This 3DAdvisors Report Covers:	
	Insider Trading: Insider Trading Behavior
✓	**Accounting**: Quality of Earnings Issues
✓	**Governance:** Corporate Governance Issues

Disclosure May Be Most Important Issue Among Many Eli Lilly & Co. (NYSE: LLY)

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Eli Lilly & Co. discovers, develops, manufactures and sells pharmaceutical products. The Company manufactures and distributes its products through owned or leased facilities in the United States, Puerto Rico and 19 other countries. Eli Lilly's products are sold in approximately 150 countries.

Summary of 3DAdvisors Findings for LLY

- **Governance:** Disclosure seems less than forthcoming
- **Governance:** Interesting and undisclosed Enron related-party relationship
- **Accounting:** A thinly disclosed non-consolidated investment
- **Accounting:** "Rabbi Trust" funding whose purpose is far from transparent
- **Accounting:** Pension issues are significant

Discussion of 3DAdvisors Findings

Governance: Disclosure seems less than forthcoming

Our original review of the Lilly picture revealed a number of curious disclosures that left many unanswered questions. Getting a conversation with the appropriate individuals proved unusually difficult. Our original call to the Company left us feeling stonewalled. We were not allowed to speak with anyone who could provide answers and instead, were told to put our questions in writing and that "someone will get back to us". The Company spokesperson was not willing to put us in touch with anyone unless we revealed our client information to them; something that we, of course, would not do. We indicated that we would put our questions in writing. However in no uncertain terms, we let them know that we expected to speak with someone knowledgeable on the subject. After the submission of our questions, and much persistence, we were, about a week later, put in touch with both the Head of Investor Relations Craig Hartman and Treasurer Tom Grein. The text below will outline the main context of our original review and Company response to our questions.

We feel that there are a number of issues brewing at Lilly that have either not been disclosed or have been revealed in an obfuscated manner. What's interesting about Lilly is that most Wall Street analysts confine company's risk picture to product pipeline issues, manufacturing problems and the loss of Prozac revenues. We have seen few who appear to acknowledge that other risks, such as those mentioned below, may exist.

Governance: Interesting and undisclosed Enron related-party relationship

Ken Lay was on the Lilly board before resigning last year. He was on the finance committee, which oversees "complex financial transactions". In February '01, Lilly and Enron had signed a $1.3 billion contract where Lilly turned all its energy requirements over to Enron for 15 years. Enron paid Lilly $50 million upfront to win the deal. Nothing about this deal was ever disclosed in Lilly financials, even as a "Related Party Transaction" in the proxy. We found it when reading text relating to the probe of former Enron executive Thomas White, as part of the confirmation process for his appointment as Army Secretary. This is more of a governance (disclosure) issue than an accounting issue to us.

Our conversations with Company Treasurer, Tom Grein, confirm the existence of this payment. Our conversation also brought out the fact that, due to the Enron Bankruptcy, that whole $1.3 billion contract between Lilly and Enron, is "being renegotiated" and that it is highly probable that Lilly will have to disgorge itself of that $50 million payment it had accepted. Grein would provide little detail as to how the payment had been booked or how the refund would be handled except to say that it was booked as an asset and not as revenues. He went on to say that the disgorgement would have "no impact whatsoever on our earnings. However, we were able to use the upfront payment in our tax planning." The evasive nature of his answers only serves to intensify our interest in this situation.

Accounting: A thinly disclosed non-consolidated investment

The disclosure on this is very brief and has only occurred once in Lilly's filing history, specifically in Lilly's '01 10K. It reads as follows: **"In addition to the financial instruments above, the company has an equity method investment in an investment company with a carrying amount of $500.6 million at December 31, 2001."** There is simply no other reference to this situation in any of Lilly's disclosures that we can find. The only thing that comes close is the following: **"Financial statements of interests of 50 percent or less, which are accounted for by the equity method, have been omitted because they do not, considered in the aggregate as a single subsidiary, constitute a significant subsidiary."** We are especially intrigued that the entity is "an Investment Company". Not your normal interest for a pharmaceutical concern.

Company Treasurer Tom Grein would shed little light on this one, only saying that this is "a vehicle designed to enhance their return on cash holdings outside of the U.S." They entered into this, with a foreign financial institution, in order to utilize that institution's "favorable tax advantages". He said it was not a high-risk equity holding but

I doubt he would state anything otherwise. Apparently, this is the only such vehicle that they have and they do not anticipate having to consolidate it. We feel that this has "derivative" written all over it. Given the old Lay connection, we feel that this is an interesting disclosure in that it has an Enron-type feel to it.

Accounting: A "Rabbi Trust" whose purpose is far from transparent

Lilly's F/Y 2001 10K contains another interesting disclosure: "In 2000, the company funded an employee benefit trust with 40 million shares of Lilly common stock to provide a source of funds to assist the company in meeting its obligations under various employee benefit plans. The funding had no net impact on shareholders' equity as the employee benefit trust is consolidated with the company. The cost basis of the shares held in the trust was $2.64 billion and is shown as a reduction in shareholders' equity, which offsets the resulting increases of $2.61 billion in additional paid-in capital and $25 million in common stock. Any dividend transactions between the company and the trust are eliminated. Stock held by the trust is not considered outstanding in the computation of earnings per share."

Since the 40 million shares involved in this funding were not being considered in the Company's EPS calculation we wondered what the risks were of their eventual inclusion in the outstanding share numbers. We asked Company Treasurer Tom Grein whether these shares had been issued and whether or not they could be used to fund the under funded Company Pension. In the latter case, should they be used, the shares would then have to be included in the EPS calculation.

Our conversations with Grein became quite interesting at this juncture. In our first round, Grein said that those shares were not issued but came from Treasury Shares. Though we saw no evidence of this in the '00 or '01 financials, we backed off on this, thinking that possibly these shares were in Treasury in '99. They were not. Further inspection revealed that there was no way the 40 million shares could have come from Treasury Shares. Grein also indicated that the trust was a "Rabbi Trust". According to Grein, these trusts typically remain unfunded and are in place to cover for certain "triggering events" such as severance payments or employee costs relating to "unfriendly takeovers". The likelihood of a "Triggering Event" brings about the need for funding. Could it be that they thought that they may be taken out back in '00, and therefore funded the Trust? We just don't know. What we do know is it seems as if Grein, in mentioning the takeover angle, may have released a smoke screen. After all, if there truly were some potential takeover event looming that could justify the funding of that Trust, we doubt that he would have ever mentioned that word, "takeover".

Grein also indicated that this Rabbi Trust was independent from the Pension and, at the time, we were left to infer that the Rabbi Trust "funded" shares could not be used to fund the Pension Fund and, as a result our concerns that the shares would eventually then included in the Company's EPS calculation were abated, for the time being, that is.

Our disagreement with the "Issued vs. Treasury" component of these 40 million shares prompted a second conversation with Grier which revealed that our first assumption (that the shares were issued by the Company) was, in fact, correct. This second conversation also revealed that the 40 million "Rabbi Fund" shares could (as opposed to earlier implications) be used to fund the Pension, if necessary. So basically, we have a trust "funded" with issued shares that, it would seem, will be used at a later date, the purposes for which are unclear. Although the shares are not Treasury Shares, they are being accounted for under the Treasury Method and, therefore, are not being included in the EPS Calculations. Slick trick.

Getting the correct information from Lilly concerning the above items turned out to be a complex exercise indeed. First we were told one thing, and were expected to go away. Upon our return we were told the opposite and what we originally expected to hear. Although the true purpose for the funding exercise is clearly not being disclosed by the company, it should be considered a reasonable likelihood that these shares will eventually be used and included in the Company's EPS calculation which, assuming the use of the entire 40 million shares, would hit EPS by $0.09 per share.

<u>Accounting: Pension issues are significant</u>

Concerning the Funded Status of the Plan: Things do, in fact, look pretty grim here. The Unrecognized Actuarial Loss jumped by $844 million (between 2000 and 2001) to $1.14 billion. This is largely a result of the fact that the good part of the smoothing curve is behind them and that they, after years of underperformance, are faced with the bad numbers dominating the smoothing game. Although Investor Relations (Hartman) tried to point to other factors for the jump, Treasurer Grein verified that about $750 million of that big $844 million increase was directly attributable to the Plan's underperformance. He also strongly hinted that the actuarial assumptions, including Expected Return on Plan Assets, would have to change. Prior to F/Y 2002, Lilly had been using very high assumptions for both Expected Rate of Return on Plan Assets (10.5%) and Discount Rate (7.2%). The Company's own estimate is that each quarter point Reduction in the Expected Rate of Return will cost it $8 million. This calculation however, falls short of estimating the cost of reducing the Discount Rate assumptions as well. Consequently, we suspect that there will be a much greater effect, in F/Y 2002 from the lowering of assumptions than the Company is willing to indicate. Indeed, with a Benefit Obligation of over $3.9 billion, any effect of a reduced Discount rate should be considered quite significant.

Clearly, internally they are feeling the effects. In our conversation, Grein indicated that, even after Company contributions of $270 million in 2000 and $63 million in 2001, Lilly would have to further fund its Pension in F/Y 2002.

The under funded situation caused the Company to carry a minimum pension liability adjustment of $95.6 million in Other Comp. Inc. in '01, up from $33.6 million the prior year and $26.7 million in '99. We have not seen a company carry one of these Minimum Pension Liability Adjustments three years running. Even after the big contributions, the under funded situation has not been cured, as the Fund still shows an unrecognized actuarial loss that increased by $844 million in '01 to $1.143 billion. This is really large and it looks as if Lilly is going to have to begin to effect greater recognition of this big net actuarial loss sooner rather than later, with the associated effects on its financials.