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## Finance: An introductory course for classes and study circles

Emile Burns

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### Recommended Citation

Burns, Emile, "Finance: An introductory course for classes and study circles" (1922). *PRISM: Political & Rights Issues & Social Movements*. 836.  
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SYLLABUS SERIES NO. 3

159

# FINANCE

AN INTRODUCTORY COURSE  
FOR CLASSES AND STUDY CIRCLES  
BY  
EMILE BURNS

PRICE SIXPENCE

LABOUR RESEARCH  
DEPARTMENT  
162 BUCKINGHAM PALACE ROAD, S.W.1

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## FINANCE

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## AUTHOR'S NOTE.

**T**HIS introduction to the study of finance has been prepared with a view to helping the student to realise, not only the abstract mechanism of finance, but also the growth of the financial system and the part it has played in the development of industrial production. The syllabus has not, therefore, been confined to "pure" finance, many of the details of which are of little interest except to bankers.

For the first five studies, the standard financial text book, "The Meaning of Money," by Hartley Withers (Murray, 6s.), is almost indispensable. A shorter and necessarily less exhaustive work, which however deals with certain newer financial developments, is "Modern Finance," by Emile Burns (Oxford University Press, 2s. 6d.).

For the ground covered by the second five studies no text books exist. At the same time, the ground covered is the actual development of industrial finance at the present day; the daily Press, some recent studies issued by the Labour Research Department, and any balance sheets of industrial companies that can be got hold of are the main aids to study. Some compensation for the absence of any definite text book is the fact that the subjects dealt with are actually current subjects of discussion in the Press, and have a more definite interest for that reason. The class-leader at least should make himself familiar with the facts given in "Wages, Prices, and Profits" (4s. 6d.) and "Labour and Capital in the Engineering Trades" (1s.) both obtainable from the Labour Publishing Co. He should also make a point of securing a balance sheet of some company known to the class, and of noting any current company reports in the Press, for discussion by the class.

The syllabus is divided into ten sections; the class will decide for itself which subjects should be examined in greater detail, if it wishes to divide it into twelve or more studies. After Section IX has been reached, the accounts of special companies would afford an inexhaustible series of studies.

E. B.

## I. WHY THE FINANCIAL SYSTEM HAS ARISEN

In beginning a study of the financial system one point must be got hold of immediately. In any modern community, there is an established system of law which lays down rules of *property* and the *right to use things*. That system does not, in most countries, correspond with either the need of people to use things, or their ability to use them.

Hence it follows that the community could not continue to exist if there were not some means of getting over the barriers of private property, and effecting transfers of the right to use from the people who have, and do not want to use, to the people who have *not*, and *do* want to use.

The class which has no property must produce in order to live; it must, by some means, get the right to use the sources of production. The feudal system was one method; the industrial capitalist system, working through financial middlemen, is another.

The financial system has grown up as a device for making industrial production possible in spite of the system of private ownership and private rights, which, rigidly adhered to, would have stifled the community. It has made possible, not only barter—the exchange of goods or rights—but also credit—the lending of goods or rights.

Nevertheless, it has been built up by those who *have* the goods and rights according to established law, so that the system is devised so as to give, to those that have, something more, which is *interest* for lending their rights to enable the world to live; while it gives to the actual users of the productive resources, not what they produce, but wages, only a partial equivalent to their production. The balance goes to maintain (1) those that have legal rights to use, but do not produce, and (2) the financial middlemen who arrange the business. The whole financial system as we know it therefore depends on the system of private ownership, and is the means by which private owners enable production to go on so long as they can draw tribute from it.

In studying the financial system we must never lose sight of the fact that, ingenious and useful as it undoubtedly is in an established system of private ownership, many of the processes involved would be done away with under public ownership. Further, we must remember that money, whether gold, silver, notes, or finance-money, is essentially a *title to the use of things*.

Money is primarily a medium of exchange, to simplify the process of barter on which modern life depends. Historically, any object—such as a shell or an iron ring—which is commonly used as a medium of exchange may be called money. In the modern pre-war period, gold, silver, or other metal coins, and Notes (Bank or State) were the universal forms of money used for comparatively petty transactions. Up to perhaps 150 years ago, normal transactions could actually be carried out in gold; in the early part of last century the common use of Bank Notes developed, and economists insisted on the importance of gold backing for Notes. Gold was important because it had *intrinsic* value; Notes had only credit value derived from the fact that they were exchangeable into gold. But when general confidence in Notes had been established, the gold basis, although still required by legislation, became meaningless, and Notes became the usual form for larger transactions.

The rapid expansion of industry and of commercial transactions on a large scale, however, soon made both gold and notes useless as means of exchange; and these forms have no special importance in modern finance. Their place has been taken in ordinary business transactions by an abstract “money of account.” It is this money of account, with the financial machinery that creates it and controls it, which requires study; coins and notes are now only the small change of finance-money.

*Suggestions for reading:—*

“The Meaning of Money,” Chapters I and II. The student should note the author’s unquestioning acceptance of the facts he describes: the question of *why* the money system has arisen does not seem to occur to him.

Todd, “The Mechanism of Exchange,” Chapters II and IV. (Humphrey Milford, 7s. 6d.)

## II. THE FUNCTIONS OF BANKS

Historically, finance-money was made possible by the growth of financial institutions. For convenience, these are here referred to generally as Banks, although they have had many forms—as one department of a general business; as Banks in the modern sense; as specialised firms, doing only money-lending or foreign exchange, &c.

In this wide sense, Banks grew up as institutions for (a) collecting money, (b) lending money, at a charge for interest.



The collecting of money is carried out in three ways :—

(1) On the formation of the Bank, the group forming it brings in a sum of money as the “ capital ” of the Bank. In former times, this group would be an individual and his family or friends ; at later periods, it would be a group including not only the promoters, but also such of the “ investing public ” as could be induced to put their money into it.

(2) When it starts business, the Bank receives money from the public in “ current ” and “ deposit ” accounts. Originally, the attraction offered by Banks was that they were safe places where money not wanted immediately could be left. The second attraction was the payment of interest on money thus left in the Bank. But the third and most important was the convenience, growing almost to a necessity as business transactions grew in size, which Banks offered through the cheque system.

[NOTE.—*Deposit accounts* are those in which a customer pays into the bank a fairly large sum of money, which he can only withdraw after giving notice. The period of notice varies—a few days for small sums, weeks or months for large sums. On such deposits the bank pays interest to the customer. *Current accounts* are those in which a customer pays in money, but retains the right to take it out at any time without notice. As a rule, banks do not pay interest on money in current accounts (except where fairly large balances are habitually kept). The customer, however, benefits by the cheque system ; he can write an order to the bank (*i.e.*, a cheque) to pay some or all of the money in his account to any person, and that cheque is negotiable through any other bank, in any part of the country.]

(3) Some of the profit made by the Bank (from interest on loans, &c.) is usually kept in the business, the rest being paid as dividends to shareholders.

Banks lend the money thus collected in a variety of ways, the most important being :—

(1) A simple loan to a customer ; interest is payable periodically, and usually there is (a) a fixed term for repayment of the loan, (b) some “ security,” as when the borrower gives a mortgage on some property, entitling the Bank to sell the property and recoup itself if the loan is not repaid.

(2) On “ overdraft,” *i.e.*, the customer is allowed to draw on his current account more than he has to his credit. Interest is charged on the amount “ overdrawn,” the customer wiping out the debt gradually by payments into his current account.



(3) Discounting "bills of exchange," *i.e.*, cheques drawn by one trader, who has sold goods, on another, who has bought them; the second having to pay the bill (by arrangement) some months later. The bank pays the amount of the bill to the first trader immediately, deducting "discount" or interest for the period until the bill is payable; and when the bill falls due for payment, usually three or six months later, the bank collects the whole amount from the second trader, thus clearing the interest.

(4) Investing in some other concern.

NOTE.—Banks have other ways of making money, for example, by acting as agents in the formation of companies, or doing other work on commission. But interest on loans and discount on bills of exchange form the main sources of income.

*Suggestions for reading :—*

"The Meaning of Money," Chapters IV.

"Modern Finance," Chapters I., III., and IV.

Todd, "The Mechanism of Exchange," Chapter IX.

For more detailed study: Dunbar, "The History and Theory of Banking."

### III. THE CREATION OF CREDIT MONEY

Up to the present we have assumed that the Banks could only lend such money as they have collected (as capital, deposits by their customers, or profits retained in the business). Before the invention of Bank Notes this was obviously the only money they could lend. When, however, a Bank could issue Notes, which in practice were accepted by the public, the Bank could also lend (and charge interest on) its Notes.

The Notes, however, had to be exchangeable into gold, or the public would not have accepted them; therefore, at first the Bank had to keep in reserve a large sum of gold in case the public demanded payment of the Notes in gold. There was, however, always a margin between the number of Notes issued and those presented at the Bank for payment in gold, owing to the fact that some holders of Notes would use them to pay their debts, instead of going to the Bank, drawing gold, and paying their debts in gold.

This margin (the Notes usually outstanding) set the limit to the additional amount of loans the Banker could give by means of Notes. As public confidence in Notes grew, the margin also grew, enabling the Banker to increase the Notes issued without an actual gold reserve to exchange them for if presented.

Thus the amount of loans the Bank could issue was determined by the margin of Notes outstanding—the amount the public usually kept in circulation without asking for their exchange into gold—in addition to the amount of the Bank's capital, deposits, and profits kept in the business.

Notes were the first form of "finance money" by the Banks, enabling them to issue as loans (and earn interest on) *more money than they had*. The development of the financial system enabled them later to develop a new form of "finance money" in the following way:—

The utility of cheques in the growing transactions of modern times led every business, public authority, and moneyed person to put their money into banks on current account, drawing cheques from time to time to meet their current needs. But just as in the case of Notes there were always some outstanding, so in the case of current accounts there was always a balance not yet drawn by the mass of customers. As the number of customers increased, the aggregate balances not yet drawn became considerable. After a time the Banks came to know the approximate size of this balance, being then able to use that amount as loans (at interest) to other customers.

The second stage was the development of branches of banks all over the country. It became increasingly common that A, who was making a payment to B, used the same bank, or another branch of the same bank as B. In such cases A draws from his current account, say, £1,000 by cheque and B pays the cheque for £1,000 into his own account. The Bank makes the transfer in its books, *but has not used any actual money in doing so*. The daily aggregate of such transactions (especially now that the number of important banks in England is reduced to five) is enormous. The Bank can use that sum in loans (at interest) to its customers, for in practice they never draw it away from the Banks.

The third stage was the realisation by the Banks that what was true of ordinary customers' current accounts was true also of the accounts of customers to whom they made loans. To lend £1,000 to A does not mean that A immediately withdraws £1,000. He may want it to pay to B, who is another customer of the same bank. The bank knows from experience that only a certain percentage of a loan placed at the disposal of a customer will actually be taken

away from it in cash, or in payments to customers of other banks.

The fourth stage was the development of mutual relations between banks. At the same time as Lloyds is lending to A, Barclays is lending to X. That proportion of Lloyds loan to A which is paid to a customer of Barclays is balanced by a proportion of Barclays loan to X which is paid to a customer of Lloyds. Here again no money is actually drawn; Barclays and Lloyds simply exchange cheques.

Thus it is that Banks can lend (at interest) considerably more money than they actually have, which at first sight seemed impossible. This extra credit or finance-money is the product of a highly developed Banking system, in which Banks are everywhere, are used for practically every transaction, and enjoy public confidence.

*Suggestions for reading :—*

“The Meaning of Money,” Chapters III., V., and VII.

D. H. Robertson, “Money” (Nisbet, 5s.), Chapter IV.

#### IV. THE CLEARING HOUSE AND CENTRAL BANK

All important business transactions are carried out by cheques. It is clear that cheques drawn from one account and paid in to another at the same bank involve mere book-keeping. In the case of cheques drawn on Bank A, but paid in to an account with Bank B, B has to collect the amount from A. Originally, this was done by a messenger actually cashing the cheques. But through the “Clearing House” system all cheques on other banks in the hands of Bank B are daily exchanged against cheques on Bank B in the hands of other banks. Any balance is settled by a transfer from one bank’s account into another at the Bank of England. The result is that all cheque transactions are reduced to bookkeeping, all banks having an account with the Bank of England. Thus no bank need keep any cash beyond what its customers need for small payments; it pays all cash into the Bank of England—cash nowadays being practically all Notes.

The Bank of England itself maintains a certain reserve of gold, as a backing for its Notes. But it also lends money (finance-money) just as other banks do; and it is able to control the granting of credits by other banks by means of its own rate of interest on loans or discounting bills.



“ Bank rate ” is the rate (per cent. per annum) at which the Bank of England will discount reliable bills of exchange.

The way in which the Bank of England’s control works is quite simple. At each moment the general financial transactions of every bank include loans to bill-discounting firms, generally “ on call ”—loans to be repaid when demanded. When the banks have been issuing loans freely, their account at the Bank of England tends to diminish; they therefore recall some of the loans to bill-brokers. The bill-brokers, however, have used the loans to discount bills, and their only way of raising the money at once is to go to the Bank of England and there re-discount some of the bills they hold.

Therefore if the Bank of England thinks that too many loans are being made, it can check the process by raising the Bank rate. This means that bill-brokers raise their own rates of discount, because they know they will have to pay the higher rate if they have to re-discount any bills at the Bank of England. The other banks similarly raise their discount rates and rates of interest on other loans (because if they lent at low interest their reserves would be soon drained), and thus the demand for loans is checked.

If on the other hand too few loans are being made the Bank of England can lower Bank rate; bill-brokers lower their rates of discount and take on business more freely, knowing that they can re-discount cheaply; the other banks do the same, in order to keep some of the business.

In normal times (*i.e.*, pre-war), a rise in the bank rate had an influence on the exchange with other countries. This was because all interest rates in England rose, and people in other countries would send money to England to earn the higher rates of interest. This led to English money (*i.e.*, money in any form payable in England) being in demand in other countries, so that the English £ was above par—or could be exchanged for more dollars or francs than previously. This in turn caused people abroad to ship gold to England—as gold is not affected by exchange rates, having intrinsic value.

The lowering of bank rate had the opposite effect.

A further result of any change in bank rate was that banks in other countries tended to follow suit—if bank rate rose, they raised their rates of interest in order to check the sending of money (especially gold) to England, and thus brought the exchange back to par. Thus the Bank of

England in practice controlled the amount of loans made not only in England, but indirectly all over the world. This is not altogether the case now, owing to the special conditions in foreign exchanges.

On what motives does the Bank of England act in changing bank rate? Originally, on pure banking motives; it held all the cash reserves in the country, and if in consequence of a too free granting of loans these reserves were being depleted, it naturally checked the process. If on the other hand its reserves were getting larger than was necessary, it would encourage the granting of loans by reducing bank rate. It might also raise rates in order to prevent too much gold leaving the country, or lower rates to get rid of the gold which was lying idle.

Since the war, however, certain wider motives have been operative. These are industrial rather than directly financial, and may even be called political. Its main attempt recently (1922) has been to encourage loans in order to revive industry and lessen unemployment. But this could only be successful if new markets for industrial products could be created by loans; if there is no market, industry will not produce, however cheaply it could borrow the money to enable it to produce. To encourage industry loans must be made to the *consumers*, not the *producers*.

This is the importance, for example, of loans to Russia, or to any other impoverished consumer of English products; no process of facilitating loans to English producers can have any serious effect on unemployment.

*Suggestions for reading* :—

“The Meaning of Money,” Chapters XI., XII., and XIV.

“Modern Finance,” Chapter VIII.

For further study: Dunbar, “The History and Theory of Banking,” and Todd, “The Mechanism of Exchange,” Chapters X and XII.

## V. FOREIGN EXCHANGE

We have now seen the outline machinery of internal finance. For transactions between one country and another a special machinery was necessary. First, the currency of one country must be converted into that of another. Gold is the most easily interchangeable form; it can be simply re-minted. But (1) payments in gold are cumbrous and expensive; (2) international transactions are nowadays on such a large scale that payments in gold are not possible.

Therefore the system of payments by cheques (usually bank drafts—cheques drawn by Banks on Banks) or bills of exchange developed, involving no actual transfer of currency. English exporters of lace want to get money from America for goods shipped to America; English importers of raw cotton from America have to send money to America. Instead of the money coming and going, the importer pays his debt into the financial machine in England, and the machine then pays the exporter out of that money. In America, the same thing happens—the importer pays the exporter, through the medium of the financial machine. The actual process is that banks buy *credits* from exporters, and sell them to importers, who use them to pay their *debts* in the other country.

As long as imports and exports between any two countries are of equal value, the *credits* for exports balance the *debts* for imports. In such a case the exchange would be at “par,” which means that in such transactions dollars would be converted into pounds, and *vice versa*, on the basis of the intrinsic value of the gold currency—the weight of pure gold in the standard sovereign or five dollar piece.

But if the British imports from America are higher in value than the British exports to America, the result is that there is a balance of debts to America which cannot be cancelled out against the credits. Therefore the debtors are competing for the credits, and have to pay more English money than usual in order to get the American credits. Moreover, the balance of debts (for which there are no corresponding credits) has to be settled against *future* credits, which means that in addition to the amount of the debt, interest must be added—to cover the period during which the bank (which arranges payment of the debt now) is out of pocket, *i.e.*, till it finds a corresponding credit. In practice, the whole volume of debts as compared with credits is affected, and not any special items forming the unpaid balance.

In normal times, variations in the exchange from par are generally seasonal—such as when a harvest is being shipped from one country to another, for which the latter pays by the export of manufactures during several following months. The trade balance, in fact, tends to right itself.

This tendency is assisted by (a) “invisible” exports—for example, credits in America for services rendered by British ships, lecturers, etc.; (b) investments, the special sending of money (creation of credits over and above trade



credits) abroad for new investment; (c) exports or services to a third country, which in turn sends its own exports to the second.

In any case, the exchange cannot be at par if there is a large and steady adverse balance of trade. Since the war, in addition to most unequal trade between countries, there has been added further indebtedness for loans or indemnities, for which sufficient credits cannot possibly exist. The rate of exchange, therefore, reflects not only the competition of buyers of credits, but also interest for very long periods. In fact, the actual rate at any time is governed, not by knowledge (as is possible in seasonal fluctuation) of *when* trade will balance, but by (a) the intensity of the demand for immediate payment, (b) the hope—or despair—of payment within any measurable period of time. This is why political events (such as the French attitude to Germany) have such an immediate and devastating effect on exchanges. Further, this state of things encourages the speculator in exchange, who is able to make huge sums by buying and selling foreign money, and whose transactions have a further bad effect on the exchanges.

The relation of prices in each country is also important—but in the long run prices follow the changes in exchange rates. The mere fact that the actual exchange rate is not the same as in pre-war days does not affect trade. Thus, the change from twenty-five to fifty francs to the £ does not matter if prices in France have doubled; French importers of English goods can sell them for fifty francs instead of twenty-five, and can thus buy the £ (to pay the English exporter) with the proceeds, just as before. What does matter is continued fluctuation, which prevents, for example, the French importer from knowing how much he will have to sell for in order to buy the English £.

*Suggestions for reading:—*

“The Meaning of Money,” Chapter X.

“Modern Finance,” Chapter VI.

Also, for further details, “Foreign Exchange before, during, and after the War,” by T. E. Gregory (Oxford University Press, 2s. 6d.); and Todd, “The Mechanism of Exchange,” Chapters XI and XIV.

## VI. MONEY CAPITAL

All industrial enterprise requires “real” capital, *i.e.*, it must have land, buildings, plant, tools, &c. It also needs labour, which itself needs “real” capital to enable it to work—food, clothing, housing, &c.

Under the system of private ownership money capital is essential, *i.e.*, money to buy the "real" capital required. Modern enterprises are on such a large scale that one person cannot, as a rule, find enough money to start them with; therefore he must attract other people with money to join him in the scheme. The usual method is to start a public limited company, inviting the public to contribute the money required, the attraction being the prospect of dividends or interest to be paid out of the profits. Such an invitation to the public is called a prospectus, which usually states (1) the capital of the company, and the amount of shares offered; (2) for what purpose the money is required; (3) the profits expected on the enterprise; (4) the terms to the public—besides other details. The whole business of getting money from the public is called "an issue of capital," *i.e.*, an issue to the public of the opportunity of contributing the money-capital required by the company. When the money has been contributed, the contributor has exchanged his money (a general right to use things) for a "share" in the company. For convenience, the share is described in money units (a £1 or £10 share, instead of  $\frac{1}{1000}$ th or  $\frac{1}{100}$ th share).

The capital of the company is the total sum with which the company is to be or has been formed. The authorised capital is the total that may be issued; the issued capital is that part of the authorised capital that has been allotted or issued to subscribers (shareholders).

Shares may be issued at par (£1 for £1 share) or above or below par. They may also be issued "part paid"—a £1 share may be issued with only 10s. paid up; the subscriber to such shares only has to pay 10s. at once, but has to "subscribe" for a £1 share, and may be called upon to pay a further 10s. at any time. Most industrial shares are, however, "fully paid."

Shares may be of different kinds: the two most usual classes are:—

(1) Preference shares, entitled to a fixed but limited dividend out of any profits, as a first charge on the profits.

(2) Ordinary shares, entitled to the whole balance of profits after the dividend on the preference shares has been paid.

The promoters may settle how many classes of capital there will be, and may give each class any rights (in voting or profits) they like; and in practice there is no uniformity

even in the names of the different classes of shares. But it is very important to distinguish between the classes in any particular case. There may be hundreds of small investors in one class of share, say the preference, with the fixed dividend of five or six per cent., and with no voting rights; while there may be a dozen or fewer investors in another class, say the ordinary, with complete voting rights, unlimited dividends, and the sole right to any distribution of bonus shares, &c.

A company may also, in addition to its share capital, raise further money from the public by way of a loan. It may accept money from anyone, paying a regular rate of interest on it; but being prepared to pay back the loan at short notice; or it may issue "debentures," in which case the lenders cannot get their money back for a certain period (5, 10, 50 years); but they can sell the debentures at any time, of course, at the market price. The debenture holders, however, usually have no control over the company, which is vested in the holders of ordinary and (in some cases) preference shares.

This loan capital, or debenture capital, is not usually spoken of as part of the capital of the company; but it has the same function as the share capital—to buy the property or goods required to enable the company to work.

A company may be either a "public" or a "private" one. Private companies are those with less than fifty shareholders; they are not required by law to publish any balance sheet, and have only to register their capital, directors, and shareholders at Somerset House. Public companies are those with more than fifty shareholders, they are obliged to file (in addition to particulars as to capital, &c.) a balance sheet at Somerset House, and usually issue it also to the Press.

*Suggestions for reading :—*

"Modern Finance," Chapters II. and III.

"An Outline of Economics," to be published shortly by the Plebs League, 2s. 6d.

## VII. COMPANY ACCOUNTS

The published accounts of companies are, even in the best cases, only summaries. There is no regular form required by law, and as enterprises have grown in size there has been a tendency to reduce the amount of information as to the company's position which is given in the published accounts.



The usual statements are :—

(1) An income and expenditure account. This theoretically is a summary of all business done during the year, and shows a balance on the year's working of gross profit (or loss).

(2) The profit and loss account. This includes the balance of profit from the income and expenditure account; adds to it special items of revenue (such as interest from investments, which is not treated as ordinary working income), and from the total profits thus arrived at deducts special items of expenditure (such as income tax, &c.). The balance of this account is the net profit, out of which dividends to shareholders are paid.

(3) The balance sheet. This theoretically shows the financial position of the company, taking into account its property and debts, and reflecting past profits (or losses) as well as the profit or loss for the last year.

The income and expenditure account is often not published, only the balance (gross profit or loss) being stated. In any case, it is usually so vague that it contains very little information. It includes on the expenditure side, all current working expenses—for salaries, wages, materials, &c.—and on the revenue side, the total proceeds of sales or other normal income.

The profit and loss account is the most useful for information as to the current year's working. It includes on the revenue side :—

(a) The net balance (after paying dividends) of profit "brought forward" from the previous year's profit and loss account.

(b) The balance from the income and expenditure account—the current year's gross profit.

(c) Special receipts, from interest, &c., during the current year.

On the expenditure side it includes :—

(a) Special payments, such as income tax.

(b) Interest paid on loans or debentures, if any.

(c) Amounts not actually spent by the company, but set aside, out of the gross profits for the year, for some special or general purpose. Such purposes are, in one form or another, general reserves, or special reserves, such as "dividend equalisation fund" (to maintain a fixed rate of dividend even in years when not enough

profit has been made); employees' pensions fund; insurance fund (to cover losses of property by fire, &c.); depreciation fund (to make good the wear and tear of plant, &c.).

The balance sheet professes to give the actual financial position of the company at the end of the year's working covered by the profit and loss account.

It contains on the liabilities (left hand) side :—

(a) The amount of capital issued and paid up, distinguishing the various classes of shares. This is on the debit side because the company (as a legal unit) owes its capital to the shareholders.

(b) The amount of loan capital (debentures, or loans from banks, or from individuals).

(c) The amount of its various reserves from past profits, which the company "owes" (*i.e.*, has decided to use later) for special purposes.

(d) The net balance (after paying dividends) of the profit and loss account; this is really on the same basis as the reserves—the company has decided not to distribute it as dividends, but has not otherwise allocated it.

(e) "Sundry creditors"—the amount it owes, in the ordinary way of business, for materials, &c. This may or may not include such items as :—

(f) Liabilities for income tax; "bills of exchange" which the company has to pay later on, &c. Such items are usually given separately if they are large.

On the assets (right hand) side of the balance sheet are :—

(a) The valuation of the company's property—land, buildings, plant, &c. This may be either the *depreciated* value (*i.e.*, original cost less the amount set aside for depreciation each year out of profits) or the original cost; in the latter case an item "depreciation fund" would appear in the liabilities side of the balance sheet, just like any other reserve.

(b) The valuation of stock and materials on hand.

(c) The valuation of investments (if any) in other companies.

(d) The amount owed to the company on ordinary trading accounts.

(e) The cash (in hand or at the company's bankers).

The items enumerated above are not exhaustive, but

cover practically everything ; other items which appear are generally only detailed examples of some of the above, which are set out separately because of their importance.

No reading is suggested for this subject. Any work on book-keeping might be consulted, but would contain masses of details which are not relevant. Any published statement of a company's accounts would be much more useful; students should examine any published company balance sheet they can secure, and make themselves familiar with the terms used.

"Wages, Prices, and Profits," Chapter III., contains a useful section, "The Interpretation of Company Accounts," which, however, includes the question of subterfuges dealt with in section IX.

### VIII. RESERVES AND THEIR SIGNIFICANCE

In the small business enterprise of the early days, the owner or group of owners normally took each year any profit made by the concern. Any "reserve" was a personal one, and was usually invested in some safe security, in case the enterprise in which the person was directly concerned proved a failure. With the growth of the large public company in the course of last century, the idea developed of setting aside part of the profits each year as a reserve against any period of bad trade. Only part of the profits was paid out to shareholders in each year of good trade, the balance being "deferred dividends," to make up a dividend to shareholders during a bad year. With that aim in view, the balance reserved for the future was kept either on deposit at a bank or in some investment outside the industry—an investment, such as consols, which would not be affected by a bad year for the company concerned.

As companies developed in size still further, and the idea of large combines began to govern the policy of the more important companies, the former conception of a reserve as cash or a realisable security, to meet a bad period, was lost sight of, and reserves became of fundamental importance in developing combines. For a reserve, accumulating year by year out of profits not distributed to shareholders, was an easy source of *new capital* required for expansion. A larger and larger proportion of the profits made each year was withheld from the shareholders, and, nominally assigned to a "reserve," was actually used for expansion—to buy up new property or plant, or, especially in more recent years, to buy up shares of other companies in the same or allied industries, in order to create large combines.



In addition to the motive of steady expansion without the trouble and expense of new public issues of capital, two new motives have given this policy of reserves a special impetus. The first was the institution of super-tax, which is payable by individuals but not by companies. The directors of important companies are mostly liable to super-tax; the more money that the company distributes in dividends to them as shareholders, the more they have to pay in super-tax. They do not need the dividends to live on, and in any case would simply re-invest them. Therefore by leaving current profits in the company they have their investment and avoid the super-tax on that amount—often running into thousands of pounds yearly. And it is the directors who decide in practice what part of the profits is to be paid out as dividends and what part retained as reserves.

The second new motive has been the enormous increase of profits during the war, coupled with the desire not to flaunt these profits by paying enormous dividends.

These are the main factors which have led to the growth of the reserves policy, with the comparatively recent development—as labour began to appreciate that dividends were not an indication of actual profits—of “secret” reserves—funds which are put aside by methods aiming at concealment which are dealt with in the next section.

We have next to consider the actual uses to which reserves are put, and the general effect of the policy on finance and industry.

The issue of bonus shares from reserves, or “capitalising” the reserves, is a frequent practice; its significance is often misunderstood. Broadly speaking, it does not give the shareholder anything that he did not have before—except a new share certificate. As was explained earlier, the ordinary shareholder has the right to (his share of) all profits left after dividend on any preference shares has been paid. He therefore is part owner of the reserve; when “bonus shares” are issued he merely gets a certificate in which his right to the reserve is expressed in money units: he gets no new rights. An issue of bonus shares is only window-dressing; though it may be intended to deceive labour with regard to future dividends. For example, a company may pay ten per cent. regularly on each £1 share; after a bonus share of £1 is issued in addition to each original share, the 10 per cent. dividend is really a 20 per cent. dividend on the original investment.

The financial importance of reserves does not consist therefore in their potential issue as bonus shares, but rather in the use to which the actual money is put. Where a company uses its reserved profits for expanding its own business, or for investment in other companies in the same industry, it is clear that these reserves do not help the company when a depression in that industry occurs.

Moreover, the control by the directors of large sums easily got together, besides the combine-motive referred to above, in practice leads the directors to buy up other concerns at inflated prices—paying more for them, in order to get control, than they are worth judged by ordinary business standards. This tendency was naturally most strongly marked during the war and early post-war period, when it seemed that boundless profits could be made, no matter what was paid for an enterprise in working order. The importance of this is that when such purchases took place, the enterprise concerned would be “recapitalised,” *i.e.*, the money paid, say £300,000 for a former £100,000 concern, would become the capital, and in order to pay a 10 per cent. dividend, £30,000 annual profit would be necessary, instead of £10,000 as formerly.

It is clear that, on a smaller turnover resulting from industrial depression, the profit per unit of output would have to be not three times, but perhaps six times what was previously normal.

The foregoing factors are undoubtedly of great importance in the present financial difficulties of industry.

*Suggested reading:—*

“Modern Finance,” Chapter V.

“Labour and Capital in the Engineering Industry” (Labour Publishing Co., 1s.) contains a clear exposition of the development of combines in that industry, showing the financial effects for Vickers and other important companies (Chapters II. and III.).

“Wages, Prices, and Profits” (Labour Publishing Co., 4s. 6d.), Chapter III. and Appendix III., should also be consulted.

## IX. SUBTERFUGES OF COMPANY FINANCE

It is a criminal offence to “cook” company accounts so as to show greater profits, or a better position, than is actually the case; but to cook the accounts so as to conceal profits or a good position is praiseworthy, and is called “sound finance.” The practice of cooking accounts in this latter direction has become almost universal, and has developed with the later stages of the policy of reserves. Every such act creates a “concealed reserve”—either in

actual money, or, more usually, in additions to property which are not included at their full value in the company's assets as shown in the balance sheet.

Full knowledge of the concealed reserves in any particular company is not possible for the outsider; but fairly clear inferences can often be drawn. The main devices adopted are :—

(1) The under-valuation of assets—all of which, except cash and some forms of investment, have not any exact realisable value at any moment; the valuation given in the balance sheet is necessarily arbitrary.

The usual method of valuation of property and plant is to use the actual cost as the basis, and year by year to "write it down" or "depreciate" it, *i.e.*, to assume that it is wearing out or losing its value at a fixed rate each year.

It is obvious that if the amount written down each year is more than the actual depreciation in value, at the end of some years the property may be valued in the balance sheet at nothing, while in fact it is still serviceable. Some property, such as land or buildings in industrial centres, may actually be worth more at the end of ten years than its original cost, while in the ten years it may have been written down in value by 5 per cent. each year.

An inference as to the "over depreciation" of property can be drawn from comparing the amount written off for depreciation each year with the total value of the property. If the depreciation, for example, is one-twentieth of the total value, this means that the company assumes that the property becomes valueless in twenty years. From knowledge of the type of property owned by the company (land, buildings, ships, &c.) a rough idea can be formed of how much this depreciation is exaggerated.

Further, if an item for "repairs and maintenance" occurs in the revenue and expenditure account, or in the profit and loss account, this item also should be compared with the total value of the property. There are many cases of companies maintaining their property at full value by repairs (often improvements!) charged as current expenditure (as if they had been wages or fuel) and at the same time writing off heavy depreciation.



Actually, of course, the value of the assets given in the balance sheet does not as a rule fall, because the amount assigned from the profits to cover depreciation is used to buy additional property.

(2) A special form of the under-valuation of assets is the under-valuation of investments in subsidiary companies. A point to note is that subsidiary companies are often "private" companies, and therefore do not have to publish accounts. The accounts of the large public company may show as an asset only the cost of its shares in the subsidiary, while in fact the subsidiary may be amassing huge reserves. In recent years many former public companies have been converted into private ones, when they were bought up by a combine, in order to conceal not only the position of the subsidiary, but that of the parent company as well. This is often done also for a special department of a large firm. In all such cases it is easy to arrange for the private firm to sell to the combine at fictitiously high rates, so that the combine, a public company, shows a loss in working, while its subsidiaries, being private companies, make but do not show enormous profits.

(3) A third device for concealing reserves is to show as "current expenditure" real additions to property. This is practically impossible to detect, without access to the company's books; but occasionally it is given in speeches at company meetings.

(4) Another method is to include, among the "sundry creditors" in the liabilities side of the balance sheet, fictitious items under various names. This also is difficult to detect, but comparison of the amount given for "sundry creditors" in the balance sheets for several years often reveals large jumps from which inferences can be drawn.

There are numerous other devices, but they all fall under the main types given above; each item in a balance sheet should be carefully considered, and its real significance discussed. If possible, it should be compared with similar items in previous balance sheets. It is important to note that there are several actual cases of secret reserves amounting to millions of pounds being distributed as bonus shares; so that the system of secret reserves in one form or other enables companies to conceal real profits and even to pretend to be running at a loss.

*Suggested reading :—*

“Wages, Prices, and Profits” (Labour Publishing Co., 4s. 6d.) contains additional explanation and many examples of subterfuges from actual company accounts. See Chapter III. and Appendix III.

## X. FINANCE, PRODUCTION, AND DISTRIBUTION

In the preceding studies we have traced the machinery of finance, and seen how it facilitated the growth of large scale enterprise leading on to the accumulation of large scale profits and industrial expansions or combines. We have also seen that this process, accentuated by the war and the short-lived boom after the war, has created a general position of financial unsoundness—the difficulty of paying dividends on an increased nominal capital, while the demand for products is shrinking.

This financial unsoundness of industry is aggravated by the position of public finance. The development of society has forced the State to take on a growing burden of public services; the war added special new burdens, especially interest on war loans (themselves largely credit money from banks). Under the system of private ownership the State has to find the money to provide these services by taxation; and this must come, directly or indirectly, out of the real wealth produced. Thus the present position of public finance involves a higher charge on annual production than formerly; as the volume of production has decreased, this means a very serious burden on each unit of production—each thing produced.

This heavy burden on industry, together with the heavy burden resulting from over-capitalisation, necessarily raises prices (or keeps them high in spite of a falling demand), so that demand is further checked. The position of both industrial finance and public finance is therefore tending to perpetuate and aggravate the industrial stagnation.

The financial system, which facilitated the growth of industrial capitalism and large-scale production, with its developments in imperialism, war, and State bankruptcy, has now reached a stage in which it is a hindrance to production.

Is production possible without the financial system as it now exists? The way in which it facilitates production at present is (a) through banking institutions, which collect and create money; (b) through industrial companies, which are enabled, by the loan of this money, to acquire rights to use the privately owned sources of production; (c) through

a commercial machinery, which uses money as a means of exchange in the distribution of industrial products from manufacturer through wholesaler and retailer to consumer.

It is clear that the utility of finance for purpose (b) only holds good under the legal system of private ownership in the means of production. Under a system of public ownership, the right to use could be given without the intervention of finance.

This would to some extent render useless purpose (a) the collection and creation of money by the banks. But only to some extent: for banking machinery is also necessary for purpose (c), the financing of distribution, or the exchange of products between their production and consumption. Even for this latter purpose, under a system of public ownership in the means of production, there would naturally be coupled machinery for distribution, which might make all financial machinery unnecessary, at least up to the stage of actual transfer to the consumer. Even at that stage money might be dispensed with (consider the free public services now given in England, such as roads); but it is probable that a legal system of public ownership would have to prevent the use by citizens of more than a fair share of the country's resources. Again, even that could be done by rationing; but a ration in money, exchangeable for any particular things up to a certain amount, would be less irksome and more economical of administrative machinery.

Therefore it is probable that money, in the form of currency, would be retained under a system of public ownership for wages (or allowances) and retail purposes, but that finance-money, and therefore banking institutions, could be dispensed with altogether.

Russia's financial experiments are of great interest in this connection. During the period of attempted complete public ownership of manufacture and distribution, no banking institutions were at work, and money was systematically lowered in value (by constant issues of notes) with a view to its ultimate abolition.

When, however, it was found essential, for the sake of securing greater output, to create semi-independent State trusts and to allow some private manufacture and trading, a State Bank was established. It was later found that, while the manufacturing industries retained by the State did not need finance-capital to acquire the means of production, yet, because the distributive apparatus was not in



the hands of the State, it was necessary to have finance-capital to enable them to distribute their goods. Thus there is a growth of the financial machinery of credit (under State control) to cover the period between manufacture and sale of goods to consumers. Experience has therefore shown that public ownership eliminates the financial machine (with its cost to industry); but that if any stage from manufacturer to retailer is still in private hands, the financial machine is required to carry out transactions at that stage.

The bearing of these facts on the necessity for "savings" is important. Economists who accept the present legal system of private ownership as permanent insist that individual savings are essential to production. Historically, it is true that such savings made possible the accumulation of money in banks and the growth of large scale enterprises.

But we have seen that already individual savings have become less essential, owing to (1) the development of credit money; (2) the creation of reserves (company savings). Public ownership of the means of production, and of any credit machinery still retained, would altogether eliminate any necessity for personal savings. The development of production would be provided for by reserves from the annual output, on the same lines as company reserves at present, *i.e.*, by assigning a certain portion of the annual output (or its equivalent in money, if still in use) for the building of new works, construction of new plant, &c. Thus public ownership can facilitate not only current production and distribution, but also the development of new productive resources, without the intervention of costly machinery for the accumulation of savings, investment, loans, and finance generally.

*Suggested reading :—*

"Modern Finance," Chapters VII. and IX.

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