TARO PHARMACEUTICAL INDUSTRIES LTD
Form 6-K
March 31, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 6-K

REPORT OF FOREIGN PRIVATE ISSUER PURSUANT TO RULE 13a-16 OR 15d-16 UNDER THE SECURITIES EXCHANGE ACT OF 1934

For the month of March, 2011

Commission File Number 000-22286

Taro Pharmaceutical Industries Ltd.

(Translation of registrant's name into English)

14 Hakitor Street, Haifa Bay 26110, Israel
(Address of principal executive office)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.
Form 20-F x Form 40-F ¨

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1): _____

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7): _____

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934. Yes ¨ No x

If "Yes" is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-_____.

The Company is filing the attached audited consolidated financial statements for the year ended December 31, 2009.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, Item 308 of Regulation S-K requires a company's Annual Report to include management's annual report on internal control over financial reporting that contains, among other items, management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The Company is currently not providing the full disclosures required in an Annual Report on Form 20-F for the year ended December 31, 2009, however, the Company's management has performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2009. In connection with its assessment, management has determined that there were material weaknesses in the Company's internal control over financial reporting as of December 31, 2009 primarily related to (1) financial reporting and closing procedures, (2) certain revenue recognition procedures and (3) inventory valuation. Accordingly, management concluded that the Company's internal control over financial reporting was not effective as of December 31, 2009. The Company has instituted control procedures in order to remediate these material weaknesses and ensure that the consolidated financial statements are in conformity with United States generally accepted accounting principles.

SAFE HARBOR STATEMENT

Certain statements in this filing are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, but are not limited to, statements that do not describe historical facts and statements that refer or relate to events or circumstances the Company "estimates," "believes," or "expects" to happen or similar language, and statements with respect to the Company's financial performance, including its financial performance during the years discussed in this filing, availability of financial information, completion of the 2010 audit, and estimates of financial results and financial information for 2010. Although Taro Pharmaceutical Industries Ltd. believes the expectations reflected in such forward-looking statements to be based on reasonable assumptions, it can give no assurances that its expectations will be attained. Factors that could cause actual results to differ include the possible unavailability of financial information, completion of the aforesaid audit, actions of the Company's lenders and creditors, general domestic and international economic conditions, industry and market conditions, changes in the Company's financial position, litigation brought by any party in any court in Israel, the United States, or any country in which Taro operates, regulatory actions and legislative actions in the countries in which Taro operates, and other risks as detailed from time to time in the Company's SEC reports, including its Annual Reports on Form 20-F. Forward-looking statements speak only as of the date on which they are made. The Company undertakes no obligations to update, change or revise any forward-looking statement, whether as a result of new information, additional or subsequent developments or otherwise.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 31, 2011

TARO PHARMACEUTICAL INDUSTRIES LTD.

By: /s/ James Kedrowski
Name: James Kedrowski
Title: Interim Chief Executive Officer

TARO PHARMACEUTICAL INDUSTRIES LTD.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
Taro Pharmaceutical Industries Ltd.

We have audited the accompanying consolidated balance sheets of Taro Pharmaceutical Industries Ltd. (the "Company") and its subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the years in the three year period ended December 31, 2009. 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 audit.

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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company and its subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America.

Tel Aviv, Israel

March 30, 2011

/s/ Ziv Haft
Ziv Haft
Certified Public
Accountants (Isr)
BDO Member Firm

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED BALANCE SHEETS

U.S. dollars and shares in thousands

	December 31,	
	2009	2008
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$93,307	$68,828
Short-term bank deposits	20,974	10,000
Accounts receivable and other:		
Trade, net	61,643	62,098
Other receivables, prepaid expenses and other	45,603	19,605
Inventories	67,977	66,099
TOTAL CURRENT ASSETS	289,504	226,630
LONG-TERM RECEIVABLES AND OTHER ASSETS	31,549	27,856
PROPERTY, PLANT AND EQUIPMENT, NET	176,168	186,543
GOODWILL	7,265	7,217
INTANGIBLE ASSETS AND DEFERRED COSTS, NET	20,883	23,756
DEFERRED INCOME TAXES	50,520	1,096
TOTAL ASSETS	$575,889	$473,098

The accompanying notes are an integral part of these consolidated financial statements.

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED BALANCE SHEETS

U.S. dollars and shares in thousands

	December 31,	
	2009	2008
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term bank credit and short-term loans	$96,090	$100,116
Current maturities of long-term debt	29,277	29,888
Accounts payable:		
Trade payables	27,979	25,877
Other current liabilities	77,063	83,522
TOTAL CURRENT LIABILITIES	230,409	239,403
LONG-TERM LIABILITIES:		
Long-term debt, net of current maturities	38,380	58,019
Deferred income taxes	3,813	3,793
Other long-term liabilities	7,591	7,666
TOTAL LONG-TERM LIABILITIES	49,784	69,478
COMMITMENTS AND CONTINGENT LIABILITIES		
TOTAL LIABILITIES	280,193	308,881
SHAREHOLDERS' EQUITY:		
Taro shareholders' equity:		
Ordinary shares of NIS 0.0001 par value:		
Authorized at December 31, 2009 and 2008: 200,000,000 shares; Issued at December 31, 2009 and 2008: 39,509,257 and 39,460,509 shares, respectively.		
Outstanding at December 31, 2009 and 2008:		
39,249,082 and 39,200,082 shares, respectively	679	679
Founders' shares of NIS 0.00001 par value:		
Authorized, issued and outstanding at December 31, 2009 and 2008:		
2,600 shares	1	1
Additional paid-in capital	222,608	222,138
Accumulated other comprehensive income	21,980	7,722
Treasury stock: 260,175 shares at December 31, 2009 and 2008	(1,329)	(1,329)
Accumulated earnings (deficit)	49,029	(64,994)
Taro shareholders' equity	292,968	164,217
Non-controlling interest	2,728	-
TOTAL SHAREHOLDERS' EQUITY	295,696	164,217
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$575,889	$473,098

The accompanying notes are an integral part of these consolidated financial statements.

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars and shares in thousands (except per share data)

	Year ended December 31,		
	2009	2008	2007
Sales, net	$357,643	$329,036	$319,554
Cost of sales	154,603	148,317	133,229
Impairment	171	27	170
Gross profit	202,869	180,692	186,155
Operating expenses:			
Research and development, net	34,243	35,044	29,817
Selling, marketing, general and administrative	102,202	99,025	97,274
Impairment	3,363	2,820	-
	139,808	136,889	127,091
Operating income	63,061	43,803	59,064
Financial expenses, net	16,527	795	22,816
Other gain, net	560	1,054	4,300
Income before income taxes	47,094	44,062	40,548
Tax (benefit) expense	(69,657)	13,541	6,212
Net income	116,751	30,521	34,336
Net income attributable to non-controlling interest	2,728	-	-
Net income attributable to Taro	$114,023	$30,521	$34,336
Basic net income per ordinary share attributable to Taro	$2.91	$0.78	$0.99
Diluted net income per ordinary share attributable to Taro	$2.81	$0.76	$0.98
Weighted-average number of ordinary shares used to compute basic income per share	39,232	39,200	34,725
Weighted-average number of ordinary shares used to compute diluted income per share	40,568	40,423	35,215

The accompanying notes are an integral part of these consolidated financial statements.

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars and shares in thousands

	Taro Shareholders' Equity									
	Number of Shares	Share Capital	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Treasury Shares	Retained Earnings (Accumulated Deficit)	Total Taro Comprehensive Income (Loss)	Total Taro Shareholders' Equity	Non-controlling Interest	Total Shareholders' Equity
Balance at January 1, 2007	29,358	$680	$165,058	$14,106	$(1,388)	$(128,673)	$ -	$49,783	$-	$49,783
Release of treasury shares to employees under ESPP	1				27			27		27
Cumulative effect adjustment upon adoption of FIN 48						(1,178)		(1,178)		(1,178)
Exercise of options and issuance of shares of ESPP	49		183					183		183
Issuance of shares and warrants to Sun, net	6,788		39,189					39,189		39,189
Exercise of Sun warrants	3,000		17,100					17,100		17,100
Share-based compensation			284					284		284
Comprehensive income (loss), net of tax:										
Foreign currency translation adjustments				13,597			13,597	13,597		13,597
Unrealized gain from available for										

sale marketable securities				11			11	11		11
Reclassification of unrealized gains from marketable securties to earnings				(94)			(94)	(94)		(94)
Net income						34,336	34,336	34,336		34,336
Total comprehensive income:							$47,850		$-	
Balance at December 31, 2007	39,196	680	221,814	27,620	(1,361)	(95,515)		153,238		153,238
Exercise of options and issuance of shares of ESPP	4		2		32			34		34
Share-based compensation			322					322		322
Comprehensive income (loss), net of tax:										
Foreign currency translation adjustments				(19,898)			(19,898)	(19,898)		(19,898)
Net income						30,521	30,521	30,521		30,521
Total comprehensive income:							$10,623		$-	
Balance at December 31, 2008	39,200	680	222,138	7,722	(1,329)	(64,994)		164,217		164,217
Exercise of options and issuance of shares of ESPP	49		163					163		163
Share-based compensation			307					307		307
Comprehensive income (loss), net of tax:										
Foreign currency translation adjustments				14,258			14,258	14,258		14,258
Net income						114,023	114,023	114,023	2,728	116,751

Total comprehensive income:							$128,281		$2,728	
Balance at December 31, 2009	39,249	$680	$222,608	$21,980	$(1,329)	$49,029		$292,968		$295,696

The accompanying notes are an integral part of these consolidated financial statements.

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2009	2008	2007
Cash flows from operating activities:			
Net income	$116,751	$30,521	$34,336
Adjustments required to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	18,445	21,187	22,614
Change in deferred charges and other assets	69	101	244
Impairment of long-lived assets	3,534	2,847	170
Share-based compensation expense	307	322	284
Accrued severance pay and other long-term liabilities, net	(539)	571	(1,492)
Loss (gain) on sale of long-lived assets	34	(56)	(3,727)
Realized gain on sale of marketable securities	-	-	(94)
Change in derivative instruments, net	(4,019)	13,066	(6,948)
Effect of exchange differences on inter-company balances	8,713	(13,328)	7,259
Increase in long-term debt due to currency fluctuations	2,401	3,736	7,714
Deferred income taxes, net	(78,191)	(115)	2,197
Decrease (increase) in trade receivables, net	1,081	6,606	(29,626)
Decrease in other receivables, prepaid expenses and other	3,229	1,187	730
(Increase) decrease in long-term receivables and other assets	(842)	(718)	2,125
Increase in income tax receivables	(1)	-	-
Decrease (increase) in inventories, net	762	(2,912)	(7,430)
Increase in trade payables	690	7,459	882
Decrease in other accounts payable and accrued expenses	(5,824)	(5,412)	(28,361)
(Decrease) increase in income tax payables	(2,681)	9,815	275
Net cash provided by operating activities	63,919	74,877	1,152

The accompanying notes are an integral part of these consolidated financial statements.

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31, 2009	2008	2007
Cash flows from investing activities:			
Purchase of property, plant and equipment	(5,025)	(3,572)	(5,984)
Investment in other intangible assets	(120)	(594)	(229)
Investment in short-term bank deposits	(10,974)	(10,000)	-
Proceeds from (investment in) restricted bank deposits	1,000	(6,250)	-
Proceeds from long-term deposits and other assets	14	70	-
Proceeds from sale of marketable securities	-	-	125
Proceeds from sale of long-lived assets	1,655	65	10,151
Net cash (used in) provided by investing activities	(13,450)	(20,281)	4,063
Cash flows from financing activities:			
Proceeds from issuance of shares, net	163	34	56,499
Proceeds (repayments) of short-term bank debt, net	1,660	2,818	(6,388)
Repayment of long-term debt	(30,403)	(31,776)	(26,373)
Net cash (used in) provided by financing activities	(28,580)	(28,924)	23,738
Effect of exchange rate changes on cash and cash equivalents	2,590	(2,031)	94
Increase in cash and cash equivalents	24,479	23,641	29,047
Cash and cash equivalents at the beginning of the year	68,828	45,187	16,140
Cash and cash equivalents at the end of the year	$93,307	$68,828	$45,187
Supplemental disclosure of cash flow transactions:			
Cash paid during the year for:			
Interest	$8,256	$12,039	$14,793
Income taxes	$11,970	$3,197	$3,644
(a) Non-cash investing and financing transactions:			
Purchase of property, plant and equipment on credit	$755	$288	$317
Investment in intangible assets on credit	$-	$-	$14

The accompanying notes are an integral part of these consolidated financial statements.

NOTE 1: — GENERAL

a. Taro Pharmaceutical Industries Ltd. (the “Company” or “Taro”) is an Israeli corporation, which operates in Israel and elsewhere through its Israeli, North American, and European subsidiaries (the “Group”). The principal business activities of the Group are the production, research, development and marketing of pharmaceutical products. The Company’s ordinary shares are quoted on the Pink Sheets Electronic Quotation Service (“Pink Sheets”) under the symbol TAROF. As used herein, the terms "we," "us," "our," “Taro” and the "Company" mean Taro Pharmaceutical Industries Ltd. and its subsidiaries, unless otherwise indicated.

The activities of the Group in North America are performed by Taro Pharmaceuticals Inc., Taro Pharmaceuticals North America, Inc. and Taro Pharmaceuticals U.S.A., Inc. (“Taro U.S.A.”). Taro Research Institute Ltd. in Israel provides research and development services to the Group. Taro International Ltd. in Israel, Taro Pharmaceuticals Ireland Ltd. and Taro Pharmaceuticals Europe B.V. are engaged in the pharmaceutical activities of the Group outside North America.

The Group manufactures generic and proprietary drug products in facilities located in Israel and Canada, and manufactures bulk active pharmaceutical ingredients in its facilities located in Israel. The Group’s research facilities are located in Israel and Canada. The majority of the Group’s sales are in North America.

In North America, the Company sells and distributes its products principally to drug industry wholesalers, drug store chains and mass merchandisers. In Israel, the Group sells and distributes its products principally to healthcare institutions and private pharmacies.

In the generic pharmaceutical industry, selling prices and related profit margins tend to decrease as products mature due to increased competition from other generic pharmaceutical manufacturers as they gain approval from the U.S. Food and Drug Administration (the “FDA”), the Canadian Health Products and Food Branch Inspectorate, and the Israeli and other Ministries of Health (“Government Agencies”) to manufacture equivalent products. The Group’s future operating results are dependent on, among other things, its ability to introduce new products and maintain its approvals to market existing drugs.

While non-compliance with Government Agencies’ regulations can result in refusal to allow entry, seizure, fines or injunctive actions to prevent the sale of products, no such actions against the Group or its products have ever occurred. The Group believes that it is in material compliance with all Government Agencies’ regulations. In February 2009, our Canadian manufacturing facility received a warning letter from the FDA (the “Warning Letter”) expressing concern identified during a July 2008 inspection about certain quality control systems, including failure to complete investigations of quality issues in a timely manner. The Company responded to the Warning Letter on March 17, 2009, submitted and discussed a full compliance work plan with the FDA, provided periodic written updates to the FDA and is committed to working with the FDA to resolve all issues. The Company has corrected the specific observations cited during the July 2008 inspection and in the Warning Letter, and, to ensure its products meet all requirements, has improved its ability to adhere to current good manufacturing practices (“cGMPs”) by adding additional qualified personnel, engaging outside experts and adding new procedures to resolve any systemic issues and prevent recurrence. The observations cited in the Warning Letter do not relate to any of the Company's other

facilities. Until remedial action is complete and the FDA has confirmed compliance with cGMPs, new applications listing the Canadian facility as a manufacturing location of finished dosage forms may not be approved. However, one new product made at the Company's Canadian facility was approved by the FDA in May 2009 after the issuance of the Warning Letter. Other Federal agencies take the Warning Letter into account when considering the awards of contracts and in some cases may have the right to terminate any agreement they have with us or remove products from their pricing schedule as one agency has done. A formal cGMP re-inspection was conducted by the FDA in February 2011 to evaluate the effectiveness of corrective actions undertaken by Taro and the Company is awaiting final disposition. This has not had a material impact on the Company's financial condition.

While the majority of the Company's products are either synthesized by the Company itself or are derived from multiple source materials, some raw materials and certain products are currently obtained from single domestic or foreign suppliers. The Company does not believe that any interruption of supply from a single supplier would have a material adverse effect on the Company's results of operations and financial position. To date, the Group has not experienced difficulties in obtaining raw materials.

b. On May 18, 2007, the Company, Alkaloida Chemical Company Exclusive Group Ltd. ("Alkaloida"), a subsidiary of Sun Pharmaceutical Industries Ltd. (together with its affiliates "Sun") (Reuters: SUN.BO, Bloomberg: SUNP IN, NSE: SUNPHARMA, BSE: 524715) and Aditya Acquisition Company Ltd. ("Aditya") entered into a merger agreement (the "Merger Agreement"). In addition, Taro entered into a Share Purchase Agreement with Alkaloida, pursuant to which Taro issued Alkaloida 6,787,500 ordinary shares at $6.00 per share, for a total of $40,725 (the "Share Purchase Agreement"). Under the terms of the Share Purchase Agreement, Sun also received a three-year warrant to purchase additional ordinary shares at $6.00 per share. On August 2, 2007, Sun exercised a portion of its warrant in favor of Alkaloida, as assignee, and purchased 3,000,000 additional shares at an exercise price of $6.00 per share, or $18,000. This additional investment, together with its original purchase of Taro's newly issued shares, brought Sun's investment in Taro to $58,725. Taro paid $2,436 in stock issuance costs and therefore retained $56,289 of the proceeds. The net proceeds were recorded within shareholders' equity on the consolidated balance sheet in accordance with FASB ASC Subtopic 815-40, "Derivatives and Hedging - Contracts in Entity's Own Equity" (formerly Emerging Issues Task Force ("EITF") Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"), as the Company did not meet the criteria of a derivative under FASB ASC Section 815-40-30, "Derivatives and Hedging - Contracts in Entity's Own Equity – Initial Measurement" (formerly EITF 00-19).

On May 28, 2008, the Company terminated the Merger Agreement. On the same day, the Company and its directors, other than the members of the Levitt and Moros families (the "Independent Directors"), brought a lawsuit against Sun and its affiliates in the Tel-Aviv District Court (the "District Court") seeking a declaratory judgment that, under the Israeli Companies Law, a "Special Tender Offer" was required. On June 25, 2008, Sun gave notice that it was exercising its option under the May 18, 2007 option agreement entered into by Sun, with Dr. Barrie Levitt, Dr. Daniel Moros, Ms. Tal Levitt, Dr. Jacob Levitt and Taro Development Corporation ("TDC") (the "Option Agreement"). Pursuant to the Option Agreement, Sun was granted the option to acquire certain ordinary shares owned by Dr. Barrie Levitt, Dr. Moros, Ms. Levitt, and TDC for $7.75 per share, as well as all of the founders' shares, which represented one third of the voting power of all of the Company's shares, for no consideration (the "Options"). A condition to the exercise of the Options required Sun to commence a tender offer to purchase any and all ordinary shares owned by all other shareholders for $7.75 per share. According to the terms of the Option Agreement, the transactions contemplated would be consummated contemporaneously with the expiration of the tender offer.

On June 30, 2008, Sun commenced a regular tender offer for any and all ordinary shares at a price of $7.75 per share (the "Sun Offer"). On August 26, 2008, the District Court ruled that Sun was not required to comply with the Special Tender Offer rules. On August 28, 2008, the Company and its Independent Directors filed an appeal to the Supreme Court of the State of Israel (the "Israeli Supreme Court") and requested a temporary injunction to prevent Sun from acquiring additional ordinary shares which would result in its voting power being more than 45% of the Company's voting power during the pendency of the appeal. On September 1, 2008, the Israeli Supreme Court granted the

temporary injunction.

On September 7, 2010, the Supreme Court denied the Company’s appeal and ordered the revocation of the temporary injunction which had prohibited the closing of the Sun Offer.

On the same day, Sun announced the decision of the Israeli Supreme Court and the expiration date of the Sun Offer (the “Announcement Date”) as the fifth business day following the Announcement Date which was 12:00 midnight, New York City time, on Tuesday, September 14, 2010.

On September 21, 2010, the Company announced that the controlling shareholders of the Company, the Levitt and Moros families (together with their affiliated entities, the “Levitt/Moros Shareholders”), executed a letter agreement (the “Letter Agreement”) on September 20, 2010 with Sun. Pursuant to the Letter Agreement, the Levitt/Moros Shareholders transferred certain beneficial interests in the Company to Sun in accordance with the Option Agreement. Among the interests transferred was beneficial ownership of the founders’ shares of Taro, which represent one-third of the voting power of Taro’s capital stock.

Concurrent with the execution of the Letter Agreement, Sun and the members of Taro’s Board of Directors (the “Board”), including the Levitt/Moros Shareholders, entered into a settlement agreement and release, pursuant to which Sun and the incumbent members of Taro’s Board agreed, among other things, to release each other from, and covenanted not to sue, based on certain claims related generally to the acquisition of Taro by Sun and litigation arising therefrom.

Also, on September 20, 2010, Taro’s Board passed a resolution appointing Dilip Shanghvi, Sudhir Valia, Aalok Shanghvi, Hasmukh Shah and Ilan Leviteh as members of the Board, and the incumbent members of Taro’s Board submitted their resignations as directors and officers of the Company and its subsidiaries, as applicable. At a subsequent Board meeting, Mr. Dilip Shanghvi was elected Chairman of Taro’s Board.

In addition to the foregoing, the Company issued a letter dated September 20, 2010, to Sun and Alkaloida acknowledging the valid exercise by Alkaloida of a certain Warrant No. 2 issued August 1, 2007, for the purchase of 3,787,500 ordinary shares of Taro for an aggregate price of $22,725. With the exercise of Warrant No. 2 as well as the completion of the acquisition of the shares from the Levitt/Moros Shareholders and the acquisition of the shares from Templeton Asset Management Ltd. (“Templeton”) on November 1, 2010, Sun increased its ownership of Taro's ordinary shares to 64.8% and, with Taro's founders' shares, its voting rights to 76.5%.

On January 18, 2011, Alkaloida acquired 712,500 ordinary shares of Taro pursuant to a certain Warrant No. 2 dated August 1, 2007 issued by the Company to Sun Pharma (the "Warrant"). Additionally, Alkaloida acquired 712,500 ordinary shares of the Company available pursuant to a certain Share Purchase Agreement dated May 18, 2007 between Alkaloida and the Company (the "SPA"). As a result of the exercise of the Warrant and the purchase of shares by Alkaloida pursuant to the SPA, the Company's issued and outstanding ordinary shares are 44,505,457 and Sun Pharma owns, or controls, 29,497,933, or 66.3%, of the Company's ordinary shares, and with the Company's founders' shares, 77.3% of the vote attributable to the share equity of the Company.

c. In July 2004, Taro U.S.A. entered into a license agreement with Medicis Pharmaceutical Corporation (“Medicis”) for four product lines used in the treatment of skin disorders, including the Lustra® product line and two previously unmarketed products in the United States, Canada and Puerto Rico. The entire purchase price of $35,565 was treated as a product rights purchase and therefore, was recorded on the balance sheet under the line item “other intangible assets and deferred charges, net.” The Company allocated $23,165 for the Lustra® product family. Lustra® and Lustra-AF® were marketed by Medicis for a number of years. One of the previously unmarketed products, from the Lustra® product family, was subsequently launched by Taro under the name Lustra-Ultra™. Taro allocated $12,400 for the second previously unmarketed product, which was subsequently launched by Taro under the name U-Kera™. During 2006, the Company recorded an impairment charge of $10,023, to write off the

remaining carrying value of the U-Kera™ intangible asset and recorded an impairment charge of $13,236 to reduce the carrying value of the Lustra® intangible asset to $6,298. These charges were the result of competitive market pressures and were recorded in cost of sales. The impairments were determined by conducting valuation studies and employing a discounted cash flow analysis. The remaining carrying value is being amortized to cost of sales over the weighted-average life of the product rights. See Note 2.k.

As part of the agreement, the Company received $20,000 from Medicis, which the Company estimated was its returns exposure for these products, and with which the Company established a reserve. This return reserve is presented together with the reserve for returns in current liabilities. The Company also agreed to accept expired returned goods in the future, even though the product returned may not have been sold by Taro. The reserve was established anticipating that customers will deduct, from their cash payments to the Company, the price that they originally paid to Medicis for the goods being returned. This reserve was utilized for the return exposure related to the acquired products.

d. In March 2005, the Company, through its subsidiaries, entered into multi-year agreements with Alterna-TCHP, LLC (“Alterna”) to license the Company’s over-the-counter ElixSure® and Kerasal® products in North America.

The terms of the agreements include, among other things, the license of rights to distribute ElixSure® and Kerasal® products and an option to acquire the ownership rights for additional consideration, multi-year manufacturing and supply arrangements and the sale of ElixSure® inventory on-hand at the outset of the arrangement. At the time of signing the agreements, the Company received $10,000 and there were to be additional payments due over the term of the agreements. In addition, the Company receives payments from Alterna for ongoing manufacturing and supply of the products during the agreement term.

The Company accounted for this transaction in accordance with FASB Subtopic ASC 605-25, “Revenue Recognition – Multiple-Element Arrangements” (formerly EITF Issue No. 00-21, “Revenue Arrangement with Multiple Deliverable”). The Company has concluded that the entire arrangement should be considered as one unit of accounting mainly because the Company could not establish fair value for all undelivered elements in the transaction. Accordingly, the total up-front consideration is being recognized as revenue over the three-year term of the arrangement. Revenue recognition is limited to cash received. In addition, the Company recorded deferred inventory cost in the amount of $2,037 related to the costs of ElixSure® products that were sold to Alterna at the outset of the agreement. The cost is amortized over the three-year term of the manufacturing and supply services under the agreements.

The Company determined that Alterna is a Variable Interest Entity (“VIE”) in accordance with FASB ASC Subtopic 810-20, “Consolidation – Control of partnerships and similar entities” (formerly Financial Accounting Standards Board (“FASB”) Interpretation No. 46 (Revised December 2003), “Consolidation of Variable Interest Entities”). However, the Company has concluded that it is not the primary beneficiary of the VIE, therefore Alterna has not been consolidated into the Company’s results of operations. The Company concluded that the amendment to the agreements in June 2006 should not change this conclusion, primarily since the Company does not have exposure to losses from its involvement with Alterna.

e. The Company, through its Irish subsidiary, owns a pharmaceutical manufacturing and research facility in Ireland, designed primarily for the manufacture of sterile products. As a result of the delay in receiving regulatory approval for the manufacture of new products, the inability to pursue the launch of certain approved products, and further financial constraints during 2006 which significantly reduced the level of additional investment in the Irish facility, the Company recorded an impairment charge related to its Irish facility during 2006.

The Company used the market approach in determining the fair value of the group of assets. During 2009 and 2008, the Company recorded further impairment charges on land, building and machinery of $3,363 and $2,820, respectively. In November 2009, the Company’s Irish subsidiary sold certain equipment, net of transaction costs, for $1,485.

During 2010, the Company announced the closure of the manufacturing facility in Ireland and is exploring its options related to the facility. The Company is currently analyzing the impact of that event on subsequent years’ financial statements and any possible additional impairment that may be required in future years.

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NOTE 2: — SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements are prepared according to United States generally accepted accounting principles ("U.S. GAAP").

a. Use of estimates:

The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates, judgments and assumptions. The Company's management believes that the estimates, judgments and assumptions used are reasonable based upon information available at the time they are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

The Company's most critical estimates are used in its determination of its sales incentives reserves (see Note 4 for details), inventory reserves, income taxes, fixed assets, intangible assets, derivative instruments and contingencies.

b. Financial statements in U.S. dollars:

A majority of the revenue of the Company and certain of its subsidiaries (exclusive of its Canadian, Irish, and U.K. subsidiaries – see below) is generated in U.S. dollars ("dollars"). In addition, a substantial portion of the costs of the Company and these subsidiaries is incurred in dollars. The Company's management believes that the dollar is the primary currency of the economic environment in which the Company and these subsidiaries operate. Thus, the functional and reporting currency of the Company and its subsidiaries is the dollar, requiring re-measurement from the local currency into the dollar for each of these entities. All exchange gains and losses resulting from the re-measurement are reflected in the statement of operations as financial income or expenses, as appropriate.

The functional currency of the Company's Canadian, Irish, and U.K. subsidiaries are the Canadian Dollar, the Euro, and the British Pound, respectively.

Accordingly, the financial statements of the Canadian, Irish and the U.K. subsidiaries have been translated into dollars. All balance sheet accounts have been translated using the exchange rates in effect at the balance sheet date. Amounts recorded in the statements of operations have been translated using the average exchange rate prevailing during the year. The resulting translation adjustments are reported as a component of shareholders' equity under accumulated other comprehensive income.

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries. Inter-company transactions and balances have been eliminated in consolidation and non-controlling interest is included in equity.

A private corporation, TDC, owns 3.125% of the shares that have economic rights and has 50% of the voting rights in Taro U.S.A.; with the Company owning the remaining shares and voting rights. In 1993, TDC signed an agreement with the Company to assign its voting rights in Taro U.S.A. in all elections of directors of Taro U.S.A. as the Company may designate. TDC may terminate the agreement upon one year written notice. As of December 31, 2009, no such notice of termination has been provided. TDC is a minority shareholder in the Company by way of its ownership of Taro U.S.A. shares that have economic rights. Since losses applicable to TDC exceeded its interest in Taro U.S.A. equity, such excess and any further losses applicable to TDC were charged against the Company as TDC has no obligation to fund such losses. Effective January 1, 2009, the Company adopted FASB ASC Section 810-10-65,

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"Consolidation – Overall – Transition and Open Effective Date Information – Transition Related to FASB Statements No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51, and No. 164, Not-for-Profit Entities: Mergers and Acquisitions" (formerly SFAS No. 160). This standard requires that the Company allocate income or loss attributable to the non-controlling interest based on the respective ownership percentages. This aspect of the standard was adopted on a prospective basis. Had the Company continued to follow the accounting standards effective in 2008, the income attributed to Taro would have been higher by $2,728 or $0.07 per share.

d. Cash and cash equivalents:

Cash equivalents are short-term, highly-liquid investments that are readily convertible into cash with original maturities of three months or less at the date acquired.

e. Marketable securities:

Marketable securities are comprised primarily of shares of stock in other publicly-traded companies. These marketable securities covered by FASB ASC Section 320-10-25, "Investments: Debt and Equity Securities – Overall – Recognition" (formerly Statement of Financial Accounting Standard ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities"), were designated as available-for-sale. Accordingly, these securities are stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income, a separate component of shareholders' equity.

f. Allowance for doubtful accounts:

The allowance for doubtful accounts is calculated primarily with respect to specific balances, which, in the opinion of the Company's management, are doubtful of collection. The allowance, in the opinion of the Company's management, is sufficient to cover probable uncollectible balances. See Note 3.

g. Inventories:

Inventories are stated at the lower of cost or net realizable value. Inventory reserves are provided to cover risks arising from slow-moving items, short-dated inventory, excess inventory or obsolescence. Changes in these provisions are charged to cost of sales. Cost is determined as follows:

Raw and packaging materials – average cost basis.

Finished goods and work in progress – average production costs including materials, labor and direct and indirect manufacturing expenses.

Purchased products for commercial purposes – average cost basis.

The amounts of inventory reserves recorded as cost of sales were $6,762, $5,704, and $2,403, for the years ended December 31, 2009, 2008, and 2007, respectively.

h. Property, plant and equipment:

1. Property, plant and equipment are stated at cost, net of accumulated depreciation. Payroll and other costs that are direct incremental costs necessary to bring an asset to the condition of its intended use incurred during the construction and validation period of property, plant and equipment are capitalized to the cost of such assets.

2. Interest costs are capitalized in accordance with FASB ASC Subtopic 835-20,“Interest – Capitalization of Interest” (formerly SFAS No. 34, “Capitalization of Interest Cost”).

3. Depreciation is calculated utilizing the straight-line method over the estimated useful lives of the assets, from the date the assets are ready for their intended use, at the following annual rates:

	%
Buildings	2.5 - 10
Machinery and equipment	5 - 20 (mainly 10)
Motor vehicles	15 - 20
Furniture, fixtures, office equipment and computer equipment	6 - 33 (mainly 20)

Leasehold improvements are depreciated using the straight-line method over the shorter of their useful lives or the terms of the leases (generally 5-10 years).

4. The Group accounts for costs of computer software developed or obtained for internal use in accordance with FASB ASC Subtopic 350-40, “Intangibles: Goodwill and Other – Internal-Use Software” (formerly Statement of Position (“SOP”) No. 98-1, “Accounting for the Costs of Computer Software Developed or Obtained for Internal Use”). FASB ASC Subtopic 350-40 requires the capitalization of certain costs incurred in connection with developing or obtaining internal use software during the application development stage. During the years 2009 and 2008, the Group capitalized $71 and $76 of software costs, respectively. Software costs are amortized using the straight-line method over their estimated useful life of three years.

5. On February 7, 2007, the Company, in an effort to improve liquidity, sold a car park adjacent to its Irish facility, net of transaction costs, for $4,050, and recorded a pre-tax gain on this transaction of $3,721.

i. Lease of land from Israel Land Administration:

The Company leases land from the Israel Land Administration (“ILA”), which is accounted for pursuant to FASB ASC Subtopic 840-20, “Leases – Operating Leases” (formerly SFAS 13, “Accounting for Leases”, as amended by SFAS 98). Taro leases several parcels from the ILA. The lease period of the industrial parcel ends between 2018 and 2058. The Company has the right to extend each of the lease agreements for an additional period of 49 years. The ILA lease agreements are standard agreements covering substantial portions of the land of Israel. The standard agreements call for a Lease Period of 49 years, with an option for one additional Lease Period (i.e., total of 98 years). The ownership of the land is not transferred at the end of the lease period and there is no option to buy the land at the end of such period. The expectation, based on practice and accumulated experience is that the renewal price would be substantially below fair market value. Since such leases do not qualify as a capital lease, they are being accounted for as operating

leases. The prepaid lease amount is included in long-term receivables and other assets and amortized over the term of the lease.

j. Goodwill:

The Company follows the provisions of FASB ASC Subtopic 350-20, “Intangibles: Goodwill and Other – Goodwill” (formerly SFAS No. 142, “Goodwill and Other Intangible Assets”). Goodwill is not amortized, but rather is subject to an annual impairment test (or more frequently if impairment indicators arise).

FASB ASC Subtopic 350-20 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment; while the second phase (if necessary) measures impairment.

In the first phase of impairment testing, goodwill attributable to one reporting unit is tested for impairment by comparing the fair value of the reporting unit with the carrying value of the reporting unit. When the carrying value exceeds the fair value, the second phase of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess.

The Company operates in one operating segment, comprising its only reporting unit. Fair value of the reporting unit is determined using market capitalization. The Company performs its annual impairment test during the fourth fiscal quarter of each year. As of December 31, 2009 and 2008, no impairment loss had been identified.

k. Intangible assets and deferred charges and long-lived assets:

Intangible assets and deferred charges:

Acquired intangible assets and product rights to be held and used are not considered to have an indefinite useful life and are amortized over their useful life of a weighted-average amortization period of 14 years using a straight-line method of amortization that reflects the pattern in which the economic benefits of the intangible assets are consumed or otherwise used up, in accordance with SFAS 142.

Debt issuance costs in respect to long-term loans from institutional investors and bondholders are deferred and amortized under the effective interest method over the term of the loans from institutional investors and bondholders.

Long-lived assets:

The Group's long-lived assets, excluding goodwill, are reviewed for impairment in accordance with FASB ASC Topic 360, "Property, Plant and Equipment" (formerly SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets"), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment exists when the carrying amount of the asset exceeds the aggregate future undiscounted cash flows expected to be generated by the asset. The impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the asset. In the years ended December 31, 2009 and 2008, the Company recorded $3,363 and $2,820 impairment loss, respectively, in operating expenses, primarily related to the fixed assets of its Irish facility. No impairment loss was recorded on these assets in the year ended December 31, 2007. See Notes 1.c, 1.d and 1.e.

l. Treasury shares:

The Company repurchases its ordinary shares from time to time on the open market and holds such shares as treasury stock. The Company presents the cost to repurchase treasury stock as a reduction of shareholders' equity.

From time to time the Company reissues treasury shares under the stock purchase plan, upon exercise of options and upon vesting of restricted stock units. When treasury stock is reissued, the Company accounts for the re-issuance in

accordance with FASB ASC Subtopic 505-30, “Equity – Treasury Stock” (formerly Accounting Principles Board Opinion (“APB”) No. 6, “Status of Accounting Research Bulletins”) and charges the excess of the purchase cost, including related stock-based compensation expenses, over the re-issuance price (loss) to retained earnings. The purchase cost is calculated based on the specific identification method.

In cases where the purchase cost is lower than the re-issuance price, the Company credits the difference to additional paid-in capital.

m. Revenue recognition:

The Company recognizes revenue from product sales when title and risk of loss have transferred to its customers and when the criteria in FASB ASC Subtopic 605-15, "Revenue Recognition – Products" (formerly the Securities and Exchange Commission's ("SEC") Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition" ("SAB 104"), codified as SAB Topic 13, "Revenue Recognition" and SFAS No. 48, "Revenue Recognition When Right of Return Exists"), have been satisfied. Those criteria generally require that (i) persuasive evidence of an arrangement exists; (ii) product delivery has occurred; (iii) the price to customers is fixed or determinable; (iv) collectability is reasonably assured, and (v) the amount of product returns, chargebacks, rebates and other sales deductions can be reasonably estimated. The Company ships products to its customers only in response to, and to the extent of, the orders that customers submit to the Company. Depending on the terms of our customer arrangements, revenue is recognized when the product is received by the customer ("FOB Destination Point") or at the time of shipment ("FOB Shipping Point").

When the Company recognizes and records revenue from the sale of its pharmaceutical products, the Company, in the same financial reporting period, records an estimate of various future deductions related to the sale. This has the effect of reducing the amount of reported product sales. These deductions include the Company's estimates, which may require significant judgment of chargebacks, product returns, rebates, cash discounts and other sales deductions.

Chargebacks result from pricing arrangements the Company has with end-user customers establishing contract prices which are lower than the wholesalers' acquisition costs or invoice prices. When these customers buy the Company's products from their wholesaler of choice, the wholesaler issues a credit memo (chargeback) to the Company for the difference between the invoice price and the end-user contract price. Chargeback reserves are estimated using current wholesaler inventory data beyond the Company's control, and historical data. Due to the passage of time from the balance sheet date to the issuance of these financial statements, the Company has considered actual wholesaler returns in estimating its chargeback reserve.

Product returns result from agreements allowing the Company's customers to return unsold inventory that is expired or close to expiration. Product return reserves are calculated using the average lag period between sales and product expiry, historical product returns experience, and specific return exposures to estimate the potential obligation for returns of inventory in the distribution channel.

Rebates result from contractual agreements with the Company's customers and are earned based on the Company's direct sales to customers or the Company's customers' sales to third parties. Rebate reserves from the Company's direct sales to customers and the Company's customers' sales to third parties are estimated using historical and contractual data.

The Company generally offers discounts to its customers for payments within a certain period of time. Cash discount reserves are calculated by multiplying the specified discount percentage by the outstanding receivable at the end of each period.

Reserves for returns, Medicaid and indirect rebates are included in current liabilities. All other sales deductions allowances are recorded as accounts receivable reserves. The reserve for returns is included in current liabilities as

substantially all of these returns will not be realized until after the year-end accounts receivable balances are settled. Medicaid and indirect rebates are included in current liabilities because the Company does not have direct customer relationships with any of the payees. See Notes 4 and 12.

The Company offers incentives to certain resellers and retailers through various marketing programs where the Company agrees to reimburse them for advertising costs incurred to include the Company's products. The Company accounts for these in accordance with FASB ASC Subtopic 605-50, "Revenue Recognition – Customer Payments and Incentives" (formerly EITF Issue No. 01-09 "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of Vendor's Product)"), as reductions of revenue unless the customer receives an identifiable benefit in exchange for the consideration that is sufficiently separable from the customer's purchase of the products and the fair value of the benefits can be reasonably estimated.

With respect to revenue recognition policies in the Alterna transaction, see Note 1.d.

n. Research and development:

Research and development expenses, net of grants received, are charged to expense as incurred.

o. Royalty-bearing grants:

Royalty-bearing grants from the government of Israel through the Office of the Chief Scientist for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the related costs incurred. The Company did not earn any grants during the years ended December 31, 2009, 2008, and 2007.

p. Advertising expenses:

The Group expenses advertising costs as incurred. Product samples are recorded within prepaid expense on the consolidated balance sheet and recorded within advertising expenses when provided to potential customers. Advertising expenses were $5,505, $6,979 and $6,473 for the years ended December 31, 2009, 2008 and 2007, respectively.

q. Income taxes:

Income taxes are accounted for in accordance with FASB ASC Topic 740, “Income Taxes” (formerly SFAS No. 109, “Accounting for Income Taxes”). FASB ASC Topic 740 prescribes the use of the liability method, whereby deferred tax asset and liability account balances are determined for temporary differences between the financial reporting and tax basis of assets and liabilities, and for carryforward losses and credits. Deferred taxes are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. As of December 31, 2009, management determined that it was more likely than not that the Company will benefit from the deferred tax asset in the U.S., resulting in the reversal of $76,694 of the valuation allowance against these deferred tax assets. As of December 31, 2008, management determined that it was more likely than not that the Company will not benefit from the deferred tax asset in the U.S., resulting in a full valuation allowance against this deferred tax asset. As of December 31, 2009 and 2008, management determined that it was more likely than not that the Company will not benefit from the deferred tax assets in the Ireland and certain other subsidiaries. Therefore, for these locations a full valuation allowance was provided against the deferred tax assets. In future years, if it is more likely than not that the Company will be in a position to utilize its deferred tax asset, the valuation allowance for such assets may be modified.

Effective January 1, 2007, the Company adopted FASB ASC Topic 740, “Income Taxes” (formerly FASB Interpretation (“FIN”) No. 48, “Accounting for Uncertainty in Income Taxes – an Interpretation of FAS 109”), which was issued in June 2006. FASB ASC Topic 740 requires that the tax effect of a position be recorded only if it is more likely than not to be sustained based solely on the tax position’s technical merits at the reporting date. If a tax position is not considered more likely than not to be sustained based solely on its technical merits, no benefits of the tax position are recorded.

The Company's accounting policy, pursuant to the adoption of ASC 740, is to classify interest and penalties recognized in the financial statements relating to uncertain tax positions as income tax expense. See Note 17. The following table presents the impact at January 1, 2007, on the consolidated balance sheet as a result of implementing ASC 740:

Increase to short-term accrued taxes	$	1,178
Decrease to valuation allowance	$	6,220
Decrease to deferred tax assets	$	6,220
Increase to accumulated deficit	$	1,178

r. Sales and other taxes collected and remitted to governmental authorities:

The Company collects various taxes from customers and remits them to governmental authorities. These taxes are recorded on a net basis and therefore do not impact the statement of operations.

s. Basic and diluted net income per share attributable to Taro:

Basic net income per share is calculated based on the weighted-average number of ordinary shares outstanding during each year. Diluted net income per share is calculated based on the weighted-average number of ordinary shares outstanding during each year, plus potential dilutive ordinary shares considered outstanding during the year (except where anti-dilutive), in accordance with FASB ASC Topic 260, “Earnings per Share” (formerly SFAS No. 128, “Earnings per Share”).

The total weighted-average number of options excluded from the calculations of diluted net earnings per share, as a result of their anti-dilutive effect, was 956,849, 1,012,359 and 1,126,528 for the years ended December 31, 2009, 2008 and 2007, respectively.

t. Freight and distribution costs:

In accordance with FASB ASC Subtopic 605-45, “Revenue Recognition – Principal Agent Considerations” (formerly EITF 00-10, “Accounting for Shipping and Handling Fees and Costs”), the Company’s accounting policy is to classify shipping and handling costs as a part of sales and marketing expense. Freight and distribution costs and distribution warehousing costs related to shipping and handling to customers, primarily through the use of common carriers or external distribution services amounted to $10,206, $9,420 and $9,436 for the years ended December 31, 2009, 2008 and 2007, respectively.

u. Accounting for stock-based compensation:

On January 1, 2006, the Company adopted FASB ASC Topic 718, “Compensation: Stock Compensation” (formerly SFAS No. 123 (revised 2004), “Share-Based Payment”), which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors. In March 2005, the SEC issued SAB No. 107 (“SAB 107”) codified as SAB Topic 14, “Share-Based Payment” relating to SFAS No. 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS No. 123(R). SFAS No. 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company’s consolidated income statement.

The Company recognizes compensation expense for the value of its awards granted subsequent to January 1, 2006, based on the straight-line method over the requisite service period of each of the awards, net of estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures. For awards granted prior to January 1, 2006, the Company recognizes compensation expense based on the

straight line-method over the requisite service period of each of the awards. Forfeitures were previously accounted for as they occurred, but have been estimated with the adoption of SFAS No. 123(R) for those awards not yet vested. Upon the adoption of SFAS No. 123(R) the expected life of the option is estimated using the "simplified" method as provided in SAB 107. Under this method, the expected life equals the arithmetic average of the vesting term and the original contractual term of the option. On December 21, 2007, the SEC issued SAB No. 110 ("SAB 110"), which, effective January 1, 2008, amends and replaces SAB 107. The Company currently uses the simplified method as adequate historical experience is not available to provide a reasonable estimate. The Company adopted SAB 110 effective January 1, 2008 and will continue to apply the simplified method until sufficient historical experience is available to provide a reasonable estimate of the expected term for stock option grants.

Stock Options: The fair value of options granted under the Stock Incentive Plan in 2009, 2008 and 2007 is amortized over their vesting period on a straight-line basis and estimated at the date of grant using a Black-Scholes options pricing model with the following assumptions:

	2009		2008		2007	
Dividend yield	0	%	0	%	0	%
Expected volatility	44.5	%	48.4	%	53.1	%
Risk-free interest rate	1.7	%	3.1	%	4.7	%
Expected life of up to	6.9 years		6.9 years		6.9 years	

The risk-free interest rate is based upon the yields of U.S. Treasury Bills with maturity terms similar to those of the expected lives of the options at the time of grant. The expected volatility is based upon daily movements in the Company’s stock price.

Employee Stock Purchase Plan: The fair value of the incentive rewards granted under the Company’s 2000 Employee Stock Purchase Plan, in 2006, is amortized over their vesting period on a straight-line basis and estimated at the date of the grant using a Black-Scholes options pricing model with the following weighted assumptions: 0% dividend yield, 72.7% volatility, 3.7% risk free interest rate and expected life of six months.

Estimated forfeitures are based on actual historical pre-vesting forfeitures.

The Company applies FASB ASC Subtopic 505-50, “Equity - Equity-Based Payments to Non-Employees” (formerly SFAS No. 123(R) and EITF No. 96-18 “Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services”), with respect to options issued to non-employees. FASB ASC Subtopic 505-50 requires the use of option valuation models to measure the fair value of the options granted. Compensation expensed to non-employees was not material.

v. Concentrations of credit risk:

Financial instruments that potentially subject the Group to concentrations of credit risk consist principally of cash and cash equivalents, bank deposits and trade receivables. Cash and cash equivalents and bank deposits are invested in major banks in Israel, the United States, Canada and the Cayman Islands. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Group’s cash and cash equivalents and bank deposits are financially sound and that low credit risk therefore exists with respect to these financial instruments. Generally, these deposits may be redeemed upon demand and, therefore, bear minimal risk.

The Group’s trade accounts receivables are mainly derived from sales to customers in the United States, Canada, Europe and Israel. At December 31, 2009, three different customers in the United States represented approximately 15.4%, 14.9% and 13.7% of the trade accounts receivable, net. The Group has adopted credit policies and standards intended to mitigate inherent risk while accommodating sales growth. The Group performs ongoing credit evaluations

of its customers' financial condition when deemed necessary, but does not generally require collateral for its customers' accounts receivable.

w. Fair value of financial instruments:

The carrying amounts of cash and cash equivalents, bank deposits, trade and other receivables and trade and other payables approximate their fair value, due to the short-term maturities of these instruments.

The carrying amount of long-term bank deposits approximates their fair value because such deposits bear market interest rates.

The carrying amounts of the Group's borrowing arrangements under its short-term and long-term debt agreements approximate their fair value since the loans bear interest at rates that approximate the Group's incremental borrowing rates for similar types of borrowing arrangements.

The fair value of currency and interest rate contracts is determined by discounting to the present all future cash flows of the currencies to be exchanged at interest rates prevailing in the market for the period the currency exchanges are due and expressing the results in U.S. dollars at the current spot foreign currency exchange rate.

x. Accounting for derivatives:

FASB ASC Topic 815, "Derivatives and Hedging" (formerly SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities"), requires companies to recognize all of their derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes (i.e., gains or losses) in the fair value of a derivative instrument depends on whether the instrument has been designated and qualifies as part of a hedging relationship and on the type of hedging relationship. For derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation. The designation is based upon the nature of the exposure being hedged. At December 31, 2009 and 2008, no derivative instruments were designated as hedging instruments.

For derivative instruments not designated as hedging instruments, the gain or loss is recognized in financial income/expense in current earnings during the period of change. See Note 9.

y. Fair value measurements:

Effective January 1, 2008, the Company adopted FASB ASC Topic 820, "Fair Value Measurements and Disclosures" (formerly SFAS No. 157, "Fair Value Measurements"). FASB ASC Topic 820 provides a fair value hierarchy that distinguishes between assumptions based on market data obtained from independent sources (observable inputs) and those based on an entity's own assumptions (unobservable inputs). FASB ASC Topic 820 also requires additional disclosure about fair value measurements. The adoption of FASB ASC Topic 820 did not impact the Company's consolidated balance sheet or consolidated statement of operations.

z. Impact of recently issued accounting standards:

In February 2007, the FASB issued FASB ASC Topic 825, "Financial Instruments" (formerly SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115"). FASB ASC Topic 825 permits companies to value many financial instruments and certain other items at fair value. The adoption of FASB ASC Topic 825 did not have a material impact on the consolidated financial statements.

In November 2007, the FASB issued FASB ASC Topic 808, "Collaborative Arrangements" (formerly EITF Issue No. 07-1, "Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property"). Companies may enter into arrangements with other companies to jointly develop, manufacture, distribute and market a product. The consensus requires collaborators in such an arrangement to present the result of activities for which they act as the principal on a gross basis and report any payments received from (made to) other collaborators based on other applicable GAAP or, in the absence of other GAAP, based on analogy to authoritative accounting literature or a reasonable, rational and consistently applied accounting policy election. FASB ASC Topic 808 is effective for collaborative arrangements in place at the beginning of the annual period beginning after December 15, 2008. The adoption of EITF 07-1 did not have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued FASB ASC Topic 805, "Business Combinations" (formerly " SFAS No. 141 (revised 2007) "Business Combinations"). FASB ASC Topic 805 will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. Key changes include: acquired in-process research and development will no longer be expensed on acquisition, but capitalized and amortized over its useful life; fair value will be based on market participant assumptions; acquisition costs will generally be expensed as incurred; and restructuring costs will generally be expensed in periods after the acquisition date. Early adoption is not permitted. The impact of the adoption of this pronouncement did not have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued FASB ASC Section 810-10-65, "Consolidation – Overall – Transition and Open Effective Date Information – Transition Related to FASB Statements No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51, and No. 164, Not-for-Profit Entities: Mergers and Acquisitions" (formerly "SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51"). FASB ASC 810-10-65 establishes accounting and reporting standards for non-controlling interests in a subsidiary and deconsolidation of a subsidiary. Early adoption is not permitted. The adoption of FASB ASC 810-10-65 resulted in the presentation of non-controlling interest in the accompanying consolidated financial statements.

In February 2008, the FASB issued FASB ASC Topic 820, "Fair Value Measurements and Disclosures" (formerly FASB Staff Position ("FSP") No. FAS 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" and FSP No. FAS 157-2, "Effective Date of FASB Statement No. 157"). Collectively, the Staff Positions defer the effective date of FASB ASC Topic 820 to fiscal years beginning after November 15, 2008, for nonfinancial assets and nonfinancial liabilities except for items that are recognized or disclosed at fair value on a recurring basis at least annually, and amend the scope of FASB ASC Topic 820. The adoption of FASB ASC Topic 820 did not have a material impact on the Company's consolidated financial statements.

In March 2008, the FASB issued FASB ASC Section 815-10-50, "Derivatives and Hedging – Overall – Disclosure" (formerly " SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB No. 133"). This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS 161 did not have a material impact on the Company's financial position, results of operations or cash flows.

In June 2008, the FASB ratified the consensus reached on FASB ASC Subtopic 815-40, "Derivatives and Hedging – Contracts in Entity's Own Equity" (formerly EITF Issue No. 07-05, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock"). FASB ASC 815-40-15 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption is not permitted. The impact of the adoption of this pronouncement did not have a material impact on the Company's consolidated financial statements.

In May 2009, the FASB issued FASB ASC Topic 855, “Subsequent Events” (formerly SFAS No. 165, “Subsequent Events”). FASB ASC Topic 855 establishes general standards of accounting for and disclosure of events that occur between the balance sheet date and the date financial statements are issued or are available to be issued. This statement is effective for interim or annual periods ending after June 15, 2009. The adoption of FASB ASC Topic 855 will not have a material effect on the Company’s consolidated financial position, results of operations or cash flows.

In June 2009, the FASB issued FASB ASC Paragraph 810-10-65-2, “Consolidation – Overall – Transition and Open Effective Date Information – Transition Related to FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R)” (formerly SFAS No. 167, “Amendments to FASB Interpretation No. 46 (R) ”), which amends existing accounting rules for consolidation of variable interest entities. Under SFAS 167, the primary beneficiary of a variable interest entity is determined by a qualitative rather than a quantitative test previously required under FIN 46 (R). In addition, SFAS 167 requires an ongoing assessment of whether an entity is a primary beneficiary of a variable interest entity, and additional disclosure. SFAS 167 is effective at the beginning of the first annual reporting period that begins after November 15, 2009. SFAS 167 will not have a material impact on the Company’s consolidated financial position, results of operations or cash flows.

In June 2009, the FASB issued FASB ASC 105-10-65-1, “Generally Accepted Accounting Principles – Overall – Transition Related to FASB Statement No. 168, The FASB Accounting Standards CodificationTM and the Hierarchy of Generally Accepted Accounting Principles” (formerly SFAS No. 168, “The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162”). With this statement, the FASB Accounting Standards Codification (“ASC”) becomes the single source of GAAP recognized by FASB in the United States. The ASC is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of this standard will not affect our results of operations or our financial position. However, because the Codification replaces any existing GAAP standards, it will affect the way we reference US GAAP within our financial statements.

In October 2009, the FASB issued Accounting Standard Update (“ASU”) No. 2009-13, “Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements” (“ASU 2009-13”). ASU 2009-13 revises the current model for recording revenue from multiple element arrangements and expands disclosure requirements. This standard requires entities to allocate revenue in an arrangement at inception using estimated selling prices of the delivered goods and services based on a selling price hierarchy. The amendments eliminate the residual method of revenue allocation and require revenue to be allocated using the relative selling price method. ASU 2009-13 will be effective for arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. The Company does not expect adoption of ASU 2009-13 to have a material impact on the results of operations or financial condition.

In December 2010, the FASB issued ASU No. 2010-27, “Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers (a consensus of the FASB Emerging Issues Task Force).” This standard addresses how fees mandated by the Patient Protection and Affordable Care Act as amended by the Health Care and Education Reconciliation Act should be recognized and classified in the income statements of pharmaceutical manufacturers. Under the proposal, the annual fee would be recognized as a liability for the total amount and a corresponding deferred cost over the calendar year. This is a liability and presented as an operating expense. This ASU is effective for calendar years beginning after December 31, 2010. Since the fees are anticipated to be less than 0.2% of net sales, the Company does not expect the provisions of ASU 2010-27 to have a material effect on its financial statements.

In December 2010, the FASB also issued ASU No. 2010-28, “Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a

consensus of the FASB Emerging Issues Task Force).” Under this standard, if the carrying amount of a reporting unit is zero or negative, an entity must assess whether it is more likely than not that goodwill impairment exists. To make that determination, an entity should consider whether there are adverse qualitative factors that could impact the amount of goodwill, including those listed in ASC 350-20-35-30. As a result of the new guidance, an entity can no longer assert that a reporting unit is not required to perform the second step of the goodwill impairment test because the carrying amount of the reporting unit is zero or negative, despite the existence of qualitative factors that indicate goodwill is more likely than not impaired. The equity or enterprise valuation premise can be used to determine the carrying amount of a reporting unit. ASU 2010-28 is effective for public entities for fiscal years, and for interim periods within those years, beginning after December 15, 2010, with early adoption prohibited. The Company’s goodwill test does not currently have a zero or negative carrying amount where this standard would apply.

In December 2010, the FASB also issued ASU No. 2010-29, "Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations (a consensus of the FASB Emerging Issues Task Force)." This standard specifies that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments in this update also expand the supplemental pro forma disclosures under Topic 805 to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The amended guidance is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. ASU 2010-29 affects the disclosure of business combinations occurring on or after January 1, 2011. Currently, Taro is not involved in any business combinations which would require this disclosure.

NOTE 3: — ACCOUNTS RECEIVABLE AND OTHER

a. Trade, net:

The following tables summarize the impact of accounts receivable reserves and allowance for doubtful accounts on the gross trade accounts receivable balances at each balance sheet date:

	December 31,	
	2009	2008
Trade accounts receivable, gross	$117,122	$126,668
Reserves for sales deductions:		
Chargebacks	(19,360)	(23,904)
Customer rebates	(16,356)	(17,544)
Other sales deductions	(19,216)	(22,492)
Allowance for doubtful accounts	(547)	(630)
Trade accounts receivable, net	$61,643	$62,098

b. Other receivables, prepaid expenses and other:

	December 31,	
	2009	2008
Prepaid expenses	$7,736	$6,277
Deferred income taxes (1)	32,069	3,815
Government authorities	2,098	1,343
Advances to suppliers	2,189	473

Derivative instruments	917	299
Receivable related to class action lawsuit (2)	-	7,000
Other	594	398
	$45,603	$19,605

(1) See Note 2.q.

(2) See Note 15.c.4.iii.

NOTE 4: — SALES INCENTIVES

When the Company recognizes and records revenue from the sale of its pharmaceutical products, it records an estimate in the same financial reporting period for product returns, chargebacks, rebates and other sales deductions, which are reflected as reductions of the related gross revenue. Beginning in 2006, the Company regularly monitors customer inventory information at its three largest wholesale customers to assess whether any excess product inventory levels may exist. The Company reviews this information together with historical product and customer experience, third-party prescription data, industry and regulatory changes and other relevant information and revises its estimates as necessary.

The Company's estimates of inventory in the distribution channel are based on inventory information reported to it by its major wholesale customers, historical shipment and return information from its accounting records, and third-party data on prescriptions filled. The Company's estimates are subject to inherent limitations pertaining to reliance on third-party information.

The Company considers any information available subsequent to the balance sheet date, but before the issuance of the financial statements, that provides additional evidence with respect to conditions existing at the balance sheet date and adjusts the reserves accordingly.

Product returns:

Consistent with industry practice, the Company generally offers its customers the right to return inventory within three to six months prior to product expiration and up to 12 months thereafter (the "return period"). Product returns are identified by their manufacturing lot number. Because the Company manufactures in bulk, lot sizes are generally large and, therefore, shipments of a particular lot may occur over a one-to-three month period. As a result, although the Company cannot associate a product return with the actual shipment in which such lot was included, the Company can reasonably estimate the period (in months) over which the entire lot was shipped and sold. The Company uses this information to estimate the average time period between lot shipment (and sale) and return for each product, which the Company refers to as the "return lag". The shelf life of most of the Company's products ranges between 18-36 months. Because returns of expired products are heavily concentrated during the return period, and given the Company's historical data, it is able to reasonably estimate return lags for each of its products. These return lags are periodically reviewed and updated, as necessary, to reflect the Company's best knowledge of facts and circumstances. Using sales and return data (including return lags), the Company determines a rolling average monthly return rate to estimate its returns reserve. The Company supplements this calculation with additional information including customer and product specific channel inventory levels, competitive developments, external market factors, the Company's planned introductions of similar new products and other qualitative factors in evaluating the reasonableness of the returns reserve. The Company continuously monitors factors that could affect its estimates and revises the reserves as necessary. The Company's estimates of expected future returns are subject to change based on unforeseen events and uncertainties.

The Company's product returns reserve at December 31, 2009 and 2008 and related statement of operations impact for the years then ended, considered actual product returns experienced subsequent to the balance sheet dates to validate

the product returns reserve estimate based on the methodology described above.

Beginning in 2006, the Company monitors the levels of inventory in its distribution channels to assess the adequacy of the product returns reserve and to identify potential excess inventory on hand that could have an impact on its revenue recognition. The Company does not ship products to its wholesalers when it appears they have an excess of inventory on hand, based on demand and other relevant factors, for that particular product. Additionally, as a general practice, the Company does not ship products that have less than 12 months until expiration (i.e., “short-dated sales”).

Chargebacks:

The Company has arrangements with certain customers that allow them to buy its products directly from its wholesalers at specific prices. Typically these price arrangements are lower than the wholesalers' acquisition costs or invoice prices. In exchange for servicing these third party contracts, the Company's wholesalers can submit a "chargeback" claim to the Company for the difference between the price sold to the third party and the price at which they purchased the product from us. The Company generally pays chargebacks on generic products, whereas branded proprietary products are typically not eligible for chargeback claims. The Company considers many factors in establishing its chargeback reserves including inventory information from its largest wholesale customers (beginning in 2006) and the completeness of their reports, estimates of Taro inventory held by smaller wholesalers and distributors, processing time lags, contract and non-contract sales trends, average historical contract pricing, actual price changes, actual chargeback claims received from the wholesalers, Taro sales to the wholesalers and other relevant factors. The Company's chargeback provision and related reserve varies with changes in product mix, changes in pricing, and changes in estimated wholesaler inventory. The Company reviews the methodology utilized in estimating the reserve for chargebacks in connection with analyzing its product returns reserve each quarter and makes revisions as considered necessary to reasonably estimate its potential future obligation. Due to the passage of time from the balance sheet date to the issuance of these financial statements, the Company has considered actual wholesaler returns in estimating its chargeback reserve.

Rebates and other deductions:

The Company offers its customers various rebates and other deductions based primarily on their volume of purchases of its products. Chain wholesaler rebates are rebates that certain chain customers claim for the difference in price between what the chain customer paid a wholesaler for a product purchase and what the chain customer would have paid if such customer had purchased the same product directly from the Company. Cash discounts, which are offered to the Company's customers, are generally 2% of the gross sales price, and provide the Company's customers an incentive for paying within invoice terms (30 to 90 days). Medicaid rebates are earned by states based on the amount of the Company's products dispensed under the Medicaid plan. Billbacks are special promotions or discounts provided over a specific time period to a defined customer base and for a defined product group. Distribution allowances are a fixed percentage of gross purchases for inventory shipped to a national distribution facility that the Company pays to its top wholesalers on a monthly basis. Administration fees are paid to certain wholesalers, buying groups, and other customers for stocking the Company's products and managing contracts and servicing other customers. Shelf-stock adjustments, which are customary in the generic pharmaceutical industry, are based on customers' existing levels of inventory and the decrease in the market price of the related product. When market prices for the Company's products decline, the Company may, depending on its contractual arrangements, elect to provide shelf-stock adjustments and thereby allow its customers with existing inventories to compete at the lower product price. The Company uses these shelf-stock adjustments to support its market position and to promote customer loyalty.

The Company establishes reserves for rebates and these other various sales deductions based on contractual terms and customer purchasing activity, tracking and analysis of rebate programs, processing time lags, the level of inventory in the distribution channel and other relevant information. Based on the Company's historical experience, substantially all claims for rebates and other sales deductions are received within 24 months. At December 31, 2009 and 2008, and for

the years then ended, the Company considered subsequent actual claims submitted by its customers in determining the Company's reserves and related statements of operations impact for rebates and other sales deductions.

As discussed above, the Company believes it has the experience and information that it believes are necessary to reasonably estimate the amounts of reserves for its sales incentives programs. Several of the assumptions used by the Company for certain estimates are based on information received from third parties, such as wholesale customer inventory levels, market data, and other factors beyond the Company's control. The most critical estimates in determining these reserves, and the ones therefore that would have the largest impact if these estimates were not accurate, are related to contract sales volumes, average contract pricing, customer inventories and return volumes. The Company regularly reviews the information related to these estimates and adjusts its reserves accordingly, if and when actual experience differs from previous estimates.

Use of estimates in reserves:

The Company believes that its reserves, allowances and accruals for items that are deducted from gross revenue are reasonable and appropriate based on current facts and circumstances. Changes in actual experience or changes in other qualitative factors could cause the Company's allowances and accruals to fluctuate, particularly with newly launched or acquired products. The Company regularly reviews the rates and amounts in its reserve estimates. If future estimated rates and amounts are significantly greater than those reflected in the Company's recorded reserves, the resulting adjustments to those reserves would decrease the Company's reported net revenue; conversely, if actual product returns, rebates and chargebacks are significantly less than those reflected in the Company's recorded reserves, the resulting adjustments to those reserves would increase the Company's reported net revenue. If the Company were to change its assumptions and estimates, its reserves would change, impacting the net revenue that the Company reports. The Company regularly reviews the information related to these estimates and adjusts its reserves accordingly, if and when actual experience differs from previous estimates.

The following tables summarize the activities for sales deductions and product returns for the years ended December 31, 2009 and 2008:

For the Year Ended December 31, 2009 (in thousands)

	Beginning balance	Provision recorded for current period sales	Credits processed/ Payments	Ending balance
Accounts Receivable Reserves				
Chargebacks	$ (23,904)	$ (208,482)	$ 213,026	$ (19,360)
Rebates and Other	(40,666)	(80,262)	84,809	(36,119)
Total	$ (64,570)	$ (288,744)	$ 297,835	$ (55,479)
Current Liabilities				
Returns	$ (22,279)	$ (11,327)	$ 11,092	$ (22,514)
Other (1)	(9,697)	(25,838)	20,271	(15,264)
Total	$ (31,976)	$ (37,165)	$ 31,363	$ (37,778)

For the Year Ended December 31, 2008 (in thousands)

	Beginning balance	Provision recorded for current period sales	Credits processed/ Payments	Ending balance
Accounts Receivable Reserves				

Chargebacks	$ (18,525)	$ (172,582)	$ 167,203	$ (23,904)
Rebates and Other	(29,015)	(65,572)	53,921	(40,666)
Total	$ (47,540)	$ (238,154)	$ 221,124	$ (64,570)
Current Liabilities				
Returns	$ (25,101)	$ (13,898)	$ 16,720	$ (22,279)
Other (1)	(10,556)	(13,509)	14,368	(9,697)
Total	$ (35,657)	$ (27,407)	$ 31,088	$ (31,976)

(1) Includes indirect rebates.

NOTE 5: — INVENTORIES

	December 31,	
	2009	2008
Raw and packaging materials	$ 22,385	$ 19,768
Finished goods	26,457	23,927
Work in progress	14,872	17,842
Purchased products for commercial purposes and other	4,263	4,562
	$ 67,977	$ 66,099

As of December 31, 2009 and 2008, reserves recorded against inventories for slow-moving, short-dated, excess and obsolete inventory totaled $12,006 and $15,726, respectively.

As for pledges, see Note 14.

NOTE 6: — PROPERTY, PLANT AND EQUIPMENT

a. Composition of assets grouped by major classifications are as follows:

	December 31,	
	2009	2008
Cost:		
Land	$12,411	$12,090
Buildings	140,068	158,570
Leasehold improvements	3,186	3,010
Machinery and equipment	144,111	145,212
Computer equipment	31,610	30,339
Motor vehicles	303	304
Furniture, fixtures and office equipment	8,787	8,402
Advances for property and equipment	489	160
	340,965	358,087
Accumulated depreciation and impairment charges:		
Buildings	$33,771	$47,177
Leasehold improvements	3,021	2,709
Machinery and equipment	91,495	86,647
Computer equipment	29,611	28,645
Motor vehicles	288	284

Furniture, fixtures and office equipment	6,611	6,082
	164,797	171,544
Depreciated cost	$176,168	$186,543

Depreciation expenses were $15,530, $18,374, and $19,874 for the years ended December 31, 2009, 2008 and 2007, respectively. For related impairment charges, see Note 2.k.

b. Cost of property, plant and equipment includes capitalized interest expenses, capitalized direct incremental costs (such as payroll and related expenses) and other internal costs incurred in order to bring the assets to their intended use in the amount of $16,826 as of December 31, 2009 and 2008. Capitalized interest and other costs were $71, $76, and $56 for the years ended December 31, 2009, 2008 and 2007, respectively.

c. Cost of computer equipment includes capitalized development costs of computer software developed for internal use in the amount of $4,634 and $4,507 as of December 31, 2009 and 2008, respectively.

d. As for pledges – see Note 14.

NOTE 7: —INTANGIBLE ASSETS AND DEFERRED COSTS

a. Composition:

	December 31,	
	2009	2008
Cost:		
Product rights	$68,382	$67,958
Deferred charges in respect of loans and bonds from institutional investors	1,304	1,277
Other deferred costs	1,541	1,541
	71,227	70,776
Accumulated amortization and impairment charges:		
Product rights	47,593	44,338
Deferred charges in respect of loans and bonds from institutional investors	1,276	1,226
Other deferred costs	1,475	1,456
	50,344	47,020
Amortized cost	$20,883	$23,756

b. Amortization expenses related to product rights were $2,915, $2,813 and $2,740 for the years ended December 31, 2009, 2008 and 2007, respectively.

c. As of December 31, 2010, the estimated amortization expense of product rights for 2010 to 2014 is as follows: 2010 - $2,819; 2011 - $2,777; 2012 - $2,604; 2013 - $2,564; 2014 - $2,328.

d. The weighted-average amortization period for product rights is approximately 8 years.

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NOTE 8: — LONG-TERM RECEIVABLES AND OTHER ASSETS

	December 31,	
	2009	2008
Prepayment of land leased from Israel Land Administration (1)	$14,774	$14,838
Restricted bank deposits (2)	5,250	6,250
Derivative instruments (3)	4,077	1,470
Severance pay fund (4)	5,480	4,221
Employee escrow (5)	1,947	967
Other	21	110
	$31,549	$27,856

(1) The land is leased for a period of 49 years and is subject to renewal. This amount was prepaid (see Note 2.i).

(2) Amount represents restricted bank deposits pursuant to an interest rate swap agreement associated with loan agreements in Israel (see Note 9).

(3) See Note 9.

(4) Under Israeli law, the Company and its Israeli subsidiaries are required to make severance or pension payments to dismissed employees and to employees terminating employment under certain other circumstances. Deposits are made with a pension fund or other insurance plans to secure pension and severance rights for the employees in Israel. These amounts represent the balance of the deposits in those funds (including profits) that will be used to cover the Company's severance obligations (see Note 12.b).

(5) In 2008, the Company established an escrow account for certain deferred payments to the Company's General Manager following a change in control.

The Company's non-Israeli subsidiaries maintain defined contribution retirement savings plans covering substantially all of their employees. Under the plans, contributions are based on specific percentages of pay and are subject to statutory limits. The subsidiaries' matching contribution to the plan was approximately $1,018, $903 and $910 for the years-ended December 31, 2009, 2008 and 2007, respectively.

	December 31,		
	2009	2008	2007
Pension, retirement savings and severance expenses	$4,047	$4,928	$3,902

NOTE 9: — DERIVATIVE INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

The Company's operations are exposed to market risks from changes in interest rates and currency exchange rates. Exposure to these risks is managed through normal operating and financing activities and, when appropriate, through derivative instruments.

a. Interest rates:

The Company manages its risk to fluctuating interest rates by opportunistically using interest rate swaps to convert its floating rate debt into fixed rate obligations. These interest rate swaps are not designated as hedges and changes in the fair value of these instruments are reflected in earnings. The Company's interest rate swaps are as follows.

In June 2005, the Company entered into a mortgage agreement for its New Jersey facility. Subsequently, in September 2005, the Company entered into an interest rate swap to mitigate variable mortgage interest rate risk by effectively establishing the mortgage rate at a fixed rate of 4.66%. In November 2008, the Company paid $344 to terminate the swap and recorded a $190 loss within financial expenses, net for year ended December 31, 2008. The Company recorded an unrealized (loss) gain of ($291) within financial expenses, net for the year ended December 31, 2007. The swap was terminated on November 28, 2008. See Note 13.a.4.

In September 2005, the Company also entered into a mortgage agreement for its New York facility and concurrently entered into an interest rate swap with the intention to mitigate the variable mortgage interest rate risk by effectively establishing the mortgage rate at a fixed rate of 6.16%. At December 31, 2009 and 2008, the fair market value of the swap was a $852 liability and $1,647 liability, respectively, and was recorded in other long-term liabilities on the consolidated balance sheet. The Company recorded an unrealized gain (loss) of $795, ($1,379) and ($446) within financial expenses, net for the years ended December 31, 2009, 2008 and 2007, respectively (see Note 13.a.5).

b. Currency exchange rates:

The Company manages its exposure to debt obligations denominated in currencies other than its functional currency by opportunistically using cross-currency swaps to convert its foreign currency debt payments into its functional currency. These cross-currency swaps are not designated as hedges and changes in fair value of these derivatives are reflected in earnings.

The following table sets forth the annual rate of inflation, the devaluation (appreciation) rate of the NIS and the Canadian dollar against the United States dollar and the exchange rates between the United States dollar and each of the NIS and the Canadian dollar at the end of the year indicated:

	Rate of Inflation		Rate of Devaluation (Appreciation) Against U.S. Dollar		Rate of Exchange of U.S. Dollar	
Year	Israel (1)	Canada (2)	Israel (1)	Canada (2)	Israel (1)	Canada (2)
2008	3.80 %	2.33 %	-1.14 %	23.93 %	3.80	1.22
2009	3.91 %	0.26 %	-0.71 %	-14.54 %	3.78	1.05

(1) Per Bank of Israel

(2) Statistics of Canada

From July 1999 to November 2000, the Company issued $24,000 of CPI plus 8.25% bonds denominated in NIS with terms of 10 years. At the same time, the Company entered into 9-10 year cross-currency swaps in which the Company receives CPI plus 6% to 8.25% in NIS and pays LIBOR plus 0.6% to 3.3% in USD based on the outstanding amount of the bonds. At December 31, 2009, the fair market value of these swaps was a $330 asset and was recorded in other receivables, prepaid expenses and other. At December 31, 2008, the fair market value of these swaps was a $513 asset and was recorded in other receivables, prepaid expenses and other ($278 short-term portion) and long-term receivables and other assets ($235 long-term portion). For the years ended December 31, 2009, 2008, and 2007, net gains of approximately $251, $556 and $883 were recorded within financial expenses, net for these swaps.

In November 2003, the Company entered into loan agreements to borrow, in Israel, NIS 210,800 for an eleven-year term at an annual interest rate of 5.8%. At the same time the Company entered into a USD/NIS, 5-year, CPI-adjusted currency swap in which it will receive at the end of the period the NIS amount linked to the CPI plus interest equal to 5.8% of the outstanding NIS balance, and will pay $47,190 plus a fixed rate of 5.9%. This swap matured on November 28, 2008 and was replaced on the maturity date by a USD/NIS, CPI-adjusted, 6-year currency swap. According to this swap agreement, the Company will receive NIS 201,270 in six annual payments (equivalent of the remaining debt balance as of November 28, 2008), which is linked to the CPI plus additional interest equal to 5.8% of the outstanding NIS balance. The Company is required to pay $51,344 plus a fixed rate of 6.59%. At December 31, 2009, the fair market value of the swap was $4,649 comprised of a $572 asset (recorded in other receivables, prepaid expenses and other) and a $4,077 asset (recorded in long-term receivables and other assets). At December 31, 2008, the fair market value of the swap was $1,013 comprised of a $1,235 asset (recorded in long-term receivables and other assets) offset by a $222 payable (recorded in other current liabilities). The Company recorded net gains of $3,708, $2,412 and $7,597 within financial expenses, net for the years ended December 31, 2009, 2008 and 2007, respectively.

NOTE 10: — FAIR VALUE MEASUREMENTS

As described in Note 2, the Company adopted ASC Topic 820 (formerly SFAS 157) as of January 1, 2008. FASB ASC Topic 820 defines fair value as the price that would be received for an asset or paid to transfer a liability, from a selling party’s perspective, in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC Topic 820 requires that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

Level 1: Quoted market prices in active markets for identical assets and liabilities. Active market means a market in which transactions for assets or liabilities occur with “sufficient frequency” and volume to provide pricing information on an ongoing unadjusted basis. The Company has no Level 1 assets or liabilities.

Level 2: Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The Company’s Level 2 assets primarily include derivative instruments. The Level 2 asset values are determined using valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible and consider counterparty credit risk in the assessment of fair value.

Level 3: Unobservable inputs that are not corroborated by market data. The Company has no Level 3 assets or liabilities.

The fair value of the Company's financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2009 and 2008 were as follows:

	December 31, 2009		
	Quoted Market Prices of Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets			
Cross-currency swaps	$ -	$ 4,979	$ -
Liabilties	$ -	$ -	$ -

	December 31, 2008		
	Quoted Market Prices of Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets			
Cross-currency swaps	$ -	$ 1,748	$ -
Liabilties			
Interest rate swap	$ -	$ 1,647	$ -
Cross-currency swaps	$ -	$ 222	$ -
	$ -	$ 1,869	$ -

NOTE 11: — SHORT-TERM BANK CREDIT AND SHORT-TERM LOANS

Classified by currency, linkage terms and interest rates, the credit and loans are as follows:

	Weighted - average interest rate December 31,		Amount December 31,	
	2009	2008	2009	2008
Short-term bank credit and short-term loans:				

In, or linked to, U.S. dollars (1) (2) (3) (4)	3.47	%	4.18	%	$	76,656	$	81,886
In NIS (5)	4.47	%	5.25	%		8,212		6,465
In Canadian dollars (6) (7)	3.18	%	4.35	%		11,222		11,765
						96,090		100,116
Reclass from long-term debt, included in the above amounts (8)						22,846		29,352
Total utilized credit lines and short-term loans					$	73,244	$	70,764
Total authorized credit lines and short-term loans					$	74,681	$	72,748
Unutilized credit lines					$	1,437	$	1,984
Weighted-average interest rates at the end of the year for all loans	3.53	%	4.27	%				

(1) Includes $28,100 of outstanding debt under a $40,000 Taro U.S.A. credit facility at December 31, 2009 and 2008. This credit facility bears interest at a rate of LIBOR plus 3.25% and is secured by a first lien on Taro U.S.A.'s accounts receivable, inventory and all products and proceeds thereof. On October 5, 2010, the Company retired the $28,100 of outstanding debt and $264 of accrued interest. The bank has no further right to any of the Company's assets as collateral since the facility was cancelled.

(2) Includes $9,750 of outstanding debt under a $10,000 Taro U.S.A. credit facility at December 31, 2009 and 2008. The Company entered into a letter agreement with this financial institution as described in Note 13.a.3. On October 28, 2010, the Company retired the $9,750 of outstanding debt and $109 of accrued interest. The bank has no further right to any of the Company's assets as collateral since the facility was cancelled.

(3) Includes $21,026 and $23,250 of outstanding debt under the Company's credit facilities in Israel at December 31, 2009 and 2008, respectively. See Note 13.a.3 for a description of the covenants.

(4) Includes $17,780 and $20,786 of long-term debt reclassified as short-term due to covenant defaults at December 31, 2009 and 2008, respectively.

(5) Represents outstanding debt, in Israel, under the Company's credit facilities of $8,212 and $4,734 and a reclassification from long-term debt of $0 and $1,731 at December 31, 2009 and 2008, respectively. See Note 13.a.3 for a description of the covenants.

(6) Includes $6,156 and $4,930 of outstanding debt at December 31, 2009 and 2008, respectively, under a demand revolving line of credit to Taro Pharmaceuticals Inc., the Company's indirect Canadian subsidiary. The amount available under this line of credit was $7,612 and $6,568 at December 31, 2009 and 2008, respectively. This facility is secured by a general security agreement over the Canadian subsidiary's assets. In addition, the agreement provides the lending institution a second lien on real property and other capital assets in Canada, and the United States. On November 1, 2010, the Company retired the remaining balance of this debt of $5,710 and paid $11 of accrued interest and a $171 prepayment fee. The bank has no further right to any of the Company's assets as collateral.

(7) Includes $5,067 and $6,835 of long-term debt reclassified as short-term due to covenant defaults at December 31, 2009 and 2008, respectively.

(8) Represents long-term debt classified as short-term debt due to covenant defaults described in Notes 13.a.1, 13.a.4 and 13.a.6.

NOTE 12: — OTHER LIABILITIES

a. Other current liabilities:

	December 31,	
	2009	2008
Returns reserve	$22,514	$22,279
Due to customers (1)	1,849	1,377
Employees and payroll accruals	11,783	11,978
Medicaid and indirect rebates	13,415	8,320
Accrued income taxes	15,854	17,581
Class action lawsuit (Note 15.c.4.iii.)	-	10,000
Legal and audit fees	3,137	2,569

Accrued expenses	5,737	5,341
Interest payable	841	841
Derivative instruments	17	433
Deferred taxes	311	561
Other	1,605	2,242
	$77,063	$83,522

(1) Amount due to customers in excess of their outstanding balance as a result of chargebacks, rebates and other deductions.

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b. Other long-term liabilities:

	December 31,	
	2009	2008
Accrued severance pay	$6,357	$5,632
Interest rate swap	852	1,647
Accrued taxes	382	382
Grant from Irish government	-	5
	$7,591	$7,666

NOTE 13: — LONG-TERM DEBT

a. Composed as follows:

	December 31,	
	2009	2008
Loans from institutional investors and bonds (1)	$1,960	$5,322
Loans from institutional investors and bonds (2)	59,975	79,171
Term loan from Canadian bank (3)	7,921	9,298
Mortgage for U.S. distribution facility (4) (5)	10,793	12,993
Mortgage for U.S. headquarters facility (5)	9,854	10,475
	90,503	117,259
Less: current maturities	29,277	29,888
Less: long-term debt reclassified as short-term loans (1, 3, 5)	22,846	29,352
	$38,380	$58,019

1. In 1999 and 2000, the Company entered into a series of debenture and loan agreements in Israel, secured by a floating charge on substantially all of its property, assets and rights. The debentures were issued in separate tranches during 1999 and 2000 for a term of 10 years, with the last tranche maturing in November 2010; most of the loan balance at December 31, 2009 and 2008 was linked to Israeli CPI plus 8.25%. Under the debentures, Taro provided certain undertakings that, among other things, as long as the loan is outstanding, (i) the ratio between long-term liabilities and shareholders' equity shall not exceed two and the current ratio (defined as current assets divided by current liabilities) shall not be less than one and (ii) the ratio of current assets and liabilities shall not exceed one. Such ratios are based on the Company's audited financial statements. As of December 31, 2009 and 2008, the Company was current with its payment obligations but not in compliance with other covenants. Since the Company was not in compliance with certain covenants as described above and since according to the provisions of the agreements, the lenders have the right to accelerate the obligations after notice and opportunity to

cure, the Company has reclassified the long-term portion of its long-term debt to these lenders in the amount of $0 and $1,870, to short-term loans at December 31, 2009 and 2008, respectively.

2. In 2003, the Company entered into two series of loan agreements, subsequently amended, with multiple lenders in Israel. Approximately half of the amount of the loans were issued in U.S. dollars at an interest rate of 6.0 – 6.1%, maturing in 2010. The other half of the loans were issued in NIS at a rate of Israeli CPI plus 5.8%, maturing in 2014. The debentures, provided certain undertakings, including (i) not to encumber any of its assets, unless to secure indebtedness, as defined in such agreements, which in the aggregate does not exceed $20,000, or unless to encumber newly acquired assets to secure financing provided to acquire such assets, and (ii) not to incur any additional indebtedness as long as the ratio of EBITDA to total net interest expense and current principal payable on long-term indebtedness is less than 2:1. The test is based on the Company's audited financial statements, and is performed on April 1 of each year with respect to the prior calendar year. Since the Company was not in compliance with the above described covenants, no additional indebtedness has been incurred by the Company. Although additional borrowing by the Company is restricted, the lenders do not have the right to accelerate their obligations and, thus, these loans have not been reclassified as short-term debt.

3. During 2004, Taro Pharmaceuticals Inc., the Company's indirect Canadian subsidiary, refinanced its mortgage payable and its plant expansion term loans with a new term loan. The new term loan was collateralized by a first lien on the Canadian subsidiary's land, buildings and certain manufacturing equipment, a lien covering all other assets, subject to prior liens indicated in Note 11 above, and a subordinated lien on the buildings and land securing the mortgage loans described in (5) below, as well as certain equipment of Taro U.S.A. Taro U.S.A. and two of its subsidiaries have provided guarantees to the lender for the full amount of the loan. The Canadian subsidiary provided undertakings in the relevant loan documentation that include certain (i) financial covenants, requiring the Canadian subsidiary to maintain a maximum ratio of debt to tangible net worth of 1.60:1 and a ratio of current assets to current liabilities of 1.5:1 or more and (ii) financial reporting covenants relating to the Company and certain subsidiaries, including the Canadian subsidiary. Since the Canadian subsidiary was not in compliance with certain covenants as described above, and in accordance with the agreement, the bank has the right to accelerate its obligation. The Company has reclassified the long-term portion of its long-term debt to this bank in the amount of $5,067 and $6,835, as short-term loans at December 31, 2009 and 2008, respectively. On November 1, 2010, the Company retired the remaining balance of this debt of $5,710 and paid $11 of accrued interest and a $171 prepayment fee. The bank has no further right to any of the Company's assets as collateral.

4. On January 8, 2004, Taro U.S.A. expanded its distribution capacity with the purchase of a 315,000 square foot distribution center on 25 acres of land in South Brunswick, New Jersey. Taro acquired the facility for $18,433, of which, $13,200 was financed by a mortgage. This facility is subject to depreciation on a straight-line basis over a 40 year period. The mortgage on the New Jersey facility was $10,793 and $12,993, as of December 31, 2009 and December 31, 2008, was for an original term of seven years, bearing interest at the rate of LIBOR plus 1.85% and has certain financial and reporting covenants. The interest rate of the mortgage was effectively fixed at 4.66%, as the Company had an interest rate swap in place through November 28, 2008. On November 28, 2008, the principal amount of this mortgage was increased $4,743 to $12,993, and the interest rate swap was terminated.

5. In 2005, Taro U.S.A. and two of its subsidiaries entered into obligations, secured by mortgages on the Company's U.S. headquarters facility located in New York and distribution facility located in New Jersey. The Company guaranteed these obligations. The Canadian bank described in (3) above has a subordinated security position in the facilities which are the subject of the mortgages. Effective November 1, 2010, the bank has no further right to any of the Company's assets as collateral. The mortgage on the New York facility was $9,854 and $10,475, as of December 31, 2009 and 2008, respectively, was for an original term of 15 years, bears interest at the rate of LIBOR plus 1.25%, and has a graduating debt service coverage ratio covenant of 1.90. At December 31, 2009 and 2008, the debt service coverage ratio was 2.05 and 2.00, respectively. The interest rate of this mortgage is effectively fixed at 6.16%, as the Company has an interest rate swap in place which is concurrent with the 15-year term of the mortgage. Since the Company, with respect to each mortgage referenced above, was not in compliance with certain covenants and because each lender has the right to accelerate its obligations, the Company has reclassified the long-term portion of each mortgage, in the amount of $17,780 and $20,647, respectively, as short-term loans at December 31, 2009 and 2008, respectively.

As discussed above, part of the undertakings also include financial reporting obligations that have not been met as a result of the delayed filing of the Company's Annual Reports on Form 20-F for the years 2008 and 2009. The

Company is also not in compliance with certain financial, reporting, and administrative covenants. Additionally, most of the Company's debt instruments have cross-default provisions that provide for acceleration of payments in the event of failure to meet payment obligations or a breach or default of covenants included in other agreements. As a result, even though the Company has been current in its payment obligations, the loans, except the one described in Note 13.a.2 above, are callable by the lenders until the Company is in compliance with its Form 20-F filing requirements as well as with all covenants. In addition, the covenants and undertakings described above restrict the Company's ability to incur additional debt.

As a result of the foregoing, various creditors have the right to elect to accelerate their indebtedness and pursue remedial action, including proceeding against collateral that has been granted to them. Other than the reclassification of certain amounts to current liabilities, the financial statements presented herein do not reflect any adjustments for the impact of any such acceleration or remedial action if they were to be taken.

b. Classified by currency, linkage terms and interest rates, the total amount of the liabilities (including current maturities and the reclassified short-term portion) is as follows:

	Weighted-Average Interest Rate				Amount			
	December 31,				December 31,			
	2009		2008		2009		2008	
In, or linked to, U.S. dollars (1)	3.25	%	4.42	%	$	34,905	$	50,506
In Canadian dollars (subject to variable interest rates)	3.40	%	4.42	%		7,921		9,298
In Israeli currency – linked to CPI	5.89	%	6.01	%		47,677		57,455
					$	90,503	$	117,259

(1) Includes loans in the amount of $23,898 and $30,178 as of December 31, 2009 and 2008, respectively, which are subject to variable interest rates linked to LIBOR. The remaining outstanding debt is subject to fixed interest rates.

c. The debt matures as follows:

		December 31, 2009
2010	$	29,277
2011		15,352
2012		18,947
2013		10,389
2014		10,439
Thereafter		6,099
	$	90,503

As of the date of these financial statements, the Company has met all of its scheduled debt obligations, however, has not been in compliance with certain financial and other covenants as described above.

For collateral, see Note 14.

NOTE 14: — LIABILITIES COLLATERALIZED BY PLEDGES

Balance of liabilities collateralized by pledges is as follows:

	December 31,	
	2009	2008
Short-term bank credit and short-term loans (1)	$ 34,256	$ 33,030
Long-term debt (including current maturities) (2)	$ 30,529	$ 38,088

(1) Short-term bank credits and short-term loans primarily include $28,100 of debt secured by accounts receivable, inventory and all products and proceeds thereof of Taro U.S.A. at December 31, 2009 and 2008. On October 28, 2010, the Company retired the $28,100 outstanding debt principal and $264 of accrued interest.

(2) Long-term debt primarily includes mortgages secured by facilities in the U.S.A. and Canada.

For further discussion of collateralized assets see Notes 11 and 13.

NOTE 15: — COMMITMENTS AND CONTINGENT LIABILITIES

a. Companies of the Group have leased offices, warehouse space and equipment under operating leases for periods through 2013. The minimum annual rental payments, under non-cancelable lease agreements, are as follows:

	December 31, 2009
2010	$ 1,978
2011	785
2012	333
2013	6
Thereafter	-
	$ 3,102

Total rent expenses were $2,920, $3,323 and $3,562 for the years ended December 31, 2009, 2008 and 2007, respectively.

b. Royalty commitments:

The Company is committed to pay royalties at the rate of 3% to 5% to the government of Israel through the Office of the Chief Scientist ("OCS") on proceeds from sales of products in which the government participates in the research and development by way of grants. The obligation to pay these royalties is contingent on actual sales of the products and, in the absence of such sales, no payment is required. The commitment is on a product by product basis, in an amount not exceeding the total of the grants received by the Company, including interest accrued thereon, and is linked to the U.S. dollar. Commencing in 1999, grants are subject to interest at a rate of LIBOR (cost of borrowing funds in U.S. dollars). As of December 31, 2009 and 2008, the aggregate contingent liability to the OCS was approximately $12,117 and $12,274, respectively.

Royalty payments to the OCS were $756, $588 and $485 for the years ended December 31, 2009, 2008 and 2007, respectively.

c. Legal proceedings:

From time to time the Company is subject to litigation arising in the ordinary course of business. Except for the accruals with respect to the Zwickel case (see c.4.iii below) and the Israeli taxation cases (see c.3 below), no accruals for any lawsuits, to which the Company is party, are required in the financial statements. Additionally, the Company is party to certain lawsuits disclosed herein, whose outcome the Company does not believe will have a material adverse effect on its consolidated financial statements.

1. Legal actions commenced by the Company:

i. Company's lawsuit related to Special Tender Offer:

For a detailed description of the Company's lawsuit related to the Sun Offer, see Note 1.b.

ii. Company's lawsuit related to Sun's failure to disclose information in the Sun Offer:

On September 29, 2009, the Company filed a lawsuit against Sun and certain of its affiliates in the United States District Court for the Southern District of New York alleging, among other things, violations of the federal securities laws for failing to disclose material information in the Sun Offer. On October 1, 2010, the Court entered a So-ordered Stipulation of Dismissal without prejudice which ended the matter in its entirety and dismissed all pending motions as moot.

iii. Company's lawsuit related to Ireland:

On June 15, 2008, the Company brought a lawsuit in the District Court seeking a declaratory ruling and permanent injunction against Sun from taking actions to hinder the Company's efforts to sell its Irish operations. This case is pending before the District Court. This is legacy litigation from the change in control of the Company in September 2010, and the lawsuit, at this time, is dormant.

iv. Company's lawsuit related to Ovide® (malathion) Lotion:

On July 27, 2009, the Company filed a lawsuit against Synerx Pharma, LLC, DPT Laboratories, Ltd. and Karalex Pharma, LLC (a subsidiary of Eagle Pharmaceuticals, Inc.) in the United States District Court for New Jersey for infringement of its United States Patent No. 7,560,445 covering its Ovide® (malathion) Lotion, 0.5%. The suit alleges that the defendants' generic malathion lotion, 0.5%, directly or indirectly infringes on Taro's patent. This matter was settled in early 2011 with no material impact on the Company's financial position.

2. Legal actions by certain shareholders:

i. Templeton’s lawsuits related to proposed merger agreement with Sun:

Between May and August 2007, Templeton filed three opening motions in the District Court related to the transactions contemplated by the Share Purchase and Merger Agreements. All of these lawsuits were dismissed by the District Court. Templeton filed an appeal with the Israeli Supreme Court with respect to one of the suits that was dismissed. On November 15, 2010, the Supreme Court dismissed Templeton’s appeal.

ii. Sun's lawsuit related to the termination of the Merger Agreement and enforcement of the Option Agreement:

On June 25, 2008, Sun filed a lawsuit in New York State Court against, among others, the Company and all of its directors. The lawsuit addressed matters related to the termination of the Merger Agreement and alleged breach of the Option Agreement by defendants. On September 29, 2010, Sun discontinued this action against all defendants.

iii. Sun's lawsuit related to the issuance of audited financial statements:

On May 14, 2009, Sun and Alkaloida brought a lawsuit against the Company and its directors at the time (including Mr. Ben Hod and Mr. Haim Fainaro, who served as the Company's statutory external directors until July and August 2009, respectively, but were struck as respondents from the lawsuit on May 5, 2010) in the District Court related to the issuance of audited financial statements for the years 2006 and thereafter. On October 6, 2010, Sun and Alkoloida moved to dismiss all claims against all defendants. The Court dismissed all claims on October 10, 2010.

iv. Sun's litigation relating to the Company's engagement of Guggenheim Securities, LLC ("Guggenheim"):

On July 27, 2010, certain affiliates of Sun that hold shares in the Company filed an originating motion against the Company with the Haifa District Court requesting a declaratory ruling that, among other things, the engagement of Guggenheim by the Company was an extraordinary transaction in which a controlling shareholder of Taro had a personal interest, thereby requiring special approvals under the Israel Companies Law. On October 6, 2010, Sun moved to dismiss its claims against the Company. On October 10, 2010, the District Court dismissed all claims against the Company.

3. Litigations related to Israeli taxation:

i. The Company has challenged a tax assessment by the Israel Income Tax Authority ("ITA") on certain options granted in 1992 to certain officers of Taro U.S.A. The ITA claimed that taxes should have been withheld by the Company and assessed a payment of approximately $34,000 nominal amount of tax and approximately $19,000 in interest and other charges to be paid by Taro. In January 2008, the Company filed an appeal against the assessment with the Haifa District Court. In addition, applications for the conduct of Mutual Agreement Proceedings ("MAP") pursuant to the Israel-United States tax treaty with respect to this matter have been filed both with the Israel Tax Authority and the U.S. Internal Revenue Service. MAP proceedings are intended to resolve matters of double taxation; the Company itself is not a party to those MAP proceedings. Based on the opinion of counsel, the Company believes that no Israeli tax liability or withholding obligation arose as a result of the option exercise because both under Israeli tax law and under the Israel/U.S. Tax Treaty, no Israeli tax can be imposed on the employment or service income (including compensatory option gains) of United States residents derived from employment or services performed in the United States.

ii. On December 31, 2009, the Company and the ITA reached an agreement related to a tax assessment for the Company's taxes for the years 2002 and 2003. The Company is fully reserved for the amounts agreed to with the ITA and believes that an unfavorable result is more likely than not (see Note 17).

4. Other Legal Actions:

i. On November 10, 2004, the Company was sued in the Superior Court of New Jersey in Atlantic County along with defendants Wyeth, Inc. (and associated entities), Upsher-Smith Laboratories, Sandoz, Inc. (and its foreign affiliate), Par Pharmaceutical Companies, Inc., Alphapharm Party Ltd., Eon Labs, Ben Venue Laboratories and unnamed John Doe entities. This was a purported class action lawsuit seeking relief related to defendants' sale of amiodarone, which plaintiffs alleged was unsafe. Plaintiffs sought damages for alleged personal injuries. The plaintiffs alleged that all defendants improperly marketed amiodarone. The Company denied any marketing of amiodarone as alleged by plaintiffs. On June 9, 2010, the class action case was dismissed with prejudice, subject to a window of 150 days within which individual claimants could file individual lawsuits. Only one individual suit was commenced against the Company prior to the expiration of the tolling period. In early 2011, an agreement to resolve this matter was reached. This agreement will have no material impact on the Company's financial position.

ii. A group of former Israeli soldiers have filed three lawsuits for personal injury against the Municipality of Haifa, The Israel Oil Refineries Ltd., The Haifa Town Union Sewage and Haifa Chemicals Ltd. alleging that they contracted serious illnesses as a result of their military service which included diving in the Kishon River near Haifa Bay. In 2005, the Company and over 40 municipalities, governmental entities (including the State of Israel), cooperative villages (kibbutzim) and other companies, were named as third party defendants in these lawsuits. The hearing of the lawsuits was consolidated with the hearing of another lawsuit filed by a group of fishermen also claiming to suffer from serious illnesses as a result of their activities in the Kishon River. The proceedings are currently in different stages, during which the parties present the evidence in the cases to the court.

iii. On April 28, 2008, the Company agreed to pay $10,000, of which $7,000 will be provided by its insurance company, as part of a settlement with plaintiffs in a class action suit, Zwickel v. Taro Pharmaceutical Industries Ltd., 04-CV-5969 (S.D.N.Y.). The legal proceedings were initially filed in 2004, and a consolidated amended complaint was filed in 2007, against the Company and certain of its current and former officers and directors alleging claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The settlement amount of $10,000 owed by the Company was accrued as part of other long-term liabilities in the 2006 consolidated balance sheet. The receivable from the insurance company was recorded as part of other receivables, prepaid expenses and other as of December 31, 2008 and as part of long-term receivables and other assets as of December 31, 2007. On October 26, 2009, the Company fulfilled its obligation as per the terms of the settlement agreement and the Company's insurer paid its respective settlement amount as well.

iv. On March 7, 2011, the Company was sued by The Blackstone Group L.P. ("Blackstone") in the Supreme Court of the State of New York, County of New York. The lawsuit alleges breach of contract relating to fees under an agreement whereby Blackstone would provide certain financial advisory services to the Company. Blackstone seeks approximately $6.3 million in fees and expenses. The proceedings are in the very early stages and the Company denies liability in the matter.

d. In 2003, the Company and its Irish subsidiary entered into an agreement with a government agency in Ireland to receive grants for the development and provision of employment for a manufacturing facility in Ireland. The

obligation to repay these grants terminated in 2008 and 2009, subject to the continued operation and control by the Company's Irish subsidiary. The grants, or portions thereof, may be revoked if jobs related to the grants remain vacant for a period in excess of six calendar months. As of December 31, 2009 and 2008, the balance of grants received was $0 and $5, respectively, and is included in other long-term liabilities. Subsequent to the balance sheet date, the Company fulfilled all of its obligations under the terms of the grant agreement and earned the full benefit of the grant. This grant was amortized as earned by the Company.

e. In 2008, the Company entered into severance agreements tied to change in control, with certain executives whereby each executive would receive salary and benefits for a period of time if terminated after a change in control.

U.S. dollars in thousands (except share and per share data)

NOTE 16: — SHAREHOLDERS' EQUITY

a. Pertinent rights and privileges of ordinary shares:

1. 100% of the rights to profits are allocated to the ordinary shares.

2. 100% of the dissolution rights are allocated to the ordinary shares.

3. Two-thirds of the voting power of all of the Company's shares is allocated to the ordinary shares.

b. Founders' shares:

One-third of the voting power of all of the Company's shares is allocated to the founders' shares.

c. Stock option plans:

1. The Company's 1991 Stock Incentive Plan provided for the issuance of incentive stock options, non-qualified stock options, and stock appreciation rights to key employees and associates of the Group.

The options were granted with an exercise price equal to 100% of the fair market value of the stock on the date of grant. As of December 31, 2009, none of the options granted include stock appreciation rights. The options are granted to employees and associates, have a four-year graded vesting term and generally expire ten years after the date of the grant. Each option entitles its holder the right to purchase one ordinary share. As of December 31, 2009 and 2008, an aggregate of 38,575 and 82,575 options in respect of the 1991 plan were outstanding and no further options in respect of the 1991 plan are available for future grants, respectively. The Company issues new shares to employees and associates exercising their stock options.

2. The Company's 1999 Stock Incentive Plan ("1999 plan") provides for the issuance of incentive stock options, non-qualified stock options, and stock appreciation rights to key employees and associates of the Group.

The options are substantially granted with an exercise price equal to 100% of the fair market value of the stock on the date of grant and the aggregate amount of the options granted may not exceed 2,100,000. As of December 31, 2009, none of the options granted include stock appreciation rights. The options are granted to employees and associates, have a four to five-year graded vesting term and generally expire ten years after the date of the grant. Each option entitles its holder the right to purchase one ordinary share of NIS 0.0001 par value (subject to adjustments). As of December 31, 2009 and 2008, an aggregate of 960,330 and 1,051,130 options in respect of the 1999 plan were outstanding, respectively, and as of March 10, 2009, no further options in respect of the 1999 plan are available for future grants. The Company issues new shares to employees and directors exercising their stock options.

3. During December 2005, the Company accelerated the vesting period of 1,052,030 options outstanding with a weighted-average exercise price of $35.23, which was higher than the market price at the time of the acceleration, and with remaining vesting periods prior to acceleration from one to five years. The decision to accelerate the

vesting of those options was based primarily upon the issuance of SFAS 123(R) which required the Company to record compensation expense for all unvested stock options effective January 1, 2006. The Company believes that the acceleration of vesting of those options will enable the Company to avoid recognizing stock-based compensation expenses associated with these options in future periods. An additional reason for the acceleration of the vesting period was to make the options more attractive to the recipients.

4. A summary of the Company's stock option activity (except options to non-employees) and related information for the year ended December 31, 2009 is as follows:

	Number of options	Exercise price $	Weighted-average exercise price $	Weighted-average remaining contractual terms (in years)	Aggregate intrinsic value
Outstanding at December 31, 2008	1,133,705	$2.38 - $69.26	$24.86		
Exercised	(49,000)	$2.80-$4.63	$3.32		
Forfeited	(105,800)	$7.66 - $69.26	$19.41		
Granted	20,000	$9.50	$9.50		
Outstanding at December 31, 2009	998,905	$2.38 - $68.51	$26.18	3.62	$ 361
Exercisable at December 31, 2009	874,055		$27.67	3.28	$ 357
Vested and expected to vest at December 31, 2009	540,732		$24.30	3.33	$ 282

There were 49,000 options exercised in the year ended December 31, 2009. Total intrinsic value of options exercised for the year ended December 31, 2009 was approximately $261. There were no options exercised in the year ended December 31, 2008.

As of December 31, 2009, there was $380 of unrecognized compensation costs related to share-based compensation arrangements granted under the Company's stock option plan. The unrecognized cost is expected to be recognized over a weighted-average period of 0.92 years for the year ended December 31, 2009. For the years ended December 31, 2009, 2008 and 2007 the Company recognized $307, $322 and $284, respectively, in stock-based compensation expense.

The number of options exercisable as of December 31, 2009, 2008 and 2007 are 874,055, 906,905 and 863,455, respectively. The weighted-average exercise prices for the options exercisable as of December 31, 2009, 2008 and 2007 are $27.67, $26.56 and $26.83, respectively.

The stock options outstanding and exercisable as of December 31, 2009 have been classified into ranges of exercise prices as follows:

	Options outstanding			Options exercisable	
Range of exercise price	Outstanding as of December 31, 2009	Weighted-average remaining contractual life (in years)	Weighted-average exercise price $	Exercisable as of December 31, 2009	Weighted-average exercise price $
$2.38 – $10.00	72,325	0.67	$ 3.89	68,325	$ 3.66
$10.01 – $20.00	309,450	3.95	$ 13.51	202,400	$ 13.19
$20.01 – $30.00	215,400	4.34	$ 24.46	215,400	$ 24.46
$30.01 – $40.00	275,880	3.32	$ 33.37	262,080	$ 33.49
$40.01 – $68.51	125,850	3.92	$ 57.34	125,850	$ 57.34
	998,905	3.62	$ 26.18	874,055	$ 27.67

5. The weighted-average price and fair values for options granted were:

	Granted below market price Year ended December 31,			Granted equal to market price Year ended December 31,		
	2009	2008	2007	2009	2008	2007
Weighted-average exercise price	$0.00	$0.00	$0.00	$9.50	$7.70	$6.75
Weighted-average fair value on the date of grant	$0.00	$0.00	$0.00	$9.02	$4.10	$4.00

6. There were 28,000 stock options exercised by non-employees, at an exercise price of $3.39 per share, during the year ended December 31, 2009.

d. Dividends:

The Company may declare and pay dividends from retained earnings (as for restrictions on dividend distribution, see Note 17.d).

e. Net income per share:

	Year ended December 31, 2009			Year ended December 31, 2008			Year ended December 31, 2007		
	Net income attributable to Taro (numerator)	Shares (denominator)	Per Share Amount	Net income attributable to Taro (numerator)	Shares (denominator)	Per Share Amount	Net income attributable to Taro (numerator)	Shares (denominator)	Per Share Amount
Basic EPS:	$114,023	39,232,270	$2.91	$30,521	39,200,342	$0.78	$34,336	34,724,702	$0.99
Effect of dilutive securities:									
Stock options	-	55,141	-	-	76,399	-	-	78,496	-
Sun Stock Warrants	-	1,280,436	-	-	1,146,060	-	-	411,439	-
Diluted EPS:	$114,023	40,567,847	$2.81	$30,521	40,422,801	$0.76	$34,336	35,214,637	$0.98

f. 2000 Employee Stock Purchase Plan:

In May 2000, the Company's Board approved and implemented the 2000 Employee Stock Purchase Plan ("2000 Plan"), which was approved at an Extraordinary General Meeting of Shareholders held on May 2, 2001. The purpose of the 2000 Plan is to provide employees of the Company and those of its subsidiaries, designated by the Board, an opportunity to purchase ordinary shares. The maximum number of shares issuable under the 2000 Plan is 500,000 ordinary shares, subject to adjustment.

Under the terms of the 2000 Plan, participating employees accrue funds in an account through payroll deductions during six month offering periods. Eligible employees can have up to 10% of their earnings withheld, up to a maximum of $25,000 annually. The funds in this account are applied at the end of such offering periods to purchase ordinary shares at a 15% discount from the closing price of the ordinary shares on (i) the first business day of the offering period or (ii) the last business day of the offering period, whichever closing price is lower. As of December 31, 2008, participating employees purchased an aggregate of $4,465 of newly issued ordinary shares, at a weighted-average exercise price of $7.73. This plan was terminated during 2008.

The amounts of consideration received from participating employees for the years ended December 31, 2008 and 2007 were $35 and $55, respectively. As noted above, this plan was terminated during 2008.

Subsequent to December 31, 2006, the Company decided to suspend the 2000 Plan until the Company was in compliance with SEC regulations to issue shares and allowed employees to withdraw funds owed to them by the plan. In accordance with SFAS No. 123(R), the 2000 Plan is compensatory, and as such, results in recognition of compensation costs. As noted above, this plan was terminated during 2008. For the years ended December 31, 2008 and 2007, the Company recognized $6 and $10, respectively, of compensation expenses in connection with the 2000 Plan.

NOTE 17: — INCOME TAXES

a. Measurement of taxable income under the Income Tax (Inflationary Adjustments) Law, 1985 of Israel:

With respect to the Israeli entity, commencing in taxable year 2003, the Company has elected to measure its taxable income and file its tax return under the Israeli Income Tax Regulations, 1986 (Principles Regarding the Management of Books of Account of Foreign Invested Companies and Certain Partnerships and the Determination of Their Taxable Income). Such an elective obligates the Company for three years. Accordingly, commencing taxable year 2003, results for tax purposes are measured in terms of earnings in U.S. dollars. After the initial three-year term, the Company has to make the election on an annual basis. Through taxable year 2009, the Company has consistently elected, for tax purposes, to measure its earnings in U.S. dollars.

b. Tax rates applicable to the income of the Israeli companies in the Group:

1. Generally, Israeli companies are subject to corporate tax on taxable income. On July 25, 2005, the Knesset (Israeli Parliament) approved the Law of the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among other things, a gradual decrease of the corporate tax rate in Israel up to 25% for the tax year 2010 and beyond. However; the effective tax rate payable by a company that derives income from an Approved Enterprise, as discussed below, may be considerably less.

2. On July 14, 2009, the Knesset approved new legislative Amendments to implement the economic program for 2009 - 2010), which states, among other things, the further gradual reduction of corporate tax rate in Israel to the following tax rates: in 2009 – 26%, in 2010 – 25%, in 2011 – 24%, in 2012 – 23%, in 2013 – 22%, in 2014 – 21%, in 2015 – 20% and in 2016 and thereafter – 18%.

3. Pursuant to another amendment to the Income Tax Ordinance, which became effective in 2003, capital gains are taxed at a reduced rate of 25% from January 1, 2003, instead of the regular corporate tax rate at which such gains were taxed until the aforementioned date. This amendment stipulates that with regard to the sale of assets acquired prior to January 1, 2003, the reduced tax rate will be applicable only for the gain allocated to capital gains earned after the implementation of the amendment, which will be calculated as prescribed by the amendment.

c. Tax benefits under the Law for the Encouragement of Industry (Taxes), 1969:

The Company is an “industrial company” as defined by this law and, as such, is entitled to certain income tax benefits, mainly accelerated depreciation in respect of machinery and equipment (as prescribed by regulations published under the Inflationary Adjustments Law) and the right to claim public issuance expenses, amortization of patents and other intangible property rights as deductions for tax purposes.

d. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 (“the Law”):

The Company’s production facilities in Israel have been granted an “Approved Enterprise” status under the Law. The main benefits arising from such status are tax exempt income for a period of two to four years and reduction in tax

rates on income derived from Approved Enterprises for the remaining benefit period. The Company is also a "foreign investors' company", as defined by the Law and, as such, is entitled to a 10 or 15 year period of benefits, based on the level of investment, and to a reduction in tax rates to 10% to 25% (based on the percentage of foreign ownership in each tax year) and to accelerated depreciation in respect of machinery and equipment.

The period of tax benefits, described above, is subject to a limit of 12 years from commencement of production or 14 years from the date of receiving the "Approved Enterprise" status, whichever occurs earlier.

The Company has four "Approved Enterprise" plans. Under the approved plans, the undistributed income derived from the Approved Enterprise will be exempt from corporate tax for a period of two to four years, and the Company will be eligible for a reduced tax rate of between 10% and 25% for an additional six to eight years. Notwithstanding the foregoing, the Company's undistributed income will be eligible for a reduced tax rate for an additional five years. Under the fourth plan, which was filed in January 2010, and is pending approval, the undistributed income will be exempt from corporate tax for a period of two years following implementation of the plan and the Company will be eligible for a reduced tax rate of between 10% and 25% (based on the percentage of foreign ownership in each tax year) for an additional eight years thereafter. The Company expects to receive approval for this plan.

The entitlement to these benefits is conditional upon the Company fulfilling the requirements of the Law, regulations published thereunder and the instruments of approval for the specific investments in Approved Enterprises. In the event of failure to comply with these requirements, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2009, management believes that the Company is meeting all of the aforementioned requirements.

The income subject to reduced tax rates, attributable to the Approved Enterprises, cannot be distributed to shareholders without subjecting the Company to additional taxes. The Company has decided not to declare dividends out of such tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's Approved Enterprises.

If the retained income subject to reduced tax rates is distributed, it will be taxed at the corporate tax rate applicable to such profits as if the Company had not chosen the alternative tax benefits (currently 10%).

If the Company pays a dividend out of income derived from the Approved Enterprises during the tax exemption period, the Company will be subject to corporate tax in the year the dividend is distributed in respect of the gross amount of dividend distributed, at the rate that would have been applicable had the Company not elected the Alternative Route (10% to 25%, depending on the level of foreign investment in the company, as explained below).

For 2009, income not eligible for Approved Enterprise benefits mentioned above is taxed at the regular rate of 26% (see b above).

On April 1, 2005, an amendment to the Investment Law came into effect (''the Amendment'') and has significantly changed the provisions of the Investment Law. The Amendment limits the scope of enterprises which may be approved by the Investment Center by setting criteria for the approval of a facility as a Benefited Enterprise, such as provisions generally requiring that at least 25% of the Benefited Enterprise's income will be derived from export. Additionally, the Amendment enacted major changes in the manner in which tax benefits are awarded under the Investment Law so that companies no longer require Investment Center approval in order to qualify for tax benefits.

However, the Amendment provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the Company's existing Approved Enterprises will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the new law, will subject the Company to taxes

upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2009, the Company did not generate income under the provisions of the new law. The amendment also added section 85a which gives the Minister of Finance the authority to legislate regulation which determines the price in international transactions between related parties (known as transfer pricing issue).

e. On July 24, 2002, Amendment 132 to the Israeli Income Tax Ordinance ("the Ordinance Amendment") was approved by the Israeli Parliament and came into effect on January 1, 2003. The principal objectives of the Ordinance Amendment were to broaden the categories of taxable income and to reduce the tax rates imposed on employees' income.

The material consequences of the Ordinance Amendment applicable to the Company include, among other things, imposing a tax on all income of Israeli residents, individuals and corporations, regardless of the territorial source of income, certain modifications in the qualified taxation tracks of employee stock options and the introduction of the "controlled foreign corporation" concept according to which an Israeli company may become subject to Israeli taxes on certain income of a non-Israeli subsidiary, if the subsidiary's primary source of income is passive income (such as interest, dividends, royalties, rental income or capital gains). An Israeli company that is subject to Israeli taxes on the income of its non-Israeli subsidiaries will receive a credit for income taxes paid by the subsidiary in its country of residence. Since the Company benefits from lower tax rates of an "Approved Enterprise," such credits are immaterial to its results of operations.

f. Income before income taxes comprises of the following:

	Year ended December 31,		
	2009	2008	2007
Domestic (Israel)	$35,836	$23,605	$20,728
Foreign (North America, the Cayman Islands, Ireland and the U.K.)	11,258	20,457	19,820
	$47,094	$44,062	$40,548

g. Taxes on income comprise of the following:

	Year ended December 31,		
	2009	2008	2007
Current taxes	$8,534	$13,656	$4,015
Deferred income taxes	(78,191)	(115)	2,197
	$(69,657)	$13,541	$6,212
Domestic	$6,609	$2,726	$3,049
Foreign	(76,266)	10,815	3,163
	$(69,657)	$13,541	$6,212

Included within current and deferred income tax expense are benefits relating to investment tax credits at Taro Canada of $1,369 and $1,327 for the years ended December 31, 2009 and 2008, respectively. Taro Canada uses the "flow-through" method and therefore records the benefits in earnings in the period the tax credits are utilized.

h. Reconciliation of the theoretical tax expenses to the actual tax expenses:

A reconciliation of the theoretical tax expense, assuming all income is taxed at the statutory rate applicable to income of the Group and the actual tax expense is as follows:

	Year ended December 31,		
	2009	2008	2007
Income before income taxes	$47,094	$ 44,062	$ 40,548
Statutory tax rate	26 %	27 %	29 %
Theoretical tax	$12,244	$ 11,897	$ 11,759
Deferred tax in respect of losses for which valuation allowance was provided	3,000	915	2,462
Tax (benefit) in respect to prior years	280	21	(601)
“Approved Enterprise” benefit (1)	(5,332)	(5,053)	(4,353)
Effect of different tax rates in other countries	186	5,871	768
Non-deductible expenses	2,609	4,373	3,480
Canadian tax benefits in respect of research and development expenses	(1,369)	(1,099)	(865)
Utilization of net operating losses	(2,969)	(15,187)	(6,452)
Deferred tax asset on temporary differences for which a valuation allowance was provided	(1,693)	12,010	(907)
Reversal of valuation allowance against deferred tax assets in the U.S.	(76,694)	-	-
Interest and penalties on tax liabilities	-	-	172
Other	81	(207)	749
Income taxes in the Statements of Operations	$(69,657)	$ 13,541	$ 6,212

(1) Per share tax benefit resulting from the income exemption:

	Year ended December 31,		
	2009	2008	2007
Basic	$0.14	$0.13	$0.13
Diluted	$0.13	$0.13	$0.12

i. Current taxes are calculated at the following rates:

	Year ended December 31,		
	2009	2008	2007
On Israeli operations (not including “Approved Enterprise”)	26.0 %	27.0 %	29.0 %
On U.S. operations *)	35.0 %	35.0 %	34.0 %
On Canadian operations *)	33.0 %	33.5 %	36.1 %
On U.K. operations *)	28.0 %	28.5 %	30.0 %
On Ireland operations *)	12.5 %	12.5 %	12.5 %

* The U.S., U.K., Irish and Canadian subsidiaries are taxed on the basis of the tax laws prevailing in their countries of residence. The Canadian subsidiary qualifies for research and development tax credits and manufacturing and processing credits, thereby reducing its effective tax rate.

j. Deferred income taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes and carryforward losses.

	December 31, 2009	December 31, 2008
Deferred tax assets:		
Net operating loss carryforward	$44,123	$44,994
Deferred revenue	2,029	2,085
Property, plant, and equipment	1,749	2,381
Accrued expenses	33,261	32,241
Bad debt allowance	83	112
Amortization and impairment	8,908	8,638
Other, net	5,977	6,920
Total deferred tax assets	96,130	97,371
Valuation allowance for deferred tax assets	(13,542)	(92,460)
Net deferred tax assets	82,588	4,911
Deferred tax liabilities:		
Property, plant, and equipment	(3,238)	(2,775)
Amortization	(10)	(34)
Other, net	(875)	(1,545)
Total deferred tax liabilities	(4,123)	(4,354)
Net deferred tax assets (liabilities)	$78,465	$557
Domestic	$3,847	$2,241
Foreign	74,618	(1,684)
	$78,465	$557

The deferred income taxes are presented in the balance sheet as follows:

	December 31, 2009	December 31, 2008
Among current assets (“other receivables, prepaid expenses and other”)	$32,069	$3,815
Long-term deferred income tax assets	50,520	1,096
Among short-term liabilities	(311)	(561)
Among long-term liabilities	(3,813)	(3,793)
	$78,465	$557

k. Carryforward tax losses:

1. The Company:

As of December 31, 2009, one of the Israeli subsidiaries has carryforward tax losses in the amount of $569.

2. Canadian subsidiary:

As of December 31, 2009, this subsidiary has no carryforward tax losses.

3. U.K. subsidiary:

As of December 31, 2009, this subsidiary has carryforward tax losses of $10,802, which may be carried forward and offset against taxable income for an indefinite period in the future. As discussed in Note 2.q, there is a full valuation allowance provided against these losses.

4. Irish subsidiary:

As of December 31, 2009, this subsidiary has carryforward tax losses of $65,617. Taro Ireland commenced trade in 2006 and therefore has satisfied any expiration deadlines. As discussed in Note 2.q., a full valuation allowance is provided against these losses.

5. U.S. subsidiary:

As of December 31, 2009, this subsidiary has carryforward tax losses of $105,424 resulting from prior years U.S. operating losses and the exercise of stock options in 2001 by selling shareholders in a public offering of the Company's shares. These losses can be carried forward against taxable income for 20 years from the year in which the losses were incurred, resulting in expiration dates of 2021 through 2026. The Company estimates that it will utilize $8,900 of such losses on its adjusted 2009 tax returns and estimates that it will utilize $40,000 on its 2010 tax returns. The Company's U.S. subsidiary has been examined by the U.S. tax authorities through 2008; however due to the fact that the U.S. subsidiary has a net operating loss carryforward, the U.S. subsidiary remains subject to examination by the U.S. tax authorities only to the extent of the amount of the net operating loss carryforward. As long as these net operating losses are available, the Company believes its U.S. subsidiary will not have significant tax assessments as a result of the examination. As discussed in Note 2.q, the Company reversed $76,694 of the valuation allowance in 2009.

6. Hungarian subsidiary:

As of December 31, 2009, this subsidiary has carryforward tax losses of $610, which may be carried forward and offset against taxable income for an indefinite period in the future. As discussed in Note 2.q, there is a full valuation allowance provided against these losses.

l. The Company's Board of Directors has determined that its U.S. subsidiary will not pay any dividend as long as such payment will result in any tax expense for the Company.

m. At December 31, 2009, deferred income taxes were not provided for on a cumulative total of $103,994 of the undistributed earnings of Taro Canada, which are not taxable provided earnings remain undistributed. Taro Canada intends to invest these earnings indefinitely in its operations.

n. Foreign withholding taxes have been accrued as necessary by the Company and its subsidiaries.

o. Tax assessments:

The Company completed its tax assessments with the Israeli tax authorities for years through 2003. The Company’s tax provision was adequate to satisfy these assessments. The Company remains subject to examination by the Israeli tax authorities for years 2004 and onward. The Company believes that its tax provision is adequate to satisfy any assessments resulting from examinations related to these years.

The Company's U.S. subsidiary has been examined by U.S. tax authorities through 2008; however, due to the fact that the U.S. subsidiary has a net operating loss carryforward, the U.S. subsidiary remains subject to examination by the U.S. tax authorities only to the extent of the amount of the net operating loss carryforward. As long as these net operating losses are available, the Company believes its U.S. subsidiary will not have any tax assessments.

The Company completed its tax assessments for domestic issues with the Canadian tax authorities for the years through 2003, and for international tax considerations for years through 1998. The Company's tax provision was adequate to satisfy these assessments. The Company remains subject to examination by the Canadian tax authorities for domestic issues for years 2004 and onward and for international issues for year 1999 and onward. The Company believes that its tax provision is adequate to satisfy any assessments resulting from examinations related to these years.

p. Uncertain tax positions:

The Company adopted FIN 48 effective January 1, 2007, which prescribes a model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return (see Note 2.q).

	December 31,	
	2009	2008
Unrecognized tax benefits balance at beginning of year	$17,626	$14,599
Increases as a result of positions taken in prior period	673	1,031
Decreases as a result of positions taken in prior period	(109)	(1,313)
Increases as a result of positions taken in current period	2,736	3,309
Decrease due to expiration of statute of limitations	(965)	-
Unrecognized tax benefits at end of year	$19,961	$17,626

The total amount of interest and penalties recognized on the consolidated statement of operations for the years ended December 31, 2009 and 2008 were $554 and $922, respectively. The total amount of interest and penalties recognized on the consolidated balance sheet at December 31, 2009 and 2008 were $2,459 and $1,836, respectively.

The total amount of unrecognized tax benefits, which would impact the effective tax rate if recognized, was $19,961 and $10,632 at December 31, 2009 and 2008, respectively.

Taro Canada and the Israeli company have the 2004 and 2005 tax years currently under examination. Taro U.S.A. is currently under examination by U.S. tax authorities for the year 2008.

The Company, to the best of its knowledge, does not believe any of its uncertain tax positions are reasonably likely to significantly increase or decrease within the next 12 months.

U.S. dollars in thousands (except share and per share data)

NOTE 18: — SELECTED STATEMENTS OF INCOME DATA

	Year Ended December 31,		
	2009	2008	2007
Sales by location of customers :			
Israel	$21,373	$22,194	$17,362
Canada	32,775	36,301	34,913
U.S.A.	278,301	255,531	258,519
Other	25,194	15,010	8,760
	$357,643	$329,036	$319,554
Selling, marketing, general and administrative expenses:			
Selling and marketing	$36,624	$35,330	$32,257
Advertising	5,505	6,979	6,473
General and administrative *	60,073	56,716	58,544
	$102,202	$99,025	$97,274
* Including provision for doubtful accounts	$75	$286	$(23)
Financial expenses:			
Interest and exchange differences on long-term liabilities	$4,608	$13,064	$9,313
Income in respect of deposits	(1,473)	(750)	(1,162)
Expenses in respect of short-term credit	2,792	4,060	6,339
Foreign currency transaction losses (gains)	10,600	(15,579)	8,326
	$16,527	$795	$22,816

NOTE 19: — SEGMENT INFORMATION

a. Geographic Area Information:

The Group operates in one industry segment, which produces, researches, develops and markets pharmaceutical products. Management organizes the Company's operations based on geographic segments, which are presented below in accordance with FASB ASC Paragraph 280-10-50-1, "Segment Reporting – Overall – Disclosure – Operating Segments" (formerly SFAS No. 131, "Disclosure About Segments of an Enterprise and Related Information").

	Israel	Canada*	U.S.A.	Other	Consolidated
Year ended December 31, 2009 and as of December 31, 2009:					

Sales to unaffiliated customers **	$	21,373	$	32,775	$	278,301	$	25,194	$	357,643
Long-lived assets ***	$	104,877	$	49,530	$	42,283	$	7,626	$	204,316
Year ended December 31, 2008 and as of December 31, 2008:										
Sales to unaffiliated customers **	$	22,194	$	36,301	$	255,531	$	15,010	$	329,036
Long-lived assets ***	$	110,671	$	49,656	$	43,998	$	13,191	$	217,516
Year ended December 31, 2007 and as of December 31, 2007:										
Sales to unaffiliated customers **	$	17,362	$	34,913	$	258,519	$	8,760	$	319,554
Long-lived assets ***	$	117,339	$	62,757	$	46,860	$	18,628	$	245,584

* Includes operations in both Canada and Cayman Islands.

** Based on customer's location.

*** Includes property, plant and equipment, net; goodwill and intangible assets, net.

b. For the year ended December 31, 2009, the Company had net sales to two different customers of 15.5% and 11.0% of consolidated net sales. For the year ended December 31, 2008, the Company had net sales to a single customer of 16.7% of consolidated net sales. For the year ended December 31, 2007, the Company had net sales to two different customers of 15.8% and 10.1% of consolidated net sales.

c. Sales by therapeutic category, as a percentage of total sales for the years ended December 31, 2009, 2008 and 2007:

	Year ended December 31,		
Category	2009	2008	2007
		%	
Dermatological and topical	57	67	67
Cardiovascular	15	12	12
Anti-inflammatory	5	5	7
Neuropsychiatric	16	8	9
Other	7	8	5
Total	100	100	100

NOTE 20: — SUBSEQUENT EVENTS

a. Licensing Agreements:

1. In May 2010, Taro and Quinnova Pharmaceuticals, Inc. entered into an agreement to co-promote Taro's Topicort and desoximetasone products. Under the terms of the arrangement, Taro manufactured and Quinnova co-promoted the products. The parties mutually agreed to terminate the agreement in January 2011.

2. In May 2010, Taro and Glenmark Generics Inc., USA, a wholly owned subsidiary of Glenmark Generics Ltd., India ("Glenmark"), entered into an exclusive license and supply agreement for a branded product. Glenmark Generics Inc., USA will manufacture the product and Taro will distribute the product to customers. Taro paid an up-front payment for distribution rights and will pay an additional amount upon the first shipment to customers. Taro will also pay royalties based on the amounts of sales to its customers.

b. Major Shareholder Transactions:

1. For a detailed description of major shareholder transactions, see Note 1.b.

c. Other:

1. Payments to pharmacies for Medicaid-covered outpatient prescription drugs are set by the states. For multiple source drugs, Federal reimbursements to states for the Federal share of those payments are subject to a Federal upper limit (FUL) ceiling. Health care reform legislation enacted in March 2010 changed the methodology by which the Centers for Medicare & Medicaid Services (CMS) calculates the FULs so that the methodology will, effective October 1, 2010, be based on the weighted average of the average manufacturer prices (AMPs) reported to the government by manufacturers of each of the therapeutically equivalent multiple source drugs. The legislation also, effective October 1, 2010, changed the definition of AMP to

exclude sales to certain customer classes that are currently included. These changes may have the effect of reducing the Medicaid reimbursement rates for certain medications that the Company currently sells. In addition, under the Medicaid Drug Rebate Program, manufacturers are required, as a condition of Federal payment for their drugs under Medicaid, to pay rebates to state Medicaid programs on drugs dispensed to Medicaid beneficiaries in the state. The amount of the rebate is based on the AMP of the drug. Besides changing the definition of AMP, the health care reform legislation increased the minimum Medicaid Rebate, effective January 1, 2010. These changes may increase the Medicaid rebates the Company has to pay for certain medications that the Company currently sells.

2. On October 29, 2010, the Company announced that the Board of Directors appointed an Interim Chief Executive Officer. On November 19, 2010, the Company filed a Form 6-K announcing the departures of certain officers of the Company. The Company also announced the appointment of an Interim Chief Financial Officer.

d. Stock options:

Between January 1, 2010 and March 30, 2011 no stock options were granted to the Company’s directors.

End of consolidated financial statements

TARO PHARMACEUTICAL INDUSTRIES LTD.

U.S. dollars in thousands

SCHEDULE II: — VALUATION AND QUALIFYING ACCOUNTS

Allowance for Inventory Obsolescence

Year	Balance at beginning of period	Additions — Charged to costs and expenses	Foreign currency translation adjustments	Deductions — Write-offs of Inventory	Balance at end of period
2009	$ 15,726	$ 6,762	$ 441	$ (10,923)	$ 12,006
2008	$ 12,435	$ 5,704	$ (614)	$ (1,799)	$ 15,726
2007	$ 14,287	$ 2,403	$ 574	$ (4,829)	$ 12,435

Allowance for Doubtful Accounts

Year	Balance at beginning of period	Additions — Charged to costs and expenses	Deductions — Write-offs	Balance at end of period
2009	$ 630	$ 75	$ (158)	$ 547
2008	$ 741	$ 286	$ (397)	$ 630
2007	$ 2,159	$ (23)	$ (1,395)	$ 741