ATH: Chronological Stages

- 1986: Founding
- 1989: Growth
- 1991: Push to Profitability
- 1992: Focus on Process
- 1993: New Management
ATH: Chronological Stages

**ATH Achievements**
- developed new product
- attracted new capital
- capitalized new venture
- earned-out plan
- built market share
- 4X Revenues
- first profit
- rewarded all employees
- developed a vision
- customer focused measures
- sales and earnings growth
- $60 million sales
- 52% gross margin
- $102 million assets
- $60 million accumulated R&D investment
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- We trace the evolution of ATH through five stages.
- What is the competitive environment?
  - The business is technology driven.
  - Technology is evolving rapidly, so product life cycles are likely to be short.
  - Product development pipeline is critical.
- What do you think of Scepter’s decision to purchase ATH?
  - Did they earn an appropriate return on investment?
    - The total price, if all earn-out conditions are met, is probably around $150m in 1990 dollars, after discounting at about 18%.
    - The target income for 1994 is $24m. This would need to grow substantially, and for a long period, in order to earn an appropriate ROI.
    - Is this likely given short product life cycles?
Was this a poor investment decision?

- There may have been non-financial considerations such as
  - access to new technologies and markets,
  - expansion of product portfolio, and
  - first mover advantages.

- However, the laissez-faire approach of Scepter after the purchase does not suggest the presence of operating synergies between Scepter and ATH.

Was this a poor outcome, as opposed to a poor decision?

- Perhaps, but was the earn-out structure appropriate?
  - i.e., did Scepter overpay for ATH, and
  - did the earn-out structure provide the right incentives from Scepter’s perspective?
Consider each component of the earn-out plan.

- $24m for FDA approval.
  - This is necessary, but should more have been contingent on approval and less paid up front?
    - Perhaps FDA approval was highly likely – the uncertainty was not about the technology but about the effort required to bring it to the stage necessary for approval.

- $25m for independent confirmation of superiority of technology.
  - If the technology can be appropriated, replicated or substituted, then investment unlikely to be recovered.
    - Remember from our calculation that payback period is long.
  - Should this be tied to any other part of the earn-out plan?
    - It should probably be tied to the next $90m.
    - It should probably also have been tied to the initial $60m.
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- $90m for three year sales and earnings goals.
  - Should this be independent of the $25m incentive?
  - Is it too rich, given the earnings goals? Recall our earlier calculation.
  - Is the incentive period too short?
    - There will be a severe horizon problem, and behavior may be excessively myopic given the richness of the payoff.
  - Should the sales and earnings goals be independent?
    - One provides incentives to sell, and the other to control costs.
    - On one hand, if sales are sustainable then it may be appropriate to reduce the emphasis on short-run profitability and delink the sales and earnings goals.
    - On the other hand, the independence of the two goals effectively says: we do not care about profits if you achieve sales goals. Is this the right message?
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- Should the earn-out formula be solely output-based?
  - Consider the input → process → output representation.
  - Processes are important for the long run viability of the organization, which is presumably what Scepter wants.
  - Output-based formulas are ‘hands-off’ and allow a lot of independence.
  - An absence of process controls (i.e., a process-based formula) is especially risky in this business.
    - The FDA could shut them down.
    - Litigation is likely if equipment malfunctions or leads to faulty diagnoses, since Scepter has ‘deep pockets.’
    - Reputation costs are high – poor quality may be an irredeemable failure.
So why are process controls absent?

- One reason is the perception that controls stifle innovation.
  - E.g., Universities, Berkeley, Kodak
- Another reason is the threat of litigation if managers are impeded in meeting their earn-out targets.
  - This is akin to the litigation threat faced by creditors if covenants are too tight.
- However, does this mean there should be no process controls?
  - Some process controls are probably optimal.

What process controls could have been installed?

- The new product pipeline should have been audited.
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- Reports on customer satisfaction, quality and adherence to FDA regulations should have been generated.
- A long term profit plan should have been developed, and incentives built around this.
- The annual budget, including R&D and marketing expenditures should have been negotiated.

- In the growth phase,
  - Was ATH buying market share at the expense of profits?
  - Was there a short run / long run tradeoff perhaps?
  - Should there have been some controls on discretionary expenditures?
In the push to profitability:

- Strong incentives – 20% bonus plus 2 tickets to Hawaii – were offered if profit plans were achieved.
- Are you surprised that Casper is dismayed when the FDA letter arrives?
  - “The same people who had been so thankful and committed had put the division on the brink of disaster!!”
  - Employees are not inherently good or bad. They just respond to incentives.
  - But the incentive system told his employees to focus on profit only. It said nothing about quality, and managers did not communicate the cost of poor quality.
  - The result should have been predictable, given the strength and unidimensionality of the incentive.
The focus on process phase:

- This phase was predictable even when the previous phase was initiated.
- Typically, output failures direct attention towards processes.
  - Companies respond by removing decision rights and imposing Standard Operating Procedures (SOP).
  - This takes away the benefit of local employee knowledge.
- In this case, no SOP’s were imposed, but process controls were introduced.
  - A Vision Statement was prepared. However, these are meaningless if incentives are not aligned with them.
  - Financial measures were balanced with non-financial measures.
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- New management phase:
  - Founders and other managers cashed out.
  - Sales began a precipitous decline.
    - The channel had been stuffed in the last quarter of 1994. Remember Sunbeam and Chainsaw Al?
  - The company was a shell.
    - Existing products were old.
    - New product pipeline was empty.
    - Knowledge was lost when old management team left.
  - ATH was blindsided by the competition, because it’s focus was inwards.
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Takeaways:
- divergent behaviors are predicted in the absence of control systems;
- control is more challenging where creativity and innovation are critical, and will generally be weaker in this environment;
- However, control and fostering creativity are not mutually exclusive. There is still room for qualitative measures, non-financial measures, milestones based on long term plans, and negotiated budgets;
- formal control systems should monitor inputs, processes and outputs. Input and process controls are more timely than output controls in flagging problems;
- If long run viability is the goal, short run incentives must be balanced with long run incentives, and input and process controls are more important.
Control Systems

Important control features in standard costing systems include:

- The materials price variance is isolated at purchase and recorded in a separate account. Materials inventory is debited at (actual quantity x standard cost per unit).
- This serves two purposes: (i) it makes the variance salient in a timely fashion, and (ii) it insulates downstream users (production) from this variance which they lack control over.
Control Systems

The materials quantity variance is isolated and recorded in a separate account at the time materials are requisitioned by production. Work-in-process inventory (WIP) is debited at standard price per material unit x standard quantity per output unit x actual number of output units.

Similarly, labor price and quantity variances are isolated and recorded in a separate account when labor is used. WIP is debited at standard wage x standard hours per output unit x actual number of output units.