TARO PHARMACEUTICAL INDUSTRIES LTD
Form 20-F/A
January 12, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F/A

(Mark One)

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

OR

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

For the fiscal year ended December 31, 2007

OR

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

For the transition period from ___to ___

OR

o SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report _____

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)

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

Michael Kalb
Interim Chief Financial Officer
Taro Pharmaceutical Industries Ltd.
c/o Taro Pharmaceuticals U.S.A., Inc.
3 Skyline Drive
Hawthorne, NY 10532
Tel: 914-345-9000
Fax: 914-345-6169
Email: Michael.Kalb@taro.com

(Name, telephone, email and/or facsimile number and address of Company contact person)

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

None
(Title of Class)

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:

39,195,869 Ordinary Shares, NIS 0.0001 nominal (par) value per share, and 2,600 Founders' Shares NIS 0.00001 nominal (par) value per share were outstanding as of December 31, 2007

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
o Yes þ No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
o Yes þ No

Note - checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those sections.

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.
o Yes þ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
o Yes o No

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

o Large Accelerated Filer þ Accelerated Filer o Non-Accelerated Filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

| | | |
|---|---|---|
| U.S. GAAP þ | International Financial Reporting Standards as issued by the International Accounting Standards Board o | Other ¨ |

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If “Other” has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

o Item 17 o Item 18

If this is an anual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes þ No

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Explanatory Note

Taro Pharmaceutical Industries Ltd. (the "Company") is filing this Amendment No. 1 (the "Amendment No. 1") to its Annual Report on Form 20-F for the year ended December 31, 2007 (the "Form 20-F") to include the inadvertent omission in the auditor’s opinion to the financial statement schedule. This Amendment No. 1 includes the corrected auditor’s opinion, together with the audited financial statements and financial statement schedule as originally filed with the Form 20-F. Additionally, as required under the Securities Exchange Act of 1934, as amended, new certifications of the Company's principal executive officer and principal financial officer are filed as exhibits hereto. No revisions are being made to the Company's financial statements and except as described above, this Amendment No. 1 does not amend any other information in the Form 20-F, does not reflect any events that may have occurred subsequent to the filing of the original Form 20-F and does not modify or update in any way any disclosures made in the Form 20-F.

PART III

ITEM 18. FINANCIAL STATEMENTS

The financial statements required by this item are found at the end of this 2007 Annual Report, beginning on page F-1.

The Financial Statement Schedule II – Valuation and Qualifying Accounts is found on page S-1 following the financial statements.

ITEM 19. EXHIBITS

The exhibits filed with this Amendment No.1 are listed on the index of exhibits below.

| Exhibit No. | Description |
|---|---|
| 12.1 | Certification of the Interim Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 12.2 | Certification of the Group Vice President, Interim Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 13 | Certification of the Interim Chief Executive Officer and Group Vice President, Interim Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

SIGNATURE

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this 2007 Annual Report on its behalf.

TARO PHARMACEUTICAL INDUSTRIES LTD.

By: /s/ Michael Kalb
Michael Kalb
Group Vice President, Interim Chief Financial Officer

Dated: January 12, 2012

TARO PHARMACEUTICAL INDUSTRIES LTD.

Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheet of Taro Pharmaceutical Industries Ltd (the "Company") and its subsidiaries as of December 31, 2007, and the related consolidated statement of operations, shareholders' equity and cash flows for the year then ended. In connection with our audits of the financial statements, we have also audited the accompanying financial statement schedule. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company and its subsidiaries as of December 31, 2007, and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2007, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated June 29, 2011 does not express an opinion on the Company's internal control over financial reporting because management was unable to complete all of its testing of internal controls and we were unable to apply other procedures to satisfy ourselves as to the effectiveness of the Company's internal control over financial reporting.

As discussed in Notes 2.q to the consolidated financial statements, the Company adopted Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" - an interpretation of FASB Statement No. 109, effective January 1, 2007.

/s/ Ziv Haft

Tel Aviv, Israel
Ziv Haft

June 29, 2011

Certified Public Accountants (Isr)

BDO Member Firm

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Taro Pharmaceutical Industries Ltd.
Yakum, Israel

We have audited the internal control over financial reporting of Taro Pharmaceutical Industries Ltd. and its subsidiaries (the "Company") as of December 31, 2007, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment on the effectiveness of internal control over financial reporting, included in the accompanying Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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

Since management was unable to complete all of its testing of internal controls and we were unable to apply other procedures to satisfy ourselves as to the effectiveness of the Company's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness of the Company's internal control over financial reporting.

Nevertheless, we draw attention to management conclusion that the Company has at least the following material weaknesses in internal control over financial reporting as of December 31, 2007:

Control Activities Associated with Financial Statement Closing Processes. The Company identified material weaknesses in its financial statement closing processes arising from the potential for a material error in the

financial statements from consideration of the following deficiencies:

Estimating certain accounts receivable reserves and sales deductions including rebates and other sales deductions.
Significant, complex and non-routine transactions, including the area of taxation and certain other accounting items.
Ensuring adequate preparation, timely review and documented approval of account reconciliations, journal entries, both recurring and non-recurring and certain information primarily in the form of spreadsheets that supports our financial reporting process, and consistent communication among the various finance and non-finance organizations across the Company on the terms of our commercial arrangements.

Revenue. The Company lacks the proper procedures and controls in estimating its rebate and other deductions reserves, including indirect and Medicaid rebates. Specifically, the Company is dependent on manual processes and experienced turnover in the roles responsible for certain estimates and lacked sufficient time and resources to properly and fully estimate these reserves. As a result, the Company did not consistently and accurately record the provision at the time of the sale.

Inventory. The Company found that adjustments of inventory and cost of goods sold were necessary and mainly relate to errors in the assessment of inventory valuation. Inventory valuation adjustments primarily resulted due to the errors identified in the accounts receivable reserves, which impacted the computation of the Company's net selling prices which resulted in changes to inventory valuation.

Income Taxes. The Company did not maintain adequate policies and procedures and related internal controls or employ adequate resources with sufficient technical expertise, on a global basis, in the area of accounting for income taxes to ensure the completeness, accuracy, and timely preparation and review of our consolidated income tax provision, related account balances and disclosures sufficient to prevent a material misstatement of related account balances. In addition, the Company was unable to finalize its tax provision due to the lack of audited financial statements for prior years.

These material weaknesses, identified by management, were considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended December 31, 2007, of the Company and this report does not affect our report dated June 29, 2011, on those financial statements.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) the consolidated balance sheets of Taro Pharmaceutical Industries Ltd. as of December 31, 2007, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for the year end December 31, 2007 and our report dated June 29, 2011 expressed an unqualified opinion thereon.

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

June 29, 2011

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
TARO PHARMACEUTICAL INDUSTRIES LTD.

We have audited the accompanying consolidated balance sheet of Taro Pharmaceutical Industries Ltd. ("the Company") and its subsidiaries as of December 31, 2006, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the two years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the Standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2006, and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2.u. to the consolidated financial statements, the Company adopted the provision of Statement of Financial Accounting Standard No. 123(R), "Share-Based Payment," effective January 1, 2006.

Tel-Aviv, Israel

/s/ Kost Forer Gabbay & Kasierer

KOST FORER GABBAY &
KASIERER

March 25, 2010

A Member of Ernst & Young
Global

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED BALANCE SHEETS
U.S. dollars and shares in thousands

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 45,187 | $ 16,140 |
| Marketable securities | - | 114 |
| Accounts receivable: | | |
| Trade, net | 70,017 | 39,456 |
| Other receivables, prepaid expenses and other | 26,260 | 15,693 |
| Inventories | 66,957 | 56,762 |
| Assets held for sale | - | 5,232 |
| TOTAL CURRENT ASSETS | 208,421 | 133,397 |
| LONG-TERM RECEIVABLES AND OTHER ASSETS | 26,576 | 31,543 |
| PROPERTY, PLANT AND EQUIPMENT, NET | 211,929 | 219,753 |
| GOODWILL | 7,287 | 7,231 |
| INTANGIBLE ASSETS AND DEFERRED COSTS, NET | 26,368 | 29,063 |
| DEFERRED INCOME TAXES | 2,772 | 3,703 |
| TOTAL ASSETS | $ 483,353 | $ 424,690 |

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED BALANCE SHEETS
U.S. dollars and shares in thousands

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Short-term bank credit and short-term loans | $108,992 | $119,326 |
| Current maturities of long-term debt | 31,348 | 28,428 |
| Accounts payable: | | |
| Trade payables | 20,326 | 18,442 |
| Other current liabilities | 72,203 | 97,383 |
| TOTAL CURRENT LIABILITIES | 232,869 | 263,579 |
| LONG-TERM LIABILITIES: | | |
| Long-term debt, net of current maturities | 76,361 | 90,377 |
| Deferred income taxes | 5,586 | 5,516 |
| Other long-term liabilities | 15,299 | 15,435 |
| TOTAL LONG-TERM LIABILITIES | 97,246 | 111,328 |
| COMMITMENTS AND CONTINGENT LIABILITIES | | |
| TOTAL LIABILITIES | 330,115 | 374,907 |
| SHAREHOLDERS' EQUITY: | | |
| Share capital: | | |
| Ordinary shares of NIS 0.0001 par value: | | |
| Authorized at December 31, 2007 and 2006: 200,000,000 shares; Issued at December 31, 2007 and 2006: 39,460,509 and 29,624,218 shares, respectively; Outstanding at December 31, 2007 and 2006: 39,195,869 and 29,358,265 shares, respectively | 679 | 679 |
| Founders' shares of NIS 0.00001 par value: | | |
| Authorized, issued and outstanding at December 31, 2007 and 2006: 2,600 shares | 1 | 1 |
| Additional paid-in capital | 221,814 | 165,058 |
| Accumulated other comprehensive income | 27,620 | 14,106 |
| Treasury stock (264,640 and 265,953 shares at December 31, 2007 and 2006, respectively) | (1,361) | (1,388) |
| Accumulated (deficit) | (95,515) | (128,673) |
| TOTAL SHAREHOLDERS' EQUITY | 153,238 | 49,783 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | $483,353 | $424,690 |

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF OPERATIONS
U.S. dollars and shares in thousands (except per share data)

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2007 | | 2006 | | 2005 | |
| Sales, net | $319,554 | | $252,269 | | $288,623 | |
| Cost of sales | 133,229 | | 123,516 | | 122,615 | |
| Impairment | 170 | | 25,862 | | - | |
| Gross profit | 186,155 | | 102,891 | | 166,008 | |
| Operating expenses: | | | | | | |
| Research and development, net | 29,817 | | 36,273 | | 45,714 | |
| Selling, marketing, general and administrative | 97,274 | | 109,048 | | 110,748 | |
| Impairment | - | | 27,923 | | - | |
| | 127,091 | | 173,244 | | 156,462 | |
| Operating income (loss) | 59,064 | | (70,353 | ) | 9,546 | |
| Financial expenses, net | 22,816 | | 11,454 | | 7,985 | |
| Other gain, net | 4,300 | | - | | - | |
| Income (loss) before income taxes | 40,548 | | (81,807 | ) | 1,561 | |
| Tax expense | 6,212 | | 872 | | 1,477 | |
| Net income (loss) | $34,336 | | $(82,679 | ) | $84 | |
| | | | | | | |
| Basic net income (loss) per ordinary share | $0.99 | | $(2.82 | ) | $0.0 | (*) |
| Diluted net income (loss) per ordinary share | $0.98 | | $(2.82 | ) | $0.0 | (*) |
| | | | | | | |
| Weighted-average number of ordinary shares used to compute basic income (loss) per share | 34,725 | | 29,347 | | 29,250 | |
| Weighted-average number of ordinary shares used to compute diluted income (loss) per share | 35,215 | | 29,347 | | 29,590 | |

(*) Amount is less than $0.01.

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
U.S. dollars and shares in thousands

| | Number of Shares | Share Capital | Additional Paid-in Capital | Deferred Stock-based Compensation | Accumulated Other Comprehensive Income (loss) | Treasury Shares | Retained Earnings (Accumulated Deficit) | Total Comprehensive Income (loss) | Total Shareholders' Equity |
|---|---|---|---|---|---|---|---|---|---|
| Balance at January 1, 2005 | 29,170 | $ 680 | $ 162,027 | $ (450) | $ 12,498 | $ (1,359) | $ (45,913) | | $ 127,483 |
| Exercise of options and issuance of shares of Employee Stock Purchase Plan (ESPP) | 132 | | 1,940 | | | | | | 1,940 |
| Share-based compensation | | | 13 | (13) | | | | | - |
| Reversal of share-based compensation related to forfeiture of stock options previously granted | | | (81) | 81 | | | | | - |
| Share-based compensation | | | | 382 | | | | | 382 |
| Purchase of treasury stock | (21) | | | | | (571) | | | (571) |
| Release of treasury shares to employees under ESPP | 20 | | | | | 532 | (130) | | 402 |
| Comprehensive income (loss), net of tax | | | | | | | | | |
| Foreign currency translation adjustments | | | | | (1,706) | | | (1,706) | (1,706) |
| Unrealized gain from available for sale marketable | | | | | 55 | | | 55 | 55 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| securities | | | | | | | | | |
| Net income | | | | | | | 84 | 84 | 84 |
| Total comprehensive (loss): | | | | | | | | (1,567) | |
| Balance at December 31, 2005 | 29,301 | 680 | 163,899 | - | 10,847 | (1,398) | (45,959) | | 128,069 |
| Exercise of options and issuance of shares of ESPP | 57 | | 560 | | | | | | 560 |
| Share-based compensation | | | 599 | | | | | | 599 |
| Purchase of treasury shares | (12) | | | | | (196) | | | (196) |
| Release of treasury shares to employees under ESPP | 12 | | | | | 206 | (35) | | 171 |
| Comprehensive income (loss), net of tax | | | | | | | | | |
| Foreign currency translation adjustments | | | | | 3,281 | | | 3,281 | 3,281 |
| Unrealized gain from available for sale marketable securities | | | | | (22) | | | (22) | (22) |
| Net (loss) | | | | | - | | (82,679) | (82,679) | (82,679) |
| Total comprehensive (loss): | | | | | | | | (79,420) | |
| Balance at December 31, 2006 | 29,358 | 680 | 165,058 | - | 14,106 | (1,388) | (128,673) | | 49,783 |
| Release of treasury shares to employees under ESPP | 1 | | | | | 27 | | | 27 |
| Cumulative effect adjustment upon adoption of FIN 48 | | | | | | | (1,178) | | (1,178) |
| Exercise of options and issuance of | 49 | | 183 | | | | | | 183 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| shares of ESPP | | | | | | | | |
| Issuance of shares and warrants to Sun, net | 6,788 | | 39,189 | | | | | 39,189 |
| Exercise of Sun warrants | 3,000 | | 17,100 | | | | | 17,100 |
| Share-based compensation | | | 284 | | | | | 284 |
| Comprehensive income (loss), net of tax | | | | | | | | |
| Foreign currency translation adjustments | | | | | 13,597 | | 13,597 | 13,597 |
| Unrealized gain from available for sale marketable securities | | | | | 11 | | 11 | 11 |
| Reclassification of unrealized gains from marketable securties to earnings | | | | | (94) | | (94) | (94) |
| Net income | | | | | | 34,336 | 34,336 | 34,336 |
| Total comprehensive income: | | | | | | | $ 47,850 | |
| Balance at December 31, 2007 | 39,196 | $ 680 | $ 221,814 | $ - | $ 27,620 | $ (1,361) | $ (95,515) | $ 153,238 |

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS
U.S. dollars in thousands

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Cash flows from operating activities: | | | |
| Net income (loss) | $ 34,336 | $ (82,679) | $ 84 |
| Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization | 22,614 | 25,112 | 24,011 |
| Change in deferred charges and other assets | 244 | 842 | 757 |
| Impairment of long-lived assets | 170 | 53,785 | - |
| Share-based compensation expense | 284 | 599 | 382 |
| Accrued severance pay and other long-term liabilities, net | (1,492) | (527) | 1,156 |
| (Gain) loss on sale of long-lived assets | (3,727) | 1,641 | 36 |
| Realized gain on sale of marketable securities | (94) | - | - |
| (Increase) decrease in fair value of derivative instruments | (6,948) | (4,638) | 2,871 |
| Effect of exchange differences on inter-company balances | 7,259 | (60) | 791 |
| Increase (decrease) in long-term debt due to currency fluctuation | 7,714 | 4,967 | (2,469) |
| Deferred income taxes, net | 2,197 | (3,231) | (884) |
| Class action liabilities, net | - | 3,000 | - |
| (Increase) decrease in trade receivables, net | (29,626) | (3,794) | 15,924 |
| Decrease in short-term other receivables, prepaid expenses and other | 730 | 3,533 | 39 |
| Decrease (increase) in long-term other receivables, prepaid expenses and other | 2,125 | (426) | (2,506) |
| Decrease (increase) in interest receivable | - | 588 | (217) |
| (Increase) decrease in inventories, net | (7,430) | 3,923 | 5,554 |
| Increase (decrease) in trade payables | 882 | (3,664) | 397 |
| Decrease in other accounts payable and accrued expenses | (28,361) | (23,959) | (28,036) |
| Increase (decrease) in income tax payable | 275 | 229 | (510) |
| Net cash provided by (used in) operating activities | 1,152 | (24,759) | 17,380 |

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS
U.S. dollars in thousands

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Cash flows from investing activities: | | | |
| Purchase of property, plant and equipment and capitalization of related direct incremental costs | (5,984) | (21,913) | (47,317) |
| Proceeds (repayments) from restricted short-term bank deposits | - | 6,326 | (22) |
| Investment in other intangible assets | (229) | (301) | (2,479) |
| Proceeds from long-term deposits and other assets | - | 14,000 | - |
| Investment in marketable securities | - | - | (17,762) |
| Proceeds from sale of marketable securities | 125 | - | 31,060 |
| Proceeds from sale of long-lived assets | 10,151 | 272 | 298 |
| Net cash provided by (used) in investing activities | 4,063 | (1,616) | (36,222) |
| | | | |
| Cash flows from financing activities: | | | |
| Proceeds from issuance of shares | 56,499 | 731 | 2,342 |
| (Repayments) proceeds of short-term bank debt, net | (6,388) | (1,996) | 9,472 |
| Proceeds from long-term debt and capital leases | - | - | 25,408 |
| Purchase of treasury shares related to ESPP | - | (196) | (571) |
| Repayment of long-term debt | (26,373) | (26,700) | (24,794) |
| Repayment of other intangible assets purchased in prior years | - | (2,200) | (5,450) |
| Net cash provided by (used in) financing activities | 23,738 | (30,361) | 6,407 |
| Effect of exchange rate changes on cash and cash equivalents | 94 | 48 | (67) |
| Increase (decrease) in cash and cash equivalents | 29,047 | (56,688) | (12,502) |
| Cash and cash equivalents at the beginning of the year | 16,140 | 72,828 | 85,330 |
| Cash and cash equivalents at the end of the year | $ 45,187 | $ 16,140 | $ 72,828 |
| | | | |
| Supplemental disclosure of cash flow transactions: | | | |
| Cash paid during the year for: | | | |
| Interest | $ 14,793 | $ 12,989 | $ 8,716 |
| Income taxes | $ 3,644 | $ 3,465 | $ 4,342 |

| | | | |
|---|---|---|---|
| (a) Non-cash investing and financing transactions: | | | |
| Purchase of property, plant and equipment on credit | $ 317 | $ 1,582 | $ 3,339 |
| Investment in intangible assets on credit | $ 14 | $ - | $ - |

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements
U.S. dollars in thousands (except share and per share data)

NOTE 1: — GENERAL

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

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

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

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

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

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

listing the Canadian facility as a manufacturing location of finished dosage forms may not be approved. However, one new product made at the Company's Canadian facility was approved by the FDA in May 2009 after the issuance of the Warning Letter. Other Federal agencies take the Warning Letter into account when considering the awards of contracts and in some cases may have the right to terminate any agreement they have with us or remove products from their pricing schedule as one agency has done. A formal cGMP re-inspection was conducted by the FDA in February 2011 to evaluate the effectiveness of corrective actions undertaken by Taro. The FDA informed the Company on April 19, 2011 that the site has an acceptable regulatory status. Therefore, the issues noted in the February 5, 2009 warning letter are considered to be resolved. This has not had a material impact on the Company's financial condition.

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

b. The Company successfully addressed its past liquidity issues by implementing initiatives to improve revenues and cash collections. During 2006, our cash flows were negatively impacted by operating losses, capital expenditures and a reduction in wholesaler inventory. During the year ended December 31, 2007, the Company's cash on hand increased by $29,047 from $16,140 to $45,187 primarily due to $56,499 of equity issuances, net of issuance costs, and $10,151 of long-lived asset sales offset by $32,761 of debt repayments and $5,982 of capital investments. During the quarter ended March 31, 2010, consolidated cash on hand increased to approximately $125,500, primarily due to higher operating cash flows from increased sales volumes and cash management activities. During the quarter ended March 31, 2010, debt decreased to $160,500, primarily due to scheduled principal payments. As of March 31, 2010, $100,200 of the Company's total debt is callable on-demand due to covenant violations. Consolidated cash at March 31, 2010 exceeds callable debt by approximately $25,300. In addition, the Company is current with all of its debt service payments. As a result of the Company's cash position at March 31, 2010 and the expected cash flows from operations, the Company has the ability to continue as a going concern for the foreseeable future.

c. On May 18, 2007, the Company, Alkaloida Chemical Company Exclusive Group Ltd. ("Alkaloida"), a subsidiary of Sun Pharmaceutical Industries Ltd. (together with its affiliates "Sun") (Reuters: SUN.BO, Bloomberg: SUNP IN, NSE: SUNPHARMA, BSE: 524715) and Aditya Acquisition Company Ltd. ("Aditya") entered into a merger agreement (the "Merger Agreement"). In addition, Taro entered into a Share Purchase Agreement with Alkaloida, pursuant to which Taro issued Alkaloida 6,787,500 ordinary shares at $6.00 per share, for a total of $40,725 (the "Share Purchase Agreement"). Under the terms of the Share Purchase Agreement, Sun also received a three-year warrant to purchase additional ordinary shares at $6.00 per share. On August 2, 2007, Sun exercised a portion of its warrant in favor of Alkaloida, as assignee, and purchased 3,000,000 additional shares at an exercise price of $6.00 per share, or $18,000. This additional investment, together with its original purchase of Taro's newly issued shares, brought Sun's investment in Taro to $58,725. Taro paid $2,436 in stock issuance costs and therefore retained $56,289 of the proceeds. The net proceeds were recorded within shareholders' equity on the consolidated balance sheet in accordance with FASB ASC Subtopic 815-40, "Derivatives and Hedging - Contracts in Entity's Own Equity", as the Company did not meet the criteria of a derivative under FASB ASC Section 815-40-30, "Derivatives and Hedging - Contracts in Entity's Own Equity – Initial Measurement".

On May 28, 2008, the Company terminated the Merger Agreement. On the same day, the Company and its directors, other than the members of the Levitt and Moros families (the "Independent Directors"), brought a lawsuit against Sun and its affiliates in the Tel-Aviv District Court (the "District Court") seeking a declaratory judgment that, under the Israeli Companies Law, a "Special Tender Offer" was required. On June 25, 2008, Sun gave notice that it was exercising its option under the May 18, 2007 option agreement entered into by Sun, with Dr. Barrie Levitt, Dr. Daniel Moros, Ms. Tal Levitt, Dr. Jacob Levitt and Taro Development Corporation ("TDC") (the "Option Agreement"). Pursuant to the Option Agreement, Sun was granted the option to acquire certain ordinary shares owned by Dr. Barrie Levitt, Dr. Moros, Ms. Levitt, and TDC for $7.75 per share, as well as all of the founders' shares, which represented one third

of the voting power of all of the Company's shares, for no consideration (the "Options"). A condition to the exercise of the Options required Sun to commence a tender offer to purchase any and all ordinary shares owned by all other shareholders for $7.75 per share. According to the terms of the Option Agreement, the transactions contemplated would be consummated contemporaneously with the expiration of the tender offer.

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

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

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

On September 21, 2010, the Company announced that the controlling shareholders of the Company, the Levitt and Moros families (together with their affiliated entities, the “Levitt/Moros Shareholders”), executed a letter agreement (the “Letter Agreement”) on September 20, 2010 with Sun. Pursuant to the Letter Agreement, the Levitt/Moros Shareholders transferred certain beneficial interests in the Company, including the beneficial ownership of the founders’ shares of Taro, to Sun in accordance with the Option Agreement.

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

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

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

On January 18, 2011, Alkaloida acquired 712,500 ordinary shares of Taro pursuant to a certain Warrant No. 2 dated August 1, 2007 issued by the Company to Sun Pharma (the "Warrant"). Additionally, Alkaloida acquired 712,500 ordinary shares of the Company available pursuant to a certain Share Purchase Agreement dated May 18, 2007 between Alkaloida and the Company (the "SPA"). As a result of the exercise of the Warrant and the purchase of shares by Alkaloida pursuant to the SPA, the Company's issued and outstanding ordinary shares are 44,505,457 and

Sun Pharma owns, or controls, 29,497,933, or 66.3%, of the Company's ordinary shares, and with the Company's founders' shares, 77.3% of the vote attributable to the share equity of the Company.

d. In July 2004, Taro U.S.A. entered into a license agreement with Medicis Pharmaceutical Corporation ("Medicis") for four product lines used in the treatment of skin disorders, including the Lustra® product line and two previously unmarketed products in the United States, Canada and Puerto Rico. The entire purchase price of $35,565 was treated as a product rights purchase and therefore, was recorded on the balance sheet under the line item "other intangible assets and deferred charges, net." The Company allocated $23,165 for the Lustra® product family. Lustra® and Lustra-AF® were marketed by Medicis for a number of years. One of the previously unmarketed products, from the Lustra® product family, was subsequently launched by Taro under the name Lustra-Ultra™. Taro allocated $12,400 for the second previously unmarketed product, which was subsequently launched by Taro under the name U-Kera™. During 2006, the Company recorded an impairment charge of $10,023, to write off the remaining carrying value of the U-Kera™ intangible asset and recorded an impairment charge of $13,236 to reduce the carrying value of the Lustra® intangible asset to $6,298. These charges were the result of competitive market pressures and were recorded in cost of sales. The impairments were determined by conducting valuation studies and employing a discounted cash flow analysis. The remaining carrying value is being amortized to cost of sales over the weighted-average life of the product rights. See Note 2.k.

As part of the agreement, the Company received $20,000 from Medicis, which the Company estimated was its returns exposure for these products, and with which the Company established a reserve. This return reserve is presented together with the reserve for returns in current liabilities. The Company also agreed to accept expired returned goods in the future, even though the product returned may not have been sold by Taro. The reserve was established anticipating that customers will deduct, from their cash payments to the Company, the price that they originally paid to Medicis for the goods being returned. This reserve is being utilized for the return exposure related to the acquired products. During 2006, $8,300 of the reserve was recorded as income based on a determination that the reserve exceeded the requirements for such returns as a result of the near-term expiration of the customer right of return.

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

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

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

In June 2006, the Company and Alterna signed an amendment to the above agreements. Pursuant to the terms of the amendment Alterna exercised its option to purchase the full rights to the Kerasal® products and settled all outstanding balances with the Company for products shipped under the manufacturing and supply arrangement in consideration for a cash payment of $12,000. According to the amendment, the Company will continue to manufacture and supply the products to Alterna. Consistent with its original accounting treatment, the Company has concluded that all of the deliverables under the amendment should be considered as one unit of accounting, therefore the consideration is being amortized over the remaining term of the agreement. As of December 31, 2007, the current and non-current portions of deferred revenue related to this agreement were $1,176 and $0, respectively, which were recorded in other current liabilities and other long-term liabilities, respectively. As of December 31, 2006, the current and non-current portions of deferred revenue related to this agreement were $7,055 and $1,176, respectively, which were recorded in other current liabilities and other long-term liabilities, respectively. Subsequently, Alterna discontinued purchasing the ElixSure® products. However, Alterna has continued to purchase Kerasal® in limited quantities.

The Company determined that Alterna is a Variable Interest Entity ("VIE") in accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 46 (Revised December 2003), "Consolidation of Variable Interest Entities." However, the Company has concluded that it is not the primary beneficiary of the VIE, therefore Alterna has not been consolidated into the Company's results of operations. The Company concluded that the amendment to the agreements in June 2006 should not change this conclusion, primarily since the Company does not have exposure to losses from its involvement with Alterna.

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

The Company used the market approach in determining the fair value of the group of assets. The Company recorded an impairment charge, in operating expenses, aggregating $27,023, resulting in a remaining book value of approximately $14,900. In addition, the Company recorded approximately $900 of loss on purchase commitments of $3,945 due to the decline in value of additional equipment that the Company committed to purchase at December 31, 2006. Subsequent to the balance sheet date, in November 2009, the Company's Irish subsidiary sold pieces of that equipment for $1,485 net of transaction costs.

During 2010, the Company announced the closure of the manufacturing facility in Ireland. The Company expects to dispose of the facility by selling it as soon as practical. The Company is currently analyzing the impact of that event on subsequent years' financial statements and any possible additional impairment that may be required in future years.

NOTE 2: — SIGNIFICANT ACCOUNTING POLICIES

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

a. Use of estimates:

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

The Company's most critical estimates are used in its determination of its sales incentives reserves. See Note 4 for details.

b. Financial statements in U.S. dollars:

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

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

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

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries. Inter-company transactions and balances have been eliminated in consolidation. A private corporation, TDC, owns 50% of the shares that have voting rights in Taro U.S.A., with the Company owning the other 50%. In 1993, TDC signed an agreement with the Company to assign its voting rights in Taro U.S.A. in all elections of directors of Taro U.S.A. as the Company may designate. TDC may terminate the agreement upon one year written notice. As of December 31, 2007, no such notice of termination has been provided. TDC is a minority shareholder in the Company by way of owning 3.1% of Taro U.S.A. shares that have economic rights. Since losses applicable to TDC exceed its interest in Taro U.S.A. equity, such excess and any further losses applicable to TDC are charged against the Company as TDC has no obligation to fund such losses.

d. Cash and cash equivalents:

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

e. Marketable securities:

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

f. Allowance for doubtful accounts:

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements
U.S. dollars in thousands (except share and per share data)

g. Inventories:

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

Raw and packaging materials – average cost basis.

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

Purchased products for commercial purposes – average cost basis.

The amounts of inventory reserves recorded as cost of sales were $2,403, $4,859, and $1,839, for the years ended December 31, 2007, 2006 and 2005, respectively.

h. Property, plant and equipment:

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

2. Interest costs are capitalized in accordance with SFAS No. 34, “Capitalization of Interest Cost”.

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

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

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

4. The Group accounts for costs of computer software developed or obtained for internal use in accordance with Statement of Position (“SOP”) No. 98-1, “Accounting for the Costs of Computer Software Developed or Obtained for Internal Use,” (“SOP No. 98-1”). SOP No. 98-1 requires the capitalization of certain costs incurred in connection with developing or obtaining internal use software during the application development stage. During the years 2007 and

2006, the Group capitalized $56 and $49 of software costs, respectively. Software costs are amortized by the straight-line method over their estimated useful life of three years.

5. On February 7, 2007, the Company, in an effort to improve liquidity, sold a car park adjacent to its Irish facility for $4,050, net of transaction costs and recorded in 2007 a pre-tax gain on this transaction of $3,721. This asset was included in property plant and equipment at December 31, 2006, as the criteria to classify this land as available-for-sale were met after the balance sheet date.

i. Lease of land from Israel Land Administration:

The Company leases land from the Israel Land Administration ("ILA"), which is accounted for pursuant to SFAS 13, as amended by SFAS 98. Taro leases several parcels from the ILA. The lease period of the industrial parcel ends between 2010 and 2058. The Company has the right to extend each of the lease agreements for an additional period of 49 years. The ILA lease agreements are standard agreements covering substantial portions of the land of Israel. The standard agreements call for a Lease Period of 49 years, with an option for one additional Lease Period (i.e., total of 98 years). The ownership over the land is not transferred at the end of the lease period and there is no option to buy the land at the end of such period. The expectation, based on practice and accumulated experience is that the renewal price would be substantially below fair market value. Since such leases do not qualify as a capital lease, they are being accounted for as operating leases. The prepaid lease amount is included in long-term receivables and other assets and amortized over the term of the lease.

j. Goodwill:

The Company follows the provisions of Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). Goodwill is not amortized, but rather is subject to an annual impairment test (or more frequently if impairment indicators arise).

SFAS 142 prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment; while the second phase (if necessary) measures impairment.

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

The Company operates in one operating segment, and this segment comprises its only reporting unit. Fair value of the reporting unit is determined using market capitalization. The Company performs its annual impairment test during the fourth fiscal quarter of each year. As of December 31, 2007 and 2006, no impairment loss had been identified.

k. Impairment of long-lived assets, intangible assets and deferred charges:

Intangible assets and deferred charges:

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

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

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

Impairment of long-lived assets:

The Group's long-lived assets, excluding goodwill, are reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets," ("SFAS 144") whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment exists when the carrying amount of the asset exceeds the aggregate future undiscounted cash flows expected to be generated by the asset. The impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the asset. In the year ended December 31, 2006, the Company recorded, in operating expenses, a $27,923 impairment loss primarily related to the fixed assets in its Irish facility. In the year ended December 31, 2006, the Company also recorded impairment charges of $25,862 in cost of sales, which is mainly comprised of a $23,259 impairment loss, primarily for its product rights for Lustra® and U-Kera and a $2,531 impairment loss related to one of its warehouses and certain equipment in Canada. No impairment loss was recorded on these assets in the year ended December 31, 2007. See also Notes 1.d and 1.e.

l. Treasury shares:

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

From time to time the Company reissues treasury shares under the stock purchase plan, upon exercise of options and upon vesting of restricted stock units. When treasury stock is reissued, the Company accounts for the re-issuance in accordance with Accounting Principles Board Opinion ("APB") No. 6, "Status of Accounting Research Bulletins" and charges the excess of the purchase cost, including related stock-based compensation expenses, over the re-issuance price (loss) to retained earnings. The purchase cost is calculated based on the specific identification method.

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

m. Revenue recognition:

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

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

require significant judgment, of chargebacks, product returns, rebates, cash discounts and other sales deductions.

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

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

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

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

Reserves for returns, Medicaid and indirect rebates are included in current liabilities. All other sales deductions allowances are recorded as accounts receivable reserves. The reserve for returns is included in current liabilities as substantially all of these returns will not be realized until after the year-end accounts receivable balances are settled. Medicaid and indirect rebates are included in current liabilities because the Company does not have direct customer relationships with any of the payees. See Notes 4 and 11 for more details.

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

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

n. Research and development:

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

o. Royalty-bearing grants:

Royalty-bearing grants from the government of Israel through the Office of the Chief Scientist for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the related costs incurred. The Company earned grants in the amounts of ($309), $430 and $559 during 2007, 2006 and 2005, respectively. Such grants are included as deductions from research and development costs.

p. Advertising expenses:

The Group expenses advertising costs as incurred. Product samples are recorded within prepaid expense on the consolidated balance sheet and recorded within advertising expenses when provided to potential customers. Advertising expenses were approximately $6,473, $11,741, and $20,836 for the years ended December 31, 2007, 2006 and 2005, respectively.

q. Income taxes:

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

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Effective January 1, 2007, the Company adopted FASB Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes – an Interpretation of FAS 109" ("FIN 48"), which was issued in June 2006. FIN 48 clarifies the accounting for uncertainty in income taxes, and prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company's accounting policy, pursuant to the adoption of FIN 48, is to classify interest and penalties recognized in the financial statements relating to uncertain tax positions as income tax expense. See Note 16. The following table presents the impact at January 1, 2007 on the consolidated balance sheet as a result of implementing FIN 48:

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

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

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

s. Basic and diluted net income (loss) per share:

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

The total weighted-average number of options excluded from the calculations of diluted net earnings per share, as a result of their anti-dilutive effect, was 1,126,528, 1,578,387, and 1,504,479 for the years ended December 31, 2007, 2006 and 2005, respectively.

t. Freight and distribution costs:

In accordance with EITF 00-10, "Accounting for Shipping and Handling Fees and Costs," the Company's accounting policy is to classify shipping and handling costs as a part of sales and marketing expense. Freight and distribution costs and distribution warehousing costs related to shipping and handling to customers, primarily through the use of common carriers or external distribution services amounted to $9,436, $9,090, and $9,454 for the years ended December 31, 2007, 2006 and 2005, respectively.

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u. Accounting for stock-based compensation:

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), “Share-Based Payment” (“SFAS No. 123(R)”), which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors. SFAS No. 123(R) supersedes APB No. 25, “Accounting for Stock Issued to Employees” (“APB No. 25”), for periods beginning in fiscal year 2006. In March 2005, the Securities and Exchange Commission (“SEC”) issued SAB No. 107 (“SAB 107”) relating to SFAS No. 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS No. 123(R). SFAS No. 123(R) requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company’s consolidated income statement.

The Company adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard starting from January 1, 2006, the first day of the Company’s fiscal year 2006. Under that transition method, compensation cost recognized in the year ended December 31, 2006, includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Results for prior periods have not been restated. The Company selected the Black-Scholes option pricing model as the most appropriate fair value method for its stock option awards and values restricted stock based on the market value of the underlying shares at the date of grant.

The Company recognizes compensation expense for the value of its awards granted subsequent to January 1, 2006, based on the straight-line method over the requisite service period of each of the awards, net of estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures. For awards granted prior to January 1, 2006, the Company recognizes compensation expense based on the straight line-method over the requisite service period of each of the awards. Forfeitures were previously accounted for as they occurred, but have been estimated with the adoption of SFAS No. 123(R) for those awards not yet vested. Upon the adoption of SFAS No. 123(R) the expected life of the option is estimated using the “simplified” method as provided in SAB 107. Under this method, the expected life equals arithmetic average of the vesting term and the original contractual term of the option.

Prior to 2006, the Company elected to follow APB No. 25 and FASB Interpretation No. 44 “Accounting for Certain Transactions Involving Stock Compensation” (“FIN 44”), in accounting for its employees’ stock options plans. According to APB No. 25, compensation expense is measured under the intrinsic value method, whereby compensation expense is equal to the excess, if any, of the quoted market price of the stock over the exercise price of the option at the grant date of the award.

Prior to the adoption of SFAS No.123(R), pro-forma information regarding the Company’s net income and net earnings per share is required by SFAS No.123(R) and has been determined as if the Company had accounted for its employee stock option plans under the fair value method prescribed by SFAS No.123(R).

As a result of adopting SFAS No. 123(R) on January 1, 2006, the Company's operating income, income before income taxes, and net income for year ended December 31, 2006, were $599 lower than if the Company had continued to account for stock-based compensation under APB No. 25. Basic and diluted net loss per share for year ended December 31, 2006, were $0.02 lower than if the Company had continued to account for stock-based compensation under APB No. 25.

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Stock Options: The fair value of options granted under the Stock Incentive Plan in 2007, 2006 and 2005 is amortized over their vesting period on a straight-line basis and estimated at the date of grant using a Black-Scholes options pricing model with the following weighted-average assumptions:

| | 2007 | | 2006 | | 2005 | |
|---|---|---|---|---|---|---|
| Dividend yield | 0 | % | 0 | % | 0 | % |
| Expected volatility | 53.1 | % | 58.5 | % | 60.0 | % |
| Risk-free interest rate | 4.7 | % | 4.4 | % | 4.2 | % |
| Expected life of up to | 6.9 years | | 6.9 years | | 6.9 years | |

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

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

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

The following table illustrates the effect on net loss and net loss per share for the year ended December 31, 2005, assuming that the Company had applied the fair value recognition provision of SFAS 123(R) on its stock-based employee compensation:

| | December 31, 2005 |
|---|---|
| Net income - as reported | $ 84 |
| Add – stock-based compensation expense recorded in reported net income | 382 |
| Less - total stock-based compensation expenses under fair value method | 14,608 |
| Net (loss) - pro-forma | $ (14,142) |
| Earnings per share: | |
| Basic and diluted net income per ordinary share - as reported(*) | $ 0.00 |
| Basic and diluted net (loss) per ordinary share - pro-forma | $ (0.48) |

(*) Amount is less than $0.01.

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

v. Concentrations of credit risk:

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

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The Group's trade accounts receivables are mainly derived from sales to customers in the United States, Canada, Europe and Israel. At December 31, 2007, three different wholesale customers in the United States represented approximately 16.0%, 14.7% and 12.2% of the trade accounts receivable, net. The Group has adopted credit policies and standards intended to mitigate inherent risk while accommodating sales growth. The Group performs ongoing credit evaluations of its customers' financial condition when deemed necessary, but does not generally require collateral for its customers' accounts receivable.

w. Fair value of financial instruments:

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

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

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

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

x. Accounting for derivatives:

SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" requires companies to recognize all of their derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes (i.e., gains or losses) in the fair value of a derivative instrument depends on whether the instrument has been designated and qualifies as part of a hedging relationship and on the type of hedging relationship. For derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation. The designation is based upon the nature of the exposure being hedged. At December 31, 2007 and 2006, no derivative instruments were designated as hedging instruments.

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

y. Impact of recently issued accounting standards:

In September 2006, the FASB issued SFAS No. 157, ''Fair Value Measurements,'' ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The adoption of SFAS 157 will not have a material impact on the Company's consolidated financial position and results of operations.

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In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," ("SFAS 159"). SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for the Company as of the beginning of the first fiscal year that begins after November 15, 2007. The Company believes that the adoption of SFAS 159 will not have a material impact on the Company's consolidated financial statements.

In June 2007, the FASB ratified EITF Issue 07-3, "Accounting for Advance Payments for Goods or Services to Be Used in Future Research and Development Activities" ("EITF 07-3"). EITF 07-3 provides guidance on the capitalization of non-refundable advance payments for goods and services to be used in future research and development activities, until such goods have been delivered or the related services have been performed. This issue will be effective for the Company for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. The Company believes that the adoption of EITF 07-3 will not have a material impact on the Company's consolidated financial statements.

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

In December 2007, the FASB issued SFAS No. 141 (revised 2007) "Business Combinations" ("SFAS 141R"). SFAS 141R will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. Key changes include: acquired in-process research and development will no longer be expensed on acquisition, but capitalized and amortized over its useful life; fair value will be based on market participant assumptions; acquisition costs will generally be expensed as incurred; and restructuring costs will generally be expensed in periods after the acquisition date. Early adoption is not permitted. This statement will be effective for us as of the year beginning January 1, 2009. The impact of the adoption of SFAS 141R on the Company's consolidated financial statements would depend on the nature, terms and magnitude of acquisitions it may consummate in the future.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51," ("SFAS No. 160"). SFAS No. 160 establishes accounting and reporting standards for non-controlling interests in a subsidiary and deconsolidation of a subsidiary. Early adoption is not permitted. These statements will be effective for us as of the year beginning January 1, 2009. The Company believes that the adoption of SFAS 160 will not have a material impact on the Company's consolidated financial statements.

In December 2007, the SEC issued SAB No. 110 ("SAB 110") relating to the use of a "simplified" method in developing an estimate of the expected term of "plain vanilla" share options. SAB 107 previously allowed the use of the simplified

method until December 31, 2007. SAB 110 allows, under certain circumstances, the continuation of the use of the simplified method beyond December 31, 2007. Effective January 1, 2008, the Company believes that the adoption of SAB 110 will not have a material impact on its consolidated financial statements.

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

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

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

In June 2009, the FASB issued SFAS No. 167, "Amendments to FASB Interpretation No. 46 (R)" ("SFAS 167"), which amends existing accounting rules for consolidation of variable interest entities. Under SFAS 167, the primary beneficiary of a variable interest entity is determined by a qualitative rather than a quantitative test previously required under FIN 46 (R). In addition, SFAS 167 requires an ongoing assessment of whether an entity is a primary beneficiary of a variable interest entity, and additional disclosure. SFAS 167 is effective at the beginning of the first annual reporting period that begins after November 15, 2009. SFAS 167 will not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

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

In October 2009, the FASB issued Accounting Standard Update ("ASU") No. 2009-13, "Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements" ("ASU 2009-13"). ASU 2009-13 revises the current model for recording revenue from multiple element arrangements and expands disclosure requirements. This standard requires entities to allocate revenue in an arrangement at inception using estimated selling prices of the delivered goods and

services based on a selling price hierarchy. The amendments eliminate the residual method of revenue allocation and require revenue to be allocated using the relative selling price method. ASU 2009-13 will be effective for arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. The Company does not expect adoption of ASU 2009-13 to have a material impact on the results of operations or financial condition.

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

In December 2010, the FASB also issued ASU No. 2010-28, "Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)." Under this standard, if the carrying amount of a reporting unit is zero or negative, an entity must assess whether it is more likely than not that goodwill impairment exists. To make that determination, an entity should consider whether there are adverse qualitative factors that could impact the amount of goodwill, including those listed in ASC 350-20-35-30. As a result of the new guidance, an entity can no longer assert that a reporting unit is not required to perform the second step of the goodwill impairment test because the carrying amount of the reporting unit is zero or negative, despite the existence of qualitative factors that indicate goodwill is more likely than not impaired. The equity or enterprise valuation premise can be used to determine the carrying amount of a reporting unit. ASU 2010-28 is effective for public entities for fiscal years, and for interim periods within those years, beginning after December 15, 2010, with early adoption prohibited. The Company's goodwill test does not currently have a zero or negative carrying amount where this standard would apply.

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NOTE 3: — ACCOUNTS RECEIVABLE

a. Trade, net:

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

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Trade accounts receivable, gross | $ 117,557 | $ 118,459 |
| | | |
| Reserves for sales deductions: | | |
| Chargebacks | (18,525 ) | (40,211 ) |
| Customer rebates | (12,421 ) | (19,628 ) |
| Other sales deductions | (15,853 ) | (17,005 ) |
| Allowance for doubtful accounts | (741 ) | (2,159 ) |
| Trade accounts receivable, net | $ 70,017 | $ 39,456 |

b. Other receivables, prepaid expenses and other:

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Prepaid expenses | $ 5,804 | $ 7,560 |
| Deferred income taxes | 3,221 | 4,735 |
| Government authorities | 3,207 | 1,433 |
| Advanced to suppliers | 551 | 843 |
| Derivative instruments | 12,953 | 497 |
| Office of the Chief Scientist | 269 | 279 |
| Employees | 17 | 21 |
| Other | 238 | 325 |
| | $ 26,260 | $ 15,693 |

NOTE 4: — SALES INCENTIVES

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

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

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

Product returns:

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

The Company's product returns reserve at December 31, 2007 and related statement of operations impact for the year ended December 31, 2007, also considered actual product returns experienced subsequent to December 31, 2007 to validate the product returns reserve estimate based on the methodology described above.

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

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Chargebacks:

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

Rebates and other deductions:

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

The Company establishes reserves for rebates and these other various sales deductions based on contractual terms and customer purchasing activity, tracking and analysis of rebate programs, processing time lags, the level of inventory in the distribution channel and other relevant information. Based on the Company's historical experience, substantially all claims for rebates and other sales deductions are received within 24 months. Therefore, at December 31, 2007 and for the year ended December 31, 2007, the Company considered subsequent actual claims submitted by its customers in determining the Company's reserves and related statements of operations impact for rebates and other sales deductions.

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

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Use of estimates in reserves:

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

The following table summarizes the activities for sales deductions and product returns for the year ended December 31, 2007:

| | Beginning balance | Provision recorded for current period sales | Credits processed / Payments | Ending balance |
|---|---|---|---|---|
| Accounts Receivable Reserves | | | | |
| Chargebacks | $ (40,211) | $ (170,447) | $ 192,133 | $ (18,525) |
| Rebates and Other | (38,792) | (63,005) | 72,782 | (29,015) |
| Total | $ (79,003) | $ (233,452) | $ 264,915 | $ (47,540) |
| | | | | |
| Current Liabilities | | | | |
| Returns | $ (34,144) | $ (9,243) | $ 18,286 | $ (25,101) |
| Others (1) | $ (23,271) | $ (14,498) | $ 27,213 | $ (10,556) |
| Total | $ (57,415) | $ (23,741) | $ 45,499 | $ (35,657) |

(1) Includes indirect rebates.

NOTE 5: — INVENTORIES

| | December 31, 2007 | 2006 |
|---|---|---|
| Raw and packaging materials | $ 21,292 | $ 15,483 |
| Finished goods | 23,806 | 26,375 |
| Work in progress | 17,162 | 11,892 |
| Purchased products for commercial purposes and other | 4,697 | 3,012 |
| | $ 66,957 | $ 56,762 |

As of December 31, 2007 and 2006, reserves recorded against inventories for slow-moving, short-dated, excess and obsolete inventory totaled $12,435 and $14,287, respectively.

As for pledges, see Note 13.

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NOTE 6: — PROPERTY, PLANT AND EQUIPMENT

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

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Cost: | | |
| Land | $ 12,840 | $ 12,500 |
| Buildings | 163,755 | 157,550 |
| Leasehold improvements | 3,263 | 3,060 |
| Machinery and equipment | 151,878 | 141,583 |
| Computer equipment | 30,901 | 29,478 |
| Motor vehicles | 281 | 281 |
| Furniture, fixtures and office equipment | 8,854 | 8,236 |
| Advances for property and equipment | 290 | 92 |
| | 372,062 | 352,780 |
| Accumulated depreciation and impairment charges: | | |
| Buildings | 42,503 | 35,475 |
| Leasehold improvements | 2,733 | 2,439 |
| Machinery and equipment | 81,417 | 67,065 |
| Computer equipment | 27,543 | 23,051 |
| Motor vehicles | 272 | 236 |
| Furniture, fixtures and office equipment | 5,665 | 4,761 |
| | 160,133 | 133,027 |
| Depreciated cost | $ 211,929 | $ 219,753 |

Depreciation expenses were $19,874, $20,098 and $18,910, for the years ended December 31, 2007, 2006 and 2005, respectively. For related impairment charges, see Note 2.k.

b. Cost of property, plant and equipment includes capitalized interest expenses, capitalized direct incremental costs such as payroll and related expenses and other internal costs incurred in order to bring the assets to their intended use in the amount of $13,147 and $15,941 as of December 31, 2007 and 2006, respectively. Capitalized interest and other costs were $56, $8,670, and $12,199 for the years ended December 31, 2007, 2006 and 2005, respectively.

c. Cost of computer equipment includes capitalized development costs of computer software developed for internal use in the amount of $4,416 and $4,158 as of December 31, 2007 and 2006, respectively.

d. As for pledges – see Note 13.

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NOTE 7: —INTANGIBLE ASSETS AND DEFERRED COSTS

a. Composition:

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Cost: | | |
| Product rights | $ 68,852 | $ 68,245 |
| Deferred charges in respect of loans and bonds from institutional investors | 1,246 | 1,216 |
| Other deferred cost | 1,541 | 1,541 |
| | 71,639 | 71,002 |
| Accumulated amortization and impairment charges: | | |
| Product rights | 42,689 | 39,602 |
| Deferred charges in respect of loans and bonds from institutional investors | 1,144 | 1,031 |
| Other deferred cost | 1,438 | 1,306 |
| | 45,271 | 41,939 |
| Amortized cost | $ 26,368 | $ 29,063 |

b. Amortization expenses related to product rights were $2,740, $5,014, and $5,101, for the years ended December 31, 2007, 2006 and 2005, respectively.

c. As of December 31, 2007, the estimated amortization expense of product rights for 2008 to 2012 is as follows: 2008 - $2,805; 2009 - $2,932; 2010 - $2,789; 2011 - $2,680; and 2012 - $2,518.

d. The weighted-average amortization period for product rights is 14 years.

NOTE 8: — LONG-TERM RECEIVABLES AND OTHER ASSETS

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Prepayment of land leased from Israel Land Administration (1) | $ 15,065 | $ 15,292 |
| Receivable related to class action lawsuit | 7,000 | 7,000 |
| Derivative instruments (2) | 659 | 5,743 |
| Severance pay fund (3) | 3,649 | 2,755 |
| Long-term deposit | 84 | - |
| Other | 119 | 753 |
| | $ 26,576 | $ 31,543 |

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

(2) See Note 9.

(3)

Under Israeli law, the Company and its Israeli subsidiaries are required to make severance or pension payments to dismissed employees and to employees terminating employment under certain other circumstances. Deposits are made with a pension fund or other insurance plans to secure pension and severance rights for the employees in Israel. These amounts represent the balance of the deposits in those funds (including profits) that will be used to cover the Company's severance obligations. See Note 11.b.

The Company's non-Israeli subsidiaries maintain defined contribution retirement savings plans covering substantially all of their employees. Under the plans, contributions are based on specific percentages of pay and are subject to statutory limits. The subsidiaries' matching contribution to the plan was approximately $910, $913 and $956 for the years-ended December 31, 2007, 2006 and 2005, respectively.

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| | December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Pension, retirement savings and severance expenses | $ 3,902 | $ 4,763 | $ 3,688 |

NOTE 9: — DERIVATIVE INSTRUMENTS

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

a. Interest rates:

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

In June 2005, the Company entered into a mortgage agreement for its New Jersey facility. Subsequently, in September 2005, the Company entered into an interest rate swap to mitigate variable mortgage interest rate risk by effectively establishing the mortgage rate at a fixed rate of 4.66%. At December 31, 2007, the fair market value of the swap was a $154 liability, and was recorded in other long-term liabilities on the consolidated balance sheet. At December 31, 2006, the fair market value of the swap was a $137 asset, and was recorded in long-term receivables and other assets on the consolidated balance sheet. The Company recorded an unrealized (loss) gain of ($291), $111 and $26 within financial expenses, net for the years ended December 31, 2007, 2006 and 2005, respectively. This swap matured on November 28, 2008. See Note 12.a.6.

In September 2005, the Company also entered into a mortgage agreement for its New York facility and concurrently entered into an interest rate swap with the intention to mitigate the variable mortgage interest rate risk by effectively establishing the mortgage rate at a fixed rate of 6.16%. At December 31, 2007, the fair market value was a $269 liability, and was recorded in other long-term liabilities on the consolidated balance sheet. At December 31, 2006, the fair market value was a $177 asset, and was recorded in long-term receivables and other assets on the consolidated balance sheet. The Company recorded an unrealized (loss) gain of ($446), $207, and ($30) within financial expenses, net, for the years ended December 31, 2007, 2006 and 2005, respectively. See Note 12.a.6.

b. Currency exchange rates:

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

From July 1999 to November 2000, the Company issued approximately $24 million of CPI + 8.25% bonds denominated in NIS with terms of 10 years. At the same time, the Company entered into 9-10 year cross currency swaps in which the Company receives CPI plus 6% to 8.25% in NIS and pays LIBOR plus 0.6% to 3.3% in USD based on the outstanding amount of the bonds. At December 31, 2007, the fair market value of these swaps was a $1,169 asset and was recorded in other receivables, prepaid expenses and other ($510 short-term portion) and

long-term receivables and other assets ($659 long-term portion). At December 31, 2006, the fair market value of these swaps was a $716 asset and was recorded in other receivables, prepaid expenses and other ($212 short-term portion) and long-term receivables and other assets ($504 long-term portion). For the years ended December 31, 2007, 2006, and 2005, net gains (losses) of approximately $883, $628 and ($972) were recorded within financial expenses, net for these swaps.

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In November 2003, the Company entered into loan agreements to borrow, in Israel, NIS 210.8 million for an eleven-year term at an annual interest rate of 5.8%. At the same time the Company entered into a USD/NIS, 5-year, CPI-adjusted currency swap in which it will receive at the end of the period the NIS amount linked to the CPI plus interest equal to 5.8% of the outstanding NIS balance, and will pay $47,190 USD plus a fixed rate of 5.9%. At December 31, 2007, the fair market value of this swap was a $12,271 asset and was recorded in other receivables, prepaid expenses and other. At December 31, 2006 the fair market value of this swap was a $5,147 asset, and was recorded in other receivables and prepaid expenses ($222 short-term portion) and long-term receivables and other assets ($4,925 long-term portion) on the consolidated balance sheet. The Company recorded net gains of $7,597, $4,101 and $749 within financial expenses, net for the years ended December 31, 2007, 2006 and 2005, respectively. This swap matured on November 28, 2008 and was replaced on the maturity date by a USD/NIS, CPI-adjusted, 6-year currency swap.

NOTE 10: — SHORT-TERM BANK CREDIT AND SHORT-TERM LOANS

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

| | Weighted - average interest rate December 31, | | Amount December 31, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Short-term bank credit and short-term loans: | | | | |
| In, or linked to, U.S. dollars (1) (2) (3) (4) | 6.92 % | 6.92 % | $ 80,841 | $ 91,304 |
| In NIS (5) | 7.07 % | 7.55 % | 10,759 | 11,002 |
| In Canadian dollars (6) (7) | 6.97 % | 6.45 % | 17,392 | 17,020 |
| | | | 108,992 | 119,326 |
| Reclass from long-term debt, included in the above amounts (8) | | | 35,181 | 42,783 |
| Total utilized credit lines and short-term loans | | | $ 73,811 | $ 76,543 |
| Total authorized credit lines and short-term loans | | | $ 76,042 | $ 78,765 |
| Unutilized credit lines | | | $ 2,231 | $ 2,222 |
| Weighted-average interest rates at the end of the year for all loans | 6.94 % | 6.91 % | | |

(1) This amount includes approximately $28,100 of outstanding debt under a $40,000 Taro U.S.A. credit facility at December 31, 2007 and 2006, respectively. This credit facility bears interest at a rate of LIBOR plus 2.75% and is secured by a first lien on Taro U.S.A.’s accounts receivable, inventory and all products and proceeds thereof. Additional borrowings are currently not available under this facility due to covenant defaults. Subsequent to the balance sheet date, the Company amended this credit agreement to extend the maturity date to October 5, 2010.

(2) This amount includes approximately $9,750 and $10,000 of outstanding debt under a $10,000 Taro U.S.A. credit facility at December 31, 2007 and 2006, respectively. The Company entered into a letter agreement with this financial institution as described in Note 12.a.3.

(3) This amount includes approximately $23,800 and $29,327 of outstanding debt under the Company's credit facilities in Israel at December 31, 2007 and 2006, respectively.

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(4) This amount includes approximately $19,191 and $23,877 of long-term debt reclassified as short-term due to covenant defaults at December 31, 2007 and 2006, respectively.

(5) This amount represents outstanding debt under the Company's credit facilities of $6,193 and $4,389 and a reclassification from long-term debt of $4,566 and $6,613 in Israel at December 31, 2007 and 2006, respectively.

(6) This amount includes approximately $5,967 and $4,728 of outstanding debt at December 31, 2007 and 2006, respectively, under a demand revolving line of credit to Taro Pharmaceuticals Inc, the Company's indirect Canadian subsidiary. The amount available under this line of credit was $8,070 and $6,865 at December 31, 2007 and 2006, respectively. This facility is secured by a general security agreement over the Canadian subsidiary's assets other than real property and certain other capital assets. In addition, the agreement provides the lending institution a second lien on real property and other capital assets in Canada, and the United States.

(7) This amount includes approximately $11,424 and $12,292 of long-term debt reclassified as short-term due to covenant defaults at December 31, 2007 and 2006, respectively.

(8) These amounts represent long-term debt classified as short-term debt due to covenant defaults described in Notes 12.a.1, 12.a.3, 12.a.4 and 12.a.6.

NOTE 11: — OTHER LIABILITIES

a. Other current liabilities:

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Returns reserve | $ 25,101 | $ 34,144 |
| Due to customers (1) | 1,626 | 16,327 |
| Employees and payroll accruals | 11,432 | 7,382 |
| Deferred revenue | 1,176 | 7,055 |
| Medicaid and indirect rebates | 5,038 | 6,944 |
| Accrued income taxes | 9,443 | 6,163 |
| Payable to Medicis | - | 5,100 |
| Legal and audit fees | 2,166 | 4,429 |
| Accrued expenses | 7,600 | 4,183 |
| Interest payable | 1,726 | 2,072 |
| Other | 6,895 | 3,584 |
| | $ 72,203 | $ 97,383 |

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

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b. Other long-term liabilities:

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Class action lawsuit | $ 10,000 | $ 10,000 |
| Accrued severance pay | 4,642 | 3,645 |
| Deferred revenue | - | 1,176 |
| Grant from Irish government | 233 | 538 |
| Other | 424 | 76 |
| | $ 15,299 | $ 15,435 |

NOTE 12: — LONG-TERM DEBT

a. Composed as follows:

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Loans from institutional investors and bonds (1) | $ 8,313 | $ 10,296 |
| Loans from institutional investors and bonds (2) | 97,040 | 102,393 |
| Banks (3) | 1,577 | 5,333 |
| Term loan from Canadian bank (4) | 14,451 | 19,308 |
| Mortgage for U.S. distribution facility (5) (6) | 10,450 | 12,650 |
| Mortgage for U.S. office facility (6) | 11,059 | 11,608 |
| | 142,890 | 161,588 |
| Less: current maturities | 31,348 | 28,428 |
| Less: long-term debt reclassified as short-term loans (1, 3, 4, 6) | 35,181 | 42,783 |
| | $ 76,361 | $ 90,377 |

1. In 1999 and 2000, the Company entered into a series of debenture and loan agreements in Israel, secured by a floating charge on substantially all of its property, assets and rights. The debentures were issued in separate tranches during 1999 and 2000 for a term of 10 years, with the last tranche maturing in November 2010; most of the loan balance at December 31, 2007 and 2006 was linked to Israeli CPI plus 8.25%. Under the debentures, Taro provided certain undertakings that, among other things, as long as the loan is outstanding, (i) the ratio between long-term liabilities and shareholders' equity shall not exceed two and the current ratio (defined as current assets divided by current liabilities) shall not be less than one and (ii) the ratio of current assets and liabilities shall not exceed one. Such ratios are based on the Company's audited financial statements. As of December 31, 2007 and 2006, the Company was current with its payment obligations but not in compliance with other covenants. Since the Company was not in compliance with certain covenants as described above and since according to the provisions of the agreements, the lenders have the right to accelerate the obligations after notice and opportunity to cure, the Company has reclassified the long-term portion of its long-term debt to these lenders in the amount of $5,032 and $7,404, to short-term loans at December 31, 2007 and 2006, respectively.

2. In 2003, the Company entered into two series of loan agreements, subsequently amended, with multiple lenders in Israel. Approximately half of the amount of the loans was issued in U.S. dollars at an interest rate of 6.0 – 6.1%,

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

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3. In 2004, in connection with the long and short-term loans provided by four banks, the Company provided each such bank with undertakings including provisions that it would: (i) not pledge any of its current or future assets without the prior written consent of such bank, provided that Taro is allowed to pledge any newly acquired assets to secure financing provided to acquire such assets and to pledge any fixed assets up to an aggregate of $20,000, which includes the pledges in favor of the lenders under the 1999 and 2000 debenture and loan agreements; (ii) not sell or transfer any of the current or future assets of the Company (excluding current assets) without the prior written consent of such lender, provided that the Company is allowed to sell any asset without consent of such lender if the sale proceeds do not exceed 5% of the total assets (based on the audited financial statements) less the current assets and goodwill (based on the audited financial statements); (iii) comply with certain financial covenants, one of which requires that the Company's operating income will exceed 12% of sales, and another which requires that the Company maintain a ratio of debt to EBITDA not to exceed 3.5 over a rolling three-year average, and (iv) comply with certain financial reporting requirements. Excluding the mortgage relating to the distribution facility in New Jersey that is described in (6) below, the loans covered by the foregoing covenants and negative pledge undertakings matured in 2008 and bore interest ranging from LIBOR plus 0.9% to LIBOR plus 2%. As of December 31, 2007, the Company was current with its payment obligations but was not in compliance with the covenants. Since the Company was not in compliance with certain covenants as described above and otherwise set forth in the original loan agreements with these banks, and since according to the agreements, the banks have the right to accelerate their obligations, the Company has reclassified the long-term portion of its long-term debt to these banks. As of December 31, 2006, the Company reclassified long-term loans in the amount of $1,577 as short-term loans. No amounts were reclassified as short-term loans at December 31, 2007.

4. During 2004, Taro Pharmaceuticals Inc., the Company's indirect Canadian subsidiary, refinanced its mortgage payable and its plant expansion term loans with a new term loan. The new term loan is collateralized by a first lien on the Canadian subsidiary's land, buildings and certain manufacturing equipment, a lien covering all other assets, subject to prior liens indicated in Note 10 above, and a subordinated lien on the buildings and land securing the mortgage loans described in (6) below, as well as certain equipment of Taro U.S.A. Taro U.S.A. and two of its subsidiaries have provided guarantees to the lender for the full amount of the loan. The Canadian subsidiary provided undertakings in the relevant loan documentation that include certain (i) financial covenants, requiring the Canadian subsidiary to maintain a maximum ratio of debt to tangible net worth of 1.60:1 and a ratio of current assets to current liabilities of 1.5:1 or more and (ii) financial reporting covenants relating to the Company and certain subsidiaries, including the Canadian subsidiary. Since the Canadian subsidiary was not in compliance with certain covenants as described above, and in accordance with the agreement, the bank has the right to accelerate its obligation. The Company has reclassified the long-term portion of its long-term debt to this bank in the amount of $11,424 and $12,293, as short-term loans at December 31, 2007 and 2006, respectively.

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5. On January 8, 2004, the Company's U.S. subsidiary expanded its distribution capacity with the purchase of a 315,000 square foot distribution center on 25 acres of land in South Brunswick, New Jersey. Taro acquired the facility for $18,433, of which, $13,200 was financed by a mortgage. This facility is subject to depreciation on a straight-line basis over a 40 year period.

6. In 2005, Taro U.S.A. and two of its subsidiaries entered into obligations, secured by mortgages on the Company's U.S. headquarters facility located in New York and distribution facility located in New Jersey. The Company guaranteed these obligations. The Canadian bank described in (4) above has a subordinated security position in the facilities which are the subject of the mortgages. The mortgage on the New York facility was $11,059 and $11,608, as of December 31, 2007 and 2006, respectively, was for an original term of 15 years, bears interest at the rate of LIBOR plus 1.25%, and has a graduating debt service coverage ratio covenant of 1.90, which the Company failed to meet. The interest rate of this mortgage is effectively fixed at 6.16%, as the Company has an interest rate swap in place which is concurrent with the 15-year term of the mortgage. The mortgage on the New Jersey facility, as described in (5) above, was $10,450 and $12,650, as of December 31, 2007 and December 31, 2006, was for an original term of seven years, bearing interest at the rate of LIBOR plus 1.85% and has certain financial and reporting covenants. The interest rate of the mortgage was effectively fixed at 4.66%, as the Company had an interest rate swap in place through November 28, 2008. The mortgage holder is one of the banks with which the Company entered into a letter agreement, with similar covenants, as described in (3) above. On November 28, 2008, the principal amount of this mortgage was increased from $4,743 to $12,992, and the interest rate swap was terminated. Since the Company, with respect to each such mortgage, was not in compliance with certain financial and other covenants and because each lender has the right to accelerate its obligations, the Company has reclassified the long-term portion of each mortgage, in the amount of $18,725 and $21,509, respectively, as short-term loans at December 31, 2007 and 2006, respectively.

As discussed above, part of the undertakings also include financial reporting obligations that have not been met as a result of the delayed filing of the Company's Annual Reports on Form 20-F for the years 2007, 2008 and 2009. The Company is also not in compliance with certain financial, reporting, and administrative covenants. Additionally, most of the Company's debt instruments have cross-default provisions that provide for acceleration of payments in the event of failure to meet payment obligations or a breach or default of covenants included in other agreements. As a result, even though the Company has been current in its payment obligations, the loans, except the one described in Note 12a.2 above, are callable by the lenders until the Company is in compliance with its Form 20-F filing requirements as well as with all covenants. In addition, the covenants and undertakings described above restrict the Company's ability to incur additional debt.

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

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

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| | Weighted Average Interest Rate | | Amount | |
|---|---|---|---|---|
| | December 31, | | December 31, | |
| | 2007 | 2006 | 2007 | 2006 |
| In, or linked to, U.S. dollars | 6.08% | 5.98% | $ 62,882 | $ 81,643 |
| In Canadian dollars | 7.09% | 6.33% | 14,451 | 19,308 |
| In Israeli currency – linked to CPI | 6.08% | 6.17% | 65,557 | 60,637 |
| | | | $ 142,890 | $ 161,588 |

Not included in the CPI-linked loans, are loans in the amount of $47,682 and $62,417 as of December 31, 2007 and 2006, respectively, which are subject to variable interest rates primarily linked to the LIBOR or the Canadian Bankers' Rate. The remaining balance of the Company's outstanding debt is subject to fixed interest rates.

c. The debt matures as follows:

| | December 31, 2007 |
|---|---|
| 2008 | $ 31,348 |
| 2009 | 29,809 |
| 2010 | 28,383 |
| 2011 | 14,648 |
| 2012 | 13,462 |
| Thereafter | 25,240 |
| | $ 142,890 |

As of the date of these financial statements, the Company has met all of its scheduled debt obligations.

For collateral, see Note 13.

NOTE 13: — LIABILITIES COLLATERALIZED BY PLEDGES

Balance of liabilities collateralized by pledges is as follows:

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Short-term bank credit and short-term loans (1) | $ 34,067 | $ 32,841 |
| Long-term debt (including current maturities) (2) | $ 44,274 | $ 53,862 |

(1) Short-term bank credits and short-term loans primarily include $28,100 of debt secured by accounts receivable, inventory and all products and proceeds thereof of Taro U.S.A. at December 31, 2007 and 2006.

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

For further discussion of collateralized assets see Notes 10 and 12.

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NOTE 14: — COMMITMENTS AND CONTINGENT LIABILITIES

a. Companies of the Group have leased offices, warehouse space and equipment under operating leases for periods through 2012. The minimum annual rental payments, under non-cancelable lease agreements, are as follows:

| | December 31, 2007 |
|---|---|
| 2008 | $ 2,183 |
| 2009 | 1,471 |
| 2010 | 975 |
| 2011 | 75 |
| 2012 and thereafter | 39 |
| | $ 4,743 |

Total rent expenses were $3,562, $2,935 and $3,395 for the years ended December 31, 2007, 2006 and 2005, respectively.

b. Royalty commitments:

The Company is committed to pay royalties at the rate of 3% to 5% to the government of Israel through the Office of the Chief Scientist (“OCS”) on proceeds from sales of products in which the government participates in the research and development by way of grants. The obligation to pay these royalties is contingent on actual sales of the products and, in the absence of such sales, no payment is required. The commitment is on a product by product basis, in an amount not exceeding the total of the grants received by the Company, including interest accrued thereon, and is linked to the U.S. dollar. Commencing in 1999, grants are subject to interest at a rate of LIBOR (cost of borrowing funds in U.S. dollars). As of December 31, 2007 and December 31, 2006, the aggregate contingent liability to the OCS was approximately $12,382 and $11,600, respectively.

Royalty payments (refunds) to the OCS were ($309), $340 and $325 for the years ended December 31, 2007, 2006 and 2005, respectively.

c. Legal proceedings:

From time to time the Company is subject to litigation arising in the ordinary course of business. Except for the accruals with respect to the Zwickel case (see Note 14.c.4.iii) and the Israeli taxation cases (see Note 14.c.3), no accruals for any lawsuits, to which the Company is party, are required in the financial statements. Additionally, the Company is party to certain lawsuits disclosed herein, whose outcome the Company does not believe will have a material adverse effect on its consolidated financial statements.

1. Legal actions commenced by the Company:

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

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

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

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

iii. Company's lawsuit related to Ireland:

On June 15, 2008, the Company brought a lawsuit in the District Court seeking a declaratory ruling and permanent injunction against Sun from taking actions to hinder the Company's efforts to sell its Irish operations. This case is pending before the District Court.

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

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

2. Legal actions by certain shareholders:

i. Templeton's lawsuits related to proposed Merger Agreement:

Between May and August 2007, Templeton filed three motions which were all dismissed by the District Court related to the Share Purchase and Merger Agreements. One decision was appealed but then subsequently dismissed on November 15, 2010.

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

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

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

On May 14, 2009, Sun and Alkaloida brought a lawsuit against the Company and its directors at the time in the District Court related to the issuance of audited financial statements for the years 2006 and thereafter. Upon Sun and Alkaloida's motion, the Court dismissed all claims on October 10, 2010.

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

On July 27, 2010, certain affiliates of Sun that hold shares in the Company filed an originating motion against the Company with the Haifa District Court requesting a declaratory ruling related to the Company's engagement of

Guggenheim. Upon Sun's affiliates' motion, the Court dismissed all claims on October 10, 2010.

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3. Litigations related to Israeli taxation:

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

ii. On December 31, 2009, the Company and the ITA reached an agreement related to a tax assessment for the Company's taxes for the years 2002 and 2003. The Company is fully reserved for the amounts agreed to with the ITA and believes that an unfavorable result is more likely than not. See Note 16 for further details.

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4. Other Legal Actions:

i. On November 10, 2004, the Company was sued in the Superior Court of New Jersey in Atlantic County along with other defendants in a purported class action lawsuit for alleged personal injuries related to defendants' sale of amiodarone. On June 9, 2010, the class action case was dismissed with prejudice, with a window of 150 days for individual claimants to file lawsuits. Only one suit was commenced against the Company. In early 2011, an agreement to resolve this matter was reached which will have no material impact on the Company's financial position.

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

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

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d. In 2003, the Company and its Irish subsidiary entered into an agreement with a government agency in Ireland to receive grants for the development and provision of employment for a manufacturing facility in Ireland. The obligation to repay these grants terminated in 2008 and 2009, subject to the continued operation and control by the Company's Irish subsidiary. The grants, or portions thereof, may be revoked if jobs related to the grants remain vacant for a period in excess of six calendar months. As of December 31, 2007 and 2006, the balance of grants received was $233 and $538, respectively, and is included in other long-term liabilities. Subsequent to the balance sheet date, the Company fulfilled all of its obligations under the terms of the grant agreement and earned the full benefit of the grant. This grant was amortized as earned by the Company.

e. Subsequent to the balance sheet date, in November 2009, the Company's Irish subsidiary sold a vial filling line for $1,485, net of transaction costs. For further details see Note 1.f.

NOTE 15: — SHAREHOLDERS' EQUITY

a. Pertinent rights and privileges of ordinary shares:

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

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

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

b. Founders' Shares:

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

c. Stock option plans:

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

The options were granted with an exercise price equal to 100% of the fair market value of the stock on the date of grant. As of December 31, 2007, none of the options granted include stock appreciation rights. The options are granted to employees and associates, have a four-year graded vesting term and generally expire ten years after the date of the grant. Each option entitles its holder the right to purchase one ordinary share. As of December 31, 2007 and 2006, an aggregate of 82,575 and 124,649 options in respect of the 1991 plan were outstanding, respectively, and no further options in respect of the 1991 plan are available for future grants. The Company issues new shares to employees and associates exercising their stock options.

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

The options are substantially granted with an exercise price equal to 100% of the fair market value of the stock on the date of grant and the aggregate amount of the options granted may not exceed 2,100,000. As of December 31, 2007, none of the options granted include stock appreciation rights. The options are granted to employees and associates, have a four to five-year graded vesting term and generally expire ten years after the date of the grant. Each option entitles its holder the right to purchase one ordinary share of NIS 0.0001 par value (subject to adjustments). As of December 31, 2007 and 2006, an aggregate of 1,132,130 and 1,268,480 options in respect of the 1999 plan were outstanding, respectively, and, as of March 10, 2009, no further options in respect of the 1999 plan are available for future grants. The Company issues new shares to employees and directors exercising their stock options.

3. During December 2005, the Company accelerated the vesting period of 1,052,030 options outstanding with a weighted-average exercise price of $35.23, which was higher than the market price at the time of the acceleration, and with remaining vesting periods prior to acceleration from one to five-years. The decision to accelerate the vesting of those options was based primarily upon the issuance of SFAS 123(R) which required the Company to record compensation expense for all unvested stock options effective January 1, 2006. The Company believes that the acceleration of vesting of those options will enable the Company to avoid recognizing stock-based compensation expenses associated with these options in future periods. An additional reason for the acceleration of the vesting period was to make the options more attractive to the recipients.

4. A summary of the Company's stock option activity (except options to non-employees) and related information for the year ended December 31, 2007 is as follows:

| | Number of options | Exercise price $ | Weighted-average exercise price $ | Weighted-average remaining contractual terms (in years) | Aggregate intrinsic value |
|---|---|---|---|---|---|
| Outstanding at December 31, 2006 | 1,387,129 | $2.38 - $69.26 | $ 25.20 | | |
| Exercised | (41,400) | $2.44 - $4.63 | $ 3.10 | | |
| Forfeited | (206,024) | $2.38 - $69.26 | $ 28.36 | | |
| Granted | 75,000 | $6.23 - $10.13 | $ 6.75 | | |
| Outstanding at December 31, 2007 | 1,214,705 | $2.38 - $69.26 | $ 24.31 | 5.66 | $ 586 |
| Exercisable at December 31, 2007 | 863,455 | | $ 26.83 | 4.74 | $ 491 |
| Vested and expected to vest at December 31, 2007 | 897,519 | | $ 25.15 | 5.40 | $ 417 |

Total intrinsic value of options exercised for the year ended December 31, 2007 and December 31, 2006 was approximately $161 and $250, respectively.

As of December 31, 2007, there was $902 of unrecognized compensation costs related to share-based compensation arrangements granted under the Company's stock option plan. The unrecognized cost is expected to be recognized over a weighted-average period of 6.72 years for the year ended December 31, 2007. For the years ended December 31, 2007, 2006 and 2005 the Company recognized $284, $599, and $382, respectively, in stock-based compensation expense.

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The number of options exercisable as of December 31, 2007, 2006 and 2005 are 863,455, 1,037,379, and 1,421,183, respectively. The weighted-average exercise prices for the options exercisable as of December 31, 2007, 2006 and 2005 are $26.83, $26.04, and $28.13, respectively.

The stock options outstanding and exercisable as of December 31, 2007 have been classified into ranges of exercise prices as follows:

| | Options outstanding | | | Options exercisable | |
|---|---|---|---|---|---|
| Range of exercise price | Outstanding as of December 31, 2007 | Weighted-average remaining contractual life (in years) | Weighted-average exercise price | Exercisable as of December 31, 2007 | Weighted-average exercise price |
| | | | $ | | $ |
| $2.38 – $10.00 | 182,325 | 4.33 | $ 4.48 | 117,325 | $ 3.52 |
| $10.01 – $20.00 | 345,150 | 6.03 | $ 13.40 | 141,100 | $ 12.56 |
| $20.01 – $30.00 | 241,900 | 6.42 | $ 24.68 | 216,700 | $ 24.66 |
| $30.01 – $40.00 | 304,980 | 5.35 | $ 33.60 | 268,980 | $ 33.55 |
| $40.01 – $69.26 | 140,350 | 5.92 | $ 56.50 | 119,350 | $ 55.42 |
| | 1,214,705 | 5.67 | $ 24.36 | 863,455 | $ 26.83 |

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

| | Granted below market price Year ended December 31, | | | Granted equal to market price Year ended December 31, | | |
|---|---|---|---|---|---|---|
| | 2007 | 2006 | 2005 | 2007 | 2006 | 2005 |
| Weighted-average exercise price | $ 0.00 | $ 0.00 | $ 33.37 | $ 6.75 | $ 14.03 | $ 28.38 |
| Weighted-average fair value on the date of grant | $ 0.00 | $ 0.00 | $ 19.61 | $ 4.00 | $ 8.64 | $ 17.63 |

6. There was no activity related to non-employees stock options as of December 31, 2007 and 2006.

d. Dividends:

The Company may declare and pay dividends out of retained earnings (as for restrictions on dividend distribution, see Note 16.d).

e. Net income (loss) per share:

| | Year ended December 31, 2007 | | | Year ended December 31, 2006 | | | Year ended December 31, 2005 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Net income (numerator) | Shares (denominator) | Per Share Amount | Net (loss) (numerator) | Shares (denominator) | Per Share Amount | Net income (numerator) | Shares (denominator) | Per Share Amount |
| Basic EPS: | $ 34,336 | 34,724,702 | $ 0.99 | $ (82,679) | 29,347,202 | $ (2.82) | $ 84 | 29,250,398 | $ 0.00 |
| Effect of dilutive securities: | | | | | | | | | |
| Stock options | - | 78,496 | - | - | - | - | - | 339,899 | - |
| Sun Stock Warrants | | 411,439 | | | | | | | |
| Diluted EPS: | $ 34,336 | 35,214,637 | $ 0.98 | $ (82,679) | 29,347,202 | $ (2.82) | $ 84 | 29,590,297 | $ 0.00 |

f. 2000 Employee Stock Purchase Plan:

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

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Under the terms of the 2000 Plan, participating employees accrue funds in an account through payroll deductions during six month offering periods. Eligible employees can have up to 10% of their earnings withheld, up to a maximum of $25,000 annually. The funds in this account are applied at the end of such offering periods to purchase ordinary shares at a 15% discount from the closing price of the ordinary shares on (i) the first business day of the offering period or (ii) the last business day of the offering period, whichever closing price is lower. As of December 31, 2007 and December 31, 2006, participating employees purchased an aggregate of $7,139 and 211,134 of newly issued ordinary shares, respectively, at weighted-average exercise prices of $7.72 and $23.12, respectively.

The amounts of consideration received from participating employees for the years ended December 31, 2007, 2006 and 2005 were $55, $598, and $1,422, respectively.

In August 2006, the Company extended, by six months, the term of the March 2006 grant under the 2000 Plan. Subsequent to the balance sheet date, the Company decided to suspend the 2000 Plan until it was in compliance with SEC regulations to issue shares and allowed employees to withdraw funds owed to them by the plan. The effect of the above modification was immaterial to the 2006 Company’s consolidated financial statements. In accordance with SFAS No. 123(R), the 2000 Plan is compensatory, and as such, results in recognition of compensation costs. For the years ended December 31, 2007 and December 31, 2006, the Company recognized $10 and $295, respectively, of compensation expenses in connection with the 2000 Plan.

NOTE 16: — INCOME TAXES

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

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

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

1. Generally, Israeli companies are subject to “corporate tax” on their taxable income. On July 25, 2005, the Knesset (Israeli Parliament) approved the Law of the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among others, a gradual decrease in the corporate tax rate in Israel to the following tax rates: in 2005 - 34%, in 2006 - 31%, in 2007 - 29%, in 2008 - 27%, in 2009 - 26% and in 2010 and thereafter - 25%. However, the effective tax rate payable by a company that derives income from an Approved Enterprise, as discussed below, may be considerably less.

2. On July 25, 2009, the Knesset approved new legislation which provides for lower tax rates in the years 2011-2016. According to the new legislation, the corporate tax rate is to be gradually reduced over the years 2010-2016. The top income tax rate will decrease from 25% in 2010 to 18% in 2016.

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

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

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

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

The Company's production facilities in Israel have been granted an "Approved Enterprise" status under the Law. The main benefits arising from such status are tax exempt income for a period of two to four years and reduction in tax rates on income derived from Approved Enterprises for the remaining benefit period. The Company is also a "foreign investors' company", as defined by the Law and, as such, is entitled to a 10 or 15 year period of benefits, based on the level of investment, and to a reduction in tax rates to 10% to 25% (based on the percentage of foreign ownership in each tax year) and to accelerated depreciation in respect of machinery and equipment.

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

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

The entitlement to these benefits is conditional upon the Company fulfilling the requirements of the Law, regulations published thereunder and the instruments of approval for the specific investments in Approved Enterprises. In the event of failure to comply with these requirements, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of December 31, 2007, management believes that the Company is meeting all of the aforementioned requirements.

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

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

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

For 2007, income not eligible for Approved Enterprise benefits mentioned above is taxed at the regular rate of 29%. See Note 16.b.

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

However, the Amendment provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the Company’s existing Approved Enterprises will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the new law, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2007, the Company did not generate income under the provisions of the new law. The amendment also added section 85a which gives the Minister of Finance the authority to legislate regulation which determines the price in international transactions between related parties (known as transfer pricing issue).

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

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

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f. Income (loss) before income taxes comprises of the following:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Domestic (Israel) | $ 20,728 | $ (17,098) | $ 22,729 |
| Foreign (North America, the Cayman Islands, Ireland and the U.K.) | 19,820 | (64,709) | (21,168) |
| | $ 40,548 | $ (81,807) | $ 1,561 |

g. Taxes on income comprise of the following:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Current taxes | $ 4,015 | $ 4,103 | $ 2,361 |
| Deferred income taxes | 2,197 | (3,231) | (884) |
| | $ 6,212 | $ 872 | $ 1,477 |
| | | | |
| Domestic | $ 3,049 | $ 1,470 | $ 1,240 |
| Foreign | 3,163 | (598) | 237 |
| | $ 6,212 | $ 872 | $ 1,477 |

Included within current and deferred income tax expense are benefits relating to investment tax credits at Taro Canada of $1,075 for the year ended December 31, 2007. Taro Canada uses the “flow-through” method and therefore records the benefits in earnings in the period the tax credits are utilized.

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

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

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Income (loss) before income taxes | $ 40,548 | $ (81,807) | $ 1,561 |
| Statutory tax rate | 29% | 31% | 34% |
| Theoretical tax (credits) | $ 11,759 | $ (25,360) | $ 531 |
| Deferred tax in respect of losses for which valuation allowance was provided | 2,462 | 24,923 | 2,287 |
| (Benefit) tax in respect to prior years | (601) | 303 | - |
| Tax in respect to advanced years | - | - | 317 |
| “Approved Enterprise” (benefit) expense (1) | (4,353) | 1,874 | (3,263) |
| Effect of different tax rates in other countries | 768 | 4,517 | 753 |

| | | | |
|---|---|---|---|
| Non-deductible expenses | 3,480 | 4,800 | 2,477 |
| Canadian tax benefits in respect of research and development expenses | (865) | (1,332) | (1,427) |
| Utilization of net operating losses | (6,452) | (29) | (5,592) |
| Deferred tax asset on temporary differences for which a valuation allowance was provided | (907) | (7,670) | 5,439 |
| Other | 921 | (1,154) | (45) |
| Income taxes in the Statements of Operations | $ 6,212 | $ 872 | $ 1,477 |

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

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Basic | $ 0.13 | $ (0.06) | $ 0.11 |
| Diluted | $ 0.12 | $ (0.06) | $ 0.11 |

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Notes to consolidated financial statements
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i. Current taxes are calculated at the following rates:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| On Israeli operations (not including “Approved Enterprise”) | 29.0 % | 31.0 % | 34.0 % |
| On U.S. operations * | 34.0 % | 35.0 % | 34.0 % |
| On Canadian operations * | 34.1 % | 34.1 % | 33.8 % |
| On U.K. operations * | 30.0 % | 35.0 % | 35.0 % |

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

j. Deferred income taxes:

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

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Deferred tax assets: | | |
| Net operating loss carryforward | $ 64,424 | $ 70,627 |
| Deferred revenue | 1,933 | 2,818 |
| Property, plant, and equipment | 2,581 | 2,537 |
| Accrued expenses | 21,474 | 18,423 |
| Bad debt allowance | 193 | 775 |
| Amortization and impairment | 9,493 | 10,078 |
| Other, net | 5,926 | 9,076 |
| Total deferred tax assets | 106,024 | 114,334 |
| Valuation allowance for deferred tax assets | (100,031) | (105,896) |
| Net deferred tax assets | 5,993 | 8,438 |
| Deferred tax liabilities: | | |
| Property, plant, and equipment | (4,394) | (4,490) |
| Amortization | (84) | (81) |
| Other, net | (1,532) | (1,450) |
| Total deferred tax liabilities | (6,010) | (6,021) |
| Net deferred tax (liabilities) assets | $ (17) | $ 2,417 |
| Domestic | $ 1,871 | $ 2,456 |
| Foreign | (1,888) | (39) |
| | $ (17) | $ 2,417 |

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

| | December 31, | |
|---|---|---|
| | 2007 | 2006 |
| Among current assets (“other receivables, prepaid expenses and other”) | $ 3,221 | $ 4,735 |
| Long-term deferred income tax assets | 2,772 | 3,703 |
| Among short-term liabilities | (424) | (505) |
| Among long-term liabilities | (5,586) | (5,516) |
| | $ (17) | $ 2,417 |

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k. Carryforward tax losses:

1. The Company:

As of December 31, 2007, the Israeli company has carryforward tax losses in the amount of $268.

2. Canadian subsidiary:

As of December 31, 2007, this subsidiary has no carryforward tax losses.

3. U.K. subsidiary:

As of December 31, 2007, this subsidiary has carryforward tax losses in the amount of $10,980, which may be carried forward and offset against taxable income for an indefinite period in the future. As discussed in Note 2.q, there is a full valuation allowance provided against these losses.

4. Irish subsidiary:

As of December 31, 2007, this subsidiary has carryforward tax losses of $28,666. Taro Ireland commenced trade in 2006 and therefore has satisfied any expiration deadlines. As discussed in Note 2.q., a full valuation allowance is provided against these losses.

5. U.S. subsidiary:

As of December 31, 2007, this subsidiary has carryforward tax losses in the amount of $164,287 resulting from prior years U.S. operating losses and the exercise of stock options in 2001 by selling shareholders in a public offering of the Company's shares. These losses can be carried forward against taxable income for 20 years from the year in which the losses were incurred, resulting in expiration dates of 2021 through 2026. As discussed in Note 2.q., a full valuation allowance is provided against these losses as it was determined then that it was not more likely than not that the Company would be in a position to utilize such losses in the future. However, in 2008, the Company utilized approximately $26.4 million of such losses on its tax returns and estimates that it will utilize a similar amount on its 2009 tax returns.

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

m. Deferred taxes for income taxes were not provided for on a cumulative total of $81,748 of the undistributed earnings of Taro Canada, which are not taxable provided earnings remain undistributed. Taro Canada intends to invest these earnings indefinitely in its operations.

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

o. Tax assessments:

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

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The Company's U.S. subsidiary has been examined by U.S. tax authorities through 2001. Due to its net operating loss carryforward, the U.S. subsidiary remains subject to examination by the U.S. tax authorities for years 2002 and onward. However, so long as these net operating losses are available, the Company believes its U.S. subsidiary will not have any tax assessments.

The Company completed its tax assessments for domestic issues with the Canadian tax authorities for the years through 2001, and for international tax considerations for years through 1998. The Company's tax provision was adequate to satisfy these assessments. The Company remains subject to examination by the Canadian tax authorities for domestic issues for years 2004 and onward and for international issues for year 1998 and onward. The Company believes that its tax provision is adequate to satisfy any assessments resulting from examinations related to these years.

p. Uncertain tax positions:

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

| | | December 31, 2007 |
|---|---|---|
| Unrecognized tax benefits at January 1, 2007 | $ | 12,023 |
| Increases as a result of positions taken in prior periods | | 408 |
| Increases as a result of positions taken in current period | | 2,168 |
| Unrecognized tax benefits at December 31, 2007 | $ | 14,599 |

The total amount of interest and penalties recognized on the consolidated statement of operations for the year ended December 31, 2007 and consolidated balance sheet at December 31, 2007 are $234 and $812, respectively.

The total amount of unrecognized tax benefits, which would impact the effective tax rate if recognized, was $7,145 at December 31, 2007.

Taro Canada and the Israeli company have the 2004 and 2005 tax years currently under examination. No tax years for Taro U.S.A. are currently under examination by IRS.

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

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Notes to consolidated financial statements
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NOTE 17: — SELECTED STATEMENTS OF INCOME DATA

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2007 | 2006 | 2005 |
| Sales by location of customers: | | | |
| Israel | $ 17,362 | $ 14,942 | $ 15,243 |
| Canada | 34,913 | 37,266 | 26,420 |
| U.S.A. | 258,519 | 192,785 | 243,416 |
| Other | 8,760 | 7,276 | 3,544 |
| | $ 319,554 | $ 252,269 | $ 288,623 |
| Research and development expenses, net: | | | |
| Total expenses | $ 29,508 | $ 36,703 | $ 46,273 |
| Less — grants and participations | (309) | 430 | 559 |
| | $ 29,817 | $ 36,273 | $ 45,714 |
| Selling, marketing, general and administrative expenses: | | | |
| Selling and marketing | $ 32,257 | $ 34,862 | $ 36,258 |
| Advertising | 6,473 | 11,741 | 20,836 |
| General and administrative * | 58,544 | 62,445 | 53,654 |
| | $ 97,274 | $ 109,048 | $ 110,748 |
| * Including provision for doubtful accounts | $ (23) | $ 1,030 | $ 1,201 |
| Financial expenses: | | | |
| Interest and exchange differences on long-term liabilities | $ 9,313 | $ 8,749 | $ 6,498 |
| Income in respect of deposits | (1,162) | (2,232) | (2,200) |
| Expenses in respect of short-term credit | 6,339 | 5,325 | 3,214 |
| Foreign currency transaction losses (gains) | 8,326 | (388) | 473 |
| | $ 22,816 | $ 11,454 | $ 7,985 |
| | | | |
| Interest capitalized in cost of property, plant, and equipment | $ - | $ 2,952 | $ 4,455 |

TARO PHARMACEUTICAL INDUSTRIES LTD.

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NOTE 18: — SEGMENT INFORMATION

a. Geographic Area Information:

The Group operates in one industry segment, which produces, researches, develops and markets pharmaceutical products. Management organizes the Company's operations based on geographic segments, which are presented below in accordance with SFAS No. 131, "Disclosure About Segments of an Enterprise and Related Information".

| | Israel | Canada*) | U.S.A. | Other | Consolidated |
|---|---|---|---|---|---|
| Year ended December 31, 2007 and as of December 31, 2007: | | | | | |
| Sales to unaffiliated customers ** | $ 17,362 | $ 34,913 | $ 258,519 | $ 8,760 | $ 319,554 |
| Long-lived assets *** | $ 117,339 | $ 62,757 | $ 46,860 | $ 18,628 | $ 245,584 |
| Year ended December 31, 2006 and as of December 31, 2006: | | | | | |
| Sales to unaffiliated customers ** | $ 14,942 | $ 37,266 | $ 192,785 | $ 7,276 | $ 252,269 |
| Long-lived assets *** | $ 126,531 | $ 62,725 | $ 51,385 | $ 15,406 | $ 256,047 |
| Year ended December 31, 2005 and as of December 31, 2005: | | | | | |
| Sales to unaffiliated customers** | $ 15,243 | $ 26,420 | $ 243,416 | $ 3,544 | $ 288,623 |
| Long-lived assets *** | $ 128,490 | $ 70,653 | $ 82,785 | $ 30,516 | $ 312,444 |

* Includes operations in both Canada and Cayman Islands.

** Based on customer's location.

*** Includes Property, Plant and Equipment, net, Goodwill and Intangible Assets, Net.

b. For the year ended December 31, 2007, the Company had net sales to two different customers of 15.8% and 10.1% of consolidated net sales. For the years ended December 31, 2006, and 2005, the Company had net sales to a different single customer of 12.0%, and 22.7% of consolidated net sales, respectively.

c. Sales by therapeutic category, as a percentage of total sales for the years ended December 31, 2007, 2006 and 2005:

| Category | Year ended December 31, 2007 | 2006 | 2005 |
|---|---|---|---|
| | | % | |
| Dermatological and topical | 67 | 67 | 71 |
| Cardiovascular | 12 | 13 | 12 |
| Anti-inflammatory | 7 | 7 | 8 |
| Neuropsychiatric | 9 | 7 | 5 |
| Other | 5 | 6 | 4 |
| Total | 100 | 100 | 100 |

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NOTE 19: — SUBSEQUENT EVENTS

a. Licensing Agreements:

1. In June 2009, Taro and Quinnova Pharmaceuticals, Inc. ("Quinnova") entered into an agreement to co-promote "Neosalus" and "Cleanse & Treat" (the "Co-Promote Products") in the United States. Until the expiration of the agreement in September 2010, Taro's branded division, TaroPharma®, and Quinnova were engaged in the coordinated marketing of the Co-Promote Products. This agreement has been terminated upon mutual agreement of the parties.

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

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

b. Major Shareholder Transactions:

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

c. Other:

Payments to pharmacies for Medicaid-covered outpatient prescription drugs are set by the states. For multiple source drugs, Federal reimbursements to states for the Federal share of those payments are subject to a Federal upper limit (FUL) ceiling. Health care reform legislation enacted in March 2010 changed the methodology by which the Centers for Medicare & Medicaid Services (CMS) calculates the FULs so that the methodology will, effective October 1, 2010, be based on the weighted average of the average manufacturer prices (AMPs) reported to the government by manufacturers of each of the therapeutically equivalent multiple source drugs. The legislation also, effective October 1, 2010, changes the definition of AMP to exclude sales to certain customer classes that are currently included. These changes may have the effect of reducing the Medicaid reimbursement rates for certain medications that the Company currently sells. In addition, under the Medicaid Drug Rebate Program, manufacturers are required, as a condition of Federal payment for their drugs under Medicaid, to pay rebates to state Medicaid programs on drugs dispensed to Medicaid beneficiaries in the state. The amount of the rebate is based on the AMP of the drug. Besides changing the definition of AMP, the health care reform legislation increased the minimum Medicaid Rebate, effective January 1, 2010. These changes may increase the Medicaid rebates the Company has to pay for certain medications that the Company currently sells.

d. On March 7, 2011, the Company was sued by The Blackstone Group L.P. ("Blackstone") in the Supreme Court of the State of New York, County of New York. The lawsuit alleges breach of contract relating to fees under an agreement whereby Blackstone would provide certain financial advisory services to the Company. Blackstone

seeks approximately $6,300 in fees and expenses. The proceedings are in the very early stages and the Company denies liability in the matter.

e. On April 28, 2011, the Company filed a lawsuit against Suven Life Sciences Ltd. ("Suven") in the United States District Court for New Jersey for infringement of its United States Patent No. 7,560,445 covering its Ovide® (malathion) Lotion, 0.5%. The suit alleges that Suven's abbreviated new drug application seeking approval from the U.S. Food and Drug Administration to sell its own malathion lotion infringes Taro's patent.

f. On April 29, 2011, the Board ratified a collective bargaining agreement dated as of April 6, 2011 (the “Agreement”) among Taro, the Histadrut Trade Union and Taro’s Employees Committee on behalf of Taro’s Israeli employees. The Agreement has a term of five years and automatically renews for two-year periods unless notice is provided by either side prior to the end of a term. The Agreement memorializes current employee-employer relations practices of Taro as well as additional rights relating to job security, compensation and other benefits. Additionally, the Agreement, inter alia, provides for a one-time payment of $1,500 (payable in NIS) to be divided among Taro’s Israeli employees as of the date of the Agreement. This amount has been accrued as of December 31, 2010.

g. In 2008, the Company entered into severance agreements tied to change in control, with certain executives whereby each executive would receive salary and benefits for a period of time if terminated after a change in control. In November 2010 and April 2011, the Company terminated employment of certain of these executives.

h. Stock options:

Between 2008 and May 25, 2011 a total of 39,000 stock options were granted to the Company’s directors and all currently remain unexercised.

End of consolidated financial statements

TARO PHARMACEUTICAL INDUSTRIES LTD.

U.S. dollars in thousands

SCHEDULE II: — VALUATION AND QUALIFYING ACCOUNTS

Allowance for Inventory Obsolescence

| Year | Balance at beginning of period | Additions — Charged to costs and expenses | Foreign currency translation adjustments | Deductions — Write-offs of Inventory | Balance at end of period |
|---|---|---|---|---|---|
| 2007 | $ 14,287 | $ 2,403 | $ 574 | $ (4,829) | $ 12,435 |
| 2006 | 18,712 | 4,859 | 82 | (9,366) | 14,287 |
| 2005 | 26,927 | 1,839 | 247 | (10,301) | 18,712 |

Allowance for Doubtful Accounts

| Year | Balance at beginning of period | Additions — Charged to costs and expenses | Deductions — Write-offs | Balance at end of period |
|---|---|---|---|---|
| 2007 | $ 2,159 | $ (23) | $ (1,395) | $ 741 |
| 2006 | 1,778 | 1,030 | (649) | 2,159 |
| 2005 | 4,421 | 1,201 | (3,844) | 1,778 |

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