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CREEP

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Creep occurs when a business moves, slowly or speedily, into areas not fully explored. When this happens, a lot of problems arise. Do you want the enterprise to creep away from its original purpose or size? Have you set up your organization, control facilities, records, to enable you to deal with the spontaneous new creature your company can come to be? Creep is almost always found in successful companies, though it is sometimes the cause of failure. The accountant is the best often the only, person able to detect creep. He may be the person to deal with the problems created.

A BUSINESS ENTERPRISE, typically is established for a limited purpose, such as the production of a single product or product group, the production of services, or the marketing of certain products. Usually this newly-established enterprise is simple in form, with specialized objectives. The profit motive leads to its creation, and it is expected that profit will be realized through pursuit of this specialized activity.

The case histories of some of the larger corporations, on the other hand, would undoubtedly show that a considerable proliferation of activities accompanies the aging process.

The addition of new activities to the one of initial specialization appears in various ways. Commonly it will appear in the form of integration through taking on the production of component parts formerly delegated to outsiders, or through extending back to the production of raw materials for use in the plant. The sales organization may be expanded to include wholesaling activities and may even be extended forward to include ownership and operation of retail outlets. This process may at the same time be accompanied by a horizontal expansion of activities in which an array of new products is added to the original specialty. In fact, the expansion, diversification, and proliferation may reach the stage where the original objective, through the multiplication of side activities, has become an obscure element in the total activity of the corporation.

Going along with this expansion process one is likely to find another, less spectacular but none the less significant, factor leading to the variegation of enterprise activity. This is the piecemeal attachment of relatively minor activities of service and supply. Examples of this are the establishment of a department for the production of tools; a department for the maintenance of machinery and electrical equipment; a department to service company-owned trucks and automobiles; an engineering department; a legal department; a carpentry and upholstering shop; a printing shop, and so on.

In many instances these accouterments are not added full grown as the result of a formal analysis and decision, but rather they edge into the picture, starting with the incidental, part-time activity of one or more employees, but ending up later as full-fledged departments of the plant.

In other instances these added activities are undertaken because they seem to offer cost-saving opportunities. The reasoning is somewhat as follows: because we have an established plant and organization an important portion of our costs is pretty well fixed; these costs will go on at approximately the same level whether our plant is fully or only partially used; it follows then that we can add odd jobs here and there, call them sideline or self-service activities, without causing increases in these fixed costs. In fact, in order to determine whether we should provide our own services and supplies in a particular case, we need consider only the variable costs or our existing organization, the variable costs of the added activity and, in cases where new equipment and new permanent personnel are required, certain added fixed costs. But the bulk of the fixed costs can be ignored since they will not be affected by the attachment of the additional operation. In many cases when the addition of a new activity is being considered, the management may go so far as to exclude overhead costs altogether in the computation of the costs to be added. They reason that addition of new activity should not relieve the old activities of any overhead costs.

Under the circumstances of this kind of cost calculation few vendor bids may hope to be successful, since by the self-service activity not only are the middlemen's profits and the distribution costs eliminated, but also the outside producer's profits, and even, in a sense, the producer's fixed costs. In fact, the situation practically offers a bonanza for the manufacturer. The added activities appear to be real bargains.

We are all aware of the advertising slogan, Direct from the factory to you, but here we are able to go one step farther, in effect bringing the factory right into the home.

In some cases the opportunity for cost saving is so obvious that the self-service activity is allowed to develop, or is taken over in toto, without any preliminary, formal cost studies.

But in other cases the margin of saving may not be so obvious, and the cost accountant may prepare detailed cost studies. In these, if he follows the more orthodox theory, his report will be based on the estimated incremental costs, rather than the total costs, of the added activity.

Creep Factors

It was noted above that minor side activities tend in some cases to edge into the operations of a business firm where no special thought has been given to their short-run or long-run effects upon costs and efficiency. It is also true, however, that such activities are frequently added by positive action on the basis of cost studies.

Attention is directed to the proposed exclusion of fixed costs in the decision-making process. Certain observations with respect to this exclusion appear to be in order.

First, if the company is in a position to make permanent additions to its side activities without adding to its fixed costs, something must be out of order. Fixed costs reflect capacity to operate, and they appear throughout the entire business organization. Evidently if the fixed costs can be ignored in such a calculation, the company is overequipped and overstaffed for its regular work.

Second, although it is probably impossible to have a condition of absolute balance of staff and equipment throughout the organization, the situation would be rare in which the added activity can be imposed upon the below-capacity segments of the company without in any way impinging on the fully active segments.

Third, equipment to some extent, and human beings to a considerable extent, are capable of being pressed beyond capacity limits for periods of time, but beyond these time limits something must be done to relieve them.

Finally, if idle capacity does temporarily exist throughout the company, the addition of extracurricular activities may so pre-empt that available time that it will be difficult to re-establish full-time regular operations when business conditions come back to normal.

All of this means that the fixed costs simply cannot be ignored in making the produce-or-purchase decision, unless one is to be satisfied with a very short sighted analysis. Fixed costs commensurate with the added activity will inevitably "creep" into the total cost picture, because even though there may be no immediate addition to the fixed costs, the added activity will encroach upon the available capacity, and sooner or later this will lead to an actual, though unanticipated and perhaps unrecognized, increase in fixed costs.

The creep effect upon fixed costs can develop in three general ways.

First, if the added activity is allowed to get out of hand in its growth it is obvious that more building space, more equipment, and more salaried personnel must eventually be added. This will be true even though the regular activity of the enterprise is maintained at a fairly fixed level. The question then is, would we have added this activity had we anticipated the fixed cost addition?

Second, even if the added activity is kept at a moderate level, when the main activity is increased fixed-cost increases will again be encountered. Thus, suppose a dozen men and some equipment are added in order that the company can repair its own transportation equipment. This may lead to no immediate addition of employees in the personnel department, the accounting department, or in the other administrative segments of the company; however, the later addition of one person to regular activities can bring into operation a chain of reactions in the form of salaried employee increases, salary increases, and fixed asset additions. The probabilities are that no one will recognize that the factor which really caused the fixed cost increases was the apparently bargain-price addition of the repair operations sometime earlier.

Finally, if the added activity is either kept level, or increased, it will be all the more difficult to cut down on fixed costs should subsequent reductions of the regular operations be necessary.

The Effects of Creep

The principal aim in the section just concluded was to point out that the exclusion of fixed costs in the contemplation of a produce-versus-purchase decision constitutes a dangerously shortsighted treatment of the problem; that a full quote of fixed costs will almost inevitably creep into the picture regardless of the subsequent activity trends of the regular and added operations.

What might be called a side effect of creep, although it is actually a direct-evidence of creep, is a tendency for the company to compensate unconsciously for overloads resulting from piecemeal additions of "bargain" activities. If, for example, an officer is hired to perform an administrative task under a particular set of conditions, and if then one by one a number of minor, peripheral activities are taken on by the company, the accumulation of these activities may more and more infringe upon the officer's time until through sheer necessity he is forced drastically to neglect his primary responsibilities.

Although no poll of managements has been taken on this point, it is suspected that they are not immune from creep, and one may well wonder if business efficiency and competitive vigor is not often impaired through the accumulation of these barnacles which appear to be bargain activities; in other words, activities which apparently do not add to the fixed costs.

Arguments Against Bargain Activities

At this point it may be well, again, to make clear just what sort of activity is being examined. This article does not pretend to weigh the wisdom of a decision to produce rather than purchase where the decision rests primarily (1) upon a question of public relations, or (2) on the basis of guaranteeing adequate supply when needed, or (3) on safeguarding quality, or (4) even decisions to produce rather than purchase during periods of depressed business conditions where the aim is to keep the working-force intact and to minimize idle capacity losses. Also it is recognized that new lines of production may properly be undertaken, and old ones dropped, in order to keep pace with changing market conditions. Rather, this is an appraisal of the wisdom of adding an activity, formerly provided by an outsider, on the basis of cost studies which appear to justify the added activity on the ground that fixed costs can be ignored.

The theme of this article is that a major danger in the addition of bargain activities is the creep danger. And this danger is likely to be overlooked in the case of any added activity, whether or not cost saving is the prime motive. In fact it is all the more likely to be overlooked where factors other than cost savings guide the decision.

Another type of danger lies in the fact that the company is not a specialist in the added activity, and that after it has become tied to it, with added personnel and equipment, the discontinued vendor may through research develop cost and sales price reductions which make the decision to produce completely untenable when looked upon with hindsight. Then it may be too late. Reversion to the purchase status is then blocked by prospective sacrifices in the disposal of equipment and the need for discharging personnel.

Public relations may constitute an argument on each side of the question. For instance, an entirely unsupportable contention may be made, particularly in the smaller community, that the local manufacturer should make himself as nearly autonomous as possible, since this means that he will thereby provide more jobs for local labor. Needless to say this is pure bunk. It is a form of disguised charity without the slightest scientific justification.

From the opposite point of view, it is evident that the maintenance of good public relations may actually dictate the avoidance of certain productive activities simply because the good will of the community compels the patronizing of small business firm suppliers.

From the economist's point of view, and unfortunately this argument is not likely to be very compelling with individual businessmen, it may be argued quite conclusively that a decision to produce, when based on a partial cost compilation (that is, with fixed costs excluded), is contrary to the public economic interest. In short, it constitutes mismanagement of economic resources. Just realize that the vendor's price, against which is being matched only a partial summation of costs, is high enough for him to cover not only his variable costs, but also fixed costs, and a profit margin on top of it all. If the vendor's offer, under this assumption, comes within gunshot of meeting the purchaser's variable cost computation, we are doing serious injury to our economic system if we make a decision to produce rather than buy from that vendor.

Another observation is this: activities are usually annexed, with cost saving as the reason, only when they are more or less intimately related to the primary functions of the company. Actually, however, it might be more reasonable, from the standpoint of impact on total profits, to take on completely extraneous operations -- again with the assumption that the fixed-cost factor need not be a matter of concern. Thus, the automobile company might just as reasonably open a public restaurant, a dance hall, or a bowling alley, confident that the present executives can soak up such minor administrative burdens as would be involved, and that thereby they have an edge over existing recreational establishments which require a full complement of personnel.

Creep Avoidance

As has been mentioned, earlier, some activities are added with clear recognition that no cost saving is attainable, simply because certain non-cost factors are of pressing importance. Others, the ones under consideration here, are annexed because, with fixed costs ignored, bargain rates appear to be achieved. Both kinds cause fixed cost pressures, and lead to unanticipated cost increases -- although they may not be recognized in some cases until years later. The important question is then, having brought the nature of creep into the open, what can be done to avoid it?

Among a number of defensive measures undoubtedly existing, four will be suggested here.

First, in the company's organization chart make notations of the number of individuals in each department or other subdivision of the company. From these notations calculate a series of ratios which may be called responsibility indexes. Thus, calculate the ratio of productive and non-productive employees to foremen in each of the productive and service departments of the plant; then, the ratio of foremen to plant manager or other personnel at the level above foremen. Similarly compute such ratios of responsibility through to top management, in each case using as the numerator of the ratio the number of persons who report, or for whom the person reported to is responsible.

WORKERS
FOREMEN

FOREMEN
MANAGER

Since the number of reporting persons will fluctuate, particularly at the lower levels of the organization, as productive activity fluctuates some judgement must be exercised in establishing certain of the ratios. Whether to use average ratios or ratios to reflect capacity might be debated; however, for present purposes it would seem that the ratios should be computed on a capacity basis. If, for example, the planned description of a given supervisory job is that it shall involve responsibility for receiving and analyzing reports from five persons, or responsibility for supervising the productive activities of twenty-five persons, any contemplation of additional activities should include recognition of probably immediate as well as long-run effects on the responsibility ratios. So far as possible this change should be taken into consideration in arriving at a decision.

A second safeguard in the insurance against creep consists of the exercise of caution that the comparative statement of costs is complete and correct. The costs of purchased supplies, services, etc., are likely to be compiled fairly completely, including an allowance for freight, handling, purchasing, and other incidents of the purchase. Certainly there is no justification for excluding, or overlooking, similar costs which will be incurred if the decision goes in favor of production rather than purchase. Interest on the additional investment should not be overlooked. If the question is one of production of component parts, the acquisition of raw materials is likely to cause a set of costs similar to those incurred in the purchasing of finished parts. A real risk is the likelihood of underestimating even the immediate costs of production.

A third factor to be considered in determining the advisability of adding a new activity is the relative merit of that particular activity as compared with alternatives. It would obviously be illogical to devote available equipment and energies to an operation which would provide a cost saving of a few hundred dollars when the same facilities, otherwise used, could accomplish savings of thousands. Even more foolish would be the addition of an activity of the minor cost-saving variety which might interfere with, or preclude, the later expansion of the company's main operations at a profit in excess of the expected cost-saving. Mistaken decisions of this sort constitute a principal creep danger, leading to a condition of overcrowded facilities and neglected responsibilities.

Creep, as has been emphasized, is not a short-run problem. It consists of the more or less gradual, unrecognized, cluttering up of business activity, accompanied by a parallel deterioration of company efficiency, a building up of fixed costs and the undermining of profit potential. A fourth factor in the protection against creep is that of flexibility New activities which are clearly temporary, which can be added and discarded on short notice without significant disruption, are much less likely to cause future trouble than are those which are less flexible. It is pretty well agreed that it is more difficult to dislodge an activity than it is to add one. For the classic object lesson on this point, consider the bureau of our federal and state governments. But, if an addition is to be made, at least as between two alternative activities which are otherwise equally attractive, the one which can later be abandoned the more easily is certainly the one to be chosen. It is therefore suggested that, among other things, serious consideration be given to the degree of permanance of any new plant, equipment, and especially, personnel, which may be required in undertaking an added activity.

If careful analysis indicates that the proposed activity meets the test of flexibility -- that is, if it can be dropped on short notice without serious sacrifice of personnel or of investment in inventories and fixed assets -- and if the contemplated addition is purely and unquestionably for a short-run period, then a "partial costs" schedule is appropriate. In other words, under these circumstances it is proper to prepare a schedule which is limited to the incremental costs, the costs which would be added, and to ignore prorations of existing fixed overhead items. Because of the importance of situations of this class, the point will be considered further under the next section heading.

If, on the other hand, it is contemplated that the new activity may be more or less permanently attached, as where the company will take on its own full-scale printing operations, its own engineering, or toolmaking, or component parts supply, a partial costs schedule is entirely inappropriate. In fact, this point is the crux of the whole situation. For purposes of making the decision to add an activity which may be fairly permanent, the schedule of estimated costs of production should include not only an exhaustive list of the probable added costs, but also a complete assignment of all of the overhead charges, even including administrative overhead, which through regular cost accounting techniques are properly prorated against any regular segment of the enterprise.

Add Allowance for Profit

But this is not all. In addition to the full charge for prorated and added costs, an allowance should be added for profit. That is, in order to justify the addition of a permanent new activity on the grounds of cost savings, the best available supplier's price must be shown not only to exceed the estimated full cost of production, with no apportionable costs omitted, but it should be higher by an amount at least equal to the rate of profit which the company is able to make through its principal operation.

The reasons for this fairly extreme view have been expressed earlier in this article, and it should be repeated that the requirement that full costs plus profit be included is, in fact, no more than a minimum protection against creep. Clearly the relationship between today's costs and today's purchase prices may be only a temporary one, and it is altogether too probable that the nonspecialist producer will lag behind the specialist supplier whom he has discarded in the hope of achieving production economies. Thus, the decision can easily turn sour in spite of all of the measures which have been suggested by way of protection.

Justifiable Bargain Activities

It was stated above that where the added activity is clearly intended to be temporary it is proper to base the decision on a partial list of costs. The point here is that the nonpermanence of the activity tends to insure against the creeping up of fixed costs and managerial overloads. However, the resolutions are too often forgotten, and unless positive plans are made in advance for the early abandonment of the activity, it will turn out to be a "sticky", if not permanent, activity, and the fixed costs will flow in to fill up the gaps in the cost analysis.

One form of added activity which, for example, may well be justifiable is that which can be started and stopped repeatedly to serve as fill-in work during periods of temporary lull in the principal activity of the company. Such fill-in work may even extend as long as the depression period of a business cycle, provided it can be stopped conveniently at the time of resumption of normal operations. Under such circumstances the presumption is that the regular working-force should be maintained and, from the cost point of view, the recovery of any portion of costs in excess of variable costs is preferable to their nonrecovery.

One may also justify the addition of activities on a partial cost, or bargain basis, when it is evident that substantial cost reductions will be achieved after a period of experience. In fact, costs during the initial period may be so unrepresentative of the future that they may in effect be disregarded. Also, where a company is chronically operating below capacity, and has found itself absolutely unable to expand its market, there is justification for taking over certain activities of its suppliers, provided that an already unfavorable position is not further weakened, and provided that existing fixed costs cannot be cut down to a level commensurate with existing activity. Again, however, it should be emphasized that the company should not take over "just any old activity" in which its variable costs will be less than the best outside price. A very careful survey of all opportunities for cost saving should be made before any is chosen.

Elimination of Creep

Assuming that one has already suffered a good case of creep, what steps can be taken to cure the situation? Can we apply the same tests in deciding upon the elimination of activities that we use when consideration is being given to the addition of such activities? Are the same tests applicable in reverse?

Obviously a fringe activity should not be eliminated if the potential cost of acquiring the supplies, services, etc., from outsiders is so far in excess of the costs of self-service that over-all profits would thereby be diminished. But, in exploring this possibility, what costs of production should be included?

It was pointed out above that perhaps the most potent defense against creep is a requirement that outside suppliers be used, in the case of any relatively permanent program, unless it can be proved that their offering prices are higher than the buyer's total costs plus a margin of profit. Does this mean that an existing activity should be dropped in favor of outside supply if it is found that the existing activity when charged with full costs would not show profit if it were given credit for its output at regular market prices?

In general the answer would appear to be yes, although subject to one exception. The rule may be expressed somewhat as follows: A company should divest itself of any activity which has been undertaken because of its cost-saving potential if such activity would not be added under the suggested rules for the prevention of creep. The only exception is this: If specialized machinery, equipment, housing, or other specialized fixed assets have been purchased, and are of such nature that they have no alternative full use, the depreciation and other non-separable costs of such assets can be eliminated from the calculation except to the extent that the assets have a significant present market value. In other words, the cost of such assets is "sunk" to the extent that such cost cannot be retrieved by sale or through other employment in the business, the cost may be said already to be invested in future production of the related product, and the sacrifice cannot, therefore, be avoided by the discontinuance of the activity. If, with depreciation of specialized assets modified or eliminated, it is found that a given activity, when charged with all costs usually prorated to a routine operation and "loaded" with a profit margin, is not able to compete with the price of comparable service as offered by outside suppliers, the activity should be abandoned.

The term "activity audit" might be adopted to describe a more or less continuous study of the ancillary activities of the business firm for purposes of detecting existing or potential creep.

Summary

A business firm, as it matures, is likely to accumulate an array of productive activities which were never contemplated when the company was founded. Many of these activities are added on a self-service basis as a matter of convenience, or they are added during periods of short supply, or to assure reliable quality, and for other reasons; such activities may well be continued provided that their full costs are adequately recognized and provided that management realizes what cost sacrifices are being made to achieve such convenience, etc. Many other activities, however, may have been taken on solely because of apparent cost savings, and additional activities may from time to time be contemplated. All such activities should be subjected to frequent activity audits to determine whether or not real cost advantages exist. Unless these activities are purely temporary, idle-time fillers, their continuance or addition cannot be justified on the grounds that they need be charged with only a part of the list of costs normally charged to regular, principal operations. This is true because fixed costs commensurate with the activity will inevitably creep into the operating costs structure.

Equally important, though not examined in detail in this article, are the additions of new lines of products which can be demonstrated to show a profit only because they are charged with costs on a partial, or incremental, basis. In course of time they too will cause creep.

Added activities, ranging all the way from minor service items to the production and sale of new product lines, not only create fixed costs but also tend to distract operating management from its principal objectives, and it may be no exaggeration to state that many business firms owe to creep not only the decline in their profit rates but also their ultimate failure.