Letter of Comment No: 55
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Eli Lilly and Company
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Date: September 12, 2005

Re: File Reference 1215-001

Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Dear Ms. Bielstein:

Eli Lilly and Company appreciates the opportunity to comment on the FASB's Proposed Interpretation, Accounting for Uncertain Tax Positions, an interpretation of FASB Statement No. 109 (hereafter referred to as the "Proposed Interpretation").

We support the Board's effort to achieve consistency in accounting practices related to uncertain tax positions. We agree that SFAS No. 109, *Accounting for Income Taxes,* does not explicitly define a required confidence level for tax positions to be recognized in the financial statements and that diverse accounting practices may have developed as a result. However, we believe the fundamental concepts set forth in the current version of SFAS 109 are sound, and any real or perceived abuses of SFAS 109 are better addressed on an individual basis by the auditing firms or the SEC rather than with a wholesale change to existing practice. Along these lines, we do not support the "asset approach" set out in the proposed interpretation. We believe the "impairment approach" based on existing language in FASB Statement No. 5, *Accounting for Contingencies*" would better support the Board's objectives in this area and is more consistent with existing practice.

Additionally, we do not support the Board's decision to establish a dual threshold under the asset approach that requires the "probable" threshold for recognition and the "more likely than not" threshold for de-recognition. We believe there will likely be disagreement over the application of the "probable" threshold, which will undermine the Board's objective of greater reporting consistency. We also believe the proposed interpretation will require companies to over-accrue tax liabilities and will result in inconsistent treatment of similar tax positions depending upon the year and circumstances in which the position may be recognized. Finally, we believe the year-end 2005 implementation date is unrealistic and would be difficult for most companies to fulfill.

We have elected to respond to the issues we believe to be the most significant. These issues are discussed in detail below.

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Issue 3: The Board decided on a dual threshold approach that would require one threshold for recognition and another threshold for derecognition. The Board concluded that a tax position must meet a probably (as that term is used in Statement 5) threshold for a benefit to be recognized in the financial statements. (Refer to paragraphs B16-B21 in the basis for conclusions.) Do you agree with the dual threshold approach? Do you agree with the selection of probable as the recognition threshold? If not, what alternative approach or threshold should the Board consider?

We strongly disagree with the Board's proposed adoption of the "asset approach" and believe the "impairment approach" would be equally successful in eliminating any inconsistencies that exist in practice concerning the reporting of uncertain tax positions, while remaining consistent with the accounting found in SFAS No. 5 for all other contingencies. In addition, we believe the "impairment approach" will result in more meaningful financial reporting of uncertain tax positions. The "asset approach" coupled with the "probable" standard for initial recognition, will result in consistent over-accrual of reserves when such transactions occur, with the possibility of large amounts of income recognized in future periods when the underlying tax issues are resolved. The "impairment approach", in our opinion, will result in more meaningful matching of tax expense to the period in which the related transactions occur. We believe this "better matching" will result in the reporting of more meaningful financial statement information.

We strongly disagree with the Board's proposed adoption of a SFAS No. 5 "probable" threshold for the initial recognition of uncertain tax positions in financial statements. SFAS No. 5 does not quantify the term "probable"; however, the term is commonly interpreted by public accounting firms as a threshold of 70-75%, as this is the level at which most firms would issue an unqualified "should prevail" tax opinion. Under the proposed interpretation, a tax position with a 50-70% likelihood of being sustained would require a 100% reserve. Thus, a company applying the proposed interpretation would be required to over-accrue reserves for many tax exposure items where it was more likely than not that they would receive some benefit, only to reverse this over-accrual to income when the position was ultimately resolved. We believe the over-accrual required by the proposed interpretation for such tax positions would distort the results in the financial statements of the company's ultimate cash tax obligation. We believe readers of financial statements are better served by statements that reflect management's best estimates of the ultimate resolutions of its tax issues. We also believe financial statement readers will be provided more meaningful information if the company records both the benefits of the tax position and any related impairments (i.e., reserves) within the same accounting period. With the use of the "probable" threshold, net income will be understated in the years reserves are established and overstated in the years reserves are reversed. We do not believe this treatment will result in meaningful financial statement information.

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If the Board were to retain an asset approach, we believe a "more likely than not" ("MLTN") threshold is more appropriate for initial recognition. We believe the MLTN threshold is more operable in practice, as this threshold requires only a win-lose assessment of a tax position. We also believe the MLTN standard allows management to more accurately reflect the value of tax positions. In practice, companies routinely receive tax benefits from positions that may be less than 75% likely at the time the position is taken. Through the normal course of an audit resolution, specific transactional facts will result in some level of tax benefits. To require a higher probability for initial recognition would ignore assets that actually have real value to a company.

Most financial statement preparers and accounting practitioners can agree about the application of the MLTN standard, and this agreement would result in greater financial statement comparability. We do not believe there would be similar agreement over the application of the probable standard. In fact, we can reasonably foresee disagreements over the application of the probable standard, and are concerned that these disagreements will result in *less* comparable financial statements.

We also disagree with the application of the dual threshold for recognition and de-recognition and believe it could lead to inconsistent treatment of similar tax positions from year to year. For example, a company claims a $5 million research tax credit in Year 1. This credit is comprised solely of spending on an internal software development project. In Year 1, the company believes, based upon existing income tax regulations and case law, the entire $5 million of credit is probable of being sustained. The company's auditors agree with this assessment. In its financial statements, the company records a $5 million benefit for this research credit.

In Year 3, the company again plans to claim a $5 million research tax credit that is solely comprised of an internal software development project. The Year 1 and Year 3 projects are very similar. However, earlier in Year 3, a court decision was issued that found certain internal software development costs did not meet the definition of qualified research. The company believes its Year 1 and Year 3 projects are distinguishable from the facts presented in the case. The company's auditors do not believe it is "probable" the Year 3 project is in fact distinguishable. As the company is unable to change the opinion of their auditors, they record no benefit in Year 3 for its research credit. However, the facts of the Year 1 project are sufficiently distinguishable such that it is at least "more likely than not" the company would prevail on the issue. Thus, the company does not derecognize the benefit it previously recorded in Year 1. As a result of the dual threshold, two similar projects are recorded in the financial statements at two very different values. We believe this treatment distorts the true value of similar tax positions that are incurred from year to year and does not result in meaningful financial statement information.

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As discussed above, we believe the "impairment approach" under SFAS 5 is more appropriate and will better serve the Board's goals on the issue of uncertain tax positions. However, if the Board elects to use the "asset approach", we believe the initial recognition level should be "more likely than not" rather than "probable". We believe the use of the "more likely than not" threshold for initial recognition is more operable for preparers of financial statements, will result in greater comparability of financial statements, and will better reflect management's best estimate of the ultimate outcome of the tax positions.

Issue 11: The Board concluded that this proposed Interpretation should be effective as of the end of the first fiscal year ending after December 15, 2005. Only tax positions that meet the probable recognition threshold at that date may be recognized. The cumulative effect of initially applying this proposed Interpretation would be recognized as a change in accounting principle as of the end of the period in which this proposed Interpretation is adopted. Restatement of previously issued interim or annual financial statements and pro forma disclosures for prior periods is not permitted. Earlier application is encouraged. (Refer to paragraphs B41-B43 in the basis for conclusions.) Do you agree with the Board's conclusions on effective date? If not, how much time would you anticipate will be necessary to apply the provisions of this proposed Interpretation? Do you agree with the Board's conclusions on transition? If not, why not?

We strongly disagree with the proposed effective date as of the end of the first fiscal year ending after December 15, 2005. The implementation of this standard will require companies to review and assess tax positions for open returns on a worldwide basis. In addition, Sarbanes-Oxley (SOX) compliant documentation will need to be prepared and reviewed. With the comment deadline of September 12 and an anticipated final standard to be issued in the fourth quarter, companies do not have adequate time to gather the information necessary to report a cumulative effect of a change in accounting principle and to prepare appropriate SOX documentation for 2005. If the final standard is issued this year, we encourage the Board to reconsider the effective date and suggest an effective date of December 31, 2006. If the final interpretation is not issued until 2006, we strongly recommend an effective date of December 31, 2007. A year-end adoption is more consistent with the normal year-end tax cycles most companies experience. We believe a mid-year adoption, regardless of the date the final standard is issued, would place undue burden on most companies. We do agree, however, that the cumulative effect of the adoption should be reported as a change in accounting principle and that restatement of previously issued financial statements should not be permitted.

We appreciate the opportunity to express our views and concerns regarding the Proposed Interpretation. If you have any questions regarding our response, or would like to discuss our comments further, please call me at (317) 276-2024.

Sincerely,

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S/Arnold C. Hanish
Executive Director, Finance and
Chief Accounting Officer