

## **On the Financial & Legal organization of Private Practice .....and the need for greed**

This essay may seem strangely anecdotal and biased towards the experience of the author as a sometime sole principal or partner in a small architect's practice specialising in publicly-funded works for community, educational and religious organisations intended to relieve 'social deprivation'. The use of a personal tone of voice allows me to use simpler forms of English and it also makes it easier to give strong characterisations of critical business decisions. There are also sound reasons for this restricted focus and the explanation of taxation rules in relation to the RIBA's Part 3 examination syllabus and the ARB's code of conduct and practice. Large organisations have financial directors and accountants and these specialists from another profession are employed specifically to manage their organisation's financial affairs and they usually measure its profitability, less often they also seek new work and new markets.

In small practices all these functions are often combined in the activities of one or two individuals. Small practices will usually employ an accountant to prepare tax returns for Her Majesty's Revenue & Customs ( HMR&C ). Commonly accountants will also prepare annual returns to Companies House if the firm is a PLC or limited company or limited liability partnership. But an external accountant will not 'manage' the firm. Instead they will use data compiled by the firm and organise it in the ways that the law demands. In the case of companies with an annual turnover of over about £ 0.3 M this will require and 'audit'. This is a legal term for a careful inspection of the firm's own financial information by the accountant and 'audited' implies that the accountant is satisfied that the accounts are a reasonably factual picture of the firm's financial affairs because he or she have made inquiries about inconsistencies etc. Indeed shareholders will sometimes sue accountants for malpractice if the accounts are fraudulent. The best recent example is ENRON in the USA. Closer to home I am aware of a multinational that bought a UK transport company on the basis that it was profitable but then discovered that its 'profits' had been a fiction backed up by a roomful of invoices to non-existent customers. In this case the multinational did not sue. The damage to their own reputation outweighed the damages they might have collected from the perpetrators of the fraud they had suffered or the auditors who had failed to spot it.

I offer this example because it illustrates the concept of 'confidence' in business. Most businesses that borrow money from banks or shareholders in order to operate can find themselves in difficulty if their customers and shareholders consider that their financial viability or management is suspect. In this sense large companies are often more volatile than small ones. Often they cannot find a way to avoid catastrophe once confidence has gone. Marconi and AGFA are the currently topical examples. Marconi can't sell anything at all to BT these days and have been famously ill-managed ever since Arnold Weinstock ceased to be their Chairman / CEO. Agfa never got into digital photography whilst competitors like Fuji and Kodak did. Sweden's Ericson, itself a wounded firm before it joined forces with Sony, seems set to buy Marconi. No-one wants Agfa as a brand . They may want the land their factories sit on, however.

Big business is not RIBA 3 business. The terms of the syllabus and the Codes of Practice concern the small professional firm and its need to be viable to serve its customers interests by achieving liquidity ( absence of crippling debt ) and, ideally, profit.

The profits of private businesses in the UK are taxed either through Corporation Tax in the case of limited companies or through personal tax returns in the case of Sole Principals, partnerships or Limited Liability Partnerships. If they have an annual turnover in excess of £ 58,000 then private business are also un-paid Value Added Tax collectors for the UK exchequer. They raise VAT on their invoices and this VAT is the property of Her Majesty. Between turnovers of £ 58 K and approximately £ 330 K small firms can use a system of reckoning their Value Added Tax liability called the 'Flat Rate scheme' and because this is the size of firm we are most interested in at RIBA 3 this is the regime I will illustrate in the essay.

Larger firms, and indeed smaller firms if they chose to, have to separate out the VAT element from ALL transactions and then every quarter ( three months ) they have to deduct from ALL the VAT they **raised** on invoices ( usually at 17.5 % at 2005 rates ) ALL the VAT they **paid out** on expenses and wages etc. and pay this difference / sum to Her Majesty's Revenue and Customs (HMR&C) within one month. VAT fraud is a criminal offence and where discovered usually leads to punitive action by HMR&C. Firms with annual turnovers below about £ 330,000 are able to calculate VAT returns at a flat rate dependent on the type of business they are. The 'flat rate' for architects is 12.5 % on the gross figure. So if a client pays £ 1,000 plus £ 175 VAT to an architect under this scheme the architect has to send HMR&C only 12.5% of £ 1,175 which is £ 146.88p. and can pocket the remaining £ 28.12. This is not such good business at it might at first appear. The £ 28.12 is taxed as profit and the architect gets no relief on the VAT they may have paid for commercial purchases or fees paid to other consultants who are registered for VAT.

These legal requirements mean that firms with an annual turnover in excess of £ 58,000 MUST keep accounts on a quarterly basis. In fact most firms keep accounts on a monthly basis in line with the rhythm of monthly salaries and invoices.

Such quarterly or monthly accounts are invariably the basis for annual returns to Companies House and HMRC in respect of Income and Corporation tax. It therefore makes sense to sort income and expenditure in these accounts into the categories that are used in Income tax returns. In fact the categories are not mandatory, but in the case of architecture businesses they work fairly well so the categories on a 2005 partnership tax return are reproduced below: The parts in italics are my amplification of the bare categories

- **Sales/business income (turnover)** *money received from clients for services rendered or materials provided*
- **Cost of Sales** (*money expended on good or materials sold on to clients not significantly altered. eg. Bananas sold by a greengrocer, OR ironmongery, modelmaking, website writing sold by an architect?.*)
- **Construction industry sub-contractor costs** *uncommon in architecture practice but not in say property development*
- **Other direct costs** (*a catch all for categories not show below but strictly related to sales*)
- **Employee Costs** *usually under PAYE and paid monthly*
- **Premises Costs** *rent, heat and light etc.*
- **Repairs**
- **General administrative expenses** *office equipment and stationery and printing*
- **Motor expenses**
- **Travel and subsistence** *getting somewhere you need to be and staying there overnight*
- **Advertising, Promotion and entertainment**
- **Legal and Professional costs** *lawyers, accountants and professional indemnity insurance*
- **Bad debts** *invoices attributed previously as profits now written off*
- **Interest** *paid to banks or others on loans*
- **Other financial charges**
- **Depreciation and Loss ( profit ) on sale** *writing off of capital goods worn out or sold or scrapped*
- **Other expenses including partnership charges**

If you compare these categories with the spoof account in excel attached to this essay you will see a reasonable level of agreement.

Broadly speaking the 'profit' which will be taxed is the difference between the first category Sales etc. and the sum of the rest of the categories which can be described as 'expenses allowable against profit'. Again you should be able to interpret this concept 'profit' in relation to the annual account in MS Excel that I attach. If you can ask me for this spreadsheet as an attachment and assuming your computer has MS Excel on it then you can 'play' with this spreadsheet inventing new expenses categories, deleting others and all the time re-calculating the 'profit' -or if the profit is negative then the 'loss'. You can in fact do many of the same things in an MS Word table and indeed this is the programme I have used to generate the spoof accounts of WOT MacLaren which are also appended to this paper. Because in this case the cells to the table are not printed it is easy to miss that this is another cruder spreadsheet in which lines wrap to fill cells rather than hide under adjacent cells.

I am personally of the opinion that understanding accounts in the modern world is as much to do with understanding how to manipulate programmes like this as it is about classical economics. The classification and manipulation of data in such programs is, of course, entirely the author's creation and responsibility. It defines the structure in which financial matters are recorded, reported and assessed. This is not classical 'double entry' accounting developed on the banking houses of the Italian Renaissance and I do not intend to show you here how double entry accounting is done or why is more fail-safe and why specialist accounting software like 'sage' is based upon the double entry system.

It would be valuable if, over the next few weeks, you could attempt to measure the profitability of your own jobs in your offices. For this you will need to assess the income and the expenditures of the office in relation to a particular job. You will need to assign costs to your own labour and that of partners and other office members. In this context you might like to know that the British Medical Association (BMA), the professional body and, in effect, the trade union of UK doctors suggests its members should not work for less than £ 70 / hr.

The RIBA, the architect's equivalent organisation to the BMA would like to suggest a similar rate for members but it is well know that many experienced principals in small practices charge themselves out at about half this figure. Larger practice on the other hand may charge £ 35 / hr for the most junior of staff and £ 70 / hr for part 2 assistants. Offices like Foster and Partners have annual incomes in excess of £ ¼ M per registered architect employed and even assuming these architects work 2500 hrs/ annum

they must be being charged out or otherwise returning £ 100 /hr. In this context note that the EU average for someone on a 35 hr. week with bank and other holiday and sickness entitlements is about 1,500 hrs / annum actually worked. Assuming an architect was to be 'worth' £ 30,000 p.a. this means their outputs must have a value of at least £ 20 / hr. or approximately 6 times the national minimum wage.

But of course no entrepreneur paying his staff £ 20 / hr. for work that he could only charge clients at £ 20 /hr. would make a profit. The entrepreneur's own time managing their staff might not be paid unless this was charged separately and neither would be the costs of running an office including rent and heat and light and insurance and advertising and equipment and consumables and telecommunications and travel etc. be covered unless they were charged separately.

So very few offices would charge out or budget their staff at less than 200% ( x 2 ) of their employment cost and in most offices the figure would be nearer 300 % or x 3. The traditional rule of thumb for small offices is that the income will be diverted into three approximately equal streams. These are office overheads, staff costs and partners remuneration. In larger offices it is likely that employment costs will be the largest of the three streams with office costs second and partners or owners ( including shareholders perhaps ) remuneration the smallest. A profile of 50% : 35 % : 15 % would be typical. But this is not by deliberate design. Entrepreneurs generally make as much money as they can on the back of their employee's labour. This is what Marx called exploitation and most UK politicians call Enterprise. In RIBA 3 you are expected to have an idea of how to go about enterprise and to always value your own skill and care well above the statutory minimum wage.

I turn now to the issue of legal organisation. This gets more and more complicated as organisations grow in size complexity, number of interested parties and degree of protection from risk.

Disregarding the ARB code for a moment I can start a business called Star-arch tomorrow. I don't need an office, a letterhead, an accountant, a phone, or any insurance. I might simply walk the streets with a printed t-shirt advertising my wares as an inspired building designer and Fung Shui expert and get into verbal contracts with customers, or 'punters' in E End jargon and take cash off them for services rendered. At the end of the year I'd be expected to declare my earning or sales or income to HMRC and claim some expenses, like shoes, tee shirts, paper, make up etc and pay tax on the difference.

But to be a registered architect and to comply with the ARB code then I need ALL those typical business accoutrements, apart from the accountant, listed as unnecessary above and as a result it's a lot more likely that HMRC will ask me about my tax affairs if they haven't heard from me recently since they will be able to trace my existence through other people's tax returns. VAT and the regulator.

So let's say I am Mr G MacLaren practicing as Wot MacLaren and I submit accounts to HMRC as reproduced in the appendix. Do they look plausible, bearing in mind I drive a Maserati and wear Armani suits and a lot of gold and am rumoured to carry a gun? Probably not, most people would think I have another, criminal, source of income and it's unlikely to be mere VAT fraud. So the point I want to make is that organisations' accounts tell you quite a lot about the nature of the organisation. Insurers take a lot of interest in a firm's accounts when assessing premiums and very often new clients, especially public clients, want to see them too.

Consider next, a more realistic Mr G. MacLaren of 8 Sutton Place E9 who owns this £ 600,000 house and garden jointly with his wife ( also an architect ) and a mortgage company. Lets say my share is worth £ ¼ M and I have nothing else of value to my name. If I were then to practice as an architect - and ignoring for the time being the fact that the ARB doesn't allow this- and I got successfully sued for not exercising reasonable skill and care and damaging my clients commercial interest to the tune of £ 100,000 and causing him to employ an expensive lawyer costing £ 150,000 then I'd very likely be homeless because the damages plus costs would be £ ¼ M.

Lets say I had a partner in a practice called Dotty MacLaren and my partner had Alzheimers disease and made some silly mistakes on a project which was not DDA friendly but was for a local authority's Social Services department and the cost of achieving DDA compliance was £ ¼ M then once again I'd be homeless unless I could get my partner to pay the lions share of the damages. But sensibly my partner would get themselves sectioned under the Mental Health act or find some way or other make themselves irresponsible for their actions.

It is probably no surprise that I do things to allay these risks. Firstly, of course, I exercise all the skill and care I am capable of in the execution of commissions and even when I am only giving unpaid advice to friends or acquaintances. Secondly, I don't practice with idiots, piss artists, crackheads or people who dislike me and are poor. Thirdly, my firm ( not I ) has Professional Indemnity Insurance in the sum of £ 1.0 M with the RIBA insurance Agency . It costs about £ 1,700 p.a. because in 20 years practice I have yet to be sued. Fourthly, I use a business vehicle or legal entity called a Limited Liability Partnership which means only the value of the LLP, which is in effect nothing, is available to successful

commercial creditors if the firm should find itself in financial difficulties for any reason including as a result of being ordered to pay damages by a judge in a civil case.

It is a principal of English law that insurance cannot be offered against criminal prosecution or damages and similarly the LLP will not offer me much protection against claims against me in 'tort' for personal injury or death, but my insurance might give some protection in this area. Insurance will for sure give me a lot of protection against claims in contract law against the LLP.

One reason for the invention c. 2000 of LLP's in the UK was the problem of 'joint and several liability' hinted at in the case of the partnership with a diseased partner. In a partnership under English Law any partner can bind another so that all partners have an equal liability for the actions of the others. In the case of large firms of lawyers or accountants with literally hundreds of partners the risk of having a rogue partner was extremely high and very uncomfortable. LLP's seem to have become the most frequently used alternative to conventional partnership for architects and lawyers and accountants but ever higher form of legal organisation exist. These are the PLC, a company with shares quoted on the Stock Exchange and strict reporting rules to Companies House, and the Limited Liability Company which can have private shareholders and has, I believe, rather less public scrutiny of its accounts. Unlike Partnerships which are governed by partnership agreements that are private to the partners ( or 'members' in official LLP jargon ), companies have to have memoranda of association which make explicit the division of responsibilities between the boards of directors and other staff. Some directors may be executive and other not and staff with no financial interest in the firm apart from their wages can be given the highest levels of responsibility. This makes limited companies more flexible vehicles for the promotion of staff and more amenable to continuous re-structuring. These characteristics, rather than just their 'limited' liability is, perhaps their chief advantage over LLP's. They have one other major difference. They pay Corporation tax, currently set at 40 %, on profits whereas LLP pay tax on the members profits, strangely enough at 40 % on personal income over about £ 35,000 p.a.

Paying 40 % tax is an interesting experience when you first experience it. UK tax rates flip from 22.5 % to 40 % at about an annual income of £ 38,000. They never exceed 40 % for earned income including the multi-million pound bonuses fat cat executive reward themselves for failure. If one's basic salary is at this level, lets say one teaches in a university, then the 'value' of an additional income from private practice is eroded if one is paid poorly per hour in the practice. If one charges £ 35 / hr. for 'consultancy', then one pays £ 14 / hr to HMRC in order to pocket £ 21 / hr. If one is working very hard, say at 2,500 hrs. p.a. and suffering stress and damage to one's health then there is a fairly strong disincentive to work for a charge-out rate of less than say £ 50 / hr. At £ 50 / hr. one pays £ 20 / hr. in tax ( assuming one isn't putting everything one earns into one's pension ) and one starts to ask is this minute of stress or tedium worth 50 p –which is the opportunity cost of not answering another E mail but instead gazing at people in the sunshine in the street outside or watching the fox in the garden or helping one's daughter clean a horse's stable.....

Time is money. At 50 you have maybe  $35 \times 356 \times 24 \times 60 \times 60 = 1,076,544,000 = 1 \text{ Bn. seconds}$  left on this earth. On the other hand the funniest sketch I saw in Bremner Bird and Fortune's series this year was of Gordon Brown asking for donations to the Disaster Relief ( Pensions ) Fund.

G McL 24.10.0 & 10.4.06

@ 15.3.07 the associated Excel spreadsheet will be WMLLP's actual 05-06 return to Companies House