FAR Part 31 Cost Principles: Compensation & Other Costs
July 13, 2010

Darryl L. Walker, CPA, CFE
Presentation Objectives

- FAR Part 31 philosophy
- Compensation:
  - Reasonableness concepts
  - Executive compensation
- Other cost principles
  - Public relations/advertising
  - Employee morale & entertainment
  - Travel
  - Taxes
  - Consulting fees
  - Business meetings & events
- Documentation
FAR Part 31 Purpose

Establish boundaries and parameters regarding allowable costs that can be negotiated and/or claimed under government contracts or subcontracts
FAR Part 31 Purpose

Key Philosophies Embedded in Cost Principles

- Government does not want to share in costs that it does not cause nor derive a benefit (“causal and beneficial”)
- Equitable allocation or identification of costs to government contracts
- Non-government programs should absorb their share of costs
- “Encourage” businesses to exercise prudence in incurring expenses, and make good business decisions
- Selected costs in FAR 31.205-XX identified as unallowable are theoretically not created by doing business with government, nor required to sustain contract performance
- Congressional involvement (e.g. statutory “cap” on compensation)
Compensation for personal services FAR 31.205-6:

- Includes wages, bonuses, pension, 401(k), fringe benefits, deferred compensation, director fees, ESOPs, living differentials, severance pay, etc.
  - Must be for work performed in current year and not retroactive adjustments of prior years’ salaries
  - Reasonable in total for work performed; however, each element making up compensation should be reasonable
  - Consistent with company policies or a consistently followed practice
  - No presumption of allowability exists where new compensation policy implemented where gov’t has not had opportunity to review
Compensation for personal services FAR 31.205-6

- Emphasis placed on certain individuals:
  - Owners of closely held corps or LLCs, partners, sole-proprietors, families, or others having substantial interest in company
  - Allowability of compensation:
    - Reasonable for services rendered
    - Not be a distribution of profits
    - For owners of closely held companies, not be in excess of costs not deductible as compensation under IRS code
Compensation for personal services FAR 31.205-6

- Most fundamental principle governing allowability of costs is reasonableness (31.205-6(b)); compared to companies:
  - Same size
  - Similar industry
  - Performing similar non-Government work, comparable circumstances
  - Same geographic area
Compensation—General Audit Approach

- Most often audited as part of annual incurred cost proposal evaluation—applicable to flexibly-priced contracts
- If compensation system review of internal controls has been performed, auditors will rely on outcome of that review—theoretically, if system deemed adequate, then s/b no challenge of incurred costs under flexibly-priced contracts
  - Exception is that for exec, owner, & others having higher risk on unreasonable compensation costs to be deemed reasonable in system review, must have been specific testing of compensation for reasonableness during internal controls review
- Values are audited by fiscal year
Compensation—General Audit Approach

- Generally, compensation evaluated on individual labor skill or category basis
- Audit of compensation levels may encompass:
  - Individual cost elements making up compensation for each labor category or
  - Total compensation value for each labor category (or each executive)
- Individual personnel making up labor skill analyzed to be sure correctly categorized
- In determining reasonableness of each labor category element, when matching survey to company pay by element, auditors will add 10% to weighted value of each element—excess considered unreasonable
Compensation—General Audit Approach

- General testing of incurred compensation:
  - Determine costs (elements) making up claimed compensation—if unallowable items included, remove those before subjecting remainder to reasonableness testing
  - Will expect contractor to support reasonableness with adequate market data & job/company benchmarking process
  - Determine market survey data used by contractor & if such data is acceptable; if not acceptable will use DCAA wage surveys to gage reasonableness or not test reasonableness & cite system deficiency
  - For exec comp, auditors often perform reasonableness test using DCAA’s wage surveys although company can support reasonableness with its own data
  - DCAA typically uses mid-point of its own surveys for each job skill
  - Add 10% to DCAA survey information (—outcome is DCAA determination of reasonable compensation)
  - Question difference between contractor compensation & DCAA recommendations
Executive Compensation

- Audit of exec. comp generated via incurred cost proposal
- Annual evaluation of certain cost elements which are included in Schedule T of Incurred cost proposal
- Cost components in this schedule:
  - Base salary
  - Bonus
  - Pension
  - Health/life insurance
  - Auto allowance
  - Deferred comp
  - Long-term insurance
## GENERAL ORGANIZATION AND EXECUTIVE COMPENSATION INFORMATION
### DCAA

<table>
<thead>
<tr>
<th>FAO:</th>
<th>CONTRACTOR:</th>
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<tbody>
<tr>
<td>CFYE:</td>
<td>PRIVATE or PUBLIC (circle one)</td>
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### NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM (NAICS) CODES

<table>
<thead>
<tr>
<th>CODE</th>
<th>DESCRIPTION</th>
<th>CONTRACTOR DATA:</th>
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### EXECUTIVE DATA

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<tr>
<th>CFY</th>
<th>EXEC POSITION</th>
<th>DIRECT CHARGES</th>
<th>OWNERSHIP %</th>
<th>BASE SALARY</th>
<th>BONUS</th>
<th>PENSION</th>
<th>HEALTH/LIFE INS.</th>
<th>AUTO</th>
<th>DEFERRED COMP.</th>
<th>LTI/OTHER **</th>
<th>VOL DELS.</th>
<th>CLAIMED COMP.</th>
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* NIAT (Net Income After Taxes)  ** LTI (Long Term Insurance or Key Man Life Insurance)
Executive Compensation

- Top executives are audited individually—not included in a general labor category for summary analysis
- Schedule P requires preparation of data for top five executive positions for three most current fiscal years, and elements may be audited individually, or in total
- Auditors should first evaluate contractor’s actions to support reasonableness via market data
  - Survey data contractor uses—is it adequate/current
  - Proper benchmarking to market job content & responsibilities
  - Meeting comparability factors (similar industry, same size, etc., although execs are benchmarked on national basis when DCAA performs its own tests)
Executive Compensation

- DCAA uses following wage surveys for evaluate executive compensation:
  - Watson Wyatt
  - ERI (Economic Research Institute)
  - COMPDATA
  - Jaffe
Executive Compensation

- Determine executive compensation actually claimed
- Review individual components that are unallowable
- Adjust amounts to remove unallowable costs—net would be amount claimed by contractor as allowable, & subject to reasonableness test

Example:
  - Claimed Exec Amount---- $800,000
    - Less: Unallowable stock options (100,000)
    - Less: Unallowable lobbying activities (50,000)
  - Net amount—subject to reasonableness test $650,000
Executive Compensation—DCAA Benchmarking for Reasonableness

- See Slides 18-19 – Applied Knowledge Company
- Three compensation surveys (subscriptions); national vs. regional for executives
- Map Company Executives to Survey (e.g. CEO, COO, Exec VP); may use fewer than three surveys if fewer match company positions
- Program Managers – DCAA uses revenues based upon the division, program or project(s)---not the overall company revenues
- Median (50th percentile) and not the arithmetic mean (reduces the impact of bonus compensation or other compensation on the “high end”)
- 10% ROR (range of reasonableness) = adding 10% to the median compensation
Executive Compensation—DCAA Benchmarking for Reasonableness

- Use of higher percentile (maximum = 75\textsuperscript{th}) plus 10\% ROR if corporate performance measures significantly better than peers (sales growth, return on equity, return on assets, return on sales)
- Pension separately added as a percentage of reasonable compensation
- Other compensation may be considered but not listed on the template if DCAA considers it to be reasonable in and of itself (e.g. car allowance)
- DCAA reliance on 1996 Techplan ASBCA Case for certain parameters (but some are DCAA interpretations including median vs. mean)
# Applied Knowledge Company

## Executive Compensation Review

For CFY Ended November 30, 2005

<table>
<thead>
<tr>
<th>Sales</th>
<th>Executive</th>
<th>Claimed Total Comp (1)</th>
<th>Watson Wyatt</th>
<th>ERI</th>
<th>Compdata</th>
<th>Survey Avg. Cash Comp + 10% RoR</th>
<th>Survey Reasonable Pension + 10% RoR (3)</th>
<th>Reasonable Total Comp + 10% RoR</th>
<th>Unreasonable Difference</th>
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<tr>
<td>$10.9 M</td>
<td>CEO</td>
<td>$399,560</td>
<td>$340,001</td>
<td>$354,541</td>
<td>$307,858</td>
<td>$367,547</td>
<td>$25,339</td>
<td>$392,886</td>
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<td>353,771</td>
<td>224,718</td>
<td>239,308</td>
<td>173,584</td>
<td>187,176</td>
<td>17,680</td>
<td>$204,856</td>
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<td>394,365</td>
<td>210,484</td>
<td>220,760</td>
<td>182,741</td>
<td>197,050</td>
<td>15,980</td>
<td>$213,030</td>
<td>181,335</td>
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<tr>
<td>$2.0 M</td>
<td>Program Mgr Project Z</td>
<td>168,552</td>
<td>136,300</td>
<td>124,677</td>
<td>100,928</td>
<td>132,699</td>
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<td>$363,736</td>
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</table>
NOTES:

FAR Compensation Limit: The CY 2004 FAR Compensation Limit is $432,851. 1 month of CY 2004 = (1/12) $432,851 = $36,071. The CY 2005 FAR Compensation Limit is $473,318. 11 months of CY 2005 = (11/12) $473,318 = $433,875. Therefore, the CFYE 11/31/05 prorated comp limit is $469,946 = ($433,875 + $36,071). The claimed covered compensation for all the executives reviewed does not exceed this limitation.

(1) Claimed total compensation includes cash compensation (base salary, bonus, and auto allowance) and pension costs less voluntary deletions.

(2) SURVEYS USED TO DETERMINE THE REASONABLENESS OF EXECUTIVE COMPENSATION:

WATSON WYATT: 2005/2006 Top Management Comp Calculator by Watson Wyatt Data Services. We used the Computer Programming and Other Software Services Industry, or the Professional and General Business Services Group, depending on data availability; executive positions (CEO, COO, and Executive Vice President); median total cash compensation related to annual sales regression analysis; survey data aged as appropriate. Division sales were used in the regression equation for the Program Mgr.

ERI: Economic Research Institute Executive Compensation Assessor; July 1, 2007 Database. We used the North American Industry Classification System (NAICS) 541512, Computer Integrated Systems Design; executive positions (CEO, COO, and Executive Vice President); median total cash compensation related to annual sales regression analysis; survey data aged as appropriate. Revised for the Geographic Location, District of Columbia Metropolitan Area. Division sales were used in the regression equation for the Program Mgr.

COMPDATA: 2005/2006 Executive Compensation, The National Executive & Senior Management Compensation Survey by CompData Surveys. We used median cash salary and average incentive compensation amounts for the CEO, COO, and President survey positions for companies in the sales ranges of $5 million to $20 million; survey data aged as appropriate. Division sales were used in the regression equation for the Program Mgr.

(3) To evaluate the reasonableness of the claimed pension costs, we used the Watson Wyatt 2005/2006 Survey Report on Total Reward Compensation & Benefits. We used the retirement as a % of reasonable base salary survey factors amounts to determine the reasonable pension for the executive positions. We used 8.90% for the CEO position, 8.95% for the Dir DHS Programs position, and 9.00% for the Director position. The calculation percentage of 8.95% represents an average of the CEO and COO survey percentages. To determine the reasonable base salaries, we used the average of the market median base salaries from the above surveys for the executive positions, plus a 10% RoR.

SUMMARY: We determined that $363,736 of the claimed total compensation is unreasonable in accordance with FAR 31.205-6(b). Our determination is based on the surveys identified above with a 10% range of reasonableness (ROR) application in accordance with the current DCAA CAM guidance and generally accepted compensation practices. The audit position is based on comparisons with the same or similar executive positions from companies of the same size and in the same industry as Applied Knowledge Company. All survey data was aged to the contractor’s fiscal year midpoint of May 31, 2005 using Salary Budget Trend Data as published by WorkatWork. We determined that the claimed auto allowance costs are reasonable, based on a cursory examination. Contractor compensation data was provided by Ms. A. Smith of the Royal Gorge Branch Office in the October 30, 2007 request for audit.

PREPARED BY: DEP, Regional Compensation Auditor, November 29, 2007
REVIEWED BY: DDD, Supervisory Auditor, Mid-Atlantic Region Compensation Team
Executive Compensation

- Statutory ceilings, FAR 31.205-6(p)
  - Although otherwise “reasonable” when compared to market place, and not inclusive of other unallowable costs, top five most highly compensated employees in management positions at each org. level have ceiling/cap for each FY
  - For Contractor fiscal year, amt. is $693,951
  - For purposes of conforming to this cap, compensation components are:
    - Wages/salary
    - Bonuses
    - Deferred compensation
    - Employer contributions to defined contribution pension plans
  - As recorded in FY cost accounting records
Executive Compensation

- Statutory ceilings, FAR 31.205-6(p)
  - Note that not all executive compensation costs are subject to the cap
    - Heath care benefits
    - Auto allowances
    - Contributions to defined benefit plans
Executive Compensation & Specific Costs

- In determining if executive compensation has met the ceiling criteria for an FY, first determined only those claimed amounts subject to cap & subtract unallowable costs that should not be claimed.

- Example:
  - Amount claimed subject to cap
    - Base wages $300,000
    - Cash bonus $400,000
    - Deferred comp $200,000
    - Total $900,000
  - Less unallowable
    - Bonus—recorded in wrong year (100,000)
    - Stock appreciation rights (deferred comp) (20,000)
  - Net subject to cap $780,000
  - Ceiling 694,000
  - Questioned due to exceeding cap $86,000
Bonuses (FAR 31.205-6 (f))

- For bonuses to be allowable, two fundamental principles apply:
  - Employment agreement exists before services are provided, or existing plan/policy is employed & consistently followed
  - Basis of award is supported
    - Reasonableness of amount
    - Justification for award
- Auditors expect written plan/policy/employment agreement
Selected Compensation Costs--FAR 31.205-6

- Securities (stock options, appreciation rights, etc.)
  - Unallowable-- compensation costs calculated based on changes in market value of securities
  - Allowable—difference between fair market value of stock, and option exercise price at measurement date (first date when no. of options & option price are known)
Unallowable public relations & advertising costs:

– Any cost/event that is related to
  ▪ Promoting sale of products or services by stimulating interest in product, or calling favorable attention to company
  ▪ Enhancing company image to sell company’s products
– Trade shows where emphasis is not on export sales of products normally sold to government
– Meetings/seminars where purpose is not business related
– Promotional materials, brochures, souvenirs, meetings, wages, etc. whose purpose is to promote products or company image (except certain direct selling costs)
– Company celebrations & new product announcements
– Memberships in community & civic organizations
Public Relations and Advertising (FAR 31.205-1)

Allowable advertising:
- Requirement of contract—acquiring scarce items or disposal of scrap or surplus items
- Recruiting needed personnel (31.205-34)
- Promoting sales of products as exports normally sold to U.S. Government (trade shows)

Allowable public relations:
- Required by contract
- Responding to inquiries on company policy, media liaison, communication with press or stockholders (also see 31.205-28)
- Certain community service activities
- Plant tours and open houses
- Product roll-out or ship-christening ceremonies (if allowed by contract)
Employee morale, health, welfare, food service, and dormitory costs and credits (FAR 31.205-13):

- Any cost that has recreational or entertainment features is *unallowable*:
  - Company picnics and holiday parties
  - Tickets to sports or other entertainment events
  - Memberships in social organizations
  - Gifts to employees, unless connected to established awards policy based on performance
  - Company sponsored trips and outings—even though purpose may be to improve employee morale, will likely be considered recreational
Employee morale, health, welfare, food service, and dormitory costs and credits (FAR 31.205-13):

Exceptions to unallowable employee morale recreational activities:
- Company sponsored sports teams
- Wellness or fitness centers
- Counseling or health advisory services
- Vending machines/cafeterias or lunch wagons
- Dormitory services
- House publications—company newsletters, announcements, human resources notifications, etc.

Gray areas:
- Coffee/snacks in break room for employees
- Awards banquets—meals, trophies, etc.
- Birthday cakes, greeting cards, seasonal decorations
Entertainment (FAR 31.205-14):

Regardless of purpose, cost for any amusement, diversion, social or recreational activity is considered unallowable.

Examples:
- Memberships in social, dining, or country clubs
- Gifts to clients or employees (unless performance related)
- Tickets to shows or sporting events
- Company picnics, parties, or other outings where activity is recreational in part
- Dinners or other after-hours events (unless solely business related)
- “Business Meetings” where spouses or guests are present
- Client entertainment of any kind
- Alcoholic beverages, music (band), organ grinder, magician
- Business lunches are suspect, especially if frequent and expensive
Professional and Consultant Costs (FAR 31.205-33)

Allowability factors specified include:

- Qualified specialist
- Need for the service given contractor’s service specialty
- Arm’s length bargaining
- Customary fees charged for same service in general market place
- Impact of services on government business
- Whether service can be performed internally
Professional and Consultant Costs (FAR 31.205-33)

Specific Documentation Requirements (FAR 31.205-33(f))

- Agreement details including scope of work to be performed, compensation rates, nature and amount of other expenses
- Evidence that the work was performed, and the details as to services provided—would include:
  - Deliverables, if applicable
  - Related documents, i.e. trip reports, minutes of meetings, monthly report of activities
- Invoices that sufficiently describe services performed and time expended
Taxes (FAR 31.205-41)

- **Allowable:**
  - State & local income, franchise taxes
  - Sales taxes
  - FICA, FUI, SUI
  - Communications taxes

- **Unallowable:**
  - Federal income & excess profits taxes
  - Interest or penalties on late payment of taxes
  - Taxes for refinancing/refunding operations
  - Taxes where exemptions are available to Government
  - **Taxes from which company is exempt (e.g. state income taxes on Subchapter S distribution)**
  - Special assessments on land that represents capital improvement
  - Taxes on property used solely for purposes other than Government contracts
Trade, business, technical & professional costs (FAR 31.205-43):

Allowable costs:

– Membership dues for technical, business, professional, and trade organizations
– Subscriptions to technical and trade journals, magazines, newsletters
– Costs for meetings or seminars when purpose is for:
  ▪ Dissemination of business/technical information
  ▪ Stimulation of production
  ▪ Improved productivity

In short, purpose of meeting has to business related—might include HR briefing on new benefits, employee staff meeting on timekeeping, etc.
Trade, business, technical & professional costs (FAR 31.205-43):

Allowable meeting costs may include:

- Organizing, setting up, advertising, sponsoring
- Rental of facility
- Travel costs of participants to meetings
- In-house working lunches & business lunches
- Refreshments
Travel costs (FAR 31.205-46):

Travel costs incurred by contractor personnel in connection with official company business are allowable subject to limitations

- **Cost principle covers**
  - Per diem (lodging and meals & incidentals)
  - Miscellaneous expenses
  - Transportation

- **Travel cost principle does not incorporate government travel regulations in their entirety; only incorporates:**
  - *Definition of lodging, meals, and incidentals*
  - *Maximum per diem rates—combination of hotel and meals/incidentals; one ceiling covering total*
  - *Special or unusual situations when higher per diem amounts may be justified*
Travel costs (FAR 31.205-46):

- Hotel, meals, and incidentals are allowable up to daily per diem ceilings (in total) for lodging and meals/incidentals specified in:
  - FTR - travel within conterminous 48 states
  - JTR - travel in other states, and U.S. possessions outside 48 states
  - Dept. of State Standardized Regulations—overseas locations
Travel costs (FAR 31.205-46):

- Airfare is restricted to lowest priced airfare available to contractor during normal business hours (recent change to FAR)
  - Exceptions are provided—medical conditions, prolonged travel, unreasonable travel hours
  - Should not be interpreted to allow Business or First Class travel
- Car rental—no specified restrictions, but should be reasonable
- Regardless of reimbursement plan, contractor must document:
  - Date and place of trip
  - Purpose of trip
  - Name of employee and relationship to contractor
FAR 31.201-2(d) (Allowability)

- Adequate documentation necessary to demonstrate:
  - Costs have been incurred
  - Are allocable to contracts
  - Comply with cost principles
- Documentation should show nature and purpose of expense
Comments and Thoughts