



MACHAKOS UNIVERSITY

University Examinations 2019/2020 Academic Year

SCHOOL OF PURE AND APPLIED SCIENCES

DEPARTMENT OF MATHEMATICS AND STATISTICS

FOURTH YEAR SPECIAL /SUPPLEMENTARY EXAMINATION FOR

BACHELOR OF SCIENCE (STATISTICS AND PROGRAMMING0)

SST 401: DECISION THEORY

DATE: 20/1/2021

TIME: 8.30-10.30 AM

INSTRUCTIONS TO CANDIDATES

Attempt question *one (compulsory)* and any other *two questions*.

QUESTION ONE (30 MARKS)

- a) Explain the meaning of the following terms as applied in decision theory
- Maximin rule
 - Opportunity loss
 - Roll-back technique
 - Outcome (8 marks)
- b) State and explain two types of nodes used in construction of decision trees. (4 marks)
- c) Differentiate between Marginal loss and Marginal profit. (4 marks)
- d) A businessman has three alternatives open to him each of which can be followed by any of the four possible events. The conditional payoff(insh) for each action-event is as shown below;

Alternatives	Payoff conditional on events			
	A	B	C	D
P	8	0	-10	6
Q	-4	12	18	-2
R	14	6	0	8

Determine which alternative should the business choose, if he adopts the

- i. Equally likely criterion. (4 marks)
 - ii. Minimax regret criterion. (4 marks)
- e) The marginal loss on Washington Reds, a brand of apples from the state of Washington is \$35 per case and the marginal profit is \$15 per case. During the past one, the mean sales of Washington Reds in cases was 45000 cases and the standard deviation was 4450. Assuming that the sales follow a normal distribution, determine how many cases of Washington Reds should be brought to the market. (6 marks)

QUESTION TWO

- a) Rick Miller has just opened a new bakery in Frisco, Colorado, called morning Fresh. In performing an economic analysis, Rick has determined that the marginal cost or loss for each dozen doughnuts sold is \$4. The marginal profit is estimated to be \$2.75 per dozen doughnuts. At this time Rick is considering stocking 10, 15, 20, 25, or 30 dozen doughnuts. The probability of selling 10 dozen doughnuts is 10%, 15 dozen doughnuts is 20%, and 30% chance that the bakery can sell either 20 or 25 dozen doughnuts. There is also 10% chance of selling 30 dozen doughnuts, which is considered by Rick to be the most that Morning Fresh would accommodate. Use marginal analysis to advise Rick. (8 marks)
- b) A company has three different security systems models namely: standard, deluxe, and super. An analysis of the probable acceptance of the models has been carried out and the pay-off table is shown below;

Model acceptance	Acceptance probability	Profit sh'000' (Model type)		
		Standard	Deluxe	Super
Excellent	0.2	60	100	20
Moderate	0.5	40	60	80
Poor	0.3	20	0	-40

- i. Decide which model should be introduced to the market using:
 - Expected pay off criterion (4 marks)
 - Maximax decision criterion. (4 marks)

- ii. In the context of this question outline briefly the limitations of the two decision criteria used. (2 marks)
- iii. What would be the value of knowing the model acceptance level before making the decision on which model to produce? (2 marks)

QUESTION THREE

- a) An investor is considering two alternatives-stocks A and stock B for which he has ksh 35000 to invest. Stock A offers 0.5 probability of doubling the investment and a 0.5 probability of losing 60 percent of the entire amount. Stock B has a 0.3 probability of doubling the stock and 0.7 probability that 60 percent of the amount invested will be lost. The investor is considering three options:

- i. To invest the complete amount in stock A
- ii. To invest the complete amount in stock B
- iii. To invest half the amount in stock A and keep half the amount

He has the following utilities for the change in his assets,

Ksh 70000=1, Ksh 35000=0.7, -ksh 10500=0.4 and -ksh 21000=0

Construct payoff utility tables for each option and select the best option. (10 marks)

- b) A tire manufacturing company wants to select one of three feasible prototypes designs for a new longer-wearing radial tire. The costs of making the tires are as follows

Tire	Fixed cost(sh)	Variable cost per unit (sh)
A	60,000	30
B	90,000	20
C	120,000	15

There are three levels of units sales: 4,000 units, 7,000 units, and 10,000 units; the respective probabilities are 0.3, 0.5 and 0.2. The selling price is sh 75 per tire

- i. Construct the payoff table using total profit as the payoff measure. (4 marks)
- ii. Determine the expected payoff for each act and choose the best. (4 marks)
- iii. Calculate the expected value of perfect information (EVPI). (2 marks)

QUESTION FOUR

- a) In the past few years, the traffic problem in Lynn McKell's hometown have gotten worse. Now, Broad street is congested about half the time. The normal travel time for Lynn is only 15 minutes when Broad Street is used and there is no congestion. With congestion, however, it takes Lynn 40 minutes to get to work. If Lynn decides to take the expressway, it will take 30 minutes regardless of the traffic conditions. Lynn's utility for travel time is (15minutes) =0.9, $U(30\text{minutes}) = 0.7$, $U(40\text{ minutes}) = 0.2$
- Determine which route will minimize Lynn's travel time. (5 marks)
 - Determine which route will maximize Lynn's utility. (4 marks)
 - With a reason is Lynn a risk seeker or a risk avoider. (1 mark)
- b) The following payoff table provides the profits for each of four alternatives in each of the three states of nature;

Alternatives	States of nature		
	A	B	C
1	120	60	-20
2	90	80	100
3	81	81	81
4	-50	90	110

The probabilities for the states of nature are; $P(A)=0.8$, $P(B)=0.1$, and $P(C)=0.1$

- Develop the opportunity loss table. (4 marks)
- Hence use the Expected opportunity Loss value to determine the best decision. (6 marks)

QUESTION FIVE

- a) An electrical company has to decide whether to develop a new type of security device. If it does go ahead, successful completion depends on a research breakthrough. There is thought to be a 60 per cent chance of achieving. If the device is successfully developed, the payoff is a profit of \$900000; if the development is attempted but not completed, there will be a loss of \$400000. All overheads and other sunk costs should be ignored.
- Draw a decision tree for the information (3 marks)
 - Determine the expected monetary value (EMV) of the whole decision (2 marks)

- iii. Explain whether the term “perfect information” mean that the payoff of \$900000 would certainly be achieved (2 marks)
 - iv. Calculate the expected value of the perfect information. (3 marks)
- b) Developing a small driving range for golfers of all abilities has been a desire of John. He however, believes that the chance of a successful driving range is only about 40%.A friend of John has suggested that he conduct a survey in the community to get a better feeling of the demand for such a facility. There is a 0.9 probability that the research will be favorable if the driving range facility will be successful. It is also estimated that there is a 0.8 probability that the marketing research will be unfavorable if indeed the facility will be unsuccessful. Using Bayes theorem determine the chances of a successful driving range given a favorable result from the marketing survey. (10 marks)