

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

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 6-K

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

For the month of May, 2011

Commission File Number 000-22286

Taro Pharmaceutical Industries Ltd.

(Translation of registrant's name into English)

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

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

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

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

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

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

The Company is filing the attached audited consolidated financial statements for the year ended December 31, 2010.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, Item 308 of Regulation S-K requires a company's Annual Report to include management's annual report on internal control over financial reporting that contains, among other items, management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The Company is currently not providing the full disclosures required in an Annual Report on Form 20-F for the year ended December 31, 2010, however, the Company's management has performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2010. In connection with its assessment, management has determined that there were material weaknesses in the Company's internal control over financial reporting as of December 31, 2010 primarily related to (1) financial reporting and closing procedures, (2) certain revenue recognition procedures and (3) inventory valuation. Accordingly, management concluded that the Company's internal control over financial reporting was not effective as of December 31, 2010. The Company has instituted control procedures in order to remediate these material weaknesses and ensure that the consolidated financial statements are in conformity with United States generally accepted accounting principles.

#### SAFE HARBOR STATEMENT

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

SIGNATURES

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

Date: May 31, 2011

TARO PHARMACEUTICAL INDUSTRIES LTD.

By: /s/ James Kedrowski

Name: James Kedrowski

Title: Interim Chief Executive Officer and Director

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TARO PHARMACEUTICAL INDUSTRIES LTD.

	Page
Report of Independent Registered Public Accounting Firm	F-2
Consolidated Balance Sheets	F-3 – F-4
Consolidated Statements of Operations	F-5
Statements of Changes in Shareholders' Equity	F-6
Consolidated Statements of Cash Flows	F-7 – F-8
Notes to Consolidated Financial Statements	F-9 – F-51

F-1

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TARO PHARMACEUTICAL INDUSTRIES LTD.

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Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Taro Pharmaceutical Industries Ltd. (the "Company") and its subsidiaries as of December 31, 2010 and 2009, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company and its subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

Tel Aviv, Israel

May 26, 2011

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

## TARO PHARMACEUTICAL INDUSTRIES LTD.

## CONSOLIDATED BALANCE SHEETS

U.S. dollars and shares in thousands

	December 31,	
	2010	2009
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 54,144	\$ 93,307
Short-term bank deposits	31,000	20,974
Marketable securities	3,693	-
Accounts receivable and other:		
Trade, net	73,406	61,643
Other receivables and prepaid expenses	49,251	45,603
Inventories	83,709	67,977
Long-term assets held for sale, net	434	-
<b>TOTAL CURRENT ASSETS</b>	<b>295,637</b>	<b>289,504</b>
<b>LONG-TERM RECEIVABLES AND OTHER ASSETS</b>	<b>30,663</b>	<b>31,549</b>
<b>PROPERTY, PLANT AND EQUIPMENT, NET</b>	<b>163,596</b>	<b>176,168</b>
<b>GOODWILL</b>	<b>7,285</b>	<b>7,265</b>
<b>INTANGIBLE ASSETS AND DEFERRED COSTS, NET</b>	<b>22,771</b>	<b>20,883</b>
<b>DEFERRED INCOME TAXES</b>	<b>36,490</b>	<b>50,520</b>
<b>TOTAL ASSETS</b>	<b>\$ 556,442</b>	<b>\$ 575,889</b>

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,	
	2010	2009
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Short-term bank credit and short-term loans	\$ 14,885	\$ 96,090
Current maturities of long-term debt	13,310	29,277
Accounts payable:		
Trade payables	21,905	27,979
Other current liabilities	79,686	77,063
<b>TOTAL CURRENT LIABILITIES</b>	<b>129,786</b>	<b>230,409</b>
<b>LONG-TERM LIABILITIES:</b>		
Long-term debt, net of current maturities	31,225	38,380
Deferred income taxes	2,342	3,813
Other long-term liabilities	8,576	7,591
<b>TOTAL LONG-TERM LIABILITIES</b>	<b>42,143</b>	<b>49,784</b>
<b>COMMITMENTS AND CONTINGENT LIABILITIES</b>		
<b>TOTAL LIABILITIES</b>	<b>171,929</b>	<b>280,193</b>
<b>SHAREHOLDERS' EQUITY:</b>		
Taro shareholders' equity:		
Ordinary shares of NIS 0.0001 par value:		
Authorized at December 31, 2010 and 2009: 200,000,000 shares; Issued at December 31, 2010 and 2009: 43,340,632 and 39,509,257 shares, respectively.		
Outstanding at December 31, 2010 and 2009:		
43,080,457 and 39,249,082 shares, respectively.	679	679
Founders' shares of NIS 0.00001 par value:		
Authorized, issued and outstanding at December 31, 2010 and 2009:		
2,600 shares	1	1
Additional paid-in capital	244,668	222,608
Accumulated other comprehensive income	24,186	21,980
Treasury stock: 260,175 shares at December 31, 2010 and 2009	(1,329 )	(1,329 )
Accumulated earnings	113,107	49,029
Taro shareholders' equity	381,312	292,968
Non-controlling interest	3,201	2,728

TOTAL SHAREHOLDERS' EQUITY	384,513	295,696
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 556,442	\$ 575,889

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

F-4

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

## CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Year ended December 31,		
	2010	2009(*)	2008(*)
Sales, net	\$ 392,535	\$ 355,936	\$ 327,351
Cost of sales	159,045	146,920	139,483
Impairment	113	171	27
Gross profit	233,377	208,845	187,841
Operating expenses:			
Research and development, net	36,393	33,303	33,681
Selling, marketing, general and administrative	107,902	100,344	97,125
Impairment	2,617	3,363	2,820
	146,912	137,010	133,626
Operating income	86,465	71,835	54,215
Financial expenses, net	11,840	13,575	(1,754 )
Other gain, net	755	548	469
Income before income taxes	75,380	58,808	56,438
Tax expense (benefit)	10,477	(69,657 )	13,541
Income from continuing operations	64,903	128,465	42,897
Net loss from discontinued operations	(352 )	(11,714 )	(12,376 )
Net income	64,551	116,751	30,521
Net income attributable to non-controlling interest	473	2,728	-
Net income attributable to Taro	\$ 64,078	\$ 114,023	\$ 30,521
Net income from continuing operations attributable to Taro	64,430	125,737	42,897
Net loss from discontinued operations attributable to Taro	(352 )	(11,714 )	(12,376 )
Net income attributable to Taro	\$ 64,078	\$ 114,023	\$ 30,521
Net income per ordinary share from continuing operations attributable to Taro:			
Basic	\$ 1.60	\$ 3.21	\$ 1.10
Diluted	\$ 1.54	\$ 3.10	\$ 1.07
Net loss per ordinary share from discontinued operations attributable to Taro:			
Basic	\$ (0.01 )	\$ (0.30 )	\$ (0.32 )
Diluted	\$ (0.01 )	\$ (0.29 )	\$ (0.31 )
Net income per ordinary share attributable to Taro:			

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Basic	\$ 1.59	\$ 2.91	\$ 0.78
Diluted	\$ 1.53	\$ 2.81	\$ 0.76
Weighted-average number of ordinary shares used to compute net income per share:			
Basic	40,272	39,232	39,200
Diluted	41,850	40,568	40,423

(\*) Adjusted for the discontinued operations of the Irish subsidiary.

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

F-5

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

U.S. dollars and shares in thousands

	Taro Shareholders' Equity						Total Taro Shareholders' Equity	Total Non-control- ling Shareholders' Equity
	Number of Shares	Share Capital	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Treasury Shares	Retained Earnings (Accumulated Deficit)		
Balance at January 1, 2008	39,196	680	221,814	27,620	(1,361)	(95,515)	153,238	153,238
Exercise of options and issuance of shares of ESPP	4		2		32		34	34
Share-based compensation			322				322	322
Comprehensive income (loss), net of tax:								
Foreign currency translation adjustments				(19,898)			(19,898)	(19,898)
Net income						30,521	30,521	30,521
Total comprehensive income:							\$ 10,623	\$-
Balance at December 31, 2008	39,200	680	222,138	7,722	(1,329)	(64,994)	164,217	164,217
Exercise of options and issuance of shares of ESPP	49		163				163	163
Share-based compensation			307				307	307
Comprehensive income (loss), net of tax:								
Foreign currency translation adjustments				14,258			14,258	14,258
Net income						114,023	114,023	2,728
							\$ 128,281	\$ 2,728

Total comprehensive income:									
Balance at December 31, 2009	39,249	\$ 680	\$ 222,608	\$ 21,980	\$(1,329)	\$ 49,029		\$ 292,968	\$ 295,696
Exercise of options and issuance of shares of ESPP	44	-	186					186	186
Exercise of Sun warrants	3,788	-	21,589					21,589	21,589
Share-based compensation			285					285	285
Comprehensive income (loss), net of tax:									
Foreign currency translation adjustments				2,436			2,436	2,436	2,436
Unrealized (loss) from Marketable Securities				(230 )			(230 )	(230 )	(230 )
Net income						64,078	64,078	64,078	473
Total comprehensive income:							\$ 66,284		\$ 3,201
Balance at December 31, 2010	43,081	\$ 680	\$ 244,668	\$ 24,186	\$(1,329)	\$ 113,107		\$ 381,312	\$ 384,513

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 (except share and per share data)

	Year ended December 31,		
	2010	2009	2008
Cash flows from operating activities:			
Net income	\$ 64,551	\$ 116,751	\$ 30,521
Adjustments required to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	18,827	18,445	21,187
Change in deferred charges and other assets	42	69	101
Impairment of long-lived assets	2,730	3,534	2,847
Share-based compensation expense	285	307	322
Accrued severance pay and other long-term liabilities, net	(122 )	(539 )	571
Loss (gain) on sale of long-lived assets	65	34	(56 )
Realized gain on sale of marketable securities	(32 )	-	-
Change in derivative instruments, net	(2,140 )	(4,019 )	13,066
Effect of exchange differences on inter-company balances	307	8,713	(13,328 )
Increase in long-term debt due to currency fluctuations	3,362	2,401	3,736
Deferred income taxes, net	6,720	(78,191 )	(115 )
(Increase) decrease in trade receivables, net	(11,519 )	1,081	6,606
Decrease in other receivables, prepaid expenses and other	3,251	3,229	1,187
(Increase) decrease in inventories, net	(14,464 )	762	(2,912 )
Decrease (increase) in long-term receivables and other assets	2,544	(842 )	(718 )
	(18 )	(1 )	-

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Increase in income tax receivables			
(Decrease) increase in trade payables	(6,367 )	690	7,459
Increase (decrease) in other accounts payable and accrued expenses	5,605	(5,824 )	(5,412 )
(Decrease) increase in income tax payables	(3,143 )	(2,681 )	9,815
Net cash provided by operating activities	70,484	63,919	74,877

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

F-7

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

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

	Year ended December 31,		
	2010	2009	2008
Cash flows from investing activities:			
Purchase of property, plant and equipment	(5,656 )	(5,025 )	(3,572 )
Investment in other intangible assets	(5,097 )	(120 )	(594 )
Investment in short-term bank deposits	(10,026 )	(10,974 )	(10,000 )
Proceeds from (investment in) restricted bank deposits	900	1,000	(6,250 )
(Investments in) proceeds from long-term deposits and other assets	(310 )	14	70
Proceeds from sale (purchase) of marketable securities, net	(3,891 )	-	-
Proceeds from sale of long-lived assets	69	1,655	65
Net cash used in investing activities	(24,011 )	(13,450 )	(20,281 )
Cash flows from financing activities:			
Proceeds from issuance of shares, net	21,775	163	34
(Repayment) proceeds of short-term bank debt, net	(73,331 )	1,660	2,818
Proceeds from long-term debt and capital leases	22	-	-
Repayment of long-term debt	(34,579 )	(30,403 )	(31,776 )
Net cash used in financing activities	(86,113 )	(28,580 )	(28,924 )
Effect of exchange rate changes on cash and cash equivalents	477	2,590	(2,031 )
(Decrease) increase in cash and cash equivalents	(39,163 )	24,479	23,641
Cash and cash equivalents at the beginning of the year	93,307	68,828	45,187
Cash and cash equivalents at the end of the year	\$ 54,144	\$ 93,307	\$ 68,828

Supplemental disclosure of cash flow transactions:

Cash paid during the year for:

Interest	\$ 6,171	\$ 8,256	\$ 12,039
Income taxes	\$ 9,454	\$ 11,970	\$ 3,197

(a) Non-cash investing and financing transactions:

Purchase of property, plant and equipment on credit	\$ 397	\$ 755	\$ 288
Investment in intangible assets on credit	\$ -	\$ -	\$ -

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

F-8

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INDUSTRIES LTD.

TARO PHARMACEUTICAL

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 and Taro Pharmaceuticals Europe B.V. are engaged in the pharmaceutical activities of the Group outside North America.

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

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

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

While non-compliance with Government Agencies’ regulations can result in refusal to allow entry, seizure, fines or injunctive actions to prevent the sale of products, no such actions against the Group or its products have ever occurred. The Group believes that it is in material compliance with all Government Agencies’ regulations. In February 2009, our Canadian manufacturing facility received a warning letter from the FDA (the “Warning Letter”) expressing concern identified during a July 2008 inspection about certain quality control systems, including failure to complete investigations of quality issues in a timely manner. The Company responded to the Warning Letter on March 17, 2009, submitted and discussed a full compliance work plan with the FDA, provided periodic written updates to the FDA and 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.

F-9

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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

b. On May 18, 2007, the Company, Alkaloida Chemical Company Exclusive Group Ltd. ("Alkaloida"), a subsidiary of Sun Pharmaceutical Industries Ltd. (together with its affiliates "Sun") (Reuters: SUN.BO, Bloomberg: SUNP IN, NSE: SUNPHARMA, BSE: 524715) and Aditya Acquisition Company Ltd. ("Aditya") entered into a merger agreement (the "Merger Agreement"). In addition, Taro entered into a Share Purchase Agreement with Alkaloida, pursuant to which Taro issued Alkaloida 6,787,500 ordinary shares at \$6.00 per share, for a total of \$40,725 (the "Share Purchase Agreement"). Under the terms of the Share Purchase Agreement, Sun also received a three-year warrant to purchase additional ordinary shares at \$6.00 per share. On August 2, 2007, Sun exercised a portion of its warrant in favor of Alkaloida, as assignee, and purchased 3,000,000 additional shares at an exercise price of \$6.00 per share, or \$18,000. This additional investment, together with its original purchase of Taro's newly issued shares, brought Sun's investment in Taro to \$58,725. Taro paid \$2,436 in stock issuance costs and therefore retained \$56,289 of the proceeds. The net proceeds were recorded within shareholders' equity on the consolidated balance sheet in accordance with FASB ASC Subtopic 815-40, "Derivatives and Hedging - Contracts in Entity's Own Equity", 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.

F-10

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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

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

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

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

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

The Company used the market approach in determining the fair value of the group of assets. During 2010 and 2009, the Company recorded further impairment charges on land, building and machinery of \$2,617 and \$3,363, respectively. In November 2009, the Company's Irish subsidiary sold certain equipment, net of transaction costs, for \$1,485.

During 2010, the Company closed the manufacturing facility in Ireland and decided to sell the facility. The Company has classified the related assets and liabilities as assets and liabilities attributed to discontinued operations on the Consolidated Balance Sheets and the losses attributable to its Irish subsidiary in the Consolidated Statements of Operations as losses from discontinued operations. See note 2.z.



TARO PHARMACEUTICAL INDUSTRIES LTD.

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

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 5), inventory reserves, income taxes, fixed assets, intangible assets, derivative instruments and contingencies.

b. Financial statements in U.S. dollars:

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

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

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

c. Principles of consolidation:

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

A private corporation, TDC, owns 3.125% of the shares that have economic rights and has 50% of the voting rights in Taro U.S.A.; with the Company owning the remaining shares and voting rights. In 1993, TDC signed an agreement with the Company to vote all of its shares in Taro U.S.A. in all elections of directors of Taro U.S.A. as the Company

shall instruct. In addition, in May 2011, TDC renewed its commitment to the Company. TDC may terminate the agreement upon one year written notice. As of December 31, 2010, no such notice of termination has been provided. TDC is a minority shareholder in the Company by way of its ownership of Taro U.S.A. shares that have economic rights. Since losses applicable to TDC exceeded its interest in Taro U.S.A. equity, such excess and any further losses applicable to TDC were charged against the Company as TDC has no obligation to fund such losses. Effective January 1, 2009, the Company adopted FASB ASC Section 810-10-65, "Consolidation – Overall – Transition and Open Effective Date Information – Transition Related to FASB Statements No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51, and No. 164, Not-for-Profit Entities: Mergers and Acquisitions". This standard requires that the Company allocate income or loss attributable to the non-controlling interest based on the respective ownership percentages. This aspect of the standard was adopted on a prospective basis.

F-12

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

d. Cash and cash equivalents:

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

e. Marketable securities:

Marketable securities are comprised primarily of shares of stock in other publicly-traded companies. These marketable securities covered by FASB ASC Section 320-10-25, "Investments: Debt and Equity Securities – Overall – Recognition", were designated as available-for-sale. Accordingly, these securities are stated at fair value, with unrealized gains and losses reported in accumulated other comprehensive income, a separate component of shareholders' equity.

f. Allowance for doubtful accounts:

The allowance for doubtful accounts is calculated primarily with respect to specific balances, which, in the opinion of the Company's management, are doubtful of collection. The allowance, in the opinion of the Company's management, is sufficient to cover probable uncollectible balances. See Note 4.

g. Inventories:

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

Raw and packaging materials – average cost basis.

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

Purchased products for commercial purposes – average cost basis.

The amounts of inventory reserves recorded as cost of sales were \$7,386, \$6,762, and \$5,704, for the years ended December 31, 2010, 2009, and 2008, respectively.

h. Property, plant and equipment:

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

(2) Interest costs are capitalized in accordance with FASB ASC Subtopic 835-20, "Interest – Capitalization of Interest".

(3)

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

F-13

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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

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

(4) The Group accounts for costs of computer software developed or obtained for internal use in accordance with FASB ASC Subtopic 350-40, “Intangibles: Goodwill and Other – Internal-Use Software”. FASB ASC Subtopic 350-40 requires the capitalization of certain costs incurred in connection with developing or obtaining internal use software during the application development stage. During the years 2010 and 2009, the Group capitalized \$40 and \$71 of software costs, respectively. Software costs are amortized using the straight-line method over their estimated useful life of three years.

i. Lease of land from Israel Land Administration:

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

j. Goodwill:

The Company follows the provisions of FASB ASC Subtopic 350-20, “Intangibles: Goodwill and Other – Goodwill”. Goodwill is not amortized, but rather is subject to an annual impairment test (or more frequently if impairment indicators arise).

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

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

goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess.

The Company operates in one operating segment, comprising its only reporting unit. Fair value of the reporting unit is determined using market capitalization. The Company performs its annual impairment test during the fourth fiscal quarter of each year. As of December 31, 2010 and 2009, no impairment loss had been identified.

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

F-14

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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 FASB ASC Topic 350, "Intangibles-Goodwill and Other."

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

Long-lived assets:

The Group's long-lived assets, excluding goodwill, are reviewed for impairment in accordance with FASB ASC Topic 360, "Property, Plant and Equipment", whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment exists when the carrying amount of the asset exceeds the aggregate future undiscounted cash flows expected to be generated by the asset. The impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the asset. In the years ended December 31, 2010, 2009 and 2008, the Company recorded \$2,719, \$3,363 and \$2,820 impairment loss, respectively, in operating expenses, primarily related to the fixed assets of its Irish facility. See Note 1.c.

l. Treasury shares:

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

From time to time the Company reissues treasury shares under the stock purchase plan, upon exercise of options and upon vesting of restricted stock units. When treasury stock is reissued, the Company accounts for the re-issuance in accordance with FASB ASC Subtopic 505-30, "Equity – Treasury Stock," and charges the excess of the purchase cost, including related stock-based compensation expenses, over the re-issuance price (loss) to retained earnings. The purchase cost is calculated based on the specific identification method.

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

m. Revenue recognition:

The Company recognizes revenue from product sales when title and risk of loss have transferred to its customers and when the criteria in FASB ASC Subtopic 605-15, "Revenue Recognition – Products," have been satisfied. Those criteria generally require that (i) persuasive evidence of an arrangement exists; (ii) product delivery has occurred; (iii) the price to customers is fixed or determinable; (iv) collectability is reasonably assured, and (v) the amount of product returns, chargebacks, rebates and other sales deductions can be reasonably estimated. The Company ships products to its customers only in response to, and to the extent of, the orders that customers submit to the Company. Depending on the terms of our customer arrangements, revenue is recognized when the product is received by the customer ("FOB Destination Point") or at the time of shipment ("FOB Shipping Point").

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

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

F-15

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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 5 and 13.

The Company offers incentives to certain resellers and retailers through various marketing programs where the Company agrees to reimburse them for advertising costs incurred to include the Company's products. The Company accounts for these in accordance with FASB ASC Subtopic 605-50, "Revenue Recognition – Customer Payments and Incentives," as reductions of revenue unless the customer receives an identifiable benefit in exchange for the consideration that is sufficiently separable from the customer's purchase of the products and the fair value of the benefits can be reasonably estimated.

n. Research and development:

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

o. Royalty-bearing grants:

Royalty-bearing grants from the government of Israel through the Office of the Chief Scientist for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the related costs incurred. The Company did not earn any grants during the years ended December 31, 2010, 2009, and 2008.

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 \$6,217, \$5,505 and \$6,979 for the years ended December 31, 2010, 2009 and 2008, respectively.

F-16

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

q. Income taxes:

Income taxes are accounted for in accordance with FASB ASC Topic 740, "Income Taxes". FASB ASC Topic 740 prescribes the use of the liability method, whereby deferred tax asset and liability account balances are determined for temporary differences between the financial reporting and tax basis of assets and liabilities, and for carryforward losses and credits. Deferred taxes are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. As of December 31, 2009, management determined that it was more likely than not that the Company will benefit from the deferred tax asset in the U.S., resulting in the reversal of \$76,694 of the valuation allowance against these deferred tax assets. As of December 31, 2010 and 2009, management determined that it was more likely than not that the Company will not benefit from the deferred tax assets in the Ireland and certain other subsidiaries. Therefore, for these locations a full valuation allowance was provided against the deferred tax assets. In future years, if it is more likely than not that the Company will be in a position to utilize its deferred tax asset, the valuation allowance for such assets may be modified.

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

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

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

Basic net income per share is calculated based on the weighted-average number of ordinary shares outstanding during each year. Diluted net income per share is calculated based on the weighted-average number of ordinary shares outstanding during each year, plus potential dilutive ordinary shares considered outstanding during the year (except where anti-dilutive), in accordance with FASB ASC Topic 260, "Earnings per Share".

t. Freight and distribution costs:

In accordance with FASB ASC Subtopic 605-45, "Revenue Recognition – Principal Agent Considerations," 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 \$11,689, \$10,206 and \$9,420 for the years ended December 31, 2010, 2009 and 2008, respectively.

u. Accounting for stock-based compensation:

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

The Company recognizes compensation expense for the value of its awards granted subsequent to January 1, 2006, based on the straight-line method over the requisite service period of each of the awards, net of estimated forfeitures. FASB ASC Topic 718 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 FASB ASC Topic 718 for those awards not yet vested. Upon the adoption of FASB ASC Topic 718 the expected life of the option is estimated using the “simplified” method as provided in SAB 107. Under this method, the expected life equals the arithmetic average of the vesting term and the original contractual term of the option. On December 21, 2007, the SEC issued SAB No. 110 (“SAB 110”), codified as Topic 14.D.2 which, effective January 1, 2008, amends and replaces SAB 107. The Company currently uses the simplified method as adequate historical experience is not available to provide a reasonable estimate. The Company adopted SAB 110 effective January 1, 2008 and will continue to apply the simplified method until sufficient historical experience is available to provide a reasonable estimate of the expected term for stock option grants.

## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

Stock Options: The Company did not grant any options during 2010. The fair value of options granted under the Stock Incentive Plan in 2009 and 2008 is amortized over their vesting period on a straight-line basis and estimated at the date of grant using a Black-Scholes options pricing model with the following assumptions:

	2010	2009	2008
Dividend yield	N/A	0%	0%
Expected volatility	N/A	44.5%	48.4%
Risk-free interest rate	N/A	1.7%	3.1%
Expected life of up to	N/A	6.9 years	6.9 years

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

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

Estimated forfeitures are based on estimates for 2010, and actual historical pre-vesting forfeitures for 2009 and 2008.

The Company applies FASB ASC Subtopic 505-50, "Equity - Equity-Based Payments to Non-Employees" with respect to options issued to non-employees. FASB ASC Subtopic 505-50 requires the use of option valuation models to measure the fair value of the options granted. Compensation expensed to non-employees was not material.

v. Concentrations of credit risk:

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

The Group's trade accounts receivables are mainly derived from sales to customers in the United States, Canada, Europe and Israel. At December 31, 2010, three different customers in the United States represented approximately 15.8%, 13.2% and 10.0% 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.

F-18

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

w. Fair value of financial instruments:

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

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

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

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

x. Accounting for derivatives:

FASB ASC Topic 815, "Derivatives and Hedging," 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, 2010 and 2009, no derivative instruments were designated as hedging instruments.

For derivative instruments not designated as hedging instruments, the gain or loss is recognized in financial income/expense in current earnings during the period of change. See Note 10.

y. Fair value measurements:

Effective January 1, 2008, the Company adopted FASB ASC Topic 820, "Fair Value Measurements and Disclosures". FASB ASC Topic 820 provides a fair value hierarchy that distinguishes between assumptions based on market data obtained from independent sources (observable inputs) and those based on an entity's own assumptions (unobservable inputs). FASB ASC Topic 820 also requires additional disclosure about fair value measurements. The adoption of FASB ASC Topic 820 did not impact the Company's consolidated balance sheet or consolidated statement of operations.

z. Discontinued operations:

Under FASB ASC 205, "Presentation of Financial statements – Discontinued Operations", when a component of an entity, as defined in ASC 205, has been disposed of or is classified as held for sale, the results of its operations, including the gain or loss on the disposed component, should be classified as discontinued operations and the assets

and liabilities of such component should be classified as assets and liabilities attributed to discontinued operations; that is, provided that the operations, assets and liabilities of the component have been eliminated from the Company's consolidated operations and the Company will no longer have any significant continuing involvement in the operations of the component.

F-19

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

aa. **Reclassification:**

Certain comparative figures have been reclassified to conform to the current year presentation.

bb. **Impact of recently issued accounting standards:**

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

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 currently have any multiple element arrangements. Accordingly, the Company does not expect the 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.

F-20

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## NOTE 3: — SHORT-TERM INVESTMENTS

a. The following is a summary of marketable securities which are classified as available-for-sale:

	December 31, 2010			2009		
	Amortized cost	Unrealized losses	Market value	Amortized cost	Unrealized losses	Market value
Available-for-sale:						
Government debentures	\$ 3,923	\$ (230)	\$ 3,693	\$ -	\$ -	\$ -

b. The estimated fair value of available-for-sale investments as of December 31, 2010 and 2009 by contractual maturity, are as follows:

	2010		December 31, 2009	
	Cost	Market Value	Cost	Market Value
Available-for-sale government debentures:				
Matures in more than five years	\$ 3,878	\$ 3,693	\$ -	\$ -
	\$ 3,878	\$ 3,693	\$ -	\$ -

## NOTE 4: — ACCOUNTS RECEIVABLE AND OTHER

a. Trade, net:

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

	December 31,	
	2010	2009
Trade accounts receivable, gross	\$ 141,532	\$ 117,122
Reserves for sales deductions:		
Chargebacks	(26,559 )	(19,360 )
Customer rebates	(18,975 )	(16,356 )
Other sales deductions	(22,518 )	(19,216 )
Allowance for doubtful accounts	(74 )	(547 )
Trade accounts receivable, net	\$ 73,406	\$ 61,643



## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## b. Other receivables and prepaid expenses:

	December 31,	
	2010	2009
Prepaid expenses	\$ 4,543	\$ 7,736
Deferred income taxes (1)	37,855	32,069
Government authorities	2,409	2,098
Advances to suppliers	1,452	2,189
Derivative instruments	1,917	917
Other	1,075	594
	49,251	45,603

(1) See Note 2.q.

## NOTE 5: — SALES INCENTIVES

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

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

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

## Product returns:

Consistent with industry practice, the Company generally offers its customers the right to return inventory within three to six months prior to product expiration and up to 12 months thereafter (the "return period"). Product returns are identified by their manufacturing lot number. Because the Company manufactures in bulk, lot sizes are generally large and, therefore, shipments of a particular lot may occur over a one-to-three month period. As a result, although the Company cannot associate a product return with the actual shipment in which such lot was included, the Company can reasonably estimate the period (in months) over which the entire lot was shipped and sold. The Company uses this information to estimate the average time period between lot shipment (and sale) and return for each product, which the Company refers to as the "return lag". The shelf life of most of the Company's products ranges between 18-36 months. Because returns of expired products are heavily concentrated during the return period, and given the

Company's historical data, it is able to reasonably estimate return lags for each of its products. These return lags are periodically reviewed and updated, as necessary, to reflect the Company's best knowledge of facts and circumstances. Using sales and return data (including return lags), the Company determines a rolling average monthly return rate to estimate its returns reserve. The Company supplements this calculation with additional information including customer and product specific channel inventory levels, competitive developments, external market factors, the Company's planned introductions of similar new products and other qualitative factors in evaluating the reasonableness of the returns reserve. The Company continuously monitors factors that could affect its estimates and revises the reserves as necessary. The Company's estimates of expected future returns are subject to change based on unforeseen events and uncertainties.

F-22

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

The Company's product returns reserve at December 31, 2009 and related statement of operations impact for the year then ended, considered actual product returns experienced subsequent to the balance sheet dates to validate the product returns reserve estimate based on the methodology described above.

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

Chargebacks:

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

Rebates and other deductions:

The Company offers its customers various rebates and other deductions based primarily on their volume of purchases of its products. Chain wholesaler rebates are rebates that certain chain customers claim for the difference in price between what the chain customer paid a wholesaler for a product purchase and what the chain customer would have paid if such customer had purchased the same product directly from the Company. Cash discounts, which are offered to the Company's customers, are generally 2% of the gross sales price, and provide the Company's customers an incentive for paying within a specified time period after receipt of invoice. 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.

F-23

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

## Notes to consolidated financial statements

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

The Company establishes reserves for rebates and these other various sales deductions based on contractual terms and customer purchasing activity, tracking and analysis of rebate programs, processing time lags, the level of inventory in the distribution channel and other relevant information. Based on the Company's historical experience, substantially all claims for rebates and other sales deductions are received within 24 months. At December 31, 2009, and for the year then ended, the Company considered subsequent actual claims submitted by its customers in determining the Company's reserves and related statements of operations impact for rebates and other sales deductions.

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

## Use of estimates in reserves:

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

The following tables summarize the activities for sales deductions and product returns for the years ended December 31, 2010 and 2009:

	For the Year Ended December 31, 2010			
	Beginning balance	Provision recorded for current period sales	Credits processed/ Payments	Ending balance
Accounts Receivable Reserves				
Chargebacks	\$ (19,360 )	\$ (170,887 )	\$ 163,688	\$ (26,559 )
Rebates and Other	(36,119 )	(85,861 )	80,413	(41,567 )
Total	\$ (55,479 )	\$ (256,748 )	\$ 244,101	\$ (68,126 )

## Current Liabilities

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Returns	\$	(22,514 )	\$	(13,146 )	\$	13,698	\$	(21,962 )
Other (1)		(15,264 )		(25,979 )		28,144		(13,099 )
Total	\$	(37,778 )	\$	(39,125 )	\$	41,842	\$	(35,061 )

F-24

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

For the Year Ended December 31, 2009

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

(1) Includes indirect rebates.

## NOTE 6: — INVENTORIES

	December 31,	
	2010	2009
Raw and packaging materials	\$ 27,857	\$ 22,385
Finished goods	33,709	26,457
Work in progress	15,979	14,872
Purchased products for commercial purposes and other	6,164	4,263
	<b>\$ 83,709</b>	<b>\$ 67,977</b>

As of December 31, 2010 and 2009, reserves recorded against inventories for slow-moving, short-dated, excess and obsolete inventory totaled \$10,904 and \$12,006, respectively.

As for pledges, see Note 15.

## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## NOTE 7: — PROPERTY, PLANT AND EQUIPMENT

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

	December 31,	
	2010	2009
Cost:		
Land	\$ 10,348	\$ 12,411
Buildings	140,806	140,068
Leasehold improvements	3,258	3,186
Machinery and equipment	147,904	144,111
Computer equipment	32,699	31,610
Motor vehicles	264	303
Furniture, fixtures and office equipment	8,915	8,787
Advances for property and equipment	679	489
	344,873	340,965
Accumulated depreciation and impairment charges:		
Buildings	\$ 37,612	\$ 33,771
Leasehold improvements	3,208	3,021
Machinery and equipment	102,343	91,495
Computer equipment	30,968	29,611
Motor vehicles	229	288
Furniture, fixtures and office equipment	6,917	6,611
	181,277	164,797
Depreciated cost	\$ 163,596	\$ 176,168

Depreciation expenses were \$15,745, \$15,530, and \$18,374 for the years ended December 31, 2010, 2009 and 2008, respectively. For related impairment charges, see Note 2.k.

b. Cost of property, plant and equipment includes capitalized interest expenses, capitalized direct incremental costs (such as payroll and related expenses) and other internal costs incurred in order to bring the assets to their intended use in the amount of \$16,832 as of December 31, 2010 and 2009. Capitalized interest and other costs were \$40 and \$71 for the years ended December 31, 2010 and 2009, respectively.

c. Cost of computer equipment includes capitalized development costs of computer software developed for internal use in the amount of \$4,701 and \$4,634 as of December 31, 2010 and 2009, respectively.

d. As for pledges – see Note 15.

## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## NOTE 8: —INTANGIBLE ASSETS AND DEFERRED COSTS

a. Composition:

	December 31,	
	2010	2009
Cost:		
Product and distribution rights	\$ 73,525	\$ 68,382
Deferred charges in respect of loans and bonds from institutional investors	183	1,304
Other deferred costs	1,541	1,541
	75,249	71,227
Accumulated amortization and impairment charges:		
Product and distribution rights	50,818	47,593
Deferred charges in respect of loans and bonds from institutional investors	166	1,276
Other deferred costs	1,494	1,475
	52,478	50,344
Amortized cost	\$ 22,771	\$ 20,883

b. Amortization expenses related to product rights were \$3,083, \$2,915 and \$2,813 for the years ended December 31, 2010, 2009 and 2008, respectively.

c. As of December 31, 2010, the estimated amortization expense of product and distribution rights for 2011 to 2015 is as follows: 2011 - \$3,597; 2012 - \$3,467; 2013 - \$3,427; 2014 - \$3,174; 2015 - \$2,974.

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

## NOTE 9: — LONG-TERM RECEIVABLES AND OTHER ASSETS

	December 31,	
	2010	2009
Prepayment of land leased from Israel Land Administration (1)	\$ 14,176	\$ 14,774
Restricted bank deposits (2)	4,350	5,250
Derivative instruments (3)	5,485	4,077
Severance pay fund (4)	6,319	5,480
Long-term security deposit	310	-
Employee escrow (5)	-	1,947
Other	23	21
	\$ 30,663	\$ 31,549

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

(2)

Amount represents restricted bank deposits pursuant to an interest rate swap agreement associated with loan agreements in Israel (see Note 10).

(3) See Note 10.

(4) Under Israeli law, the Company and its Israeli subsidiaries are required to make severance or pension payments to dismissed employees and to employees terminating employment under certain other circumstances. Deposits are made with a pension fund or other insurance plans to secure pension and severance rights for the employees in Israel. These amounts represent the balance of the deposits in those funds (including profits) that will be used to cover the Company's severance obligations (see Note 13.b).

(5) Amount represents an escrow account for certain deferred payments to the Company's former General Manager. The amount was remitted to this individual following his separation from the Company in November 2010.

F-27

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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 \$839, \$1,018 and \$903 for the years-ended December 31, 2010, 2009 and 2008, respectively.

	2010	December 31, 2009	2008
Pension, retirement savings and severance expenses	\$ 7,614	\$ 4,047	\$ 4,928

## NOTE 10: — DERIVATIVE INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

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

## a. Interest rates:

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

In June 2005, the Company entered into a mortgage agreement for its New Jersey facility. Subsequently, in September 2005, the Company entered into an interest rate swap to mitigate variable mortgage interest rate risk by effectively establishing the mortgage rate at a fixed rate of 4.66%. In November 2008, the Company paid \$344 to terminate the swap and recorded a \$190 loss within financial expenses, net for year ended December 31, 2008. The swap was terminated on November 28, 2008. See Note 14.a.4.

In September 2005, the Company also entered into a mortgage agreement for its New York facility and concurrently entered into an interest rate swap with the intention to mitigate the variable mortgage interest rate risk by effectively establishing the mortgage rate at a fixed rate of 6.16%. At December 31, 2010 and 2009, the fair market value of the swap was a liability of \$1,120 and \$852, respectively, and was recorded in other long-term liabilities on the consolidated balance sheet. The Company recorded an unrealized (loss) gain of (\$268), \$795 and (\$1,379) within financial expenses, net for the years ended December 31, 2010, 2009 and 2008, respectively. See Note 14.a.5.

## b. Currency exchange rates:

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



## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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

Year	Rate of Inflation		Rate of Devaluation (Appreciation) Against U.S. Dollar		Rate of Exchange of U.S. Dollar	
	Israel	Canada	Israel	Canada	Israel	Canada
	(1)	(2)	(1)	(2)	(1)	(2)
2009	3.91 %	1.32 %	-0.71 %	-14.54 %	3.78	1.05
2010	2.66 %	2.35 %	-5.99 %	-4.97 %	3.55	0.99

(1) Per Bank of Israel

(2) Statistics of Canada

From July 1999 to November 2000, the Company issued \$24,000 of CPI plus 8.25% bonds denominated in NIS with terms of 10 years. At the same time, the Company entered into 9-10 year cross-currency swaps in which the Company receives CPI plus 6% to 8.25% in NIS and pays LIBOR plus 0.6% to 3.3% in USD based on the outstanding amount of the bonds. At December 31, 2010 and 2009, the fair market value of these swaps was an asset of \$0 and \$330, respectively, and was recorded in other receivables and prepaid expenses. For the years ended December 31, 2010, 2009, and 2008, net gains of approximately \$102, \$251 and \$556 were recorded within financial expenses, net for these swaps.

In November 2003, the Company entered into loan agreements to borrow, in Israel, NIS 210,800 for an eleven-year term at an annual interest rate of 5.8%. At the same time, the Company entered into a USD/NIS, 5-year, CPI-adjusted currency swap in which it will receive at the end of the period the NIS amount linked to the CPI plus interest equal to 5.8% of the outstanding NIS balance, and will pay \$47,190 plus a fixed rate of 5.9%. This swap matured on November 28, 2008, and was replaced on the maturity date by a USD/NIS, CPI-adjusted, 6-year currency swap. In accordance with this swap agreement, the Company will receive NIS 201,270 in six annual payments (equivalent of the remaining debt balance as of November 28, 2008), which is linked to the CPI plus additional interest equal to 5.8% of the outstanding NIS balance. The Company is required to pay \$51,344 plus a fixed rate of 6.59%. At December 31, 2010, the fair market value of the swap was \$7,092 comprised of a \$1,607 asset (recorded in other receivables and prepaid expenses) and a \$5,485 asset (recorded in long-term receivables and other assets). At December 31, 2009, the fair market value of the swap was \$4,649 comprised of a \$572 asset (recorded in other receivables and prepaid expenses) and a \$4,077 asset (recorded in long-term receivables and other assets). The Company recorded net gains of \$3,356, \$3,708 and \$2,412 within financial expenses, net for the years ended December 31, 2010, 2009 and 2008, respectively.

## NOTE 11: — FAIR VALUE MEASUREMENTS

FASB ASC Topic 820 defines fair value as the price that would be received for an asset or paid to transfer a liability, from a selling party's perspective, in the principal or most advantageous market for the asset or liability in an orderly

transaction between market participants on the measurement date. ASC Topic 820 requires that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

Level 1: Quoted market prices in active markets for identical assets and liabilities. Active market means a market in which transactions for assets or liabilities occur with “sufficient frequency” and volume to provide pricing information on an ongoing unadjusted basis.

F-29

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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

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

The fair value of the Company's financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2010 and 2009 were as follows:

	December 31, 2010 Quoted Market Prices of Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets			
Marketable securities	\$ 3,693	\$ -	\$ -
Cross-currency swaps	-	7,092	-
	\$ 3,693	\$ 7,092	\$ -
Liabilities			
Interest rate swap	\$ -	\$ 1,120	\$ -

	December 31, 2009 Quoted Market Prices of Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets			
Cross-currency swaps	\$ -	\$ 4,979	\$ -
Liabilities			
Interest rate swap	\$ -	\$ 852	\$ -

## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## NOTE 12: — 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,	
	2010		2009		2010	2009
Short-term bank credit and short-term loans:						
In, or linked to, U.S. dollars (1) (2) (3) (4)	1.78	%	3.47	%	\$ 14,885	\$ 76,656
In NIS (5)	0.00	%	4.47	%	-	8,212
In Canadian dollars (6) (7)	0.00	%	3.18	%	-	11,222
					14,885	96,090
Reclass from long-term debt, included in the above amounts (8)					14,885	22,846
Total utilized credit lines and short-term loans					\$ -	\$ 73,244
Total authorized credit lines and short-term loans					\$ 5,000	\$ 74,681
Unutilized credit lines					\$ 5,000	\$ 1,437
Weighted-average interest rates at the end of the year for all loans	1.78	%	3.53	%		

- (1) Includes \$14,885 and \$17,780 of long-term debt reclassified as short-term due to covenant defaults at December 31, 2010 and 2009, respectively.
- (2) Includes \$28,100 of outstanding debt under a \$40,000 Taro U.S.A. credit facility at December 31, 2009. This credit facility bears interest at a rate of LIBOR plus 3.25% and is secured by a first lien on Taro U.S.A.'s accounts receivable, inventory and all products and proceeds thereof. On October 5, 2010, the Company retired the \$28,100 of outstanding debt and \$264 of accrued interest. The bank has no further right to any of the Company's assets as collateral since the facility was cancelled.
- (3) Includes \$9,750 of outstanding debt under a \$10,000 Taro U.S.A. credit facility at December 31, 2009. The Company entered into a letter agreement with this financial institution as described in Note 14.a.3. On October 28, 2010, the Company retired the \$9,750 of outstanding debt and \$109 of accrued interest. The bank has no further right to any of the Company's assets as collateral since the facility was cancelled.
- (4) Includes \$21,026 of outstanding debt under the Company's credit facilities in Israel at December 31, 2009. At December 31, 2010 the Company had no outstanding borrowings under these credit facilities. See Note 14.a.3 for a description of the covenants.

- (5) Represents outstanding debt, in Israel, under the Company's credit facilities of \$8,212 at December 31, 2009. At December 31, 2010 the Company had no outstanding borrowings under these credit facilities. See Note 14.a.2 for a description of the covenants.
- (6) Includes \$6,156 of outstanding debt at December 31, 2009 under a demand revolving line of credit to Taro Pharmaceuticals Inc., the Company's indirect Canadian subsidiary. The amount available under this line of credit was \$7,612 at December 31, 2009. This facility is secured by a general security agreement over the Canadian subsidiary's assets. This debt was retired in May 2010. The bank has no further right to any of the Company's assets as collateral.
- (7) Includes \$5,067 of long-term debt reclassified as short-term due to covenant defaults at December 31, 2009. On November 1, 2010, the Company retired the remaining balance of this debt of \$5,710 and paid \$11 of accrued interest and a \$171 prepayment fee. The bank has no further right to any of the Company's assets as collateral.
- (8) Represents long-term debt classified as short-term debt due to covenant defaults described in Notes 14.a.1, 14.a.4 and 14.a.6.

## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## NOTE 13: — OTHER LIABILITIES

a.

## Other current liabilities:

	December 31,	
	2010	2009
Returns reserve	\$ 21,962	\$ 22,514
Due to customers (1)	390	1,849
Employees and payroll accruals	17,401	11,783
Deferred revenue	1,052	20
Medicaid and indirect rebates	12,709	13,415
Accrued income taxes	12,882	15,854
Legal and audit fees	945	3,137
Accrued expenses	7,627	5,737
Interest payable	312	841
Deferred taxes	335	311
OCS and other royalties	2,771	771
Other	1,300	831
	\$ 79,686	\$ 77,063

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

b.

## Other long-term liabilities:

	December 31,	
	2010	2009
Accrued severance pay	\$ 7,013	\$ 6,357
Interest rate swap	1,121	852
Accrued taxes	442	382
	\$ 8,576	\$ 7,591

F-32

## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## NOTE 14: — LONG-TERM DEBT

a. Composed as follows:

	December 31,	
	2010	2009
Loans from institutional investors and bonds (1)	\$ -	\$ 1,960
Loans from institutional investors and bonds (2)	41,607	59,975
Bank loans (3)	25	-
Term loan from Canadian bank (4)	-	7,921
Mortgage for U.S. distribution facility (5) (6)	8,594	10,793
Mortgage for U.S. headquarters facility (6)	9,194	9,854
	59,420	90,503
Less: current maturities	13,310	29,277
Less: long-term debt reclassified as short-term loans (1, 4, 6)	14,885	22,846
	\$ 31,225	\$ 38,380

- (1) In 1999 and 2000, the Company entered into a series of debenture and loan agreements in Israel, secured by a floating charge on substantially all of its property, assets and rights. The debentures were issued in separate tranches during 1999 and 2000 for a term of 10 years, with the last tranche maturing in November 2010; most of the loan balance at December 31, 2009 was linked to Israeli CPI plus 8.25%. Under the debentures, Taro provided certain undertakings that, among other things, as long as the loan is outstanding, (i) the ratio between long-term liabilities and shareholders' equity shall not exceed two and the current ratio (defined as current assets divided by current liabilities) shall not be less than one and (ii) the ratio of current assets and liabilities shall not exceed one. Such ratios are based on the Company's audited financial statements. As of December 31, 2009, the Company was current with its payment obligations but not in compliance with other covenants. The Company retired the remaining balance in November 2010.
- (2) In 2003, the Company entered into two series of loan agreements, subsequently amended, with multiple lenders in Israel. Approximately half of the amount of the loans were issued in U.S. dollars at an interest rate of 6.0 – 6.1%, maturing in 2010. The other half of the loans were issued in NIS at a rate of Israeli CPI plus 5.8%, maturing in 2014. The debentures, provided certain undertakings, including (i) not to encumber any of its assets, unless to secure indebtedness, as defined in such agreements, which in the aggregate does not exceed \$20,000, or unless to encumber newly acquired assets to secure financing provided to acquire such assets, and (ii) not to incur any additional indebtedness as long as the ratio of EBITDA to total net interest expense and current principal payable on long-term indebtedness is less than 2:1. The test is based on the Company's audited financial statements, and is performed on April 1 of each year with respect to the prior calendar year. Since the Company was not in compliance with the above described covenants, no additional indebtedness has been incurred by the Company. Although additional borrowing by the Company is restricted, the lenders do not have the right to accelerate their obligations and, thus, these loans have not been reclassified as short-term debt.
- (3) In April 2010, the Company entered into a vehicle financing loan of \$28 at 0.0% interest rate over 5 years for which the bank registered a lien. The loan will expire in April 2015.

- (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 was collateralized by a first lien on the Canadian subsidiary's land, buildings and certain manufacturing equipment, a lien covering all other assets, subject to prior liens indicated in Note 12 above, and a subordinated lien on the buildings and land securing the mortgage loans described in (5) below, as well as certain equipment of Taro U.S.A. Taro U.S.A. and two of its subsidiaries have provided guarantees to the lender for the full amount of the loan. The Canadian subsidiary provided undertakings in the relevant loan documentation that include certain (i) financial covenants, requiring the Canadian subsidiary to maintain a maximum ratio of debt to tangible net worth of 1.60:1 and a ratio of current assets to current liabilities of 1.50:1 or more and (ii) financial reporting covenants relating to the Company and certain subsidiaries, including the Canadian subsidiary. Since the Canadian subsidiary was not in compliance with certain covenants as described above, and in accordance with the agreement, the bank has the right to accelerate its obligation. The Company has reclassified the long-term portion of its long-term debt to this bank in the amount of \$5,067 as short-term loans at December 31, 2009. On November 1, 2010, the Company retired the remaining balance of this debt of \$5,710 and paid \$11 of accrued interest and a \$171 prepayment fee. The bank has no further right to any of the Company's assets as collateral.

TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

- (5) On January 8, 2004, Taro U.S.A. expanded its distribution capacity with the purchase of a 315,000 square foot distribution center on 25 acres of land in South Brunswick, New Jersey. Taro acquired the facility for \$18,433, of which, \$13,200 was financed by a mortgage. This facility is subject to depreciation on a straight-line basis over a 40 year period. The mortgage on the New Jersey facility was \$8,594 and \$10,793, as of December 31, 2010 and 2009, respectively, was for an original term of seven years, bearing interest at the rate of LIBOR plus 1.85% and has certain financial and reporting covenants. The interest rate of the mortgage was effectively fixed at 4.66%, as the Company had an interest rate swap in place through November 28, 2008. On November 28, 2008, the principal amount of this mortgage was increased \$4,743 to \$12,993, and the interest rate swap was terminated.
- (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 (3) above has a subordinated security position in the facilities which are the subject of the mortgages. Effective November 1, 2010, the Canadian bank has no further right to any of the Company's assets as collateral. The mortgage on the New York facility was \$9,194 and \$9,854 as of December 31, 2010 and 2009, respectively, was for an original term of 15 years, bears interest at the rate of LIBOR plus 1.25%, and has a graduating debt service coverage ratio covenant of 1.90. At December 31, 2010 and 2009 the debt service coverage ratio was 2.10 and 2.05, respectively. The interest rate of this mortgage is effectively fixed at 6.16%, as the Company has an interest rate swap in place which is concurrent with the 15-year term of the mortgage. Since the Company, with respect to each mortgage referenced above, was not in compliance with certain covenants and because each lender has the right to accelerate its obligations, the Company has reclassified the long-term portion of each mortgage, in the amount of \$14,885 and \$17,780 as short-term loans at December 31, 2010 and 2009, 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 2009, 2008 and 2007. The Company is also not in compliance with certain reporting, and administrative covenants. Additionally, certain 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 14.a.2 above, are callable by the lenders until the Company is in compliance with its Form 20-F filing requirements as well as with all covenants. In addition, the covenants and undertakings described above restrict the Company's ability to incur additional debt.

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

## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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

	Weighted-Average Interest Rate				Amount	
	December 31,		December 31,		2010	2009
	2010		2009		2010	2009
In, or linked to, U.S. dollars (1)	2.18	%	3.25	%	\$ 19,473	\$ 34,905
In Canadian dollars (subject to variable interest rates)	0.00	%	3.40	%	25	7,921
In Israeli currency – linked to CPI	5.80	%	5.89	%	39,922	47,677
					\$ 59,420	\$ 90,503

- (1) Includes loans in the amount of \$17,787 and \$23,898 as of December 31, 2010 and 2009, respectively, which are subject to variable interest rates linked to LIBOR. The remaining outstanding debt is subject to fixed interest rates.

- c. The debt matures as follows:

	December 31,
	2010
2011	\$ 13,310
2012	17,547
2013	11,202
2014	11,252
2015	900
Thereafter	5,209
	\$ 59,420

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

For collateral, see Note 15.

## NOTE 15: — LIABILITIES COLLATERALIZED BY PLEDGES

Balance of liabilities collateralized by pledges is as follows:

	December 31,	
	2010	2009
Short-term bank credit and short-term loans (1)	\$ 6	\$ 34,256
Long-term debt (including current maturities) (2)	\$ 17,787	\$ 30,529

- (1)



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

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

F-35

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

For further discussion of collateralized assets see Notes 12 and 14.

## NOTE 16: — COMMITMENTS AND CONTINGENT LIABILITIES

- a. Companies of the Group have leased offices, warehouse space and equipment under operating leases for periods through 2015. The minimum annual rental payments, under non-cancelable lease agreements, are as follows:

	December 31, 2010
2011	\$ 2,571
2012	2,172
2013	1,586
2014	3,291
2015	265
Thereafter	-
	\$ 9,885

Total rent expenses were \$3,285, \$2,920 and \$3,323 for the years ended December 31, 2010, 2009 and 2008, 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, 2010 and 2009, the aggregate contingent liability to the OCS was approximately \$11,606 and \$12,117, respectively.

Royalty payments to the OCS were \$990, \$756 and \$588 for the years ended December 31, 2010, 2009 and 2008, respectively.

- c. Legal proceedings:

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

1. Legal actions commenced by the Company:

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

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

F-36

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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 is legacy litigation from the change in control of the Company in September 2010, and the lawsuit, at this time, is dormant.

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

On July 27, 2009, the Company filed a lawsuit against Synerx Pharma, LLC, DPT Laboratories, Ltd. and Karalex Pharma, LLC (a subsidiary of Eagle Pharmaceuticals, Inc.) in the United States District Court for New Jersey for infringement of its United States Patent No. 7,560,445 covering its Ovide® (malathion) Lotion, 0.5%. 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.

F-37

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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 18).

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 a result of their military service which included diving in the Kishon River near Haifa Bay. In 2005, the Company and over 40 municipalities, governmental entities (including the State of Israel), cooperative villages (kibbutzim) and other companies, were named as third party defendants in these lawsuits. The hearing of the lawsuits was consolidated with the hearing of another lawsuit filed by a group of fishermen also claiming to suffer from serious illnesses as a result of their activities in the Kishon River. The proceedings are currently in different stages, during which the parties present the evidence in the cases to the court.
- iii. On March 7, 2011, the Company was sued by The Blackstone Group L.P. (“Blackstone”) in the Supreme Court of the State of New York, County of New York. The lawsuit alleges breach of contract relating to fees under an agreement whereby Blackstone would provide certain financial advisory services to the Company. Blackstone seeks approximately \$6.3 million in fees and expenses. The proceedings are in the very early stages and the Company denies liability in the matter.

- d. In 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.

F-38

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

e. Licensing Agreements:

1. In May 2010, Taro and Quinnova Pharmaceuticals, Inc. entered into an agreement to co-promote Taro's Topicort and desoximetasone products. Under the terms of the arrangement, Taro manufactured and Quinnova co-promoted the products. The parties mutually agreed to terminate the agreement in January 2011.
2. In May 2010, Taro and Glenmark Generics Inc., USA, a wholly owned subsidiary of Glenmark Generics Ltd., India ("Glenmark"), entered into an exclusive license and supply agreement for a branded product. Glenmark Generics Inc., USA manufactures the product and Taro distributes the product to customers. Taro made an up-front payment of \$2,500 for distribution rights and an additional amount of \$2,500 upon the first shipment to customers, for a total of \$5,000, which is being amortized over six years. Taro also pays royalties based on the amounts of sales to its customers.

f. Other:

- a. 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, effective October 1, 2010, the methodology is based on the weighted average of the average manufacturer prices (AMPs) reported to the government by manufacturers of each of the therapeutically equivalent multiple source drugs. The legislation also, effective October 1, 2010, changed the definition of AMP to exclude sales to certain customer classes that were previously included. 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.

NOTE 17: — SHAREHOLDERS' EQUITY

a. Pertinent rights and privileges of ordinary shares:

1. 100% of the rights to profits are allocated to the ordinary shares.
2. 100% of the dissolution rights are allocated to the ordinary shares.
3. Two-thirds of the voting power of all of the Company's shares is allocated to the ordinary shares.

b. Founders' shares:

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





## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## 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, 2010, 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, 2010 and 2009, an aggregate of 11,325 and 38,575 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.

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, 2010, 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, 2010 and 2009, an aggregate of 579,855 and 960,330 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. A summary of the Company's stock option activity (except options to non-employees) and related information for the year ended December 31, 2010 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, 2009	998,905	\$2.38 - \$68.51	\$ 26.18		
Exercised	(44,975 )	\$2.44-\$12.91	\$ 4.14		
Forfeited	(362,750 )	\$2.44-\$66.95	\$ 29.47		
Granted	-	-	\$ -		
Outstanding at December 31, 2010	591,180	\$2.38 - \$68.51	\$ 25.84	2.59	\$ 480
Exercisable at December 31, 2010	557,080		\$ 26.56	2.44	\$ 462

Vested and expected to vest at December 31, 2010	375,343	\$ 25.07	2.58	\$ 392
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There were 44,975 options exercised in the year ended December 31, 2010. Total intrinsic value of options exercised in the year ended December 31, 2010 was approximately \$410. There were 49,000 options exercised in the year ended December 31, 2009. Total intrinsic value of options exercised in the year ended December 31, 2009 was approximately \$261.

As of December 31, 2010, there was \$21 of unrecognized compensation costs related to share-based compensation arrangements granted under the Company's stock option plan. The unrecognized cost is expected to be recognized over a weighted-average period of 0.06 years for the year ended December 31, 2010. As of December 31, 2009, there was \$380 of unrecognized compensation costs related to share-based compensation arrangements granted under the Company's stock option plan. The unrecognized cost is expected to be recognized over a weighted-average period of 0.92 years for the year ended December 31, 2009. For the years ended December 31, 2010, 2009 and 2008 the Company recognized \$285, \$307 and \$322, respectively, in stock-based compensation expense.

## TARO PHARMACEUTICAL INDUSTRIES LTD.

## Notes to consolidated financial statements

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

The number of options exercisable as of December 31, 2010, 2009 and 2008 are 557,080, 874,055 and 906,905, respectively. The weighted-average exercise prices for the options exercisable as of December 31, 2010, 2009 and 2008 are \$26.56, \$27.67 and \$26.56, respectively.

The stock options outstanding and exercisable as of December 31, 2010 have been classified into ranges of exercise prices as follows:

Range of exercise price	Options outstanding			Options exercisable	
	Outstanding as of December 31, 2010	Weighted-average remaining contractual life (in years)	Weighted-average exercise price \$	Exercisable as of December 31, 2010	Weighted-average exercise price \$
\$2.38 – \$10.00	20,200	0.00	\$ 3.43	20,200	\$ 3.43
\$10.01 – \$20.00	197,250	2.50	\$ 13.23	163,150	\$ 13.09
\$20.01 – \$30.00	151,000	3.22	\$ 24.22	151,000	\$ 24.22
\$30.01 – \$40.00	152,680	2.27	\$ 33.47	152,680	\$ 33.47
\$40.01 – \$68.51	70,050	2.92	\$ 54.63	70,050	\$ 54.63
	591,180	2.59	\$ 25.84	557,080	\$ 26.56

## 4. 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,		
	2010	2009	2008	2010	2009	2008
Weighted-average exercise price	\$ -	\$ -	\$ -	\$ -	\$ 9.50	\$ 7.70
Weighted-average fair value on the date of grant	\$ -	\$ -	\$ -	\$ -	\$ 9.02	\$ 4.10

5. There were 18,000 stock options exercised by non-employees, at an exercise price of \$3.39 per share, during the year ended December 31, 2010.

## d. Dividends:

The Company may declare and pay dividends from retained earnings (as for restrictions on dividend distribution, see Note 18.d).

## e. Net income per share:

	Year ended December 31, 2010			Year ended December 31, 2009			Year ended December 31, 2008		
	Net income attributable to Taro (numerator)	Shares (denominator)	Per Share Amount	Net income attributable to Taro (numerator)	Shares (denominator)	Per Share Amount	Net income attributable to Taro (numerator)	Shares (denominator)	Per Share Amount
Basic EPS:	\$ 64,078	40,271,669	\$ 1.59	\$ 114,023	39,232,270	\$ 2.91	\$ 30,521	39,200,342	\$ 0.78
Effect of dilutive securities:									
Stock options	-	68,169	-	-	55,141	-	-	76,399	-
Sun Stock Warrants	-	1,510,486	-	-	1,280,436	-	-	1,146,060	-
Diluted EPS:	\$ 64,078	41,850,324	\$ 1.53	\$ 114,023	40,567,847	\$ 2.81	\$ 30,521	40,422,801	\$ 0.76

## f. 2000 Employee Stock Purchase Plan:

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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

The amount of consideration received from participating employees for the year ended December 31, 2008 was \$35. As noted above, this plan was terminated during 2008.

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

NOTE 18: — 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 2010, the Company has consistently elected, for tax purposes, to measure its earnings in U.S. dollars.

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

1. Generally, Israeli companies are subject to corporate tax on taxable income. On July 25, 2005, the Knesset (Israeli Parliament) approved the Law of the Amendment of the Income Tax Ordinance (No. 147), 2005, which prescribes, among other things, a gradual decrease of the corporate tax rate in Israel up to 25% for the tax year 2010 and beyond. However; the effective tax rate payable by a company that derives income from an Approved Enterprise, as discussed below, may be considerably less.
2. On July 14, 2009, the Knesset approved new legislative Amendments to implement the economic program for 2009 - 2010, which states, among other things, the further gradual reduction of corporate tax rate in Israel to the following tax rates: in 2009 – 26%, in 2010 – 25%, in 2011 – 24%, in 2012 – 23%, in 2013 – 22%, in 2014 – 21%, in 2015 – 20% and in 2016 and thereafter – 18%.
3. Pursuant to another amendment to the Income Tax Ordinance, which became effective in 2003, capital gains are taxed at a reduced rate of 25% from January 1, 2003, instead of the regular corporate tax rate at which such gains

were taxed until the aforementioned date. This amendment stipulates that with regard to the sale of assets acquired prior to January 1, 2003, the reduced tax rate will be applicable only for the gain allocated to capital gains earned after the implementation of the amendment, which will be calculated as prescribed by the amendment.

TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

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 five “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 fifth plan is according to the new “Approved Enterprise” plan which do not need approval and its benefits start in 2010. The undistributed income will be exempt from corporate tax for a period of two years and another eight years of 10% - 25% tax. The first two plans already finished their benefit periods.

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, 2010, 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).

F-43

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

For 2010, income not eligible for Approved Enterprise benefits mentioned above is taxed at the regular rate of 25% (see b above).

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

However, the Amendment provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the law as they were on the date of such approval. Therefore, the Company’s existing Approved Enterprises will generally not be subject to the provisions of the Amendment. As a result of the Amendment, tax-exempt income generated under the provisions of the new law, will subject the Company to taxes upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. As of December 31, 2009, the Company did not generate income under the provisions of the new law. The amendment also added section 85a which gives the Minister of Finance the authority to legislate regulation which determines the price in international transactions between related parties (known as transfer pricing issue).

Recently, new legislation amending the Investment Law was adopted. Under this new legislation, a uniform corporate tax rate will apply to all qualifying income of certain Industrial Companies, as opposed to the current law’s incentives, which are limited to income from Approved Enterprises during their benefits period. Under the new law, the uniform tax rate will be 10% in areas in Israel designated as Development Zone A and 15% elsewhere in Israel during 2011-2012, 7% and 12.5%, respectively, in 2013-2014, and 6% and 12%, respectively thereafter. Certain “Special Industrial Companies” that meet certain criteria (somewhat equivalent to the criteria for the Strategic Investment Track) will enjoy further reduced tax rates of 5% in Zone A and 8% elsewhere. The profits of these Industrial Companies will be freely distributable as dividends, subject to a 15% withholding tax (or lower, under an applicable tax treaty).

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

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

f. Income from continuing and discontinued operations before income taxes comprises of the following:

		Year ended December 31,		
	2010	2009	2008	
Domestic (Israel)	\$ 37,371	\$ 35,836	\$ 23,605	
Foreign (North America, the Cayman Islands, Ireland and the U.K.)	37,657	11,258	20,457	
Income from continuing and discontinued operations before taxes	\$ 75,028	\$ 47,094	\$ 44,062	

F-44

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

g. Taxes on income comprise of the following:

	Year ended December 31,		
	2010	2009	2008
Current taxes	\$ 7,021	\$ 8,263	\$ 13,158
Prior years' taxes	(3,264 )	271	498
Deferred income taxes	6,720	(78,191 )	(115 )
	\$ 10,477	\$ (69,657 )	\$ 13,541
Domestic	\$ 1,400	\$ 6,609	\$ 2,726
Foreign	9,077	(76,266 )	10,815
	\$ 10,477	\$ (69,657 )	\$ 13,541

Included within current and deferred income tax expense are benefits relating to investment tax credits at Taro Canada of \$1,751 and \$1,369 for the years ended December 31, 2010 and 2009, respectively. Taro Canada uses the “flow-through” method and therefore records the benefits in earnings in the period the tax credits are utilized.

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

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

	Year ended December 31,		
	2010	2009	2008
Income from continuing and discontinued operations before taxes	\$ 75,028	\$ 47,094	\$ 44,062
Statutory tax rate	25 %	26 %	27 %
Theoretical tax	\$ 18,757	\$ 12,244	\$ 11,897
Deferred tax in respect of losses for which valuation allowance was provided	(1,062 )	3,000	915
Tax (benefit) in respect to prior years	(14 )	280	21
“Approved Enterprise” benefit (1)	(5,199 )	(5,332 )	(5,053 )
Effect of different tax rates in other countries	414	186	5,871
Non-deductible expenses	(912 )	2,609	4,373
Canadian tax benefits in respect of research and development expenses	(1,462 )	(1,369 )	(1,099 )
Utilization of net operating losses	-	(2,969 )	(15,187 )
Deferred tax asset on temporary differences for which a valuation allowance was provided	52	(1,693 )	12,010
	-	(76,694 )	-

Reversal of valuation allowance against deferred tax assets in the U.S.			
Other	(97 )	81	(207 )
Income taxes in the Statements of Operations	\$ 10,477	\$ (69,657 )	\$ 13,541

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

	Year ended December 31,		
	2010	2009	2008
Basic	\$ 0.13	\$ 0.14	\$ 0.13
Diluted	\$ 0.12	\$ 0.13	\$ 0.13

F-45

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

i. Current taxes are calculated at the following rates:

	Year ended December 31,					
	2010		2009		2008	
On Israeli operations (not including "Approved Enterprise")	25.0	%	26.0	%	27.0	%
On U.S. operations *	35.0	%	35.0	%	35.0	%
On Canadian operations *	31.0	%	33.0	%	33.5	%
On U.K. operations *	26.0	%	28.0	%	28.5	%
On Ireland operations *	12.5	%	12.5	%	12.5	%

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

j. Deferred income taxes:

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

	December 31,	
	2010	2009
Deferred tax assets:		
Net operating loss carryforward	\$ 32,948	\$ 44,123
Deferred revenue	2,368	2,029
Property, plant, and equipment	1,959	1,749
Accrued expenses	38,647	33,261
Bad debt allowance	11	83
Amortization and impairment	8,003	8,908
Other, net	5,631	5,977
Total deferred tax assets	89,567	96,130
Valuation allowance for deferred tax assets	(15,222 )	(13,542 )
Net deferred tax assets	74,345	82,588
Deferred tax liabilities:		
Property, plant, and equipment	(2,393 )	(3,238 )
Amortization	18	(10 )
Other, net	(302 )	(875 )
Total deferred tax liabilities	(2,677 )	(4,123 )
Net deferred tax assets (liabilities)	\$ 71,668	\$ 78,465
Domestic	\$ 3,577	\$ 3,847
Foreign	68,091	74,618
	\$ 71,668	\$ 78,465

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

	December 31,	
	2010	2009
Among current assets (“other receivables and prepaid expenses”) \$	37,855	\$ 32,069
Long-term deferred income tax assets	36,490	50,520
Among short-term liabilities	(335 )	(311 )
Among long-term liabilities	(2,342 )	(3,813 )
	\$ 71,668	\$ 78,465

F-46

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

k. Carryforward tax losses:

1. The Company:

As of December 31, 2010, one of the Israeli subsidiaries has carryforward tax losses in the amount of \$964.

2. Canadian subsidiary:

As of December 31, 2010, this subsidiary has no carryforward tax losses.

3. U.K. subsidiary:

As of December 31, 2010, this subsidiary has carryforward tax losses of \$11,090, 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, 2010, this subsidiary has carryforward tax losses of \$56,874. 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, 2010, this subsidiary has carryforward tax losses of \$68,910 resulting from prior years U.S. operating losses and the exercise of stock options in 2001 by selling shareholders in a public offering of the Company's shares. These losses can be carried forward against taxable income for 20 years from the year in which the losses were incurred, resulting in expiration dates of 2021 through 2026. The Company estimates that it will utilize \$36,500 of such losses on its adjusted 2010 tax returns. The Company's U.S. subsidiary has been examined by the U.S. tax authorities through 2008; however due to the fact that the U.S. subsidiary has a net operating loss carryforward, the U.S. subsidiary remains subject to examination by the U.S. tax authorities from 2002 onward, but only to the extent of the amount of the net operating loss carryforward. As long as these net operating losses are available, the Company believes its U.S. subsidiary will not have significant tax assessments as a result of the examination. As discussed in Note 2.q, the Company reversed \$76,694 of the valuation allowance in 2009.

6. Hungarian subsidiary:

As of December 31, 2010, this subsidiary has carryforward tax losses of \$551, 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.

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



- m. At December 31, 2010, deferred income taxes were not provided for on a cumulative total of \$121,132 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. At December 31, 2010, the Company reversed \$4,270 of withholding tax accruals due to the favorable treaty provisions realized from the assignment of intercompany loans to its Hungarian subsidiary.

F-47

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## o. Tax assessments:

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

The Company is now in the process of a tax audit for the years 2004-2006, Taro Research Institute Ltd. is now in the process of a tax audit for the year 2006, Taro International Ltd. is now in the process of a tax audit for the years 2004-2007.

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

The Company completed its tax assessments with the Canadian tax authorities for the years through 2003. The Company's tax provision was adequate to satisfy these assessments. The Company remains subject to examination by the Canadian 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.

## p. Uncertain tax positions:

The Company adopted FASB ASC Section 740-10-25, "Income taxes-Overall-Recognition," effective January 1, 2007, which prescribes a model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that it has taken or expects to take on a tax return (see Note 2.q).

	December 31,	
	2010	2009
Unrecognized tax benefits balance at beginning of year	\$ 19,961	\$ 17,626
Increases as a result of positions taken in prior period	260	673
Decreases as a result of positions taken in prior period	(27 )	(109 )
Increases as a result of positions taken in current period	1,594	2,736
Decreases due to expiration of statute of limitations	(671 )	(965 )
Unrecognized tax benefits at end of year	\$ 21,117	\$ 19,961

The total amount of interest and penalties recognized on the consolidated statement of operations for the years ended December 31, 2010 and 2009 were \$1,296 and \$554, respectively. The total amount of interest and penalties recognized on the consolidated balance sheet at December 31, 2010 and 2009 were \$3,779 and \$2,459, respectively.

The total amount of unrecognized tax benefits, which would impact the effective tax rate if recognized, was \$21,117 and \$19,961 at December 31, 2010 and 2009, respectively.

Taro Canada and the Israeli company have the 2004 and 2005 tax years currently under examination.

The Company, to the best of its knowledge, believes \$7,000 of its uncertain tax positions are reasonably likely to decrease within the next 12 months.

F-48

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## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## NOTE 19: — SELECTED STATEMENTS OF INCOME DATA

	Year Ended December 31,		
	2010	2009(*)	2008(*)
Sales by location of customers :			
Israel	\$ 19,589	\$ 21,373	\$ 22,194
Canada	44,169	32,775	36,301
U.S.A.	305,858	278,301	255,531
Other	22,919	23,487	13,325
	\$ 392,535	\$ 355,936	\$ 327,351
Selling, marketing, general and administrative expenses:			
Selling and marketing	\$ 41,673	\$ 36,624	\$ 35,330
Advertising	6,827	5,505	6,979
General and administrative *	59,402	58,215	54,816
	\$ 107,902	\$ 100,344	\$ 97,125
* Including provision for doubtful accounts	\$ (473 )	\$ 75	\$ 286
Financial expenses:			
Interest and exchange differences on long-term liabilities	\$ 5,252	\$ 1,656	\$ 10,515
Income in respect of deposits	(985 )	(1,473 )	(750 )
Expenses in respect of short-term credit	2,291	2,792	4,060
Foreign currency transaction losses (gains)	5,282	10,600	(15,579 )
	\$ 11,840	\$ 13,575	\$ (1,754 )

(\*) Adjusted for the discontinued operations of the Irish subsidiary.

## TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

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

## NOTE 20: — SEGMENT INFORMATION

## a. Geographic Area Information:

The Group operates in one industry segment, which produces, researches, develops and markets pharmaceutical products. Management organizes the Company's operations based on geographic segments, which are presented below in accordance with FASB ASC Paragraph 280-10-50-1, "Segment Reporting – Overall – Disclosure – Operating Segments".

	Israel	Canada*	U.S.A.	Other **	Consolidated **
Year ended December 31, 2010 and as of December 31, 2010:					
Sales to unaffiliated customers ***	\$ 19,589	\$ 44,169	\$ 305,858	\$ 22,919	\$ 392,535
Long-lived assets ****	\$ 99,353	\$ 45,718	\$ 45,334	\$ 3,247	\$ 193,652
Year ended December 31, 2009 and as of December 31, 2009:					
Sales to unaffiliated customers ***	\$ 21,373	\$ 32,775	\$ 278,301	\$ 23,487	\$ 355,936
Long-lived assets ****	\$ 104,877	\$ 49,530	\$ 42,283	\$ 7,626	\$ 204,316
Year ended December 31, 2008 and as of December 31, 2008:					
Sales to unaffiliated customers ***	\$ 22,194	\$ 36,301	\$ 255,531	\$ 13,325	\$ 327,351
Long-lived assets ****	\$ 110,671	\$ 49,656	\$ 43,998	\$ 13,191	\$ 217,516

\* Includes operations in both Canada and Cayman Islands.

\*\* Adjusted for the discontinued operations of the Irish subsidiary.

\*\*\* Based on customer's location.

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

- b. For the year ended December 31, 2010, the Company had net sales to three different customers of 15.9%, 11.0% and 10.5% of consolidated net sales. For the year ended December 31, 2009, the Company had net sales to two different customers of 15.5% and 11.0% of consolidated net sales. For the year ended December 31, 2008, the Company had net sales to a single customer of 16.7% of consolidated net sales.
- c. Sales by therapeutic category, as a percentage of total sales for the years ended December 31, 2010, 2009 and 2008:

Category	2010	Year ended December 31,	
		2009	2008
		%	
Dermatological and topical	60	57	67
Cardiovascular	14	15	12
Neuropsychiatric	14	16	8
Anti-inflammatory	5	5	5
Other	7	7	8
Total	100	100	100

NOTE 21: DISCONTINUED OPERATIONS

- a. During 2010, the Company's management decided to sell the Irish facility. The results of operations of the Irish facility have been classified as discontinued operations in the Consolidated statements of operations and prior periods results have been reclassified accordingly.

- b. The following is the composition from discontinued operations:

## TARO PHARMACEUTICAL INDUSTRIES LTD.

## Notes to consolidated financial statements

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

	Year ended December 31,		
	2010	2009	2008
Sales, net	\$ (931 )	\$ (1,705 )	\$ (1,685 )
Cost of sales	3,278	7,682	8,834
Gross loss	2,347	5,977	7,149
Operating expenses:			
Research and development, net	267	940	1,364
Selling, marketing, general and administrative	921	1,858	1,900
Operating loss	3,535	8,775	10,413
Financial expenses, net	(3,139 )	2,952	2,549
Other gain, net	(44 )	(13 )	(586 )
Loss before income taxes	352	11,714	12,376
Tax expense	-	-	-
Net loss from discontinued operations	\$ 352	\$ 11,714	\$ 12,376

## NOTE 22: — SUBSEQUENT EVENTS

- a. On April 28, 2011, the Company filed a lawsuit against Suven Life Sciences Ltd. ("Suven") in the United States District Court of 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.
- b. 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.

## c. Stock options:

Between January 1, 2011 and May 25, 2011 no stock options were granted to the Company's directors.

End of consolidated financial statements

## TARO PHARMACEUTICAL INDUSTRIES LTD.

U.S. dollars in thousands

## SCHEDULE II: — VALUATION AND QUALIFYING ACCOUNTS

## Allowance for Inventory Obsolescence

Year	Balance at beginning of period	Additions — Charged to costs and expenses	Foreign currency translation adjustments	Deductions — Write-offs of Inventory	Balance at end of period
2010	\$ 12,006	\$ 6,693	\$ 181	\$ (7,976 )	\$ 10,904
2009	\$ 15,726	\$ 6,762	\$ 441	\$ (10,923 )	\$ 12,006
2008	\$ 12,435	\$ 5,704	\$ (614 )	\$ (1,799 )	\$ 15,726

## Allowance for Doubtful Accounts

Year	Balance at beginning of period	Additions — Charged to costs and expenses	Deductions — Write-offs	Balance at end of period
2010	\$ 547	\$ (473 )	\$ -	\$ 74
2009	\$ 630	\$ 75	\$ (158 )	\$ 547
2008	\$ 741	\$ 286	\$ (397 )	\$ 630

S-1