

DIAMOND FINANCE

the financial & accounting newsletter for the diamond industry

Issue no. 4 August 2007

www.diamondfinance.info

Jeremy writes

we have the right to know

The DTC has imposed two important procedures on its customers, the sightholders. The first is Best Practice Principles – BPP - which emulates the approach of the ISO 14001 environmental management system standard developed by ISO (International Organization for Standardization). The DTC has retained SGS to review the compliance of the sightholders. Some of the other rough mining companies have also imposed standards and principles on their customers. What is unique here is that it is the supplier requiring such compliance of its customer, rather than customer demanding standards of its suppliers.

Roger Frost, Communication Manager of ISO in Geneva commented, “in the US motor industry, the big three manufacturers gave all of their suppliers four years to be certified to a sector specific version of the ISO 9001 quality management system standard and in some countries, medical device suppliers must by law be certified with a sector specific ISO 9001. We do not know of another case where suppliers require accreditation of their customers, but we are not surprised due to the nature of the diamond industry.”

The sightholders have now gone through two BPP processes but there has been little detailed feedback of these processes. How many sightholders had major breaches of money laundering or employment law? How many were threatened with the cancellation of their contracts for low compliance? What were the sanctions taken against sightholders who publicly abrogated some of the most important standards?

A second important procedure has been the DTC's involvement of forensic accountants to verify the content of sightholders' and applicants' profiles. The name of the firm, Kroll Associates, strikes fear into many sightholders, sometimes justifiably so. The pressure to artificially enhance a profile is great; after all, the future of the company is at stake, and the competition between the sightholders and applicants for a dwindling supply is intense. Ensuring the truthfulness of the profiles and financials is no less important than any other standards compliance and is an integral part of professional ethics. Nobody wants the pain of a Kroll visit, but the DTC can make the process more worthwhile if the full report is made available to the investigated companies.

A clean bill of health from Kroll could be something you 'can take to the bank' as Loet Kniphorst, global head of ABN-Amro's diamond banking comments: "A second independent and objective opinion on a company would give a bank a greater degree of comfort."

Unfortunately, neither Kroll nor DTC make the content's of Kroll's findings available to sightholders, unless there are major restatements to be made to their profiles. This is a pity, and in my opinion this is wrong. Even tax inspectors make their findings known to taxpayers. More than 30 years ago, auditors added value to their audits with recommendations to their clients.

In order to make the Kroll investigations more worthwhile for the sightholders, a clean certificate from Kroll should be something sightholders should definitely receive. And it is

inconceivable that Kroll passes on its negative findings to the DTC without the sightholders benefiting from the basic right to respond. Furthermore, a report published of the overall findings of the forensic accountants showing how many sightholders were deficient, how many were clean, etc. would show that it is not a mere box ticking exercise.

Accountability takes many guises, and the publication of reviews and investigations is one which should be promoted.



FINANCIAL AND TAX SERVICES
FOR THE DIAMOND INDUSTRY

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technical corner

accounting for inventories

One of the most important lines on a diamond or jewellery company's assets on its balance sheet is its inventory.

In order to understand the approach of International Accounting Standard 2, IAS 2, on inventories, one should refer to the IAS Framework for the Preparation and Presentation of Financial Statements.

An asset is defined as "a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise." This basically means that an asset is expected to give an economic benefit such as sales revenues.

Inventories are defined in Para 2.6 as:

- assets held for sale in the ordinary course of business (finished goods),
- assets in the production process for sale in the ordinary course of business (work in process), and
- materials and supplies that are consumed in production.

IAS 2 does not deal with construction contracts, financial instruments and biological assets which are covered by other standards.

The fundamental principle of IAS 2 is that inventories are valued at the lower of cost and net realisable value, NRV.

Cost

Para 10 prescribes that costs should include

- costs of purchase (including taxes, transport, and handling) net of trade discounts received
- costs of conversion (including fixed and variable manufacturing overheads) and
- other costs incurred in bringing the inventories to their present location and condition.

However, the following costs must not be excluded:

- abnormal waste
- storage costs
- administrative overheads unrelated to production selling costs
- foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
- interest cost when inventories are purchased with deferred settlement terms

For items that are specifically identifiable and interchangeable, such as larger items of jewellery and large diamonds, specific costs should be attributed to the items, while for items that are interchangeable, IAS 2 allows the weighted average or first in first out, FIFO, methods.

The last in first out, LIFO, method is no longer allowed. The same cost formulae should be used, and any variations should be justified.

NRV

Net realisable value is the estimated selling price in the ordinary course of business less the estimated cost of completion and the estimated costs necessary to make the sale. [IAS 2.6] Any write-down to NRV should be recognised as an expense in the period in which the write-down occurs. Any reversal should be

recognised in the income statement in the period in which the reversal occurs. [IAS 2.34].

When inventories are sold, revenue is recognised and those inventories sold are recognised as an expense in the cost of sales. Any write-down to NRV and any inventory losses are also recognised as an expense when they occur. [IAS 2.34]

Disclosure

Required disclosures: [IAS 2.36]

- accounting policy for inventories.
- carrying amount, generally classified as merchandise, supplies, materials, work in progress, and finished goods. The classifications depend on what is appropriate for the enterprise.
- carrying amount of any inventories carried at fair value less costs to sell.
- amount of any write-down of inventories recognised as an expense in the period.
- amount of any reversal of a write down to NRV and the circumstances that led to such reversal.
- carrying amount of inventories pledged as security for liabilities.
- cost of inventories recognised as expense (cost of goods sold).

US GAAP

The major difference between IFRS and US GAAP is that US GAAP permits LIFO.

Relevance for Diamond Companies

Appendix BC7 to IAS2 exceptionally allows the higher of cost and net realisable value for biological and agricultural products, mineral ores and broker-dealers' inventories of commodities. US GAAP also allows the higher of cost and net realisable value for specific products, such as precious metals. If there was a significant increase in the value of specific goods in diamond dealer's inventory and the price increase can be documented, then the diamonds can be recorded in the books at the higher net realisable value. ■

SoCrates

Fair Value or Fairy Value

A lot of readers of Diamond Finance have been watching closely the meltdown of the financial markets. When I saw an article in The Economist's 21st July issue titled "Bearing It All" which dealt with the fair value of derivatives, the implications for diamond accounting started to become apparent. The article dealt with the difficulty in ascertaining the fair value of securities backed by sub-prime mortgages in light of the crisis in that market.

The debates in the accounting profession regarding IFRS 39, accounting for financial derivatives have been left to the banking and financial services industries. I even skipped out that part of the IFRS course I recently took, expecting the act of omission to boomerang back, which it now has. →

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The closest the sightholders came to grappling with the concept of fair value was during the DTC's prevarications over whether or not to require IFRS for all sightholders in the winter of 2005/6. The main assets which would have required revaluation were the land, building, plant and equipment. Buildings and some manufacturing equipment are normally depreciated in accordance with the rates imposed by the local tax authorities, and as a result can be recorded in the balance sheet at values well below their fair values. For example, a factory building in some jurisdictions is depreciated over 20 years, but in today's heated property markets, today's 20 year old factory can be worth a multiple of its original cost. The catch being that in some jurisdictions, a revaluation of fixed assets can give rise to a tax charge. This, however, is covered by IFRS 16 and not by IFRS 39.

The article described two hedge funds of Bear Stearns which had invested in securities backed by sub-prime mortgages. These are mortgages lent to higher risk borrowers in the US for a higher rate of interest and which are 'packaged together' and sold as collateral for other financial transactions. The problem was that when the mortgagees started to default on their payments nobody else wanted to buy these higher risk packages so their price went down. It is politely called an 'illiquid market' when the real term is low value or valueless assets.

Before IFRS 39, financial derivatives were recorded at historic cost, under IFRS 39 they have to be recorded at their fair value, i.e. the price it would fetch on the market. But many complex derivatives do not trade smoothly and frequently in "arm's length markets." Instead, the accountants have to use computer models which simulate trading to reach a valuation, but are easy to tweak to reach the desired valuation. And, if the fund managers sell some derivatives at a loss in order to raise cash, they risk pushing down the market and devaluing their whole portfolio of that class of derivative. Instead, the managers are tempted to hold the derivatives at cost even when they know they are practically worthless.

One consultancy, RiskData, estimated that one third of the 1,000 hedge funds it studied were "smoothing" the results of illiquid securities to avoid volatility in their accounts. Using historic cost is also problematic as it too involves the use of guesses such as for depreciation rates, and in some transactions, the historic cost, other than brokerage and professional fees, can be zero.

The accountants and auditors, who are usually blamed for unreliable financial statements, have to resort to making educated assumptions and disclosing them in the notes.

With all of the noise concerning commoditisation of diamonds over the last few months, the CFOs and auditors on 31st December each year will have to be able to value the futures and options that are the direct result of commoditisation. Fortunately, diamonds always have an intrinsic value, which cannot necessarily be said for sub-prime mortgage backed

securities.

It is expected that most of the annual polished output of \$18bn to \$20bn will continue to be sold directly down the pipeline, which will mean a relatively 'illiquid' market for the futures and options – illiquid here genuinely means low trading volumes. The ramification is that it will be difficult or even impossible to value portfolios of diamond backed derivatives at the end of the year which may deter the fund managers whose funds we want to attract into the industry. It will certainly cause a headache for those same bankers pushing for commoditisation, who will now have to value these derivatives for Basel 2.

The good news is, more work for the accountants who understand what's going on. ■

branded for life



part III
by **Tulli Padwa**
director: Iceberg Advertising,
Antwerp

There are many kinds of brands out there in the marketplace and the strategy behind them is not always the same.

Take Coca Cola. The sweet, black, fizzy soft drink is a well known product that needs no selling to the public. I was watching the customers at the chip stand of a stock car racing rally this holidays. Under a faint blue haze of diesel smoke, and with their mouths full of soggy, vinegar soaked and ketchup drenched chips and fiery hot barbecued sausages, I doubt most could have tasted the difference between champagne and shampoo, let alone between Pepsi and Coke. But practically every customer had a clear preference, for Coke.

The brander's job in these mass market brands, is to convince consumers to choose their product rather than the rival one. In the case of Coke, emotional attributes are used to convince the consumer. Rather than tell us "Coke tastes better", a subjective proposition the modern consumer would consider patronising, we are assured that, "Coke is it!" Ergo: fun lovers drink Coke. It obviously works, although the physiques of those guzzlers at the stock car rally were rather less persuasive than the models in the Coke ads.

Nike does not praise the workmanship of their sports shoe, nor it's design and durability. Instead they proudly

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convey to me (or more importantly my neighbour) that they, as a company, promote going that extra mile in sports. They also make sure it is the brand of choice of some of the choicest sports figures of our day, and highly visibly so. Choosing their swoosh on my child's tennis socks almost feels like doing something positive for her.

Both these brand's strategies rely on creating an aura that envelopes their brand and promises to brush some of it off onto those who buy it.

The distinctive Playboy bunny rabbit logo, on the other hand, has the job of sanitising and putting a friendly and playful face onto a company and industry that would otherwise be perceived as sordid and grubby. While IBM relies almost entirely on the quality of their product to maintain their brand. Remember that old adage, "Nobody ever got fired for choosing IBM!"

There are other forms of branding too. Think of how the names in the fashion industry rely on their brand to portray an image. There are a million and one messages that that can be flashed across the room at a party, by a lady's handbag. In this fashion-semaphore, the alphabet is formed, not by fabrics and colours and shapes but, because every brand has its own identity, by designers' names and brands. Wearing a shirt by Vivian Westwood says something about you because it is by her, despite it looking like something the cat brought in; or even because of it.

Some brands are harder to define. It might surprise you to learn that Google was ranked as the world's top brand in the annual Brandz Top 100, with a brand value of over \$66 billion. Ironically their branding has become so successful that it is in danger of actually winning them out of business. As their brand name enters the vocabulary, they face the risk that the word 'googling' will become a generic word for searching the web, and

that could cost them their entire brand's worth.

Creating and maintaining a brand requires first and foremost a thorough awareness of what the brand is trying to do, is it a quality mark, promising a perfect cut and ideal proportions, or does it have a personality or an aura? Should it exude confidence and assurance, or should it whisper sweet nothings?

Happily, now that the DTC has dropped branding from the list of requirements of their sightholders, the era of failed brands, so damaging to my industry, is probably over. With the pressure now off companies to create brands they are not really passionate about, dare we hope that the industry will now focus its attention and develop those few truly valuable brands it still has in it? Only time will tell.

jurisdictions



virgin
territory

In the previous issue of Diamond Finance we looked at the basics of a company in the British Virgin Islands – BVI. In this issue we look at the operations and advantages of a BVI offshore company.

Operational

The BVI Government's Development Planning Unit lists the trust companies authorised to form BVI companies and which provide the local registered office and agent. Some of them can also provide nominee directors and shareholders although as the local registrar of companies is 'closed' this is just an extra precaution.

However, all of the trust companies will require full due diligence disclosure of beneficial ownership, as will any bank where the bank the corporate account is opened. The total cost including the first year's fees starts at around €1,000. Subsequent annual fees are less than that.

Onshore Trading

Company that are resident for tax purposes on the BVI pay income tax of 15%. If they are offshore, but part of the revenues are generated onshore, or if profits are remitted to the BVI then they are also liable at a rate of 15% which keeps it out of the OECD tax haven definition. There are no withholding taxes except that like other British 'dependent



Wishing all our readers
a happy Jewish New Year

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territories', the BVI was forced to apply the EU's Savings Tax Directive from 1st July, 2005, and chose to apply a withholding tax (initially of 15%) to the returns on savings paid to nationals of EU Member States. The Directive does not apply to corporate entities

Offshore Trading

A BVI company can be used to for any legitimate trading activity, including diamonds. Where transactions are between members of diamond bourses that belong to the World Federation of Diamond Bourses, the personal liability cannot be avoided by using a BVI company. There may also be difficulties in obtaining diamond trading and Kimberley licenses in countries like Israel for a BVI company.

Tax Uses

Where BVI companies come into their own is in international tax structures. Because they are not required to submit any financial information to the local BVI authorities and are do not have to undergo an annual audit, they well suited to tax efficient trading activities. If a BVI company is part of a DTC sightholder group it has to be audited, however, one is not limited to the jurisdiction of the auditor and can select an auditor anywhere in the world. BVI companies are often used for bringing in capital into a group structure.

A very effective use is as a buffer between the source of funds and the recipient where for commercial reasons, a degree of anonymity is required.

Double Taxation

The BVI has double taxation treaties with UK, Japan and Switzerland. The limited number of treaties results from the small amount of onshore trading and tax payments.

Disadvantages

It is the advantages of a BVI company that are its disadvantages. Whenever a regulatory authority sees a BVI company the question arises of 'what are they trying to hide?' and should be used cautiously. ■

Diamond Finance

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tip of the month

Board Meeting or Bored Meeting

Meeting Management Key - Stand PAT

I use a "PAT" approach to meetings.

A meeting has to have: a Purpose, an Agenda, and a Timeframe or I don't do it. You should be able to define the purpose of the meeting in 1 or 2 sentences at most. "This meeting is to plan the new marketing campaign" or "this meeting is to review shipping's new policy for handling returns." That way everyone knows why they are there, what needs to be done, and how to know if they are successful.

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Set an agenda. List the items you are going to review/discuss/inspect. I like to assign a time limit to each agenda item (see below) and identify the person responsible to speak or moderate the discussion.

Set a timeframe; at the very least set a start and end time. I also recommend setting a duration for each item in the agenda. These should total to the overall meeting timeframe.

Don't Wait. Meetings need to start on time. Don't wait for stragglers to show up. When someone arrives late, don't go back and review what has already been covered. That just wastes the time of the people who showed up on time for the meeting.

If the meeting organizer/sponsor doesn't show up on time, consider the meeting cancelled and go back to work. How long to wait for the organizer to show up varies among companies, but I wouldn't wait any longer than 5 minutes.

Keep and send minutes. Someone, other than the meeting organizer, should keep minutes of the meeting. How detailed these are depends on the nature of what is being discussed and the skill of the available note taker.

If you set an agenda in the first place, as you should have, the note taker can use that as an outline. The minutes should record who attended, what was discussed, any agreements that were

reached, and any action items that were assigned.

Soon after the meeting, usually within 24 hours, the minutes of the meeting should be distributed to all who attended, any invitees who did not attend, and anyone else effected by the discussion.

Email is a great vehicle for distributing them. Distributing the minutes informs those not at the meeting of the progress that was made and reminds everyone of their action items.

Stay Focused. Every meeting should have a "topic keeper". I like to ask for a volunteer at the beginning of the meeting. The topic keeper's job is to interrupt whenever the discussion strays from the topic under discussion.

These new topics can either be tabled until later or scheduled for their own meeting. There is a fine line between what are amplifying remarks about the topic under discussion and what is a tangential topic. The meeting organizer can decide. It never hurts to say "let's take that up off-line".

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DIAMOND LAW

the only legal, fiscal and accounting newsletter for the diamond industry

Issue no. 4 August 2007

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lifting the veil of incorporation

Most readers of Diamond Law are familiar with corporations. Ltd, LLC, NV, BVBA, SA, PLC are but a few of the denominations. In general, the world of company law is divided into two, the Anglo Saxon and the continental European.

In theory, both approaches aim to separate the company from its shareholders. This is one of the major advances of corporations, besides the convenience of a vehicle for a varying numbers of partners and investments, was the limiting the liability of the shareholders to their subscribed amounts of the share capital. This protected the downside of a shareholder's investment to the amount of his investment.

If a third party lends money to a corporation it is done with the full knowledge that the repayment of the loan is not the responsibility of the shareholders.

This principle was enshrined in company law by the House of Lords decision of 1897 in *Salomon v Salomon & Co.* Mr Salomon owned 20,001 shares in the company, *Salomon & Co Ltd.* and six other people held one share each. He was the managing director and his two sons were also directors. He sold his old shoe business to the corporation for £39,000 of which £10,000 was a secured debt or debenture to himself. When the company went into liquidation the unsecured creditors successfully argued in court that the corporation was in fact acting as an agency for Mr Salomon and he was liable. The Court of Appeal held that the corporation was "a myth and a fiction, the incorporation of the business by Mr. Salomon had been a mere scheme to enable him to carry on as before but with limited liability."

The House of Lords unanimously overturned the previous decisions and held that the company was totally independent of Mr Salomon and is a totally different person altogether. And it is this judgement which established that a corporation is a separate legal person for all intents and purposes from its shareholders. Directors can be liable personally for their actions as officers of a

company under certain circumstances, but that is not the issue for discussion in this article.

This barrier between the shareholders and the corporation is called the corporate veil and when this distinction is removed, it is called lifting the corporate veil.

What is relevant here for diamond traders is that any member of a recognised diamond bourse is personally liable for all transactions executed with other bourse members whose bourse belongs to the World Federation of Diamond Bourses, WFDB. This means that if Mr Smith is a shareholder in Smith Diamonds NV in Antwerp, then he is personally liable for all of the transactions with other bourse members, even if he has no active role in the company.

This personal liability is quite extreme in its ramifications. If Smith Diamonds NV has a subsidiary in Antwerp called Smith Gems BVBA which is a partner in a New York Jewellery manufacturer called Jones Jewels Inc. Even though the manager and shareholder of Jones Jewels Inc, Mr Jones is not a member of the New York Diamond Dealers Club, if Mr Jones or his employee buys diamonds from another bourse member, Mr Smith in Antwerp is personally liable in the event of a default in payment.

Resigning one's membership of a bourse will only exempt the personal liability of the bourse member from future transactions, but not from prior transactions, including goods on memo but not yet invoiced.

This makes the diamond industry unique as in legal terms, the veil of incorporation does not exist. Nominee shareholders of bearer shares in jurisdictions with closed company registries will be of no use here

"A diamond is a chunk of coal that is made good under pressure."

Former American Secretary of State Henry Kissinger



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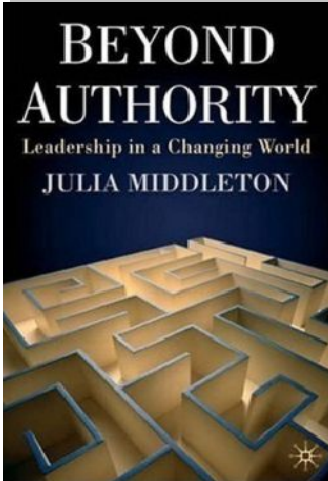
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Book Review

Beyond Authority

leadership in a changing world
by Julia Middleton . Palgrave Macmillan £25



As many, many people will tell you, you do not forget the first time that you meet Julia Middleton. She has more enthusiasm, energy and focus than anyone else I know. A whirlwind arrives in the room. But it is a benign experience. And, unlike many people who tackle life at speed, she is blessed with enormous reserves of understanding.

I first met her many years ago. At that time I edited UK's Accountancy Age

magazine and we co-sponsored the annual awards for reporting financial results in an understandable way to employees. Our fellow sponsor in this hugely successful venture was the Industrial Society, these days the Work Foundation. And the person in charge for them was Julia. Much of what is now done in the name of narrative reporting was pioneered in those days through the network of people working at the simplified reporting end of the corporate reporting spectrum.

Julia went on to found the charity Common Purpose, which now operates not just in the UK but around the world. It is based on a simple idea. Cities are communities. But the people running their disparate parts do not necessarily connect up with each other. Common Purpose connects them when they are making their way in their communities. It provides community based leadership development programmes. It has been a phenomenal success since she started it in 1989. And now, needless to say, she has written a book to share leadership thoughts and insights.

Working together is where you start. Being in authority, sorting out the objectives, motivating and delivering. That is fine. But, as she points out, most leadership isn't like that anymore. 'Directors have to work with partners outside their business', for example. 'Boundaries are blurring', she says. 'Authority is becoming less clear-cut.' New leadership skills and tools are required. She calls this 'leading without authority'. It is about

choosing not to have authority. 'It is about earning legitimacy with ideas that resonate.' It is not about pushing the legitimacy upwards to someone else. 'The great "They"', as she terms it. She quotes Jude Kelly of the South Bank Centre in London: 'We cannot wait to be given legitimacy. We need to legitimise ourselves.' And people tend to look outwards, beyond their circle of authority. Trends outside need to be spotted and understood. People need to think like entrepreneurs, who want to know what is happening elsewhere, rather than like CEOs who tend to work their way upwards rather than outwards.

She recalls being in a meeting discussing homelessness in Northern Ireland. One man there kept asking: 'What is our legitimacy?' Eventually an infuriated Julia pointed out this had nothing to do with politicians or processes. These people in this meeting, she said, 'are simply thinking what they can do next – themselves. That is their legitimacy. It is a highly democratic legitimacy and it's a glorious one.' Do it.

She suggests that partnerships are good places to learn. 'I wonder if people are better at leading outside the core circle if they've had less authority than most within it,' she says. Likewise she suggests that businesspeople make poor politicians because they have never learned to suffer fools gladly and what can be done.

So what should you do? 'The danger,' she observes, 'is that our networks, far from serving us, begin to limit us. 'Set your bandwidth on broad.' And, mostly, it is about keeping going. She approves of Woody Allen's remark: 'Ninety percent of life is just about being there.' She returns to Jude Kelly's idea. 'We have to stop delegating to the great "They"', she says. 'Stop waiting for mandates to be handed to us. And start taking responsibility for problems which may not belong to us, but we almost certainly witness or suffer the consequences of.'

All great stuff. So why do it? 'Because' she concludes, 'if you do not go outside your core circle, negotiate the complexities, develop the networks, and do it all successfully, your life becomes much more interesting. And so do you.'

This review, by Robert Bruce, a leading commentator on accounting and financial reporting issues and columnist for the Financial Times, originally appeared in accounting & business, published by the Association of Chartered Certified Accountants. ■

Diamond Finance – June 2007

Diamond Finance and Diamond Law are published by CFO +, an independent firm of financial and management consultants.

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