

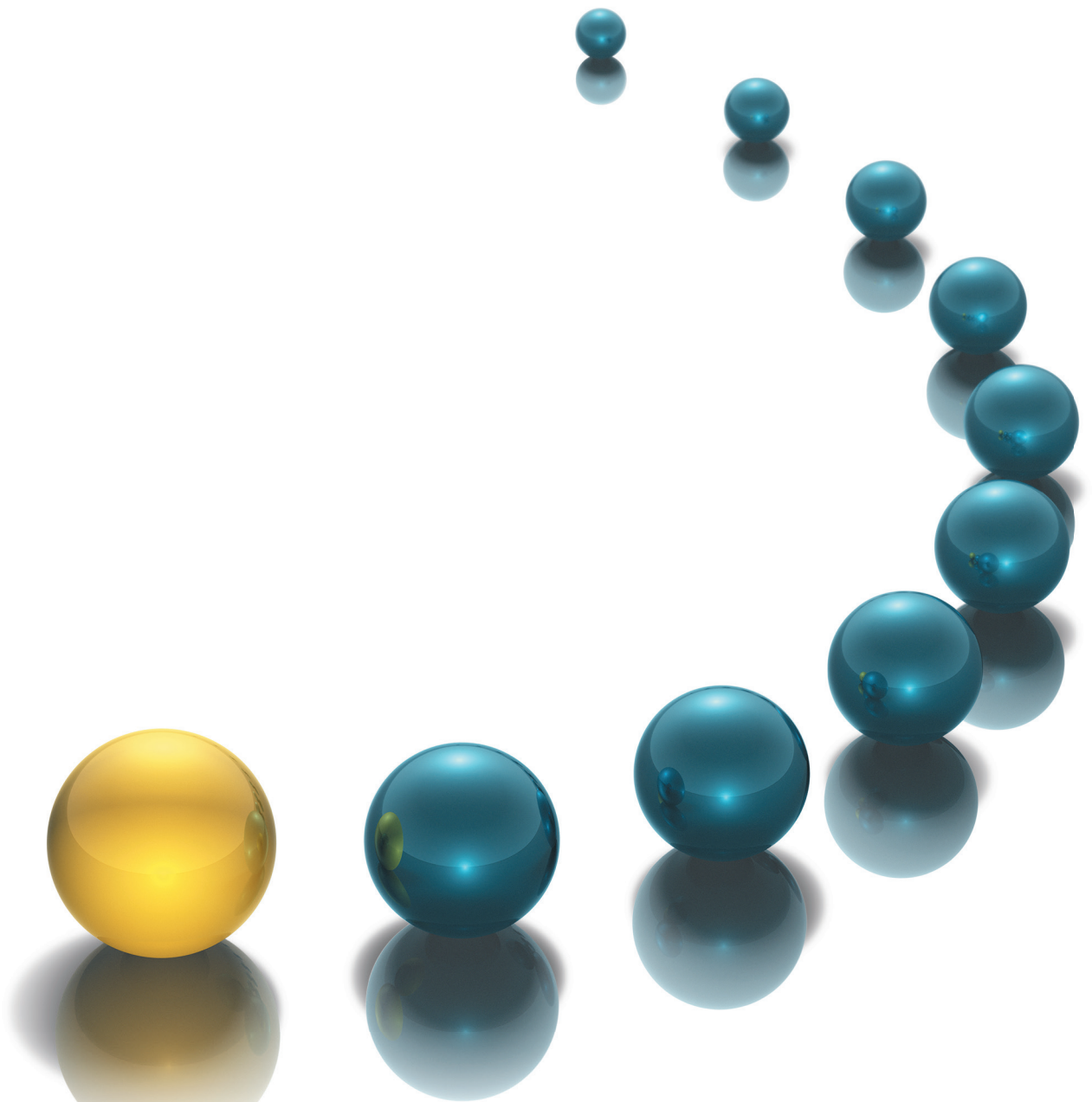
ROBERT STINE

DEAN FOSTER

Statistics for Business

Decision Making and Analysis

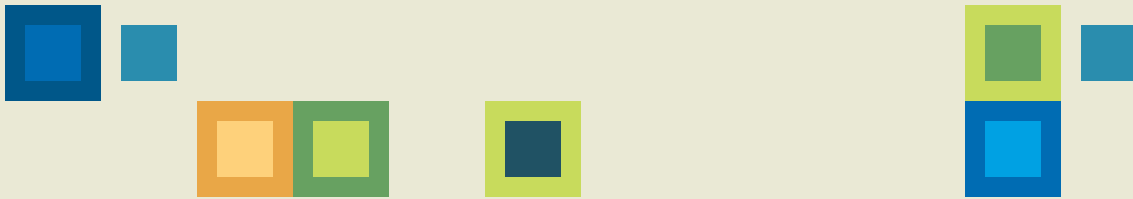
Third Edition



Statistics for Business

DECISION MAKING AND ANALYSIS

THIRD EDITION



ROBERT STINE

Wharton School of the University of Pennsylvania

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Bob Stine and Dean Foster (along with Richard Waterman) have co-authored two casebooks: *Basic Business Statistics* (Springer-Verlag) and *Business Analysis Using Regression* (Springer-Verlag). These casebooks offer a collection of data analysis examples that motivate and illustrate key ideas of statistics, ranging from standard error to regression diagnostics and time series analysis. They also have collaborated on a number of research articles.

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CONTENTS

Preface xi

Index of Application xxi

PART I

Variation

1 Introduction 2

1.1 What Is Statistics? 2

1.2 Previews 4

2 Data 10

2.1 Data Tables 11

2.2 Categorical and Numerical Data 12

2.3 Recoding and Aggregation 14

2.4 Time Series 17

2.5 Further Attributes of Data 18

Chapter Summary 22

3 Describing Categorical Data 26

3.1 Looking at Data 27

3.2 Charts of Categorical Data 28

3.3 The Area Principle 33

3.4 Mode and Median 38

Chapter Summary 42

4 Describing Numerical Data 51

4.1 Summaries of Numerical Variables 52

4.2 Histograms 57

4.3 Boxplots 59

4.4 Shape of a Distribution 62

4.5 Epilog 68

Chapter Summary 72

5 Association between Categorical Variables 80

5.1 Contingency Tables 81

5.2 Lurking Variables and Simpson's Paradox 89

5.3 Strength of Association 92

Chapter Summary 100

6 Association between Quantitative Variables 109

6.1 Scatterplots 110

6.2 Association in Scatterplots 111

6.3 Measuring Association 114

6.4 Summarizing Association with a Line 120

6.5 Spurious Correlation 123

6.6 Correlation Matrix 126

Chapter Summary 129

CASE: STATISTICS IN ACTION Financial Time Series 140

CASE: STATISTICS IN ACTION Executive Compensation 148

PART II

Probability

7 Probability 156

7.1 From Data to Probability 157

7.2 Rules for Probability 161

7.3 Independent Events 166

Chapter Summary 170

8 Conditional Probability 179

8.1 From Tables to Probabilities - 180

8.2 Dependent Events 184

8.3 Organizing Probabilities 187

8.4 Order in Conditional Probabilities 190

Chapter Summary 195

9 Random Variables 202

9.1 Random Variables 203

9.2 Properties of Random Variables 205

9.3 Properties of Expected Values 211

9.4 Comparing Random Variables 214

Chapter Summary 216

10 Association between Random Variables 224

10.1 Portfolios and Random Variables 225

10.2 Joint Probability Distribution 227

10.3 Sums of Random Variables 230

10.4 Dependence Between Random Variables 232

10.5 IID Random Variables 236

10.6 Weighted Sums 239

Chapter Summary 243

11	Probability Models for Counts	251
11.1	Random Variables for Counts	252
11.2	Binomial Model	254
11.3	Properties of Binomial Random Variables	255
11.4	Poisson Model	259
	Chapter Summary	265
12	The Normal Probability Model	270
12.1	Normal Random Variable	271
12.2	The Normal Model	274
12.3	Percentiles	280
12.4	Departures from Normality	282
	Chapter Summary	290
	CASE: STATISTICS IN ACTION Managing Financial Risk	298
	CASE: STATISTICS IN ACTION Modeling Sampling Variation	306


PART III
Inference

13	Samples and Surveys	314
13.1	Two Surprising Properties of Samples	315
13.2	Variation	320
13.3	Alternative Sampling Methods	323
13.4	Questions to Ask	326
	Chapter Summary	329
14	Sampling Variation and Quality	334
14.1	Sampling Distribution of the Mean	335
14.2	Control Limits	340
14.3	Using a Control Chart	344
14.4	Control Charts for Variation	347
	Chapter Summary	354
15	Confidence Intervals	362
15.1	Ranges for Parameters	363
15.2	Confidence Interval for the Mean	368
15.3	Interpreting Confidence Intervals	372
15.4	Manipulating Confidence Intervals	373
15.5	Margin of Error	376
	Chapter Summary	384
16	Statistical Tests	391
16.1	Concepts of Statistical Tests	392
16.2	Testing the Proportion	397
16.3	Testing the Mean	404

- 16.4 Significance versus Importance 408
- 16.5 Confidence Interval or Test? 409
- Chapter Summary 413

17 Comparison 420

- 17.1 Types of Comparisons 421
- 17.2 Data for Comparisons 421
- 17.3 Two-Sample z-Test for Proportions 424
- 17.4 Two-Sample Confidence Interval for Proportions 425
- 17.5 two-Sample t -Test 429
- 17.6 Confidence Interval for the Difference Between Means 433
- 17.7 Paired Comparisons 436
- Chapter Summary 446

18 Inference for Counts 453

- 18.1 Chi-Squared Tests 454
- 18.2 Test of Independence 454
- 18.3 General versus Specific Hypotheses 466
- 18.4 Tests of Goodness of Fit 467
- Chapter Summary 477

CASE: STATISTICS IN ACTION Rare Events 484

CASE: STATISTICS IN ACTION Data Mining Using Chi-Squared 491

PART IV

Regression Models

19 Linear Patterns 498

- 19.1 Fitting a Line to Data 499
- 19.2 Interpreting the Fitted Line 501
- 19.3 Properties of Residuals 506
- 19.4 Explaining Variation 508
- 19.5 Conditions for Simple Regression 510
- Chapter Summary 520

20 Curved Patterns 528

- 20.1 Detecting Nonlinear Patterns 529
- 20.2 Transformations 531
- 20.3 Reciprocal Transformation 532
- 20.4 Logarithm Transformation 538
- Chapter Summary 550

21 The Simple Regression Model 557

- 21.1 The Simple Regression Model 558
- 21.2 Conditions for the SRM 562
- 21.3 Inference in Regression 565
- 21.4 Prediction Intervals 573
- Chapter Summary 587

22	Regression Diagnostics	596
22.1	Changing Variation	597
22.2	Outliers	607
22.3	Dependent Errors and Time Series	611
	Chapter Summary	622
23	Multiple Regression	630
23.1	The Multiple Regression Model	631
23.2	Interpreting Multiple Regression	632
23.3	Checking Conditions	640
23.4	Inference In Multiple Regression	642
23.5	Steps In Fitting A Multiple Regression	646
	Chapter Summary	656
24	Building Regression Models	667
24.1	Identifying Explanatory Variables	668
24.2	Collinearity	673
24.3	Removing Explanatory Variables	678
	Chapter Summary	694
25	Categorical Explanatory Variables	703
25.1	Two-Sample Comparisons	704
25.2	Analysis of Covariance	706
25.3	Checking Conditions	711
25.4	Interactions and Inference	712
25.5	Regression with Several Groups	719
	Chapter Summary	726
26	Analysis of Variance	736
26.1	Comparing Several Groups	737
26.2	Inference in ANOVA Regression Models	744
26.3	Multiple Comparisons	748
26.4	Groups of Different Size	754
	Chapter Summary	759
27	Time Series	768
27.1	Decomposing a Time Series	769
27.2	Regression Models	772
27.3	Checking the Model	782
	Chapter Summary	797
	CASE: STATISTICS IN ACTION Analyzing Experiments	807
	CASE: STATISTICS IN ACTION Automated Modeling	815

Appendix: Tables 823

Answers A-1

Credits C-1

Index I-1

Supplementary Material (online-only)

S1 Alternative Approaches to Inference S1-1

S2 Two-Way Analysis of Variance S2-1

S3 Regression with Big Data S3-1

PREFACE

Knowledge of statistics is a great asset in business, but getting the most value from this asset requires knowing how to ask and answer the right questions. Choosing the right question and solving the problem correctly require an appreciation of business as well as the subtleties of statistics. Unless you understand the business issue from a finance, marketing, management, or accounting perspective, you won't see how statistics can help solve the problem. Performing the statistical analysis must wait until you have grasped the issue facing the business.

Solving Business Problems

This application-directed approach is key to business analytics and shapes our examples. We open each chapter with a business question that motivates the contents of the chapter. For extra practice, worked-out examples within each chapter follow our 4M (Motivation, Method, Mechanics, Message) problem-solving strategy. The *motivation* sets up the problem and explains the relevance of the question at hand. We then identify the appropriate statistical *method* and work through the *mechanics* of its calculation. Finally, the *message* answers the question in language suitable for a business presentation or report. Through the 4Ms, we'll show you how a business context guides the statistical procedure and how the results determine a course of action. Motivation and Message are critical. The Motivation answers the question "Why am I doing this analysis?". If you cannot answer that question, it's hard to get the statistics correct. The Message has to express your answer in language that is used in the business world. Understand the business first, then use statistics to help formulate your conclusion. Notice that we said "help." A statistical analysis by itself is not the final answer. You must frame that analysis in terms that others in the business will understand and find persuasive.

Our emphasis on the substantive use of statistics in business shapes our view that the ideal reader for this text is someone with an interest in learning how statistical thinking improves the ability of a manager to run or contribute to a business. Whether you're an undergraduate with an interest in business, an MBA looking to improve your skills, or a business owner looking for

another way to get ahead of the competition, the key is a desire to learn how statistics can produce better decisions and insights from the growing amount of data generated in modern businesses.

We don't assume that readers have mastered the domains of a business education, such as economics, finance, marketing, or accounting. We do assume, though, that you care how ideas from these areas can improve a business. If you're interested in these applications—and we think you will be—then our examples provide the background you will need to appreciate why we want to solve the challenges that we present in each chapter. Readers with more experience will discover that we've simplified the technical details of some applications, such as those in finance or marketing. Even so, we think that the examples offer those with substantive experience a new perspective on familiar problems. We hope that you will agree that the examples are realistic and get to the heart of quantitative applications of statistics in business.

Technology

You cannot do research in modern applied statistics without computing. Data sets have grown in size and complexity, making it impossible to work out the calculations by hand. Rather than dwell on routine calculations, we rely on software (often referred to as a statistics package) to compute the results. Although we emphasize the use of technology, we give the formulas and illustrate the calculations introduced in each chapter so that you will always know what the software is doing. It is essential to appreciate what happens in the calculations: You need to understand how the calculations are done in order to recognize when they are appropriate and when they fail. That does not mean, however, that you need to spend hours doing routine calculations. Your time is precious, and there's only so much of it to go around. We think it makes good economic sense to take advantage of modern technology in order to give us more time to think harder and more thoroughly about the motivating context for an application and to successfully present the business message.

When we present results obtained with a calculator or computer, we typically round them. You don't

need to know that the profits from a projected sale are \$123,234.32529. It's usually better to round such a number to \$123 thousand. To let you know when we've rounded a calculation, we say *about* or *approximately*. In expressions, we denote rounding with the symbol \approx , as in $1/6 \approx 0.167$.

To help you learn how to use software, each chapter includes hints on using Excel®, MinitabExpress®, and JMP® for calculations. These hints won't replace the help provided by your software, but they will point you in the right direction so that you don't spin your wheels figuring out how to get started with an analysis. Supplemental software study cards are available for specific packages.

Data

Statistical analysis uses data, and we've provided lots of data to give you the opportunity to have some real hands-on experience. As you read through the chapters, you'll discover a variety of data sets that include real estate markets, stocks and bonds, technology, retail sales, human resource management, and fundamental economics. These data come from a range of sources, and each chapter includes a discussion about where we found the data used in examples. We hope you'll use our suggestions and find more.

Prerequisite Knowledge

To appreciate the illustrative calculations and formulas, readers will need to be familiar with basic algebra. Portions of chapters that introduce a statistical method often include some algebra to show where a formula comes from. Usually, we only use basic algebra (up through topics such as exponents and square roots). Several chapters make extensive use of the logarithm function. If you're interested in business and economics, this is a function worth getting to know a lot better. The applications we've provided, such as modeling sales or finding the best price, show why the logarithm is so important. Occasionally, we give credit to calculus for solving a problem, but we don't present derivations using calculus. You'll do fine if you are willing to accept that calculus is a branch of more advanced mathematics that provides, among other things, the ability to derive formulas that have special properties. If you do know calculus, you'll be able to see where these expressions come from.

WHAT'S NEW IN THIS EDITION

This edition adds more of what readers have found really useful:

- **Business analytics** relies on linking data to business decisions. Businesses ranging from traditional banks to the latest game developers are clamoring for employees who can connect data and models to substantive business problems. This edition adds emphasis,

examples, and illustrations that stress the importance of these connections. For example, previous editions introduced the 4M paradigm—motivation, method, mechanics, and message—that shows how to combine data and statistics to solve problems in business. This edition carries this metaphor further. By explicitly linking this paradigm to analytics, this edition shows that business analytics requires blending substantive relevance with statistical analysis.

- **Up-to-date applications** explore problems related to “big data” and introduce hot topics such as A/B testing that are popular in today's businesses. Although the methods behind these new topics are familiar within statistics, the names are new. This edition makes sure students know the new names so that they can link what they learn in the classroom to what they read online.
- This edition features more than **90 new and updated data sets**. The changed data range from examples used within chapters to those underlying exercises. Important, highly visible changes include “through the cycle” finance and economic time series that span the 2008 recession.
- **More than 100 enhanced exercises** remove ambiguities and capture nuances in revised data. Many of these changes address issues identified by tracking online student performance in completing related exercises in MyStatLab. Problems that were worded in a way that might confuse students were clarified.
- **Excel** is the workhorse tool of many businesses. This edition adds a section to every chapter that shows step by step how to complete analytic exercises with the latest version of Excel. Excel is the most popular software for introductory statistics, but some prefer the features offered by statistics packages such as Minitab or JMP. We've retained and updated hints in each chapter for these as well.
- It's the little things. **Hundreds of changes** have been made throughout this edition to emphasize and clarify key points. For example, this edition highlights additional tips throughout the text that help readers recognize important points that might be overlooked. Clarified explanations, analogies, and examples in every chapter encourage students to delve deeper and learn for themselves.

COVERAGE AND ORGANIZATION

We have organized the chapters of this book into four parts:

1. Variation
2. Probability
3. Inference
4. Regression Models

Part I. These chapters introduce summary statistics such as the mean and important graphical summaries, including bar charts, histograms, and scatterplots. Even

if you are familiar with these methods, we encourage you to skim the examples in these chapters. These examples introduce important terminology that appears in subsequent chapters. A quick review will introduce the notation that we use (which is rather standard) as well as give you a chance to look at some interesting data. If you do skip past these, take advantage of the index of Key Terms in each chapter to find definitions and examples.

Part II. Many courses in mathematics now include topics from probability. Even if you have seen basic probability, you might benefit from reviewing how methods, such as Bayes' Rule, can be used to improve business processes (Chapter 8). If you plan to skip or move briskly through the rest of the chapters in Part 2, be sure that you're familiar with the concept of a random variable (Chapter 9). Statistical models use random variables to present an idealized description of the data in applications. Unless you're familiar with random variables, you won't appreciate the important assumptions that come with their use in practice. Chapter 11 describes special random variables used to model counts, and Chapter 12 defines normal random variables that appear so often in statistical models.

Part III. This part presents the foundations for statistical inference, the process of inferring properties of an entire population from those of a subset known as a sample. Even if you are not interested in quality control, we encourage you to read Chapter 14. Chapter 14 uses quality control to introduce a fundamental concept of inferential statistics, the sampling distribution and standard error. You can get by in statistics with a basic understanding of the concept of a sampling distribution, but the more you know about sampling distributions, the better. Each inferential procedure comes with a checklist of conditions that tell you whether your data and situation match up to the various inferential techniques in these chapters.

Part IV. The chapters in Part 4 describe regression modeling. Regression modeling allows us to associate how differences in data that describe one phenomenon are related to differences in others. Regression models are among the most powerful ways to use statistics in business, providing methods for assessing profitability, setting prices, identifying anomalies, and generating forecasts. We encourage you to slow down and take your time studying these chapters. Even if you don't see yourself doing statistics in your career in business, you can be sure that you will be presented with the results of regression models. Because the examples in these chapters allow us to describe the interconnectedness of several business processes at once, they become even more interesting than those in prior chapters. Be careful if you skip Chapter 20. The material in this chapter shows how to model a richer set of patterns and is less common in business textbooks, but we think these ideas are an essential component of every manager's tool set.

Case Studies

Each of the four main parts of this book includes two supplemental case studies called *Statistics in Action*. Each case study provides an in-depth look at a business application of statistics. Every case uses real data and takes students through the details of using those data to address a business question. For example, a case study for Part 1 explains details of stock market data, such as how stock returns account for dividends, and elaborates the nuances of financial data beyond the coverage in the surrounding chapters.

We've found that it is easy to have a "chapter-centric" view of any subject; you know how to approach a problem if the question identifies a chapter. Executing the right approach is more difficult without that sort of clue.

Case studies allow us to extend the statistical concepts introduced in the accompanying chapters in the context of a longer, more complex case. For example, the second case in Part 1 carefully explains how to interpret and use logarithms in the context of executive salaries. A case in Part 3 explores the use of many chi-squared tests in an operations management problem that resembles data mining. While logs, chi-squared tests, and issues of multiple testing all appear in the regular flow of the main chapters, case studies provide a means for us to cover these topics in more detail than we thought was appropriate for everyone.

Supplementary Chapters

For this edition, we've added a few supplementary chapters that are available online. These cover topics that are less common in the typical business stats course, but often useful. One chapter covers methods that are needed when the usual approaches don't apply. For example, suppose data are so skewed that one cannot use standard methods for building a confidence interval for the mean. What are you to do? The supplemental chapter **Alternative Approaches to Inference** gives an answer. Two other supplemental chapters go deeper into regression modeling. The chapter **Two-Way Analysis of Variance** goes beyond Chapter 26 and looks at two-way (and higher) analysis of variance, including those with randomized blocking and interactions. The chapter **Regression Modeling with Big Data** goes beyond Chapter 24 and the *Statistics in Action* cases with coverage of how to build regression models when confronted by "big-data" issues that have become more common in business.

FEATURES

Motivating Examples. Each chapter opens with a business example that frames a question and motivates the contents of the chapter. We return to the example throughout the chapter; as we present the statistical

methods that provide answers to the question posed in the opening example.

4M Analytics Examples The 4M (Motivation, Method, Mechanics, Message) problem-solving strategy gives students a clear outline for solving any business problem. Each 4M example first expresses a business question in context, then guides students to determine the best statistical method for working the problem using statistical software, and, finally, frames the analysis in terms that others in the business world will understand.

What Do You Think? Short question sets throughout each chapter give students the opportunity to check their understanding of what they've just read. These questions are intended to be a quick check of key concepts and ideas presented in the chapter; most questions involve very little calculation. Answers are located in a footnote so that students can easily check their answers before moving on in the text.

tip **Tips.** We highlight useful hints for applying statistical methods within the exposition so that students don't miss them.

caution **Caution.** You'll see the caution icon next to material that might be confusing. You should be extra careful to make sure you understand the material being discussed.

✓ **Checklist.** Some statistics presume that the information presented satisfies several conditions or assumptions. For example, certain statistics only detect patterns that resemble lines. You would not want to use these if you were looking for a curve. To help you keep track of the assumptions, the conditions are collected in a checklist.

■ **Best Practices.** At the end of each chapter, we include a collection of tips for applying the chapter's concepts successfully and ethically.

■ **Pitfalls.** Most of the unintentional mistakes people make when learning statistics are avoidable and usually come from using the wrong method for the situation or misinterpreting the results. This feature at the end of each chapter provides useful tips for avoiding common mistakes.

Data Analytics: The authors analyzed aggregated student usage and performance data from MyStatLab™ for the previous edition of this text. The results of this analysis helped improve the quality and quantity of exercises that matter the most to instructors and students.

■ **Software Hints.** Each chapter includes hints on using Excel, Minitab, and JMP for calculations. These hints give students a jumping off point for getting started doing statistical analysis with software. Supplemental study cards for these and other software packages are available from the publisher.

■ **Behind the Math.** At the end of most chapters, a Behind the Math section provides interesting technical details that explain important results, such as the justification or interpretation for an underlying formula. If you are so inclined, they will help you appreciate the subtleties and logic behind the mechanics, but they are not necessary for using statistics.

Chapter Summary. These chapter-ending summaries provide a complete review of the content.

- **Key Terms** We provide an index of the chapter's key terms at the end of each chapter to give students a quick and easy way to return to important definitions in the text.
- **Objectives** This new feature provides a list of what students should understand after having read a chapter.
- **Formulas** Important formulas introduced within the chapter are restated.
- **About the Data** This feature provides sources for the data used throughout the chapter with further background.

Exercises. Each chapter contains a variety of exercises at escalating levels of difficulty in order to give students a full complement of practice in problem solving using the skills they've learned in the chapter. Types of exercises include Matching, True/False, Think About It, You Do It, and 4M Exercises. You'll find the data for the 4M and You Do It exercises on Pearson's Math and Statistics Resources Website: <http://www.pearsonhighered.com/mathstats>

- **Matching and True/False** exercises test students' ability to recognize the basic mathematical symbols and terminology they have learned in the chapter. We avoid unnecessary formulas, but certain symbols and terminology show up so often that students are well served to recognize them.
- **Think About It** exercises ask students to pull together the chapter's concepts in order to solve conceptual problems. You don't need a computer or calculator for most of these.
- **You Do It** exercises give students practice solving problems that reinforce the mechanics they've learned in the chapter. These exercises apply the methods of the chapter to data related to a business

application. Working through the steps of these exercises helps you practice the mechanics. We expect you to use a statistics software package for many of these.

- **4M Analytics** exercises are rich, challenging applications rooted in real business situations. These ask students to apply the statistical knowledge they've developed in the chapter to a set of questions about a particular business problem.

ACKNOWLEDGMENTS

We didn't develop our approach to business statistics in isolation. Our colleagues at Wharton have helped shape our approach to teaching statistics in business. Many of the ideas and examples that you'll find here arose from suggestions made by colleagues, including Andreas Buja, Sasha Rakhlin, Paul Shaman, Richard Waterman, and Adi Wyner. Over the years, members of our department have come to share a common attitude toward the use of statistics in business, and this text reflects that shared perspective. Most of the examples and many exercises from the text have been tried in other classes and improved using that feedback. We owe these friends a debt of gratitude for their willingness to talk about the fundamental use of statistics in business and to explore alternative explanations and examples.

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INDEX OF APPLICATIONS

CO = Chapter Opener; **IE** = In-Text Example; **WT** = What Do You Think?; **4M** = Motivation, Method, Mechanics, Message; **P** = Pitfalls; **BP** = Best Practices; **AE** = Analytics in Excel; **AD** = About the Data; **BTM** = Behind the Math; **TAI** = Think About It; **YDI** = You Do It; **SA** = Statistics in Action; **QT** = Questions for Thought

Accounting

Accounting Firm Filing Tax Forms (TAI) 295
Accounting Procedures (TAI) 332
Auditing a Business (4M) 178
Auditor Checking Transactions (WT) 368
Auditor Comparing Billable Invoices (TAI) 728
Budget Allocation of a New Business (4M) 701–702
Cost Accounting (4M) 139
Research and Development Expenses (YDI) 525, 593, 626, 663, 699, 732

Advertising

Advertising Among Internet Hosts (CO) 83; (IE) 80–83, 180–185; (WT) 183
Advertising and Sales (IE) 559–561; (TAI) 591
Advertising Firm Renewing Contract (TAI) 175
App advertising 187–190
Direct Mail Advertising (4M) 418
Display Space (YDI) 553
Evaluating a Promotion (4M) 435–436
Financial Advisor (YDI) 804
Judging the Credibility of Advertisements (4M) 751–754; (AE) 756–758
Monthly Sales and Advertising (P) 513
New Advertising Program (TAI) 449
Pharmaceutical Advertising (CO) 251–251
Priming in Advertising (4M) 723–725
Promotion Response (4M) 389–390
Television Advertising (TAI) 102
Television Commercials (4M) 403; (AE) 411; (TAI) 416

Agriculture

Blood Sample from Cattle (WT) 319
Dairy Farming (YDI) 267
Food-Safety Inspectors Visiting Dairy Farms (TAI) 331
Grain Produced per Acre (CO) 736
Wheat Trials (IE) 737–742, 744–754; (TAI) 763

Automotive

Auto Dealer Attending Car Auctions (TAI) 592
Residual Car Values (4M) 665
Base Price and Horsepower of Cars (YDI) 525–526, 593, 627, 663–664, 699–700, 732–733
Buying Tires at an Auto Service Center (WT) 205; (IE) 212
Car Theft (4M) 86–88; (AE) 98
Cars in 1989 (4M) 555
Customer Options When Ordering a New Car (YDI) 198

Dealer Earnings per Day (TAI) 266
Door Seam of a Vehicle (YDI) 359
Fatal Roll-Over Accidents (4M) 35–36; (AE) 40–41
Favorite Car Color (TAI) 103
Fuel Consumption in Cars (CO) 528; (IE) 529–538
Leasing Cars (4M) 390
Male Drivers Involved in Serious Accidents (YDI) 296
Motor Shafts in Automobile Engines (YDI) 359
Predicting Sales of New Cars (4M) 775–778; (AE) 792–793
Price of New Cars (WT) 632
Pricing of a Car (IE) 7–9
Rated Highway Gasoline Mileage (YDI) 77
Stopping Distances (YDI) 765
Trade in Asian Models (TAI) 44
Trade in Domestic Models (TAI) 44
Used Cars (WT) 14; (TAI) 76; (YDI) 449, 553–554

Banking

Adjustable Rate Mortgage (TAI) 74
ATM (YDI) 221
Bank Collecting Data on Customers (TAI) 23, 24
Banks Compete by Adding Special Services (YDI) 418
Basel II Standards for Banking (TAI) 386–387
Check Fees (TAI) 23
Credit Card Offer (CO) 362; (IE) 363, 366–367, 370–371, 374, 409
Credit Card Profit Earned from a Customer (IE) 375–376
Credit Cards (IE) 372; (AE) 472–473; (4M) 527
Credit Risk (IE) 185
Direct Deposits for Employees (TAI) 331
Federal Regulators Requiring Bank to Maintain Cash Reserves (IE) 373
Loan Approval (IE) 161; (WT) 166
Loan Balances (TAI) 74
Loan Defaults (YDI) 267–268
Manager Tracking Bank Transactions (YDI) 267
Mortgage Loan Defaults (WT) 161–161
On Time Loan Repayment (IE) 166–167
Profit for a Bank (IE) 374–375
Size of Credit Card Transactions (IE) 321–322
Subprime Mortgages (4M) 646–650; (AE) 651–653

Business (General)

Auto Dealer (TAI) 173
Bookstore (YD I) 804
Catalog Sales Companies (TAI) 387
Clothing Buyer for a Chain of Department Stores (TAI) 386
Company Free Giveaways (IE) 207–208
Company Stocking Shelves in Supermarkets (YDI) 416, 422

Customer Focus (4M) 19
 Data-driven Culture (TAI) 45
 Display Space (TAI) 765
 Employee Absences (YDI) 48
 Employee Drug Testing (TAI) 197–198
 Fast-Food Restaurant Chains (YDI) 176, 177; (WT) 253
 Forecasting Profits (4M) 787–790; (AE) 794–795
 Gross Profit (YDI) 804
 Growth Industries (4M) 49–50
 Large Company Correlation (IE) 126–127
 Mail-Order Catalog (TAI) 74
 Multinational Retail Company (TAI) 523
 Optimal Pricing (4M) 543–545; (AE) 546–548; (BTM) 550
 Price and Weights of Diamonds (WT) 114; (TAI) 134, 591;
 (CO) 498; (IE) 499–504, 507–509, 529, 576
 Price Scanners at Check-Out Registers (TAI) 76
 Reams of Paper Used in an Office (YDI) 220
 Repairing an Office Machine (YDI) 221
 Restaurant Chain Choosing a Location (CO) 630
 Revenue Generated by Individual Sales Representatives (TAI)
 727–728
 Sales by Day of the Week (TAI) 74
 Shopping Mall Environment (TAI) 74
 Start-Up Company (TAI) 24, 48
 Supermarket Scanner Data (4M) 200
 Technology Businesses Moving Corporate Headquarters near a
 Mall (WT) 639
 Value of New Orders for Computers and Electronics (WT) 772
 Women-Owned Businesses (YDI) 48

Company Names

Apple (TAI) 45
 Amazon (CO) 26; (IE) 27, 32, 38; (P) 40
 Bike Addicts (CO) 10; (IE) 12, 14, 17, 22
 Dell Revenue and Inventories (TAI) 800–801
 Facebook 176
 Ford (WT) 326
 Intel (IE) 772
 L.L. Bean (TAI) 387
 Levi Strauss (IE) 18
 Lockheed Martin (IE) 35
 Netflix (TAI) 44–45
 Target (CO) 10; (4M) 125; (YDI) 552–553
 Wal-Mart (CO) 10, 703; (4M) 451–452; (IE) 15, 17, 18, 125, 151,
 320, 703, 715; (SA) 491; (YDI) 552, 804

Construction

City Building a New Public Parking Garage (YDI) 387
 Construction Estimates (4M) 240–241; (AE) 242
 Construction Firm Bidding on a Contract (YDI) 219, 248
 Contractor Building Homes in a Suburban Development (TAI)
 295
 Contractor Replaces Windows and Siding in Suburban Homes
 (WT) 639, 643
 Cost of Building an Elementary School (TAI) 523
 Housing Permits and Construction (YDI) 804–805
 Kitchen Remodeling (TAI) 246

Consumers

Bargain on Blouses (YDI) 199
 Buying a Laptop (YDI) 176
 Buying Running Shoes (TAI) 174
 Cell Phone Subscribers (4M) 614–615; (AE) 620–621; (YDI) 802
 Choices for Paint Colors and Finishes at a Hardware Store (TAI)
 103–104

Convenience Store Shopper Choosing Food (TAI) 173; (WT)
 231–232
 Cost of Diamonds (IE) 271–272, 499, 503–504; (YDI) 730
 Customer Preferences of a New Product (TAI) 102
 Customer Rating a Power Tool (TAI) 591
 Customer Satisfaction with Calls to Customer Service (CO) 156;
 (IE) 157–159; (BP) 169; (TAI) 172–173; (YDI) 175, 200
 Diamond Ring Prices (YDI) 523–524, 592, 625
 Drive Preferences (YDI) 135
 Emerald Diamonds (YDI) 730
 Estimating Consumption (4M) 504–506; (AE) 514–516
 Gasoline Prices (4M) 805–806
 Gasoline Sales (YDI) 104
 Gold Chain Prices (YDI) 661, 698
 Guest Satisfaction (4M) 332
 Lease Costs (4M) 511–512; (AE) 517–518
 Pant Choices at a Clothing Store (TAI) 173
 Purchasing Habits (TAI) 45
 Rating Hotel Chains (TAI) 23
 Spending at a Convenience Store (TAI) 45; (YDI) 524, 592,
 625–626, 661–662, 698, 730

Demographics

Ages of Shoppers (TAI) 75
 Heights of Students (TAI) 74
 Number of Children of Shoppers in a Toy Store (TAI) 75

Distribution and Operations Management

Assembly Line Production (TAI) 358
 Book Shipments to University Bookstores (YDI) 388
 Cost of Building Cars at Plants (TAI) 728
 Customized Milling Operation (TAI) 523
 Delivery Stops for a Freight Company (YDI) 247
 Efficiency of Automated Factories (TAI) 728
 Forecasting Inventory Levels at Wal-Mart (YDI) 803, 804
 Importer of Electronic Goods (YDI) 417
 Imports (YDI) 803–804
 Maintenance Staff of a Large Office Building (YDI) 220
 Managing Inventories (SA) 491–493
 Number of Employees and Items Produced (TAI) 134
 Operating Margin of a National Motel Chain (TAI) 661
 Overnight Shipping Firm (YDI) 763–764
 Package Delivery Service and Fuel Costs (TAI) 523
 Packages Processed by Federal Express (TAI) 75
 Packaging Types (SA) 491–495; (QT) 495–496
 Performance of Two Shipping Services (IE) 89–90
 Planning Operating Costs (4M) 249–250
 Production Costs (YDI) 524–525, 592–593, 626, 662, 698, 731
 Production Line Filling Bottles (TAI) 358
 Production Time and Number of Units (WT) 505–506
 Seasonal Component of Computer Shipments (IE) 770–771
 Shipping Companies (YDI) 450
 Shipping Computer Systems (TAI) 103
 State of a Production Line (IE) 340–343, 345–346
 Value of Shipments of Computers and Electronics (CO) 768; (IE)
 770–771, 773–775, 778–784; (TAI) 800
 Windows Shipped Daily (IE) 212–213
 Wine Exports (IE) 33–34

E-Commerce

A/B Testing of Web Site Design (IE) 428–429
 Click fraud (YDI) 389
 Filtering Junk Mail (4M) 193–194; (CO) 391; (IE) 392–393, 402;
 (TAI) 416
 Internet Ad Spending (CO) 26

Internet Browsers (YDI) 49
 Internet Hosts (IE) 28–30, 32; (P) 40
 Monitoring an E-mail system (4M) 360
 Recipe Source (IE) 33
 Web Purchases (4M) 50; (TAI) 266, 416
 Web Hits (YDI) 360; (AE) 474–476
 Web Site Monitoring the Number of Customer Visits (TAI) 762–763
 Web Site of a Photo Processor (TAI) 359
 Web Site to Take Photography Lessons (TAI) 799
 Web Site Visitors Clicking on an Ad (TAI) 174

Economics

Consumer Sentiment and Inflation (TAI) 134
 Dollar/Euro Exchange Rate (IE) 229, 374
 Economic Time Series (4M) 24
 Estimating the Rise of Prices (4M) 324–326
 Exchange Rate (YDI) 220, 221; (4M) 229–230
 Expectations for the Economy (IE) 485
 Forecasting Unemployment (4M) 784–787; (AE) 793–794
 Gross Domestic Product (IE) 394–395
 Housing and Stocks (YDI) 135
 Macro Economics (YDI) 137–138
 Organization for Economic Cooperation and Development (TAI) 133; (YDI) 526, 593, 627; (IE) 394
 Seasonally Adjusted Civilian Unemployment Rate (YDI) 802
 U.S. Gross National Product (TAI) 799

Education

Annual Tuition of Undergraduate Business Schools (TAI) 76–77
 College Attended by CEOs (TAI) 46
 College Graduate Debt (TAI) 198
 Education and Income (CO) 179
 High/Scope Perry Preschool Project (YDI) 389
 Letter Grades (IE) 39
 Multiple Choice Quiz (YDI) 176
 Public College Tuition (WT) 65
 SAT and Normality (4M) 277–279; (AE) 288
 SAT Scores (TAI) 294
 Test Scores (IE) 66

Energy

Annual Use of Natural Gas per Household (CO) 109; (WT) 120; (IE) 120–121
 Daylight Savings Time and Reducing Energy Consumption (TAI) 449
 Electricity Supplied to Residences (TAI) 294
 Energy Policy Act (TAI) 76
 Heating Degree Days (IE) 110–117, 121–122
 Lighting Efficiency (TAI) 44
 Natural Gas and Electricity Use (YDI) 248
 Steel Mill Monitoring Energy Costs (TAI) 697
 U.S. Department of Energy (IE) 18, 130

Environment

Arctic Ice (YDI) 802
 Carbon Dioxide Emissions (YDI) 138–139
 Hurricane Bond (YDI) 296
 Hurricane Katrina (IE) 4, 5, 6–7
 January Average Temperatures (CO) 109
 Polluting a Local River System (TAI) 415
 Temperature (IE) 13
 Weather at a Beachside Vacation Resort (TAI) 174
 Weather Forecasts (4M) 628–629; (YDI) 664, 700

Finance and Investments

Apple Stock (YDI) 222, 526–527, 594, 628, 665, 701
 Bond Ratings (TAI) 103
 Calendar Effects on Stocks (4M) 767
 Capital Asset Pricing Model (CO) 667; (IE) 668–669; (TAI) 697; (4M) 594–595
 Cash or Credit Card (YDI) 137, 268
 Climate Change (4M) 577–580; (AE) 583–586
 Comparing Returns on Investments (4M) 406–408
 Continuous Compound Interest (BTM) 489
 Credit Rating Agency (TAI) 173
 Credit Risk (4M) 766–767
 Credit Scores (4M) 79, 223
 Day Trading (CO) 202; (WT) 214
 Defaults on Corporate Bonds (SA) 485
 Disney Stock (YDI) 222
 Disposable Income and Household Credit Debt (TAI) 696
 Enron Stock Prices (SA) 140–145
 Exxon Stock (YDI) 802
 Familiar Stock (YDI) 78
 FICO Score (YDI) 105
 Financial Ratios (4M) 78
 Fraud Detection (4M) 201; (AE) 473–474
 General Motors Stock Return (TAI) 294
 Hedge Funds (YDI) 296
 High-Frequency Data (4M) 595
 Historical Monthly Gross Returns of Stocks and Treasury Bills (SA) 304–305
 Holdings of U.S. Treasury Bonds (TAI) 44
 Household Credit Market Debt (TAI) 799–800
 Household Incomes (TAI) 74, 75; (4M) 297
 IBM Stock (IE) 206, 208–209, 225–227, 230–231, 233–234, 236–238; (AE) 411–412; (AD) 217, 244–245
 Investing in Stock (YDI) 219
 Investment Risk (SA) 298
 IRA (TAI) 23
 Loan Status (TAI) 102
 McDonalds Stock (IE) 214
 Microsoft Stock (IE) 225–227, 230–231, 233–234, 237, 239; (AD) 244–245
 Monthly Prices of Shares in JCPenny (YDI) 802–803
 Normality of Stock Returns (4M) 296–297
 Pfizer Stock (QT) 146–147
 Quality Control of Finance Data (4M) 360–361
 Real Money (4M) 249
 Sony Stock (IE) 668–678; (TAI) 697
 Startup Technology Companies (YDI) 268
 Stock Exchanges (CO) 224
 Stock Market (IE) 66, 271–272, 275, 303; (4M) 138; (TAI) 591
 Stock Returns (SA) 142–145
 Student Budget (YDI) 247
 Student Loan Debt (TAI) 198
 Tech Stocks (YDI) 78
 Value at Risk (4M) 281–282; (AE) 289; (YDI) 295–296; (SA) 145
 Whole Stock Market and S&P 500 (TAI) 696

Food/Drink

Artificial Sweetener (YDI) 47–48, 763
 Bread Volume (YDI) 764–765
 Chocolate Snacks (YDI) 48–49
 Fast Food Restaurant Customers (YDI) 247
 Food and Drug Administration Vetoing Name Choices (YDI) 268
 Frozen Food Package Weight (IE) 347–348
 Gourmet Steaks (TAI) 295
 Low-Calorie Sports Drink (YDI) 417

M&Ms (IE) 58; (AE) 69; (TAI) 74; (YDI) 175; (SA) 306–309; (4M) 55–56
 Package Weights of M&Ms (SA) 310–311; (QT) 312
 Take-Out Food at a Local Pizzeria (YDI) 388
 Taste Test (TAI) 267, 331; (IE) 437
 Weights of Cereal Boxes (IE) 280
 Wine (YDI) 449, 553, 733

Games

Arcade Game (TAI) 219
 Dice Game (SA) 298–304; (QT) 305
 Fair Coin (TAI) 415; (WT) 253
 Fair Game (TAI) 219
 Game Consoles (YDI) 49
 Lotteries (TAI) 219
 Lucky Ducks Carnival Game (WT) 208
 Online Poker (YDI) 247
 Slot Machine (QT) 305
 Video Game Previewed by Teenagers (TAI) 24

Government

Political Candidate Anxious about the Outcome of an Election (TAI) 386
 Political Poll (4M) 379–380
 Property Taxes (4M) 378–379; (AE) 381–382
 Sales Tax (TAI) 75, 133
 Tax Audits (4M) 333
 Top Government Research Priority (YDI) 47
 Travel Expenses for Staff (WT) 637

Human Resource Management/Personnel

Average Age of MBAs Hired (TAI) 386
 Businesses Planning to Hire Additional Employees (TAI) 386
 Calls Handled at a Corporate Call Center (BP) 68
 Correlation between Employee Absent from Year to Year (TAI) 133
 Dexterity Testing and Hiring People for a Factory Assembly Line (YDI) 449
 Direct Sales Team (YDI) 199
 Discrimination in Hiring (4M) 107
 Employee Experience 175
 Employee Testing (YDI) 135
 Employees Interested in Joining a Union (TAI) 697
 Employment in Four Industries (YDI) 105
 Evaluating the Performance of New Hires (TAI) 658, 664
 Headhunters (YDI) 418
 Hiring (YDI) 526, 593–594, 627, 664, 700–701, 733
 Hiring Engineering Graduates Who Speak a Foreign Language (TAI) 173
 Home-Based Operator (YDI) 176
 Outsourcing High-Level White Collar Jobs (YDI) 49
 Personality Test (TAI) 416
 Predicting Success of Candidates (TAI) 658
 Reasons for Missing Work (TAI) 102
 Reducing Turnover Rates (4M) 419; (YDI) 450
 Sex Discrimination in the Workplace (4M) 451–452
 Training Program (YDI) 248; (WT) 729–730; (TAI) 664

Insurance

Auto Insurance Premiums (TAI) 75
 Comparing Average Sales of an Insurance Company (YDI) 764
 Cost of Covering Auto Accidents (TAI) 246
 Insurance Policies (TAI) 197, 198

Insurance Salesman (YDI) 221
 Life Insurance Benefits (IE) 122–123
 Selling Life and Auto Insurance (YDI) 247
 Stock Market Insurance (CO) 270

Labor

Absent Employees (YDI) 199
 Assembly Line Workers Missing Work (YDI) 102
 Civilian Unemployment Rate (IE) 17
 Days Employees Were Out Sick (WT) 56
 Predicting Employment (IE) 4–7
 Tornado insurance (WT) 253
 Worker Productivity (TAI) 523
 Workforce by Gender (YDI) 199

Law

Jury Trial (TAI) 415–416
 Law Firm (YDI) 219–220
 Law Suit against Wal-Mart (CO) 703–704; (4M) 451–452

Management

Analyzing the Performance of a Fast-Food Chain (TAI) 658
 Average Amount of a Purchase Order (WT) 371
 Business Offering Free Fitness Center Membership to Staff (TAI) 448
 Employee Confidence in Senior Management (YDI) 389
 Management of a Chain of Hotels (YDI) 417
 Management Presentation (WT) 33
 Management Tracking Growth of Sales versus Number of Outlets (TAI) 625
 Manager Predicting Sales (TAI) 799
 Managers with an MBA (YDI) 198
 Managing a Process (4M) 167–168; (IE) 167–168
 Project Management (4M) 222–223
 Sales Force Comparison (4M) 438–440; (TAI) 449
 Supervising Experimental Projects (TAI) 267
 Supervisors Tracking the Output of a Plant (TAI) 625

Manufacturing

Appliance Assembly (YDI) 199
 Assembly Line (YDI) 175
 Canadian Paper Manufacturer (TAI) 23
 Car Manufacturer (TAI) 23–24, 332
 Making M&Ms (4M) 55–56
 Printer Manufacturing (YDI) 220–221
 Tire Manufacturer (YDI) 296

Marketing

Age, Income and Product Rating (TAI) 658–659, 697; (IE) 681–682
 Analysis of Car Buyers (YDI) 418
 Coupons expiring 765
 Coupons Increasing Sales (TAI) 103
 Launching a Product (IE) 214
 Locating a New Store (4M) 125–126; (AE) 128
 Loyalty Programs (YDI) 417
 Mailing List (WT) 88, 94; (4M) 418
 Market Analyst (TAI) 175
 Market Segmentation (4M) 678–682; (AE) 688–691
 Market Share for Artificial Sweeteners (YDI) 47–48
 Marketing Courier Paks (TAI) 729
 Marketing Team Designing a Promotional Web Page (WT) 431
 Retailer Offering Scratch-Off Coupons (YDI) 176
 Smartphone Sales (AE) 41; (YDI) 388–389

Spending for Promoting a Cholesterol-Lowering Drug (YDI) 526, 594, 627, 664–665, 701, 733
 Supermarket Mailing Coupons (TAI) 23
 U.S. Wireless Telephone Market (TAI) 45

Media and Entertainment

Beatles (YDI) 77
 Box-Office Gross of Movies (WT) 114
 Flat-Screen Television Registration Card (TAI) 331
 Flat-Screen TV and Surge Suppressors (YDI) 221
 iTunes (YDI) 734
 Junk Mail (YDI) 193–194, 388
Literary Digest (IE) 316–318
 Movie Reviews (YDI) 766
 Movie Schedule (IE) 165
 News Report Summarizing a Poll of Voters (TAI) 386
 Public Radio Station Soliciting Contributions (WT) 258
 Song Lengths (YDI) 766
 Textbooks (4M) 24–25
 Types of Media in Children's Bedrooms (YDI) 47

Pharmaceuticals, Medicine, and Health

Accidents at a Construction Site (WT) 161; (TAI) 175
 Average Caloric Intake of Female Customers (IE) 377
 Births by Day of the Week (IE) 160
 Bone Density (IE) 271–272, 275, 291
 Breathing Illness and Smoking (YDI) 200
 Clinical Trials (SA) 484–485, 487
 Comparing Diets (CO) 420; (IE) 420–423, 433–435; (4M) 431–433
 Competing Promotions (4M) 665–666
 Diagnostic Testing (4M) 191–193; (TAI) 198
 Doctors Testing a New Contact Lens (TAI) 449
 Drug Researchers (TAI) 415
 Drug to Help Insomniacs Sleep (TAI) 247
 Efficacy of a New Medication (TAI) 416
 Flu (TAI) 103
 Losing Weight (4M) 450–451
 Lung Cancer (YDI) 176
 Medical Researchers Receiving Money from Drug Manufacturers (YDI) 106
 Pharma Promotion (YDI) 296
 Pharmaceutical Rep Meeting a Doctor (IE) 251–253, 255–257; (BTM) 264; (TAI) 267
 Picking a Hospital (4M) 107–108
 Smoking and Lung Cancer (TAI) 103
 Staffing a Maternity Ward (WT) 160–161
 Therapies for Lower Back Pain (WT) 743–744, 746, 751
 Therapy Lowering Blood Pressure (TAI) 415

Quality Control

Average Life of Light Bulbs (YDI) 388
 Complaints Received at a Catalog Sales Center (TAI) 102
 Computer Defects (YDI) 175–176, 267
 Computer Shipments and Quality (4M) 209–210; (IE) 210
 Damaged Appliances (YDI) 416
 Defect Rate (YDI) 199–200
 Defective Parts (YDI) 199; (IE) 253
 Defects in Electronic Components (YDI) 416; (SA) 485
 Defects in Semiconductors (4M) 261; (AE) 263
 Failure Rate of Electronic Devices (YDI) 198
 Financial Data (4M) 360–361
 Highly Accelerated Life Test (CO) 334; (IE) 335–340, 344–346; (WT) 340
 Kitchen Appliance Breaking in the First Month (TAI) 415
 Mistakes Made by Data Entry Clerks (YDI) 135–136

Safety Monitoring (4M) 269
 Snack Food Quality (TAI) 331

Real Estate

Average Value of Home Sales per Agent (YDI) 764
 Boston Housing (YDI) 137
 Crime and Housing Prices in Philadelphia (4M) 555–556
 Developer Choosing Heating Systems and Appliances (4M) 96–97
 Do Fences Make Good Neighbors? (4M) 629
 Home Prices and Square Feet (CO) 593; (AE) 617–619; (IE) 602–607; (YDI) 662, 698–699; (TAI) 697, 734–735
 House Price Index (YDI) 802
 Leasing Office Space (YDI) 525, 593, 626, 663, 699, 731–732
 Locating a Franchise Outlet (4M) 571–573; (AE) 582–583
 Philadelphia Housing (YDI) 136–137
 Seattle Homes (YDI) 525, 593, 604–605, 626, 731; (IE) 597–599

Salary and Benefits

CEOs Average Total Compensation (P) 288; (WT) 570–571
 Executive Compensation (4M) 64, 148–152; (AE) 69
 Health Care Benefits (IE) 15; (TAI) 763, 765
 Hourly Compensation in the U.S. Manufacturing Sector (YDI) 803
 Salaries of Male and Female Managers (IE) 703–715
 Salary and Years of Experience (IE) 705–715
 Salary Data (TAI) 728–729
 Top Paid CEOs (SA) 148–152
 Weekly Salary (TAI) 294–295

Sales and Retail

Amount Purchased in a Supermarket Express Lane (WT) 340
 Annual Sales at Clothing Stores (YDI) 248–249
 Cash Taken During a Two-Hour Shift (TAI) 75
 Cigarette Sales (TAI) 102
 Clothing Purchases (IE) 14
 Decoy Security Cameras (YDI) 450
 Dress Shoe Sizes (TAI) 294
 Focus on Sales (4M) 258–259; (AE) 262
 Forecasting Change in Sales (TAI) 801–802
 Hand Soap Sales (SA) 491–493
 Hospital Supply Sales versus Number of Sales Representatives (WT) 601
 Item Produced during a Shift (TAI) 523
 Local Supermarket Spending (TAI) 523
 Missing Items from Storage Bins (TAI) 332
 Net Sales (SA) 151–152; (QT) 153
 Number of Customers and Sales (TAI) 133
 Online Retailer (YDI) 388
 Paper Towel Sales (SA) 492–493
 Placing Orders on Outdoor Gear (YDI) 198
 Purchases at a 24-Hour Supermarket (TAI) 103
 Quarterly Report of Sales for a Department Store (TAI) 386
 Retail Chain Store Sales in Three Markets (IE) 719–722
 Retail Profits (4M) 682–687; (AE) 691–693
 Retail Sales (TAI) 246; (YDI) 449–450
 Sales and Price of Pet Food (IE) 538–543; (YDI) 554
 Sales at a Convenience Store (TAI) 75, 524, 592, 625–626, 661–662, 730
 Sales at Best Buy (4M) 787–789, 805
 Sales by Company Representatives (TAI) 133
 Sales, Income and Competitors (IE) 631–646; (BTM) 654–655
 Shirt Sales at a Men's Clothing Retailer (IE) 85–86; (YDI) 104
 Shoppers Using Coupons versus Shoppers Who do Not (WT) 706, 709, 710; (YDI) 764
 Snack Bars 47

Snack Counter at a Movie Theater (YDI) 198
 Soft Drinks Sold in the United States (YDI) 46–47
 Weekly Sales at a Home Improvement Center (WT) 343
 Weekly Sales of Men's Shirts (TAI) 763

Science

Diamond Cutting (YDI) 267
 Insulation Damage to the Space Shuttle (IE) 3
 Mosquito Breeding Areas (TAI) 332
 Research Chemist Producing Synthetic Yarn (TAI) 763

Service Industries

Monitoring a Call Center (4M) 349–350; (AE) 351–352
 Number of Calls at a Customer Help Line (IE) 259–260; (YDI) 358, 388
 Repair Service Calls (YDI) 198, 221

Sports

Basketball (TAI) 175; (YDI) 177, 221–222, 247–248, 268
 Betting on a Horse Race (4M) 177–178
 Field Goals (YDI) 222
 Fitness Center Scales (TAI) 133
 Football Game (YDI) 268
 Interval Training (TAI) 74
 Kentucky Derby (TAI) 77
 New York Giants (YDI) 248
 Tour de France (YDI) 135

Surveys and Opinion Polls

Attitudes toward Sharing Copyrighted Music (IE) 92–93, 95–96
 Banking Hours Survey (TAI) 331
 Consumer Satisfaction Survey (TAI) 101–102
 Dealership Survey (TAI) 332
 Exit Surveys (4M) 322–323
 Federal Reserve Survey of Consumer Finances (TAI) 76
 Hotel Exit Survey (IE) 323, 409
 Hotel Manager Surveying Customers (IE) 323
 J.D. Power and Associates Questionnaire (CO) 314
 Market Survey on Hybrid Cars (4M) 269
 Marketing Survey of Car Owners (YDI) 104
 Online Survey of Wealthy Homeowners about Their Insurance Coverage (YDI) 389

Questionnaire to Human Resource Directors (TAI) 331
 Shoppers' Opinions (WT) 319
 Stock Market Poll (YDI) 104–105
 Survey of Brand Awareness (IE) 377
 Survey on Trusting Different Figures in the News (YDI) 105–106

Technology

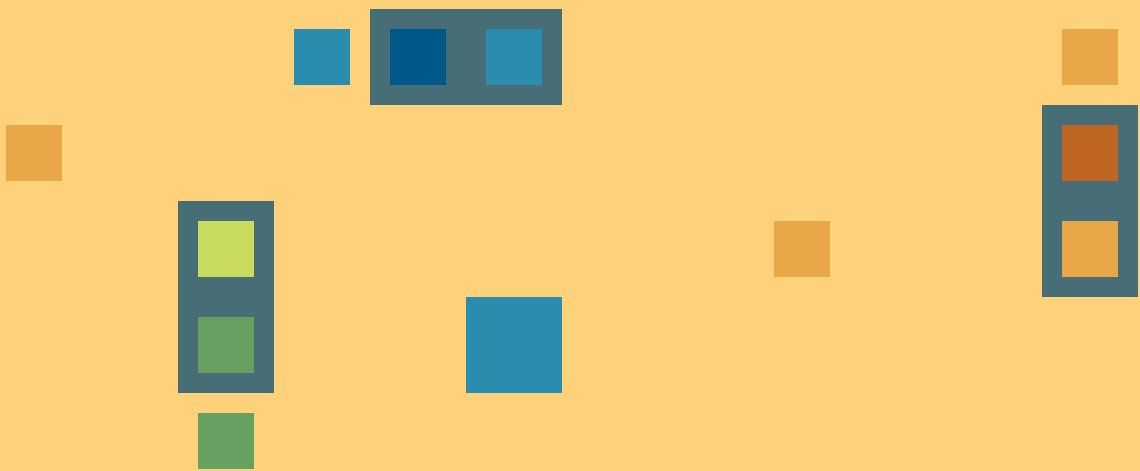
Android Devices (YDI) 450
 Assembling Computer Systems (YDI) 199
 Capacity of an Apple iPhone (CO) 51; (IE) 52, 68; (TAI) 74
 Cellular Phones in Africa (YDI) 554
 Cellular Phones in the United States (YDI) 554
 Digital Recording (TAI) 219
 Download (YDI) 524, 592, 626, 662, 698, 731
 Downloading Songs (TAI) 74
 GPS Chips (CO) 334, 335
 Insulator Applied to Semiconductor Chip (YDI) 359–360
 Internet Access (YDI) 200
 Internet Connection (YDI) 48
 Internet Search Engines (YDI) 450
 MP3 Player (IE) 14
 New Type of Cellular Telephone (YDI) 106
 Sizes of Songs on a Computer (IE) 57–64; (TAI) 76
 Software Project (TAI) 267

Transportation

Airline Arrivals (4M) 90–91; (AE) 98; (IE) 91–92
 Airline Crash (TAI) 175
 Airline On-Time Arrival Performance (YDI) 106–107
 Airline Predicting Revenue from Feeder City Flights (TAI) 660, 661
 Cars Sold in the United States (YDI) 77, 136, 525–526, 593, 627, 663–664, 699–700, 732–733
 City's Income from Parking Fees (YDI) 387–388
 Commuting Time (TAI) 448
 Flight Arrival and Luggage (YDI) 200
 Flight Delays (YDI) 138
 Frequent Flyers (4M) 734
 Lost Luggage (WT) 253
 Overbooking Flights (YDI) 267
 Road Time of a Sales Representative (TAI) 74
 Types of Vehicles in a Lot (TAI) 24
 Weight of Passenger Luggage (TAI) 174
 Weights of Commercial Trucks (YDI) 136

PART I

Variation





1.1 | WHAT IS STATISTICS?

What do you think statistics is all about?

Statistics answers questions using data, or information about the situation. A **statistic** is a property of data, be it a number such as an average or a graph that displays information. Statistics—the discipline—is the science and art of extracting answers from data. Some of these answers do require putting numbers into formulas, but you can also do every statistical analysis with graphs and tables. It's hard to be fooled when the answer stares you in the face.

Think of statistics as art. An artist must choose the right subject, and a good statistician finds the right picture. Rather than learning to paint, in this course you'll learn how to use statistics to interpret data and answer interesting questions. Learning how to use data to solve problems is central to business analytics and data science.

Which questions are interesting? The answer is simple: those you care about. Of course, what interests one person may be of no interest to someone else. In this text we apply statistics to a mix of topics, ranging from finance and marketing to personal choices. Most of the questions in this book concern business, but statistics applies more generally. We'll help you appreciate the generality of statistics by solving problems from health and science, too.

1.1 WHAT IS STATISTICS?

1.2 PREVIEWS

statistic A property of data.

Variation

What kinds of questions can be answered with statistics? Let's start with an example. In November 2011, Barnes and Noble debuted its entry into the market for tablet computers called the Nook Tablet™ and joined the field of challengers to the Apple iPad. A question facing Barnes and Noble was, What's the right price for the Nook Tablet?

That's a hard question. To find an answer, you need to know basic economics, particularly the relationship among price, supply, and demand. A little finance and accounting determine the cost of development and production. Then come questions about the customers. Which customers are interested in a tablet computer? How much are they willing to pay? The Nook Tablet was smaller than an iPad with less technology, making it cheaper to produce. It could be sold at a profit for less than the \$499 iPad, but how much less? Should it cost more than the competing \$199 Kindle Fire?

Suddenly, the initial pricing question branches into several questions, and the answers depend on whom you ask. There's **variation** among customers; customers react differently. One customer might be willing to pay \$300, whereas another would pay only \$200. Once you recognize these differences among customers, how are you going to set *one* price? Statistics

variation Differences among individuals or items; also fluctuations over time.

shows how to use your data—what you know about your product and your customers—to set a price that will attract business and earn a profit. That you likely have not heard of the Nook tells you Barnes and Noble didn't find the right combination of price and technology.

Here's another interesting question: Why does a shopper choose a particular box of cereal? Modern grocers have become information-rich retailers, tracking every item purchased by each patron. That's why they give out personalized shopping cards; they're paying customers with discounts in return for tracking purchases. Customers keep retailers off balance because they don't buy the same things every time they shop. Did the customer buy that box of cereal because it was conveniently positioned at the end of an aisle, because he or she had a discount coupon, or simply because a six-year-old just saw a commercial while watching *Sponge Bob*? Variation makes the question harder to answer.

Patterns and Models

pattern A systematic, predictable feature in data.

Statistics helps you answer questions by providing methods designed to handle variation. These methods filter out the clutter by revealing patterns. A **pattern** in data is a systematic, predictable feature. If customers who receive coupons typically buy more cereal than customers without coupons, there's a pattern.

statistical model A breakdown of variation into a predictable pattern and the remaining variation.

Patterns form one part of a **statistical model**. A statistical model describes the variation in data as the combination of a pattern plus a background of remaining, unexplained variation. The pattern in a statistical model describes the variation that we claim to understand. The pattern tells us what we can anticipate in new data and thus goes beyond describing the data we observe. Often, an equation summarizes the pattern in a precise mathematical form. The remaining variation represents the effects of other factors we cannot explain because we lack enough information to do so. For instance, retail sales increase during holiday seasons. Retailers recognize this pattern and prepare by increasing inventories and hiring extra employees. It's impossible, though, for retailers to know exactly which items customers will want and how much they will spend. The pattern does not explain everything.

Good statistical models simplify reality to help us answer questions. Indeed, the word *model* once meant the blueprints, the plans, for a building. Plans answer some questions about the building. How large is the building? Where are the bathrooms? The blueprint isn't the building, but we can learn a lot from this model. A model of an airplane in a wind tunnel provides insights about flight even though it doesn't mimic every detail of flight. Models of data provide answers to questions even though those answers may not be entirely right. A famous statistician, George Box, once said, "All models are wrong, but some are useful."

A simple model that we understand is generally better than a complex model that we do not understand. A challenge in learning statistics is to recognize when a model can be trusted. Models based on physics and engineering often look impressively complex, but don't confuse complexity with being correct. Complex models fail when the science does not mimic reality. For example, NASA used the following elaborate equation to estimate the chance of foam insulation breaking off during take-off and damaging the space shuttle:

$$p = \frac{0.0195(L/d)^{0.45}(d)\rho_F^{0.27}(V - V^*)^{.67}}{S_T^{.25}\rho_T^{.16}}$$

The model represented by this equation failed to anticipate the risk of damage from faulty insulation. Damage from insulation caused the space shuttle *Columbia* to break apart on reentry in 2003.

Models also fail if we mistake random variation for a pattern. People are great at finding patterns. Ancient people looked into the sky and found patterns among the stars. Psychiatrists use the Rorschach ink blot test to probe deep feelings. People even find patterns in clouds, imagining shapes or faces floating in the sky. The phenomenon of perceiving something familiar in a place where it does not occur is so common that it even has a name: pareidolia.¹ A key task in statistics is deciding whether the pattern we have discovered is real or something that we've imagined. Finding a pattern allows us to anticipate what is most likely to happen next, to understand the data in order to plan for the future and make better decisions. But if we imagine a pattern when there is none, we become overconfident and make poor decisions.

1.2 | PREVIEWS

The following two examples preview the use of statistics to answer questions. Movie theaters show previews of coming attractions with lots of action and explosions, and save the character development for later. These examples introduce recurring themes and showcase several methods that are fully developed in later chapters. The point is to advertise the types of analyses you will be able to do after you finish this book.

Each example begins with a question motivated by a story in the news, and then uses a statistical model to formulate an answer to the question. The first example uses a model to predict the future, and the second uses a model to fill in for an absence of data. These are previews, so we emphasize the results and skip the details.

Predicting Employment

In early November 2005, national broadcasts announced surprising and disturbing economic results. The big story was not a recession, but rather the U.S. economy's slower than expected growth. The Labor Department reported that only 56,000 jobs had been created in October 2005, far short of the 100,000 additional jobs expected by Wall Street forecasters.

Financial markets react to surprises. If everyone on Wall Street expects the Labor Department to report large numbers of new jobs, the stock market can tumble if the report announces only modest growth. What should we have expected? What made Wall Street economists expect 100,000 jobs to be created in October? Surely they didn't expect *exactly* 100,000 jobs to be created. Was the modest growth a fluke? These are serious questions. If the shortfall in jobs is the start of a downward trend, it could indicate the start of an economic recession. Businesses need to anticipate where the economy is headed in order to schedule production and supplies.

Was the weather responsible for the modest growth? On August 29, 2005, Hurricane Katrina slammed into Louisiana, devastating the Gulf Coast (see Figure 1.1). Packing sustained winds of 175 miles per hour, Katrina overwhelmed levees in New Orleans, flooded the city, and wrecked the local economy. Estimates of damages reached \$130 billion, the highest ever attributed to a hurricane in the United States, with more than 1,000 deaths. Katrina and the hurricanes that followed during the 2005 season devastated the oil industry concentrated along the Gulf of Mexico and disrupted energy supplies around the country. Did Katrina wipe out the missing jobs?

Let's see if we can build our own forecast. Back in September 2005, how could you forecast employment in October?

¹The *New York Times* article "Is That Jesus in Your Toast" (April 4, 2014) discusses the underlying psychology and offers several more examples.



FIGURE 1.1 Hurricane Katrina on August 29, 2005.

We need two things to get started: relevant data and a method for using these data to address the question at hand. Virtually every statistical analysis proceeds in this way. Let's start with data. At a minimum, we need the number employed before October. For example, if the number of jobs had been steady from January through the summer of 2005, our task would be easy; it's easy to forecast something that doesn't change.

The problem is that employment does change. Table 1.1 shows the number of thousands employed each month since 2003. These are the data behind the story.

TABLE 1.1 Nonfarm employment in the United States, in thousands on payrolls.

	2003	2004	2005
Jan	130,247	130,372	132,573
Feb	130,125	130,466	132,873
Mar	129,907	130,786	132,995
Apr	129,853	131,123	133,287
May	129,827	131,373	133,413
Jun	129,854	131,479	133,588
Jul	129,857	131,562	133,865
Aug	129,859	131,750	134,013
Sep	129,953	131,880	134,005
Oct	130,076	132,162	134,061
Nov	130,172	132,294	
Dec	130,255	132,449	

Each column gives the monthly counts for a year. The first number in the table represents 130,247,000 jobs on payrolls in January 2003. The following number shows that payrolls in February 2003 fell by 122,000. At the bottom of the third column, we can see that employment increased by 56,000 from September to October 2005, as reported by Reuters. This variation complicates the task of forecasting. We've got to figure out how we expect employment to change next month.

We won't replicate the elaborate models used by Wall Street economists, but we can go a long way toward understanding their models by plotting the data. Plots are among the most important tools of statistics. Once we see the plot, we can decide how to make a forecast.

The graph in Figure 1.2 charts employment over time, a common type of display that we'll call a **timeplot**. To keep the vertical axis nicely scaled and avoid showing extraneous digits, we labeled the employment counts in millions

timeplot A chart of values ordered in time, usually with the values along the y-axis and time along the x-axis.



FIGURE 1.4 Projected path for Katrina.

To get a forecast, we extend the pattern. It is easy to extend the line beyond the data, as in Figure 1.3. The line passes above the count for October. This model predicts employment to be near 134,150,000 in October 2005, about 90,000 more than the reported count. That's close to the value claimed in the news reports mentioned at the beginning of this subsection. We can also extend the region of uncertainty around the line. We should not expect counts of employment in the future to be closer to the line than those in the past. The line—our pattern—forecasts employment to be near that predicted by Wall Street economists. On the basis of this pattern, we would forecast employment in October to lie between 134,130,000 and 134,533,000 jobs.

Our simple model confirms that the level of employment in October 2005 *is* surprising. Not only is the reported count of 134,061,000 for October less than expected, but it's also outside the anticipated range. Even allowing for variation around the pattern, employment is smaller than expected. Something happened in October that reduced the number of jobs. This is a large break from the pattern and demands our attention. Do we know *why* the employment was less than expected?

Anticipating the impact of weather on employment is an ongoing concern. In the fall of 2008, Hurricanes Ike and Gustav were blamed for putting 50,000 Americans out of work, and the Department of Commerce estimated that Hurricane Sandy put 65,000 out of work in New Jersey and New York in 2012. The only way to arrive at these estimates is to predict what would have happened had these hurricanes not struck. That's a job for a statistical model.

Pricing a Car

For our second preview, let's talk about cars. You may not be interested in cars, but, even so, you have almost certainly heard of the automaker BMW.

Writers for *Car and Driver* magazine love cars made by BMW, particularly the popular sporty sedans that go by numeric names like the 328 or the 335. According to these journalists, competitors have yet to figure out a way to beat the BMW 3-series. Competitors keep trying to knock BMW off the top of the pedestal but keep falling short in comparison. Year after year, *Car and Driver* has included BMW 3-series models in its "top 10" list of best cars of the year.

What's it going to cost to get behind the wheel of a BMW 3-series? The manufacturer's suggested retail price for a basic 2016 BMW 328i is \$38,350, excluding options like leather seats that add \$1,500 to the bottom line. That's a lot to spend, so let's see what a used BMW costs. For example, a search on the Web turned up a 2013 BMW 328i advertised for \$27,000. The car has 40,000 miles, an automatic transmission, and a variety of options. On one hand, it sounds like a lot to spend \$27,000 on a used car. On the other hand, its price

is \$11,350 less than the cost of a stripped-down new car that lacks options like the heated leather seats found on this car.

Companies face similar decisions: Should a company buy new equipment, or should it look for a deal on used substitutes? As for cars, auto dealerships face these questions every day. What should the dealership charge for a three-year lease? The ultimate resale value has a big effect. If, when the car comes back, the dealership can sell it for a good price, then it can offer a better deal on a lease.

Once again, we need to identify data and decide how to use them. To get data on the resale value of used BMWs, students in a class downloaded prices for used cars offered by BMW dealers. They gathered information about 153 cars in the 328-series, from the 2011 through the 2016 model years. Table 1.2 summarizes the prices of these cars, broken out by model year. Eighty-four of these cars are 2013 models, like the car in the online ad. On average, these sell for \$29,784. That's \$2,784 more than the car in the ad.

TABLE 1.2 Average prices vary by year.

Model Year	Number	Average Price
2011	16	\$22,967
2012	3	\$25,993
2013	84	\$29,784
2014	15	\$34,409
2015	34	\$38,385
2016	1	\$38,999

Before we decide that the used car in the ad is a bargain, we ought to consider other things that affect the price. You can probably name a few. We've taken into account the age (2013 model year) and style (328), but not the mileage. We'd guess you'd be willing to pay more for a car with 10,000 miles than an otherwise similar car with 100,000 miles.

scatterplot A graph that shows pairs of values (x, y) laid out on a two-dimensional grid.

The **scatterplot** in Figure 1.5 shows that mileage is related to price. Each point shows the mileage and price of one of these 84 cars. None of these cars has exactly the same mileage as the advertised car. We can use a statistical model to compensate for our lack of cars with the same mileage. The plot in Figure 1.6 shows a line that relates mileage to price. The plot includes the region of uncertainty around the line. The region of uncertainty is wide because other factors, such as the condition of the car and its options, affect the price. There's much more variation around this pattern than around the line in Figure 1.3.

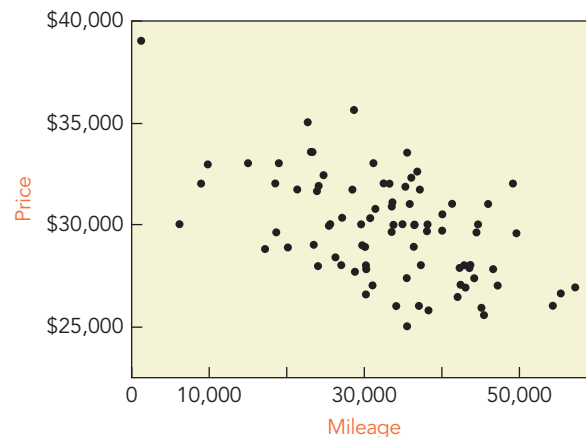


FIGURE 1.5 Scatterplot of price versus mileage.

In our first example, we extrapolated a pattern in historic data. In this example, the pattern serves a different purpose. The line in Figure 1.6 allows us to

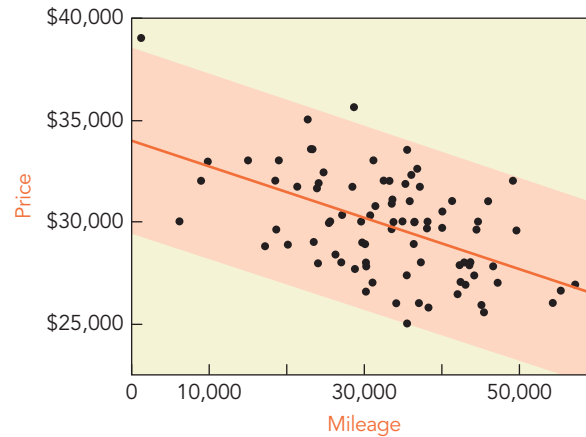


FIGURE 1.6 A line relates mileage to price for these cars.

borrowing strength The use of a model to allow all of the data to answer a specific question.

borrow strength. **Borrowing strength** refers to using a model to glean more from data for answering a question. Rather than search for used cars with exactly 40,000 miles, this model—the line—allows us to estimate the price of a car with 40,000 miles, even though we haven't seen a car with exactly this mileage. Even though the mileage varies among these cars, the pattern allows us to “borrow” some of the information about each car to estimate the price of a car with specific mileage. The estimated value, reading off the height of the line, is about \$28,900. As an added bonus, the negative slope of the line in Figure 1.6 shows how higher mileage reduces the value of a car. On average, these cars lose about 13 cents of value per mile.

Having seen this analysis, do you think the car in the classified ad is a bargain? Its \$27,000 price is less than the predicted price from this model, but well within the range for cars of this age and mileage. It might be worth a further look, particularly if you like the options that it includes!

The following chapters contain many more examples like these that illustrate the use of statistics in business. The only difference is that you will be doing the analysis, making the choices, and interpreting the results. The first step in learning these methods is to appreciate the importance of data, and that is the subject of the next chapter.