

Health Care Providers Spotlight

Imminent Transition to ICD-10 Leads to Questions About Accounting for Incurred Costs

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The Bottom Line

In determining the appropriate accounting for incurred costs, health care entities should refer to the guidance in ASC 350-40 and ASC 720-45.

- In accordance with a mandate issued by the U.S. Department of Health and Human Services (HHS), health care entities must change the information technology system they use to document and code diseases by the end of 2013.¹ Specifically, entities must replace the ninth edition of the World Health Organization's *International Classification of Diseases* ("ICD-9") coding system with the tenth edition ("ICD-10").
- The upgrade to ICD-10 will require health care entities to extensively modify or replace their existing technology. In addition, they will need to revise their business processes and train their staffs in the new system.
- Health care entities are expected to incur significant costs during the transition from ICD-9 to ICD-10, and it is critical that they understand the appropriate accounting for such costs.
- In determining the appropriate accounting for incurred costs, health care entities should refer to the guidance in ASC 350-40² and ASC 720-45.
- The AICPA is expected to issue a Technical Practice Aid on the transition from ICD-9 to ICD-10 in July 2012.

¹ In April 2012, the HHS [proposed delaying the ICD-10 implementation deadline](#) to October 1, 2014. Additional information about the HHS proposal is available in [fact sheets](#) published by the Centers for Medicare and Medicaid Services.

² For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's ["Titles of Topics and Subtopics in the FASB Accounting Standards Codification."](#)

Beyond the Bottom Line

This *Health Care Providers Spotlight* discusses the transition from ICD-9 to ICD-10 and what health care entities need to consider in accounting for the costs they incur as a result of the change.

Why the Change?

By the end of 2013, all health care entities are required to migrate to ICD-10 for the documentation and coding of diseases. ICD-10 will replace ICD-9, which has existed for over 30 years. The HHS has requested the change for a number of reasons.

First, ICD-9 is antiquated; it uses obsolete terminology and outdated codes that are no longer consistent with those currently used in the medical field. Second, ICD-10 will expand the number of available codes from approximately 24,000 to over 150,000. This will allow for improved precision and granularity in related medical documentation and greater accuracy in the processing of claims. Lastly, the higher-quality data will improve trending capabilities and provide a better understanding of medical costs. This insight can then be used to enhance disease management programs.

Accounting for the Costs Incurred

In addition to remediating or replacing their technology, health care entities will need to revise their business processes and train their coding staffs in the new systems. Accounting for the costs associated with these efforts may be complex. Most of the questions health care entities have raised thus far focus on whether implementation costs should be expensed or capitalized and the appropriate guidance to follow in making such a determination. Differentiating between costs associated with changes in information technology systems and those associated with assessing business processes is a critical step in determining the appropriate accounting.

Costs Related to Information Technology Systems

Health care entities should refer to the guidance in ASC 350-40 when determining how to account for the costs associated with acquiring a new system or modifying existing software in conjunction with the ICD-10 conversion. According to ASC 350-40, health care entities that must acquire a new system to comply with the changes may capitalize incurred costs in accordance with their current policy. An entity would most likely purchase a new system only if the costs to upgrade its current system were too high because the system was impaired or obsolete.

Alternatively, entities that are able to modify their existing system should first determine whether the changes to internal-use software constitute (1) an upgrade and enhancement or (2) maintenance. Although the determination will be based on an entity's particular circumstances, a number of factors should be considered in the assessment of whether the changes constitute an upgrade or maintenance, including but not limited to (1) the extent and types of changes being made to the software design, (2) the amount of additional software coding required and new software processes developed, (3) prior experiences with clinical coding system upgrades, (4) the way the entity is being billed by the vendor for the changes (i.e., part of normal maintenance or separate billing), and (5) whether new uses, or uses in addition to the submission of claims, are intended for the billing system.

ASC 350-40-05-9 defines upgrades and enhancements as "modifications to existing internal-use software that result in additional functionality — that is, modifications to enable the software to perform tasks that it was previously incapable of performing. Upgrades and enhancements normally require new software specifications and may also require a change to all or part of the existing software specifications." Once changes are deemed upgrades or enhancements, an entity must determine whether the costs associated with the changes should be capitalized or expensed. Entities should use the criteria in ASC 350-40-25-1 through 25-6 to determine how to account for these

Health care entities have raised questions about whether the implementation costs associated with the transition to ICD-10 should be expensed or capitalized and about the appropriate guidance to follow in making such a determination.

Regardless of the stage in which training costs are incurred, they should be expensed in accordance with ASC 350-40-25.

specific costs depending on when they are incurred during the project (i.e., during the preliminary project stage, the application development stage, or the post-implementation operation stage).

According to ASC 350, preliminary-stage project costs related to upgrades and enhancements are expensed as incurred. Examples of such costs related to ICD-10 implementation may include those associated with the health care entity's initial assessment of the impact to its systems, its strategic plan development, and its initial training and change-management programs.

Determining the appropriate accounting for upgrade and enhancement costs incurred during the application development stage is less obvious. For example, during this stage, health care entities would capitalize costs related to (1) the development of internal-use computer software or (2) obtaining software that allows access to or conversion of old data by new systems. However, entities must expense the training costs or data conversion costs (other than those related to conversion of the old data by a new system) incurred during the application development stage.

Health care entities will need to use judgment in determining whether costs incurred during the application development stage qualify for capitalization or should be expensed. Typical costs expected during this phase include those for the actual information technology remediation (i.e., various system upgrades or acquisition of software), testing of the codes and system interfaces, and training conducted during this phase of the project.

The accounting for upgrade and enhancement costs incurred during the post-implementation operation stage is similar to that for preliminary-stage costs in that such costs are expensed as incurred. Examples of typical costs expected during this phase include those for internal and external training and maintenance.

Although it addresses upgrades and enhancements, ASC 350 does not specifically define "maintenance" or specify what qualifies as maintenance costs. However, ASC 985-20-20 defines maintenance as those "[a]ctivities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions."

Because maintenance costs are traditionally viewed as post-implementation costs and do not result in additional functionality, they should be expensed as incurred. Such guidance would also apply to health care entities that believe that their software modifications do not result in additional functionality.

Training Costs

As noted above, implementing ICD-10 will require health care entities to conduct extensive training during the various phases of the project. Such training would include but not be limited to (1) teaching clinical coders how to use ICD-10, (2) instructing clinicians in preparing their documentation according to the requirements of ICD-10, and (3) educating personnel on the overall impact of the change. Regardless of the stage in which training costs are incurred, they should be expensed in accordance with ASC 350-40-25.

Business Process Reengineering Costs

As health care entities begin the conversion from ICD-9 to ICD-10, they will incur certain costs that are not directly related to upgrading the system or software. When such costs apply to reengineering business processes or assessing the current state of the business, health care entities should refer to the guidance in ASC 720-45. Under that guidance, business process reengineering costs would be expensed as incurred.

Although costs as well as changes to the industry will be significant, there are many potential benefits to the implementation.

Third-Party Consulting Costs

Health care entities must consider how to account for costs related to engaging third-party consultants to assist in the management and implementation of ICD-10. Unlike training and education costs, which are accounted for under ASC 350-40-25, the costs of hiring third-party consultants should be evaluated in accordance with the criteria in ASC 720-45. This guidance addresses more specifically how to account for typical components of a business process reengineering and an information technology transformation project.

ASC 720-45-55-1 contains a grid that displays “the accounting for typical components of a business process reengineering/information technology transformation project.” Reproduced for reference in the [appendix](#) below, the grid illustrates when entities should expense costs rather than capitalize them and when they should consult the appropriate software guidance. Health care entities should refer to the guidance that applies to their particular circumstances.

Other Considerations

Health care entities may also consider the existing guidance in AICPA Technical Practice Aids, TIS Section 6400.34, “Accounting for Computer Systems Costs Incurred in Connection With the Health Insurance Portability and Accountability Act of 1996 (HIPAA),” which addresses the accounting for certain costs related to computer system upgrades and enhancements needed to conform to the HIPAA standard. The guidance indicates, in general, that if a change is related to a task that the software could not previously perform, then application-development-stage costs should be capitalized. However, if the change does not result in additional functionality and is made merely to satisfy regulatory requirements, then the costs should be expensed as incurred.

Thinking Ahead

Health care entities are already preparing for the change from ICD-9 to ICD-10 and considering obstacles that may confront them. Although costs as well as changes to the industry will be significant, there are many potential benefits to the implementation. Proper planning, and ensuring that associated costs are correctly accounted for, will be critical to the success of the migration.

For additional information on accounting for the transition, health care entities should consult the Technical Practice Aid expected to be issued by the AICPA in July 2012.

Appendix — Accounting for Typical Components of a Business Process Reengineering and an Information Technology Transformation Project

The grid below, reproduced from ASC 720-45-55-1, outlines “the accounting for typical components of a business process reengineering/information technology transformation project.” As stated in ASC 720-45-55-1, such accounting would be based on whether the component should be:

- Expensed as incurred in accordance with the guidance contained in this Subtopic
- Expensed as incurred in accordance with internal-use software guidance contained in Subtopic 350-40
- Capitalized in accordance with internal-use software guidance contained in Subtopic 350-40
- Capitalized as part of the cost of acquiring a fixed asset in accordance with a company’s existing policy.

(Note that letters in the grid refer to the corresponding guidance listed above.)

Steps	Third Party		Internal	
	Expense	Capitalize	Expense	Capitalize
Business process reengineering and information technology transformation:				
Preparation of request for proposal	a		a	
Current state assessment	a		a	
Process reengineering	a		a	
Restructuring work force	a		a	
Preliminary software project stage activities:				
Conceptual formulation of alternatives	b		b	
Evaluation of alternatives	b		b	
Determination of existence of needed technology	b		b	
Final selection of alternatives	b		b	
Application development stage activities:				
Design of chosen path, including software configuration and software interface		c		c
Coding		c		c
Installation to hardware		c		c
Testing, including parallel processing phase		c		c
Data conversion costs:				
a. Costs to develop or obtain software that allows for access of old data by new software		c		c
b. All other data conversion processes	b		b	
Training	b		b	
Post-implementation/operation stage activities:				
Training	b		b	
Application maintenance	b		b	
Ongoing support	b		b	
Acquisition of fixed assets:				
Purchase of new computer equipment, office furniture, or work stations		d	N/A	N/A
Reconfiguration of work area—architect fees and hard construction costs		d		d

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