Assessing when costs are reasonable and necessary

During the course of our work in the University, we encounter instances when we have to ask ourselves:

- “Is this expense reasonable?”
- “Is it necessary to purchase this?”
- “Wouldn’t this claim be considered excessive?”

Sometimes, the answers to these questions will be black and white—as we can find what is allowed and not allowed in University policies and procedures. But when there are no policies or procedures to consult, what do we do in these instances? The following was adapted from a self-study course on Cost Principles written by Sefton Boyars and Bill Allen and offered by AuditSkills and Yellowbook-CPE.com. This excerpt provides some guidelines on what to do in these instances.

**Reasonable and Necessary**

**The Prudent Person Rule**

Appendix A of both Title 2, Code of Federal Regulations CFR 225.2 (applicable to State and Local Governments) and Title 2 CFR 230.3 (applicable to Non-Profits) clarifies that to be reasonable, a cost may not be more than a “prudent person” would spend depending on the circumstances.

*Reasonable costs. A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost.*

The prudent person rule is also used in the Government Auditing Standards—(GAGAS also known as the Yellow Book) to define abuse. Under GAGAS 4.12, “Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances."

To determine whether a cost is reasonable in a given situation, we must consider whether each cost would have been expended by a “prudent person.” Who is this prudent person? The determination of what is reasonable is quite subjective. The cost principles fail to define this vague term, but they do the best possible job defining what is OK and what is not OK to charge.

**Subfactors Used to Determine Reasonableness**

The determination of whether a cost is reasonable requires the application of the following sub-criteria:

1. The cost generally would be recognized as ordinary and necessary for the operation of the governmental unit or the performance of the federal award.
2. The cost conforms to:
   - Sound business practices,
   - Arm’s length bargaining,
   - Laws and regulations, and
   - Terms and conditions of the federal award.
3. The cost was incurred using the organization’s established practices. (Significant deviations from established organizational practices of the governmental unit may unjustifiably increase the federal award’s cost.)

Appendix A to Title 2, Part 225 (State and Local Governments)

*Reasonable costs. The question of reasonableness is particularly important when governmental units or components are predominately federally-funded. In determining reasonableness of a given cost, consideration shall be given to:*

a. Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the governmental unit or the performance of the Federal award.

(continued on page 2)
When costs are reasonable and necessary (continued)

- The restraints or requirements imposed by such factors as: sound business practices, arm’s length bargaining, Federal, State and other laws and regulations and terms and conditions of the Federal award.
- Market prices for comparable goods or services.
- Whether the individuals concerned acted with prudence in the circumstances considering their responsibilities to the governmental unit, its employees, the public at large, and the Federal Government.
- Significant deviations from the established practices of the governmental unit which may unjustifiably increase the Federal award’s cost.

Appendix A to Title 2, Part 230 (Non-Profits)

Reasonable costs. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with organizations or separate divisions thereof which receive the preponderance of their support from awards made by Federal agencies. In determining the reasonableness of a given cost, consideration shall be given to:

- Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization or the performance of the award.
- The restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, Federal and State laws and regulations and terms and conditions of the award.
- Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees, and clients, the public at large, and the Federal Government.
- Significant deviations from the established practices of the organization which may unjustifiably increase the award costs.

The University’s Travel Policy 515 does not allow first class travel. However, suppose that your boss informs you that you need to fly across the continent immediately. The only coach seats available are on a red-eye that makes two stops and arrives around noon the next day. Since such a trip may be considered unreasonable; with appropriate administrative approval, you may justify flying first-class.

What about charging the costs of an out-of-town meeting to a grant? Let us assume, for purposes of this example, that the meeting is necessary for the efficient delivery of grant services. It could be argued that, to assure uninterrupted training, holding the meeting at a location other than the grantee’s place of business is necessary. But, if a federal reviewer finds that the costs or the location selected is inappropriate (e.g., a mainland organization holds a meeting in Honolulu or in a five-star hotel), then the costs may be disallowed as unreasonable and not necessary to properly administer the federal award.

The policies and regulations do not expect grantees to suffer the use of poor quality equipment, beg for supplies on the street corner, or work for food. These simply require the wise use of federal award funds by grantees. The delivery of grant services should always be paramount but within the constraints of the cost principles.

One guideline that is often used is the “Washington Post” test (or substitute the name of your local newspaper). If the paper found out what you were doing, would they report it on one of the first three pages? They don’t put the good news on those pages. If the newspaper were to consider it reportable, it doesn’t consider the cost to be reasonable.

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