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February 26, 2007

Nancy M. Morris, Secretary
Securities & Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Reference: File Number S7-24-06

Dear Ms. Morris,

Eli Lilly and Company (Lilly) appreciates the opportunity to provide its views on the U.S. Securities and Exchange Commission's ("Commission") *Proposed Interpretive Guidance for Management's Reports on Internal Control over Financial Reporting*. Lilly supports the Commission's continued willingness to solicit input and address various concerns of preparers and auditors on the important topic of internal control reporting. We have long supported the position that effective internal controls are vital to the integrity of the financial reporting process.

We believe passage of the Act has helped to restore investor confidence in the financial reporting and disclosure practices of larger companies, but we also believe there is opportunity for additional improvements in compliance practices that will better balance benefits and costs while still achieving the legislative intent of the Act, specifically Section 404 on internal control reporting. The new proposed guidance opens the door for productive dialogue with our auditors about how to make our assessments and their audits much more efficient. We especially appreciate that the proposed guidance has moved to a more principles-based approach. It allows for a high level of judgment in applying the principles to individual company situations. We support the top-down, risk-based approach.

In addition to our support for the proposed guidance, we have a concern regarding inconsistencies between the Commission's guidance and proposed PCAOB standard. Management guidance and external audit standards must be aligned. We believe the changes to AS2 must be concurrent with guidance issued by the Commission in order to realize the desired changes. Any inconsistencies in the final guidance and AS2 would likely increase costs and introduce new inefficiencies. We believe that the proposed standards, although improved from the existing PCAOB Audit Standard No. 2 ("AS2"), are still more detailed and prescriptive than the proposed guidance. These differences will result in external audits that are more conservative than management assessments, which will cause companies to incur unnecessary costs to remain aligned with their external auditors.

We also have several suggestions for clarifications or enhancements to the proposed guidance itself. All suggestions are described more fully below, but the top priority items in terms of improving efficiency and effectiveness are:

- Focus on change in controls for testing, allowing for rotation testing of controls that have operated effectively in the past and have not changed
- Increased reliance on entity-level controls to reduce process-level testing
- Elimination of the “interim” financial statement component from the definition of material weakness

We believe these suggestions are critically important to have a meaningful impact in striking the right balance between costs and benefits of internal controls assessments. We have also included these suggestions in our letter to the PCAOB. As noted above it is essential to maintain alignment between the proposed guidance and proposed standards.

ALIGNMENT BETWEEN MANAGEMENT AND EXTERNAL AUDITORS

With the flexibility to focus on a top-down, risk-based approach to detect only material weaknesses, we anticipate that companies will drive to narrow their focus to the truly high risk areas, achieving a better tradeoff between the quality of controls assurance and the cost of compliance. Companies are certainly motivated to become more efficient in their compliance processes. It stands to reason that the external auditors, under the proposed standards, would be able to mirror management’s efficiencies.

We want to emphasize how critical it is that the audit standards are aligned with management guidance. The external auditors must be comfortable with management’s assessment approach to optimize reliance and achieve overall cost savings. Although the requirement for an opinion on management’s assessment process has been eliminated, the opinion on the controls themselves remains, which is acceptable. If the auditors do not embrace the top-down risk-based approach which clearly permits more judgment, their more detailed or conservative approach will drive companies to continue to document and assess lower-risk controls, thereby continuing to incur unnecessary costs and failing to achieve the objective of more effective and efficient assessments. In addition if the inspection process continue to focus on detailed auditing steps as apposed to the bigger picture, it too will drive undesirable behavior.

CLARIFICATIONS AND ENHANCEMENTS

Focus on changes in controls

The proposed guidance encourages the use of prior knowledge and assessment results to guide the risk assessment and testing approach. After the initial assessment, subsequent reviews of risk and design can be focused on changes in risks and controls. Prior testing results can be used to guide the risk assessment of both the significant accounts and the controls.

We support the focus on changes in controls and believe that it could lead to the logical conclusion that a control would not need to be tested or assessed each year. In spite of the discussion about incorporating prior year information and results to guide the extent of testing, the proposed guidance does not address the current practice of “each year standing on its own,” requiring some type of assessment of each control each year. By contrast the PCAOB proposed standards specifically provide for benchmarking of automated controls. We suggest that the SEC consider where and how management might be encouraged to benchmark or rotate testing of controls in all areas. If management could confirm that the control design had not changed and that the control had been operating effectively in prior assessments, we should have the freedom to forego any testing of that control, particularly for lower risk controls.

Entity-level controls

Companies have put much thought and effort into identifying and enhancing entity-level controls. Although we are confident that entity-level controls are the key to preventing future Enron-type failures, in some cases it remains unclear as to how these controls can be leveraged to reduce testing of transaction level controls, particularly indirect entity-level controls such as ethics programs and Board of Directors oversight. Specific examples of potential linkage included in the proposed guidance would be very helpful in building the case for leveraging these higher level controls.

Linking entity-level controls to significant account risks is more clear in the case of direct entity-level controls, such as analytic reviews and budget-to-actual comparisons. One issue here has been establishing the precision at which these controls operate. With the new focus on detecting material misstatements, the precision should be less of an issue. The proposed guidance does address the need to establish that entity-level controls adequately prevent material misstatements but again, specific examples would be helpful to reinforce that the precision can be at a fairly high level.

The entity-level testing combined with individual control level testing on a rotational or focused basis (i.e., looking at points of change or high-risk areas) would be an effective risk mitigation strategy in this area.

Annual vs. interim financial statements considered in evaluating deficiencies

The definition of "material weakness" in the proposed guidance (page 13) includes a misstatement of the company's "annual or interim financial statements." We believe that the deficiency evaluation should only consider the impact on annual financial statements. The management assessment of internal controls is an annual assessment of whether controls are operating effectively as of the end of the year. To consider interim financial statements would be inconsistent with the objective of the assessment. Furthermore, deficiencies are evaluated in terms of their potential impact on financial statements, a forward-looking evaluation with the focus on internal control weaknesses as leading indicators of potential misstatements. Finally, the proposed guidance states that, "As part of the evaluation of ICFR, management considers whether the deficiencies, individually or in combination, are material weaknesses as of the end of the fiscal year." For all of these reasons, we suggest that the reference to interim financial statements should be removed from the definition in the proposed guidance.

Detection of Fraud

The proposed guidance states on page 23 that, along with other factors, management should consider the risk of material misstatement due to fraud in its risk assessment. This clarification is helpful as it has been unclear whether companies should be identifying and assessing controls that would detect ANY fraud committed by a senior executive. Contradicting that point, however, is the language on page 45 which says that fraud of any magnitude on the part of senior management is an indicator of a material weakness. It may be appropriate to define the specific types of fraud that should be considered to be an indicator of a material weakness (e.g., intentional manipulation of financial statements, versus misappropriation of assets).

Removal of opinion on management's assessment
We support the elimination of the opinion on management's assessment process. Although we do not expect to see substantial efficiencies result from the change, we believe that the opinion on the management assessment is superfluous and should be eliminated. If companies want to optimize auditor reliance on management testing, they will still need to mirror the external auditors' standards of testing and documentation. However, the elimination of the opinion will give companies the leeway to make that decision, as opposed to the current environment where all companies are compelled to conform their assessments to AS2 standards.

Point-in-time assessment
In the spirit of internal control over financial reporting, we would suggest the Commission consider moving away from the point-in-time assessment and rather recommend guidance that directs companies to a continuous monitoring of the effectiveness of internal controls throughout the year. This would allow companies to reduce costs by spreading testing throughout the year (e.g., more of a steady-state environment) and monitor if changes have occurred rather than back-end loading the testing or requiring an excessive amount of roll forward testing to verify the effectiveness at year-end or a point-in-time, which may or may not reflect a true assessment of the controls during the year.

In conclusion, we believe that the changes suggested in the proposed guidance along with the modifications proposed in this letter should result in a more meaningful reduction in the effort and related costs of the management assessments and the external audits. But if the external audit standards and practices are more conservative than management assessments, we will not achieve this reduction.

Thank you for considering our views. We would be happy to discuss our comments and recommendations at your convenience.

Sincerely,

Arnold C. Hanish
Executive Director and Chief Accounting Officer
Eli Lilly and Company