



Letter of Comment No: 136
File Reference: 1102-001
Date Received: 1-31-03

Eli Lilly and Company
Lilly Corporate Center
Indianapolis, Indiana 46285
U.S.A.

www.lilly.com

January 31, 2002

Suzanne Q. Bielstein
Director
Major Projects and Technical Activities
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference 1102-001

Dear Ms. Bielstein:

Eli Lilly and Company appreciates the opportunity to comment on Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and Its Related Interpretations, and IASB Proposed IFRS, *Share-based Payment*.

Measuring Fair Value of Employee Stock Options

We believe that standard option pricing models overstate the value of employee stock options. An adjustment must be made for the lack of transferability inherent in this type of option in order to properly reflect its value. We disagree that the adjustment to the life of the stock option is sufficient in accounting for this (expected life vs. contractual life).

We agree that no specific option pricing model should be required by the standard. We would support suggested guidelines in determining the assumptions used in order to enhance consistency among companies. We think that guidelines in the following areas would be helpful:

- Expected life of the option
- Volatility
- Expected dividends
- Effect of lack of transferability
- Risk-free interest rate

Issuance

We agree with the FASB's interpretation of issuance. Consideration must be exchanged in order for equity instruments to be issued. We believe the measurement focus should be on the fair value of equity instruments issued rather than on the net assets received which is the basis for the IASB approach. Performance based options are granted but not issued until the specific performance condition has been achieved. We do not agree with the IASB's approach of recording expense on performance based options regardless of whether or not the performance condition was met.

Forfeitures

We disagree with the IASB's conclusion on forfeitures. We do not support the notion that this should be considered in determining the fair value of each option at grant date. We feel that it is inappropriate to recognize compensation expense related to a forfeited equity instrument. If the option is never issued, the employee gets no benefit and the employer incurs no cost. It does not make sense to record expense in this situation. The option is considered issued at the vesting date and forfeited options are not considered issued. We agree that compensation cost should be based on the actual number of shares issued. For example, consider the structure of a contract with a vendor that required 5 years worth of service for \$5000 and it included a rebate clause of \$2000 if they wanted out of the agreement before the fifth year. If the vendor activated the rebate clause, we would record a net expense of \$3000 not the full \$5000.

Attribution of Compensation Cost

We disagree with the IASB's unit of service approach as it is not clear how this would be an improvement to Statement 123. We believe that compensation cost should be expensed over the period the employee provides services. For cliff vesting instruments, expense is recognized in a straight-line method. We think that this type of attribution provides consistency when comparing financial statements among companies and accurately reflects the economics of the transaction. We believe that the design of the option program reflects the value of the services provided by the employees.

Income Taxes

We disagree with the IASB's approach to income taxes. The income statement volatility that would result from reflecting all tax benefits through income would misrepresent the economics of the exchange. A preferable method is to tax effect the transactions initially and any difference should be reflected in equity. The goal is to match the tax effect with the compensation expense recognized. Any other method could lead to misleading results in the income statement.

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

Sincerely,

ELI LILLY AND COMPANY

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