TARO PHARMACEUTICAL INDUSTRIES LTD
Form 20-F
June 30, 2005

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

£ **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

R **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2004

OR

£ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ___to ___

Commission file number 0-22286

TARO PHARMACEUTICAL INDUSTRIES LTD.

(Exact name of Registrant as specified in its charter)

N/A
(Translation of Registrant s name into English)

Israel
(Jurisdiction of incorporation or organization)

Italy House, Euro Park, Yakum 60972, Israel
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
None	None

Securities registered or to be registered pursuant to Section 12(g) of the Act:

Ordinary Shares, NIS 0.0001 nominal (par) value per share
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report:

29,170,405 Ordinary Shares, NIS 0.0001 nominal (par) value per share

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

R Yes No £

Indicate by check mark which financial statement item the registrant has elected to follow.

£ Item 17 R Item 18

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INTRODUCTION

We develop, manufacture and market prescription and over-the-counter, or OTC, pharmaceutical products, as well as active pharmaceutical ingredients, or APIs, primarily in the United States, Canada and Israel. We were incorporated in 1959 under the laws of the State of Israel. In 1961, we completed the initial public offering of our ordinary shares in the United States. Our ordinary shares are currently traded on the Nasdaq National Market under the symbol TARO.

Except for the historical information contained in this annual report, the statements contained herein are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to our business, financial condition and results of operations. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including all the risks discussed in Item 3D Key Information: Risk Factors and elsewhere in this annual report. We urge you to consider that statements which use the terms *believe, expect, plan, intend, estimate, anticipate, should, will, may"*, *hope* and similar expressions are intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and are subject to risks and uncertainties. Except as required by applicable law, including the securities laws of the United States, we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Our consolidated financial statements appearing in this annual report are prepared in U.S. dollars and in accordance with U.S. generally accepted accounting principles, or U.S. GAAP. All references in this annual report to dollars, or $, are to U.S. dollars and all references in this annual report to NIS are to New Israeli Shekels. The published representative exchange rate between the NIS and the dollar for May 31, 2005 was NIS 4.42 per $1.00. The published representative exchange rate between the Canadian dollar and the dollar for May 31, 2005 was $1.25 Canadian dollar per $1.00.

As used in this annual report, the terms we, us, our and the Company mean Taro Pharmaceutical Industries Ltd. and its subsidiaries, unless otherwise indicated.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. SELECTED FINANCIAL DATA

We have derived the following selected consolidated financial data as of December 31, 2004 and 2003 and for each of the years ended December 31, 2004, 2003 and 2002 from our consolidated financial statements set forth elsewhere in this annual report that have been prepared in accordance with U.S. GAAP. We have derived the consolidated selected financial data as of December 31, 2002, 2001 and 2000 and for each of the years ended December 31, 2001 and 2000 from our audited consolidated financial statements not included in this annual report. In July 2001, we completed a split of our ordinary shares, NIS 0.0001 nominal (par) value per share, by distributing as a dividend, one ordinary share for every ordinary share then outstanding and one ordinary share for every ten founders shares then outstanding. All ordinary share and per share numbers contained in this annual report have been adjusted to give effect to this stock split.

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You should read the selected consolidated financial data together with Item 5 - Operating and Financial Review and Prospects and our consolidated financial statements included elsewhere in this annual report.

	Year Ended December 31,				
	2004	2003	2002	2001	2000
	(In thousands of U.S. dollars except per ordinary share data)				
Statement of Income Data:					
Sales	$ 284,130	$ 315,458	$ 211,581	$ 149,230	$ 103,797
Cost of sales	119,404	102,454	79,468	54,736	41,206
Gross profit	164,726	213,004	132,113	94,494	62,591
Operating expenses:					
Research and development, net	41,943	40,601	26,373	19,633	14,593
Selling, General and Administrative	123,299	97,718	52,481	42,086	31,902
Total operating expenses	165,242	138,319	78,854	61,719	46,495
Operating income	(516)	74,685	53,259	32,775	16,096
Financial expenses, net	6,417	1,722	162	2,594	3,855
Other income (loss), net		(7)	78	272	344
Income before taxes on income	(6,933)	72,956	53,175	30,453	12,585
Taxes on income	(16,991)	11,475	8,406	4,378	2,538
	10,058	61,481	44,769	26,075	10,047
Minority interest in (earnings) loss of a subsidiary	1,017	(326)	(214)	(81)	(20)
Net income	$ 11,075	$ 61,155	$ 44,555	$ 25,994	$ 10,027
Earnings per ordinary share:					
Basic	$ 0.38	$ 2.12	$ 1.55	$ 1.11	$ 0.47
Diluted	$ 0.37	$ 2.06	$ 1.52	$ 0.99	$ 0.42
Number of ordinary shares used in computing earnings per ordinary share (in thousands):					
Basic	29,058	28,873	28,665	23,370	21,420
Diluted	29,657	29,674	29,408	26,302	23,864

	As of December 31,				
	2004	2003	2002	2001	2000
	(In thousands of U.S. dollars)				
Consolidated Balance Sheet Data:					
Working capital	$ 201,585	$ 279,955	$ 198,871	$ 196,711	$ 43,588
Property, plant and equipment, net	241,966	182,306	93,358	54,024	41,827
Total assets	696,847	616,523	379,845	307,762	120,446
Short-term debt, including current maturities	81,905	43,544	10,272	8,231	8,491
Long-term debt	187,346	156,937	47,127	49,285	38,250
Minority interest	694	1,711	1,159	776	168

Shareholders equity	368,120	347,400	269,137	218,364	50,214

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B. CAPITALIZATION AND INDEBTEDNESS

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS

Not applicable.

D. RISK FACTORS

Our business, operating results and financial condition may be seriously harmed due to any of the following risks, among others. If we do not successfully address the risks to which we are subject, we may experience a material adverse effect on our business, results of operations and financial condition and our share price may decline. We cannot assure you that we will successfully address any of these risks.

Risks Relating to Our Industry

The pharmaceutical industry in which we operate is intensely competitive. We are particularly subject to the risks of competition. For example, the competition we encounter may have a negative impact upon the prices we may charge for our products, the market share of our products and our revenues and profitability.

The pharmaceutical industry in which we operate is intensely competitive. The competition which we encounter has an effect on our product prices, market share, revenues and profitability. Depending upon how we respond to this competition, its effect may be materially adverse to us. We compete with:

the original manufacturers of the brand-name equivalents of our generic products;

other drug manufacturers (including brand-name companies that also manufacture generic drugs); and

manufacturers of new drugs that may compete with our generic drugs and proprietary products.

Most of the products that we sell are either generic drugs or drugs in respect of which patents have expired. Most of these products do not benefit from patent protection and are therefore more subject to the risk of competition than patented products. In addition, because many of our competitors have substantially greater financial, production, and research and development resources, substantially larger sales and marketing organizations, and substantially greater name recognition than we have, we are particularly subject to the risks inherent in competing with them. For example, many of our competitors may be able to develop products and processes competitive with, or superior to, our own. Furthermore, we may not be able to differentiate our products from those of our competitors, successfully develop or introduce new products that are less costly or offer better performance than those of our competitors or offer purchasers of our products payment and other commercial terms as favorable as those offered by our competitors.

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Brand-name companies frequently take actions to prevent or discourage the use of generic drug products such as ours.

Brand-name companies have increasingly taken actions, including the use of state and federal legislative and regulatory mechanisms, to prevent, delay or discourage the use of generic equivalents to their products, including generic products that we manufacture or market. If these efforts to delay or prevent generic competition are successful, our ability to sell our generic versions of those brand-name products may be limited or prevented. This could have a material adverse effect on our future results of operations. These efforts have included, among others:

- filing new patents or extensions of existing patents on brand-name products whose original patent protection is about to expire, which could extend patent protection for the product and delay launch of generic equivalents;
- developing patented controlled-release products or other product improvements;
- developing and marketing branded products as over-the-counter products;
- pursuing pediatric exclusivity for brand-name products;
- submitting citizen petitions to request that the Commissioner of the United States Food and Drug Administration, or the FDA, take administrative action with respect to an abbreviated new drug application, or ANDA approval;
- attaching special patent extension amendments to unrelated federal legislation;
- engaging in state-by-state initiatives to enact legislation that restricts the substitution of some brand-name drugs with generic drugs; and
- introducing authorized generics to the marketplace.

Generally, no additional regulatory approvals are required for brand-name manufacturers to sell directly or through a third party to the generic market. Brand-name products that are licensed to third parties and are marketed under their generic names at discounted prices are known as authorized generics. This facilitates the sale by brand-name manufacturers of generic equivalents of their own brand-name products. Because many brand-name companies are substantially larger than we are and have substantially greater resources than we have, we are particularly subject to the risks of their undertaking to prevent or discourage the use of those of our products that compete with theirs. Moreover, the introduction of authorized generics may make competition in the generic market more intense. It may also reduce the likelihood that a generic company like ours that obtains the first ANDA approval for a particular product, will be the first-to-market and/or the only generic alternative offered to the market and thus may diminish the economic benefit associated with this position.

New developments by others could make our products or technologies non-competitive or obsolete.

The markets in which we compete and intend to compete are undergoing, and are expected to continue to undergo, rapid and significant technological change. We expect competition to

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intensify as technological advances are made. Our competitors may succeed in developing products and technologies that are more effective or less costly than any that we are developing, or that would render our products obsolete and noncompetitive. For example, AstraZeneca Pharmaceuticals has filed a New Drug Application for a novel oral direct thrombin inhibitor, Exanta® (ximelagatran). If approved by regulatory authorities, the launch of Exanta® may have an adverse effect on our sales of Coumadin® in Israel and warfarin sodium tablets in the United States and Canada. A reduction in the sales and profitability of warfarin sodium tablets may have an adverse effect on the results of our operations and financial condition.

We anticipate that we will face increased competition in the future as new companies enter the market and advanced technologies emerge. Smaller or early-stage companies may also prove to be significant competitors, particularly through collaborative arrangements with large and established companies. Many of our competitors have significantly greater research and development, financial, sales and marketing, manufacturing, and other resources than we have. As a result, they may be able to devote greater resources to the development, manufacture, marketing or sale of their products, initiate or withstand substantial price competition, or more readily take advantage of acquisitions or other opportunities.

Our ability to market products successfully depends, in part, upon the acceptance of the products not only by consumers, but also by independent third parties.

Our ability to market generic or proprietary pharmaceutical products successfully depends, in part, on the acceptance of the products by independent third parties (including physicians, pharmacies, government formularies, managed care providers, insurance companies, and retailers) as well as patients. In addition, unanticipated side effects or unfavorable publicity concerning any of our products, or any brand-name product of which our generic product is the equivalent, could have an adverse effect on our ability to achieve acceptance by prescribing physicians, managed care providers, pharmacies and other retailers, customers and patients.

Our ongoing profitability depends upon our ability to introduce new generic or innovative products on a timely basis.

Our ongoing profitability depends, to a significant extent, upon our ability to introduce, on a timely basis, new generic or innovative products for which we either are the first to market (or among the first to market) or can otherwise gain significant market share. Our ability to achieve any of these objectives is dependent upon, among other things, the timing of regulatory approval of these products and the number and timing of regulatory approvals of competing products. Inasmuch as this timing is not within our control, we may not be able to develop and introduce new generic and innovative products on a timely basis, if at all.

Our revenues and profits from individual generic pharmaceutical products are likely to decline as our competitors introduce their own generic equivalents.

Revenues and gross profit derived from generic pharmaceutical products tend to follow a pattern based on regulatory and competitive factors unique to the generic pharmaceutical industry. As the patents for a brand-name product and the related exclusivity periods expire, the first generic manufacturer to receive regulatory approval for a generic equivalent of the product is often able to capture a substantial share of the market. However, as other generic manufacturers receive regulatory approvals for competing products, or brand-name

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manufacturers introduce authorized generics, that market share and the price of that product will decline.

We are subject to extensive government regulation that increases our costs and could prevent us from marketing or selling our products.

We are subject to extensive regulation by the United States, Canada, Israel and other jurisdictions. These jurisdictions regulate the approval, testing, manufacture, labeling, marketing and sale of pharmaceutical products. For example, approval by the FDA is generally required before any new drug or the generic equivalent to any previously approved drug may be marketed in the United States. In order to receive approval from the FDA for each new drug product we wish to market, we must demonstrate, through rigorous clinical trials, that the new drug product is safe and effective for its intended use and that our manufacturing processes for that product candidate complies with current good manufacturing practices, or cGMPs. We cannot provide an assurance that the FDA will, in a timely manner, or ever, approve our applications for new drug products. The FDA may require substantial additional clinical testing or find our drug product does not satisfy the standards for approval. In addition, in order to obtain approval for our product candidates that are generic versions of brand-name drugs, we must demonstrate to the FDA that each generic product candidate is bioequivalent to a drug previously approved by the FDA through the new drug approval process, known as an innovator drug. Bioequivalency may be demonstrated by comparing the generic product to the innovator drug product in dosage form, strength, route of administration, quality, performance characteristics and intended use. If the FDA determines that an ANDA for a generic drug product is not adequate to support approval, it could deny our application or request additional information, including clinical trials, which could delay approval of the product and impair our ability to compete with other versions of the generic drug product.

If our product candidates receive FDA approval, the labeling claims and marketing statements that we can make for our new and generic products are limited by statues and regulations and, with respect to our generic drugs, by the labeling claims made in brand-name packaging. In addition, if the FDA and/or a foreign regulatory authority approves any of our products, the labeling, packaging, adverse event reporting, storage, advertising and promotion for the product will be subject to extensive and ongoing regulatory requirements. As a manufacturer of pharmaceutical products distributed in the U.S., we must also comply with cGMPs, which include requirements related to production processes, quality control and assurance, and recordkeeping. Products that we manufacture and distribute in foreign jurisdictions may be regulated under comparable laws and regulations in those jurisdictions. Our manufacturing facilities and procedures and those of our suppliers are subject to periodic inspection by the FDA and foreign regulatory agencies. Any violations of cGMPs or other applicable standards identified during such inspections may result in enforcement actions, including delaying or preventing new product approvals, a delay or suspension in manufacturing operations, consent decrees, or civil or criminal penalties. Further, discovery of previously unknown problems with a product or manufacturer may result in restrictions or sanctions with respect to the product, including withdrawal of the product from the market.

In addition, because we market a controlled substance in the United States and other controlled substances in Canada and Israel, we must meet the requirements of the United States Controlled Substances Act and its equivalents in Canada and Israel, as well as the regulations promulgated thereunder in each country. These regulations include stringent requirements for

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manufacturing controls, importation, receipt and handling procedures and security to prevent diversion of, or unauthorized access to, the controlled substances in each stage of the production and distribution process. The U.S. Drug Enforcement Administration, or DEA, and comparable regulatory authorities in Israel and Canada may periodically inspect our facilities for compliance with the United States Controlled Substances Act and its equivalents in Israel and Canada. Any failure to comply with these laws and regulations could lead to a variety of sanctions, including the revocation, or a denial of renewal, of our DEA registration (or Israeli or Canadian equivalent), injunctions, or civil or criminal penalties.

Furthermore, most of the products that we manufacture and distribute are manufactured outside the United States and must be shipped into the United States. The FDA and the DEA, in conjunction with the U.S. Customs Service, can exercise greater legal authority over goods that we seek to import into the United States than they can over products that are manufactured in the United States.

Although we devote significant time, effort and expense to addressing the extensive government regulations applicable to our business and obtaining regulatory approvals, we remain subject to the risk of being unable to obtain necessary approvals on a timely basis, if at all. Delays in receiving regulatory approvals could adversely affect our ability to market our products.

Product approvals by the FDA and by comparable foreign regulatory authorities may be withdrawn if compliance with regulatory standards is not maintained or if problems relating to the products are experienced after initial approval. In addition, if we fail to comply with governmental regulations we may be subject to fines, unanticipated compliance expenditures, interruptions of our production and/or sale, prohibition of importation, seizures and recalls of our products, criminal prosecution and debarment of us and our employees from the generic drug approval process.

Reimbursement policies of third parties, cost containment measures and healthcare reform could adversely affect the demand for our products and limit our ability to sell our products.

Our ability to market our products depends, in part, on reimbursement levels for them and related treatment established by healthcare providers (including government authorities), private health insurers and other organizations, including health maintenance organizations and managed care organizations. Reimbursement may not be available for some of our products and, even if granted, may not be maintained. Limits placed on reimbursement could make it more difficult for people to buy our products and reduce, or possibly eliminate, the demand for our products. In the event that governmental authorities enact additional legislation or adopt regulations which affect third party coverage and reimbursement, demand for our products may be reduced with a consequent adverse effect, which may be material, on our sales and profitability. In addition, the purchase of our products could be significantly influenced by the following factors, among others:

trends in managed healthcare in the United States;

developments in health maintenance organizations, managed care organizations and similar enterprises;

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legislative proposals to reform healthcare and government insurance programs; and

price controls and reimbursement policies.

These factors could result in lower prices and/or a reduced demand for our products.

We are susceptible to product liability claims that may not be covered by insurance and could require us to pay substantial sums.

We face the risk of loss resulting from, and adverse publicity associated with, product liability lawsuits, whether or not such claims are valid. We may not be able to avoid such claims. In addition, our product liability insurance may not be adequate to cover such claims and we may not be able to obtain adequate insurance coverage in the future at acceptable costs. A successful product liability claim that exceeds our policy limits could require us to pay substantial sums.

The manufacture and storage of pharmaceutical products are subject to inherent risk.

Because chemical ingredients are used in the manufacture of pharmaceutical products and due to the nature of the manufacturing process itself, there is a risk of incurring liability for damages caused by or during the storage or manufacture of both the chemical ingredients and the finished pharmaceutical products. Although we have never incurred any material liability for damages of that nature, we may be subject to liability in the future. In addition, while we believe our insurance coverage is adequate, it is possible that a successful claim would exceed our coverage, requiring us to pay a substantial sum.

The manufacture and storage of pharmaceutical and chemical products are subject to environmental regulation and risk.

Because of the chemical ingredients of pharmaceutical products and the nature of their manufacturing process, the pharmaceutical industry is subject to extensive environmental regulation and the risk of incurring liability for damages or the costs of remedying environmental problems. Although we have never incurred any such liability in any material amount, we may be subject to liability in the future. We may also be required to increase expenditures to remedy environmental problems and comply with applicable regulations. If we fail to comply with environmental regulations to use, discharge or dispose of hazardous materials appropriately or otherwise to comply with the conditions attached to our operating licenses, the licenses could be revoked and we could be subject to criminal sanctions and substantial liability. We could also be required to suspend or modify our manufacturing operations.

Testing required for the regulatory approval of our products is sometimes conducted by independent third parties. Any failure by any of these third parties to perform this testing properly may have an adverse effect upon our ability to obtain regulatory approvals.

Our applications for the regulatory approval of our products incorporate the results of testing and other information that are sometimes provided by independent third parties (including, for example, manufacturers of raw materials, testing laboratories, contract research organizations or independent research facilities). The likelihood that the products being tested will receive regulatory approval is, to some extent, dependent upon the quality of the work performed by

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these third parties, the quality of the third parties facilities and the accuracy of the information provided by these third parties. We have little or no control over any of these factors.

Risks Relating to Our Company

Three wholesale customers account for a very substantial portion of our consolidated sales.

During 2003 and 2004, AmerisourceBergen Corporation, McKesson Corporation and Cardinal Health, Inc., collectively accounted for approximately 46% and 39%, respectively, of our consolidated sales. We have no long-term agreements with these wholesalers and they may therefore reduce or cease their purchases from us at any time. Any cessation or reduction of their purchases from us would likely have a material adverse effect on the results of our operations and our financial condition. Furthermore, changes in their buying patterns or in their policies and practices in relation to their working capital and inventory management may result in a reduction of, or a change in the timing of, their purchases of our products. For example, we believe that the decrease in our sales to each of these customers during 2004, as compared to 2003, was, to a significant extent, attributable to changes in their buying patterns and inventory management practices. We have no ability to obtain advance knowledge of such changes. We base our manufacturing schedules, inventories and internal sales projections principally on historical data. To the extent that actual orders from these wholesalers differ substantially from our internal projections, we may either find ourselves with excess inventory or in an out of stock position. In 2004, orders received from these three wholesalers were substantially below our internal projections, resulting in an increase in inventory and an adverse effect on our operating results. Hence, factors beyond our control relative to these customers have had in the recent past, and may have from time to time in the future, a material adverse effect upon our operating results, which has, in the recent past, resulted, and may from time to time in the future result, in substantial volatility of the market prices of our securities.

We derive most of our revenues and profits from a small group of product lines.

During 2004, seven product lines accounted for 48% of our consolidated sales. In 2003 and 2002, seven product lines accounted for 54% and 53% of consolidated sales, respectively. In 2004, one product line accounted for approximately 10% of our consolidated sales. A significant decline in revenues or profitability of any one of these product lines may adversely affect the results of our operations and financial condition.

The nature of our business requires us to estimate future charges against wholesaler accounts receivable. If these estimates are not accurate, the results of our operations and financial condition could be adversely affected.

Sales to third parties, including government institutions, hospitals, hospital buying groups, pharmacy buying groups, pharmacy chains and others generally are made through wholesalers. We sell our goods to wholesalers, and the wholesalers subsequently resell the goods to third parties at times and in quantities ordered by the third parties. Typically, we have a contract price with a third party to which a wholesaler resells our goods that may be equal to or less than the price at which we sold the goods to the wholesaler. In such a case, at the time the third party purchases from the wholesaler, the wholesaler charges us back for any shortfall. At the time of any individual sale by us to a wholesaler, we do not know under which contracts the wholesaler will resell goods to third parties. Therefore, we estimate the amount of chargebacks and other

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credits that may be associated with these sales and we reduce our revenue accounts accordingly. From time to time, the amount of such chargebacks and other credits reported by a wholesaler may be different from our estimates. Discrepancies of this nature may result in a reduction in the value of our accounts receivable and a related charge to our net income. The reconciliation of our accounts with wholesalers may, from time to time, delay, or otherwise impact upon, the collection of our accounts receivable or result in a decrease in their value and in a related charge to our net income.

Our inventories of finished goods have expiration dates after which they cannot be sold.

Industry standards require that pharmaceutical products be made available to customers from existing stock levels rather than on a made-to-order basis. Therefore, in order to accommodate market demand adequately, we strive to maintain sufficiently high levels of inventories. However, inventories prepared for sales that are not realized as or when anticipated may approach their expiration dates and have to be written off. These write-offs, if any, could have an adverse affect on the results of our operations and financial condition.

Our future success depends on our ability to develop, manufacture and sell new products.

Our future success is largely dependent upon our ability to develop, manufacture and market new commercially viable pharmaceutical products and generic equivalents of proprietary pharmaceutical products whose patents and other exclusivity periods have expired. Delays in the development, manufacture and marketing of new products will negatively impact the results of our operations. Each of the steps in the development, marketing and manufacture of our products involves significant time and expense. We are, therefore, subject to the risks, among others, that:

- any products under development, if and when fully developed and tested, will not perform in accordance with our expectations;
- any generic product under development will, when tested, not be bioequivalent to its brand-name counterpart;
- necessary regulatory approvals will not be obtained in a timely manner, if at all;
- any new product cannot be successfully and profitably produced and marketed;
- other companies may launch their version of generic products, either prior to or following the launch of our newly approved generic version of the same product; or
- brand-name companies may launch their products, either themselves or through third parties, in the form of authorized generic products which can reduce sales, prices and profitability of our newly approved generic products.

If we are unable to obtain raw materials, our operations could be seriously impaired.

We currently obtain some raw materials for our products from either a single supplier or a limited number of suppliers. Although we have not experienced significant difficulty in obtaining raw materials to date, material supply interruptions may occur in the future and we may have to obtain substitute materials or products. While we do have long-term supply

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agreements for some raw materials, for most raw materials we do not have any long-term supply agreements and we are therefore subject to the risk that our suppliers of raw materials may not continue to supply us with raw materials on satisfactory terms or at all.

Furthermore, obtaining the regulatory approvals required for adding alternative suppliers of raw materials for finished products we manufacture may be a lengthy process. We strive to maintain adequate inventories of single source raw materials in order to ensure that any delays in receiving regulatory approvals will not have a material adverse effect upon our business. However, we may not be successful in doing so and, as a consequence, we may be unable to sell some products pending approval of one or more alternate sources of raw materials. Any significant interruption in our supply stream could have a material adverse effect on our operations.

We are increasing our efforts to develop new proprietary pharmaceutical products, but these efforts may not be successful.

Our principal business in North America has traditionally been the development, manufacture and marketing of generic equivalents of pharmaceutical products first introduced by other companies. However, we have greatly increased our efforts to develop new proprietary products, including T-2000 and T2001 (our patented non-sedating barbiturate compounds) and products utilizing NonSpil (our patented spill-resistant liquid drug delivery system).

Expanding our focus beyond generic products and broadening our product pipeline to include new proprietary products may require additional internal expertise or external collaboration in areas in which we currently do not have substantial resources and personnel. We may have to enter into collaborative arrangements with others that may require us to relinquish rights to some of our technologies or products that we would otherwise pursue independently. We may not be able to acquire the necessary expertise or enter into collaborative agreements on acceptable terms, if at all, to develop and market new proprietary products.

In addition, although a newly developed product may be successfully manufactured in a laboratory setting, difficulties may be encountered in scaling up for manufacture in commercially-sized batches. For this reason and others, only a small minority of all new proprietary research and development programs ultimately results in commercially successful drugs. A program (including any program of ours) cannot be deemed successful until it actually produces a drug that is commercially marketed for a significant period of time.

In order to obtain regulatory approvals for the commercial sale of our new proprietary products, we are required to complete extensive clinical trials in humans to demonstrate the safety and efficacy of the products to the satisfaction of FDA and regulatory authorities abroad. Conducting clinical trials is a lengthy, time-consuming and expensive process, and the results of such trials are inherently uncertain. We have limited experience in conducting clinical trials in these new product areas.

A clinical trial may fail for a number of reasons, including:

failure to enroll a sufficient number of patients meeting eligibility criteria;

failure of the new product to demonstrate safety and/or efficacy;

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the development of serious (including life threatening) adverse events (including, for example, side effects caused by or connected with exposure to the new product); or

the failure of clinical investigators, trial monitors and other consultants or trial subjects to comply with the trial plan or protocol.

The results from early clinical trials may not be predictive of results obtained in later clinical trials. Clinical trials may not demonstrate the safety and efficacy of a product sufficient to obtain the necessary regulatory approvals, or to support a commercially viable product. Any failure of a clinical trial for a product in which we have invested significant time or other resources could have a material adverse effect on our results of operations and financial condition.

Even if launched commercially, our proprietary products may face competition from existing or new products of other companies. These other companies may have greater resources, market access, and consumer recognition than we have. Thus, even if launched commercially, there can be no assurance that our proprietary products will be successful or profitable. In addition, advertising and marketing expenses associated with the launch of a proprietary product may adversely affect the results of our operations and our financial condition.

We may not be able to successfully identify, consummate and integrate recent and/or future acquisitions.

We have in the past pursued, and may in the future pursue, acquisitions of product lines and/or companies and seek to integrate them into our operations. Acquisitions of additional product lines and companies involve risks that could adversely affect our future revenues and results of operations. For example:

we may not be able to identify suitable acquisition targets or acquire companies on favorable terms;

we compete with other companies that may have stronger financial positions to acquire product lines and companies. We believe that this competition will increase and may result in decreased availability or increased prices for suitable acquisition targets;

we may not be able to obtain the necessary financing, on favorable terms or at all, to finance any of our potential acquisitions;

we may not be able to obtain the necessary regulatory approvals, including the approval of antitrust regulatory bodies, in any of the countries in which we may seek to consummate potential acquisitions;

we may ultimately fail to complete an acquisition after we announce that we plan to acquire a product line or a company;

we may fail to integrate our acquisitions successfully in accordance with our business strategy;

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we may choose to acquire a business that is not profitable, either at the time of acquisition or thereafter;

acquisitions may require significant management resources and divert attention away from our daily operations, result in the loss of key customers and personnel, and expose us to unanticipated liabilities;

we may not be able to retain the skilled employees and experienced management that may be necessary to operate businesses we acquire, and if we cannot retain such personnel, we may not be able to locate and hire new skilled employees and experienced management to replace them; or

we may purchase a company that has contingent liabilities that include, among others, known or unknown patent or product liability claims.

In the event that we grant licenses to third parties to market or distribute any of our products, the level of sales of such products and of the manufacturing or license fees that we receive as a result thereof will depend to a very substantial extent upon the efforts of our licensees.

We may, from time to time, grant licenses to unaffiliated third parties, which may or may not be exclusive, to market or distribute certain of our products. For example, in March, 2005, we granted exclusive licenses to market and distribute our proprietary Kerasal® and ElixSure® lines of products in North America to an unaffiliated third party. To the extent that our revenues from the granting of such licenses (whether in respect of these two product lines or any other products) are dependent upon the sale of the underlying products (for example, if we receive fees for manufacturing the products or royalties based upon the sale of the products), to a very substantial extent such revenues will depend upon the extent, quality and results of the efforts of our licensees. Our ability to have an impact upon these factors is limited and there can be no assurance that the revenue that we realize from licensing any product will be sufficient to enable us to recover our investment in the development of the product.

We depend on our ability to protect our intellectual property and proprietary rights, but we may not be able to maintain the confidentiality, or assure the protection, of these assets.

Our success depends, in large part, on our ability to protect our current and future technologies and products and to defend our intellectual property rights. If we fail to protect our intellectual property adequately, competitors may manufacture and market products similar to ours. Numerous patents covering our technologies have been issued to us, and we have filed, and expect to continue to file, patent applications seeking to protect newly developed technologies and products in various countries, including the United States. Some patent applications in the United States are maintained in secrecy until the patent is issued. Because the publication of discoveries tends to follow their actual discovery by many months, we may not be the first to invent, or file patent applications on any of our discoveries. Patents may not be issued with respect to any of our patent applications and existing or future patents issued to or licensed by us may not provide competitive advantages for our products. Patents that are issued may be challenged, invalidated or circumvented by our competitors. Furthermore, our patent rights may not prevent our competitors from developing, using or commercializing products that are similar or functionally equivalent to our products. Where trade secrets are our sole protection, we may

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not be able to prevent third parties from marketing generic equivalents to our products, reducing prices in the marketplace and reducing our profitability.

We also rely on trade secrets, non-patented proprietary expertise and continuing technological innovation that we seek to protect, in part, by entering into confidentiality agreements with licensees, suppliers, employees and consultants. These agreements may be breached and there may not be adequate remedies in the event of a breach. Disputes may arise concerning the ownership of intellectual property or the applicability of confidentiality agreements. Moreover, our trade secrets and proprietary technology may otherwise become known or be independently developed by our competitors. If patents are not issued with respect to products arising from research, we may not be able to maintain the confidentiality of information relating to these products.

Third parties may claim that we infringe on their proprietary rights and may prevent us from manufacturing and selling certain of our products.

There has been substantial litigation in the pharmaceutical industry with respect to the manufacture, use and sale of new products. These lawsuits relate to the validity and infringement of patents or proprietary rights of third parties. We may be required to commence or defend against charges relating to the infringement of patent or proprietary rights. Any such litigation could:

require us to incur substantial expenses, even if we are insured or successful in the litigation;

require us to divert significant time and effort of our technical and management personnel;

result in the loss of our rights to develop or make certain products; and

require us to pay substantial monetary damages or royalties in order to license proprietary rights from third parties.

Although patent and intellectual property disputes within the pharmaceutical industry have often been settled through licensing or similar arrangements, costs associated with these arrangements may be substantial and could include the long-term payment of royalties. These arrangements may be investigated by U.S. regulatory agencies and, if improper, may be invalidated. Furthermore, the required licenses may not be made available to us on acceptable terms. Accordingly, an adverse determination in a judicial or administrative proceeding or a failure to obtain necessary licenses could prevent us from manufacturing and selling some of our products or increase our costs to market these products.

From time to time, we seek to market products before the patents for them expire. In order to do so in the United States, we must challenge the patent under the procedures set forth in the Hatch-Waxman Act of 1984. (In the United States, in order to obtain a final approval for a generic product prior to expiration of certain of the innovator s patents, we must, under the terms of the Drug Price Competition and Patent Term Restoration Act of 1984 (Hatch-Waxman Act), as amended by the Medicare Prescription Drug Improvement and Modernization Act of 2003, notify the patent holder as well as the owner of a New Drug Application that we believe that the patents listed in the Approved Drug Products with Therapeutic Equivalence Evaluations (Orange Book) for the new drug are either invalid or not infringed by our product.) To the

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extent that we engage in patent challenge procedures, we are involved and expect to be involved in patent litigation regarding the validity or infringement of the originator s patent. Patent challenges are complex, costly and can take a significant amount of time to complete.

In addition, when seeking regulatory approval for some of our products, we are required to certify to regulatory authorities, including the FDA, that such products do not infringe upon third party patent rights. Filing a certification against a patent gives the patent holder the right to bring a patent infringement lawsuit against us. Any lawsuit would delay regulatory approval by the FDA until the earlier of the resolution of such claim or 30 months from the patent holder s receipt of notice of certification. A claim of infringement and the resulting delay could result in substantial expenses and even prevent us from manufacturing and selling certain of our products.

In addition, it is not required that pharmaceutical patents be listed with the Food and Drug Administration or other regulatory authorities. For example, patents relating to antibiotics might not be listed in the Orange Book. Any launch of a pharmaceutical product by us that infringes a patent, whether listed or not, may involve us in litigation; in certain circumstances, litigation may result in significant damages which could have a material adverse effect on the results of our operations or financial condition.

Our launch of a product prior to a final court decision or the expiration of a patent held by a third party may result in substantial damages to us. Depending upon the circumstances, a court may award the patent holder damages equal to three times the patent holder s loss of income. If we are found to infringe a patent held by a third party and become subject to significant damages, these damages could have a material adverse effect on the results of our operations and financial condition.

Volatility of the market price of our ordinary shares could adversely affect us and our shareholders.

The market price of our ordinary shares may be volatile, has recently been subject to substantial fluctuation and may, in the future, continue to be subject to wide fluctuations, for the following reasons, among others:

actual or anticipated variations in our quarterly operating results or those of our competitors;

announcements by us or our competitors of new and enhanced products;

market conditions or trends in the pharmaceutical industry;

developments or disputes concerning proprietary rights;

introduction of technologies or product enhancements by others that reduce the need for our products;

the inaccuracy of, or changes, in financial estimates by securities analysts;

general economic and political conditions;

departures of key personnel;

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changes in the market valuations of our competitors;

regulatory considerations; and

the other risk factors listed in this section.

Three of our directors, and members of their immediate families, currently control 45.6% of the voting power in our company.

Dr. Barrie Levitt, Dr. Daniel Moros, Tal Levitt and members of their immediate families currently control, through their beneficial ownership of outstanding ordinary shares and founders shares, approximately 45.6% of the voting power in our company. Dr. Levitt and Dr. Moros are cousins and Ms. Levitt is Dr. Levitt s daughter. By reason of their shareholdings, the Levitt and Moros families should be able to control the outcome of most actions that require majority shareholder approval, including the election of directors, the approval of mergers, sales of substantially all of our assets and other extraordinary transactions that require shareholder approval.

50% of the voting power in our subsidiary, Taro U.S.A., is held by a corporation which is controlled by the Chairman and Vice Chairman of Taro s Board of Directors and their families.

The share capital of Taro U.S.A. is divided into two classes. Taro owns 96.9% of the shares that have economic rights and 50% of the shares that have voting rights in Taro U.S.A. Taro Development Corporation, or TDC, owns 3.1% of the shares that have economic rights and 50% of the shares that have voting rights in Taro U.S.A. Dr. Levitt, Dr. Moros and their families are able to vote the majority of the outstanding voting shares of TDC and thereby control TDC. Although TDC has agreed to vote all of its shares in Taro U.S.A. for the election to its board of directors of such persons as we may designate, TDC may terminate the agreement upon one year written notice. In the event that TDC were to cease voting its shares in Taro U.S.A. for our designees or otherwise in accordance with our preference, TDC could prevent us from electing a majority of the board of directors of Taro U.S.A., effectively block actions that require approval of a majority of the voting power in Taro U.S.A. and potentially preclude us from consolidating Taro U.S.A. into our financial statements. Taro U.S.A. accounted for approximately 90% and 87%, of our consolidated sales during 2003 and 2004, respectively.

No citizen or resident of the United States who acquired or acquires any of our ordinary shares at any time after October 21, 1999 is permitted to exercise more than 9.9% of the voting power in our company, with respect to such ordinary shares, regardless of how many shares the shareholder owns.

In order to reduce our risk of being classified as a Controlled Foreign Corporation under the United States Internal Revenue Code of 1986, as amended, or the Code, we amended our Articles of Association in 1999 to provide that no owner of any of our ordinary shares is entitled to any voting right of any nature whatsoever with respect to such ordinary shares if (a) the ownership or voting power of such ordinary shares was acquired, either directly or indirectly, by the owner after October 21, 1999 and (b) the ownership would result in our being classified as a Controlled Foreign Corporation. This provision has the practical effect of prohibiting each

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citizen or resident of the United States who acquired or acquires our ordinary shares after October 21, 1999 from exercising more than 9.9% of the voting power in our company, with respect to such ordinary shares, regardless of how many shares the shareholder owns. The provision may therefore discourage U.S. persons from seeking to acquire, or from accumulating, 15% or more of our ordinary shares (which, due to the voting power of the founders shares, would represent 10% or more of the voting power of our company).

We face risks related to foreign currency exchange rates.

Because some of our revenue, operating expenses, assets and liabilities are denominated in foreign currencies, we are subject to foreign exchange risks that could adversely affect our operations and reported results. To the extent that we incur expenses in one currency but earn revenue in another, any change in the values of those foreign currencies relative to the U.S. dollar could cause our profits to decrease or our products to be less competitive against those of our competitors. To the extent that our foreign currency holdings and other assets denominated in a foreign currency are greater or less than our liabilities denominated in a foreign currency, we have foreign exchange exposure.

Our business requires us to move goods across international borders. Any events that interfere with, or increase the costs of, the transfer of goods across international borders could have a material adverse effect on our business.

We transport most of our goods across international borders, primarily those of the United States, Canada and Israel. Since September 11, 2001, there has been more intense scrutiny of goods that are transported across international borders. As a result, we may face delays, and increases in costs due to such delays, in delivering goods to our customers. Any events that interfere with, or increase the costs of the transfer of goods across international borders could have a material adverse effect on our business.

Risks Relating to Our Location in Israel

Conditions in Israel affect our operations and may limit our ability to produce and sell our products.

We are incorporated under Israeli law and our principal offices and a significant component of our manufacturing and research and development facilities are located in Israel. Political, economic and military conditions in Israel directly affect our operations, and we could be adversely affected by hostilities involving Israel, the interruption or curtailment of trade between Israel and its trading partners or a significant downturn in the economic or financial condition of Israel. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, as well as incidents of civil unrest. Although Israel has entered into various agreements with Egypt, Jordan and the Palestinian Authority, Israel frequently has been subject to civil unrest and terrorist activity, with varying levels of severity. Furthermore, certain parties with whom we do business periodically have declined to travel to Israel, forcing us to make alternative arrangements where necessary, and the United States Department of State has issued an advisory regarding travel to Israel, impeding the ability of travelers to attain travel insurance. As a result, the FDA has at various times curtailed or prohibited its inspectors from traveling to Israel to inspect the facilities of Israeli companies, which, should it occur with respect to our company, could result in the FDA withholding

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approval for new products we intend to produce at those facilities. Also, although it has not yet occurred, the political and security situation in Israel may result in certain parties with whom we have contracts claiming that they are not obligated to perform their commitments pursuant to force majeure provisions of those contracts.

In addition, since a significant component of our manufacturing and research and development facilities are located in Israel, we could experience disruption of our manufacturing and research and development due to terrorist attacks. If terrorist acts were to result in substantial damage to our facilities, our business activities would be disrupted since, with respect to some of our products, we would need to obtain prior FDA approval for a change in manufacturing site. Our business interruption insurance may not adequately compensate us for losses that may occur and any losses or damages sustained by us could have a material adverse effect on our business.

Some neighboring countries, as well as certain companies and organizations, continue to participate in a boycott of Israeli firms and others doing business with Israel or with Israeli companies. We are also precluded from marketing our products to certain of these countries due to U.S. and Israeli regulatory restrictions. Because none of our revenue is currently derived from sales to these countries, we believe that the boycott has not had a material adverse effect on our current operations. However, continuation or extension of the boycott and the implementation of additional restrictive laws, policies or practices directed towards Israel or Israeli businesses could have an adverse impact on the expansion of our business.

Finally, many male Israeli citizens, including our employees, are subject to compulsory annual military service through middle age. Additionally, these employees are subject to being called to active duty at any time under emergency circumstances. While we believe that we have operated relatively efficiently given these requirements, we cannot predict the effect on our business operations if the conflict with the Palestinians continues to escalate or intensify. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of our other employees due to obligatory military service requirement. Any disruption in our operations would harm our business.

We may be adversely affected if the rate of inflation in Israel exceeds the rate of devaluation of the New Israeli Shekel, or NIS, against the U.S. dollar.

A substantial portion of our expenses, primarily labor and occupancy expenses in Israel, is incurred in NIS. As a result, the cost of our operations in Israel, as measured in U.S. dollars, is subject to the risk that the rate of inflation in Israel will exceed the rate of devaluation of the NIS in relation to the U.S. dollar or that the timing of any devaluation will lag behind inflation in Israel. If the U.S. dollar cost of our operations in Israel increases, our U.S. dollar-measured results of operations will be adversely affected.

Our operations may be affected by negative economic conditions in Israel.

Israel has experienced periods of recession in economic activity in recent years, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel deteriorate. In addition, due to significant economic measures proposed by the Israeli government, there have been several general strikes and work stoppages in 2003 and 2004, affecting all banks, airports and ports. These strikes have had an adverse effect

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on the Israeli economy and on business, including our ability to deliver products to our customers or to receive raw materials from our suppliers in a timely manner. From time to time, the Israeli trade unions threaten strikes or work-stoppages, which may, if carried out, have a material adverse effect on the Israeli economy and us.

Government price control policies can materially impede our ability to set prices for our products.

All pharmaceutical products sold in Israel are subject to price controls. Permitted price increases are enacted by the Israeli government as part of a formal review process. The inability to control the prices of our products may adversely affect our operations.

We currently benefit from government programs and tax benefits, both or either of which may be discontinued or reduced.

We currently receive grants and substantial tax benefits under government of Israel programs, including the Approved Enterprise program and programs of the Office of the Chief Scientist of the Ministry of Commerce and Industry of the State of Israel. In order to maintain our eligibility for these programs and benefits, we must continue to meet specified conditions, including making specified investments in fixed assets from our equity and paying royalties with respect to grants received. In addition, some of these programs restrict our ability to manufacture particular products and transfer particular technology outside of Israel. If we fail to comply with these conditions in the future, the benefits received could be canceled and we could be required to refund payments previously received under these programs or pay increased payments and/or taxes. In recent years, the government of Israel has reduced the benefits available under these programs, and these programs and tax benefits may be discontinued or curtailed in the future. Various proposals have been put forth for new legislation to amend the benefits available under these programs. We are not able to predict whether or when this new legislation will be enacted, nor can we predict the nature and scope of benefits that may be available under any new laws. If the government of Israel ends these programs and tax benefits, our business, financial condition and results of operations could be materially adversely affected.

Provisions of Israeli law may delay, prevent or make more difficult a merger or acquisition. This could prevent a change of control and depress the market price of Taro s ordinary shares.

Provisions of Israeli corporate and tax law may have the effect of delaying, preventing or making more difficult a merger or acquisition. The Israeli Companies Law, or the Companies Law, generally requires that a merger be approved by a company s board of directors and by a shareholder vote at a shareholders meeting that has been called on at least 21 days advance notice by each of the merger parties. Under our Articles of Association, the required shareholder vote is a supermajority of at least 75% of the shares voting in person or by proxy on the matter. Any creditor of a merger party may seek a court order blocking a merger if there is a reasonable concern that the surviving company will not be able to satisfy all of the obligations of any party to the merger. Moreover, a merger may not be completed until at least 70 days have passed from the time that the merger proposal has been filed with the Israeli Registrar of Companies.

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Other potential means of acquiring a public Israeli company such as ours might involve additional obstacles. In addition, a body of case law has not yet developed with respect to the Companies Law. Until this happens, uncertainties will exist regarding its interpretation.

Finally, Israeli tax law treats some acquisitions, such as stock-for-stock exchanges between an Israeli company and a foreign company, less favorably than do U.S. tax laws. The provisions of Israeli corporate and tax law and the uncertainties surrounding such laws may have the effect of delaying, preventing or making more difficult a merger or acquisition. This could prevent a change of control of Taro and depress the market price of Taro s ordinary shares which otherwise might rise as a result of such a change of control.

It may be difficult to effect service of process and enforce judgments against our directors and officers.

We are incorporated in Israel. A majority of our executive officers and directors are nonresidents of the United States and a substantial portion of our assets and the assets of such persons are located outside the United States. Therefore, it may be difficult to enforce a judgment obtained in the United States against us or any of those persons or to effect service of process upon those persons. It may also be difficult to enforce civil liabilities under U.S. federal securities laws in original actions instituted in Israel.

Risks Relating to Our Location in Canada

Government price control policies can materially impede our ability to set prices for our products.

The Canadian Government Patented Medicine Prices Review Board, or PMPRB, monitors and controls prices of patented drug products marketed in Canada by persons holding, or licensed under, one or more patents. The PMPRB will approve an introductory price (based on a comparative analysis) and will require that the price not be increased each year thereafter by more than the annual increase of the Canadian Consumer Price Index. Consequently, the existence of one or more patents relating to a drug product, while providing some level of proprietary protection for the product, also triggers a governmental price control regime that significantly affects the Canadian pharmaceutical industry s ability to set pricing. The inability to control the prices of our products may adversely affect our operations.

Sales of our products in Canada depend, in part, upon their being eligible for reimbursement from drug benefit formularies.

In each province of Canada there is a drug benefit formulary. A formulary lists the drugs for which a provincial government will reimburse qualifying persons and the prices at which the government will reimburse such persons. There is not complete uniformity among provinces. However, provincial governments generally will reimburse the lowest available price of the generic equivalents of any drug listed on the formulary list of the province. The formularies can also provide for drug substitution, even for patients who do not qualify for government reimbursement. The effect of these provincial formulary regimes is to encourage the sale of lower-priced versions of pharmaceutical products. The potential lack of reimbursement represents a significant threat to our business. Additionally, the substitution effect may adversely affect our ability to profitably market our products.

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We may be adversely affected if the rate of inflation in Canada exceeds the rate of devaluation of the Canadian dollar against the U.S. dollar.

A substantial portion of our expenses, primarily labor and occupancy expenses in Canada, is incurred in Canadian dollars. As a result, the cost of our operations in Canada, as measured in U.S. dollars, is subject to the risk that the rate of inflation in Canada will exceed the rate of devaluation of the Canadian dollar in relation to the U.S. dollar or that the timing of any devaluation will lag behind inflation in Canada. If the U.S. dollar cost of our operations in Canada increases, our U.S. dollar-measured results of operations will be adversely affected. During the year-ended December 31, 2004, the value of the Canadian dollar has increased 6.9% with respect to the U.S. dollar. This increase in the value of the Canadian dollar has had the effect of increasing the cost of our goods manufactured in Canada.

ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY

The legal and commercial name of our company is Taro Pharmaceutical Industries Ltd. We were incorporated under the laws of the State of Israel in 1959 under the name Taro-Vit Chemical Industries Ltd. In 1984, we changed our name to Taro Vit Industries Ltd. and in 1994 we changed our name to Taro Pharmaceutical Industries Ltd.

In 1961, we completed the initial public offering of our ordinary shares, which are currently traded on the Nasdaq National Market under the symbol TARO. In that year, we also acquired 97% of the outstanding stock of an Israeli corporation, then known as Taro Pharmaceutical Industries Ltd., or TPIL. In 1981, we sold 37% of our interest in TPIL. In 1993, after acquiring all of the outstanding shares of TPIL, we merged TPIL into our company. In July 2001, we completed a split of our ordinary shares by distributing a dividend of one ordinary share for each ordinary share then outstanding and one ordinary share for every ten founders shares then outstanding. In October 2001, we sold 3,950,000 of our ordinary shares, and selling shareholders sold 1,800,000 of our ordinary shares, in a public offering.

In May 2002, a newly-created subsidiary of Taro U.S.A. purchased substantially all of the assets of Thames Pharmacal Company, Inc., or Thames, a manufacturer of prescription and OTC pharmaceuticals. The purchase price was approximately $6.4 million, all of which was paid in cash. The assets acquired included the right to all of Thames generic prescription and OTC products, as well as Thames laboratories and manufacturing operations. We also added to our operations all of Thames approximately 60 employees and acquired the leases for its facilities, which include laboratories, manufacturing and warehousing operations, located in Ronkonkoma, New York. As of December 31, 2004, manufacturing operations at this site have been transferred to Canada.

On January 14, 2003, Taro Pharmaceuticals North America Inc., or TNA, entered into a license and option agreement with Medicis Pharmaceutical Corporation, or Medicis. According to the agreement, TNA, on June 1, 2004, exercised its option and purchased from Medicis four branded prescription product lines for sale in the United States and Puerto Rico for an aggregate purchase price of $23.8 million. Approximately $11.7 million was for the licensing period and was payable over five consecutive quarters. The balance of $12.1 million was due upon the

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exercise of the purchase option. Two of these products are used in dermatology and the other two are used in pediatrics.

On March 21, 2003, our Irish subsidiary, Taro Pharmaceuticals Ireland Ltd., acquired, for 5.55 million Euros, a multi-purpose pharmaceutical manufacturing and research facility in Ireland. The facility was purchased out of liquidation proceedings under the Official Liquidator appointed by the High Court of Ireland. The facility consists of 124,000 square feet of manufacturing, laboratory, office and warehouse space located on a 14-acre campus in central Ireland. The facility, which had been operating until the end of 2002, has been licensed and approved by the Irish Medicines Board to manufacture and distribute pharmaceutical products in Ireland and the European Union.

In December 2003, our Canadian subsidiary expanded its distribution capacity with the purchase of a 108,797 square foot distribution facility located on 6.7 acres in Brampton, Ontario in close proximity to our existing facilities.

In January 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 U.S.A. acquired the facility for approximately $18 million. In conjunction with the purchase, the U.S. subsidiary receives certain financial incentives from the New Jersey Economic Development Authority.

In July 2004, Taro U.S.A. entered into a license and option agreement with Medicis for four products including the Lustra® product line. These products are used for the treatment of dyschromia or discoloration of the skin.

In March 2005, the Company divested the ElixSure® and Kerasal® brands in North America. However, the Company will continue to manufacture and supply these products from its Canadian plant.

Our principal executive offices are located at Yakum Business Park, Yakum 60972, Israel. Our telephone number at that address is +972-9-971-1800. Our registered office is located at 14 Hakitor Street, Haifa Bay 26110, Israel. Our telephone number at that address is +972-4-847-5700.

Capital Expenditures

During 2004, 2003 and 2002, our capital expenditures were approximately $72.3 million, $94.4 million and $43.2 million, respectively. The focus of our capital expenditure program has been the expansion and upgrade of our manufacturing facilities and information technology systems in order to enable us to increase operational efficiencies, remain in compliance with cGMP, accommodate increasing demand for our products, and maintain a competitive position in the marketplace.

The major projects undertaken during the past three years, as part of our capital expenditure program, include:

the expansion of our production and distribution facilities in Canada and Israel;

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the construction of new research, development and manufacturing facilities in Canada and Israel;

the acquisition of additional production and packaging equipment;

the upgrade of our information technology systems;

acquisition of additional land in Haifa Bay, Israel for expansion of our facilities;

acquisition of a facility (previously rented by us) in Canada;

acquisition of Thames;

acquisition of a 124,000 square feet building in Hawthome, N.Y. for the research laboratory and administrative offices of Taro U.S.A.;

acquisition of a multi-purpose pharmaceutical manufacturing and research facility in Ireland;

acquisition of a distribution center facility in New Jersey;

acquisition of a distribution facility in Ontario, Canada; and

acquisition of product rights to Topicort®, Ovide®, Primsol®, A/T/S®, and Lustra® in the United States. We have not launched A/T/S® and the rights to Primsol® were sold in March, 2005.

In addition, during the above period, in anticipation of an increase in sales and the overall growth of our operations, we purchased, leased or contracted to purchase additional properties and ordered new equipment for construction of new multi-purpose pharmaceutical and chemical plants in Haifa Bay, Israel. (For a detailed presentation of our property, plant and equipment, please see Note 5 to our consolidated financial statements included elsewhere in this report.)

B. BUSINESS OVERVIEW

We are a multinational, science-based pharmaceutical company. We develop, manufacture and market prescription and OTC pharmaceutical products, as well as active pharmaceutical ingredients, or APIs, primarily in the United States, Canada and Israel. Our primary areas of focus include topical creams and ointments, liquids, capsules and tablets, mainly in the dermatological, cardiovascular and central nervous system therapeutic categories. We operate principally through three entities: Taro Pharmaceutical Industries Ltd., or Taro Israel, and two of its subsidiaries, Taro Pharmaceuticals Inc., or Taro Canada, and Taro U.S.A. The principal activities and primary product lines of these subsidiaries may be summarized as follows:

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Entity	Principal Activities	Primary Product Lines
Taro Israel	Manufactures more than 65 finished dosage form pharmaceutical products for sale in Israel and for export Produces, for its own use and for sale to third parties, APIs used in the manufacture of finished dosage form pharmaceutical products Markets both proprietary and generic products in the local Israeli market Performs research and development independently and through Taro Research Institute Ltd., a wholly-owned subsidiary	Dermatology: Prescription and OTC semi-solid products (creams, ointments and gels) and liquids Cardiology and Neurology: Prescription oral dosage products Oral Analgesics: Prescription and OTC OTC Nasal Sprays and Nutritional Supplements Oral, Opthalmic and OTC preparations
Taro Canada	Manufactures more than 45 finished dosage form pharmaceutical products for sale in Canada and for export Markets both proprietary and generic products in the local Canadian market Independently performs research and development and through Taro Research Institute Ltd.	Dermatology: Prescription and OTC semi-solid products (creams, ointments and gels) and liquids Cardiology and Neurology: Prescription oral dosage products
Taro U.S.A.	Markets and distributes both proprietary and generic products in the local U.S. market Performs research and development	Dermatology: Prescription and OTC semi-solid products (creams, ointments and gels) and liquids Cardiology and Neurology: Prescription oral dosage products Other prescription and OTC products

Warfarin sodium tablets are sold as Coumadin® by us in Israel under the brand-name, and as generic warfarin sodium tablets in the United States, Canada, the United Kingdom, and elsewhere. This product accounted for 10% of our sales in 2004.

As of June 20, 2005, 25 of our ANDAs and one NDA are being reviewed by the FDA. In addition, there are several products for which either development or internal regulatory work is in process. The applications pending before the FDA are at various stages in the review process, and there can be no assurance that we will be able to successfully complete any remaining testing or that, upon completion of such testing, approvals for any of the applications currently under review at the FDA will be granted. In addition, there can be no assurance that the FDA will not grant approvals for competing products submitted by our competitors, prior to or simultaneous with the granting of approval to us.

The Generic Pharmaceutical Industry

Generic pharmaceuticals are the chemical and therapeutic equivalents of brand-name drugs and are typically marketed after the patents for brand-name drugs have expired. Generic pharmaceuticals generally must undergo clinical testing that demonstrates that they are

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bioequivalent to their branded equivalents and are manufactured to the same standards. Proving bioequivalence generally requires data demonstrating that the generic formulation results in a product whose rate and extent of absorption are within an acceptable range of the results achieved by the brand-name reference drug. In some instances, bioequivalence can be established by demonstrating that the therapeutic effect of the generic formula falls within an acceptable range of the therapeutic effects achieved by the brand-name reference drug.

Generic pharmaceutical products must meet the same quality standards as branded pharmaceutical products although they are sold at prices that are substantially lower than those of their branded counterparts. As a result, generic pharmaceuticals represent a much larger percentage of total drug prescriptions dispensed than their corresponding percentage of total sales. This discount tends to increase (and margins tend to decrease) as the number of generic competitors increases for a given product. Because of this pricing dynamic, companies that are among the first to develop and market a generic pharmaceutical tend to earn higher profits than companies that subsequently enter the market for that product. Furthermore, products that are difficult to develop or are intended for niche markets generally attract fewer generic competitors and therefore may offer higher profit margins than those products that attract a larger number of competitors. However, profit is influenced by many factors other than the number of competitors for a given drug or the size of the market. Depending on the actions of each of our competitors, price discounts can be just as significant for a specific product with only a few competitors or a small market, as for a product with many competitors or a large market.

In recent years, the market for generic pharmaceuticals has grown dramatically. We believe that this growth has been driven by the following factors, among others:

efforts by governments, employers, third-party payors and consumers to control healthcare costs;

increased acceptance of generic products by physicians, pharmacists and consumers; and

the increasing number of pharmaceutical products whose patents have expired and are therefore subject to competition from, and substitution by, generic equivalents.

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Products

We currently market more than 180 pharmaceutical products in over 20 countries. The following table represents some of our key product groups and the major markets in which they are sold:

Product Groups	Dosage Form	U.S. Brand Name*	Therapeutic Category	Major Markets	Rx/ OTC
Amiodarone HCI	tablets	Cordarone ®	Cardiovascular	U.S.	Rx
Ammonium Lactate	cream, lotion	Lac-Hydrin ®	Moisturizer	U.S. Canada	Rx/ OTC
Bethamethasone Dipropionate (augmented)	cream, gel	Diprolene ®	Topical Corticosteroid	U.S.	Rx
Carbamazepine	tablets, controlled release tablets, chewable tablets, oral suspension cream, ointment	Tegretol ®	Anticonvulsant	U.S. Canada Israel	Rx
Clobetasol Propionate	gel, topical solution, emollient cream	Temovate ®	Topical Corticosteroid	U.S.	Rx
Clorazepate Dipotassium	tablets	Tranxene ®	Antianxiety	U.S.	Rx
Clotrimazole	cream, topical solution, vaginal cream	Lotrimin ®/ Gyne-Lotrimin ®	Antifungal	U.S. Canada	Rx/ OTC
Clotrimazole and Betametasone Dipropionate	cream, lotion	Lotrisone ®	Antifungal	Israel U.S.	Rx
Desonide	cream, ointment	Tridesilon ®	Topical Corticosteroid	U.S.	Rx
Desoximetasone	cream, ointment, gel	Topicort ® **	Topical Corticosteroid	U.S. Canada Israel	Rx
Diflorasone Diacetate	cream, ointment	Psorcon ®	Topical Corticosteroid	U.S.	Rx
Econazole Nitrate	cream	Spectazole ®	Antifungal	U.S.	Rx
Enalapril	tablets	Vasotec ®	Cardiovascular	U.S.	Rx
Enalapril and Hydrochlorothiazide	tablets	Vaseretic ®	Cardiovascular	U.S.	Rx
Etodolac	tablets, capsules	Lodine ®	Analgesic	U.S. Canada Israel	Rx
Etodolac	extended release tablets	Lodine® XL	Analgesic	U.S. Israel	Rx
Fluconazole	tablets	Diflucan ®	Antifungal	U.S.	Rx
Fluocinonide	cream, ointment, gel, topical	Lidex ®	Topical Corticosteroid	U.S. Canada	Rx

	solution, emollient cream				
Fluorouracil	solution	Efudex ®	Topical	U.S.	Rx
Halobetasol Propionate	ointment	Ultravate ®	Topical Corticosteroid	U.S.	Rx

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Product Groups	Dosage Form	U.S. Brand Name*	Therapeutic Category	Major Markets	Rx/ OTC
Hydrocortisone Valerate	cream, ointment	Westcort ®	Topical Corticosteroid	U.S.	Rx
Hydrocortisone	cream, ointment	Cortizone ®	First Aid	U.S. Canada Israel	OTC
Ketoconazole	tablets, cream	Nizoral ®	Antifungal	U.S.	Rx
Malathion	lotion	Ovide ® **	Pediculicide	U.S.	Rx
Miconazole Nitrate	vaginal cream, cream	Monistat® 3 Monistat® 7 Micatin®	Antifungal	U.S.	OTC
Mometasone Furoate	cream, ointment	Elocon ®	Topical Corticosteroid	U.S.	Rx
Nystatin	oral suspension, vaginal cream	Mycostatin ®	Antifungal	U.S. Canada Israel	Rx
Salicyclic Acid and Urea	ointment	Kerasal ® ***	Exfoliating Moisturizer	U.S. Canada	OTC
Terconazole	vaginal cream	Terazol ®	Antifungal	U.S.	Rx
Triamcinolone Acetonide	cream, ointment, dental paste	Kenalog ®	Topical Corticosteroid	U.S. Canada Israel	Rx
Warfarin Sodium	tablets	Coumadin ®	Anticoagulant	U.S. Canada Israel	Rx

* Presented in this column are the brand-names under which the products are most commonly prescribed in the United States. Except as noted below, we do not own any of the specific names. In some cases, we manufacture and sell the generic equivalent of the product sold by the third party owner of such name. Thus, for example, we sell our product Warfarin Sodium under that name in the United States. Warfarin is the generic equivalent of Coumadin, a product sold under that name in the United States by the third party owner of the U.S. rights to that name and by us in Israel, where we own the right to use that name.

** Taro brands

*** Brand rights for North America were sold on March 3, 2005.

Topical corticosteroids are used in the treatment of some dermatologic conditions (including psoriasis, eczema and various types of skin rashes). Antifungals are used in the treatment of some infections (including athlete s foot, ringworm and vaginal yeast infections). Anticonvulsants are used in the treatment of various seizure disorders (including epilepsy). Cardiovascular products are used in the treatment of heart disease. There are several categories of cardiovascular drugs, including anticoagulants, antihypertensive and antiarrhythmics. Anticoagulants are blood thinners used in the treatment of heart disease and stroke associated with heart disease.

Sales and Marketing

In the United States, Israel and Canada, our sales are primarily generated by our own dedicated sales force. In other countries, we sell through agents and other distributors. Our sales force is supported by our medical representatives,

customer service, and marketing employees.

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The following is a breakdown of our sales by geographic region, including the percentage of our total consolidated sales for each period:

	2004		2003		2002	
	In thousands	% of our total sales	In thousands	% of our total sales	In thousands	% of our total sales
U.S.A.	$ 247,765	87%	$ 283,197	90%	$ 183,857	87%
Canada	18,353	6%	15,603	5%	12,819	6%
Israel	14,587	5%	13,468	4%	11,809	5%
Other	3,425	2%	3,190	1%	3,096	2%
Total	$ 284,130	100%	$ 315,458	100%	$ 211,581	100%

In 2004, sales in the United States accounted for approximately 87% of our total consolidated sales. In addition to marketing prescription drugs, Taro U.S.A. markets its generic OTC products primarily as store brands under its customers labels to wholesalers, drug chains, food chains and mass merchandisers. During 2004, we sold to approximately 250 customers in the United States. The following table represents sales to our three largest wholesale customers as a percent of consolidated sales during the last three years:

Customer	2004	2003	2002
AmerisourceBergen Corporation	16%	20%	22%
McKesson Corporation	15%	17%	12%
Cardinal Health, Inc.	8%	9%	9%

The following table sets forth the contributions to sales by each type of customer of Taro U.S.A. in 2004:

Customer Type	Percentage of Consolidated Sales
Drug wholesalers	43%
Drug store chains	17%
Mass merchandisers food and retail chains	15%
Generic drug distributors	7%
Managed care organizations	5%

In 2004, sales in Israel accounted for approximately 5% of our total consolidated sales. The marketing, sales and distribution of prescription pharmaceuticals and OTC products in Israel is closely monitored by the Israeli government. The market for these products is dominated by institutions that are similar to health maintenance organizations in the United States, as well as private pharmacies. Most of our marketing efforts in Israel focus on selling directly to these groups. In 2004, sales to other international markets accounted for approximately 1% of our consolidated sales.

All pharmaceutical products sold in Israel are subject to price controls. Permitted price increases are enacted by the Israeli government as part of a formal review process. In addition, recently enacted parallel import regulations are expected to further increase pressure within the industry to lower prices on prescription products. There are no restrictions on the import of pharmaceuticals, provided that they comply with registration requirements of the Israeli Ministry of Health.

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In Israel, the pharmaceutical market generally is divided into two market segments: (i) the private market, which includes drug store chains, private pharmacies and wholesalers; and (ii) the institutional market, which includes Kupat Holim Clalit or Kupat Holim (the largest health maintenance organization in Israel), the Israel Ministry of Health and other health insurance groups.

The following table sets forth the contributions to sales by each type of customer of Taro Israel and other international markets in 2004:

Customer Type	Percentage of Consolidated Sales
Institutional market	4%
Private market	2%
Other international markets	1%

In 2004, sales in Canada accounted for approximately 6% of our total consolidated sales. Taro Canada has approximately 600 customers, which consist primarily of independent pharmacies.

The following table sets forth the contributions to sales by each type of customer of Taro Canada in 2004:

Customer Type	Percentage of Consolidated Sales
Drug wholesalers	4%
Drug chains, independent pharmacies and others	2%

We have expanded the production capacity of our Israeli and Canadian operations to meet anticipated demand for our products. In addition, we utilize contract manufacturing for certain products to satisfy customer demand in a timely manner. As a result, in each of 2002, 2003 and 2004, backorders generally represented less than one percent (1%) of our consolidated sales.

Competition and Pricing

The pharmaceutical industry is intensely competitive. We compete with the original manufacturers of the brand-name equivalents of our generic products, other generic drug manufacturers (including brand-name companies that also manufacture generic drugs or license their products to other generic drug manufacturers), and manufacturers of new drugs that may compete with our generic drugs. Many of our competitors have greater financial, production and research and development resources, substantially larger sales and marketing organizations, and substantially greater name recognition than we have.

Historically, brand-name drug companies have attempted to prevent generic drug manufacturers from producing certain products and to prevent competing generic drug products from being accepted as equivalent to their brand-name products. We expect such efforts to continue in the future. Also, some brand-name competitors, in an attempt to participate in the generic drug sales of their branded products, have introduced generic equivalents of their own branded products, both prior and subsequent to the expiration of their patents or FDA exclusivity periods for such drugs. These competitors have also introduced generic equivalents of brand-name drug products other than their own.

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In the United States, we compete with such brand-name manufacturers as Novartis, Schering-Plough, Medicis Pharmaceutical, GlaxoSmithKline and Bristol-Myers Squibb, as well as with generic companies such as Alpharma, Altana, Barr Laboratories, Perrigo, Mylan Laboratories, QLT, Sandoz Pharmaceuticals, Teva Pharmaceuticals U.S.A. and Warrick Pharmaceuticals. These companies have more resources, market and name recognition and better access to customers than we have. Therefore, there can be no assurance of the success of any of our products.

We compete in the Canadian market with Hoffmann-La Roche, Schering Canada, Novartis, GlaxoSmithKline, Bayer and Bristol-Myers Squibb Canada, as well as with other manufacturers of generic products, such as Apotex, Novopharm (Teva), Ratiopharm, Genpharm and Pharmascience.

Pricing in Canada is established in part by competitive factors and in part by Canadian formulary price lists published by the Canadian provinces.

In Israel, we compete with Teva Pharmaceuticals Industries, Ltd., Agis Industries (1983) Ltd., Dexxon Ltd. and Rafa Laboratories Ltd., among others. In addition, many leading multinational companies, including Bayer, Eli Lilly, Merck and Pfizer, market their products in Israel.

In Israel, the government establishes the prices for pharmaceutical products as part of a formal review process. In addition, recently enacted parallel import regulations are expected to further increase pressure within the industry to lower prices. There are no restrictions on the import of pharmaceuticals provided that they comply with registration requirements of the Israeli Ministry of Health.

Manufacturing and Raw Materials

We currently manufacture finished pharmaceutical products at our government approved facilities in Canada and Israel and active pharmaceutical ingredients at our facilities in Israel. We have expanded our research and development and warehousing facilities.

For the manufacture of our finished dosage form pharmaceutical products, we use pharmaceutical chemicals that we either produce ourselves or purchase from chemical manufacturers in the open market globally. Substantially all of such chemicals are obtainable from a number of sources, subject to regulatory approval. However, we purchase certain raw materials from single source suppliers. The decision to purchase APIs is a function of our sales forecast and prevailing prices in the market. When appropriate purchasing opportunities arise, the Company may acquire certain APIs in excess of its ordinary requirements or rate of growth. Obtaining the regulatory approvals required to add alternative suppliers of such raw materials for products sold in the United States or Canada may be a lengthy process. We strive to maintain adequate inventories of single source raw materials in order to ensure that any delays in receiving such regulatory approvals will not have a material adverse effect on our business. However, we may become unable to sell certain products in the United States or Canada pending approval of one or more alternate sources of raw materials.

We synthesize the active pharmaceutical ingredients used in some of our key products, including our warfarin sodium tablets, our carbamazepine products, our etodolac tablets, and our clorazepate dipotassium tablets. We plan to continue the strategic selection of active pharmaceutical ingredients for synthesis in order to maximize the advantages from this scientific and manufacturing capability.

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Industry Practices Relating to Working Capital Items

Certain customary industry selling practices affect our supply of working capital, including, but not limited to, providing favorable payment terms to customers and discounting selling prices through the issuance of free products as well as other incentives within a specified time frame if a customer purchases more than a specified threshold of a product. These incentives are provided principally with the intention of maintaining or expanding our distribution to the detriment of competing products.

Industry practice requires that pharmaceutical products be made available to customers from existing stock rather than on a made-to-order basis. Therefore, in order to accommodate market demand adequately, we strive to maintain a sufficient level of inventory. In 2004, we initiated an inventory reduction program as a result of a change in market conditions for our products. This program necessitated a decrease in production output and a reduction in manufacturing personnel.

Government Regulation

We are subject to extensive pharmaceutical industry regulation in the United States, Canada, Israel and other jurisdictions, and may be subject to future legislative and other regulatory developments concerning our products and the healthcare field generally. Any failure by us to comply with applicable policies and regulations of any of the numerous authorities that regulate our industry could have a material adverse effect on our results of operations.

In the United States, Canada, Israel and other jurisdictions, the manufacture and sale of pharmaceutical products are regulated in a similar manner. Legal requirements generally prohibit the handling, manufacture, marketing and importation of any pharmaceutical product unless it is properly registered in accordance with applicable law. In addition, approval is required before any new drug or a generic equivalent to a previously approved drug can be marketed. Furthermore, each country requires approval of manufacturing facilities, including adherence to good manufacturing practices during the production and storage of pharmaceutical products. As a result, we have had periodic inspections of our facilities and records. For example, Taro Canada was inspected by the FDA in 1995, 1996, 1998, 2001 and 2005. Our facilities in Haifa Bay, Israel were inspected by the FDA in 1996, 1997, 1999 and 2002, and by the Irish Medicines Board in 2005.

Regulatory authorities in each country also have extensive enforcement powers over the activities of pharmaceutical manufacturers, including the power to seize, force the recall of and prohibit the sale or import of non-complying products and to halt the operations of and criminally prosecute and fine non-complying manufacturers. These regulatory authorities also have the power to revoke approvals previously granted and remove from the market previously approved drug products.

In the United States, Canada, Israel and other jurisdictions, we, as well as other manufacturers of drugs, are dependent on obtaining timely approvals for products. The approval process in each country has become more rigorous and costly in recent years. There can be no assurance that approvals will be granted in a timely manner or at all. In the United States, Canada, Israel and other jurisdictions, the procedure for drug product approvals, if such approval is ultimately

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granted, generally takes longer than one year. Inability or delay in obtaining approvals for our products could adversely affect our product introduction plans and our results of operations.

In the United States, any drug that is not generally recognized as safe and effective by qualified experts for its intended use is deemed to be a new drug which requires FDA approval. Approval is obtained, either by the submission of an ANDA or an NDA. If the new drug is a new dosage form, a strength not previously approved, a new indication or an indication for which the ANDA procedure is not available, an NDA is required.

We generally receive approval for generic products by submitting an ANDA to the FDA. When processing an ANDA, the FDA waives the requirement of conducting complete clinical studies, although it may require bioavailability and/or bioequivalence studies. Bioavailability is generally determined by the rate and extent of absorption and levels of concentration of a drug product in the blood stream needed to produce a therapeutic effect. Bioequivalence compares the bioavailability of one drug product with another and, when established, indicates that the rate of absorption and levels of concentration of a generic drug in the body or on the skin are substantially equivalent to the previously approved brand-name reference drug. An ANDA may be submitted for a drug on the basis that it is bioequivalent to a previously listed drug, contains the same active ingredient, has the same route of administration, dosage form, and strength as the listed drug, and otherwise complies with legal and regulatory requirements. There can be no assurance that approval for ANDAs can be obtained in a timely manner, or at all. ANDA approvals are granted after the review by the FDA of detailed information submitted as part of the ANDA regarding the pharmaceutical ingredients, drug production methods, quality control, labeling, and demonstration that the product is therapeutically equivalent or bioequivalent to the brand-name reference drug. Demonstrating bioequivalence generally requires data demonstrating that the generic formula results in a product whose rate and extent of absorption are within an acceptable range of the results achieved by the brand-name reference drug. In some instances, bioequivalence can be established by demonstrating that the therapeutic effect of the generic formula falls within an acceptable range of the therapeutic effects achieved by the brand-name reference drug. Approval of an ANDA, if granted, generally takes more than one year from the submission of the application.

Products resulting from our proprietary drug program may require us to submit an NDA to the FDA. When processing an NDA, the FDA generally requires, in addition to the ANDA requirements (except for bioequivalence), complete pharmacological and toxicological studies in animals and humans to establish the safety and efficacy of the drug. However, the clinical studies required prior to the NDA submission are both costly and time consuming, and often take five to seven years or longer, depending, among other factors, on the nature of the chemical ingredients involved and the indication for which the approval is sought. Approval of an NDA, if granted, generally takes at least one year from the submission of the application to the FDA.

Among the requirements for drug approval by the FDA is that manufacturing procedures and operations conform to cGMP as defined in the U.S. Code of Federal Regulations. The cGMP regulations must be followed at all times during the manufacture of pharmaceutical products. In complying with the standards set forth in the cGMP regulations, a manufacturer must expend time, money and effort in the areas of production and quality control to ensure full compliance.

If the FDA believes a company is not in compliance with cGMP, certain sanctions may be imposed, including: (i) withholding new drug approvals as well as approvals for supplemental

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changes to existing applications; (ii) preventing the receipt of necessary licenses to export products; (iii) preventing the importation of certain products into the United States; (iv) classifying the company as an unacceptable supplier and thereby disqualifying the company from selling products to federal agencies and (v) pursuing a consent decree or court action that limits company operations or imposes monetary fines. We believe that we are currently in substantial compliance with cGMP.

In addition, because we market a controlled substance in the United States and other controlled substances in Israel, we must meet the requirements of the United States Controlled Substances Act and its equivalents in Canada and Israel, as well as the regulations promulgated thereunder in each country. These regulations include stringent requirements for manufacturing controls, receipt and handling procedures and security to prevent diversion of, or the unauthorized access to, the controlled substances in each stage of the production and distribution process.

In May 1992, the Generic Drug Enforcement Act of 1992, or the Generic Act, was enacted. The Generic Act, a result of legislative hearings and investigations into the generic drug approval process, allows the FDA to impose debarment and other penalties on individuals and companies that commit certain illegal acts relating to the generic drug approval process. In some situations, the Generic Act requires the FDA not to accept or review for a period of time, ANDAs from a company or an individual that has committed certain violations. It also provides for temporary denial of approval of applications during the investigation of certain violations that could lead to debarment and also, in more limited circumstances, provides for the suspension of the marketing of approved drugs by the affected company.

Lastly, the Generic Act allows for civil penalties and withdrawal of previously approved applications. To our knowledge, neither we nor any of our employees has ever been subject to debarment.

The review process in Canada and Israel is substantively similar to the review process in the United States.

Environmental Compliance

We believe that we are currently in compliance with all applicable environmental laws and regulations in Canada, the United States and Ireland. In Israel, in light of the continued expansion of our Haifa Bay facility and an enhanced general enforcement program instituted by the Israeli Ministry of the Environment, we have taken steps to improve our waste water treatment facility and plan to further upgrade our facility in accordance with a plan submitted to the Ministry. The cost of this program is not anticipated to have a material adverse effect on our business or operations. However, environmental laws and regulations may become more stringent and therefore require us to commit substantial additional resources which are beyond our current plan.

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C. ORGANIZATIONAL STRUCTURE

The legal and commercial name of our company is Taro Pharmaceutical Industries Ltd. We were incorporated under the laws of the State of Israel in 1959 under the name Taro-Vit Chemical Industries Ltd. In 1984, we changed our name to Taro Vit Industries Ltd., and in 1994, we changed our name to Taro Pharmaceutical Industries Ltd.

The following is a list of our significant subsidiaries and their countries of incorporation as of December 31, 2004:

Name of Subsidiary	Country of Incorporation
Taro Research Institute Ltd.	Israel
Taro Pharmaceuticals U.S.A., Inc.	United States
Taro Pharmaceuticals Inc.	Canada
Taro Pharmaceuticals North America, Inc.	Cayman Islands
Taro Pharmaceuticals Europe B.V.	The Netherlands
Taro Pharmaceuticals Ireland Ltd.	Ireland

See Note 2c to our consolidated financial statements included elsewhere in this annual report for information regarding the ownership of Taro U.S.A. Taro owns, directly or indirectly, 100% of the ownership and voting interests in the other subsidiaries listed above.

D. PROPERTY, PLANT AND EQUIPMENT

The following is a list of our principal facilities as of December 31, 2004:

Location	Square Footage	Main Use	Own/Lease
Haifa Bay, Israel	325,000	Pharmaceutical manufacturing, production laboratories, offices, warehousing, chemical production (including tank farm and chemical finishing plant), and research facility	Own
Haifa Bay, Israel	10,000	Warehouse, maintenance	Lease
Yakum, Israel	15,000	Administrative offices	Lease
Brampton, Canada	250,800	Pharmaceutical manufacturing, production laboratories, laboratories, administration, distribution and warehousing	Own
Brampton, Canada	75,400	Administration and warehousing	Lease
Hawthorne, New York	124,000	Research laboratory and administrative offices	Own
Hawthorne, New York	102,000	Administrative offices and warehousing	Lease
South Brunswick, New Jersey	315,000	Distribution facility	Own
Roscrea, Ireland	124,000	Pharmaceutical manufacturing, research laboratories and warehousing	Own

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Our plant, research and office facilities in Haifa Bay, Israel are located in a complex of buildings with an aggregate area of approximately 325,000 square feet. We lease much of the land underlying these facilities from the Israel Land Authority pursuant to long-term ground leases that expire between 2009 and 2049. We have the option to renew each lease for an additional 49 years. We also lease approximately 10,000 square feet of adjacent space in Haifa Bay. The lease for this property commenced in January 2001, with an option to purchase this property at the termination of the lease. For additional information, please refer to Note 5 to our consolidated financial statements included elsewhere in this annual report.

Since December 2000, we have purchased approximately 600,000 square feet of land adjacent to the Haifa Bay plant for expansion of our manufacturing and warehouse facilities. We lease approximately 15,000 square feet of space in a facility located in Yakum, Israel, which is used for administrative and marketing offices.

In February 2002, Taro Canada purchased 74,000 square feet of space that it had leased since March 1997 adjacent to the 68,000 square foot main manufacturing facility which it owns in Brampton, Canada. In September 2000, Taro Canada leased an additional 75,400 square feet of office and warehouse space, adjacent to the other two facilities, for a period of five years, with renewal options, which can extend the lease period for an additional twenty years. In December 2003, Taro Canada purchased a 108,797 square foot building in close proximity to its existing facilities for $3.6 million. This building is used for warehousing and distribution.

In August 2002, Taro U.S.A. purchased a 32% interest in a 124,000 square foot building in Hawthorne, NY, in which it located its U.S. research operations for approximately $4.4 million.

In February 2005, Taro U.S.A. exercised its option to purchase the remaining 68% interest in this building and, in May 2005, Taro U.S.A. consolidated its administrative offices and research laboratory to this location.

In January 2004, Taro U.S.A. purchased a 315,000 square foot distribution facility in South Brunswick, New Jersey for approximately $18 million.

In addition, Taro U.S.A. leases approximately 102,000 square feet of office and warehouse space in Hawthorne, New York pursuant to two leases that expire in July 2007. In May 2004, we consolidated the warehouse and distribution operations of Taro U.S.A. into our South Brunswick, New Jersey facility.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. OPERATING RESULTS

The following discussion should be read in conjunction with our consolidated financial statements and related notes for the three years ended December 31, 2004, which are included elsewhere in this annual report.

OVERVIEW

We are a multinational, science-based pharmaceutical company. We develop, manufacture and market prescription and OTC pharmaceutical products, as well as active pharmaceutical ingredients, primarily in Israel, Canada and the United States. Our primary areas of focus include

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topical creams and ointments, liquids, capsules and tablets. We operate principally through three entities: Taro Israel and two of its subsidiaries, Taro Canada and Taro U.S.A.

The following is a breakdown of our sales by geographic region, including the percentage of our total consolidated sales for each period:

	2004		2003		2002	
	In thousands	% of our total sales	In thousands	% of our total sales	In thousands	% of our total sales
U.S.A.	$ 247,765	87%	$ 283,197	90%	$ 183,857	87%
Canada	18,353	6%	15,603	5%	12,819	6%
Israel	14,587	5%	13,468	4%	11,809	5%
Other	3,425	2%	3,190	1%	3,096	2%
Total	$ 284,130	100%	$ 315,458	100%	$ 211,581	100%

Operating income varies among the different geographic areas in which we conduct our business. The variation in operating income reflects the different activities in and contributions to our business by each geographic area. Operating income is allotted to each geographic area in accordance with the ownership of intellectual property, the performance of manufacturing activities and the distribution and sale of product to third parties. The ownership of intellectual property, manufacturing facilities and know-how is primarily located in Canada and Israel, while distribution occurs mainly in the United States. Each of these geographic areas is compensated according to the economic value of its activity. Therefore, Taro Israel and Taro Canada, which bear more risk in terms of actually deploying substantial assets to develop and manufacture products, earn a greater share of the profit derived from such products. Taro U.S.A. distributes to third parties the products developed, manufactured or owned by the other geographic areas of the group. Inter-area sales are based on arms-length transactions and prices usually charged among third parties with similar economic circumstances and profile. Inter-area transactions and balances have been eliminated in consolidation. Profits from inter-area sales not yet realized outside the Company have been eliminated in consolidation.

We generate most of our revenues from the sales of prescription and OTC pharmaceutical products. Portions of our OTC products are sold as private label products primarily to chain drug stores, food stores, drug wholesalers, drug distributors and mass merchandisers in the United States. During the past three years, three major drug wholesalers in the United States accounted for the following proportion of our total consolidated sales (in millions of dollars):

	2004		2003		2002	
Customer	Amount	Percent	Amount	Percent	Amount	Percent
AmerisourceBergen Corporation	$ 44.5	16%	$ 62.7	20%	$ 46.5	22%
McKesson Corporation	$ 43.2	15%	$ 53.0	17%	$ 25.4	12%
Cardinal Health, Inc.	$ 23.8	8%	$ 28.4	9%	$ 19.0	9%
Total	$ 111.5	39%	$ 144.1	46%	$ 90.9	43%

We also sell active pharmaceutical ingredients to unaffiliated customers around the world. Sales of active pharmaceutical ingredients to third parties have historically represented less than 1% of consolidated revenues. Our primary reason for manufacturing active pharmaceutical ingredients is to support our pharmaceutical manufacturing

operations.

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Due to increased competition from other generic pharmaceutical manufacturers as they gain regulatory approvals to manufacture generic products, selling prices and related profit margins tend to decrease as products mature. Thus, our future operating results are dependent on, among other factors, our ability to introduce new products. In addition, our operating results are dependent on the impact of pricing pressures on existing products. These pricing pressures are inherent in the generic pharmaceutical industry.

In 2004, seven product lines accounted for 48% of our consolidated sales. One oral product, warfarin sodium, contributed approximately 10% and 9% to our consolidated sales in 2004 and 2003, respectively. In 2003 and 2002, seven product lines accounted for 54% and 53% of consolidated sales, respectively.

As evidenced by this year s sales, our sales of these and other product lines are subject to market conditions and other factors. We are therefore unable to predict the extent, if any, to which the relative contribution to our total revenues of these seven product lines as well as other product lines may increase or decrease in the future.

Cost of goods sold consists of direct costs and allocated costs. Direct costs consist of raw materials, packaging materials and direct labor identified with a specific product. Allocated costs are costs not associated with a specific product. Since the allocation of various elements of overhead to individual products or product lines is to some extent arbitrary, it is not practical to determine the specific amount or percentage of our profits that may be attributed to any individual product or product line.

Certain customary industry selling practices affect our supply of working capital, for example, industry practice requires that pharmaceutical products be made available to customers on demand from existing stock levels rather than on a made-to-order basis. Therefore, in order to accommodate market demand, we try to maintain adequate levels of inventories. Increased demand for existing products and preparation for new product launches, the exact timing of which cannot be determined accurately, have generally resulted in higher levels of inventory. However, anticipated growth in sales of any individual product or of all products may not materialize. Consequently, inventories prepared for these sales may become obsolete and have to be written off.

Another industry practice that impacts upon our working capital is the provision of favorable payment terms to customers and the discounting of selling prices through the issuance of free products as well as other incentives within a specified time frame if a customer purchases more than a specified threshold of product. Such incentives are provided primarily with the intention of maintaining and expanding our distribution to the detriment of competing products.

Another such industry practice causes us to provide some of our customers with limited rights to return products, receive rebates, assert chargebacks and take other deductions with respect to sales that we make to them. See Critical Accounting Policies Allowance for sales deductions and product returns . The exercise of these rights by customers to which we have granted them has an impact, which may be substantial, upon our accounts receivable from those customers. In addition, because we operate in a highly competitive environment, our days sales in accounts

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receivable may, from time to time, exceed company terms. This issue, if any, is one of timing, not collectibility. Thus, for example, in our press release dated February 17, 2004, we acknowledged that we had higher than expected trade accounts receivable due to a payment timing issue with a major customer. This customer mailed us a payment on December 30, 2003, in the amount of $12.5 million. The payment arrived on January 5, 2004.

Similarly, disputes concerning chargebacks and other sales deductions are common and occur in the ordinary course of business. For example, in 2003 we increased the price for certain of our products to the trade, including to certain wholesale customers. When these wholesale customers sold merchandise to third parties acquired under their old cost, they submitted to us chargebacks based on their new cost. In error, they withheld the difference between their new and old costs. The amount withheld initially totaled $20 million. During the second half of 2004, $9 million of such amount was paid to us. The revenue for the merchandise was recognized appropriately by us at the old (lower) price and we believe that our recognition of revenue was appropriate. Moreover, on the basis of active discussions to resolve the remainder of the disputed deductions, we believe that the remainder of the amounts withheld will be collected.

After adjustment for these two events, our days sales outstanding, or DSOs, at year end 2003 and at the end of the first quarter of 2004 would have been 125 and 126, as compared to 139 and 148, before such adjustment. For December 31, 2000, 2001, 2002, 2003 and 2004, our DSO s as adjusted for the events described above, were 137, 100, 119, 125 and 144 days, respectively, or an average of 125 days.

Sales during the first half of 2004 were substantially lower than sales during the second half of the year. The DSO is computed by dividing the adjusted accounts receivable at the end of the year, including the reserve established for the acquired Medicis products, by the average daily sales during the year. Using this formula, the lower sales in the first half of the year increases the DSOs when calculated on an annual basis. Accounts receivable at year end, however, are principally the result of sales made during the second half of the year. When average daily sales for the second half of the year are used in the same formula, the results are DSOs of 130 days, which is consistent with the Company s historical trends.

In light of the level of accounts receivable, we continuously monitor our aged receivables and our customers creditworthiness. In addition, we maintain accounts receivable insurance to protect us from possible payment defaults by our customers. We also engage in active and intensive collection efforts as necessary.

The decision to purchase APIs is a function of our sales forecast and prevailing prices in the market. When appropriate purchasing opportunities arise, the Company may acquire certain APIs in excess of its ordinary requirements or rate of growth.

CRITICAL ACCOUNTING POLICIES

Our significant accounting policies are described in Note 2 to our consolidated financial statements, which we have prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We evaluate, on an ongoing basis, our estimates, including those related to bad debts, income taxes and contingencies. We base our estimates on currently available information, our historical

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experience and various other assumptions that we believe to be reasonable under the circumstances. The results of these assumptions are the basis for determining the carrying values of assets and liabilities that are not readily apparent from other sources. Since the factors underlying these assumptions are subject to change over time, the estimates on which they are based are subject to change accordingly.

The following is a summary of certain policies that have a critical impact upon our financial statements and, we believe, are most important to keep in mind in assessing our financial condition and operating results;

Revenue Recognition. In accordance with Staff Accounting Bulletin 104 and SFAS 48, we recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is determinable, payment is reasonably assured and product returns can be reasonably estimated. We ship products to our customers only in response to, and to the extent of, the orders that they submit to us.

Allowance for sales deductions and product returns. When we recognize and record revenue from the sale of our pharmaceutical products, we simultaneously record an estimate of various future costs related to the sale. This has the effect of reducing the amount of reported product sales. These costs include our estimates of product returns, rebates, chargebacks and other sales deductions. Chargebacks result from price arrangements we have with end-user customers establishing contract prices which are typically lower than the wholesalers acquisition costs or invoice prices. When these customers buy our products from their wholesaler of choice, the wholesaler issues a credit memo (chargeback) to us for the difference between the invoice price and the end-user contract price. In addition, it is customary in the generic industry to grant customers shelf-stock adjustments based on customers existing levels of inventory and the decrease in the market price of the related product. When market prices for our products decline, we may therefore elect to provide shelf-stock adjustments and thereby allow our customers with existing inventories to compete at the lower product price. We use these shelf-stock adjustments to support our market position and to promote customer loyalty. Also, consistent with industry practice, we maintain a return policy in some markets that allows our customers to return products within a specified period before, and subsequent to, the products expiration dates. We base our estimates for sales deductions on a variety of factors, including actual experience of products returned, rebate agreements for each product and estimated sales by our wholesale customers to third parties who have contracts with us. Although these estimates are based upon extensive and substantial historical data that we use to arrive at these estimates, actual experience associated with any of these items may, in the future, differ materially from our estimates. We review the factors that influence our estimates periodically. If actual product returns, credits and other sales deductions differ from our established reserves, we adjust our estimates and reserves. If conditions in future periods deviate from their historical pattern, a revision of our estimates may be required. Such revision may affect our reported revenues and results of operations. The following table summarizes the activities for sales deductions:

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	Returns and Price Adjustments	Doubtful Accounts	Total Allowances
Balance at December 31, 2002	**$ 51,910**	**$ 112**	**$ 52,022**
Sales provisions made in the current period	271,226	52	271,278
Deductions allowed to customers	(278,084)		(278,084)
Decrease due to write-offs of uncollectible accounts		(23)	(23)
Balance at December 31, 2003	**45,052**	**141**	**45,193**
Sales provisions made in the current period*	364,239	83	364,322
Deductions allowed to customers	(342,661)		(342,661)
Decrease due to write-offs of uncollectible accounts		(34)	(34)
Balance at December 31, 2004	**$ 66,630**	**$ 190**	**$ 66,820**

* See Note 1.f to our financial statements included elsewhere in this report.

Our estimates reflect the inherent risks and uncertainties in our industry, which include future changes in: the number of sales contracts to new and existing customers, the price environment for our products, the number of new products introduced to the marketplace, and the number of competing products. Based on such factors, our estimates of the balance for sales provision decreased from $52.0 million at December 31, 2002 to $45.2 million at December 31, 2003 reflecting our assessment of market conditions during the period. As a result of the factors cited above, the reserve established for returns and other deductions for the acquired Medicis products and changes in market conditions for our products, we increased our sales provision resulting in a balance of $66.8 million at December 31, 2004.

***Product Rights*.** Our rights in licensed or acquired products are stated at cost, less accumulated amortization. Product rights are amortized using the straight-line method over their estimated useful lives ranging from five to twenty years. We determine amortization periods for product rights based on our assessment of various factors impacting estimated useful lives and cash flows of the acquired products. These factors include a product s position in its life cycle, the existence of like products in the marketplace, various other competitive and regulatory issues, and contractual terms. Significant changes to any of these factors may result in a reduction in a product right s useful life and an acceleration of related amortization expense, which could cause our operating income, net income and earnings per share to decline. For further discussion on Long-lived assets, see Note 2.k to our financial statements included elsewhere in this report.

***Deferred Taxes*.** As of December 31, 2004, deferred tax assets totaled approximately $37.8 million, including $32.8 million in the United States. Of this amount, approximately $28.2 million results from the remaining portion of U.S. loss carryovers that were created in 2001 due to the exercise of stock options and the future benefit from 2004 U.S. operating losses. The remaining deferred tax assets result from miscellaneous temporary differences, most of which represent items that have been accrued for financial statement purposes but not yet deducted for tax purposes.

We estimate that, based on the cost reduction measures implemented during the second half of the year, the tax asset will be realized in coming years. However, in the event that it appears that the amount of these deferred tax assets is greater than the amount that we will more than likely

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realize, we will reduce the amount at which we carry the deferred tax assets accordingly. Any such reduction would result in a charge to income, in the amount of the reduction, for the period in which the reduction was made. For additional analysis of tax issues, please refer to Note 14 of our consolidated financial statements included elsewhere in this annual report.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, selected items from our consolidated statement of income as a percentage of total sales:

	Year ended December 31,		
	2004	**2003**	**2002**
Statement of Income Data:			
Sales	100%	100%	100%
Cost of sales	42	32	38
Gross Profit	58	68	62
Operation expenses:			
Research and development, net	15	13	12
Selling, marketing, general and administrative	43	31	25
Total operating expenses	58	44	37
Operating income	(0.2)	24	25
Financial expenses, net	2.3	1	
Other income, net	0		
Income before taxes on income	(2)	23	25
Taxes on income	(6)	4	4
Minority interest in earnings of a subsidiary			
Net income	**4%**	**19%**	**21%**

YEAR ENDED DECEMBER 31, 2004 COMPARED WITH YEAR ENDED DECEMBER 31, 2003

***Sales*.** During 2004, our sales decreased by $31.3 million, or 10%, from the amount of sales we reported in 2003. This decrease in sales in 2004 was primarily attributable to reduced purchases by our three major wholesale customers, as we believe these customers reduced the level of inventory they customarily kept on hand in prior periods. These wholesalers purchased $111.5 million during 2004 and $144.1 million during 2003. Sales in the United States during 2004 decreased by $35.4 million, or 12.5% of sales reported in 2003. Sales in Canada increased by $2.8 million, or 18% above 2003 sales while sales in Israel and other international markets increased by $1.4 million, or 8%, from 2003. During 2004, products that we introduced in the United States included phenytoin oral suspension 125 mg/mL clindamycin phosphate topical solution 1%; hydrocortisone butyrate topical solution, 0.1%; terconazole vaginal cream, 0.8%; ammonium lactate lotion, 12%; clotrimazole and betamethasone dipropionate lotion; alclometasone dipropionate ointment, 0.05%; fluconazole tablets in 50, 100, 150, and 200 mg tablets, betamethasone dipropionate ointment augmented, 0.05%; mometasone furoate ointment, 0.1% and cream, 0.1%; and loratadine syrup 5 mg/5 ml. In the United States, we also introduced our ElixSure® brand ibuprofen oral suspension 100mg/5ml; and Kerasal® Lotion, and we entered into an agreement with Medicis pursuant to which Medicis licenses to us dermatologic

products, including Lustra® and Lustra-AF®, which are used for the treatment of dyschromia or discoloration of the skin.

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Cost of Sales. Cost of sales increased by 17% in 2004, as a result of several factors, including the appreciation of the Canadian dollar, increasing the cost of goods manufactured abroad, as well as a lower level of capacity utilization of our manufacturing facilities, which resulted in a higher level of overhead costs per unit.

Gross Profit. Gross profit was $213.0 million in 2003 and $164.7 million in 2004. This decrease reflects the impact of reduced sales and increased cost of goods for the reasons mentioned above.

Research and Development. Net R&D expenses increased by $1.2 million, or 3%, in 2004. R&D expenses equaled 15% and 13% of sales in 2004 and 2003, respectively. The increase in R&D expenses during 2004 was the result of our continued commitment to research and development. Approximately 80% of the R&D investment was focused on our generic pipeline and the remaining 20% was focused on our proprietary pipeline, which includes products that use our NonSpil™ drug delivery system, Kerasal® lotion, an extension to our Kerasal® line of footcare products, and our new class of non-sedating barbiturate compounds. (See Item 4 Information on the Company History and Development of the Company for information on the licensing of the rights of Kerasal® and ElixSure®).

Selling, General and Administrative. In 2004, SG&A increased $25.6 million, or 26%, from the amount we recorded in 2003. Our SG&A expenses as a percentage of sales increased from 31% in 2003 to 43% in 2004. Selling and marketing expenses increased by $16.4 million, or 31%, primarily due to increased advertising and promotion of our proprietary OTC product lines, Kerasal® and ElixSure®, as well as the full effect of building and supporting our TaroPharma detail force of approximately 60 representatives who call on physicians. Administrative expenses increased by $9.0 million, or 20%. (See Item 4 Information on the Company History and Development of the Company for information on the licensing of the rights of Kerasal® and ElixSure®).

Operating Results. Operating income decreased by $75.2 million in 2004. The decrease reflects the decrease in revenues and higher level of product cost, as well as the impact of our marketing and promotional activities to support our proprietary product line and the increased level of R&D investment. The variation in operating income among our geographic areas compensates for the use of their intellectual property and manufacturing facilities to produce our products. Israel and Canada, which bear more risk in terms of deploying more assets to develop and manufacture products, earn a greater share of the profit derived from such products. The USA subsidiary primarily distributes products developed, manufactured or owned by the other subsidiaries.

Financial Expenses. Financial expenses result from interest expense and income, and the impact of currency fluctuations. Net financial expenses increased $4.7 million, or 273%, in 2004. The increase is primarily the result of the full impact of our increased level of borrowing in 2003. This increase in interest expenses was partially offset by interest income that we earned on our cash balances, capitalization of interest expenses related to plant and equipment under construction and hedges against currency fluctuations.

Taxes. Due to the pre-tax loss in 2004, our tax benefit was $17.0 million, as compared with a tax expense of $11.5 million in 2003. Our effective tax rate was 16% on pre-tax income in 2003 (See our discussion on Deferred Taxes under Critical Accounting Policies).

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Net Income. Our net income decreased by $50.1 million from $61.2 million in 2003 to $11.1 million in 2004, by reason of the factors noted above.

YEAR ENDED DECEMBER 31, 2003 COMPARED WITH YEAR ENDED DECEMBER 31, 2002

Sales. During 2003, our sales increased $103.9 million, or 49%, from the amount of sales we reported in 2002. Of this increase, $27.7 million, or 27%, was attributable to the sale of products that we introduced in 2003. The balance of this increase was attributable to increased sales of products which were sold in both 2002 and 2003, including clotrimazole and betamethasone dipropionate cream, our generic version of Lotrisone®, which we began to sell in May 2001. Sales in the United States during 2003 increased $99.3 million, or 54%, from the amount we reported in 2002. Sales in Canada increased by $2.8 million, or 22%, and sales in Israel and other international markets increased $1.8 million, or 12%, from 2002. The products introduced during the year in the United States included betamethasone dipropionate (augmented) cream, ammonium lactate cream and etodolac XR tablets in three strengths, 400, 500 and 600 mg. In the United States, we also introduced our ElixSure® line of products and the four branded products we acquired earlier this year from Medicis.

Our sales in 2003 grew by a greater percentage than our cost of sales primarily because of the following factors:

Our sales of newly introduced products, which we sell at higher margins than our existing products, were responsible for most of the increase in our gross profit percentage, which grew from 62.4% to 67.5%.

During 2003, we experienced a more favorable competitive environment for generic products than in 2002. Such an environment includes, for example, an environment in which our products are the initial generic entrants into the market (and, occasionally, remain the sole generic versions of the product); an environment in which we are able to compete particularly well (for example, because of operational efficiencies or less expensive access to raw materials); and/or an environment in which there is, for any number of reasons (including, for example, a market perception more favorable to our products than to those of our competitors) a particularly great demand for our products.

Over the past several years, we have invested in a number of capital projects designed to increase our production efficiency. As demand for our products increased in 2003, we benefited from economies of scale which decreased our per unit cost of production.

Cost of Sales. Cost of sales increased by 29% in 2003, as a result of the 49% increase in sales described above.

Gross Profit. Gross profit margin increased from 62% in 2002 to 68% in 2003. The increase reflects a higher level of branded product sales and a more favorable competitive environment for generic products.

Research and Development. Net R&D expenses increased $14.2 million, or 54% in 2003. R&D expenses equaled 13% and 12% of sales in 2003 and 2002, respectively. The increase in R&D

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expenses during 2003 was the result of expanding our research facilities, recruiting additional scientists, and pursuing more projects.

Selling, General and Administrative. In 2003, SG&A increased $45.2 million, or 86%, from the amount we recorded in 2002. Our SG&A expenses as a percentage of sales increased from 25% in 2002 to 31% in 2003. Selling and marketing expenses increased $32.4 million, or 162%, primarily due to the recruitment of representatives who call on physicians and promotional campaigns, including media advertising, aimed at supporting our branded initiatives in the United States. General and administrative expenses increased $12.8 million, or 39%, primarily due to investments in personnel, facilities and infrastructure necessary to accommodate continued growth and expansion in the United States and other markets.

Operating Results. Operating income increased $21.4 million, or 40%, in 2003. The increase was primarily the result of increased sales and improved gross profit margins. The variation in operating income among our geographic areas compensates for the use of their intellectual property and manufacturing facilities to produce our products. Israel and Canada, which bear more risk in terms of deploying more assets to develop and manufacture products, earn a greater share of the profit derived from such products. The USA subsidiary primarily distributes products developed, manufactured or owned by the other subsidiaries.

Financial Expenses. Net financial expenses increased $1.5 million, or 962%, in 2003. The increase is primarily the result of a higher level of interest expenses as we increased our level of borrowing during the second half of 2003. The increase in interest expenses was partially offset by interest income that we earned on our cash balances and from hedges against currency fluctuations.

Taxes on Income. Due to a higher level of pre-tax income, our tax expense increased $3.1 million, or 36%, in 2003. Our effective tax rate was 16% in both 2002 and 2003.

Net Income. Our net income increased $16.6 million from $44.6 million in 2002 to $61.2 million in 2003, an increase of 37%, based on the factors cited above.

The years 2002-2003 represented a period of rapid growth for the Company. It is typical during such a period for a company to experience an increase in accounts receivable and inventories. In light of the growing demand for our products that we experienced during this period, we decided to increase our inventories in order to assure uninterrupted supply of our products to our customers. This was the main reason for our lower level of cash generated from operating activities during 2003.

IMPACT OF INFLATION, DEVALUATION (APPRECIATION) AND EXCHANGE RATES ON RESULTS OF OPERATIONS, LIABILITIES AND ASSETS

We conduct manufacturing, marketing and research and development operations primarily in Israel, Canada and the United States. As a result, we are subject to risks associated with fluctuations in the rates of inflation and foreign exchange in each of these countries.

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

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Year	Rate of Inflation		Rate of Devaluation (Appreciation) Against U.S. Dollar		Rate of Exchange of U.S. Dollar	
	Israel(1)	Canada(2)	Israel(1)	Canada(3)	Israel(1)	Canada(3)
2000	0.0%	3.2%	(2.7%)	3.9%	4.04	1.50
2001	1.4%	0.7%	9.3%	6.2%	4.42	1.59
2002	6.5%	3.9%	7.2%	(1.2%)	4.74	1.58
2003	(1.9%)	2.0%	(7.6%)	(17.8%)	4.38	1.29
2004	1.2%	2.1%	(1.6%)	(6.9%)	4.31	1.20

Sources: (1) Bank of Israel. (2) Statistics Canada. (3) Bank of Canada.

B. LIQUIDITY AND CAPITAL RESOURCES

LIQUIDITY

Cash and cash equivalents decreased by $60.5 million to $98.6 million at December 31, 2004. This decrease funded our working capital requirements, capital investments, and product acquisition programs. Trade accounts receivable increased by 3.4% to $124.7 million at December 31, 2004. Inventory levels increased by 2% to $86.6 million, reflecting our policy of maintaining sufficient finished goods required to meet customer demand. Shareholders equity increased from $347.4 million at December 31, 2003 to $368.1 at December 31, 2004, principally due to retained earnings and foreign currency fluctuations.

Cash used in operating activities for the year ended December 31, 2004 was $21.8 million as compared to cash provided by operating activities of $5.2 million in the prior year. The decrease in cash from operations is the result of increases in trade receivables and inventory, which were partially offset by higher amortization and depreciation, our net income and other working capital items.

Our long-term debt outstanding as of December 31, 2004 was approximately $204.3 million, including current maturities of $16.9 million, and was comprised of the following:

bonds payable of $129.1 million;

obligations of $37.6 million under bank agreements; and

mortgage payable and other obligations of $38.9 million.

Our loans from institutional investors and bond obligations consist of the following, in thousands:

Amount	Linkage	Rate	Maturity
$13,753	Israel CPI(a)	8.25%	2005-2010
$49,275	Israel CPI(a)	5.80%	2005-2014
$ 2,950	Dollar	Libor + 2.25%	2005-2014
$ 1,773	Dollar	Libor + 2-3%	2005-2010
$44,500	Dollar	6%	2005-2010
$15,500	Dollar	Libor + 2.25%	2005-2010

(a) We have a contract to hedge our exposure to CPI fluctuations in Israel.

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Covenants in some of our loan agreements stipulate that our debt to equity ratio may not exceed 2:1 and that our current ratio may not be lower than 1:1. In addition, the loan agreements that the Company entered into during 2003 require that, prior to incurring additional debt in Israel, the Company s interest coverage ratio be greater than 2:1 to be measured on April 1 of each year of the loan, commencing on April 1, 2005. The interest coverage ratio is defined as earnings before interest, taxes, depreciation, and amortization, or EBITDA, divided by net interest expenses plus the current principal repayment.

In the first quarter of 2005, the loan agreements entered into by the Company in May 2003 and November 2003 were amended to defer measurement of the interest coverage ratio until April 1, 2006. In addition, the Company undertook, with two of the institutional investors who had made loans to the Company of approximately $6.5 million, to perform a review of the Company s compliance with the interest coverage ratio on August 15, 2005, with respect to the 12-month period ending June 30, 2005. These covenants, as amended, may restrict the Company s ability to incur additional debt in Israel.

We anticipate that our cash balances and operating cash flow, together with available borrowings under our credit facilities and cash balances, will be sufficient to meet all of our working capital, capital expenditure and interest requirements for both the short-term and the foreseeable future. For information with respect to commitments for future capital expenditures, please see Note 5(d) to our consolidated financial statements included elsewhere in this annual report.

CAPITAL EXPENDITURES

We invested $72.3 million in capital equipment and facilities in the year ended December 31, 2004 and $94.4 million during the year ended December 31, 2003. These investments are principally related to our pharmaceutical and chemical manufacturing facilities, expanding and upgrading our research and development laboratories in Israel, Canada, Ireland, and the United States, and maintaining compliance with cGMPs. In addition to facility-related investments, we acquired certain manufacturing and packaging equipment to increase production capacity. We also continued to upgrade our information systems infrastructure, to enable more efficient production scheduling and enhanced inventory analysis. See Note 5 to our consolidated financial statements included elsewhere in this annual report.

Tax Matters

Tax Loss Carryforward and Effective Tax Rates

As of December 31, 2004, on an unconsolidated basis, we had available tax loss carryforwards of $1.3 million in Israel, $6.8 million in the United Kingdom, $6.8 million in Ireland and $74.8 million in the United States. The loss carryforward in the United States principally resulted from the exercise by employees of stock options during 2001 and the operating results in 2004. In 2004, we recorded a tax benefit. Our consolidated effective tax rate was 16% in both 2003 and 2002.

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Approved Enterprise Status in Israel

Israeli companies are generally subject to tax at the rate of 35% (declining to 34% in 2005, 32% in 2006, and 30% in 2007) of taxable income. However, our facilities in Israel have received Approved Enterprise status from the Israel Investment Center, which entitles us to receive specified tax benefits. We have received three approvals granting us a package of benefits, subject to compliance with applicable requirements. Under the first approval, our undistributed income derived from one Approved Enterprise will be exempt from corporate tax for a period of four years from 2001, and we will be eligible for a reduced tax rate of between 10% and 25% for two additional years. Under the second approval, our undistributed income derived from another Approved Enterprise was exempt from corporate tax for a period of two years from 2001 and we will be eligible for a reduced tax rate of 10% to 25% for eight additional years. Under the third approval (benefit period starting 2003), our undistributed income will be exempt from corporate tax for a period of two years following implementation of the plan. We will be eligible for a reduced tax rate of between 10% and 25% for thirteen additional years thereafter. Under the fourth approval (benefit period most likely to be implemented during 2005), our undistributed income, derived from this approval, will be exempt from corporate tax for a period of two years following implementation and we will be eligible for a reduced tax rate of 10% to 25% for eight additional years thereafter. All of these programs are subject to time limits imposed by the Law for Encouragement of Capital Investments, 1959 and based upon the level of foreign ownership in our company in each tax year. To retain the most favorable rates we must maintain a foreign shareholders level of at least 90%. Currently, we exceed this level. As a result of these programs, a substantial portion of the profits derived from products manufactured in Israel may benefit from a reduced Israeli tax rate.

C. RESEARCH AND DEVELOPMENT, PATENTS, TRADEMARKS AND LICENSES

Most of our sales are derived from products that are the result of our own research and development. We believe that our research and development activities have been a principal contributor to our achievements to date and that our future performance will depend, to a significant extent, upon the results of these activities.

In 1991, we formed the Taro Research Institute for the purpose of consolidating our pharmaceutical and chemical research activities. The Institute coordinates all of our research and development activities on a global basis.

Recruiting talented scientists is essential to the success of our research and development programs. Approximately 20% of our employees work in our worldwide research and development programs. More than 90 of our scientists hold either M.D. or Ph.D. degrees.

We currently conduct research and development in three principal areas:

generic pharmaceuticals, where our programs have resulted in our developing and introducing a wide range of pharmaceutical products (including tablets, capsules, injectables, suspensions, solutions, creams and ointments) that are equivalent to numerous brand-name products whose patents and FDA exclusivity periods have expired;

proprietary pharmaceuticals and delivery systems, in which we are developing T-2000 and products utilizing the NonSpil delivery system; and

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organic and steroid chemistry, where our programs have enabled us to synthesize the active ingredients used in many of our products.

Generic Pharmaceuticals

In 2004, we received several product approvals in Canada, Israel and the United States. The following table sets forth the approvals received in the United States from the FDA from January 1, 2004 through June 20, 2005:

	Brand Name*
FINAL NDA APPROVAL	
Ibuprofen Oral Suspension	ElixSure®
FINAL ANDA APPROVALS	
Alclometasone dipropionate ointment, 0.05%	Aclovate®
Ammonium lactate lotion, 12%	Lac-Hydrin®
Betamethasone dipropionate ointment (augmented) 0.05%	Diprolene®
Ciclopirox olamine cream, 0.77%	Loprox®
Ciprofloxacin tablets 100, 250, 500, 750 mg	Cipro®
Clindamycin phosphate topical solution	Cleocin®
Clotrimazole and betamethasone dipropionate lotion	Lotrisone®
Fluconazole tablets 50, 100, 150 and 200 mg	Diflucan®
Halobetasol ointment, 0.05%	Ultravate®
Hydrocortisone butyrate ointment, 0.1%	Locoid®
Hydrocortisone butyrate solution, 0.1%	Locoid®
Loratadine syrup, 5 mg / 5 mL	Claritin®
Miconazole nitrate vaginal cream, 4%	Monistat®
Mometasone furoate cream, 0.1%	Elocon®
Mometasone furoate ointment, 0.1%	Elocon®
Phenytoin oral suspension, 125 mg / 5 mL	Dilantin®
Terconazole vaginal cream, 0.4%	Terazol®
Terconazole vaginal cream, 0.8%	Terazol®
Fluticasone propionate ointment, 0.005%	Cutivate®
TENTATIVE ANDA APPROVALS	
Gabapentin oral solution, 250 mg / 5 mL	Neurontin®
Mometasone furoate topical solution, 0.1% (lotion)	Elocon®

* The above trademarks are the property of their respective owners.

As of June 20, 2005, we had 25 of our ANDAs, including two tentative approvals, and one NDA under review by the FDA. In addition, there are multiple products for which either developmental or internal regulatory work is in process. The applications pending before the FDA are at various stages in the review process, and there can be no assurance that we will be able to successfully complete any remaining testing or that, upon completion of such testing, approvals for any of the applications currently under review at the FDA will be granted. In addition, there can be no assurance that the FDA will not grant approvals for competing products submitted by our competitors.

Proprietary Technologies

T-2000

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We are currently preparing for Phase III studies in Canada for T-2000, our non-sedating barbiturate compound developed by us. These trials will be directed toward the treatment of essential tremor. However it is important to note that there can be no assurance of the successful completion of Phase III testing, the approval by any regulatory authority of the drug, or the commercial success of the drug if and when approved.

NonSpil

We also continue to work on our NonSpil liquid drug delivery system, which allows liquid medications to pour, but not spill, thereby increasing the accuracy of dosage and ease of use. NonSpil development activities include improving product formulations, refining taste and texture, scaling up from laboratory sized manufacturing to commercial sized manufacturing.

In the second half of 2003, the Company started marketing ElixSure® in the U.S. ElixSure® is a line of children s OTC medication using the Nonspil™ vehicle. On March 3, 2005, the Company divested the ElixSure® product line in North America. However, the Company will continue to develop prescription products using the Nonspil™ delivery system. In addition, the Company will continue to manufacture and supply ElixSure® products from its Canadian plant.

Patents, Trademarks and Licenses

We have filed and received patents in the United States for a variety of products and processes, including:

- a class of anticonvulsant, tranquilizer and muscle relaxant drugs;
- a class of antiarrhythmic drugs;
- novel oral delivery for pharmaceutical and related products; and
- the synthesis and formulation of certain of our products.

We do not believe that any single patent or license is of material importance to us in relation to our current commercial activities.

We have registered trademarks in the United States and in Canada. Moreover, we have recently acquired the rights to use the A/T/S®, Kerasal®, Ovide®, Primsol®, Lustra®, and Topicort® trademarks in the United States. Taro U.S.A. typically does not use trademarks in the sale and marketing of its generic products. On March 3, 2005, the Company divested the Kerasal® and Primsol® trademarks.

From time to time, we seek to develop products for sale in various countries prior to patent expiration. In the United States, in order to obtain a final approval for a generic product prior to expiration of certain of the innovator s patents, we must, under the terms of the Drug Price Competition and Patent Term Restoration Act of 1984 (Hatch-Waxman Act), as amended by the Medicare Prescription Drug Improvement and Modernization Act of 2003, notify the patent holder as well as the owner of a NDA, that we believe that the patents listed in the Approved Drug Products with Therapeutic Equivalence Evaluations (Orange Book) for the new drug are

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either invalid or not infringed by our product. To the extent that we seek to utilize this mechanism to obtain approval to sell products, we are involved and expect to be involved in patent litigation regarding the validity, enforceability or infringement of patents listed in the Orange Book, as well as other patents, for a particular product for which we have sought approval. We may also be involved in patent litigation with third parties to the extent that claims are made that our finished product, an ingredient in our product, or our manufacturing process, may infringe the innovator s or third party s process patents. We may also become involved in patent litigation in other countries where we conduct business, including Israel, and Canada and various countries in Europe.

D. TREND INFORMATION

Please see Item 4-Information on the Company and Item 5-Operating and Financial Review and Prospect for trend information.

E. OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have any material off-balance sheet arrangements.

F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table describes the payment schedules of our contractual obligations as of December 31, 2004, in millions:

	Payments due by period (in millions)				
Type of Contractual Obligation	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**Over 5 years**
Operating lease obligations	$ 5.9	$ 1.6	$ 2.9	$ 1.2	$ 0.2
Purchase obligations	11.5	11.5			
Long-term debt obligations	204.3	16.9	65.9	53.9	67.6
Total	$ 221.7	$ 30.0	$ 68.8	$ 55.1	$ 67.8

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ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

A. DIRECTORS AND SENIOR MANAGEMENT

The following table lists our current directors and executive officers as of June 15, 2005:

Name	Age	Position
Barrie Levitt, M.D.	69	Director and Chairman of the Board of Directors
Daniel Moros, M.D.	57	Director and Vice Chairman of the Board of Directors
Myron Strober, C.P.A.	75	Director and Chairman of the Audit Committee
Heather Douglas, Esq.	50	Director
Micha Friedman, Ph.D.	64	Director
Eric Johnston, Esq.	60	Director
Gad Keren, M.D.	53	Director
Tal Levitt, Esq.	35	Director
Ben Zion Hod, C.P.A.	51	Director (1)
Haim Fainaro, C.P.A.	62	Director (1)
Samuel Rubinstein	65	Senior Vice President and General Manager
Kevin Connelly, C.P.A.	44	Senior Vice President, Chief Financial Officer
Avraham Yacobi, Ph.D.	59	Senior Vice President, Research and Development
Zahava Rafalowicz	58	Group Vice President, Sales and Marketing and Deputy General Manager, Israel
Mariana Bacalu	55	Vice President, Pharmaceutical Production
Hannah Bayer, C.P.A.	55	Vice President, Chief Accounting Officer
Marc Coles, Esq.	48	Vice President, General Counsel
Puah Dekel	45	Vice President, Administration, Israel
Yohanan Dichter	58	Vice President, Quality Assurance
Roman Kaplan, Ph.D.	59	Vice President, Technical Operations, Pharmaceuticals
Iftach Katz	41	Vice President, Technical Services, Israel
Alon Korb	46	Vice President, Engineering and Projects, Israel
Sigalit Portnoy, Ph.D.	41	Vice President, Haifa Operations
Tzvi Tal	55	Vice President, Information Technology, Israel

(1) Statutory independent director elected in accordance with the Israeli Companies Law.

Certain Familial Relationships

Tal Levitt is the daughter, and Dr. Daniel Moros is a first cousin, of Dr. Barrie Levitt.

Business Experience

Barrie Levitt, M.D. became Chairman of our board of directors in 1991. Dr. Levitt has been a director since 1963. Dr. Levitt, a pharmacologist (basic as well as clinical), has been involved in pharmacologic research and clinical cardiology since 1963. From 1974 to 1977, he was Professor of Medicine and Pharmacology and Director of Cardiology and Clinical Pharmacology at New York Medical College. From 1977 to 1985, he was Clinical Professor of Medicine and Visiting Professor of Pharmacology at the Albert Einstein College of Medicine in New York. From 1982 to 2000, he was Chairman of the Committee on Clinical Investigations at that institution. Dr. Levitt is a Fellow of the American College of Cardiology and of the American College of Clinical Pharmacology. He is a member of the

American Society for Pharmacology and Experimental Therapeutics. In addition, Dr. Levitt served as a consultant to the FDA from 1971 through March 1991, when he resigned in order to increase his involvement in our company.

Daniel Moros, M.D. was elected to our board of directors in 1988 and is currently Vice Chairman. He is instrumental in overseeing our clinical research program, including the design

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and conduct of clinical trials. Dr. Moros has been Associate Professor of Neurology at the Mount Sinai School of Medicine of the City University of New York since 1991, and currently is Associate Clinical Professor at such institution.

Myron Strober, C.P.A. was elected to our board of directors in 2002 and serves as the chairman of our audit committee. A Certified Public Accountant in the United States, Mr. Strober was an audit partner of Ernst & Young, New York, from 1969 to 1990. Since his retirement in 1990, Mr. Strober has been actively involved as a financial consultant to a number of organizations. He was a financial consultant to our company from 1993 to 2002 and served on our advisory board.

Heather Douglas, Esq. was elected to our board of directors in 1998. Ms. Douglas is a partner with the Canadian law firm of Borden Ladner Gervais LLP.

Micha Friedman, Ph.D. was elected to our board of directors in 2002 and is currently a Professor in the Department of Pharmacy at the Hebrew University of Jerusalem in Israel. He has served as Dean of the School of Pharmacy of the Hebrew University and has published numerous articles both in Israel and internationally. He is also a member of many professional pharmaceutical societies.

Eric Johnston, Esq. was elected to our board of directors in 1984. Mr. Johnston is currently an attorney in Ottawa and consultant to the Canadian law firm of Perley-Robertson, Hill and McDougall LLP. From 1974 to 1998, Mr. Johnston served as a Deputy Regional Solicitor of The Regional Municipality of Ottawa-Carleton, Ontario, Canada and from 1998 to 2001 as Regional Solicitor and Counsel.

Gad Keren, M.D. served on our board of directors from 1991 to 2000 and was reelected in 2001. Dr. Keren is currently Chairman of the Cardiology Department at the Tel Aviv Medical Center, where he was named Professor of Cardiology in 1995, and he has been secretary of the Israel Cardiology Society since 1991. Dr. Keren was a research fellow at the National Institute of Health in 1989 and 1990. Dr. Keren also acts as a research consultant to the Taro Research Institute (Institute).

Tal Levitt, Esq. was elected to our board of directors in 1998. Ms. Levitt joined our company in 1995 as Associate Counsel and currently serves as Senior Vice President, Corporate Affairs and Treasurer of Taro U.S.A. She previously worked as a corporate attorney at the New York law firm of Jenkens Gilchrist Parker and Chapin, LLP from 1994 to 1995.

Ben Zion Hod, C.P.A. was elected to our board of directors in 2003 as a statutory independent director. Mr. Hod is a certified public accountant in Israel and for the past 11 years, has served as company comptroller for Zim Integrated Shipping Services Ltd.. Prior to joining Zim, Mr. Hod was a senior manager at Kesselman & Kesselman, a member of PricewaterhouseCoopers International Ltd. Mr. Hod previously served as a public director of the Company from 1993 to 1998.

Haim Fainaro, C.P.A. was elected to our board of directors in 2003 as a statutory independent director. He is a certified public accountant in Israel, managing a private accounting practice in Tel Aviv since 1969. Mr. Fainaro has previously served as the Company s internal auditor in Israel and as public director from 1988 to 1993.

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Samuel Rubinstein joined our company in 1990 and currently serves as Senior Vice President and General Manager. From 1986 to 1989, Mr. Rubinstein served as President of Laminated Plastics, Inc., a joint venture of two Israeli corporations operating in the United States. From 1974 until 1986, Mr. Rubinstein managed several different Israeli companies.

Kevin Connelly, C.P.A. joined our company in 1993 and has served as our Senior Vice President and Chief Financial Officer since 1994. A Certified Public Accountant in the United States, Mr. Connelly has a background in financial management. From 1990 to 1993, he served as a Vice President and Controller of BT-Financial Services and Information Systems, a subsidiary of Bankers Trust Co. Prior to 1990, he held the position of Vice President and Divisional Controller with First American Bank of New York.

Avraham Yacobi, Ph.D. joined our company in 1994 as President of the Institute and was appointed our Senior Vice President, Research and Development in 1998. Dr. Yacobi directs our pharmaceutical, scientific and regulatory initiatives. Prior to joining our company, he was the Director of Pharmacodynamics Research for the Medical Research Division of American Cyanamid Company from 1982 to 1994. From 1976 to 1982, Dr. Yacobi served as Section Head of Clinical Pharmacology and Drug Metabolism of American Critical Care. He has extensive experience in drug development, with over 120 publications in the field.

Zahava Rafalowicz joined our company in 1997 as Marketing Manager of our Israeli operations. Ms. Rafalowicz presently serves as Group Vice President, Sales and Marketing, and Deputy General Manager in Israel. She is responsible for our Israeli and European sales and marketing operations and planning. Prior to joining us, Ms. Rafalowicz was the Deputy Managing Director of the Pharmaceutical Division of Teva Pharmaceutical Industries Ltd. She also spent several years at IMS Health Global Services, or IMS, where she established IMS in the Eastern European Bloc.

Mariana Bacalu joined our company in 1984 as Senior Analyst in the Quality Control Laboratory. As Vice President, Pharmaceutical Production, she is currently responsible for pharmaceutical production at the Haifa Bay facility. Prior to joining us, Ms. Bacalu served as a production manager for Polymer Industry in Romania.

Hannah Bayer, C.P.A. joined our company in 2001 as Vice President and Chief Accounting Officer. Ms. Bayer is a Certified Public Accountant in Israel. From 1999 to 2000, she served as Chief Financial Officer of Omrix Biopharmaceuticals, Ltd. From 1990 to 1999, Ms. Bayer held several financial positions in Teva Pharmaceutical Industries Ltd.

Marc Coles, Esq. joined our company in 1992 as in-house legal counsel in Israel and currently serves as our General Counsel responsible for legal affairs in Israel. Before joining our company, Mr. Coles was the Director of Regulatory Affairs for Biodan Medical Systems, Rehovot, Israel.

Puah Dekel joined our company in 1987 in our Human Resources Department. She served as the Director of Human Resources for the company from 1990 until 2003. Mrs. Dekel currently serves as Vice President, Administration, Israel. Prior to joining the company, she worked in the field of human resources for various companies, including Bank Leumi.

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Yohanan Dichter joined our company in 1986 in the research department and since 1988 has served as the Vice President, Pharmacist in Charge of the Haifa Bay pharmaceutical manufacturing plant. He is responsible for the review and release of all pharmaceutical products manufactured or sold in Israel. Prior to joining us, Mr. Dichter served in the Medical Corps of the Israel Defense Forces, Kupat Holim Clalit (Israel s largest healthcare fund) and worked in a private pharmacy.

Roman Kaplan, Ph.D. joined our company in 1991 and currently serves as Vice President, Technical Operations, Pharmaceuticals. He is responsible for process and product formulation improvements. Dr. Kaplan served from 1982 to 1987 as project manager of the biochemical laboratory of Abic Chemical and Pharmaceutical Industries and from 1987 to 1991 as head of its solid dosage forms development group.

Iftach Katz joined our company in 1995 and is now the head of the Company s Pharmaceutical Technical Services Group in Israel. Mr. Katz has over 17 years of experience in the industry and has held several key positions in the areas of product improvement and production.

Alon Korb joined our company in 2002 and is currently serving as Vice President, Engineering and Projects in Israel. Prior to joining our company, Mr. Korb was the Facilities Manager for Tower Semiconductor Ltd. in Israel, responsible for engineering, maintenance and the management of large-scale projects. He has extensive experience in engineering, industrial plant operations and project management.

Sigalit Portnoy, Ph.D. joined our company in 1997 as Head of Sterile Production. Thereafter, she was promoted to the position of Pharmaceutical Production Manager and subsequently as Vice President, Training and Planning. Dr. Portnoy is presently the Site Manager, Operations, Haifa, Israel. From 1990 to 1997, she taught at the Technion Institute, Israel.

Tzvi Tal joined our company in 1996 and currently serves as our Vice President, Information Technology in Israel. He is responsible for all information technology programs at our facilities in Israel. From 1977 to 1996, Mr. Tal was Head of Information Technology for the Vargus Group and Plant Manager for Egmo Industries.

B. COMPENSATION

Our directors, other than the statutory independent directors, are paid $6,000 per year for their service as directors. Directors who are not executive officers are also paid $500 for each meeting of our board of directors that they attend. Because of the increased responsibilities imposed by the Sarbanes-Oxley Act, the Chairman of our Audit Committee receives additional compensation of $6,000 per year. Our statutory independent directors, as defined under Israeli law, may not be compensated in connection with their services as statutory independent directors in excess of the amounts set forth in the Israeli Companies Law and regulations promulgated thereunder. Each of our statutory independent directors receives $390 as a participation fee for each board meeting that he attends and $6,400 as an annual fee.

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Cash Compensation of Executive Officers

We paid an aggregate of $5,482,947 to all of our directors and officers (24 persons) for services rendered to us in all capacities during the year ended December 31, 2004. This amount does not include certain additional benefits which, as to all directors and officers as a group, aggregated approximately $100,000.

C. BOARD PRACTICES

We are subject to the provisions of the Israeli Companies Law, which became effective on February 1, 2000.

Board of Directors

According to the Companies Law and our Articles of Association, the management of our business is vested in our board of directors. The board of directors may exercise all powers and may take all actions that are not specifically granted to our shareholders. As part of its powers, our board of directors may cause us to borrow or secure payments of any sum or sums of money for our purposes, at times and upon conditions as it thinks fit, including the grant of security interests on all or any part of our property.

Our board of directors currently consists of ten directors. The following members of our board of directors have been determined to be independent within the meaning of applicable Nasdaq regulations: Myron Strober, C.P.A., Heather Douglas, Esq., Micha Friedman, Ph.D., Eric Johnston, Esq., Gad Keren, M.D., Ben Zion Hod, C.P.A. and Haim Fainaro, C.P.A. The board of directors includes two statutory independent directors, Ben Zion Hod, C.P.A. and Haim Fainaro, C.P.A., mandated under Israeli law and subject to additional criteria to help ensure their independence. See Statutory Independent Directors below.

According to our Articles of Association (as amended in 2002), our board of directors may neither consist of fewer than five directors nor more than 25 directors. The Companies Law, as amended, requires the board of directors of a public company to determine the number of directors who shall possess accounting and financial expertise. This requirement is subject to and will only enter into effect upon promulgation of regulations by the Israeli Minister of Justice. Such regulations have not yet been published. The board of directors must make such determination by no later than 90 days following publication of such regulations.

Our directors, other than our statutory independent directors, are elected at annual general meetings of our shareholders, which are required to be held at least once during every calendar year and not more than fifteen months after the last preceding meeting. Directors may also be appointed, whether to fill vacancies or as additional members of the board of directors, by a resolution passed at an extraordinary general meeting of our shareholders. Likewise, in the event of a vacancy, the board of directors is empowered to appoint a director to fill such vacancy until the next annual general meeting of shareholders. A director holds office until the next annual general meeting, unless he or she resigns or is earlier removed from office by an ordinary resolution passed at an extraordinary general meeting of our shareholders.

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Statutory Independent Directors

Qualifications of Statutory Independent Directors

Under the Companies Law, companies incorporated under the laws of Israel whose shares are listed for trading on a stock exchange or have been offered to the public by a prospectus and are held by the public, in or outside of Israel, are required to elect two statutory independent directors. The Companies Law provides that a person may not be elected as a statutory independent director if the person or the person s relative, partner, employer or any entity under the person s control has, as of the date of the person s election to serve as a statutory independent director, or had, during the two years preceding that date, any affiliation with:

our company;

any entity controlling our company; or

any entity controlled by our company or under common control with our company.

The term affiliation includes an employment relationship, a business or professional relationship maintained on a regular basis, control of the company, and service as an office holder.

The Companies Law defines the term office holder as a director, general manager, chief business manager, deputy general manager, vice general manager, any other person assuming the responsibilities of any of the forgoing positions without regard to such person s title, or any manager that reports directly to the general manager. The Companies Law further provides that no person can serve as a statutory independent director if the person s other positions or other business creates, or may create, a conflict of interest with the person s responsibilities as a statutory independent director or may otherwise interfere with the person s ability to serve as a statutory independent director. Until the lapse of two years from termination of office, a company may not engage a statutory independent director to serve as an office holder and cannot employ or receive services from that person, either directly or indirectly, including through a corporation controlled by that person.

A person shall be qualified to serve as a statutory independent director only if he or she possesses accounting and financial expertise or professional qualifications. At least one statutory independent director must posses accounting and financial expertise. The conditions and criteria for possessing accounting and financial expertise or professional qualifications are subject to promulgation of regulations by the Israeli Minister of Justice in consultation with the Israeli Securities Authority, which have not yet been published; moreover, these criteria do not apply to external directors appointed before the recent amendment to the Companies Law but will apply to their reappointment for an additional term.

Election of Statutory Independent Directors

Statutory independent directors generally are elected by a majority vote at a shareholders meeting, provided that either:

the majority includes at least one third of the shares of non-controlling shareholders (as defined in the Companies Law) or their representatives voted at the meeting in favor of the election; or

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the total number of shares voted against the election of the statutory independent director by the non-controlling shareholders does not exceed one percent of the aggregate voting rights in the company.

The initial term of a statutory independent director is three years and may be extended for three additional years. Statutory independent directors may be removed from office only by the same percentage of shareholders as is required for their election or by a court, if the statutory independent directors cease to meet the statutory qualifications for their appointment or if they violate their duty of loyalty to the company. Each committee of a company s board of directors is required to include at least one statutory independent director, except for the audit committee which is required to include all the statutory independent directors.

Our statutory independent directors, Ben Zion Hod and Haim Fainaro, were elected by our shareholders in 2003, pursuant to the provisions of the Israeli Companies Law for initial three year terms, which will end on July 31, 2006 and August 28, 2006, respectively.

Alternate Directors

Pursuant to our Articles of Association and the Israeli Companies Law, any director may appoint, by written notice to us, any person who is not serving as a director, or as an alternate director, to serve as an alternate director and may also remove such alternate director. An alternate director possesses all the rights and obligations of the appointing director except that the alternate, in his capacity as such, has no standing at any meeting if the appointing director is present. Unless the appointing director limits the time or scope of the appointment, it shall be effective for all purposes until the appointing director ceases to be a director or terminates the appointment. The appointment of an alternate director does not diminish the responsibility of the appointing director as a director.

Committees

Subject to the provisions of the Israeli Companies Law, our board of directors may delegate its powers to certain committees comprised of board members. Pursuant to the Companies Law, any committee of the board of directors that is authorized to perform any function of the board, must include at least one statutory independent director. Our board of directors has formed Audit, Executive, Finance, Compensation and Stock Option committees.

Audit Committee

Under the Israeli Companies Law, our board of directors is required to appoint an audit committee, comprised of at least three directors including both statutory independent directors, but excluding:

the chairman of the board of directors; and

a controlling shareholder or a relative of a controlling shareholder and any director employed by our company or who provides services to us on a regular basis.

As of June 15, 2005, our audit committee consisted of the following directors: Myron Strober, Chairman, Eric Johnston, Heather Douglas, Ben Zion Hod, and Haim Fainaro, all of

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whom have been determined to be independent as defined by the applicable Nasdaq rules and those of the SEC.

The role of the audit committee is, among other things, to examine flaws in our business management, in consultation with the and the independent accountants and to propose remedial measures to the board. The audit committee is responsible for making proposals to the board with respect to the compensation of our executive officers. Thus, the determination, or recommendation for determination, of the compensation of our executive officers is made by a majority of our independent directors (as defined by the applicable Nasdaq rules).

Audit Committee Report

The audit committee has reviewed and discussed with management the Company s audited consolidated financial statements as of and for the year ended December 31, 2004.

The audit committee has also discussed with Kost, Forer, Gabbay & Kasierer, a member of Ernst & Young Global, the matters required to be discussed by the Statement on Auditing Standards No. 61, Communication with Audit Committees, as amended, issued by the Auditing Standards Board of the American Institute of Certified Public Accountants.

Based on the reviews and discussions referred to above, the audit committee has recommended to the board of directors of the Company that the audited consolidated financial statements referred to above be included in this Form 20-F for the year ended December 31, 2004.

Approval of Interested Party Transactions

The approval of the audit committee is required to effect specified actions and transactions with office holders, controlling shareholders and entities in which they have a personal interest. An audit committee may not approve an action or a transaction with the Company s controlling shareholders or with its office holders unless at the time of approval the two statutory independent directors are serving as members of the audit committee and at least one of our statutory independent directors serving as members of our audit committee was present at the meeting in which such approval was granted. A controlling shareholder is defined in the Companies Law for this purpose as a person with the ability to direct the actions of a company, or a person who holds 25% or more of the voting rights in a public company if no other shareholder owns more than 50% of the voting rights in the company, provided that two or more persons holding voting rights in the company who each have a personal interest in the approval of the same transaction shall be deemed to be one holder.

Audit committee approval is also required to approve the grant of an exemption from the responsibility for a breach of the duty of care towards the company, or for the provision of insurance or an undertaking to indemnify any office holder who is not a director of the company. In addition, among other things the audit committee must approve contracts between the company and any of its directors relating to the service or employment of a director.

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Internal Auditor

Under the Companies Law, the board of directors is required to appoint an internal auditor proposed by the audit committee. The internal auditor may not be an interested party, an office holder, or a relative of any of the foregoing, nor may the internal auditor be our independent accountant or its representative. The Companies Law defines the term interested party to include a person who holds 5% or more of our outstanding share capital or voting rights, a person who has the right to appoint one or more directors or the general manager, or any person who serves as a director or as the general manager. The role of the internal auditor is to examine, among other things, whether our actions comply with the law and orderly business procedure. Mr. Elisha Sa ar, C.P.A., an independent public accountant, currently serves as our internal auditor. The internal auditor has the right to demand that the chairman of the audit committee convene an audit committee meeting and the internal auditor may participate in all audit committee meetings. In addition, there are two employees whose sole responsibilities are to perform internal audit functions.

Compensation Committee

The compensation committee is responsible for making proposals to the board with respect to the compensation of employees other than executive officers. However, the determination, or recommendation for determination, of the compensation of our executive officers is made by the audit committee which is a majority of our independent directors (as defined by the applicable Nasdaq rules). As of June 15, 2005, our compensation committee consisted of the following directors: Tal Levitt, Esq., Chair, Myron Strober, C.P.A., Eric Johnston, Esq., and Ben Zion Hod, C.P.A.

D. EMPLOYEES

The following table sets forth the number of our employees as of December 31, 2004:

	Israel	**Canada**	**U.S.A.**	**Ireland**	**Other**	**Total**
Sales and Marketing	35	39	165	1	2	218
Administration	48	33	127	8	3	243
Research and Development	139	76	36	12	1	264
Production and Quality Control	376	214	0	32		622
Total	598	362	328	53	6	1,347

As part of the Company s efforts to control costs during 2004, our work force was reduced by approximately 10%.

In general, our relationship with our employees is satisfactory. We have no collective bargaining agreements with any of our employees. However, certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Israeli Coordination Bureau of Economic Organizations (including the Industrialists Association) apply to all of our employees in Israel by order of the Israeli Ministry of Labor. These provisions concern principally the length of the workday, minimum daily wages for professional workers, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay, and other conditions of employment. We generally provide our employees with benefits and working conditions beyond the required minimums.

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Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment without cause. We currently fund our ongoing severance obligations by contributing on behalf of our senior employees to a fund known as the Managers Insurance. This fund provides a combination of savings plan, life insurance and severance pay benefits to our employees, and each employee receives a lump sum payment upon retirement and severance pay, if the employee is legally entitled to it, upon termination of employment. We decide whether each employee is entitled to participate in the plan, and each employee who agrees to participate contributes an amount equal to 5% of his or her salary and we contribute an additional sum of between 13.3% and 15.8% of the employee s salary. In addition, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute (an agency similar to the United States Social Security Administration), which include payments for national health insurance. The payments to the National Insurance Institute are approximately 14.5% of an employee s wages (up to a specified amount), of which the employee contributes approximately 66% and we contribute approximately 34%.

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E. SHARE OWNERSHIP

The following table sets forth certain information regarding the ownership of our ordinary shares by our directors and officers as of May 31, 2005. The percentage of ownership is based on 29,530,535 ordinary shares outstanding as of May 31, 2005. Ordinary shares subject to options currently exercisable, or exercisable within 60 days of May 31, 2005, are deemed outstanding for computing the percentage ownership of the person holding such options, but are not deemed outstanding for computing the percentage ownership of any other person.

Name	Number of Ordinary Shares	Percentage of Outstanding Ordinary Shares
Barrie Levitt, M.D. (1)	1,206,232	4.1%
Daniel Moros, M.D. (2)	820,851	2.8%
Tal Levitt, Esq.	569,514	1.9%
Myron Strober, C.P.A.	*	*
Heather Douglas, Esq.	*	*
Micha Friedman, Ph.D	*	*
Eric Johnston, Esq	*	*
Gad Keren, M.D.	*	*
Ben Zion Hod, C.P.A.	*	*
Haim Fainaro, C.P.A.	*	*
Samuel Rubinstein	*	*
Kevin Connelly, C.P.A.	*	*
Avraham Yacobi, Ph.D	*	*
Zahava Rafalowicz	*	*
Mariana Bacalu	*	*
Hannah Bayer, C.P.A.	*	*
Marc Coles, Esq.	*	*
Yohanan Dichter	*	*
Roman Kaplan, Ph.D	*	*
Iftach Katz	*	*
Sigalit Portnoy, Ph.D	*	*
Alon Korb	*	*
Tzvi Tal	*	*
Puah Dekel	*	*
Total for all directors and officers (24 persons) listed above, as a group	2,893,521	9.8%

(1) Of the ordinary shares beneficially owned by Dr. Levitt, (1) 319,066 ordinary shares are owned individually by Dr. Levitt, (2) 585,780 ordinary shares are held by Dr. Levitt as trustee for trusts established by Dr. Levitt, (3) 12,934 ordinary shares are owned by Dr. Levitt and his wife as joint tenants, (4) 780 ordinary shares are owned by Morley and Company, Inc., or Morley, which is controlled by Dr. Levitt, (5) 198,032 ordinary shares are owned by Orenova Corporation, which is wholly-owned by Dr. Levitt and members of his immediate family, (6) 24,200 ordinary shares, which are not currently outstanding, are subject to incentive options granted to Dr. Levitt that are presently exercisable, (7) 65,440 ordinary shares are owned by Taro Research Foundation, Inc., or the Research Foundation, a charitable foundation established by Dr. Levitt. In addition, Dr. Levitt has the right to appoint a majority of the Board of Directors of Morley and Company, Inc. which owns all 2,600 of our

outstanding founders shares, whose holders are entitled to exercise one-third of the total voting power in our company regardless of the number of ordinary shares then outstanding.

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In 2001, the Research Foundation was created by means of a gift of 65,440 shares from the Levitt Family. The members of the Foundation are: Dr. Barrie Levitt, Dr. Daniel Moros, Tal Levitt, Dr. Jacob Levitt, and Taro U.S.A.,and its trustees are: Dr. Barrie Levitt and Dr. Daniel Moros. The purpose of the Foundation is to make charitable contributions to health related educational and research institutions.

(2) Of the ordinary shares owned by Dr. Moros, (1) 353,217 ordinary shares are owned individually by Dr. Moros, (2) 190,960 ordinary shares are held by Dr. Moros as co-trustee of the Nathan Moros Trust, (3) 253,574 ordinary shares are held by Dr. Moros as trustee for trusts established by Isabel Moros, and (4) 23,100 ordinary shares, which are not currently outstanding, are subject to incentive options granted to Dr. Moros that are presently exercisable.

* Less than 1%

As of May 31, 2005, the directors and executive officers listed above, as a group, held options to purchase 611,650 of our ordinary shares at a weighted average exercise price of $21.53, such options expiring between June 2005 and January 2015.

Stock Option Plans

From time to time, we have granted options to purchase our ordinary shares. As of May 31, 2005, there were 1,472,278 options outstanding to acquire our ordinary shares.

Compensation Pursuant to Plans

1991 Stock Incentive Plan

Our 1991 Stock Incentive Plan was unanimously adopted by our board of directors on November 19, 1991 and approved by our shareholders on April 10, 1992. The purpose of the 1991 Stock Incentive Plan is to attract, retain and provide incentives to key employees, including directors and officers who are key employees, and to consultants and directors who are not our employees by enabling them to participate in our long-term growth. Dr. Levitt and Dr. Moros were not eligible to participate in the 1991 Stock Incentive Plan.

The 1991 Stock Incentive Plan permits the grant of options and stock appreciation rights, or SARs. Options may either be incentive stock options, or ISOs, or nonqualified stock options, or NQSOs. The total number of our ordinary shares with respect to which options and SARs may be granted under the 1991 Plan may not exceed 1,000,000, subject to appropriate adjustment in the event of stock dividends, stock splits and similar transactions.

All key employees of, and consultants to us, and our directors, including officers and directors who are key employees, other than the Optionees, and members of our stock option committee, as defined in the 1991 Stock Incentive Plan, were eligible to participate in the 1991 Stock Incentive Plan. However, ISOs may only be granted to employees, including officers and directors who are also employees. Under the plan, directors, excluding Identified Public Directors who are not employees of our company or Outside Directors, both as defined in the 1991 Stock Incentive Plan, are granted, on the date that such individual is initially elected a director, a one-time nonqualified option to purchase 4,000 ordinary shares, or the Initial Outside Director Award.

The 1991 Stock Incentive Plan is administered by our board of directors (as required by the Companies Law) and by a Plan Committee, composed of not less than two members, each of

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whom must be disinterested persons as defined by the Securities and Exchange Commission (as required by U.S. law). Within the limits of the 1991 Stock Incentive Plan, the board of directors and Plan Committee are authorized to determine, among other things, to whom and the time or times at which options and SARs are to be granted, the types of options and SARs to be granted, the number of shares which will be subject to any option or SAR, the term of each option and SAR, the exercise price of each option and base price of each SAR, and the time or times and conditions under which options and SARs may be exercised. The board of directors and the Plan Committee may, with the consent of the holder of the option or SAR, cancel or modify an option or SAR or grant an option or SAR in substitution for any canceled option or SAR, provided that any substituted option or SAR and any modified option or SAR is permitted to be granted on such date under the terms of the 1991 Stock Incentive Plan and the Code. In such case, the board of directors and the Plan Committee may give credit toward any required vesting period for the substituted option or SAR for the period during which the employee held the canceled option or SAR.

The exercise price of an option or base price of a SAR granted under the 1991 Stock Incentive Plan, other than the Initial Outside Director Award, shall be determined by the board of directors and the Plan Committee, but may not be less than 100% of the fair market value of the ordinary shares on the date of grant or 110% of such fair market value in the case of an ISO granted to an optionee who owns or is deemed to own stock possessing more than 10% of the combined voting power of all classes of our stock. The exercise price of an Initial Outside Director Award shall equal the fair market value of the ordinary shares subject to such option on the date of grant.

Upon exercise of a SAR, subject to applicable law, the holder is entitled to receive an amount, in cash, ordinary shares or a combination of the two, as determined by the board of directors and the Plan Committee, equal to the excess of the fair market value of the shares with respect to which the SAR is, exercised calculated as of the exercise date, over the base price.

The term of each option and SAR other than an Initial Outside Director Award will be for such period, and such option or SAR may be exercised at such times during such period and on such terms and conditions, as the board of directors and the Plan Committee may determine, consistent with the terms of the 1991 Stock Incentive Plan. The term of an Initial Outside Director Award will be five years. Each Initial Outside Director Award will become exercisable in each of the four years commencing one year after the date of grant to the extent of one-fourth of the number of our ordinary shares originally subject to the option granted therein. Ordinary shares not purchased pursuant to an Initial Outside Director Award in any one exercise period may be purchased in any subsequent exercise period prior to the termination of the award. The term of any option or SAR may not exceed ten years, or five years with respect to ISOs granted to optionees who own or are deemed to own stock representing more than 10% of the combined voting power of all classes of our shares.

There is no limit on the number of shares for which options or SARs may be granted or awarded to any eligible employee, consultant or director. However, the aggregate fair market value (determined as of the date of grant) of ordinary shares with respect to which ISOs granted to any employee may be first exercisable in any calendar year under all of our incentive stock option plans may not exceed $100,000. To the extent such limit is exceeded, the excess will be treated as a separate NQSO.

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As of June 16, 2005, 158,623 ordinary shares were subject to outstanding options. Of such options, 62,000 (at an average exercise price of $2.87 per share) were held by executive officers; 50,000 (at an average exercise price of $2.96 per share) were held by directors who are not executive officers; and 46,623 (at an average exercise price of $2.86 per share) were held by other persons. None of such options was an SAR.

1999 Stock Incentive Plan

Our 1999 Stock Incentive Plan was unanimously adopted by our board of directors on March 10, 1999, and was approved at the annual meeting of shareholders held on July 29, 1999. An amendment that had been previously adopted by our board of directors was approved at the annual meeting of shareholders held on August 5, 2004. The purpose of the 1999 Stock Incentive Plan is to attract, retain and provide incentives to key employees (including directors and officers who are key employees) and to consultants and directors who are not our employees by enabling them to participate in our long-term growth. The total number of ordinary shares with respect to which options and SARs may be granted under the 1999 Plan may not exceed 2,100,000 subject to appropriate adjustment in the event of stock dividends, stock splits and similar transactions.

The 1999 Stock Incentive Plan permits the grant of options and SARs. Options may either be ISOs or NQSOs. SARs may be granted either alone or in tandem with ISOs or NQSOs, and may be granted before, simultaneously with or subsequent to the grant of an option. Any option granted in tandem with a SAR would no longer be exercisable to the extent the SAR is exercised and the exercise of the related option would cancel the SAR to the extent of such exercise.

All key employees and directors of, and consultants to us, (as defined in the 1999 Stock Incentive Plan), are eligible to participate in the 1999 Stock Incentive Plan. However, ISOs may only be granted to employees (including officers and directors who are also employees). Each Outside Director, including statutory independent directors, shall be granted, on the date initially elected a director, a one-time nonqualified option to purchase the Initial Outside Director Award.

The 1999 Stock Incentive Plan is administered by our board of directors (as required by the Companies Law), and, by a committee of our board of directors, which shall contain at least the minimum number of and type of directors (the Administrators) that may be required in order for options granted under the Plan to be entitled to benefits under Section 162(m) of the Code. Within the limits of the 1999 Stock Incentive Plan, the Administrators are authorized to determine, among other things, to whom and the time or times at which, options and SARs are to be granted, the types of options and SARs to be granted, the number of shares which will be subject to any option or SAR, the term of each option and SAR, the exercise price of each option and base price of each SAR, and the time or times and conditions under which options and SARs may be exercised. The Administrators may (with the consent of the holder of the option or SAR) cancel or modify an option or SAR, or grant an option and/or SAR in substitution for any canceled option or SAR, provided that any substituted option or SAR and any modified option or SAR is permitted to be granted on such date under the terms of the 1999 Stock Incentive Plan and the Code. In such case, the Administrators may give credit toward any required vesting period for the substituted option or SAR for the period during which the employee held the canceled option or SAR.

The exercise price of an option or base price of a SAR granted under the 1999 Stock Incentive Plan shall be determined by the Administrators, but may not be less than 100% of the fair market

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value of the ordinary shares on the date of grant (110% of such fair market value in the case of an ISO granted to an optionee who owns or is deemed to own stock possessing more than 10% of the combined voting power of all classes of our stock). The exercise price of an Initial Outside Director Award shall equal the fair market value of the ordinary shares subject to such option on the date of grant.

Upon exercise of a SAR, the holder is entitled to receive an amount in cash, ordinary shares or a combination of the two, as determined by the Administrators, equal to the excess of the fair market value of the shares with respect to which the SAR is exercised (calculated as of the exercise date) over the base price.

The term of each option and SAR, subject to applicable law, other than an Initial Outside Director Award will be for such period, and such option or SAR may be exercised at such times during such period and on such terms and conditions, as the Administrators may determine, consistent with the terms of the 1999 Stock Incentive Plan. The term of an Initial Outside Director Award will be five years. Each Initial Outside Director Award will become exercisable in each of the four years commencing one year after the date of grant to the extent of one-fourth of the number of ordinary shares originally subject to the option granted therein.

Ordinary shares not purchased pursuant to an Initial Outside Director Award in any one exercise period may be purchased in any subsequent exercise period prior to the termination of the award. The term of any ISO may not exceed ten years (five years with respect to ISOs granted to optionees who own or are deemed to own stock representing more than 10% of the combined voting power of all classes of our shares).

The maximum number of shares for which options may be granted or awarded in any calendar year to any eligible employee is 1,000,000. There is no limit on the number of shares for which options may be granted or awarded to any consultant or director, or for which SARs may be granted or awarded to any eligible employee, consultant or director. However, the aggregate fair market value (determined as of the date of grant) of ordinary shares in respect of which ISOs granted to any employee may be first exercisable in any calendar year under all incentive stock option plans of our company may not exceed $100,000. To the extent such limit is exceeded, the excess will be treated as a separate NQSO.

As of June 16, 2005, 1,313,655 ordinary shares were subject to outstanding options. Of such options, 423,650 (at an average exercise price of $33.23 per share) were held by executive officers; 76,000 (at an average exercise price of $32.73 per share) were held by directors who are not executive officers; and 814,005 (at an average exercise rice of $33.14 per share) were held by other persons. None of such options was an SAR.

2000 Employee Stock Purchase Plan

Our 2000 Employee Stock Purchase Plan was adopted by our board of directors on May 3, 2000, and was approved at an extraordinary general meeting of shareholders held on May 2, 2001. The purpose of the 2000 Employee Stock Purchase Plan is to provide our employees and those of certain of our subsidiaries designated by our board of directors with an opportunity to purchase our ordinary shares. Dr. Levitt, Ms. Levitt and Dr. Moros are not eligible to participate in the 2000 Employee Stock Purchase Plan.

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The 2000 Employee Stock Purchase Plan is administered by our board of directors (as required by the Companies Law) and by a committee named by our board of directors, which, subject to applicable law, has the power to adopt, amend and rescind any rules deemed desirable and appropriate for the administration of the 2000 Employee Stock Purchase Plan and not inconsistent with the 2000 Employee Stock Purchase Plan, to construe and interpret the 2000 Employee Stock Purchase Plan, and to make all other determinations necessary or advisable for the 2000 Employee Stock Purchase Plan. The composition of the committee shall be in accordance with the requirements to obtain or retain any available exemption from the operation of Section 16(b) of the Securities and Exchange Act of 1934 pursuant to Rule 16b-3 promulgated thereunder.

Under the terms of the 2000 Employee Stock Purchase Plan, participating employees accrue funds in an account through payroll deductions during six-month offering periods. The funds in this account are applied at the end of such offering periods to purchase our 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 shall be less.

The maximum number of shares issuable under the 2000 Employee Stock Purchase Plan is 500,000 ordinary shares, subject to adjustment. To be eligible to participate in the 2000 Employee Stock Purchase Plan, an individual must be employed by us or one of our subsidiaries designated by the board of directors on the first day of the applicable plan period. Notwithstanding the foregoing, anyone who is both a highly compensated employee within the meaning of the Code and is designated by the board of directors as ineligible to participate in the 2000 Employee Stock Purchase Plan shall not be entitled to participate in the 2000 Employee Stock Purchase Plan.

In addition, no employee will be granted a right under the 2000 Employee Stock Purchase Plan if (i) immediately after the grant, such employee would own stock and/or hold outstanding options to purchase stock constituting 5% or more of the total combined voting power or value of our stock or any of our subsidiaries or (ii) such grant would result in such employee s rights to purchase stock under all of our employee stock purchase plans or of our subsidiaries to accrue at a rate that exceeds $25,000 of the fair market value of such stock (determined as of the last business day of the preceding semi-annual period) for each calendar year.

As of December 31, 2004, approximately 125,438 ordinary shares have been purchased through the 2000 Employee Stock Purchase Plan at a weighted average purchase price of $21.06.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

A. MAJOR SHAREHOLDERS

The following table sets forth certain information as of June 15, 2005, with respect to the ownership of our ordinary shares by all persons who are known to us to beneficially own more than 5% of our outstanding ordinary shares, and by all of our directors and officers as a group. Except as indicated, each such shareholder has sole voting and investment power with respect to the ordinary shares beneficially owned by such shareholder. Beneficial ownership is determined in accordance with rules of the United States Securities and Exchange Commission and generally

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includes voting and investment power with respect to our ordinary shares. Percentage ownership is based on 29,530,535 ordinary shares outstanding as of May 31, 2005.

Name	Ordinary Shares Beneficially Owned	Percent of Ordinary Shares Outstanding
Neuberger Berman, Inc./Neuberger Berman, LLC(1)	3,073,632	10.4%
Taro Development Corporation(2)	2,332,937	7.9%
T. Rowe Price Associates, Inc. (3)	1,983,100	6.7%
Franklin Resources, Inc. (4)	1,817,305	6.2%
Brookside Capital Partners Fund, L.P. (5)	1,610,810	5.5%

(1) Based on information contained in a Schedule 13F filed on February 8, 2005 by Neuberger Berman, LLC.

(2) Dr. Levitt, Dr. Moros, and their families may be deemed to control all of the ordinary shares owned by TDC by virtue of their ownership of more than 50% of the shares of TDC.

(3) Based on information contained in a Schedule 13G, filed on February 14, 2005 by T. Rowe Price Associates, Inc.

(4) Based on information contained in a Schedule 13G, filed on February 14, 2005 by Franklin Resources, Inc.

(5) Based on information contained in a Schedule 13G, filed on April 12, 2005 by Brookside Capital Partners Fund, L.P.

Founders Shares

At the formation of our company in 1959, two classes of shares were created, founders shares and ordinary shares. One third of the voting power of all of our voting shares is allocated to the founders shares. Morley and Company, which is controlled by Dr. Levitt, owns all of the 2,600 outstanding founders shares. Holders of Morley s class A shares are entitled to elect one director of Morley and holders of Morley s class B shares are entitled to elect two directors of Morley.

As the holder of all of Morley s class B Shares, Dr. Levitt may cause the election of two of the three directors and, therefore, may be deemed to control the voting and disposition of the founders shares.

Voting Power

As of May 31, 2005, Dr. Levitt, Dr. Moros, Tal Levitt and members of their respective immediate families, in the aggregate, control 45.6% of the voting power in our company by reason of their (i) beneficial ownership, other than through TDC, of an aggregate of 10.5% of our ordinary shares, (ii) their majority ownership of TDC, which owns 7.9% of our ordinary shares, and (iii) Dr. Levitt s control of Morley, which, through its ownership of the founders shares, has one-third of the voting power of our shares.

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As of May 31, 2005 29,530,535 of our ordinary shares were outstanding. They were held of record by 347 persons.

B. RELATED PARTY TRANSACTIONS

Not applicable.

C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

ITEM 8. FINANCIAL INFORMATION

A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

The Financial Statements required by this item are found at the end of this annual report, beginning on page F-1.

Other Financial Information

We manufacture pharmaceutical products in our facilities in Israel and Canada. A substantial amount of these products are exported, both to our affiliates and non-affiliates. For a breakdown of our sales by geographic market for the past three years, see Item 4 Information on the Company-Business Overview-Sales and Marketing.

Legal Proceedings

From time to time, we are a party to routine litigation incidental to our business, none of which, individually or in the aggregate, is expected to have a material adverse effect on our financial position. Prior to 2004, a claim in the approximate amount of $550,000 was filed by a customer. Based upon a legal opinion and our insurance coverage, we believe that the ultimate resolution of this matter will not result in a material adverse effect on our financial position.

On August 2, 2004, a purported securities class action complaint was filed against us and certain of our current and former officers and directors in the United States District Court for the Southern District of New York. The complaint alleges that the defendants made statements during the period February 20, 2003 through July 29, 2004 in press releases, our 2003 Annual Report and during conference calls with analysts which were materially false and misleading and which artificially inflated the price of our ordinary shares. The complaint alleges claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. Nine additional purported securities class action complaints were subsequently filed in the United States District Court for the Southern District of New York, all containing similar allegations. On October 5, 2004, a motion to consolidate the ten actions, appoint lead plaintiffs and for approval of selection of lead counsel was filed. The motion is still pending. We and the individual defendants intend to vigorously defend against the claims in these actions.

On August 17, 2004, two shareholders derivative actions were filed in the United States District Court for the Southern District of New York against certain of our current and former officers and directors alleging that defendants breached their fiduciary duties based on the same

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alleged course of conduct identified in the securities actions described above. On October 27, 2004, the two actions were consolidated. Subsequently, plaintiffs counsel agreed to voluntarily dismiss the lawsuit, in its entirety, without prejudice. On November 24, 2004, a stipulation and proposed order dismissing the litigation, in its entirety, without prejudice, was submitted to the court for approval and was approved.

As described in our Annual Report on Form 20-F for the year ended December 31, 2003, on November 14, 2003, Godecke Aktiengesellschaft, Pfizer and Warner-Lambert, responding to our filing of an abbreviated new drug application requesting approval for gabapentin capsules prior to the expiration of certain listed patents, filed a complaint against us and our U.S. subsidiary, Taro Pharmaceuticals U.S.A., Inc., in the district court in New Jersey alleging that under the provisions of the Hatch-Waxman Act that our ANDA infringed certain Warner-Lambert patents. By mutual consent between the parties, the case was dismissed without prejudice by the court in August 2004.

Dividend Policy

We have never paid cash dividends and we do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain our earnings to finance the development of our business, but such policy may change depending upon, among other things, our earnings, financial condition and capital requirements.

B. SIGNIFICANT CHANGES

Not applicable.

ITEM 9. THE OFFER AND LISTING

A. OFFER AND LISTING DETAILS

The following table sets forth the high and low closing sale prices of our ordinary shares as quoted on the Nasdaq National Market during the last five years:

	High	Low
2000	$ 17.47	$ 3.66
2001	$ 48.50	$ 13.44
2002	$ 39.26	$ 21.60
2003	$ 72.11	$ 30.14
2004	$ 66.53	$ 18.99

The following table sets forth the high and low closing sale prices of our ordinary shares as quoted on the Nasdaq National Market during each fiscal quarter of the last two years and any subsequent period:

	High	Low
First Quarter 2003	$ 38.92	$ 30.14
Second Quarter 2003	$ 57.77	$ 39.43
Third Quarter 2003	$ 58.71	$ 48.85
Fourth Quarter 2003	$ 72.11	$ 57.34

First Quarter 2004	$ 66.53	$ 57.40

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	High	Low
Second Quarter 2004	$ 63.61	$ 39.91
Third Quarter 2004	$ 43.48	$ 18.99
Fourth Quarter 2004	$ 35.42	$ 21.12
First Quarter 2005	$ 34.11	$ 26.54

The following table sets forth the high and low closing sale prices of our ordinary shares as quoted on the Nasdaq National Market during the last six months:

	High	Low
December 2004	$ 35.42	$ 30.90
January 2005	$ 34.11	$ 30.04
February 2005	$ 30.23	$ 26.54
March 2005	$ 32.01	$ 28.60
April 2005	$ 31.85	$ 27.89
May 2005	$ 34.59	$ 29.98

B. PLAN OF DISTRIBUTION

Not applicable.

C. MARKETS

Our ordinary shares have been traded in the over the counter market in the United States since 1961. Our ordinary shares were first registered for trading on NASDAQ in 1982. Our ordinary shares have been quoted on the Nasdaq National Market since 1993 under the symbol TARO. In May 2001, the Chicago Option Exchange started to quote options on our ordinary shares under the symbol QTT. There is no non-United States trading market for our ordinary shares.

D. SELLING SHAREHOLDERS

Not applicable.

E. DILUTION

Not applicable.

F. EXPENSES OF THE ISSUE

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. SHARE CAPITAL

Not applicable.

B. MEMORANDUM AND ARTICLES OF ASSOCIATION

Our registration number at the Israeli Registrar of Companies is 52-002290-6.

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Objects and Purposes

Our Articles of Association provides that our main objects and purposes include any business connected with the developing, manufacturing, processing, supplying, marketing and distributing of prescription, over-the-counter medical and other health care products. These products include active pharmaceutical ingredients and final dosage form products.

In February 2000, the Company s Ordinance (New Version 1983) was replaced with the Companies Law, which was most recently amended in March 2005. Since our Articles of Association were adopted before the enactment of the Companies Law, they are not always consistent with the provisions of the new law. In all instances in which the Companies Law changes or amends provisions in the Companies Ordinance, and as a result our Articles of Association are not consistent with the Companies Law, the provisions of the Companies Law apply unless specifically stated otherwise in the Companies Law. Similarly, in all places where our Articles of Association refer to a section of the Companies Ordinance that has been replaced by the Companies Law, the Articles of Association are understood to refer to the relevant section of the Companies Law.

Approval of Specified Related Party Transactions Under Israeli Law

Fiduciary Duties of Office Holders

The Companies Law imposes fiduciary duties that office holders owe to a company. An office holder s fiduciary duties consist of a duty of care and a duty of loyalty. The duty of care requires an office holder to act with the level of care that a reasonable office holder in the same position would have acted under the same circumstances. The duty of care includes a duty to use reasonable means to obtain information on the advisability of a given action brought for the office holder s approval or performed by the office holder by virtue of his or her position and all other important information pertaining to these actions.

The duty of loyalty generally requires an office holder to act in good faith and for the good of the company. Specifically, an office holder must avoid any conflict of interest between the office holder s position in a company and his or her other positions or personal affairs. In addition, an office holder must avoid competing against the company or exploiting any business opportunity of a company to receive a personal gain for himself, herself or others. An office holder must also disclose to a company any information or documents relating to that company s affairs that the office holder has received due to his or her position in the company.

Under the Companies Law, all arrangements as to compensation of public companies directors require the approval of the audit committee, the board of directors and shareholder approval, in that order.

Disclosure of Personal Interest of an Office Holder

The Companies Law requires that an office holder promptly disclose to the company any personal interest that he or she may have, and all related material information known to him or her, in connection with any existing or proposed transaction by the company. A personal interest of an office holder includes an interest of a company in which the office holder is, directly or indirectly, a 5% or greater shareholder, holder of 5% or more of the voting power, director or

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general manager or in which he or she has the right to appoint at least one director or the general manager. In the case of an extraordinary transaction, the office holder s duty to disclose applies also to a personal interest of the office holder s spouse, siblings, parents, grandparents, descendants, spouse s descendants and the spouses of any of these people. An extraordinary transaction is a transaction executed other than in the ordinary course of business, other than according to prevailing market terms, or that is likely to have a material impact on the company s profitability, assets or liabilities.

Under the Companies Law, once the office holder complies with the above disclosure requirement, the board of directors may approve the transaction between the company and an office holder or a third party in which an office holder has a personal interest, unless the company s articles of association provide otherwise. A transaction that is adverse to the company s interest may not be approved. If the transaction is an extraordinary transaction, then it also must be approved by the company s audit committee and board of directors, and, under certain circumstances, by the shareholders of the company, in that order.

A director who has a personal interest in a matter that is considered at a meeting of the board of directors or a committee of the board may not be present at this meeting or vote on this matter, unless a majority of the members of the board of directors or such committee, as the case may be, has a personal interest in the matter. If a majority of members of the board of directors have a personal interest therein, shareholder approval is also required.

Disclosure of Personal Interests of a Controlling Shareholder

Under the Companies Law, the disclosure requirements that apply to an office holder also apply to a controlling shareholder of a public company. A controlling shareholder is a shareholder who has the ability to direct the activities of a company, including a shareholder that owns 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights, but excluding a shareholder whose power derives solely from his or her position on the board of directors or any other position with the company. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and the engagement of a controlling shareholder as an office holder or employee, require the approval of the audit committee, the board of directors and the shareholders of the company, in that order. The