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April 8, 2004

Letter of Comment No: 35
File Reference: 1200-400
Date Received: 4/8/04

Director of Major Projects and Technical Activities
Financial Accounting Standards Board of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: The Following Proposed Rules:

Earnings per Share, an amendment of FASB Statement No. 128 (File Reference 1200-200)

Exchanges of Productive Assets, an amendment of APB Opinion No. 29 (File Reference 1200-300)

Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (File Reference 1200-400)

Dear Director of Major Projects and Technical Activities:

Eli Lilly and Company appreciates the opportunity to respond to the Proposed Rules referenced above. We support the overall effort of the Financial Accounting Standards Board (Board) to achieve more comparability in financial reporting through convergence of accounting standards of Generally Accepted Accounting Principles in the United States and those of the International Accounting Standards Board (IASB). Although we believe the idea of convergence is beneficial, we do not support sacrificing the integrity and principles of Generally Accepted Accounting Principles in the U.S. solely in the name of convergence. We have read the Proposed Rules and we have the following comments.

Earnings per Share, an amendment of FASB Statement No. 128

We support the proposed amendment to paragraph 46 of FASB Statement No. 128, *Earnings per Share*, regarding the change in calculating the treasury stock method when computing the annual and year-to-date diluted earnings per share. This new calculation will move us toward global comparability on one of the most common measurement tools used by investor's today.

However, in today's environment, we believe that there is a negative connotation with a "restatement", even if required by an adoption of a new accounting standard. In addition, a restatement adds additional internal costs to recalculate earnings per share for all periods presented, external auditor costs in reviewing the new calculations, and finally the cost of explaining the restatement to the investment analysts and public. This amendment should be dealt with on a prospective basis, as the additional costs and negative public scrutiny exceed any benefit provided by a restatement.

Exchanges of Productive Assets, an amendment of APB Opinion No. 29

While we have some reservations about whether an exchange of productive assets should be accounted for based on the fair value of the assets involved, we are willing to accept this in the effort to support convergence. However, we believe this Proposed Rule should exclude an exchange of intangible assets such as those identified in Appendix A of SFAS 141, *Business Combinations*.

In the pharmaceutical industry for example, a transaction may ensue that would, among other aspects, lead to an exchange of drug candidates currently under development. As required by SFAS 2, *Accounting for Research and Development Costs*, the research and development costs incurred thus far for these drug candidates would have been immediately expensed; therefore, these drug candidates typically would have no carrying value on the balance sheet of a pharmaceutical company. We are troubled by the fact that simply exchanging drug candidates between two parties (assuming that the parties are able to prove the transaction has commercial substance) could lead to recognition of income.

Although we do not have an alternative suggestion to the Board, we ask that the Board reconsider the concept of Commercial Substance in the Proposed Rule. While we agree with the concept and the Proposed Rule, we are concerned that applying commercial substance in practice will be difficult and judgmental.

Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3

We support the continued treatment of the adoption of a new accounting principle as a "cumulative effect of change in an accounting principle" in the period of adoption and we disagree with the Proposed Rule's retrospective adoption in all prior periods. We believe that the cumulative effect adoption approach is the appropriate mechanism for adopting new accounting standards due to the following factors:

- Current public perception of "restatements" and potential confusion of the general public and investment community;
- Comparability of adoption of new pronouncements for all companies;
- The cost of determining the impact of the new pronouncement on each of the quarterly periods; and
- The subjective nature of determining the impact on the adoption of new pronouncements.

Due to the recent public scandals involving companies such as Enron and Worldcom, the current public perception of "restatements" is very negative. Despite the fact that this restatement would be due to the adoption of a new accounting principle, we believe the general public would not necessarily understand this differentiation, which according to the Proposed Rule, would be required to be discussed for at least the next four consecutive quarters as companies explain their earnings and the restatement of the prior period due to the adoption of the new accounting rule.

We believe it is important that all companies report the effect of a change in accounting principles in exactly the same manner. Under the Proposed Rule, some companies would continue to report the effect of the adoption of a new rule as a cumulative effect adjustment, while other companies would be required to restate financial results to prior periods. According to paragraph 11(a), a company can continue to utilize a cumulative effect approach, if "the effects of retrospective application are

not determinable". This vague exception may very well create a situation whereby some companies in the same industry adopt a new accounting pronouncement as a "cumulative effect" while others retrospectively apply the new pronouncement. This will lead to greater incomparability between companies, even in the same industry.

While we are supportive of requiring all companies to use the same method to report a change in accounting principles, we could not support a requirement for all companies to use the retrospective adoption because the costs may often outweigh the benefits. These costs include the costs of the financial systems that need to be modified, the costs of internal accounting personnel to complete and review the quarterly / yearly restatements, the costs of explaining the restatements quarterly to investment analysts and the public, and the increased external auditor costs in reviewing all quarterly adjustments. We generally do not believe additional costs are worth the benefit that retrospective restatement would create.

Applying most new accounting pronouncements requires at least some judgment and interpretation of the new rule. We are concerned that retrospective restatements of new accounting pronouncements could lead to more "gamesmanship" by public registrants in determining the quarterly adjustments necessary to apply the new accounting pronouncement. Most registrants currently discuss the impact of a cumulative effect adjustment as a one-time event in the year of adoption and if material, appropriately adjust for the future impact of the new rule in future earnings guidance. We fear that "gamesmanship" by some public registrants could occur in applying a retrospective approach to the adoption of new accounting rules in the prior quarterly results.

Again, we are supportive of convergence, but we have significant concerns about this proposal as discussed above. If the final decision is to move ahead with the requirement for restatement, we believe it is critical that the concept of "undue cost" be added to the exception in paragraph 11(a).

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

Sincerely,

ELI LILLY AND COMPANY

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