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

"Investment Company" Disclosure Still Lacking
Eli Lilly & Company (NYSE:LLY) Update

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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:** Offshore "Investment Company" disclosure still lacking
- **Accounting:** LLY still paying too much for repurchased shares
- **Accounting:** Inventory rise becoming more interesting

Discussion of 3DAdvisors Findings

Governance: Offshore "Investment Company" disclosure still lacking

We remain more-than-intrigued by Lilly's $500 million investment in an "Investment Company." Reference to this has only surfaced once and that was in the 10K (for F/Y 2001) issued back in March of 2002. At that time, a footnote in Note No. 6 – Financial Instruments, indicated the following: **"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."** The disclosure could easily be missed. Subsequent conversations with Company treasurer Tom Grein would not shed much more light on this, except to reveal that this was an investment in a foreign financial institution in order to take advantage of that institution's "favorable tax advantages."

After the initial disclosure, all reference to this investment drops off. From the looks of things, we certainly do not get the impression that the investment is a passive one. There has been a rather dramatic escalation in a certain area, and the timing of this activity seems to correlate with the creation of the offshore Investment Company investment.

This activity deals with trading (read: both buying and selling) in debt securities, which are booked by Lilly as “Non-current Investments”. Activity in this category has picked up dramatically with virtually nothing said about the kinds of investments involved and more importantly whether any material portion of the transactions are with the offshore Investment Company. The escalation in activity is clear: the carrying value of Debt Securities, listed as components of Non-current Investments in Lilly’s Financial Instruments section of its balance sheet, had averaged $98 million for the years 1996 though 2000. In 2001, the year of the initial Investment Company investment, the carrying value of these Debt Securities had jumped to $1.98 billion. By Y/E 2002, their value on the books had jumped to $2.46 billion.

The magnitude of the dealings driving this escalation in the level of Non-current Investments is illustrated by the increases in the level of buying and selling of “Non-current Investments”. Purchases of Non-current Investments used $5.2 billion of cash in 2002, which were offset partially by sales of $4.8 billion. In 2001, purchases of $5.9 billion were partially offset by sales of $3.7 billion. In 2000, before the Investment Company investment, these purchases totaled just $715 million vs. sales of $803 million for the period and seem negligible in prior periods.

So now we see an extremely large volume of transactions in securities, which has occurred during the same period the Company has acquired an interest in the Investment Company over which, it is probably a safe to assume, Lilly has significant influence. In our initial conversation Tom Grein (Lilly treasurer) indicated that the Company does not anticipate having to consolidate this entity. The Company does, however, disclose that it exercises “significant influence” over its Equity Method investments. To us, plenty of unanswered questions exist, concerning this entity. We are wondering, for instance, if the Investment Company may have financial dealings with some of Lilly’s offshore subsidiaries? If so, things could get interesting if those offshore subsidiaries, that are not 100% owned, are also investing in that Investment Company and if that Investment Company could be investing in the offshore subsidiaries. If the Investment Company is a minority owner of the subsidiaries, could Lilly have found a way for those dealings to put earnings into the Investment Company and, through the Equity Method, Lilly could pick up some of those earnings on its income statement?

Certainly, this is conjecture on our part, which may be clarified only by further conversation with Company management. The point is, however, that the Company has done nothing to disclose its purposes for the Investment Company or its reasons for the dramatic escalation in activity in Non-current Investments. This action, or perhaps better put, inaction only leaves much to conjecture. Indeed, it would seem that adequate and transparent disclosure of these items should not pose a competitive risk, so why the obfuscation?

What is clear at this time is that Lilly’s carrying value of Equity Method investments has risen to $606 million by Y/E 2002 (up from $548 million in 2001). By the Company’s admission, the Investment Company is an offshore entity whereby mutual dealings would allow Company to utilize “favorable tax advantages”, and there has been a material escalation, since the initiation of dealings with this Investment Company, in Lilly’s reported trading of “Non-current Investments” (read: Debt securities).

As of Y/E 2002, the Company had an aggregate of $8 billion of unremitted earnings of foreign subsidiaries that have been sheltered from U.S. taxes. A total, we're sure, large enough to attract IRS interests should there be any repatriation of these earnings. Could it be that the Investment Company exists to facilitate Lilly's access to those unremitted (read: foreign) earnings for use in the U.S.? More speculation on our part that could be settled with improved disclosure.

The conundrum represented by Lilly is the fact that we have a company that seems to go to great lengths to explain its compliance with GAAP (indeed, in my conversations with them, the word "transparency", and how they strive for it, came up numerous times), while at the same time, it seems to play its cards extremely close to the vest insofar as disclosure of certain items is concerned.

We will be attempting to get answers from the Company concerning these items.

Accounting: LLY still paying too much for repurchased shares

Lilly's depressed share price has caused problems for its share repurchases programs, and these problems linger. As of the Q1 10Q, the Company still had outstanding commitments to purchase 2.2 million shares, from a third party, at significant premiums to market prices: $86 to $100 per share, or a weighted average of $94 each.

In Q1, the Company bought 732,000 shares at prices averaging about $90 each, or about 33% over market price. The 2.2 million share obligation remains. This problem will become a considerably more acute during the next three quarters as the agreements to purchase shares (put agreements) expire in December of 2003. Under the agreements, the purchase price for the shares would approximate $207 million.

Accounting: Inventory rise becoming more interesting

Lilly's rising inventory picture, already of concern to some, worsened considerably in 2002 and again in Q1 2003. Inventories, carried at $1.06 billion at Y/E 2001, jumped 41% to $1.5 billion by Y/E 2002. Things continued to get worse in Q1 of '03 with another jump to $1.59 billion for the three months. The Company places the primary blame for the rise in inventories on foreign currency translation adjustments. There is a downside to this. Unless they make an offset in some way, which they do not in any way indicate, but which may be the case, cost of goods sold in subsequent periods will be correspondingly higher as inventory is shipped, resulting in lower margins. This is the sort of thing they might better explain, but do not.