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November 21, 2003

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Proposed Auditing Standard - An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, *PCAOB Rulemaking Docket Matter No. 008*

Ladies and Gentlemen:

Eli Lilly and Company appreciates the opportunity to respond to the Proposed Auditing Standard - *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.* Reliable and trustworthy financial statements are part of our corporate brand and we at Eli Lilly and Company take internal controls related to financial statement reporting and disclosure very seriously and believe that good controls need to be emphasized and set by the tone-at-the-top of an organization.

We support and appreciate the Public Company Accounting Oversight Board's (the "Board") efforts to provide guidance on the role of external auditor when auditing internal controls as required by Section 404 of the Sarbanes-Oxley Act (the "Act").

We have specific concerns over the proposed standard that, if not addressed, will increase the amount of work carried out by business operations and will result in costs that are disproportional to the benefits gained. Specific responses to certain questions of the proposed standard on which we have concerns are included in the Appendix. A summary of our response is as follows:

- We believe that the proposed standard presents a balanced approach to the audit of internal controls over financial reporting. However, we believe that the proposed standard does not allow the auditors to use their judgment on the amount of testing to be carried out. Auditors should be allowed to determine the strength of the controls structure and then use their judgment on the amount of testing that needs to be carried out. The amount of testing on routine transactions for an organization with a strong controls environment should be less than one with a weaker controls environment.

The Act requires the auditors to attest on the management's assessment of the effectiveness of internal control, and therefore requiring the auditors to obtain the same amount of direct evidence for a strong controls organization as for a weak controls organization seems to add cost but does not add value.

- We also believe that the proposed standard does not allow the auditors to rely enough on the work (both walkthrough procedures and testing) carried out by a competent, independent internal audit department. The auditor should evaluate the internal audit department as prescribed by SAS 65, and use their judgment as to if they can rely on the work carried out by the internal audit department. In not relying on work of the internal auditors, there is a risk that the external auditor will be performing work that is both duplicitous and non-value added. In addition, there will be an increase in audit fees that would not seem justifiable for corporations with independent, competent internal audit departments. We believe if the proposed standard is left unchanged, it could lead to a decreased recognition and reliance on the internal audit function when it comes to audit of the financial statements. We believe that the proposed standard should allow management to assist the auditors in the performance of the walkthrough tests by providing the required documentation and evidence that the auditor requires. Alternately the proposed standard should allow an independent, objective and competent internal audit department to carry out the walkthrough tests while the auditors observe, re-perform and/or review the results.
- We also do not believe that it is appropriate for auditors to be required to evaluate the effectiveness of the audit committee. We believe that an inherent conflict of interest exists for an auditor to evaluate the audit committee, as the audit committee is responsible for the hiring and firing of the auditor. We believe that it may be more appropriate for the Board of Directors to evaluate the effectiveness of the audit committee.
- We do not believe that there should be an assumption that an ineffective audit committee would necessarily lead to an auditor believing that a significant deficiency in internal controls exists over financial reporting in a company. While we agree that effective oversight of a company's external financial reporting and internal control over financial reporting by the audit committee should be a key component to an effective system of internal control, we note that a "significant deficiency" has been defined as an internal control deficiency that "results in more than a remote likelihood of a material misstatement in the company's financial statements". We believe it is quite possible that a company could have a very strong internal control environment in spite of weak oversight by the audit committee and that the threshold for a "significant deficiency" would not be met.
- We would like the Board to consider having separate dates for the financial statements and management's assessment of internal control over financial reporting. A requirement to have the two reports to be within 2-3 months of one another would allow both management of the company and the auditor to meet the tight reporting windows far more easily.

We appreciate the opportunity to express our views and concerns in regards to the proposed auditing standard. If you have any questions regarding our response or would like to discuss our comments, please feel free to contact me at 317-276-2024.

Sincerely,

ELI LILLY AND COMPANY

/S/Arnold C. Hanish

Arnold C. Hanish
Executive Director, Finance, and
Chief Accounting Officer

Appendix A
Response to Specific Questions

6. *Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?*

We believe that the Act requires the auditors to attest on management's assessment of the effectiveness of internal control, and not performing tests to allow them to support their own conclusion and that the scope of the audit should be limited to accomplishing their objective. There should not be a requirement for the auditor to obtain, directly, evidence about whether internal control over financial reporting is effective as this could lead to duplicitous testing and additional cost without adding value. We believe that the auditors should be allowed to use their judgment on the amount of testing that they carry out, depending on the control environment within the organization. The amount of testing for an organization with a strong controls environment should be less than one with a weaker environment.

10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors or others?

We agree walkthroughs provide the auditor with important audit evidence for purposes of confirming the auditor's understanding of the process flow of transactions and evaluating design effectiveness. However, we believe that it is reasonable for the auditor to rely on walkthroughs procedures performed by internal audit for companies with strong internal audit department. The standard should allow for the auditor to determine the control environment in a company and then use their judgment as to if they can rely on work performed by internal audit or management. We do not believe that the auditor will be able to perform a walkthrough efficiently and effectively without the help of internal audit or management.

11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

In many circumstances the processes and internal controls over these processes will be identical from year to year. We believe that it is appropriate for the auditor to use their judgment to determine the extent of testing, especially if there haven't been significant changes in the internal controls or processes.

12. *To what extent should the auditor be permitted or required to use the work of management and others?*

We believe that the proposed standard does not utilize work that can be carried out by an independent, objective and competent internal audit department. We believe if the proposed standard is left unchanged, it could lead to a decreased recognition and reliance on the internal audit function when it comes to audit of the financial statements. We also believe that the proposed standard should allow management to assist the auditor in the performance of the walkthrough tests by providing the required documentation and evidence that the auditor requires. Alternately, the proposed standard should allow an independent, objective and competent internal audit department to carry out the walkthrough tests while the auditor observes, re-performs and/or reviews the results.

14. *Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?*

We believe that the proposed standard does not provide adequate recognition to the work of internal auditors by not allowing the external auditor to rely on the internal auditor's work. The external auditor should use his or her judgment as prescribed by SAS 65 to determine as to what extent to rely on the work of the internal auditors. In not relying on work of the internal auditors, there is a risk that the external auditor will be performing work that is both duplicitous and non-value added. In addition, there will be an increase in audit fees that would not seem justifiable for corporations with independent, competent internal audit departments. As we stated above, we believe if the proposed standard is left unchanged, it could lead to a decreased recognition and reliance on the internal audit function when it comes to audit of the financial statements.

21. *Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?*

Section 404 of the Act and the proposed standard focus on internal controls over the financial reporting and not controls related to compliance with regulations and laws. We do not believe that weak regulatory compliance controls necessarily mean weak controls over financial reporting. It is our opinion that controls over regulations and law are beyond the scope of the Act and of the proposed auditing standard.

22. *Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?*

We do not believe that it is appropriate for auditors to be required to evaluate the effectiveness of the audit committee. We believe that an inherent conflict of interest exists for an auditor to evaluate the audit committee, as the audit committee is responsible for the hiring and firing of the auditor. We also do not believe that there should be an assumption that an ineffective audit committee would necessarily lead to an auditor believing that a significant deficiency in internal controls exists over financial reporting in a company. While we agree that effective oversight of a company's external financial reporting and internal control over financial reporting by the audit committee should be a key component to an effective system of internal control, we note that a "significant deficiency" has been defined as an internal control deficiency that "results in more than a remote likelihood of a material misstatement in the company's financial statements". We believe it is quite possible that a company could have a very strong internal control environment in spite of weak oversight by the audit committee and that the threshold for a "significant deficiency" would not be met.

23. *Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?*

We believe than an inherent conflict of interest exists for an auditor to evaluate the audit committee, as the audit committee is responsible for the hiring and firing of the auditor.