and Urban Development		

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TOWN OF CHAPEL HILL, NORTH CAROLINA

SCHEDULE OF EXPENDITURES OF FEDERAL AND STATE AWARDS
FOR THE YEAR ENDED JUNE 30, 2003

Federal Grantor/Pass-Through Grantor/Program Title	Federal CFDA Number	Grantor's Number
FEDERAL ASSISTANCE		
U.S. Department of Transportation		
Direct Programs:		
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.507	NC-90-X314-00
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.507	NC-90-X295-00
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.507	NC-90-X281-00
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.507	NC-90-X265-00
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.507	NC90-X243-00
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.507	NC90-X227-01
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.507	NC90-X330
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.505	04-08-002
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.507	NC-90-X304
Federal Transit Administration - Federal Transit Capital and Planning Formula Grant	20.507	NC-90-X278
Federal Transit Administration - Federal Transit Capital Improvement Grant	20.500	NC-03-0044

TOWN OF CHAPEL HILL, NORTH CAROLINA

SCHEDULE OF EXPENDITURES OF FEDERAL AND STATE AWARDS (Continued)
 FOR THE YEAR ENDED JUNE 30, 2003

Federal Grantor/Pass-Through Grantor/Program Title	Federal CFDA Number	Grantor's Number
U.S. Department of Justice		
Direct Programs:		
COPS More01 Grant	16.710	2001CMWX0269
Local Law Enforcement Block Grant	16.592	02-LB-BX-2505
Total U.S. Department of Justice		
U.S. Department of Energy		
Passed-Through the NC Solar Center NC Solar Grant	81.041	2002-0080-05
U.S. Department of Interior		
Passed-Through N. C. Department of Cultural Resources Historic Preservation - Certified Local Government Grant	15.904	53-0197094
National Foundation on the Arts and Humanities		
Passed-Through the N C State Library	45.310	
TOTAL FEDERAL ASSISTANCE		
STATE ASSISTANCE		
North Carolina Department of Transportation		
Powell Bill		
Interest		
State Maintenance Assistance for Urban and Small Urban Areas		
Bicycles/Pedestrian Safety Grant		
North Carolina State Technology Funding		02-AT-002
Total North Carolina Department of Transportation		
State Library Aid		
State Clean Water Management Grant		
Aerial Photography		
Governor's Crime Commission Grant		
TOTAL STATE ASSISTANCE		
TOTAL FINANCIAL ASSISTANCE		