ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of --	)	
	)	
General Electric Company	)	ASBCA No. 44646
	)	
Under Contract Nos. F34601-91-G-7713-0001	)	
F34601-91-G-7713-0006	)	
F34601-89-G-6673-0081	)	
F34601-89-G-6673-0085	)	
F34601-89-G-6673-0087	)	
F34601-89-G-6673-0089	)	

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APPEARANCES FOR THE GOVERNMENT:	COL John M. Abbott, USAF Chief Trial Attorney Richard L. Hanson, Esq. Deputy Chief Trial Attorney CAPT Jennifer L. Grimm, USAF Trial Attorney

OPINION BY ADMINISTRATIVE JUDGE TUNKS

This is an appeal from a contracting officer's final decision disallowing a portion of the depreciation charges proposed by a Turkish subcontractor of General Electric Company (GE or appellant) in connection with six delivery orders for spare parts. The charges were disallowed because, in a period when the Turkish lira was falling against the dollar, the subcontractor used its "average historic exchange rates" instead of the current exchange rates to translate its depreciation charges into U.S. dollars. The contracting officer found that use of the "average historic exchange rates" would result in a prohibited valuation of the subcontractor's tangible capital assets under FAR 31.205-11(a) and the recovery of more Turkish lira in depreciation than the amount of Turkish lira recorded on the subcontractor's books of account in violation of FAR 31.205-11(e). Accordingly, she disallowed all depreciation charges in excess of those that would have been realized if the current exchange rates had been used. Only entitlement is before us.

FINDINGS OF FACT

I. TUSAS Engineering Industries, Inc. (TEI)

1. In 1983, Turkey and the United States (U.S.) established the Peace Onyx Program, under which the U.S. agreed to sell, and Turkey agreed to buy, a quantity of F-16 aircraft powered by GE's F110 engine. The U.S. also agreed to establish parts manufacturing capability in TUSAS Engineering Industries, Inc. (TEI), a Turkish entity to be formed for that purpose, and to coproduce a quantity of parts with TEI. (SR4, tab 38)

2. On 9 January 1985, GE, through two wholly owned subsidiaries, General Electric Technical Services Company, Inc. (GETSCO) and General Electric International Operations Company, Inc. (GEIOC), entered into a "Joint Venture Agreement for the Formation of TUSAS Engineering Industries, Inc." (JVA) with three Turkish entities, TUSAS Aircraft Industries, Inc. (TUSAS), the Turkish Air Force Foundation and the Turkish Air League (R4, tab 32; tr. 2/13).

3. Under the JVA, TEI's initial capital was to be Turkish lira (TL) 250,000,000 in cash. Its final capital was to be the Turkish lira equivalent of $56,160,000. The Turkish partners agreed to contribute $28,640,000, most of which was to be in Turkish lira. GE agreed to contribute $27,520,000, most of which was to be in equipment. In return, the partners received shares of stock in TEI denominated in Turkish lira. After making an initial cash payment, the partners agreed to make contributions according to the following schedule:

AMOUNT IN U.S. DOLLARS
IN MILLIONS

	1984	1985	1986	1987	TOTAL
T O T A L S	3.28	29.89	17.25	5.74	56.16
(1) TUSAS, the Turkish Air Force Foundation and Turkish Air League,					
In Cash	0.08	9.77	12.85	5.74	28.44
In Kind	0.20	-	-	-	0.20
			TOTAL		28.64
(2) GETSCO and GEIOC					
In Cash	0.10	0.10	0.10	-	0.30
In Kind					

Services	0.50	0.90	0.50	-	1.90
Equipment	2.40	19.12	3.80	-	25.32
			TOTAL		27.52

(SR4, tab 32; tr. 1/177)

4. TEI was incorporated under the laws of Turkey on 10 October 1985. The Articles of Incorporation (Articles) stated that TEI's capital “may be increased by resolution adopted by the General Assembly” provided that “[t]he ratio of equity interest[s] of the shareholders shall always remain fixed.” The required equity interests were as follows: GETSCO--48%, GEOIC--1%, TUSAS--49%, the Turkish Air Force Foundation--1.9% and the Turkish Air League--0.1%. (SR4, tab 35)

5. By March 1986, TEI needed to increase its capital, but the shareholders' equity interests were not in the proportions required by the Articles (tr. 1/75-76). In order to satisfy the Turkish legal requirements for increasing its capital, the shareholders entered into a protocol on 22 November 1986 which stated, in part, as follows:

> Article 1
>
> Advances that shall be made by the Turkish shareholders to be credited to capital increase shall be taken into account according to U.S. Dollar equivalency as per the official exchange rates prevailing on the dates such advances are made.
>
> . . . .
>
> Article 3
>
> Advances that shall be made by American partners when converted to equity capital shall be taken into account on a dollar for dollar basis at the exchange rates as used by the Turkish partners for their advances to capital using the exchange rate applicable to the Turkish partners at the time such advance is made.

(SR4, tab 36)

6. The shareholders established the capital contribution record (CCR) to track their ownership interests under the protocol (SR4, tab 69; tr. 1/75-81). GE does not allege that either the protocol or the CCR was part of TEI's books and records (ex. A-12). The CCR

recorded the amount of each contribution in the manner agreed upon in the protocol. Thus, GE's contributions were taken into account at the historic exchange rates in effect when the Turkish shareholders made their contributions, while the contributions of the Turkish shareholders were taken into account at the exchange rates in effect on the date of their contributions. Since GE made its in-kind contributions later than the Turkish shareholders "most of the time" and at times when Turkish inflation was steadily increasing, application of the protocol resulted in a substantial understatement of the Turkish lira value of GE's contributions on the CCR and all the records that were based on the CCR, including the general ledger (tr. 1/69-71, 88, 146; exs. A-3, -4).

7. Under Turkish law, TEI was required to submit the cost of GE's in-kind contributions and their proposed Turkish lira equivalent to the State Planning Organization (SPO) for approval (tr. 1/60-61; SR4, tab 32 at 9). TEI determined the Turkish lira equivalent in the manner prescribed by the protocol (tr. 1/61). Thus, GE's CIF costs were converted into Turkish lira at the exchange rates in effect on the dates the Turkish shareholders made their contributions as reflected on the CCR (ex. A-8; tr. 1/80-81). TEI referred to the U.S. dollar and Turkish lira costs recorded on the CCR as its "first costs" (tr. 1/49-50). To calculate the book value of the asset, Turkish law required TEI to add an export tax and subtract a resource credit from the approved Turkish lira equivalent (tr. 1/71).

8. For example, GE contributed a cutter grinder with a CIF cost of $93,773 to TEI on 23 February 1989. Using the exchange rate of $1.00 = TL 784.5, which was derived from the CCR, TEI translated the CIF cost into TL 73,564,919 and submitted it to the SPO for approval (tr. 1/69-71, 81; R4, tab 69 at 21). After the SPO approved its proposed Turkish lira equivalent, TEI added the export tax, deducted the resource credit and recorded TL 78,230,016 on its books of account (tr. 1/70-71, 82-87). If TEI had used the actual exchange rate in effect on 23 February 1989 ($1.00 = TL 2,029.5), it would have recorded TL 190,312,304 on the CCR (tr. 1/88). Turkish Customs translated the CIF cost of the cutter grinder into Turkish lira at the current exchange rate in effect on 23 February 1989, which was TL 2,029.5, resulting in a Turkish lira equivalent of TL 190,312,304 (tr. 1/85-88).

9. TEI's first full year of production was 1988 (tr. 2/92-93). In September 1988, the shareholders amended the protocol to increase TEI's final capital to $60,000,000. GE refused to increase its capital commitment, reducing its interest in TEI to 46.2%. (R4, tab 9, SR4, tab 36) By the end of 1992, TEI had met the $60,000,000 goal set by the amended protocol. Ultimately, GE contributed a total of $14,364,772 in equipment. (SR4, tab 83 at A0000969)

10. Through 1992, virtually all of TEI's business was as a subcontractor under GE's prime contracts with the U.S. Government (tr. 1/93).

11. In preparing its financial statements, GE used the equity method to account for its interest in TEI (tr. 2/31, 67-71; SR4, tabs 74, 76, 78, 80, 82).

12. TEI does not pay U.S. Federal income tax.

II. <u>The Delivery Orders</u>

13. On 24 August 1989 and 22 January 1991, the Government awarded Basic Ordering Agreements F34601-89-G-6673 and F34601-91-G-7713 to GE. The Government issued the six delivery orders (DOs) at issue here between 21 December 1990 and 28 February 1991. The DOs were negotiated firm, fixed price contracts and were priced in U.S. dollars (R4, tabs 1 through 6).

14. GE's proposals for the DOs included unit prices based on hourly charges for effort to be performed by TEI as an independent subcontractor (tr. 2/74, 100-01; R4, tab 9).

15. During negotiations, the parties disagreed over TEI's use of what we refer to as the "average historic exchange rates," the rates TEI used to translate its hourly depreciation charges into U.S. dollars for pricing purposes. Rather than delay award, the Government added a "reopener" clause to the DOs, setting aside negotiation of TEI's depreciation costs to a later time. As extended, the clause required the contracting officer (CO) to issue a unilateral price adjustment if the parties failed to reach agreement by 31 October 1991. (R4, tabs 1 through 6)

III. <u>The Regulations</u>

16. The following portions of the Federal Acquisition Regulation (FAR) are applicable to this dispute:

> FAR 31.201-1 COMPOSITION OF TOTAL COST.
>
> The total cost of a contract is the sum of the allowable direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits, plus any allocable cost of money . . . . In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used . . . .

. . . .

FAR 31.201-2 TYPES OF CAS COVERAGE

. . . .

(b) *Modified coverage*. (1) Modified CAS coverage requires only that the contractor comply with Standard 401, Consistency in Estimating, Accumulating, and Reporting Costs, and Standard 402, Consistency in Allocating costs Incurred for the Same Purpose.

. . . .

(e) *Foreign concerns*. Contracts with foreign concerns subject to CAS shall only be subject to modified coverage.

. . . .

FAR 31.205-11 DEPRECIATION.

(a) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. . . .

. . . .

(c) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, if the contractor is able to demonstrate that it is reasonable and allocable (but see paragraph (i) below) [inapplicable].

. . . .

(d) Depreciation shall be considered reasonable if the contractor follows policies and procedures that are—

(1) Consistent with those followed in the same cost center for business other than Government;

> (2) Reflected in the contractor's books of accounts and financial statements; and
>
> (3) Both used and acceptable for Federal income tax purposes.
>
> (e) . . . Allowable depreciation shall not exceed the amounts used for book and statement purposes . . . .

IV. FAS52

17. The parties disagree as to whether Statement of Financial Accounting Standards No. 52 (FAS52), "Foreign Currency Translation," issued by the Financial Accounting Standards Board in December 1981, is applicable. FAS52 provides, in part, as follows:

> INTRODUCTION
>
> . . . .
>
> 2. This Statement establishes revised standards of financial accounting and reporting for foreign currency transactions in financial statements of a reporting enterprise . . . . It also revises the standards for translating foreign currency financial statements . . . that are incorporated in the financial statements of an enterprise by consolidation, combination, or the equity method of accounting. Translation of financial statements from one currency to another for purposes other than consolidation, combination, or the equity method is beyond the scope of this Statement. For example, this Statement does not cover translation of the financial statements of an enterprise from its reporting currency into another currency for the convenience of readers accustomed to that other currency.
>
> . . . .
>
> STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING
>
> Objectives of Translation
>
> 4. Financial statements are intended to present information in financial terms about the performance, financial position, and cash flows of an enterprise. . . .

> . . . .
>
> 5. The assets, liabilities, and operation of a foreign entity shall be measured using the functional currency of that entity. An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally that is the currency of the environment in which an entity primarily generates and expends cash . . . .
>
> . . . .
>
> 11. The financial statements of a foreign entity in a highly inflationary economy shall be remeasured as if the functional currency were the reporting currency. . . . [A] highly inflationary economy is one that has cumulative inflation of approximately 100 percent or more over a 3-year period.
>
> . . . .
>
> 48. The table below lists common nonmonetary balance sheet items and related revenue, expense, gain, and loss accounts that should be remeasured using historical rates in order to produce the same result in terms of the functional currency that would have occurred if those items had been initially recorded in the functional currency.
>
> Accounts to be Remeasured Using Historical Exchange Rates
>
> . . . .
>
> Property, plant, and equipment.

(SR4, tab 85)

V. <u>TEI's Books and Records</u>

18. The parties agree that TEI maintained the following legal books:

> Among the books and records maintained by TEI are the following books and records required by Turkish law: (1) a cash book; (2) a ledger; (3) a general ledger; and (4) a fixed

> asset book. The cash book is for daily cash transactions, such as employee advances or travel expenses. The ledger includes debits and credits for each account. The general ledger also records debits and credits, but in a daily sequence fashion rather than by account. The fixed asset account lists all fixed assets showing each asset's first cost and then the depreciation for each year. These official records are available for inspection and review by the Turkish government. The currency used for each of these accounts is the Turkish lira.

(Stipulation 12)

19. TEI's Cost Accounting Standards (CAS) Dislosure Statement dated 9 February 1989 represented that TEI's cost accounting system was "integrated" with its financial accounting system and that its "[s]ubsidiary cost accounts are all reconcilable to general ledger control accounts" (R4, tab 42, ¶ 1.9.0).

20. GE did not introduce TEI's books of account into evidence, particularly its general ledger and its fixed asset book.

21. TEI maintained 28 subsidiary records, 14 of which were used for pricing purposes (ex. A-12; tr. 1/18-19). Of these, Mr. Demir, TEI's Director of Finance, identified three records that TEI used to track capital assets and calculate depreciation: the advance payments report, the fixed asset log (not the same as the fixed asset book that is part of TEI's legal books) and the TEI Balance Sheet Translation (TBST) (tr. 1/16-24).

22. GE did not explain how the advance payments report was used or introduce a copy of the report into evidence.

23. TEI did not begin to record U.S. dollars on its fixed asset log until 1 January 1993 (SR4, tab 68; tr. 1/28-29, 34, 149).

24. The TBST reflected the "first cost" of TEI's fixed assets in both currencies by category of asset (*e.g,* cash, accounts receivable, fixed assets, etc.) (tr. 1/38, 46). TEI obtained the data in the TBST from the CCR, the record used to track the ownership interests of the shareholders under the protocol (tr. 80-81). Based on the data on the TBST, TEI derived the "average historic exchange rates," which it used to translate its depreciation charges into U.S. dollars. The "average historic exchange rates" were calculated by dividing total cumulative Turkish lira by total cumulative U.S. dollars. (Tr. 1/48-49, 54-55, 117-23, 125-26; SR4, tab 64; ex. A-6)

25. For example, TEI used the TBST for 31 December 1990 to calculate the "average historic exchange rate" for 1990:

	AMOUNT (TL 000)	AMOUNT (US 000)	BASE	RATE
FIXED ASSETS BALANCE 1/1				
LAND	130,000	197	HIST	0.001512
BUILDINGS	17,878,534	26,901	HIST	0.001523
MACH & EQUIP	18,673,369	26,739	HIST	0.001637
MTR VEHICLES	210,507	311	HIST	0.001457
FURN & FIX	455,222	756	HIST	0.001523
[LIVING ANIMALS	0	0]		
[SUBTOTAL	37,347,632	54,904]		
CURRENT YEAR ADDITIONS				
LAND	0	0	CYHIST	0.000379
BUILDINGS	521,998	214	CYHIST	0.000409
MACH & EQUIP	1,676,158	679	HIST	0.000405
MTR VEHICLES	41,077	16	HIST	0.000379
FURN & FIX	59,023	14	CYHIST	0.000237
. . . .				
LIVING ANIMALS	4,900	2	CYHIST	0.000379
[SUBTOTAL	2,303,156	925]		
[TOTAL	39,650,788	55,829]		

"Fixed Assets Balance 1/1" of TL 37,347,632,000 and $54,904,000 were added to "Current Year Additions" of TL 2,303,156,000 and $925,000 to obtain total costs of TL 39,650,788,000 and $55,829,000. Total Turkish lira costs of TL 39,650,788,000 were then divided by total U.S. dollar costs of $55,829,000, yielding an "average historic exchange rate" of TL 710 for the year. (Tr. 1/117-23; SR4, tab 64; ex. A-11)

26. Exhibit A-7/G-8 entitled "Questions received from and materials provided to DCAA . . . on April 7, 1989," includes schedules entitled "Total Assets" which purport to show the total costs of TEI's fixed assets in both currencies from 1985 through 1989. The schedules are similar to the TBST, but contain less detail. Some of the schedules overlap TBSTs in the record. Our review indicated that the schedules for 1988 and 1989 were not necessarily consistent with the corresponding TBSTs (SR4, tab 64). GE did not identify the source of the costs shown on the schedules or demonstrate that they could be reconciled to the general ledger. However, DCAA was able to reconcile the amounts shown with TEI's Trial Balance (ex. A-7/G-8).

VI. <u>TEI's Calculation of Depreciation</u>

27. TEI uses the straight line method and depreciates machinery and equipment over 10 years without any allowance for residual value for purposes of contract pricing and Turkish income taxes (tr. 1/147; SR4, tab 41). DCAA took no exception to TEI's method of depreciation other than its failure to estimate a residual value. That issue is not before us.

28. According to Mr. Demir, TEI calculated its depreciation charges in Turkish lira and converted them into U.S. dollars using the following method:

> . . . [F]irst of all we have to know what is the first cost for fixed asset, either TL or U.S. dollar. TEI accumulated first costs, TL historically. . . . Now, once we got first cost for fixed asset we have different life of depreciation. For instance for machinery equipment is ten year, and buildings 25 years. Once fixed asset placed in service, so first year ten percent of the first cost of the fixed asset or 15, 12 percent off the building, kept as a depreciation expense.
>
> So then we calculate how much TL depreciation cost for the given year. Then for the pricing purpose of course we will not give our price in Turkish lira to our customer because we're dealing with foreign company. Then we have to convert this TL depreciation into U.S. dollar . . .

(Tr. 1/47-48, 58)

29. For contract pricing purposes, TEI used the “average historic exchange rates” from the TBST to translate its depreciation charges into U.S. dollars (tr. 1/47-55, 58, 3/141-42; ex. G-6; R4, tabs 15, 18; SR4, tabs 43, 44, 45, 47). For example, TEI used the pool allocation sheet for 30 December 1990 to compute the hourly rate for 1990, which provided, in part, as follows:

Depr	8,905.20	/	710.00	=	12.54
All Other	70,176.72	/	2,634.00	=	26.64
					39.18

On the first line, TL 8,905.20 was TEI’s hourly depreciation charge, TL 710 was the “average historic exchange rate” and $12.54 was TEI’s hourly depreciation charge. On the second line, TL 70,176.72 was TEI’s hourly rate for labor and other costs, TL 2,634.47 was the current exchange rate and $26.64 was TEI's hourly labor charge. Adding the two together yielded an hourly rate of $39.18 for 1990. (R4, tab 18 at 5; tr. 1/52-56) TEI included a copy of one of its pool allocation sheets with its CAS Disclosure Statement and the record contains other examples of TEI's pool allocation sheets (R4, tab 18; SR4, tab 42).

30. The "average historic exchange rates" were not reflected on TEI's legal books or financial statements and were not in accordance with Turkish requirements for income taxes or financial reporting (tr. 1/62-64; SR4, tabs 43 at 5-6, tab 64 at 10, tabs 74 through 83).

31. In an attempt to keep up with inflation, Turkey revalues the Turkish lira every December and requires Turkish companies to increase the costs recorded on their legal books by a specified percentage. TEI was required to use the revalued costs reflected on its legal books as the basis for computing Turkish income taxes and preparing its financial statements. Appellant did not use the "revalued costs" for purposes of calculating proposed hourly depreciation for the DOs and does not argue in this appeal that it should be able to do so. (Tr. 1/90-93, 147-48)

32. If TEI were required to translate its depreciation charges at the current exchange rates, it would recover only a small portion of GE's original U.S. dollar costs. For example, GE purchased a power supply for $331,820 and contributed it to TEI in 1987. TEI's book value was TL 201,588,654. Assuming that the asset was depreciated using the straight line method over 10 years, TEI would recover $64,977 in depreciation, calculated as follows:

Years	U.S. Dollar Actual	Annual Depreciation Charge	Current Exchange Rate	U.S. Dollar Recovery
1987	33,182	20,158,865	866	23,278
1988	33,182	20,158,865	1,448	13,922
1989	33,182	20,158,865	2,138	9,429
1990	33,182	20,158,865	2,635	7,650
1991	33,182	20,158,865	4,265	4,727
1992	33,182	20,158,865	7,001	2,879
1993	33,182	20,158,865	11,215	1,797
1994	33,182	20,158,865	30,285	666
1995	33,182	20,158,865	50,857	396
1996	33,182	20,158,865	86,457	233
	331,820	201,588,654		$64,977

(Ex. A-3)

33. If permitted to use the "average historic exchange rates," TEI would recover several times more U.S. dollars in depreciation than it would if it used the current exchange rates. This is demonstrated by an analysis of both exchange rates for the years 1989, 1990 and 1991, the only years for which the record contains data for both exchange rates. Table 1 reflects the number of U.S. dollars ($21,806) TEI would recover using the current exchange rates. Table 2 reflects the number of U.S. dollars ($83,472) it would recover using the "average historic exchange rates." Thus, TEI would recover an additional $61,666 in depreciation for the three years in question. As can be seen from the current exchange rates for the 10 years in question, Turkish inflation increased dramatically between 1993 and 1996 (see finding 32) which would only exacerbate the difference in recovery. Since GE contributed a total of $14,364,772 in equipment, this would result in a very substantial increase in the overall number of U.S. dollars TEI would recover.

Table 1
Dollar Recovery Using Current Exchange Rates

Year	Annual Depreciation Charge	Current Exchange Rate	US Dollar Recovery
1989	TL 20,158,865	2,138	$9,429
1990	TL 20,158,865	2,635	$7,650
1991	TL 20,158,865	4,265	$4,727
		TOTAL	$21,806

(Ex. A-3)

Table 2
Dollar Recovery Using "Average Historic Exchange Rates"

Year	Annual Depreciation Charge	Average Historic Exchange Rate	US Dollar Recovery
1989	TL 20,158,865	665	$30,314
1990	TL 20,158,865	710	$28,393
1991	TL 20,158,865	814	$24,765
		TOTAL	$83,472

(R4, tab 15, Pool Allocation Sheet dtd 11/9/90; tab 18, Pool Allocation Sheets dtd 12/31/89 and 12/31/90)

34. Under Turkish law, TEI could have depreciated its machinery and equipment in as few as four years, but chose not to do so (tr. 1/150). Since Turkish inflation increased steeply between 1993 and 1996 (see finding 31), using a four-year useful life instead of a 10-year useful life would have resulted in a substantial increase in TEI's recovery of depreciation.

VII. DCAA's Opinion

35. Ms. Joyce Kokoska has worked for DCAA since 1971 and has been a Supervisory Auditor since 1985. She participated in the formulation of DCAA's interpretation of FAR 31.205-11(a) and is familiar with how foreign contractors in Turkey, Israel and virtually every country in Europe calculate their annual depreciation charges. With the exception of TEI and two Israeli companies, all the companies she is familiar with use the current exchange rates to translate their depreciation charges into U.S. dollars. DCAA disallows the depreciation charges of the companies that do not use the current exchange rates to compute depreciation. (Tr. 3/5-12)

36. DCAA interprets the word "cost" in FAR 31.205-11(a) to refer to the Turkish lira costs recorded on TEI's books of account because TEI is a Turkish company and maintains its books of account in Turkish lira (tr. 3/34-46, 72-73, 103).

37. Even if TEI maintained records in both currencies, TEI's costs would still be the Turkish lira costs recorded on its legal books because TEI's costs are incurred in Turkish lira (tr. 3/56-58, 62-63).

38. According to DCAA, use of the "average historic exchange rate" results in a valuation of assets, which is prohibited by FAR 31.205-11(a):

> The "historical" exchange rate used by [TEI] represents the average of exchange rates effected on the dates "contributions to equity" were made by the joint venture partners . . . . The [JVA] stipulates that capital investment/contribution to equity will be in Turkish lira but credited to the partners in U.S. dollars equivalency according to the exchange rate value effective on the dates capital investment through either in cash or in kind contribution payments are made. The [protocol] stipulates further that contributions, when converted to equity capital, will be taken into account on a dollar-for-dollar basis at the exchange rates as used by the first (Turkish government) partners for their contributions to capital. . . . This stipulation

> was obviously necessary to protect the proportion of each partner's equity interest expressed in Turkish lira as well as the US dollar equivalencies thereof. This is clearly a valuation procedure and the "historical" rate was developed for this purpose only. It is not acceptable for calculating annual depreciation costs.

(Tr. 3/14-18; SR4, tab 41 at 11)

39. In DCAA's view, the proper exchange rate for converting TEI's depreciation is the current exchange rate, the same rate TEI uses for all its other expenses (tr. 3/60).

40. According to DCAA, if TEI is permitted to use the "average historic exchange rate," it will realize more Turkish lira in depreciation than the book value of its assets in violation of FAR 31.205-11(e) (tr. 18-19, 68-73).

41. It is DCAA's position that FAS52 does not apply to cost accounting for depreciation for the following reasons:

> The whole purpose of FASB-52 is to value things in a consistent currency so that they can be reported on a set of financial statements that can be understood by the general public. That's the sole purpose of FASB-52, is to value foreign currency transactions, combine them with U.S. dollar transactions so that they can be presented as a snapshot picture in time of a company's financial position and not necessarily reflective of the reporting or cost accounting for a cost asset.

(Tr. 3/93, 96)

VIII. The Final Decision

42. The Government and GE were unable to reach agreement on the costs subject to the reopener clause by 31 October 1991 (tr. 2/259-65; R4, tabs 16, 17, 21 through 26).

43. On 13 March 1992, the CO issued unilateral modifications reducing the price of the DOs (R4, tab 28). The final decision, which was written by the CO and issued on 13 March 1992, disallowed all costs in excess of those that would have resulted from use of the current exchange rate (R4, tab 28; tr. 2/266). She set forth the following rationale for her decision:

> 3. The books of accounts and financial statements of TEI are in Turkish lira. The functional currency and reporting currency of TEI is Turkish lira. For the sale of parts to GE, TEI converts the direct and indirect rates from Turkish lira to U.S. dollars at the current exchange rate. The historical exchange rate is used only in the calculation of depreciation. The use of the historical exchange rate in the calculation of depreciation results in a revaluation of the assets as the contractor recovers more Turkish lira than what was originally placed on the books. This is contrary to the FAR 31.205-11.
>
> 4. In addition, FAR does not provide for determining contract costs on the basis of current purchasing power or constant dollar value accounting.

44. The CO concluded that TEI's functional currency was the Turkish lira because TEI did business and kept its books in that currency (tr. 2/280-85). She did not connect the term functional currency with FAS52 when she wrote the decision (tr. 2/185). Since TEI pays income taxes in Turkish lira, she concluded that TEI's reporting currency was the Turkish lira (tr. 2/283). In reaching her decision, the CO relied on the advice of DCAA, her price analyst and the internal approval system for issuance of unilateral modifications (tr. 2/256, 266; SR4, tab 43).

45. GE appealed the CO's final decision and this appeal ensued.

IX. <u>The Experts</u>

46. Mr. Berthold Bodenheimer, the Government's expert, is a founding member and partner in the accounting firm of Caldwell & Bodenheimer. He has been with that firm or its predecessors since 1980. From 1971 to 1980, he was a member of the staff of the CAS Board, last serving as Deputy Executive Secretary. From 1965 to 1971, he was employed by DCAA, serving as a member and Chairman of the Armed Services Procurement Regulations Cost Principles Subcommittee. During his tenure as Chairman, the Subcommittee revised the cost principles, including ASPR 15-205.11, which survives as FAR 31.205-11 (tr. 3/162). Prior to 1965, he was employed by the Department of the Navy as its representative on the Subcommittee and an auditor. He is a certified public accountant (CPA) and has testified as an expert before this Board, the U.S. Claims Court (now the U.S. Court of Federal Claims) and U.S. District Courts on numerous occasions. (Tr. 3/155-156, Resume) In summary, his views are as follows:

(a) FAR 31.205-11(a) requires that depreciation be based on the cost of the asset or derived therefrom (tr. 3/161). Under FAR 31.201-1, "any generally accepted method" may be used to determine a cost (tr. 3/170-74).

(b) The only generally accepted method of determining a cost is one "that can be in some way or fashion be tied into, or reconciled, with the general ledger" (tr. 3/174-75, 186-87, 197, 205). Mr. Bodenheimer explained as follows:

> Well, since there is nothing specific, I have to rely on my experience. . . . I have been an auditor [and accountant] for, I guess, 35 years. . . . I have never, ever seen costs accepted or used even, other than here, that are not derived from . . . the general ledger of the company.
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> . . . [T]o an accountant, and particularly to an auditor, if you can't trace the cost to a general ledger that the contractor or the company represents to be its records, then you don't have any costs. I mean, that's something other than acceptable costs for contract costing purposes.

(Tr. 3/171-72)

(c) Since TEI's general ledger is in Turkish lira, TEI's depreciation charges must be calculated in Turkish lira (tr. 3/170-79).

(d) The accounting profession has considered issuing standards addressing the impact of inflation on depreciation on several occasions, but has not yet promulgated any guidance on this subject (tr. 3/182-85). Thus, using the costs recorded on the general ledger, "however they may have been devalued, is still a generally accepted method of depreciation" (tr. 3/180).

(e) Depreciation is an expense that is not incurred until the year in which it arises and, like all other expenses, it must be converted at the current exchange rate (tr. 3/204).

(f) Use of the "average historic exchange rates" results in a process of valuation. Mr. Bodenheimer explained as follows:

> The use of the exchange rates which prevailed at the time of the asset acquisition to translate depreciation costs is tantamount to depreciating the U.S. dollar cost of the asset. Because TEI costs for the purpose of books and financial statements are

> expressed in TL, dollar depreciation violates the proviso that depreciation is a charge which "distributes the cost of a tangible asset." Dollar depreciation revalues the asset in relation to the TL costs and therefore contravenes the second sentence of FAR 31.205-11(a), which states that depreciation does not involve a process of valuation.

(Bodenheimer statement at 8)

(g) FAR 31. 205-11(e) prohibits the recognition of more than the book value of the asset. Once the entire cost has been depreciated, "you have to stop." (Tr. 3/168)

(h) FAS52 governs how GE converts TEI's financial statements into U.S. dollars for purposes of preparing its financial statements, but does not affect TEI's financial statements or balance sheets and does not change TEI's basis for depreciation (tr. 3/190-91). "[T]herefore, it becomes totally unnecessary and, in fact, irrelevant, if not redundant and confusing, to go to FASB-52 to determine what the depreciation is" (tr. 3/166-67, 192).

(i) Mr. Bodenheimer agreed that inflation is a "problem" and that the Government is getting "a good deal" under the existing regulation, but concluded that TEI is still getting everything it is entitled to under the regulation (tr. 3/193). He concluded that if the regulatory scheme is "inadequate [f]or whatever purpose you might want, such as contract costing[, t]hen you have to seek other cures" (tr. 3/181-82).

47. Mr. William T. Keevan, GE's expert, is a partner and Managing Director of Government Contract Consulting Services for Arthur Andersen LLP. With the exception of five years, he has been employed by that firm since 1969. He has provided advice to contractors on a wide variety of issues, including preparation of bids, proposals, change orders and termination claims as well as self-governance and compliance matters. He directed Arthur Andersen's *Study of Government Audit and Other Oversight Activities Relating to Defense Contractors* for the Packard Commission. He is a CPA and has testified before the Board as an expert in several appeals. In summary, his opinions were as follows:

(a) The term "books and records" is very expansive and may include "almost anything." TEI's books and records include its formal books and records, subsidiary ledgers, cost reports and memorandum records. Mr. Keevan cited section 3.6 of the Armed Services Pricing Manual as support for the proposition that books and records include memorandum records. Section 3.6 states that memorandum records are "acceptable" only if they can be "reconciled to the company's general ledger." (Tr.

2/109-25; Authorities, tab 17)

(b) TEI's fixed asset log, the schedules entitled “Total Assets” attached to exhibit A-7/G-8 and the TBST are part of TEI's books and records (tr. 2/121-25).

(c) With respect to the schedules, Mr. Keevan testified that he had “seen them before,” listened to testimony regarding the first column of the schedules the day before and was “refreshed with that.” According to Mr. Keevan, the schedules were adequate to identify “whatever they depict” by major category (tr. 2/123). He did not testify that the schedules could be reconciled to TEI's general ledger or explain on what basis he found the costs acceptable for contract costing purposes (tr. 2/122-23).

(d) With respect to the TBST, Mr. Keevan testified that he had “seen it, looked at it.” He agreed that it was “adequate to provide a record of the historic cost of TEI's . . . fixed assets,” but did not testify that the costs could be reconciled to TEI's general ledger or explain on what basis he found the costs acceptable for contract costing purposes. (Tr. 2/125)

(e) TEI did not incur any U.S. dollar costs in connection with the equipment contributed by GE. The equipment was “received as part of GE's investment” (tr. 2/215).

(f) Although FAR 205-11(a) does not define a cost, “[t]he fundamental concept of depreciation is the same” under FAR, CAS and generally accepted accounting principles (GAAP) (tr. 2/131-32). Mr. Keevan explained that:

> The concept of depreciation embodied in those three regimes is that a tangible capital asset acquired for a certain price should be recorded at that price, that is the historical cost, the acquisition cost of the asset. The acquisition cost then forms the basis for all future cost accounting determinations, really, related to that asset . . . .
>
> . . . .
>
> If the asset was acquired two, three, four or five years ago, then it’s the cost at the time that the asset was acquired that forms the basis for the depreciation. And the current year, five years later, gets a depreciation charge which simply represents the allocable portion of that original cost. So if, for example, price levels had gone up and it would cost you twice as much to buy that asset today, it’s not talking about adjusting the asset value

> and the related depreciation for that current cost, that current replacement value. We're not talking about that. We're talking about sticking with original historical cost generally represented by a cash outlay at the time the asset was acquired.

(Tr. 2/132, 137-38)

(g) Depreciation is a charge of the current year and the total amount that may be depreciated is capped by the original cost of the asset (tr. 2/147-50).

(h) Depreciation is a process of allocation, not valuation. Mr. Keevan interprets the phrase "systematic and rational" in the regulation to refer to the method of depreciation:

> [W]hat it's saying is you can't pick and choose every year how much you're going to write off. There has to be some logical, reasonable basis for the depreciation charge. . . .
> [I]f you're going to use an asset pretty much evenly over its useful life . . . then straight line depreciation makes some sense. But if . . . there is a greater consumption . . . in the early years, . . . you might [use] accelerated depreciation. . . .

(Tr. 2/143-44)

(i) Based on the foregoing reasoning, he concluded that $100 per year was a systematic and logical charge for an asset that was purchased in 1987 for $1,000 (when the exchange rate was $1.00 = TL 866), assuming a useful life of 10 years and straight-line depreciation without any residual value. This charge was systematic and logical charge because it represented an allocable share of the cost of the asset. (Tr. 2/144-45)

(j) FAR 31.205-11(a) which states that depreciation "does not involve a process of valuation," prohibits current value accounting appraisals as opposed to historical cost accounting. Thus, the acquisition cost may not be adjusted to reflect increases or decreases in market value. (Tr. 2/150-51)

(k) In the absence of currency fluctuations reflecting relatively greater inflation in Turkey than the U.S., TEI would realize the same amount in depreciation regardless of which currency it used to calculate its depreciation charges (tr. 2/155). If, for example, a hypothetical asset with a purchase price of $1,000 and a book value of TL 866,000 was depreciated using the straight line method over 10 years and the exchange rate remained constant at $1.00 = TL 866, TEI would realize $100 or TL 86,600 a year and TEI would recover 100 percent of its acquisition cost. (Tr. 2/144-45)

(l) If “one of these units of measure loses its utility as a store of value to the point where it becomes a meaningless measure, you can't use it anymore” (tr. 2/155-56). Thus, if the value of the Turkish lira declined to $1.00 = TL 86,457 in 1996 in the example above, TEI would realize only $1.00 in depreciation in 1996 (tr. 2/126-30). Under these circumstances, Mr. Keevan testified that use of the current exchange rate is not rational:

> . . . $1 depreciation in the last year is simply not rational. That can't be a rational economic result. And the reason you get $1 depreciation is solely a function of the exchange rate. It's got nothing to do with the asset, it's got nothing to do with the production under the contract, it's got nothing to do with the contractor's performance of the work, it's simply a mathematical computation which is the function of a currency that's . . . lost its utility for anything. . . .

(Tr. 2/174, ex. A-4)

(m) Since FAR 31.205-11(a), as interpreted by the Government, deprives foreign contractors in highly inflationary economies of a meaningful recovery of depreciation, Mr. Keevan urges us to look to FAS52 as a guide to remedy the problem (tr. 2/180). FAS52 is a standard promulgated by the Financial Accounting Standards Board which establishes procedures for translating foreign currency financial statements for purposes of financial accounting and reporting.

(n) FAS52 states that the standard was not intended to apply to anything other than translation of financial statements for purposes of consolidation, combination or the equity method of accounting. Although Mr. Keevan conceded that FAS52 was not directly applicable to cost accounting or TEI’s as opposed to GE’s financial statements, he was, nonetheless, of the opinion that it is an appropriate guide in this and other similar situations (tr. 2/203-04).

(o) FAS52 requires a reporting enterprise (such as GE) to remeasure the foreign currency financial statements (such as those of TEI) which are incorporated into the financial statements of the reporting enterprise by consolidation, combination or the equity method of accounting in two situations: (1) if the foreign entity (TEI) is in a highly inflationary economy (100 percent or more inflation over three years); or (2) if the local economy is not highly inflationary, the foreign entity’s functional currency is the same as the reporting currency (tr. 2/156-57, 167-70, 178-79). Mr. Keevan contends that TEI’s functional currency is the U.S. dollar (tr. 2/157).

(p) Under FAS52, most accounts are measured at the current exchange rates. However, property, plant and equipment, and certain other accounts are remeasured at the historic exchange rates. By using the historic exchange rates instead of the current exchange rates as in the example in subparagraph (1) above, TEI would recover $1000 in year ten instead of $1.00. Since use of the historic exchange rates "gets you to $100," Mr. Keevan concluded that "[i]t makes sense. It's rational. That should be the basis of contract pricing . . . ." (Tr. 2/180)

DECISION

The Government disallowed a portion of the depreciation charges proposed by GE's Turkish subcontractor, TEI, asserting that the subcontractor's use of the so-called "average historic exchange rates" to translate its depreciation charges into U.S. dollars resulted in a prohibited valuation under FAR 31.205-11(a). The Government alleges that depreciation is an expense of the current year that, like all other expenses, must be translated at the current exchange rates. The Government also contends that use of the "average historic exchange rates" would result in the recovery of more Turkish lira in depreciation than the amount of Turkish lira recorded on TEI's books of account in violation of the book value limit imposed by FAR 31.205-11(e). Accordingly, the Government concludes that all depreciation charges in excess of those that would have been realized using the current exchange rates are unallowable. Since this is a cost disallowance, the Government bears the burden of proof. *Talley Defense Systems, Inc.*, ASBCA No. 39878, 93-1 BCA ¶ 25,521 at 127,154.

The Government has proven that TEI's use of the "average historic exchange rates" resulted in a revaluation. Under FAR 31.205-11(a), what may be depreciated is the "cost" of the asset as recorded on the contractor's books of account. Although FAR 31.205-11(a) does not define a cost, Mr. Keevan testified that the concept of a cost is consistent under FAR, CAS and GAAP. CAS 404, "Capitalization of tangible assets," indicates that the capitalized cost of a tangible capital asset is the purchase price plus the costs necessary to put the asset into service. 48 C.F.R. § 9904.404-50 (1999). Once established, the basis of the asset may not be adjusted to reflect market value changes. Thus, Mr. Keevan, GE's expert, explained that "if the asset was acquired two, three, four or five years ago . . . it's the cost at the time that the asset was acquired that forms the basis for the depreciation."

TEI used the straight line method of depreciation and depreciated its machinery and equipment over a useful life of 10 years without any allowance for residual value. After calculating its depreciation charges in Turkish lira, TEI translated them into U.S. dollars using the "average historic exchange rates." TEI derived the "average historic exchange rates" from the TBST, which displayed cumulative "first costs" by category of asset in Turkish lira and U.S. dollars. TEI then computed the "average historic exchange rates" by dividing the total cumulative Turkish lira "first costs" by the total cumulative U.S. dollar "first costs." TEI used these rates to translate its hourly depreciation charges into U.S. dollars as shown on TEI's pool allocation sheets.

If TEI is permitted to use the "average historic exchange rates" to convert its depreciation charges, it would recover several times more U.S. dollars in depreciation than it would if it used the current exchange rates, effectively revaluing its assets. This is demonstrated by an analysis of both exchange rates for the years 1989, 1990 and 1991, the only years for which the record contains data for both rates. Table 1 reflects the number of U.S. dollars ($21,806) TEI would recover for an asset whose book value was TL 201,588,654 using the current exchange rates. Table 2 reflects the number of U.S. dollars ($83,472) it would recover using the "average historic exchange rates." Thus, TEI would recover an additional $61,666 in depreciation for the three years in question. Between 1993 and 1996, Turkish inflation increased dramatically, going from TL 11,215 to the $1.00, to TL 86,457 to the $1.00, which would only exacerbate the difference in recovery.

Table 1
Dollar Recovery Using Current Exchange Rates

Year	Annual Depreciation Charge	Current Exchange Rate	US Dollar Recovery
1989	TL 20,158,865	2,138	$9,429
1990	TL 20,158,865	2,635	$7,650
1991	TL 20,158,865	4,265	$4,727
		TOTAL	$21,806

Table 2
Dollar Recovery Using "Average Historic Exchange Rates"

Year	Annual Depreciation Charge	Average Historic Exchange Rate	US Dollar Recovery
1989	TL 20,158,865	665	$30,314
1990	TL 20,158,865	710	$28,393
1991	TL 20,158,865	814	$24,765
		TOTAL	$83,472

The Government has also proven that use of the "average historic exchange rates" would violate FAR 31.205-11(e). This subparagraph prohibits recovery of depreciation in excess of book value. As demonstrated above, given Turkey's high rate of inflation, use of the "average historic exchange rates" would of mathematical necessity result in the recovery of depreciation in excess of TEI's book values.

GE does not seriously deny that TEI's use of the "average historic exchange rates" resulted in a revaluation. GE contends that the purpose of FAR 31.205-11(a) is to allow a contractor to recover a meaningful portion of its capital investments in depreciation. If the Government prevails, GE argues that TEI will recover less than 2 percent of its depreciation charges on an annual historic dollar basis, a result that "is so inequitable as to make it unconscionable" (app. br. at 2, 4). In order to remedy this situation, GE maintains that TEI should be allowed to depreciate on the basis of the U.S. dollar, arguing that: (1) TEI may depreciate on the basis of the U.S. dollar because FAR 31.205-11(a) is silent with respect to the medium of currency to be used to calculate depreciation; (2) TEI maintained adequate U.S. dollar records of its costs and legitimately used those records to calculate depreciation; and (3) FAS52 permits foreign contractors in highly inflationary economies to remeasure their assets and liabilities into U.S. dollars.

GE first argues that TEI should be allowed to depreciate on the basis of the U.S. dollar because the regulation fails to specify the medium of currency to be used for depreciation. What may be depreciated under FAR 31.205-11(a) is the "cost" of an asset. The Government interprets the word to mean the historic cost in the currency of the general ledger. Mr. Bodenheimer pointed out that FAR 31.201-1 permits a cost to be determined by "any generally accepted method." In his opinion, the only generally accepted method of determining a cost is to reconcile it with the general ledger. In his 35 years of experience, he has "never, ever seen costs accepted or used . . . that are not derived from . . . the general ledger." If the cost cannot be traced to the company's general ledger, "then you don't have any costs" for contract costing purposes. Notably, Mr. Keevan did not address FAR 31.201-1, generally accepted methods of determining a cost or reconciliation.

DCAA has consistently interpreted the word cost to require contractors to depreciate on the basis of the currency of their general ledgers. Ms. Kokoska, a Supervisory DCAA Auditor in the European Branch Office, who has participated in audits of companies in Turkey and Israel as well as virtually every country in Europe, testified that with the exception of TEI and two Israeli companies, all the companies she was familiar with depreciated tangible capital assets on the basis of the currency of their general ledger and that costs proposed on the basis used by TEI have been disallowed.

We are confident that TEI understood that it was required to depreciate on the basis of the Turkish lira because it represented on its CAS Disclosure Statement that its cost accounting system was integrated with its financial accounting system and that its subsidiary cost accounts were "all reconcilable to general ledger control accounts." Since TEI's general ledger accounts are maintained exclusively in Turkish lira, TEI could only reconcile Turkish lira records with those accounts.

Secondly, GE argues that TEI should be allowed to depreciate in U.S. dollars because it maintained adequate records of its U.S. dollar costs and used those records to calculate its depreciation charges. We have found as fact that TEI did not calculate its depreciation charges on the basis of the U.S. dollar. In any event, the argument is moot in view of our holding that TEI must depreciate on the basis of the Turkish lira.

Thirdly, GE argues that, in the absence of any direction in the regulation, TEI should be allowed to depreciate on the basis of the U.S. dollar under FAS52, alleging that it is relevant GAAP. In explaining this view, Mr. Keevan testified that FAR 31.205-11(a) requires that a cost be allocated in a systematic and logical manner, interpreting the phrase to refer to the method of depreciation (straight line, accelerated, etc.). Thus, he considered $100 a year in depreciation to be a systematic and logical charge for an asset purchased in 1987 for $1,000 that was depreciated over 10 years using the straight line without any allowance for residual value. The exchange rate on the date of acquisition was TL 866 to $1.00. According to Mr. Keevan, this charge is systematic and logical because it represents an allocable share of the cost of the asset. If, however, the exchange rate in the above example went from TL 866 in 1987, to TL 86,457 in 1996, the situation presented by this case, TEI would recover only $1.00 in depreciation in year ten. In Mr. Keevan's view, this is not a "rational economic result" despite the fact $1.00 represents an allocable share of the cost of the asset.

Since the regulation does not yield a "rational economic result" for foreign contractors in highly inflationary economies, Mr. Keevan was of the opinion that we should use FAS52 as a guide for remedying the problem. With some exceptions, FAS52 provides that the assets of a foreign entity in a highly inflationary economy be remeasured into its functional currency at the current exchange rates. In TEI's case the functional currency is arguably the U.S. dollar. Under FAS52, depreciation is remeasured at the historic exchange rates rather than the current exchange rates. Using the same $1,000 asset that yielded $1.00 in depreciation in year ten as an example, Mr. Keevan explained his opinion as follows:

> [W]hat [FAS52 says] is [that] to make sense out of these numbers, you have to use the historic rate. . . . "I had to have something more than [$1 in depreciation in 1996]. I spent $1,000, I used the asset for ten years, $1 isn't rational."
>
> And use of the historic rate gets you to $100. It makes sense. It's rational. That should be the basis of the contract pricing in my view.

While the present scheme may not yield an equitable result for foreign contractors in highly inflationary economies, the fact that the FAR does not explicitly address their situation does not *ipso facto* make FAS52 applicable. Under *Marquardt Company v. United States,* 822 F.2d.1573, 1578 (Fed. Cir. 1987), the contractor must also show that it is consistent with the governing regulations. GE has not made this showing. FAS52 states on its face "[t]ranslation of financial statements from one currency to another for purposes other than consolidation, combination, or the equity method is beyond the scope of this Statement." Since this dispute does not involve consolidation, combination or the equity method of accounting, FAS52 is not applicable.

CONCLUSION

The appeal is denied.

Dated: 10 February 2000

ELIZABETH A. TUNKS
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

MARK N. STEMPLER
Administrative Judge
Acting Chairman
Armed Services Board
of Contract Appeals

I concur

EUNICE W. THOMAS
Administrative Judge
Acting Vice Chairman
Armed Services Board
of Contract Appeals

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA No. 44646, Appeal of General Electric Company, rendered in conformance with the Board's Charter.

Dated:

EDWARD S. ADAMKEWICZ
Recorder, Armed Services
Board of Contract Appeals