



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

Iron Range Resources

July 1, 2001, through June 30, 2005



Financial Audit Division

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OFFICE OF THE LEGISLATIVE AUDITOR

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Members of the Legislative Audit Commission

Members of the Iron Range Resources and Rehabilitation Board

Ms. Sandy Layman, Commissioner
Iron Range Resources

We have audited Iron Range Resources for the period July 1, 2001, through June 30, 2004. The scope of our audit focused on the processes used to administer grants and loans. We assessed the adequacy of internal controls over these processes and determined if the agency complied with applicable legal provisions.

The enclosed Report Summary highlights our overall audit conclusions. The specific audit objectives and conclusions for each area are contained in the individual chapters of this report.

We would like to thank staff from Iron Range Resources for their cooperation during this audit.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Claudia J. Gudvangen

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: May 13, 2005

Report Signed On: September 29, 2005

Iron Range Resources Grant and Loan Controls

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Audit Participation

The following members of the Office of the Legislative Auditor prepared this report:

Claudia Gudvangen, CPA	Deputy Legislative Auditor
Chris Buse, CPA, CISA, CISSP	Information Technology Audit Manager
John Hirschfeld, CPA	Auditor-in-Charge
George Deden, CPA	Senior Auditor
Laurinda Zavala	Auditor

Exit Conference

We discussed the findings and recommendations in this report with the following staff of the Iron Range Resources at an exit conference on September 6, 2005:

Sandy Layman	Commissioner
Brian Hiti	Deputy Commissioner
Jean Dolensek	Director of Administrative Services

Iron Range Resources Grant and Loan Controls

Report Summary

Key Conclusion:

Iron Range Resources did not always comply with grant and loan approval procedures that are outlined in statutory provisions. *Minnesota Statutes* require that the Iron Range Resources and Rehabilitation Board and the Governor review and approve many types of projects. The agency exceeded its statutory authority by initiating projects without seeking or obtaining the required approvals.

Key Findings:

- Iron Range Resources issued some grants without obtaining the approvals required by *Minnesota Statutes*. (Finding 1, page 6)
- Iron Range Resources circumvented *Minnesota Statutes* by instructing one grantee to use grant funds to pay costs that pertained to a different grant. (Finding 2, page 8)

This report contained five audit findings relating to internal control and legal compliance. Two of those findings were included in our prior audit report.

Audit Scope:

Audit Period:

Fiscal Years 2002 - 2004

Selected Audit Areas:

- Grants
- Loans

Background:

The Iron Range Resources and Rehabilitation Board and the Office of the Commissioner of Iron Range Resources and Rehabilitation are created in *Minnesota Statutes*. Their mission is to strengthen and diversify the economy of northeastern Minnesota. The thirteen-member board is controlled by legislators, while the commissioner is appointed by the Governor to manage the executive branch agency that currently refers to itself as Iron Range Resources.

Working together, the board and the agency make grants and loans to profit and nonprofit corporations, higher education institutions, and other units of government. For the period including fiscal years 2002 through 2004, \$67 million in grants and loans were issued.

Our audit scope included only the activities of the executive branch agency—Iron Range Resources. We did not audit expenses for the board (i.e. per diems and travel expenses).

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Iron Range Resources Grant and Loan Controls

Chapter 1. Introduction

The Iron Range Resources and Rehabilitation Board and the Office of the Commissioner of Iron Range Resources and Rehabilitation are created in *Minnesota Statutes*. Their mission is to strengthen and diversify the economy in the Taconite Assistance Area, which encompasses the Cuyuna, Mesabi, and Vermilion iron ranges. The area covers 13,000 square miles and includes all or portions of Cook, Lake, St. Louis, Aitkin, Itasca, and Crow Wing counties.

The thirteen-member board is controlled by legislators: five senators, five representatives, one non-legislator appointed by the Speaker of the House, one non-legislator appointed by the Senate Majority Leader, and one non-legislator appointed by the Governor. The commissioner is appointed by the Governor and is the chief administrator of the executive branch agency that refers to itself as Iron Range Resources. The current commissioner is Ms. Sandy Layman, appointed by Governor Tim Pawlenty.

Working together, the board and the agency make grants and loans to profit and nonprofit corporations, higher education institutions, and other units of government. Our audit scope included only the activities of the executive branch agency—Iron Range Resources. We did not audit expenses for the board (i.e., per diems and travel expenses).

Iron Range Resources receives no funding from the State of Minnesota’s General Fund. Instead, the agency gets most of its funding from taconite production taxes paid by mining companies. *Minnesota Statutes* dedicate these receipts to four accounts in the state treasury. Table 1-1 outlines the name and purpose of these accounts.

Table 1-1
Accounts Containing Dedicated Taconite Tax Receipts

Account Name	Purpose of Account
Iron Range Resources and Rehabilitation Board Account	Primarily used to pay general operating costs of the agency, including payroll and administrative expenditures. However, the agency also can use board account proceeds to issue grants and loans.
Taconite Economic Development Fund	Issue grants to mining companies to upgrade equipment or improve mining technology. The agency credits each company’s account with their share of the tax. Mining companies can recover these funds for specific projects to enhance the mining industry in Minnesota.
Taconite Area Environmental Protection Fund	Issue grants and loans to reclaim, restore, and enhance areas within the Taconite Assistance Area.
Douglas J. Johnson Economic Protection Trust Fund	Provide funding for projects that stimulate employment and encourage diversification of the economy in the Taconite Assistance Area.

Source: Auditor prepared from *Minnesota Statutes*, Chapter 298.

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Audit Approach

We conducted our audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of internal controls that are relevant to the audit objectives. We used the guidance contained in *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission, as criteria to evaluate controls. *Government Auditing Standards* also require that we plan our work to provide reasonable assurance that the agency complied with financial-related legal provisions that are significant to the audit. In determining the agency's compliance with legal provisions, we considered requirements of laws, regulations, contracts, and grant agreements.

To meet our audit objectives, we interviewed employees and reviewed documentation to gain an understanding of policies and procedures pertaining to the issuance of grants and loans. We also analyzed accounting data to identify unusual trends or significant changes in financial operations. Finally, we examined specific transactions to assess the adequacy of internal controls and to determine if the agency complied with finance-related legal provisions.

Chapter 2. Grant and Loan Issuance Controls

Chapter Conclusions

Iron Range Resources did not always comply with grant approval procedures that are outlined in statutory provisions. Minnesota Statutes require that the Iron Range Resources and Rehabilitation Board and the Governor review and approve many types of projects. The Legislature established these procedures to provide oversight of agency grant and loan projects and to ensure that the agency uses its resources to fund allowable projects that provide the greatest benefit to the Taconite Assistance Area. We think the agency exceeded its statutory authority by initiating projects without seeking or obtaining the required approvals.

Iron Range Resources established controls to safeguard its grant and loan resources. However, management has not defined grant and loan monitoring expectations or documentation requirements. As a result, we could not determine if individual grant and loan officers were performing monitoring activities that were consistent with management's expectations. Some grant agreements that we examined did not precisely define the grantee's duties. Without defined deliverables, we question how the agency could effectively monitor its grants to know if grantees had completed their work.

Audit Objectives

We designed our audit work to answer the following questions:

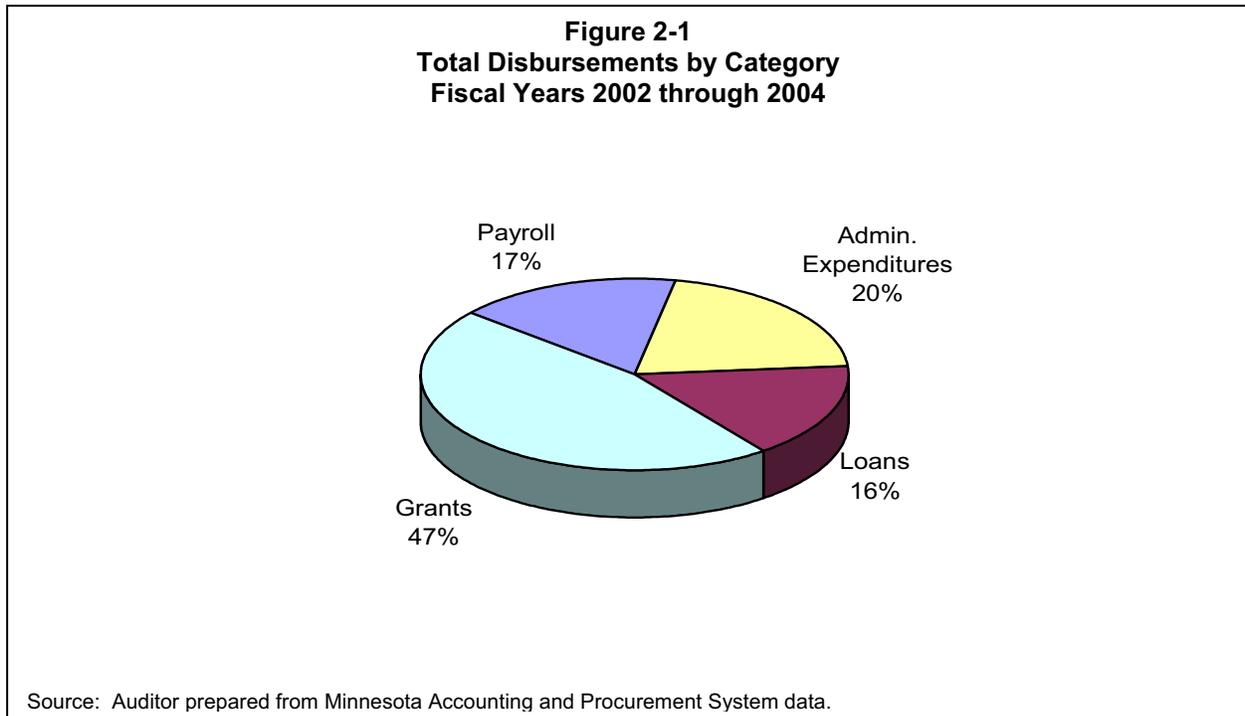
- Did Iron Range Resources establish controls over grants and loans to safeguard assets and ensure compliance with legal provisions?
- Did Iron Range Resources comply with key legal provisions pertaining to the issuance of grants and loans?

Background

Grants and loans are the primary tools used by Iron Range Resources to fulfill its mission. The agency issues grants and loans to profit and nonprofit corporations, higher education institutions, and other units of government.

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Iron Range Resources issued over \$67 million in grants and loans from fiscal years 2002 through 2004. As illustrated in Figure 2-1, grants and loans accounted for approximately 63 percent of the agency's total disbursements during that period.



All grant and loan projects go through a rigorous review process. Organizations seeking grants or loans must complete an application package. Agency grant and loan officers review these packages to determine if they are complete and meet a predetermined set of business criteria. If funds are available, acceptable grant and loan projects are sent to the commissioner for approval. If approved by the commissioner, grant and loan projects must also be reviewed and approved by the Iron Range Resources and Rehabilitation Board. Finally, depending on the funding source, some grant and loan projects must be approved by the Governor and reviewed by a technical advisory committee.

Current Findings and Recommendations

1. **PRIOR FINDING NOT RESOLVED. Iron Range Resources issued some grants without obtaining the approvals required by *Minnesota Statutes*.**

Iron Range Resources did not always follow the grant approval requirements outlined in *Minnesota Statutes*. The agency issues grants out of four distinct accounts in the state treasury: 1) the Iron Range Resources and Rehabilitation Board Account, 2) the Taconite Economic Development Fund, 3) the Taconite Area Environmental Protection Fund, and 4) the Douglas J. Johnson Economic Protection Trust Fund. *Minnesota Statutes* define permissible uses of each of

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these accounts. *Minnesota Statutes* also specify individuals or groups who must review and approve all projects funded by each account. Issuing grants without obtaining all of the required approvals circumvents the control processes established by the Legislature to ensure that taconite tax receipts are only used to fund the most beneficial projects.

We examined eleven grant projects and found four that did not have the appropriate approvals. These grants ranged from \$10,000 to \$278,000. For example, in February 2005, the agency issued a \$10,000 grant to the Lake Vermilion Resort Association to help support the Governor's Fishing Opener. This grant was paid out of the Taconite Area Environmental Protection Fund. We found no evidence that this grant was approved by a majority of the members of the Iron Range Resources and Rehabilitation Board, as required by *Minnesota Statutes*. We also found no evidence that this grant was approved by the Governor. As authority for the grant, the agency cited in its grant agreement a statutory provision that outlines permissible uses of the Taconite Area Environmental Protection Fund. This provision states, in part, that funds may be used for:

...local economic development projects including construction of sewer and water systems, and other public works located in the taconite assistance area....

The agency concluded that the Governor's Fishing Opener was a local economic development project. Therefore, issuing the grant out of the Taconite Area Environmental Protection Fund was within the confines of the law. We were troubled by the fact that the Iron Range Resources and Rehabilitation Board and the Governor were not given their opportunities to challenge this decision. Given the opportunity, the board or the Governor may have felt that funding the Governor's Fishing Opener was not an appropriate use of the Taconite Area Environmental Protection Fund's resources. Furthermore, the board or the Governor may have denied the grant because they felt that there were better uses for this money.

Agency managers concurred that their current grant approval practices differ from the provisions in *Minnesota Statutes*. However, they felt that they were following the spirit of the law because the board approves the agency's annual budget. We disagree. Board approval of the annual budget does not include the review and approval of specific projects, a key control provision designed by the Legislature and codified in *Minnesota Statutes*. Also, current grant approval practices often disregard provisions in law requiring the approval of specific projects by the Governor.

Agency managers also told us that the grant approval provisions in *Minnesota Statutes* were outdated. Of greatest concern, the statutory grant approval provisions relate to an annual grant processing cycle that the agency no longer uses. Officials told us that following current law would increase the amount of time it takes to issue grants. Though this may be true, the agency does not have the authority to selectively choose which laws it wants to follow.

Our prior audit of the agency cited similar concerns. In that audit, we recommended that the agency and its board seek statutory clarification to define actions that can be initiated by the agency and those that require specific board approval. In response to the audit, agency leaders

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told us that they approached legislative members of the board with a request to amend the laws to remedy the lack of clarity. However, the legislative members of the board were unwilling to support the changes. Absent statutory changes, the agency has no alternative but to follow the laws as currently written.

Recommendation

- *Iron Range Resources should follow all grant approval requirements outlined in Minnesota Statutes.*

2. Iron Range Resources inappropriately instructed a grantee to use grant money to pay costs unrelated to the grant's purpose.

In September 2001, Iron Range Resources issued a \$25,000 grant out of the Douglas J. Johnson Economic Protection Trust Fund to the Northspan Group, Incorporated. The purpose of this grant was to participate in a partnership to host the Governor's First Annual Golf Challenge, held on September 10, 2001. Expenses for the event exceeded the available funding from all public and private sector contributors. After learning of this shortage, the agency's marketing, recruitment, and technology manager sent a memo to the president of the Northspan Group instructing him to submit invoices to the agency to charge the excess golf event costs to two other outstanding Northspan grants:

- **\$37,000 grant, issued on August 4, 2000.** This grant had a \$4,200 balance at the time that the agency learned about the excess golf event costs. The marketing, recruitment, and technology manager told Northspan to use the entire remaining balance in this grant to pay excess golf event costs. After receiving the requested invoice, the agency paid Northspan \$4,200 on November 14, 2001.
- **\$60,700 grant, issued on June 29, 1999.** The marketing, recruitment, and technology manager told Northspan to charge \$6,574 to this grant. We could not determine if the Northspan Group was paid this or a different amount, because the agency was unable to locate all of the invoices.

The Northspan Group served as the fiscal agent for the golf event. Therefore, we question whether the agency's decision to assume responsibility for the cost overruns was a legal or prudent use of state resources. Furthermore, instructing a grantee to use funds from one grant to pay costs that pertained to another circumvented the grant review and approval process outlined in *Minnesota Statutes*. A more appropriate mechanism would have been to seek the required approvals to issue a grant amendment. Finally, as discussed in more detail in Finding 1, the agency issued the original \$25,000 grant out of the Douglas J. Johnson Economic Protection Trust Fund without obtaining the approvals required by *Minnesota Statutes*. Grants out of this fund must be approved by both the Iron Range Resources and Rehabilitation Board and the Governor. We found no evidence that these required approvals were ever sought or obtained.

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Unclear grant writing practices made it difficult for us to determine if funds were always used for the purposes that were originally negotiated with grantees. Of greatest concern, some grant agreements that we reviewed did not precisely define the grantee's duties. Some agreements also had grant periods that exceeded two years. These grant writing practices allowed organizations like Northspan to have multiple grants open at the same time, sometimes with virtually identical terms. For example, the agreements underlying the \$37,000 and \$60,700 Northspan grants each provided funding for the development of "special marketing initiatives." However, neither agreement defined specific deliverables that the agency hoped to see developed. Without defined deliverables, we question how the agency could effectively monitor its grants to know if grantees had completed their work. We also question how the agency could determine if grantees needed or planned to use all of the money available under their grant agreements. The fact that the agency was able to charge the golf event cost overruns to prior Northspan grants indicates that the entire unspent balances in those grants were not needed.

Commissioner Layman and the agency's chief financial officer told us that they took steps to strengthen grant administration controls after the commissioner assumed her duties in May 2003. Specifically, they told us that the agency is now defining duties more precisely in its grant agreements. They also told us that the agency no longer writes grant contracts that exceed one year, except for rare cases where specific projects will take longer than one year to complete. Most grants that we tested were written before Commissioner Layman assumed her duties in May 2003.

Recommendations

- *The agency should prohibit grantees from charging costs to grant projects that were not defined in the original grant agreements.*
- *The agency should define grantee duties as precisely as possible and limit grant terms to the minimum time frame needed to complete those duties.*

3. Iron Range Resources does not have formal grant monitoring procedures.

Management has not defined specific monitoring expectations for the various types of grants that the agency issues. Management also has not defined documentation requirements for monitoring activities. As a result, we could not determine if individual grant officers were performing monitoring activities that were consistent with management's expectations. Of the eleven grant projects that we reviewed, only three contained written evidence that grant officers monitored the activities during the course of the project.

It is important to have strong project oversight controls to ensure that grant recipients use their funds for the intended purposes. Formal grant monitoring procedures will help management

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make sure that its oversight expectations are understood. They also will provide a baseline for management to assess whether grant officers are fulfilling their oversight responsibilities.

Recommendation

- *Iron Range Resources should develop baseline grant monitoring procedures.*

4. PRIOR FINDING NOT RESOLVED. Iron Range Resources does not have a conflict of interest policy.

Management has not developed a policy that addresses ways to avoid or resolve potential conflicts of interest. A conflict of interest policy is particularly important in an agency like Iron Range Resources, which issues a substantial amount of grants and loans to entities that have close ties to its own employees. For example, during our audit, we identified several employees of Iron Range Resources who also held elected positions with cities that received grants or loans. Though we found no evidence that these employees used their positions to provide undue influence, defining and enforcing conflict of interest policies is one way to ensure that organizations applying for grants and loans do not receive preferential treatment.

We reported a similar finding in our last audit of the agency. In its response, Iron Range Resources stated that it had a conflict of interest policy and it was in effect. However, when questioned, the current administration told us that it was unaware of any policy.

Recommendation

- *The agency should develop and communicate conflict of interest policies to all of its employees.*

Chapter 3. Other Financial Issues

Chapter Conclusions

Iron Range Resources provided an unreasonable subsidy to employees who participate in a ridesharing program.

The primary focus of this audit was grant and loans. However, we conducted a broad overview of other financial areas while planning this audit. During the course of our fieldwork, we also investigated certain allegations of financial impropriety that were brought to our attention.

Current Findings and Recommendations

5. Iron Range Resources provided an unreasonable subsidy to employees who participate in a ridesharing program.

Iron Range Resources sponsors carpools for its employees who live near Duluth and Aurora. Under this arrangement, the agency leases vehicles and pays for all gas and maintenance costs. The agency then charges each carpool rider an amount to help recover its costs. We reviewed agency deposit records and determined that the average monthly recoveries during fiscal year 2005 from the Duluth and Aurora carpools were \$289 and \$106, respectively. These recovery amounts appear to be substantially less than it costs to lease and operate the vehicles. *Minnesota Statutes* give state agencies the authority to run ridesharing programs and use state vehicles. However, they also require the establishment of reasonable reimbursement rates.

Recommendation

- *Iron Range Resources should establish reimbursement rates for its ridesharing program that recover all costs incurred.*

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Status of Prior Audit Issues As of May 13, 2005

Legislative Audit Report 02-66, issued in October 2002, covered the three fiscal years ending June 30, 2001. The audit scope included financial management, the Northeast Minnesota Economic Protection Trust Fund, the Taconite Area Environmental Protection Fund, loans, grants, Giants Ridge Golf and Ski Resort, Ironworld Discovery Center, payroll, and other administrative expenditures. The report contained 17 findings. Iron Range Resources implemented six findings, numbers 5, 6, 8, 10, 11, and 12. The agency did not implement Finding 1, related to the agency not submitting all projects to the board for approval, and Finding 2, which related to developing a conflict of interest policy. We did not determine the status of other findings, since we did not include those areas in the scope of the audit.

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

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IRON RANGE RESOURCES LEGISLATIVE AUDIT RESPONSE SEPTEMBER 2005

Audit Finding One: Grant Approval Process

Iron Range Resources believes that its current budget approval process complies with the approval requirements set forth in *Minnesota Statutes*. Specifically, the agency's annual budget lists anticipated revenues and allocates these funds to its various divisions, facilities, programs and projects. Each budget is required to be approved by a "super majority" of at least eight Board members to ensure that the approval satisfies the most stringent approval requirements contained in any of the agency's governing statutes. In addition, the Governor approves portions of the budget as set forth in Minnesota law.

The agency acknowledges that the *Minnesota Statutes* setting forth the grant approval process are ambiguous and updating those laws would clarify the approval process. To that end, Iron Range Resources will promptly work to pass legislation that clarifies the ambiguities in the current grant approval process.

Audit Finding Two: Grant Requirements

Iron Range Resources believes that it acted within the parameters of the referenced grant agreements to fund the costs of the business recruitment golf event cited by the auditors. At the same time, the agency agrees that some of the language contained in the agreements was overly vague. Certainly, better cost controls could have been instituted to avoid the overruns noted. Going forward, the agency will strive for more precise wording, more explicit deliverables and shorter expiration dates in its grant agreements.

As the auditors note, since Sandy Layman became the Iron Range Resources Commissioner in May 2003 the agency has strengthened its grant administration controls. This process is ongoing.

Audit Finding Three: Grant Monitoring

Grants at Iron Range Resources are monitored by individual staff members assigned to a particular grant rather than through a formalized, written process. The individual staff members that administer individual grants are expected to provide ongoing oversight of each



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grant agreement through phone calls, project reports and site visits. This process is intended to ensure that every grantee is complying with the terms of the individual grant contract. Nevertheless, the agency acknowledges that formal grant monitoring checklists or other baseline procedures designed to improve grant contract compliance could be a more effective internal control mechanism. The process of developing these more formalized grant monitoring procedures is currently underway.

Audit Finding Four: Additional Conflict of Interest Policies

Employees of Iron Range Resources are governed by the state ethics rules set forth in *Minnesota Statutes* 43A.38 and the Department of Employee Relations' code of ethics. Iron Range Resources does not, however, have its own free-standing conflict of interest policy. The auditor's report expresses concern that the agency needs an additional policy to address situations where grants and loans are directed toward municipalities with close ties to certain agency employees. In the past, the agency felt that this concern was adequately addressed by the existing law and DOER policy. There was concern that another layer of policy would be redundant and overly confusing.

Based on the auditor's report, the agency is quickly moving forward to address the need for an Iron Range Resources specific conflict of interest policy and the need to train its employees on how to handle potential conflicts. The agency is currently drafting a conflict of interest policy to address situations where agency grants or loans are directed toward municipalities where certain employees have close ties. In addition, the agency continues to provide training to its employees on conflict of interest and code of ethics policies. As recently as August 31, 2005, all Iron Range Resources employees received such training.

Audit Finding Five: Ride-Sharing Policy

For many years, Iron Range Resources has encouraged ride sharing and is proud of its leadership in this area. There are great benefits to such programs, especially in northeastern Minnesota where employees often commute long distances from the small communities that are spread across the Iron Range.

In response to the auditor's finding of an unreasonable subsidy in its ride sharing program, the agency developed and implemented a comprehensive ride sharing policy that will recover all agency costs incurred from the program. Specifically, the new per mile cost will be tied directly to the widely recognized reimbursement rate set forth by the Internal Revenue Service.

Respectfully submitted,

/s/ Sandy Layman

Sandy Layman
Commissioner
Iron Range Resources