

# DIAMOND FINANCE

THE FINANCIAL & ACCOUNTING NEWSLETTER FOR THE DIAMOND INDUSTRY  
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## Editor's Column

The diamond industry has long been supported by an underestimated group of people, who are critical to the sector. They work in an environment of ever increasing complexity from accounting standards, anti-money laundering and terrorism funding legislation and taxation changes. Add to this the other tasks which fall on their desks, like standards compliance and human resource administration.

These are the accounting and finance teams of the diamond companies. In a small company, the CEO or one of the partners will be responsible for this function. In larger companies there will be a whole team of such people. They all have the need to be informed and knowledgeable in their areas of expertise, yet there is little out there in the way of specific publications and resources for the diamond financial professional.

This newsletter, which will be issued monthly, shall address that need. Rappaport, IDEX and others, do excellent work with their news services and magazines, and Diamond Finance aims to complement them with financial and accounting information specific to the industry.

In each issue, Diamond Finance will look at an accounting standard from an IFRS and US GAAP perspective and how it relates to our sector. A tax jurisdiction will be introduced and a selection of important bankers, starting with HSBC's Jeff Pfeffer, accountants and other professionals active in our industry will be interviewed. Diamond Finance shall review accounting and diamond software and issue in-depth articles on banking, insurance, AML/CFT, BPP and professional training. Diamond Finance will feature a current

event guest columnist who is called SOCrates, named after the Greek philosopher who was excited by beauty, but with his unflinching views will have positive recommendations on SoC and other issues.

Lastly, there will be a classified section where financial and accounting positions and other opportunities in the industry will be posted.

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## Interview

### Did he Pull the Plug?

Diamond Finance interviews **Jeff Pfeffer**, Senior Vice-President of HSBC Bank USA and head of its Diamond and Jewellery team.

After working for Bank Leumi in New York, Jeff, aged 54, moved to HSBC in June 2004 to head its diamond and jewellery division. When he took over, there were seven main clients who were inherited from HSBC's US predecessor, Republic National Bank. Today it is the second largest bank in this sector after ABN Amro, and includes a healthy number of sightholders and their group companies.

*DF The question everybody asks is whether you are to blame for pulling the plug on Fabrikant?*

**Jeff** – Before I answer the question, what I am saying here is based on publicly available information.

This is an unfair question. A bank does not bring down a 106 year old business, its management does. Our sector, especially at the sightholder end,

is a high volume and low margin business and you have to pay attention to the basics. Large offices in the Rockefeller Center, heavy overheads and not enough outsourcing, impact on the profitability. In an environment where most sightholders were losing money on their DTC goods, a fallout was predictable.



But what really hit Fabrikant was its exposure to many of the large retail bankruptcies and Chapter 11s. When your large customers are not paying, you

are in trouble. The lessons for the industry are that businesses have to be managed by *diamantaires* who pay attention to all of the aspects of their businesses and do not pursue growth by taking on large credit exposures.

**DF** – *What is HSBC's growth rate and what prevents it from growing faster?*

**Jeff** – HSBC is second largest in the US after ABN Amro and before ADB, and we aim to grow between 15% to 20% per year, but with the right clients. We are aware that this sometimes means taking clients away from our competitors, but that also works *vice versa*. While we can often compete on banking charges and interest rates, what we offer our clients are our global reach and our knowledge of the industry.

We are limited in our growth potential by not having branches in the two important locations of Antwerp and Ramat-Gan. Before we could open there, we have to find the right people to manage the branches, but HSBC does not have any plans for the near future in these two vital centres.

Africa represents a big challenge for us, HSBC has a branch in South Africa, but we are still evaluating Botswana, Namibia and Angola.

**DF** – *Your largest competitor is ABN Amro, what are the implications of the pending Barclays takeover?*

**Jeff** – ABN's diamond team is only a small part of the global bank, but within our sector it is by far the biggest. I am not sure if the new owners of ABN will want to keep the diamond division with its high risk portfolio. HSBC might be interested in taking it over if it came on offer, but we expect some serious bidding from our Indian competitors. ADB would be prevented from buying it for EU anti-trust reasons. First, we have to wait and see whether the takeover will go through.

**DF** – *Where do you stand on Basel II*

**Jeff** – We are ahead of the curve here, but diamond companies will have to present stronger and more transparent balance sheets in order to reduce sectoral risk and prevent overall bank liquidity flowing to less risky sectors.

**DF** – *What is your view of 2007?*

**Jeff** – We are seeing a lot of consolidation in the industry in the US, and the medium size jewellery and retail companies require, more and more, the backing of large players like the sightholders, and this trend will continue. 2007 in the US is going to be a difficult year, and companies will have to pay attention to their bottom lines.

**DF** – *Lastly, what about DTC's selection this year?*

**Jeff** – I expect a net reduction of about eight sightholders with 20 deselections and 12 new sightholders coming in. This will be spread across the four main centres, New York, Antwerp, Ramat-Gan and Mumbai. I disagree with Chaim Even-Zohar's prediction of no US sightholders in 2008.

#### QUOTE OF THE MONTH

"Look at a day when you are supremely satisfied at the end. It's not a day when you lounge around doing nothing - it's when you've had everything to do, and you've done it."

MARGARET THATCHER 1986

# Technical Corner

## IAS 23 Borrowing Costs

*Clarification* - This article does not deal with assets constructed for lease or sale.

The objective of IAS 23 is to prescribe the accounting treatment for borrowing costs on fixed assets. Borrowing costs include interest on bank overdrafts and borrowings, amortisation of discounts or premiums on borrowings, amortisation of ancillary costs incurred in the arrangement of borrowings, finance charges on finance leases and exchange differences on foreign currency borrowings where they are regarded as an adjustment to interest costs.

A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use. In our industry, this is most likely to be a diamond factory or office building.

Section 7 states that all borrowing costs should be expensed in the period in which they are incurred. There is an alternative treatment, sections 10 and 11, that costs in relation to the acquisition, construction and production of a qualifying asset should be treated as part of the cost of the relevant asset. Whichever approach is used, the company must be consistent and its policy disclosed.

Where there is specific financing, such as a direct loan for building, then the actual costs incurred are identifiable. However, where the company's general debt financing is used, then the capitalisation rate will be weighted average of the borrowing costs of the pool of finance.

If a project is developed in stages and there are interruptions, then the capitalisation of the interest charges should be suspended for the duration of the interruption. Also, the capitalisation ends when substantially all of the activities necessary to prepare the asset for its intended use or sale are complete, and not when the asset is first used.

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The alternatives are available until the end of 2008. However, the IASB issued a revised IAS 23 on 29 March this year and the alternative not to capitalise falls away and companies will be obligated to capitalise borrowing costs on qualifying assets.

US GAAP in SFAS 34 is much tighter in its definition of a qualifying asset on "accumulated production expenditures", although confusingly, the IRS in Notices 88 and 89 is more lenient than SFAS 34, to include pre- production planning and design activities and pre-production acquisition of land and raw materials.

And, SFAS is based on cashflow and excludes land, while the IRS approach is based on the capitalised amounts and includes land.

In fact there was some opposition in the US accounting profession to the revision of IAS 23 as it impedes the convergence between IFRS and US GAAP.

### Relevance to the Diamond Industry

Diamond companies who submit their financial statements to the banks, and more specifically, for sightholders who have to submit consolidated financials to the DTC, the capitalisation of financing charges when building a factory can have a significant effect on the financials of the group. Moving some of the finance expense from the Profit & Loss statement to the Balance Sheet improves:

- ◆ the investment in fixed assets,
- ◆ the equity and the
- ◆ EBITDA,

especially as the depreciation only starts to hit the P & L after the fixed assets come into use.

For further advice, please contact your accountant or [CFOPLUS@GMAIL.COM](mailto:CFOPLUS@GMAIL.COM).

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# SoCrates

## The Wonderful Member

Convention dictates not to start with an apology, but Socrates apologises *ab initio* if his monthly column is too focused on the Supplier of Choice (SoC), but it does dominate the direction of a large proportion of the diamond industry and De Beers' London based Diamond Trading Company, the DTC, is still the largest player in the pipeline.

The DTC publishes in its profile notes, a diagram of a theoretical sightholder called Wundergems which demonstrates the various permutations of inclusion of companies within a sightholder group. In 2005 the DTC had three definitions of a group company:

- ◆ One for BPP – Best Practice Principles;
- ◆ A group company for consolidation; and
- ◆ A non-consolidated group company for reporting to DTC.

The latter two, but not the first, required that the parent company must be a member, i.e. shareholder, of the subsidiary.

The in November 2005 the idea of requiring IFRS was floated, which gives a fourth definition not requiring a shareholding. In Q1 2006 after some sightholders spent money to become IFRS compliant, IFRS was dropped, but the requirement of maintaining a shareholding still remained. By the end of July 2006 when the absolutely final Profile Lite notes were published, the shareholding requirement was thankfully dropped. All this, you remember, was retrospective to 2005.

Now in 2007, the Profile notes are even more convoluted. The shareholding requirement is back, yet there is one exception; “*the holding company does not have to be a member of the applicant*” which would appear to apply only to the holding company of the sightholder company applying for a contract.

Given that this was published in May 2007 and is applicable to 2006 gives rise to the conundrum of how, if you followed the 2005 definition without a shareholding, to change your group company structure retroactively to 2006. A proposal to 'grandfather' group companies recognised for 2005 to be accepted as group companies for 2006 was not accepted.

Fortunately, the separate BPP definition has disappeared and all group companies have to be consolidated, or at least combined, with Appendix One being the authoritative list.

It is a pity that the DTC did not adopt the internationally acceptable IFRS definition, see IAS 27, section 13; perhaps next year?

But Socrates invites readers to decipher the *wonderful* line from the 2007 Notes, "The applicant being a member of the applicant.."

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## Jurisdictions

Diamond Finance, in this first issue, looks at the popular jurisdiction of Singapore, where quite a few diamond companies have one of their group entities. The first article looks at the basics of forming a business in Singapore.

### Singapore

Singapore was founded as a British trading colony in 1819. It joined the Malaysian Federation in 1963 but separated two years later and became independent. Singapore subsequently became one of the world's most prosperous countries with strong international trading links (its port is one of the world's busiest in terms of tonnage handled) and with its 4.5 million population enjoying a *per capita* GDP, \$30,900 (2006 estimate) equal to that of the leading nations of Western Europe.

Singapore, though small, is undoubtedly an advanced and bustling economy. It thrives on an excellent infrastructure, highly educated labour force, political stability and an efficient, and English speaking, business environment. Singapore is an ideal holding company and

headquarters location and a gateway for foreign investments in to the emerging economies of Asia,



such as China, India, Vietnam, Indonesia and Thailand

The legal system is based on the English common law system and most of the company and tax law is anchored in the recent Companies Act and the Income Tax Act.

The basics for of Singapore companies are:

- ◆ Minimum of one shareholder which can be corporate;
- ◆ One local resident director, other directors do not have to be resident, but cannot be corporate
- ◆ One local company secretary;
- ◆ Minimum share capital S\$1;
- ◆ Open registry of companies (Accounting & Corporate Regulatory Authority – [www.acra.gov.sg](http://www.acra.gov.sg));
- ◆ Requirement to audit companies with turnover of at least S\$5m (US\$3.3m);
- ◆ Requirement to file accounts with ACRA;

### Exempt Private Company

If a company has less than 20 shareholders and none of whom are corporate, then Singapore allows its classification as an Exempt Private

Company and does not have to file its annual financial statements with ACRA.

However, it is important to note that this exemption does not cover the filing of financial statements with the Inland Revenue Authority of Singapore – IRAS, and as Singapore has double taxation treaties with: Belgium, UAE (Dubai), Israel and most Western European countries, the information would have to be handed over if requested. Singapore does not have full double taxation treaties with the US and Hong Kong.

### Money Laundering

According to the International Monetary Fund and World Bank, Singapore is noted as having in place a sound and comprehensive legal, institutional, policy and supervisory framework for anti-money laundering (AML) and counter-terrorist financing (CTF).

The banks are obligated to inspect transactions for AML and CFT as they are supervised by the Monetary Authority of Singapore and they have the main obligation in this area. To a large extent, the auditors usually rely on banks for AML and CFT compliance.

### Holding Companies

All of these characteristics make Singapore a popular jurisdiction for regional offices and holding companies.

In the next issue we will look at the taxation of offshore and onshore Singapore corporations.

### Diamond Trading

For all diamond transactions that physically go through Singapore, even for trans-shipments, the company has to register for Singapore Sales Tax – GST. If rough is involved, then registration with the local Kimberley Process authority is required.

## Tip of the Month

How we respond to people and situations says a lot about ourselves and our organisations. Sometimes, a second of positive thought before a response can

change the outside perception of who and what we are.

Below are some examples:

### POSITIVE THINKING

#### NEGATIVE

I haven't got time

I don't like it

You're wrong

It won't work

I can't do it

The staff are useless

#### POSITIVE

I'm available a bit later

Let's generate some alternatives

Please consider...

How can we make it work?

I can do it /when/if

The staff need training /briefing/extra skills

## Book Review

**"Management f-laws – How Organisations Really Work"** by Russell Ackoff and Herb Adison with considered responses by Sally Bibb.

**Triarchy Press £20**

Here is a delightful little book, filled with mischief, irony and wisdom. But seeing the name of one of the authors – Russell Ackoff – we should not be surprised to find these qualities, and more, in its pages.

Ackoff is one of the business world's most distinguished commentators, a visionary who pioneered the discipline of 'systems thinking', an approach which urges executives to consider their organisation's operations as a whole and not in isolation from each other. Ackoff's wonderful insight was that the interconnectedness of our actions could easily be misunderstood, and that working on separate parts of the business could be counter-productive if managers did not see and make those connections.

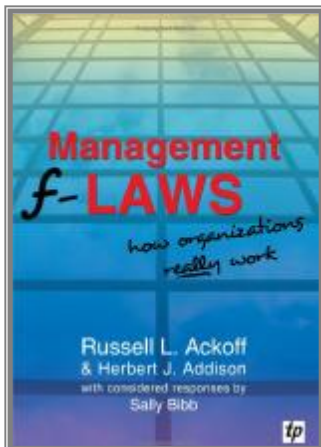
This latest publication from the Ackoff production line is far removed from the sort of weighty

academic texts he has been associated with over the last 50 years. Rather, it is a series of sketches, thoughts and observations about management and the many idiocies carried out in its name. There are many so-called 'f-laws' presented here, each providing an epigrammatic look at some of the nonsense familiar to anyone who has ever turned up for work anywhere.

For example, f-law number 19 states that 'the only thing more difficult than starting something new in an organisation is stopping something old'. Ackoff and Addison elaborate: 'The momentum of an organisational practice is proportional to its age... Innovations have no age, hence no momentum, and therefore easy to stop.'

F-law 21 declares: 'The less managers understand their business, the more variables they require to explain it... Consequently,' the authors add, 'they suffer much more from an oversupply of irrelevant information than from a shortage of relevant information.'

And f-law 66 says: 'The morality that many managers espouse in public is inversely proportional to the morality they practise in private.'



But, so far, this review is only telling half the story – literally. On the page facing the wit and wisdom of Ackoff and Addison are offered the responses of Sally Bibb, a director of The Economist Group, and a published author herself. Bibb wrestles gamely with the

laconic views of her two senior colleagues, developing a kind of latter-day Socratic dialogue of management insight. Bibb speaks as a reasonable, modern practitioner. In a sense she is the voice of the honest reader, struggling to absorb and reflect on the advice on offer.

There is a risk, as you work your way through all these quips and comments, that the whole

becomes a little indigestible. This is probably not a book to be read cover to cover in one sitting, but rather dipped into on a more *ad hoc* basis.

There is another risk, tacitly acknowledged by the authors, that their wisdom benefits from 20:20 hindsight. 'Retired executives and generals become experts when they are freed of responsibility for their opinions,' they say. 'It is amazing how capable retired generals and executives become in solving the problems they could not solve before they retired.'

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

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FINANCIAL CONSOLIDATION, TAX  
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