CASE STUDY: DOWNSIZING STRATEGY INFLUENCE ON THE STRUCTURE OF THE FIRM

Alfonso Herrero de Egaña Espinosa de los Monteros*
Carmen Soria Bravo**

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This case study analyzes the effectiveness of the downsizing strategy in the Telefonica through the Event Study method. An event study is designed to examine market reactions to excess returns around specific information events. The information events can be market-wide, such as macroeconomic announcements, or firm specifics, such as downsizing announcements. The question of whether the excess returns around the announcements are different from 0 is answered by estimating the t statistic for each day, by dividing the average excess return by the standard error. If the t statistics are statistically significant, the event affects the returns; the sign of the excess of returns determines whether the effect is positive or negative. Teaching notes for each section are included.

1. INTRODUCTION

We can see every day in the press how a great number of companies carry out reductions in the size of their business units, restructuring themselves around their core competencies in order to achieve greater flexibility and efficiency improvements.

Downsizing is defined in this study as a strategy that aims to improve business results by reducing the resources of a business unit, adjusting the organizational structure to the new strategy and environment. This trend is

* Alfonso Herrero de Egaña Espinosa de los Monteros, Facultad de Ciencias Económicas y Empresariales, Departamento Economía Aplicada y Estadística - Despacho 1.20, C/Paseo Senda del rey nº 11, 28040 Madrid, Spain, Phone: +34.609.90.67.55, E-mail: alherrero@cee.uned.es

** Carmen Soria Bravo, C/Balandro, Nº14 2ªA, 28042 Madrid, Spain, Phone: +34.629.28.52.19, E-mail: csoriabravo@telefonica.net
observed in industrial and service sectors (Littler, 1998; Gandolfi, 2007) and is present globally in the U.S., Europe, Asia and specifically in Spain (Morris, Cascio & Young, 1999; Dahl and Neshheim, 1998; Suarez, 2000).

2. DOWNSIZING AS A STRATEGIC ALTERNATIVE

There is not a single downsizing definition accepted by all researchers (Davis, Savage, Steward & Chapman, 2003). This research, within the systemic changes, conceptualizes downsizing as a strategic alternative that includes different combinations of decreases in physical systems, and human and organizational aspects to adjust the company to the competitive conditions (DeWitt, 1998).

Intention, timing and effects on work processes and staff are the main characteristics of the term downsizing, and differentiate this strategy from other related terms, such as the decline, which is not intended. Downsizing is also implemented in periods of growth, although layoffs can be considered as a consequence of the strategy, but not the strategy itself.

The downsizing model proposed by DeWitt (1998) presents three strategies that represent a range of possibilities between retention and abandonment of the industry. Based on different physical and personnel reductions related to the company’s competitive positions, the and mobility barriers are the source of information to select the strategy of downsizing. This downsizing classification is also used in the studies of Grennhalg, Lawrence and Sutton 1998, and Budros 2002.

![Figure 1: Downsizing strategies based on resource reductions](source: DeWitt (1998))
• *Retrenchment* or cost reduction: the strategy is based on improving productivity by reengineering processes, product concentration and redundant work elimination (Feeman & Cameron, 1993).

• *Downscaling*: this strategy maintains the activities of the company, but reduces the output level to suit the demand. This means reductions of human and physical resources, sacrificing the benefits of scale for adapting to demand cycles (Kotler, 1986).

• *Downscoping or Refocusing*: reduces the scope of activity by decreasing vertical or horizontal differentiation (Johnson, 1996; Markides, 1995).

To select the downsizing strategy, three factors should be analyzed: firm resources, investment, and activity field. Firm resources can create competitive advantages, but they also reduce the mobility and exit of the industry. Thus, a downsizing strategy could be satisfactory if selling resources at the market generate more value than keeping them in the organization. Second, if the company has made recent investments in capacity or products, it is possible to achieve higher revenues (Caves & Porter, 1976), but it also limits the scope reduction strategy, so a retrenchment approach is more likely. Finally, if the company has wide fields of activity, factors related to business are more important than the industrial ones.

Depending on the specific objectives pursued, one will select one of the resource reduction strategies (Gresov, 1989, Drazin & Van de Ven 1985). Thus, the Retrenchment is more likely when a firm has not invested in the capacity and product and tries to take advantage operating at maximum capacity, or when competitors have made investments. Downscaling involves the removal of large factories, so it will be done when the company has a wide field of activity and has not invested in the product or capacity, or in case of fall in demand. Downscoping reduces the variety or output produced, so it is more effective if the company has a wide field and has not recently invested in capacity.

The fit concept has been a central idea in the success of organizations (Nadler & Tushman, 1988). Following the system approach, organizational fit occurs when the organizational design balances all the contextual factors of the organization and its internal variables. Thus, with the Nadler and Tushman model, organizational effectiveness is due to the adjustment of its components.
It includes the conditions under which the organization operates, the company’s strategy that defines managerial decisions about the relationship with the environment, thus its mission, how it competes, the objectives and the structure. Results indicate the efficiency and effectiveness level in achieving the goals.

The model central idea is that organization effectiveness depends on the fit degree between the different components. Thus, implementation of downsizing strategies alter, if necessary, the structural design of the company, modifying structures, processes and methods to facilitate individual performance, and allowing the correct downsizing implementation (Miles & Snow, 1995; Worley & Lawler, 2006). Structural movement will depend on the selected downsizing strategy and the structure that exists in the organization since it will try to adjust to the environmental change and reallocate human resources to new activities.

Managers can act and correct formal design variables, which makes the formal structure important within the structural organization. Therefore, this study focuses on the fit between the strategy and formal structure of the company. Sutton and D’Aunno (1989) propose two structural movements:

- Long-term movements towards mechanical structures: present high levels of centralization and standardization.
- Movements towards organic structures: personnel expertise is the mechanism of coordination and control.
Table 1. Teaching notes – Downsizing as a strategic alternative

<table>
<thead>
<tr>
<th>Instructional direction</th>
<th>Student understanding</th>
<th>Discussion or simulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Show the objectives that the different downsizing strategies try to achieve.</td>
<td>• Students should know the variables to be analyzed in downsizing strategies.</td>
<td>• Introduce a discussion: is downsizing a long-term optimal strategy?</td>
</tr>
<tr>
<td>• Provide lists of various firms that implemented downsizing strategies, and discuss about which ones took the appropriate decision according to their strategy and environment.</td>
<td>• Students should be able to differentiate between downsizing strategies and layoffs or decline situations.</td>
<td>• Introduce a discussion: when layoffs are a consequence of a strategy; and when they are implemented without considering the firm strategy.</td>
</tr>
</tbody>
</table>

3. PROPOSAL FOR ANALYSIS

Based on the necessary adjustment between strategy and structure, the model should analyze the downsizing strategy, the sector and company characteristics, considering whether there have been structural movements associated with different strategies to achieve the objectives of efficiency, productivity and competitiveness pursued by the company. That is, the model should consider whether the proper relationship between the strategy of downsizing and corporate structure causes an increase in the results.

Figure 3. Analysis model
• Retrenchment strategy is characterized by a specialized production, concentrating activities to achieve economies of scale. Structures tend to mechanical models, with increased levels of standardization, formalization and centralization.

• Downsizing strategy is associated with structural movements, aimed at organic configurations. These structures have low levels of horizontal differentiation and standardization, but high levels of vertical differentiation and centralization.

• Downscooping strategies reduce the product-market complexity level leading to less differentiation of activities. If the reduction of complexity is caused by the elimination of products or customers, the organization tends to matrix structures. On the other hand, if the complexity is reduced due to the elimination of activities in the value system, the primary structure will continue with the same configuration but reducing the differentiation and standardization levels, so it will configure virtual structures or company’s networks.

This case study focuses on downscooping strategies because, according to business evidence, most diversified firms held a lower diversification level since the ’90s, and downscooping is the most common strategy (Markides, 1995). The analysis is based on a case study that, as it is shown in several studies (Hartley, 1995), allows the analysis of one or more organizations to examine a contemporary phenomenon in its own context. This analysis is also particularly relevant in research areas where there are complex processes with several variables.

The results of the case are analyzed by their value on the stock market. In addition to the results analysis, it is necessary to test whether the downsizing strategies implemented have had an effect on them. For this analysis, we used a statistical event study. Hotchkiss & Stricklan (2003) use this methodology to analyze mergers, explaining how financial investors act according to the information issued by the company.

However, financial markets react not only to the event, but to the information itself, so it is necessary to create temporal windows of events in which to analyze the effect on profitability. The event date is the time that the information provided by the company has an effect, or the dates around which the event takes effect. This study refers to downscooping strategies, so it considers a time window of four months prior to the finalization of the sale of the business, and four months after it. The relevant facts reported by the company are the basis for calculating these time frames because they are
considered as all the information that will affect investors to buy or sell securities.

![Monthly Performance Timeline](image)

*Figure 4. Definition of the analysis period in an event-study*

In this study, we should analyze a growing sector at the same time that downsizing strategies were conducted, so that these strategies could be analyzed isolated from the effect or economic decline. Thus, the empirical study was conducted in the telecommunication sector. Telecommunication is an expanding industry where some of the factors defined as relevant in the selection of the downsizing are present, such as the investment in specific assets, movements in demand and the activity scope.

*Table 2. Teaching notes – Proposal for analysis*

<table>
<thead>
<tr>
<th>Instructional direction</th>
<th>Student understanding</th>
<th>Discussion or simulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Introduce students to the strategy and structure adjustment in order to increase results.</td>
<td>• Students should understand the relationship between strategy and structure.</td>
<td>• Have a discussion about structural movements caused by the strategy selected.</td>
</tr>
<tr>
<td>• Analyze what steps should be followed to carry out a strategy of downsizing.</td>
<td>• Students should understand the relation between existing firm characteristics and the strategy selected.</td>
<td>• Have a discussion about how different firms implemented these strategies and the results they have obtained.</td>
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</table>

4. EMPIRICAL ANALYSIS - THE CASE OF TELEFÓNICA S.A.

The telecommunications sector has undergone a structural change due to the processes of deregulation conducted since the early '90s that made
companies analyze the business they were in, redefining the activities – before that date, most of the telecommunication companies were public and operated as a monopoly in their local markets.

As indicated in the study of López (2002), globalization changes trade patterns, increasing company internationalization, which allows exploiting global technological and organizational advantages, decreasing costs, entering new markets and diversifying investment risks. In this global market, Telefónica has continuously transformed its business, evolving from a local company to a multinational monopoly that operates in four continents with a high operating efficiency. This transformation is due to external factors, such as technological development and sector liberalization; as management factors which have been modified to adjust to the environment.

Since the late ’80s, the liberalization of the sector in almost all countries combined with removing barriers to foreign capital inflows generated Telefónica internationalization opportunities by acquiring companies already established in other countries. This was the period in which the Telefónica Group experiences a high geographic growth, which began in Latin America, that represents the expansion centre, and in Eastern Europe.

The new integrated multinational perspective allowed cost savings, economies of scale, and synergies; by common products and services promotion, branding, networking rationalization and knowledge transfers within the group. Technology standards, suppliers and common products also increase Telefónica’s negotiation power.

The search for efficiencies also led the company to gradually segregate resources and activities that are not within their core business. Thus, the Shared Service Centres were created as shared drives between different lines of business to manage administration activities in market conditions. These units allowed economies of scale and provided business flexibility by changing fixed costs to variable ones. They also permitted different units to focus their resources in their core business and avoid the multiplication of staff units.

Other divestments in this period are clearly related to downsizing strategies, carried out by the gradual exit from the non-strategic business activity of the group as a subsidiary of public telephones, data transmission or installing equipment lines.
With this new scenario, Telefónica centred its development over the next three years, based on three sources of growth:

- Further strategic alliances in non-core businesses
- Latin America expansion
- Business development and acquisition agreements. It is important to emphasize the media business, which tries to maximize the value of Telefónica distribution networks and strengthen the capacity of creation and exploitation of content. During 2000-2003, Telefónica Media was developed through agreements and acquisitions, as Endemol, Via Digital TV and Antena 3 in Spain or through Telefé and Canal Azul in Argentina.

From 2003, Telefónica focused its management priorities on strengthening its position in key markets and improving operational efficiency, continuing with the cost control policy and investment, by divesting in businesses that had not reached the projected development. Thus, the business of Telefónica Media, which developed greatly since 2000, suffers divestiture and reorganization processes from the year 2003 because thanks to Telefónica’s size, Telefónica could negotiate, with advantage, the broadband content without being tied to a specific production company. This downscoping strategy culminates when Endemol was sold in 2007. At the same time, Telefónica performed investment rearrangement processes of non-strategic assets, such as Airwave, specialized in digital security communications, or TPI, specialized in the telephone directory market.

Parallel to this process of divestment, since 2005 Telefónica concentrated its activities in the telecommunications business, expanding their business in the Value Added Services and digital content. The key business grew geographically, emphasizing the acquisition of all shares of O2, the 50% of Colombia Telecomunicaciones SA, later renamed Telefónica Telecom, the increased participation in Telecom Italia and the entry and increased participation in China Netcom Group. In addition to the development along these years, Telefónica changed its structure to fit the strategy defined by the following phases:

- In 1994, a structure focused in business lines, markets, customers and products was approved. The corporate centre in turn guided the group’s strategy and carried out planning, corporate finance and institutional relations. Finally, two units of shared resources and infrastructure provided support to business units.
- In 1999, a new structure was created to take advantage of geographical business opportunities and new business lines due to the growing
During the following years, the business line structure was maintained, showing the development of several units and the subsequent restructuring of them.

In 2006, refocusing strategy to core business concluded, and Telefónica adopted a regional and integrated management model. Three units were created, each one responsible for fixed and mobile assets in Spain, Europe and Latin America.

This continuous adjustment of the structure with the strategies allowed that the Group found the right mix in scale and business diversification, by activity and geographical areas. This mix leverages the growth in several businesses and extracts the value of scale and diversity through integrated management. The greater business integration of Telefónica also allows carrying out global projects in infrastructure and systems, and centralizing purchasing activities such as trade or convergence products, services and distribution channels.

On the other hand, the regional management can focus on the customer, allowing the development of products and services to be carried out dynamically with the market. The customer focus strategy led to structural movements toward organic configurations, increasing the importance of knowledge throughout the organization, lateral communication and decision making based on information and advice rather than on instructions and decisions.

Higher levels of operational efficiency also enabled the company to act within the requirements of the current competitive environment, gradually reducing investment. In this sense, efforts in information systems and in established businesses layoffs, mainly in the fixed line business, have been important. It is noteworthy that the layoff plans proposed aimed to ensure the competitiveness of established businesses in the new market environment, and were based on the principles of voluntariness, universality and non-discrimination of the employees, incorporating functional and geographical adaptation procedures for the employees that stay connected with the company, as well as specific training plans to cover new professional profiles required by the environment.

All these movements confirm that downsizing processes were implemented in a systemic way, making the company grow in resources, while reducing in size the different units to make them more flexible. The return to shareholders,
during the analyzed period of 15 years, has had the annual average of 19.1%, higher than the IBEX 35 (Fernandez & Carabias, 2007).

Table 3. Telefónica profitability from 1992 to 2007

<table>
<thead>
<tr>
<th>Year</th>
<th>Shareholders' return (million EUR)</th>
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<tbody>
<tr>
<td>1992</td>
<td>-2.5%</td>
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<tr>
<td>1993</td>
<td>69.2%</td>
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<tr>
<td>1994</td>
<td>-13.7*</td>
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<tr>
<td>1995</td>
<td>11.3%</td>
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<tr>
<td>1996</td>
<td>84.4%</td>
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<tr>
<td>1997</td>
<td>46.8%</td>
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<tr>
<td>1998</td>
<td>53.9%</td>
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<tr>
<td>1999</td>
<td>104.4%</td>
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<td>2000</td>
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<td>2007</td>
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<td>2008</td>
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</table>

Table 4. Telecommunication companies’ profitability

<table>
<thead>
<tr>
<th>Year</th>
<th>AT&amp;T Inc</th>
<th>China Mobile Hong Kong</th>
<th>Deutsche Telekom</th>
<th>France Telecom</th>
<th>NTT (XSO)</th>
<th>NTT Dooco</th>
<th>American Movile SA</th>
<th>Sprint Nextel</th>
<th>Telecom Italia</th>
<th>WorldCom</th>
<th>BellSouth</th>
<th>Telefónica Moviles</th>
<th>Telecom Italia</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>169.737</td>
<td>84.432</td>
<td>96.875</td>
<td>92.879</td>
<td>92.749</td>
<td>46.643</td>
<td>-</td>
<td>38.281</td>
<td>3.944</td>
<td>49.556</td>
<td>48.081</td>
<td>-</td>
<td>47.034</td>
</tr>
<tr>
<td>2004</td>
<td>177.746</td>
<td>66.786</td>
<td>93.802</td>
<td>73.857</td>
<td>73.857</td>
<td>49.431</td>
<td>-</td>
<td>37.023</td>
<td>3.944</td>
<td>49.556</td>
<td>52.302</td>
<td>-</td>
<td>37.023</td>
</tr>
<tr>
<td>2005</td>
<td>132.757</td>
<td>35.782</td>
<td>108.273</td>
<td>126.278</td>
<td>126.278</td>
<td>33.431</td>
<td>-</td>
<td>42.666</td>
<td>3.944</td>
<td>49.556</td>
<td>50.095</td>
<td>-</td>
<td>33.431</td>
</tr>
<tr>
<td>2006</td>
<td>146.132</td>
<td>172.303</td>
<td>104.605</td>
<td>93.698</td>
<td>93.698</td>
<td>41.480</td>
<td>-</td>
<td>42.666</td>
<td>3.944</td>
<td>49.556</td>
<td>50.095</td>
<td>-</td>
<td>41.480</td>
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<tr>
<td>2007</td>
<td>198.564</td>
<td>354.154</td>
<td>154.730</td>
<td>93.698</td>
<td>93.698</td>
<td>41.480</td>
<td>-</td>
<td>42.666</td>
<td>3.944</td>
<td>49.556</td>
<td>50.095</td>
<td>-</td>
<td>41.480</td>
</tr>
</tbody>
</table>
Regarding the profitability of the largest companies, Telefónica was ranked third in the period 2003-2007, and by capitalization, it has moved from the 12th position to second in 2008.

In the event-study, we analyzed specifically four downsizing decisions taken by Telefónica: the divestment of Antena 3 TV, TPI, Airwave and Endemol, as shown below.

Data was taken from the Telefónica stock market prices during the period 2000-2007. During these years, Telefónica carried out the downsizing strategies that are analyzed. Data of the two index prices against which the events are to be analyzed were taken during the same periods. Dow Jones was selected as an index of Industrial Average, an efficient market; and the S&P 500, which is commonly used as a proxy for the market as a whole, was the second selected index. The IBEX index was removed from the study because Telefónica S.A. capitalization represents 15-20% of the total capitalization index, which distorts the result.

By definition, a market has a beta, which represents the trend or slope of the same. Individual companies that participate in the market are classified according to their deviation from that market. Once the time windows are defined, betas are calculated for Telefónica and each of the indices, calculated

Figure 5: Business Divestitures Analysis

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By definition, a market has a beta, which represents the trend or slope of the same. Individual companies that participate in the market are classified according to their deviation from that market. Once the time windows are defined, betas are calculated for Telefónica and each of the indices, calculated
outside the time window under study, taking into account a period 10 times superior to the time window. The expected returns of the company, during each time window, are calculated and compared with each selected index, thus rentability variation due to the event analyzed is as follows:

\[ \text{ER} = R_{\text{TEL}} - \beta R_{\text{index}} \]

Expected returns were calculated based on the high, low and closing prices, for having a wide range of returns for each period. To find whether the excess return on the time window is different from zero, one should analyze the t-student value, dividing the average return variation in the time window by the standard error obtained. If the t-student is statistically significant, the event influences the results of the company.

Analyzed results are statistically significant and show extraordinary results associated to the months following the implementation of the downsizing strategy, as shown by following figures.

Figure 6. Event-study results related to Dow Jones
Figure 7. Event-study results related to S&P 500

Table 5. Teaching notes – Empirical analysis - the Case of Telefónica SA

<table>
<thead>
<tr>
<th>Instructional direction</th>
<th>Student understanding</th>
<th>Discussion or simulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Define the Event study as a method to calculate result variations as a consequence of information.</td>
<td>Understand the relation of information announcements and different variables.</td>
<td>Have a discussion about how a firm should focus a divestment announcement.</td>
</tr>
<tr>
<td>Provide a list of government information and how it influences the stock market.</td>
<td>Students should understand the effect that information has on the stock market.</td>
<td>Analyze the effects of the information that government and market analysts present on the risk level of several countries.</td>
</tr>
</tbody>
</table>
5. CONCLUSIONS AND FUTURE RESEARCH

Telefónica, before undertaking downsizing strategies, showed some ratios and return values lower than those obtained after carrying out these strategies. This is due primarily to the perceived Telefónica risk, which is less in carrying out the downsizing strategies since it focused on sectors in its core business. Consequently, the expected return is higher and the value of the shares increases. Additionally, the debt market values the situation of the company, which allows to reduce operational risk and obtain a better treatment of credit institutions in financing its core business, such as purchase or increase participation in Cesky Telecom, O2 or Telecom Italia. All this promotes the creation of the Telefónica market value.

In summary, in this period of just 15 years, we can observe Telefonica’s growth and development. However, at the same time, Telefónica has also carried out downsizing strategies for achieving a better fit with the environment, among which are:

- Non-strategic activities’ concentration on shared units, so as to achieve synergies and economies of scale.
- Activities of the value system not associated to strategic activities were eliminated of its business portfolio.
- Focus on core businesses.
- Constant adjustment of the structure of the firm with the strategy developed.

These downscoping strategies were carried out with clear objectives of increasing the efficiency of resources. They also took place in a specific moment in time and were proactively planned, trying to anticipate the environmental changes. They were implemented as a systemic change, affecting the entire organization, its structure, its processes and its staff. Downsizing is a strategic alternative that allows a better adaptation to the environment, and that should not only be associated with situations of decline or business decrease.

Future research will focus on the verification of the proposed model, in other sectors and in the variables associated to the model. Expanding the database, research could examine the adequacy of the downsizing strategy and sector characteristics of the company, comparing it to the strategies carried out by Telefónica with Deutsche Telecom and Telecom Italia. This would analyze whether different strategies have caused differences in value creation.
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**STUDIJA SLUČAJA: UTJECAJ STRATEGIJE SMANJENJA BROJA ZAPOSLENIH NA STRUKTURU PODUZEĆA**

**Sažetak**

U ovoj studiju slučaja, analizira se učinkovitost strategije smanjivanja poduzeća i radne snage na primjeru Telefonice, koristeći metodu proučavanja događaja. Proučavanjem događaja se analiziraju reakcije tržišta na natprosječne prinose, koji se javljaju oko objave specifičnih informacija. Ove informacije mogu biti zajedničke za cijelo tržište (npr. makroekonomske priorde), ili specifične za poduzeće (kao što je nacija smanjivanja veličine poduzeća, otpuštanja, itd.). Na pitanje jesu li natprosječni prinosi u vrijeme oko najave različiti od nule analizira se procjenom vrijednosti statističkog t-testa za svaki od dana, dijeljenjem prosječnog natprosječnog povrata sa standardnom greškom. Ukoliko su vrijednosti statističkog t-testa značajne, navedeni događaj djeluje na prinose. Predznak prinosa određuje je li efekt pozitivan ili negativan. Za svaki od dijelova studije slučaja, dane su i bilješke za korištenje u nastavi.