This is a sample of the instructor resources for Fundamentals of Healthcare Finance by Louis Gapenski. This sample contains the instructor notes and PowerPoint slides for Chapter 11.

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ANSWERS TO END-OF-CHAPTER QUESTIONS

11.1 a. Stakeholders are the parties who have a financial interest in a business. In a not-for-profit business, such as a community hospital, stakeholders include managers, staff physicians, employees, suppliers, creditors, patients, and even the community at large. Investor-owned businesses have essentially the same set of stakeholders, with the addition of owners (in corporations, stockholders).

b. Because all stakeholders, by definition, have at least some financial interest in the business, all stakeholders have an interest in its financial condition. However, of all the outside stakeholders, investors typically have the greatest financial interest in healthcare organizations, and hence are the parties most interested in the business's financial condition. In addition to investors, the business's managers, including its board of directors (trustees), also are vitally concerned about financial condition. After all, managers are charged with ensuring that the organization has the financial strength to accomplish its mission, whether that mission is to maximize the wealth of its shareholders or to provide healthcare services to the community at large.

11.2 a. Generally accepted accounting principles (GAAP) can be thought of as a set of guidelines (objectives, conventions, and principles) that have evolved through the years to guide the preparation and presentation of financial statements.

b. The GAAP were designed to provide the information needed by stockholders, creditors, and other interested parties to make the best-informed decisions, primarily investment decisions.

c. Several organizations are involved in establishing the GAAP. The Securities and Exchange Commission (SEC), an independent regulatory agency of the U.S. government, has the overall authority to establish and enforce the form and content of financial statements. However, the SEC does not create the standards, but rather allows other organizations to create and implement the standard system. For the most part, the SEC has delegated the responsibility for establishing standards to the Financial Accounting Standards Board (FASB), a private organization whose mission is to establish and improve standards of financial accounting and reporting for private businesses. (The Government Accounting Standards Board [GASB] has the identical responsibility for public businesses.) The FASB and its predecessor organization (the Accounting Principles Board) promulgate guidelines in pronouncements with various names such as statements or opinions. Typically, the guidelines established by the FASB apply across a wide range of industries and, by design, are somewhat general in nature. Yet another organization is needed to provide more specific implementation rules, especially when industry-unique guidance is required. This task is accomplished by the American Institute of Certified Public Accountants (AICPA), which is the professional association of public (financial) accountants. The AICPA has substantial influence with its membership, much like the influence that the American Medical Association (AMA) has on its member physicians. The AICPA, through its industry committees, promulgates the actual rules that accountants follow when preparing and auditing an organization’s financial statements. For example, financial statements in the healthcare industry are based on the AICPA Audit and Accounting Guide titled Health Care Organizations. Finally, when even more specific guidance is required, other professional organizations may participate in the standard-setting process, although such work does not have the same degree of influence as the FASB or the AICPA. For example, the Healthcare Financial Management...
Association (HFMA) has established a *Principles and Practices Board*, which develops position statements on issues requiring further guidance.

11.3 Under **cash accounting**, as its name implies, revenues and expenses are recorded when the cash transaction occurs. Supporters of accrual accounting argue that the cash basis of accounting fails to portray the true economic status of the organization—the primary goal of financial accounting—because it is the provision of the service that actually creates the revenue. In rebuttal, the supporters of cash accounting argue that accrual accounting is misleading because readers of financial statements logically expect revenues to represent cash inflows to the reporting organization.

Under **accrual accounting**, both revenues and expenses are recorded when the obligation to make payment occurs. This logic depends on the *revenue recognition principle*, which states that revenue is recognized when it is *realizable* and *earned*. Thus, revenue is recognized when a service is rendered that creates a measurable payment obligation on the part of the purchaser, rather than when the payment is actually received. Expenses are treated in the same way; they are recorded when the obligation is created. In addition, under accrual accounting, expenses must follow the *matching principle*, which requires that an organization’s expenses be matched, to the extent possible, with the revenues to which they are related. In essence, after the revenues have been allocated to a particular accounting period, all expenses associated with producing those revenues should be matched to the same period.

11.4 The *income statement* summarizes the operations (i.e., the activities) of an organization with a focus on its revenues, expenses, and profitability. Thus, the income statement is often called the *statement of operations* or the *statement of activities*. Revenues are the starting point of an income statement; then, expenses are subtracted to determine an organization’s net income, or accounting profitability. Often, the income statements of not-for-profit providers are structured in such a way so that both net income and net operating income are presented.

11.5 a. *Gross revenues* are revenues based on a provider’s schedule of charges, while *net revenues* are the revenues that are actually anticipated. To obtain the amount of net revenues, revenues lost to payer discounts and to charity care patients are subtracted from gross revenues.

b. *Patient service revenue* stems directly from the provision of patient services, as opposed to revenues stemming from related or unrelated activities. *Other operating revenue* is related to patient services (operations) but is not a direct result of such services. Other operating revenue includes revenues associated with activities such as parking garages and visitor food services. Note that *other revenue* (often called *other income*) is nonpatient related and includes items such as interest earned on securities investments.

c. *Charity care* represents services that are provided to patients who do not have the capacity to pay. *Bad debt losses* result from the failure to collect for services provided to patients or third-party payers that do have the capacity to pay. Charity care is not reported directly on the income statement because net, rather than gross, revenues are reported. However, charity care is typically reported in a footnote. Conversely, bad debt losses are reported as an operating expense directly on the income statement.
11.6 a. An expense, which represents the cost of doing business, is an accounting deduction from revenues. Expenses may be reported using either a natural classification, which classifies expenses by the nature of the expense such as salaries or supplies; or a functional classification, which classifies expenses by purpose such as inpatient services or outpatient services. Note that under accrual accounting, expenses reported on the income statement do not precisely match the cash outflows of the business.

b. To match the cost of fixed assets to the services supported by those assets, accountants use the concept of depreciation expense, which spreads the cost of a fixed asset over many years. In essence, depreciation expense recognizes that fixed assets, which are not free, are required to provide the services that generate revenues. However, because fixed assets often can be used for long periods, and hence generate revenues over many years, the costs associated with such assets, which should be matched to the revenues, must also be spread over long periods. The calculation of depreciation expense is somewhat arbitrary, so its amount generally is neither closely related to the actual usage (wear and tear) of a fixed asset nor its true loss in market value.

c. Other categories of expenses include operating expenses such as salaries and benefits, amortization expense, medical supplies, and lease expense, as well as nonoperating expenses such as interest expense.

11.7 a. Operating income is the difference between operating revenues and operating expenses. It focuses on the economic profitability of an organization’s core business.

b. Net income is the difference between total revenues and total expenses. It differs from operating income in that net income includes nonoperating items. The largest of these nonoperating items often are endowment income and contributions. It is not uncommon for not-for-profit hospitals to have a negative operating income but a positive net income because operating losses can be offset by nonoperating revenues.

c. Net income often is called the “bottom line” because it is the primary focus of the income statement. In essence, the entire rationale for estimating a business’ revenues and expenses is to determine its total profitability, which net income provides.

d. Because the revenues and expenses listed on the income statement follow accrual accounting concepts, net income measures accounting or economic profitability rather than the actual movement of cash. Cash flow, on the other hand, represents the actual cash that a business generates over some period. As a first approximation, cash flow can be estimated by adding noncash expenses to net income.

e. One could argue that, over the long run, financial condition is more closely related to net income because net income attempts to measure a business’s economic (long-term) profitability. There is no doubt, however, that current and near-term financial condition is more closely related to cash flow.
11.1 Here is one version of a correctly ordered income statement. Note, however, that some of the items can be ordered differently as long as the general format below is followed.

Revenues:
- Patient service revenue $440,000
- Other revenue 10,000
- Interest income 40,000
Total revenues $490,000

Expenses:
- Salaries and benefits $150,000
- Purchased clinical services 90,000
- General/administrative expenses 70,000
- Depreciation expense 90,000
- Bad debt expense 40,000
- Interest expense 20,000
Total expenses $460,000

Net income $ 30,000

11.2 a. The primary difference is in the listing of revenues. Being an HMO, revenues are listed as premiums earned and coinsurance rather than as net patient service revenue. Otherwise, the expense categories are roughly the same.

b. BestCare did not spend $367,000 on new fixed assets during 2008. The depreciation expense entry recognizes the loss of value, or “wear and tear,” that the HMO’s fixed assets presumably experienced during the year. Note, however, that depreciation expense is calculated according to somewhat arbitrary rules, so the amount listed may not reflect the actual change in market value of those assets.

c. The HMO gets its revenues from employers and individuals. On the basis of contracts in force, the amount of revenues due for coverage in 2007 was $440,000. However, BestCare expects that not all of these revenues will be collected. The estimated amount of uncollectible revenues, $19,000, is listed as an expense item called provision for bad debts.

d. Total (profit) margin is defined as net income divided by total revenues. Thus, BestCare’s total margin for 2008 was $1,218 ÷ $28,613 = .043 = 4.3%. This means that each dollar of revenue produced 4.3 cents of earnings for the HMO. The higher the total profit margin, the better the organization’s expense control because the greater the amount of revenues that flows through to net income.

11.3 a. The primary difference here is that lines are added that contain the operating (taxable) income and provision for income taxes entries. These lines indicate that Green Valley is an investor-owned, and hence taxable, nursing home. Note that Green Valley’s implied tax rate is $31,167 ÷ $89,048 = .35 = 35%.
b. As stated in the response to Part a, Green Valley is an investor-owned (for-profit) entity.

c. Green Valley’s total (profit) margin was $57,881 ÷ $3,269,404 = .018 = 1.8%. This is significant lower than the 2007 total profit margins of Sunnyvale (4.5 percent) and BestCare (4.3 percent). Of course, profitability depends on the line of business, the local operating environment, and how well a specific organization is managed. All things the same, however, investor-owned businesses, because of taxes, would be expected to have lower total profit margins than not-for-profit businesses.

d. Green Valley’s before-tax profit margin was $89,048 ÷ $3,269,404 = .027 = 2.7%, which is higher than its total profit margin. Because the before-tax margin removes the influence of taxes, it is a better measure of expense control when comparing investor-owned and not-for-profit businesses.

11.4 a. With a net income of $2.4 million on total revenues of $30 million, total expenses must be $30 – $2.4 = $27.6 million.

b. With $1 million in noncash expenses (depreciation), cash expenses must total $26.6 million.

c. Using only income statement data, cash flow can be approximated as Net income + Noncash expenses = Net income + Depreciation. For Great Forks, Cash flow = $2.4 + $1 = $3.4 million.

11.5 a. Here is Brandywine’s 2008 income statement (in millions):

<table>
<thead>
<tr>
<th>Total revenues</th>
<th>$12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>All but depreciation (75%)</td>
<td>$9</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>1.5</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$10.5</td>
</tr>
<tr>
<td>Net income</td>
<td>$1.5</td>
</tr>
</tbody>
</table>

b. Net income = $12 – $9 – $1.5 = $1.5 million.
Total profit margin = Net income ÷ Total revenues = $1.5 ÷ $12 = .125 = 12.5%.
Cash flow = Net income + Depreciation expense = $1.5 + $1.5 = $3 million.

c. Net income = $12 – $9 – $3 = $0.
Total profit margin = $0 ÷ $12 = 0%.
Cash flow = $0 + $3 = $3 million.

d. Net income = $12 – $9 – $.75 = $2.25 million.
Total profit margin = $2.25 ÷ $12 = .188 = 18.8%.
Cash flow = $2.25 + $.75 = $3 million.

The key point here is that depreciation, as a noncash expense, affects accounting profitability (net income), but it does not affect cash flow in not-for-profit businesses.
11.6 a. Here is MainLine’s 2008 income statement (in millions):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues</td>
<td>$12</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>All but depreciation (75%)</td>
<td>$9</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>$1.5</td>
</tr>
<tr>
<td>Total expenses</td>
<td>$10.5</td>
</tr>
<tr>
<td>Operating income</td>
<td>$1.5</td>
</tr>
<tr>
<td>Taxes (40%)</td>
<td>.6</td>
</tr>
<tr>
<td>Net income</td>
<td>$.9</td>
</tr>
</tbody>
</table>

b. Net income = ($12 – $9 – $1.5) – ($12 – $9 – $1.5) x .4
   = $1.5 – $.6 = $.9 million.
   Total profit margin = Net income ÷ Total revenues = $.9 ÷ $12 = .075 = 7.5%.
   Cash flow = Net income + Depreciation expense = $.9 + $1.5 = $2.4 million.

c. Net income = ($12 – $9 – $3) – ($12 – $9 – $3) x .4
   = $.0 – $.0 = $.0.
   Total profit margin = $.0 ÷ $12 = 0%.
   Cash flow = $.0 + $3 = $3 million.

d. Net income = ($12 – $9 – $.75) – ($12 – $9 – $.75) x .4
   = $2.25 – $.9 = $1.35 million.
   Total profit margin = $1.35 ÷ $12 = .112 = 11.2%.
   Cash flow = $1.35 + $.75 = $2.1 million.

With taxes introduced, the situation changes. Now, the greater the depreciation, the lower
the reported profitability but the greater the cash flow. Because depreciation expense
reduces taxable income but not cash flow, higher depreciation means that less money
goes for taxes and hence more is left for the business.
CHAPTER 11
Reporting Profits

- Introduction to financial accounting
- The income statement
  - Revenues
  - Expenses
  - Operating income
  - Nonoperating income
  - Net income
Financial accounting involves identifying, recording, and communicating the operational results and status of an organization (as opposed to a subunit).

Financial accounting information is conveyed by a business’s financial statements. The three most important are

- the income statement,
- the balance sheet, and
- the statement of cash flows.
The requirement to provide financial accounting information is driven by the need for outside stakeholders (primarily investors) to have reliable information regarding the financial status of an organization.

However, the information presented in financial statements is as important to managers as it is to outsiders.

Should the preparation and presentation of financial accounting data be regulated?
The Securities and Exchange Commission (SEC) has the legal authority to regulate the form and content of financial statements. However, the SEC relies on other organizations for implementation. The result is a set of guidelines for the preparation of financial statements called generally accepted accounting principles (GAAP).

Do GAAP remain static over time?
Cash Versus Accrual Accounting

- **Cash accounting** recognizes an event when a **cash transaction** takes place.
  - Simple and easy
  - Mimics tax statements

- **Accrual accounting** recognizes an event when an **obligation** is created.
  - More complicated
  - Provides a better picture of the true economic status of a business
  - Is required by GAAP
Perhaps the most important question about a business’s **financial status** is whether it is making money.

The **income statement** provides information about a business’s operations and **economic profitability**.

The income statement is often called by other names:
- Statement of operations
- Statement of activities
The income statement reports the results of operations over some period (e.g., a year). It has three key elements:

- **Revenues**, which, under accrual accounting, represent both cash received and payer obligations

- **Expenses**, which are the resource expenditures required to produce the revenues (Again, note that under accrual accounting, both cash and noncash expenses are recognized.)

- **Profit measure(s)** = Revenues − Expenses.
Sunnyvale Clinic: Revenues
(in thousands)

We will use Sunnyvale Clinic, a large not-for-profit provider, to illustrate financial statements, beginning with the revenue section of its income statement.

<table>
<thead>
<tr>
<th>Year</th>
<th>Net patient service revenue</th>
<th>Other operating revenue</th>
<th>Total revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$172,013</td>
<td>1,079</td>
<td>$173,092</td>
</tr>
<tr>
<td>2007</td>
<td>$140,896</td>
<td>704</td>
<td>$141,600</td>
</tr>
</tbody>
</table>

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Revenues are shown in several different formats, depending on the type of provider. Sunnyvale has two revenue categories.

**Net patient service revenue**—key definitions:

- **Net** (as opposed to **gross**)  
- **Patient service revenue** (as opposed to other operating revenue)

Note that revenue from capitated patients typically is called **premium revenue**.
In reporting revenues, note how the following categories are handled:

- **Discounts** (not reported as revenue)
- **Charity care** (not reported as revenue)
- **Bad debt losses** (reported, but expensed later)

Other operating revenue represents revenues from sources related to operations (patient care), including

- parking garage receipts, and
- cafeteria sales.
Revenues (cont.)

Note that the revenue reported does not represent the amount of cash collected:

- Some portion has not yet been collected. The *uncollected portion* will appear on the balance sheet in an account titled *receivables*.
- In addition, some revenues reported in the previous year were collected this year.

¿What is the difference between *gross* and *net* patient service revenue?
## Sunnyvale Clinic: Expenses
*(in thousands)*

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and benefits</td>
<td>$126,223</td>
<td>$102,334</td>
</tr>
<tr>
<td>Supplies</td>
<td>20,568</td>
<td>18,673</td>
</tr>
<tr>
<td>Insurance</td>
<td>4,518</td>
<td>3,710</td>
</tr>
<tr>
<td>Leases</td>
<td>3,189</td>
<td>2,603</td>
</tr>
<tr>
<td>Depreciation</td>
<td>6,405</td>
<td>5,798</td>
</tr>
<tr>
<td>Provision for bad debts</td>
<td>2,000</td>
<td>1,800</td>
</tr>
<tr>
<td>Interest</td>
<td>5,329</td>
<td>3,476</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td><strong>$168,232</strong></td>
<td><strong>$138,394</strong></td>
</tr>
</tbody>
</table>
Expenses

- Expenses represent the resources used to create revenues; they are the costs of doing business. Like revenues, under accrual accounting, expenses do not necessarily reflect cash outlays.

- Expenses may be presented in different ways:
  - For example, salaries, supplies, insurance, leases, and so on, as shown here
  - Or, inpatient services, outpatient services, ancillary services, administration, and so on
Expenses (cont.)

- **Salaries and benefits expense** represents labor costs.
  - Typically, salaries and benefits expense is the largest expense category for health services organizations.
  - Although only summary information is given on the income statement, details are available from the managerial accounting system.

- **Supplies expense** represents the cost of expendable (primarily medical) materials.
  - The dollar amount shown represents the amount of supplies consumed, not the amount purchased.
  - Supply stocks are reported on the balance sheet.
Insurance expense represents the cost of commercial insurance purchased to protect the clinic against several risks, including the following:

- **Property risks**
  - Fire
  - Weather

- **Liability risks**
  - Managerial malfeasance
  - Medical liability
Sunnyvale owns most of its land and buildings, but it leases much of its diagnostic equipment. Leases expense reports these costs.

Different types of leases require different balance sheet treatment. However, all lease expense is reported on the income statement.

Why do organizations use leases?
According to GAAP, **depreciation expense** arises because expenses must be matched to the revenues with which they are associated.

While **operating costs** such as labor and supplies are assumed to produce immediate revenues and hence are more or less immediately reported (expensed) on the income statement, the costs of long-lived assets (buildings and equipment) are **not** reported on the income statement at the time the acquisition is made.
Rather, the “cost” of a long-lived asset is first capitalized (recorded on the balance sheet as an asset of the business). Then, this amount is amortized (or spread) over the accounting life of the asset, which means the cost is shown (expensed) on the income statement as small increments over time.

The amortization expense of buildings and equipment when listed on the income statement is called depreciation.

For financial accounting purposes, depreciation is calculated by the straight-line method.
Most expense items listed on the income statement only approximate actual cash expenditures. The relationship is not exact because of accrual accounting.

However, depreciation expense typically has no associated cash expenditure during the accounting period.

Such an expense is referred to as a noncash expense.
Expenses (cont.)

- **Provision for bad debts expense** reports the amount of net patient service revenue that is not *expected* to be collected.
  - It is an estimate based on past experience.
  - Past estimates are reconciled when the data are known.

- **Interest expense** reports the amount of interest paid (or obligated) on debt financing.
### Sunnyvale Clinic: Operating Income
(in thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenues</th>
<th>Total Expenses</th>
<th>Operating Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$173,092</td>
<td>$168,232</td>
<td>$4,860</td>
</tr>
<tr>
<td>2007</td>
<td>$141,600</td>
<td>$138,394</td>
<td>$3,206</td>
</tr>
</tbody>
</table>

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Although the reporting of revenue and expenses is important, the difference between the two, **operating income**, is even more important.

Operating income measures the **profitability** of a provider’s core (patient services) operations as defined by GAAP.

Because providers have nonoperating income, operating income does not tell the whole story regarding profitability.
### Sunnyvale Clinic: Nonoperating Income
(in thousands)

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributions</td>
<td>$2,600</td>
<td>$1,408</td>
</tr>
<tr>
<td>Investment income</td>
<td>$1,308</td>
<td>$1,704</td>
</tr>
<tr>
<td><strong>Total nonoperating income</strong></td>
<td><strong>$3,908</strong></td>
<td><strong>$3,112</strong></td>
</tr>
</tbody>
</table>
Nonoperating Income

Nonoperating income is income (actually revenue) from sources unrelated to patient services.

Typically, the two largest sources are
- charitable contributions, and
- income from securities investments.

Thus, total profitability (net income) consists of operating income plus nonoperating income.
## Sunnyvale Clinic: Net Income (in thousands)

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating income</td>
<td>$4,860</td>
<td>$3,206</td>
</tr>
<tr>
<td>Nonoperating income</td>
<td>3,908</td>
<td>3,112</td>
</tr>
<tr>
<td>Net income</td>
<td>$8,768</td>
<td>$6,318</td>
</tr>
</tbody>
</table>

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Net Income

- **Net income** is the “bottom line” of the income statement.
- Net income measures **total profitability** as defined by GAAP.
- In **not-for-profit businesses**, net income is typically called
  - revenues over expenses,
  - excess of revenues over expenses, or
  - change in net assets.
In a **not-for-profit corporation**, the entire amount of net income is reinvested in the business.

In a **for-profit business**, net income, which constitutes the residual earnings of the business, belongs to the owners.

- Some portion of net income may be returned to owners as dividends.
- The remainder is reinvested in the business.
Net Income (cont.)

- The income statements of many not-for-profit corporations contain a section that reconciles net income with the balance sheet equity account.

- Note that economic profitability is a complex concept that is difficult to measure because economic gains and losses often are not matched by easily identifiable and measurable events.

? What does this complexity mean for users of financial statement information?
Because of **accrual accounting**, net income does not represent **cash flow**.

- Some income statement items represent cash flows; others do not.
- Some, such as revenues, represent partial cash flows.

With only income statement data, cash flow (CF) can be **approximated**:

\[
CF = \text{Net income} + \text{Noncash expenses} \\
= \text{Net income} + \text{Depreciation} \\
= $8,768,000 + $6,405,000 = $15,173,000
\]
The income statements of investor-owned and not-for-profit businesses are similar.

- The revenues and costs to organizations in the same line of business are similar, regardless of ownership.

- However, some transactions, such as income tax payments, clearly are applicable to only for-profit businesses.

- Also, for-profit statements typically do not differentiate between operating and nonoperating income.
This concludes our discussion of Chapter 11 (Reporting Profits).

Although not all concepts were discussed in class, you are responsible for all of the material in the text.

Do you have any questions?