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## Finance Administrative Requirements Introduction to Cost Principles

[www.fhwa.dot.gov/federal-aidessentials](http://www.fhwa.dot.gov/federal-aidessentials)

*Standards for determining if costs are allowable or not allowable for Federal awards*



The Federal-aid highway program supports local public agencies (LPAs) with funding for highway-related construction projects. This funding is in the form of reimbursements, or payments, for allowable project expenses. In deciding whether and how to apply for funding, LPAs need to know which project costs are allowable, to qualify for reimbursement.



There are three basic conditions an expense must meet in order to qualify as allowable. These three conditions are that the expense must be necessary, reasonable, and allocable. We'll explain more about each of these conditions a bit later, but first let's get an understanding of the two types of costs that make up a project's total direct and indirect costs.

A direct cost is an expense for an item or service bought specifically and entirely for the project. Some good examples of direct costs are project travel, rights-of-way, equipment usage, employee salaries for time specifically devoted to the project,

and project building materials, such as concrete and asphalt.

An indirect cost is an expense for an item or service that benefits more than one project or purpose. These may be costs experienced within a department of the LPA, for example within the accounting or facilities maintenance departments. Some good examples of indirect costs include those for accounting systems, buildings and facilities, general office equipment, and supplies, as well as costs for salaries and other compensation for employees who carry out these functions.



In order to request and qualify for reimbursement on federally funded projects, an LPA will need to provide evidence of the costs related to the project to its State department of transportation, or State DOT. Invoices can serve as an appropriate record and evidence of the expenses for the purpose of reimbursement of direct costs. However, to include indirect costs for reimbursement on federally funded projects, you must develop an approved

Indirect Cost Allocation Plan, or ICAP. Your ICAP will need to spell out all of the methods the LPA will use to consistently allocate indirect costs to all projects.

Now that we have discussed the difference between direct and indirect costs, let's go back to the three conditions an expense must meet in order to qualify as allowable. As you may remember, the expense must be *necessary*, *reasonable*, and *allocable* to the project.

First, necessary expenses are those without which, the project cannot be completed. Some good examples are safety equipment or construction materials such as steel and asphalt.



The second condition an expense must meet to qualify as allowable is that it must also be reasonable. To determine whether an expense is reasonable, you must look at the amount paid and the circumstances under which the purchase was made. A good rule of thumb is to ask, "Would a sensible person pay this expense under the same circumstances?" If the answer is "yes," then the cost is reasonable.

The third and final condition that an expense must meet in order to qualify as allowable is that it must be allocable. To be allocable, an expense must directly benefit the project. Some examples of allocable expenses are those for project-related salaries, supplies, travel, materials, and services.



In summary, Federal-aid highway project expenses must be allowable in order to qualify for Federal reimbursement. To be allowable, they must meet the three conditions of being necessary, reasonable, and allocable.

For additional guidance, contact your State DOT.

### Additional Resources

- Link to Title 2 Grants and Agreements covering cost principles for State, local, and Indian tribal governments  
<http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=b1a93d4780a735b935fe0fb65198988e&rgn=div5&view=text&node=2:1.1.2.10.6&idno=2>
- Description of free Web-based course *FHWA Planning & Research Grants: Cost Principles*  
[http://www.nhi.fhwa.dot.gov/training/course\\_detail.aspx?num=FHWA-NHI-151048&cat=&key=&num=&loc=&sta=%25&typ=3&ava=1&str=&end=&tit=&lev=&drl](http://www.nhi.fhwa.dot.gov/training/course_detail.aspx?num=FHWA-NHI-151048&cat=&key=&num=&loc=&sta=%25&typ=3&ava=1&str=&end=&tit=&lev=&drl)

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This Companion Resource is the script content for the video production of the same name.