Eli Lilly and Company

Answers for Shareholders 2005

2005 Annual Report, Notice of 2006 Annual Meeting, and Proxy Statement

Lilly

Answers That Matter.

Year in Review

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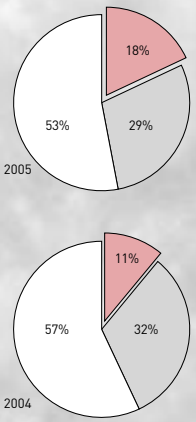
2005 Financial Highlights

ELI LILLY AND COMPANY AND SUBSIDIARIES (Dollars in millions, except per-share data) Year Ended December 31	2005	2004	Change %
Net sales	**$14,645.3**	$13,857.9	6
Research and development	**3,025.5**	2,691.1	12
Research and development as a percent of sales	**20.7%**	19.4%	
Net income	**$ 1,979.6**	$ 1,810.1	9
Earnings per share—basic	**1.82**	1.67	9
Earnings per share—diluted	**1.81**	1.66	9
Reconciling items:[1]			
Product liability charge, primarily related to Zyprexa	**.90**	—	
Asset impairments, restructuring and other special charges	**.14**	.38	
Cumulative effect of a change in accounting principle	**.02**	—	
Tax expense on the repatriation of earnings under the American Jobs Creation Act	—	.43	
Acquired in-process research and development for AME acquisition and insomnia compound	—	.35	
Pro forma stock option expense for 2004	—	(.24)	
Adjusted earnings per share—diluted	**2.87**	2.58	11
Dividends paid per share	**1.52**	1.42	7
Capital expenditures	**1,298.1**	1,898.1	(32)
Employees	**42,600**	44,500	

[1] For more information on these reconciling items, see the Financial Results section of the Executive Overview on page 13.

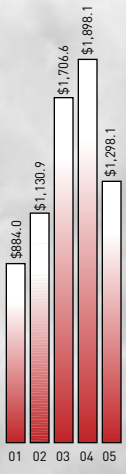
NEWER PRODUCTS CONTRIBUTED $2.6 BILLION IN SALES DURING 2005

Our newer products, launched since 2001, include Alimta, Byetta, Cialis, Cymbalta, Forteo, Strattera, Symbyax, Xigris, and Yentreve. The newer products contributed $2.6 billion to net sales and decreased our reliance on Zyprexa for product sales growth.



CAPITAL EXPENDITURES
($ millions)

Capital expenditures decreased to $1.3 billion in 2005 from record levels in 2004 and 2003, which were significant years for investment in our manufacturing and research and development initiatives. We remain committed to further development in these areas and anticipate that our 2006 capital expenditures will remain relatively flat.



Sidney Taurel
Chairman of the Board and Chief Executive Officer

Prepared for the Future

The intense pressures on the pharmaceutical industry that I have discussed with you over the past few years continued unabated in 2005. Several factors are at play.

First, payers around the world are struggling with the costs of health care in general and drugs in particular. In the European Union and Japan, aging populations are straining health care budgets, and governments are pursuing policies that hold down prices of and access to innovative medicines.

In the U.S., pressure on payers—whether employers, states or the federal government—is also intense. The new Medicare Modernization Act will profoundly change how drugs are paid for in the U.S. Starting in January, Medicare for the first time began providing prescription drug coverage for more than 42 million people over age 65 or with disabilities. As a result, the percentage of Lilly's drugs paid for by federal and state governments in the U.S. will rise from 33 percent to about 50 percent. While we may see some modest near-term benefit from the MMA, we anticipate ongoing pressure on our prices over the long term.

Second, in the wake of some antidepressants being associated with suicidal thoughts as well as the withdrawal of Vioxx®, concerns over safety are overwhelming any sense of balance with efficacy in the media and among politicians—and this in turn has made regulatory agencies more cautious. For example, in 2005 the FDA required 60 black box warnings be added to product labels—nearly triple the 21 it required in 2003.

Third, these challenges come during a period when the industry is struggling to produce new drugs. For example, in the five years from 2001 to 2005, the FDA approved nearly 40 percent fewer new molecular entities than in the preceding five-year period. In addition, in this decade the industry will lose patent exclusivity on products with annual sales of some $100 billion. As a result, global pharmaceutical sales growth has slowed from the strong double-digits in the late '90s to the single digits today and into the foreseeable future.

In this industry environment, Lilly delivered adjusted earnings-per-share of $2.87, up 11 percent over 2004. This compares with about 7 percent EPS growth average for large pharmaceutical companies as a whole. (For a reconciliation of our adjusted EPS to the reported EPS of $1.81, please see page 1.) This performance was the result of 6 percent sales growth, disciplined expense control and increased productivity.

In addition, in 2005 we moved past major uncertainties—several involving Zyprexa®, our top-selling product. The U.S. district court in Indianapolis emphatically reaffirmed the validity of our Zyprexa patent and we announced a tentative settlement of the bulk of our U.S. product liability litigation involving this important product. The CATIE study—a seminal comparison of antipsychotics conducted by the National Institute of Mental Health—concluded that patients in the study taking Zyprexa were more likely to stay on their medication than patients taking other antipsychotics studied, and were less likely to be hospitalized for a psychotic relapse. In addition, after a series of successful inspections of our global manufacturing sites, the FDA has strongly endorsed our manufacturing and quality improvements.

Focus on innovation bears fruit

Lilly has distinguished itself with the innovation-driven strategy we have implemented for the past decade. We chose to remain independent; to invest in R&D at the top of the industry with the goal of delivering a steady flow of innovative products; to build the capabilities to manufacture these products and market them effectively

NINE PRODUCTS LAUNCHED SINCE THE U.S. PROZAC PATENT EXPIRATION HAVE DRIVEN OUR SALES GROWTH ($ millions)

Combined net sales of our newer products—Cymbalta, Strattera, Alimta, Forteo, Xigris, Cialis, Symbyax, Byetta, and Yentreve—increased by 67 percent over 2004, representing $2.6 billion, or 18 percent of total net sales, compared with $1.5 billion, or 11 percent in 2004. Combined net sales of Gemzar, Humalog, Evista, and Actos increased 7 percent to $4.1 billion and represented 28 percent of sales. Zyprexa sales declined 5 percent in 2005.

around the world; and to augment our own capabilities and resources through partnerships.

We have built one of the most productive R&D organizations in the pharmaceutical industry. Over the past four years, at a time when many of our peers have struggled to deliver innovation, we have launched nine new products. They account for a growing portion of our sales—up from 11 percent in 2004 to 18 percent in 2005. We are currently readying another generation of promising molecules for the market (please see second question on page 4) and restocking our early-stage pipeline at a record pace. And, unlike most of our peers, we have no major patent expirations through this decade.

Our strength in developing both small-molecule and large-molecule "biotech" medicines also distinguishes Lilly from most other major pharmaceutical companies. Our eight bioproducts currently on the market make Lilly one of the world's leading biotech companies, and we are studying 11 large-molecule candidates and line extensions in clinical trials.

Partnering has enabled us to selectively add molecules, capabilities and muscle to create additional value. For example, four of our current marketed products are the result of partnerships, as are two of our late-stage compounds. And, our Office of Alliance Management has helped make Lilly a sought-after partner; biotech companies that took part in a respected IBM survey ranked Lilly number one for our partnering capabilities.

We are also working relentlessly to build a reputation as a company that not only provides breakthrough products and medical expertise, but also is reliable and trustworthy, and listens and responds to customers and to society. Among our responses to public skepticism over pharmaceutical company drug data, for example, was the industry's first online clinical trial registry—for which both *The New York Times* and *In Vivo* magazine singled out Lilly for our transparency and leadership. Actions like these (which you can read more about on page 12) are among the reasons that Lilly's reputation was ranked highest in the industry in a *Pharmaceutical Executive* survey of industry executives and analysts who specialize in pharmaceutical companies.

Right strategy for the future

While many aspects of our business environment will remain uncertain, the keys to success are clear. The winners will be those companies that consistently deliver innovative medicines valued by patients, providers and payers, and continually elevate their productivity and flexibility.

These are Lilly's current areas of focus, and I believe our proven strategy remains the best base from which to adapt to—and succeed in—this new environment.

Our strategic focus on innovation provides the platform from which to leverage the revolutionary advances in the life sciences. We have begun to pursue the development of "tailored therapeutics" through the application of new tools and technologies, such as pharmacogenomics and biomarkers—biological telltales like blood sugar levels in people with diabetes—that signal specific diseases. Ninety percent of our clinical candidates have biomarkers associated with them. Our ultimate vision is to be able to deliver to patients the right drug at the right dose at the right time. Tailored therapies will provide patients more effective treatment, physicians more powerful tools, and payers the value they seek.

Establishing this new model will take years. To invest in this transformation, we must dramatically improve the productivity of our current business model. So, for example, we've set a goal to cut our investment to bring a medicine to market by one-third by the end of the decade—from about $1.2 billion per new molecular entity to $800 million. Among the many tools we are using to this end, our use of biomarkers is helping us identify early which molecules have the best chance of success, enabling us to make better decisions about which ones to pursue. We're also streamlining and improving the conduct of clinical trials—the most costly and time-consuming part of producing new drugs.

In October 2004, we began applying Six Sigma—a methodology that has delivered sustainable productivity improvements and customer benefits across a wide variety of companies and industries—throughout our global operations. By the end of 2006 we expect to complete 1,600 projects in our sales and marketing affiliates, manufacturing sites, R&D operations and administrative areas.

We currently estimate that, in total, these efforts will contribute approximately $250 million in benefits in 2006. In 2007, we expect benefits that exceed $500 million. In addition to these direct financial benefits, many of our projects will provide indirect benefits by increasing productivity in existing business processes.

Altogether, these improvements will allow us to free up resources so that we can continue to invest in critical sales and marketing capabilities and R&D technologies; speed up the time it takes to discover, develop and deliver

breakthrough products; enhance our interactions with customers around the world; and improve earnings with a portion of the overall benefit.

Six Sigma is just one of the tools we are using to increase productivity and reduce our cost structure. Since we instituted a hiring freeze in July 2004, Lilly has reduced its headcount by 3,400—or more than 7 percent. And because our position is different than some of our peers, we accomplished this without layoffs and the loss of motivation and commitment that comes with them. We are also outsourcing work that can be done at lower cost and equal—or better—quality. For example, 20 percent of our chemists are in China and nearly 40 percent of our information technology services are being completed by outsourced suppliers. These efforts will accelerate as we go forward.

As a result of these efforts, in 2005 our productivity—as measured by adjusted operating income per Lilly employee—rose 15 percent.

As we work to lower our cost structure and increase our flexibility, the logic for partnering remains compelling. We will continue to strengthen our core capabilities while we partner to access innovation, technology, talent and expertise, and to share risks and mitigate costs across our value chain.

Leading in a new era

To accelerate our momentum and sharpen our implementation during this time of change, in October the board appointed Dr. John Lechleiter president and chief operating officer. John joined Lilly in 1979 with a Ph.D. in organic chemistry from Harvard University and for more than two decades, he has held pivotal roles in the company. He will focus our employees' efforts on the needs of our customers and strive to maximize the commercial potential of Lilly's R&D output, drive productivity throughout the company and help us deliver strong results.

At the end of April, Charlie Golden will retire from his position as executive vice president and chief financial officer. During his tenure, Charlie used his broad business experience and sound judgment to help steer the company's course; among his many contributions, he was instrumental in further strengthening the company's excellent reputation for transparency, internal controls and investor relations.

Assuming the role of CFO will be Derica Rice, who has been vice president and controller of the company since 2003. In his 15-year career, Derica has distinguished himself in key roles of increasing responsibility in both financial and general management in the United States, Canada and the United Kingdom.

With major uncertainties behind us, a proven strategy that remains right for our challenging business environment, strong leadership, and no patent expirations through this decade, Lilly is poised for consistent growth in the years ahead. I look forward to keeping you abreast of our progress.

Questions and Answers

Q: Can Lilly accelerate Cymbalta performance? What other products will drive growth?

A: Cymbalta® has been approved in countries around the world for major depressive disorder, or MDD, and diabetic peripheral neuropathic pain, or DPNP. In 2005—its first full year on the market in the U.S.—its sales were $680 million.

We are reinforcing Cymbalta's reputation as an effective treatment for the physical and emotional symptoms of depression while establishing the drug as a first-line therapy for the broader group of patients suffering from major depression. In late 2005, our "Depression Hurts" direct-to-consumer campaign in the U.S. drove more than 1 million unique visits to our www.depressionhurts.com website.

We're also working to maximize Cymbalta's role in treating DPNP, which currently accounts for between 15 and 20 percent of prescriptions in the United States. We're reaching more primary-care doctors with our combined major depression-DPNP message.

Cymbalta also is getting off to a very strong start overseas, where we partner with Boehringer Ingelheim. In 2006, we will launch Cymbalta for MDD in 18 countries and for DPNP in 19 countries.

In addition, we're on track to submit Cymbalta for the treatment of generalized anxiety disorder, or GAD, this year. Like depression, GAD is closely associated with pain and represents a great opportunity to expand Cymbalta's role in mental health treatment. We also continue to make progress on our fibromyalgia indication, which is in Phase III studies.

Along with Cymbalta, we expect Byetta®, Forteo®, and Alimta® among our newer products—as well as Humalog®—to drive our sales growth.

Q: Give us an appraisal of Lilly's near-term pipeline.

A: We have a number of very promising molecules in Phase III clinical trials. Our application to market Arxxant™ has been submitted to the FDA. If approved, it would be the first pharmaceutical treatment for moderate to severe non-proliferative diabetic retinopathy—a microvascular complication associated with diabetes that can cause vision loss or, eventually, blindness. We're also studying Arxxant for the treatment of other serious complications of diabetes.

We're developing prasugrel, in collaboration with Sankyo, for acute coronary syndromes. We're comparing its effectiveness with that of the cardiovascular medicine clopidogrel in a Phase III head-to-head study. The goal of this study is to determine whether prasugrel—a platelet inhibitor that works by preventing clots and their complications—can do a better job reducing death, heart attacks, and stroke in high-risk patients undergoing stent placement.

Enzastaurin is being studied for use as an oral, once-a-day cancer agent. It targets an enzyme involved in regulat-

ing tumor cell survival and in inhibiting angiogenesis—the proliferation of blood vessels necessary to support the growth of tumors. Our lead indication is for the treatment of glioblastomas—brain tumors that are among the deadliest cancers. We are also studying enzastaurin in the treatment of non-Hodgkin's lymphoma and other tumors.

Our Lilly-Alkermes collaboration is making good progress with an inhaled-insulin formulation and device, which we believe, if approved, will be more convenient for patients than the recently-approved Exubera. In 2005 we started a comprehensive Phase III clinical program to confirm the efficacy and safety of our inhaled insulin.

We are also studying arzoxifene—our next-generation selective estrogen receptor modulator—for the prevention and treatment of osteoporosis and the risk reduction of breast cancer in postmenopausal women. Based on our expertise in this class, we created a molecular structure that has greater potency and bioavailability than Evista®.

Looking further out, we're replenishing our early-stage pipeline, pursuing from external sources interesting molecules and capabilities, and adopting new tools. For example, the molecular engineering technologies we've acquired through Applied Molecular Evolution give us powerful new capabilities to customize antibodies and proteins to make better drugs.

Q: How will the Medicare drug benefit impact Lilly's business?

A: We believe the new drug benefit, despite its complexities, can help virtually all seniors and people with disabilities, and it provides the greatest benefit for those with the greatest needs. We've been preparing for this change since early 2004 and believe we are well-positioned for the transition. Our business-to-business team has strengthened our connection to payers and we have trained our sales teams and support functions to operate in this new environment.

Despite many uncertainties, such as the percentage of seniors who ultimately enroll, we believe we will get a modest benefit in the near term. However, we also expect the highly competitive nature of this market to put pressure in the future on both the use of medicines and their prices.

Q: With increasing scrutiny around drug safety, what is Lilly doing to underscore the importance of an appropriate benefit/risk assessment?

A: The bulk of our research and development—comprising an average of some eight years of clinical study in thousands of patients at a cost of more than $1 billion per marketed product—goes to ensuring the safety and effectiveness of our drugs. During development, we carefully analyze all our clinical data and assess the efficacy seen in the trials, usually compared to a placebo, with the side effects. We often consult outside experts who can give us an independent view of a potential medicine's benefit-risk profile.

When we launch our products, we communicate very important efficacy and safety information to prescribers. We point out not only the benefits but also the side effects so that the health professional can make educated choices for his or her patients.

Once a drug is on the market, we closely monitor for adverse drug events and product complaints globally and analyze and report those events as required by regulatory authorities. Based on such analysis, we update our product labels as necessary to provide prescribers with important new information.

For consumers, we provide information via our company website, product websites, and call centers in the U.S. and many of our other affiliates.

Board changes

Finally, I would like to note some changes in our board of directors since I last wrote to you.

In April 2005, Dr. Steven Beering retired after serving 22 years on our board. Dr. Beering, who was dean of the School of Medicine at Indiana University for 10 years and president of Purdue University from 1983 to 2000, was the board's longest-serving member and first independent presiding director. We greatly miss his level-headed leadership and unwavering commitment to the company.

Sir John Rose, chief executive officer of Rolls Royce Group since 1996, also stepped down from our board last year to devote his full attention to his family and his duties at Rolls Royce. We will miss Sir John's guidance and international perspective.

Effective April 30, Charlie Golden will retire from the board along with his position in the company.

In 2005, we were pleased to welcome three new members to our board of directors. J. Michael Cook, former chairman and chief executive officer of Deloitte and Touche LLP, is a recognized expert on accounting standards and corporate governance and a member of the Accounting Hall of Fame. J. Erik Fyrwald is group vice president of DuPont Agriculture & Nutrition. His more than 20 years' experience and leadership in an innovation-driven company like DuPont will contribute significantly to Lilly's goal of providing better health outcomes for patients. And Dr. John Lechleiter also joined our board when he became president and chief operating officer.

For the Board of Directors,

Sidney Taurel
Chairman of the Board and Chief Executive Officer

Innovation at Lilly: The Portfolio and the Pipeline

Major Marketed Products

(Dates indicate the year of first global launch)

2005	**Byetta**®	for type 2 diabetes *(codeveloped with Amylin Pharmaceuticals, Inc., and copromoted with Amylin in the U.S.)*
2004	**Cymbalta**®	for major depressive disorder for diabetic peripheral neuropathic pain (2004) *(copromoted with Quintiles Transnational Corp. in the U.S., and with Boehringer Ingelheim elsewhere in the world, except Japan)*
	Alimta®	for malignant pleural mesothelioma for second-line treatment of non-small-cell lung cancer (2004)
	Symbyax®	for bipolar depression
	Yentreve®	for stress urinary incontinence (approved and launched outside the U.S.)
2003	**Cialis**®	for erectile dysfunction *(developed by Lilly ICOS in a joint venture with ICOS Corp.; copromoted by Lilly ICOS in North America and Europe and by Lilly elsewhere)*
	Strattera®	for attention-deficit hyperactivity disorder in children, adolescents, and adults
2002	**Forteo**®	for treatment of men and postmenopausal women with osteoporosis who are at high risk for a fracture
2001	**Xigris**®	for adult severe sepsis patients at high risk of death
1999	**Actos**®	for type 2 diabetes *(developed by Takeda Chemical Industries, Ltd., and copromoted with Takeda)*
1998	**Evista**®	for prevention of osteoporosis in postmenopausal women for treatment of osteoporosis in postmenopausal women (1999)
1996	**Zyprexa**®	for schizophrenia for acute bipolar mania (2000) Zyprexa® Zydis® tablet (2000) for schizophrenia maintenance (2001) as combination therapy with lithium or valproate for acute bipolar mania (2002) for bipolar maintenance (2003) Rapid-acting IntraMuscular formulation (2004) Zyprexa® granules (2004; launched in Japan only)
	Humalog®	for treatment of type 1 and type 2 diabetes Humalog® mixtures (1999) Humalog® Mix 50/50 (1999)
1995	**Gemzar**®	for non-small-cell lung cancer for pancreatic cancer (1996) for bladder cancer (1999; approved and launched outside the U.S.) for metastatic breast cancer (2003) for recurrent ovarian cancer (2004; under review in the U.S.)

	ReoPro®	for prevention of cardiac ischemic complications in patients undergoing coronary intervention, such as angioplasty for unstable angina associated with stent procedure (1997) *(developed by Centocor and promoted by Lilly, except in Japan)*
1987	**Humatrope**®	for growth failure caused by pediatric growth hormone deficiency for replacement therapy for adult growth hormone deficiency (1995) for short stature caused by Turner syndrome (1997) for idiopathic short stature (2003)
1983	**Humulin**®	for type 1 and type 2 diabetes

New Drug Application Submitted For Review to the U.S. Food and Drug Administration

Arxxant™ (ruboxistaurin)	for diabetic retinopathy

Select Drug Candidates in Late-Stage Investigation

Prasugrel	for acute coronary syndromes *(codeveloping with Sankyo Company, Ltd.)*
Enzastaurin	for glioblastoma, a type of brain tumor; and non-Hodgkin's lymphoma
Inhaled insulin	for type 1 and type 2 diabetes *(codeveloping with Alkermes, Inc.)*
Arzoxifene	for prevention and treatment of osteoporosis and for reducing the risk of breast cancer, all in postmenopausal women

Select Drug Candidates in Mid-Stage Investigation

Pruvanserin (5-HT2A antagonist)	for insomnia
Peroxisome Proliferator-Activated Receptor compounds:	
PPAR alpha agonist (LY518674)	for reducing the progression of atherosclerosis
PPAR gamma agonist (Naveglitazar)	for type 2 diabetes
Factor Xa inhibitor	for prevention and treatment of venous and arterial thrombotic events
Anti-obesity compound	for reducing craving and addictive behavior in obese patients
Gamma-secretase inhibitor	for slowing the progression of Alzheimer's disease

Information is current as of February 20, 2006. The search for new drugs is risky and uncertain, and there are no guarantees. Remaining scientific and regulatory hurdles may cause pipeline compounds to be delayed or even to fail to reach the market.

Karen N. Horn, Ph.D.

Retired President, Private Client Services, and Managing Director, Marsh, Inc.

Sidney Taurel

Chairman of the Board and Chief Executive Officer

Alfred G. Gilman, M.D., Ph.D.

Dean, The University of Texas Southwestern Medical School and Regental Professor of Pharmacology, The University of Texas Southwestern Medical Center

Sir Winfried Bischoff

Chairman, Citigroup Europe

George M.C. Fisher

Retired Chairman of the Board and Chief Executive Officer, Eastman Kodak Company

Martin S. Feldstein, Ph.D.

President and Chief Executive Officer, National Bureau of Economic Research and George F. Baker Professor of Economics, Harvard University

Listed in order of seniority. Please see pages 64–66 for additional information about the Board of Directors.

Franklyn G. Prendergast, M.D., Ph.D.

Edmond and Marion Guggenheim Professor of Biochemistry and Molecular Biology, Professor of Molecular Pharmacology and Experimental Therapeutics, Mayo Medical School, and Director, Mayo Clinic Cancer Center

Kathi P. Seifert

Retired Executive Vice President, Kimberly-Clark Corporation

Charles E. Golden

Executive Vice President and Chief Financial Officer

Ellen R. Marram

President, The Barnegat Group LLC

J. Michael Cook

Retired Chairman and Chief Executive Officer, Deloitte & Touche LLP

John C. Lechleiter, Ph.D.

President and Chief Operating Officer

J. Erik Fyrwald

Group Vice President, DuPont Agriculture & Nutrition

Gino Santini*†	Alecia A. DeCoudreaux	Sidney Taurel*†	Peter J. Johnson	Andrew M. Dahlem, Ph.D.	William W. Chin, M.D.	Michael C. Heim	Joshua M. Salisbury	Timothy R. Franson, M.D.
Senior Vice President, Corporate Strategy and Policy	*Vice President and General Counsel, Lilly USA*	*Chairman of the Board and Chief Executive Officer*	*Executive Director, Corporate Strategy*	*Vice President, Toxicology, Drug Disposition, Pharmaco-kinetics, and Lilly Research Laboratories, Europe*	*Vice President, Discovery Biology Research and Clinical Investigation*	*Vice President and Chief Information Officer*	*Vice President, Corporate Business Development*	*Vice President, Global Regulatory Affairs*

Alan Breier, M.D.	Lori V. Queisser†	Frank M. Deane, Ph.D.†	Albertus J. van den Bergh	Sharon Sullivan	E. Paul Ahern, Ph.D.	Lorenzo Tallarigo, M.D.†	Deirdre P. Connelly†	Bryce Carmine†	Robert A. Armitage*†
Vice President, Medical, and Chief Medical Officer	*Vice President and Chief Compliance Officer*	*Vice President, Quality*	*Vice President, Global Customer Solutions*	*Vice President, Human Resources, Global Compensation, and HR Services*	*Vice President, Global API Manufacturing*	*President, International Operations*	*President, U.S. Operations*	*President, Global Brand Development*	*Senior Vice President and General Counsel*

*Policy and Strategy Committee †Operations Committee

Charles E. Golden*†	Thomas W. Grein	Patrick C. James	Robert A. Cole	J. Carmel Egan, Ph.D.	Anne Nobles	Newton F. Crenshaw	Steven M. Paul, M.D.*†	Thomas R. Verhoeven, Ph.D.
Executive Vice President and Chief Financial Officer	*Vice President and Treasurer*	*President, Elanco Animal Health*	*Vice President, Global Parenteral Operations, Engineering, and Environmental Health and Safety*	*Vice President, Project Management*	*Vice President, Corporate Affairs*	*President and General Manager, Lilly Japan*	*Executive Vice President, Science and Technology, and President, Lilly Research Laboratories*	*Vice President, Product Research and Development*

Jacques Tapiero	Derica W. Rice	Scott Canute*†	Richard D. Pilnik	Anthony J. Murphy, Ph.D.*†	John C. Lechleiter, Ph.D.*†	Steven R. Plump	Robert W. Armstrong, Ph.D.	Elizabeth H. Klimes†
President, Intercontinental Operations	*Vice President and Controller*	*President, Manufacturing Operations*	*President, European Operations*	*Senior Vice President, Human Resources*	*President and Chief Operating Officer*	*Group Vice President, Global Marketing and Sales*	*Vice President, Discovery Chemistry Research*	*Vice President, Six Sigma*

Lilly: Taking Its Role as a Good Corporate Citizen To Heart

In a year of urgent needs, Lilly and its people stepped forward with extraordinary efforts.

To ease the suffering of hurricane and earthquake victims, we provided essential medicines, cash, and supplies. To ensure that seniors and low-income patients had affordable access to drugs, we offered six patient assistance programs. And to halt the spread of multi-drug-resistant tuberculosis, we continued to partner with the World Health Organization and other groups to share expertise, improve treatment, and save lives.

Those and other initiatives in 2005 follow an honored tradition of giving back to the communities where we live and work. Lilly's global philanthropy in 2005 totaled more than $511 million. Contributions included more than $453 million (net wholesale value) worth of product donations for patient assistance programs or international humanitarian causes. Lilly and its philanthropic foundation also gave nearly $58 million in cash donations for a number of urgent or special causes. That total included matches for employee donations that aided disaster relief efforts in the wake of the tsunami in Southeast Asia, Hurricane Katrina in the United States, and the devastating earthquakes near the Pakistan-India border.

In the U.S., Lilly employees also donated generously to United Way charities; their contributions combined with matches from the foundation totaled $9.2 million.

Reacting quickly to Katrina

As Hurricane Katrina struck the U.S. Gulf Coast in late August, Lilly quickly mobilized to deliver medicines directly to the disaster zone and to more than 40 affected communities across 10 states. "This storm left profound devastation in its wake, and we wanted to do our part to help those in need," said Lilly Foundation President Robert L. Smith. "Given the scope of the disaster, the private sector was able to play a critically important role."

Lilly dispatched a corporate jet filled with 1,600 pounds of supplies, including 800 vials of insulin and 1,700 doses of tetanus vaccine, to Mobile, Alabama. From there, the U.S. Coast Guard helped rush the medicines to a hospital in Bay St. Louis, Mississippi. Barely 70 hours earlier, Katrina's eye had passed directly over the site.

"Clearly, we believe that we saved lives that day," said Jim Collins, executive director of global delivery devices, who organized the mission and whose own family was affected.

Access to medicines in the U.S.

Nor were everyday health care needs forgotten. To ensure that people had affordable access to Lilly's medicines, the company donated products through six patient assistance programs that last year aided more than 410,000 people in the U.S. Lilly Cares, which offers free medicines to patients who can't pay for them, assisted 176,000 participants, while LillyAnswers provided low-cost prescriptions to 230,000 Medicare-enrolled individuals. Other assistance programs helped patients gain reimbursement or access to drugs that battle cancer, severe sepsis, osteoporosis, and diabetes.

And in a partnership with the National Urban League, a wide spectrum of health and wellness initiatives supported by a multi-year funding commitment from the foundation are helping to improve the quality of health care for African-Americans across the nation.

"Whether they are patients needing access to quality health care or survivors of a disaster, we do our best to ensure that people in need are not forgotten," said Chairman Sidney Taurel. "Our founders established these values nearly 130 years ago, and we live by them today."

Earning society's trust

The depth and breadth of Lilly's corporate good works might surprise you. For a full report on these initiatives, as well as challenges that lie ahead, visit **www.lilly.com/about/citizenship**.

There, you can learn more about how Lilly is earning society's trust by establishing the first online clinical trial registry (**www.lillytrials.com**); working to improve the industry's good promotional practices and code of ethics; respecting the environment; partnering with world health leaders to combat MDR-TB with the goal of treating 20,000 patients annually by 2010 (**www.lillymdr-tb.com**); and implementing a broad range of other programs that improve the lives of patients every day.

Review of Operations

EXECUTIVE OVERVIEW

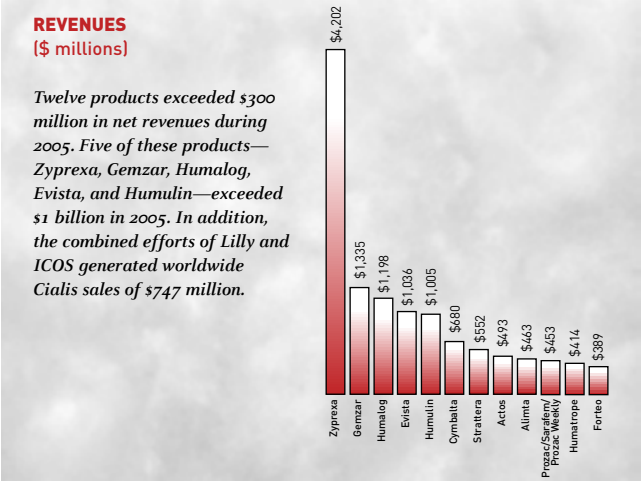
This section provides an overview of our financial results, product launches and late-stage product pipeline developments, and legal and governmental matters affecting our company and the pharmaceutical industry.

Financial Results

We achieved worldwide sales growth of 6 percent, due in part to the launch in 2004 of five new products as well as six new indications or formulations for expanded use of new and existing products in key markets. In addition, we launched one new product in the U.S. and several new products, new indications, or new formulations in key markets in 2005. We continued our substantial investments in our manufacturing operations and research and development activities, resulting in cost of products sold and research and development costs increasing at rates greater than sales. Despite product launch expenditures, our cost-containment and productivity measures contributed to marketing and administrative expenses increasing at a rate less than sales. During 2005, we began to expense stock options, which had the effect of increasing our research and development and marketing and administrative expenses. We also benefited from an increase in net other income due primarily to increased profitability of the Lilly ICOS joint venture and a decrease in the tax rate in 2005. Net income was $1.98 billion, or $1.81 per share, in 2005 as compared with $1.81 billion, or $1.66 per share, in 2004, representing an increase in net income and earnings per share of 9 percent. Net income comparisons between 2005 and 2004 are also affected by the impact of the following significant items that are reflected in our financial results (see Notes 1, 2, 3, 4, 7, 11, and 13 to the consolidated financial statements for additional information):

2005

- We incurred a charge related to product liability litigation matters, primarily related to Zyprexa®, of $1.07 billion (pretax), which decreased earnings per share by $.90 in the second quarter of 2005 (Notes 4 and 13).
- In 2005, we began to expense stock options in accordance with SFAS 123(R). Had we expensed stock options in 2004, our 2004 net income would have been lower by $266.4 million, which would have decreased earnings per share by $.24 per share (Notes 1 and 7).
- We recognized asset impairment and other special charges of $171.9 million (pretax) in the fourth quarter, which decreased earnings per share by $.14 (Note 4).
- We adopted Financial Accounting Standards Board (FASB) Interpretation (FIN) 47, Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143, in the fourth quarter of 2005. The adoption of FIN 47 resulted in an adjustment for the cumulative effect of a change in accounting principle of $22.0 million (after-tax), which decreased earnings per share by $.02 (Note 2).



2004

- We recognized asset impairment charges, streamlined our infrastructure, and provided for the anticipated resolution of the government investigation of Evista® marketing and promotional practices, resulting in charges of $108.9 million (pretax) in the second quarter and $494.1 million (pretax) in the fourth quarter, which decreased earnings per share by $.08 and $.30, respectively (Note 4).
- We incurred charges for acquired in-process research and development (IPR&D) of $362.3 million (no tax benefit) in the first quarter related to the acquisition of Applied Molecular Evolution, Inc. (AME), and $29.9 million (pretax) in the fourth quarter related to our acquisition of a Phase I compound currently under development as a potential treatment for insomnia, which decreased earnings per share by $.33 in the first quarter and $.02 in the fourth quarter (Note 3).
- As discussed further in Financial Condition, we recognized tax expenses of $465.0 million in the fourth quarter associated with the anticipated repatriation in 2005 of $8.00 billion of our earnings reinvested outside the U.S., as a result of the passage of the American Jobs Creation Act of 2004 (AJCA). This tax expense decreased earnings per share by $.43 in that quarter (Note 11).

Recent Product Launches and Late-Stage Product Pipeline Developments

Our long-term success depends, to a great extent, on our ability to continue to discover and develop innovative pharmaceutical products and acquire or collaborate on compounds currently in development by other biotechnology or pharmaceutical companies. We have achieved a number of successes with recent product launches and late-stage pipeline developments, including:

- We are in the process of rolling out the global launches of a number of new products, including Alimta®, Byetta®, Cialis®, Cymbalta®, Forteo®, Strattera®, Symbyax®, and Yentreve®. In addition, we recently launched new indications or formulations of Alimta, Cymbalta, Gemzar®,

Humatrope®, and Zyprexa.
- We launched Cymbalta for the treatment of major depressive disorder in the U.S. in August 2004. In September 2004, Cymbalta received its second U.S. approval and became the first FDA-approved treatment for diabetic peripheral neuropathic pain (DPNP). Cymbalta was launched in the United Kingdom and Germany in the first quarter of 2005 for the treatment of major depressive episodes. Other launches in the European Union are expected to occur throughout 2006. The European Commission also granted marketing authorization of Cymbalta for the treatment of DPNP in adults in July 2005. Cymbalta has achieved $728.9 million in U.S. sales since its launch.
- In June 2005, Lilly and Amylin Pharmaceuticals, Inc., launched Byetta (exenatide), the first in a new class of medicines known as incretin mimetics, in the U.S. for the treatment of type 2 diabetes. In the fourth quarter of 2005, we submitted Byetta for the treatment of type 2 diabetes in Europe.
- We expect to advance our pipeline during 2006 with three significant submissions anticipated, including Arxxant™ for diabetic retinopathy, Cymbalta for generalized anxiety disorder, and Evista for breast cancer risk reduction in postmenopausal women.

Legal and Governmental Matters

Certain generic manufacturers have challenged our U.S. compound patent for Zyprexa and are seeking permission to market generic versions of Zyprexa prior to its patent expiration in 2011. On April 14, 2005, the U.S. District Court in Indianapolis ruled in our favor on all counts, upholding our patents. The decision has been appealed.

In 2005, we entered into an agreement with plaintiffs' attorneys involved in certain U.S. Zyprexa product liability litigation to settle a majority of the claims against us relating to the medication. We established a fund of $690 million for the claimants who agree to settle their claims. Additionally, we paid $10 million to cover administration of the settlement. As a result of our product liability exposures, the substantial majority of which were related to Zyprexa, we recorded a net pretax charge of $1.07 billion in the second quarter of 2005.

In March 2004, we were notified by the U.S. Attorney's office for the Eastern District of Pennsylvania that it has commenced a civil investigation relating to our U.S. sales, marketing, and promotional practices.

In the United States, implementation of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA), which provides a prescription drug benefit under the Medicare program, took effect January 1, 2006. While it is difficult to predict the business impact of this legislation, we currently anticipate a modest short-term increase in sales. However, in the long term there is additional risk of increased pricing pressures. While the MMA prohibits the Secretary of Health and Human Services (HHS) from directly negotiating prescription drug prices with manufacturers, we expect continued challenges to that prohibition over the next several years. Also, the MMA retains the authority of the Secretary of HHS to prohibit the importation of prescription drugs, but we expect Congress to consider several measures that could remove that authority and allow for the importation of products into the U.S. regardless of their safety or cost. If adopted, such legislation would likely have a negative effect on our U.S. sales. We believe there is some chance that the new and expanded prescription drug coverage for seniors under the MMA will alleviate the need for a federal importation scheme.

As a result of the passage of the MMA, aged and disabled patients jointly eligible for Medicare and Medicaid began receiving their prescription drug benefits through the Medicare program, instead of Medicaid, on January 1, 2006. This may relieve some state budget pressures but is unlikely to result in reduced pricing pressures at the state level. A majority of states have begun to implement supplemental rebates and restricted formularies in their Medicaid programs, and these programs are expected to continue in the post-MMA environment. Several states are also attempting to extend discounted Medicaid prices to non-Medicaid patients. Additionally, notwithstanding the federal law prohibiting drug importation, approximately a dozen states have implemented importation schemes for their citizens, usually involving a website that links patients to selected Canadian pharmacies. One state has such a program for its state employees. As a result, we expect pressures on pharmaceutical pricing to continue.

International operations are also generally subject to extensive price and market regulations, and there are many proposals for additional cost-containment measures, including proposals that would directly or indirectly impose additional price controls or reduce the value of our intellectual property protection.

OPERATING RESULTS—2005

Sales

Our worldwide sales for 2005 increased 6 percent, to $14.65 billion, driven primarily by sales growth of Cymbalta, Alimta, Forteo, and Gemzar. As a result of restructuring our arrangements with our U.S. wholesalers in early 2005, reductions occurred in wholesaler inventory levels for certain products (primarily Strattera, Prozac®, and Gemzar) that reduced our sales by approximately $170 million. Sales growth in 2005 was also affected by decreased U.S. demand for Zyprexa, Strattera, and Prozac. Despite this wholesaler destocking and decreased demand, sales in the U.S. increased 2 percent, to $7.80 billion, driven primarily by increased sales of Cymbalta and Alimta. Sales outside the U.S. increased 11 percent, to $6.85 billion, driven by growth of Zyprexa, Alimta, and Gemzar. Worldwide sales reflected a volume increase of 3 percent, with global selling prices contributing 1 percent and an increase due to favorable changes in exchange rates contributing 1 percent. (Numbers do not add due to rounding.)

Zyprexa, our top-selling product, is a treatment for schizophrenia, bipolar mania, and bipolar maintenance. Zyprexa sales in the U.S. decreased 16 percent in 2005, resulting from a decline in underlying demand due to continuing competitive pressures. Sales outside the U.S. in 2005 increased 9 percent, driven by volume growth in a number of major markets and the favorable impact of exchange rates. Excluding the impact of exchange rates, sales of Zyprexa outside the U.S. increased by 6 percent. In September 2005, the National Institute of Mental Health released the results of its Clinical Antipsychotic Trial of Intervention Effectiveness (CATIE) study, which showed that Zyprexa was statistically superior on time to discontinuation in patients with schizophrenia as compared to other medications. Patients taking Zyprexa also experienced significantly fewer hospitalizations for schizophrenia than patients taking other medications. In addition, the study noted that Zyprexa patients experienced greater weight gain and increases in measures of glucose and lipid metabolism than patients using other antipsychotics.

Diabetes care products, composed primarily of Humalog®, our insulin analog; Humulin®, a biosynthetic human insulin; Actos®, an oral agent for the treatment of type 2 diabetes; and recently-launched Byetta, the first in a new class of medicines known as incretin mimetics for type 2 diabetes that we market with Amylin Pharmaceuticals, had aggregate worldwide revenues of $2.80 billion in 2005, an increase of 7 percent. Diabetes care revenues in the U.S. increased 7 percent, to $1.59 billion, primarily driven by higher prices, offset partially by a decline in underlying demand due to continued competitive pressures in the insulins market and reductions in wholesaler inventory levels of insulins. Diabetes care revenues outside the U.S. increased 8 percent, to $1.20 billion. Humalog sales increased 8 percent in the U.S. and 10 percent outside the U.S. Humulin sales in the U.S. decreased 3 percent, while Humulin sales outside the U.S. increased 3 percent. Actos revenues, the majority of which represent service revenues from a copromotion agreement in the U.S. with Takeda Pharmaceuticals North America (Takeda), increased 9 percent in 2005. Actos is manufactured by Takeda Chemical Industries, Ltd., and sold in the U.S. by Takeda. Our U.S. marketing rights with respect to Actos expire in September 2006; however, we will continue receiving royalties from Takeda. As a result, our revenues from Actos will decline each year from 2006 through 2009. Our arrangement in the U.S. ceases after October 2009. Sales of Byetta were $74.6 million following its June 2005 launch. We report as revenue our 50 percent share of Byetta's gross margin and our sales of Byetta pen delivery devices to Amylin. This revenue totaled $39.6 million in 2005.

Sales of Gemzar, a product approved to fight various cancers, increased 4 percent in the U.S. Sales growth in the U.S. in 2005 was negatively affected by reductions in wholesaler inventory levels as a result of our restructured

The following table summarizes our net sales activity in 2005 compared with 2004:

Product	Year Ended December 31, 2005 U.S.[1]	Outside U.S.	Total	Year Ended December 31, 2004 Total	Percent Change from 2004
(Dollars in millions)					
Zyprexa	$2,034.9	$ 2,167.4	$ 4,202.3	$ 4,419.8	(5)
Gemzar	586.1	748.4	1,334.5	1,214.4	10
Humalog	739.6	458.1	1,197.7	1,101.6	9
Evista	652.9	383.2	1,036.1	1,012.7	2
Humulin	410.7	594.0	1,004.7	997.7	1
Animal health products	370.3	493.4	863.7	798.7	8
Cymbalta	636.2	43.5	679.7	93.9	NM
Strattera	498.7	53.4	552.1	666.7	(17)
Actos	355.7	137.3	493.0	452.9	9
Alimta	296.3	166.9	463.2	142.6	NM
Fluoxetine products	249.1	204.3	453.4	559.0	(19)
Anti-infectives	133.3	310.6	443.9	478.0	(7)
Humatrope	184.5	229.9	414.4	430.3	(4)
Forteo	264.7	124.6	389.3	238.6	63
ReoPro®	119.8	176.9	296.7	362.8	(18)
Xigris®	118.9	95.7	214.6	201.8	6
Cialis[2]	2.3	167.6	169.9	130.6	30
Symbyax	52.6	1.3	53.9	70.2	(23)
Other pharmaceutical products	91.5	290.7	382.2	485.6	(21)
Total net sales	$7,798.1	$6,847.2	$14,645.3	$13,857.9	6

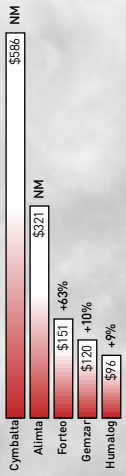
NM—Not meaningful

[1] U.S. sales include sales in Puerto Rico.

[2] Cialis had worldwide 2005 sales of $746.6 million, representing an increase of 35 percent compared with 2004. The sales shown in the table above represent results only in the territories in which we market Cialis exclusively. The remaining sales relate to the joint-venture territories of Lilly ICOS LLC (North America, excluding Puerto Rico, and Europe). Our share of the joint-venture territory sales, net of expenses, is reported in net other income in our consolidated income statement.

KEY CONTRIBUTORS TO 2005 SALES GROWTH
($ in millions of growth; percentages represent changes from 2004)

Five of our products—Cymbalta, Alimta, Forteo, Gemzar, and Humalog—generated $4.1 billion in net sales during 2005, an increase of $1.3 billion over 2004. In addition, global sales of Cialis, promoted with our partner ICOS, increased $194 million to $747 million (a 35 percent increase from 2004).



arrangements with our U.S. wholesalers. Gemzar sales increased 15 percent outside the U.S., driven by strong volume growth in a number of cancer indications.

Sales of Evista, a product for the prevention and treatment of osteoporosis, decreased 2 percent in the U.S. due to a decline in U.S. underlying demand resulting from continued competitive pressures and reductions in wholesaler inventory levels. This decline was partially offset by price increases. Outside the U.S., sales of Evista increased 11 percent, driven by volume growth in several markets and the early 2004 launch of the product in Japan.

Cymbalta was launched in the U.S. in late August 2004 for the treatment of major depressive disorder and in September 2004 for the treatment of diabetic peripheral neuropathic pain. Cymbalta launches began in Europe for the treatment of major depressive disorder during the first quarter of 2005, with additional launches expected through 2006. Cymbalta has been well accepted, generating $679.7 million in sales in 2005.

Sales of Strattera, the only nonstimulant medicine approved for the treatment of attention-deficit hyperactivity disorder in children, adolescents, and adults, declined 24 percent in the U.S. in 2005 due to wholesaler destocking resulting from restructured arrangements with our U.S. wholesalers and a decline in underlying demand. Sales outside the U.S. were $53.4 million in 2005, compared with $10.3 million in 2004, primarily reflecting recent launches in Australia, Canada, Germany, Mexico, and Spain. In the third quarter of 2005, we announced an important update to the Strattera label, communicating new information regarding uncommon reports of suicidal thoughts among children and adolescents. We have added a boxed warning to the label in the U.S. and are working with other regulatory agencies in countries where Strattera is approved to update the label information appropriately.

Alimta was launched in the U.S. in February 2004 for the treatment of malignant pleural mesothelioma and in August for second-line treatment of non-small-cell lung cancer (NSCLC). Alimta was launched in several European countries in the second half of 2004 and throughout 2005. Alimta generated sales of $463.2 million in 2005.

Forteo, a treatment for both men and postmenopausal women suffering from severe osteoporosis, increased 34 percent in the U.S. in 2005, driven by strong growth in underlying demand. Sales growth was offset, in part, by wholesaler destocking in the first half of 2005 related to our new arrangements with U.S. wholesalers.

Cialis, an erectile dysfunction treatment, is promoted in North America and Europe jointly by Lilly and ICOS Corporation, and by Lilly exclusively in the rest of the world. The $746.6 million of worldwide Cialis sales in 2005, an increase of 35 percent compared to 2004, comprises $169.9 million of sales in our territories, which are reported in our net sales, and $576.7 million of sales in the joint-venture territories. Within the joint-venture territories, U.S. sales of Cialis were $272.9 million for 2005, an increase of 32 percent, despite wholesaler destocking in the first half of the year as a result of our restructured arrangements with our U.S. wholesalers. Cialis continues to increase its market share in most major markets in this extremely competitive category.

Animal health product sales in the U.S. increased 9 percent, while sales outside the U.S. increased 7 percent, led by Rumensin® and Paylean®.

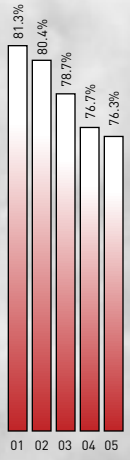
Gross Margin, Costs, and Expenses

The 2005 gross margin decreased to 76.3 percent of sales compared with 76.7 percent for 2004. The decrease was primarily due to higher manufacturing expenses, partially offset by favorable product mix and lower factory inventory losses.

Operating expenses (the aggregate of research and development and marketing and administrative expenses) increased 8 percent in 2005. Investment in research and development increased 12 percent, to $3.03 billion, in 2005, due to the adoption of stock option expensing in 2005, decreased reimbursements from collaboration partners, and increased incentive compensation and benefits expenses. We continued to be a leader in our industry peer group by investing approximately 21 percent of our sales into research and development during 2005. Marketing and administrative expenses increased

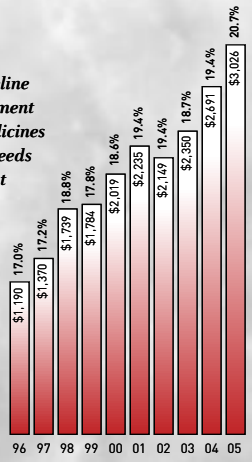
GROSS MARGIN
(as a percent of total net sales)

Gross margin as a percentage of sales decreased by 0.4 percentage points to 76.3 percent. This decrease was primarily due to higher manufacturing expenses, partially offset by favorable product mix and lower factory inventory losses. We expect our 2006 gross margin to improve modestly from 2005.



RESEARCH AND DEVELOPMENT
($ millions; percent of net sales)

Significant financial investment in our pipeline of products supports our continued commitment to develop best-in-class and first-in-class medicines to provide answers for the unmet medical needs of our customers. Research and development increased by 12 percent, to $3.0 billion, in 2005 primarily due to the adoption of stock option expensing effective January 1, 2005, decreased reimbursements from collaboration partners and increased incentive compensation and benefit expenses. At nearly 21 percent of net sales, we continue to be a leader in our industry peer group in proportion of revenue reinvested in research and development.



5 percent in 2005, to $4.50 billion, due to the adoption of stock option expensing in 2005, and increased incentive compensation and benefits expenses. This comparison also benefited from a charitable contribution to the Lilly Foundation during the fourth quarter of 2004. Research and development expenses would have increased by 8 percent, and marketing and administrative expenses would have been flat for 2005, if 2004 had been restated as if stock options had been expensed.

Net other income for 2005 increased $89.4 million, to $419.4 million, primarily due to the Lilly ICOS LLC joint venture becoming profitable during 2005 and increased interest income, partially offset by less income related to the outlicense of legacy products and partnered products in development. We report our 50 percent share of the operating results of the Lilly ICOS joint venture in our net other income. For 2005, our net income from the joint venture was $11.1 million, compared with a net loss of $79.0 million in 2004. The joint venture became profitable for the first time in the third quarter of 2005.

Interest expense for 2005 increased $53.6 million, to $105.2 million, primarily due to an increase in interest rates.

The effective tax rate for 2005 was 26.3 percent, compared with 38.5 percent for 2004. The effective tax rate for 2005 was affected by the product liability charge of $1.07 billion. The tax benefit of this charge was less than our effective tax rate, as the tax benefit was calculated based upon existing tax laws in the countries in which we reasonably expect to deduct the charge. The effective tax rate for 2004 was affected by the tax provision related to the expected repatriation of $8.00 billion of earnings reinvested outside the U.S. pursuant to the AJCA and the charge for acquired IPR&D related to the AME acquisition, which is not deductible for tax purposes. See Note 11 to the consolidated financial statements for additional information.

OPERATING RESULTS—2004

Financial Results

We achieved worldwide sales growth of 10 percent, due in part to the launch during the year of five new products as well as six new indications or formulations for expanded use of new and existing products in key markets. We continued our substantial investments in our manufacturing operations and research and development activities, resulting in costs of products sold and research and development costs increasing at rates greater than sales. Despite significant product launch expenditures, our cost-containment and productivity measures resulted in marketing and administrative expenses increasing at a rate significantly less than sales. We also benefited from an increase in net other income in 2004. Net income was $1.81 billion, or $1.66 per share, in 2004, as compared with $2.56 billion, or $2.37 per share, in 2003, decreases of 29 and 30 percent, respectively.

Certain items, reflected in our operating results for 2004 and 2003, should be considered in comparing the two years. The significant items for 2004 are summarized in the Executive Overview. The 2003 items are summarized as follows (see Note 4 to the consolidated financial statements for additional information).

- We recognized asset impairments, primarily relating to manufacturing assets in the U.S., and streamlined our infrastructure, resulting in severance-related and other charges totaling $167.1 million (pretax) in the first quarter and $28.3 million (pretax) in the fourth quarter, which decreased earnings per share by approximately $.10 and $.02 in the first and fourth quarters of 2003, respectively (Note 4).
- Separately, we recognized asset impairments and other charges of $186.8 million (pretax) in the first quarter of 2003 related primarily to our common stock ownership and loan agreements with Isis Pharmaceuticals, Inc. (Isis), which decreased earnings per share by $.13 in that quarter (Note 4).
- In the fourth quarter of 2003, we recorded a gain of $65.0 million (pretax) related to the sale of patent rights to dapoxetine for development in the field of genitourinary disorders to PPD, Inc., which increased earnings per share by $.04 in that quarter.

Sales

Our worldwide sales for 2004 increased 10 percent, to $13.86 billion, due primarily to the increased global sales of Strattera, Gemzar, Forteo, Zyprexa, Evista, Humatrope, and Cialis, and sales related to the launches of Alimta and Cymbalta. Sales in the U.S. increased 6 percent, to $7.67 billion. Sales outside the U.S. increased 15 percent, to $6.19 billion. Worldwide sales reflected a volume increase of 5 percent, with global selling prices contributing 2 percent and an increase due to favorable changes in exchange rates contributing 3 percent.

Zyprexa sales in the U.S. decreased 8 percent in 2004 due to a decline in underlying demand from continued competitive pressures. Zyprexa sales outside the U.S. increased 22 percent, driven by volume growth in a number of major markets outside the U.S. International Zyprexa sales growth also benefited from the impact of foreign exchange rates.

Excluding the impact of exchange rates, sales of Zyprexa outside the U.S. increased 13 percent in 2004.

Diabetes care products had aggregate worldwide revenues of $2.61 billion in 2004, an increase of 2 percent. Diabetes care revenues in the U.S. decreased 6 percent, to $1.49 billion. Diabetes care revenues outside the U.S. increased 14 percent, to $1.12 billion. Humulin sales in the U.S. decreased 19 percent, driven primarily by volume declines due to competitive pressures. Humulin sales outside the U.S. increased 7 percent. Humalog sales in the U.S. increased 3 percent as increased prices offset slight volume declines. Humalog sales outside the U.S. increased 16 percent, to $416.2 million. Actos revenues increased 5 percent in 2004.

Sales of Gemzar increased 8 percent in the U.S. largely due to the May 2004 approval for the treatment of late-stage metastatic breast cancer. Gemzar sales increased 31 percent outside the U.S., driven by strong volume growth in a number of cancer indications as well as favorable foreign exchange rates.

Sales of Evista increased 1 percent in the U.S. due to continued competitive pressures. Outside the U.S., Evista maintained a strong growth rate of 32 percent, driven by volume growth in several markets and the early 2004 launch of the product in Japan.

In 2004, Strattera generated an 80 percent increase over 2003 sales despite a very competitive landscape. In December 2004, we added a bolded warning to the product label, which indicates that the medication should be discontinued in patients with jaundice (yellowing of the skin or whites of the eyes) or in the event of laboratory evidence of liver injury.

Forteo generated $238.6 million in sales in 2004, continuing the product's strong growth trajectory following its U.S. launch in December 2002 and European launches in late 2003 and during 2004.

The $552.3 million of worldwide Cialis sales in 2004, an increase of 172 percent compared to 2003, comprises $130.6 million of sales in our territories, which are reported in our net sales, and $421.7 million of sales in the joint-venture territories. Within the joint-venture territories, U.S. sales of Cialis were $206.6 million for 2004.

Animal health product sales in the U.S. increased 9 percent, while sales outside the U.S. increased 10 percent, led by Tylan®, Rumensin, and Paylean.

Gross Margin, Costs, and Expenses

The 2004 gross margin decreased to 76.7 percent of sales compared with 78.7 percent for 2003. The decrease was due primarily to continued investment in our manufacturing technical capabilities and capacity and the impact of foreign exchange rates, offset partially by favorable changes in product mix due to growth in sales of higher margin products.

Operating expenses increased 9 percent in 2004. Investment in research and development increased 15 percent, to $2.69 billion, due to increased clinical trial and development expenses and increased incentive

The following table summarizes our net sales activity in 2004 compared with 2003:

Product	Year Ended December 31, 2004 U.S.[1]	Outside U.S.	Total	Year Ended December 31, 2003 Total	Percent Change from 2003
(Dollars in millions)					
Zyprexa	$2,422.2	$1,997.6	$ 4,419.8	$ 4,276.9	3
Gemzar	565.1	649.3	1,214.4	1,021.7	19
Humalog	685.4	416.2	1,101.6	1,021.3	8
Evista	667.9	344.8	1,012.7	922.1	10
Humulin	422.7	575.0	997.7	1,060.4	(6)
Animal health products	338.9	459.8	798.7	726.6	10
Strattera	656.4	10.3	666.7	370.3	80
Fluoxetine products	327.3	231.7	559.0	645.1	(13)
Anti-infectives	110.2	367.8	478.0	489.9	(2)
Actos	340.4	112.5	452.9	431.2	5
Humatrope	204.8	225.5	430.3	370.9	16
ReoPro	175.4	187.4	362.8	364.4	0
Forteo	198.0	40.6	238.6	65.3	NM
Xigris	123.3	78.5	201.8	160.4	26
Alimta	121.8	20.8	142.6	—	NM
Cialis[2]	1.4	129.2	130.6	73.5	78
Cymbalta	92.7	1.2	93.9	—	NM
Symbyax	70.1	0.1	70.2	—	NM
Other pharmaceutical products	144.5	341.1	485.6	582.5	(17)
Total net sales	$7,668.5	$6,189.4	$13,857.9	$12,582.5	10

NM—Not meaningful

[1] U.S. sales include sales in Puerto Rico.

[2] Cialis had worldwide 2004 sales of $552.3 million, an increase of 172 percent compared with 2003. The sales shown in the tables above represent results in the territories in which we market Cialis exclusively. The remaining sales relate to the joint-venture territories of Lilly ICOS LLC (North America, excluding Puerto Rico, and Europe). Our share of the joint-venture territory sales, net of expenses, is reported in net other income in our consolidated income statement.

Consolidated Statements of Income

ELI LILLY AND COMPANY AND SUBSIDIARIES

(Dollars in millions, except per-share data) Year Ended December 31	2005	2004	2003
Net sales	**$14,645.3**	$13,857.9	$12,582.5
Cost of sales	**3,474.2**	3,223.9	2,675.1
Research and development	**3,025.5**	2,691.1	2,350.2
Marketing and administrative	**4,497.0**	4,284.2	4,055.4
Acquired in-process research and development (Note 3)	**—**	392.2	—
Asset impairments, restructuring, and other special charges (Note 4)	**1,245.3**	603.0	382.2
Interest expense	**105.2**	51.6	61.0
Other income—net	**(419.4)**	(330.0)	(203.1)
	11,927.8	10,916.0	9,320.8
Income before income taxes and cumulative effect of a change in accounting principle	**2,717.5**	2,941.9	3,261.7
Income taxes (Note 11)	**715.9**	1,131.8	700.9
Income before cumulative effect of a change in accounting principle	**2,001.6**	1,810.1	2,560.8
Cumulative effect of a change in accounting principle, net of tax (Note 2)	**(22.0)**	—	—
Net income	**$ 1,979.6**	$ 1,810.1	$ 2,560.8
Earnings per share—basic (Note 10)			
Income before cumulative effect of a change in accounting principle	**$1.84**	$1.67	$2.38
Cumulative effect of a change in accounting principle	**(0.02)**	—	—
Net income	**$1.82**	$1.67	$2.38
Earnings per share—diluted (Note 10)			
Income before cumulative effect of a change in accounting principle	**$1.83**	$1.66	$2.37
Cumulative effect of a change in accounting principle	**(0.02)**	—	—
Net income	**$1.81**	$1.66	$2.37

See notes to consolidated financial statements.

compensation and benefits expenses, partially offset by reimbursements for research activities from our collaboration partners. We reinvested more than 19 percent of our sales into research and development. Marketing and administrative expenses increased 6 percent in 2004, to $4.28 billion, attributable primarily to increased selling expenses in support of the new and anticipated product launches, the impact of foreign exchange rates, increased incentive compensation and benefits expenses, increased charitable contributions to the Lilly Foundation, and increased product liability expenses, offset partially by ongoing marketing cost-containment measures and marketing expense reimbursement from collaboration partners. A majority of the reimbursements are ongoing.

Net other income for 2004 increased $126.9 million to $330.0 million. The increase for 2004 was primarily due to income related to the outlicensing of legacy products outside the United States, milestone payments from collaborations on the duloxetine molecule, income related to a previously assigned patent arrangement of $30.0 million, and other miscellaneous income. This was offset partially by an increase in the net loss of the Lilly ICOS LLC joint venture, due primarily to increased marketing costs of Cialis in joint-venture territories, and the 2003 sale of dapoxetine patent rights. For 2004, our net loss from the joint venture was $79.0 million, compared with $52.4 million in 2003.

The effective tax rate for 2004 was 38.5 percent, compared with 21.5 percent for 2003. The increase in the effective tax rate was caused by the tax provision related to the expected repatriation of $8.00 billion of earnings reinvested outside the U.S. pursuant to the AJCA and the charge for acquired IPR&D related to the AME acquisition, which is not deductible for tax purposes. See Note 11 to the consolidated financial statements for additional information.

FINANCIAL CONDITION

As of December 31, 2005, cash, cash equivalents, and short-term investments totaled $5.04 billion compared with $7.46 billion at December 31, 2004. Cash flow from operations of $1.91 billion and net issuances of long-term debt of $2.00 billion were more than offset by net repayments of short-term debt of $1.99 billion, dividends paid of $1.65 billion, capital expenditures of $1.30 billion, net purchases of noncurrent investments of $638.0 million, and repurchases of common stock of $377.9 million.

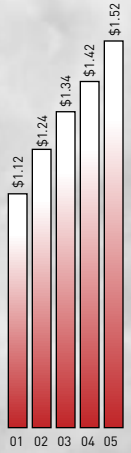
Capital expenditures of $1.30 billion during 2005 were $600.0 million less than in 2004, due primarily to the management of capital spending and completion of key projects. We expect near-term capital expenditures to remain approximately the same as 2005 levels while we continue to invest in the long-term growth of our diabetes care and other products, as well as research and development activities.

Total debt at December 31, 2005, was $6.50 billion, essentially unchanged compared to December 31, 2004. Our current debt ratings from Standard & Poor's and Moody's remain at AA and Aa3, respectively.

Dividends of $1.52 per share were paid in 2005, an increase of 7 percent from 2004. In the fourth quarter of 2005, effective for the first-quarter dividend in 2006, the quarterly dividend was increased to $.40 per share (a 5 percent increase), resulting in an indicated annual rate for 2006 of $1.60 per share. The year 2005 was the 121st consecutive year in which we made dividend payments and the 38th consecutive year in which dividends have been increased.

DIVIDENDS PAID PER SHARE
(dollars)

Dividends paid during 2005 increased to $1.52 per share. This constitutes the 38th consecutive increase in annual dividends. We continued this tradition into 2006 by declaring a first-quarter 2006 dividend of $.40 per share, a 5 percent increase over first-quarter 2005. This record clearly reflects our continued commitment to delivering outstanding shareholder value.



On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (AJCA), which created a temporary incentive for U.S. corporations to repatriate undistributed income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. We planned to repatriate $8.00 billion in incentive dividends, as defined in the AJCA, during 2005 and accordingly, we recorded a related tax liability of $465.0 million as of December 31, 2004. During 2005, we repatriated all $8.00 billion of eligible incentive dividends. The proceeds from the incentive dividends have been or will be used for research and development activities, capital asset expenditures, and other permitted activities.

We believe that cash generated from operations, along with available cash and cash equivalents, will be sufficient to fund our operating needs, including debt service, capital expenditures, dividends, and taxes in 2006. We believe that amounts available through our existing commercial paper program should be adequate to fund maturities of short-term borrowings, if necessary. Our commercial paper program is also currently backed by $1.23 billion of unused committed bank credit facilities. We currently expect to repay approximately $1.5 billion of debt by the end of 2006, using available cash. Various risks and uncertainties, including those discussed in the Financial Expectations for 2006 section, may affect our operating results and cash generated from operations.

In the normal course of business, our operations are

Consolidated Balance Sheets

ELI LILLY AND COMPANY AND SUBSIDIARIES
(Dollars in millions)

December 31	2005	2004
Assets		
Current Assets		
Cash and cash equivalents	**$ 3,006.7**	$ 5,365.3
Short-term investments	**2,031.0**	2,099.1
Accounts receivable, net of allowances of $66.3 (2005) and $66.1 (2004)	**2,313.3**	2,058.7
Other receivables	**448.4**	494.3
Inventories	**1,878.0**	2,291.6
Deferred income taxes (Note 11)	**756.4**	255.3
Prepaid expenses	**362.0**	271.5
Total current assets	**10,795.8**	12,835.8
Other Assets		
Prepaid pension (Note 12)	**2,419.6**	2,253.8
Investments (Note 5)	**1,296.6**	561.4
Sundry (Note 8)	**2,156.3**	1,665.1
	5,872.5	4,480.3
Property and Equipment, net	**7,912.5**	7,550.9
	$24,580.8	$24,867.0
Liabilities and Shareholders' Equity		
Current Liabilities		
Short-term borrowings and current maturities of long-term debt (Note 6)	**$ 734.7**	$ 2,020.6
Accounts payable	**781.3**	648.6
Employee compensation	**548.8**	471.6
Sales rebates and discounts	**491.2**	475.3
Dividends payable	**436.5**	414.4
Income taxes payable (Note 11)	**884.9**	1,703.9
Other current liabilities (Note 8)	**1,838.9**	1,859.3
Total current liabilities	**5,716.3**	7,593.7
Other Liabilities		
Long-term debt (Note 6)	**5,763.5**	4,491.9
Deferred income taxes (Note 11)	**695.1**	620.4
Other noncurrent liabilities (Note 8)	**1,614.0**	1,241.1
	8,072.6	6,353.4
Commitments and contingencies (Note 13)		
Shareholders' Equity (Notes 7 and 9)		
Common stock—no par value		
Authorized shares: 3,200,000,000		
Issued shares: 1,131,070,629 (2005) and 1,132,884,801 (2004)	**706.9**	708.0
Additional paid-in capital	**3,323.8**	3,119.4
Retained earnings	**10,027.2**	9,724.6
Employee benefit trust	**(2,635.0)**	(2,635.0)
Deferred costs—ESOP	**(106.3)**	(111.9)
Accumulated other comprehensive income (loss) (Note 14)	**(420.6)**	218.6
	10,896.0	11,023.7
Less cost of common stock in treasury		
2005—933,584 shares		
2004—942,677 shares	**104.1**	103.8
	10,791.9	10,919.9
	$24,580.8	$24,867.0

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

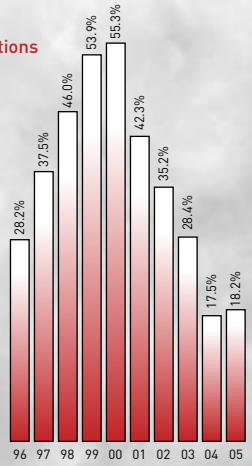
ELI LILLY AND COMPANY AND SUBSIDIARIES

(Dollars in millions) Year Ended December 31	2005	2004	2003
Cash Flows From Operating Activities			
Net income	**$ 1,979.6**	$ 1,810.1	$ 2,560.8
Adjustments To Reconcile Net Income To Cash Flows From Operating Activities			
Depreciation and amortization	**726.4**	597.5	548.5
Change in deferred taxes	**(347.5)**	772.4	130.9
Stock-based compensation expense	**403.5**	53.0	—
Acquired in-process research and development, net of tax	—	381.7	—
Asset impairments, restructuring, and other special charges, net of tax	**1,128.7**	374.3	261.7
Other, net	**(30.0)**	171.5	61.0
	3,860.7	4,160.5	3,562.9
Changes in operating assets and liabilities			
Receivables—increase	**(286.4)**	(240.8)	(195.1)
Inventories—(increase) decrease	**72.1**	(111.6)	(170.8)
Other assets—increase	**(269.4)**	(765.2)	(211.9)
Accounts payable and other liabilities—increase (decrease)	**(1,463.4)**	(173.4)	661.6
	(1,947.1)	(1,291.0)	83.8
Net Cash Provided by Operating Activities	**1,913.6**	2,869.5	3,646.7
Cash Flows From Investing Activities			
Purchase of property and equipment	**(1,298.1)**	(1,898.1)	(1,706.6)
Disposals of property and equipment	**11.1**	20.5	61.2
Net change in short-term investments	**62.7**	(1,119.0)	774.0
Proceeds from sales and maturities of noncurrent investments	**545.1**	14,849.3	6,762.4
Purchase of noncurrent investments	**(1,183.1)**	(11,967.7)	(7,005.3)
Purchase of in-process research and development	—	(29.9)	—
Cash paid for acquisition of Applied Molecular Evolution, net of cash acquired	—	(71.7)	—
Other, net	**(353.6)**	(468.2)	(217.2)
Net Cash Used in Investing Activities	**(2,215.9)**	(684.8)	(1,331.5)
Cash Flows From Financing Activities			
Dividends paid	**(1,654.9)**	(1,539.8)	(1,443.0)
Purchase of common stock	**(377.9)**	—	(276.8)
Issuances of common stock under stock plans	**105.9**	117.9	99.3
Net change in short-term borrowings	**(1,988.7)**	1,478.2	(247.3)
Proceeds from issuance of long-term debt	**3,000.0**	1,000.0	830.0
Repayments of long-term debt	**(1,004.7)**	(839.2)	(540.0)
Other, net	**39.8**	(13.4)	(.5)
Net Cash (Used for) Provided by Financing Activities	**(1,880.5)**	203.7	(1,578.3)
Effect of exchange rate changes on cash	**(175.8)**	220.6	73.5
Net (decrease) increase in cash and cash equivalents	**(2,358.6)**	2,609.0	810.4
Cash and cash equivalents at beginning of year	**5,365.3**	2,756.3	1,945.9
Cash and cash equivalents at end of year	**$ 3,006.7**	$ 5,365.3	$ 2,756.3

See notes to consolidated financial statements.

RETURN ON SHAREHOLDERS' EQUITY
(based on income from continuing operations divided by average shareholders' equity)

Return on shareholders' equity (ROE) increased in 2005 to 18.2 percent. ROE was negatively affected by charges associated with the Zyprexa settlement and restructuring charges in 2005, and additional tax expense associated with anticipated repatriation of earnings as the result of the American Jobs Creation Act, as well as charges related to acquired in-process research and development restructuring activities in 2004.



exposed to fluctuations in interest rates and currency values. These fluctuations can vary the costs of financing, investing, and operating. We address a portion of these risks through a controlled program of risk management that includes the use of derivative financial instruments. The objective of controlling these risks is to limit the impact on earnings of fluctuations in interest and currency exchange rates. All derivative activities are for purposes other than trading.

Our primary interest rate risk exposure results from changes in short-term U.S. dollar interest rates. In an effort to manage interest rate exposures, we strive to achieve an acceptable balance between fixed and floating rate debt positions and may enter into interest rate derivatives to help maintain that balance. Based on our overall interest rate exposure at December 31, 2005 and 2004, including derivatives and other interest rate risk-sensitive instruments, a hypothetical 10 percent change in interest rates applied to the fair value of the instruments as of December 31, 2005 and 2004, respectively, would have no material impact on earnings, cash flows, or fair values of interest rate risk-sensitive instruments over a one-year period.

Our foreign currency risk exposure results from fluctuating currency exchange rates, primarily the U.S. dollar against the euro and the Japanese yen. We face transactional currency exposures that arise when we enter into transactions, generally on an intercompany basis, denominated in currencies other than the local currency. We also face currency exposure that arises from translating the results of our global operations to the U.S. dollar at exchange rates that have fluctuated from the beginning of the period. We use forward contracts and purchased options to manage our foreign currency exposures. Our policy outlines the minimum and maximum hedge coverage of such exposures. Gains and losses on these derivative positions offset, in part, the impact of currency fluctuations on the existing assets, liabilities, commitments, and anticipated revenues. Considering our derivative financial instruments outstanding at December 31, 2005 and 2004, a hypothetical 10 percent change in exchange rates (primarily against the U.S. dollar) as of December 31, 2005 and 2004, respectively, would have no material impact on earnings, cash flows, or fair values of foreign currency rate risk-sensitive instruments over a one-year period. These calculations do not reflect the impact of the exchange gains or losses on the underlying positions that would be offset, in part, by the results of the derivative instruments.

Off-Balance Sheet Arrangements and Contractual Obligations

We have no off-balance sheet arrangements that have a material current effect or that are reasonably likely to

Our current noncancelable contractual obligations that will require future cash payments are as follows (in millions):

	Payments Due by Period				
	Total	Less Than 1 Year	1–3 Years	3–5 Years	More Than 5 Years
Long-term debt, including interest payments[1]	$12,024.1	$ 983.3	$3,893.8	$187.6	$6,959.4
Capital lease obligations	177.1	21.0	36.5	31.4	88.2
Operating leases	335.5	86.5	130.2	84.5	34.3
Purchase obligations[2]	2,388.5	2,299.5	58.1	28.5	2.4
Other long-term liabilities reflected on our balance sheet[3]	599.7	—	90.6	90.6	418.5
Other[4]	73.1	73.1	—	—	—
Total	$15,598.0	$3,463.4	$4,209.2	$422.6	$7,502.8

[1] Our long-term debt obligations include both our expected principal and interest obligations and our interest rate swaps. We used the interest rate forward curve at December 31, 2005 to compute the amount of the contractual obligation for interest on the variable rate debt instruments and swaps.
[2] We have included the following:
- Purchase obligations, consisting primarily of all open purchase orders at our significant operating locations as of December 31, 2005. Some of these purchase orders may be cancelable; however, for purposes of this disclosure, we have not distinguished between cancelable and noncancelable purchase obligations.
- Contractual payment obligations with each of our significant vendors, which are noncancelable and are not contingent.

[3] We have included our long-term liabilities consisting primarily of our nonqualified supplemental pension funding requirements and deferred compensation liabilities.
[4] This category comprises primarily minimum pension funding requirements.

have a material future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources. We acquire assets still in development and enter into research and development arrangements with third parties that often require milestone and royalty payments to the third party contingent upon the occurrence of certain future events linked to the success of the asset in development. Milestone payments may be required contingent upon the successful achievement of an important point in the development life cycle of the pharmaceutical product (e.g., approval of the product for marketing by the appropriate regulatory agency). If required by the arrangement, we may have to make royalty payments based upon a percentage of the sales of the pharmaceutical product in the event that regulatory approval for marketing is obtained. Because of the contingent nature of these payments, they are not included in the table of contractual obligations.

These arrangements are not material individually. However, if milestones for multiple products covered by these arrangements would happen to be reached in the same year, the aggregate charge to expense could be material to the results of operations in any one period. The inherent risk in pharmaceutical development makes it unlikely that this will occur, as the failure rate for products in development is very high. In addition, these arrangements often give us the discretion to unilaterally terminate development of the product, which would allow us to avoid making the contingent payments; however, we are unlikely to cease development if the compound successfully achieves clinical testing objectives. We also note that, from a business perspective, we view these payments as positive because they signify that the product is successfully moving through development and is now generating or is more likely to generate cash flows from sales of products.

The contractual obligations table is current as of December 31, 2005. The amount of these obligations can be expected to change materially over time as new contracts are initiated and existing contracts are completed, terminated, or modified.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

In preparing our financial statements in accordance with generally accepted accounting principles (GAAP), we must often make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and related disclosures. Some of those judgments can be subjective and complex, and consequently actual results could differ from those estimates. For any given individual estimate or assumption we make, it is possible that other people applying reasonable judgment to the same facts and circumstances could develop different estimates. We believe that, given current facts and circumstances, it is unlikely that applying any such other reasonable judgment would cause a material adverse effect on our consolidated results of operations, financial position, or liquidity for the periods presented in this report. Our most critical accounting policies have been discussed with our audit committee and are described below.

Revenue Recognition and Sales Rebate and Discount Accruals

We recognize revenue from sales of products at the time title of goods passes to the buyer and the buyer assumes the risks and rewards of ownership. This is generally at the time products are shipped to the customer, typically a wholesale distributor or a major retail chain. Provisions for discounts and rebates to customers are established in the same period the related sales are recorded.

We regularly review the supply levels of our significant products sold to major wholesalers in the U.S. and in major markets outside the U.S., primarily by reviewing periodic inventory reports supplied by our major wholesalers and available prescription volume information for our products, or alternative approaches. We attempt to maintain wholesaler inventory levels at an average of approximately one month or less on a consistent basis across our product portfolio. We are generally able to determine when significant wholesaler stocking or destocking has occurred during a particular period, but we are not always able to accurately quantify the amount of stocking or destocking. Causes of unusual buying patterns include actual or anticipated product supply issues, weather patterns, anticipated changes in the transportation network, redundant holiday stocking, and changes in wholesaler business operations. An unusual buying pattern compared with underlying demand of our products outside the U.S. could also be the result of speculative buying by wholesalers in anticipation of price increases. When we believe wholesaler purchasing patterns have caused an unusual increase or decrease in the sales of a major product compared with underlying demand, we disclose this in our product sales discussion if the amount is believed to be material to the product sales trend.

As a result of restructuring our arrangements with our U.S. wholesalers in early 2005, reductions occurred in wholesaler inventory levels for certain products (primarily Strattera, Prozac, and Gemzar) that reduced our sales by approximately $170 million. The new structure eliminates the incentive for speculative wholesaler buying we have seen in the past and provides us improved data on inventory levels at our U.S. wholesalers. Wholesaler stocking and destocking activity historically has not caused any material changes in the rate of actual product returns, which have been approximately 1 percent or less of our net sales over the past three years and have not fluctuated significantly as a percent of sales.

We establish sales rebate and discount accruals in the same period as the related sales. The rebate/discount amounts are recorded as a deduction to arrive at our net sales. Sales rebates/discounts that require the use of judgment in the establishment of the accrual include Medicaid,

managed care, chargebacks, long-term-care, hospital, discount card programs, and various other government programs. We base these accruals primarily upon our historical rebate/discount payments made to our customer segment groups and the provisions of current rebate/discount contracts. We calculate these rebates/discounts based upon a percentage of our sales for each of our products as defined by the statutory rates and the contracts with our various customer groups.

The largest of our sales rebate/discount amounts are rebates associated with sales covered by Medicaid. Although we accrue a liability for Medicaid rebates at the time we record the sale (when the product is shipped), the Medicaid rebate related to that sale is typically billed up to six months later. Due to the time lag, in any particular period our rebate adjustments may incorporate revisions of accruals for several periods. In determining the appropriate accrual amount, we consider our historical Medicaid rebate payments by product as a percentage of our historical sales as well as any significant changes in sales trends, an evaluation of the current Medicaid rebate laws and interpretations, the percentage of our products that are sold to Medicaid recipients, and our product pricing and current rebate/discount contracts.

Most of our rebates outside the U.S. are contractual or legislatively mandated and are estimated and recognized in the same period as the related sales. In some large European countries, government rebates are based on the anticipated pharmaceutical budget deficit in the country. A best estimate of these rebates, updated as governmental authorities revise budgeted deficits, is recognized in the same period as the related sale. If our estimates are not reflective of the actual pharmaceutical budget deficit, we adjust our rebate reserves.

We believe that our accruals for sales rebates and discounts are reasonable and appropriate based on current facts and circumstances. Federally mandated Medicaid rebate and state pharmaceutical assistance programs reduced sales by $626.6 million, $641.0 million, and $567.6 million in 2005, 2004, and 2003, respectively. A 5 percent change in the Medicaid rebate expense we recognized in 2005 would lead to an approximate $31 million effect on our income before income taxes and cumulative effect of change in accounting principle. As of December 31, 2005, our Medicaid rebate liability was $272.5 million.

Approximately 90 percent and 86 percent of our global rebate and discount liability results from sales of our products in the U.S. as of December 31, 2005 and 2004, respectively. The following represents a roll-forward of our most significant U.S. rebate and discount liability balances, including Medicaid (in millions):

	2005	2004
Rebate and discount liability, beginning of year	**$ 367.9**	$ 398.0
Reduction of net sales due to discounts and rebates[1]	**1,289.6**	1,157.0
Cash payments of discounts and rebates	**(1,288.6)**	(1,187.1)
Rebate and discount liability, end of year	**$ 368.9**	$ 367.9

[1] Adjustments of the estimates for these rebates and discounts to actual results were less than 0.3 percent of net sales for each of the years presented.

Product Litigation Liabilities and Other Contingencies

Product litigation liabilities and other contingencies are, by their nature, uncertain and are based upon complex judgments and probabilities. The factors we consider in developing our product litigation liability reserves and other contingent liability amounts include the merits and jurisdiction of the litigation, the nature and the number of other similar current and past litigation cases, the nature of the product and the current assessment of the science subject to the litigation, and the likelihood of settlement and current state of settlement discussions, if any. In addition, we have accrued for certain product liability claims incurred, but not filed, to the extent we can formulate a reasonable estimate of their costs. We estimate these expenses based primarily on historical claims experience and data regarding product usage. We accrue legal defense costs expected to be incurred in connection with significant product liability contingencies when probable and reasonably estimable.

We also consider the insurance coverage we have to diminish the exposure. In assessing our insurance coverage, we consider the policy coverage limits and exclusions, the potential for denial of coverage by the insurance company, the financial position of the insurers, and the possibility of and the length of time for collection.

We believe that the accruals and related insurance recoveries we have established for product litigation liabilities and other contingencies are appropriate based on current facts and circumstances.

Pension and Retiree Medical Plan Assumptions

Pension benefit costs include assumptions for the discount rate, retirement age, and expected return on plan assets. Retiree medical plan costs include assumptions for the discount rate, retirement age, expected return on plan assets, and health-care-cost trend rates. These assumptions have a significant effect on the amounts reported. In addition to the analysis below, see Note 12

to the consolidated financial statements for additional information regarding our retirement benefits.

Periodically, we evaluate the discount rate and the expected return on plan assets in our defined benefit pension and retiree health benefit plans. In evaluating these assumptions, we consider many factors, including an evaluation of the discount rates, expected return on plan assets and the health-care-cost trend rates of other companies; our historical assumptions compared with actual results; an analysis of current market conditions and asset allocations (approximately 85 percent to 95 percent of which are growth investments); and the views of leading financial advisers and economists. We use an actuarially-determined, company-specific yield curve for purposes of determination of the discount rate. In evaluating our expected retirement age assumption, we consider the retirement ages of our past employees eligible for pension and medical benefits together with our expectations of future retirement ages.

We believe our pension and retiree medical plan assumptions are appropriate based upon the above factors. If the health-care-cost trend rates were to be increased by one percentage point each future year, the aggregate of the service cost and interest cost components of the 2005 annual expense would increase by approximately $26 million. A one-percentage-point decrease would decrease the aggregate of the 2005 service cost and interest cost by approximately $22 million. If the discount rate for 2005 were to be changed by a quarter percentage point, income before income taxes and cumulative effect of change in accounting principle would change by approximately $27 million. If the expected return on plan assets for 2005 were to be changed by a quarter percentage point, income before income taxes and cumulative effect of change in accounting principle would change by approximately $13 million. If our assumption regarding the expected age of future retirees for 2005 were adjusted by one year, our income before income taxes and cumulative effect of change in accounting principle would be affected by approximately $22 million.

Income Taxes

We prepare and file tax returns based on our interpretation of tax laws and regulations and record estimates based on these judgments and interpretations. In the normal course of business, our tax returns are subject to examination by various taxing authorities, which may result in future tax and interest assessments by these authorities. Inherent uncertainties exist in estimates of tax contingencies due to changes in tax law resulting from legislation, regulation and/or as concluded through the various jurisdictions' tax court systems. We record a liability for tax contingencies when we believe it is probable that we will be assessed and the amount of the contingency can be reasonably estimated. The tax contingency reserve is adjusted for changes in facts and circumstances, and additional uncertainties. For example, adjustments could result from significant amendments to existing tax law and the issuance of regulations or interpretations by the taxing authorities, new information obtained during a tax examination, or resolution of an examination. We believe that our estimates for tax contingency reserves are appropriate and sufficient to pay assessments that may result from examinations of our tax returns.

We have recorded valuation allowances against certain of our deferred tax assets, primarily those that have been generated from net operating losses in certain taxing jurisdictions. In evaluating whether we would more likely than not recover these deferred tax assets, we have not assumed any future taxable income or tax planning strategies in the jurisdictions associated with these carryforwards where history does not support such an assumption. Implementation of tax planning strategies to recover these deferred tax assets or future income generation in these jurisdictions could lead to the reversal of these valuation allowances and a reduction of income tax expense.

We believe that our estimates for the valuation allowances reserved against the deferred tax assets are appropriate based on current facts and circumstances. A 5 percent change in the valuation allowance would result in a change in net income of approximately $23 million.

FINANCIAL EXPECTATIONS FOR 2006

For the full year of 2006, we expect earnings per share to be in the range of $3.10 to $3.20. We expect sales to grow 7 to 9 percent and gross margins as a percent of sales to improve modestly compared with 2005. In addition, we expect operating expenses to grow in the mid-single digits in the aggregate, with marketing and administrative expenses accelerating while research and development expense growth moderates somewhat. However, we will continue to be among the industry leaders in terms of research and development investment as a percent of sales. We also expect other income, net of interest expense, to contribute approximately $175 million to $275 million; this ongoing net contribution is expected to be driven primarily by net interest income, Lilly ICOS joint venture after-tax profit, and partnering and out-licensing of molecules. We also anticipate the effective tax rate to be approximately 21 percent.

Actual results could differ materially and will depend on, among other things, the continuing growth of our currently marketed products; developments with competitive products; the timing and scope of regulatory approvals and the success of our new product launches; asset impairments, restructurings, and acquisitions of compounds under development resulting in acquired in-process research and development charges; foreign exchange rates; wholesaler inventory changes; other regulatory developments, litigation, and government investigations; the outcome of the Zyprexa patent appeal; and the impact of governmental actions regarding pricing, importation, and reimbursement for pharmaceuticals. We undertake no duty to update these forward-looking statements.

LEGAL AND REGULATORY MATTERS

Three generic pharmaceutical manufacturers, Zenith Goldline Pharmaceuticals, Inc. (Zenith), Dr. Reddy's Laboratories, Ltd. (Reddy), and Teva Pharmaceuticals (Teva), submitted abbreviated new drug applications (ANDAs) seeking permission to market generic versions of Zyprexa in various dosage forms several years prior to the expiration of our U.S. patents for the product. The generic companies alleged that our patents are invalid, unenforceable, or not infringed. We filed suit against the three companies in the U.S. District Court for the Southern District of Indiana, seeking a ruling that the challenges to our compound patent (expiring in 2011) are without merit. The cases were consolidated, and on April 14, 2005, the district court upheld our 2011 U.S. patent on Zyprexa. In the case of Eli Lilly and Company v. Zenith Goldline Pharmaceuticals et al., the court ruled in our favor on all counts, including the patent doctrines of obviousness, double patenting, inequitable conduct, novelty, and public use. The decision has been appealed. We are confident, and the trial court confirmed, that the generic manufacturers' claims are without merit, and we expect to prevail in this litigation. However, it is not possible to predict or determine the outcome of this litigation and, accordingly, we can provide no assurance that we will prevail on appeal. An unfavorable outcome would have a material adverse impact on our consolidated results of operations, liquidity, and financial position.

In 2002, Barr Laboratories, Inc. (Barr), submitted an ANDA with the FDA seeking permission to market a generic version of Evista (raloxifene) several years prior to the expiration of our U.S. patents covering the product, alleging that the patents are invalid or not infringed. In November 2002, we filed suit against Barr in the U.S. District Court for the Southern District of Indiana, seeking a ruling that Barr's challenges to our patents claiming the methods of use and pharmaceutical form (expiring from 2012 to 2017) are without merit. Barr has also asserted that the method of use patents are unenforceable. The U.S. Patent and Trademark Office issued to us two new patents (expiring in 2017) directed to pharmaceutical compositions containing raloxifene and a method for preventing postmenopausal osteoporosis and a third (expiring in 2012) directed to methods of inhibiting postmenopausal bone loss by administering a single daily oral dose of raloxifene. These patents have been listed in the FDA's *Orange Book*. Barr has challenged these patents, alleging that each is invalid, unenforceable, or will not be infringed. These patents have been added to the pending suit. The suit is in discovery. No trial date has been set at this time. While we believe that Barr's claims are without merit and we expect to prevail, it is not possible to predict or determine the outcome of the litigation. Therefore, 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.

In January 2006, we were notified that Sicor Pharmaceuticals, Inc. (Sicor), a subsidiary of Teva, submitted an ANDA with the FDA seeking permission to market a generic version of Gemzar several years prior to the expiration of two U.S. patents covering the product. Sicor alleged that both U.S. patents are invalid. In February, we filed suit against Sicor in the U.S. District Court for the Southern District of Indiana, seeking a ruling that Sicor's challenges to our patents claiming the compound (expiring in 2010) and the methods of use (expiring in 2012) are without merit. While we believe that Sicor's claims are without merit and we expect to prevail, it is not possible to predict or determine the outcome of the litigation. Therefore, we can provide no assurance that we will prevail. An unfavorable outcome could have a material adverse impact on our consolidated results of operations.

In July 2002, we received the first of several grand jury subpoenas for documents from the Office of Consumer Litigation, U.S. Department of Justice, related to our marketing and promotional practices and physician communications with respect to Evista. We reached a settlement with the U.S. Department of Justice in the fourth quarter of 2005, which was subsequently approved by the U.S. District Court for the Southern District of Indiana in February 2006. As part of the settlement, Lilly pleaded guilty to one misdemeanor violation of the Food, Drug, and Cosmetic Act. The plea is for the off-label promotion of Evista during 1998. The government did not, however, charge the company with any unlawful intent, nor do we acknowledge any such intent. In connection with the overall settlement, we have agreed to pay a total of $36 million. As previously reported, Lilly took a charge in the fourth quarter of 2004 in connection with this investigation. The 2004 charge was sufficient to cover this settlement payment; consequently, no further charge will be necessary.

In March 2004, the office of the U.S. Attorney for the Eastern District of Pennsylvania advised us that it has commenced a civil 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 October 2005, the U.S. Attorney's office 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 Lilly's Medicaid best price reporting related to the product sales covered by the rebate agreements. We are cooperating with the U.S. Attorney in these investigations, including providing a broad range of documents and information relating to the investigations. 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. 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 predict or 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 could have a material adverse impact on our consolidated results of operations, liquidity, and financial position. We have implemented and continue to review and enhance a broadly based compliance program that includes comprehensive compliance-related activities designed to ensure that our marketing and promotional practices, physician communications, remuneration of health care professionals, managed care arrangements, and Medicaid best price reporting comply with applicable laws and regulations.

We have been named as a defendant in a large number of Zyprexa product liability lawsuits in the United States and have been notified of several thousand claims of individuals who have not filed suit. The lawsuits and unfiled claims (together the "claims") allege a variety of injuries from the use of Zyprexa, with the majority alleging that the product caused or contributed to diabetes or high blood-glucose levels. The claims seek substantial compensatory and punitive damages and typically accuse us of inadequately testing for and warning about side effects of Zyprexa. Many of the claims also allege that we improperly promoted the drug. Almost all of the federal lawsuits are part of a Multi-District Litigation (MDL) proceeding before The Honorable Jack Weinstein in the Federal District Court for the Eastern District of New York (MDL No. 1596). The MDL includes three lawsuits requesting certification of class actions on behalf of those who allegedly suffered injuries from the administration of Zyprexa. We have entered into agreements with various plaintiffs' counsel halting the running of the statutes of limitation (tolling agreements) with respect to a large number of claimants who do not have lawsuits on file.

In June 2005, we entered into an agreement in principle (followed by a definitive master settlement agreement in September 2005) with a group of plaintiffs' attorneys involved in U.S. Zyprexa product liability litigation to settle a majority of the claims. The agreement covers more than 8,000 claimants, including a large number of previously filed lawsuits (including the three purported class actions), tolled claims, and other informally asserted claims. We established a fund of $690 million for the claimants to settle their claims, and $10 million to cover administration of the settlement. The settlement fund is being overseen and distributed by claims administrators appointed by the court. The agreement and the distribution of funds to participating claimants are conditioned upon, among other things, our obtaining full releases from no fewer than 7,193 claimants.

Following this settlement, the remaining U.S. Zyprexa product liability claims include approximately 150 lawsuits in the U.S. covering 465 claimants, and approximately 825 tolled claims. In addition, we have been informally advised of a number of additional potential U.S. claims, but to date have received no substantiation of the claims. Also, in early 2005, we were served with five lawsuits seeking class action status in Canada on behalf of patients who took Zyprexa. The allegations in the Canadian actions are similar to those in the litigation pending in the United States. We are prepared to continue our vigorous defense of Zyprexa in all remaining cases.

In 2005, two lawsuits were filed in the Eastern District of New York purporting to be nationwide class actions on behalf of all consumers and third party payors, excluding governmental entities, which have made or will make payments on account of their members or insured patients being prescribed Zyprexa. These actions have now been consolidated into a single lawsuit, which is brought under certain state consumer protection statutes, the federal civil RICO statute, and common law theories, seeking a refund of the cost of Zyprexa, treble damages, punitive damages, and attorneys' fees. In addition, in 2006 a similar lawsuit was filed in the Eastern District of New York on similar grounds. As with the product liability suits, these lawsuits allege that we inadequately tested for and warned about side effects of Zyprexa and improperly promoted the drug.

In December 2004, we were served with two lawsuits brought in state court in Louisiana on behalf of the Louisiana Department of Health and Hospitals, alleging that Zyprexa caused or contributed to diabetes or high blood-glucose levels, and that we improperly promoted the drug. These cases have been removed to federal court and are now part of the MDL proceedings in the Eastern District of New York. In these actions, the Department of Health and Hospitals seeks to recover the costs it paid for Zyprexa through Medicaid and other drug-benefit programs, as well as the costs the department alleges it has incurred and will incur to treat Zyprexa-related illnesses.

In connection with the Zyprexa product liability claims, certain of our insurance carriers have raised defenses to their liability under the policies and to date have failed to reimburse us for claim-related costs despite demand from the first-layer carriers for payment. However, in our opinion, the defenses identified to date appear to lack substance. In March 2005, we filed suit against several of the carriers in state court in Indiana to obtain reimbursement of costs related to the Zyprexa product liability litigation. The matter has been removed to the federal court in Indianapolis. Several carriers have asserted defenses to their liability, and some carriers are seeking rescission of the coverage. While we believe our position is meritorious, there can be no assurance that we will prevail.

In addition, we have been named as a defendant in numerous other product liability lawsuits involving primarily diethylstilbestrol (DES) and thimerosal.

With respect to the product liability claims currently asserted against us, we have accrued for our

estimated exposures to the extent they are both probable and estimable based on the information available to us. In addition, we have accrued for certain product liability claims incurred but not filed to the extent we can formulate a reasonable estimate of their costs. We estimate these expenses based primarily on historical claims experience and data regarding product usage. Legal defense costs expected to be incurred in connection with significant product liability loss contingencies are accrued when probable and reasonably estimable. A portion of the costs associated with defending and disposing of these suits is covered by insurance. We record receivables for insurance-related recoveries when it is probable they will be realized. These receivables are classified as a reduction of the litigation charges on the statement of income. We estimate insurance recoverables based on existing deductibles, coverage limits, our assessment of any defenses to coverage that might be raised by the carriers, and the existing and projected future level of insolvencies among the insurance carriers.

In the second quarter of 2005, we recorded a net pre-tax charge of $1.07 billion for product liability matters, which includes the following:

- The $700 million Zyprexa settlement and administration fee;
- Reserves for product liability exposures and defense costs regarding currently known and expected claims to the extent we can formulate a reasonable estimate of the probable number and cost of the claims. A substantial majority of these exposures and costs relate to current and expected Zyprexa claims not included in the settlement. We have estimated these charges based primarily on historical claims experience, data regarding product usage, and our historical product liability defense cost experience.

The $1.07 billion net charge took into account our estimated recoveries from our insurance coverage related to these matters. The after-tax impact of this net charge was $.90 per share. The $700 million for the Zyprexa settlement was paid during 2005, while the cash related to the other reserves for product liability exposures and defense costs is expected to be paid out over the next several years. The timing of our insurance recoveries is uncertain.

We cannot predict with certainty the additional number of lawsuits and claims that may be asserted. In addition, although we believe it is probable, there can be no assurance that the Zyprexa settlement described above will be concluded. The ultimate resolution of Zyprexa product liability and related litigation could have a material adverse impact on our consolidated results of operations, liquidity, and financial position.

We are subject to a substantial number of product liability claims, and because of the nature of pharmaceutical products, it is possible that we could become subject to large numbers of product liability claims for other products in the future. We have experienced difficulties in obtaining product liability insurance due to a very restrictive insurance market, and therefore will be largely self-insured for future product liability losses. In addition, there is no assurance that we will be able to fully collect from our insurance carriers on past claims.

While it is not possible to predict or determine the outcome of the patent, product liability, or other legal actions brought against us, we believe that, except as noted above, 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 the consolidated results of operations in any one accounting period.

PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995—A CAUTION CONCERNING FORWARD-LOOKING STATEMENTS

Under the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, we caution investors that any forward-looking statements or projections made by us, including those made in this document, are based on management's expectations at the time they are made, but they are subject to risks and uncertainties that may cause actual results to differ materially from those projected. Economic, competitive, governmental, technological, legal, and other factors that may affect our operations and prospects are discussed earlier in this section and our most recent report on Forms 10-Q and 10-K filed with the Securities and Exchange Commission. We undertake no duty to update forward-looking statements.

Consolidated Statements of Comprehensive Income

ELI LILLY AND COMPANY AND SUBSIDIARIES

(Dollars in millions) Year Ended December 31	2005	2004	2003
Net income	**$1,979.6**	$1,810.1	$2,560.8
Other comprehensive income (loss)			
Foreign currency translation gains (losses)	**(533.4)**	441.7	473.0
Net unrealized gains (losses) on securities	**0.3**	(25.9)	72.0
Minimum pension liability adjustment	**(87.8)**	(4.4)	(9.8)
Effective portion of cash flow hedges	**(81.7)**	(53.7)	(2.1)
Other comprehensive income (loss) before income taxes	**(702.6)**	357.7	533.1
Provision for income taxes related to other comprehensive income (loss) items	**63.4**	21.0	(22.4)
Other comprehensive income (loss) (Note 14)	**(639.2)**	378.7	510.7
Comprehensive income	**$1,340.4**	$2,188.8	$3,071.5

See notes to consolidated financial statements.

Segment Information

ELI LILLY AND COMPANY AND SUBSIDIARIES
(Dollars in millions)

We operate in one significant business segment—pharmaceutical products. Operations of the animal health business segment are not material and share many of the same economic and operating characteristics as pharmaceutical products. Therefore, they are included with pharmaceutical products for purposes of segment reporting.

Year Ended December 31	2005	2004	2003
Net sales—to unaffiliated customers			
Neurosciences	**$ 6,080.0**	$ 6,052.5	$ 5,554.8
Endocrinology	**4,636.9**	4,290.9	3,926.7
Oncology	**1,801.0**	1,366.2	1,039.8
Animal health	**863.7**	798.7	726.6
Cardiovascular	**608.9**	658.7	669.3
Anti-infectives	**443.9**	478.0	489.9
Other pharmaceutical	**210.9**	212.9	175.4
Net sales	**$14,645.3**	$13,857.9	$12,582.5
Geographic Information			
Net sales—to unaffiliated customers[1]			
United States	**$ 7,798.1**	$ 7,668.5	$ 7,221.6
Europe, Middle East, and Africa	**4,184.0**	3,858.4	3,355.8
Other foreign countries	**2,663.2**	2,331.0	2,005.1
	$14,645.3	$13,857.9	$12,582.5
Long-lived assets			
United States	**$ 6,524.5**	$ 5,874.1	$ 5,296.0
Europe, Middle East, and Africa	**1,563.1**	1,627.9	1,299.9
Other foreign countries	**1,740.7**	1,556.1	1,188.4
	$ 9,828.3	$ 9,058.1	$ 7,784.3

[1] Net sales are attributed to the countries based on the location of the customer.

The largest category of products is the neurosciences group, which includes Zyprexa, Cymbalta, Strattera, Prozac, Permax®, Symbyax, and Yentreve. Endocrinology products consist primarily of Humalog, Humulin, Actos, Byetta, Evista, Forteo, and Humatrope. Oncology products consist primarily of Gemzar and Alimta. Animal health products include Tylan®, Rumensin®, Coban®, and other products for livestock and poultry. Cardiovascular products consist primarily of ReoPro and Xigris. Anti-infectives include primarily Ceclor® and Vancocin®. The other pharmaceutical product group includes Cialis, Axid, and other miscellaneous pharmaceutical products and services.

Most of the pharmaceutical products are distributed through wholesalers that serve pharmacies, physicians and other health care professionals, and hospitals. In 2005, our three largest wholesalers each accounted for between 12 percent and 17 percent of consolidated net sales. Further, they each accounted for between less than 1 percent and 13 percent of accounts receivable as of December 31, 2005. Animal health products are sold primarily to wholesale distributors.

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. The accounting policies of the individual segments are substantially the same as those described in the summary of significant accounting policies in Note 1 to the consolidated financial statements. Income before income taxes and cumulative effect of a change in accounting principle for the animal health business was approximately $215 million, $223 million, and $204 million in 2005, 2004, and 2003, respectively.

The assets of the animal health business are intermixed with those of the pharmaceutical products business. Long-lived assets disclosed above consist of property and equipment and certain sundry assets.

We are exposed to the risk of changes in social, political, and economic conditions inherent in foreign operations, and our results of operations and the value of our foreign assets are affected by fluctuations in foreign currency exchange rates.

Selected Quarterly Data (unaudited)

ELI LILLY AND COMPANY AND SUBSIDIARIES
(Dollars in millions, except per-share data)

2005	Fourth	Third	Second	First
Net sales	$3,879.1	$3,601.1	$3,667.7	$3,497.4
Cost of sales	898.2	845.7	871.3	859.0
Operating expenses	1,999.5	1,821.9	1,908.5	1,792.6
Asset impairments, restructuring, and other special charges	171.9	—	1,073.4	—
Other—net	(85.2)	(85.0)	(45.4)	(98.6)
Income (loss) before income taxes and cumulative effect of a change in accounting principle	894.7	1,018.5	(140.1)	944.4
Net income (loss)	700.6[2,4]	794.4	(252.0)[1]	736.6
Earnings (loss) per share—basic	.64	.73	(.23)	.68
Earnings (loss) per share—diluted	.64	.73	(.23)	.68
Dividends paid per share	.38	.38	.38	.38
Common stock closing prices				
High	57.81	57.26	60.44	57.78
Low	49.76	52.52	51.19	51.73

2004	Fourth	Third	Second	First
Net sales	$3,644.3	$3,280.4	$3,556.3	$3,376.9
Cost of sales	865.7	810.1	796.4	751.7
Operating expenses	1,803.7	1,606.7	1,854.4	1,710.5
Acquired in-process research and development	29.9	—	—	362.3
Asset impairments, restructuring, and other special charges	494.1	—	108.9	—
Other—net	(69.1)	(104.6)	(41.6)	(63.1)
Income before income taxes	520.0	968.2	838.2	615.5
Net income (loss)	(2.4)[3]	755.2	656.9	400.4
Earnings per share—basic	.00	.70	.61	.37
Earnings per share—diluted	.00	.69	.60	.37
Dividends paid per share	.355	.355	.355	.355
Common stock closing prices				
High	62.01	69.37	76.26	74.70
Low	50.44	60.05	67.60	65.00

Our common stock is listed on the New York, London, and other stock exchanges.

[1] In the second quarter of 2005, we incurred a tax expense of $111.9 million despite reporting a net loss before income taxes for the quarter. The product liability charge of $1.07 billion (Note 13) in the second quarter resulted in a tax benefit that was less than our effective tax rate, as the tax benefit was calculated based upon existing tax laws in the countries in which we reasonably expect to deduct the charge.

[2] A fourth-quarter 2005 analysis, which included the impact of a recently completed IRS examination for tax years 1998 to 2000, led us to conclude that our tax rate for 2005 should be 26.3 percent. As a result, the fourth-quarter tax rate declined to 19.2 percent.

[3] The net loss in the fourth quarter of 2004 included tax expenses of $465.0 million associated with the anticipated repatriation of $8.00 billion of our earnings reinvested outside the U.S. as a result of the American Jobs Creation Act (Note 11).

[4] Reflects the impact of a cumulative effect of a change in accounting principle in the fourth quarter of $22.0 million, net of income taxes of $11.8 million. The diluted earnings per share impact of this cumulative effect of a change in accounting principle was $.02. The net income per diluted share before the cumulative effect of a change in accounting principle was $.66. See Note 2 for additional information.

Selected Financial Data (unaudited)

ELI LILLY AND COMPANY AND SUBSIDIARIES (Dollars in millions, except per-share data)	2005	2004	2003	2002	2001
Operations					
Net sales	**$14,645.3**	$13,857.9	$12,582.5	$11,077.5	$11,542.5
Cost of sales	**3,474.2**	3,223.9	2,675.1	2,176.5	2,160.2
Research and development	**3,025.5**	2,691.1	2,350.2	2,149.3	2,235.1
Marketing and administration	**4,497.0**	4,284.2	4,055.4	3,424.0	3,417.4
Other	**931.1**	716.8	240.1	(130.0)	222.9
Income before income taxes and cumulative effect of a change in accounting principle	**2,717.5**	2,941.9	3,261.7	3,457.7	3,506.9
Income taxes	**715.9**	1,131.8	700.9	749.8	726.9
Net income	**1,979.6**[1]	1,810.1	2,560.8	2,707.9	2,780.0
Net income as a percent of sales	**13.5%**	13.1%	20.4%	24.4%	24.1%
Net income per share—diluted	**1.81**	1.66	2.37	2.50	2.55
Dividends declared per share	**1.54**	1.45	1.36	1.27	1.15
Weighted-average number of shares outstanding—diluted (thousands)	**1,092,150**	1,088,936	1,082,230	1,085,088	1,090,793
Financial Position					
Current assets	**$10,795.8**	$12,835.8	$ 8,768.9	$ 7,804.1	$ 6,938.9
Current liabilities	**5,716.3**	7,593.7	5,560.8	5,063.5	5,203.0
Property and equipment—net	**7,912.5**	7,550.9	6,539.0	5,293.0	4,532.4
Total assets	**24,580.8**	24,867.0	21,688.3	19,042.0	16,434.1
Long-term debt	**5,763.5**	4,491.9	4,687.8	4,358.2	3,132.1
Shareholders' equity	**10,791.9**	10,919.9	9,764.8	8,273.6	7,104.0
Supplementary Data					
Return on shareholders' equity	**18.2%**	17.5%	28.4%	35.2%	42.3%
Return on assets	**8.2%**	7.8%	12.6%	15.2%	17.8%
Capital expenditures	**$1,298.1**	$ 1,898.1	$ 1,706.6	$ 1,130.9	$ 884.0
Depreciation and amortization	**726.4**	597.5	548.5	493.0	454.9
Effective tax rate	**26.3%**	38.5%	21.5%	21.7%	20.7%
Number of employees	**42,600**	44,500	45,000	42,900	40,500
Number of shareholders of record	**50,800**	52,400	54,600	56,200	57,700

[1] Reflects the impact of a cumulative effect of a change in accounting principle in 2005 of $22.0 million, net of income taxes of $11.8 million. The diluted earnings per share impact of this cumulative effect of a change in accounting principle was $.02. The net income per diluted share before the cumulative effect of a change in accounting principle was $1.83. See Note 2 for additional information.

Notes to Consolidated Financial Statements

ELI LILLY AND COMPANY AND SUBSIDIARIES
(Dollars in millions, except per-share data)

Note 1: Summary of Significant Accounting Policies

Basis of presentation: The accompanying consolidated financial statements have been prepared in accordance with accounting practices generally accepted in the United States (GAAP). The accounts of all wholly owned and majority-owned subsidiaries are included in the consolidated financial statements. Where our ownership of consolidated subsidiaries is less than 100 percent, the outside shareholders' interests are reflected in other noncurrent liabilities. All intercompany balances and transactions have been eliminated.

The preparation of financial statements in conformity with GAAP requires management to 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.

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

Cash equivalents: We consider all highly liquid investments, generally with a maturity of three months or less, to be cash equivalents. The cost of these investments approximates fair value. If items meeting this definition are part of a larger investment pool, they are classified consistent with the classification of the pool.

Inventories: We state all inventories at the lower of cost or market. We use the last-in, first-out (LIFO) method for substantially all our inventories located in the continental United States, or approximately 49 percent of our total inventories. Other inventories are valued by the first-in, first-out (FIFO) method. FIFO cost approximates current replacement cost. Inventories at December 31 consisted of the following:

	2005	2004
Finished products	**$ 471.3**	$ 717.5
Work in process	**1,272.4**	1,356.3
Raw materials and supplies	**214.7**	305.7
	1,958.4	2,379.5
Reduction to LIFO cost	**(80.4)**	(87.9)
	$1,878.0	$2,291.6

Investments: Substantially all debt and marketable equity securities are classified as available-for-sale. Available-for-sale securities are carried at fair value with the unrealized gains and losses, net of tax, reported in other comprehensive income. Unrealized losses considered to be other-than-temporary are recognized in earnings. Factors we consider in making this evaluation include company-specific drivers of the decrease in stock price, status of projects in development, near-term prospects of the issuer, the length of time the value has been depressed, and the financial condition of the industry. We do not evaluate cost-method investments for impairment unless there is an indicator of impairment. We review these investments for indicators of impairment on a regular basis. Realized gains and losses on sales of available-for-sale securities are computed based upon specific identification of the initial cost adjusted for any other-than-temporary declines in fair value. Investments in companies over which we have significant influence but not a controlling interest are accounted for using the equity method with our share of earnings or losses reported in other income. We own no investments that are considered to be trading securities.

Derivative financial instruments: Our derivative activities are initiated within the guidelines of documented corporate risk-management policies and do not create additional risk because gains and losses on derivative contracts offset losses and gains on the assets, liabilities, and transactions being hedged. As derivative contracts are initiated, we designate the instruments individually as either a fair value hedge or a cash flow hedge. Management reviews the correlation and effectiveness of our derivatives on a quarterly basis.

For derivative contracts that are designated and qualify as fair value hedges, the derivative instrument is marked to market with gains and losses recognized currently in income to offset the respective losses and gains recognized on the underlying exposure. For derivative contracts that are designated and qualify as cash flow hedges, the effective portion of gains and losses on these contracts is reported as a component of other comprehensive

income and reclassified into earnings in the same period the hedged transaction affects earnings. Hedge ineffectiveness is immediately recognized in earnings. Derivative contracts that are not designated as hedging instruments are recorded at fair value with the gain or loss recognized in current earnings during the period of change.

We enter into foreign currency forward and option contracts to reduce the effect of fluctuating currency exchange rates (principally the euro and the Japanese yen). Generally, foreign currency derivatives used for hedging are put in place using the same or like currencies and duration as the underlying exposures. Forward contracts are principally used to manage exposures arising from subsidiary trade and loan payables and receivables denominated in foreign currency. These contracts are recorded at fair value with the gain or loss recognized in other income. The purchased option contracts are used to hedge anticipated foreign currency transactions, primarily intercompany inventory activities expected to occur within the next year. These contracts are designated as cash flow hedges of those future transactions and the impact on earnings is included in cost of sales. We may enter into foreign currency forward contracts and currency swaps as fair value hedges of firm commitments. Forward and option contracts generally have maturities not exceeding 12 months.

In the normal course of business, our operations are exposed to fluctuations in interest rates. These fluctuations can vary the costs of financing, investing, and operating. We address a portion of these risks through a controlled program of risk management that includes the use of derivative financial instruments. The objective of controlling these risks is to limit the impact of fluctuations in interest rates on earnings. Our primary interest rate risk exposure results from changes in short-term U.S. dollar interest rates. In an effort to manage interest rate exposures, we strive to achieve an acceptable balance between fixed and floating rate debt and investment positions and may enter into interest rate swaps or collars to help maintain that balance. Interest rate swaps or collars that convert our fixed rate debt or investments to a floating rate are designated as fair value hedges of the underlying instruments. Interest rate swaps or collars that convert floating rate debt or investments to a fixed rate are designated as cash flow hedges. Interest expense on the debt is adjusted to include the payments made or received under the swap agreements.

Goodwill and other intangibles: Other intangibles with finite lives arising from acquisitions and research alliances are amortized over their estimated useful lives, ranging from 5 to 15 years, using the straight-line method. Goodwill is not amortized. Goodwill and other intangibles are reviewed to assess recoverability at least annually and when certain impairment indicators are present. Goodwill and net other intangibles with finite lives were $139.6 million and $110.3 million, respectively, at December 31, 2005 and 2004, and were included in sundry assets in the consolidated balance sheets. We currently have no other intangible assets with indefinite lives. No material impairments occurred with respect to the carrying value of our goodwill or other intangible assets in 2005, 2004, or 2003.

Property and equipment: Property and equipment is stated on the basis of cost. Provisions for depreciation of buildings and equipment are computed generally by the straight-line method at rates based on their estimated useful lives (generally 12 to 50 years for buildings and 3 to 18 years for equipment). We review the carrying value of long-lived assets for potential impairment on a periodic basis, and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Impairment is determined by comparing projected undiscounted cash flows to be generated by the asset to its carrying value. If an impairment is identified, a loss is recorded equal to the excess of the asset's net book value over the asset's fair value, and the cost basis is adjusted.

At December 31, property and equipment consisted of the following:

	2005	2004
Land	**$ 166.8**	$ 147.0
Buildings	**4,584.5**	3,569.5
Equipment	**6,314.1**	5,627.2
Construction in progress	**2,070.6**	2,995.2
	13,136.0	12,338.9
Less allowances for depreciation	**5,223.5**	4,788.0
	$ 7,912.5	$ 7,550.9

Depreciation expense for 2005, 2004, and 2003 was $577.2 million, $495.9 million, and $469.3 million, respectively. Approximately $140.5 million, $111.3 million, and $61.0 million of interest costs were capitalized as part of property and equipment in 2005, 2004, and 2003, respectively. Total rental expense for all leases, including contingent rentals (not material), amounted to approximately $294.4 million, $286.8 million, and $268.5 million for 2005, 2004, and 2003, respectively. Capital leases included in property and equipment in the consolidated balance sheets, capital lease obligations entered into, and future minimum rental commitments are not material.

Revenue recognition: We recognize revenue from sales of products at the time title of goods passes to the buyer and the buyer assumes the risks and rewards of ownership. This is generally at the time products are shipped to the customer. Provisions for discounts and rebates to customers are established in the same period the related sales are recorded.

We also generate income as a result of collaboration agreements. Revenue from copromotion services (primarily Actos) is based upon net sales reported by our copromotion partner and, if applicable, the number of sales calls we perform. We immediately recognize the full amount of milestone payments due to us upon the achievement of the milestone event if the event is substantive, objectively determinable, and represents an important point in the development life cycle of the pharmaceutical product. Milestone payments earned by us are generally recorded in other income-net. Initial fees we receive from the partnering of our compounds under development are amortized through the expected product approval date. Initial fees received from out-licensing agreements that include both the sale of marketing rights to our commercialized products and a related commitment to supply the products are generally recognized as net sales over the term of the supply agreement.

Research and development: We recognize as incurred the cost of directly acquiring assets to be used in the research and development process that have not yet received regulatory approval for marketing and for which no alternative future use has been identified. Once the product has obtained regulatory approval, we capitalize the milestones paid and amortize them over the period benefited. Milestones paid prior to regulatory approval of the product are generally expensed when the event requiring payment of the milestone occurs.

Income taxes: Deferred taxes are recognized for the future tax effects of temporary differences between financial and income tax reporting based on enacted tax laws and rates. Federal income taxes are provided on the portion of the income of foreign subsidiaries that is expected to be remitted to the United States and be taxable. We record a liability for tax contingencies when we believe it is probable that we will be assessed and the amount of the contingency can be reasonably estimated. The tax contingency reserve is adjusted for changes in facts and circumstances, and additional uncertainties. See Note 11 regarding the 2004 tax expense associated with the now completed repatriation of earnings reinvested outside the U.S. pursuant to the American Job Creations Act.

Earnings per share: We calculate basic earnings per share based on the weighted-average number of outstanding common shares and incremental shares. We calculate diluted earnings per share based on the weighted-average number of outstanding common shares plus the effect of dilutive stock options and other incremental shares.

Stock-based compensation: As discussed more fully in Note 7, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R), effective January 1, 2005. SFAS 123R requires the recognition of the fair value of stock-based compensation in net income. Stock-based compensation primarily consists of stock options and performance awards. Stock options are granted to employees at exercise prices equal to the fair market value of our stock at the dates of grant. Generally, options fully vest three years from the grant date and have a term of 10 years. Performance awards are granted to officers and key employees and are payable in shares of our common stock. The number of performance award shares actually issued, if any, varies depending on the achievement of certain earnings-per-share targets. In general, performance awards fully vest at the end of the fiscal year of the grant. We recognize the stock-based compensation expense over the requisite service period of the individual grantees, which generally equals the vesting period. We provide newly issued shares and treasury stock to satisfy stock option exercises and for the issuance of performance awards.

Prior to January 1, 2005, we followed Accounting Principles Board (APB) Opinion 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for our stock options and performance awards. Under APB 25, because the exercise price of our employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense was recognized. However, SFAS 123R requires us to present pro forma information as if we had accounted for our employee stock options and performance awards under the fair value method of that statement. For purposes of pro forma disclosure, the estimated fair value of the options and performance awards at the date of the grant is amortized to expense over the requisite service period, which generally is the vesting period.

The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of SFAS 123R to stock-based employee compensation.

	2004	2003
Net income, as reported	**$1,810.1**	$2,560.8
Add: Compensation expense for stock-based performance awards included in reported net income, net of related tax effects	**34.5**	—
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	**(300.9)**	(210.8)
Pro forma net income	**$1,543.7**	$2,350.0
Earnings per share:		
Basic, as reported	**$1.67**	$2.38
Basic, pro forma	**$1.42**	$2.18
Diluted, as reported	**$1.66**	$2.37
Diluted, pro forma	**$1.42**	$2.17

Note 2: Implementation of New Financial Accounting Pronouncements

In 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) 46, Consolidation of Variable Interest Entities. FIN 46 defines a variable interest entity (VIE) as a corporation, partnership, trust, or any other legal structure that does not have equity investors with a controlling financial interest or has equity investors that do not provide sufficient financial resources for the entity to support its activities. FIN 46 requires consolidation of a VIE by the primary beneficiary of the assets, liabilities, and results of activities. FIN 46 also requires certain disclosures by all holders of a significant variable interest in a VIE that are not the primary beneficiary. We do not have any material investments in variable interest entities; therefore, the adoption of this interpretation in the first quarter of 2004 had no material impact on our consolidated financial position or results of operations.

In 2005, the FASB issued FIN 47, Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143. FIN 47 requires us to record the fair value of a liability for conditional asset retirement obligations in the period in which it is incurred, which is adjusted to its present value each subsequent period. In addition, we are required to capitalize a corresponding amount by increasing the carrying amount of the related long-lived asset, which is depreciated over the useful life of the related long-lived asset. The adoption of FIN 47 on December 31, 2005 resulted in a cumulative effect of a change in accounting principle of $22.0 million, net of income taxes of $11.8 million.

As discussed previously, we adopted SFAS 123R effective January 1, 2005. The adoption of this standard required recognition of the fair value of stock-based compensation in net income.

Note 3: Acquisitions

Applied Molecular Evolution, Inc. Acquisition

On February 12, 2004, we acquired all the outstanding common stock of Applied Molecular Evolution, Inc. (AME) in a tax-free merger. Under the terms of the merger agreement, each outstanding share of AME common stock was exchanged for our common stock or a combination of cash and our stock valued at $18. The aggregate purchase price of approximately $442.8 million consisted of issuance of 4.2 million shares of our common stock valued at $314.8 million, issuance of 0.7 million replacement options to purchase shares of our common stock in exchange for the remaining outstanding AME options valued at $37.6 million, cash of $85.4 million for AME common stock and options for certain AME employees, and transaction costs of $5.0 million. The fair value of our common stock was derived using a per-share value of $74.14, which was our average closing stock price for February 11 and 12, 2004. The fair value for the options granted was derived using a Black-Scholes valuation method using assump-

tions consistent with those we used in valuing employee options. Replacement options to purchase our common stock granted as part of this acquisition have terms equivalent to the AME options being replaced.

In addition to acquiring the rights to two compounds currently under development, we expected the acquisition of AME's protein optimization technology to create synergies that will accelerate our ability to discover and optimize biotherapeutic drugs for cancer, critical care, diabetes, and obesity, areas in which proteins are of great therapeutic benefit.

In accordance with SFAS 141, Business Combinations, the acquisition was accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed from AME at the date of acquisition were 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 was recorded as goodwill in the amount of $9.6 million. Goodwill resulting from this acquisition was fully allocated to the pharmaceutical products segment. No portion of this goodwill is expected to be deductible for tax purposes. AME's results of operations are included in our consolidated financial statements from the date of acquisition.

As of the date of acquisition, we determined the following estimated fair values for the assets purchased and liabilities assumed. The determination of estimated fair value requires management to make significant estimates and assumptions. We hired independent third parties to assist in the valuation of assets that were difficult to value.

Estimated Fair Value at February 12, 2004	
Cash and short-term investments	$ 38.7
Acquired in-process research and development	362.3
Platform technology	17.9
Goodwill	9.6
Other assets and liabilities—net	14.3
Total estimated purchase price	$ 442.8

The acquired in-process research and development (IPR&D) represents compounds currently under development that have not yet achieved regulatory approval for marketing. The estimated fair value of these intangible assets was derived using a valuation from an independent third party. AME's two lead compounds for the treatment of non-Hodgkin's lymphoma and rheumatoid arthritis represent approximately 80 percent of the estimated fair value of the IPR&D. 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 were written off by a charge to income immediately subsequent to the acquisition because the compounds did not have any alternative future use. This charge was 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 were 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 were then discounted to the present value using an appropriate discount rate. This analysis was performed for each project independently. The discount rate we used in valuing the acquired IPR&D projects was 18.75 percent.

Product Acquisition

In October 2004, we entered into an agreement with Merck KGaA (Merck) to acquire Merck's compound for a potential treatment for insomnia. At the inception of this agreement, this compound was in the development stage (Phase I clinical trials) and no alternative future uses were identified. As with many development phase compounds, launch of the product, if approved, was not expected in the near term. Our charge for acquired in-process research and development expense related to this arrangement was $29.9 million in the fourth quarter of 2004.

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

The components of the charges included in asset impairments, restructuring, and other special charges in our consolidated statements of income are described below.

In December 2005, management approved, as part of our ongoing efforts to increase productivity and reduce our cost structure, decisions that resulted in non-cash charges of $154.6 million for the write-down of certain im-

paired assets, and other charges of $17.3 million, primarily related to contract termination payments. The impaired assets, which have no future use, include manufacturing buildings and equipment no longer needed to supply projected capacity requirements, as well as obsolete research and development equipment. The impairment charges are necessary to adjust the carrying value of the assets to fair value.

As discussed further in Note 13, in 2005 we entered into a master settlement agreement with plaintiffs' attorneys involved in the U.S. Zyprexa product liability litigation to settle a majority of the claims against us relating to the medication. According to the agreement, we established a fund of $690 million for the claimants who agreed to settle their claims. Additionally, $10 million was paid to cover administration of the settlement. In the second quarter of 2005, we recorded a net pre-tax charge of $1.07 billion for product liability matters, which included the following:

- The $700 million Zyprexa settlement and administration fee;
- Reserves for product liability exposures and defense costs regarding currently known and expected claims to the extent we can formulate a reasonable estimate of the probable number and cost of the claims. A substantial majority of these exposures and costs relate to current and expected Zyprexa claims not included in the settlement. We have estimated these charges based primarily on historical claims experience, data regarding product usage, and our historical product liability defense cost experience.

The $1.07 billion net charge takes into account our estimated recoveries from our insurance coverage related to these matters. The after-tax impact of this net charge is $.90 per share. The $700 million for the Zyprexa settlement was paid during 2005, while the other product liability exposures and defense costs are expected to be paid out over the next several years. The timing of our insurance recoveries is uncertain.

In the fourth quarter of 2004, management approved actions designed to increase productivity, to address current challenges in the marketplace, and to leverage prior investments in our product portfolio. These actions, which are described further below, affect primarily operations in the manufacturing, research and development, and sales and marketing components and resulted in asset impairments, severance and other related charges. These actions were substantially completed during 2005.

- We discontinued our plans to produce the bulk active ingredient for Xigris at our Indianapolis operations. Although we remain committed to this important lifesaving product, we have determined that our manufacturing partner, Lonza Biologics plc, has enough capacity to supply anticipated Xigris demand for the foreseeable future. In addition, we determined that a redesign of our Prince William County, Virginia, facility that is currently under construction was warranted. This decision rendered obsolete certain engineering and construction costs that have already been incurred. Also, the mission of our Clinton, Indiana, manufacturing site has been narrowed to make products solely for the Elanco Animal Health business. The portion of that site that produced human pharmaceutical products has ceased operation.
- We have focused our research efforts on the therapeutic areas of neuroscience, endocrine, oncology, and cardiovascular and have discontinued our efforts in inflammation. In addition to this narrowing of therapeutic focus, we have closed our RTP Laboratory site in Research Triangle Park, North Carolina. This site has historically been our center for high-throughput screening and combinatorial chemistry, but much of that technology has evolved such that these operations can be more efficiently performed in existing facilities in Indianapolis. The site has been written down to fair value less cost to sell and is currently held for sale.
- We closed all district and regional sales offices throughout the United States, and these operations are now managed from home-based offices. In addition, we reorganized our U.S. sales force to create an organization that better meets customer needs and maximizes sales potential. We also streamlined some sales and marketing support activities as well as our field-based operations that support our medical function.

As a result of these actions, we recognized asset impairment charges of $377.4 million in the fourth quarter of 2004. We have ceased using these assets, and have disposed of or destroyed substantially all of the assets. The impairment charges are necessary to adjust the carrying value of the assets to fair value. Other site charges, including lease termination payments, were $12.2 million.

In addition, nearly 1,400 positions globally were eliminated as a result of these actions. While a substantial number of the affected employees were successfully placed in other positions in the company, severance expenses were incurred in the fourth quarter of 2004 for those employees who elected a severance package. The restructuring and other special charges incurred in the fourth quarter of 2004 related to the elimination of positions totaled $68.5 million, including $35.1 million of severance charges related to restructuring activities in our overseas affiliates. The severance charges consisted primarily of voluntary severance expenses. All of this charge has been expended.

The other significant component of our fourth-quarter 2004 special charges was a provision for $36.0 million for the anticipated resolution of the previously reported Evista marketing and promotional practices investigation. See Note 13 for additional discussion.

In addition, in the second quarter of 2004, as part of our ongoing review of our manufacturing and research

and development strategies to maximize performance and efficiencies, including the streamlining of manufacturing operations and research and development activities, we made decisions that resulted in the impairment of certain assets. This review did not result in any closure of facilities or layoffs, but certain assets located at various sites were affected. We have ceased using these assets, written down their carrying value to zero, and have disposed of or destroyed substantially all of the assets. The asset impairment charges incurred in the second quarter of 2004 aggregated $108.9 million.

Similar to 2004, during 2003, management approved global manufacturing strategies across our product portfolio to improve plant performance and efficiency, including the outsourcing of production of certain anti-infective products. These decisions resulted in the impairment of certain assets, primarily manufacturing assets in the U.S. This review did not result in any closure of facilities, but certain assets located at various manufacturing sites were affected. We have ceased using these assets, and substantially all of these assets have been disposed of or destroyed. The impairment charges were necessary to adjust the carrying value of these assets to zero. These asset impairment charges incurred totaled $142.9 million, of which $114.6 million was incurred in the first quarter of 2003 with the remaining $28.3 million incurred in the fourth quarter of 2003.

In December 2002, we initiated a plan of eliminating approximately 700 positions worldwide in order to streamline our infrastructure. While a substantial majority of affected employees were successfully placed in other positions in the company, severance expenses were incurred in the first quarter of 2003 for those employees who elected a severance package. The restructuring and other special charges incurred in the first quarter of 2003 were $52.5 million, consisting primarily of voluntary severance expenses. All of this charge has been expended.

In 2001, we licensed from Isis Pharmaceuticals, Inc. (Isis), Affinitak, a non-small-cell lung cancer drug candidate, and entered into an agreement regarding an ongoing research collaboration. In conjunction with this agreement, we purchased approximately 4.2 million shares of Isis common stock with a cost basis of approximately $68.0 million, and we committed to loan Isis $100 million over the four-year term of the research agreement. The Isis loan was repayable at the end of the research agreement term in cash or Isis stock, at Isis's option, using a conversion price of $40 per share. In addition, we committed to loan Isis $21.2 million for the building of a manufacturing suite for Affinitak. On March 17, 2003, we announced, along with Isis, the results of the Phase III trial that evaluated Affinitak when combined with chemotherapy in patients with advanced non-small-cell lung cancer. No difference was observed in the overall survival of the two groups. Due to this announcement and the decline in Isis's stock price that occurred in the previous 12 months, we concluded in the first quarter of 2003 that our investment in Isis common stock was other-than-temporarily impaired as defined by generally accepted accounting principles. For the same reasons, it was probable that the value of the consideration that we would be eligible to receive from Isis pursuant to the terms of the loan agreements would be less than the carrying amount of the loans. Therefore, in the first quarter of 2003, we recognized an impairment in our investment in Isis common stock of $55.0 million and a reserve related to the loans of $92.9 million. In addition, we recognized a charge of $38.9 million for contractual obligations related to Affinitak. The primary portion of this charge resulted from our supply agreement with Isis. The supply agreement obligated us to pay certain costs associated with work-in-process and raw materials and other costs that were triggered when we canceled our order of Affinitak. The remaining portion of the charge resulted from our contractual obligations related to the conduct of Affinitak clinical trials. All our contractual obligations have been fulfilled. The stock and loan impairments and other special charges incurred in the first quarter of 2003 related to this relationship totaled $186.8 million. In the third quarter of 2005, Isis exercised its option to repay its loan obligation with 2.5 million shares of Isis common stock.

Note 5: Financial Instruments and Investments

Financial instruments that potentially subject us to credit risk consist principally of trade receivables and interest-bearing investments. Wholesale distributors of life-sciences products and managed care organizations account for a substantial portion of trade receivables; collateral is generally not required. The risk associated with this concentration is mitigated by our ongoing credit review procedures. We place substantially all our interest-bearing investments with major financial institutions, in U.S. government securities, or with top-rated corporate issuers. At December 31, 2005, our investments in debt securities were comprised of 41 percent asset-backed securities, 34 percent corporate securities, and 25 percent U.S. government securities. In accordance with documented corporate policies, we limit the amount of credit exposure to any one financial institution or corporate issuer. We are exposed to credit-related losses in the event of nonperformance by counterparties to financial instruments but do not expect any counterparties to fail to meet their obligations given their high credit ratings.

Fair Value of Financial Instruments

A summary of our outstanding financial instruments and other investments at December 31 follows:

	2005		2004	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Short-term investments				
Debt securities	**$2,031.0**	$2,031.0	$2,099.1	$2,099.1
Noncurrent investments				
Marketable equity	**$ 118.0**	$ 118.0	$ 80.4	$ 80.4
Debt securities	**1,076.2**	1,076.2	366.1	366.1
Equity method and other investments	**102.4**	N/A	114.9	N/A
	$ 1,296.6		$ 561.4	
Long-term debt, including current portion	**$6,484.8**	$6,484.2	$4,858.5	$4,868.6
Risk-management instruments—liabilities	**336.0**	336.0	213.4	213.4

We determine fair values based on quoted market values where available or discounted cash flow analyses (principally long-term debt). The fair value of equity method and other investments is not readily available and disclosure is not required. Approximately $2.6 billion of our investments in debt securities mature within five years.

A summary of the unrealized gains and losses (pretax) of our available-for-sale securities in other comprehensive income at December 31 follows:

	2005	2004
Unrealized gross gains	**$52.0**	$43.7
Unrealized gross losses	**15.9**	7.9

The net adjustment to unrealized gains and losses (net of tax) on available-for-sale securities increased (decreased) other comprehensive income by ($4.6) million, ($18.2) million, and $45.4 million in 2005, 2004, and 2003, respectively. Activity related to our available-for-sale investment portfolio was as follows:

	2005	2004	2003
Proceeds from sales	**$2,048.6**	$7,774.7	$5,303.7
Realized gross gains on sales	**25.6**	37.3	72.1
Realized gross losses on sales	**7.1**	17.6	26.4
Interest income	**212.1**	156.7	143.1

During the years ended December 31, 2005, 2004, and 2003, net losses related to ineffectiveness and net losses related to the portion of fair value and cash flow hedging instruments excluded from the assessment of effectiveness were not material.

We expect to reclassify an estimated $4.7 million of pretax net losses on cash flow hedges of anticipated foreign currency transactions and the variability in expected future interest payments on floating rate debt from accumulated other comprehensive loss to earnings during 2006. This assumes that short-term interest rates remain unchanged from the prevailing rates at December 31, 2005.

Note 6: Borrowings

Long-term debt at December 31 consisted of the following:

	2005	2004
4.50 to 7.13 percent notes (due 2012-2036)	**$1,487.4**	$1,487.4
2.90 to 8.38 percent notes (due 2006-2008)	**811.4**	811.4
Floating rate extendible notes (due 2007)	**1,500.0**	—
Floating rate bonds (due 2008-2037)	**1,939.2**	1,424.7
Private placement bonds (due 2007-2008)	**460.7**	652.6
8.38 percent eurodollar bonds (due 2005)	**—**	150.0
6.55 percent ESOP debentures (due 2017)	**92.6**	93.6
Other, including capitalized leases	**113.0**	122.8
SFAS 133 fair value adjustment	**80.5**	116.0
	6,484.8	4,858.5
Less current portion	**721.3**	366.6
	$5,763.5	$4,491.9

In September 2005, Eli Lilly Services, Inc. (ELSI), our indirect wholly-owned finance subsidiary, issued $1.5 billion of floating rate notes (4.53 percent at December 31, 2005). The notes mature in September 2008 and pay interest quarterly at LIBOR plus 5 basis points. The notes may be redeemed at our option beginning in September 2006. In August 2005, ELSI issued $1.5 billion of 13-month floating rate extendible notes. The maturity date of these notes is January 1, 2007, but holders of the notes may extend the maturity of the notes, in monthly increments, until September 1, 2010. These notes pay interest at essentially a rate equivalent to LIBOR (4.26 percent at December 31, 2005). The parent company fully and unconditionally guarantees the ELSI notes.

In August 2004, we issued $1.00 billion of floating rate notes due in 2007. We repaid these notes in August 2005. In March 2003, we issued $300.0 million of 2.9 percent 5-year notes and $200.0 million of 4.5 percent 15-year notes. In July 2002 and May 2001, we issued $150.0 million and $250.0 million, respectively, of floating rate bonds that mature in 2037. The variable interest rate on these bonds is at LIBOR plus our six-month credit spread, adjusted semiannually (total of 4.64 percent at December 31, 2005). The interest accumulates over the life of the bonds and is payable upon maturity. We have an option to begin periodic interest payments at any time. At the time of option exercise, we would owe all previously accrued interest on the bonds. Additionally, in July 2003 and July 2002, respectively, we executed a $330.0 million and $542.8 million private placement note with a financial institution. Principal and interest are due semiannually over the five-year terms of each of these notes. In conjunction with these notes, we entered into interest rate swap agreements with the same financial institution, which converts the fixed rate into a variable rate of interest at essentially LIBOR over the term of the notes.

The 6.55 percent Employee Stock Ownership Plan (ESOP) debentures are obligations of the ESOP but are shown on the consolidated balance sheet because we guarantee them. The principal and interest on the debt are funded by contributions from us and by dividends received on certain shares held by the ESOP. Because of the amortizing feature of the ESOP debt, bondholders will receive both interest and principal payments each quarter.

The aggregate amounts of maturities on long-term debt for the next five years are as follows: 2006, $721.3 million; 2007, $1.71 billion; 2008, $1.89 billion; 2009, $17.7 million; and 2010, $15.9 million.

At December 31, 2005 and 2004, short-term borrowings included $13.4 million and $1.65 billion, respectively, of notes payable to banks and commercial paper. At December 31, 2005, unused committed lines of credit totaled approximately $1.23 billion. Compensating balances and commitment fees are not material, and there are no conditions that are probable of occurring under which the lines may be withdrawn.

We have converted substantially all fixed rate debt to floating rates through the use of interest rate swaps. The weighted-average effective borrowing rate based on debt obligations and interest rates at December 31, 2005 and 2004, including the effects of interest rate swaps for hedged debt obligations, were 4.75 percent and 2.7 percent, respectively.

In 2005 and 2003, cash payments of interest on borrowings totaled $32.0 million and $44.7 million, respectively, net of capitalized interest. In 2004, capitalized interest exceeded cash payments of interest on borrowings, due in large part to certain debt instruments requiring interest payments only at maturity, as previously noted.

In accordance with the requirements of SFAS 133, the portion of our fixed-rate debt obligations that is hedged is reflected in the consolidated balance sheet as an amount equal to the sum of the debt's carrying value plus the fair value adjustment representing changes in fair value of the hedged debt attributable to movements in market interest rates subsequent to the inception of the hedge.

Note 7: Stock Plans

We adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R), effective January 1, 2005. SFAS 123R requires the recognition of the fair value of stock-based compensation in net income. Stock-based compensation primarily consists of stock options and performance awards. Stock options are granted to employees at exercise prices equal to the fair market value of our stock at the dates of grant. Generally, options fully vest three years from the grant date and have a term of 10 years. Performance awards are granted to officers and key employees and are payable in shares of our common stock. The number of performance award shares actually issued, if any, varies depending on the achievement of certain earnings-per-share targets. In general, performance awards fully vest at the end of the fiscal year of the grant. We recognize the stock-based compensation expense over the requisite service period of the individual grantees, which generally equals the vesting period. We provide newly issued shares and treasury stock to satisfy stock option exercises and for the issuance of performance awards.

Prior to January 1, 2005, we followed Accounting Principles Board (APB) Opinion 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for our stock options and performance awards. Under APB 25, because the exercise price of our employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense was recognized. See Note 1 for a calculation of our net income and earnings per share if we had applied the fair value recognition provisions of SFAS 123R to stock-based employee compensation prior to January 1, 2005.

We have elected the modified prospective transition method for adopting SFAS 123R. Under this method, the provisions of SFAS 123R apply to all awards granted or modified after the date of adoption. In addition, the unrecognized expense of awards not yet vested at the date of adoption, determined under the original provisions of SFAS 123, shall be recognized in net income in the periods after the date of adoption. We recognized stock-based compensation cost in the amount of $403.5 million, $53.0 million, and $0 in 2005, 2004, and 2003, respectively, as well as related tax benefits of $122.9 million, $18.5 million, and $0, respectively. The amounts for 2004 relate only to expenses for performance awards because no expense was recognized for stock options under APB 25. In addition, after adopting SFAS 123R, we now classify tax benefits resulting from tax deductions in excess of the compensation cost recognized for exercised stock options as a financing cash flow in the consolidated statements of cash flows rather than an operating cash flow as under our previous disclosure.

As a result of the adoption of SFAS 123R and compensation plan structural changes effective January 1, 2005, the incremental impact on our stock compensation expense caused our income before income taxes and cumulative effect of a change in accounting principle and net income for the year ended December 31, 2005, to be $318.5 million and $225.4 million lower, respectively, than if we had continued to account for our equity compensation programs under APB 25. As a result, the reported basic and diluted earnings per share for the year ended December 31, 2005 are $.21 lower than they would have been had we not adopted SFAS 123R effective January 1, 2005.

In connection with the adoption of SFAS 123R, we reassessed the valuation methodology for stock options and the related input assumptions. As a result, beginning with the 2005 stock option grant, we utilized a lattice-based option valuation model for estimating the fair value of the stock options. The lattice model allows the use of a range of assumptions related to volatility, risk-free interest rate, and employee exercise behavior. Expected volatilities utilized in the lattice model are based on implied volatilities from traded options on our stock, historical volatility of our stock price, and other factors. Similarly, the dividend yield is based on historical experience and our estimate of future dividend yields. The risk-free interest rate is derived from the U.S. Treasury yield curve in effect at the time of grant. The model incorporates exercise and post-vesting forfeiture assumptions based on an analysis of historical data. The expected life of the 2005 grants is derived from the output of the lattice model.

Prior to 2005, we utilized a Black-Scholes option-pricing model to estimate the fair value of the options. This model did not allow for the input of a range of factors. Accordingly, volatility was derived from the historical volatility of our stock price and the risk-free interest rate was derived from the weighted-average yield of a treasury security with the same term as the expected life of the options. The expected life of the options was based on the weighted-average life of our historical option grants and the dividend yield was based on our historical dividends paid.

The weighted-average fair values of the individual options granted during 2005, 2004, and 2003 were $16.06, $26.19, and $20.59, respectively, determined using the following assumptions:

	2005	2004	2003
Dividend yield	2.0%	1.57%	1.50%
Weighted-average volatility	27.8%	35.20%	35.10%
Range of volatilities	27.6%–30.7%	—	—
Risk-free interest rate	2.5%–4.5%	3.43%	3.32%
Weighted-average expected life	7 years	7 years	7 years

The fair values of performance awards granted in 2005 and 2004 were $55.65 and $70.33, respectively. No performance awards were granted in 2003.

Stock option activity during 2005 is summarized below:

	Shares of Common Stock Attributable to Options (in thousands)	Weighted-Average Exercise Price of Options	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2005	93,658	$68.02		
Granted	5,084	55.65		
Exercised	(4,338)	24.42		
Forfeited or expired	(4,322)	69.82		
Outstanding at December 31, 2005	90,082	69.37	5.59	$57.3
Exercisable at December 31, 2005	57,543	71.64	4.27	52.7

A summary of the status of nonvested shares as of December 31, 2005, and changes during the year then ended, is presented below:

	Shares (in thousands)	Weighted-Average Grant Date Fair Value
Nonvested at January 1, 2005	39,342	$24.45
Granted	5,084	16.06
Vested	(10,220)	25.98
Forfeited	(1,667)	22.66
Nonvested at December 31, 2005	32,539	22.75

The intrinsic value of options exercised during 2005, 2004, and 2003 amounted to $131.9 million, $163.8 million, and $178.6 million, respectively. The total grant date fair value of options vested during 2005, 2004, and 2003, amounted to $265.5 million, $337.2 million, and $236.2 million, respectively. We received cash of $105.9 million, $117.9 million, and $99.3 million from exercises of stock options during 2005, 2004, and 2003, respectively, and recognized related tax benefits of $36.8 million, $36.8 million, and $44.3 million during those same years.

As of December 31, 2005, the total remaining unrecognized compensation cost related to nonvested stock options amounted to $216.2 million, which will be amortized over the weighted-average remaining requisite service period of 16 months. The number of shares ultimately issued for the performance award program is dependent upon the earnings achieved during the vesting period. Pursuant to this plan, no shares were issued in 2003 or 2004, and approximately 0.5 million shares were issued in 2005. Approximately 1.7 million shares are expected to be issued in 2006.

At December 31, 2005, additional options, performance awards, or restricted stock grants may be granted under the 2002 Lilly Stock Plan for not more than 49.1 million shares.

Note 8: Other Assets and Other Liabilities

Our sundry assets include our capitalized computer software, estimated insurance recoveries from our product litigation and environmental contingencies (Note 13), prepaid retiree health benefit (Note 12), goodwill and intangible assets (Note 1), and a variety of other items. The increase in sundry assets is primarily attributable to an increase in estimated insurance recoveries relating to litigation.

Our other current liabilities include the fair value of interest rate swaps and related accrued interest of $443.1

million associated with our borrowings, product litigation and environmental liabilities (Note 13), other taxes, and a variety of other items. The decrease in other current liabilities is caused primarily by a reduction in deferred income from our collaboration and out-licensing arrangements offset by an increase in product litigation liabilities and the interest rate swaps.

Our other noncurrent liabilities include the accrued liabilities from our pension and retiree health plans (Note 12), product litigation and environmental liabilities (Note 13), deferred income from our collaboration and out-licensing arrangements, and a variety of other items. The increase in other noncurrent liabilities is primarily attributable to an increase in product litigation and environmental liabilities.

None of the components of sundry assets exceeds 5 percent of total assets, and none of the components of other current liabilities (except for the interest rate swaps) or other noncurrent liabilities exceeds 5 percent of current or total liabilities, respectively.

Note 9: Shareholders' Equity

Changes in certain components of shareholders' equity were as follows:

	Additional Paid-in Capital	Retained Earnings	Deferred Costs—ESOP	Common Stock in Treasury	
				Shares (in thousands)	Amount
Balance at January 1, 2003	$2,610.0	$ 8,500.1	$(123.3)	1,008	$109.5
Net income		2,560.8			
Cash dividends declared per share: $1.36		(1,465.4)			
Retirement of treasury shares	(289.1)			(3,180)	(291.2)
Purchase for treasury				2,976	276.8
Issuance of stock under employee stock plans	150.4			148	9.1
ESOP transactions	13.6		4.7		
Reclassification	125.1	(125.1)			
Balance at December 31, 2003	2,610.0	9,470.4	(118.6)	952	104.2
Net income		1,810.1			
Cash dividends declared per share: $1.45		(1,555.9)			
Retirement of treasury shares	(17.4)			(271)	(17.6)
Issuance of stock under employee stock plans	110.7			262	17.2
Stock-based compensation	53.0				
ESOP transactions	13.2		6.7		
Acquisition of AME	349.9				
Balance at December 31, 2004	3,119.4	9,724.6	(111.9)	943	103.8
Net income		1,979.6			
Cash dividends declared per share: $1.54		(1,677.0)			
Retirement of treasury shares	(381.7)			(6,874)	(386.0)
Purchase for treasury				6,704	377.9
Issuance of stock under employee stock plans	172.9			161	8.4
Stock-based compensation	403.5				
ESOP transactions	9.7		5.6		
Balance at December 31, 2005	$3,323.8	$10,027.2	$ 106.3	934	$104.1

As of December 31, 2005, we have purchased $2.46 billion of our announced $3.0 billion share repurchase program. We acquired approximately 6.7 million and 3.0 million shares in 2005 and 2003 under this program.

We have 5 million authorized shares of preferred stock. As of December 31, 2005 and 2004, no preferred stock has been issued.

We have funded an employee benefit trust with 40 million shares of Lilly common stock to provide a source of funds to assist us in meeting our obligations under various employee benefit plans. The funding had no net impact on shareholders' equity as we consolidated the employee benefit trust. 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 us and the trust are eliminated. Stock held by the trust is not considered outstanding in the computation of earnings per share. The assets of the trust were not used to fund any of our obligations under these employee benefit plans

in 2005, 2004, or 2003.

We have an ESOP as a funding vehicle for the existing employee savings plan. The ESOP used the proceeds of a loan from us to purchase shares of common stock from the treasury. The ESOP issued $200 million of third-party debt, repayment of which was guaranteed by us (see Note 6). The proceeds were used to purchase shares of our common stock on the open market. Shares of common stock held by the ESOP will be allocated to participating employees annually through 2017 as part of our savings plan contribution. The fair value of shares allocated each period is recognized as compensation expense.

Under a Shareholder Rights Plan adopted in 1998, all shareholders receive, along with each common share owned, a preferred stock purchase right entitling them to purchase from the company one one-thousandth of a share of Series B Junior Participating Preferred Stock (the Preferred Stock) at a price of $325. The rights are exercisable only after the Distribution Date, which is generally the 10th business day after the date of a public announcement that a person (the Acquiring Person) has acquired ownership of 15 percent or more of our common stock. We may redeem the rights for $.005 per right, up to and including the Distribution Date. The rights will expire on July 28, 2008, unless we redeem them earlier.

The rights plan provides that, if an Acquiring Person acquires 15 percent or more of our outstanding common stock and our redemption right has expired, generally each holder of a right (other than the Acquiring Person) will have the right to purchase at the exercise price the number of shares of our common stock that have a value of two times the exercise price.

Alternatively, if, in a transaction not approved by the board of directors, we are acquired in a business combination transaction or sell 50 percent or more of our assets or earning power after a Distribution Date, generally each holder of a right (other than the Acquiring Person) will have the right to purchase at the exercise price the number of shares of common stock of the acquiring company that have a value of two times the exercise price.

At any time after an Acquiring Person has acquired 15 percent or more but less than 50 percent of our outstanding common stock, the board of directors may exchange the rights (other than those owned by the Acquiring Person) for our common stock or Preferred Stock at an exchange ratio of one common share (or one one-thousandth of a share of Preferred Stock) per right.

Note 10: Earnings Per Share

The following is a reconciliation of the denominators used in computing earnings per share before cumulative effect of a change in accounting principle:

	2005	2004	2003
		(Shares in thousands)	
Income before cumulative effect of a change in accounting principle available to common shareholders	**$2,001.6**	$1,810.1	$2,560.8
Basic earnings per share			
Weighted-average number of common shares outstanding, including incremental shares	**1,088,754**	1,083,887	1,076,547
Basic earnings per share before cumulative effect of a change in accounting principle	**$1.84**	$1.67	$2.38
Diluted earnings per share			
Weighted-average number of common shares outstanding	**1,088,115**	1,083,677	1,076,547
Stock options and other incremental shares	**4,035**	5,259	5,683
Weighted-average number of common shares outstanding—diluted	**1,092,150**	1,088,936	1,082,230
Diluted earnings per share before cumulative effect of a change in accounting principle	**$1.83**	$1.66	$2.37

Note 11: Income Taxes

Following is the composition of income taxes attributable to income before cumulative effect of a change in accounting principle:

	2005	2004	2003
Current			
Federal	**$ 517.4**	$ 47.6	$391.2
Foreign	**649.8**	519.9	284.7
State	**11.6**	(10.6)	(6.2)
	1,178.8	556.9	669.7
Deferred			
Federal	**89.4**	175.2	(112.9)
Foreign	**(86.8)**	(74.0)	138.2
State	**(.5)**	8.7	5.9
Unremitted earnings to be repatriated due to change in tax law	**(465.0)**	465.0	—
	(462.9)	574.9	31.2
Income taxes	**$ 715.9**	$1,131.8	$700.9

Significant components of our deferred tax assets and liabilities as of December 31 are as follows:

	2005	2004
Deferred tax assets		
Inventory	**$ 637.8**	$ 538.4
Compensation and benefits	**396.6**	320.7
Other carryforwards	**391.5**	492.5
Sale of intangibles	**235.7**	411.5
Tax credit carryforwards and carrybacks	**218.7**	220.6
Financial instruments	**166.0**	117.1
Asset purchases	**92.4**	88.6
Asset disposals	**45.5**	165.3
Other	**414.8**	359.7
	2,599.0	2,714.4
Valuation allowances	**(455.7)**	(508.4)
Total deferred tax assets	**2,143.3**	2,206.0
Deferred tax liabilities		
Prepaid employee benefits	**(1,145.6)**	(952.8)
Property and equipment	**(702.6)**	(681.3)
Unremitted earnings to be repatriated due to change in tax law	**—**	(465.0)
Unremitted earnings	**—**	(327.4)
Other	**(236.8)**	(215.5)
Total deferred tax liabilities	**(2,085.0)**	(2,642.0)
Deferred tax assets (liabilities)—net	**$ 58.3**	$ (436.0)

At December 31, 2005, we had other carryforwards, primarily net operating loss carryforwards, for international and U.S. income tax purposes of $89.4 million: $54.6 million will expire within five years and $1.9 million thereafter; $32.9 million of the carryforwards will never expire. The primary component of the remaining portion of the deferred tax asset for other carryforwards is related to net operating losses for state income tax purposes that are fully reserved. We also have tax credit carryforwards and carrybacks of $218.7 million available to reduce future income taxes; $80.7 million will be carried back and $12.0 million of the tax credit carryforwards will never expire. The remaining portion of the tax credit carryforwards is related to state tax credits that are fully reserved.

Domestic and Puerto Rican companies contributed approximately 30 percent, 6 percent, and 22 percent in

2005, 2004, and 2003, respectively, to consolidated income before income taxes and cumulative effect of a change in accounting principle. We have a subsidiary operating in Puerto Rico under a tax incentive grant that begins to expire at the end of 2007.

The American Jobs Creation Act of 2004 (AJCA) created a temporary incentive for U.S. corporations to repatriate undistributed income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations in 2005. Although the deduction is subject to a number of limitations and uncertainty remained as to how to interpret certain provisions of the AJCA, we believed we had the information necessary to make an informed decision on the impact of the AJCA on our repatriation plans as of December 31, 2004. Based on that decision, we recorded a related tax liability of $465.0 million as of December 31, 2004, and subsequently repatriated $8.00 billion in incentive dividends, as defined in the AJCA, during 2005.

At December 31, 2005, we had an aggregate of $4.1 billion of unremitted earnings of foreign subsidiaries that have been or are intended to be permanently reinvested for continued use in foreign operations and that, if distributed, would result in taxes at approximately the U.S. statutory rate. The amount of unremitted earnings for which no tax has been provided decreased substantially in 2004 due to the change in tax law described above, which caused us to change our previous plans to permanently reinvest a portion of those unremitted earnings.

Cash payments of income taxes totaled $1.78 billion, $487.0 million, and $614.0 million in 2005, 2004, and 2003, respectively. The higher cash payments of income taxes in 2005 are primarily attributable to the tax liability associated with the implementation of the AJCA and the resolution of an IRS examination for the years 1998 to 2000.

Following is a reconciliation of the effective income tax rate applicable to income before income taxes and cumulative effect of a change in accounting principle:

	2005	2004	2003
United States federal statutory tax rate	**35.0%**	35.0%	35.0%
Add (deduct)			
International operations, including Puerto Rico	**(9.5)**	(19.1)	(15.7)
Additional repatriation due to change in tax law	—	15.8	—
Non-deductible acquired in-process research and development	—	4.3	—
General business credits	**(1.5)**	(1.3)	(0.7)
Sundry	**2.3**	3.8	2.9
Effective income tax rate	**26.3%**	38.5%	21.5%

Note 12: Retirement Benefits

We used a measurement date of December 31 to develop the change in benefit obligation, change in plan assets, funded status, and amounts recognized in the consolidated balance sheets at December 31 for our defined benefit pension and retiree health benefit plans, which were as follows:

	Defined Benefit Pension Plans		Retiree Health Benefit Plans	
	2005	2004	2005	2004
Change in benefit obligation				
Benefit obligation at beginning of year	**$5,190.7**	$4,703.1	**$1,388.4**	$1,039.6
Service cost	**297.4**	238.8	**61.5**	47.6
Interest cost	**296.2**	286.4	**80.7**	62.5
Actuarial loss	**261.7**	39.7	**64.8**	161.2
Benefits paid	**(270.4)**	(259.4)	**(77.2)**	(71.5)
Reduction in discount rate, foreign currency exchange rate changes, and other adjustments	**(147.2)**	182.1	**155.4**	149.0
Benefit obligation at end of year	**5,628.4**	5,190.7	**1,673.6**	1,388.4
Change in plan assets				
Fair value of plan assets at beginning of year	**4,797.8**	3,721.9	**745.4**	553.9
Actual return on plan assets	**651.9**	494.6	**102.8**	58.7
Employer contribution	**375.0**	784.0	**194.7**	204.3
Benefits paid	**(268.4)**	(257.3)	**(77.2)**	(71.5)
Foreign currency exchange rate changes and other adjustments	**(73.9)**	54.6	—	—
Fair value of plan assets at end of year	**5,482.4**	4,797.8	**965.7**	745.4
Funded status	**(146.0)**	(392.9)	**(707.9)**	(643.0)
Unrecognized net actuarial loss	**2,237.9**	2,339.7	**1,089.1**	979.5
Unrecognized prior service cost (benefit)	**71.4**	66.0	**(101.3)**	(116.9)
Net amount recognized	**$2,163.3**	$2,012.8	**$ 279.9**	$ 219.6
Amounts recognized in the consolidated balance sheet consisted of				
Prepaid pension	**$2,419.6**	$2,253.8	**$ 377.2**	$ 310.4
Accrued benefit liability	**(567.5)**	(464.4)	**(97.3)**	(90.8)
Accumulated other comprehensive loss before income taxes	**311.2**	223.4	—	—
Net amount recognized	**$2,163.3**	$2,012.8	**$ 279.9**	$ 219.6

(Percents)	Defined Benefit Pension Plans		Retiree Health Benefit Plans	
	2005	2004	2005	2004
Weighted-average assumptions as of December 31				
Discount rate for benefit obligation	**5.8**	5.9	**6.0**	6.0
Discount rate for net benefit costs	**5.9**	6.2	**6.0**	6.2
Rate of compensation increase for benefit obligation	**4.7**	5.6	—	—
Rate of compensation increase for net benefit costs	**5.6**	5.3	—	—
Expected return on plan assets for net benefit costs	**9.0**	9.2	**9.0**	9.3

In evaluating the expected return on plan assets, we have considered our historical assumptions compared with actual results, an analysis of current market conditions, asset allocations, and the views of leading financial advisers and economists. Our plan assets in our U.S. defined benefit pension and retiree health plans comprise approximately 87 percent of our worldwide benefit plan assets. Including the investment losses due to overall market conditions in 2001 and 2002, our 10- and 20-year annualized rates of return on our U.S. defined benefit pension plans and retiree health benefit plan were approximately 9.3 percent and 11.3 percent, respectively, as of December 31, 2005. Health-care-cost trend rates were assumed to increase at an annual rate of 9 percent in 2006,

decreasing 1 percent per year to 6 percent in 2009 and thereafter.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows:

	Defined Benefit Pension Plans	Retiree Health Benefit Plans
2006	$ 271.7	$ 85.4
2007	278.2	92.3
2008	285.3	98.1
2009	293.1	104.3
2010	302.8	110.1
2011–2015	1,702.7	645.7

The total accumulated benefit obligation for our defined benefit pension plans was $4.88 billion and $4.55 billion at December 31, 2005 and 2004, respectively. The projected benefit obligation and fair value of the plan assets for the defined benefit pension plans with projected benefit obligations in excess of plan assets were $1.51 billion and $870.3 million, respectively, as of December 31, 2005, and $1.33 billion and $780.3 million, respectively, as of December 31, 2004.

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

	Defined Benefit Pension Plans			Retiree Health Benefit Plans		
	2005	2004	2003	2005	2004	2003
Components of net periodic benefit cost						
Service cost	**$297.4**	$238.8	$195.4	**$ 61.5**	$47.6	$38.2
Interest cost	**296.2**	286.4	267.2	**80.7**	62.5	60.4
Expected return on plan assets	**(445.9)**	(402.2)	(382.7)	**(75.6)**	(60.2)	(53.6)
Amortization of prior service cost	**7.6**	7.3	11.9	**(15.6)**	(15.6)	(15.6)
Recognized actuarial loss	**106.7**	99.7	52.4	**86.6**	57.8	50.6
Net periodic benefit cost	**$262.0**	$230.0	$144.2	**$137.6**	$92.1	$80.0

If the health-care-cost trend rates were to be increased by one percentage point each future year, the December 31, 2005, accumulated postretirement benefit obligation would increase by 14.0 percent and the aggregate of the service cost and interest cost components of the 2005 annual expense would increase by 18.4 percent. A one-percentage-point decrease in these rates would decrease the December 31, 2005, accumulated postretirement benefit obligation by 12.2 percent and the aggregate of the 2005 service cost and interest cost by 15.5 percent.

We have defined contribution savings plans that cover our eligible employees worldwide. The purpose of these defined contribution plans is generally to provide additional financial security during retirement by providing employees with an incentive to save. Our contributions to the plan are based on employee contributions and the level of our match. Expenses under the plans totaled $96.1 million, $75.5 million, and $72.9 million for the years 2005, 2004, and 2003, respectively.

We provide certain other postemployment benefits primarily related to disability benefits and accrue for the related cost over the service lives of employees. Expenses associated with these benefit plans in 2005, 2004, and 2003 were not significant.

Our U.S. defined benefit pension and retiree health benefit plan investment allocation strategy currently comprises approximately 85 percent to 95 percent growth investments and 5 percent to 15 percent fixed-income investments. Within the growth investment classification, the plan asset strategy encompasses equity and equity-like instruments that are expected to represent approximately 75 percent of our plan asset portfolio of both public and private market investments. The largest component of these equity and equity-like instruments is public equity securities that are well diversified and invested in U.S. and international small-to-large companies. The remaining portion of the growth investment classification is represented by other alternative growth investments.

Our defined benefit pension plan and retiree health plan asset allocations as of December 31 are as follows:

(Percents)	Percentage of Pension Plan Assets 2005	2004	Percentage of Retiree Health Plan Assets 2005	2004
Asset Category				
Equity securities and equity-like instruments	**75**	74	**80**	78
Debt securities	**10**	9	**11**	10
Real estate	**1**	1	**0**	1
Other	**14**	16	**9**	11
Total	**100**	100	**100**	100

In 2006, we expect to contribute approximately $26 million to our defined benefit pension plans to satisfy minimum funding requirements for the year. In addition, we expect to contribute approximately $125 million of additional discretionary funding in 2006 to our defined benefit plans. We also expect to contribute approximately $120 million of discretionary funding to our postretirement health benefit plans during 2006.

Note 13: Contingencies

Three generic pharmaceutical manufacturers, Zenith Goldline Pharmaceuticals, Inc. (Zenith), Dr. Reddy's Laboratories, Ltd. (Reddy), and Teva Pharmaceuticals (Teva), submitted abbreviated new drug applications (ANDAs) seeking permission to market generic versions of Zyprexa in various dosage forms several years prior to the expiration of our U.S. patents for the product. The generic companies alleged that our patents are invalid, unenforceable, or not infringed. We filed suit against the three companies in the U.S. District Court for the Southern District of Indiana, seeking a ruling that the challenges to our compound patent (expiring in 2011) are without merit. The cases were consolidated, and on April 14, 2005, the district court upheld our 2011 U.S. patent on Zyprexa. In the case of Eli Lilly and Company v. Zenith Goldline Pharmaceuticals et al., the court ruled in our favor on all counts, including the patent doctrines of obviousness, double patenting, inequitable conduct, novelty, and public use. The decision has been appealed. We are confident, and the trial court confirmed, that the generic manufacturers' claims are without merit, and we expect to prevail in this litigation. However, it is not possible to predict or determine the outcome of this litigation and, accordingly, we can provide no assurance that we will prevail on appeal. An unfavorable outcome would have a material adverse impact on our consolidated results of operations, liquidity, and financial position.

In 2002, Barr Laboratories, Inc. (Barr), submitted an ANDA with the FDA seeking permission to market a generic version of Evista (raloxifene) several years prior to the expiration of our U.S. patents covering the product, alleging that the patents are invalid or not infringed. In November 2002, we filed suit against Barr in the U.S. District Court for the Southern District of Indiana, seeking a ruling that Barr's challenges to our patents claiming the methods of use and pharmaceutical form (expiring from 2012 to 2017) are without merit. Barr has also asserted that the method of use patents are unenforceable. The U.S. Patent and Trademark Office issued to us two new patents (expiring in 2017) directed to pharmaceutical compositions containing raloxifene and a method for preventing postmenopausal osteoporosis and a third (expiring in 2012) directed to methods of inhibiting postmenopausal bone loss by administering a single daily oral dose of raloxifene. These patents have been listed in the FDA's *Orange Book*. Barr has challenged these patents, alleging that each is invalid, unenforceable, or will not be infringed. These patents have been added to the pending suit. The suit is in discovery. No trial date has been set at this time. While we believe that Barr's claims are without merit and we expect to prevail, it is not possible to predict or determine the outcome of the litigation. Therefore, 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.

In January 2006, we were notified that Sicor Pharmaceuticals, Inc. (Sicor), a subsidiary of Teva, submitted an ANDA with the FDA seeking permission to market a generic version of Gemzar several years prior to the expiration of two U.S. patents covering the product. Sicor alleged that both U.S. patents are invalid. In February, we filed suit against Sicor in the U.S. District Court for the Southern District of Indiana, seeking a ruling that Sicor's challenges to our patents claiming the compound (expiring in 2010) and the methods of use (expiring in 2012) are without merit. While we believe that Sicor's claims are without merit and we expect to prevail, it is not possible to predict or determine the outcome of the litigation. Therefore, we can provide no assurance that we will prevail. An unfavorable outcome could have a material adverse impact on our consolidated results of operations.

In July 2002, we received the first of several grand jury subpoenas for documents from the Office of Consumer Litigation, U.S. Department of Justice, related to our marketing and promotional practices and physician communi-

cations with respect to Evista. We reached a settlement with the U.S. Department of Justice in the fourth quarter of 2005, which was subsequently approved by the U.S. District Court for the Southern District of Indiana in February 2006. As part of the settlement, Lilly pleaded guilty to one misdemeanor violation of the Food, Drug, and Cosmetic Act. The plea is for the off-label promotion of Evista during 1998. The government did not, however, charge the company with any unlawful intent, nor do we acknowledge any such intent. In connection with the overall settlement, we have agreed to pay a total of $36 million. As previously reported, Lilly took a charge in the fourth quarter of 2004 in connection with this investigation. The 2004 charge was sufficient to cover this settlement payment; consequently, no further charge will be necessary.

In March 2004, the office of the U.S. Attorney for the Eastern District of Pennsylvania advised us that it has commenced a civil 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 October 2005, the U.S. Attorney's office 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 Lilly's Medicaid best price reporting related to the product sales covered by the rebate agreements. We are cooperating with the U.S. Attorney in these investigations, including providing a broad range of documents and information relating to the investigations. 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. 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 predict or 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 could have a material adverse impact on our consolidated results of operations, liquidity, and financial position. We have implemented and continue to review and enhance a broadly based compliance program that includes comprehensive compliance-related activities designed to ensure that our marketing and promotional practices, physician communications, remuneration of health care professionals, managed care arrangements, and Medicaid best price reporting comply with applicable laws and regulations.

We have been named as a defendant in a large number of Zyprexa product liability lawsuits in the United States and have been notified of several thousand claims of individuals who have not filed suit. The lawsuits and unfiled claims (together the "claims") allege a variety of injuries from the use of Zyprexa, with the majority alleging that the product caused or contributed to diabetes or high blood-glucose levels. The claims seek substantial compensatory and punitive damages and typically accuse us of inadequately testing for and warning about side effects of Zyprexa. Many of the claims also allege that we improperly promoted the drug. Almost all of the federal lawsuits are part of a Multi-District Litigation (MDL) proceeding before The Honorable Jack Weinstein in the Federal District Court for the Eastern District of New York (MDL No. 1596). The MDL includes three lawsuits requesting certification of class actions on behalf of those who allegedly suffered injuries from the administration of Zyprexa. We have entered into agreements with various plaintiffs' counsel halting the running of the statutes of limitation (tolling agreements) with respect to a large number of claimants who do not have lawsuits on file.

In June 2005, we entered into an agreement in principle (followed by a definitive master settlement agreement in September 2005) with a group of plaintiffs' attorneys involved in U.S. Zyprexa product liability litigation to settle a majority of the claims. The agreement covers more than 8,000 claimants, including a large number of previously filed lawsuits (including the three purported class actions), tolled claims, and other informally asserted claims. We established a fund of $690 million for the claimants to settle their claims, and $10 million to cover administration of the settlement. The settlement fund is being overseen and distributed by claims administrators appointed by the court. The agreement and the distribution of funds to participating claimants are conditioned upon, among other things, our obtaining full releases from no fewer than 7,193 claimants.

Following this settlement, the remaining U.S. Zyprexa product liability claims include approximately 150 lawsuits in the U.S. covering 465 claimants, and approximately 825 tolled claims. In addition, we have been informally advised of a number of additional potential U.S. claims, but to date have received no substantiation of the claims. Also, in early 2005, we were served with five lawsuits seeking class action status in Canada on behalf of patients who took Zyprexa. The allegations in the Canadian actions are similar to those in the litigation pending in the United States. We are prepared to continue our vigorous defense of Zyprexa in all remaining cases.

In 2005, two lawsuits were filed in the Eastern District of New York purporting to be nationwide class actions on behalf of all consumers and third party payors, excluding governmental entities, which have made or will make payments on account of their members or insured patients being prescribed Zyprexa. These actions have now been consolidated into a single lawsuit, which is brought under certain state consumer protection statutes, the federal

civil RICO statute, and common law theories, seeking a refund of the cost of Zyprexa, treble damages, punitive damages, and attorneys' fees. In addition, in 2006 a similar lawsuit was filed in the Eastern District of New York on similar grounds. As with the product liability suits, these lawsuits allege that we inadequately tested for and warned about side effects of Zyprexa and improperly promoted the drug.

In December 2004, we were served with two lawsuits brought in state court in Louisiana on behalf of the Louisiana Department of Health and Hospitals, alleging that Zyprexa caused or contributed to diabetes or high blood-glucose levels, and that we improperly promoted the drug. These cases have been removed to federal court and are now part of the MDL proceedings in the Eastern District of New York. In these actions, the Department of Health and Hospitals seeks to recover the costs it paid for Zyprexa through Medicaid and other drug-benefit programs, as well as the costs the department alleges it has incurred and will incur to treat Zyprexa-related illnesses.

In connection with the Zyprexa product liability claims, certain of our insurance carriers have raised defenses to their liability under the policies and to date have failed to reimburse us for claim-related costs despite demand from the first-layer carriers for payment. However, in our opinion, the defenses identified to date appear to lack substance. In March 2005, we filed suit against several of the carriers in state court in Indiana to obtain reimbursement of costs related to the Zyprexa product liability litigation. The matter has been removed to the federal court in Indianapolis. Several carriers have asserted defenses to their liability, and some carriers are seeking rescission of the coverage. While we believe our position is meritorious, there can be no assurance that we will prevail.

In addition, we have been named as a defendant in numerous other product liability lawsuits involving primarily diethylstilbestrol (DES) and thimerosal.

With respect to the product liability claims currently asserted against us, we have accrued for our estimated exposures to the extent they are both probable and estimable based on the information available to us. In addition, we have accrued for certain product liability claims incurred but not filed to the extent we can formulate a reasonable estimate of their costs. We estimate these expenses based primarily on historical claims experience and data regarding product usage. Legal defense costs expected to be incurred in connection with significant product liability loss contingencies are accrued when probable and reasonably estimable. A portion of the costs associated with defending and disposing of these suits is covered by insurance. We record receivables for insurance-related recoveries when it is probable they will be realized. These receivables are classified as a reduction of the litigation charges on the statement of income. We estimate insurance recoverables based on existing deductibles, coverage limits, our assessment of any defenses to coverage that might be raised by the carriers, and the existing and projected future level of insolvencies among the insurance carriers.

In the second quarter of 2005, we recorded a net pre-tax charge of $1.07 billion for product liability matters, which includes the following:

- The $700 million Zyprexa settlement and administration fee;
- Reserves for product liability exposures and defense costs regarding currently known and expected claims to the extent we can formulate a reasonable estimate of the probable number and cost of the claims. A substantial majority of these exposures and costs relate to current and expected Zyprexa claims not included in the settlement. We have estimated these charges based primarily on historical claims experience, data regarding product usage, and our historical product liability defense cost experience.

The $1.07 billion net charge took into account our estimated recoveries from our insurance coverage related to these matters. The after-tax impact of this net charge was $.90 per share. The $700 million for the Zyprexa settlement was paid during 2005, while the cash related to the other reserves for product liability exposures and defense costs is expected to be paid out over the next several years. The timing of our insurance recoveries is uncertain.

We cannot predict with certainty the additional number of lawsuits and claims that may be asserted. In addition, although we believe it is probable, there can be no assurance that the Zyprexa settlement described above will be concluded. The ultimate resolution of Zyprexa product liability and related litigation could have a material adverse impact on our consolidated results of operations, liquidity, and financial position.

We are subject to a substantial number of product liability claims, and because of the nature of pharmaceutical products, it is possible that we could become subject to large numbers of product liability claims for other products in the future. We have experienced difficulties in obtaining product liability insurance due to a very restrictive insurance market, and therefore will be largely self-insured for future product liability losses. In addition, there is no assurance that we will be able to fully collect from our insurance carriers on past claims.

Also, under the Comprehensive Environmental Response, Compensation, and Liability Act, commonly known as Superfund, we have been designated as one of several potentially responsible parties with respect to fewer than 10 sites. Under Superfund, each responsible party may be jointly and severally liable for the entire amount of the cleanup. We also continue remediation of certain of our own sites. We have accrued for estimated Superfund cleanup costs, remediation, and certain other environmental matters. This takes into account, as applicable, avail-

able information regarding site conditions, potential cleanup methods, estimated costs, and the extent to which other parties can be expected to contribute to payment of those costs. We have reached a settlement with our liability insurance carriers providing for coverage for certain environmental liabilities.

The litigation accruals and environmental liabilities and the related estimated insurance recoverables have been reflected on a gross basis as liabilities and assets, respectively, on our consolidated balance sheets.

While it is not possible to predict or determine the outcome of the patent, product liability, or other legal actions brought against us or the ultimate cost of environmental matters, we believe that, except as noted above, 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 the consolidated results of operations in any one accounting period.

Note 14: Other Comprehensive Income (Loss)

The accumulated balances related to each component of other comprehensive income (loss) were as follows:

	Foreign Currency Translation Gains (Losses)	Unrealized Gains (Losses) on Securities	Minimum Pension Liability Adjustment	Effective Portion of Cash Flow Hedges	Accumulated Other Comprehensive Income (Loss)
Beginning balance at January 1, 2005	$551.4	$24.3	$ (147.0)	$(210.1)	$ 218.6
Other comprehensive loss	(533.4)	(4.6)	(55.9)	(45.3)	(639.2)
Balance at December 31, 2005	$ 18.0	$19.7	$ (202.9)	$(255.4)	$ (420.6)

The amounts above are net of income taxes. The income taxes related to other comprehensive income were not significant, as income taxes were generally not provided for foreign currency translation.

The unrealized gains (losses) on securities is net of reclassification adjustments of $9.1 million, $9.8 million, and $37.4 million, net of tax, in 2005, 2004, and 2003, respectively, for net realized gains on sales of securities included in net income. The effective portion of cash flow hedges is net of reclassification adjustments of $3.8 million, $23.1 million, and $27.2 million, net of tax, in 2005, 2004, and 2003, respectively, for realized losses on foreign currency options and $21.4 million, $15.6 million, and $14.2 million, net of tax, in 2005, 2004, and 2003, respectively, for interest expense on interest rate swaps designated as cash flow hedges.

Generally, the assets and liabilities of foreign operations are translated into U.S. dollars using the current exchange rate. For those operations, changes in exchange rates generally do not affect cash flows; therefore, resulting translation adjustments are made in shareholders' equity rather than in income.

Management's Reports

Management's Report for Financial Statements—Eli Lilly and Company and Subsidiaries

Management of Eli Lilly and Company and subsidiaries is responsible for the accuracy, integrity, and fair presentation of the financial statements. The statements have been prepared in accordance with generally accepted accounting principles in the United States and include amounts based on judgments and estimates by management. In management's opinion, the consolidated financial statements present fairly our financial position, results of operations, and cash flows.

In addition to the system of internal accounting controls, we maintain a code of conduct (known as *The Red Book*) that applies to all employees worldwide, requiring proper overall business conduct, avoidance of conflicts of interest, compliance with laws, and confidentiality of proprietary information. *The Red Book* is reviewed on a periodic basis with employees worldwide, and all employees are required to report suspected violations. A hotline number is published in *The Red Book* to enable employees to report suspected violations anonymously. Employees who report suspected violations are protected from discrimination or retaliation by the company. In addition to *The Red Book*, the CEO, the COO, and all financial management must sign a financial code of ethics, which further reinforces their fiduciary responsibilities.

The financial statements have been audited by Ernst & Young LLP, an independent registered public accounting firm. Their responsibility is to examine our consolidated financial statements in accordance with generally accepted auditing standards of the Public Company Accounting Oversight Board (United States). Ernst & Young's opinion with respect to the fairness of the presentation of the statements (see opinion on page 56) is included in our annual report. Ernst & Young reports directly to the audit committee of the board of directors.

Our audit committee includes five nonemployee members of the board of directors, all of whom are independent from our company. The committee charter, which is published in the proxy statement, outlines the members' roles and responsibilities and is consistent with enacted corporate reform laws and regulations. It is the audit committee's responsibility to appoint an independent registered public accounting firm subject to shareholder ratification, approve both audit and nonaudit services performed by the independent registered public accounting firm, and review the reports submitted by the firm. The audit committee meets several times during the year with management, the internal auditors, and the independent public accounting firm to discuss audit activities, internal controls, and financial reporting matters, including reviews of our externally published financial results. The internal auditors and the independent registered public accounting firm have full and free access to the committee.

We are dedicated to ensuring that we maintain the high standards of financial accounting and reporting that we have established. We are committed to providing financial information that is transparent, timely, complete, relevant, and accurate. Our culture demands integrity and an unyielding commitment to strong internal practices and policies. Finally, we have the highest confidence in our financial reporting, our underlying system of internal controls, and our people, who are objective in their responsibilities and operate under a code of conduct and the highest level of ethical standards.

Management's Report on Internal Control Over Financial Reporting—Eli Lilly and Company and Subsidiaries

Management of Eli Lilly and Company and subsidiaries is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. We have global financial policies that govern critical areas, including internal controls, financial accounting and reporting, fiduciary accountability, and safeguarding of corporate assets. Our internal accounting control systems are designed to provide reasonable assurance that assets are safeguarded, that transactions are executed in accordance with management's authorization and are properly recorded, and that accounting records are adequate for preparation of financial statements and other financial information. A staff of internal auditors regularly monitors, on a worldwide basis, the adequacy and effectiveness of internal accounting controls. The general auditor reports directly to the audit committee of the board of directors.

We conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under this framework, we concluded that our internal controls over financial reporting were effective as of December 31, 2005.

The internal control over financial reporting has been assessed by Ernst & Young LLP. Their responsibility is to evaluate management's assessment and evidence about whether internal control over financial reporting was designed and operating effectively. Ernst & Young's report with respect to the effectiveness of internal control over financial reporting is included on page 57 of our annual report.

Sidney Taurel
Chairman of the Board and Chief Executive Officer

John C. Lechleiter, Ph.D.
President and Chief Operating Officer

Charles E. Golden
Executive Vice President and Chief Financial Officer

February 13, 2006

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Eli Lilly and Company

We have audited the accompanying consolidated balance sheets of Eli Lilly and Company and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of income, cash flows, and comprehensive income for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Eli Lilly and Company and subsidiaries at December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Eli Lilly and Company and subsidiaries' internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 13, 2006 expressed an unqualified opinion thereon.

As discussed in Notes 2 and 7 to the financial statements, in 2005 Eli Lilly and Company adopted new accounting pronouncements for asset retirement obligations and stock-based compensation.

Ernst & Young LLP

Indianapolis, Indiana
February 13, 2006

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Eli Lilly and Company

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Eli Lilly and Company and subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Eli Lilly and Company and subsidiaries' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Eli Lilly and Company and subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Eli Lilly and Company and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2005 consolidated financial statements of Eli Lilly and Company and subsidiaries and our report dated February 13, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP

Indianapolis, Indiana
February 13, 2006

Notice of 2006 Annual Meeting and Proxy Statement

March 13, 2006

Dear Shareholder:

You are cordially invited to attend our annual meeting of shareholders on Monday, April 24, 2006, at the Lilly Center Auditorium, Lilly Corporate Center, Indianapolis, Indiana, at 11:00 a.m. EDT. If you are unable to attend in person, please join us via live webcast on the company's website at www.lilly.com. The webcast will be available for replay for 30 days.

The notice of meeting and proxy statement that follow describe the business we will consider at the meeting. Your vote is very important. I urge you to vote by mail, by telephone, or on the Internet in order to be certain your shares are represented at the meeting, even if you plan to attend.

Please note our procedures for admission to the meeting described on page 62.

I look forward to seeing you at the meeting.

Sidney Taurel
Chairman of the Board and Chief Executive Officer

Notice of Annual Meeting of Shareholders

April 24, 2006

The annual meeting of shareholders of Eli Lilly and Company will be held at the Lilly Center Auditorium, Lilly Corporate Center, Indianapolis, Indiana, on Monday, April 24, 2006, at 11:00 a.m. EDT for the following purposes:

- to elect four directors of the company to serve three-year terms
- to ratify the appointment by the audit committee of Ernst & Young LLP as principal independent auditors for the year 2006
- to consider and vote on a shareholder proposal requesting that the board of directors report on the feasibility of extending our Animal Care and Use Policy to contract laboratories
- to consider and vote on a shareholder proposal requesting that the board of directors establish a policy of separating the roles of chairman and chief executive officer
- to consider and vote on a shareholder proposal requesting that the board of directors implement annual election of each director
- to consider and vote on a shareholder proposal requesting that the board of directors amend the company's articles of incorporation to elect directors by a majority of votes cast.

Shareholders of record at the close of business on February 15, 2006, will be entitled to vote at the meeting and at any adjournment of the meeting.

Attendance at the meeting will be limited to shareholders, those holding proxies from shareholders, and invited guests from the media and financial community. A page at the back of this proxy statement contains an admission ticket. If you plan to attend the meeting, please bring this ticket with you.

This combined proxy statement and annual report to shareholders and the proxy are being mailed on or about March 13, 2006.

By order of the board of directors,

James B. Lootens
Secretary

March 13, 2006

Indianapolis, Indiana

General Information

Why did I receive this proxy statement?
The board of directors of Eli Lilly and Company is soliciting proxies to be voted at the annual meeting of shareholders (the annual meeting) to be held on Monday, April 24, 2006, and at any adjournment of the annual meeting. When the company asks for your proxy, we must provide you with a proxy statement that contains certain information specified by law.

What will the shareholders vote on at the annual meeting?
Six items:

- election of directors
- ratification of the appointment of principal independent auditors
- a shareholder proposal on extending the company's Animal Care and Use Policy to contract laboratories
- a shareholder proposal on separating the roles of chairman and chief executive officer
- a shareholder proposal on annual election of each director
- a shareholder proposal on election of directors by majority vote.

Will there be any other items of business on the agenda?
We do not expect any other items of business because the deadline for shareholder proposals and nominations has already passed. Nonetheless, in case there is an unforeseen need, the accompanying proxy gives discretionary authority to the persons named on the proxy with respect to any other matters that might be brought before the meeting. Those persons intend to vote that proxy in accordance with their best judgment.

Who is entitled to vote?
Shareholders as of the close of business on February 15, 2006 (the record date), may vote at the annual meeting. You have one vote for each share of common stock you held on the record date, including shares:

- held directly in your name as the shareholder of record
- held for you in an account with a broker, bank, or other nominee
- attributed to your account in the Lilly Employee 401(k) Plan (the 401(k) plan).

What constitutes a quorum?
A majority of the outstanding shares, present or represented by proxy, constitutes a quorum for the annual meeting. As of the record date, 1,129,982,580 shares of company common stock were issued and outstanding.

How many votes are required for the approval of each item?
There are differing vote requirements for the various proposals.

- The four nominees for director receiving the most votes will be elected. Abstentions and instructions to withhold authority to vote for one or more of the nominees will result in those nominees receiving fewer votes but will not count as votes against a nominee.
- The appointment of principal independent auditors will be approved if the votes cast for the proposal exceed those cast against the proposal. Abstentions will not be counted either for or against the proposal.
- The shareholder proposals will be approved if the votes cast for the proposal exceed those cast against the proposal. Abstentions and broker nonvotes will not be counted either for or against the proposal.

Broker nonvotes. If your shares are held by a broker, the broker will ask you how you want your shares to be voted. If you give the broker instructions, your shares will be voted as you direct. If you do not give instructions, one of two things can happen, depending on the type of proposal. For the election of directors and the ratification of auditors, the broker may vote your shares in its discretion. For the shareholder proposals, the broker may not vote your shares at all. When that happens, it is called a "broker nonvote."

How do I vote by proxy?
If you are a shareholder of record, you may vote your proxy by any one of the following methods.

By mail. Sign and date each proxy card you receive and return it in the prepaid envelope. Sign your name exactly as it appears on the proxy. If you are signing in a representative capacity (for example, as an attorney-in-fact, executor, administrator, guardian, trustee, or the officer or agent of a corporation or partnership), please indicate your name and your title or capacity. If the stock is held in custody for a minor (for example, under the Uniform Transfers to Minors

Act), the custodian should sign, not the minor. If the stock is held in joint ownership, one owner may sign on behalf of all owners. If you return your signed proxy but do not indicate your voting preferences, we will vote on your behalf for the election of the four nominees for director listed below, for the ratification of the appointment of the independent auditors, and against the shareholder proposals.

Note that if you previously elected to receive these materials electronically, you did not receive a proxy card. If you wish to vote by mail, rather than by telephone or on the Internet as discussed below, you may request paper copies of these materials, including a proxy card, by calling 317-433-5112. Please make sure you give us the control number from the e-mail message that you received notifying you of the electronic availability of these materials, along with your name and mailing address.

By telephone. Shareholders in the United States, Puerto Rico, and Canada may vote by telephone by following the instructions on the enclosed proxy card or, if you received these materials electronically, by following the instructions in the e-mail message that notified you of their availability. Voting by telephone has the same effect as voting by mail. If you vote by telephone, do not return your proxy card. Telephone voting will be available until 11:59 p.m. EDT, April 23, 2006.

By Internet. You may vote online at www.proxyvote.com. Follow the instructions on the enclosed proxy card or, if you received these materials electronically, the instructions in the e-mail message that notified you of their availability. Voting on the Internet has the same effect as voting by mail. If you vote on the Internet, do not return your proxy card. Internet voting will be available until 11:59 p.m. EDT, April 23, 2006.

You have the right to revoke your proxy at any time before the meeting by (1) notifying the company's secretary in writing or (2) delivering a later-dated proxy by telephone, on the Internet, or in writing. If you are a shareholder of record, you may also revoke your proxy by voting in person at the meeting.

How do I vote shares that are held by my broker?

If you have shares held by a broker or other nominee, you may instruct your broker or other nominee to vote your shares by following instructions that the broker or nominee provides for you. Most brokers offer voting by mail, telephone, and on the Internet.

How do I vote in person?

If you are a shareholder of record, you may vote your shares in person at the meeting. However, we encourage you to vote by proxy card, by telephone, or on the Internet even if you plan to attend the meeting.

How do I vote my shares in the 401(k) plan?

You may instruct the plan trustee on how to vote your shares in the 401(k) plan by mail, by telephone, or on the Internet as described above, except that, if you vote by mail, the card that you use will be a voting instruction card rather than a proxy card.

How many shares in the 401(k) plan can I vote?

You may vote all the shares allocated to your account on the record date. In addition, unless you decline, your vote will also apply to a proportionate number of other shares held in the 401(k) plan for which voting directions are not received. These undirected shares include:

- shares credited to the accounts of participants who do not return their voting instructions (except for a small number of shares from a prior stock ownership plan, which can be voted only on the directions of the participants to whose accounts the shares are credited)
- shares held in the plan that are not yet credited to individual participants' accounts.

All participants are named fiduciaries under the terms of the 401(k) plan and under the Employee Retirement Income Security Act (ERISA) for the limited purpose of voting shares credited to their accounts and the portion of undirected shares to which their vote applies. Under ERISA, fiduciaries are required to act prudently in making voting decisions.

If you do not want to have your vote applied to the undirected shares, you should check the box marked "I decline." Otherwise, the trustee will automatically apply your voting preferences to the undirected shares proportionally with all other participants who elected to have their votes applied in this manner.

What happens if I do not vote my 401(k) plan shares?

Your shares will be voted by other plan participants who have elected to have their voting preferences applied proportionally to all shares for which voting instructions are not otherwise received.

What does it mean if I receive more than one proxy card?
It means that you hold shares in more than one account. To ensure that all your shares are voted, sign and return each card. Alternatively, if you vote by telephone or on the Internet, you will need to vote once for each proxy card and voting instruction card you receive.

Who tabulates the votes?
The votes are tabulated by an independent inspector of election, IVS Associates, Inc.

What should I do if I want to attend the annual meeting?
All shareholders as of the record date may attend by presenting the admission ticket that appears at the end of this proxy statement. Please fill it out and bring it with you to the meeting. The meeting will be held at the Lilly Center Auditorium. Please use the Lilly Center entrance to the south of the fountain at the intersection of Delaware and McCarty streets. You will need to pass through security, including a metal detector. Present your ticket to the usher at the meeting.

Parking will be available on a first-come, first-served basis in the garage indicated on the map on page 95. If you have questions about admittance or parking, you may call 317-433-5112.

Will the annual meeting be available on the Internet?
The annual meeting will be broadcast live via webcast on the company's website. To join the live webcast, go to www.lilly.com and click on the annual meeting link that appears on the home page. The webcast will be available in both the Windows Media™ Player and RealPlayer® formats. It will be available for replay on the Lilly website until May 24, 2006.

How do I contact the board of directors?
You can send written communications to one or more members of the board, addressed to:

Presiding Director, Board of Directors
Eli Lilly and Company
c/o Corporate Secretary
Lilly Corporate Center
Indianapolis, Indiana 46285

All such communications will be forwarded to the relevant director(s), except for solicitations or other matters unrelated to the company.

How do I submit a shareholder proposal for the 2007 annual meeting?
The company's 2007 annual meeting is scheduled for April 16, 2007. If a shareholder wishes to have a proposal considered for inclusion in next year's proxy statement, he or she must submit the proposal in writing so that we receive it by November 13, 2006. Proposals should be addressed to the company's corporate secretary, Lilly Corporate Center, Indianapolis, Indiana 46285. In addition, the company's bylaws provide that any shareholder wishing to propose any other business at the annual meeting must give the company written notice by November 13, 2006. That notice must provide certain other information as described in the bylaws. Copies of the bylaws are available online at http://investor.lilly.com/bylaws.cfm.

Does the company offer an opportunity to receive future proxy materials electronically?
Yes. If you are a shareholder of record or a member of the 401(k) plan, you may, if you wish, receive future proxy statements and annual reports online. If you elect this feature, you will receive an e-mail message notifying you when the materials are available along with a web address for viewing the materials and instructions for voting by telephone or on the Internet. If you have more than one account, you may receive separate e-mail notifications for each account.

You may sign up for electronic delivery in two ways:

- If you vote online as described above, you may sign up for electronic delivery at that time.
- You may sign up at any time by visiting http://proxyonline.lilly.com.

If you received these materials electronically, you do not need to do anything to continue receiving materials electronically in the future.

If you hold your shares in a brokerage account, you may also have the opportunity to receive proxy materials electronically. Please follow the instructions of your broker.

What are the benefits of electronic delivery?
Electronic delivery reduces the company's printing and mailing costs. It is also a convenient way for you to receive your proxy materials and makes it easy to vote your shares online. If you have shares in more than one account, it is an easy way to avoid receiving duplicate copies of proxy materials.

What are the costs of electronic delivery?
The company charges nothing for electronic delivery. You may, of course, incur the usual expenses associated with Internet access, such as telephone charges or charges from your Internet service provider.

May I change my mind later?
Yes. You may discontinue electronic delivery at any time. For more information, call 317-433-5112.

What is "householding"?
We have adopted "householding," a procedure under which shareholders of record who have the same address and last name and do not receive proxy materials electronically will receive only one copy of our annual report and proxy statement unless one or more of these shareholders notifies us that they wish to continue receiving individual copies. This procedure saves printing and postage costs by reducing duplicative mailings.

Shareholders who participate in householding will continue to receive separate proxy cards. Householding will not affect dividend check mailings.

Beneficial shareholders can request information about householding from their banks, brokers, or other holders of record.

What if I want to receive a separate copy of the annual report and proxy statement?
If you participate in householding and wish to receive a separate copy of the 2005 annual report and 2006 proxy statement, or if you wish to receive separate copies of future annual reports and proxy statements, please call us at 317-433-5112 or write to: Householding Department, 51 Mercedes Way, Edgewood, New York 11717. We will deliver the requested documents to you promptly upon your request.

Board of Directors

Directors' Biographies

Class of 2006
The following four directors' terms will expire at this year's annual meeting. Each of these directors has been nominated and is standing for election to serve another term that will expire in 2009. See page 86 of this proxy statement for more information. Charles E. Golden is also a member of the class of 2006. In light of his retirement from the company effective April 30, 2006, he is not standing for re-election.

Martin S. Feldstein, Ph.D. Age 66 Director since 2002
President and Chief Executive Officer, National Bureau of Economic Research, and George F. Baker Professor of Economics, Harvard University
Dr. Feldstein is president and chief executive officer of the National Bureau of Economic Research and the George F. Baker Professor of Economics at Harvard University. He became an assistant professor at Harvard in 1967 and an associate professor in 1968. From 1982 through 1984, he served as chairman of the Council of Economic Advisers and President Ronald Reagan's chief economic adviser. He is a member of the American Philosophical Society, a corresponding fellow of the British Academy, a fellow of the Econometric Society, and a fellow of the National Association for Business Economics. Dr. Feldstein is a member of the executive committee of the Trilateral Commission and a director of the Council on Foreign Relations; American International Group, Inc.; Economic Studies, Inc.; and HCA Inc. He is a member of the American Academy of Arts and Sciences and past president of the American Economic Association.

J. Erik Fyrwald Age 46 Director since 2005
Group Vice President, DuPont Agriculture & Nutrition
Mr. Fyrwald has been group vice president of DuPont Agriculture & Nutrition since 2003. He was previously vice president and general manager of DuPont's nutrition and health businesses, which included The Solae Company, DuPont Qualicon, Liqui-Box, and DuPont Food Industry Solutions. Mr. Fyrwald joined DuPont in 1981 as a production engineer, and held a variety of sales and management positions in a number of areas. In 1990, he became the leader of the DuPont Engineering Polymers and DuPont™ Butacite® businesses for the Asia Pacific region, a position he held until 1994. He was named leader of the DuPont Nylon Plastics business for the Americas until 1996, when he became head of global sales and marketing for engineering polymers. In 1998, he was appointed vice president of corporate plans and business development and then vice president of e-commerce. Mr. Fyrwald serves on the boards of the Biotechnology Industry Organization (BIO); CropLife International President's Advisory Group; Des Moines Art Center; Farm Foundation; 8th Continent L.L.C.; and The Solae Company. He has been serving under interim election since November 2005.

Ellen R. Marram Age 59 Director since 2002
President, The Barnegat Group LLC
Ms. Marram is the president of The Barnegat Group LLC, a firm that provides business advisory services. She was a managing director at North Castle Partners, LLC from 2000 to 2005 and is currently an advisor to the firm. Prior to joining North Castle, she served as the chief executive officer of a start-up B2B exchange for the food and beverage industry. From 1993 through 1998, Ms. Marram was president and chief executive officer of Tropicana and the Tropicana Beverage Group. From 1988 to 1993, she was president and chief executive officer of the Nabisco Biscuit Company, an operating unit of Nabisco, Inc.; from 1987 to 1988, was president of Nabisco's Grocery Division; and from 1970 to 1986, held a series of marketing positions at Nabisco/Standard Brands, Johnson & Johnson, and Lever Brothers. Ms. Marram is a member of the board of directors of Ford Motor Company and The New York Times Company as well as several private companies. She serves on the boards of The New York-Presbyterian Hospital, Lincoln Center Theater, Families and Work Institute, and Citymeals-on-Wheels.

Sidney Taurel Age 57 Director since 1991
Chairman of the Board and Chief Executive Officer
Mr. Taurel has been the company's chief executive officer since July 1998 and chairman of the board since January 1999. He also served as president from February 1996 through September 2005. He joined the company in 1971 and has held management positions in the company's international operations based in São Paulo, Vienna, Paris, and London. Mr. Taurel served as president of Eli Lilly International Corporation from 1986 to 1991, executive vice president of the pharmaceutical division from 1991 to 1993, and executive vice president of the company from 1993

until 1996. He is a member of the boards of IBM Corporation and The McGraw-Hill Companies, Inc. He is also a member of the executive committee of the board of directors of Pharmaceutical Research and Manufacturers of America (PhRMA), a member of the board of overseers of the Columbia Business School, a trustee at the Indianapolis Museum of Art, a director of the RCA Tennis Championships, and a member of The Business Council and The Business Roundtable. In 2001, Mr. Taurel became a chevalier of the French Legion of Honor. He was appointed in February 2003 to the President's Export Council.

Class of 2007
The following four directors will continue in office until 2007.

Sir Winfried Bischoff Age 64 Director since 2000
Chairman, Citigroup Europe
Sir Winfried Bischoff has served as chairman, Citigroup Europe, since April 2000. From 1995 to 2000, he was chairman of Schroders, plc. He joined the Schroder Group in 1966 and held a number of positions there, including chairman of J. Henry Schroder Co. and group chief executive of Schroders, plc. He is a nonexecutive director of The McGraw-Hill Companies, Inc., and Land Securities plc.

J. Michael Cook Age 63 Director since 2005
Retired Chairman and Chief Executive Officer, Deloitte and Touche LLP
Mr. Cook served as chairman and chief executive officer of Deloitte and Touche, LLP from 1989 until his retirement in 1999. He joined Deloitte, Haskins & Sells in 1964 and served as chairman and chief executive officer from 1986 through 1989. Mr. Cook is a member of the Advisory Council of the Public Company Accounting Oversight Board and is a trustee of The Scripps Research Institute. He serves on the boards of Comcast Corporation, The Dow Chemical Company and International Flavors & Fragrances Inc. He is chairman of the Accountability Advisory Council to the Comptroller General of the United States. He was a member of the National Association of Corporate Directors Blue Ribbon Panel on Corporate Governance and was named the 62nd member of the Accounting Hall of Fame in 1999. He is president of the Institute of Outstanding Directors.

Franklyn G. Prendergast, M.D., Ph.D. Age 60 Director since 1995
Edmond and Marion Guggenheim Professor of Biochemistry and Molecular Biology and Professor of Molecular Pharmacology and Experimental Therapeutics, Mayo Medical School, and Director, Mayo Clinic Cancer Center
Dr. Prendergast is the Edmond and Marion Guggenheim Professor of Biochemistry and Molecular Biology and Professor of Molecular Pharmacology and Experimental Therapeutics at Mayo Medical School and the director of the Mayo Clinic Cancer Center. He has held several other teaching positions at the Mayo Medical School since 1975. Dr. Prendergast serves on the board of trustees of the Mayo Foundation and the Mayo Clinic Board of Governors.

Kathi P. Seifert Age 56 Director since 1995
Retired Executive Vice President, Kimberly-Clark Corporation
Ms. Seifert served as executive vice president for Kimberly-Clark Corporation until June 2004. She joined Kimberly-Clark in 1978 and served in several capacities in connection with both the domestic and international consumer products businesses, most recently leading the team that develops and manages global plans for branding and product positioning, R&D programs, and capital investment for personal care products. She also oversaw Kimberly-Clark's U.S. and Canadian sales forces. Prior to joining Kimberly-Clark, Ms. Seifert held management positions at Procter & Gamble, Beatrice Foods, and Fort Howard Paper Company. She is chair of Pinnacle Perspectives, LLC. Ms. Seifert serves on the boards of Albertsons, Inc.; Revlon, Inc.; Appleton Papers Inc.; the U.S. Fund for UNICEF; and the Fox Cities Performing Arts Center.

Class of 2008
The following four directors will continue in office until 2008.

George M.C. Fisher Age 65 Director since 2000
Retired Chairman of the Board and Chief Executive Officer, Eastman Kodak Company
Mr. Fisher served as chairman of the board of Eastman Kodak Company from 1993 to December 2000. He also served as chief executive officer from 1993 to January 2000 and as president from 1993 until 1996. Prior to joining Kodak, he was an executive officer of Motorola, Inc., serving as chairman and chief executive officer from 1990 to October 1993, and president and chief executive officer from 1988 to 1990. Mr. Fisher is chairman of PanAmSat Corporation, a

senior advisor for Kohlberg Kravis Roberts & Company, and a director of General Motors Corporation and Visant Corporation. He is a member of The Business Council and was chairman of the National Academy of Engineering from 2000 to 2004.

Alfred G. Gilman, M.D., Ph.D. Age 64 Director since 1995

Dean, The University of Texas Southwestern Medical School and Regental Professor of Pharmacology, The University of Texas Southwestern Medical Center

Dr. Gilman has served as dean of The University of Texas Southwestern Medical School since 2005 and professor of pharmacology at The University of Texas Southwestern Medical Center since 1981. He holds the Raymond and Ellen Willie Distinguished Chair in Molecular Neuropharmacology, the Nadine and Tom Craddick Distinguished Chair in Medical Science, and the Atticus James Gill, M.D. Chair in Medical Science at the university and was named a regental professor in 1995. Dr. Gilman was on the faculty of the University of Virginia School of Medicine from 1971 until 1981 and was named a professor of pharmacology there in 1977. He is a director of Regeneron Pharmaceuticals, Inc. Dr. Gilman was a recipient of the Nobel Prize in Physiology or Medicine in 1994.

Karen N. Horn, Ph.D. Age 62 Director since 1987

Retired President, Private Client Services, and Managing Director, Marsh, Inc.

Ms. Horn served as president, Private Client Services, and managing director of Marsh, Inc., a subsidiary of MMC, from 1999 until her retirement in 2003. Prior to joining Marsh, she was senior managing director and head of international private banking at Bankers Trust Company; chair and chief executive officer, Bank One, Cleveland, N.A.; president of the Federal Reserve Bank of Cleveland; treasurer of Bell of Pennsylvania; and vice president of First National Bank of Boston. Ms. Horn serves as director of T. Rowe Price Mutual Funds; The U.S. Russia Investment Fund, a presidential appointment; and Simon Property Group, Inc. Ms. Horn has been senior managing director, Brock Capital Group since 2004.

John C. Lechleiter, Ph.D. Age 52 Director since 2005

President and Chief Operating Officer

Dr. Lechleiter has served as president and chief operating officer of the company since October 2005. He joined Lilly in 1979 as a senior organic chemist and has held management positions in England and the U.S. He was named vice president of pharmaceutical product development in 1993 and vice president of regulatory affairs in 1994. In 1996, he was named vice president for development and regulatory affairs. Dr. Lechleiter became senior vice president of pharmaceutical products in 1998, and executive vice president, pharmaceutical products and corporate development in 2001. He was named executive vice president, pharmaceutical operations in 2004. He is a member of the American Chemical Society. In 2004, Dr. Lechleiter was appointed to the Visiting Committee of Harvard Business School and to the Health Policy and Management Executive Council of the Harvard School of Public Health. He also serves as a member of the Board of Trustees of Xavier University (Cincinnati, Ohio). In addition, he serves as a distinguished advisor to The Children's Museum of Indianapolis and as a member of the Dean's Advisory Board at the Indiana University School of Medicine. Dr. Lechleiter has been serving under interim election since October 2005.

Highlights of the Company's Corporate Governance Guidelines

The board of directors has established guidelines that it follows in matters of corporate governance. The following summary provides highlights of those guidelines. A complete copy of the guidelines is available online at http://investor.lilly.com/guidelines.cfm or in paper form upon request to the company's corporate secretary.

I. Role of the Board

The directors are elected by the shareholders to oversee the actions and results of the company's management. Their responsibilities include:

- providing general oversight of the business
- approving corporate strategy and major management initiatives
- providing oversight of legal and ethical conduct
- selecting, compensating, and evaluating directors
- evaluating board processes and performance
- selecting, compensating, evaluating, and, when necessary, replacing the chief executive officer, and compensating other executive officers
- ensuring that a succession plan is in place for all senior executives.

II. Composition of the Board

Mix of Independent Directors and Officer-Directors

There should always be a substantial majority (75 percent or more) of independent directors. The chief executive officer should be a board member. Other officers may, from time to time, be board members, but no officer other than the chief executive officer should expect to be elected to the board by virtue of his or her office.

Selection of Director Candidates

The board is responsible for selecting candidates for board membership and for establishing the criteria to be used in identifying potential candidates. The board delegates the screening process to the directors and corporate governance committee. For more information on the director nomination process, including the current selection criteria, see Directors and Corporate Governance Committee Matters on page 73.

Independence Determinations

The board annually determines the independence of directors based on a review by the directors and corporate governance committee. No director is considered independent unless the board has determined that he or she has no material relationship with the company, either directly or as a partner, shareholder, or officer of an organization that has a material relationship with the company. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable, and familial relationships, among others. To evaluate the materiality of any such relationship, the board has adopted categorical independence standards consistent with the revised New York Stock Exchange listing guidelines adopted in November 2003 and amended in November 2004.

Specifically, a director is not considered independent if (i) the director or an immediate family member is a current partner of Lilly's independent auditor (currently Ernst & Young LLP); (ii) the director is a current employee of such firm; (iii) the director has an immediate family member who is a current employee of such firm and who participates in the firm's audit, assurance, or tax compliance (but not tax planning) practice; or (iv) the director or immediate family member was within the last three years (but is no longer) a partner or employee of such firm and personally worked on the listed company's audit within that time.

In addition, a director is not considered independent if any of the following relationships existed within the previous three years:

- a director who is an employee of Lilly, or whose immediate family member is an executive officer of Lilly. Temporary service by an independent director as interim chairman or chief executive officer will not disqualify the director from being independent following completion of that service.
- a director who receives any direct compensation from Lilly other than the director's normal director compensation, or whose immediate family member receives more than $100,000 per year in direct compensation from Lilly other than for service as a non-executive employee.
- a director who is employed (or whose immediate family member is employed as an executive officer) by another company where any Lilly executive officer serves on that company's compensation committee.
- a director who is employed by, who is a 10 percent shareholder of, or whose immediate family member is an executive officer of a company that makes payments to or receives payments from Lilly for property or services

that exceed the greater of $1 million or 2 percent of that company's gross revenues in a single fiscal year.
- a director who is an executive officer of a nonprofit organization that receives grants or contributions from Lilly in a single fiscal year exceeding the greater of $1 million or 2 percent of that organization's gross revenues in a single fiscal year.

Members of the audit, compensation, and directors and corporate governance committees must meet all applicable independence tests of the New York Stock Exchange, Securities and Exchange Commission, and Internal Revenue Service.

The board has determined that all 10 of the nonemployee directors listed on pages 64–66 are independent pursuant to the above criteria and that the board committee members meet all applicable independence standards.

Director Tenure

Subject to the company's charter documents, the governance guidelines establish the following expectations for director tenure:

- A company officer-director, including the chief executive officer, will resign from the board at the time he or she retires or otherwise ceases to be an active employee of the company.
- Nonemployee directors will retire from the board not later than the annual meeting of shareholders that follows their seventy-second birthday.
- Directors may stand for reelection even though the board's retirement policy would prevent them from completing a full three-year term.
- A nonemployee director who retires or changes principal job responsibilities will offer to resign from the board. The directors and corporate governance committee will assess the situation and recommend to the board whether to accept the resignation.

Voting for Directors

In an uncontested election, any nominee for director who receives a greater number of votes "withheld" from his or her election than votes "for" such election (a "majority withheld vote") shall promptly tender his or her resignation following certification of the shareholder vote.

The directors and corporate governance committee shall consider the resignation offer and recommend to the board whether to accept it. The board will act on the committee's recommendation within 90 days following the shareholder meeting. Board action on the matter will require the approval of a majority of the independent directors.

The company will disclose the board's decision on a Form 8-K furnished to the Securities and Exchange Commission within four business days after the decision, including a full explanation of the process by which the decision was reached and, if applicable, the reasons why the board rejected the directors' resignation. If the resignation is accepted, the directors and corporate governance committee will recommend to the board whether to fill the vacancy or reduce the size of the board.

Any director who tenders his or her resignation pursuant to this provision shall not participate in the committee or board deliberations regarding whether to accept the resignation offer.

If each member of the directors and corporate governance committee receives a majority withheld vote at the same election, then the independent directors who did not receive a majority withheld vote shall appoint a committee amongst themselves to consider the resignation offers and recommend to the board whether to accept them.

III. Director Compensation and Equity Ownership

The directors and corporate governance committee annually reviews board compensation. Any recommendations for changes are made to the full board by the committee.

Directors should hold meaningful equity ownership positions in the company; accordingly, a significant portion of overall director compensation is in the form of company equity.

IV. Key Responsibilities of the Board

Selection of Chairman and Chief Executive Officer; Succession Planning

The board customarily combines the roles of chairman and chief executive officer, believing this generally provides the most efficient and effective leadership model for the company. The board anticipates that, in certain occasional circumstances, and particularly during relatively short periods of leadership transition, these roles could be assigned to two different persons for a period of time. The presiding director recommends to the board an appropriate process by which a new chairman and chief executive officer will be selected.

The independent directors are responsible for overseeing succession and management development programs for senior leadership. The chief executive officer develops and maintains a process for advising the board on succession planning for the chief executive officer and other key leadership positions. He or she reviews this plan with the independent directors at least annually.

Evaluation of Chief Executive Officer
The chair of the compensation committee leads the independent directors annually in assessing the performance of the chief executive officer. The results of this review are discussed with the chief executive officer and considered by the compensation committee in establishing his or her compensation for the next year.

Corporate Strategy
Once each year, the board devotes an extended meeting to an update from management regarding the strategic issues and opportunities facing the company, allowing the board an opportunity to provide direction for the corporate strategic plan. Throughout the year, significant corporate strategy decisions are brought to the board for approval.

Code of Ethics
The board approved the company's code of ethics, which complies with the requirements of the New York Stock Exchange and Securities and Exchange Commission. This code is set forth in:

- *The Red Book*, a comprehensive code of ethical and legal business conduct applicable to all employees worldwide and to our board of directors
- the company's Code of Ethical Conduct for Lilly Financial Management, a supplemental code for our chief executive officer, chief operating officer, and all members of financial management that recognizes the unique responsibilities of those individuals in assuring proper accounting, financial reporting, internal controls, and financial stewardship.

Both documents are available online at http://investor.lilly.com/code_business_conduct.cfm or in paper form upon request to the company's corporate secretary.

The audit committee and public policy and compliance committee assist in the board's oversight of compliance programs with respect to matters covered in the code of ethics.

V. Functioning of the Board

Executive Session of Directors
The independent directors meet alone in executive session at every regularly scheduled board meeting. In addition, at least twice a year, the independent directors meet in executive session with the chief executive officer.

Presiding Director
The board appoints a presiding director from among the independent directors (currently Ms. Horn). The presiding director:

- leads the board's process for selecting and evaluating the chief executive officer;
- presides at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors unless the directors decide that, due to the subject matter of the session, another independent director should preside;
- serves as a liaison between the chairman and the independent directors;
- generally approves information sent to the board and meeting agendas and schedules; and
- has the authority to call meetings of the independent directors.

Conflicts of Interest
Occasionally a director's business or personal relationships may give rise to an interest that conflicts, or appears to conflict, with the interests of the company. Directors must disclose to the company all relationships that create a conflict or an appearance of a conflict. The board, after consultation with counsel, takes appropriate steps to ensure that all directors voting on an issue are disinterested. In appropriate cases, the affected director will be excused from discussions on the issue.

To avoid any conflict or appearance of a conflict, board decisions on certain matters of corporate governance are made solely by the independent directors. These include executive compensation and the selection, evaluation, and removal of the chief executive officer.

Orientation and Continuing Education
A comprehensive orientation process is in place for new directors. In addition, directors receive ongoing continuing education through educational sessions at meetings, the annual strategy retreat, and periodic mailings between meetings. We hold periodic mandatory training sessions for the audit committee, to which other directors and executive officers are invited. We also afford directors the opportunity to attend external director education programs.

Director Access to Management and Independent Advisers
Independent directors have direct access to members of management whenever they deem it necessary. The independent directors and the committees are also free to retain their own independent advisers, at company expense, whenever they feel it would be desirable to do so. In accordance with New York Stock Exchange listing standards, the audit, compensation, and directors and corporate governance committees have sole authority to retain independent advisers to their respective committees.

Assessment of Board Processes and Performance
The directors and corporate governance committee annually assesses the performance of the board, its committees, and board processes based on inputs from all directors. The committee also considers the contributions of individual directors at least every three years when considering whether to recommend nominating the director to a new three-year term.

VI. Board Committees

Number, Structure, and Independence
The duties and membership of the six board-appointed committees are described below. Only independent directors may serve on the audit, compensation, directors and corporate governance, and public policy and compliance committees. Only independent directors may chair any committee.

Committee membership and selection of committee chairs are recommended to the board by the directors and corporate governance committee after consulting the chairman of the board and after considering the desires of the board members.

Functioning of Committees
Each committee reviews and approves its own charter annually, and the directors and corporate governance committee reviews and approves all committee charters annually. The board may form new committees or disband a current committee (except the audit, compensation, and directors and corporate governance committees) as it deems appropriate. The chair of each committee determines the frequency and agenda of committee meetings.

All six committee charters are available online at http://investor.lilly.com/board-committees.cfm or in paper form upon request to the company's corporate secretary.

Committees of the Board of Directors

Audit Committee
The duties of the audit committee are described in the audit committee report found on page 74 of this proxy statement.

Directors and Corporate Governance Committee
The duties of the directors and corporate governance committee are described on page 73.

Compensation Committee
- evaluates and establishes compensation for executive officers
- oversees the deferred compensation plan, the company's management stock plans, and other management incentive programs.

The compensation committee report is shown on pages 76–79 of this proxy statement.

Public Policy and Compliance Committee

- oversees the processes by which the company conducts its business so that the company will do so in a manner that complies with laws and regulations and reflects the highest standards of integrity
- reviews and makes recommendations regarding policies, practices, and procedures of the company that relate to public policy and social, political, and economic issues that may affect the company.

Finance Committee

- reviews and makes recommendations regarding capital structure and strategies, including dividends, stock repurchases, capital expenditures, financings and borrowings, and complex business development projects.

Science and Technology Committee

- reviews and makes recommendations regarding the company's strategic research goals and objectives
- reviews new developments, technologies, and trends in pharmaceutical research and development.

Membership and Meetings of the Board and Its Committees

In 2005, each director attended more than 80 percent of the total number of meetings of the board and the committees on which he or she serves. In addition, all board members are expected to attend the annual meetings of shareholders, and all attended in 2005. Current committee membership and the number of meetings of the full board and each committee in 2005 are shown in the table below.

	Board	Audit	Compensation	Directors and Corporate Governance	Finance	Public Policy and Compliance	Science and Technology
Sir Winfried Bischoff	Member	Chair			Member		
Mr. Cook	Member	Member	Member		Member		
Dr. Feldstein	Member	Member			Chair	Member	
Mr. Fisher	Member		Member	Chair			Member
Mr. Fyrwald[1]	Member		Member				Member
Dr. Gilman	Member					Member	Member
Mr. Golden	Member				Member		
Ms. Horn	Member		Chair	Member			
Dr. Lechleiter[2]	Member						Member
Ms. Marram	Member		Member	Member			
Dr. Prendergast	Member	Member				Member	Chair
Ms. Seifert	Member	Member			Member	Chair	
Mr. Taurel	Chair						
Number of 2005 Meetings	7	12	3	3	4	6	3

[1] Mr. Fyrwald joined the board in November 2005.
[2] Dr. Lechleiter joined the board in October 2005.

Directors' Compensation

Directors who are employees receive no additional compensation for serving on the board or its committees.

In 2005, we provided the following annual compensation to directors who are not employees:

Name	Total ($)	Fees Earned or Paid in Cash ($)	Stock Awards ($)	Option Awards ($)	Non-Stock Incentive Plan Compensation ($)	All Other Compensation (1) ($)
Sir Winfried Bischoff	178,145	96,200	75,758	0	0	6,187
Mr. Cook	147,405	70,050	75,758	0	0	1,597
Dr. Feldstein	156,764	76,555	75,758	0	0	4,451
Mr. Fisher	161,969	71,800	75,758	0	0	14,411
Mr. Fyrwald	88,628	12,300	75,758	0	0	570
Dr. Gilman	204,822	64,200	75,758	0	0	64,864
Ms. Horn	181,171	72,200	75,758	0	0	33,213
Ms. Marram	150,027	61,000	75,758	0	0	13,269
Dr. Prendergast	188,138	83,000	75,758	0	0	29,380
Ms. Seifert	189,140	89,000	75,758	0	0	24,382

(1) Includes interest and dividends on amounts in the Lilly Directors' Deferral Plan and tax reimbursement.

Cash Compensation

- retainer of $3,750 per month
- $1,600 for each board meeting attended (or $1,600 per day for multi-day meetings)
- $1,600 for each committee or other meeting attended if not held on the same day as a board meeting
- $2,000 to the committee chairpersons for each committee meeting attended as compensation for the chairperson's preparation time
- reimbursement for customary and usual travel expenses.

Stock Compensation

- 1,500 shares of Lilly stock in a deferred stock account in the Lilly Directors' Deferral Plan (as described below), payable after service on the board has ended.

Lilly Directors' Deferral Plan

This plan allows directors to defer receipt of all or part of their retainer and meeting fees until after their service on the board has ended. Each director can choose to invest the funds in either of two accounts:

- **Deferred Compensation Account.** Funds in this account earn interest each year at an annual rate of 120 percent of the applicable federal long-term rate as established for the preceding December by the U.S. Treasury Department under Section 1274(d) of the Internal Revenue Code with monthly compounding. The rate for 2006 is 5.6 percent. The aggregate amount of interest that accrued in 2005 for the participating directors was $176,225 at a rate of 5.64 percent.
- **Deferred Share Account.** This account allows the director, in effect, to invest his or her deferred cash compensation in Lilly stock. In addition, the annual award of shares to each director noted above (1,500 shares in 2005) is credited to this account. Funds in this account are credited as hypothetical shares of Lilly stock based on the market price of the stock at the time the compensation would otherwise have been earned. Hypothetical dividends are "reinvested" in additional shares based on the market price of the stock on the date dividends are paid. All shares in the deferred share accounts are hypothetical and are not issued or transferred until the director ends his or her service on the board or dies.

Both accounts may be paid in a lump sum or in annual installments for up to 10 years. The deferred compensation account may also be paid in monthly installments for up to 10 years. Amounts in the deferred share account are paid in the form of shares of Lilly stock.

Directors and Corporate Governance Committee Matters

Overview

The directors and corporate governance committee recommends candidates for membership on the board and board committees. The committee also oversees matters of corporate governance, director independence, director compensation, and board performance. The committee's charter is available online at http://investor.lilly.com/board-committees.cfm or in paper form upon request to the company's corporate secretary.
All committee members are independent as defined in the New York Stock Exchange listing requirements.

Director Nomination Process

The board seeks independent directors who represent a mix of backgrounds and experiences that will enhance the quality of the board's deliberations and decisions. Candidates shall have substantial experience with one or more publicly traded national or multinational companies or shall have achieved a high level of distinction in their chosen fields.

Board membership should reflect diversity in its broadest sense, including persons diverse in geography, gender, and ethnicity. The board is particularly interested in maintaining a mix that includes the following backgrounds:

- active or retired chief executive officers and senior executives, particularly those with experience in operations, finance or banking, and marketing or sales
- international business
- medicine and science
- government and public policy
- information technology.

The board delegates the screening process to the directors and corporate governance committee, which receives direct input from other board members. Potential candidates are identified by recommendations from several sources, including:

- incumbent directors
- management
- shareholders
- an independent executive search firm retained by the committee to assist in locating candidates meeting the board's selection criteria.

The committee employs the same process for evaluating all candidates, including those submitted by shareholders. The committee initially evaluates the candidate based on publicly available information and any additional information supplied by the party recommending the candidate. If the candidate appears to satisfy the selection criteria and the committee's initial evaluation is favorable, the committee, assisted by management, gathers additional data on the candidate's qualifications, availability, probable level of interest, and any potential conflicts of interest. If the committee's subsequent evaluation continues to be favorable, the candidate is contacted by the chairman of the board and one or more of the independent directors for direct discussions to determine the mutual levels of interest in pursuing the candidacy. If these discussions are favorable, the committee makes a final recommendation to the board to nominate the candidate for election by the shareholders (or to select the candidate to fill a vacancy, as applicable). Mr. Fyrwald, who is standing for election, was referred to the company by an independent executive search firm.

Process for Submitting Recommendations and Nominations

A shareholder who wishes to recommend a director candidate for evaluation by the committee pursuant to this process should forward the candidate's name and information about the candidate's qualifications to the chairman of the directors and corporate governance committee, in care of the corporate secretary, at Lilly Corporate Center, Indianapolis, Indiana 46285. The candidate must meet the selection criteria described above and must be willing and expressly interested in serving on the board.

Under Section 1.9 of the company's bylaws, a shareholder who wishes to directly nominate a director candidate at the 2007 annual meeting (i.e., to propose a candidate for election who is not otherwise nominated by the board through the recommendation process described above) must give the company written notice by November 13, 2006. The notice should be addressed to the corporate secretary at Lilly Corporate Center, Indianapolis, Indiana 46285. The notice must contain prescribed information about the candidate and about the shareholder proposing the candidate as described in more detail in Section 1.9 of the bylaws. A copy of the bylaws is available online at http://investor.lilly.com/bylaws.cfm. The bylaws will also be provided by mail without charge upon request to the corporate secretary.

Audit Committee Matters

Audit Committee Membership

All members of the audit committee are independent as defined in both the New York Stock Exchange listing standards and the Securities and Exchange Commission standards applicable to audit committee members. The board of directors has determined that Sir Winfried Bischoff and Mr. J. Michael Cook are audit committee financial experts as defined in the rules of the Securities and Exchange Commission.

Audit Committee Report

The audit committee ("we" or "the committee") reviews the company's financial reporting process on behalf of the board. Management has the primary responsibility for the financial statements and the reporting process, including the systems of internal controls and disclosure controls. In this context, we have met and held discussions with management and the independent auditors. Management represented to us that the company's consolidated financial statements were prepared in accordance with generally accepted accounting principles, and we have reviewed and discussed the audited financial statements and related disclosures with management and the independent auditors, including a review of the significant management judgments underlying the financial statements and disclosures.

The independent auditors report to us and to the board. We have sole authority to appoint (subject to shareholder ratification) and to terminate the engagement of the independent auditors.

We have discussed with the independent auditors matters required to be discussed by Statement on Auditing Standards No. 61 (Communication with Audit Committees), including the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments, and the clarity of the disclosures in the financial statements. In addition, we have received the written disclosures and the letter from the independent auditors required by the Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees) and have discussed with the independent auditors the auditors' independence from the company and its management. In concluding that the auditors are independent, we determined, among other things, that the nonaudit services provided by Ernst & Young LLP (as described below) were compatible with their independence. Consistent with the requirements of the Sarbanes-Oxley Act of 2002, we have adopted policies to avoid compromising the independence of the independent auditors, such as prior committee approval of nonaudit services and required audit partner rotation.

We discussed with the company's internal and independent auditors the overall scope and plans for their respective audits including internal control testing under Section 404 of the Sarbanes-Oxley Act. We periodically meet with the internal and independent auditors, with and without management present, and in private sessions with members of senior management (such as the chief financial officer and the chief accounting officer) to discuss the results of their examinations, their evaluations of the company's internal controls, and the overall quality of the company's financial reporting. We also periodically meet in executive session.

In reliance on the reviews and discussions referred to above, we recommended to the board (and the board subsequently approved the recommendation) that the audited financial statements be included in the company's annual report on Form 10-K for the year ended December 31, 2005, for filing with the Securities and Exchange Commission. We have also appointed the company's independent auditors, subject to shareholder ratification, for 2006.

Audit Committee
Sir Winfried Bischoff, Chair
J. Michael Cook
Martin S. Feldstein, Ph.D.
Franklyn G. Prendergast, M.D., Ph.D.
Kathi P. Seifert

Services Performed by the Independent Auditor

The audit committee preapproves all services performed by the independent auditor, in part to assess whether the provision of such services might impair the auditor's independence. The committee's policy and procedures are as follows:

- The committee approves the annual **audit services** engagement and, if necessary, any changes in terms, conditions, and fees resulting from changes in audit scope, company structure, or other matters. The committee may also preapprove other audit services, which are those services that only the independent auditor reasonably can provide. Since 2004, audit services have included internal controls attestation work under Section 404 of the Sarbanes-Oxley Act.

- **Audit-related services** are assurance and related services that are reasonably related to the performance of the audit, and that are traditionally performed by the independent auditor. The committee believes that the provision of these services does not impair the independence of the auditor.
- **Tax services.** The committee believes that, in appropriate cases, the independent auditor can provide tax compliance services, tax planning, and tax advice without impairing the auditor's independence.
- The committee may approve **other services** to be provided by the independent auditor if (i) the services are permissible under SEC and Public Company Accounting Oversight Board rules, (ii) the committee believes the provision of the services would not impair the independence of the auditor, and (iii) management believes that the auditor is the best choice to provide the service.
- **Process.** At the beginning of each audit year, management requests prior committee approval of the annual audit, statutory audits, and quarterly reviews for the upcoming audit year as well as any other engagements known at that time. Management will also present at that time an estimate of all fees for the upcoming audit year. As specific engagements are identified thereafter, they are brought forward to the committee for approval. To the extent approvals are required between regularly scheduled committee meetings, preapproval authority is delegated to the committee chair.

For each engagement, management provides the committee with information about the services and fees sufficiently detailed to allow the committee to make an informed judgment about the nature and scope of the services and the potential for the services to impair the independence of the auditor.

After the end of the audit year, management provides the committee with a summary of the actual fees incurred for the completed audit year.

Independent Auditor Fees

The following table shows the fees incurred for services rendered on a worldwide basis by Ernst & Young LLP, the company's independent auditor, in 2005 and 2004. All such services were preapproved by the committee in accordance with the preapproval policy.

	2005 (millions)	2004 (millions)
Audit Fees • Annual audit of consolidated and subsidiary financial statements, including Sarbanes-Oxley 404 attestation • Reviews of quarterly financial statements • Other services normally provided by the auditor in connection with statutory and regulatory filings	$5.8	$5.2
Audit-Related Fees • Assurance and related services reasonably related to the performance of the audit or reviews of the financial statements: —2005 and 2004: primarily related to employee benefit plan and other ancillary audits, and accounting consultations	$1.0	$0.5
Tax Fees • 2005 and 2004: primarily related to tax planning and various compliance services	$1.8	$2.4
All Other Fees • 2005 and 2004: primarily related to upgrading and maintaining on-line training programs	$0.1	$0.4
Total	$8.7	$8.5

Executive Compensation

Compensation Committee Report

The following is a report of the compensation committee of the board regarding executive compensation. The committee's membership and duties are described on pages 70–71.

Executive Compensation Policy

The compensation committee ("the committee" or "we") bases its executive compensation policy on the same principles that guide the company in establishing all its compensation programs. The company designs programs to attract, retain, and motivate highly talented individuals at all levels of the organization. In particular:

- Compensation is based on the level of job responsibility, individual performance, and company performance. As employees progress to higher levels in the organization, an increasing proportion of their pay is linked to company performance and shareholder returns.
- Compensation reflects the value of the job in the marketplace. To attract and retain a highly skilled work force, the company must remain competitive with the pay of other premier employers who compete with the company for talent.
- Compensation programs should deliver top-tier compensation given top-tier individual and company performance; likewise, where individual performance falls short of expectations and/or company performance lags the industry, the programs should deliver lower tier compensation.
- The company develops and administers its compensation programs to foster the long-term focus required for success in the pharmaceutical industry.

The program consists of both annual and long-term components, which are considered together in assessing whether the program is attaining its objectives.

The Committee's Processes

We consider various measures of company and industry performance, including sales, earnings per share, return on assets, return on equity, and total shareholder return. These data assist us in exercising judgment in establishing total compensation ranges. We do not assign these performance measures relative weights. Instead, we make a subjective determination after considering such measures collectively. We also compare, or benchmark, the company's programs with a peer group of global pharmaceutical companies identified on page 83. The peer group represents leading companies with which the company competes for executive and scientific talent. We compare the executive compensation programs as a whole, and we also compare the pay of individual executives if we believe the jobs are sufficiently similar to make the comparison meaningful.

We use the peer group data primarily to ensure that the executive compensation program as a whole is within the broad middle range of comparative pay of the peer group companies when the company achieves the targeted performance levels. We do not target a specific position in the range of comparative data for each individual or for each component of compensation. We establish individual amounts in view of the comparative data and such other factors as level of responsibility and internal relativity, prior experience, and individual performance. We do not apply formulas or assign these factors specific mathematical weights; instead, we exercise judgment and discretion.

We also retain an independent compensation consultant to assist us in evaluating our executive compensation programs and in setting our chief executive officer's compensation. The consultant reports directly to us, and we determine the consultant's compensation. The use of an independent consultant provides additional assurance that the company's executive compensation programs are reasonable and consistent with company objectives.

Components of Executive Compensation for 2005

Annual Compensation. Annual cash compensation for 2005 consisted of base salary and a cash bonus.

- We determined **base salaries** based on company and individual performance for the previous year, internal relativity, and market conditions, including pay at the peer group companies. As noted above, we used the peer group data to test for reasonableness and competitiveness of base salaries, but we also exercised subjective judgment in view of our compensation objectives. The merit budget processes for executives are essentially the same as those used for all employees.
- **Cash bonuses** for all management employees worldwide, as well as all non-management employees in the U.S. other than sales representatives, were determined under the Eli Lilly and Company Bonus Plan, a shareholder-approved formula-based bonus plan adopted in 2004. Under the plan, bonus target amounts, expressed as a percentage of base salary, are established for participants at the beginning of each year. Bonus payouts

for the year are then determined by the company's financial results relative to predetermined performance measures. Satisfactory individual performance is a condition to payment.

- **Bonus targets.** We established bonus targets based on job responsibilities, internal relativity, and peer group data. Our objective was to set bonus targets such that total annual cash compensation was within the broad middle range of peer group companies and a substantial portion of that compensation was linked to company performance. Consistent with our executive compensation policy, individuals with greater job responsibilities had a greater proportion of their total cash compensation tied to company performance through the bonus plan.
- **Company performance measures.** We established company performance measures based 25 percent on sales growth and 75 percent on earnings per share growth (adjusted for unusual items). In establishing the measures, we considered the expected performance of Lilly and the other companies in our peer group. Under the plan formula, payouts can range from zero to 200 percent of target depending on company performance. The bonuses paid to executive officers for 2005 were approximately 130 percent of target as a result of above-target growth in both sales and adjusted earnings per share.

Long-Term Incentives. We normally employ two forms of long-term equity incentives granted under the 2002 Lilly Stock Plan: stock options and performance awards. These incentives foster the long-term perspective necessary for continued success in our business. They also ensure that our leaders are properly focused on shareholder value. Stock options and performance awards have traditionally been granted broadly and deeply within the organization, with approximately 4,900 management and professional employees now participating.

- **Stock options** align employee incentives with shareholders because options have value only if the stock price increases over time. The company's 10-year options, granted at the market price on the date of grant, help focus employees on long-term growth. In addition, options are intended to help retain key employees because they typically cannot be exercised for three years and, if not exercised, are forfeited if the employee leaves the company before retirement. The three-year vesting also helps keep employees focused on long-term performance.
- **Performance awards** provide employees with shares of Lilly stock if certain company performance goals are achieved. The awards, normally granted annually, are structured as a schedule of shares of Lilly stock based on the company's achievement of specific earnings-per-share (EPS) levels over specified time periods of one or more years. We granted performance awards for 2005 with possible payouts ranging from zero to 200 percent of the target amount, depending on 2005 EPS growth as adjusted based on predetermined criteria. For executive officers, the payout was in the form of restricted stock, as noted below. In establishing the company performance measures in January 2005, we considered the expected performance of Lilly and the other companies in our peer group. Above-target growth in adjusted earnings per share resulted in a 2005 performance award payout at 125 percent of target.
- **Share retention guidelines** help foster a focus on long-term growth. We expect our executive officers to retain all net shares received from stock options and performance awards, net of taxes, for at least one year. Consistent with this objective, performance award shares earned for 2005 performance were issued in the form of restricted stock that is subject to forfeiture if the executive leaves the company prior to February 2007, except by reason of death, disability, retirement, or by consent of the committee.

For 2005, we maintained our two-part, long-term incentive award; however, in order to link the program even more closely to company performance, we increased our emphasis on performance awards and decreased emphasis on stock options. In determining the value of grants, our overall objective was to set combined grant values of stock options and performance awards that were competitive within the broad middle range of peer company long-term incentive grant amounts. We lowered grant values significantly at all levels, consistent with marketplace trends, while maintaining broad-based employee participation. Grant values for individuals were determined by internal relativity and individual performance.

Deductibility Cap on Executive Compensation. Under U.S. federal income tax law, the company cannot take a tax deduction for certain compensation paid in excess of $1 million to the five executive officers listed in the summary compensation table below. However, performance-based compensation, as defined in the tax law, is fully deductible if the programs are approved by shareholders and meet other requirements. Our policy is to qualify our incentive compensation programs for full corporate deductibility to the extent feasible and consistent with our overall compensation goals.

The company has taken steps to qualify compensation under the Eli Lilly and Company Bonus Plan, as well as stock options and performance awards under its management stock plans, for full deductibility as "performance-based compensation." We may make payments that are not fully deductible if, in our judgment, such payments are necessary to achieve our compensation objectives and to protect shareholder interests.

Adjustments for Unusual Items. Consistent with past practice and based on predetermined criteria, we adjusted the earnings results on which 2005 bonuses and performance awards were determined to eliminate the effect of certain unusual items. The adjustments are intended to ensure that award payments represent the underlying growth of the core business and are not artificially inflated or deflated due to such unusual items either in the award year or the previous (comparator) year. For the 2005 awards calculation, we adjusted EPS to eliminate the effect in both 2004 and 2005 of major asset impairments, restructuring and other special charges, as well as the 2004 effect of acquired in-process research charges and a one-time tax expense for the expected repatriation of earnings under the American Jobs Creation Act. In addition, in light of our voluntary adoption of stock option expensing in 2005, for purposes of determining growth rates between 2004 and 2005 we adjusted 2004 earnings per share results as if we had expensed stock options in that year. Finally, we eliminated the 2005 cumulative effect of an accounting change relating to the adoption of FIN 47 (conditional asset retirement obligations).

Other Compensation. In 2003 and 2004, we undertook a total executive compensation review with the guidance of our independent consultant. In addition to the primary compensation elements of salary, cash bonuses, and long-term incentives discussed above, we reviewed the deferred compensation program, other annual compensation, and payments that would be required under various severance and change-in-control scenarios. We determined that these elements of compensation were reasonable in the aggregate. Following our review, we recommended to the board, and it approved, amendments to the deferred compensation and change-in-control severance pay programs in 2004 that modestly reduced the future benefit levels under those programs.

Chief Executive Officer Compensation for 2005

In establishing Mr. Taurel's compensation for 2005, we applied the principles outlined above in the same manner as they were applied to the other executives. We compared company performance with that of the peer group companies, including EPS growth, return on assets, return on equity, and total shareholder return. We did not assign these performance measures relative weights but rather made a subjective determination after considering the data collectively. In addition, consistent with our annual process, in an executive session including all independent directors, we assessed Mr. Taurel's 2004 performance. We considered the company's and Mr. Taurel's accomplishment of objectives that had been established at the beginning of the year and our own subjective assessment of his performance. We noted that under Mr. Taurel's leadership, in 2004 the company achieved double-digit sales growth and growth in adjusted earnings per share that exceeded external expectations while launching five new products and several new indications or formulations. Mr. Taurel also successfully led important initiatives to improve productivity and reduce the company's cost structure. In addition, as a result of his leadership, the company made substantial progress in its efforts to align all its actions with the Lilly brand—Answers That Matter—and the four attributes of the brand: breakthrough products, medical expertise, active listening and responding, and reliable and trustworthy. For example, in 2004 the company strengthened its compliance activities and adopted the industry's most progressive principles of medical research and clinical trial registry.

In recognition of his continued strong leadership in 2004, we increased Mr. Taurel's annual salary by 4 percent effective March 2005. Mr. Taurel's 2005 target bonus remained at 110 percent of his base salary. As previously discussed under "Cash bonuses," the actual payout of $2.26 million was approximately 130 percent of target due to above-target growth in company sales and adjusted earnings per share in 2005.

As previously described, in 2005 we substantially reduced the value of equity awards for management at all levels and shifted the mix of awards to increase emphasis on performance awards and decrease emphasis on stock options. Mr. Taurel's award consisted of a stock option grant of 255,621 shares and a performance award with a target payout of 51,752 shares. The combined value of these awards at the time of grant was an estimated $7.2 million using the company's trinomial lattice method (30.37 percent of the option price) and a stock price of $55.65 to value the awards. In determining the value of the stock option and performance award grants for both years, we took into consideration Mr. Taurel's individual performance, internal relativity, peer group data, and the value of grants previously made to Mr. Taurel. The reductions in Mr. Taurel's award values compared with the prior year were the result of our decision to reduce award values to all levels of management.

Conclusion

The committee and the board believe that the caliber and motivation of all our employees, and especially our executive leadership, are essential to the company's performance. We believe our management compensation programs contribute to our ability to differentiate our performance from others in the marketplace. We will continue to design executive compensation programs in a manner that we believe will be in shareholders' interests and worthy of shareholder support.

Compensation Committee

Karen N. Horn, Ph.D., Chair
J. Michael Cook (from February 1, 2005)
George M.C. Fisher
J. Erik Fyrwald (from November 1, 2005)
Ellen R. Marram

Summary Compensation Table

Name and Principal Position	Year	Annual Compensation			Long-Term Compensation (1)			All Other Compensation (6) ($)	Total Compensation ($)
					Awards				
		Salary ($)	Bonus (2) ($)	Other Annual Compensation (3) ($)	Restricted Stock Awards (4) ($)	Number of Securities Underlying Options Granted	Grant Date Value of Options (5) ($)		
Sidney Taurel	2005	1,569,857	2,262,163	7,826	3,689,918	255,621	4,320,000	94,191	11,943,955
Chairman of the Board and	2004	1,501,050	1,486,040	70,524	1,590,120	400,000	10,792,000	72,050	15,511,784
Chief Executive Officer	2003	1,432,860	1,193,595	138,372	0	350,000	7,161,000	68,777	9,994,604
John C. Lechleiter, Ph.D.	2005	966,383	1,039,534	2,356	1,844,959	127,811	2,160,000	57,983	6,071,215
President and Chief	2004	894,000	603,450	2,894	795,060	200,000	5,396,000	42,912	7,734,316
Operating Officer	2003	725,625	417,657	6,249	0	120,000	2,455,200	34,830	3,639,561
Steven M. Paul, M.D.	2005	834,205	848,263	606	1,230,011	85,207	1,440,000	50,052	4,403,137
Executive Vice President,	2004	763,020	515,039	3,099	511,110	120,000	3,237,600	36,625	5,066,493
Science and Technology	2003	630,090	303,949	1,086	0	50,000	1,023,000	30,244	1,988,369
Charles E. Golden	2005	841,600	826,872	751	1,127,453	78,107	1,320,000	50,496	4,167,172
Executive Vice President	2004	813,210	548,917	3,366	511,110	120,000	3,237,600	39,034	5,153,237
and Chief Financial Officer	2003	789,540	444,117	6,492	0	120,000	2,455,200	37,898	3,733,247
Robert A. Armitage	2005	632,877	538,894	0	768,785	53,254	900,000	37,973	2,878,529
Senior Vice President and	2004	578,175	338,232	3,060	318,024	80,000	2,158,400	27,752	3,423,643
General Counsel	2003	550,020	268,137	28,899	0	80,000	1,636,800	26,401	2,510,257

(1) No stock appreciation rights were granted during the years indicated.

(2) For 2005 and 2004, amounts represent the individual's earned bonus under the Eli Lilly and Company Bonus Plan, based on the company's actual growth in sales and adjusted earnings per share for the year. For 2003, amounts represent a one-time discretionary bonus equivalent to 75 percent of the individual's normal bonus target under the company's prior bonus plan, the EVA® Bonus Plan.

(3) Amounts in this column represent primarily tax reimbursements on personal use of the corporate aircraft and above-market interest on deferred compensation. Beginning in 2004, the deferred compensation program was revised to provide for interest at a rate that is considered a market rate under Securities and Exchange Commission proxy reporting rules, 120 percent of the applicable federal long-term rate (5.64 percent in 2005).

For Mr. Taurel, the amounts also include the company's incremental cost to provide company aircraft to him for his personal travel, as follows: 2005: $0.00; 2004, $41,050; and 2003, $90,678. Under board policy, for security reasons the company-owned aircraft is made available to Mr. Taurel for both business and personal travel. Mr. Taurel did not use the corporate aircraft for any personal flights in 2005.

We report the incremental cost to the company of any such personal travel based on the cost of fuel, trip-related maintenance, crew travel expenses, on-board catering, landing fees, trip-related hangar/parking costs and smaller variable costs. Since the company-owned aircraft are used primarily for business travel, we do not include the fixed costs that do not change based on usage, such as pilots' salaries, the purchase costs of the company-owned aircraft, and the cost of maintenance not related to trips.

(4) All eligible global management received a payout of shares of Lilly stock under the performance award program based on earnings per share growth in 2005. For most management employees, the payout was in the form of freely tradable shares. However, consistent with our stock retention guidelines for executive officers, the payout for executive officers was in the form of restricted stock that vests on February 1, 2007. Mr. Taurel received 64,690 shares; Dr. Lechleiter received 32,345 shares; Dr. Paul received 21,564 shares; Mr. Golden received 19,766 shares; and Mr. Armitage received 13,478 shares. The table reflects the value of the shares awarded, based on the stock price of $57.04, the average of the high and low price of stock on January 20, 2006, the day the restricted shares were issued. Dividends will be paid on the restricted shares. In addition to the restricted shares awarded from the performance award payout, as of December 31, 2005, Mr. Taurel held 28,000 shares of restricted stock valued at $1,584,520; Dr. Lechleiter held 14,000 shares of restricted stock valued at $792,260; Dr. Paul held 17,000 shares of restricted stock valued at $962,030; Mr. Golden held 9,000 shares of restricted stock valued at $509,310; and Mr. Armitage held 10,600 shares of restricted stock valued at $599,854.

(5) The value of the 2005 stock option grant was established using the company's lattice-based valuation model described in footnote 3 to the table below titled Option Shares Granted in the Last Fiscal Year. The values for 2004 and 2003 were established using a Black-Scholes valuation model that we used for determining pro forma stock compensation expense under the prior Statement of Financial Accounting Standards (SFAS) No. 123.

(6) Company contribution to the named individual's account in the Lilly Employee 401(k) Plan.

Option Shares Granted in the Last Fiscal Year (1)

	Individual Grants				
Name	Number of Securities Underlying Options Granted	% of Total Option Shares Granted to Employees in Fiscal Year	Exercise or Base Price Per Share(2)	Expiration Date	Grant Date Present Value (3)
Sidney Taurel	255,621	5.03	55.65	February 10, 2015	$4,320,000
John C. Lechleiter, Ph.D.	127,811	2.51	55.65	February 10, 2015	$2,160,000
Steven M. Paul, M.D.	85,207	1.68	55.65	February 10, 2015	$1,440,000
Charles E. Golden	78,107	1.54	55.65	February 10, 2015	$1,320,000
Robert A. Armitage	53,254	1.05	55.65	February 10, 2015	$900,000

(1) No stock appreciation rights were granted in 2005.

(2) Options are granted at the market price of company common stock on the date of grant. Options are exercisable three years after their grant date.

(3) These values were established using a lattice-based option valuation model, consistent with the model used for our 2005 financial reporting. Assumptions used to calculate the grant date present value of option shares granted during 2005 were in accordance with SFAS No. 123 (revised 2004), share-based payment, as follows:

- (a) Expected Volatilities—Expected volatilities in the lattice model are based on implied volatilities from traded option on our stock, historical volatility of our stock price, and other factors. The volatilities were in a range of 27.6 to 30.7 percent with a weighted average of 27.8 percent.
- (b) Risk-Free Interest Rate—The range of rates is derived from the U.S. Treasury yield curve in effect at the time of the grant. The ranges of risk-free interest rates were 2.5 to 4.5 percent.
- (c) Dividend Yield—the expected dividend yield was 2.0 percent based on our historical experience and our estimate of future dividend yields.
- (d) Expected Life—the expected life of the grant was seven years, derived from the output of the lattice model.
- (e) Employee Behavior—based on an analysis of historical data, the model incorporated exercise and post-vesting forfeiture behavior, as well as the non-transferability component of the options.

Aggregate Option Shares Exercised in the Last Fiscal Year and Fiscal Year-End Option Values (1)

Name	Number of Shares Acquired On Exercise	Value Realized	Number of Securities Underlying Unexercised Options at Fiscal Year-End		Value of Unexercised, In-the-Money Options at Fiscal Year-End (2)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Sidney Taurel	295,728	$9,019,113	1,787,110	1,005,621	$3,235,684	$240,284
John C. Lechleiter, Ph.D.	0	$0	453,110	447,811	$288,354	$120,142
Charles E. Golden	90,830	$2,193,593	669,170	318,107	$2,532,459	$73,421
Steven M. Paul, M.D.	37,110	$977,737	363,790	330,207	$242,566	$80,095
Robert A. Armitage	0	$0	67,900	213,254	$0	$50,059

(1) No stock appreciation rights were exercised during 2005 and none were outstanding on December 31, 2005.
(2) Represents the amount by which the market price of Lilly stock exceeded the exercise prices of unexercised options held by the named individuals on December 31, 2005.

Retirement Benefits

We maintain two programs to provide retirement income to all eligible U.S. employees, including executive officers:

- The Lilly Employee 401(k) Plan, a defined contribution plan qualified under sections 401(a) and 401(k) of the Internal Revenue Code. Eligible employees may elect to contribute a portion of their salary to the plan, and the company provides matching contributions on the employees' contributions up to 6 percent of base salary. The employee contributions, company contributions, and earnings thereon are paid out in accordance with elections made by the participant. See the Summary Compensation Table on page 79 for information about the company contributions to the named executive officers.
- The Lilly Retirement Plan (the retirement plan), a tax-qualified defined benefit plan that provides monthly retirement benefits to eligible employees.

The following information further describes the retirement plan, including potential payments to named executive officers.

Pension Plan Table

Average Annual Earnings (Highest 5 of Last 10 Years)	Years of Service						
	15	20	25	30	35	40	45
$ 500,000	$ 103,010	$ 137,365	$ 171,685	$ 206,015	$ 240,360	$ 240,360	$ 249,000
1,000,000	210,805	281,065	351,350	421,610	491,870	491,870	498,010
1,500,000	318,600	424,790	531,000	637,190	743,390	743,390	747,010
2,000,000	426,395	568,525	710,650	852,780	994,920	994,920	996,010
2,500,000	534,180	712,235	890,305	1,068,370	1,246,430	1,246,430	1,247,430
3,000,000	641,975	855,970	1,069,970	1,283,950	1,497,950	1,497,950	1,497,950
3,500,000	749,770	999,695	1,249,620	1,499,545	1,749,470	1,749,470	1,749,470
4,000,000	857,570	1,143,420	1,429,270	1,715,125	2,000,975	2,000,975	2,000,975
4,500,000	965,350	1,287,145	1,608,935	1,930,715	2,252,495	2,252,495	2,252,495
5,000,000	1,073,150	1,430,870	1,788,590	2,146,295	2,504,030	2,504,030	2,504,230
5,500,000	1,180,945	1,574,590	1,968,240	2,361,890	2,755,535	2,755,535	2,755,535
6,000,000	1,288,740	1,718,315	2,147,905	2,577,480	3,007,055	3,007,055	3,007,055

The named executive officers will, upon retirement, be eligible for benefits under the retirement plan. The above table sets forth a range of annual retirement benefits for various levels of average annual earnings and years of service, assuming the employee retires at age 65 with a 50 percent survivor income benefit. The retirement plan benefits shown in the table are generally paid as a monthly annuity for the life of the retiree. The amounts shown in the table are not subject to reduction for Social Security benefits or any other offset amounts except that the ultimate pension benefits for Mr. Golden will be reduced by the amount of the pension payments

he receives from his previous employer. The annual benefit under the plan is calculated using the average of the annual earnings for the highest 5 out of the last 10 years of service (average annual earnings). Annual earnings covered by the retirement plan consist of salary, bonus, and, for years prior to 2004, long-term incentive plan payouts as set forth in the Summary Compensation Table on page 79 but calculated for the amount of bonus paid (rather than credited) and for the year in which earnings are paid (rather than earned or credited). For purposes of determining the annual benefit of the named executive officers under the retirement plan described above, below are their projected years of service at age 65 and their current average annual earnings:

Named Executive	Years of Service at Age 65	Current Average Annual Earnings
Mr. Taurel	43	$4,646,865
Dr. Lechleiter	39	$1,541,845
Mr. Golden	41	$2,486,772
Dr. Paul	34	$1,291,980
Mr. Armitage	14	$716,031

Mr. Golden received additional service credit when be began his employment in 1996. His retirement benefits will include the standard retiree medical benefits that would be available to retirees of the same age and with the same number of years of service credited. Dr. Paul joined the company in 1993. If he remains employed by the company past age 60, he will receive additional service credit, and his retirement benefit will not be reduced for early retirement. This additional service credit is included in the table above. When Mr. Armitage joined the company in 1999, the company agreed to provide him with a retirement benefit based on his actual years of service and earnings at age 60. Mr. Armitage will be eligible to retire under the retirement plan at age 61.

Section 415 of the Internal Revenue Code (the code) generally places a limit of $175,000 on the amount of annual pension benefits that may be paid at age 65 from a plan such as the retirement plan. Under an unfunded plan adopted in 1975, however, the company will make payments as permitted by the code to any employee who is a participant in the retirement plan in an amount equal to the difference, if any, between the benefits that would have been payable under the plan without regard to the limitations imposed by the code and the actual benefits payable under the plan as so limited.

Change-in-Control Severance Pay Arrangements

The company has adopted a Change-in-Control Severance Pay Program (the program) covering most employees of the company and its subsidiaries, including the company's executive officers. In general, the program would provide severance payments and benefits for eligible employees and executive officers in the event their employment is terminated under certain circumstances within fixed periods of time following a change in control. A change in control would occur if 15 percent or more of the company's voting stock were acquired by an entity other than the company, a subsidiary, an employee benefit plan of the company, or Lilly Endowment, Inc. There are additional conditions that could result in a change-in-control event. The program may not be amended by the board, whether prior to or following a change in control, in any manner adverse to a participant without his or her prior written consent.

Under the portion of the program covering the named executive officers, each would be entitled to severance payments and benefits in the event that his or her employment is terminated following a change in control (i) without cause by the company or (ii) for good reason by the executive officer, each as is defined in the program. In such case, the executive officer would be entitled to a severance payment equal to three times his or her current annual cash compensation. Additional benefits would include a pension supplement and full and immediate vesting of all stock options and other equity incentives. In the event that any payments made or benefits realized in connection with the change in control would be subject to the excise tax imposed under Section 4999 of the Internal Revenue Code as a result of the aggregate compensation payments and benefits made to the individual, under the program or otherwise, the company would cover the cost of the excise tax.

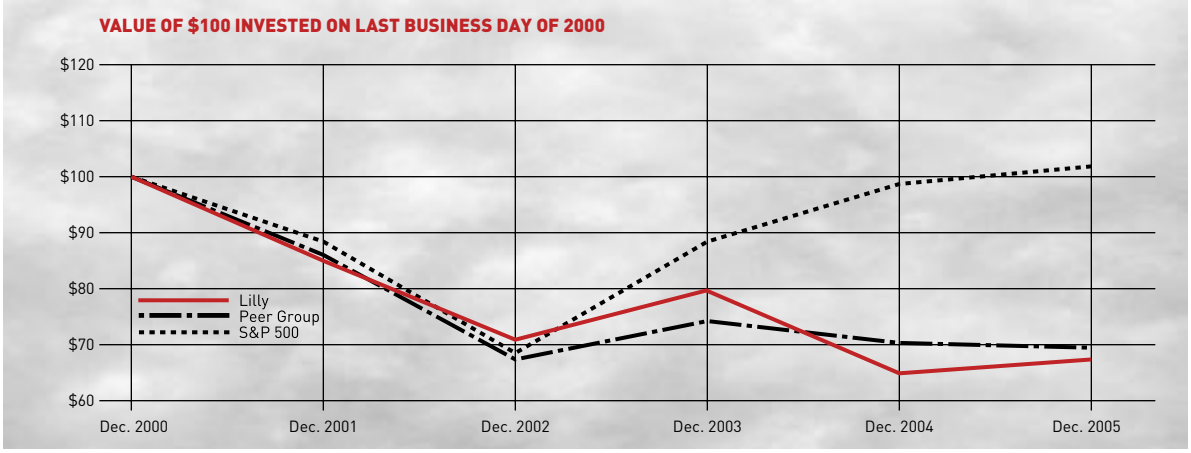
Related Transaction

As noted above, under board policy, for security reasons the company aircraft is made available to Mr. Taurel for all travel. The company has entered into a time-share arrangement with Mr. Taurel in connection with his personal use of company aircraft. Under the time-share agreement, Mr. Taurel leases the company aircraft, including crew and flight services, for personal flights. He pays a time-share fee based on the company's cost of the flight but capped at the greater of (i) an amount equivalent to first-class airfare for the relevant flight (if commercially available), and (ii) the Standard Industry Fare Levels as established by the Internal Revenue Service for purposes of determining taxable fringe benefits.

Performance Graph

This graph compares the return on Lilly stock with that of Standard & Poor's 500 Stock Index and our peer group* for the years 2001 through 2005. The graph assumes that, on December 31, 2000, a person invested $100 each in Lilly stock, the S&P 500 Stock Index, and the peer group's common stock. The graph measures total shareholder return, which takes into account both stock price and dividends. It assumes that dividends paid by a company are reinvested in that company's stock.

Comparison of Five-Year Cumulative Total Return Among Lilly, S&P 500 Stock Index, and Peer Group*



	2000	2001	2002	2003	2004	2005
Lilly	$100.00	$85.62	$70.62	$79.89	$65.93	$ 67.60
S&P 500	$100.00	$88.17	$68.73	$88.41	$98.00	$102.80
Peer Group	$100.00	$86.53	$67.37	$74.04	$71.27	$ 69.71

* We constructed the peer group as the industry index for this graph. It comprises the eight companies in the pharmaceutical industry that we used to benchmark 2005 compensation of executive officers: Abbott Laboratories; Bristol-Myers Squibb Company; GlaxoSmithKline; Johnson & Johnson; Merck & Co.; Pfizer, Inc. (including the results of Pharmacia Corporation up to the time of its merger with Pfizer); Schering-Plough Corporation; and Wyeth (formerly American Home Products Corporation).

Ownership of Company Stock

Common Stock Ownership by Directors and Executive Officers

The following table sets forth the number of shares of company common stock beneficially owned by the directors, the named executive officers, and all directors and executive officers as a group, as of February 3, 2006.

The table shows shares held by named executives in the Lilly Employee 401(k) Plan, shares credited to the accounts of outside directors in the Directors' Deferral Plan, and total shares beneficially owned by each individual, including the shares in the respective plans. In addition, the table shows shares that may be purchased pursuant to stock options that are exercisable within 60 days of February 3, 2006.

Name of Individual or Identity of Group	401(k) Plan Shares	Directors' Deferral Plan Shares (1)	Total Shares Owned Beneficially (2)	Stock Options Exercisable Within 60 Days of February 3, 2006
Mr. Armitage	944	—	31,119	147,900
Sir Winfried Bischoff	—	5,268	7,268	8,400
Mr. Cook	—	2,937	4,738	—
Dr. Feldstein	—	3,727	4,727	5,600
Mr. Fisher	—	10,431	20,430	8,400
Mr. Fyrwald	—	1,510	1,610	—
Dr. Gilman	—	10,851	10,851	11,200
Mr. Golden	1,471	—	108,146	789,170
Ms. Horn	—	22,894	24,950	11,200
Dr. Lechleiter	11,952	—	202,716 (3)	573,110
Ms. Marram	—	3,727	4,727	2,800
Dr. Paul	2,714	—	94,972	413,790
Dr. Prendergast	—	16,169	16,167	11,200
Ms. Seifert	—	12,432	15,559	11,200
Mr. Taurel	15,722	—	1,021,414	2,137,110
All directors and executive officers as a group (20 people)			1,817,060	

(1) See description of the Directors' Deferral Plan, page 72.

(2) Unless otherwise indicated in a footnote, each person listed in the table possesses sole voting and sole investment power with respect to the shares shown in the table to be owned by that person. No person listed in the table owns more than 0.09 percent of the outstanding common stock of the company. All directors and executive officers as a group own 0.16 percent of the outstanding common stock of the company.

(3) The shares shown for Dr. Lechleiter include 11,616 shares that are owned by a family foundation for which he is a director. Dr. Lechleiter has shared voting power and shared investment power over the shares held by the foundation.

Principal Holders of Stock

To the best of the company's knowledge, the only beneficial owners of more than 5 percent of the outstanding shares of the company's common stock are Lilly Endowment, Inc. (the "Endowment"), Capital Research and Management Company, and Wellington Management Company, LLP. The following table sets forth information regarding this ownership:

Name and Address	Number of Shares Beneficially Owned	Percent of Class
Lilly Endowment, Inc. 2801 North Meridian Street Indianapolis, Indiana 46208	147,645,804 (as of February 1, 2006)	13.0%
Capital Research and Management Company 333 South Hope Street Los Angeles, California 90071	80,429,400 (as of December 31, 2005)	7.1%
Wellington Management Company, LLP 75 State Street Boston, Massachusetts 02109	66,995,567 (as of December 30, 2005)	5.9%

The Endowment has sole voting and sole investment power with respect to its shares. The board of directors of the Endowment is composed of Mr. Thomas M. Lofton, chairman; Mr. N. Clay Robbins, president; Mrs. Mary K. Lisher; Drs. Otis R. Bowen and William G. Enright; and Messrs. Daniel P. Carmichael, Eli Lilly II, and Eugene F. Ratliff (Emeritus Director). Each of the directors is, either directly or indirectly, a shareholder of the company.

Capital Research and Management Company acts as investment adviser to various registered investment companies. It has sole voting power with respect to 13,489,100 shares (approximately 1.2 percent of shares outstanding) and sole investment power with respect to all of its shares.

Wellington Management Company, LLP acts as investment adviser to various clients. It has shared voting power with respect to 27,970,771 shares (approximately 2.5 percent of shares outstanding) and shared investment power with respect to all of its shares.

Items of Business to Be Acted Upon at the Meeting

Item 1. Election of Directors

Under the company's articles of incorporation, the board is divided into three classes with approximately one-third of the directors standing for election each year. The term for directors elected this year will expire at the annual meeting of shareholders held in 2009. Each of the nominees listed below has agreed to serve that term. If any director is unable to stand for election, the board may, by resolution, provide for a lesser number of directors or designate a substitute. In the latter event, shares represented by proxies may be voted for a substitute director.

The board recommends that you vote FOR each of the following nominees:
- Martin S. Feldstein, Ph.D.
- J. Erik Fyrwald
- Ellen R. Marram
- Sidney Taurel

Biographical information about these nominees can be found on pages 64–65 of this proxy statement.

Item 2. Proposal to Ratify the Appointment of Principal Independent Auditors

The audit committee has appointed the firm of Ernst & Young LLP as principal independent auditors for the company for the year 2006. In accordance with the bylaws, this appointment is being submitted to the shareholders for ratification. Ernst & Young served as the principal independent auditors for the company in 2005. Representatives of Ernst & Young are expected to be present at the annual meeting and will be available to respond to appropriate questions. Those representatives will have the opportunity to make a statement if they wish to do so.

The board recommends that you vote FOR ratifying the appointment of Ernst & Young LLP as principal independent auditors for 2006.

Item 3. Shareholder Proposal Regarding Care and Use of Animals

Meredith Page, on behalf of People for the Ethical Treatment of Animals (PETA), 501 Front Street, Norfolk, Virginia 23510, beneficial owner of approximately 100 shares, has submitted the following proposal.

The board recommends that you vote AGAINST this proposal.

WHEREAS, the Company conducts tests on animals as part of its product research and development; and
WHEREAS, the Company also retains independent laboratories to conduct tests on animals as part of product research and development; and
WHEREAS, Covance Inc. is an independent laboratory testing facility that the Company has retained to perform animal-based testing; and
WHEREAS, abuses of animals at Covance have been recently revealed and disclosed by the media; and
WHEREAS, the Company has an Animal Care and Use Policy posted on its website;
NOW THEREFORE,
BE IT RESOLVED, that the shareholders request that the Board issue a report to shareholders on the feasibility of amending the Company's Animal Care and Use Policy to ensure (a) that it extends to all contract laboratories and is reviewed with such outside laboratories on a regular basis, and (b) superior standards of care for animals who continue to be used for these purposes, both by the Company itself and by all independently retained laboratories, including provisions to ensure that animals' psychological, social and behavioral needs are met. Further, the shareholders request that the Board issue an annual report to shareholders on the extent to which in-house and contract laboratories are adhering to this policy, including the implementation of the psychological enrichment measures.

Statement of Support: A number of pharmaceutical companies have adopted and prominently published animal welfare policies on their websites relating to the care of animals used in product research and development. Eli Lilly as an industry leader is commended for its recognition of an "ethical and scientific obligation to ensure the appropriate treatment of animals used in research ..."[1]

However, the recent disclosure of atrocities recorded at Covance, Inc. has made the need for a formalized, publicly available animal welfare policy that extends to all outside contractors all the more relevant, indeed urgent. Filmed footage showed primates being subjected to such gross physical abuses and psychological torments that Covance sued to stop PETA Europe from publicizing it. The Honorable Judge Peter Langan, in the United Kingdom, who denied Covance's petition, stated in his decision that the video was "highly disturbing" and that just two aspects of it, namely the "rough manner in which animals are handled and the bleakness of the surroundings in which they are kept ... even to a viewer with no particular interest in animal welfare, at least cry out for explanation."[2]

Shareholders cannot monitor what goes on behind the closed doors of animal testing laboratories, so the Company must. Accordingly, we urge the Board to commit to ensuring that basic animal welfare measures are an integral part of our Company's corporate stewardship.

We urge shareholders to support this Resolution.

Statement in Opposition to Animal Care and Use Proposal

Lilly's public policy and compliance committee of the board has reviewed this proposal and believes that the additional reporting is an unnecessary use of the company's resources. The use of animals in clinical research is critical to advance drug discovery without endangering human life and to verify product safety prior to administering investigational drugs and biologics to human beings. We are committed to treating animals with appropriate care, and this commitment also extends to the third parties we work with.

Regulation and bioethics require us to carefully and thoroughly evaluate our products using the best scientific technologies available. Meeting this commitment requires the use of animals. We recognize that, in doing so, we have an ethical, scientific, and legal obligation to ensure the appropriate treatment of animals used in research, to minimize the number of animals involved, and to pursue the development of alternative test systems.

Where animals must be used, measures are taken to assure that discomfort and distress are minimized; living conditions of animals are appropriate for their species and contribute to their health and comfort; and all animals at the company are cared for under the close supervision of veterinarians and trained animal caretakers. The company's animal use care policies and guidelines are published on our website (www.lilly.com/about/policies).

Lilly complies with local, state, and federal laws, regulations and guidelines on the use of animals in clinical research, which are enforced through unannounced site inspections by the U.S. Department of Agriculture or local authorities. Other institutions engaged in animal research are subject to the same requirements, which include preparing and submitting formal reports to the U.S. Government detailing the type of research conducted and the use of animals in that research.

All institutions engaged in animal research must have an Institutional Animal Care and Use Committee (including an independent, third-party member), which approves and oversees animal research activities and care programs.

We select and maintain relationships with suppliers based on the merit and value of their products and services. When contracting with third parties to do research involving animal studies, we seek to do business with companies that share our commitment to best practices in animal welfare. We expect our suppliers to operate in full compliance with applicable laws and consistently with high standards of social, environmental, and economic performance.

Item 4. Shareholder Proposal Regarding Separating the Roles of Chairman and Chief Executive Officer

The Adrian Dominican Sisters, 1257 East Siena Heights Drive, Adrian, Michigan 49221-1793, beneficial owners of approximately 700 shares, have notified the company that they intend to present the following proposal at the annual meeting.

The board recommends that you vote AGAINST this proposal.

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[1] http://www.lilly.com/about/policies/#animal

[2] The case captioned Covance Laboratories Limited v. PETA Europe Limited was filed in the High Court of Justice, Chancery Division, Leeds District Registry, Claim No. 5C-00295. In addition to ruling in PETA's favor, the Court ordered Covance to pay PETA £50,000 in costs and fees.

Separating the Roles of Chairman and Chief Executive Officer
Resolved, the shareholders of Eli Lilly and Company request the Board of Directors establish a policy of, whenever possible, separating the roles of Chairman and Chief Executive Officer, so that an independent director who has not served as an executive officer of the Company serves as Chair of the Board of Directors.

This proposal shall not apply to the extent that complying would necessarily breach any contractual obligations in effect at the time of the 2006 shareholder meeting.

Statement of Support: We believe in the principle of the separation of the roles of Chairman and Chief Executive Officer. This is a basic element of sound corporate governance practice. In addition, the lack of access to medicines has created a leadership crisis at our company which a separation of the Chair and CEO would begin to address.

We believe an independent Board Chair—separated from the CEO—is the preferable form of corporate governance. The primary purpose of the Board of Directors is to protect shareholder's interests by providing independent oversight of management and the CEO. The Board gives strategic direction and guidance to our Company.

The Board will likely accomplish both roles more effectively by separating the roles of Chair and CEO. An independent Chair will enhance investor confidence in our Company and strengthen the integrity of the Board of Directors.

A number of respected institutions recommend such separation. CalPER's Corporate Core Principles and Guidelines state: "the independence of a majority of the Board is not enough" and that "the leadership of the board must embrace independence, and it must ultimately change the way in which directors interact with management."

An independent board structure will also help the board address complex policy issues facing our company, foremost among them the crisis in access to pharmaceutical products.

Millions of Americans and others around the world have limited or no access to our company's life-saving medicines. We believe an independent Chair and vigorous Board will bring greater focus to this ethical imperative, and be better able to forge solutions for shareholders and patients to address this crisis.

The current business model of the pharmaceutical sector is undergoing significant challenges. The industry has generated substantial revenue from American purchasers, who pay higher prices for medicines than those in other developed countries. Pressure on drug pricing and dependence on this business model may impact our company's long-term value. We believe independent Board leadership will better position our company to respond to these enduring challenges.

A similar resolution voted on in 2005 was supported by 24.5% of shareholders.

In order to ensure that our Board can provide the proper strategic direction for our Company with independence and accountability, we urge a vote FOR this resolution.

Statement in Opposition to the Proposal Regarding Separating the Roles of Chairman and Chief Executive Officer
The board of directors, the directors and corporate governance committee, and the public policy and compliance committee of the board have reviewed this proposal and recommend a vote against it. We believe that Lilly has a strong, independent board that operates under sound principles of corporate governance. (See pages 67–70 for a description of the board's governance principles.) We also believe that combining the roles of board chair and chief executive officer (CEO) generally provides the most efficient and effective leadership model for the company. Although we do not separate the chair and the CEO, we ensure independence through a counterbalancing governance structure. The board is substantially independent; our principles require that at least 75 percent of the board be independent, non-employee members. The presiding director, an independent director who is appointed by the board, presides at all meetings of the board at which the chairman is not present (unless another independent director is chosen, based on the subject matter), including an executive session after each regular board meeting and an annual review of the CEO's performance. In addition, the presiding director:

- leads the board process for selecting and evaluating the CEO
- serves as a liaison between the chairman and the independent directors
- generally approves information sent to the board and meeting agendas and schedules, and
- has authority to call meetings of the independent directors.

We agree that access to medicine continues to be a serious concern; however, the board's corporate governance principles ensure effective independent oversight of the company's responses to this problem. The public policy and compliance committee of the board, composed solely of independent directors, provides independent oversight of public policy issues for the board, including access to medicines.

We also agree that significant changes are needed in the U.S. health care system. We recognize and embrace

the need for sustainable reforms that will improve patient access to health care and cut waste and inefficiency out of the system, while preserving the free-market, competitive environment that produces innovative, customer-focused health care solutions for patients. Until such a comprehensive solution is reached, we are working to address the immediate needs of those without access to health care while maintaining our ability to discover and develop new medicines. For this reason, we have taken a number of steps to increase patient access to medicines, including supporting the Medicare Modernization Act (MMA) of 2003, under which all seniors can choose from a range of prescription drug benefits based on their needs and budgets. We also participate in Partnership for Prescription Assistance (PPA), which brings together America's biopharmaceutical research companies, health care providers, patient advocacy organizations, and community groups to help patients who lack prescription coverage in the United States get the medicines they need at the best prices available. In addition, Lilly has its own programs intended to supplement both industry efforts and government benefits to those in need. These include:

- patient assistance programs, through which Lilly provided more than $425 million in Lilly products to approximately 410,000 people in 2005.
- the Lilly MDR-TB Partnership, through which we donate medicines and technology to treat multi-drug resistant tuberculosis. Our commitment is valued at $70 million.
- financial support of philanthropic organizations.

For details on these programs, please see our website at: www.lilly.com/about/citizenship.

Guided by the active oversight of our independent directors, our company will continue to be a strong advocate for reforms that improve access to needed medicines while maintaining a free-market health care system and protecting our ability to deliver breakthrough medicines.

Item 5. Shareholder Proposal Regarding Annual Election of Each Director

The board recommends that you vote AGAINST this proposal.

William Steiner, 112 Abbotts Ford Gate, Piermont, New York 10968, beneficial owner of approximately 1,200 shares, has submitted the following proposal:

Elect Each Director Annually
RESOLVED: Shareholders request that our Directors take the necessary steps, in the most expeditious manner possible, to adopt and implement annual election of each director (in our Charter or Bylaws if practicable). This includes complete transition from the current staggered system to 100% annual election of each director in one election cycle if practicable. Also to transition solely through direct action of our board if practicable.

Statement of Support: The Safeway 2004 definitive proxy is one example of converting from a 100% staggered system to a 100% annual election of each director system in one election cycle. Southwest Airlines began transition to annual election of each director solely through direct action by the Southwest Airlines board in 2005.

66% Yes-Vote. Thirty-three (33) shareholder proposals on this topic won an impressive 66% average yes vote in 2005 through late-September. The Council of Institutional Investors www.cii.org, whose members have $3 trillion invested, recommends adoption of this proposal topic.

Progress Begins with One Step. It is important to take one step forward in our corporate governance and adopt the above RESOLVED statement since our 2005 governance standards were not impeccable. For instance in 2005 it was reported (and certain concerns are noted):

- The Corporate Library (TCL) http://www.thecorporatelibrary.com/ a pro-investor research firm rated our company: "F" in Takeover Defenses.
- We had no Independent Chairman—Independent oversight concern.
- We were allowed to vote on individual directors only once in 3-years—Accountability concern.
- We had to marshal an awesome 80% shareholder vote to make certain key governance improvements—Entrenchment concern.
- Cumulative voting was not allowed.

Additionally:

- Our directors and management were still protected or entrenched by a poison pill with a 15% threshold.

- Our company's takeover defenses included an "effective classified board," which means that our company combined a classified board election structure with certain other defensive elements in order to make hostile takeovers (and potentially profitable takeovers) virtually impossible.
- Mr. Cook was designated a "problem director" because he chaired the director nominations committee at Dow Chemical Company, which received a Board Composition grade of "F" by The Corporate Library.
- This was compounded by Mr. Cook being assigned to our audit and compensation committees.

A Single Yes-Vote from Our 1 Billion Shares Can Elect a Director for 3-Years. I believe our directors can be complacent under our present system. Our directors can be elected (and entrenched) with only one vote per director from our 1 billion voting shares. This is under our current plurality voting.

Best for the Investor. Arthur Levitt, Chairman of the Securities and Exchange Commission, 1993-2001 said: "In my view it's best for the investor if the entire board is elected once a year. Without annual election of each director shareholders have far less control over who represents them." "Take On The Street" by Arthur Levitt.

Elect Each Director Annually
Yes on 5

Statement in Opposition to the Proposal Regarding Annual Election of Each Director
The board of directors believes that this proposal is not in the best interests of the company or its shareholders. The company's system for electing directors, with the board divided into three classes of directors serving staggered three-year terms, was adopted by the company's shareholders in 1985. The board believes this system provides important benefits for the company:

- It enhances the board's ability to negotiate the best results for the shareholders in a takeover situation. It encourages potential acquirers to negotiate with the board since it could take more than one annual meeting to effect a change in control of the board. Therefore, this structure can provide the board additional time to evaluate the adequacy and fairness of any takeover proposal and to consider alternative methods of maximizing shareholder value. It can also give the board greater leverage in negotiating a transaction that is optimal for the shareholders and other stakeholders of the company.
- It promotes continuity and stability of the company's business strategies. At all times a majority of directors will have specific knowledge of the company's business and strategy. This fosters an in-depth focus on long-term strategy and other areas of oversight, as well as collaborative deliberations. Board continuity is especially important for an innovation-based pharmaceutical company such as Lilly. The process of guiding a new medicine from discovery to a marketed product typically requires many years and hundreds of millions of dollars, and the risks of failure for any single compound are enormous. In this environment, a long-term focus is essential to successfully planning and implementing corporate strategy.

The proponent suggests that the board is not sufficiently accountable to shareholders. On the contrary, the board is fully accountable to shareholders and committed to increasing shareholder value. The board has instituted a comprehensive set of corporate governance guidelines that foster the independence, professionalism and accountability of the directors. The guidelines are summarized on pages 67–70 of this proxy statement. Notably, in December 2005 the board adopted a new policy on director voting requiring any director who receives a majority of "withhold" votes to submit his or her resignation. This progressive policy further enhances board accountability and keeps Lilly a leader in corporate governance.

The classified board serves the company and its shareholders well by fostering a strong, stable, independent board of directors to guide the company in implementing its long-term strategy of growth through innovation.

Item 6. Shareholder Proposal Regarding Election of Directors by Majority Vote

The United Brotherhood of Carpenters Pension Fund, 101 Constitution Avenue, N.W., Washington, D.C. 20001, beneficial owner of approximately 18,400 shares, has notified the company that it intends to present the following proposal at the annual meeting.

The board recommends that you vote AGAINST this proposal.

Director Election Majority Vote Standard Proposal
Resolved: That the shareholders of Eli Lilly and Company ("Company") hereby request that the Board of Directors

initiate the appropriate process to amend the Company's articles of incorporation to provide that director nominees shall be elected by the affirmative vote of the majority of votes cast at an annual meeting of shareholders.

Statement of Support: Our Company is incorporated in Indiana. Among other issues, Indiana corporate law addresses the issue of the level of voting support necessary for a specific action, such as the election of corporate directors. Indiana law provides that unless a company's articles of incorporation provide otherwise, a plurality of all the votes cast at a meeting at which a quorum is present is sufficient to elect a director. (Indiana Code 23-1-30-9 Sec. 9. (a), Election of directors; cumulative voting.

Our Company presently uses the plurality vote standard to elect directors. This proposal requests that the Board initiate a change in the Company's director election vote standard to provide that nominees for the board of directors must receive a majority of the vote cast in order to be elected or re-elected to the Board.

We believe that a majority vote standard in director elections would give shareholders a meaningful role in the director election process. Under the Company's current standard, a nominee in a director election can be elected with as little as a single affirmative vote, even if a substantial majority of the votes cast are "withheld" from that nominee. The majority vote standard would require that a director receive a majority of the vote cast in order to be elected to the Board.

The majority vote proposal received high levels of support last year, winning majority support at Advanced Micro Devices, Freeport McMoRan, Marathon Oil, Marsh and McClennan, Office Depot, Raytheon, and others. Leading proxy advisory firms recommended voting in favor of the proposal.

Some companies have adopted board governance policies requiring director nominees that fail to receive majority support from shareholders to tender their resignations to the board. We believe that these policies are inadequate for they are based on continued use of the plurality standard and would allow director nominees to be elected despite only minimal shareholder support. We contend that changing the legal standard to a majority vote is a superior solution that merits shareholder support.

Our proposal is not intended to limit the judgment of the Board in crafting the requested governance change. For instance, the Board should address the status of incumbent director nominees who fail to receive a majority vote under a majority vote standard and whether a plurality vote standard may be appropriate in director elections when the number of director nominees exceeds the available board seats.

We urge your support for this important director election reform.

Statement in Opposition to the Majority Vote Proposal

The board has reviewed this proposal and recommends a vote against it. The board agrees that shareholders should have a meaningful role in the director election process. However, under current law, majority voting creates legal and practical complications that make its adoption inadvisable at this time. As an alternative, in December 2005, the board adopted a progressive corporate governance policy on director voting that gives shareholders influence in the director election process similar to majority voting while avoiding the legal problems inherent in majority voting under current law.

The system of plurality voting, which the proponent seeks to replace, has long been the accepted system among U.S. public companies and is the default system under Indiana corporate law. The rules governing plurality voting are well understood. In addition, it is important to note that Lilly directors have consistently received broad shareholder support—typically well over 90 percent of the votes cast. The proposal suggests that Lilly directors are being elected by minimal affirmative votes. That clearly is not the case.

The majority vote system suggested by the proponent is simple in concept, but in practice it raises complications under current law. A "failed election"—an uncontested election where a director nominee does not achieve a majority of the votes cast—could create a variety of outcomes that would frustrate the goal of providing shareholders a greater voice. Under Indiana law and the company's articles of incorporation, a director whose term expires continues to serve as a "holdover director" until his or her successor is elected and qualified. Thus, if the unsuccessful candidate in a failed election is an incumbent, he or she would continue to serve as a director, until at least the next annual meeting, and perhaps until the end of the next three-year term despite the failed election. If the candidate is not an incumbent, the director position would become vacant and could be filled by the directors acting alone—thus effectively bypassing the election process entirely for a three-year term. We do not believe such a result furthers shareholder democracy. On the other hand, if the "holdover" rule were to be abolished, a failed election could create a large number of immediate board vacancies, resulting in unintended consequences such as:

- inadvertently triggering "change-in-control" provisions in various compensation plans and third-party agreements;

- giving undue influence to special-interest voters who use director votes to forward their particular agenda; or
- facilitating opportunistic hostile takeover bids.

A number of legal scholars, practicing attorneys, corporations, and investors are actively studying these and other issues with majority voting under current laws to determine if there are workable, practical solutions that appropriately balance the interests of the shareholders, corporations, and their board members. For example, in January 2006, a blue-ribbon study committee of the American Bar Association issued a preliminary report recommending against adopting majority voting as the default rule, largely due to the problems noted above.[1] The board believes it is premature to adopt a majority voting standard until solutions to these problems have been identified and implemented.

In the meantime, the board has adopted a new corporate governance principle that gives real meaning to a majority "withhold" vote while avoiding the unintended consequences noted above. In an uncontested election, any director who receives a greater number of "withhold" votes than "for" votes is required to promptly tender his or her resignation. The directors and corporate governance committee will promptly consider the resignation and will recommend to the board whether to accept or reject it. Both the directors and corporate governance committee and the board will consider all factors they deem relevant in the exercise of their fiduciary duties, including without limitation:

- The director's qualifications, length of service, and contributions to the company
- The stated reasons why the shareholders withheld their votes for the director
- Whether the shareholders' concerns are more appropriately addressed by other means
- The company's corporate governance guidelines.

The board will act on the recommendation within 90 days after the shareholder meeting. The affected director cannot participate in any part of the process, and any board decision must have the support of a majority of the unaffected independent directors. The company will disclose the board's decision on a Form 8-K furnished to the Securities and Exchange Commission within four business days after the decision, including a full explanation of the process by which the decision was reached and, if applicable, the reasons why the board rejected the director's resignation. If the resignation is accepted, the directors and corporate governance committee will recommend to the board whether to fill the vacancy or reduce the size of the board.

The board believes that this new governance principle is the right solution under current law to ensure a meaningful director election process. Accordingly, we recommend that you vote against this shareholder proposal. We will continue to monitor developments in the ongoing debate about majority voting and will take appropriate action to maintain our commitment to corporate governance leadership.

[1] *Preliminary Report of the Committee on Corporate Laws on Voting by Shareholders for the Election of Directors*, Committee on Corporate Laws of the Section of Business Law of the American Bar Association, January 17, 2006. The Committee recommended maintaining plurality voting as a default but endorsed provisions that would facilitate, on an opt-in basis, a "modified plurality" approach that is similar in broad outline to the new governance principle adopted by the company.

Other Matters

Section 16(a) Beneficial Ownership Reporting Compliance

Under Securities and Exchange Commission rules, our directors and executive officers are required to file with the Securities and Exchange Commission reports of holdings and changes in beneficial ownership of company stock. We have reviewed copies of reports provided to the company, as well as other records and information. Based on that review, we concluded that all reports were timely filed except that, due to administrative error, Mr. Gino Santini was late in reporting a sale of stock under his 10b5-1 trading plan, Dr. Lorenzo Tallarigo was late in reporting a sale of stock associated with a stock option exercise, and Mr. Scott Canute was late in reporting a disposition of shares of stock withheld to pay taxes due upon vesting of a restricted stock grant. Upon discovery, these matters were promptly reported.

Other Information Regarding the Company's Proxy Solicitation

We will pay all expenses in connection with our solicitation of proxies. We will pay brokers, nominees, fiduciaries, or other custodians their reasonable expenses for sending proxy material to and obtaining instructions from persons for whom they hold stock of the company. We expect to solicit proxies primarily by mail, but directors, officers, and other employees of the company may also solicit in person or by telephone, telefax, or electronic mail. We have retained Georgeson Shareholder Communications Inc. to assist in the distribution and solicitation of proxies. Georgeson may solicit proxies by personal interview, telephone, telefax, mail, and electronic mail. We expect that the fee for those services will not exceed $17,000 plus reimbursement of customary out-of-pocket expenses.

By order of the board of directors,

James B. Lootens
Secretary

March 13, 2006

Corporate Information

Annual meeting

The annual meeting of shareholders will be held at Lilly Center Auditorium, Eli Lilly and Company, Indianapolis, Indiana, on Monday, April 24, 2006, at 11:00 a.m. EDT. For more information, see the proxy statement section of this report, beginning on page 58.

10-K and 10-Q reports

Paper copies of the company's annual report to the Securities and Exchange Commission on Form 10-K and quarterly reports on Form 10-Q are available upon written request to:

Eli Lilly and Company
P.O. Box 88665
Indianapolis, Indiana 46208-0665

To access these reports more quickly, you can find all of our SEC filings online at: http://investor.lilly.com/edgar.cfm

Stock listings

Eli Lilly and Company common stock is listed on the New York, London, and Swiss stock exchanges. NYSE ticker symbol: LLY. Most newspapers list the stock as "Lilly (Eli) and Co."

CEO and CFO certifications

The company's chief executive officer and chief financial officer have provided all certifications required under Securities and Exchange Commission regulations with respect to the financial information and disclosures in this report. The certifications are available as exhibits to the company's Form 10-K and 10-Q reports.

In addition, the company's chief executive officer has filed with the New York Stock Exchange a certification to the effect that, to the best of his knowledge, the company is in compliance with all corporate governance listing standards of the Exchange.

Transfer agent and registrar

Wells Fargo Shareowner Services
Mailing address:
Shareowner Relations Department
P.O. Box 64854
St. Paul, Minnesota 55164-0854
Overnight address:
161 North Concord Exchange
South St. Paul, Minnesota 55075
Telephone: 1-800-833-8699
E-mail: stocktransfer@wellsfargo.com
Internet: http://www.wellsfargo.com/com/shareowner_services

Dividend reinvestment and stock purchase plan

Wells Fargo Shareowner Services administers the Shareowner Service Plus Plan, which allows registered shareholders to purchase additional shares of Lilly common stock through the automatic investment of dividends. The plan also allows registered shareholders and new investors to purchase shares with cash payments, either by check or by automatic deductions from checking or savings accounts. The minimum initial investment for new investors is $1,000. Subsequent investments must be at least $50. The maximum cash investment during any calendar year is $150,000. Please direct inquiries concerning the Shareowner Service Plus Plan to:

Wells Fargo Shareowner Services
Shareowner Relations Department
P.O. Box 64854
St. Paul, Minnesota 55164-0854
Telephone: 1-800-833-8699

Online delivery of proxy materials

Shareholders may elect to receive annual reports and proxy materials online. This reduces paper mailed to the shareholder's home and saves the company printing and mailing costs. To enroll, go to http://proxyonline.lilly.com and follow the directions provided.

Annual Meeting Admission Ticket

Eli Lilly and Company 2006 Annual Meeting of Shareholders
Monday, April 24, 2006
11 a.m. EDT

Lilly Center Auditorium
Lilly Corporate Center
Indianapolis, Indiana 46285

The top portion of this page will be required for admission to the meeting.

Please write your name and address in the space provided below and present this ticket when you enter the Lilly Center.

A reception (beverages only) will be held from 10:00 a.m. to 10:45 a.m. in the Lilly Center.

Name _____

Address _____

City, State, and Zip Code _____

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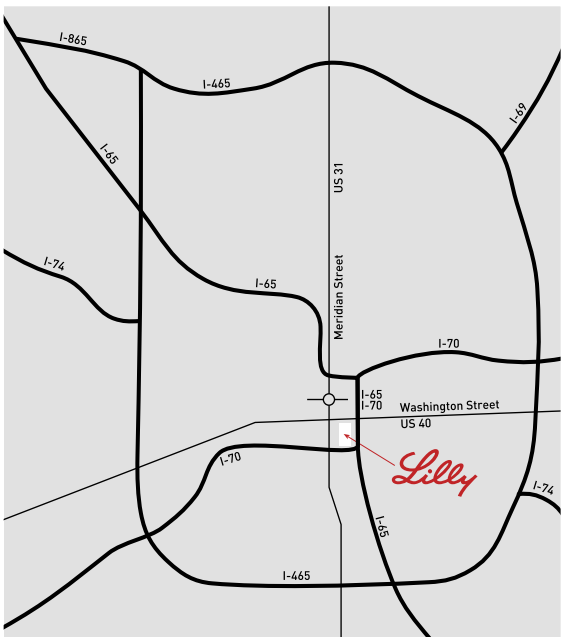
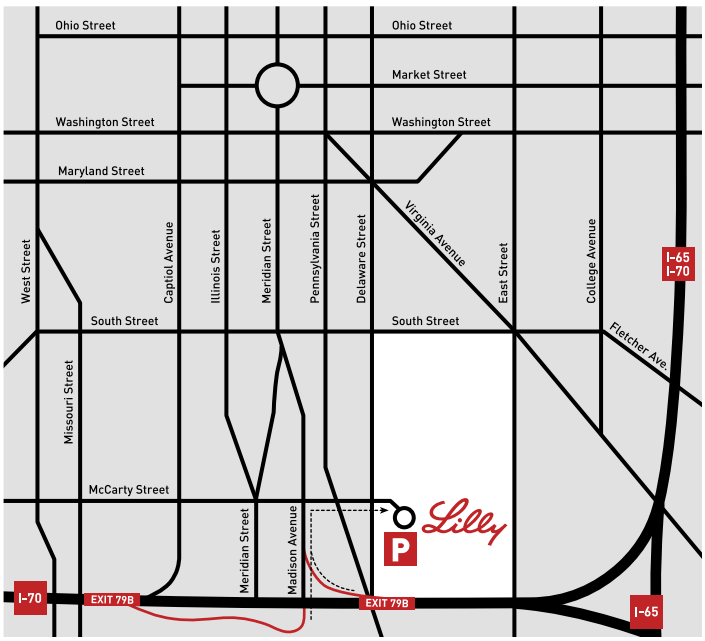
Detach here





Directions and Parking

From I-70 take Exit 79B; follow signs to McCarty Street. Turn right (east) on McCarty Street; go straight into Lilly Corporate Center. You will be directed to parking. **Be sure to take the admission ticket (the top portion of this page) with you to the meeting and leave this parking pass on your dashboard.**

Take the top portion of this page with you to the meeting.

Detach here

Detach here

Eli Lilly and Company
Annual Meeting of Shareholders
April 24, 2006

Complimentary Parking
Lilly Corporate Center

Please place this identifier on the dashboard of your car as you enter Lilly Corporate Center so it can be clearly seen by security and parking personnel.

Trademarks

Actos®	*(pioglitazone hydrochloride)*
Alimta®	*(pemetrexed disodium)*
Arxxant™	*(ruboxistaurin mesylate)*
Axid®	*(nizatidine)*
Byetta®	*(exenatide injection)*
Ceclor®	*(cefaclor)*
Cialis®	*(tadalafil)*
Coban®	*(monensin sodium), Elanco*
Cymbalta®	*(duloxetine hydrochloride)*
Evista®	*(raloxifene hydrochloride)*
Forteo®	*(teriparatide of recombinant DNA origin)*
Gemzar®	*(gemcitabine hydrochloride)*
Humalog®	*(insulin lispro of recombinant DNA origin)*
Humatrope®	*(somatropin of recombinant DNA origin)*
Humulin®	*(human insulin of recombinant DNA origin)*
Paylean®	*(ractopamine hydrochloride), Elanco*
Permax®	*(pergolide mesylate)*
Prozac®	*(fluoxetine hydrochloride)*
Prozac® Weekly™	*(fluoxetine hydrochloride)*
ReoPro®	*(abciximab)*
Rumensin®	*(monensin sodium), Elanco*
Sarafem®	*(fluoxetine hydrochloride)*
Strattera®	*(atomoxetine hydrochloride)*
Symbyax®	*(olanzapine/fluoxetine hydrochloride)*
Tylan®	*(tylosin), Elanco*
Vancocin®	*(vancomycin hydrochloride)*
Xigris®	*(drotrecogin alfa [activated])*
Yentreve®	*(duloxetine hydrochloride)*
Zyprexa®	*(olanzapine)*
Zyprexa® Zydis®	*(olanzapine)*

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Byetta® is a trademark of Amylin Pharmaceuticals, Inc.
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Vioxx® is a trademark of Merck and Co., Inc.
Zydis® is a trademark of Cardinal Health.

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For More Information

Lilly corporate responsibility	**www.lilly.com/about/citizenship**
Lilly clinical trials registry	**www.lillytrials.com**
Multi-drug resistant tuberculosis initiative	**www.lillymdr-tb.com**
Medicare prescription drug coverage	**www.lillymedicareanswers.com**
Pharmaceutical industry patient assistance programs	**www.pparx.org**
Lilly Cares	**www.lillycares.com** or call toll-free **1-800-545-6962**
LillyAnswers (for current participants through May 15, 2006)	**www.lillyanswers.com** or call toll-free **1-877-RX-LILLY**

 500002R

Eli Lilly and Company
Lilly Corporate Center
Indianapolis, Indiana 46285 USA

www.lilly.com

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Answers That Matter.