

# How to pay for that EHR

Selecting financing vehicles for your group's electronic health record

## reader take-away

- Understand the three types of leases that can help you acquire an EHR
- Get the definition of "capitalized cost" for an EHR
- Learn the pros and cons of buying, leasing or leasing with a buy-back at the end of the term
- View two financing scenarios
- Get a financial vehicle selection matrix to help you choose a financing option



**A**s the health care industry embraces electronic health record (EHR) technology, medical groups must decide how to finance it. Lease, buy or use a hybrid lease? Selecting the right financing option may allow you to obtain the high-end EHR that could optimize the quality of your practice's care.

## Debt financing

Banks use your accounts receivable (A/R) as collateral and often request access to patient information as it pertains to receivables; this may also include patients' medical records. Read the fine print and understand your obligations under the Health Insurance Portability and Accountability Act.

A/R financing comes with reporting requirements such as accrual-basis or cash-basis accounting; the size of your organization determines which method you use. Have an accountant review the financial reporting obligations in the financing agreement.

Are you financing the service, maintenance and hardware of the EHR? If so, you may save thousands in interest payments over the life of the loan by separating these items from the agreement. In-house technical staff (if you have it) can handle service and maintenance, or you can pay for it as

needed. Consider leasing the hardware with low buy-back or buyout options. Many computer hardware vendors offer leasing programs to replace aging hardware and keep your equipment current.

## Leasing: Three options

There are three types of leases — operating lease (a.k.a. service lease), financial lease

**Select the lease based on how you want to implement the application and to get the most value for your dollar.**

(a.k.a. capital lease) and hybrid lease. Select the lease based on how you want to implement the application and to get the most value for your dollar.

**Service lease** — Typically offered by EHR vendors a service lease generally includes both financing and maintenance of the EHR application and hardware. Be sure you know what's included. It should include a cancellation clause so you can stop the service

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## Financial vehicle selection matrix

portion of the lease if the lessor's support is inadequate.

**Financing lease** — Typically used for the EHR hardware, it may have replacement agreements at regular intervals to keep the hardware current. It does not offer a cancellation policy, maintenance or service. Smaller practices may prefer this type of lease to lower the monthly expense. Larger groups, with their own IT staff to maintain the technology, might find financing a better option.

**Hybrid lease** — May have a wide variety of terms, including a cancellation policy for a financing lease. It may have both service and financing options.

		Useful life	
		Short	Long
Hidden costs	Low	Lease	Hybrid
	High	Hybrid	Purchase

The EHR vendor will often use a leasing company to administer any type of lease. These third-party companies typically have ironclad contracts that don't allow cancellation. However, you may find their rates

see **How to pay**, page 52

## Scenario 1: Short-term EHR ownership

Assumptions	Cost of EHR (software and hardware)	\$150,000	Annual depreciation	\$30,000	Tax rate	0.40
	Residual value	0	After-tax cost debt/Discount rate	0.06	Interest	0.10
					Cap rate	0.12
Financing lease cost	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
EHR lease payment	(\$33,600)	(\$33,600)	(\$33,600)	(\$33,600)	(\$33,600)	
Hidden costs	(\$15,000)	\$0	\$0	\$0	\$0	\$0
Tax savings on hidden costs	\$6,000	\$0	0	0	0	0
Maintenance cost	(\$1,500)	(\$1,500)	(\$1,500)	(\$1,500)	(\$1,500)	
Tax savings on maintenance	600	600	600	600	600	
Tax savings on payment	\$13,440	\$13,440	\$13,440	\$13,440	\$13,440	
Net cash flow	(\$30,060)	(\$21,060)	(\$21,060)	(\$21,060)	(\$21,060)	\$0
Net present value of leasing	(\$103,035)					
Debt financing cost	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
EHR cost	(\$150,000)					
Hidden costs	(\$15,000)	\$0	\$0	\$0	\$0	\$0
Tax savings on hidden costs	\$6,000	\$0	\$0	\$0	\$0	\$0
Maintenance cost	(\$1,500)	(\$1,500)	(\$1,500)	(\$1,500)	(\$1,500)	
Tax savings on maintenance	\$600	\$600	\$600	\$600	\$600	
Tax savings on depreciation	\$12,000	\$12,000	\$12,000	\$12,000	\$12,000	\$0
Net cash flow	(\$147,900)	\$11,100	\$11,100	\$11,100	\$11,100	\$0
Net present value of owning	(\$109,437)					
Hybrid lease cost	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
EHR lease payment	(\$37,600)	(\$37,600)	(\$37,600)	(\$37,600)	(\$37,600)	
Hidden costs	(\$15,000)	\$0	\$0	\$0	\$0	\$0
Tax savings on hidden costs	\$6,000	\$0	\$0	\$0	\$0	
Tax savings on payment	\$15,040	\$15,040	\$15,040	\$15,040	\$15,040	
Net cash flow	(\$31,560)	(\$22,560)	(\$22,560)	(\$22,560)	(\$22,560)	\$0
Net present value of leasing	(\$109,733)					

more appealing than the vendor's lease. Third-party leasing companies pay the EHR vendor directly for the technology. Therefore, their leases can create a barrier between the vendor and the lessee, making it difficult to cancel the lease if the application fails to perform.

### Negotiating EHR price terms

Regardless of the type of lease or financing, you need to understand components of the

agreement. The cost of the EHR is referred to as the capitalized cost, or "cap cost." Failure to negotiate the cap cost can cost your practice thousands of dollars. Negotiate the EHR price as if you are going to own the technology before considering your finance options. The lessee or financier will apply a money factor or interest rate to the cap cost. To understand the hardware's depreciation rate, learn the residual value or the market value of the EHR hardware (if any) at the end of the financing term.

## Scenario 2: Long-term EHR ownership

Assumptions	Cost of EHR (software and hardware)	\$500,000	Annual depreciation	\$100,000	Tax rate	0.40	
	Hidden costs	\$100,000/\$50,000	After-tax cost debt/Discount rate	0.06	Interest	0.10	
					Cap rate	0.12	
<b>Financing lease cost</b>	<b>Year 0</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Year 5</b>	<b>Year 6</b>
EHR lease payment	(\$112,000)		(\$112,000)	(\$112,000)	(\$112,000)	(\$112,000)	\$0
Hidden costs	(\$100,000)		\$0	\$0	\$0	\$0	(\$50,000)
Tax savings on hidden costs	\$40,000					\$20,000	
Maintenance cost	(\$2,500)		(\$2,500)	(\$2,500)	(\$2,500)	(\$2,500)	(\$2,500)
Tax savings on maintenance	\$1,000		\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
Tax savings on payment	\$44,800		\$44,800	\$44,800	\$44,800	\$44,800	\$0
EHR buyback						(\$50,000)	
Tax savings on buyback						\$20,000	
<b>Net cash flow</b>	<b>(\$128,700)</b>	<b>(\$68,700)</b>	<b>(\$68,700)</b>	<b>(\$68,700)</b>	<b>(\$68,700)</b>	<b>(\$61,500)</b>	<b>(\$1,500)</b> (\$1,500)
<b>Net present value of leasing</b>	<b>(\$416,593)</b>						
<b>Debt financing cost</b>	<b>Year 0</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Year 5</b>	<b>Year 6</b>
EHR cost (loan amount)	(\$500,000)						
Hidden costs	(\$100,000)	\$0	\$0	\$0	\$0	(\$50,000)	\$0
Tax savings on hidden costs	\$40,000	\$0	\$0	\$0	\$0	\$20,000	\$0
Maintenance cost	(\$2,500)	(\$2,500)	(\$2,500)	(\$2,500)	(\$2,500)	(\$2,500)	(\$2,500)
Maintenance tax savings	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
Depreciation tax savings	\$40,000	\$40,000	\$40,000	\$40,000	\$40,000	\$0	\$0
<b>Net cash flow</b>	<b>(\$521,500)</b>	<b>\$38,500</b>	<b>\$38,500</b>	<b>\$38,500</b>	<b>\$38,500</b>	<b>(\$31,500)</b>	<b>(\$1,500)</b> (\$1,500)
<b>Net present value of owning</b>	<b>(\$415,516)</b>						
<b>Hybrid lease cost</b>	<b>Year 0</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Year 5</b>	<b>Year 6</b>
EHR lease payment	(\$121,440)	(\$121,440)	(\$121,440)	(\$121,440)	(\$121,440)	\$0	\$0
Hidden costs	(\$100,000)	\$0	\$0	\$0	\$0	(\$50,000)	\$0
Tax savings on hidden costs	\$40,000					\$20,000	
Maintenance cost	\$0	\$0	\$0	\$0	\$0	(\$2,500)	(\$2,500)
Tax savings on maintenance	\$0		\$0	\$0	\$0	\$0	\$1,000
Tax savings on payment	\$48,576		\$48,576	\$48,576	\$48,576	\$48,576	\$0
EHR buyback						(\$50,000)	
Tax savings on EHR buyback	\$0	\$0	\$0	\$0	\$0	\$20,000	\$0
<b>Net cash flow</b>	<b>(\$132,864)</b>	<b>(\$72,864)</b>	<b>(\$72,864)</b>	<b>(\$72,864)</b>	<b>(\$72,864)</b>	<b>(\$61,500)</b>	<b>(\$1,500)</b> (\$1,500)
<b>Net present value of leasing</b>	<b>(\$435,186)</b>						

## Selecting a financing vehicle

Next, decide whether it is more advantageous to lease or finance the EHR, or a combination of the two. Limit the variability and base your decision on the useful life of the EHR (including hardware and software) and hidden costs (see financial vehicle selection matrix, page 51). Most technology has a shelf life of three to five years.

Thus, you need to have a plan for the EHR after its useful life to align your financ-

ing appropriately. It's rarely more advantageous to lease an EHR and purchase the product at the end of the lease if the residual value is greater than or equal to 20 percent of the cap cost. EHR software typically does not have a second market value, and the hardware depreciates in three to five years. Also, many EHRs have hidden costs, such as interfaces, custom reports, entry rules, training, setup and conversions.

Consider options to buy, lease or lease with a buyback at the end of the term based on useful life and hidden costs of the EHR. If the useful life is short, with low hidden costs, you will typically save money by leasing the software and hardware. Be prepared to renew the lease or buy the EHR at the end of the finance term. A lease option typically

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works best for small practices that use an application service provider (ASP) and connect to the EHR via a Web browser. The ASP agreements are a form of hybrid lease that include services such as billing, data storage, maintenance and support.

Let's look at two financial scenarios using a dollar cost analysis to better understand ownership vs. leasing.

### Scenario 1: Short-term EHR ownership

Medical Group Practice A wants to buy an EHR for \$150,000. Its leaders believe the system will last five years; therefore the technology's residual value is \$0. Let's assume the tax rate is 40 percent (state and federal). The interest rate is 10 percent; the cap cost for owning the equipment or leasing is 12 percent (leasing companies typically won't

see **How to pay**, page 54

Year 7	Year 8	Year 9	Year 10
\$0	\$0	\$0	\$0
\$0	\$0	\$0	\$0
			\$0
(\$2,500)	(\$2,500)	(\$2,500)	(\$2,500)
\$1,000	\$1,000	\$1,000	\$1,000
\$0	\$0	\$0	\$0

(\$1,500) (\$1,500) \$0

Year 7	Year 8	Year 9	Year 10
\$0	\$0	\$0	
\$0	\$0	\$0	
(\$2,500)	(\$2,500)	(\$2,500)	
\$1,000	\$1,000	\$1,000	
\$0	\$0	\$0	

(\$1,500) (\$1,500) \$0

Year 7	Year 8	Year 9	Year 10
\$0	\$0	\$0	
\$0	\$0	\$0	
(\$2,500)	(\$2,500)	(\$2,500)	
\$1,000	\$1,000	\$1,000	\$1,000
\$0	\$0	\$0	\$0

(\$1,500) (\$1,500) \$0

release cap cost information). Assume simple interest and straight-line depreciation. The group will incur \$15,000 in hidden costs incurred prior to installation. It is getting the EHR via a nonguideline lease (see box below, "Tax considerations").

The finance lease option has the least present value and therefore offers the greatest financial savings among alternatives for the same period of time. However, at the end of the five-year term, the practice will still need the EHR and faces the costs of lease renewal or ownership, plus upgraded hardware.

## Tax considerations

If your practice is investor-owned, verify that the lease is tax-oriented if you intend to use the payments as a tax deduction. A tax-oriented lease, also known as a capitalized lease, has specific Internal Revenue Service guidelines. Consult a tax adviser for details.

In scenario 2 (pages 52-53), we look at the long-term ownership of the EHR software and hardware.

### Scenario 2: Long-term EHR ownership

Medium-sized Medical Group B requires a fairly robust EHR. It has strong in-house IT staff able to maintain and service the technology. However, it is due to replace older computer hardware and will incur significant hidden costs to meet the new EHR specifications. The practice will also need two interfaces with a local hospital for lab and imaging and conversion of data from the practice management system.

Group B's hidden costs will total \$100,000 for the first year. The equipment will fully depreciate in five years. The software has no resale value. The practice will assume another round of hidden costs at the end of five years to replace equipment and



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upgrade interfaces. Leaders have decided on an EHR that costs \$500,000. The tax rate is 40 percent. The interest rate on debt financing is 10 percent; the cap rate for leasing is 12 percent. For simplicity, let's assume simple annual interest and straight-line depreciation. Both lease options allow a \$50,000 system buyback at the end of the term. For comparative purposes, let's assume that Medical Group B will exercise this buyback option and the lease will not be capitalized (see "Tax considerations").

Medical Group B leaders would elect the debt-financing option because the net present value is most advantageous under the dollar-cost analysis. Ownership over a longer term shows significant savings in depreciation and taxes through debt financing, compared with the other options. The hybrid lease may be better for a medical group that does not have IT expertise. The group would probably not elect the lease-financing option because the EHR software

## Consider options to buy, lease or lease with a buyback at the end of the term based on useful life and hidden costs of the EHR.

would yield no resale or market value at the end of lease term; the buyback option is set too high.

A practice wanting EHR technology must decide whether to purchase, lease or go with a hybrid lease. Understanding your quadrant in the financing vehicle matrix will help you define your financing options. The right financing can allow your organization to drive a high-end EHR and optimize quality care. 

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