



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

www.lilly.com

Date: March 8, 2011

Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Exposure Draft – “Hedge Accounting”

Dear Sir David:

Eli Lilly and Company (“Lilly”) appreciates the opportunity to comment on the International Accounting Standards Board’s (the “IASB”) Exposure Draft “Hedge Accounting”. Lilly is a multinational pharmaceutical company with legal entities in over 50 jurisdictions.

Lilly 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.

We are concerned however, that some of the proposed changes will create more complexities and may result in significant system and operational challenges, particularly for non-financial institutions. We point to the lack of clarity on how the proposed model should be applied to a number of relatively common hedging scenarios. Clarity and illustrative examples would need to be provided in order to ensure consistent application and reduce the risk of future practice issues. Furthermore, we specifically assert that equity instruments should be able to be hedged and recorded in other comprehensive income, and this consideration was not allowable per the exposure draft.

Following are the responses to the questions addressed in the exposure draft.

Question 1

Do you agree with the proposed objective of hedge accounting? Why or why not? If not, what changes do you recommend and why?

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, fundamentally allow economic hedges to also be accounting hedges, and should make hedge accounting more accessible to constituents. However, we believe that while in some cases the suggested changes will make applying hedge accounting easier, in other instances it may make it more onerous, specifically in regards to the frequency of effectiveness testing and rebalancing of the hedge portfolio. It is also sometimes unclear how the proposed model should be applied to a number of relatively common hedging scenarios, and as a result, clarity and illustrative examples would need to be provided in order to ensure consistent application and reduce the risk of future practice issues.

Question 2

Do you agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments? Why or why not? If not, what changes do you recommend and why?

We agree that a non-derivative financial asset and a non-derivative financial liability measured at fair value through profit or loss should be eligible hedging instruments. This would allow more flexibility when it comes to hedging forecasted transactions and would provide a more accurate picture of risk management in the financial statements of companies. However, we specifically assert that equity instruments should be able to be hedged and recorded in other comprehensive income, and this consideration was not allowable per the exposure draft.

Question 3

Do you agree that an aggregated exposure that is a combination of another exposure and a derivative may be designated as a hedged item? Why or why not? If not, what changes do you recommend and why?

We agree that an aggregated exposure that is a combination of another exposure and a derivative should be allowed to be designated as a hedged item. 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 or a combination of risks should exist.

Question 4

Do you agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks (ie a risk component), provided that the risk component is separately identifiable and reliably measurable? Why or why not? If not, what changes do you recommend and why?

We agree that an entity should be allowed to designate as a hedged item in a hedging relationship changes in the cash flows or fair value of an item attributable to a specific risk or risks. 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. 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 in instances when these are not contractually specified.

Question 5

- (a) Do you agree that an entity should be allowed to designate a layer of the nominal amount of an item as the hedged item? Why or why not? If not, what changes do you recommend and why?*
- (b) Do you agree 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 risk? Why or why not? If not, what changes do you recommend and why?*

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. We 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 6

Do you agree with the hedge effectiveness requirements as a qualifying criterion for hedge accounting? Why or why not? If not, what do you think the requirements should be?

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, 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 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 7

- (a) Do you agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment an entity should be required to rebalance the hedging relationship, provided that the risk management objective for a hedging relationship remains the same? Why or why not? If not, what changes do you recommend and why?*
- (b) Do you 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 relationship? Why or why not? If not, what changes do you recommend and why?*

We agree that if the hedging relationship fails to meet the objective of the hedge effectiveness assessment, an entity should be required 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 practice to apply this guidance or to decide when rebalancing is appropriate without illustrative examples to assist in implementation.

Question 8

- (a) Do you agree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable)? Why or why not? If not, what changes do you recommend and why?*
- (b) Do you agree that an entity should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria? Why or why not?*

We disagree that an entity should discontinue hedge accounting prospectively only when the hedging relationship (or part of a hedging relationship) ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship, if applicable) or should not be permitted to discontinue hedge accounting for a hedging relationship that still meets the risk management objective and strategy on the basis of which it qualified for hedge accounting and that continues to meet all other qualifying criteria. We do not believe the ability to de-designate hedges leads to earnings management by entities because future changes in fair value of financial instruments are not predictable. Entities are subjected to the potential risk of market changes if they elect to de-designate and are accountable for

any impact to earnings. It is administratively easier to de-designate a hedge than to rebalance a hedge portfolio, and the impact to an entity's net income is essentially the same. Therefore, no longer allowing voluntary de-designation would not align well with risk management strategies, particularly in instances where de-designation would not be allowed to occur when hedging the risk of foreign currency fluctuations on forecasted transactions, since these hedges would not be allowed to be de-designated just because the hedged item is recognized, and this type of de-designation is a common practice today. We do however acknowledge that the flexibility in the hedge accounting proposal elsewhere may counteract the removal of voluntary de-designation, but would need to see this flexibility in practice before we would concur with a prohibition against voluntary de-designation.

Question 9

- (a) Do you agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognized in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss? Why or why not? If not, what changes do you recommend and why?*
- (b) Do you agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position? Why or why not? If not, what changes do you recommend and why?*

We agree that for a fair value hedge the gain or loss on the hedging instrument and the hedged item should be recognized in other comprehensive income with the ineffective portion of the gain or loss transferred to profit or loss. This would be critical for interest rate swaps. Regarding whether a gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position and whether a linked presentation should be allowed for fair value hedges, see our response to Question 13 below.

Question 10

- (a) Do you agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements (eg like a basis adjustment if capitalized into a non-financial asset or into profit or loss when hedged sales affect profit or loss)? Why or why not? If not, what changes do you recommend and why?*
- (b) Do you 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? Why or why not? If not, what changes do you recommend and why?*

We agree that for transaction related hedged items, the change in fair value of the option's time value accumulated in other comprehensive income should be reclassified in accordance with the general requirements. 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. We 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 purchase 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.

Question 11

Do you agree with the criteria for the eligibility of groups of items as a hedged item? Why or why not? If not, what changes do you recommend and why?

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. 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.

Question 12

Do you agree that for a hedge of a group of items with offsetting risk positions that affect different line items in the income statement (eg in a net position hedge), any hedging instrument gains or losses recognized in profit or loss should be presented in a separate line from those affected by the hedged items? Why or why not? If not, what changes do you recommend and why?

While we agree that when a company is hedging multiple risks it inherently makes sense to clearly identify the results of the hedge and not bury it in the income statement, we have certain reservations that are clarified in our response to Question 13 below, and believe that a more appropriate alternative may be to provide this information through more robust disclosures.

Question 13

- (a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?*
- (b) What other disclosures do you believe would provide useful information (whether in addition to or instead of the proposed disclosures) and why?*

We agree that the proposed 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. In addition, the compulsory use of a basis adjustment would also increase consistency of financial reporting. However, 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. We question if the presentation of the hedged rate may be a better indicator of hedging economics for non-financial institutions.

Question 15

- (a) *Do you agree that all of the three alternative accounting treatments (other than hedge accounting) to account for hedges of credit risk using credit derivatives would add unnecessary complexity to accounting for financial instruments? Why or why not?*

We believe that the possibility to hedge credit risk using credit derivatives is in line 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. In addition, we would welcome specific mention of whether or not the fair value of a hedge need incorporate counter-party credit risk, and how this would factor into ineffectiveness.

Question 16

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

We agree with prospective application of the proposed hedge accounting standard. However, it would be beneficial to have sufficient time to compare any changes to the FASB exposure draft on financial instruments (the hedging component) resulting from the FASB “wrapper” around this IASB exposure draft and to provide additional comments at that time since the desired hedge designation under the IFRS proposal could differ significantly from the designation as proposed in the FASB exposure draft.

Further clarifications are also needed for companies currently following U.S. GAAP as to whether companies will be permitted to re-designate existing hedges using a different characterization of the hedged item, such as change from hedging the fair value of an entire debt instrument as currently required under U.S. GAAP to change only to hedging the portion of the coupon attributable to the LIBOR swap rate. In such cases, it will need to be determined if and how the fact that the derivative was initially off-market in the re-designated hedge relationship will affect the measurement of hedge effectiveness and the accounting for the derivative. When designating or re-designating a new hedge relationship for an already existing swap in a fair value hedge, it will also need to be determined if a company is permitted to hedge the portion of the coupon that was attributable to the LIBOR swap rate at the initial inception of the swap, or must the company use the LIBOR swap rate at the time of re-designation. While we believe this would be permissible based on paragraph B26 of the exposure draft, the analogy is not entirely clear since paragraph B26 explicitly talks about changes in rates since the hedged item was acquired, rather than changes in rates since the swap was executed.

Conclusion

While significant changes have been proposed for hedge accounting, we are not convinced the proposal 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 would also 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.

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

/s/Arnold C. Hanish
Vice President-Finance and
Chief Accounting Officer