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

www.lilly.com

May 27, 2015

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

Re: File Reference No. 2015-200 – I, *Intra-Entity Asset Transfers*, and
File Reference No. 2015-210 – II, *Balance Sheet Classification of Deferred Taxes*

Dear Director:

Eli Lilly and Company ("Lilly") appreciates the opportunity to comment on the Financial Accounting Standards Board's (the "Board") Proposed Accounting Standards Updates, *"Intra-Entity Asset Transfers"* and "*Balance Sheet Classification of Deferred Taxes*" (the "Exposure Draft"). Lilly is a multinational pharmaceutical and animal health company with legal entities in over 50 jurisdictions.

Lilly supports the Board's objective to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements. We agree with the Board's proposal to remove the requirement to distinguish between current and noncurrent deferred taxes; however, we strongly disagree with the proposal to eliminate the GAAP exception related to intra-entity asset transfers which would mandate the recognition of current and deferred income tax consequences.

We are deeply concerned by the proposed guidance to recognize current and deferred tax consequences for transactions which have not been recognized in the financial statements. This practice will not only be at odds with ASC 810-10-45-8 (formerly ARB No. 51, Paragraph 17), but it will also cause the effective tax rate reconciliation to be less useful because tax expense will not align with pre-tax earnings. In addition, we are concerned that we will see greater volatility in earnings solely because of intra-entity asset transfers as they will impact tax expense. Also troubling is the requirement to undergo resource-consuming IT and control reviews and changes. Given the number of intra-entity asset transfers that occur within Lilly, substantially related to inventory transfers, we would need to re-program our general ledger system to calculate income tax expense and deferred tax assets/liabilities differently. While we understand the FASB's efforts to achieve convergence with the IASB, we question whether this change will provide better information to financial statement users. Also, we feel that the intra-entity asset transfer proposal is inconsistent with the Simplification Initiative since the proposal adds costs and complexity to implement and to integrate internal supply chain assumptions into the effective tax rate forecasting processes.

On the other hand, we applaud the Board's proposed guidance on the balance sheet classification of deferred taxes. Removing the requirement to distinguish between current and noncurrent deferred taxes will save time, and we believe that it achieves the Simplification Initiative's goal.

Following are responses to selected questions in the Exposure Draft:

Intra-Entity Asset Transfers

Question 1: Should the current and deferred income tax consequences of an intra-entity asset transfer be recognized when the transfer occurs? If not, why?

No, the current and deferred income tax consequences of an intra-entity asset transfer should not be recognized when the transfer occurs for the following reasons:

- The proposed guidance does not increase the accuracy of financial data as the Board intends. ASC 810-10-10-1 prescribes that financial statements should reflect activity "as if the consolidated group were a single economic entity". To allow intra-entity transactions to impact tax expense before the related revenue or expense is recognized in the consolidated financial statements will disconnect tax expense from underlying operating results. This disconnect will make financial information less useful.
- The proposed guidance will trigger unnecessary volatility in companies' effective tax rates. Similar to other companies in our industry, Lilly operates a highly sophisticated global supply chain. Our inventory transfers, which represent the vast majority of our intra-entity asset transfers, occur more than once among members of our affiliated group before products are ultimately sold to unrelated third parties. Under this proposed guidance, tax expense will be recognized for every intra-entity sale throughout the supply chain while revenue will not be recognized until sales to third parties occur. Intercompany sales of inventory could alter our effective tax rate by several percentage points when compared to the effective tax rate under the existing guidance. In addition, our effective tax rate could fluctuate during the year with un-forecasted intercompany sales. This result distorts the correlation between pre-tax income and tax expense and causes unnecessary effective tax rate volatility. The distortion will also make it difficult to reconcile and explain effective tax rate changes.
- The proposed guidance will create unnecessary difficulty during estimation and reconciliation of the effective tax rate. As explained above, companies' effective tax rates will become sensitive to intercompany sales under the proposed guidance. Estimating the annual effective tax rate in this environment requires forecasting of supply chain activities which can be very challenging for companies with complex supply chains. We are troubled that, under the proposed guidance, the estimation of our effective tax rate for quarterly reporting would require us to work closely with our supply chain teams to anticipate and monitor intercompany movements of inventory and to provide disclosures and explanations which go along with those movements.

- The proposed guidance may cause perceptions of earnings manipulation. Since different intercompany sales patterns can result in different income tax expense consequences in a specific reporting period, financial information users may suspect that companies could manipulate their after-tax income by altering supply chain activities to shift tax expense between reporting periods.
- The proposed guidance will impose undue burden for companies to re-configure accounting systems and internal control processes. Lilly's general ledger system, like many other companies, is programmed to eliminate sellers' income tax expense related to intra-entity transfers of inventory. In order to comply with the proposed guidance, companies will have to incur costs and allocate resources to re-configure their accounting systems and internal control processes.

To maintain the relevance of financial information, alleviate unnecessary difficulties and costs, and avoid public misperception, we urge the Board to abandon the proposed accounting standards update for intra-entity asset transfers. If this is not possible, we strongly urge the Board to continue the exception for intra-entity *inventory* transfers.

Question 2: If the income tax consequences should not be recognized when the transfer occurs, should the income taxes payable or paid upon transfer be expensed as incurred? If not, how should income taxes payable or paid be recognized?

Paragraph 145 of Statement of Financial Accounting Concepts no. 6 states the following, "recognition of revenues, expenses, gains, and losses and the related increments or decrements in assets and liabilities – including matching of costs and revenues, allocation, and amortization – is the essence of using accrual accounting to measure performance of entities". Recognizing the current and deferred income tax consequences of an event amongst related entities which has been eliminated for financial reporting purposes is the exact opposite of matching revenue with related tax expense. In order to ensure the revenue is matched with expense and the reliability of financial statements is not compromised, we urge the Board to maintain current guidance.

Question 3: Should the proposed guidance be applied on a modified retrospective basis? Are the transition disclosures appropriate?

Although we do not support the proposed guidance, in the event of its implementation, it should be applied on a modified retrospective basis because to apply it on either a full retrospective or prospective basis would consume more resources than it would add value to the financial statements. As discussed in our response to Question 1, calculating the impact for a full retrospective approach would consume valuable resources since our supply chain is complex. The modified retrospective approach would be the least labor-intensive option. The disclosures regarding the nature of and the reason for the change are reasonable.

Question 4: Should the amendments in this proposed Update be effective for:

> **a. Public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2016**
>
> **b. All other entities for annual periods beginning after December 15, 2017, and interim periods in annual periods beginning after December 15, 2018, with early adoption permitted, but not before the effective date for public business entities?**

Given the large number of pressing configurations already scheduled for our IT systems, we are concerned by the proposed deadline. If a decision is made to proceed with the proposed update, we would desire final guidance by the end of 2015 in order to meet the January 1, 2017 deadline for public business entities.

Question 5: What would be the expected transition costs of adopting the guidance in the proposed Update? What would be the expected recurring costs of applying the proposed guidance compared with the costs of applying current GAAP?

We do not yet have an estimate of the expected transition costs of adopting the proposed guidance. However, ongoing compliance costs would be significant due to the substantial time that will be spent developing internal processes and controls related to forecasting the effective tax rate as intercompany transfers of inventory would now impact the effective tax rate. We find this result to be counterintuitive. In addition, the increased level of effort required to coordinate information between supply chain teams and tax departments does not support the objectives of the Simplification Initiative.

<u>Balance Sheet Classification of Deferred Taxes</u>

Question 1: Should all deferred income tax liabilities and assets be presented as noncurrent in a classified statement of financial position? If not, why, and what alternatives should the Board consider, and what is the conceptual basis for the alternatives?

Yes, all deferred income tax liabilities and assets should be presented as noncurrent.

Classifying all deferred income tax liabilities and assets as noncurrent will reduce the resources required to classify deferred income tax liabilities and assets as current. The process to classify deferred tax items is a manual process for Lilly; therefore, we will save time with this proposal.

The proposed guidance will also make the presentation of valuation allowances more reasonable. The current process of allocating valuation allowances between current and noncurrent on a pro rata basis can distort the presentation since usually all or some large percentage of the valuation allowances is truly noncurrent.

Question 2: Should the proposed guidance be applied on a prospective basis?

Yes, the proposed guidance should be applied prospectively. We believe mandating a retrospective approach would provide no significant benefit to financial statement users; however, we would be supportive of an election to adopt retrospectively.

Question 3: Should the amendments in this proposed Update be effective for:

a. Public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2016

b. All other entities for annual periods beginning after December 15, 2017, and interim periods in annual periods beginning after December 15, 2018, with early adoption permitted, but not before the effective date for public business entities?

Yes, the amendments for this proposed Update should be effective as soon as possible; we request that early adoption be permitted for public business entities.

Question 4: What would be the expected transition costs of adopting the guidance in the proposed Update? What would be the expected recurring costs of applying the proposed guidance compared with the costs of applying current GAAP?

The transition costs are expected to be minimal. Since the bifurcation of deferred income tax liabilities and assets as current or noncurrent is already a predominantly manual process, IT system configuration would not be required to comply with the proposed guidance. In addition, we believe that this proposed Update will reduce recurring costs as manual processes will be eliminated.

Conclusion

As discussed in our responses above, the intra-entity asset transfers proposal does not accomplish the objectives of the Simplification Initiative. It will increase costs and complexity and reduce the usefulness of the information provided to users of the financial statements. We suggest that the Board abandon this proposed Update. If this is not possible, we strongly urge the Board to make an exception for intra-entity inventory transfers.

We are in favor of the proposed Update regarding the Balance Sheet Classification of Deferred Taxes. This guidance indeed accomplishes the Simplification Initiative.

We appreciate the opportunity to express our view and concerns regarding the discussion paper. If you have any questions regarding our response, or would like to discuss our comments further, please call me at (317) 651-2310.

Sincerely,

ELI LILLY AND COMPANY

/s/Donald A. Zakrowski

Donald A. Zakrowski
Vice President, Finance and
Chief Accounting Officer