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

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC 4M 6XH
United Kingdom

Via email: director@fasb.org

Re: File Reference No. 1820-100: Proposed Accounting Standards Update, "*Revenue from Contracts with Customers*"

Dear Sirs:

Eli Lilly and Company appreciates the opportunity to comment on the Financial Accounting Standards Board (FASB) and International Accounting Standard Board's (IASB's) Proposed Accounting Standards Update, "Revenue from Contracts with Customers". Eli Lilly is a large, multinational company that creates and delivers innovative medicines that enable people to live longer, healthier, more active lives.

We support the FASB and IASBs desire to harmonize the accounting guidance for revenue with customers across all industries as well as with the IASB. We believe that the achievement of a fully converged standard with the IASB is of utmost importance to creating comparability across jurisdictions as well as simplifying a potential future transition to IFRS.

While we generally support the proposed ASU, we do have certain concerns on its proposals. Our primary concerns with the proposed ASU relate to the lack of clarity on what makes a performance obligation distinct, the use of probability weighted average for calculating variable and contingent consideration, the accelerated recognition of royalty revenue, the application of customer credit risk, accounting for collaborations, and finally, the proposal for full retrospective application.

We address each of these concerns below and further answer specific questions proposed by the boards in later sections.

Distinct Performance Obligation

We support the boards attempt to develop a methodology for determining the various performance obligations created by a contract. We are concerned with the current wording surrounding the evaluation of an obligation as distinct when the good or service is not currently sold separately by the entity or any other entity. The evaluation of distinct function and distinct profit margin will be difficult and very subjective in application. We have particular concerns regarding the application of the distinct profit margin concept. The determination of profit margin is difficult without knowledge of costs and risks. We believe that a distinct risk is a better indicator of a unique obligation and, while remaining subjective, might be more easily applied than a mechanical determination of profit margin.

We understand that the application of the distinct function criteria will require reviewing the timing of the transfer of goods and services to determine if the function is distinct. We do not agree with the assertion that the timing of transfers should be a determining factor of the distinct nature of an obligation. The addition of timing criteria to the determination of distinct adds unneeded complexity.

We propose that the boards improve the guidance provided regarding the determination of distinct, eliminate the notion of timing from the determination of distinct, and provide more commentary regarding its intended application.

Variable consideration

We have significant concerns with the proposed ASU's guidance on the accounting for variable consideration. This concern is primarily related to the theoretical and operational aspects of applying a probability weighted average to variable and contingent consideration and recognizing revenue that is unlikely to be received.

We believe that our current practice of recording revenue at the "best estimate" of revenue to be received at the time of fulfilling our performance obligations is similar to the board's intent in requiring a probability weighted average. We believe that the operational burden of performing the calculation of a probability weighted average to meet the requirements of the proposed ASU would add more effort, but would not result in any increase in the precision of the estimate. We believe that the use of "best estimate" will yield a similar answer to probability weighting in instances where there are multiple outcomes, and in situations where the outcome is binary, the use of "best estimate" will result in an answer indicative of management's assessment of the facts and circumstances and not simply an average of the possible outcomes, which is not a potential outcome itself. Therefore, the use of "best estimate" would provide more useful information to users of the financial statements.

The use of a "best estimate" would reduce the likelihood of revenue being reversed in a subsequent period and also for revenue being recorded for highly unlikely events. In the life science industry there is significant risk in developing research and development assets as there are many more failures than successes in advancing early stage intellectual property to regulatory approval to be used in a commercial state. It is common for life science entities to

structure arrangements with significant consideration in the form of milestones and royalties. The milestones are frequently tied to the progression of the asset through a normal development and regulatory process. In light of the significant uncertainty in the development process, the contract asset and revenues recognized in one period using a probability weighted average approach would frequently be reversed in the subsequent period. We do not believe that the proposed ASU should require an entity to recognize revenue with a corresponding asset that is more likely than not to be reversed. The use of probability weighting will result in reporting of results with little chance of occurring. For instance, if a milestone has a 10% chance of being achieved, the proposed ASU would require an entity to show revenue for 10% of the milestone even though a company's "best estimate" would show that there is a 90% chance that the milestone will not be achieved, leading to a conclusion that no revenue should be recognized.

We are concerned that the application of the proposed guidance to variable consideration may provide increased risk of criticism with the benefit of hindsight as well as increase the opportunity for abuse. We propose that the board eliminate the requirement to record revenue at the probability weighted average consideration and rather provide an option to record the revenue using a "best estimate" concept.

Royalty Revenue

As a type of variable consideration, we are particularly concerned with the impact of the proposed ASU on the accounting for royalty revenue. We do not believe that any revenue model that accelerates the recognition of royalty revenue in advance of the recognition of a receivable provides useful information to users of the financial statements.

The application of the proposed ASU would require companies to calculate the present value of all estimable royalties and record this as current revenue when the obligation is fulfilled. This would result in life science companies recognizing revenue for royalties on sales several years prior to the acquirer recording the actual sales generating the royalty. Further, it is common for assets in the life sciences area to be sold more than once. With each sale, an entity may keep a royalty obligation, while at the same time creating a new one. The application of the proposed ASU to this fact pattern would result in a misalignment between the recognition of the sold royalty stream and the liability for the owed royalty stream. The entity would recognize the probability weighted present value of the royalty stream to be received upon fulfillment of the performance obligation, but would recognize the liability for the royalty expense upon actual sales by the customer to the end consumer. There could be several years between these two events.

We spoke with a stock analyst regarding the proposed ASU's treatment of royalty revenues. The analyst noted that the boards' approach of recognizing earlier would add unneeded complexity to the analysis of financial statements and felt that the increased costs of analyzing the revenue stream did not provide a commensurate benefit of improved reporting of financial results.

We do not believe that the inclusion of royalty revenue in the proposed revenue model generates useful information for users of the financial statements. We believe that the boards should exclude royalties from the estimation of variable consideration and retain the current US GAAP accounting recognizing royalty revenue when the sales that trigger the royalty occur.

Customer credit risk

We agree with the elimination of credit risk as a criterion for recording revenue; however, we are concerned with the proposed ASU's guidance on the incorporation of customer credit risk in the determination of revenue. While we understand the desire for conceptual purity, the practical application of these concepts is difficult and, in our view, will add little benefit.

We believe that it will be difficult to accurately apply the proposed standard. When evaluating each customer independently, we generally expect to receive 100% payment of each invoice. It is only when the customers are pooled together that the collective credit risk would cause us to anticipate less than full collections. This is accounted for today through an allowance for doubtful accounts and is a well understood practice.

We propose that the boards eliminate the proposed guidance on incorporating customer credit risk in the calculation of revenue, but rather rely on current accounting guidance regarding accounting for doubtful accounts. We further propose the boards include a comprehensive example with variable consideration, time value of money, and customer credit risk adjusted through time to clarify the accounting entries required for each of these concepts, as well as, the interaction between them.

Collaborations

Our concerns with collaborations stem from both the limited guidance on the appropriate determination of whether a collaboration agreement is with a customer or a collaborator together with a further lack of guidance on how to account for an arrangement if the determination is made that an agreement is a collaboration.

Due to the inherent risks in our business, we frequently utilize risk sharing collaboration arrangements with third parties to both speed assets through development as well as share the large financial burden of the development of these assets. These arrangements can be with other pharmaceutical companies, biotech companies, or other unrelated third parties. In the proposed ASU, the boards provided some limited discussion in the Basis for Conclusions regarding collaborations and the determination of a customer. The guidance currently proposed instructs us to evaluate if a good or service is an output of our normal activities. Most collaboration agreements contain certain provisions that may meet the definition of a contract with a customer, while other provisions are collaborative in nature. The main purpose of collaboration agreements however are not intended to generate income from the partner, but rather to share in the risks and collective rewards if an asset is successfully commercialized. The structure and terms of each arrangement vary greatly, but since the arrangement is risk sharing, there is seldom any compensation built into the arrangement, with the exception of any up-fronts and milestones that may occur.

We believe that the boards should include a principle regarding the determination of a collaboration to solidify guidance on when to include or exclude a collaboration from the proposed ASU. A sample principle may read: if substantially all of the value received in an agreement is in the form of cost-sharing and/or profit-sharing payments, the agreement should be considered a collaboration agreement and completely scoped out of the proposed ASU. The application of this principle would provide additional clarity regarding the inclusion or exclusion of contracts for the proposed ASU. While this principle would allow for certain amounts of consideration that could be considered revenue in a collaboration agreement to be excluded from the proposed rules, we feel that it is appropriate to exclude the entire contract as it aligns the primary intent of a contract, risk sharing, with the most appropriate accounting.

We have further concerns pertaining to accounting for a collaboration once it is deemed that the agreement is not within the scope of the proposed ASU. Currently, we refer to extensive guidance in US GAAP regarding accounting for multiple element arrangements. While this guidance does not directly address the accounting for collaboration agreements, we refer to it in determinations of stand-alone value and units of account. A majority of this guidance is being eliminated by the proposed ASU. In the absence of guidance, we are concerned that we will be scoped back into the proposed ASU. We do not believe that this is appropriate as we have already stated that collaboration agreements are not contracts with customers and therefore not covered under the proposed revenue recognition rules.

Finally, the value received from a collaborator can be for any number of goods or services ranging from reimbursement for past R&D, a buy-in to an asset, or a prepayment for future supply of product. While not perfect, the existing guidance is at least reasonably well understood. If this guidance is eliminated as is currently contemplated, we believe that each entity should make a policy election regarding the accounting for the receipt of such payments from a collaboration that reflects the underlying economics of the transaction, disclose this policy, and apply it consistently across similar arrangements. It is likely that we would adopt a policy that is similar to existing practice.

In summary, we would propose that the boards move the current guidance on what constitutes an output of ordinary business, what defines a customer, and identifying collaborations into the implementation guidance section. We would also propose the inclusion of a principle similar to the one provided above to clarify what collaboration agreements should be excluded from the scope of the proposed ASU. Finally, we propose that the boards clearly state that once a collaboration is determined to be not with a customer, that the agreement is not covered under the proposed ASU.

Full Retrospective Application

The proposed ASU calls for companies to apply the ASU retrospectively to all arrangements. Life science companies, like many industries, have numerous agreements that span several years. When these deals were contracted, they did not contemplate the proposed ASU. Applying the proposed standard in a full retrospective fashion will lead to variable consideration being moved to prior periods, royalty revenue being permanently reduced, and changes in the amortization amounts and periods. The costs incurred to recalculate and reassess the revenue

from every agreement will far exceed the incremental benefit of having restated financial statements reflecting all agreements.

We would propose that the standard allow for the ASU to be applied in a modified retrospective manner. The effective date of the proposed ASU should allow for companies to account for all new arrangements entered into after the date of issuance of the final ASU. There should be suitable time given between the issuance and the effective date so that a company may comply with the Securities and Exchange Commission (SEC) requirements for two years of comparative financials. We would recommend the removal the requirement for full retrospective application, but rather make it optional.

Summary

We believe the proposed ASU is an improvement on current GAAP and focuses appropriately on principles. However, we think that the proposed ASU does not provide enough clarity on significant concepts, opens the door for significant diversity in practice, and creates significant operational difficulty. Therefore, we strongly recommend that the Proposed ASU not be finalized as written.

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

Sincerely,

S/Arnold Hanish
Vice President, Finance
and Chief Accounting Officer

Answers to proposed ASU questions

Question 2: The boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

Answer: As mentioned above, we agree with the principle of separating distinct performance obligations. We believe that the inclusion of distinct risks instead of distinct profit margins is a better proxy for determining the distinct nature of an obligation. We also feel that the current wording describing “distinct function” is difficult to understand and may lead to an interpretation that every obligation is distinct. The board should clarify the intended application of this wording.

Question 4: The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

Answer: We agree that an entity should recognize revenue based on an estimated transaction price, however, we believe that the use of “best estimate” is a more appropriate measurement method. We believe that the addition of a probability threshold as a criterion for recognition would improve the usefulness of financial reporting and prevent the recognition of revenue with a low likelihood of occurring from being reflected in the financial statements.

We are concerned that the application of the proposed may provide increased risk of criticism with the benefit of hindsight as well as increase the opportunity for abuse. We believe that royalties should be specifically excluded from the calculation of variable consideration. We do not believe that this inclusion of royalties as variable consideration provides useful information to the users of financial statements given the reasons highlighted in our letter.

Question 5: Paragraph 43 proposes that the transaction price should reflect the customer’s credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer’s credit risk should affect *how much* revenue an entity recognizes when it satisfies a performance obligation rather than *whether* the entity recognizes revenue? If not, why?

Answer: We agree with the removal of collectability as a criterion for recognition of revenue, but we do not believe that a company should incorporate the customer’s credit risk in the determination of the amount of revenue. We believe that the current US GAAP method of accounting for doubtful accounts is fair, well understood by users, and accurately reflects the

net compensation received for the goods or services. We believe that if the boards insist on keeping customer credit risk as a factor in determining the amount of revenue, and then all subsequent changes should go through revenue. The current proposed ASU does away with this symmetry. This does not improve financial reporting.

Further, we believe that an entity should be able to include a strategic decision on factoring when making the determination of the impact of customer credit risk. The use of non-recourse factoring to increase cash flow is a common practice in certain jurisdictions. Although the factoring decision is separate, by not including this in a computation of credit risk, an entity might have a day 2 gain on a receivable which is not a logical answer.

Question 6: Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

Answer: We do not believe that a company should incorporate the time value of money into the recognition of all revenue as the conceptual purity of this approach does not justify the additional work and complexity that will result. At a minimum, we believe that the boards should set a time-frame (such as 1 year) where the effects of the time value of money should not be considered. As is mentioned in the basis for conclusions, we do agree that the inclusion of an bright line may result in certain material adjustments in high interest rate environments not being made. While the concept of using materiality as a guide appears good on paper, the practical application of it results in a large corporation being broken into smaller legal entities. When materiality at the smaller legal entity level is considered, there are several accounting adjustments made that do not materially impact the consolidated results, but rather only serve to increase workload. If a threshold of say 1 year were used, this would eliminate much unnecessary work.

Question 13: Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)? If not, why? Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

Answer: No, we do not believe that full retrospective application should be required. We would propose a prospective adoption from the date of issuance to the new standard. Thus, if the proposed effective date is fiscal years ending after Dec 14, 2014, the guidance would be applied to all contracts entered into after January 1, 2012 to remain in compliance with the SEC requirements for 10K disclosures and borrow the concept of a transition date from IFRS 1. Since all contracts entered into prior to January 1, 2012 would be under prior guidance, users would be familiar with accounting policies. For all new contracts, the details would be laid out in new disclosures, and any material impacts would be included. This would balance the needs of investors to understand accounting, with the overwhelming amount of work required to review any outstanding contract and retroactively restate revenues.

Question 14: The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

Answer: We would like to see a comprehensive example in the determination of transaction price utilizing all concepts considered in the final standard. These concepts would

include the time value of money, customer credit risk, and return estimate. All of these concepts add considerable complexity to the accounting and an example would allow both companies and auditors a better understanding of the boards' intent.

Question 16: The Boards propose the following if a license is not considered to be a sale of intellectual property:

- (a) if an entity grants a customer an exclusive license to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the license; and
- (b) if an entity grants a customer a nonexclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license.

Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the Boards? Why or why not?

Answer: We do not agree that the determination of exclusive vs non-exclusive should determine the accounting treatment. We appreciate the boards' desire to reach perceived consistency between the lease standard and the revenue recognition standard. We believe that the evaluation of revenue recognition for licenses is more closely aligned with the guidance on financial instruments.

A license is similar to a financial instrument in that a license can be broken into several distinct parts and each part sold separately. You might sell rights to a region, certain application, future royalties, distribution, marketing, etc. Each sale is distinct and grants distinct rights. Once sold, either exclusive or non-exclusive, the entity has fulfilled its obligation.

In a financial instrument, an entity can sell a tranche of mortgages or a treasury strip. These transactions are treated as sales since the entity has fulfilled its obligation once sold. We believe that the revenue for a licensing transaction should be recognized immediately whether the license is exclusive or non-exclusive.

Question 17: The Boards propose that in accounting for the gain or loss on the sale of some nonfinancial assets (for example, intangible assets and property, plant, and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

Answer: We agree with this provision, unless the sale of the nonfinancial asset is a part of a collaboration agreement. Until the boards provide guidance specific to collaborations, we believe, as stated above, that value received in a collaboration agreement should be recorded consistent with an internal policy.

Other Comments:

As a final point of comment, we feel strongly that the FASB should work with the SEC to consolidate and eliminate any redundant accounting guidance regarding revenue recognition. With the goal of creating a global set of accounting principles, any guidance that the SEC

provides would not be consistent with global standards. We feel that the SEC should comment on the board's proposal and the FASB should strongly consider any feedback. Further, we feel that the SEC needs to delete SAB 104 fully.