

# DIAMOND FINANCE

the financial & accounting newsletter for the diamond industry

Issue no. 3 July 2007

www.diamondfinance.info

## Jeremy writes

### Is more money for diamonds good?

The world of diamond finance in the month of June 2007 experienced three important announcements: the launch of a \$400m fund to invest in large diamonds, polished tenders and commoditisation. All three announcements, if they materialise, can significantly affect the diamond industry.

Oddly enough, the one which shall have the worst impact on consumers shall be the large diamond fund. As planned, the fund will only invest in diamonds worth more than \$1m, which it aims to sell on at a profit. In reality, the fund shall corner the market for these large stones, going against the trend of the industry to create more efficient channels of distribution. The industry will benefit from the availability of an extra few hundred million dollars, but this liquidity will only go to a select number of diamond manufacturers. The majority of diamond manufacturers never see a stone worth \$100k yet alone \$1m. Is it really good for the industry when the new funding goes to a few suppliers only, at the expense of higher prices passed on to the consumer? Don't the very rich consumers deserve the best prices too?

Martin Rapaport's ambition to create a transparent pricing index, through the tenders of polished diamonds, is not driven by pure philanthropy, although he does a lot of that as well. Profit will be made managing the tenders and selling the resultant price list. Tendere and auctions are not necessarily the best indicator of market prices. A good auctioneer in other areas can be expected to achieve higher than market prices, and diamonds should be no different. However, because the online trading platforms do not record the actual transaction prices, this will be first open record of actual transaction prices.

Unlike in the stock and commodity exchanges, members of the diamond bourses do not have to report their individual transactions. On the contrary, diamantaires profit precisely from this inefficient dissemination of pricing information. A move to disclosing the winning bid prices from the tenders will be a worthy enterprise. Over a period of time, a series of adjustments and discounts will be established to reflect the actual market prices.

Commoditisation seems to strike fear into a lot of diamantaires but it follows the trends of a lot of other raw and processed products. A lot of technical, legal and accounting work is required before the futures and options can be traded, and there are enough parallels with other products and exchanges to make it work.

The entry of investment and speculative funds will add liquidity to the market, but will also increase volatility. Also, the polished diamond market is not that large and there is always the risk of large players cornering the market and raising prices.

Lowell Kwiatt, co-president of Kwiatt, New York, commented "A diamond futures market affords the

opportunity to hedge diamond inventory against short-term fluctuations in pricing. It also can compensate for the carrying cost of inventory, which is something that we, as merchants, are not currently paid for. It is possible that the entry of speculators will fuel volatility, which could mean higher prices for the consumer. There will be many beneficial aspects to commoditisation, but there are likely to be unforeseen and unintended consequences."



Contact: Jeremy Sulzbacher BA FCCA  
cfoplus@gmail.com +32 47 223 66 55

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## technical corner

### negative goodwill

*In the previous issue we looked at the definition and treatment of goodwill in the books of a company. In this issue we look at the interesting concept of negative goodwill, and how to handle the purchase of companies at a premium or at a discount.*

When a company is purchased at a premium, the premium can be recorded as an intangible asset in the balance sheet called goodwill. But if the company is bought at a discount, when the balance sheets of the parent and subsidiary are consolidated, there will be a shortfall in the equity. This shortfall is called negative goodwill, and according to IFRS 3 it must be written off immediately in the profit and loss account. Until recently, this would have appeared as an extraordinary profit, but now it should be included above the line in the P&L and explained in a note to the accounts.

Also, it has to be shown in the changes in equity statement, which, for some reason the DTC does not require, for some reason.

The nature of the surplus of assets determines where the write-off will appear. If the assets are sufficiently similar to the goods sold by the acquiring company, your auditor may allow the extra profit to go to cost of goods sold and thereby improve your gross profit performance.

Say, EFG Ltd wants to buy LMN NV for \$2m on 1st January X7. On the 31 December X6, assuming only \$1 of share capital in each company, their balance sheets were:

	EFG ltd	LMN nv
Goodwill	-	-
Stock	1,100	1,750
Debtors	2,150	1,250
Cash	4,550	250
<b>Total Assets</b>	<b>2,800</b>	<b>3,250</b>
Creditors	2,100	1,050
Loans	3,400	950
<b>Total Liabilities</b>	<b>5,500</b>	<b>2,000</b>
<b>Total Equity</b>	<b>2,300</b>	<b>1,250</b>
	7,800	3,250

Following the acquisition, the consolidated balance sheet will be as follows:

Consolidated - acquired \$2m.	
Goodwill	750
Investment in Subsidiary	1,250
Stock	2,850
Debtors	3,400
Cash	2,800
<b>Total Assets</b>	<b>11,050</b>
Creditors	3,150
Loans	4,350
<b>Total Liabilities</b>	<b>7,500</b>
<b>Total Equity</b>	<b>3,550</b>
	11,050

But if the acquisition was for only \$0.5m then the consolidated balance sheet will look like:

Consolidated - acquired \$0.5m.	
Goodwill	-
Investment in Subsidiary	1,250
Stock	2,850
Debtors	3,400
Cash	2,800
<b>Total Assets</b>	<b>11,800</b>
Creditors	3,150
Loans	4,350
<b>Total Liabilities</b>	<b>7,500</b>
<b>Total Equity</b>	<b>4,300</b>
	11,800

### Relevance for Diamond Companies

If the development of a brand is carried out in a separate company which is independent of the sightholder group and using external funding, then when it is clear that the brand is robust enough to survive an impairment test, the company can be purchased, either at a discount or a premium. If at a premium, then an intangible asset called goodwill is created. If at a discount, then an opportunity to create some profit is created. But if the brand does not take-off then the loss is kept off the balance sheet. ■

## SoCrates

### Revaluing for an IFRS deviant

This time last year the Antwerp diamond sector was all abuzz about the proposed 'amnesty' (sorry, I must not call it that) whereby diamond companies and sole traders would be allowed to revalue their inventories, upwards. In order to avoid reporting profits over the years, diamond companies were devaluing their inventories each year to the extent that in some companies the book value was less than 50% of the real value.

Experts were brought in to lecture on the benefits of the revaluation such as more equity for the banks and stronger balance sheets for the sightholders.

The main conditions of the revaluation were a 4.5% one time tax on the revalued amount to be paid in December '06 and the revaluation amount put in a reserve that cannot be distributed for 10 years. Many companies took advantage of this and the more astute overvalued their inventory to avoid paying taxes in future years.

Now with hindsight, the banks are still not sure how to treat the revaluation reserves for Basel 2 and a revaluation reserve that does not go through the profit and loss account is of less use to the sightholders. In fact, the 4.5% tax charge shows up as an expense, while the revaluation does not go through the profit and loss account so performance deteriorates. And the 4.5% was from retained profits, so it actually was more like 6.5%.

Those Belgian diamond companies with good tax structures are able to bring in profits from overseas →

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subsidiaries at much lower tax rates than 4.5% and, unlike the revaluation reserve, benefit from distributions and subsequent notional interest.

But what about the accounting treatment? If for example ABC Ltd revalued its \$30m inventory up by \$20m, it would have paid tax of \$900k. If ABC had sales of \$200m, gross profit of \$15m and expenses of \$5m and \$0.1m tax, its P&L would look like this.

2006	
Sales	200
Cost of goods	(185.0)
Gross profit	15.0
Expenses	(5.0)
<b>Net profit</b>	<b>10.0</b>
<b>Tax (0.1+0.9)</b>	<b>(1.0)</b>
<b>Profit for year</b>	<b>9.0</b>

The revaluation would have been disclosed in the financial statements with the note to the accounts that this treatment was not compliant with IFRS which does not allow revaluations upward and has also moved away from extraordinary and exceptional items.

Even though the DTC has claimed that it will not use the financials other than for verifying that sales were more than \$30m, some sightholders brought the revaluation surplus into the P&L in an even more non-IFRS manner:

2006	
Sales	200.0
Cost of goods	(185.0)
Gross profit	15.0
Expenses	(5.0)
Net profit	10.0
Tax (0.1+0.9)	(1.0)
	9.0
<b>Extraordinary item</b>	<b>20.0</b>
<b>Profit for year</b>	<b>29.0</b>

As its name implies, an extraordinary item is ignored when analysing financial statements, and the DTC's reporting template no longer has a separate line for it. Technically speaking, it is more of an exceptional item than an extraordinary item, but in either case the treatment is incorrect. And, if you are going to pump up your profit from \$9m to more than your gross profit, you are inviting unwanted attention!

Now, if you are going to deviate from IFRS and have a good accountant and an agreeable auditor, you could justifiably claim that the revaluation was a correction to the cost of goods and that it should be written off to the P & L over the duration of the 10 year freezing of the revaluation reserve. And on the same basis you could spread the tax charge over the same ten year period and put the timing difference in the balance sheet.

Now ABC has a much better P&L:

2006	
Sales	200.0
Cost of goods (+\$2m)	(183.0)
Gross profit	17.0
Expenses	(5.0)
<b>Net profit</b>	<b>12.0</b>
<b>Tax (0.1+0.1)</b>	<b>(0.2)</b>
<b>Profit for year</b>	<b>11.8</b>

\$11.8m looks a lot better than \$9m and the gross profit ratio has improved from 7.5% to 8.5%, but you need a good accountant to do this.....

## Branded for life



**By Tulli Padwa**  
 Director:  
 Iceberg Advertising Bvba,  
 Antwerp.

Art. II,  
**The meltdown.**

The most vociferous arguments against branding for diamonds come from the sightholders who have tried it and failed. This is no small group. The graveyard of the industry is littered with the remains of many an expensive experiment, often never even officially laid to rest. Most are filed away, ignored and forgotten, only to be dusted down every few years when the DTC SOC profile arrives. A name, duly registered and trademarked, a slick print-advert extolling its virtues and of course, an incremental premium, testimony of the commitment to modern and down-stream marketing techniques.

To be fair, despite the hype, and the pressure to create branding, the naysayers are not entirely wrong. The truth is, the days when a large budget, and universal media exposure were all you needed to launch and maintain a new worldwide brand, are definitely over.

The global media world is changing. The big national TV and media channels are steadily losing influence. In their place multiple, localised and specialist channels jostle to provide personalised content direct to users. Meanwhile the Internet is fast becoming the medium of choice for news and information. The captive audience, that we advertisers could once bewitch with our carefully crafted spells, have wised-up and now take their news, information and entertainment on their own terms, in their own time, and relatively ad free.

Even the world's top brands like Coke and MacDonald's are scaling back their classic advertising budget. In its place they are concentrating their efforts on more novel and



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exciting ways of attracting customers to absorb their message. Smirnoff, the vodka people are paying game developers to incorporate their product in popular video games. Car manufacturers Toyota paid sixteen million dollars to have their cars featured on popular the USA TV show "The Contenders". Creditcard company AmEx hired popular comedian, Jerry Sienfeld, to play in an extended play, online advertainment campaign.

As we well know, diamonds are not like cars or soap powder. You do not try, or even want to, reach every household in the developed world with your diamond branding; unless you have come up with an idea as good as the engagement-ring, which has. But the target audience for diamond jewellery has been extensively touched by the efforts of the industry of the last five years and it is worth noting that most of the successes that have been booked in diamond (jewellery) branding have come at the expense of non-branded products. There is very evidence of customers being attracted to buy a diamond instead of some other luxury gift, because of the branding.

There is some good news in the market however, although not everybody is entirely sure how to deal with it. Bling is in! Yet, it is not every diamantaire's dream to feature prominently, as the supplier of diamonds, on websites with names like GangstaGold, selling personalised gold teeth and diamond encrusted dogcollar pendants, at seventeen thousand dollars a throw, to the hip-hop generation or itsmybinky.com who do a diamond encrusted baby's dummy.

The bling revolution is deliberately in-your-face, in line with the whole hip-hop culture, and the fact that the establishment is uncomfortable with it is actually necessary to keep it credible. And yes, it does stand in stark contrast to the caring, sharing, family orientated, Love Forever image that the DTC and the diamond establishment promote. But then, denim jeans also started out as a protest garment and today we have Versace and Dolce and Gabbana versions, adorning the posteriors of those the bling-wearers are trying to annoy.

Not that I am promoting a massive rush to push the diamond studded 'Ice Box' for the storage of chemical entertainment. We have to work hard to maintain the very successful link that has been made in human minds between diamonds and eternal love. I am saying that the brands of tomorrow will probably not fit into the mould that has been constructed. The 'I love you' part of the human relationship has practically been covered ad nauseam and it is up to the industry to create the new buzz that will lure new customer to the diamond counter.

As long as diamonds are available, creative minds will be searching for ways to convince consumers to buy them. But it will be totally new concepts and novel new uses that will capture the hearts and wallets of the cyber generation, not just pretty pictures of beautiful jewellery with inventive names.

## Diamond Finance

### Notice

The material discussed in this newsletter is intended to provide general information only and should not be acted upon without first obtaining professional advice tailored to your particular needs.

Please contact your professional, legal or financial advisors, for guidance.

## jurisdictions

### Going for a British Virgin



Many diamond groups include a company or two incorporated in the British Virgin Islands, (BVI), so this first of two articles provides more information about this tax jurisdiction.

The Virgin Islands were discovered in 1493 by Christopher Columbus, who named them 'Las Virgenes' in

honour of St Ursula and her company of eleven thousand maidens. They were settled by the Dutch in 1648 and then annexed by the English in 1672. The islands were part of the British colony of the Leeward Islands from 1872-1960; they were granted autonomy in 1967. The economy is closely tied to the larger and more populous US Virgin Islands to the west; the US dollar is the legal currency.

The 23,500 inhabitants' main income is from tourism and financial services and its GDP per capita is \$38,500. The main language spoken is English, the legal system is based on the English common law system and most of the company and tax law is anchored in the Business Companies Act of 2004.

The BVI introduced its outstandingly successful International Business Company (IBC) in 1984, the time the original Act was superseded by the BVI Business Companies Act 2004, which effectively removed the distinction between 'offshore' and 'onshore' companies. By that time, well over 600,000 had registered in the jurisdiction - Hong Kong and Latin America being the main sources of clients.

#### The basics for BVI companies are:

- Minimum of one shareholder which can be corporate;
- One director who may be corporate and does not have to be local;
- A company secretary is optional and can be corporate;
- Minimum share capital \$1;
- No disclosure of beneficial ownership to the authorities;
- No publicly accessible records;
- Accounts have to be maintained, but do not have to be filed or audited
- A local office must be maintained at the office of a licensed management company;
- Meetings can be held anywhere in the world.

#### Money Laundering

The BVI authorities decided not to encourage offshore banks to establish themselves in large numbers, as a defence against money-laundering. Unlike Bermuda, however, which created local banks to the exclusion of external banks, the BVI authorities allowed in a small number of international banks.

There are in fact a total of nine banks in the BVI, including Barclays Bank and ABN Amro. Lately there has been pressure on the Government from the business community to allow in larger numbers of respectable offshore

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banks; professional firms in particular feel that the BVI's legislative and regulatory apparatus is well up to global standards and well able to defend the BVI and its good reputation against scams, criminals and drug money.

Banks are regulated under the Banks and Trust Companies Act 1990, and supervised by the Banking and Fiduciary Division of the Financial Services Commission.

#### Tax Haven

The British Virgin Islands was among 35 jurisdictions identified by the OECD in June 2000 as meeting the technical criteria for being a tax haven. As a result of having implemented an improvement in the transparency of its tax and regulatory systems and established effective exchange of information for tax matters with OECD countries in December 2005, the British Virgin Islands are no longer included in the ORCD's list of unco-operative tax havens.

*In the next issue we will look at the taxation of BVI corporations and their use and limitations in group structures.* ■

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## tip of the month

*Here, are seven suggested guidelines to ensure that laptops contribute to productive meetings rather than to distract and annoy participants.*

#### Make sure there's a point.

Few businesspeople would discount the productive oomph that computers can bring to a meeting, no matter if they're part of a presentation or a means of recording the proceedings. But it's usually a good idea to discourage someone from using a laptop for something other than the business at hand.

It is impossible to have a productive, interactive meeting with laptops separating the attendees. So meeting participants should leave their laptops in their offices unless they have a reason to have them in the meeting.

#### Designate a laptop.

Again, laptops can be integral to the business of a meeting. If a computer needs to be part of the proceedings, consider putting one person in charge of computer duties. If notes need to be taken, that one person can look after the chore, then share them with the other attendees once the meeting is completed. Likewise, if presentations such as PowerPoint are necessary, there's really no necessity for more than one computer.

#### Be ready to explain why you've brought a laptop.

If you bring your machine to a meeting, it's courteous to let the person in charge know why it's there, be it for recording purposes or access to pertinent data. That can head off sour feelings if someone is mysteriously hunkered down over a laptop for no apparent purpose.

#### Use some discretion.

Just because your laptop's in front of you doesn't mandate its constant use. Even if you're taking notes, never looking up from your machine can be alienating to the presenter and those around you. It is also inefficient to spend too much time with your computer and later have to be briefed about what actually went on in a meeting.

Strike a balance. Use your machine but pay due attention to the discussion at hand.

#### Turn down the bells and whistles.

Yet another point of compromise: Treat your computer as you would your cell phone at the theater. If you choose to bring it along, take a few moments beforehand to mute any sort of sound that may prove distracting to your colleagues.

#### When in doubt, leave them out.

There is nothing cast in stone that makes laptops an essential element of business meetings. If you're concerned that laptops may be more of a hindrance rather than help, you might consider keeping them out of meetings altogether. Do it on a trial basis and see if meetings suddenly blossom in productivity and efficiency.

#### Dissect your meetings.

If you spot problems seemingly stemming from laptop use - poor attention, scattered discussions or the like - the issue may not be with the machines themselves. Rather, take a

## Can you trust your lawyer?

In December 2006, all of the various Belgian bar associations applied to the Belgian Constitutional Court for a ruling on whether under the Belgian anti-money laundering legislation (AML) lawyers were obligated to inform the appropriate authorities on their clients money laundering activities - known as whistle blowing.

The European Community legislature laid down the principle of the prohibition of money laundering in the Community and required the Member States to introduce a system of obligations concerning identification, information and prevention of suspicious transactions for the attention of credit and financial institutions.

This case dealt with an amendment made to the Directive 91/308, which in the light of the experience built up over the first few years of its operation, to extend its coverage to new fields and activities. This amendment widened the scope of the obligation to inform the responsible authorities of any suspicions regarding money laundering, Article 6 of Directive 91/308, to include "notaries and other independent legal professionals" in the performance of certain of their activities.

The EC has recognised the importance of maintaining the confidentiality of the lawyer client relationship, so when drafting the directives to Member States on how to legislate locally, the various councils and committees at the EC reached a compromise on the obligation that "Member States shall not be obliged to apply the obligations laid down in paragraph 1 to notaries, independent legal professionals, auditors, external accountants and tax advisors with regard to information they receive from or obtain on one of their clients, in the course of ascertaining the legal position for their client or performing their task of defending or representing that client in, or concerning judicial proceedings, including advice on instituting or avoiding proceedings, whether such information is received or obtained before, during or after such proceedings."

By stating that "Member States shall not be obliged..." left the door open to allow Member States, such as Belgium, to

impose whistle blowing obligations on their legal professionals.

The Belgian Law of 2004 recognised the confidentiality of client money laundering information "if it was received from or obtained on one of their clients, in the course of ascertaining the legal position for their client or performing their task of defending or representing that client in, or concerning judicial proceedings, including advice on instituting or avoiding proceedings, whether such information is received or obtained before, during or after such proceedings". This meant that if a client approached his lawyer for advice on his tax structure which had elements of money laundering in it, as it was not advice for judicial proceedings the lawyer was obligated to blow the whistle.

The practical implication of this was that during consultations on tax issues, lawyers would have to stop the discussion, and clients could not obtain clear advice whether their activities were tax avoidance or tax evasion.

On June 26th 2007 the Court decided that as lawyers were a legally recognised and controlled profession, it would not be appropriate under the Directive [91/308] to put these legal professionals : under an obligation to report suspicions of money laundering. There must be exemptions from any obligation to report information obtained either before, during or after judicial proceedings, or in the course of ascertaining the legal position for a client. Thus, legal advice remains subject to the obligation of professional secrecy unless the legal counsellor is taking part in money laundering activities, the legal advice is provided for money laundering purposes, or the lawyer knows that the client is seeking legal advice for money laundering purposes.

One Antwerp based lawyer commented, "this decision clarifies the issue but does not provide a full exemption to recognise lawyer client confidentiality. When seeking advice, I strongly recommend that you use 'what if' questions with fictitious personal and company names to avoid falling into the category of 'legal advice provided for money laundering purposes'. And, make sure that your lawyer is not your partner in the money laundering activities!" ■

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Editor..... Jeremy Sulzbacher Ba FCCA, editor@diamondfinance.info

Advertising..... Shifra Senderowicz, advertise@diamondfinance.info

Classified.....classified@diamondfinance.info

Letters.....letters@diamondfinance.info

Subscribe.....subscribe@diamondfinance.info

Socrates.....socrates@diamondfinance.info

Tel: +32 47 223 66 55 Fax: +32 3 232 55 74

St Thomasstraat 51, Antwerp 2018, Belgium

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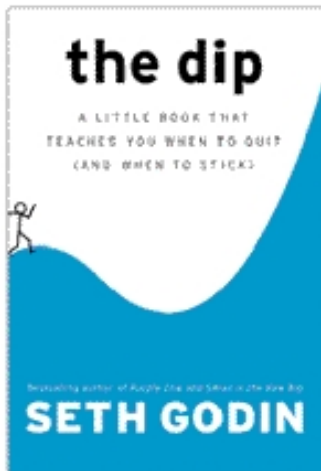
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## Book Review

### The Dip

a little book that teaches you  
when to quit (and when to stick)

by Seth Godin. Portfolio Books - US\$12.95/£6.60



Vince Lombardi is one of the most venerated American football coaches in history. The team he built, the Green Bay Packers, won the NFL championship five times in the nine years he was coaching them. And Lombardi came up with one of the world's most famous motivational commands of all, beloved of managers everywhere: 'Quitters never win, and winners never quit.'

Seth Godin, the marketing guru, blogger and best-selling author of Purple Cow, quotes Lombardi at the start of this slim new book. And Godin's verdict on the great Lombardi's views? 'Bad advice.'

That is typical Godin, who possesses one of the cheekiest and most energetic voices in business today. That is partly why his latest offering is worth a look even though, at nearly £7 for 100 pages, it might not appear to offer the best value for money. Godin's counter-intuitive insight is simply this: winners do quit, they quit all the time, it's just that they pick the right moment and the right place to quit, so that they can concentrate their fire on an area where winning is a much more likely (and indeed more profitable) outcome.

The book's title refers to that low point in any task or project where we have to decide whether to carry on with what we are doing - in the hope of overcoming a dip - or whether we should in fact abandon the work in hand and move on. One of our biggest problems, Godin says, is that we fail to recognise when a dip is in fact a cul-de-sac, a dead end. He hails Jack Welch, former chief of

General Electric, as a boss who knew when certain business units were coming up against a dead end. "Be number one or number two in a sector, or get out of it," was the Welch doctrine.

Quitting is important because winning is important, Godin says. "Extraordinary benefits accrue to the tiny majority of people who are able to push just a tiny bit longer than most," he writes. "Extraordinary benefits also accrue to the tiny majority with the guts to quit early and refocus their efforts on something new."

Godin is the enemy of muddling through, making do, and coping. Either get through the dip and reach for the stars, or find something else to do, he advises. But don't mess with 'Mr Inbetween'.

"The most common response to the dip is to play it safe," Godin says. "To do ordinary, blameless work, work that's beyond reproach. When faced with the dip most people 'suck it up' and try to average their way to success. Which is precisely why so few people end up the best in the world... The problem with coping is that it never leads to exceptional performance," he adds.

"Mediocre work is rarely because of a lack of talent and often because of the cul-de-sac. All coping does is waste your time and misdirect your energy. If the best you can do is cope, you're better off quitting."

So that's us told then. Sounds like a good place to stop!

*This review, by Stefan Stern, a columnist for the Financial Times, originally appeared in accounting & business, published by the Association of Chartered Certified Accountants.*

**"Money cannot buy health,  
but I'd settle for a diamond-studded wheelchair."**

Dorothy Parker *US author, humorist, poet, & wit (1893 - 1967)*



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paul@bourgetandassociates.com