Technical Director  
Financial Accounting Standards Board  
401 Merritt 7, P.O. Box 5116  
Norwalk, CT 06856-5116  

Re: File Reference No. 2011-175 – Accounting for Financial Instruments and Selected Issues about Hedge Accounting

Dear Director:

Eli Lilly and Company ("Lilly") appreciates the opportunity to comment on the Financial Accounting Standards Board’s (the “FASB”) Discussion Paper (the “Discussion Paper”) “Selected Issues about Hedge Accounting”. Lilly is a multinational pharmaceutical company with legal entities in over 50 jurisdictions.

Lilly supports the FASB’s objective to develop a new, comprehensive standard for financial instruments that is principles-based and less complex. We believe certain proposed changes will bring the standard closer to a principles-based approach. We further commend the FASB on its efforts to simplify hedge accounting. Lilly also supports the IASB's objective to develop a new standard for hedge accounting that is risk management based and that is not intended to be as complex as existing, current standards. We do believe certain of the proposed changes will bring the standard closer to a risk management based activities approach and will improve financial disclosures for companies, fundamentally allowing economic hedges to also be accounting hedges.

However, we believe multinational entities should not be required to review and comprehend revised IFRS as well as revised US GAAP standards; and we would therefore like to see the FASB and IASB continue to bring guidance on financial instruments closer to convergence. We strongly believe both boards should continue to work together to create a converged standard and not create multiple revisions that require multiple implementations, and acknowledge that a request for comments on the Discussion Paper appears to be more aligned with a move towards convergence.

Following are responses to the questions addressed in the Discussion Paper.
Risk Management

Question 1

When an entity uses financial instruments to manage risk exposures in economic hedges but those instruments are not designated in hedging relationships for accounting purposes, do you believe that the proposed guidance would provide useful information about all of the effects of an entity’s risk management objectives?

We agree with the IASB’s overall proposed objective of hedge accounting, which is to provide a more accurate picture of risk management in the financial statements of companies. This objective will improve the usefulness of the financial statements for users, fundamentally allow economic hedges to also be accounting hedges, and should make hedge accounting more accessible to constituents. While we do not agree that the proposed guidance will provide useful information about “all” of the effects of an entity’s risk management objectives, we believe it will certainly provide a better picture than is currently being portrayed in the financial statements of entities.

Question 2

Do you believe that the proposed guidance and illustrative examples included in the IASB’s Exposure Draft are sufficient to understand what is meant by risk management, how to apply that notion to determine accounting at a transaction level, and how to determine the appropriate level of documentation required? Why or why not?

Lilly supports the objective to develop a new, comprehensive standard for financial instruments that is principles-based and less complex. However, we believe that additional implementation guidance without deterring from the principles-based approach should be provided to facilitate a better alignment of what the boards, auditors and constituents may interpret the broader term of risk management to be defined as, and to further clarify what documentation all parties interpret as being required to meet the final standard. In addition, we also believe risk management objectives and strategies of entities are often operational at a macro and not at a transactional level, so we would urge the FASB to issue final guidance with that in mind.

Question 3

Do you foresee an entity changing how it determines, documents, and oversees its risk management objectives as a result of this proposed guidance? If yes, what changes do you foresee? Do you foresee any significant difficulties that an entity would likely encounter in establishing the controls related to complying with the proposed guidance?

We do not foresee an entity changing how it determines or oversees its risk management objectives as a result of the proposed guidance. The proposed guidance would facilitate a more accurate reflection of actual risk management objectives than is currently being portrayed in the financial statements of companies. This would allow more flexibility when it comes to hedging certain risk management transactions, such as forecasted transactions, and although additional documentation may be necessary to support the risk management rationale for these transactions and to support control establishment and control testing around the process, we believe the resulting flexibility of being able to hedge
economic transactions that could not previously receive hedge accounting treatment would make the additional documentation requirements worth the while of companies.

**Question 4**

*Do you foresee any significant auditing issues arising from the proposed articulation of risk management and its link to hedge accounting? For example, is the information required to be disclosed regarding an entity’s risk management strategies measurable and objective? Could the inclusion of an entity’s risk management objectives create an expectation gap that the auditor is implicitly opining on the adequacy of the entity’s risk management objectives?*

Per our response to Question 2 above, Lilly supports the objective to develop a new, comprehensive standard for financial instruments that is principles-based and less complex. However, we believe that additional implementation guidance without detracting from the principles-based approach should be provided to facilitate a better alignment of what the boards, auditors and constituents may interpret the broader term of risk management to be defined as, and to further clarify what documentation all parties interpret as being required to meet the final standard. We do not believe an auditor should implicitly opine on the adequacy of an entity’s risk management objectives, and providing additional guidance with illustrative examples should help alleviate such expectation gaps.

**Hedging Instruments**

**Question 5**

*Should cash instruments be eligible to be designated as hedging instruments? Why or why not? If yes, is there sufficient rigor to prevent an entity from circumventing the classification and measurement guidance in other relevant accounting guidance (for example, IFRS 9, Financial Instruments, and IAS 21, The Effects of Changes in Foreign Exchange Rates)? Are there any operational concerns about designating cash instruments (such as items within a portfolio of receivables) as hedging instruments?*

To the extent that cash instruments are used as a component of a risk management mitigation plan for which a type of risk can be separately identified and measured and a non-accidental hedging relationship can be proven, cash instruments that are measured at fair value through earnings should be allowed to be designated as hedging instruments. If the premise of allowing a more principles-based approach is to also provide more flexibility in being able to hedge economic transactions that could not previously receive hedge accounting treatment, the nature of an instrument should not preclude that determination, and thus operational concerns are not anticipated. By limiting the eligibility to cash instruments measured at fair value through earnings, a resultant circumvention of classification and measurement accounting guidance should not occur.

**Hedged Items**

**Question 6**

*Do you believe that the proposed guidance is sufficient to understand what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item (for example, equity instruments measured at fair value through profit or loss, standalone*
derivatives, hybrid instruments, and components of instruments measured at fair value through profit or loss that are not permitted to be bifurcated? If not, what additional guidance should be provided?

As long as a type of risk can be separately identified and measured and a non-accidental hedging relationship can be proven, the ability to hedge a risk component should exist, and this should be inclusive of prepayment, credit, and inflation risk components. Designating a hedged item with more specificity would help reduce hedge ineffectiveness due to duration mismatches between, for example, an interest rate swap and a bond. Allowing hedging of risk components would allow hedge accounting to better reflect the “economic outcome” of a risk transaction and would therefore create better alignment with risk management practices. Allowing companies to design hedges that focus only on a component of non-financial risk would reduce what constitutes hedge ineffectiveness in the income statement. However, the limits of “separately identifiable and reliably measurable” as proposed remain unclear, and we question whether there are more appropriate tests to stratify risk components and how non-financial items should be disaggregated and hedge effectiveness assessed in instances when these are not contractually specified. Additional implementation guidance, without detracting from a principles-based approach, would be helpful to delineate what constraints apply when determining whether an item in its entirety or a component thereof is eligible to be designated as a hedged item, but once again, we believe that if a type of risk can be separately identified and measured and a non-accidental hedging relationship can be proven, the ability to hedge a risk component should exist, and that risk component should not be limited to risk components that are contractually specified.

**Question 7**

*Do you believe that the proposed criteria are appropriate when designating a component of an item as a hedged item? If not, what criteria do you suggest? Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to determine when the criteria of separately identifiable and reliably measurable have been met? If not, please describe what additional guidance should be provided.*

See response to Question 6.

**Question 8**

*Do you believe that “separately identifiable” should be limited to risk components that are contractually specified? Why or why not?*

See response to Question 6.

**Question 10**

*Do you believe that the proposed guidance is sufficient to understand what constraints apply to determining a layer component from a defined, but open, population? (For example, do you believe that the sale of the last 10,000 widgets sold during a specified period could be designated a layer component in a cash flow hedge?) If not, what additional guidance should be provided?*

We agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item because this would better align with the risk management activities of entities and allow for more flexibility and less ineffectiveness. However, we believe clarified guidance should be provided
and we specifically disagree that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option’s fair value is affected by changes in the hedged risks. In certain instances prepayment may not be more probable than not and the determination of this probability would be unclear.

Question 11

Do you foresee any operational concerns applying other guidance in IFRS (for example, guidance on impairment, income recognition, or derecognition) to those aggregated positions being hedged? For example, do you foresee any operational concerns arising when an impairment of individual items within a group being hedged occurs? If yes, what concerns do you foresee and how would you alleviate them? The proposed guidance would define an aggregated exposure as a combination of another exposure and derivative. The proposed guidance would permit an entity to recognize changes in the fair values of derivatives that are part of the aggregated exposure to be reflected in other comprehensive income rather than through profit or loss.

While we defer to constituents that are currently applying this “other guidance” in IFRS, we do not foresee any operational concerns applying other guidance in IFRS and we agree that as long as we can separately identify and measure each type of risk and prove a non-accidental hedging relationship, we should be able to hedge a risk or a combination of risks, and this includes aggregated exposures.

Question 12

Do you believe that the proposed guidance on aggregated exposures will provide more transparent and consistent information about an entity’s use of derivatives? Why or why not? The proposed guidance would permit net offsetting positions involving only cash instruments to be accounted for as a hedge if certain requirements are met.

We agree with the overall proposed objective of hedge accounting, which is to provide a more accurate picture of risk management in the financial statements of companies. This objective will improve the usefulness of the financial statements for users, and by showing how multiple risks are managed in the aggregate the proposed guidance on aggregated exposures should provide more transparent and consistent information about an entity’s use of derivatives.

Question 13

Do you believe that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance and satisfy the proposed hedge effectiveness criteria? Why or why not?

We agree that an entity should be permitted to apply hedge accounting to a group of cash instruments or portions thereof that offset and qualify as a group under the proposed guidance. The ability to hedge a “net” position is particularly welcomed. However, it is proposed that all items must impact earnings in the same period and this is inconsistent with common risk management practices, which are not mandated by cut-off. The frequency of an entity’s financial reporting could thus affect an entity’s ability to use hedge accounting and may therefore reduce hedge accounting application in practice.
Hedge Effectiveness

Question 14

Do you foresee any significant operational concerns, including auditing issues, in determining how to assess whether a hedge achieves other-than-accidental offset? If yes, what concerns do you foresee and how would you alleviate them? The IASB’s proposed guidance would require an entity to assess hedge effectiveness on a prospective basis in an ongoing manner.

We support alignment of the hedge effectiveness requirements with risk management policies and the removal of the “bright-line” requirements. However, the new requirements seem susceptible to varying degrees of interpretation, particularly the achievement of “other-than-accidental-offset” which may create some disparity in practice. While we support the effort to reduce excessive quantitative analysis and promote more practical guidance, entities need to comprehend how auditors will evaluate the facts and circumstances that led an entity to enter into a hedging relationship so as to prevent disqualified hedges. Since the burden of proof remains with the entity and any ineffectiveness will be recognized in earnings, this modification will increase subjectivity in determining whether a hedging relationship qualifies for hedge accounting (e.g., no bright line). We therefore propose that additional examples or illustrative scenarios be provided in the guidance to clarify the intent of the board without using bright lines. In addition, the “unbiased” test could be equally burdensome and the purpose/benefit remains unclear. While eliminating the requirement to assess effectiveness retrospectively would reduce the work involved in effectiveness testing, the measurement process will potentially become more complex and the methodology is not specified. Complying with IASB criteria as proposed may be more onerous on an ongoing basis since effectiveness must be assessed at least quarterly and it also must be established that there is no systematic "over" or "under" hedge, and the hedge must be rebalanced if that is no longer true. Annual effectiveness testing or effectiveness testing as mandated by a specific triggering event may be more pragmatic. There could also be considerable ineffectiveness for companies that use shorter duration derivatives to hedge longer duration derivatives, due to credit or market constraints.

Question 15

Do you believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness (for example, how to measure the change in the value of the hedged item attributable to the related hedged risk for nonfinancial items)? If not, what additional guidance is needed?

We do not believe that the proposed guidance and illustrative examples are sufficient to understand how to analyze hedge effectiveness. Without detracting from the principles-based approach, additional examples could provide helpful guidance. Since the focus of the guidance appeared to be more quantitative in nature, clarity should be provided specifically around qualitative measures for analyzing hedge effectiveness.
Changes to a Hedging Relationship

Question 16

Do you foresee any significant operational concerns or constraints in determining whether (a) a change to a hedging relationship represents a rebalancing versus a discontinuation of the hedging relationship or (b) an entity’s risk management objective has changed? If yes, what concerns or constraints do you foresee and how would you alleviate them? The IASB’s proposed guidance would require an entity to assess hedge effectiveness at every reporting date (at a minimum). Depending on that assessment, an entity may be required to rebalance its hedging relationship to continue to qualify for hedge accounting.

We agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment, an entity should be permitted to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same. We also agree that if an entity expects that a designated hedging relationship might fail to meet the objective of the hedge effectiveness assessment in the future, it may also proactively rebalance the hedge. Rebalancing allows for the flexibility to proactively rebalance the hedge real-time when fact patterns and forward looking risk management policies change. Footnote disclosures would thus provide a better assessment of the risks faced by a company at a given point in time. Treating a rebalanced hedge as a continuation of the originally documented hedge relationship rather than mandating a fresh start to hedge accounting would also be beneficial and help reduce the administrative burden associated with hedge accounting. However, rebalancing the hedging relationship may require significant judgment. It may be difficult in operational practice to apply this guidance or to decide when rebalancing is appropriate without further illustrative examples to assist in implementation. Further, as previously stated, we believe that additional implementation guidance without detracting from the principles-based approach should be provided to facilitate a better alignment of what the boards, auditors and constituents may interpret the broader term of risk management to be defined as, and what documentation all parties interpret as being required to meet the final standard.

Question 17

Do you foresee any significant operational concerns or constraints relating to the potential need to rebalance the hedging relationship to continue to qualify for hedge accounting? If yes, what concerns or constraints do you foresee and how would you alleviate them?

See response to Question 16.

Accounting for the Time Value of Options

Question 18

Do you believe that capitalizing the time value of an option as a basis adjustment of nonfinancial items (in other words, marking the asset or liability away from market) will improve the information that is provided in an entity’s statement of financial position? Why or why not?

We agree that capitalizing the time value of an option is a better approach. We further agree that for period-related hedged items, the part of the aligned time value that relates to the current period should be transferred from accumulated other comprehensive income to profit or loss on a rational basis.
agree that this portion of the proposal would remove the possible impediment to hedging with options by removing the volatility of purchased options from earnings. The time value premium would be treated as a cost of hedging and presented in other comprehensive income, which makes hedging with purchased options more attractive. However, it remains unclear over what time period the time value would be recognized/amortized into net income, whether it would be over a future period, in the hedged item, or over the life of the hedge. Further clarification is warranted on these concepts as well as the implications to hedges involving forward contracts where the spot element is separated from the forward points and is not discounted.

**Hedge Accounting and Presentation**

**Question 19**

Do you believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information? Why or why not? The IASB’s Exposure Draft would change the presentation of fair value hedges in the statement of financial position. The hedged items would no longer be adjusted for changes in fair value attributable to the hedged risk. Rather, those changes would be reflected as a separate line item in the statement of financial position, presented next to the line item that includes the hedged asset or liability.

We do not believe that the proposed presentation of the gains and losses in other comprehensive income will provide users of financial statements with more useful information, but rather feel it will create additional complexities that could cause significant accounting and treasury system changes. Furthermore, additional line items in the primary financial statements may be of limited usefulness to non-financial institutions. While gross presentation may better reflect the hedging economics of a financial institution, it may not do so for non-financial institutions for which financial statement users will undoubtedly be more interested in analyzing the operations related to the primary business purpose of the entity. For non-financial institutions, investing and financing activities are not considered the primary operations of the entity. The FASB’s proposal is intended to improve comparability of financial statements across entities and provide more relevant and reliable information that can be used to evaluate an entity’s performance. Disclosing necessary information in the notes to the financial statements should be sufficient to clarify risk management objectives and strategies for the financial statement users and we question if the presentation of the hedged rate may be a better indicator of hedging economics for non-financial institutions.

**Question 20**

Do you believe that the proposed presentation of a separate line item in the statement of financial position would increase the transparency and the usefulness of the information about an entity’s hedging activities? Why or why not?

See response to Question 19.
Question 21

Do you believe that there is sufficient guidance to specifically link the hedging adjustments to the hedged assets and liabilities that compose a hedged net position with respect to presenting a separate line item in the statement of financial position?

See response to Question 19.

Disclosures

Question 22

Do you foresee any significant auditing issues arising from the inclusion of risk management disclosures in the notes to the financial statements? If yes, what issues do you foresee and how would you alleviate them? Do you believe that it is appropriate to include risk management disclosures in the notes to the financial statements rather than in other information in documents containing financial statements? Why or why not?

We agree that the proposed IASB footnote disclosure requirements would provide more information to financial statement users on the risks managed by companies. The proposal is intended to improve comparability of financial statements across entities and to provide more relevant and reliable information that can be used to evaluate an entity’s performance. As long as the necessitated disclosures are qualitative in nature, we do not foresee as many significant auditing issues and think the place for the disclosures is in the notes to the financial statements and not in other information in documents containing financial statements.

Question 23

Do you believe that the changes proposed by the IASB provide a superior point for any changes to U.S. GAAP as it relates to derivatives and hedging activities? Why or why not? Should the FASB be making targeted changes to U.S. GAAP or moving toward converging its overall standards on derivatives and hedging activities with the IASB’s standards?

We note that the IASB’s proposed hedge revisions would result in hedge accounting guidance that would differ in further aspects as compared to the FASB’s proposed guidance, and we welcome convergence of the proposed FASB hedge accounting standards with those of the proposed IASB hedge accounting standards, and note that the IASB appears to have developed a standard that allows the accounting to better match up with the underlying risk management activities of companies.
Conclusion

Lilly once again supports the FASB’s objective to develop a new, comprehensive standard for financial instruments that is principles-based and less complex. We believe certain proposed changes will bring the standard closer to a principles-based approach. We once again commend the FASB on its efforts to simplify hedge accounting. While significant changes have been proposed for hedge accounting, we are not convinced the Discussion Paper meets all of the objectives of reducing the complexities of hedge accounting brought up by constituents. As indicated in our responses above, we believe some of the proposed standards need further clarification or additional consideration, and that certain of the proposed standards need not apply to non-financial institutions. We also strongly believe both boards should continue to work together to create a converged standard.

We appreciate the opportunity to express our view 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

[Signature]

Arnold C. Hanish
Vice President, Finance and
Chief Accounting Officer