Dear Director:

Eli Lilly and Company appreciates the opportunity to comment on the FASB’s Exposure Draft, *Business Combinations, a replacement of FASB Statement No. 141*, and *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries, a replacement of ARB No. 51* (hereafter referred to collectively as the “Exposure Draft”). We have focused our comments on the items of greatest significance to us and our industry.

**In-process research and development (IPR&D) activities acquired**

We do not believe that it is appropriate to capitalize the fair value of IPR&D acquired until the technology is proven and has been approved by regulatory agencies, if required. *Statement of Financial Concepts 6* states, “Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Probable in this instance “refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.” Many research and development activities that are being investigated have a low likelihood of future success. In short, we believe that consideration spent directly on IPR&D programs should be viewed as costs and not assets.

After our participation in the roundtable discussion, which resulted in a deeper understanding of the Board’s sensitivity to this issue, we are proposing what we believe is a reasonable alternative to the current Exposure Draft. While we believe IPR&D should be expensed and the FASB should wait until they can consider all R&D related issues at once, if the Board continues to believe that IPR&D should be capitalized in a business combination, we would urge the FASB to consider the immediate expensing of any pharmaceutical compounds under development for pre-Phase III compounds, and require capitalization **only** if the potential product has completed Phase II testing and has entered Phase III.

In the pharmaceutical industry compounds entering the following testing phases in their research and development life cycle have the corresponding probability of achieving commercialization based upon current industry averages:

<table>
<thead>
<tr>
<th>Testing Phase</th>
<th>Probability of being approved for sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-clinical - lead molecule identification</td>
<td>15%</td>
</tr>
<tr>
<td>Phase I</td>
<td>20%</td>
</tr>
<tr>
<td>Phase II</td>
<td>30%</td>
</tr>
<tr>
<td>Phase III</td>
<td>80%</td>
</tr>
</tbody>
</table>

Answers That Matter.
It is difficult to understand the FASB's position on the capitalization of IPR&D when the likelihood of success for many compounds is very low. This point of view is more difficult to understand when considering the opposite viewpoint that the FASB expressed in the Accounting for Uncertain Tax Positions Exposure Draft, when the FASB proposed that tax exposure items cannot be recorded as assets unless they are “probable” of being realized. Probable in the tax world usually equates to a “should” level opinion, which generally means a 70% - 80% likelihood of success. Many of the IPR&D assets, based upon the above percentages, are far less likely than “probable” of achieving success. It is unclear to us how the Board could arrive at such different conclusions in these two proposals that are presumably both based on the same conceptual definition of “probable”.

While we agree that compounds in development have some value and that a purchaser of the business may consider that value when negotiating the purchase, we do not believe that all acquired compounds under development meet the definition of an asset as defined by Concepts Statement 6. It may not be precisely clear what percentage is implied in the definition of “probable” in Concepts Statement 6, but it is hard to imagine that anything with a less than 50% chance of ever being marketed could meet the definition of having “probable future economic benefits.” Paragraph 175 of Concepts Statement 6 further states that, “Uncertainty about business and economic outcomes often clouds whether or not particular items that might be assets have the capacity to provide future economic benefits to the entity…, sometimes precluding their recognition as assets.”

In addition, the AICPA Practice Aid, Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries, provided a bright line for the pharmaceutical industry that only compounds that have achieved regulatory approval represent an asset that requires capitalization in an acquisition. The SEC, an observer of this Task Force, was very clear at that time that they did not believe pharmaceutical assets should be capitalized prior to regulatory approval because of their high risk. The AICPA Practice Aid also required that any compounds prior to the start of Phase I, would not be included in the valuation of IPR&D, as it was presumed that the fair value could not be computed with reasonable reliability. Instead, these early-stage compounds would be included in the determination of goodwill. This issue has not been addressed in the Exposure Draft.

We are also concerned with the determination of impairment, should capitalization of IPR&D be required, as a result of this Exposure Draft. It is common in the industry to shelve projects for a period of time due to funding constraints or temporary technical issues that develop. It is not a rare event for those temporarily shelved compounds to have additional testing performed in the future and some become commercialized products. Our current commercialized products include several that were “shelved” for a variety of reasons. The timing of when a compound is impaired would be extremely subjective in our industry and we are concerned that this could lead to criticism with the benefit of hindsight regarding the timing of impairments. Additionally, we believe the impairment analysis based upon an updated fair value assessment of the project, will lead to more complexity and higher outside consulting expenses. Unfortunately, this impairment model would also provide significant opportunities for accounting manipulation.

Further, we do not believe it is appropriate that different accounting conclusions would be reached dependant solely upon the method of “acquisition”. While we recognize that a major goal of the FASB’s project is convergence with international standards, the proposed change will result in significant inconsistency in the accounting for research and development (R&D) costs under U.S. GAAP. For example, if an acquirer chose to purchase just the compounds of a “potential acquiree” and not the entire company, the acquirer would expense the entire purchase price of the compounds. Comparability
between companies that choose one acquisition method over another would be negatively affected, which we do not believe will be helpful for users of financial statements.

We are also concerned about the investor confusion that this Exposure Draft may cause. Not only will the divergent IPR&D capitalization criteria, dependant on the type of acquisition, be confusing for investors, but we are also concerned with the constant and steady impairment of projects that this Exposure Draft is destined to cause. We believe that we will be required in our Management's Discussion and Analysis section to discuss the low likelihood that any of these IPR&D assets will provide the company "future economic benefit." We believe investors will not understand why we are capitalizing assets that we then tell them are likely to be written off in the near future.

Rather than looking at R&D accounting on a piecemeal basis, we believe it would be preferable to reconsider all R&D accounting at the time that SFAS 2, Accounting for Research and Development Costs, is revisited. This Exposure Draft seems to indicate that the FASB has already reached a conclusion as to what the answer will be when they revisit SFAS 2, but we believe this issue should receive appropriate consideration in the full reconsideration and debate around SFAS 2. It seems that this decision cannot be made without a complete reconsideration of SFAS 2 and perhaps the conceptual definition of an asset as well. Given the inconsistency with our existing conceptual guidance, the inconsistency with accounting for normal R&D activities and IPR&D acquired outside a business combination, many of the practical issues that would result from the accounting for IPR&D as proposed in this Exposure Draft, and the fact that there are no significant problems with our existing model, it would appear that the goal of convergence does not justify pursuing changes in this area at this time. We also note that it will be difficult to give this issue adequate consideration as part of this project, without slowing down the project appreciably to give this issue full due process. As stated earlier, while we believe IPR&D should be expensed and the FASB should wait until they can consider all R&D related issues at once, if the Board continues to believe that IPR&D should be capitalized in a business combination, we would urge the FASB to consider the immediate expensing of any pharmaceutical compounds under development for pre-Phase III compounds, and require capitalization only if the potential product has completed Phase II testing and has entered Phase III.

Contingent gains and losses of acquiree

We believe that accounting for contingencies under the SFAS 5 model is more appropriate than the approach tentatively reached in the Exposure Draft. We do not agree that contingent assets and contingent liabilities should be accounted for based upon a fair value approach at the time of an acquisition. When evaluating a potential acquisition, the acquirer does not contemplate the approach discussed in this Exposure Draft. Acquirers typically evaluate both contingent gains and contingent losses as SFAS 5 evaluates these contingencies. We believe the accounting for acquisitions should match the reality of the circumstance. No market mechanism exists to buy and sell the fair value of legal exposure or contractual disputes between parties; therefore, we do not believe that accounting for these contingencies under a fair value approach is practical or a reasonable alternative. It is difficult for us to understand the relevance of the "fair value" of these items to a user of the financial statements post-acquisition, especially when there is no market that would allow a company to settle these contingencies at fair value. We believe that the more relevant amount to a user of the financial statements is what management believes they will probably have to pay to settle a contingent liability. Consider the following two examples utilizing the Exposure Draft approach for the recognition of acquisition contingencies.

First, assume it has been determined that an acquiree has a 20% probability that it will lose a contractual dispute and if they are unsuccessful in the dispute, the resultant payment will be $100 million. As a result
of the Exposure Draft, the acquirer would record a $20 million liability (assuming a simplified fair value calculation). The likely offset to this liability is a $20 million addition to goodwill. If the acquirer wins the contractual dispute (which is expected), the acquirer reverses the legal liability by recording $20 million into income, while the goodwill balance will remain on the financial records of the acquirer forever, subject to impairment testing. It seems to us that this is somewhat misleading to a user of the financial statements when ultimately income is created related to an obligation that management never believed they would have to pay. We struggle with how this result is useful to a user of the financial statements.

Secondly, if an acquirer acquires the same contractual dispute, but believes there is an 80% chance they will lose the dispute, the acquirer would record a liability for $80 million (assuming a simplified fair value calculation). Prior to the acquisition, the acquiree had recognized the entire $100 million liability as the acquiree believed the likelihood of a loss associated with the contract dispute was both probable and reasonably estimable as required by SFAS 5. Upon losing the contract dispute (which is expected), the acquirer will be required to record the remaining $20 million expense. Again, we struggle with the relevance to the users of the financial statements if management is precluded from recording a liability for the amount they expect to pay. It would be different if a market existed that would allow a company to sell off these obligations for “fair value”, but as this market doesn’t exist, it is difficult to see the relevance of fair value.

We ask the Board to reconsider this conclusion. We believe the accounting required by SFAS 5 represents a more understandable and certainly more practical approach to this example. Under SFAS 5, the acquirer would record no liability in the first instance and a $100 million liability in the second instance. Upon resolution of the contract dispute, no entries would be recorded as the probable result occurred. We do not believe that the Exposure Draft conclusions provide better financial information to investors or the public. In addition, we are concerned about second-guessing as to the probability percentages and dollar amounts used in assessing the fair value of certain situations. We believe the accounting required by the Exposure Draft may lead to negative publicity and additional public criticism of the accounting profession. We request that the Board consider the negative publicity possibilities associated with the two examples discussed above.

Additionally, we are concerned about the ability to develop fair value estimates for gain and loss contingencies in an acquiree. From a practical standpoint, it is exceedingly difficult today just to make a decision on whether or not we have met the “probable” threshold in SFAS 5 when evaluating many contingencies. This difficulty will be compounded if we are now required to estimate a “fair value” for each of these contingencies. The use of valuation experts would be required and certain exposures may be very difficult to conclude upon. Even with the use of valuation experts, it is hard to believe that the results of their work will be reliable within any type of reasonable range. We also believe that it would be very difficult for public accountants and their valuation experts to provide an opinion associated with the fair value of certain of these contingencies. We are also concerned that this accounting model may have the unintended consequence of appearing to display a level of precision that does not really exist. The problem will be exacerbated by the requirement to continue to adjust these contingencies to fair value post-acquisition.

If the Board still believes that initially valuing the contingencies based upon a fair value determination is the best solution, we believe that the continued fair value assessment for the life of the contingency as required by the Exposure Draft is not appropriate. We believe the continual update of these contingencies utilizing a fair value approach versus the SFAS 5 guidance for post-acquisition periods is impractical and inconsistent. Continual updating of these contingencies on a quarterly basis using a fair value approach appears time consuming, costly, confusing to investors, and does not appear to add value. We are
concerned that this requirement will both result in questions about the reliability of reported results due to changes in these very subjective “fair values,” and result in confusion due to the different accounting for contingencies that are acquired versus those that arise during the normal course of business.

As a result of these factors, we strongly believe that the SFAS 5 model is more appropriate when considering gain and loss contingencies, regardless of whether or not the contingencies are the result of an acquisition.

Contingent consideration in an acquisition

Contingent consideration in an acquisition is often the result of disagreements between the future prospects of the acquiree, as viewed by an acquirer and an acquiree. SFAS 141 requires contingent consideration in purchase accounting to be deferred until the contingency has been resolved, and the purchase price adjusted when the contingency is resolved. For much the same reasons as previously discussed in the contingent gains and losses of an acquiree section, we do not believe it is appropriate to estimate the fair value of contingent consideration and include it in the acquisition accounting.

First, if a fair value is assessed for the contingent consideration, the resolution of the contingency will result in either the recording of income or a loss from the resolution. Had the parties been able to reach agreement at the beginning, no income or loss would have been recorded. We do not believe that the resultant conclusion of the contingency should cause income or loss to be realized.

Second, as we previously noted contingent consideration is often the result of disagreements over fair value between the acquirer and the acquiree. Therefore determining the “fair value” of contingent consideration is in the eye of the beholder and is very judgmental. Obtaining a fair value of the contingent consideration that is auditable by the outside accountants and their experts would likely be difficult, subjective, and subject to second-guessing. It seems that the accounting proposed in the Exposure Draft will cause the accounting to differ from the economics of the transaction. The reality of the situation may well be that the parties couldn’t agree on fair value at the acquisition date and developed a mechanism that would ultimately result in fair value being paid at the point the contingency is resolved. However, the accounting proposed would cause us to use a “fair value” for accounting purposes that doesn’t match either party’s estimate of fair value as of the acquisition date.

If the Board continues to believe that fair value is the most acceptable approach for contingent consideration, we would support Deloitte’s recommendation presented during the round table discussion, which included initial fair value assessment of the contingent consideration at the time of the acquisition, with adjustments to the fair value of the contingent consideration adjusted through the purchase price.

Definition of a business

While we agree with the definition of a business, we are concerned with paragraph A7 of the Exposure Draft, as we believe that this definition could bring into scope certain transactions that were not intended such as an acquisition of a building, software, or in-licensing of potential pharmaceutical compounds under development. We do not believe that this was the intended consequence of this Exposure Draft, and we urge the FASB to consider eliminating paragraph A7. As discussed in the roundtable forums on October 27, 2005, we also believe examples would be helpful for preparers.
Market value of stock issued in an acquisition

The Exposure Draft requires the acquirer to value the stock issued as consideration on the date of acquisition, rather than the date of the public announcement of the acquisition. We believe that the date of the announcement of the transaction as discussed in EITF 99-12, Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination, represents the negotiated value of the acquisition between the parties. Events that transpire after the announcement of the acquisition that affect the stock price of the acquirer often have nothing to do with the acquisition.

For example, consider a situation where an acquirer, Company A agrees to buy a smaller biotechnology company, Company B, through a stock exchange transaction whereby Company A purchases all of the outstanding shares of Company B for 1,000,000 shares of its stock. Between the date of the acquisition announcement and the closing of the acquisition, Company A decides to discontinue the sale of its leading pharmaceutical product causing Company A’s stock price to decrease from approximately $50 per share before the announcement to $30 per share after the announcement. We believe the fair value of the acquisition was $50 million, based upon the result of the arms-length negotiations between the parties at the time of the negotiation. The decision to discontinue the sale of the leading pharmaceutical product was not the result of the acquisition. We continue to believe that the value of the acquisition should be based upon the negotiated value between the parties, consistent with the consensus reached in EITF 99-12. The basis for conclusions in the Exposure Draft says that the Board did not find the arguments in 99-12 compelling, but it is not clear to us how the Board arrived at the conclusion that the argument that the value of securities issued at the acquisition date is a better indicator of the fair value of the business acquired than the fair value that was actually negotiated by the parties at the time the deal was agreed to and announced.

Acquisition-related costs

We believe acquisition-related costs are a direct cost of completing the acquisition and would not have occurred in the absence of an acquisition, therefore these costs should be considered part of the acquisition of the acquiree. In addition, the acquirer considers the amount that will be incurred as acquisition costs in determining the acquisition offer that the acquirer is willing to pay for the acquiree. These acquisition costs are similar to installation costs associated with the purchase of certain fixed assets. These installation costs are considered part of the cost of the equipment and capitalized as fixed assets.

Planned restructuring activities of the acquiree

Integration activities and restructurings of acquirees are often necessary and are considered probable at the time of an acquisition. These rationalization strategies often help to explain the economies of the acquisition and may well be key components of an acquirer’s determination of the value of an acquisition. However, on the date of the closing of the acquisition, the communication requirements of the restructurings outlined in SFAS 146 have often not been completed. We believe it is illogical to record the fair value of a contingent liability for a 20% probability of a contract dispute of an acquiree (as required in the Exposure Draft, as discussed above), and not record planned restructurings of an acquiree after an acquisition, which are nearly certain to occur. In most acquisitions a certain amount of resource rationalization occurs and we believe it is inappropriate to not consider these rationalizations in the determination of the purchase price allocation.
Measurement period associated with the purchase price allocation

We agree with the tentative position in the Exposure Draft requiring the acquirer to obtain all information possible to complete the acquisition-related accounting within one year of the acquisition date. However, we do not agree that income statement adjustments from the initial acquisition accounting should be completed retrospectively.

Given the combination of additional information required in this Exposure Draft, such as the market valuation of stock as consideration in the acquisition, and the fair value of contingent consideration and contingent gains and losses, the additional amount of work that will be required in a short period of time has increased exponentially. Certain information may not be available to complete the acquisition accounting as quickly as needed and the ability to obtain timely assistance from valuation consultants in valuing contingent gains and losses prior to the end of the accounting period after the acquisition may not be realistic. As a consequence, we would expect many acquisitions to require restatements, perhaps in every quarter for the full year subsequent to the acquisition.

For example, assume an SEC registrant completes a hostile acquisition a few days prior to the end of a quarter. Since the acquisition was hostile, the acquirer would not be allowed to complete any due diligence, other than information that was publicly available. The probability the acquirer could complete the business combination accounting by gathering all the information necessary, including the fair valuation of the gain and loss contingencies prior to their filing of the 10-Q, without some reasonable estimations of valuations is unlikely. To penalize the acquirer by requiring them to restate the prior period financial statements is unnecessary, costly, and potentially damaging.

The public sensitivity to “restatements”, regardless of the reason, is very intense in today’s environment. To require a restatement associated with information that is not readily available related to an acquisition is not appropriate. SFAS 141 requires disclosure of the information the acquirer is awaiting to complete its post-combination accounting, which we believe is sufficient. Therefore, we request the Board consider the practical alternative of allowing prospective income statement adjustments when circumstances require an adjustment of an opening balance sheet of an acquiree.

Change in ownership interest in subsidiary (without loss of control)

We disagree with the Board’s tentative conclusions regarding step acquisitions and dispositions. We believe that the guidance under SFAS 141, which essentially required purchase accounting for increases in ownership and gain or loss recognition as a result of decreases in ownership, was a more appropriate model in these types of transactions. We believe the tentative conclusions reached in the Exposure Draft do not reflect appropriately the substance of the transactions. It is likely that our disagreement in this area is a result of our belief that the noncontrolling interests are not a part of the consolidated equity of the company. We believe our shareholders have the view that the company’s “equity” is what they own, and would not include the noncontrolling ownership interests.

In a step acquisition, we believe it is appropriate to reflect the current financial condition of the acquiree at each period in the step-acquisition process. Consider the following example:

<table>
<thead>
<tr>
<th>Acquiree:</th>
<th>$100 million net book value, which equals fair value. No other intangible assets.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Period 1:</td>
<td>Company purchases 60% of acquiree for $90 million.</td>
</tr>
<tr>
<td>Period 2:</td>
<td>Company purchases remaining 40% of acquiree for $120 million.</td>
</tr>
</tbody>
</table>

We believe the Exposure Draft would have the acquirer account for this Period 1 partial acquisition by recording net assets of $100 million, goodwill of $50 million and a credit to minority interests (in the
equity section according to the Exposure Draft) of $60 million. In Period 2, we believe the Exposure Draft would have the acquirer account for the step acquisition as a debit to minority interest of $60 million (to eliminate minority interest) and a debit to additional paid-in capital of $60 million. The effect of this transaction does not account for the significant change in value of the subsidiary between period 1 and period 2 as a result of the accounting in this Exposure Draft.

Furthermore, assume that in period 3, the company sold the subsidiary for $170 million. The result of selling this subsidiary would result in a gain by the company of $20 million ($170 million less $150 million initial valuation determined in period 1). We do not believe that this accounting captures the economics of the transaction. The company would record a gain of $20 million, although economically the company lost $40 million ($170 million less the $210 million paid for each of the pieces of the step acquisition). The difference between the $20 million gain recorded in the transaction as required in the Exposure Draft and the $40 million in economic loss remains in additional paid-in capital for perpetuity. We do not believe that this accounting result is appropriate given the substance of the acquisition and disposition.

Similarly, we could construct an example of a disposition (but not loss of control) in which the accounting as required in the Exposure Draft does not appropriately account for the economics of the transaction. We continue to believe that the appropriate accounting for step acquisitions and dispositions was prescribed in SFAS 141, and we urge the Board to reconsider its tentative conclusions.

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

Sincerely,

ELI LILLY AND COMPANY

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