LILLY ELI & CO
Form 10-Q
May 06, 2008

**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**
**Form 10-Q**
**Quarterly Report Under Section 13 or 15(d) of the**
**Securities Exchange Act of 1934**
**FOR THE QUARTER ENDED MARCH 31, 2008**
**COMMISSION FILE NUMBER 001-6351**
**ELI LILLY AND COMPANY**
(Exact name of Registrant as specified in its charter)

| INDIANA | 35-0470950 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

LILLY CORPORATE CENTER, INDIANAPOLIS, INDIANA 46285
(Address of principal executive offices)
Registrant s telephone number, including area code (317) 276-2000

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of a large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o Smaller reporting company o
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

The number of shares of common stock outstanding as of April 20, 2008:

| Class | Number of Shares Outstanding |
|---|---|
| Common | 1,136,974,738 |

PART I. FINANCIAL INFORMATION

*Item 1. Financial Statements*

CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(Unaudited)
Eli Lilly and Company and Subsidiaries

| | Three Months Ended March 31, | |
|---|---|---|
| | 2008 | 2007 |
| | (Dollars in millions except per-share data) | |
| Net sales | $ 4,807.6 | $ 4,226.1 |
| Cost of sales | 1,111.3 | 922.5 |
| Research and development | 877.1 | 834.2 |
| Marketing, selling, and administrative | 1,550.5 | 1,336.8 |
| Acquired in-process research and development (Note 3) | 87.0 | 328.5 |
| Asset impairments, restructuring, and other special charges (Note 4) | 145.7 | 123.0 |
| Other income net (Note 12) | (20.3) | (38.3) |
| | 3,751.3 | 3,506.7 |
| Income before income taxes | 1,056.3 | 719.4 |
| Income taxes (Note 9) | (8.0) | 210.7 |
| Net income | $ 1,064.3 | $ 508.7 |
| Earnings per share basic (Note 8) | $ .97 | $ .47 |
| Earnings per share diluted (Note 8) | $ .97 | $ .47 |
| Dividends paid per share | $ .47 | $ .425 |

See Notes to Consolidated Condensed Financial Statements.

CONSOLIDATED CONDENSED BALANCE SHEETS
Eli Lilly and Company and Subsidiaries

| | March 31, 2008 (Unaudited) | December 31, 2007 |
|---|---|---|
| | (Dollars in millions) | |
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | $ 3,145.4 | $ 3,220.5 |
| Short-term investments (Note 5) | 2,289.1 | 1,610.7 |
| Accounts receivable, net of allowances of $109.7 (2008) and $103.1 (2007) | 2,661.1 | 2,673.9 |
| Other receivables | 709.0 | 1,030.9 |
| Inventories | 2,594.4 | 2,523.7 |
| Deferred income taxes | 565.4 | 583.6 |
| Prepaid expenses | 529.8 | 613.6 |
| TOTAL CURRENT ASSETS | 12,494.2 | 12,256.9 |
| OTHER ASSETS | | |
| Prepaid pension (Note 10) | 1,842.5 | 1,670.5 |
| Investments (Note 5) | 596.1 | 577.1 |
| Goodwill and other intangibles net (Note 3) | 2,378.5 | 2,455.4 |
| Sundry | 1,246.8 | 1,252.8 |
| | 6,063.9 | 5,955.8 |
| PROPERTY AND EQUIPMENT | | |
| Land, buildings, equipment, and construction-in-progress | 15,164.5 | 14,841.3 |
| Less allowances for depreciation | (6,502.4) | (6,266.2) |
| | 8,662.1 | 8,575.1 |
| | $27,220.2 | $ 26,787.8 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| CURRENT LIABILITIES | | |
| Short-term borrowings | $ 73.0 | $ 413.7 |
| Accounts payable (Note 1) | 789.8 | 924.4 |
| Employee compensation | 468.2 | 823.8 |
| Sales rebates and discounts | 728.1 | 706.8 |
| Dividends payable | | 513.6 |
| Income taxes payable (Note 9) | 280.5 | 238.4 |
| Other current liabilities (Note 1) | 1,824.7 | 1,647.6 |
| TOTAL CURRENT LIABILITIES | 4,164.3 | 5,268.3 |
| Long-term debt | 4,648.3 | 4,593.5 |

| | | |
|---|---|---|
| Accrued retirement benefit (Note 10) | 1,169.6 | 1,145.1 |
| Long-term income taxes payable (Note 9) | 951.0 | 1,196.7 |
| Deferred income taxes | 339.3 | 287.5 |
| Other noncurrent liabilities | 1,037.5 | 632.3 |
| | 8,145.7 | 7,855.1 |
| SHAREHOLDERS EQUITY (Notes 6 and 7) | | |
| Common stock | 711.2 | 709.5 |
| Additional paid-in capital | 3,787.7 | 3,805.2 |
| Retained earnings | 13,033.8 | 11,967.2 |
| Employee benefit trust | (2,635.0) | (2,635.0) |
| Deferred costs-ESOP | (95.3) | (95.2) |
| Accumulated other comprehensive income | 207.0 | 13.2 |
| | 15,009.4 | 13,764.9 |
| Less cost of common stock in treasury | 99.2 | 100.5 |
| | 14,910.2 | 13,664.4 |
| | $27,220.2 | $ 26,787.8 |

See Notes to Consolidated Condensed Financial Statements.

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)
Eli Lilly and Company and Subsidiaries

| | Three Months Ended March 31, | |
|---|---|---|
| | 2008 | 2007 |
| | (Dollars in millions) | |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | $ 1,064.3 | $ 508.7 |
| Adjustments to reconcile net income to cash flows from operating activities: | | |
| Changes in operating assets and liabilities, net of acquisition of ICOS Corporation | (33.6) | (35.6) |
| Depreciation and amortization | 277.5 | 245.1 |
| Stock-based compensation expense | 58.5 | 72.7 |
| Change in deferred taxes | 162.8 | (289.6) |
| Acquired in-process research and development, net of tax | 56.6 | 319.6 |
| Asset impairments, restructuring, and other special charges, net of tax | 94.9 | 84.9 |
| Other, net | 21.6 | (14.0) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 1,702.6 | 891.8 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Net purchases of property and equipment | (184.2) | (239.4) |
| Net change in short-term investments | (715.7) | (15.4) |
| Purchase of noncurrent investments | (41.5) | (210.2) |
| Proceeds from sales and maturities of noncurrent investments | 36.0 | 267.1 |
| Cash paid for ICOS Corporation, net of cash acquired | | (2,225.6) |
| Purchase of in-process research and development | (87.0) | (25.0) |
| Other, net | (41.6) | (6.8) |
| NET CASH USED IN INVESTING ACTIVITIES | (1,034.0) | (2,455.3) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Dividends paid | (513.6) | (462.9) |
| Proceeds from issuance of long-term debt | 0.1 | 2,500.0 |
| Repayment of long-term debt | (0.8) | (1,097.2) |
| Issuances of common stock under stock plans | | 7.6 |
| Net change in short-term borrowings | (342.5) | (3.9) |
| Other, net | (5.1) | |
| NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES | (861.9) | 943.6 |
| Effect of exchange rate changes on cash and cash equivalents | 118.2 | 2.0 |

| | | |
|---|---|---|
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (75.1) | (617.9) |
| Cash and cash equivalents at January 1 | 3,220.5 | 3,109.3 |
| CASH AND CASH EQUIVALENTS AT MARCH 31 | $ 3,145.4 | $ 2,491.4 |

See Notes to Consolidated Condensed Financial Statements.

CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
Eli Lilly and Company and Subsidiaries

| | Three Months Ended March 31, | |
|---|---|---|
| | 2008 | 2007 |
| | (Dollars in millions) | |
| Net income | $1,064.3 | $508.7 |
| Other comprehensive income[1] | 193.8 | 31.7 |
| Comprehensive income | $1,258.1 | $540.4 |

[1] The significant component of other comprehensive income was a gain of $259.9 million from foreign currency translation adjustments for the three months ended March 31, 2008, compared with a gain of $73.5 million from foreign currency translation adjustments for the three months ended March 31, 2007.

See Notes to Consolidated Condensed Financial Statements.

SEGMENT INFORMATION

We operate in one significant business segment pharmaceutical products. Operations of our animal health business segment are not material and share many of the same economic and operating characteristics as our pharmaceutical products. Therefore, they are included with pharmaceutical products for purposes of segment reporting. Our business segments are distinguished by the ultimate end user of the product: humans or animals. Performance is evaluated based on profit or loss from operations before income taxes. Income before income taxes for the animal health business for the first quarters of 2008 and 2007 was $26.9 million and $38.2 million, respectively.

SALES BY PRODUCT CATEGORY

Worldwide sales by product category were as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2008 | 2007 |
| | (Dollars in millions) | |
| Net sales to unaffiliated customers: | | |
| Neurosciences | $1,971.4 | $1,797.5 |
| Endocrinology | 1,410.8 | 1,265.7 |
| Oncology | 673.3 | 564.7 |
| Cardiovascular | 462.0 | 321.3 |
| Animal health | 235.3 | 215.1 |
| Other pharmaceuticals | 54.8 | 61.8 |
| Net sales | $4,807.6 | $4,226.1 |

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

Note 1: Basis of Presentation

We have prepared the accompanying unaudited consolidated condensed financial statements in accordance with the requirements of Form 10-Q and, therefore, they do not include all information and footnotes necessary for a fair presentation of financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States (GAAP). In our opinion, the financial statements reflect all adjustments (including those that are normal and recurring) that are necessary for a fair presentation of the results of operations for the periods shown. In preparing financial statements in conformity with GAAP, we must make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosures at the date of the financial statements and during the reporting period. Actual results could differ from those estimates.

The information included in this Quarterly Report on Form 10-Q should be read in conjunction with our consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2007. We reclassified an immaterial amount within current liabilities in the December 31, 2007 balance sheet, shifting $94.1 million from accounts payable to other current liabilities.

Note 2: Implementation of New Financial Accounting Pronouncements

We adopted the provisions of Emerging Issues Task Force (EITF) Issue No. 07-3 (EITF 07-3), Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities, on January 1, 2008. Pursuant to EITF 07-3, nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense when the related goods are delivered or services are performed, or when the goods or services are no longer expected to be received. This Issue is to be applied prospectively for contracts entered into on or after the effective date.

We adopted the provisions of Financial Accounting Standards Board (FASB) Statement No. 157 (SFAS 157), Fair Value Measurements, on January 1, 2008. SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. The implementation of this Statement was not material to our consolidated financial position or results of operations.

In March 2008, the FASB issued Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 applies to all derivative instruments and related hedged items accounted for under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. This Statement requires entities to provide enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity s financial position, results of operations, and cash flows. This Statement is effective for us January 1, 2009, and we do not anticipate the implementation will be material to our consolidated financial position or results of operations.

In December 2007, the FASB revised and issued Statement No. 141, Business Combinations (SFAS 141(R)). SFAS 141(R) changes how the acquisition method is applied in accordance with SFAS 141. The primary revisions to this Statement require an acquirer in a business combination to measure assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, at their fair values as of that date, with limited exceptions specified in the Statement. This Statement also requires the acquirer in a business combination achieved in stages to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in

the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with the Statement). Assets acquired and liabilities assumed arising from contractual contingencies as of the acquisition date are to be measured at their acquisition-date fair values, and assets or liabilities arising from all other contingencies as of the acquisition date are to be measured at their acquisition-date fair value, only if it is more likely than not that they meet the definition of an asset or a liability in FASB Concepts Statement No. 6, Elements of Financial Statements. This Statement significantly amends other Statements and authoritative guidance, including FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, and now requires the capitalization of research and development assets acquired in a business combination at their acquisition-date fair values, separately from goodwill. SFAS No. 109, Accounting for Income Taxes, was also amended by this Statement to require the acquirer to recognize changes in the amount of its deferred tax benefits that are recognizable because of a business combination either in income from continuing operations in the period of the combination or directly in contributed capital, depending on the circumstances. This Statement is effective for us for business combinations for which the acquisition date is on or after January 1, 2009.

In December 2007, in conjunction with SFAS 141(R), the FASB issued Statement No. 160, Accounting for Noncontrolling Interests. This Statement amends Accounting Research Bulletin No. 51, Consolidated Financial Statements (ARB 51), by requiring companies to report a noncontrolling interest in a subsidiary as equity in its consolidated financial statements. Disclosure of the amounts of consolidated net income attributable to the parent and the noncontrolling interest will be required. This Statement also clarifies that transactions that result in a change in a parent s ownership interest in a subsidiary that do not result in deconsolidation will be treated as equity transactions, while a gain or loss will be recognized by the parent when a subsidiary is deconsolidated. This Statement is effective for us January 1, 2009, and we do not anticipate the implementation will be material to our consolidated financial position or results of operations.

In December 2007, the FASB ratified the consensus reached by the EITF on Issue No. 07-1 (EITF 07-1), Accounting for Collaborative Arrangements. EITF 07-1 defines collaborative arrangements and establishes reporting requirements for transactions between participants in a collaborative arrangement and between participants in the arrangement and third parties. This Issue is effective for us beginning January 1, 2009 and will be applied retrospectively to all prior periods presented for all collaborative arrangements existing as of the effective date. While we have not yet completed our analysis, we do not anticipate the implementation of this Issue will be material to our consolidated financial position or results of operations.

Note 3: Acquisitions

ICOS Corporation Acquisition

On January 29, 2007, we acquired all of the outstanding common stock of ICOS Corporation (ICOS), our partner in the Lilly ICOS LLC joint venture for the manufacture and sale of Cialis® for the treatment of erectile dysfunction. The acquisition brings the full value of Cialis to us and enables us to realize operational efficiencies in the further development, marketing, and selling of this product. Under the terms of the agreement, each outstanding share of ICOS common stock was redeemed for $34 in cash for an aggregate purchase price of approximately $2.3 billion, which was financed through borrowings.

The acquisition has been accounted for as a business combination under the purchase method of accounting. Under the purchase method of accounting, the assets acquired and liabilities assumed from ICOS are recorded at their respective fair values as of the acquisition date in our consolidated financial statements. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill in the amount of $646.7 million. No portion of this goodwill is expected to be deductible for tax purposes. ICOS s results of operations are included in our consolidated financial statements from the date of acquisition.

We have determined the following estimated fair values for the assets purchased and liabilities assumed as of the date of acquisition. The determination of estimated fair value required management to make significant estimates and assumptions.

| | Estimated Fair Value at January 29, 2007 |
|---|---|
| Cash and short-term investments | $ 197.7 |
| Developed product technology (Cialis)[1] | 1,659.9 |
| Acquired in-process research and development | 303.5 |
| Tax benefit of net operating losses | 404.1 |
| Goodwill | 646.7 |
| Other assets and liabilities net | (32.1) |
| Deferred taxes | (583.5) |
| Long-term debt assumed | (275.6) |
| Total purchase price | $ 2,320.7 |

[1] The intangible asset will be amortized over the remaining expected patent lives of Cialis in each country; patent expiry dates range from 2015 to 2017.

The acquired in-process research and development (IPR&D) represents compounds currently under development that have not yet achieved regulatory approval for marketing. New indications for and formulations of the Cialis compound in clinical testing at the time of the acquisition represented approximately 48 percent of the estimated fair value of the IPR&D. The remaining value of IPR&D represents several other products in development, with no one asset comprising a significant portion of this value. In accordance with FIN 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, these IPR&D intangible assets totaling $303.5 million have been written off by a charge to income immediately subsequent to the acquisition because the compounds do not have any alternative future use. This charge is not deductible for tax purposes. The ongoing activity with respect to each of these compounds under development is not material to our research and development expenses.

There are several methods that can be used to determine the estimated fair value of the acquired IPR&D. We utilized the income method, which applies a probability weighting to the estimated future net cash flows that are derived from projected sales revenues and estimated costs. These projections are based on factors such as relevant market size, patent protection, historical pricing of similar products, and expected industry trends. The estimated future net cash flows are then discounted to the present value using an appropriate discount rate. This analysis is performed for each project independently. The discount rate we used in valuing the acquired IPR&D projects was 20 percent.

Product Acquisitions

In December 2007, we entered into an agreement with BioMS Medical Corp. to acquire the rights to its compound for the treatment of multiple sclerosis. This agreement was contingent upon clearance under the Hart-Scott-Rodino Anti-Trust Improvements Act and became effective after clearance was received in January 2008. At the inception of this agreement, this compound was in the development stage (Phase III clinical trials) and had no alternative future use. As with many development-phase compounds, launch of the product, if approved, was not expected in the near term. Our charge for acquired IPR&D related to this arrangement was $87.0 million, was included as expense in the first quarter of 2008, and is deductible for tax purposes.

In January 2007, we entered into an agreement with OSI Pharmaceuticals, Inc. to acquire the rights to its compound for the treatment of type 2 diabetes. At the inception of this agreement, this compound was in the development stage (Phase I clinical trials) and had no alternative future use. As with many development-phase compounds, launch of the product, if approved, was not expected in the near term. Our charge for acquired IPR&D related to this arrangement was $25.0 million, was included as expense in the first quarter of 2007, and is deductible for tax purposes.

In connection with these arrangements, our partners are generally entitled to future milestones and royalties based on sales should these products be approved for commercialization.

Note 4: Asset Impairments, Restructuring, and Other Special Charges

In April 2008, we announced a streamlining of a portion of our manufacturing operations in Indianapolis and are offering a voluntary exit program to employees in selected areas. In total, this voluntary program is expected to reduce our Indianapolis employment by up to 500 people, predominantly in manufacturing but with a small portion in selected areas of research and development. As a result of these actions, we will be recording a restructuring charge in the second quarter of 2008. The amount of the charge has not yet been determined, as it will depend upon the number of employees that choose to take the exit package.

In March 2008, we terminated development of our AIR® Insulin program, which was being conducted in collaboration with Alkermes, Inc. The program had been in Phase III clinical development as a potential treatment for type 1 and type 2 diabetes. This decision was not a result of any observations during AIR Insulin trials relating to the safety of the product, but rather was a result of increasing uncertainties in the regulatory environment, and a thorough evaluation of the evolving commercial and clinical potential of the product compared to existing medical therapies. As a result of this decision, we halted our ongoing clinical studies and are transitioning the AIR Insulin patients in these studies to other appropriate therapies. We are implementing a patient program in the U.S., and other regions of the world where allowed, to provide clinical trial participants with appropriate financial support to fund their medications and diagnostic supplies through the end of 2008.

We recognized asset impairment, restructuring (exit costs), and other special charges of $145.7 million in the first quarter of 2008. These charges are primarily related to the decision to terminate development of AIR Insulin. Components of these charges include non-cash charges of $40.9 million for the write-down of impaired manufacturing assets that had no use beyond the AIR Insulin program, as well as charges of $91.7 million for estimated contractual obligations and wind-down costs associated with the termination of clinical trials and certain development activities, and costs associated with the patient program to transition participants from AIR Insulin. This amount includes an estimate of Alkermes wind-down costs for which we are contractually obligated. The wind-down activities and patient programs should be substantially complete by the end of 2008. The remaining component of these charges, $13.1 million, is related to exit costs incurred in the first quarter of 2008 in connection with previously announced strategic decisions made in prior periods.

In connection with previously announced strategic decisions, we recorded asset impairment, restructuring, and other special charges of $123.0 million in the first quarter of 2007. These charges primarily related to a voluntary severance program at one of our U.S. plants and other costs related to this action as well as management actions taken in the fourth quarter of 2006. The component of these charges related to the non-cash asset impairment was $67.6 million, and was necessary to adjust the carrying value of the assets to fair value. These restructuring activities were substantially complete at December 31, 2007.

Note 5: Fair Value Measurements

The following table summarizes certain fair value information at March 31, 2008 for assets and liabilities measured at fair value on a recurring basis, as well as the carrying amount of certain other investments:

| | | | Fair Value Measurements Using | | |
|---|---|---|---|---|---|
| Description | Carrying Amount | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Short-term investments | | | | | |
| Debt securities | $ 2,289.1 | $ 2,289.1 | $ 883.2 | $ 1,405.9 | $ |
| Noncurrent investments | | | | | |
| Marketable equity | $ 73.7 | $ 73.7 | $ 73.7 | $ | $ |
| Debt securities | 418.9 | 418.9 | 80.3 | 338.6 | |
| Equity method and other investments | 103.5 | N/A[1] | | | |
| | $ 596.1 | | | | |
| Risk-management instruments assets | $ 76.4 | $ 76.4 | $ | $ 76.4 | $ |

[1]The fair value of equity method and other investments is not readily available and disclosure is not required.

Total pretax unrealized gains and losses of our available-for-sale securities in other comprehensive income at March 31, 2008 were $29.1 million and $66.9 million, respectively, and the fair value of securities in an unrealized loss position was $993.2 million. Substantially all of the securities in a loss position are investment-grade debt securities and have no indications of deterioration in credit quality. The majority of these securities first moved into an unrealized loss position during the first quarter of 2008. We have the intent and ability to hold these securities until the market values recover or the underlying cash flows have been received and we have concluded that no other-than-temporary loss exists at March 31, 2008. We did not hold auction rate securities, collateralized debt obligations, or securities issued by structured investment vehicles at March 31, 2008.

Note 6: Stock-Based Compensation

In 2008 and 2007, our stock-based compensation expense consists primarily of performance awards (PAs), shareholder value awards (SVAs), and stock options. We recognized pretax stock-based compensation cost in the amount of $58.5 million and $72.7 million in the first quarter of 2008 and 2007, respectively.

PAs are granted to officers and management and are payable in shares of our common stock. The number of PA shares actually issued, if any, varies depending on the achievement of certain earnings-per share targets over a one-year period. PA shares are accounted for at fair value based upon the closing stock price on the date of grant and fully vest at the end of the fiscal year of the grant. As of March 31, 2008, the total remaining unrecognized compensation cost related to non vested PAs amounted to $124.3 million, which will be amortized over the weighted-average remaining requisite service period of nine months.

SVAs are granted to officers and management and are payable in shares of common stock at the end of a three-year period. The number of shares actually issued varies depending on our stock price at the end of the three-year vesting period compared to pre-established target prices. We measure the fair value of the SVA unit on the grant date using a Monte Carlo simulation model. The Monte Carlo simulation model utilizes multiple input variables that determine the probability of satisfying the market condition stipulated in the award grant and calculates the fair value of the award. As of March 31, 2008, the total remaining unrecognized compensation cost related to nonvested SVAs amounted to $76.0 million, which will be amortized over the weighted-average remaining requisite service period of 30 months. We discontinued issuing stock options subsequent to 2006. As of March 31, 2008, the total remaining unrecognized compensation cost related to nonvested stock options amounted to $16.3 million, which will be amortized over the weighted-average remaining requisite service period of 10 months.

Note 7: Shareholders Equity

As of March 31, 2008, we have purchased $2.58 billion of our previously announced $3.0 billion share repurchase program. During the first quarter of 2008, we did not acquire any shares pursuant to this program, nor do we expect any share repurchases under this program for the remainder of 2008.

Note 8: Earnings Per Share

Unless otherwise noted in the footnotes, all per-share amounts are presented on a diluted basis, that is, based on the weighted-average number of outstanding common shares plus the effect of all potentially dilutive common shares (primarily unexercised stock options).

Note 9: Income Taxes

We file income tax returns in the United States (U.S.) federal jurisdiction and various state, local, and non-U.S. jurisdictions. We are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations in major taxing jurisdictions for years before 2002. During the first quarter of 2008, we completed and effectively settled our Internal Revenue Service (IRS) audit of tax years 2001-2004 except for one matter for which we will seek resolution through the IRS administrative appeals process. As a result of the IRS audit conclusion, gross unrecognized tax benefits were reduced by approximately $618 million, and the consolidated results of operations were benefited by $210.3 million through a reduction in income tax expense. The majority of the reduction in gross unrecognized tax benefits related to intercompany pricing positions that were agreed with the IRS in a prior audit cycle for which a prepayment of tax was made in 2005. Application of the prepayment and utilization of tax carryovers resulted in a refund of approximately $50 million.

Note 10: Retirement Benefits

Net pension and retiree health benefit expense included the following components:

| | Defined Benefit Pension Plans Three Months Ended March 31, | | Retiree Health Benefit Plans Three Months Ended March 31, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| | (Dollars in millions) | | | |
| Components of net periodic benefit cost | | | | |
| Service cost | $ 64.3 | $ 65.5 | $ 14.4 | $ 19.1 |
| Interest cost | 102.9 | 86.0 | 26.5 | 25.3 |
| Expected return on plan assets | (151.5) | (134.2) | (29.4) | (26.3) |
| Amortization of prior service cost | 1.8 | 1.3 | (9.0) | (3.9) |
| Recognized actuarial loss | 19.2 | 31.3 | 16.5 | 23.4 |
| Net periodic benefit cost | $ 36.7 | $ 49.9 | $ 19.0 | $ 37.6 |

In 2008, we expect to contribute approximately $85 million to our defined benefit pension plans to satisfy minimum funding requirements for the year. In addition, we expect to contribute approximately $100 million of additional discretionary funding in 2008 to our defined benefit plans. As of March 31, 2008, approximately $175 million of the total $185 million expected 2008 contributions has been contributed.

Note 11: Contingencies

We are a party to various legal actions, government investigations, and environmental proceedings. The most significant of these are described below. While it is not possible to determine the outcome of these matters, we believe that, except as specifically noted below, the resolution of all such matters will not have a material adverse effect on our consolidated financial position or liquidity, but could possibly be material to our consolidated results of operations in any one accounting period.

Patent Litigation

We are engaged in the following patent litigation matters brought pursuant to procedures set out in the Hatch-Waxman Act (the Drug Price Competition and Patent Term Restoration Act of 1984):

Evista®: Barr Laboratories, Inc. (Barr), submitted an Abbreviated New Drug Application (ANDA) in 2002 seeking permission to market a generic version of Evista prior to the expiration of our relevant U.S. patents (expiring in 2012-2017) and alleging that these patents are invalid, not enforceable, or not infringed. In November 2002, we filed a lawsuit against Barr in the U.S. District Court for the Southern District of Indiana, seeking a ruling that these patents are valid, enforceable, and being infringed by Barr. Teva Pharmaceuticals USA, Inc. (Teva) has also submitted an ANDA seeking permission to market a generic version of Evista. In June 2006, we filed a similar lawsuit against Teva in the U.S. District Court for the Southern District of Indiana. The lawsuit against Teva is currently scheduled for trial beginning March 9, 2009, while no trial date has been set in the lawsuit against Barr. In April 2008, the FDA granted Teva tentative approval of its ANDA, but Teva s ability to market a generic product before a decision at trial is subject to expiration of a current statutory stay and our right to seek an extension of that stay on final FDA approval of Teva s ANDA or a preliminary injunction barring marketing by Teva of any approved generic product. We believe that Barr s and Teva s claims are without merit and we expect to prevail. However, it is not possible to determine the outcome of this litigation, and accordingly, we can provide no assurance that we will prevail. An unfavorable outcome could have a material adverse impact on our consolidated results of operations, liquidity, and financial position.

Gemzar®: Sicor Pharmaceuticals, Inc. (Sicor), Mayne Pharma (USA) Inc. (Mayne), and Sun Pharmaceutical Industries Inc. (Sun) each submitted ANDAs seeking permission to market generic versions of Gemzar prior to the expiration of our relevant U.S. patents (compound patent expiring in 2010 and method of use patent expiring in 2013), and alleging that these patents are invalid. We filed lawsuits in the U.S. District Court for the Southern District of Indiana against Sicor (February 2006) and Mayne (October 2006, now closed, and January 2008), seeking rulings that these patents are valid and are being infringed. In November 2007, Sun filed a declaratory judgment action in the United States District Court for the Eastern District of Michigan, seeking rulings that our method-of-use and compound patents are invalid or unenforceable, or would not be infringed by the sale of Sun s generic product. We expect to prevail in this litigation and believe that these claims are without merit. However, it is not possible to determine the outcome of this litigation, and accordingly, we can provide no assurance that we will prevail. An unfavorable outcome could have a material adverse impact on our consolidated results of operations, liquidity, and financial position.

Strattera®: Actavis Elizabeth LLC (Actavis), Glenmark Pharmaceuticals Inc., USA (Glenmark), Sun Pharmaceutical Industries Limited (Sun), Sandoz Inc. (Sandoz), Mylan Pharmaceuticals Inc. (Mylan), Teva Pharmaceuticals USA, Inc. (Teva), Apotex Inc. (Apotex), Aurobindo Pharma Ltd. (Aurobindo), Synthon Laboratories, Inc. (Synthon), and Zydus Pharmaceuticals, USA, Inc. (Zydus) each submitted an ANDA seeking permission to market generic versions of Strattera prior to the expiration of our relevant U.S. patent (expiring in 2017), and alleging that this patent is invalid. We filed a lawsuit against Actavis in the United States District Court for the District of New Jersey in August 2007, and added Glenmark, Sun, Sandoz, Mylan, Teva, Apotex, Aurobindo, Synthon, and Zydus as defendants in September 2007. In December 2007, Zydus agreed to entry of a consent judgment in which Zydus conceded the validity and enforceability of the patent and agreed to a permanent injunction. We expect to prevail in this litigation and believe that these claims are without merit. However, it is not possible to determine the outcome of this litigation, and accordingly, we can provide no assurance that we will prevail. An unfavorable outcome could have a material adverse impact on our consolidated results of operations, liquidity, and financial position.

We have received challenges to Zyprexa® patents in a number of countries outside the U.S.:

In Canada, several generic pharmaceutical manufacturers have challenged the validity of our Zyprexa compound and method-of-use patent (expiring in 2011). In April 2007, the Canadian Federal Court ruled against the first challenger, Apotex Inc. (Apotex), and that ruling was affirmed on appeal in February 2008. In June 2007, the Canadian Federal Court held that the invalidity allegations of a second challenger, Novopharm Ltd. (Novopharm), were justified and denied our request that Novopharm be prohibited from receiving marketing approval for generic olanzapine in Canada. Novopharm began selling generic olanzapine in Canada in the third quarter of 2007. We have sued Novopharm for patent infringement, and the trial is scheduled for November 2008. In November 2007, Apotex filed an action seeking a declaration of the invalidity of our Zyprexa compound and method-of-use patents, and no trial date has been set.

In Germany, generic pharmaceutical manufacturers Egis-Gyogyszergyar and Neolabs Ltd. challenged the validity of our Zyprexa compound and method-of-use patents (expiring in 2011). In June 2007, the German Federal Patent Court held that our patent is invalid. We are appealing the decision. Generic olanzapine was launched by competitors in Germany in the fourth quarter of 2007.

We have received challenges in a number of other countries, including Spain, the United Kingdom (U.K.), and several smaller European countries. In Spain, we have been successful at both the trial and appellate court levels in defeating the generic manufacturers challenge, but we anticipate further legal challenges from generic manufacturers. In the U.K., a trial date has tentatively been set for July 2008.

We are vigorously contesting the various legal challenges to our Zyprexa patents on a country-by-country basis. We cannot determine the outcome of this litigation. The availability of generic olanzapine in additional markets could have a material adverse impact on our consolidated results of operations.

Xigris® and Evista: In June 2002, Ariad Pharmaceuticals, Inc., the Massachusetts Institute of Technology, the Whitehead Institute for Biomedical Research, and the President and Fellows of Harvard College in the U.S. District Court for the District of Massachusetts sued us, alleging that sales of two of our products, Xigris and Evista, were inducing the infringement of a patent related to the discovery of a natural cell signaling phenomenon in the human body, and seeking royalties on past and future sales of these products. On May 4, 2006, a jury in Boston issued an initial decision in the case that Xigris and Evista sales infringe the patent. The jury awarded the plaintiffs approximately $65 million in damages, calculated by applying a 2.3 percent royalty to all U.S. sales of Xigris and Evista from the date of issuance of the patent through the date of trial. In addition, a separate bench trial with the U.S. District Court of Massachusetts was held in August 2006, on our contention that the patent is unenforceable and impermissibly covers natural processes. In June 2005, the United States Patent and Trademark Office (USPTO) commenced a reexamination of the patent, and in August 2007 took the position that the Ariad claims at issue are unpatentable, a position that Ariad continues to contest. In September 2007, the Court entered a final judgment indicating that Ariad s claims are patentable, valid, and enforceable, and finding damages in the amount of $65 million plus a 2.3 percent royalty on net U.S. sales of Xigris and Evista since the time of the jury decision. However, the Court deferred the requirement to pay any damages until after all rights to appeal have been exhausted. We have appealed this judgment. We believe that these allegations are without legal merit, that we will ultimately prevail on these issues, and therefore that the likelihood of any monetary damages is remote.

Government Investigations and Related Litigation

In March 2004, the Office of the U.S. Attorney for the Eastern District of Pennsylvania (EDPA) advised us that it had commenced an investigation related to our U.S. marketing and promotional practices, including our communications with physicians and remuneration of physician consultants and advisors, with respect to Zyprexa, Prozac, and Prozac Weekly. In November 2007, we received a grand jury subpoena from the EDPA for a broad range of documents related to Zyprexa. A number of State Medicaid Fraud Control Units are coordinating with the EDPA in its investigation of any Medicaid-related claims relating to our marketing and promotion of Zyprexa. In October 2005, the EDPA advised that it is also conducting an inquiry regarding certain rebate agreements we entered into with a pharmacy benefit manager covering Axid®, Evista, Humalog®, Humulin®, Prozac, and Zyprexa. The inquiry includes a review of our Medicaid best price reporting related to the product sales covered by the rebate agreements.

In June 2005, we received a subpoena from the Office of the Attorney General, Medicaid Fraud Control Unit, of the State of Florida, seeking production of documents relating to sales of Zyprexa and our marketing and promotional practices with respect to Zyprexa.

In September 2006, we received a subpoena from the California Attorney General s Office seeking production of documents related to our efforts to obtain and maintain Zyprexa s status on California s formulary, marketing and promotional practices with respect to Zyprexa, and remuneration of health care providers.

In February 2007, we received a subpoena from the Office of the Attorney General of the State of Illinois, seeking production of documents and information relating to sales of Zyprexa and our marketing and promotional practices, including our communications with physicians and remuneration of physician consultants and advisors, with respect to Zyprexa.

Beginning in August 2006, we have received civil investigative demands or subpoenas from the attorneys general of a number of states under various state consumer protection laws. Most of these requests are now part of a multistate investigative effort being coordinated by an executive committee of attorneys general. We are aware that more than 30 states are participating in this joint effort, and it is possible that additional states will join the investigation. These attorneys general are seeking a broad range of Zyprexa documents, including documents relating to sales, marketing and promotional practices, and remuneration of health care providers.

We are cooperating in each of these investigations, including providing a broad range of documents and information relating to the investigations. It is possible that other Lilly products could become subject to investigation and that the outcome of these matters could include criminal charges and fines, penalties, or other monetary or nonmonetary remedies. We cannot determine the outcome of these matters or reasonably estimate the amount or range of amounts of any fines or penalties that might result from an adverse outcome. It is possible, however, that an adverse outcome cou