

## Case 05-6

### Centcom Inc.

Centcom Inc., a telephone company, entered into an agreement to manage Britel, a telecommunications company based in Italy. Britel is a wholly-owned subsidiary of TTL Group LLC. The terms of the management agreement are as follows:

- Centcom would manage Britel for a period of five years.
- Centcom would be entitled to receive a variable management fee that would allow Centcom to receive 80 percent of Britel's EBTIDA during the agreement period. However, payment of the management fee is contingent on sufficient cash being generated from Britel's operations.
- Centcom would select one member on the six-member board of directors and TTL Group would select the remaining five.
- Major expansion transactions (i.e., acquisitions, joint ventures, issuance of capital or debt, etc.) would require unanimous approval of the board.
- Centcom would manage the administrative and operational activities of Britel, including hiring and terminating employees.
  - Centcom plans to integrate Britel's activities into its own operations, through consolidating finance, accounting and customer services departments, by terminating the majority of Britel's employees.
- Centcom would be able to provide additional services to Britel's customers that Britel did not provide as of the date of the management agreement.
- In the event that Britel's operations do not generate the required cash flow to satisfy Britel's debt obligations, Centcom will be required to fund any shortfall. Such shortfalls are not reimbursable by Britel or TTL Group.
- TTL Group has no responsibility to fund Britel's operations as a result of the agreement.
- TTL Group received a premium of €6 million for writing a call option to Centcom that, if exercised, would allow Centcom to purchase 100 percent of Britel's outstanding common shares, as of the date of the agreement, at a strike price of €1 million. The option is exercisable at each anniversary date and expires five years from the date of the agreement.

Additional Information

- Britel is highly leveraged, and its balance sheet contains a deficit in shareholders' equity.
- Centcom estimates that under its management of Britel, economies of scale benefits will be realized, and, thus, will reduce Britel's operating costs. Below is Britel's summary Balance Sheet as of the date of the agreement.

<b>Assets</b>	(in Thousands)
Total current assets	€11,500
Fiber optic cable	70,500
Other assets	3,500
<b>Total assets</b>	<b>€85,500</b>
<b>Liabilities</b>	
Provision and payables	€ 5,000
Deferred liabilities	10,500
Long-term debt	100,000
<b>Total liabilities</b>	<b>€115,500</b>
<b>Total shareholders' deficit</b>	<b>€30,000</b>

Assume for discussion purposes that Britel meets the definition of a business in Appendix A of IFRS 3.

**Required:**

On the basis of your analysis of the factors presented in the case, determine whether Centcom, TTL Group, or neither party should consolidate Britel under International Financial Reporting Standards (IFRS). Be certain to discuss the relevant factors in the case that would support consolidation by either entity.