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March 1, 2004

The Honorable Mike Hatch
Attorney General
102 State Capitol
St. Paul, Minnesota 55155

Dear Attorney General Hatch:

Thank you for sharing with me your concerns about contracts school districts have entered into with National School Fitness Foundation (NSFF) for fitness equipment and a related fitness program. You asked us to review these contracts. We have been reviewing this issue for several months, following an inquiry from a school board treasurer who received a brief letter from you in October 2003 in response to concerns he raised about these contracts. In short, we share your concerns, and offer the following additional insights.

We found that at least thirteen Minnesota school districts have paid almost \$5 million to enter into these agreements, most of it within an eight-month period of time. We agree with you that school districts should not enter these agreements until questions surrounding these agreements are resolved. We also believe some of these issues should be reviewed by agencies with appropriate oversight authority, to whom we have made referrals. We have also identified at least one area of concern for which your Office may have enforcement authority.

This letter will provide you with a summary of our review, discuss issues raised during our review, and present questions that we believe school districts should resolve before entering these agreements.

Background

NSFF is registered as a 501(c)(3) organization. According to its website, NSFF is a nonprofit, public organization operating in the educational services sector. It provides schools with a fitness program referred to as L.I.F.T. America (Program). According to NSFF's website, the Program includes exercise equipment, faculty training and

certification, an inclusive medical supply bag, high-tech assessment kiosks, and a physical education curriculum.

NSFF's address, according to the Utah Department of Commerce website, is 915 S. 500 E., No.110, American Fork, Utah 84003. NSFF's authorized distributor is School Fitness Systems, L.L.C. (SFS), a limited liability company. SFS's address, according to the Utah Department of Commerce website, is also 915 S. 500 E., Ste. 110, American Fork, Utah 84003. The registered agents for both entities, according to the Utah website, are located at the same address. Neither NSFF nor SFS are registered with the Minnesota Secretary of State, according to our review on February 23, 2003 of the Minnesota Secretary of State's website.

We found thirteen Minnesota school districts that have entered into agreements with NSFF. A chart of those school districts is attached. We reviewed the contracts these school districts entered with NSFF and its authorized distributor. We understand that other Minnesota school districts may also be considering agreements with NSFF. For high schools and middle schools, the cost of the Program appears to be \$218,901.34 per school; for elementary schools, the cost of the Program appears to be \$112,395.70 per school.¹

NSFF requires school districts to pay for the Program up-front. Most of the Minnesota school districts obtained financing for the Program by entering a three-year lease-purchase agreement with a financial institution (bank). Thus, NSFF's authorized distributor receives full payment up-front, and the school districts are obligated to repay the bank, plus interest, over three years.

We learned that the Minneapolis School District (Minneapolis) did not have to enter a lease-purchase agreement to purchase the Program. Instead, Minneapolis paid for the Program in six of seven locations by using funds that it had borrowed at 1% until state funding was released to the school district. The total cost to Minneapolis for all seven locations was more than \$1.44 million

When a school district enters into an agreement with NSFF, NSFF agrees to make a monthly "charitable contribution" to the school district equal to the school district's lease-purchase payments, if certain conditions are met.² NSFF tells school districts that they can receive the program "free of cost, but not free from obligation." However, in bold and capital letters contained in the agreements drafted by NSFF, the school districts acknowledge "the potential and business risk" that NSFF may be unable to perform its

¹ For Minneapolis and Floodwood, the cost of the high school/middle school program was \$221,940.00. For school districts that obtained financing, the costs including interest for high schools and middle schools vary from \$229,089.96 to \$234,170.01.

² If the Program is purchased out of a school district's general fund, as was done in Minneapolis, the monthly "contribution" is the purchase price divided by 36. Under the agreements, the "contribution" can be in any form, including cash, property, services, discounts, credits, offsets or the like.

obligation to make the “charitable contributions.” If NSFF stops making the “contributions,” for any reason, the exclusive remedy under the agreements is limited to discounted payments for the remainder of the school district’s budgetary period in which the payments stopped, or the remainder of the three-year license term, whichever is shorter. The school district remains liable for any lease-purchase agreements it entered.

According to NSFF’s website, NSFF has “contributed more than \$16 million to schools around the country and has not missed providing a contribution payment to a school that upheld its obligations” to NSFF. NSFF claims that 500 schools in 18 states are using the Program.

Issues

With that background in mind, it is useful to consider the issues that we believe should be resolved **before** a school district enters one of these agreements. The resolution of these issues will require a detailed discussion between and among the school districts, their counsel, any financial institution, and NSFF. We recommend that these discussions take place **before** Minnesota school districts enter any additional contracts with NSFF.

In addition, we identified several areas that we believe warrant further review by other authorities. We have referred these concerns to the appropriate authorities.

I. Concerns with NSFF

We share your concerns regarding the risk to school districts if NSFF does not meet its “contribution” requirements under these agreements. We request that you review whether NSFF needs to comply with Minnesota’s charitable solicitation regulations. We also question whether NSFF is making a “contribution” to the school districts, and whether school districts should consider these agreements to be “grants.” Finally, the tax forms filed by NSFF raise many questions, and we recommend that independently audited financial statements from NSFF be obtained and reviewed by school districts before they enter these agreements.

A. Minnesota’s Charitable Solicitation Regulations

We raise the issue that NSFF may need to comply with Minnesota’s charitable solicitation laws. In Minnesota, charitable solicitations are governed by Minnesota Statutes, Chapter 309. NSFF is registered as a 501(c)3 organization. Under Minnesota’s law, charitable organizations must file certain forms with your Office before soliciting contributions in Minnesota. In addition, financial statements of charitable organizations

with total annual revenues in excess of \$350,000 must have an independently audited financial statement.³

Under Minnesota law, “contributions” include a request for payment for merchandise if a representation is made that any part of the price will be applied to a charitable purpose.⁴ In addition, when the charitable organization offers goods and services, “contributions” include the difference between the direct cost of the goods and services to the charitable organization and the price at which the items are sold.⁵ A “charitable purpose” includes any actual or purported educational purpose.⁶ “Solicitation” include direct and indirect requests for “contributions” with the representation that the contribution will or may be used for any charitable purpose, including the sale or attempt to sell any merchandise, or where the name of the charitable organization is used in the sale as an inducement to purchase the merchandise, or any statement is made in connection with the sale that the whole or any part of the proceeds of the sale will be used for charitable purposes.

NSFF is soliciting Minnesota school districts, and representing that it will make “contributions” to schools that enter agreements with NSFF. We have found that Minnesota school districts have paid more than \$4.8 million for the Program, in less than two years, as a result of those solicitations.

In addition, any difference between the direct cost of the Program and the price at which the Program is sold to the school districts would appear to be a “contribution” that was solicited by NSFF. If the direct cost of the products offered as part of the Program is less than the price paid by the school districts, the difference would be a contribution solicited by NSFF.

Your Office is authorized to conduct investigations to determine whether Minnesota’s charitable solicitation requirements have been met.⁷ We would encourage you to consider initiating such an investigation of NSFF’s actions in Minnesota if you deem it is warranted. We are willing to provide you with any of the information we have acquired during the course of our review, if that would be of assistance to you.

B. NSFF’s “Contributions”

Most school districts took out a loan to pay up-front the full purchase price of the Program. The up-front payment was made to NSFF’s “authorized distributor.” NSFF

³ See Minn. Stat. § 309.53, subd. 3 (2002). According to NSFF’s 2001 (fiscal year ending June 30, 2002) tax returns (Form 990), NSFF had revenues of nearly \$34 million. Federal tax returns may be filed in lieu of audited financial statements if the tax returns are prepared in accordance with generally accepted accounting principles and meet certain statutory requirements. *Id.* at subd. 3a.

⁴ See Minn. Stat. § 309.50, subd. 5 (2002) (“contribution”).

⁵ *Id.*

⁶ See Minn. Stat. § 309.50, subd. 3 (2002) (“charitable purpose”).

⁷ See Minn. Stat. § 309.533 (2002). Enforcement authority by your Office is found in Minn. Stat. § 309.57 (2002).

then agreed to make monthly “contributions” equal to the school district’s loan payment (principal plus interest payments). It does not appear that NSFF is giving a “contribution” to the school districts. Rather, it appears that NSFF has agreed to a monthly schedule to repay the school districts their purchase price, plus the interest the school districts paid on their loans. More accurately, it appears that the school districts are contributing more than \$200,000 to NSFF’s distributor up-front, with a monthly repayment schedule by NSFF. As a result, the relationship between NSFF and its authorized distributor should be explored before school districts enter these agreements.

C. Classification of the Contracts as “Grants”

Some school districts have characterized the NSFF agreements as a “grant.” For example, the Minneapolis School District (Minneapolis) held a staff development meeting for its physical education and health teachers. The teachers were informed that an NSFF program had been installed at the Anne Sullivan School, with all equipment, training and support provided by a “grant” from NSFF. In addition, the Interim Superintendent described these contracts as a “grant” when he recommended School Board approval of the contracts. Similarly, the April 14, 2003 minutes of the White Bear Lake School District (White Bear) School Board characterize the L.I.F.T. Program as a “grant.”

We believe these agreements are mischaracterized when they are called a “grant.” Most “grants” do not require the public entity to pay up-front the full purchase price of the item received under the grant. NSFF’s “contribution” to the school district is essentially returning the school district its money on a three-year monthly repayment schedule. The return “contributions” are not guaranteed by NSFF. In our view, NSFF is not providing a “grant” to the school district; instead, it appears to be promising that the school district might receive a return of its money. We acknowledge that, to our knowledge, NSFF has not missed a monthly return payment to Minnesota schools at the time our review was conducted.

D. NSFF’s Form 990 (Tax Forms for 501(c)3 Organizations)

On February 19, 2004, NSFF informed us that it has not yet filed its 2002 tax forms for NSFF’s fiscal year ending June 30, 2003. As a result, we were only able to review NSFF’s 2000 and 2001 tax forms. The tax forms we reviewed raise a number of questions.

According to the contracts we have reviewed, the cost of the Program for high schools and middle schools is \$218,901.34 or \$221,940.00 per school. However, NSFF’s website states the Program is valued at over \$300,000. From the contracts we have reviewed, the cost of the Program for elementary schools appears to be \$112,395.70 per school. However, NSFF’s website states the Program is valued at nearly \$180,000.

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NSFF provided some Minnesota school districts with copies of its 2001 Tax Form 990, for the year ending June 30, 2002, and “explanatory notes” to the form. NSFF’s explanatory notes state that contributions, gifts or grants to NSFF are recorded at fair market value. NSFF’s notes also state that “NSFF management has valued non-cash assets at fair market value, generally as determined by a third party appraisal engaged or otherwise retained by NSFF.” For the year ended June 30, 2002, NSFF reported \$26,000,426 in direct public support. However, only \$426 of that amount was in cash contributions, gifts and grants. The remainder, \$26 million, is attributed to non-cash contributions, gifts and grants.

Given the difference between the contract prices and the value of these programs as claimed by NSFF on its website, questions arise about NSFF’s valuation of non-cash assets. In addition, we question how payments from school districts to NSFF’s authorized distributor and to NSFF are reflected on the tax forms. Finally, questions exist about how “contributions” to the school districts are reflected by NSFF on the tax forms. We have forwarded our concerns to the IRS.

E. Need for Independently Audited Financial Statements

NSFF informed us on February 19, 2004, that independently audited financial statements of NSFF have not been completed. Nor are there independently audited financial statements for any prior years, even though millions of dollars of public funds have been sent to NSFF or its authorized distributor.

Many of the lease agreements used by school districts to purchase the NSFF Program have been through Wells Fargo in Utah. However, Wells Fargo informed us that, for its own due diligence purposes, Wells Fargo asked NSFF for an audited financial statement of its 2002 fiscal year. As of February 19, 2004, Wells Fargo has not received the requested audited financial statements. Wells Fargo has informed us that until they obtain and review independently audited financial statements from NSFF, Wells Fargo has stopped offering these lease purchase agreements.

School districts, in exercising due diligence over the public funds entrusted to them, should request and review audited financial statements from NSFF **before** entering these agreements. Waiting until after the agreements are signed may be too late, because the agreements state that NSFF is not required to account to the school districts concerning NSFF’s “fundraising efforts or the proceeds thereof.” Without such an accounting, we question whether school districts should be giving public funds to NSFF or its authorized distributor. We would be happy to review any audited financial statements that school districts receive from NSFF and/or its authorized distributor.

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Additionally, this Office will continue to pursue its efforts to acquire and review NSFF's audited financial statements since more than \$4.8 million in Minnesota public funds have been sent to NSFF or its authorized distributor.⁸

⁸ See Minn. Stat. §§ 6.551 and 16C.05, subd. 5 (2002).

II. Contracting Procedures Used by School Districts

Many of the school districts appear to have consulted with counsel before entering these agreements. We disagree with the analysis used by some of the attorneys who signed Opinion of Counsel letters, and we believe that additional concerns exist.

A. Lease Agreements

Most of the school districts entered three-year lease-purchase agreements with a financial institution to pay for the NSFF Program. That is, they took out a loan. We do not believe school districts had the authority to enter these agreements to pay for the NSFF Program.

School districts may purchase real or personal property under an installment contract, or a lease-purchase agreement.⁹ While the physical equipment purchased under these agreements could be purchased through a lease-purchase agreement, we understand that the equipment is only a portion of the purchase price. The additional costs of the NSFF Program, such as personnel costs, training services, travel costs and consultant fees, are generally not considered purchases of real or personal property. In fact, some school districts have argued that these agreements are outside Minnesota's bid laws precisely because they cover far more than a traditional property purchase. We question the authority of school districts to undertake lease-purchase financing for the purchase of items or services in addition to real or personal property.

Under Minnesota law, a school district must have the right to terminate a lease-purchase agreement at the end of any fiscal year during its term.¹⁰ This provision must be included in all lease-purchase agreements.¹¹ Most of the lease-purchase financing agreements we reviewed contain the school district's right to terminate the lease-purchase agreement at the end of any fiscal year.

Even with such termination provisions, however, school districts should be aware of what they would lose if NSFF fails to make all monthly "contributions," and the school district terminates its lease. At a minimum, the school district will be obligated to pay the bank the remaining monthly payments for the fiscal year. In addition, under most of the lease-purchase agreements, the financial institution, not the school district, will own the equipment. Finally, school districts should discuss with counsel and their financial advisors how ending the lease-purchase agreements before the end of the three-year term may affect the school district's ability to borrow funds in the future.

⁹ See Minn. Stat. § 465.71 (2002). Under a lease-purchase agreement title may be retained by the seller or vendor, or assigned to a third party as security for the purchase price, including interest. *Id.*

¹⁰ *Id.*

¹¹ *Id.*

B. Compliance with Bid Laws

School districts must bid contracts for goods and services that cost over \$50,000, with certain exceptions.¹² When lease-purchase agreements are used, the \$50,000 threshold for bidding is the total of all lease payments for the entire term of the lease.¹³ Contracts for the purchase of property made in violation of the school district's contract law are void.¹⁴

Under the contracts we reviewed, the total of all lease payments for the three-year leases is over the dollar threshold requiring sealed bids. On its face, the sales agreements that school districts entered with NSFF's authorized distributor for over \$200,000 would come within the parameters of Minnesota's statutory bid law. Yet, these agreements have generally not been put out for bid by school districts.

Some school districts have argued that the net amount of the agreements for purposes of the bid law is zero, so bids were not required. The Program is not free. "Free" does not include paying money for the chance to receive a refund of your money. NSFF expressly recognizes that it is not obligated to make "contributions" if it does not receive sufficient funding and donations. We have found that nearly \$5 million of public funds have been paid to NSFF or its authorized distributor by Minnesota school districts. Schools are obligated to pay the loans they have obtained to pay for the Program. Obviously, paying money or incurring a debt is not necessary if something is given to the school district for "free."

Some school districts have argued that the Program is an integrated program of equipment, assessment tools, curriculum, staff training, and contributions, so bids were not required. However, if these contracts are integrated programs comprised of more than personal property, the contracts were not appropriate for lease-purchase agreements. To the extent these are contracts for materials, supplies or equipment, and therefore eligible for purchase through a lease-purchase agreement, these contracts should have been bid.¹⁵

Based on the cost alone, we believe these contracts contain something primarily other than equipment and other personal property. For example, according to the minutes of the June 9, 2003 Brainerd School Board and Building Committee meetings, a representative from NSFF reported that the value of the equipment in the NSFF package

¹² See Minn. Stat. §§ 123B.52 (school district contracts) and 471.345 (municipal contracting law applicable to school districts) (2002).

¹³ See Minn. Stat. § 465.71 (2002).

¹⁴ See Minn. Stat. § 123B.52, subd.1 (2002) (school board contracts not made in compliance with this section are void).

¹⁵ See *Hubbard Broadcasting, Inc. v. Metropolitan Sports Facilities Comm'n*, 381 N.W.2d 842, 846 (Minn. 1986).

was only about \$90,000 - \$100,000, and the remaining \$119,000 - \$129,000 was for the curriculum, training, service warranty and data collection equipment.

If the curriculum was important to the school districts, they could have first contracted separately with a vendor for a curriculum. The school districts could have then solicited competitive bids for the equipment, specifically requiring that training, service warranties and data collection equipment be included as part of the bid. The school districts and NSFF cannot circumvent the requirements of the competitive bidding statutes simply by including curriculum, training, service warranties and data collection in a contract for the purchase of exercise equipment.¹⁶

We also reject arguments made by some school district's counsel that these contracts are unique products, akin to a scoreboard system with advertising rights installed at the Metrodome.¹⁷ The exercise and fitness equipment provided to the schools is not unique. We understand that both Universal and Hoist equipment has been provided to Minnesota schools under these agreements. Other dealers than NSFF's authorized distributor exist for that equipment. Other brands of equipment are also readily available. We believe that providing fitness equipment and a related fitness program to a school is fairly typical of other contracts that school districts enter to provide an education to their students. In our view, the sales agreements school districts entered with NSFF's authorized distributor are not unique. We believe those contracts were subject to the competitive bidding requirements.

The most unique portion of these contracts is found in the NSFF Fitness Program and Contribution Agreement where NSFF imposes a number of conditions before it is obligated to make "charitable contributions" to the school district. To obtain access to the potential "charitable contributions," NSFF requires school districts to buy equipment from its authorized distributor. We do not believe that the purchase of exercise equipment can be removed from the bidding requirements by tying the purchase of the equipment to NSFF's offer to potentially make "charitable contributions" equal to the purchase price.

Competitive bidding statutes are designed to ensure that taxpayers receive the best bargain for the least money.¹⁸ The "fundamental purpose of competitive bidding is to deprive or limit the discretion of contract making officials in the areas which are susceptible to such abuses as fraud, favoritism, improvidence, and extravagance."¹⁹ We

¹⁶ See *W.V. Nelson Constr. Co. v. City of Lindstrom*, 565 N.W.2d 434, 436 (Minn. App. 1997) (city should have first contracted for design services, and then bid for construction services).

¹⁷ See *Hubbard Broadcasting, Inc. v. Metropolitan Sports Facilities Comm'n*, 381 N.W.2d 842 (Minn. 1986).

¹⁸ See, e.g., *Byrd v. Independent Sch. Dist. No. 194*, 495 N.W.2d 226, 232 (Minn. App. 1993), review denied (Minn. Apr. 20, 1993); *W.V. Nelson Constr. Co. v. City of Lindstrom*, 565 N.W.2d 434, 435-36 (Minn. App. 1997).

¹⁹ *Griswold v. Ramsey Co.*, 242 Minn. 529, 536, 65 N.W.2d 647, 652 (1954).

believe the purpose of the competitive bidding statutes would have been well served if school districts had put the contracts for the purchase of exercise equipment and any related curriculum program out for bids.

C. The Value of Products Received

The NSFF agreements have several components: physical equipment, a program/curriculum/data exchange, and a possibility of a monthly repayment of the school district's purchase price plus interest. NSFF's authorized distributor informs schools that it will only sell the "complete package" and it is unable to comply with any request for a breakdown of prices. We believe that school districts may be able to obtain the same value of equipment and a program at less cost and less risk.

We have reviewed a bid received by one school district from another vendor for some of the products offered in the NSFF agreements. The vendor submitted a bid for circuit/strength and cardiovascular equipment, staff training, posters, and operations manuals similar to those contained in the NSFF high school package. The bid was for \$53,376.47. That would leave the school district \$165,524.87 to purchase the remaining products included in the NSFF package.²⁰ Other equipment suppliers offer equipment of similar quality and design as those included in the NSFF package, all for under \$100,000.00. We seriously question whether the actual cost of the remaining products could possibly be between \$118,000 and \$165,000.00.

It appears that some school districts never asked for a cost break-down of the items received under the Program. When school districts did ask for a break-down of costs, they were informed by NSFF's authorized distributor, SFS, that SFS was "unable to comply." SFS claimed that it had negotiated volume discounts with its supporting vendors, offering prices considerably lower than those at which the vendors' own dealers could purchase the products. Thus, according to SFS, the vendors requested that SFS not release the individual prices that make up the Program.²¹

To the extent that the actual value of the physical equipment and the actual value of the program/curriculum/data exchange do not add up to the price charged in these agreements, that price is inflated. An argument might be made that NSFF, or its

²⁰ Those items include 30 stretching straps, 1 sit and reach unit, 1 sports medicine bag (with an automated external defibrillator and digital blood pressure cuff), 7 cardio monitors, 2 body composition analyzers, 1 computer with a monitor, 1 laser printer, 1 fitness information input system, 1 athletic program, 1 curriculum manual, a 4-drawer filing cabinet, 50 hanging folders, 100 file folders, 4 large clipboards, 1 surge protector, 1 labeler, a 2-hole punch, and forms for physical health, injury reports, fitness assessments and equipment repair. We obtained a catalog of institutional fitness equipment. It included various data base programs varying from \$129 to \$299; total program packages, including logbooks and record cards, varying from \$39 to \$69; body composition analyzers varying from \$259 to \$1699; and a sit and reach box for \$39.

²¹ See, e.g., August 7, 2003 Letter to Brainerd Independent School District from W. Michael Jarema, SFS President.

equipment distributor, can accept the difference between the actual value of the Program and the price received, as a donation because NSFF is a 501(c)(3) organization. However, school districts have no authority to simply give money to a non-profit organization. As a result, we believe schools districts should have examined the true value of the Program to determine that they were not giving a “gift” to NSFF or its authorized distributor.

D. Data Practices

While data practice issues are not within the State Auditor’s scope of review, school districts should work with their counsel to explore any data privacy issues involved with the data sharing portions of the contracts.

III. Concerns with Specific School Districts

Our review has raised concerns about the procedures used by specific school districts when entering these agreements. Some of our concerns are specifically related to the use of federal grant funds. We also have concerns about the procedures used by the Minneapolis School District in entering these agreements.

A. Federal P.E.P. Grants

Under the No Child Left Behind Act of 2001, Carol M. White Physical Education Program (P.E.P.) grants are available from the United States Department of Education. The purpose of the grants is to initiate, expand, or improve physical education programs.

We are aware of at least three Minnesota school districts that received P.E.P. grants and adopted NSFF’s L.I.F.T. America (the Program). We have concerns with how one of those P.E.P. grants was obtained and used.

1. Delano’s P.E.P. Grant

The Delano School District (Delano) appears to be the first school district in Minnesota to have entered agreements with NSFF. In May 2002, the Delano School Board approved a plan to enter a lease for NSFF equipment, and to work with NSFF on writing a P.E.P. grant to pay for the equipment.

In June 2002, Delano applied for a P.E.P. grant to implement the Program in its high school, middle school, and elementary school.²² Delano stated in its grant application that Delano would “be unable to make a timely transition to this valuable curriculum” without the P.E.P. grant.

²² We were informed that the equipment obtained through the PEP grant would be placed in the elementary schools and at the high school facility, and that middle school students would use the high school facility’s equipment.

In June 2002, Delano also entered an agreement with NSFF, and signed a three-year lease-purchase agreement with the local bank to place the Program in the high school. As part of the agreement, NSFF agreed to make “contributions” to Delano to reimburse Delano for its lease payments. Delano has been unable to provide us with a fully executed copy of its high school agreement with NSFF. However, Delano did provide us with a copy of the agreement that was signed by NSFF.

In July 2002, Delano accepted the property financed with the lease-purchase agreement, and the Bank sent \$152,787.12 to SFS, NSFF’s authorized distributor. Delano’s Superintendent informed us that the NSFF fitness equipment was installed at Delano’s high school in August 2002.

In September 2002, Delano was notified that it received a P.E.P. grant award of \$186,021.00. In October 2002, NSFF sent Delano an invoice for, among other things, over \$100,000.00 of middle and high school weight equipment, the equipment that had been placed in the high school facility in July or August. In a letter dated October 21, 2002, NSFF explained that it would make an “in-kind donation” of \$19,040.00 to Delano, so Delano would only owe NSFF \$175,691.00. In the letter, NSFF also said that NSFF would need to be paid in full in order to place Delano’s equipment order.

Delano made its first payment to the bank under the lease (\$27,622.65) on January 22, 2003. On April 17, 2003, NSFF reimbursed Delano for the \$27,622.65 lease payment. Delano did not receive the P.E.P. grant funds until June 30, 2003, at which time, Delano paid NSFF \$175,691.00, based upon the October 2002 invoice.²³ On July 16, 2003, NSFF paid the bank the amount remaining on the high school lease-purchase agreement (\$131,726.29).

As a result of these transactions, NSFF’s authorized distributor was paid \$152,787.12 (from the Bank), and NSFF was paid \$175,691.00 (from the P.E.P. grant proceeds), for a total of \$328,478.12. NSFF paid out \$27,622.65 (to Delano for the lease payment reimbursement) plus \$131,726.29 (to the Bank), for a total of \$159,348.94. NSFF and its authorized distributor were therefore able to retain \$169,129.18 to pay their costs.

In addition, in June 2003, the Delano School Board approved a second set of agreements with NSFF, this time for the middle school, at a cost of \$218,901.34. Under a new lease-purchase agreement, the total rent for the middle school Program is \$234,170.01, with a final option to purchase of \$1.00. Delano’s Superintendent informed us that Delano does not intend to seek a P.E.P. grant to cover the middle school Program.

²³ According to the 2003 agreements we have reviewed, NSFF’s “contributions” are reduced by any grants, gifts or contributions received by the school district for the Program. In addition, NSFF is authorized in the agreements to seek funds on behalf of the district for the Program, and to charge the district a fee of \$150 per funding application. Similar provisions did not appear in the 2002 Delano agreements with NSFF that were provided to us.

In addition to our general concerns about the inflated cost of the Program, the lack of bids, and the use of lease-purchase agreements for these contracts, we have two specific concerns regarding Delano's use of the federal P.E.P. grant funds. First, we question whether Delano's application accurately stated the need for the federal grant.²⁴ By entering two separate agreements with NSFF for the high school and the middle school, Delano appears to have found a means to place the Program in its schools without use of P.E.P. grant proceeds. It appears to us that the high school Program had already been financed by Delano through the lease-purchase agreement, and NSFF was obligated to reimburse Delano's lease payments, before Delano received the P.E.P. grant. It is at least questionable whether Delano needed the P.E.P. grant to timely implement the Program at the high school.²⁵ If not, the statement to that effect in the grant application was false. In addition, because the P.E.P. grant funds paid off the remainder of the lease-purchase agreement, NSFF was relieved of its contractual "contribution" obligations. It therefore appears to us that NSFF, not Delano, was the true beneficiary of the P.E.P. grant.

Second, we question why the federal funds were used to pay a non-profit organization. NSFF's authorized distributor SFS had already been paid \$152,787.12 for the high school Program by the bank. It appears that neither NSFF nor SFS were owed the additional \$175,691.00 that Delano paid NSFF out of the grant proceeds. To the extent that a portion of the payment to NSFF was for elementary school equipment, we question why the October invoice was from NSFF, not SFS, and why the invoice also billed Delano for the high school Program previously paid for under the lease-purchase agreement.²⁶ Delano's lease-purchase agreement was with the bank, not with NSFF. At most, the P.E.P. grant proceeds used to pay off the lease-purchase agreement should have gone directly to the bank.

The procedures Delano used to pay the October invoice were improper under Minnesota law. Under Minnesota law, school boards must not pay bills until the person claiming payment itemizes the claim in writing.²⁷ In addition, the person claiming payment must sign a declaration to the effect that the claim is just and correct and that no part of it has been paid.²⁸ The October invoice from NSFF does not contain the statutorily required declaration that no part of the claim has been paid. Because the bank had already paid NSFF's authorized distributor for the high school equipment in July, any such declaration by NSFF in October would not have been true. Thus, the October invoice should not have been sent by NSFF, or paid by Delano.

We have forwarded our concerns to the U.S. Department of Education.

²⁴ We also question a claim in the grant application regarding Delano's "high incidence of poverty."

²⁵ P.E.P. grants may not be used for pre-award costs, according to the U.S. Department of Education.

²⁶ The October 18, 2002 invoice from NSFF reflects \$11,464.00 of "elementary fitness supplies."

²⁷ See Minn. Stat. § 471.38, subd. 1 (2002).

²⁸ *Id.*, see also Minn. Stat. § 471.391 (2002) (reverse side of check may also contain the required declaration).

2. Duluth's P.E.P. Grant

The Duluth School District (Duluth) applied for a \$322,832.00 P.E.P. grant in June 2002 for its elementary, middle school, and high school students. Duluth was awarded a grant of \$316,678.00 on October 1, 2002. Duluth is using the P.E.P. grant proceeds to place fitness equipment in its middle schools, to pay for curriculum development by a staff member, and to provide data cabling and technology related to the programs. Duluth used the competitive bidding process to purchase the middle school equipment using the P.E.P grant funds.

Duluth has informed us that the first inquiries it made about NSFF were in October 2002. The Duluth School Board approved entering agreements with NSFF and SFS in August 2003. Under sales agreements with SFS signed July 14, 2003, and amended October 31, 2003, Duluth agreed to pay SFS a total of \$656,704.02 to place the Program in its three high schools. On October 31, 2003, Duluth entered a lease-purchase agreement to place the Program in its three high schools at a cost of \$656,704.02, with a total rent including interest payments of \$692,858.88.

The NSFF Programs placed in the three Duluth high schools cost more than twice the amount that Duluth paid to place equipment, and related cable and technology, in its middle schools, and to develop a curriculum for the middle schools. Duluth used the competitive bidding process to purchase the middle school equipment with P.E.P. grant funds. For the reasons we discussed earlier, we believe that Duluth should have bid the high school equipment, just as it bid the middle school equipment. We believe that Duluth would have been able to receive comparable equipment for the high schools at less cost and at less risk.

3. Brainerd's P.E.P. Grant

We were informed that the Brainerd School District (Brainerd) applied for P.E.P. grant funds in the spring of 2003. According to Brainerd's P.E.P. grant application, the P.E.P. grant would be used to operate fitness centers in grades 6-9, and Brainerd would lease equipment and supplies from NSFF to provide a fitness center for grades 10-12.

The Brainerd School Board decided at a July 2003 School Board meeting to pursue the NSFF program through a competitive bidding process. At the School Board's August meeting, the Board was informed that it had received one partial bid for \$53,376.47 from a vendor for some equipment only, and one bid from NSFF for the "complete system as specified" for \$218,901.34.²⁹ The Brainerd School Board approved the bid received from

²⁹ The vendor submitting the partial bid also provided a second proposal with upgraded cardiovascular equipment for \$55,246.60. The contents of the partial bid were described previously in this letter.

SFS.³⁰ On August 28, 2003, Brainerd entered into agreements with NSFF and SFS, and a lease purchase agreement, to place the NSFF Program in Brainerd's high school.

Brainerd was notified of a \$482,000.00 P.E.P. grant award on September 27, 2003. Brainerd's Director of Business informed us that Brainerd does not anticipate using the P.E.P. grant to pay for the NSFF Program, unless NSFF stops making its monthly payments.

Brainerd's rejection of the vendor's partial bid again highlights our concerns with what appears to be the inflated cost of the Program sold through NSFF and SFS. We believe that by separating the components contained in NSFF's "complete system" and purchasing them through a competitive bidding process, school districts will be able to serve more students for the same amount of money.

B. Minneapolis School District

During our review, we learned that the Minneapolis School Board did not approve the over \$1.44 million spent by the Minneapolis School District (Minneapolis) on these agreements. Instead, for six of the seven sites, we were informed that the Executive Leadership Team approved the expenditure out of funds Minneapolis borrowed until state aid money was available.³¹ Then, after discussions with this Office, the approval of the contracts was put on the consent agenda and approved as part of the School Board's February 10, 2004 meeting. The Interim Superintendent recommended approval of the contracts, stating that the contracts are "a grant" that will be repaid to the School District.

The Minneapolis School Board has the authority to borrow money in anticipation of the receipt of state and federal aid.³² To do so, the Board must pass a resolution specifying the amount and the purpose of the borrowing. We reviewed the Board's resolution for the \$75 million borrowed by Minneapolis.³³ The funds were to be used "solely to pay claims duly approved and allowed with respect to current operating expenditures of the kinds and within the amounts provided in the official budget of the District."

A school board has the authority to approve contracts.³⁴ The NSFF contracts had not been approved by the School Board when they were signed by the District's business manager. A school board may authorize its superintendent or business manager to

³⁰ The bid identified in the School Board minutes as the NSFF bid was actually a bid from NSFF's authorized distributor SFS.

³¹ We were informed that the seventh site, installation at Sullivan School, was approved by the Executive Leadership Team on January 31, 2003.

³² See Minn. Stat. §§ 126C.50 – 126C.56; 123B.78, subd. 3; and 128D.16, subd. 2 (2002).

³³ See Resolution Relating to \$75,000,000 General Obligation Aid Anticipation Certificates of Indebtedness, Series 2003B; Authorizing the Issuance and the Sale Thereof and Establishing the Terms Thereof, adopted by the Board of Education on July 8, 2003.

³⁴ See Minn. Stat. §§ 123B.02, 123B.52, subd. 1 (2002).

contract for good and services within the budget approved by the board.³⁵ However, we were informed that the size of these contracts are not within the budget approved by the School Board. Therefore, it appears that the School Board should have approved these contracts before they were executed.

For the reasons we discussed earlier in this letter, we do not believe that these agreements are appropriately referred to as “grants.” Due to the risk involved in these contracts, we believe they should have been discussed by the School Board. Finally, as with all of these agreements, we believe that Minneapolis could have served more students at less cost by following competitive bidding requirements. We have written to Minneapolis about our concerns.

IV. Alternative Methods to Improve Fitness Programs

We applaud school districts for bringing fitness programs to their students. However, we believe that by following standard purchasing procedures, including competitive bidding for contracts over \$50,000, school districts can obtain more equipment for less cost and less risk than the NSFF Program offers. We also believe that school districts would be better able to tailor the equipment they receive to the size and needs of their schools by using standard purchasing procedures. Finally, we encourage schools to seek P.E.P. grants to help pay for their new fitness programs. By following standard purchasing procedures, we believe the limited P.E.P. grant funds will be able to serve more schools because comparable programs will be obtained for less cost.

School districts should seriously consider whether they are able to achieve a fitness program more fully suited to the needs of their schools at less cost, and substantially less risk, than the “one-size fits all” NSFF program. For example, we understand that the Upsala School District (Upsala) considered entering the NSFF agreements, but decided instead to obtain quotes to place an exercise program in its schools. Upsala accepted a quote for \$46,845.00 to place a variety of fitness equipment in its high school.

Several Minnesota schools have successfully applied for and received P.E.P. grants to place a fitness program unrelated to NSFF in their schools. We encourage Minnesota school districts to apply for P.E.P. grants. The application form for the grants, and instructions, are contained on the United States Department of Education’s website: www.ed.gov/programs/whitephysed/awards.html.

However, Minnesota school districts that have already entered contracts with NSFF appear to be unable to make the statements that “but for” the P.E.P. grant, they would not be able to implement the NSFF Program. If the NSFF Program has been implemented in these schools, and NSFF is obligated to make “contributions” to the school district, the P.E.P. grants would not be facilitating a program otherwise unavailable in the schools.

³⁵ See Minn. Stat. § 123B.52, subd. 2 (2002).

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Instead, any P.E.P. grants awarded to these schools would simply appear to relieve NSFF of its contractual obligation to repay the school its purchase price through “contributions.”

We also believe that using competitive bidding will allow school districts to put comparable equipment in their schools for less cost and with less risk. As a result, the limited federal funding for P.E.P grants will go further and serve more students. For example, the Robbinsdale School District applied for and received a P.E.P. grant for \$150,000. As a result of that award, the Robbinsdale School District is planning to place new fitness equipment in two high schools, three middle schools and all of their elementary schools. Robbinsdale also plans to use some of the P.E.P. grant funds for staff training. Robbinsdale informed us that it will advertise for bids since the total equipment package exceeds \$50,000.

Conclusion

We share your concerns, and have additional concerns about the NSFF contracts we have reviewed. While there does not appear to be additional action that we can take regarding this matter, we remain available to assist you or any school district in reviewing any financial documentation that may be obtained regarding NSFF. We recommend that school districts obtain answers to these concerns **before** any additional public funds are expended on these agreements.

Sincerely,

Patricia Anderson
State Auditor

cc. Commissioner Cheri Pierson Yecke
Minnesota Department of Education

Mr. Donald May, President
Minnesota School Boards Association