REDWOOD TRUST INC
Form DEF 14A
April 03, 2012

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

SCHEDULE 14A
(RULE 14a-101)

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant: x
Filed by a Party other than the Registrant: o
Check the appropriate box:

o Preliminary Proxy Statement
o Confidential, for Use of the Commission Only (as Permitted by Rule 14a-6(e)(2))
x Definitive Proxy Statement
o Definitive Additional Materials
o Soliciting Material Pursuant to §240.14a-12

REDWOOD TRUST, INC.

(Name of Registrant as Specified in Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.
o Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.
(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

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(4) Proposed maximum aggregate value of transaction:

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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REDWOOD TRUST, INC.
One Belvedere Place, Suite 300
Mill Valley, California 94941
(415) 389-7373

NOTICE OF 2012 ANNUAL MEETING OF STOCKHOLDERS

To the Stockholders of Redwood Trust, Inc.:

You are cordially invited to attend the Annual Meeting of Stockholders of Redwood Trust, Inc., a Maryland corporation, to be held on May 17, 2012 at 10:30 a.m., local time, at the Acqua Hotel, 555 Redwood Highway, Mill Valley, California 94941, for the following purposes:

1. To elect George E. Bull, III and Georganne C. Proctor as Class III directors to serve until the Annual Meeting of Stockholders in 2015 and until their successors are duly elected and qualify;
2. To ratify the appointment of Grant Thornton LLP as our independent registered public accounting firm for 2012;
3. To vote on an advisory resolution to approve named executive officer compensation;
4. To vote on an amendment to our charter to increase the number of shares authorized for issuance;
5. To vote on an amendment to our 2002 Incentive Plan;
6. To vote on an amendment to our 2002 Employee Stock Purchase Plan;
7. To vote on an amendment to our charter to eliminate the classification of our Board of Directors;
8. To vote on an amendment to our Bylaws to adopt a majority voting provision for uncontested director elections; and
9. To transact such other business as may properly come before the Annual Meeting or any adjournment or postponement of the Annual Meeting.

A Proxy Statement describing the matters to be considered at the Annual Meeting is attached to this notice. Our Board of Directors has fixed the close of business on March 30, 2012 as the record date for determination of stockholders entitled to notice of, and to vote at, the Annual Meeting and any adjournment or postponement of the Annual Meeting.

We would like your shares to be represented at the Annual Meeting. Whether or not you plan to attend the Annual Meeting, we respectfully request that you mark, date, sign, and promptly mail the enclosed proxy card in the accompanying postage-paid envelope or, pursuant to instructions on the enclosed proxy card, authorize a proxy to cast your votes by telephone or through the Internet.

Important Notice Regarding the Availability of Proxy Materials for the Annual Meeting to Be Held on May 17, 2012:

our Proxy Statement can be directly accessed through our website at: *http://www.redwoodtrust.com/Proxy* our Annual Report on Form 10-K for the year ended December 31, 2011 is available within the Investor Information section of our website at: *http://www.redwoodtrust.com*

By Order of the Board of Directors,
/s/ Andrew P. Stone
Secretary

April 3, 2012

YOUR VOTE IS IMPORTANT.

PLEASE PROMPTLY MARK, DATE, SIGN, AND RETURN YOUR PROXY CARD IN THE ENCLOSED ENVELOPE OR, PURSUANT TO INSTRUCTIONS ON YOUR PROXY CARD, AUTHORIZE A PROXY TO CAST YOUR VOTES BY TELEPHONE OR THROUGH THE INTERNET.

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REDWOOD TRUST, INC.
One Belvedere Place, Suite 300
Mill Valley, California 94941
(415) 389-7373

PROXY STATEMENT

ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD ON MAY 17, 2012

INTRODUCTION

This Proxy Statement is being furnished in connection with the solicitation of proxies by the Board of Directors of Redwood Trust, Inc., a Maryland corporation (Redwood, we, or us), for exercise at the Annual Meeting of Stockholders (the Annual Meeting) to be held on Thursday, May 17, 2012 at 10:30 a.m., local time, at the Acqua Hotel, 555 Redwood Highway, Mill Valley, California 94941, and at any adjournment or postponement thereof. This Proxy Statement, the accompanying proxy card, and the Notice of Annual Meeting are being mailed to stockholders of record as of the record date for the Annual Meeting beginning on or about April 11, 2012.

Redwood, together with its subsidiaries, is a financial institution that seeks to invest in real estate related assets that have the potential to provide attractive cash flows over a long period of time and support our goal of distributing attractive levels of dividends to our stockholders. For tax purposes, we are structured as a real estate investment trust, or REIT. We are able to pass through substantially all of our earnings generated at our REIT to our stockholders without paying income tax at the corporate level. We pay income tax on the REIT taxable income we retain and on the income we earn at our taxable subsidiaries. Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941.

The address and telephone number of our principal executive office are as set forth above and our website is *www.redwoodtrust.com.* Information on our website is not a part of this Proxy Statement.

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INFORMATION ABOUT THE ANNUAL MEETING

Who May Attend the Annual Meeting

Only stockholders who own our common stock as of the close of business on March 30, 2012, the record date for the Annual Meeting, will be entitled to attend the Annual Meeting. In the discretion of management, we may permit certain other individuals to attend the Annual Meeting, including members of the media and our employees.

Who May Vote

Each share of our common stock outstanding on the record date for the Annual Meeting entitles the holder thereof to one vote. The record date for determining stockholders entitled to notice of, and to vote at, the Annual Meeting is the close of business on March 30, 2012. As of the record date, there were 78,756,319 shares of common stock issued and outstanding. You can vote in person at the Annual Meeting or by proxy. To vote by authorizing a proxy to cast your votes, please mark, date, sign, and mail the enclosed proxy card. You may also authorize a proxy to vote your shares by telephone or through the Internet as instructed on the proxy card.

If your shares are held in the name of a bank, broker, or other holder of record, you will receive instructions from the holder of record that you must follow in order for your shares to be voted. If your shares are not registered in your own name and you plan to cast your votes in person at the Annual Meeting, you should contact your broker or agent to obtain a broker s proxy card and bring it to the Annual Meeting in order to vote.

Voting by Proxy; Board of Directors Voting Recommendations

If you vote by proxy, the individuals named on the proxy, or their substitutes, will cast your votes in the manner you indicate. If you date, sign, and return the proxy card without marking your voting instructions, your votes will be cast in accordance with the recommendations of Redwood s Board of Directors, as follows:

For the election of each of the two Class III nominees to serve as directors until the Annual Meeting of Stockholders in 2015 and until their successors are duly elected and qualify;
For the ratification of the appointment of Grant Thornton LLP as our independent registered public accounting firm for 2012;
For the approval, on an advisory basis, of the resolution approving the compensation of our named executive officers;
For the approval of the amendment to our charter to increase the number of shares authorized for issuance;
For the approval of the amendment to our 2002 Incentive Plan;
For the approval of the amendment to our 2002 Employee Stock Purchase Plan;
For the approval of the amendment to our charter to eliminate the classification of our Board of Directors;
To abstain from the vote on the amendment to our Bylaws to adopt a majority voting provision for uncontested director elections; and
In the discretion of the proxy holder on any other matter that properly comes before the Annual Meeting.

You may revoke or change your proxy at any time before it is exercised by delivering to us a signed proxy with a date later than your previously delivered proxy, by submitting a new proxy by telephone or through the Internet, by voting in person at the Annual Meeting, or by sending a written revocation of your proxy addressed to Redwood s Secretary at our principal executive office.

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Quorum Requirement

The presence, in person or by proxy, of stockholders entitled to cast a majority of all the votes entitled to be cast at the Annual Meeting constitutes a quorum for the transaction of business. Abstentions and broker non-votes are counted as present for purposes of establishing a quorum. A broker non-vote occurs when a nominee holding shares for a beneficial owner returns a proxy card but does not vote on a matter because the nominee holder has not received instructions from the beneficial owner and does not have or chooses not to exercise discretionary authority to vote the shares.

Other Matters

Our Board of Directors knows of no other matters that may be presented for stockholder action at the Annual Meeting. If other matters properly come before the Annual Meeting, however, it is intended that the persons named in the proxies will vote on those matters in their discretion.

Information About the Proxy Statement and the Solicitation of Proxies

The enclosed proxy is solicited by our Board of Directors and we will bear the costs of this solicitation. Proxy solicitations will be made by mail, and also may be made by our directors, officers, and employees in person or by telephone, facsimile transmission, e-mail, or other means of communication. Banks, brokerage houses, nominees, and other fiduciaries will be requested to forward the proxy soliciting material to the beneficial owners of shares of our common stock entitled to be voted at the Annual Meeting and to obtain authorization for the execution of proxies on behalf of beneficial owners. We will, upon request, reimburse those parties for their reasonable expenses in forwarding proxy materials to their beneficial owners.

Annual Report

Our 2011 Annual Report, consisting of our Annual Report on Form 10-K for the year ended December 31, 2011, is being mailed to stockholders together with this Proxy Statement and contains financial and other information about Redwood, including audited financial statements for our fiscal year ended December 31, 2011. Certain sections of our 2011 Annual Report are incorporated into this Proxy Statement by reference, as described in more detail under Information Incorporated by Reference below. Our 2011 Annual Report is also available on our website.

Householding

We have adopted a procedure approved by the Securities and Exchange Commission (SEC) called householding. Under this procedure, stockholders of record who have the same address and last name and do not participate in electronic delivery of proxy materials will receive only one copy of our Notice of Annual Meeting, Proxy Statement, and Annual Report, unless one or more of these stockholders notifies us that they wish to continue receiving individual copies. This procedure reduces our printing costs and postage fees.

Stockholders who participate in householding will continue to receive separate proxy cards. Also, householding will not in any way affect dividend check mailings.

If you are eligible for householding, but you and other stockholders of record with whom you share an address currently receive multiple copies of the Notice of Annual Meeting, Proxy Statement, and Annual Report, or if you hold stock in more than one account, and in either case you wish to receive only a single copy of each of these documents for your household, please contact our transfer agent, Computershare Trust Company, N.A. (in writing at: Computershare Investor Services, 250 Royall Street, Canton, MA 02021; or by telephone at: (888) 472-1955).

If you participate in householding and wish to receive a separate copy of the Notice of Annual Meeting, Proxy Statement, and Annual Report, or if you do not wish to participate in householding and prefer to receive separate copies of these documents in the future, please contact Computershare as indicated above.

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

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CORPORATE GOVERNANCE

Corporate Governance Standards

Our Board of Directors has adopted Corporate Governance Standards (Governance Standards). Our Governance Standards are available on our website as well as in print at the written request of any stockholder addressed to Redwood s Secretary at our principal executive office. The Governance Standards contain general principles regarding the composition and functions of our Board of Directors and its committees.

Process for Nominating Potential Director Candidates

Identifying and Evaluating Nominees for Directors. Our Board of Directors nominates director candidates for election by stockholders at each annual meeting and elects new directors to fill vacancies on our Board of Directors between annual meetings of the stockholders. Our Board of Directors has delegated the selection and initial evaluation of potential director nominees to the Governance and Nominating Committee with input from the Chief Executive Officer and President. The Governance and Nominating Committee makes the final recommendation of candidates to our Board of Directors for nomination. Our Board of Directors, taking into consideration the assessment of the Governance and Nominating Committee, also determines whether a nominee would be an independent director.

Stockholders Nominees. Our Bylaws permit stockholders to nominate a candidate for election as a director at an annual meeting of the stockholders subject to compliance with certain notice and informational requirements, as more fully described below in this Proxy Statement under Stockholder Proposals for the 2013 Annual Meeting. A copy of the full text of our Bylaws may be obtained by any stockholder upon written request addressed to Redwood s Secretary at our principal executive office. Among other matters required under our Bylaws, any stockholder nominations should include the nominee s name and qualifications for Board membership and should be addressed to Redwood s Secretary at our principal executive office.

The policy of the Governance and Nominating Committee is to consider properly submitted stockholder nominations for candidates for election to our Board of Directors. The Governance and Nominating Committee evaluates stockholder nominations in connection with its responsibilities set forth in its written charter and applies the qualification and diversity criteria set forth in the Governance Standards.

Director Qualifications. Our Governance Standards contain Board membership criteria that apply to nominees for our Board of Directors. Each member of our Board of Directors must exhibit high standards of integrity, commitment, and independence of thought and judgment, and must be committed to promoting the best interests of Redwood. In addition, each director must devote the time and effort necessary to be a responsible and productive member of our Board of Directors. This includes developing knowledge about Redwood s business operations and doing the work necessary to participate actively and effectively in Board and committee meetings.

Our Governance Standards also contain criteria that are intended to guide our Governance and Nominating Committee s considerations of diversity in identifying nominees for our Board of Directors. In particular, our Governance Standards provide that the members of our Board of Directors should collectively possess a broad range of talent, skill, expertise, and experience useful to effective oversight of our business and affairs and sufficient to provide sound and prudent guidance with respect to our operations and interests. The self-assessments that are conducted each year by our Board of Directors and our Governance and Nominating Committee include an assessment of whether the Board s then current composition represents the broad range of talent, skill, expertise, and experience that is called for by our Governance Standards.

Director Independence

As required under Section 303A of the New York Stock Exchange (NYSE) Listed Company Manual and our Governance Standards, our Board of Directors has affirmatively determined that none of the following directors has a material relationship (either directly or as a partner, shareholder, or officer of an organization that has a relationship) with us and that each of them qualifies as independent under Section 303A: Richard D. Baum, Thomas C. Brown, Mariann Byerwalter, Douglas B. Hansen, Greg H. Kubicek, Jeffrey T. Pero, Georganne C. Proctor, and Charles J. Toeniskoetter. The Board of Directors determination

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was made with respect to Mr. Pero after consideration of the following: Mr. Pero is a retired partner of Latham & Watkins LLP and has been a director of Redwood since November 2009; Latham & Watkins LLP provides legal services to Redwood; and Mr. Pero s retirement payments from Latham & Watkins LLP are adjusted to exclude any proportionate benefit received from the fees paid by Redwood to Latham & Watkins LLP.

Two of the members of our Board of Directors, George E. Bull, III and Martin S. Hughes, do not currently qualify as independent under Section 303A of the NYSE Listed Company Manual or our Governance Standards. Mr. Bull does not currently qualify as independent due to the fact that until his retirement in May 2010, he served as Redwood s Chief Executive Officer. Mr. Hughes does not qualify as independent because he is Redwood s current Chief Executive Officer.

Board Leadership Structure

At Redwood, there is a separation of the chairman and chief executive officer roles. The Chairman of the Board of Directors presides over meetings of the Board and serves as a liaison between the Board and management of Redwood. In addition, the Chairman provides input regarding Board agendas, materials, and areas of focus, and may represent Redwood to external constituencies such as investors, governmental representatives, and business counterparties. The Chairman is currently George E. Bull, III, who was one of the founders of Redwood in 1994 and who has continuously served as the Chairman since the inception of Redwood. Mr. Bull is a non-employee director, but is not an independent director due to the fact that he retired as our Chief Executive Officer in May 2010.

Under our Governance Standards, the Board of Directors also has a Presiding Director elected annually by the independent directors, who acts as a lead independent director and carries out certain other responsibilities, as described below. In addition, each of the Audit Committee, Compensation Committee, and Governance and Nominating Committee is chaired by an independent director. Richard D. Baum serves as the Presiding Director. The Presiding Director is responsible for chairing executive sessions of our independent directors, as well as providing input regarding Board agendas, materials, and areas of focus, serving as one of the liaisons between management and the Board, working with the chair of each of the Board s committees to ensure that each committee functions effectively, and performing other functions to facilitate effective communication and corporate governance.

The Board believes this leadership structure is appropriate for Redwood, as it provides for the Board to be led by non-employee directors. As a non-employee Chairman of the Board, Mr. Bull brings significant prior experience as the Chief Executive Officer to bear on his leadership responsibilities, while Mr. Baum, in his role as Presiding Director, brings the important perspective of an independent director.

Executive Sessions

Our Governance Standards require that our non-employee directors (i.e., the nine of our ten directors that who are not Redwood employees) meet in executive session at each regularly scheduled meeting of our Board of Directors and at such other times as determined by our Presiding Director. In addition, if any non-employee director is not also an independent director, then our Governance Standards require that our independent directors meet at least annually without any such non-independent directors.

Board of Directors Role in Risk Oversight

The Board of Directors takes an active role in risk oversight. At its regular meetings it reviews Redwood s business and investment strategies and plans and seeks an understanding of the related risks as well as management s approach to identifying and managing those risks. Because of the nature of Redwood s business, the Board of Directors focuses on, among other things, establishing the appropriate philosophy with respect to investment risk and determining whether risks actually taken are in accordance with this philosophy. In carrying out its role in risk oversight, the Board of Directors receives and discusses quarterly reports from the Chief Executive Officer and quarterly reports from the Audit Committee, which also carries out a risk oversight function delegated by the Board of Directors.

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Under its charter, the Audit Committee is specifically charged with (i) inquiring of management and Redwood s independent registered public accounting firm about significant risks or exposures with respect to corporate accounting, reporting practices of Redwood, the quality and integrity of the financial reports and controls of Redwood, regulatory and accounting initiatives, and any off-balance sheet structures and (ii) assessing the steps management has taken to minimize such risks. In addition, the Audit Committee is specifically charged with regularly discussing with management Redwood s policies with respect to risk assessment and risk management, including identification of Redwood s major financial and operational risk exposures and the steps management has taken to monitor and control those exposures.

The Audit Committee carries out this function by, among other things, receiving a quarterly risk management report from Redwood s Chief Executive Officer and a quarterly internal audit report from Redwood s head of internal audit, reviewing these reports, and discussing them by asking questions and providing direction to management. In addition, as noted below under Audit Committee Matters Audit Committee Report, the Audit Committee also receives and discusses regular and required communications from Redwood s independent registered public accounting firm regarding, among other things, Redwood s internal controls. In addition to discussion of these reports during Audit Committee meetings, as circumstances merit, the Audit Committee holds separate executive sessions with one or more of the Chief Executive Officer, Redwood s head of internal audit, and representatives of Redwood s independent registered public accounting firm to discuss any matters that the Audit Committee or these persons believe should be discussed in the absence of other members of management.

In addition, when appropriate, the Board of Directors may delegate to other standing committees risk oversight responsibilities with respect to certain matters or request that other committees review certain risk oversight matters. For example, the Compensation Committee has been delegated to review, on an annual basis, whether Redwood s compensation policies and practices are reasonably likely to have a material adverse effect on Redwood.

The Board of Directors believes that this manner of administering the risk oversight function effectively integrates such oversight into the Board of Directors leadership structure, because the risk oversight function is carried out both at the Board level as well as through delegation to the Audit Committee, which consists solely of independent directors, and when appropriate to the other standing committees of the Board of Directors, which also consist solely of independent directors.

Communications with the Board of Directors

Stockholders and other interested parties may communicate with our Board of Directors by e-mail addressed to *boardofdirectors@redwoodtrust.com*. The Presiding Director has access to this e-mail address and provides access to the other directors as appropriate. Communications that are intended specifically for non-employee directors should be addressed to the Presiding Director.

Director Attendance at Annual Meetings of Stockholders

Pursuant to our Governance Standards, our directors are expected to attend annual meetings of stockholders. All of our directors attended last year s Annual Meeting of Stockholders in person. We currently expect all of our directors to attend this year s Annual Meeting of Stockholders.

Code of Ethics

Our Board of Directors has adopted a Code of Ethics that applies to all of our directors, officers, and employees. Our Code of Ethics is available on our website as well as in print at the written request of any stockholder addressed to Redwood s Secretary at our principal executive office.

We intend to post on our website and disclose in a Current Report on Form 8-K, to the extent required by applicable regulations, any change to the provisions of our Code of Ethics and any waiver of a provision of the Code of Ethics.

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STOCK OWNERSHIP REQUIREMENTS

Required Stock Ownership by Directors

Pursuant to our Governance Standards, non-employee directors are required to purchase from their own funds at least $50,000 (as measured on a purchase cost basis, including deferred stock units credited to our Executive Deferred Compensation Plan through the voluntary deferral of what otherwise would have been current cash compensation) of our common stock within three years from the date of commencement of their Board membership. Any director whose status has changed from being an employee director to being a non-employee director is not subject to this requirement if that director held at least $50,000 of our common stock at the time of that change in status (as measured on the purchase cost basis outlined in the prior sentence).

In addition, during 2011 non-employee directors were required to own at least $280,000 of our common stock (as measured on a purchase/acquisition cost basis, including deferred stock units acquired through both voluntary and involuntary deferred compensation) by the later of December 31, 2011 or five years from the date of commencement of their Board membership. On March 8, 2012, the Board of Directors increased this ownership requirement to $350,000 and provided that incumbent directors would have through December 31, 2013 to satisfy this increased ownership requirement (or, if later, through five years from the date of commencement of their Board membership). Stock and deferred stock units acquired with respect to the $50,000 stock ownership requirement count toward the attainment of this additional stock ownership requirement.

As of the date of this Proxy Statement, all of our non-employee directors were in compliance with these guidelines.

Required Stock Ownership by Executive Officers

The Compensation Committee of our Board of Directors has set the following executive stock ownership guidelines with respect to our executive officers (as measured on a purchase/acquisition cost basis, including deferred stock units acquired through both voluntary and involuntary deferred compensation).

Each executive officer is required to own stock with a value at least equal to (i) five times current salary for the Chief Executive Officer, (ii) three times current salary for the President, and (iii) two times current salary for the other executive officers;
Three years are allowed to initially attain the required level of ownership, and three years are allowed to acquire additional incremental shares if promoted to a position with a higher guideline (if not in compliance at the indicated times, then the executive officer is required to retain net after-tax shares delivered as compensation or from the Executive Deferred Compensation Plan until compliance is achieved); and
All shares owned outright are counted, including those held in trust for the executive officer and his or her immediate family, as well as vested deferred stock units and any other vested shares held pursuant to other employee plans.

As of the date of this Proxy Statement, all of our executive officers were in compliance with these guidelines.

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ITEM 1 ELECTION OF DIRECTORS

Redwood s charter, as currently in effect (the Charter), and Bylaws provide for a classified Board of Directors consisting of Classes I, II, and III. Class III directors are scheduled to be elected at the 2012 Annual Meeting to serve for a three-year term and until their successors are duly elected and qualify. The nominees for the two Class III director positions are set forth below. In the event we are advised prior to the Annual Meeting that any nominee will be unable to serve or for good cause will not serve as a director if elected at the Annual Meeting, the proxies will cast votes for any person who shall be nominated by the present Board of Directors to fill the vacancy. As of the date of this Proxy Statement, we are not aware of any nominee who is unable or unwilling to serve as a director for the full three-year term. The nominees listed below currently are serving as directors of Redwood.

Vote Required

If a quorum is present, a plurality of the votes cast at the Annual Meeting is required for the election of a director. Cumulative voting in the election of directors is not permitted. Abstentions and broker non-votes will not be counted as votes cast and will have no effect on the results of the vote in the election of directors.

THE BOARD OF DIRECTORS RECOMMENDS THAT STOCKHOLDERS VOTE FOR THE NOMINEES IDENTIFIED BELOW.

Class III Nominees to Board of Directors

Name	Position with Redwood
George E. Bull, III	Chairman of the Board
Georganne C. Proctor	Director

Certain biographical information regarding each nominee for election at the Annual Meeting is set forth below along with biographical information for other directors.

George E. Bull, III, age 62, is a founder of Redwood and Chairman of the Board. Mr. Bull has served as Chairman of the Board of Redwood since 1994 and served as Chief Executive Officer from 1994 to May 2010. From 1983 through 1997, Mr. Bull was the President of GB Capital. GB Capital assisted banks, insurance companies, and savings and loans in managing portfolios of securitized and unsecuritized mortgage loans, in arranging collateralized borrowings, in hedging balance sheet risks, and with other types of capital markets transactions. Mr. Bull holds a B.A. in Economics from the University of California at Davis.

The Board of Directors concluded that Mr. Bull should be nominated to continue to serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

Leadership attributes and management experience, including experience as Chief Executive Officer of Redwood Trust since its founding in 1994 to May 2010

Skill and experience in investing in real estate-related assets and managing portfolios of such investments

Skill and experience in managing balance sheet exposures and managing financial risks

Skill and experience in executing capital markets transactions

Professional and educational background

Georganne C. Proctor, age 55, has been a director of Redwood since March 2006. Ms. Proctor is the former Chief Financial Officer of TIAA-CREF, and served in that position from June 2006 to July 2010. From July 2010 to October 2010, Ms. Proctor served as Executive Vice President for Enterprise Integration at TIAA-CREF. From 2003 to 2005, Ms. Proctor was Executive Vice President of Golden West Financial Corporation, a thrift institution. From 1994 to 1997, Ms. Proctor was Vice President of Bechtel Group, a global engineering firm, and also served as its Senior Vice President and Chief Financial Officer from 1997 to 2002 and as a director from 1999 to 2002. From 1991 to 1994, Ms. Proctor served as finance director of certain divisions of The Walt Disney Company, a diversified worldwide entertainment company. Ms. Proctor currently serves on the Board of Directors of Och-Ziff Capital Management Group. Ms. Proctor previously served on the Board of Directors of Kaiser Aluminum Corporation from 2006 to 2009. Ms. Proctor holds a B.S. in Business Management from the University of South Dakota and an M.B.A. from California State University East Bay.

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The Board of Directors concluded that Ms. Proctor should be nominated to continue to serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

- Management experience
- Experience as a chief financial officer
- Expertise and experience in the banking and investment management industries
- Professional and educational background

Current Directors Terms Expiring After 2012

Richard D. Baum, age 65, has been a director of Redwood since 2001. Mr. Baum is currently the President and Managing Partner of Atwater Retirement Village LLC (a private company). From 2008 to mid-2009, Mr. Baum served as Executive Director of the California Commission for Economic Development. He also served as the Chief Deputy Insurance Commissioner for the State of California from 1991 to 1994 and 2003 to 2007. Mr. Baum served from 1996 to 2003 as the President of Care West Insurance Company, a worker s compensation insurance company, and prior to 1991 as Senior Vice President of Amfac, Inc., a diversified operating company engaged in various businesses, including real estate development and property management. Mr. Baum holds a B.A. from Stanford University, an M.A. from the State University of New York, and a J.D. from George Washington University, National Law Center. Mr. Baum is a Class I director whose term expires in 2013.

The Board of Directors concluded that Mr. Baum should continue to serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

- Leadership attributes and management experience
- Experience as a chief executive officer
- Experience in government service and financial regulation
- Expertise and experience relating to the insurance industry
- Expertise and experience relating to the real estate development industry and property management business
- Expertise and experience relating to institutional governance
- Professional and educational background

Mariann Byerwalter, age 51, has been a director of Redwood since 1998. Ms. Byerwalter is currently Chairman of JDN Corporate Advisory LLC (a privately held advisory services firm). Ms. Byerwalter served as the Chief Financial Officer and Vice President for Business Affairs of Stanford University from 1996 to 2001. She was a partner and co-founder of America First Financial Corporation from 1987 to 1996, and she served as Chief Operating Officer, Chief Financial Officer, and a director of America First Eureka Holdings, a publicly traded institution and the holding company for Eureka Bank, from 1993 to 1996. She serves on the Board of Directors of Pacific Life Corp., SRI International, Burlington Capital Corporation, WageWorks, Inc., the Lucile Packard Children s Hospital, and the Stanford Hospital and Clinics. She also currently serves on the Board of Trustees of Stanford University and as a Trustee of certain investment companies affiliated with Charles Schwab Corporation. Ms. Byerwalter holds a B.A. from Stanford University and an M.B.A. from Harvard Business School. Ms. Byerwalter is a Class I director whose term expires in 2013.

The Board of Directors concluded that Ms. Byerwalter should continue to serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

- Leadership attributes and management and entrepreneurial experience
- Experience as a chief financial officer
- Expertise and experience in the banking and insurance industries

Expertise and experience relating to institutional governance
Professional and educational background

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Douglas B. Hansen, age 54, is a founder of Redwood and served as President from 1994 through 2008. Mr. Hansen retired from his position as President of Redwood at the end of 2008. From 1990 through 1997, Mr. Hansen was a Principal with GB Capital. GB Capital assisted banks, insurance companies, and savings and loans in managing portfolios of securitized and unsecuritized mortgage loans, in arranging collateralized borrowings, in hedging balance sheet risks, and with other types of capital markets transactions. Mr. Hansen currently serves on the Board of Governors for Opportunity International, the Board of Directors of the Pinhead Institute, and on the Board of Trustees of the International Center of Photography. Mr. Hansen holds a B.A. in Economics from Harvard College and an M.B.A. from Harvard Business School. Mr. Hansen is a Class II director whose term expires in 2014.

The Board of Directors concluded that Mr. Hansen should continue to serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

Leadership attributes and management experience, including experience as President of Redwood Trust since its founding in 1994 through 2008
Skill and experience in investing in real estate-related assets and managing portfolios of such investments
Skill and experience in managing balance sheet exposures and managing risks
Skill and experience in executing capital markets transactions
Experience in finance and accounting matters
Professional and educational background

Martin S. Hughes, age 54, has served as Chief Executive Officer since May 2010. Mr. Hughes served as President from January 2009 to January 2012, Co-Chief Operating Officer from November 2007 to May 2010, Chief Financial Officer from 2006 to April 2010, Treasurer from 2006 to 2007, and Vice President from 2005 to 2007. Mr. Hughes has over 18 years of senior management experience in the financial services industry. From 2000 to 2004, Mr. Hughes was the President and Chief Financial Officer for Paymap, Inc. In addition, Mr. Hughes served as a Vice President and Chief Financial Officer for Redwood from 1998 to 1999. Mr. Hughes also served as Chief Financial Officer for North American Mortgage Company from 1992 to 1998. Prior to 1992, Mr. Hughes was employed for eight years at an investment banking firm and for four years at Deloitte & Touche. Mr. Hughes has a BS in accounting from Villanova University. Mr. Hughes is a Class II director whose term expires in 2014.

The Board of Directors concluded that Mr. Hughes should continue to serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

Leadership attributes and management experience, including experience as Chief Executive Officer, President, and Chief Financial Officer of Redwood
Skill and experience in managing balance sheet exposures and managing risks
Skill and experience in executing capital markets transactions
Expertise and experience in the mortgage lending and investment banking industries
Accounting expertise and experience
Professional and educational background

Greg H. Kubicek, age 55, has been a director of Redwood since 2002. Mr. Kubicek is President of The Holt Group, Inc., a real estate company that develops, owns, and manages commercial real estate properties and is a residential homebuilder. Mr. Kubicek currently serves as a director for Cadet Manufacturing Co. He has also served as Chairman of the Board of Cascade Corporation, an international manufacturing corporation. Mr. Kubicek holds a B.A. in Economics from Harvard College. Mr. Kubicek is a Class II director whose term expires in 2014.

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The Board of Directors concluded that Mr. Kubicek should continue to serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

- Leadership attributes
- Management and entrepreneurial experience
- Expertise and experience in the real estate development industry
- Experience and expertise in the property management business
- Professional and educational background

Charles J. Toeniskoetter, age 67, has been a director of Redwood since 1994. Mr. Toeniskoetter is Chairman of Toeniskoetter Development, Inc. a company that has developed, owns, and manages over $250 million of commercial and industrial real estate properties, and Chairman & CEO of Toeniskoetter Construction, Inc. Mr. Toeniskoetter serves on the Board of Directors of SJW Corp. (NYSE: SJW) and Heritage Commerce Corp. (NASDAQ: HTBK), as well as a number of other community organizations. Mr. Toeniskoetter holds a B.S. in Mechanical Engineering from the University of Notre Dame and an M.B.A. from the Stanford University Graduate School of Business. Mr. Toeniskoetter is a Class II director whose term expires in 2014.

The Board of Directors concluded that Mr. Toeniskoetter should continue to serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

- Leadership attributes, including experience as a chief executive officer
- Management and entrepreneurial experience
- Experience as director of public companies
- Expertise and experience in the commercial real estate industry
- Expertise and experience in the banking and investment management industries
- Professional and educational background

Jeffrey T. Pero, age 65, has been a director of Redwood since November 2009. Mr. Pero retired in October 2009, after serving as a partner for more than 23 years, from the international law firm of Latham & Watkins LLP. At Latham & Watkins LLP, Mr. Pero s practice focused on advising clients regarding corporate governance matters, debt and equity financings, mergers and acquisitions, and compliance with U.S. securities laws; Mr. Pero also served in various firm management positions. Mr. Pero currently serves as a director of BRE Properties, Inc., a real estate investment trust. Mr. Pero holds a B.A. from the University of Notre Dame and a J.D. from New York University School of Law. Mr. Pero is a Class I director, whose term expires in 2013.

The Board of Directors concluded that Mr. Pero should continue to serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

- Expertise and experience in structuring and negotiating debt and equity financings
- Expertise and experience relating to corporate governance
- Management experience
- Expertise and experience relating to real estate investment trusts
- Expertise and experience relating to the U.S. securities laws
- Professional and educational background

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Current Directors Terms Expiring in May 2012

Thomas C. Brown, age 63, has been a director of Redwood since 1998. Mr. Brown is currently CEO and Principal shareholder of Urban Bay Properties, Inc. Mr. Brown has previously held CEO or senior officer positions with McGuire Real Estate, PMI Mortgage Insurance, Centerbank, and Merrill Lynch and Co., Inc. Mr. Brown s experience encompasses over 25 years in mortgage finance, real estate, banking, and investment banking. Mr. Brown holds a B.S. from Boston University and an M.B.A. from the University of Buffalo.

The Board of Directors concluded that Mr. Brown should serve as a director on account of, among other things, the following experience, qualifications, attributes, and skills:

Leadership attributes and management experience
Experience as a chief executive officer and chief operating officer
Expertise and experience in the mortgage finance, real estate, banking, and investment banking industries
Professional and educational background

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MEETINGS AND COMMITTEES OF THE BOARD OF DIRECTORS

Our Board of Directors currently consists of ten directors. Our Board of Directors has established three standing committees of the Board: the Audit Committee, the Compensation Committee, and the Governance and Nominating Committee. The membership of each committee and the function of each committee are described below. Each of the committees has adopted a charter and the charters of all committees are available on our website and in print at the written request of any stockholder addressed to Redwood s Secretary at our principal executive office.

Our Board of Directors held a total of six meetings during 2011. The non-employee directors of Redwood met in executive session at each of the five regularly scheduled meetings, for a total of five times during 2011. The Presiding Director, who was also the Chair of the Governance and Nominating Committee during 2011, presided at executive sessions of the independent directors. No director attended fewer than 75% of the meetings of the Board of Directors and the committees on which he or she served and all of our directors attended last year s Annual Meeting of Stockholders in person.

Audit Committee

The Audit Committee provides oversight regarding accounting, auditing, risk management, and financial reporting practices of Redwood. The Audit Committee consists solely of non-employee directors, all of whom our Board of Directors has determined are independent within the meaning of the listing standards of the NYSE and the rules of the SEC. Our Board of Directors has determined that all members of the Audit Committee are financially literate within the meaning of the applicable regulations and standards and has designated Ms. Proctor and Mr. Hansen as audit committee financial experts within the meaning of the applicable regulations and standards. The Audit Committee met four times in 2011 in order to carry out its responsibilities, as discussed below under Audit Committee Matters Audit Committee Report.

Compensation Committee

The Compensation Committee reviews and approves Redwood s compensation philosophy, reviews the competitiveness of Redwood s compensation practices, as well as risks that may arise from those practices, determines and approves the annual base salaries and incentive compensation paid to our executive officers, approves the terms and conditions of proposed incentive plans applicable to our executive officers and other key management employees, approves and oversees the administration of Redwood s employee benefit plans, and reviews and approves hiring and severance arrangements for our executive officers. The Compensation Committee consists solely of non-employee directors, all of whom our Board of Directors has determined are independent within the meaning of the listing standards of the NYSE, are non-employee directors within the meaning of the rules of the SEC, and are outside directors within the meaning of the rules of the Internal Revenue Service (the IRS). The Compensation Committee met six times in 2011 in order to carry out its responsibilities as more fully discussed below under Executive Compensation Compensation Discussion and Analysis.

Governance and Nominating Committee

The Governance and Nominating Committee reviews and considers corporate governance guidelines and principles, evaluates potential director candidates and recommends qualified candidates to the full Board, reviews the management succession plan and evaluates executives in connection with succession planning, and oversees the evaluation of the Board of Directors. The Governance and Nominating Committee consists solely of non-employee directors, all of whom our Board of Directors has determined are independent within the meaning of the listing standards of the NYSE. The Governance and Nominating Committee met seven times in 2011 in order to carry out its responsibilities.

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Committee Members

The current members of each of the three standing committees are listed below, with the Chair appearing first.

Audit	Compensation	Governance and Nominating
Greg H. Kubicek	Georganne C. Proctor	Richard D. Baum
Thomas C. Brown	Richard D. Baum	Douglas B. Hansen
Mariann Byerwalter	Thomas C. Brown	Greg H. Kubicek
Douglas B. Hansen	Mariann Byerwalter	Jeffrey T. Pero
Georganne C. Proctor	Jeffrey T. Pero	Charles J. Toeniskoetter
Charles J. Toeniskoetter		

DIRECTOR COMPENSATION

Information on our non-employee director cash compensation to be paid in 2012 is set forth in the table below.

Annual Retainer	$ 70,000*
Committee Meeting Fee (in person attendance)	$ 2,000
Committee Meeting Fee (telephonic attendance)	$ 1,000

* The Chair of the Audit Committee receives an additional annual cash retainer of $20,000 and the Chairs of the Compensation Committee and the Governance and Nominating Committee each receive an additional annual cash retainer of $15,000. The Presiding Director receives an additional annual cash retainer of $20,000. The Chairman of the Board of Directors receives an additional annual cash retainer of $50,000 per annum.

Non-employee directors are also reimbursed for reasonable out-of-pocket expenses incurred in attending Board and committee meetings, as well as for their and, in some cases, their guest s attendance at other Redwood-related meetings or events. Non-employee directors may also be reimbursed for out-of-pocket expenses incurred in attending conferences or educational seminars that relate to their Board service.

Non-employee directors are also granted deferred stock units (or comparable equity-based awards) each year at the time of the annual meeting of stockholders. The number of deferred stock units (or comparable equity-based awards) granted is determined by dividing $75,000 by the closing price of Redwood s common stock on the NYSE on the day immediately prior to grant. Non-employee directors may also be granted equity-based awards upon their initial election to the Board. Deferred stock units (or comparable equity-based awards) may be credited under our Executive Deferred Compensation Plan. These deferred stock units (or comparable equity-based awards) are fully vested upon grant, although they are generally subject to a mandatory four-year holding period. Dividend equivalent rights on deferred stock units (or comparable equity-based awards) are generally paid in cash to directors on each dividend distribution date.

Each director may elect to defer receipt of cash compensation or dividend equivalent rights through our Executive Deferred Compensation Plan. Cash balances in the Executive Deferred Compensation Plan are unsecured liabilities of Redwood and are utilized by Redwood as available capital to fund investments and operations. Based on each director s election, deferred compensation can either be deferred into a cash account and earn a rate of return that is equivalent to 120% of the applicable long-term federal rate published by the IRS compounded monthly or be deferred into deferred stock units which will, among other things, entitle them to receive dividend equivalent rights.

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The following table provides information on non-employee director compensation for 2011, which compensation was paid in accordance with the 2011 director compensation policy disclosed in Redwood s 2011 annual proxy statement or in accordance with the changes to that policy subsequently approved by the Board. Director compensation is set by the Board and is subject to change. Directors who are employed by Redwood do not receive any compensation for their Board activities.

Non-Employee Director Compensation 2011(1)

Name	Fees Earned or Paid in Cash ($)[2]	Stock Awards ($)[3]	All Other Compensation ($)[4]	Total ($)
Richard D. Baum	$ 123,354	$ 74,993		$ 198,347
Thomas C. Brown	$ 90,000	$ 74,993		$ 164,993
George E. Bull, III	$ 142,582	$ 74,993		$ 217,575
Mariann Byerwalter	$ 89,000	$ 74,993		$ 163,993
Douglas B. Hansen	$ 70,000	$ 74,993		$ 144,993
Greg H. Kubicek	$ 109,000	$ 74,993		$ 183,993
Jeffrey T. Pero	$ 92,000	$ 74,993		$ 166,993
Georganne C. Proctor	$ 105,000	$ 74,993		$ 179,993
Charles J. Toeniskoetter	$ 89,000	$ 74,993		$ 163,993

(1) The table does not include dividend equivalent rights paid on deferred stock units or options, as the value of the dividend equivalent rights was factored into the grant date fair value of the original deferred stock unit and option awards in accordance with FASB Accounting Standards Codification Topic 718.

(2) Fees earned include the annual retainer and meeting fees.

(3) Value of deferred stock units awarded determined in accordance with FASB Accounting Standards Codification Topic 718.

(4) Six directors brought a guest to the annual retreat of Redwood s Board of Directors, at a cost per guest of less than $1,000 and at an aggregate cost to Redwood for all six guests of approximately $4,500.

The following table provides information on stock unit distributions to non-employee directors from our Executive Deferred Compensation Plan in 2011. With the exceptions of Ms. Byerwalter and Mr. Bull, there were no distributions to non-employee directors from the Plan. Stock units distributed represent compensation previously awarded in prior years and were reported as director compensation in those prior years.

Name	Stock Units Distributed	Aggregate Value of Stock Units Distributed ($)
Mariann Byerwalter[1]	1,216	$ 19,242
George Bull[2]	362,673	$ 5,741,117

(1) Ms. Byerwalter had deferred stock units distributed in 2011 that were awarded in 2007. The aggregate value of stock units distributed is calculated by multiplying the number of stock units distributed by the fair market value of

Redwood common stock on the date of distribution.

(2) Mr. Bull had deferred stock units distributed in 2011 that were awarded from 2005 to 2009, while he was still employed at Redwood as the Chief Executive Officer. The aggregate value of stock units distributed is calculated by multiplying the number of stock units distributed by the fair market value of Redwood common stock on the date of distribution.

Non-Employee Director Compensation 2011(1)

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EXECUTIVE OFFICERS

Executive officers and their positions with Redwood as of December 31, 2011 are listed in the table below. Of these executive officers, for purposes of this Proxy Statement, the Named Executive Officers (NEOs) include: Mr. Hughes, Mr. Nicholas, Ms. Merdian, Mr. Chisholm, and Mr. Isbrandtsen.

Name	Position with Redwood as of December 31, 2011	Age
Martin S. Hughes	President & Chief Executive Officer(1)	54
Brett D. Nicholas	Executive Vice President, Chief Operating Officer & Chief Investment Officer(1)	43
Diane L. Merdian	Chief Financial Officer(2)	52
Scott M. Chisholm	Managing Director	46
John H. Isbrandtsen	Managing Director	50
Fred J. Matera	Managing Director(1)	48
Andrew P. Stone	Managing Director, General Counsel & Secretary	41
Harold F. Zagunis	Managing Director	54

(1) As previously announced, beginning on January 12, 2012, Mr. Nicholas assumed the sole role of President, Mr. Matera assumed the role of Chief Investment Officer, and Mr. Hughes continued to serve solely in the role of Chief Executive Officer.

(2) As previously announced, effective March 9, 2012, Ms. Merdian ceased employment with Redwood and Mr. Christopher J. Abate was appointed as interim Chief Financial Officer and as an executive officer of Redwood.

Executive officers of Redwood serve at the discretion of our Board of Directors. Biographical information regarding Mr. Hughes is provided in the preceding pages. Biographical information regarding Mr. Nicholas, Ms. Merdian, Mr. Chisholm, Mr. Isbrandtsen, Mr. Matera, Mr. Stone, and Mr. Zagunis is set forth below. In addition, biographical information regarding Mr. Abate is set forth below.

Brett D. Nicholas, age 43, has served as President since January 2012. Mr. Nicholas served as Executive Vice President and Chief Operating Officer from May 2010 to January 2012 and as Chief Investment Officer from 2007 to January 2012. Mr. Nicholas also served as Co-Chief Operating Officer from 2007 to May 2010 and as a Vice President from 1996 to 2007. Prior to joining Redwood, he was Vice President of Secondary Marketing at California Federal Bank, FSB and Vice President of Secondary Marketing at Union Security Mortgage. Mr. Nicholas holds a B.A. in economics from the University of Colorado at Boulder and is a graduate of the Stanford University Executive Program.

Diane L. Merdian, age 52, served as Chief Financial Officer from April 2010 until she ceased employment with Redwood on March 9, 2012. Ms. Merdian was a Class III Director of Redwood from August 2008 to November 2009. Ms. Merdian has 24 years experience as an equity research analyst focused on the banking sector. From 2003 to April 2008, Ms. Merdian was a bank strategist and senior bank research analyst of Keefe, Bruyette & Woods, where she also served as a Managing Director and head of the large-cap bank group. Between 1984 and 2002, Ms. Merdian also held equity analyst positions at Morgan Stanley, Montgomery Securities, Wellington Management, Smith Barney, and Salomon Brothers. Ms. Merdian was an economic research associate for the Federal Reserve Bank of Kansas City from 1981 to 1983. Ms. Merdian holds a B.A. in economics, with highest distinction, from the University of Kansas. Ms. Merdian also attended the Graduate School of Business at the University of Chicago as a Leon C. Marshal Scholar and New York University.

Scott M. Chisholm, age 46, has served as a Managing Director since September 2009 and is the head of commercial investments. Prior to joining Redwood, he was a Managing Director and managed the New York office of Prudential Mortgage Capital Company from January 2001 until September 2009. Prior to 2001, Mr. Chisholm held various positions in the real estate finance departments at Deutsche Bank, Lehman Brothers and JPMorgan Chase. Mr. Chisholm holds a B.A. in history from Trinity College and an M.S. in real estate from Columbia University.

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John H. Isbrandtsen, age 50, has served as a Managing Director since March 2008 and is head of residential acquisitions and securitization. Mr. Isbrandtsen has been employed by Redwood since February 1999. Prior to joining Redwood, he served as Residential Securitization Manager at Bank of America, Senior Vice President at Walsh Acquisition Corp., Vice President at Gruntal Financial Corp., Assistant Treasurer at Carteret Savings Bank, and as an Analyst at City Federal Savings Bank. Mr. Isbrandtsen has a B.S. degree in finance and economics from Babson College.

Fred J. Matera, age 48, has served as Chief Investment Officer since January 2012. Mr. Matera served as Managing Director since July 2008, when he joined Redwood. Prior to joining Redwood and since the spring of 2001, he was a Managing Director and Co-Head of Structured Credit at RBS Greenwich Capital. Mr. Matera began his career in finance in 1989 as a mortgage trader, and has held a number of trading positions in financial services firms, including Goldman Sachs, DLJ, and First Boston. Prior to graduating from business school, Mr. Matera was an analyst at the Federal Reserve Bank of New York. Mr. Matera has a B.A. in economics from Tufts University, and an M.B.A. in finance from The Wharton School of the University of Pennsylvania.

Andrew P. Stone, age 41, has served as Managing Director, General Counsel and Secretary since December 2008. Prior to joining Redwood, he served as Deputy General Counsel of Thomas Weisel Partners Group, Inc. from 2006 to 2008 and between 1996 and 2006 practiced corporate and securities law at Sullivan & Cromwell LLP and Brobeck, Phleger & Harrison LLP. Mr. Stone holds a B.A. in mathematics and history from Kenyon College and a J.D. from New York University School of Law.

Harold F. Zagunis, age 54, has served as a Managing Director since March 2008. Mr. Zagunis served as Vice President from 1995 to 2008, and served as Chief Risk Officer, Chief Financial Officer, Controller, Treasurer, and Secretary at different times between 1999 and 2011. Currently, Mr. Zagunis is the head of commercial credit and operations. Prior to joining Redwood, from 1986 to 1995, he was Vice President of Finance for Landmark Land Company, Inc., a publicly traded company owning savings and loan and real estate development interests. Mr. Zagunis holds B.A. degrees in mathematics and economics from Willamette University and an M.B.A. from Stanford University Graduate School of Business.

As noted above, effective as of March 9, 2012, Mr. Abate was also designated as an executive officer of Redwood.

Christopher J. Abate, age 32, has served as interim Chief Financial Officer since March 9, 2012. Mr. Abate has also served as Redwood s Controller since January 2009 and has been employed by Redwood since April 2006. Prior to being named Controller, Mr. Abate served as a Vice President beginning in December 2007 and as a Managing Director since December 2008, with responsibility during the majority of that time for Redwood s accounting and financial reporting functions. Before joining Redwood, Mr. Abate was employed by PricewaterhouseCoopers LLP as an auditor and consultant. He holds a B.A. in accounting and finance from Western Michigan University, an M.B.A. from the University of California at Berkeley and Columbia University, and is a certified public accountant.

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SECURITY OWNERSHIP OF DIRECTORS AND EXECUTIVE OFFICERS

The following table sets forth information, as of March 30, 2012, on the beneficial ownership of our common stock by our directors, executive officers, and by all of our directors and executive officers as a group. As indicated in the notes, the table includes common stock equivalents held by these individuals through Redwood-sponsored benefits programs. Except as otherwise indicated and for such power that may be shared with a spouse, each person has sole investment and voting power with respect to the shares shown to be beneficially owned. Beneficial ownership is determined in accordance with the rules of the SEC.

Executive Officers[1]	Number of Shares of Common Stock Beneficially Owned[2]	Percent of Class[3]
Martin S. Hughes[4]	439,181	*
Brett D. Nicholas[5]	407,084	*
Christopher J. Abate[6]	9,266	*
Scott M. Chisholm[7]	25,359	*
John H. Isbrandtsen[8]	92,349	*
Fred J. Matera[9]	58,661	*
Andrew P. Stone[10]	25,156	*
Harold F. Zagunis[11]	199,566	*
Non-Employee Directors		
Richard D. Baum[12]	27,927	*
Thomas C. Brown[13]	21,324	*
George E. Bull, III[14]	978,111	1.24 %
Mariann Byerwalter[15]	21,504	*
Douglas B. Hansen[16]	436,915	*
Greg H. Kubicek[17]	142,697	*
Jeffrey T. Pero[18]	21,188	*
Georganne C. Proctor[19]	41,293	*
Charles J. Toeniskoetter[20]	42,096	*
All directors and executive officers as a group (17 persons)[21]	2,989,675	3.72 %

* Less than 1%.

(1) As previously announced, effective March 9, 2012, Diane L. Merdian, who served as Chief Financial Officer during 2011, ceased employment with Redwood and Mr. Christopher J. Abate was appointed as interim Chief Financial Officer and as an executive officer of Redwood. As of March 30, 2012, Ms. Merdian held 13,179 shares of common stock and 20,430 vested deferred stock units.

(2) Represents shares of common stock outstanding, common stock underlying vested options that are exercisable within 60 days of the date of this Proxy Statement, and common stock underlying deferred stock units that have

vested or will vest within 60 days of the date of this Proxy Statement. Does not include deferred stock units scheduled to be granted to non-employee directors in accordance with our non-employee director compensation policy following our 2012 Annual Meeting of Stockholders.

(3) Based on 78,756,319 shares of our common stock outstanding as of March 30, 2012.

(4) Includes 52,273 shares of common stock and 386,908 deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

(5) Includes 71,656 shares of common stock, 53,537 shares issuable upon the exercise of stock options exercisable within 60 days the date of this Proxy Statement, and 281,891 deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

(6) Includes 2,238 shares of common stock and 7,028 deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

(7) Includes 854 shares of common stock and 24,505 deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

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(8) Includes 10,721 shares of common stock, 12,652 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 68,976 deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

(9) Includes 58,661 deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

(10) Includes 845 shares of common stock, and 24,311 deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

(11) Includes 34,219 shares of common stock, 34,521 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 130,826 deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

(12) Includes 11,222 shares of common stock, 4,256 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 12,449 vested deferred stock units.

(13) Includes 6,375 shares of common stock, 2,500 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 12,449 vested deferred stock units.

(14) Includes 706,054 shares of common stock held of record by the Bull Trust, 600 shares held of record by Mr. Bull s spouse, 131,265 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 140,792 deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

(15) Includes 4,723 shares of common stock, 2,500 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 14,281 vested deferred stock units.

(16) Includes 306,746 shares of common stock, 117,608 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 12,561 vested deferred stock units.

(17) Includes 92,024 shares of common stock held in direct ownership, living trusts and through an unaffiliated pension plan, 1,913 shares held of record by Mr. Kubicek s spouse, 2,500 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 46,260 vested deferred stock units.

(18) Includes 4,225 shares of common stock and 16,963 vested deferred stock units.

(19) Includes 9,845 shares held in the Proctor Trust and 31,448 vested deferred stock units that have vested or will vest within 60 days of the date of this Proxy Statement.

(20) Includes 22,147 shares with respect to which Mr. Toeniskoetter has voting and investment power that are held in the Toeniskoetter & Breeding, Inc. Development Profit Sharing Trust, 7,500 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 12,449 vested deferred stock units.

(21) Includes 1,338,080 shares of common stock, 368,839 shares issuable upon the exercise of stock options exercisable within 60 days of the date of this Proxy Statement, and 1,282,756 vested deferred stock units.

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SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS

The following table sets forth information as of the dates noted below, with respect to shares of our common stock owned by each person or entity known by us to be the beneficial owner of more than 5% of our common stock.

Name of Beneficial Owner	Number of Shares of Common Stock Beneficially Owned	Percent of Class[(1)]
BlackRock, Inc.[(2)]	5,215,170	6.6 %
Janus Capital Management LLC[(3)]	5,633,686	7.2 %
RS Investment Management Co. LLC[(4)]	3,954,803	5.0 %
Wallace R. Weitz & Company[(5)]	7,478,568	9.5 %

(1) Based on 78,756,319 shares of our common stock outstanding as of March 30, 2012.

(2) Address: 40 East 52nd Street, New York, New York 10022. The information in the above table and this footnote concerning the shares of common stock beneficially owned by BlackRock, Inc. (BlackRock) is based on the amended Schedule 13G filed by BlackRock with the SEC on February 13, 2012, which indicates that BlackRock and certain other subsidiary entities make aggregate reports on Schedule 13G and that the such entities, in the aggregate, have sole dispositive power and sole voting power with respect to 5,215,170 shares.

(3) Address: 151 Detroit Street, Denver, Colorado 80206. The information in the above table and this footnote concerning the shares of common stock beneficially owned by Janus Capital Management LLC (Janus) is based on the amended Schedule 13G filed by Janus with the SEC on February 14, 2012, which indicates that Janus and certain other entities, in their respective capacities as investment advisers: (i) make aggregate reports on Schedule 13G with respect to securities held by portfolios they manage, and with respect to which they do not have the right to receive dividends or the proceeds from any sale securities, and (ii) disclaim any ownership associated with such rights. The aggregate number of shares of common stock which may be deemed to be beneficially owned by Janus includes 5,633,686 shares with respect to which Janus has shared dispositive power and shared voting power.

(4) Address: 388 Market Street, Suite 1700, San Francisco, California 94111. The information in the above table and this footnote concerning the shares of common stock beneficially owned by RS Investment Management Co. LLC (RS) is based on the Schedule 13G jointly filed with the SEC on February 9, 2012 by RS and two of its parent companies namely, The Guardian Life Insurance Company of America and Guardian Investor Services LLC. The aggregate number of shares of common stock reported as beneficially owned by RS includes 3,954,803 shares with respect to which RS has shared dispositive power, of which RS has shared voting power with respect to 3,920,213 shares.

(5) Address: 1125 South 103rd Street, Suite 200, Omaha, Nebraska 68124. The information in the above table and this footnote concerning the shares of common stock beneficially owned by Wallace R. Weitz & Company and Wallace R. Weitz (Weitz) is based on the amended Schedule 13G filed by Weitz with the SEC on February 3, 2012. The aggregate number of shares of common stock reported as beneficially owned by Weitz includes 7,478,568 shares with respect to which Weitz has sole dispositive power and sole voting power.

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EXECUTIVE COMPENSATION

Compensation Discussion and Analysis

Compensation Committee

The Compensation Committee (the Committee) of Redwood s Board of Directors consists exclusively of independent directors as defined by the New York Stock Exchange (NYSE). The Committee acts on behalf of Redwood s Board of Directors in administering Redwood s executive compensation plans and programs.

The Committee currently consists of Georganne C. Proctor (Chair), Richard D. Baum, Thomas C. Brown, Mariann Byerwalter, and Jeffrey T. Pero. The Committee met six times in 2011 and has met two times to date in 2012.

The Committee is committed to providing disclosure within this Compensation Discussion and Analysis that gives insight into the process by which it arrives at determinations relating to executive compensation and the underlying rationale for those determinations. Among other things, this Compensation Discussion and Analysis describes:

The Committee s process for reviewing all components of the compensation of the Chief Executive Officer (CEO) and that of the other Named Executive Officers (NEOs).
The reasons for paying each element of compensation to the NEOs and Redwood s compensation philosophy, objectives, and methodology for competitive benchmarking, including the use of peer groups.
The performance measures and goals used for performance-based compensation and the factors taken into account in the Committee s determination of whether those measures and goals are satisfied.
The severance and change of control payments that certain executives may become entitled to under certain circumstances.
The role of the Committee s independent compensation consultant.

Executive Summary

Redwood has adopted a performance-based compensation philosophy for its executive officers. Under that philosophy, Redwood seeks to provide incentives to achieve both short-term and long-term business objectives, align the interests of executive officers with the interests of Redwood s long-term stockholders, and ensure that Redwood can hire and retain talented individuals in a competitive marketplace. Executive officers receive compensation through a combination of the following types of compensation: base salary; performance-based annual bonus; long-term equity-based awards; and other non-cash benefits such as coverage for themselves and their families under Redwood s medical, dental, and vision health insurance plans.

Executive officers of Redwood are designated by the Board of Directors. For 2011 there were eight executive officers, which as of December 31, 2011 were Redwood s:

President & Chief Executive Officer;
Chief Operating Officer, Chief Investment Officer & Executive Vice President;
Chief Financial Officer;
General Counsel & Secretary; and
Four other Managing Directors

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In accordance with SEC regulations, this Compensation Discussion and Analysis is focused on the compensation of Redwood s Named Executive Officers (NEOs) for 2011, although it also provides some general discussion and analysis of aspects of Redwood s compensation programs, plans, and practices that apply to all of Redwood s executive officers. Under SEC regulations, Redwood has five NEOs for 2011, which as of December 31, 2011 were Redwood s:

President & Chief Executive Officer;
Chief Operating Officer, Chief Investment Officer & Executive Vice President
Chief Financial Officer; and
Two other Managing Directors

Redwood s NEOs for 2011 account for five of the 77 employees of Redwood as of December 31, 2011.

Each year the Committee reviews Redwood s compensation philosophy and its executive compensation plans and programs and, after taking into account the outcome of the most recent shareholder advisory vote on executive compensation, makes compensation determinations it believes are necessary or appropriate in light of its executive compensation objectives. Highlighted below are summaries of some of the key determinations made by the Committee with respect to 2011 and, in some cases, 2012. Each of these key items is discussed more fully within this Compensation Discussion and Analysis, as well as within the section of this Proxy Statement relating to the stockholders vote on an advisory resolution to approve Named Executive Officer compensation (pages 62 65).

- ***2011 and 2012 base salary for the CEO position remains unchanged from 2007***. The base salary paid for the position of chief executive officer was not increased for 2011 or 2012, and remains at the same level that was in place at Redwood for that position in 2007.
- ***2011 base salaries for the other NEOs remained unchanged from 2010***. The base salary paid for the other NEOs was not increased for 2011.

Annual bonus compensation for Redwood s CEO in 2011 declined by 75% from 2010 and total 2011 compensation for Redwood s CEO declined by 30% from 2010, reflecting the Committee s adherence to pay-for-performance principles. Redwood s financial performance in 2011 was not as strong as it was in 2010. Net income of $26.3 million in 2011 was $83.7 million lower than net income in 2010 and return-on-equity in 2011 was 2.6%, as compared to a return-on-equity of 10.92% in 2010. Consistent with pay-for-performance principles, the 2011 annual bonus compensation and 2011 total compensation for Martin S. Hughes, Redwood s chief executive officer, also declined in 2011 as compared to 2010.

- o Mr. Hughes received a 2011 annual performance-based bonus of $288,750, which represents a decline of 75% from the annual performance-based bonus of $1.17 million he received for 2010.
- o Mr. Hughes received total compensation for 2011 of $3.23 million, which represents a decline of 30% from the total compensation of $4.59 million Mr. Hughes received for 2010 (based on the Summary Compensation table on page 46 of this Proxy Statement). Of his total compensation for 2011, approximately 70% was in the form of long-term equity-based awards with three- or four-year vesting or holding periods.

In accordance with pay-for-performance principles, 2011 annual bonus compensation for NEOs was primarily determined by Redwood s 2011 financial performance. For 2011, Redwood had $26.3 million of net income and a 2.6% return-on-equity. This financial performance was below the threshold established by the Committee in early 2011 for the payment of any portion of the component of annual bonus compensation determined based on Redwood s financial performance. Accordingly, for 2011, of the aggregate $4.1 million in target annual bonus compensation that could have been earned by NEOs, only an aggregate of $1.08 million, or 26%, was paid. The $1.08 million aggregate amount of annual bonus compensation that was paid to NEOs for 2011 was paid in respect of the component of annual bonus compensation determined based on individual executive performance.

Compensation paid to NEOs continued to align the interests of stockholders and NEOs by delivering approximately 63% of total 2011 compensation to NEOs in the form of equity-based awards. For 2011, aggregate compensation paid to NEOs totaled approximately $9 million, of which approximately $5.6 million (or 63%) was in the form of equity-based awards that generally vest over three- or four-year periods. The Committee believes that delivering a significant portion of compensation in the form of equity-based awards is appropriate to align the interests of NEOs with those of long-term Redwood stockholders.

The Committee continued to use performance-based equity awards in 2011 for NEOs. Of the long-term equity-based awards granted in the fourth quarter of 2011 to NEOs, 50% were performance-based awards that vest after three years only if total stockholder return over the December 2011 to December 2014 three-year period exceeds a specified performance threshold further described below under 2011 Long-Term Equity-Based Awards.

The Committee continued to impose mandatory holding periods for long-term equity grants to NEOs. The Committee continues to impose mandatory holding periods on equity grants to NEOs. For example, deferred stock units granted to NEOs that vest on a pro-rata basis over four years (*i.e.*, ¼th of the awards vest each year over the four-year vesting period) are subject to a mandatory holding period with respect to all underlying shares that vest prior to the four-year anniversary of the grant date with the result that none of underlying shares could be transferred or sold by the NEOs until after the fourth anniversary of the grant date.

Redwood eliminated excise tax gross-ups for change-in-control severance payments. In March 2011, each of the three outstanding employment agreements between an executive officer and Redwood was amended to eliminate the provisions of those agreements that provided for tax gross-ups with respect to excise taxes that could be imposed on change-in-control severance payments that could be made under these agreements in the future. As a result, Redwood does not have any employment agreements in place with any executive (or any other employee) that provide for an excise tax gross-up. The Committee does not intend to offer excise tax gross-up provisions in any future employment agreements for executives (or any other employees).

In 2011, the Committee continued to use the methodology it previously adopted for making annual bonus payments to NEOs, which methodology generally reduces the proportion of annual bonuses paid in cash and increases the proportion of annual bonuses paid in equity awards with a mandatory three-year holding period. In March 2011, the Committee decided that any annual bonus paid to an NEO for 2011 that exceeded $250,000 in value would not be paid fully in cash. In particular, as any NEO s annual bonus increases in value above $250,000, an increasing proportion of that bonus would be paid in the form of equity awards with a mandatory three-year holding period, rather than paid in cash. Under this methodology, in years when any NEO s annual bonus exceeds $250,000, a greater portion of that NEO s annual bonus will be exposed to the future financial performance of Redwood, which the Committee believes results in a greater alignment of executive and stockholder interests.

Shareholders Most Recent Say-on-Pay Vote

At Redwood s 2011 annual meeting of stockholders, shareholders had the opportunity to cast an advisory vote on executive compensation. Approximately 94% of the votes cast in that 2011 say-on-pay vote were voted for approval of the compensation of the named executive officers as disclosed in the 2011 proxy statement. The Committee has considered the results of the 2011 say-on-pay vote and believes that the overwhelming support of Redwood shareholders in the 2011 say-on-pay vote indicates that shareholders are generally supportive of Redwood s approach to executive compensation. This support was one of the factors the Committee took into account in not making material changes to Redwood s performance-based compensation philosophy for executive officers or the components of executive compensation in response to the 2011 say-on-pay vote. At Redwood s 2011 annual meeting of stockholders, shareholders also voted in favor of a proposal to hold say-on-pay votes every year. In the future, the Committee will continue to consider the outcome of the annual say-on-pay vote when making compensation decisions regarding executive officers.

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Overall Compensation Philosophy and Objectives

Redwood has adopted a performance-based compensation philosophy for its executive officers that seeks to provide incentives to achieve both short-term and long-term business objectives and ensure that Redwood can hire and retain talented individuals in a competitive marketplace. The Committee is generally responsible for evaluating Redwood s executive compensation programs, plans, and practices to ensure that they provide proper incentives and appropriately support corporate performance without creating risks that are likely to have a material adverse effect on Redwood.

Redwood s executive compensation objectives are as follows:

Attract and retain highly qualified and productive executives.
Motivate executives to enhance the overall performance and profitability of Redwood, both on a short-term and a long-term basis, with an emphasis on the long-term.
Reinforce the linkage between the interests of Redwood s executives and its long-term stockholders by encouraging ownership of Redwood stock by executives and rewarding stockholder value creation.
Ensure that compensation levels are both externally competitive and internally equitable.

Components of Compensation in 2011

In 2011, as in past years, cash compensation for Redwood s NEOs included a base salary and a performance-based annual bonus. The annual bonus was primarily determined based on a company performance bonus formula, with individual performance a secondary determinant. Redwood seeks to have an executive compensation structure that awards annual bonus compensation upon achievement of performance targets. It is generally intended that the salary and annual bonus targets for each NEO be similar to a market-based benchmark of the median salary and target annual bonus compensation for each NEO. The market-based benchmarks used by the Committee for this purposes are determined with the assistance of the Committee s independent compensation consultant, Frederic W. Cook & Co., Inc. (Cook & Co.), by reviewing compensation practices of a peer group of companies consisting of companies with broadly similar size and complexity that are competitors for executive talent and capital, as well as through the review of other supplemental benchmarking data relating to certain NEO positions that was obtained by Redwood from McLagan, a third party compensation consultant that is nationally recognized as qualified to provide such data. The peer group of companies used by the Committee in 2011 for competitive benchmarking comparisons as well as other data used for benchmarking comparisons is further described below under Compensation Benchmarking for 2011.

The target level for Redwood s 2011 financial performance that was used in determining the component of 2011 annual bonuses based on company financial performance, was a 9% annual adjusted return on equity (Adjusted ROE). Adjusted ROE is a non-GAAP performance measure that is defined and described below under 2011 Performance-Based Annual Bonus Compensation. For annual Adjusted ROE performance above or below the target level, it is the intention that the compensation program results in total annual bonus compensation for NEOs that is above or below the benchmarked market median, as applicable. To a lesser degree, annual bonus compensation also varies as a function of individual executive performance.

With respect to long-term equity-based compensation, the Committee generally seeks to make regular annual awards to NEOs at levels that exceed a market-based benchmark of the median for such awards for each NEO, with market-based benchmarks determined in the same manner as described above with respect to salary and target annual bonus. These awards provide an incentive to create long-term stockholder value, encourage employment retention, and build executive ownership. In particular, for 2011 the value of the annual long-term equity-based compensation granted to NEOs was determined after taking into account the Committee s philosophy that:

depending on Redwood s company performance and each NEO s individual performance, for each NEO, the value of year-end long-term equity-based awards should approximate the 75^{th} percentile relative to the marked-based benchmark; and

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NEO compensation earned and realized from annual bonuses and long-term equity-based awards should correlate with long-term stockholder value creation through dividend distributions and share-price growth over, at a minimum, the vesting and mandatory holding periods determined by the Committee to be appropriate.

Determination of Compensation for 2011

Each year the Committee makes determinations regarding the compensation of Redwood s NEOs. For 2011, the NEOs consisted of the following individuals, who held the titles noted below as of December 31, 2011:

Mr. Martin S. Hughes, President & Chief Executive Officer
(Note: As of January 12, 2012, Mr. Hughes sole title is Chief Executive Officer)
Mr. Brett D. Nicholas, Chief Operating Officer, Chief Investment Officer & Executive Vice President
(Note: As of January 12, 2012, Mr. Nicholas was promoted and his sole title is President)
Ms. Diane L. Merdian, Chief Financial Officer (Note: As previously announced, effective March 9, 2012, Ms. Merdian ceased employment with Redwood.)
Mr. Scott M. Chisholm, Managing Director
Mr. John H. Isbrandtsen, Managing Director

The process for determining NEO compensation is dynamic and compensation levels are evaluated throughout each year, with the Committee having the authority to re-examine and adjust any aspect of the compensation program or process it may determine to be necessary or appropriate to take into account changing circumstances throughout the year. As has been its practice for a number of years, for 2011 the Committee directly engaged and used the services of a nationally recognized independent compensation consultant, Cook & Co., to assist it in determining the elements of compensation and to provide benchmarking analyses. Cook & Co. does no other work for Redwood or its management and the Committee has the sole authority to establish and terminate the relationship with Cook & Co.

On an annual basis, Cook & Co. reviews the compensation program for Redwood s executive officers with the Committee and assesses the competitiveness of compensation levels and targets to evaluate whether the compensation program is aligned with Redwood s compensation philosophy. Cook & Co. also provides the Committee with data regarding compensation practices among Redwood s peer group and analyzes the compensation levels and targets of each NEO. The analysis prepared by Cook & Co. includes tally sheets that show total cash compensation for each NEO (and year-to-year comparisons of total cash compensation), total equity ownership in Redwood by each NEO (and the value of those equity stakes at different prices per share), and total compensation in cash and equity-based grants for each NEO. Cook & Co. s analysis assists the Committee in understanding the extent to which different components of each NEO s compensation are above or below the market-based benchmarked median (based on Redwood s peer group and on other supplemental benchmarking data) and in understanding the year-to-year changes in awarded, realized, accumulated, and potential NEO compensation.

In addition, Cook & Co. assists the Committee in determining the amounts, form, and structure of the compensation programs adopted by Redwood. Based on the Committee s judgment, and reflecting input from Cook & Co., the compensation package for each NEO consists of a fixed base salary, a variable performance-based annual bonus, and a long-term equity-based award, with a significant portion of compensation allocated to the variable annual bonus and the long-term equity-based components to appropriately align total executive compensation with Redwood s company performance and each NEO s individual performance. Each of these compensation elements is reviewed by the Committee annually with respect to each NEO.

As part of its process for determining 2011 NEO compensation, the Committee considered the following recommendations:

Mr. Hughes and Mr. Nicholas provided the Committee with their performance evaluations and joint recommendations with respect to the compensation of all of the other NEOs, namely: Ms. Merdian, Mr. Chisholm, and Mr. Isbrandtsen; and

Cook & Co. provided general directional recommendations regarding the components of the compensation of Mr. Hughes, Mr. Nicholas, Ms. Merdian, Mr. Chisholm, and Mr. Isbrandtsen based on peer comparisons and other supplemental benchmarking data, which recommendations were based on Redwood s compensation philosophy, as described above.

In addition, on an annual basis, the Committee is provided with a self-assessment from each of the NEOs that addresses individual and collective performance over the prior year. The Committee reviewed these self-evaluations and took them into consideration when determining the level of compensation to be paid to each NEO for 2011.

In preparation for making determinations regarding 2011 compensation matters, beginning in August 2010 the Committee conducted a fundamental review of two particular aspects of the executive compensation program; namely, the methodology used for determining the company performance component of annual bonuses and the structure of long-term equity-based awards. This fundamental review was prompted by, among other things, the commitment made by the Committee in 2010 regarding the future use of performance-based equity awards, changes in the business and financial environment in which the company operates and competes, and changes in management leadership of Redwood following Mr. George E. Bull, III s retirement in May 2010 from the chief executive officer position. This review encompassed input from and consultation with management and Cook & Co., as well as input from other members of the Board of Directors.

As part of this review, the Committee, among other things, reviewed:

The general design of the compensation program, including the appropriateness of continuing to pay annual bonuses based in part on company financial performance and in part based on individual performance and the use of annual long-term equity-based compensation awards;

The appropriateness of continuing to use Adjusted ROE as the performance measure for the company performance component of annual bonuses and alternatives to this measure (such as, total rate of return to shareholders, dividend yield, earnings per share, change in book value, and ratio of price to book value);

Various performance thresholds for determining the company performance component of annual bonuses (including fixed/absolute thresholds, thresholds relative to the performance of a peer group, and thresholds relative to an index or other benchmark) and the relationship between these thresholds and Redwood s business model and competition;

The extent to which annual bonus amounts should be paid in cash or equity-based awards and the extent to which mandatory holding periods or hold-backs of annual bonus amounts are appropriate; and

Different methodologies for structuring performance-based equity awards, including:

Consideration of the use of various types of: performance measures (*e.g*., return on equity, total rate of return to shareholders, change in book value, ratio of price to book value, and earnings per share); performance thresholds (*e.g*., fixed/absolute thresholds, thresholds relative to the performance of a peer group, and thresholds relative to an index or other benchmark); and vesting periods (*e.g*., cliff vesting and a multi-year period and pro-rata vesting over a multi-year period); and

The extent to which vesting leverage is appropriate (*i.e*., the extent to which more or less than a target award amount would vest based on over- or under-performing established performance thresholds) and, if so, at what levels of performance such leverage was appropriate.

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With respect to each aspect of this review, the Committee considered, among other things, whether each alternative was consistent with Redwood s compensation philosophy, including whether each alternative would align the interests of Redwood s executives and employees with those of Redwood s long-term shareholders, motivate executives and employees to enhance the performance and profitability of Redwood both on a short-term and long-term basis (with an emphasis on the long-term), allow Redwood to continue to attract and retain highly qualified and productive executives and employees, and maintain a compensation program that was competitive with the marketplace. In addition, the Committee was focused on how the design of a compensation program can be a factor that could impact business risk taking and focused on whether the design of the compensation program would introduce material risks to Redwood. In conducting its review, the Committee was aware that the design of each aspect of its compensation program was part of a comprehensive whole, and therefore, that each element needed to be analyzed in the context of how it contributed to the whole program and how risks associated with one aspect of the program could be balanced by other aspects of the program.

As a result of this process, during this annual review, not only did the Committee make certain determinations of the type it has traditionally made each year, such as determining base salary levels and target annual bonus amounts, but it also determined to make certain changes to aspects of the executive compensation program that had previously remained constant for several years. For example, the Committee established a performance measure, performance thresholds, and other terms for long-term equity-based awards with performance-based vesting (*i.e.*, the performance stock units referred to below under 2011 Long-Term Equity-Based Awards). In addition, the Committee determined that it would change the financial performance thresholds used in determining the company performance component of annual bonuses for 2011. Certain of these changes were implemented immediately (*e.g.*, performance stock units were used in making 2010 year-end long-term equity-based awards), while it was determined to implement other changes (including changes to the performance thresholds used in determining the company performance component of annual bonuses) over the course of 2011 and 2012.

Compensation Benchmarking for 2011

As in prior years, in 2011 the Committee asked Cook & Co. to conduct a market pay analysis with respect to various compensation matters, including compensation of NEOs. Cook & Co. s market pay analysis relied in part on publicly disclosed executive compensation data from a group of peer companies and, due to the fact that not all of the peer group companies publicly disclose executive compensation information for officers with responsibilities comparable to some of Redwood s NEOs, in part on supplemental data relating to certain NEO positions that was obtained from McLagan, a third party compensation consultant that is nationally recognized as qualified to provide such data. Redwood also uses data and consulting services from McLagan and its affiliates, including for determining compensation for other executive officers and employees who are not executive officers.

The Committee considers the use of market-based compensation analysis, including analysis of a peer group of companies, important for competitive positioning in attracting and retaining executive talent. In considering the market analysis provided by Cook & Co., the Committee recognized that the peer group did not include generally higher-paying externally-managed REITs, private equity firms, and hedge funds with which Redwood must compete for executive talent. Cook & Co. did not include those organizations in the peer group because they have different business economics and pay models than Redwood.

Following the completion of the competitive pay analysis prepared by Cook & Co., the Committee concluded that:

Both a core and secondary peer group should be designated and included in the analysis, with the core peer group to include internally managed mortgage REITs with which Redwood directly competes for business, capital, and executive talent and the secondary peer group to include a broader set of similar-sized companies in related industries with which Redwood may compete for capital and executive talent, but which Redwood does not necessarily compete directly with for business.

Base salaries and target annual bonuses should continue to be oriented at or near the market-based benchmark for median target levels of these components of compensation.

Performance-based bonuses should have adequate upside opportunity so that delivered total annual compensation may potentially reach the top-quartile of the market-based benchmark for this component of compensation for strong Redwood performance.

Competitive pressure from higher-paying related market sectors should be addressed by making long-term equity-based awards with values that approximate the 75th percentile of the market-based benchmark for this component of compensation.

The core peer group of companies used by the Committee in 2011 consisted of: Annaly Capital Management, Inc., Anworth Mortgage Asset Corporation, Capstead Mortgage Corporation, MFA Financial, Inc., Northstar Realty Finance Corporation, and RAIT Financial Trust. Each of these companies was also included in the peer group of companies the Committee designated in 2010 for purposes of the market pay analysis conducted by Cook & Co. s for the Committee for 2010 executive compensation. The secondary peer group of companies used by the Committee in 2011 consisted of: AllianceBernstein Holding L.P., Altisource Portfolio Solutions S.A., Artio Global Investors Inc., CBOE Holdings, Inc., Cohen & Steers, Inc., Credit Acceptance Corporation, Encore Capital Group, Inc., Financial Engines, Inc., Janus Capital Group, Inc., Knight Capital Group, Inc., Nelnet, Inc., PHH Corporation, Portfolio Recovery Associates, Inc., W.P. Carey & Co. LLC, and World Acceptance Corporation.

The Committee reviews the list of peer companies on an annual basis to confirm that they continue to meet the Committee s criteria for inclusion. The Committee also takes into consideration changes in real estate and capital markets and changes in competitors. Accordingly, the companies included as peers may change from year to year as a result of this review.

2011 Base Salaries

Base salary is a traditional component of executive compensation. Redwood seeks to establish base salaries for NEOs by reference to a market-based benchmarked median for similar executives and groups of similar executives. The Committee reviews base salaries as one part of overall compensation for the NEOs annually. The Committee may make adjustments to base salary in connection with this annual review or at other times based on the executive s experience and responsibilities and after consideration of other components of compensation and consideration of the competitive levels necessary for executive retention.

In December 2010, the Committee determined that the 2011 base salaries for each of the NEOs would remain unchanged from their year-end 2010 base salary levels.

As a result, for 2011:

- the salary for Mr. Hughes remained at its year-end 2010 level of $700,000;
- the salary for Mr. Nicholas remained at its 2007 level of $500,000;
- the salary for Ms. Merdian remained at its 2010 level of $400,000;
- the salary for Mr. Chisholm remained at its 2009 level of $400,000; and
- the salary for Mr. Isbrandtsen remained at its 2010 level of $400,000.

2011 Performance-Based Annual Bonus Compensation

Redwood s compensation program is designed to reward NEOs based on Redwood s financial performance and each NEO s individual performance, including his or her contribution to Redwood s performance. As an integral part of this program, each NEO can earn an annual bonus based on the Committee s review of the satisfaction of a specific pre-established target level of Redwood financial performance and specific individual performance measures.

In order to align the interests of Redwood s NEOs with the interests of its long-term stockholders, the Committee determined during the first quarter of 2011, after consultation with Cook & Co., that 2011 target annual bonuses for NEOs would continued to be weighted:

75% on the achievement of a predetermined target level of company financial performance, with this component of bonus compensation being referred to as the company performance component of target bonus or company performance bonus; and

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25% on the achievement of pre-established individual goals, with this component of bonus compensation being referred to as the individual performance component of target bonus or individual performance bonus.

This weighting has been used so that most of an NEO s target annual bonus will depend directly on the achievement of the target level of company financial performance, while also providing incentives for achievement of individual goals that the Committee believes are in the interests of Redwood and its stockholders, but which may be difficult to quantitatively link directly to company financial performance. The Committee also determined that the individual performance component of the bonus could be earned up to 100% of the individual performance component of target annual bonus, subject to adjustment when circumstances warrant at the discretion of the Committee.

Also during the first quarter of 2011, after consultation with Cook & Co. and completion of the review of Redwood s compensation program described above and below, the Committee determined to continue to use in 2011 the same financial metric to underlie the company performance bonus formula that was used for that purpose in 2010 and to use in 2011 the specific financial performance thresholds described below. As noted above, the company performance bonus formula is based on Adjusted ROE, which is defined as income determined in accordance with GAAP divided by average core equity, subject to adjustment when circumstances warrant at the discretion of the Committee. Average core equity is defined as average GAAP equity excluding unrealized mark-to-market adjustments as reflected in accumulated other comprehensive income (loss). The Committee believes that Adjusted ROE generally provides an appropriate measurement of Redwood s financial performance because, as a company whose primary source of earnings is income from real estate-related debt investments, the use of average core equity reflects the amount of capital Redwood has to invest (as it excludes the effect of unrealized market valuation adjustments).

During the second half of 2010 and the first quarter of 2011, the Committee undertook a review of Redwood s compensation program, including a review of the formula used in determining the company performance component of annual bonuses for executive officers. This review included a review of the metric used to measure company financial performance and the company financial performance levels, or thresholds, at which company performance bonus will be paid at target levels, as well as a review of the company financial performance threshold below which no company performance bonus would be paid, and the company performance bonuses that would be paid for various levels of company financial performance above and below target performance. This review encompassed input from and consultation with management and Cook & Co., as well as input from other members of the Board of Directors.

The Committee decided, as a result of its review, to change its methodology for determining the performance thresholds at which different levels of company performance bonuses would be paid. In particular, the Committee decided to discontinue the use of the fixed performance thresholds that had been used in prior years and replace them with variable performance thresholds that could change each year, with the variable performance thresholds to be determined at the beginning of each year in an amount equal to a risk-free interest rate plus an incremental premium. As a result, the performance thresholds could vary from year to year both as the result of changes in the risk-free rate and changes to the incremental premium determined by the Committee to be appropriate. This decision was premised in large part on the nature of Redwood s business model, which is primarily focused on investing in real-estate related debt instruments. One result of this business model is that returns that Redwood can earn on new investments are, to an extent, correlated with the market-driven interest rates being offered for these and other types of debt instruments (which rates depend on the perceived risk of these investments) which, in turn, are correlated to a certain extent with the market-driven risk-free interest rates being offered for investment in U.S. Treasury obligations (and other debt backed by the full faith and credit of the U.S.).

Over the several years preceding 2011, Redwood s financial performance thresholds were as follows for executive officers: no company performance bonus would be earned for Adjusted ROE below 7%; target company performance bonus would be earned when Adjusted ROE was 11%; and above-target company performance bonuses would be earned when Adjusted ROE was greater than 11%. In reviewing each of Redwood s first eight years as a public company (1995 2002), the prior-year risk-free interest rate for U.S. Treasury obligations with a five year maturity remained relatively constant, with an average of 5.8% during

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that period. As a result, the target company performance threshold of an 11% Adjusted ROE that was used during this period in determining the company performance component of annual NEO bonuses reflected an average premium of 5.2% above the prior year risk-free rate for U.S. Treasury obligations with a five year maturity. Over the few years immediately subsequent to 2002, this risk-free rate dipped and then increased again. Then, beginning in 2008, the prior year risk-free rates on U.S. Treasury obligations with a five year maturity have declined to average levels significantly below the average for the prior decade. A five-year risk-free interest rate was used for this analysis because it generally corresponds to the weighted average duration of investments historically made by Redwood.

As a result of this recent significant decline in risk-free interest rates, maintaining a target level of company performance of 11% Adjusted ROE would require that Redwood seek returns much higher above the risk-free rate than it had in the past in order to achieve target company performance. Conversely, if risk-free interest rates were to rise significantly in future years, as some believe they may, maintaining a target level of company performance of 11% Adjusted ROE, would require that Redwood seek much lower incremental returns above the risk-free rate than it had in the past in order to achieve target company performance. The Committee was mindful that Redwood does not currently intend to significantly alter its business model. In addition, the Committee recognized that reaching for the same returns in a lower interest environment would necessitate taking greater investment or other risks and that accomplishing the same returns in a higher interest rate environment would only require seeking lower risk, lower yielding investments. Therefore, the Committee determined that as Redwood made new investments in the future, the target level of Redwood s company performance should be structured to vary along with varying risk-free rates.

Setting a target Adjusted ROE performance threshold at an appropriate level above the risk-free rate is intended to provide executives with an incentive to achieve attractive investment returns for Redwood (and align the interests of executives and shareholders in seeking this level of return), without exposing Redwood to inappropriate risk. If interest rates return to a prolonged period of stability, the variable performance target will likely not vary significantly from year-to-year, and will effectively function much like the fixed performance target did in the past. Alternatively, if interest rates experience significant periods of volatility in the future or experience long-term upward or downwards trends, the variable performance target will provide the Committee with the ability to adjust compensation incentives in a manner consistent with a stable business model.

The Committee recognized that implementing a change from a fixed target of 11% to a variable target was significant and believed it should be done deliberately and over a time period that would allow for observation of the impact of the change and an opportunity to make any necessary adjustments. Accordingly, the Committee determined to fully implement this change in 2012 and to treat 2011 as a transition year, during which much of the change would be implemented, but certain aspects of the design of the company performance bonus formula would remain consistent with 2010 and prior years.

Based on the comprehensive review of the Company performance bonus metric and performance thresholds, and after consultation with Cook & Co., the Committee made the following determinations with respect to company performance bonuses for NEOs for 2011, which, as noted above, was intended to be the year during which Redwood transitions from the fixed performance threshold methodology used in 2010 and prior years to the variable performance threshold methodology to be used in 2012 and currently intended to be used in years subsequent to 2012:

The target performance threshold (*i.e.*, the level of company performance at which the target company performance bonus would be paid) for 2011 would be Adjusted ROE equal to a risk-free rate of 3% plus an incremental premium of 6%.
The use of a 3% risk-free rate for 2011 represents a transition year determination to use a risk-free rate that is higher (*i.e.*, more difficult to achieve) than the risk-free rate of approximately 2% that would otherwise have resulted from the use of the average interest rate during 2010 for five-year U.S. Treasury obligations.

The use of a 6% incremental premium for 2011 was intended to provide executives with an incentive to achieve attractive investment returns for Redwood (and align the interests of executives and shareholders in seeking this level of return), without exposing Redwood to inappropriate risk.
No company performance bonus would be paid for 2011 if Adjusted ROE was 2% less (or lower) than the target performance threshold (*i.e.*, no company performance bonus would be paid if Adjusted ROE is 7% or less).
The use of an initial performance threshold of 2% less (or lower) than the target performance threshold for 2011 represents a transition year determination that the minimum level of Adjusted ROE necessary for the payment of any company performance bonus should remain consistent with the level required in 2010 (*i.e.*, remain at 7%).
Company performance bonuses for 2011 in excess of the target for those bonus amounts would not be paid unless Adjusted ROE was more than 2% above the target performance threshold (*i.e.*, until Adjusted ROE is more than 11%).
The use of a performance threshold for above-target company performance bonuses of 2% above the target performance threshold for 2011 represents a transition year determination that the minimum level of Adjusted ROE necessary for the payment of any above-target company performance bonus should remain consistent with the level required in 2010 (*i.e.*, remain at 11%).
As noted below, each NEO was subject to a maximum total bonus for 2011.
Any 2011 Company performance bonus amount that exceeds the amount that would have been paid for the same Adjusted ROE performance under the 2010 company performance bonus formula, would be paid in vested deferred stock units (DSUs) with a mandatory three-year holding period.
The use of vested DSUs with a mandatory three-year holding period to pay any 2011 company performance bonus amount that exceeds the amount that would have been paid for the same Adjusted ROE performance under the 2010 company performance bonus formula represents a transition year determination that the change to the company performance bonus formula for the 2011 transition year should not result in higher cash bonus payments to NEOs than would have been made under the formula in place for 2010.

As a result of the Committee s decisions, including those described above, the company performance bonus formula for use in 2011 for NEOs was as follows:

For Adjusted ROE of less than or equal to 7%, no company performance bonus would be paid;
For Adjusted ROE between 7% and 9%, the company performance bonus would be pro-rated between 0% and 100% of the target company performance bonus;
For Adjusted ROE between 9% and 11%, 100% of target company performance bonus would be paid; and
For Adjusted ROE in excess of 11%, the company performance bonus would be increased by an amount such that the total target bonus would increase by one-third for every 1% increase in Adjusted ROE above 11%, subject to the maximum total bonus amounts described below.
Because total bonus is used in the formula described in the immediately preceding bullet point, solely for the purpose of calculating the increase in company performance bonus in accordance with the described formula, an individual performance bonus equal to 100% of the target for the individual performance bonus is assumed (although it would not affect the calculation of his or her company performance bonus, an executive officer may, in fact, be awarded an individual performance bonus of more or less than 100% of the target for his or her individual performance bonus).

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Using a formula for 2011 that results in a pro-rated portion of the company performance bonus being earned for Adjusted ROE between 7% and 9% was determined as appropriate by the Committee to reward good financial performance below the target level; and continuing to maintain a formula for 2011 that results in a company performance bonus in excess of target for Adjusted ROE above 11% was determined as appropriate by the Committee to reward financial performance that exceeded the target threshold.

In addition, in November 2010, the Committee determined, after discussion with Cook & Co., that the target bonus percentages (which are percentages of base salary) for 2011 for Mr. Hughes, Mr. Nicholas, Mr. Chisholm, and Mr. Isbrandtsen would remain the same as the percentages in place with respect to each of them as of year-end 2010 and that Ms. Merdian s target bonus percentage for 2011 would be increased from 75% of her base salary to 100% of her base salary to respond to an increase in the market-based benchmark for her position.

The Committee also determined during the first quarter of 2011 that individual performance in 2011 for each NEO would be reviewed in the context of, among other things, the specific pre-determined goals and factors discussed below under Performance-Based Annual Bonuses Paid for 2011 Individual Performance Component of Annual Bonuses Awarded for 2011. As in past years, during 2011 these individual factors and goals were subject to adjustment if circumstances warranted, at the discretion of the Committee.

The Committee also established that the maximum annual bonus (*i.e.*, the maximum sum of the two components of the annual bonus) in 2011 would continue to be $5 million for each of Mr. Hughes and Mr. Nicholas and $2 million for each of the other NEOs. These maximum amounts were determined after consultation with Cook & Co., and were considered appropriate by the Committee as maximum total annual bonuses for each of these NEOs based on their position, responsibilities, level of performance needed to reach the maximum, and competitive considerations.

The table below sets forth the 2011 target annual bonuses that were established for each NEO assuming achievement of the criteria necessary to achieve 100% of the target annual bonus, together with the company performance and individual performance components of these target annual bonus amounts.

NEO	2011 Base Salary	2011 Target Annual Bonus (as % of Base Salary)	Company Performance Component of 2011 Target Annual Bonus ($)	Individual Performance Component of 2011 Target Annual Bonus ($)	Total 2011 Target Annual Bonus ($)
Mr. Hughes	$ 700,000	165 %	$ 866,250	$ 288,750	$ 1,155,000
Mr. Nicholas	$ 500,000	150 %	$ 562,500	$ 187,500	$ 750,000
Ms. Merdian	$ 400,000	100 %	$ 300,000	$ 100,000	$ 400,000
Mr. Chisholm	$ 400,000	100 %	$ 300,000	$ 100,000	$ 400,000
Mr. Isbrandtsen	$ 400,000	100 %	$ 300,000	$ 100,000	$ 400,000

Form of Payment of 2011 Performance-Based Annual Bonuses.

At its meeting in March 2011, the Committee also decided, after consultation with Cook & Co., that performance-based annual bonuses paid to NEOs for 2011 that exceeded $250,000 would not be paid fully in cash, but would instead be paid in part in the form of vested DSUs with a mandatory three-year holding period. Payment for annual bonus amounts in this manner exposes a greater portion of NEOs annual bonuses to the future financial performance of Redwood, which the Committee believes results in a greater alignment of executive and stockholder interests.

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The following table sets forth the step function that determines the amount of any NEO s 2011 annual bonus that would be paid in the form of vested DSUs with a mandatory three-year holding period and illustrates that, as the value of an NEO s annual bonus increases, an increasingly smaller percentage of that bonus is paid in cash.

Incremental Annual Bonus Amount ($)			Form of Payment of Incremental Annual Bonus Amount Cash	DSUs[(1)]
$	to	$ 250,000	100 %	0 %
$ 250,000	to	$ 500,000	60 %	40 %
$ 500,000	to	$ 1,000,000	55 %	45 %
$ 1,000,000	to	$ 1,500,000	50 %	50 %
$ 1,500,000	to	$ 2,000,000	45 %	55 %
$ 2,000,000	to	$ 5,000,000	40 %	60 %

(1) As noted above, these DSUs would be vested at grant, but subject to a mandatory three-year holding period.

Performance-Based Annual Bonuses Paid for 2011

In 2011, the Company s Adjusted ROE was 2.8%, which was below the initial performance threshold of 7% Adjusted ROE established by the Committee for 2011, as described above under 2011 Performance-Based Annual Bonus Compensation. As a result, no company performance component of performance-based annual bonuses was paid to NEOs for 2011 and performance-based annual bonuses for NEOs for 2011 consisted solely of the individual performance component of annual bonuses. A further discussion of the Committee s process for determining each of these components is set forth below.

As described above, Adjusted ROE is defined as income determined in accordance with GAAP divided by average core equity. Average core equity is defined as average GAAP equity excluding unrealized mark-to-market adjustments as reflected in accumulated other comprehensive income (loss).

Company Performance Component of 2011 Annual Bonuses. Under the company performance bonus formula that was established by the Committee at the beginning of 2011, which is described above under 2011 Performance-Based Annual Bonus Compensation, Adjusted ROE for 2011 was 2.8%, which was below the initial performance threshold of 7% Adjusted ROE established by the Committee for 2011. Accordingly, no company performance component of annual bonuses was paid to any NEO for 2011. The table below shows the target amount of this component of annual bonus for each NEO for 2011 and also indicates, as noted above, that none of those target amounts were paid.

NEO	Company Performance Component of 2011 Target Annual Bonus ($)	% of Company Performance Component Paid	2011 Company Performance Component of Annual Bonus Paid ($)
Mr. Hughes	$ 866,250	0 %	$ 0
Mr. Nicholas	$ 562,500	0 %	$ 0
Ms. Merdian	$ 300,000	0 %	$ 0
Mr. Chisholm	$ 300,000	0 %	$ 0

Mr. Isbrandtsen	$ 300,000	0 %	$ 0

Individual Performance Component of 2011 Annual Bonuses. For 2011, the individual performance components of annual bonuses were determined after a review of the individual achievements of each NEO and his or her individual contribution to the collective achievements of the senior management team, as well as a review of competitive considerations. The Committee s review of individual performance included a review of each NEO s self-assessment, the joint assessment by Mr. Hughes and Mr. Nicholas of the other NEOs (all of whom report directly to them), and input from Cook & Co. Among other factors, the Committee considered each of the company-wide goals noted below that the Committee had previously determined would be reviewed in assessing individual performance for 2011. With respect to each of these goals, the Committee noted various factors in evaluating the level of attainment of the goal and each NEO s contribution to achieving the goal, including the principal factors described below and the related level of attainment

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(presented in italics after each listed factor). In considering these goals and factors, the Committee did not assign specific weightings to each factor and goal, but instead considered them together as part of a comprehensive review.

Goal: Expand Redwood s Sequoia securitization platform *the Committee evaluated achievement of this goal in the context of various factors, including that during 2011 Redwood executed the only two private-sector securitizations of newly originated residential mortgages, Redwood entered into master loan purchase agreements with more than twenty residential mortgage originators through which Redwood can acquire mortgage loans for securitization, Redwood established contractual relationships with mortgage loan servicers that enable it to acquire mortgage loans from originators that do not service securitized loans, and Redwood improved its operational and information-technology infrastructure to enable it to further scale its securitization platform.*

Goal: Appropriately manage Redwood s securities investments and associated risks *the Committee evaluated achievement of this goal in the context of various factors, including that during 2011 Redwood was able to acquire $129 million of residential mortgage-backed securities issued by third parties for its investment portfolio, Redwood executed a re-securitization transaction in July 2011 to permanently finance a portfolio of these securities, and, through appropriate management reporting, Redwood consistently monitored the risk profile of its securities investments.*

Goal: Develop Redwood s commercial real estate lending platform *the Committee evaluated achievement of this goal in the context of various factors, including that during 2011 Redwood s commercial real estate lending platform become a recognized lender in the marketplace, established relationships with first mortgage lenders that will enhance its platform, established a significant number of correspondent/broker relationships, and originated a portfolio of $128 million of mezzanine loans and investments.*

Goal: Be recognized as a leader in re-establishing the residential mortgage securitization market *the Committee evaluated achievement of this goal in the context of various factors, including that during 2011 Redwood s residential mortgage securitization transactions were recognized as establishing new standards for the industry and marketplace, Redwood executives met regularly with Federal policymakers regarding mortgage finance and securitization reforms and initiatives, Redwood s Chief Executive Officer provided input on regulatory and market reforms through testimony to Congressional and Senate Committees or Sub-Committees on four separate occasions, and Redwood provided commentary and input on various regulatory initiatives and business initiatives of Federal policymakers and government-sponsored enterprises relating to housing finance and securitization reform.*

Goal: Manage operations and expenses appropriately *the Committee evaluated achievement of this goal in the context of various factors, including that during 2011 Redwood s operations were carried out efficiently and additional operational resources were added only as expected to respond to increased business activity and operational expense was managed well and overall operational expense of $48 million was in-line with budgeted amounts.*

Based on the above-described review of each NEO s individual achievements and their contribution to the collective achievements of the executive team, the Committee determined the individual performance component of annual bonuses for each NEO for 2011, each of which is set forth in the table below, together with the target amount of such component and the percentage of that target amount that was paid (or, in the case of a portion of Mr. Hughes 2011 individual performance bonus, granted in the form of deferred stock units) on February 28, 2012.

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NEO	Individual Performance Component of 2011 Target Annual Bonus ($)	% of Individual Performance Component Paid/ Granted	2011 Individual Performance Component of Annual Bonus Paid/Granted ($)
Mr. Hughes	$ 288,750	100 %	$ 288,750 (1)
Mr. Nicholas	$ 187,500	100 %	$ 187,500
Ms. Merdian	$ 100,000	100 %	$ 100,000
Mr. Chisholm	$ 100,000	150 %	$ 150,000
Mr. Isbrandtsen	$ 100,000	100 %	$ 100,000

(1) In accordance with the step function described above under Form of Payment of 2011 Performance-Based Annual Bonuses, $15,500 of Mr. Hughes 2011 individual performance component of annual bonus was delivered in the form of a grant of vested DSUs with a mandatory three-year holding period.

2011 Long-Term Equity-Based Awards

As discussed above, equity ownership in Redwood provides an important linkage between the interests of stockholders and executives by rewarding long-term stockholder value creation. To meet this objective, officers, directors, key employees, and other persons expected to contribute to the management, growth, and profitability of Redwood are eligible to receive long-term equity-based awards. The Committee, in consultation with Cook & Co., determines guidelines and procedures for the issuance of those awards to NEOs. Awards are made based upon a number of factors, including the NEO s position, responsibilities, and total compensation level, individual and Redwood financial performance, and market-based benchmarks for each NEO. The Committee also takes into consideration past awards and outstanding awards.

The Committee s normal practice is to make long-term equity-based awards to the NEOs (and to other executives and employees) at the regularly scheduled fourth quarter meeting of the Committee (which for 2011 occurred on December 7, 2011). The date of this meeting was determined more than six months in advance as part of the normal process for scheduling Board of Directors and Committee meetings. On December 7, 2011, the Compensation Committee made 2011 year-end long-term equity-based awards to NEOs in two forms: deferred stock units (DSUs) and performance stock units (PSUs). The terms of each of these two types of awards are summarized below.

The DSUs granted on December 7, 2011 will vest over four years, with 25% of each award vesting on January 1, 2013, and an additional 6.25% vesting on the first day of each subsequent quarter, with full vesting on January 1, 2016. The shares of Redwood common stock underlying these DSUs will be distributed to the award recipients on May 1, 2016, unless distribution is electively deferred by a recipient under the terms of Redwood s Executive Deferred Compensation Plan. The number of DSUs granted to each NEO was determined based on a dollar amount for each award divided by the closing price of the Redwood s common stock on the NYSE on the trading day immediately prior to grant.

The terms of the DSUs granted on December 7, 2011 are generally consistent with the terms of the 2010 long-term equity-based awards made to NEOs in November 2010 and are established under a deferred stock unit award agreement and Redwood s 2002 Incentive Plan, which terms include provisions relating to dividend equivalent rights, forfeiture, mandatory net settlement for income tax withholding purposes, and change-in-control.

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The PSUs granted on December 7, 2011 are performance-based equity awards under which the number of underlying shares of Redwood common stock that vest and that the award recipient becomes entitled to receive at the time of vesting will generally range from 0% to 200% of the target number of PSUs granted, with the target number of PSUs granted being adjusted to reflect the value of any dividends paid on Redwood common stock during the vesting period (as further described below). Vesting of these PSUs will generally occur at the end of three years (on December 6, 2014) based on three-year cumulative (not annualized) total stockholder return (TSR), as follows:

- If three-year cumulative TSR is negative, then 0% of the PSUs will vest;
- If three-year cumulative TSR is 25%, then 100% of the PSUs will vest;

If three-year cumulative TSR is between 0% and 25%, then between 0% and 100% of the PSUs will vest determined based on a straight-line, mathematical interpolation between the applicable vesting percentages;

- If three-year cumulative TSR is greater than or equal to 125%, then 200% of the PSUs will vest; and

If three-year cumulative TSR is between 25% and 125%, then between 100% and 200% of the PSUs will vest determined based on a straight-line, mathematical interpolation between the applicable vesting percentages.

Under the terms of the PSUs, (i) three-year cumulative TSR is defined as the percentage by which the Per Share Price (defined below) as of December 6, 2014 has increased or decreased, as applicable, relative to the Per Share Price as of December 7, 2011 (which was $10.30), adjusted to include the impact on such increase or decrease that would be realized if all cash dividends paid on a share of Redwood common stock during such three-year period were reinvested in Redwood common stock on the applicable dividend payment dates, and (ii) Per Share Price is defined, as of any date, as the average of the closing prices of a share of Redwood common stock on the NYSE during the twenty (20) consecutive trading days ending on the trading day prior to such date. The TSR performance thresholds for determining whether 0%, 100%, or 200% (or some other percentage in between those levels) of the underlying shares of Redwood common stock will vest were determined by the Committee based on a 25% cumulative TSR over three years being an attractive level of total stockholder return for investors, with the minimum and maximum vesting thresholds also reflecting an appropriate level of vesting for the related level of cumulative TSR over the three year period.

Subject to vesting, the shares of Redwood common stock underlying these PSUs will be distributed to the recipients on May 1, 2015, unless distribution is electively deferred by a recipient under the terms of the Redwood s Executive Deferred Compensation Plan. Prior to vesting, no dividend equivalent rights are paid in respect of PSUs. At the time of vesting, the value of any dividends paid during the vesting period will be reflected in the PSUs by increasing the target number of PSUs granted by an amount corresponding to the incremental number of shares of Redwood common stock that a stockholder would have acquired during the three-year TSR measurement period had all dividends during that period been reinvested in Redwood common stock on the applicable dividend payment dates. After the vesting of these PSUs in December 2014 (if any vest) and until the delivery of the underlying shares of Redwood common stock, the underlying vested award shares will have attached dividend equivalent rights, resulting in the payment of dividend equivalents each time Redwood pays a common stock dividend during that period.

The terms of the PSUs granted on December 7, 2011 are established under a performance stock unit award agreement and Redwood s 2002 Incentive Plan, which terms include provisions relating to forfeiture, mandatory net settlement for income tax withholding purposes, and change-in-control.

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An example of how vesting of the PSUs granted on December 7, 2011 could occur is set forth in the bullet points below:

Assume for purposes of this example that a recipient had received a PSU grant on December 7, 2011 with a target number of 10,000 PSUs and that the Per Share Price as of December 6, 2014 was $10.30 (*i.e.*, unchanged from the Per Share Price on the grant date of the PSUs); and
Assume for purposes of this example that a quarterly dividend of $0.25 per share of Redwood common stock was maintained over the three-year vesting period for these PSUs and that the price for Redwood common stock on each dividend payment date during this period was $10.30.

Under the above assumptions, three-year cumulative TSR over the three-year vesting period would be 29.13%, with the result that 13,886 underlying shares of Redwood common stock would vest on December 6, 2014. The calculation of the vesting of underlying shares is set forth in the following two bullet points:

as noted above, dividends paid during the vesting period would be reflected by adjusting the target number of PSUs granted by an amount corresponding to the incremental number of shares of Redwood common stock that would have been acquired during the vesting period had all such dividends been reinvested in additional shares on the applicable dividend payment dates (*i.e.*, the target number of PSUs granted in this example would be adjusted by 3,335 (from 10,000 to 13,335)); and
based on a 29.13% three-year cumulative TSR, 104.13% of the adjusted 13,335 target number of PSUs granted would vest (*i.e.*, 13,886 underlying shares of Redwood common stock would vest on December 6, 2014).

The long-term equity-based awards granted to NEOs in the fourth quarter of 2011 were determined by the Committee after receiving input from Cook & Co., with each award being determined based on the Committee s philosophy that the grant date value of these long-term equity-based awards should approximate the 75th percentile relative to the marked-based benchmark for this component of compensation. The 2011 long-term equity-based awards granted to NEOs are consistent with the Committee s performance-based compensation philosophy and the Committee believes that the awards reinforce the linkage between the interests of Redwood s NEOs and its long-term stockholders by encouraging ownership of Redwood stock by executives and rewarding stockholder value creation.

The number and grant date fair value of DSUs and PSUs comprising the 2011 long-term equity-based awards granted to each NEO are set forth in the table below:

	Deferred Stock Units		Performance Stock Units	
NEO[1]	#	Aggregate Grant Date Fair Value[1]	#	Aggregate Grant Date Fair Value[2]
Mr. Hughes	108,055	$ 1,137,819	108,055	$ 1,062,181
Mr. Nicholas	77,358	$ 814,580	77,358	$ 760,429
Ms. Merdian	27,014	$ 284,457	27,014	$ 265,548
Mr. Chisholm	34,381	$ 362,032	34,381	$ 337,965
Mr. Isbrandtsen	29,470	$ 310,319	29,470	$ 289,690

(1) Redwood s NEOs for 2011 account for five of the 77 employees of Redwood as of December 31, 2011.
(2) Determined in accordance with FASB Accounting Standards Codification Topic 718 at the time the grant was made.

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DSUs awarded in 2011 have attached dividend equivalent rights, resulting in the payment of dividend equivalents each time Redwood pays a common stock dividend. The value of dividend equivalent rights was taken into account in establishing the grant date fair value of these DSUs under FASB Accounting Standards Codification Topic 718 at the time the awards were granted. Therefore, current dividend equivalent right payments are not considered part of the compensation reported above in the table of non-employee director compensation under Director Compensation or below in the summary table of NEO compensation under Executive Compensation Tables Summary Compensation.

Mandatory Holding Periods for 2011 Long-Term Equity-Based Awards

DSUs Granted in December 2011. The long-term equity-based awards granted to NEOs in December 2011 that were in the form of DSUs have the four-year vesting schedule described above under 2011 Long-Term Equity-Based Awards. Notwithstanding this vesting schedule, the NEOs are subject to a mandatory holding period with respect to all shares underlying the DSU awards made in December 2011 that vest prior to the distribution date. Consequently, assuming continued employment of the NEOs receiving those awards, the earliest these DSU awards will be distributed to recipients in shares of Redwood common stock (and, as a result, the earliest these shares could be sold or transferred) is May 1, 2016.

PSUs Granted in December 2011. The long-term equity grants made to NEOs in December 2011 that were in the form of PSUs have the three-year cliff vesting schedule described above under 2011 Long-Term Equity-Based Awards. Notwithstanding this vesting schedule, the NEOs are subject to a mandatory holding period with respect to all shares underlying the PSU awards made in December 2011 that vest prior to the distribution date. Consequently, assuming continued employment of the NEOs receiving these awards, if any of these PSUs vest, the earliest these PSUs will be distributed to recipients in shares of Redwood common stock (and, as a result, the earliest these shares could be sold or transferred) is May 1, 2015.

DSUs Granted in February 2012. As previously noted, in accordance with the step function described above under Form of Payment of 2011 Performance-Based Annual Bonuses, $15,500 of Mr. Hughes 2011 annual bonus was paid in the form of vested DSUs with a mandatory three-year holding period. Consequently, the earliest these DSU awards will be distributed to Mr. Hughes in shares of Redwood common stock (and, as a result, the earliest these shares could be sold or transferred) is May 1, 2015.

Executive Stock Ownership Guidelines; Hedging of Shares Held by Executives Not Permitted

As described on page 7 of this Proxy Statement, the Committee has established executive stock ownership guidelines with respect to Redwood s executive officers. These guidelines are summarized below and the Committee believes that they reinforce the linkage between the interests of Redwood s executives and its long-term stockholders by requiring ownership of Redwood stock by executives and rewarding stockholder value creation.

Each executive officer is required to own stock with a value at least equal to (i) five times current salary for the Chief Executive Officer, (ii) three times current salary for the President, and (iii) two times current salary for the other executive officers;

Three years are allowed to initially attain the required level of ownership and three years are allowed to acquire additional incremental shares if promoted to a position with a higher guideline (if not in compliance at the indicated times, then the executive officer is required to retain net after-tax shares delivered as compensation or from the Executive Deferred Compensation Plan until compliance is achieved); and

All shares owned outright are counted, including those held in trust for the executive officer and his or her immediate family, as well as vested DSUs and any other vested shares held pursuant to other employee plans.

For purposes of determining compliance, the original purchase or acquisition price is used as the value of shares held and, as of the date of this Proxy Statement, all of Redwood s executive officers were in compliance with these guidelines either because he or she owned the requisite number of shares or because he or she was within the time period during which the executive is permitted to attain the required level of ownership.

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In addition, under Redwood s Insider Trading Policy, Redwood s executive officers may not engage in any of the following hedging or other transactions with respect to their ownership of Redwood common stock, each of which the Committee believes would be inconsistent with the purposes and intent of the executive stock ownership guidelines:

Prohibition on Short Sales of Redwood Securities. Engaging in a short sale of common stock or other securities issued by Redwood is not permitted.

Prohibition on Use of Publicly-Traded Options and Derivatives or Other Transactions for Hedging Ownership of Redwood Securities. Transactions in publicly traded options or derivatives that reference Redwood s common stock or other Redwood securities are not permitted. Accordingly, transactions in puts, calls or other derivative securities, on an exchange or in any other organized market, are not permitted. Similarly, hedging or monetization transactions are not permitted.

Compensation Determinations Relating to 2012

In accordance with its normal practice, at meetings in December 2011, January 2012, and March 2012, the Committee made certain decisions relating to NEO compensation for 2012, as further described below.

2012 Base Salaries. In accordance with its above-described policy and practice relating to establishing base salaries (see 2011 Base Salaries above), the Committee reviewed the base salaries of the NEOs for 2012. This review was made after consultation with Cook & Co. and after review of the marked-based benchmark for this component of compensation, analysis of the type described above under Compensation Benchmarking for 2011, and consideration of the competitive levels necessary for executive retention. As a result of this review, for 2012:

- the salary for Mr. Hughes remained at its year-end 2010 level of $700,000;
- the salary for Mr. Nicholas remained at its 2007 level of $500,000;
- the salary for Ms. Merdian remained at its 2010 level of $400,000;
- the salary for Mr. Chisholm was increased to $475,000 from its 2011 level of $400,000; and
- the salary for Mr. Isbrandtsen remained at its 2010 level of $400,000.

The Committee retains the discretion to make adjustments to these base salaries prior to its annual year-end review in December 2012, although it does not currently contemplate any such intra-year adjustments.

2012 Targets for Performance-Based Annual Bonuses. The Committee also made two determinations regarding 2012 targets for performance-based annual bonuses for NEOs. First, the Committee determined, after consultation with Cook & Co., that 2012 target annual bonuses for each of these NEOs would continue to be weighted 75% on Redwood company performance (*i.e.*, Adjusted ROE) and 25% on individual performance metrics. Second, in accordance with its above-described policy and practice relating to establishing target annual bonuses (see 2011 Performance-Based Annual Bonus Compensation above), and after consultation with Cook & Co. and consideration of the competitive levels necessary for executive retention, the Committee determined 2012 target annual bonus amounts for each of the NEOs, which target amounts are expressed as a percentage of base salary.

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The table below sets forth the 2012 target annual bonuses (expressed both as a percentage of base salary and in dollars) for each of the NEOs assuming achievement of the criteria necessary to achieve 100% of the target annual bonus, together with the company performance and individual performance components of the 2011 target annual bonus and a comparison to target annual bonuses for 2011.

NEO	2012 Base Salary	2012 Target Annual Bonus (%)	Change from Total 2011 Target Annual Bonus Percentage (%)(1)	Company Performance Component of 2012 Target Annual Bonus ($)(2)	Individual Performance Component of 2012 Target Annual Bonus ($)(2)	Total 2012 Target Annual Bonus ($)(2)
Mr. Hughes	$ 700,000	175 %	6 %	$ 918,750	$ 306,250	$ 1,225,000
Mr. Nicholas	$ 500,000	160 %	7 %	$ 600,000	$ 200,000	$ 800,000
Ms. Merdian	$ 400,000	100 %	0 %	$ 300,000	$ 100,000	$ 400,000
Mr. Chisholm	$ 475,000	125 %	25 %	$ 445,313	$ 148,437	$ 593,750
Mr. Isbrandtsen	$ 400,000	100 %	0 %	$ 300,000	$ 100,000	$ 400,000

(1) Amounts set forth in the table under Change from Total 2011 Target Annual Bonus (%) reflect the increase, if any, in 2012 Target Annual Bonus % from the 2011 Target Annual Bonus %.

(2) As described below under Form of Payment of 2012 Performance-Based Annual Bonuses, annual bonuses paid to NEOs for 2012 that exceed $250,000 will not be paid fully in cash, but will instead be paid in part in the form of vested DSUs with a mandatory three-year holding period, based on a step function that provides that as the value of an NEO s 2012 annual bonus increases, an increasingly smaller percentage of that bonus will be paid in cash.

In addition, as was the case in 2011, the Committee determined that the maximum sum of the two annual bonus components (*i.e.*, the maximum total annual bonus) in 2012 will continue to be $5 million for each of Mr. Hughes and Mr. Nicholas, and $2 million for each of the other NEOs. These maximum amounts were determined after consultation with Cook & Co., and were considered appropriate by the Committee as maximum total annual bonuses for each of these NEOs based on their position, responsibilities, level of performance needed to reach the maximum, and competitive considerations.

Form of Payment of 2012 Performance-Based Annual Bonuses. The Committee also determined, after consultation with Cook & Co., to continue the practice it had adopted for 2011 relating to the form of payment of annual bonuses to NEOs. Accordingly, annual bonuses paid to NEOs for 2012 that exceed $250,000 will not be paid fully in cash, but will instead be paid in part in the form of vested DSUs with a mandatory three-year holding period in accordance with the step function (and related table) described and set forth above under Form of Payment of 2011 Performance-Based Annual Bonuses. Payment of annual bonus amounts in this manner has the result that, as the value of an NEO s annual bonus increases, an increasingly smaller percentage of that bonus is paid in cash. Because this exposes a greater portion of NEOs annual bonuses to the future financial performance of Redwood, the Committee believes this practice results in a greater alignment of executive and stockholder interests.

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The table below sets forth total 2012 target annual bonus amounts for each NEO and the portions of such target amounts that, if earned, would be paid in cash and vested DSUs with a mandatory three-year holding period as a result of the application of the above-described step function.

NEO	Value of Total 2012 Target Bonus ($)	Portion of Total 2012 Target Bonus That Would be Paid in Cash ($/%)		Portion of Total 2012 Target Bonus That Would be Paid in DSUs(1) ($/%)
Mr. Hughes	$1,225,000	$787,500/(64 %)	Historically, brand-name drug companies have attempted to prevent generic drug manufacturers from producing certain products and to prevent competing generic drug products from being accepted as equivalent to their brand-name products. We expect such efforts to continue in the future. Also, some brand-name competitors, in an attempt to participate in the generic drug sales of their branded products, have introduced generic equivalents of their own branded products, both prior and subsequent to the expiration of their patents or FDA exclusivity periods for such drugs. These	

competitors have also introduced authorized generics or generic equivalents of brand-name drug products.

In the United States, we compete with branded pharmaceutical manufacturers such as Bristol-Myers Squibb, GlaxoSmithKline, Medicis Pharmaceutical, Novartis, Pfizer/Wyeth and Merck/Schering-Plough, as well as with generic companies such as Altana (now Nycomed), Teva Pharmaceuticals U.S.A. (now including Barr Laboratories) ("Teva"), Mylan Laboratories, Perrigo Company, Ranbaxy Pharmaceuticals Inc. and Sandoz Pharmaceuticals. Many of these companies have more resources, market and name recognition and better access to customers than we have. Therefore, there can be no assurance of the success of any of our products.

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

Depending on the product, pricing in Canada is established by competitive factors or by Canadian formulary price lists published by the Canadian provinces.

In Israel, we compete with Teva Pharmaceutical Industries Ltd., Perrigo Israel Pharmaceuticals Ltd., Dexxon Ltd., and Rafa Laboratories Ltd., among others. In addition, many leading multinational companies, including Bayer AG, Eli Lilly and Company, Merck & Co., Inc. and Pfizer Inc., market their products in Israel.

In Israel, the government establishes the prices for pharmaceutical products as part of a formal review process. There are no restrictions on the import of pharmaceuticals provided that they comply with registration requirements of the Israeli Ministry of Health.

Manufacturing and Raw Materials

We manufacture finished pharmaceutical products at our government approved facilities in Canada and Israel and APIs at our facilities in Israel. We have expanded our research and development and warehousing facilities in Israel. An auxiliary warehouse in Canada that was used primarily for warehousing of finished goods pharmaceutical products for the U.S. market was sold for $5.2 million on March 29, 2007, as Taro U.S.A. acquired a warehouse in Cranbury, New Jersey.

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

We synthesize the APIs used in some of our key products, including our warfarin sodium tablets, carbamazepine products, etodolac tablets, terbinafine cream, oxcarbazepine tablets and clorazepate dipotassium tablets. We also synthesize the API for our Ovide® lotion. We plan to continue the strategic selection of APIs for synthesis in order to maximize the advantages from this scientific and manufacturing capability.

Although, prices of principal raw materials have been relatively stable, the Company has instituted programs to keep the cost of APIs consistent or to improve upon them; for example, by the qualification of alternate suppliers.

Industry Practices Relating to Working Capital Items

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

Industry practice requires that pharmaceutical products be made available to customers from existing stock rather than on a made-to-order basis. Therefore, in order to accommodate market demand adequately, we strive to maintain a sufficient level of inventory.

Government Regulation

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

In the United States, Canada, Israel and other jurisdictions, the manufacture and sale of pharmaceutical products are regulated in a similar manner. Legal requirements generally prohibit the handling, manufacture, marketing and importation of any pharmaceutical product unless it is properly registered in accordance with applicable law. In addition, approval is required before any new drug or a generic equivalent to a previously approved drug can be marketed. Furthermore, each country requires approval of manufacturing facilities, including adherence to cGMPs during the production and storage of pharmaceutical components, including, but not limited to, raw materials and finished products. As a result, we have had periodic inspections of our facilities and records. For example, Taro Canada was inspected by the FDA in 1995, 1996, 1998, 2001, 2005, 2008 and 2011. Our facilities in Haifa Bay, Israel were inspected by the FDA in 1996, 1997, 1999, 2002, 2006, 2009 and 2010, by the United Kingdom Medicines Control Agency in 1997 and 1998, and by the Irish Medicines Board in 2005.

As described in the Risk Factors, our Canadian manufacturing facility received a Warning Letter from the FDA in February 2009 expressing concerns identified during a July 2008 inspection about certain quality control systems, including failure to complete investigations of quality issues in a timely manner. A formal cGMP re-inspection was conducted by the FDA in February 2011 to evaluate the effectiveness of corrective actions undertaken by Taro and the FDA announced in April 2011 that the site has an acceptable regulatory status and issues were considered resolved.

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

In the United States, Canada, Israel and other jurisdictions, we, as well as other manufacturers of drugs, are dependent on obtaining timely approvals for products. The approval process in each country has become more rigorous and costly in recent years. There can be no assurance that approvals will be granted in a timely manner or at all. In the United States, Canada, Israel and other jurisdictions, the procedure for drug product approvals, if such approval is ultimately granted, generally takes longer than one year. Inability or delay in obtaining approvals for our products could adversely affect our product introduction plans and our results of operations.

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

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

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

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

If the FDA believes a company is not in compliance with cGMP, certain sanctions may be imposed, including: (i) withholding new drug approvals as well as approvals for supplemental changes to existing applications; (ii) preventing the receipt of necessary licenses to export products; (iii) preventing the importation of certain products into the United States; (iv) classifying the company as an unacceptable supplier and thereby disqualifying the company from selling products to federal agencies; and (v) pursuing a consent decree or court action that limits company operations or imposes monetary fines.

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

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

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

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

Environmental Compliance

We believe that we are in compliance with all applicable environmental laws and regulations in Canada and the United States. In Israel, we are in compliance with all applicable environmental laws and regulations subject to the following clarification: new regulations concerning air emissions were enacted in Israel during 2008. The Israel Ministry of Environmental Protection (the "MEP") conducted tests of air emissions at the Haifa Bay facility during May 2008 and provided the results of such testing to the Company in January 2009. The MEP concluded that the Company should reduce its levels of emissions. In response, the Company has taken steps to improve its emission output by implementing a Regenerative Thermal Oxidizer ("RTO") system to meet the EU TALUFT 2002 standards. Implementation is in its final stages. See Item 5 – "Operating and Financial Review and Prospects – Recent Developments" for an update.

C. ORGANIZATIONAL STRUCTURE

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

The following is a list of our significant subsidiaries and their countries of incorporation as of March 31, 2011:

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

The share capital of Taro U.S.A. is divided into two classes. The Company owns 96.9% of the shares that have economic rights and 50% of the shares that have voting rights in Taro U.S.A. TDC owns 3.1% of the shares that have economic rights and 50% of the shares that have voting rights in Taro U.S.A. TDC has agreed to vote all of its shares in Taro U.S.A. for such persons as we may designate for any election to its board of directors; however, TDC may terminate the agreement upon one year's written notice.

The Company owns 99.8% of the shares of Taro Research Institute Ltd. and Taro International Ltd. owns the remaining 0.2%. The Company owns 100% of Taro Pharmaceuticals North America, Inc., which owns 100% of Taro Pharmaceuticals Inc. The Company owns 99.75% of Taro Pharmaceuticals Europe B.V. and Taro Pharmaceuticals North America, Inc. owns the remaining 0.25%.

Sun beneficially owns 77.5% of the voting power of the Company.

D. PROPERTY, PLANT AND EQUIPMENT

The following is a list of our principal facilities as of December 31, 2009:

Location	Square Footage	Main Use	Own/Lease
Haifa Bay, Israel1	890,000	Pharmaceutical manufacturing, production laboratories, offices, warehousing, chemical production (including tank farm and chemical finishing plant), and research	Long-term Lease Own Lease Use permit
Yakum, Israel	15,000	Administrative offices	Lease
Brampton, Canada	142,000	Pharmaceutical manufacturing, production laboratories, laboratories, administration, distribution and warehousing	Own
Brampton, Canada	75,400	Administration and warehousing	Lease
Hawthorne, New York	124,000	Administrative offices	Own
South Brunswick, New Jersey	315,000	Distribution facility	Own

Roscrea, Ireland2	124,000	Pharmaceutical manufacturing, research laboratories and warehousing	Own

1. The majority of the land is held by the Company under a long-term lease from the Israeli Land Authority ("ILA"), which has not yet provided approval for the change of control of the Company.
2. The Irish facility has been discontinued and is held for sale.

From 2007 through 2009, we invested $14.6 million in property, plant and equipment (“PP&E”) projects. Most of these projects have been completed and are subject to depreciation in accordance with our accounting policy of capitalizing costs that are direct and incremental to the activities required to bring the facilities to commercial production.

Our plant, research and office facilities in Haifa Bay, Israel, are located in a complex of buildings with an aggregate area of approximately 890,000 square feet. We lease much of the land underlying these facilities from the ILA pursuant to long-term ground leases that expire between 2018 and 2058. We have the option to renew each lease for an additional 49 years. We also lease approximately 10,000 square feet of adjacent space in Haifa Bay. The lease for this property commenced on September 30, 1994. For additional information, please refer to Note 2.i. to our consolidated financial statements included elsewhere in this 2009 Annual Report.

We lease approximately 15,000 square feet of space in a facility located in Yakum, Israel, which is used for administrative and marketing offices.

In February 2002, Taro Canada purchased 74,000 square feet of space that it had leased since March 1997, adjacent to the 68,000 square foot main manufacturing facility which it owns in Brampton, Canada. In September 2000, Taro Canada leased an additional 75,400 square feet of office and warehouse space, adjacent to the other two facilities, which lease term continues to 2015. In December 2003, Taro Canada purchased a 108,797 square foot building in close proximity to its existing facilities for $3.6 million. This building was used primarily for warehousing and was sold for net proceeds of $5.2 million on March 29, 2007.

In August 2002, Taro U.S.A. purchased a 32% interest in a 124,000 square foot building in Hawthorne, New York, in which it located its United States research operations, for $4.4 million. In February 2005, Taro U.S.A. exercised its option to purchase the remaining 68% interest in this building and, in May 2005, Taro U.S.A. consolidated its administrative offices and research laboratory to this location. In September 2006, such research laboratory operations were discontinued. As of December 31, 2009, a subsidiary of Taro U.S.A. had a mortgage on this property of $9.9 million.

In January 2004, Taro U.S.A. purchased a 315,000 square foot distribution facility in South Brunswick, New Jersey for $18.0 million. As of December 31, 2009, a subsidiary of Taro U.S.A. had a mortgage on this property of $10.8 million.

In the pharmaceutical industry, both manufacturing plants and equipment must be constructed and installed in accordance with regulations designed to meet stringent quality and sterility guidelines, among others. In order to meet these requirements, certain validation processes are required to be completed prior to commencing commercial production.

Design qualification (“DQ”), installation qualification (“IQ”), operational qualification (“OQ”), performance qualification (“PQ”) and validation are the steps required by cGMPs to bring plants and/or equipment to the status of their intended use. In the performance of these activities, the Company uses both internal and external resources. The Company capitalizes external costs and those internal costs that are direct and incremental to the activities required to bring the facilities and activities to commercial production.

In the pharmaceutical industry, project life cycles (e.g., the construction of a new manufacturing facility) are typically longer than those in other industries. Such projects are technically complicated due to the highly regulated nature of the industry and the necessity of complying with specific detailed demands of regulatory authorities such as the FDA.

Certain internal resources utilized in bringing these facilities to the status required for their intended use are completely dedicated to these projects. The costs of personnel involved in such a process are capitalized only to the extent that they are directly dedicated to the completion of the facilities.

As fully described below, the nature of the activities performed by the employees whose salaries were capitalized include only the work and the direct costs associated with the factory acceptance test ("FAT"), the installation of equipment and the qualification and testing of the equipment prior to its commercial use.

The typical stages for defining the beginning and the completion of such construction projects include: planning and design of the facilities; construction; purchase, transportation and installation of equipment; equipment and facility validation (run in tests); and process and product validation.

All new equipment must undergo IQ, OQ and PQ in order to test and verify, according to written protocols, that all aspects of the equipment meet pre-determined specifications. IQ is defined as the documented evidence that the equipment has been installed according to the approved drawings and specifications. OQ is the documented evidence that all aspects of the equipment and the facility operate as intended within pre-determined ranges, according to the operational specifications. PQ is defined as the documented evidence that all aspects of the facility, utility or equipment that can affect product quality perform as intended in the pre-determined acceptance criteria.

Such qualification and validation activities are required for all equipment and systems that have an impact on or affect product quality and are required prior to commencing commercial production. At the time of installation and validation, all employees who will operate and maintain the equipment from the engineering, technology and maintenance departments are appropriately trained. At this stage in the installation and validation process, experts from the equipment manufacturer are on site, as part of the purchase contract, to provide training to Company employees in the operation and maintenance of the equipment.

This phase, which is necessary to bring the asset to the condition required for its intended use, is handled by a multi-functional team of engineers and technologists. The direct costs are the direct labor and the material consumed during this stage of installation and validation such as bottles, ampoules and raw materials. Incremental costs, which have arisen in direct response to the additional activity, include the expenses directly attributable to any employee's time fully dedicated to the project in question.

After the equipment has passed all IQ, OQ and PQ tests, it is then tested for its ability to actually manufacture the specific products that are intended to be produced on the equipment. Three consecutive successful validation batches must be produced. This process is performed jointly by the technology and the manufacturing departments. In addition, the cleaning of the equipment must be validated to assure that there is no carry-over residue to the next product to be manufactured using the equipment. Only after the validation batches that are manufactured using the new equipment pass quality control and quality assurance tests can they be released for sale, completing the validation process. No further costs are capitalized. This process is performed for all products.

This phase is handled by the technology department. On occasion, the engineering department is also involved. Direct costs for this stage would include all direct costs, such as payroll, attributable to the project. Incremental costs would include the expenses attributable to any management time fully dedicated to the project in question.

During the installation process, materials from inventory are consumed. For example, in order to qualify a tablet press machine or an ampoule filling machine, we use raw materials, including APIs and excipients, to run the qualification test. As part of this test, actual tablets are manufactured and costs are incurred. These tablets may neither be distributed nor sold. These qualification procedures are part of cGMPs mandated by the FDA and its international counterparts. The amount of inventory capitalized as part of these projects is less than one percent of the total cost of the assets. We do not capitalize, as part of the asset cost, inventories that are routinely produced in commercial quantities on a repetitive basis.

ITEM 4A. UNRESOLVED STAFF COMMENTS

None

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

RECENT DEVELOPMENTS

Investment by Sun

In early November 2006, because of decreasing liquidity, the Company retained The Blackstone Group (“Blackstone”), an investment banking firm, to assist it in exploring strategic alternatives, which included efforts to raise capital or find a suitable merger partner for Taro. Following an extensive process begun in 2006 and review of numerous proposals, on May 18, 2007, we entered into a merger agreement, among the Company, Alkaloida Chemical Company Exclusive Group Ltd. (“Alkaloida”), a subsidiary of Sun Pharma and Aditya Acquisition Company Ltd. (“Aditya”), a subsidiary of Alkaloida (the “Merger Agreement”) to effect an investment and a merger with Alkaloida. On that same day, we entered into a share purchase agreement (the “Share Purchase Agreement”) with Alkaloida, pursuant to which, in May 2007, Alkaloida invested $40.7 million in consideration for 6,787,500 of our ordinary shares at a price per share of $6.00, and Sun received a 3-year warrant to purchase an additional 6,787,500 of our ordinary shares with an exercise price per share of $6.00.

On May 28, 2008, the Company terminated the Merger Agreement. The proposed merger was subject to a number of terms and conditions, including the approval by our shareholders, certain Israeli governmental authorities and the U.S. Federal Trade Commission (the "FTC"). After it became clear that the merger may not be approved by the shareholders at the proposed price of $7.75 per share, Sun offered, in early 2008, to raise the merger price to $10.25, subject to certain conditions. The Company's board of directors (the "Board" or "Board of Directors") and its advisors evaluated Sun's offer and found that it was inadequate. On May 27, 2008, the Board determined that permitting the Merger Agreement to remain in force was no longer in the best interests of the Company's shareholders. On May 28, 2008, the Company announced it had terminated the Merger Agreement in accordance with its terms. That same day, Taro and its directors (other than the members of the Levitt and Moros families, who are comprised of Dr. Barrie Levitt, Ms. Tal Levitt and Dr. Daniel Moros), filed an originating motion against Sun Pharma, Alkaloida and Aditya with the Tel-Aviv District Court (the "District Court") seeking, among other things, a declaratory ruling and a permanent injunction prohibiting Sun Pharma, Alkaloida and Aditya from purchasing or offering to purchase additional ordinary shares that would result in an increase in Sun's voting power to more than 45% of the total voting power of the Company, other than by means of a special tender offer ("Special Tender Offer") in accordance with provision 328 of the Israeli Companies Law – 1999 (the "Israeli Companies Law"). The "special tender offer" rules under Israeli law provide certain protections for minority shareholders. An additional shareholder in the Company, Franklin Advisers, Inc. and Templeton Asset Management Ltd. (together "Templeton"), joined as an applicant to the proceeding, also arguing that a Special Tender Offer is required.

Sun thereafter claimed that the Company was not entitled to terminate the Merger Agreement and on June 25, 2008, Sun gave notice that it was exercising its option under the option agreement entered into by Sun on May 18, 2007, with Dr. Barrie Levitt, Dr. Daniel Moros, Ms. Tal Levitt, Dr. Jacob Levitt and 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 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, while Sun is not permitted to consummate the transactions contemplated by the Options until such tender offer expires.

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

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

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

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

Concurrent with the execution of the Letter Agreement, Sun and the members of 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 Pharma 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 $22,725,000. As of December 31, 2010, 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 on November 1, 2010, Sun owned, or controlled, 28,072,933, or 65.2%, of Taro's Ordinary Shares and, with Taro's Founders' Shares, 76.8% of the vote attributable to the share equity of the Company.

Subsequent to December 31, 2010, Alkaloida acquired 712,500 Ordinary Shares remaining under the Share Purchase Agreement and 712,500 Ordinary Shares pursuant to Warrant No. 2. The Ordinary Shares available pursuant to the Share Purchase Agreement and the Warrant had been reserved for purchase pending the outcome of a lawsuit initiated on May 10, 2007 in Israel against, among others, the Company and Sun by Templeton. Sun and Templeton subsequently entered into a settlement agreement, whereby the litigation ceased and Sun became eligible to purchase the reserved Ordinary Shares of the Company. As a result of the exercise of Warrant No. 2 and the purchase of shares by Alkaloida pursuant to the Share Purchase Agreement, Sun owns, or controls, 29,497,933, or 66.3%, of the Company’s Ordinary Shares, and with the Company’s Founders’ Shares, 77.5% of the vote attributable to the share equity of the Company.

As a result of the changes described in the preceding paragraphs, the Company has a substantial relationship with Sun. Certain of Taro’s Board members, including the Chairman, are also on Sun Pharma’s Board of Directors. In addition, certain of Taro’s officers and executives are also executives of Sun. Taro's Interim Chief Executive Officer, who is also a member of the Board of Directors of Taro, is an officer of an indirect subsidiary of Sun Pharma.

General Shareholders Meeting

The Company held its annual general shareholders meeting on December 30, 2010, in Yakum, Israel. The Company’s shareholders voted to elect all of the directors who were recommended for election, including two statutory external directors. The Company’s shareholders also approved the appointment of the Company’s independent auditors. At an extraordinary general shareholders meeting held on May 12, 2011, in Yakum, Israel, the Company’s shareholders approved indemnification of directors, elected James Kedrowski as an additional director to the Board and approved and ratified the remuneration of the directors who are not statutory external directors.

Late Filing of our Annual Reports on Form 20-F for Years-Ended 2005, 2006, 2007, 2008 and 2009

We did not timely file our Annual Report on Form 20-F for fiscal years ended 2005, 2006, 2007, 2008 and 2009. As a result, the Company experienced a number of significant negative consequences. See “NASDAQ Stock Market Delisting,” and “Compliance with Covenants in Debt and Loan Agreements,” in this “Recent Developments” section.

In addition, we are not able to access public capital markets due to our non-compliance with SEC reporting requirements.

The Company received a letter from the SEC in May 2009 noting that the Company is not in compliance with its SEC reporting requirements, and advising that, until the Company complies with such reporting requirements, an administrative proceeding could be brought to revoke the Company’s registration under the Exchange Act and that the Company’s stock also could be subject to a trading suspension by the SEC pursuant to the Exchange Act. The Company communicated with the SEC, explaining the reasons for the delay in filing its annual reports as well as its significant and continuing efforts to return to compliance with its financial reporting obligations as soon as possible. As of September 22, 2011, the Company has filed an Annual Report on Form 20-F for the fiscal years ended 2005, 2006, 2007, 2008, 2009 and 2010.

Appointment of New Interim Chief Financial Officer

On November 19, 2010, we announced that we had appointed Michael Kalb to the position of Interim Chief Financial Officer of the Company following the departure of the Company's former Chief Financial Officer. Mr. Kalb is also Group Vice President, Chief Accounting Officer of the Company and Chief Financial Officer of Taro U.S.A.

NASDAQ Stock Market Delisting

On July 21, 2006, we received a staff determination from the Listing Qualifications Department of The NASDAQ Stock Market stating that because NASDAQ had not received our 2005 Annual Report as required by NASDAQ Marketplace Rule 4320(e)(12), our ordinary shares were subject to delisting from The NASDAQ Global Select Market unless we requested a hearing. We requested a hearing before a NASDAQ Listing Qualifications Panel (the "Panel") to review the staff determination. Our ordinary shares remained listed pending the review. The Panel determined to continue the listing of our ordinary shares on The NASDAQ Global Select Market, subject to certain conditions, until November 17, 2006. Subsequently, the Panel granted a further extension of time to December 11, 2006. On December 12, 2006, we received a notification from the Listing Qualifications Department of NASDAQ that our ordinary shares would be delisted from The NASDAQ Global Select Market after the close of business on Wednesday, December 13, 2006, because we had failed to file our 2005 Annual Report by December 11, 2006.

Following delisting, our ordinary shares are now quoted on the Pink Sheets under the symbol TAROF. Information regarding the Pink Sheets is available at www.pinksheets.com. Investors should be aware that trading on the Pink Sheets may result in a reduction in liquidity and trading volume of our ordinary shares.

Compliance with Covenants in Debt and Loan Agreements

The delay in issuing the audited financial statements for the years ended December 31, 2005, 2006, 2007, 2008 and 2009 resulted in the Company not being in compliance with certain reporting obligations with respect to certain debt instruments, however, as all of our Form 20-Fs have been filed as of September 22, 2011, we are in compliance with all material reporting covenants under our debt instruments. For further information on our debt instruments, see Note 13 "Long-Term Debt" to the consolidated financial statements herein.

Although we are current with respect to our payment obligations under our various loan agreements, we are not in compliance with certain financial covenants and other provisions contained in certain loan agreements. As a result of the foregoing, various creditors have the right to accelerate their indebtedness and certain creditors may elect to proceed against the collateral granted to them to secure such indebtedness. In the event such indebtedness is accelerated, Management believes we have sufficient capacity to satisfy such obligations.

Recent Developments as of and since the Filing of the 2010 Annual Report

The Company filed its 2010 Annual Report on Form 20-F with the SEC on June 29, 2011.

As of June 29, 2011, the Company finalized its implementation of the RTO system to meet the EU TALUFT 2002 standards in Israel and is in compliance with applicable environmental laws and regulations in Israel.

The Company has been involved in an appeal challenging a tax assessment by the Israel Income Tax Authority ("ITA") on certain options granted in 1992 to certain officers of Taro U.S.A., as further described in Item 8A – "Legal Proceedings." As of June 29, 2011, the Company has entered into a settlement agreement with the ITA whereby the Company will pay the ITA NIS 7,500,000.

Effective August 22, 2011, Mr. Hasmukh Shah resigned from the Board due to personal reasons and the vacancy was filled by the appointment of Professor Dov Pekelman, who will serve until Taro's next Annual General Meeting of Shareholders. Professor Pekelman also agreed to serve on the Company's Audit Committee. Professor Pekelman is currently Chairman of Atera Networks Ltd. as well as Gilon Investments (TASE: GILN) and serves as a long standing Director of Makhteshim Agan Industries Ltd. (TASE: MAIN). He lectures at the Arison School of Business of the Interdisciplinary Center (IDC), Herzliya, Israel, serves on the Board of Directors of the IDC and is Chairman of the

IDC Corporation, the center's economic arm. Professor Pekelman served as a senior consultant to Teva Pharmaceutical Industries Ltd. (NASDAQ: TEVA) from 1985 to 2008 and also founded and ran a leading, Israeli-based management-consulting firm, P.O.C. Ltd. Professor Pekelman served on the Board of Directors of several large industrial corporations, including Koor Industries Ltd. (TASE: KOR). Professor Pekelman was also a member of the advisory committee of the Bank of Israel. He holds a Ph.D. from the University of Chicago and a B.S. from the Technion, Israeli Institute of Technology. Professor Pekelman is a published author writing on various aspects of business operations.

As of September 22, 2011, the Company has filed all of its required Annual Reports on Form 20-F.

A. OPERATING RESULTS

The following discussion should be read in conjunction with our consolidated financial statements and related notes for the three years ended December 31, 2007, 2008 and 2009, which are included elsewhere in this 2009 Annual Report.

OVERVIEW

We are a multinational, science-based pharmaceutical company. We develop, manufacture and market prescription and OTC pharmaceutical products, primarily in the United States, Canada and Israel. We also develop and manufacture APIs primarily for use in our finished dosage form products. Our primary areas of focus include topical creams and ointments, liquids, capsules and tablets. We operate principally through three entities: Taro Israel and two of its subsidiaries, Taro Canada and Taro U.S.A.

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

	2009		2008		2007	
	Sales in thousands	% of our total sales	Sales in thousands	% of our total sales	Sales in thousands	% of our total sales
U.S.A.	$ 278,301	78 %	$ 255,531	78 %	$ 258,519	81 %
Canada	32,775	9 %	36,301	11 %	34,913	11 %
Israel	21,373	6 %	22,194	7 %	17,362	5 %
Other	25,194	7 %	15,010	4 %	8,760	3 %
Total	$ 357,643	100 %	$ 329,036	100 %	$ 319,554	100 %

We generate most of our revenue from the sale of prescription and OTC pharmaceutical products. Portions of our OTC products are sold as private label products primarily to chain drug stores, food stores, drug wholesalers, drug distributors and mass merchandisers in the United States. During the years ended 2009, 2008 and 2007, two customers in the United States accounted for the following proportion of our total consolidated net sales:

Customer	2009	2008	2007
Customer A	15.5 %	16.7 %	15.8 %
Customer B	11.0 %	*	10.1 %

* Less than 10%

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

Percentage of net sales of certain products on a consolidated basis:

Product	2009		2008		2007	
Warfarin	13	%	11	%	12	%
Desoximetasone	15	%	13	%	*	

* Less than 10%

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

Cost of goods sold consists of direct costs and allocated costs. Direct costs consist of raw materials, packaging materials and direct labor identified with a specific product. Allocated costs are costs not associated with a specific product.

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

Another industry practice causes us to provide our customers with limited rights to return products, receive rebates, assert chargebacks and take other deductions with respect to sales that we make to them. See Item 5.A – "Critical Accounting Policies – Allowance for Sales Deductions and Product Returns." The exercise of these rights by customers to whom we have granted them has an impact, which may be substantial, upon our working capital. Although we feel that such sales are collectible, payment may not be received in a timely manner.

We continuously monitor our aged receivables and our customers' creditworthiness. We also engage in active and intensive collection efforts as necessary.

CRITICAL ACCOUNTING POLICIES

Our significant accounting policies are described in Note 2 to our consolidated financial statements, which are prepared in conformity with U.S. GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We evaluate, on an ongoing basis, our estimates, including those related to bad debts, income taxes and contingencies. We base our estimates on available information, our historical experience and various other assumptions that we believe to be reasonable under the circumstances. The results of these assumptions are the basis for determining the carrying values of assets and liabilities that are not readily apparent from other sources. Since the factors underlying these assumptions are subject to change over time, the estimates on which they are based are subject to change accordingly.

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

Use of Estimates. In preparing the consolidated financial statements, we use certain estimates and assumptions that affect reported amounts and disclosures. These estimates and underlying assumptions can impact all elements of our financial statements. Taro uses estimates when accounting for product returns and sales deductions from revenues, determining the valuation and recoverability of assets (e.g., accounts receivables, inventories, and intangible assets), and the reported amounts of accrued liabilities. We regularly evaluate our estimates and assumptions, using historical experience, third-party data, and market and external factors. Our estimates are often based on complex judgments, probabilities and assumptions that we believe to be reasonable but that are inherently uncertain and unpredictable. As future events and their effects cannot be determined with precision, our estimates and assumptions may prove to be incomplete or inaccurate, or unanticipated events and circumstances may occur that might cause us to change those estimates and assumptions. We adjust our estimates and assumptions when facts and circumstances indicate the need for change. It is possible that other professionals, applying reasonable judgment to the same facts and circumstances, could develop and support a range of alternative estimated amounts.

Revenue Recognition. We sell our products directly to wholesalers, retail drug store chains, mass merchandisers, grocery chains and other direct purchasers and customers that acquire our products indirectly through wholesalers.

We recognize revenue from product sales when title and risk of loss have transferred to our 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) our price to our customers is fixed or determinable; (iv) collectibility is reasonably assured; and (v) the amount of product returns, chargebacks, rebates and other sales deductions can be reasonably estimated. We ship products to our customers only in response to, and to the extent of, the orders that customers submit to us. 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").

Allowance for Sales Deductions and Product Returns. When we recognize and record revenue from the sale of our pharmaceutical products, we record 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, we regularly monitor customer inventory information at our three largest wholesale customers to assess whether any excess product inventory levels may exist. We review this information along with historical product and customer experience, third-party prescription data, industry and regulatory changes and other relevant information and revise our estimates as necessary.

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

Product returns

Consistent with industry practice, we generally offer our 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 we manufacture 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 we cannot associate a product return with the actual shipment in which such lot was included, we can reasonably estimate the period (in months) over which the entire lot was shipped and sold. We use this information to estimate the average time period between lot shipment (and sale) and return for each product, which we refer to as the "return lag." The shelf life of most of our products ranges between 18-36 months. Because returns of expired products are heavily concentrated during the return period, and given our historical data, we are able to reasonably estimate return lags for each of our products. These return lags are periodically reviewed and updated, as necessary, to reflect our best knowledge of facts and circumstances. Using sales and return data (including return lags), we determine a rolling average monthly return rate to estimate our return reserves. We supplement this calculation with additional information including customer and product specific channel inventory levels, competitive developments, external market factors, our planned introductions of similar new products and other qualitative factors in evaluating the reasonableness of our return reserve. We continuously monitor factors that could affect our estimates and revise the reserves as necessary. Our estimates of expected future returns are subject to change based on unforeseen events and uncertainties.

Our product returns reserve at December 31, 2009 and 2008 and related statement of operations impact for the years then ended, considered actual product returns experienced subsequent to the balance sheet dates to validate the product returns reserve estimate based on the methodology described above. We monitor the levels of inventory in our distribution channels to assess the adequacy of our product returns reserve and to identify potential excess inventory on hand that could have an impact on our revenue recognition. We do not ship product to our 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, we do not ship products that have less than 12 months until expiration (i.e., "short dated sales").

Chargebacks

We have arrangements with certain customers that allow them to buy our products directly from our 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, our wholesalers can submit a "chargeback" claim to us for the difference between the price sold to the third-party and the price at which it purchased the product from us. We generally pay chargebacks on generic products, whereas branded products are typically not eligible for chargeback claims. We consider many factors in establishing our chargeback reserves including inventory information from our 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. Our chargeback provision and related reserve varies with changes in product mix, changes in pricing, and changes in estimated wholesaler inventory. We review the methodology utilized in estimating the reserve for chargebacks in connection with analyzing our product return reserve each quarter and make revisions as considered necessary to reasonably estimate our potential future obligation.

Rebates and other deductions

We offer our customers various rebates and other deductions based primarily on their volume of purchases of our 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 us. Cash discounts, which are offered to our customers, are generally 2% of the gross sales price, and provide our customers an incentive for paying within invoice terms (30 to 90 days). Medicaid rebates are earned by states based on the amount of our 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 we pay to our top wholesalers on a monthly basis. Administration fees are paid to certain wholesalers, buying groups, and other customers for stocking our 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 our products decline, we may, depending on our contractual arrangements, elect to provide shelf-stock adjustments and thereby allow our customers with existing inventories to compete at the lower product price. We use these shelf-stock adjustments to support our market position and to promote customer loyalty.

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 our historical experience, substantially all claims for rebates and other sales deductions are received within 24 months. Therefore, for the years ended December 31, 2009 and 2008, we considered subsequent actual claims submitted by our customers in determining our reserves and related statements of operations impact for rebates and other sales deductions.

Three-year summary

The following table summarizes the activities for sales deductions and product returns for the three years ended December 31, 2009:

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

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

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

	Beginning Balance	Provision recorded for current period sales	Credits processed	Ending balance
Accounts Receivable Reserves				
Chargebacks	$ (18,525)	$ (172,582)	$ 167,203	$ (23,904)
Rebates and Other	(29,015)	(65,572)	53,921	(40,666)
Total	$ (47,540)	$ (238,154)	$ 221,124	$ (64,570)
Current Liabilities				
Returns	$ (25,101)	$ (13,898)	$ 16,720	$ (22,279)
Others (1)	(10,556)	(13,509)	14,368	(9,697)
Total	$ (35,657)	$ (27,407)	$ 31,088	$ (31,976)

For the Year Ended December 31, 2007 (in thousands)

	Beginning Balance	Provision recorded for current period sales	Credits processed	Ending balance
Accounts Receivable Reserves				
Chargebacks	$ (40,211)	$ (170,447)	$ 192,133	$ (18,525)

Rebates and Other	(38,792)	(63,005)	72,782	(29,015)
Total	$ (79,003)	$ (233,452)	$ 264,915	$ (47,540)
Current Liabilities				
Returns	$ (34,144)	$ (9,243)	$ 18,286	$ (25,101)
Others (1)	(23,271)	(14,498)	27,213	(10,556)
Total	$ (57,415)	$ (23,741)	$ 45,499	$ (35,657)

(1) Includes indirect rebates and others.

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Inventory. Inventories are stated at the lower of cost or market. Cost is determined as follows: raw and packaging materials—mainly on an average cost basis; finished goods products and products still in process, mainly on an average production cost including direct and indirect, or overhead, manufacturing expenses. Our finished goods inventories generally have a limited shelf life and are subject to obsolescence as they approach their expiration dates. As a result, we record a reserve against our entire finished goods inventory with expiration dates of less than 12 months and use historical experience to estimate the reserve for products with expiration dates of more than 12 months from the balance sheet date. When available, we used actual data to validate our estimates. We regularly evaluate our policies and the carrying value of our inventories and establish a reserve against the carrying value of our inventories. The determination that a valuation reserve is required, as well as the appropriate level of such reserve, requires us to utilize significant judgment. Although we make every effort to ensure the accuracy and reasonableness of our forecasts of future demand for our products, any significant unanticipated decreases in demand, or unanticipated changes in our major customer inventory management policies, could have a material impact on the carrying value of our inventories and reported operating results.

Valuation of Long-Lived Assets and Goodwill. We evaluate our long-lived assets for impairment and perform annual impairment testing on December 31 for goodwill and other indefinite-lived intangible assets and other long-lived assets when impairment indicators exist. Impairments are recorded for the excess of a long-lived asset's carrying value over fair value. Some examples of impairment indicators are as follows:

- Changes in legal or business climate that could affect an asset's value. For example, a failure to gain regulatory approval for a product or the extension of an existing patent that prevents our ability to produce a generic equivalent.

- Changes in our ability to continue using an asset. For example, restrictions imposed by the FDA could reduce our production and sales volume.

- Decreases in the pricing of our products. For example, consolidation among our wholesale and retail customers could place downward pressure on the prices of some of our products.

We estimate the fair value of our long-lived assets other than goodwill, such as product rights, using a discounted cash flow analysis or market approach where appropriate when required under applicable U.S. GAAP. Under the discounted cash flow method, we estimate cash flows based on our forecasts and discount these cash flows using the appropriate rate to determine the net present value of the asset. The net present value of our assets is affected by several estimates, such as:

- The timing and amount of forecasted cash flows
- Discount rates
- Tax rates
- Regulatory actions
- Amount of competition
- Manufacturing efficiencies
- The number and size of our customers

For the years-ended December 31, 2009 and 2008, we recorded $3.5 million and $2.8 million of impairment losses, respectively, primarily related to the fixed assets of our Irish facility. We may have additional impairments related to our manufacturing facilities in future years.

We estimate the fair value of goodwill using a two step procedure. First, we compare the market value of our equity to the carrying value of our equity. If the carrying value exceeds the market value of our equity, we calculate the implied fair value of our goodwill by taking the excess of our market capitalization over the fair value of our assets other than goodwill and obligations. An impairment is recorded for the difference between the implied fair value and carrying value of goodwill. The implied fair value of goodwill and any potential impairment is sensitive to estimates of the fair value of other assets and liabilities. We have not recorded any impairments for goodwill for the years ended December 31, 2009, 2008, and 2007.

Income Taxes. We determined deferred taxes by utilizing the asset and liability method based on the estimated future tax effects of differences between the financial accounting and tax basis of assets and liabilities under the applicable tax laws. 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 we 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, 2009, Management determined that it was more likely than not that we 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 we will be in a position to utilize its deferred tax asset, the valuation allowance for such assets may be modified.

Stock Options. We account for stock-based compensation in accordance with the provisions of ASC Topic 718 "Compensation – Stock Compensation." Under the fair value recognition provisions of ASC 718, stock-based compensation cost is estimated at the grant date based on the fair value of the award and is recognized as expense ratably over the requisite service period of the award. We estimate the fair value of stock options granted using the Black-Scholes-Merton option-pricing model and valued restricted stock based on the market value of the underlying shares at the date of grant. We recognize 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.

The fair value of an award is affected by our stock price on the date of grant and other assumptions, including the estimated volatility of our stock price over the term of the awards and the estimated period of time that we expect employees to hold their stock options.

Recent Accounting Pronouncements that may have an impact on future consolidated financial statements.

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. We do not expect the adoption of ASC Paragraph 810-10-65-2 to have a material impact on our 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 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. We do not have any multiple element arrangements. Accordingly, we do not expect adoption of ASU 2009-13 to have a material impact on the results of operations or financial condition.

In December 2010, the FASB issued ASU No. 2010-27, "Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers (a consensus of the FASB Emerging Issues Task Force)." This standard addresses how fees mandated by the Patient Protection and Affordable Care Act as amended by the Health Care and

Education Reconciliation Act should be recognized and classified in the income statements of pharmaceutical manufacturers. Under the proposal, the annual fee would be recognized as a liability for the total amount and a corresponding deferred cost over the calendar year. This is a liability and presented as an operating expense. This ASU is effective for calendar years beginning after December 31, 2010. Since the fees are anticipated to be less than 0.2% of net sales, we do 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. Our goodwill test does not have a zero or negative carrying amount where this standard would apply.

RESULTS OF OPERATIONS

The following table sets forth selected items from our consolidated statements of operations as a percentage of total sales:

	For the year ended December 31, 2009		2008		2007	
Consolidated Statements of Operations						
Sales, net	100.0	%	100.0	%	100.0	%
Cost of sales	43.3	%	45.1	%	41.6	%
Impairment	*		*		0.1	%
Gross profit	56.7	%	54.9	%	58.3	%
Operating expenses:						
Research and development, net	9.6	%	10.7	%	9.3	%
Selling, marketing, general and administrative	28.6	%	30.0	%	30.5	%
Impairment	0.9	%	0.9	%	0.0	%
Total operating expenses	39.1	%	41.6	%	39.8	%
Operating income	17.6	%	13.3	%	18.5	%
Financial expenses, net	4.6	%	0.2	%	7.1	%
Other gain, net	0.2	%	0.3	%	1.3	%
Income before taxes	13.2	%	13.4	%	12.7	%
Tax (benefit) expense	-19.6	%	4.1	%	2.0	%
Net income	32.8	%	9.3	%	10.7	%
Net income attributable to non-controlling interest	0.8	%	0.0	%	0.0	%
Net income attributable to Taro	32.0	%	9.3	%	10.7	%

* Less than 0.05%

YEAR ENDED DECEMBER 31, 2009, COMPARED WITH YEAR ENDED DECEMBER 31, 2008

Sales, net. During 2009, net sales increased $28.6 million, or 8.7%, compared to 2008. This increase was primarily attributable to increased net sales in the United States during 2009 of $22.8 million, or 8.9%, compared to 2008, primarily due to new product launches of carbamazepine extended release tablets and lamotrigine which contributed approximately $27.8 million to net sales, as well as price increases on Topicort®/desoximetasone and Oralone®/triamcinolone acetonide dental paste which contributed approximately $13.8 million to net sales. This was offset by volume and price decreases on clotrimazole and price decreases on malathion gel (generic Ovide®) to meet competition in the aggregate of $16.1 million. Net sales in Canada decreased $3.5 million, or 9.7% compared to 2008 net sales, primarily due to the change in the foreign exchange rate, while net sales in Israel and other international markets increased $9.4 million, or 25.2%, compared to 2008, due primarily to an increase of warfarin sales.

Cost of Sales. Cost of sales, as a percentage of net sales, remained relatively consistent at 43.3% in 2009 compared to 45.1% in 2008.

Gross Profit. Gross profit was $202.9 million, or 56.7% of net sales, in 2009 compared to $180.7 million, or 54.9% of net sales, in 2008, an increase of $22.2 million, or 12.3%. This increase reflects the impact of the increased sales within the marketplace.

Research and Development, net (“R&D”). R&D expenses decreased $0.8 million, or 2.3%, in 2009 compared to 2008. R&D expenses equalled 9.6% of net sales in 2009 and 10.7% of net sales in 2008. The majority of the R&D investment was focused on our generic pipeline and the remainder was focused on our proprietary pipeline, which included our class of non-sedating barbiturate compounds.

Selling, Marketing, General and Administrative ("SMG&A"). In 2009, SMG&A increased $3.2 million, primarily due to an increase in audit and consulting fees related to the restatement of the Company's financial statements for years prior to 2006. These were offset by decreases in payroll and depreciation expense.

Operating Results. Operating income increased $19.3 million from $43.8 million in 2008 to $63.1 million in 2009. This change reflects the increase in sales and gross profit combined with the decrease in SMG&A expenses and R&D expenses as a percentage of net sales. Operating results, as a percentage of net sales, increased from 13.3% in 2008 to 17.6% in 2009.

Financial Expenses. Financial expenses result from interest expense offset by other income, and the impact of foreign currency exchange rate fluctuations. Net financial expenses were $16.5 million in 2009, compared to an $0.8 million expense in 2008, an increase of $15.7 million. The financial expenses in 2009 reflect the impact of our increased level of borrowing, higher interest rates and changes in foreign currency exchange rates.

Taxes. Due to the reversal of the valuation allowance in the United States and a change in the Company's tax rate in Israel and various permanent and timing differences between accounting and tax, our tax benefit in 2009 was $69.7 million as compared to tax expense of $13.5 million in 2008. (See Note 17 to the consolidated financial statements included in this 2009 Annual Report.)

Net Income. Our net income increased $83.5 million, from net income of $30.5 million in 2008 to net income of $114.0 million in 2009, primarily due to the reversal of $76.7 of the valuation allowance against deferred tax asset in the U.S. (See Note 2.q of the consolidated financial statements included in this 2009 Annual Report.)

YEAR ENDED DECEMBER 31, 2008, COMPARED WITH YEAR ENDED DECEMBER 31, 2007

Sales, net. During 2008, net sales increased $9.5 million, or 3.0%, compared to 2007. This increase was primarily attributable to increased Warfarin sales in Israel and other international markets during 2008 of $11.1 million. Net sales in the United States and Canada remained fairly consistent as compared to 2007 with net sales in the U.S. decreasing by $3.0 million primarily due to price erosion and Canada net sales increasing by $1.4 million.

Cost of Sales. Cost of sales increased $15.0 million, or 11.3% from 2007 to 2008 and from 41.6% as a percentage of net sales in 2007 to 45.1% in 2008. This increase was primarily due to an increase in raw material costs, an increase in direct labor costs, and an increase in inventory reserves.

Gross Profit. Gross profit was $180.7 million, or 54.9% of net sales, in 2008 compared to $186.2 million, or 58.3% of net sales, in 2007, a decrease of $5.5 million, or 2.9%. This decrease is due to the fact that cost of sales increased greater than sales over the period.

Research and Development, net. R&D expenses increased by $5.2 million, or 17.5%, in 2008 compared to 2007. R&D expenses equalled 10.7% of net sales in 2008 and 9.3% of net sales in 2007. The majority of the increase in R&D was due to an increase in clinical studies and personnel to focus on our product pipeline and increased filing fees.

Selling, Marketing, General and Administrative. In 2008, SMG&A increased $1.8 million, primarily due to an increase in selling and marketing personnel in the U.S. SMG&A as a percentage of net sales has been relatively consistent from 30.5% in 2007 to 30.0% in 2008.

Operating Results. Operating income decreased $15.3 million from $59.1 million in 2007 to $43.8 million in 2008. This change reflects the decrease in gross profit combined with the increase in R&D expenses and SMG&A

expenses and an impairment charge of $2.8 million in 2008. Operating income, as a percentage of net sales, decreased from 18.5% in 2007 to 13.3% in 2008.

Financial Expenses. Financial expenses result from interest expense offset by other income, and the impact of foreign currency exchange rate fluctuations. Net financial expenses were $0.8 million in 2008, compared to $22.8 million in 2007, a decrease of $22.0 million. The financial expenses in 2008 primarily reflect the favorable impact of foreign currency changes from the strengthening of the Canadian dollar.

Other gain, net. Other gains decreased $3.2 million in 2008 due to the sale in 2007 of a car park adjacent to our Irish facility.

Taxes. Tax expense was $13.5 million in 2008 compared to $6.2 million in 2007. The $7.3 million increase is due primarily to increased net taxable income in our Canadian subsidiary primarily relating to the change in financial expenses.

Net Income attributable to Taro. Our net income decreased $3.8 million, to $30.5 million in 2008, primarily due to the decreased operating income and increased tax expense, partially offset by the other gain and decrease in financial expenses.

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

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

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

	Rate of Inflation				Rate of Devaluation (Appreciation) Against U.S. Dollar				Rate of Exchange of U.S. Dollar	
Year	Israel (1)		Canada (2)		Israel (1)		Canada (2)		Israel (1)	Canada (2)
2005	2.40	%	2.20	%	6.85	%	-3.14	%	4.60	1.17
2006	-0.10	%	1.96	%	-8.21	%	-0.03	%	4.23	1.17
2007	3.40	%	2.20	%	-8.97	%	-15.21	%	3.85	0.99
2008	3.80	%	2.33	%	-1.14	%	23.93	%	3.80	1.22
2009	3.91	%	1.32	%	-0.71	%	-14.54	%	3.78	1.05

(1) Bank of Israel.

(2) Bank of Canada.

B. LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents increased $24.5 million to $93.3 million at December 31, 2009. This increase was principally due to increased sales and increased collections from customers. Short-term bank deposits increased $11.0 million to $21.0 million at December 31, 2009. Total Shareholders' equity increased from $164.2 million at December 31, 2008 to $295.7 million at December 31, 2009, principally due to a net income of $114.0 million and foreign currency translation adjustments of $14.3 million.

Net cash provided by operating activities for the year ended December 31, 2009 was $63.9 million compared to net cash provided by operating activities of $74.9 million in the prior year, a decrease of $11.0 million. For the year ended December 31, 2009, the Company had net cash used in investing activities of $13.5 million compared to net cash used in investing activities of $20.3 million in 2008. For the year ended December 31, 2009, the Company had net cash used in financing activities of $28.6 million as compared to net cash used in financing activities of $28.9 million in the prior year.

The change in our liquidity for the year ended 2009 resulted from a number of factors, including:

- Net cash provided by operating activities primarily consists of the significant net income, an increase in long-term debt due to currency fluctuations of $2.4 million, a decrease in trade receivables, prepaid expenses and other receivables of $4.3 million and non cash items of depreciation and amortization of $18.4 million and impairment of long-lived assets of $3.5 million, and effect of foreign exchange differences of $8.7 million. These items were partially offset by decreases in other account payables and accrued expenses and income taxes payable of $8.5 million, a change in derivative instruments of $4.0 million and a change in deferred income taxes of $78.2 million.

- Net cash used in investing activities primarily consists of the investment in plant, property and equipment, which consumed $5.0 million, investment in short-term bank deposits of $11.0 million partially offset by proceeds from the sale of long-lived assets of $1.7 million and proceeds from restricted bank deposits of $1.0 million.

- Net cash used in financing activities primarily consists of the repayment of long-term debt of $30.4 million partially offset by proceeds from short-term bank debt, net of $1.7 million.

Debt

As of December 31, 2009, total debt, including current maturities, was $163.7 million. As discussed below, we have reclassified $22.8 million of the non-current portion of such long-term debt as short-term liabilities. (For more on our debt obligations, see Notes 11 and 13 to our 2009 financial statements.)

During 2009, we did not incur any additional indebtedness from new or existing lenders, including increases in our borrowing capacity under existing lines of credit or refinancings. We have been current on all our payment obligations due to our various lenders under their respective indentures and loan agreements.

Despite being current with our payment obligations, we are not in compliance with respect to certain covenants and other provisions contained in our various indentures and loan agreements with our lenders, including financial reporting obligations that have not been met as a result of the delay in issuing audited financial statements for the years 2006, 2007, 2008 and 2009. Additionally, most of the Company's debt instruments have cross-default provisions that provide for acceleration of payments in the event of failure to meet payment obligations or a breach of other undertakings.

As a result of the foregoing, various creditors have the right to accelerate their indebtedness and pursue remedial action, including proceeding against collateral that has been granted to them. The consolidated 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. However, for purposes of our consolidated financial statements ended December 31, 2009, we have reclassified $22.8 million of the non-current portion of our long-term debt obligations to short-term liabilities. However, see "Item 5 Recent Developments – Late Filing of our Annual Reports on Form 20-F for Years-Ended 2005, 2006, 2007, 2008 and 2009" for disclosure that all of our Annual Reports are filed as of September 22, 2011.

As of December 31, 2009, our total long-term debt obligations (including current maturities and the reclassified short-term portion) are as follows:

- bonds of $61.9 million with various investors; and
- mortgages of $28.6 million with three lenders.

Our currency denominations, interest rates and maturities regarding our material long-term debt obligations, including current maturities and the reclassified short-term portion but excluding mortgages, consist of the following:

Amount		Linkage	Rate		Maturity
$	1,809	Israel CPI(a)	8.25	%	2009-2010
	151	Dollar	Libor + 2-3%		2009-2010
	8,125	Dollar	6% Fixed		2010
	3,875	Dollar	Libor + 2.25%		2010
	45,868	Israel CPI(a)	5.80	%	2014
	2,107	Dollar	6.10	%	2014
$	61,935				

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

As of March 31, 2011, we have no available borrowings under our lines of credit.

Liquidity

On March 31, 2011, we had total unrestricted cash and cash equivalents of $120.0 million and total indebtedness to our financial creditors of $63.0 million. We expect that existing cash resources and cash from operations will be sufficient to finance our foreseeable working capital requirements. None of our cash and cash equivalents is held captive by any financial covenants or government regulation. As of December 31, 2009 and March 31, 2011, we had no commitment for capital expenditures which we consider to be material to our consolidated financial position. The Company had approximately $1.4 million of available and undrawn credit facilities in place at December 31, 2009.

Capital Expenditures

We invested $5.0 million in capital equipment and facilities in the year ended December 31, 2009 and $3.6 million in the year ended December 31, 2008. These investments are principally related to our pharmaceutical and chemical manufacturing facilities, expanding and upgrading our research and development laboratories in Israel and Canada and maintaining compliance with cGMPs. In addition to facility-related investments, we acquired certain manufacturing and packaging equipment to increase production capacity. We also continued to upgrade our information systems infrastructure to enable more efficient production scheduling and enhanced inventory analysis. (See Note 6 of our consolidated financial statements included in this 2009 Annual Report.)

C. RESEARCH AND DEVELOPMENT, PATENTS, TRADEMARKS AND LICENSES

We believe that our research and development activities have been a principal contributor to our achievements to date and that our future performance will depend, to a significant extent, upon the results of these activities.

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

Recruiting talented scientists is essential to the success of our research and development programs. Approximately 14% of our employees work in our worldwide research and development programs.

We conduct research and development in three principal areas:

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

- proprietary pharmaceuticals and delivery systems, including a novel formulation of Ovide® and products utilizing the NonSpil® delivery system; and

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

Generic Pharmaceuticals

In 2009, we received several product approvals in Canada, Israel and the United States. The following table sets forth the approvals received in the United States from the FDA from January 1, 2009 through March 31, 2011:

FINAL ANDA APPROVALS	Brand Name*
Carbamazepine Extended-Release Tablets USP, 100 mg, 200 mg, and 400 mg	Tegretol® - XR
Cetirizine HCl Tablets, 5 mg and 10 mg	Zyrtec®
Ciclopirox Shampoo 1%	Loprox®
Fluorouracil Topical Cream USP, 5%	Effudex®
Granisetron Hydrochloride Tablets 1 mg	Kytril®
Lamotrigine Chewable Dispersible Tablets, 5 mg and 25 mg	Lamictal® - CD
Lamotrigine Tablets 25mg, 100mg, 150mg and 200mg	Lamictal®
Levetiracetam Oral Solution 100 mg/mL	Keppra®
Levetiracetam Tablets, 250 mg, 500 mg, 750 mg and 1000 mg	Keppra®
Ondansetron Hyrdrochloride Tablets USP, 4mg, 8mg and 24 mg	Zofran®
Risperidone Oral Solution 1mg/mL	Risperdal®
Sulfacetamide Sodium Topical Suspension USP, 10%	Klaron®
ANADA** APPROVALS	
Mupirocin Ointment USP, 2%	Bactoderm®
TENTATIVE ANDA APPROVALS	
Gabapentin Capsules, 100, 300 and 400 mg***	Neurontin®
Gabapentin Oral Solution, 250 mg/5 mL***	Neurontin®
Ranitidine Hydrochloride Syrup USP, 15mg/mL	Zantac®

* The above trademarks are the property of their respective owners.
** Abbreviated New Animal Drug Application.
*** Tentative approval received prior to January 1, 2009 but currently under review by the FDA.

As of March 31, 2011, we had 24 of our ANDAs and the three tentative approvals listed above, under review by the FDA. In addition, there are multiple products for which either developmental or internal regulatory work is in process. The applications pending before the FDA are at various stages in the review process, and there can be no assurance that we will be able to successfully complete any remaining testing or that, upon completion of such testing, approvals for any of the applications under review at the FDA will be granted. In addition, there can be no assurance that the FDA will not grant approvals for competing products.

T2000

On December 4, 2009, the FDA approved an IND exemption to study T2000 in the United States.

T2007

The Company’s Phase I clinical trials for T2007, a non-sedating barbiturate compound, began in Canada in December 2009. On March 23, 2010, the U.S. Patent and Trademark Office issued a patent covering T2007.

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NonSpil®

We also continue to work on additional products utilizing our patented NonSpil® liquid drug delivery system, which allows liquid medications to pour, but resist spilling, thereby assuring the accuracy of dosage and ease of use. NonSpil® development activities include improving product formulations, refining taste and texture, and scaling up from laboratory sized manufacturing to commercial sized manufacturing.

Ovide® (malathion)

We have developed a highly purified form of malathion, a pediculicide used in treating head lice, which contains a lower percentage of impurities when compared with other commercially available forms of malathion. A patent application directed to both the process of making this highly purified form of malathion, as well as the final product itself, has been filed and a notice of allowance was issued. We have also developed a novel, stabilized gel formulation of malathion, and this product is in Phase III clinical testing. There can be no assurance of the successful completion of Phase III testing, the approval by any regulatory authority of the drug or the commercial success of the drug if and when approved. A patent application for this new purified form of malathion was approved by the U.S. Patent and Trademark office in July 2009.

Patents, Trademarks and Licenses

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

- a novel class of drug with utility as anticonvulsants, tranquilizers, muscle relaxants and agents for treatment of movement disorders;
- novel oral delivery for pharmaceutical and related products; and
- the synthesis and formulation of certain products.

With the exception of the Ovide® patent granted in July 2009, we do not believe that any single patent or license is of material importance to us in relation to our commercial activities.

We have registered trademarks in the United States, Canada and other countries. Taro U.S.A. typically does not use trademarks in the sale and marketing of its generic products.

From time to time, we seek to develop products for sale in various countries prior to patent expiration. In the United States, in order to obtain a final approval for a generic product prior to expiration of certain innovator's patents, we must, under the terms of the Hatch-Waxman Act, as amended by the Medicare Prescription Drug Improvement and Modernization Act of 2003, notify the patent holder as well as the owner of an NDA, that we believe that the patents listed in the Orange Book for the new drug are either invalid or not infringed by our product. To the extent that we seek to utilize this mechanism to obtain approval to sell products, we are involved and expect to be involved in patent litigation regarding the validity, enforceability or infringement of patents listed in the Orange Book, as well as other patents, for a particular product for which we have sought approval. We may also be involved in patent litigation with third parties to the extent that claims are made that our finished product, an ingredient in our product or our manufacturing process, may infringe the innovator's or third party's process patents. We may also become involved in patent litigation in other countries where we conduct business, including Israel, Canada and various countries in Europe.

D. TREND INFORMATION

See Item 4 – "Information on the Company" and Item 5 – "Operating and Financial Review and Prospects" for trend information.

E. OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have off-balance sheet arrangements.

F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table describes the payment schedules of our contractual obligations as of December 31, 2009:

	Payments due by period (in millions of dollars)				
Type of Contractual Obligation	Total	Less than 1 year	1-3 years	3-5 years	Over 5 years
Long-term debt obligations (1)	$ 90.50	$ 52.11	$ 28.79	$ 9.60	$ -
Operating lease obligations	3.10	1.98	1.12	-	-
Other Long-term liabilities (2)	11.40	1.43	3.35	2.34	4.28
Total	$ 105.00	$ 55.52	$ 33.26	$ 11.94	$ 4.28

(1) "Less than 1 year" includes $22.85, which was reclassified to short-term loans. See Note 11 and 13.
(2) Includes severance commitments and tax accruals.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

A. DIRECTORS AND SENIOR MANAGEMENT

The following table lists our directors and executive officers as of March 31, 2011:

Name	Age	Position
Dilip Shanghvi	56	Director and Chairman of the Board
Aalok Shanghvi	27	Director
Sudhir Valia	55	Director
Hasmukh Shah	77	Director and Chairman of the Audit Committee
Ilan Leviteh	65	Director
Ilana Avidov-Mor	60	Director
Dan Biran	68	Director
James Kedrowski	60	Interim Chief Executive Officer
Michael Kalb, C.P.A. (New York)	40	Interim Chief Financial Officer
Zahava Rafalowicz	64	Group Vice President, Sales and Marketing and Deputy General Manager, Israel
Hannah Bayer, C.P.A. (Israel)	61	Group Vice President, Finance
Rami Zajicek, Esq.	47	Group Vice President, Haifa Site Manager
Rita Gerson, C.P.A. (Israel), CIA	56	Group Vice President, Internal Auditor
Mariana Bacalu	59	Vice President, Quality Affairs
Yohanan Dichter	64	Vice President, Pharmacist in Charge and Senior Quality Manager
Roman Kaplan, Ph.D.	64	Vice President, Scientific and Technical Compliance Manager
Hagai Reingold	46	Vice President, API Division
Yoel Shamir	55	Vice President, Pharma Division
Tzvi Tal	61	Vice President, Information Technology, Israel
Yael Stein Doukhan	40	Vice President, Legal Department
Itzik Baruch	48	Vice President, Technical Services

As of August 22, 2011, Dov Pekelman replaced Hasmukh Shah as a director. See “Item 5 - Recent Developments as of and since the Filing of the 2010 Annual Report” for further information and Professor Pekelman’s business experience.

Certain Familial Relationships

Mr. Aalok Shanghvi is the son, and Mr. Sudhir Valia is a brother-in-law, of Mr. Dilip Shanghvi.

Business Experience

Dilip Shanghvi became Chairman of the Board of Directors and of the Nominating Committee in September 2010. Mr. Shanghvi is also Chairman and Managing Director of Sun Pharma. Sun Pharma is the fastest growing, most profitable and highest valued pharmaceutical company in India. Sun Pharma has leadership in 11 specialty therapy areas within India, has 53% of sales coming from international markets and invested over Rs 17 billion in R&D until now. Mr. Shanghvi's extensive experience in the pharmaceutical industry includes being Chairman and Managing Director of Sun Pharma Advanced Research Company Ltd., an international pharmaceutical company engaged in research and development of drugs and delivery systems. In addition, Mr. Shanghvi is also the Chairman of the Board of Directors of Caraco Pharmaceutical Laboratories, Ltd. ("Caraco"), a Sun Pharma subsidiary, since 1997.

Aalok Shanghvi became a member of the Board of Directors in September 2010. Mr. Aalok Shanghvi works as a Manager, Business Development in International Marketing for Sun Pharma. He also founded PV Powertech Pvt. Ltd., a manufacturer and exporter of photo-voltaic solar panels. Mr. Aalok Shanghvi earned his Bachelor of Science in Molecular Biology at the University of Michigan.

Sudhir Valia became a member of the Board of Directors of the Company and the Nominating Committee in September 2010. Mr. Valia joined Sun Pharma as a full-time director since his appointment in April 1994 and is responsible for finance, commercial, operations, projects and quality control, among other things. Prior to joining Sun Pharma, Mr. Valia was a qualified chartered accountant in private practice. In addition to being on the Board of Directors of a number of companies in Sun's group, including Sun Pharma Advanced Research Company Ltd., he is also on the Board of Directors of Caraco.

Hasmukh Shah became a member of the Board of Directors, the Audit Committee and Nominating Committee in September 2010. Mr. Shah has been an independent director of Sun Pharma since March 2001 and is a member of its audit committee. He has been a partner in a consulting firm, Hasmukh & Associates since March 1999. Mr. Shah has four decades of experience in senior management, and was formerly the Chairman and Managing Director of Indian Petrochemical Corporation Ltd., as well as the Vice Chairman of GE Capital and advisor to GE in India. Mr. Shah has had wide experience in various government departments, including as Joint Secretary to the Prime Minister, as Secretary, Post & Telegraph and as Chairman, National Institute of Design, as well as the Institute of Rural Management, Anand and the Gujarat Council of Science & Technology.

Ilan Leviteh became a member of the Board of Directors and of the Audit Committee in September 2010. Mr. Leviteh served as President and CEO of Makhteshim Agan Industries, Ltd. (TASE: MAIN), a public company traded on the Tel Aviv Stock Exchange, for sixteen years. Mr. Leviteh has also chaired the boards of directors of LycoRed Ltd., Galam Ltd. and Enzymotec Ltd., among other companies, and served as a director on other public company boards. Mr. Leviteh received a BSC of Chemical Engineering from the Technion Israeli Institute of Technology.

Ilana Avidov-Mor is a Certified Accountant who became a member of the Board of Directors in December 2010. She serves as Chief Executive Officer of a private company which gives services to advanced study Funds and to Provident Funds. Ms. Avidov-Mor formerly worked at Bank Yahav Ltd. for civil servants (the "Bank"), fulfilling various positions between the years 1994 and 2009. Among these positions, Ms. Avidov-Mor served as Deputy General Manager of the Bank for over a decade, and as Comptroller for eight years. Between the years 1974 and 1994, Ms. Avidov-Mor worked for Braude & Partners Accountants. Ms. Avidov-Mor is also a former member of the following Directorates: Intercosma Ltd. (a company for the manufacture and marketing of cosmetics and toiletries) and 3 pension funds for doctors, nurses and para-medicals (Director on behalf of the Bank). Ms. Avidov-Mor is a former General Manager on behalf of Bank Yahav of 4 pension funds owned by the bank. Ms. Avidov-Mor earned her B.A. in Economics and Accounting at the Tel Aviv University, and her M.A. in Business Administration (Financing and Banking) at the Hebrew University of Jerusalem.

Dan Biran became a member of the Board of Directors in December 2010. Mr. Biran serves as Chairman of the Board of Directors of Galam Ltd. K. Maanit; Biological Industries Ltd.; Ducart Ltd.; as well as a director of the Board of Directors of Netafim and Enzymotek. Between the years 1992 and 2006, Mr. Biran served as a Chief Executive Officer of Arkal Filtration Systems. Between the years 2004 and 2006, Mr. Biran served as the Chairman of the Board of Directors of Pep Filters Inc. He also served as an external director of Maachteshim – Agan Ind. during the years 1997 and 2004, as well as the Chief Executive Officer of Netafim – Magal during the years 1983 and 1992. Mr. Biran also served as a director of Netafim USA during the years 1986 and 1992. Mr. Biran has fulfilled various management positions in the Unified Kibbutz Movement, Israel and at Kibbutz Magal, Israel.

James Kedrowski became Interim Chief Executive Officer of the Company in October 2010 and a member of the Board of Directors of the Company in May 2011. Mr. Kedrowski has been with Chattem Chemicals, an indirect subsidiary of Sun Pharma since 1997 and is its Executive Vice President. Mr. Kedrowski's prior experience includes over twenty years with Alcoa Inc., where he held increasingly responsible positions including North America Operations Vice President for Alcoa Chemicals.

Michael Kalb, C.P.A. (New York) became Interim Chief Financial Officer of the Company in November 2010. Mr. Kalb has been GVP, Chief Accounting Officer of the Company since May 2010 and Chief Financial Officer of Taro U.S.A. since June 2009. Mr. Kalb has over eighteen years of financial and accounting advisory experience. From June 2004 to June 2009, Mr. Kalb was a Director in the Accounting and Financial Consulting Group of Huron Consulting Group, Inc. ("Huron"). Mr. Kalb was an integral part of Huron's advisory team that assisted the Company with the restatement of its financial statements for 2005 and prior years. Mr. Kalb's experience also includes over ten years at Ernst & Young, LLP within the Transaction Advisory Services Group and Audit and Assurance Services Group.

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

Hannah Bayer, C.P.A. (Israel) joined our company in 2001 as Vice President and Chief Accounting Officer. In 2010, she was promoted to Group Vice President, Chief Financial Officer for Israeli Operations. Ms. Bayer is a Certified Public Accountant in Israel. From 1999 to 2000, she served as Chief Financial Officer of Omrix Biopharmaceuticals, Ltd. From 1990 to 1999, Ms. Bayer held several finance positions at Teva Pharmaceutical Industries Ltd.

Rami Zajicek, Esq. joined our company in April of 2006 as Group Vice President, Haifa Site Manager. From 2002 to 2006, he was a partner of Tefen USA, Ltd., an international operations consulting firm. From 1998 to 2001, Mr. Zajicek was President and CEO of ProActivity Inc.

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

Yohanan Dichter joined our company in 1986 in the research department and since 1988 has served as the Vice President, Pharmacist in Charge of the Haifa Bay pharmaceutical manufacturing plant. In 2006, he was also named Senior Quality Manager. He is responsible for the review and release of all pharmaceutical products manufactured or sold in Israel. Prior to joining us, Mr. Dichter served in the Medical Corps of the Israel Defense Forces, was employed by Kupat Holim and worked in a private pharmacy.

Rita Gerson, C.P.A. (Israel), CIA joined our company in 2003 as Internal Auditor and now serves as Group Vice President, Internal Audit. Ms. Gerson is also responsible for the implementation of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) requirements for the Company. Ms. Gerson is a Certified Public Accountant in Israel and a Certified Internal Auditor by the IIA. Prior to joining the Company, Ms. Gerson was the International Activity and Subsidiaries Financial Comptroller, Assistant CFO, for a multi-national plastics and irrigation systems company headquartered in Israel.

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

Hagai Reingold joined our company in 2002 and serves as our Vice President, API Division in Israel. He is responsible for all API production, technology, quality and safety. From 2002 to 2004, Mr. Reingold was Supply Chain and Industrial Engineering Manager. From 2000 to 2002, Mr. Reingold worked as Industrial and Product Engineering Manager for Kulicke & Soffa Company.

Yoel Shamir joined our company in 2003 as Dry Production Manager. In 2007, Mr. Shamir was promoted to Vice President, Pharmaceutical Production and is in charge of our pharmaceutical production division in Israel. Prior to joining our company, Mr. Shamir was Plant & Logistics Director at Alumayer Group Industries.

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

Yael Stein Doukhan joined our company in 2006 as Legal Department Director. In 2010 Mrs. Stein Doukhan was promoted to Vice President, Legal and is in charge of the Legal Department in Israel. Prior to joining our company, Mrs. Stein Doukhan practiced law in Israel and the UK for 10 years and holds a bachelor degree in law and Master of Business Administration. Mrs. Stein Doukhan has been licensed as an attorney in Israel since 1997.

Itzik Baruch joined our Company in 2003 as Taro's Utilities and Maintenance Director. In 2010, Mr. Baruch was promoted to Vice President, Technical Services. Mr. Baruch is responsible for all engineering and maintenance activities and general site services. Prior to joining our Company, Mr. Baruch was employed as Operational Director at BEE and as Maintenance Director at Tnuva as well as other position in the Chemical Industry. Mr. Baruch received his B.Sc. degree in Mechanical Engineering from the Technion – Israel Institute of Technology in 1992.

B. COMPENSATION

Our directors, other than Dilip Shanghvi, Aalok Shanghvi and Sudhir Valia, are paid NIS 115,400 per year, linked to the Israeli CPI, for their service as directors. Dilip Shanghvi is paid $836,200 per year for his service as director and chairman of the board. Aalok Shanghvi and Sudhir Valia are each paid $538,591 per year for their service as directors. All of the directors are also paid NIS 3,470, linked to the Israeli CPI, for each board meeting that they attend. The compensation for our statutory external directors, as defined under Israeli law, is not in excess of the amounts set forth in the Israeli Companies Law and regulations promulgated thereunder.

We paid an aggregate of $7,897,864 to all of our then current directors and executive officers for services rendered to us in all capacities during the year ended December 31, 2009. This amount does not include certain additional benefits which, as to all directors and executive officers as a group, aggregated less than $150,000. In addition, $305,781 was set aside in 2009 to provide all executive officers and directors with pension, retirement or similar benefits. During 2009, the Company's executive officers and directors received 20,000 options to purchase Taro stock.

As of March 31, 2011, the Company's executive officers and directors held options to purchase an aggregate of 122,100 ordinary shares, at exercise prices ranging from $4.63 to $68.51 per share, under Taro's stock option plans, such options have original expiration dates between May 2010 and May 2016. Because the Company was not current with its SEC filings, such executive officers and directors were ineligible to exercise options, therefore the option exercise date was extended until such time as Taro is current with its filings, at which time, options that would have expired, must be exercised within 90 days.

C. BOARD PRACTICES

We are incorporated in Israel and, therefore, we are subject to the provisions of the Israeli Companies Law, in addition to the relevant provisions of U.S. laws.

Board of Directors

According to the Israeli Companies Law, the Board of Directors sets the policy of a company and supervises the general manager of a company in the performance of his or her roles. The Board has residual powers so that it may exercise any power of the company not granted to any other organ either by law or by our Articles of Association. According to our Articles of Association, as part of its powers, our Board may cause us to borrow or secure payments of any sum or sums of money for our purposes, at times and upon conditions as it thinks fit, including the grant of security interests on all or any part of our property.

Our Board consists of eight directors. As of August 22, 2011, the following members of our Board have been determined to be independent within the meaning of applicable NASDAQ regulations: Ilan Leviteh, Ilana Avidov-Mor, Dan Biran and Dov Pekelman.

According to our Articles of Association, our Board may neither consist of fewer than five directors nor more than 25 directors.

Our directors, other than our statutory external directors, are elected at annual general meetings of our shareholders, which are required to be held at least once during every calendar year and not more than 15 months after the last preceding meeting. Directors may also be appointed to fill vacancies, or as additional members of the Board, by an ordinary resolution passed at an extraordinary general meeting of our shareholders. Likewise, in the event of a vacancy, the Board is empowered to appoint a director to fill such vacancy until the next annual general meeting of shareholders. A director, other than a statutory external director, holds office until the next annual general meeting, unless such directorship is earlier vacated in accordance with the provisions of any applicable law or regulation or under our Articles of Association.

We do not have any contracts with any of our directors that would provide for benefits upon termination of employment.

Statutory External Directors

Qualifications of Statutory External Directors

Under the Israeli Companies Law, companies incorporated under the laws of the State of Israel whose shares, inter alia, are listed for trading on a stock exchange or have been offered to the public by a prospectus and are held by the public, are required to have at least two statutory external directors. The Israeli Companies Law provides that a person may not be elected as a statutory external director if the person is a relative of a controlling shareholder and/or the person or the person's relative (as defined below), partner, employer, anyone to whom the person is subordinate, directly or indirectly, or any entity under the person's control has, as of the date of the person's election to serve as a statutory external director, or had, during the two years preceding that date, any affiliation (as defined below) with:

- our company;
- any entity controlling our company or relative thereof as of the date of the election; or
- any entity controlled by our company or under common control with our company as of the date of the election or during the two years preceding that date.

The term "affiliation" includes an employment relationship, a business or professional relationship even if not maintained on a regular basis (but excluding insignificant relationships), or control of the company, and service as an office holder (as defined below).

Under the Israeli Companies Law, "relative" is defined as a spouse, brother or sister, parent, grandparent, child and a child/brother/sister/parent of such person's spouse or the spouse of any of the preceding.

The Israeli Companies Law defines the term "office holder" as general manager, chief business manager, deputy general manager, vice general manager, any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title, and any director or manager that reports directly to the general manager.

The Israeli Companies Law provides that no person can serve as a statutory external director if the person's other positions or other business creates, or may create, a conflict of interest with the person's responsibilities as a statutory external director or may otherwise interfere with the person's ability to serve as a statutory external director. Until the lapse of two years from termination of office as statutory external director, a company, its controlling shareholder and any entity controlled by the controlling shareholder, may not grant a former statutory external director, his/her spouse or child any benefits, directly or indirectly, including engaging the former statutory external director, his/her spouse or child to serve as an office holder in the company or in any company controlled by the controlling shareholder of the company and cannot employ or receive professional services from that person for consideration, either directly or indirectly, including through a corporation controlled by such former statutory external director. The same shall apply to a relative, who is not a former statutory external director's spouse or child, for a period of one year from termination of office as statutory external director.

A person shall be qualified to serve as a statutory external director only if he or she possesses accounting and financial expertise or professional competence, as defined in the regulations promulgated under the Israeli Companies Law. At least one statutory external director must possess accounting and financial expertise.

The Israeli Companies Law also provides that a shareholders' general meeting at which the appointment of a statutory external director is to be considered will not be called unless the nominee has declared to the company that he or she complies with the qualifications for appointment as a statutory external director.

Election of Statutory External Directors

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

- the majority includes the majority of the total votes of non-controlling shareholders (as defined in the Israeli Companies Law) or shareholders who do not have a personal interest in such election present at the meeting in person or by proxy (abstentions will not be taken into account); or

- the total number of votes against the election of the statutory external director by the non-controlling shareholders or shareholders who do not have a personal interest in such election does not exceed two percent of the aggregate voting rights in the company.

For purposes of determining a controlling shareholder, Section 1 of the Israeli Companies Law defines "control" by reference to the definition of the Securities Law, 5728-1968 (the "Securities Law"), which defines "control" as "the ability to direct the activity of a corporation, excluding an ability deriving merely from holding an office of director or another office in the corporation, and a person shall be presumed to control a corporation if he or she holds half or more of a certain type of means of control of the corporation." "Means of control" in Section 1 of the Securities Law is defined as "any one of the following: (1) the right to vote at a general meeting of a company or a corresponding body of another corporation; or (2) the right to appoint directors of the corporation or its general manager."

The initial term of a statutory external director is three years and may be extended for two consecutive terms of three years each. Statutory external directors may be removed from office only by the same percentage of votes as is required for election or by a court, if the statutory external director ceases to meet the statutory qualifications for his or her appointment or if he or she violates his or her duty of loyalty to the company.

Each committee of a company's board of directors that is empowered to exercise one of the functions of the board of directors is required to include at least one statutory external director, except for the Audit Committee which is required to include all the statutory external directors.

A statutory external director is entitled to compensation determined by the board within the scope provided in regulations adopted under the Israeli Companies Law.

Ilana Avidov-Mor and Dan Biran serve as statutory external directors on the Company's Board.

Alternate Directors

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

Committees

Subject to the provisions of the Israeli Companies Law, our Board may delegate its powers to certain committees comprised of Board members. Pursuant to the Israeli Companies Law, any committee of the board of directors that is authorized to perform any function of the board (other than committees constituted solely as advisory committees), must include at least one statutory external director. Our Board has formed audit and nominating committees.

Audit Committee

Under the Israeli Companies Law and our Articles of Association, our Board is required to appoint an Audit Committee, comprised of at least three directors including all statutory external directors (at least two), but excluding:

- the chairman of the board of directors and a director employed by our company, or by the company's controlling shareholder, directly or indirectly, or who provides services to any of the foregoing on a regular basis and a director whose main livelihood stems from the controlling shareholder; and

- a controlling shareholder or a relative of a controlling shareholder.

The chairman of the Audit Committee shall be a statutory external director.

A person who is not qualified to serve as a member of the audit committee shall not be present at the committee's meetings and at the time resolutions are adopted thereby, unless such person's participation is required in order to present to the committee a particular matter.

As of August 22, 2011, our Audit Committee consists of the following directors: Dan Biran, Ilana Avidov-Mor and Dov Pekelman, all of whom have been determined to be independent as defined by the applicable NASDAQ rules and those of the SEC. Ilana Avidov-Mor and Dan Biran are statutory external directors. Dan Biran is the chairman of the Audit Committee.

Under the Israeli Companies Law, the roles of the Audit Committee include, among other things, the approval of extraordinary transactions and material actions and transactions that involve conflicts of interests, (including interested party transactions), as described below and examination of flaws in the management of the company's business, inter alia, in consultation with the internal auditor of the company or with its independent auditors and propose remedial measures to the board of directors. In accordance with the Sarbanes-Oxley and NASDAQ requirements, our Audit Committee is directly responsible for the appointment, compensation and oversight of our independent auditors. In addition, the Audit Committee is also responsible for, among other things, assisting the Board in reviewing, and recommending actions to the Board with respect to, our financial statements, the effectiveness of our internal controls and our compliance with legal and regulatory requirements.

The Audit Committee is also responsible for making proposals to the Board with respect to the compensation of our executive officers. Thus, the determination, or recommendation for determination, of the compensation of our executive officers is made by a majority of our independent directors (as defined by the applicable NASDAQ rules).

The Audit Committee has reviewed and discussed with Management the Company's audited consolidated financial statements as of and for the year ended December 31, 2009. The Audit Committee has also discussed with our independent registered public accounting firm the matters required to be discussed by the Statement on Auditing Standards No. 114, "The Auditor's Communication With Those Charged With Governance," issued by the Auditing Standards Board of the American Institute of Certified Public Accountants which replaced SAS No. 61, "Communication With Audit Committees." Based on the reviews and discussions referred to above, the Audit Committee has recommended to the Board of the Company that the audited consolidated financial statements referred to above be included in this 2009 Annual Report.

Under the Israeli Companies Law, it is the responsibility of the Board to approve the financial statements.

Approval of Interested Party Transactions

Under the Israeli Companies Law, the approval of the Audit Committee is required to effect certain actions and transactions with office holders, controlling shareholders and entities in which they have a personal interest. Such interested party transactions (including matters described in the following paragraph) require the approval of the Audit Committee, the Board and in certain cases, the shareholders. Such shareholders approval, in certain cases, also includes a special voting procedure. See-Disclosure of Personal Interests of a Controlling Shareholder.

Audit Committee approval is also required to approve the grant of an exemption from the responsibility for a breach of the duty of care towards the Company, or for the provision of compensation arrangement including insurance or indemnity to any office holder who is not a director.

Internal Auditor

Under the Israeli Companies Law, the board of directors of a public company is required to appoint an internal auditor proposed by the Audit Committee. The internal auditor may not be an interested party, an office holder, or a relative of any of the foregoing, nor may the internal auditor be our external independent auditors or their representatives. The role of the internal auditor is to examine, among other things, whether our actions comply with the law and orderly business procedure. Mr. Elisha Sa'ar, C.P.A., an independent public accountant, serves as our internal auditor. The internal auditor has the right to demand that the chairman of the Audit Committee convene an Audit Committee meeting and the internal auditor may participate in all Audit Committee meetings. In addition to the internal auditor, an officer of the Company is also responsible for performing internal audit functions and implementing Sarbanes-Oxley requirements.

Compensation Committee

Under the Israeli Companies Law, compensation arrangements of an office holder (who is not a director) require the approval of the audit committee and the board, regardless of whether such transaction is an extraordinary transaction. Such a transaction may be approved by the Compensation Committee of the board, in lieu of the audit committee; to the extent such committee exists and complies with all provisions relating to the audit committee. In addition, in case of an amendment to an existing compensation arrangement, only the audit committee approval will be required, if the audit committee determines that the amendment is not material in relation to the existing arrangement. The Compensation Committee is responsible for making proposals to the Board with respect to the compensation of employees other than office holders. The determination or recommendation for determination of the compensation of our office holders is made by the Audit Committee. Arrangements regarding the compensation of directors require Audit Committee, Board and shareholders' approval, in such order. As of March 31, 2011, the Company did not have a Compensation Committee.

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Nominating Committee

The Nominating Committee recommends candidates for election to our Board of Directors pursuant to a written charter. As of March 31, 2011, our Nominating Committee consisted of the following directors: Dilip Shanghvi, Chairman, Sudhir Valia and Hasmukh Shah.

D. EMPLOYEES

The following table sets forth the number of full time equivalents as of December 31, 2009*:

December 31, 2009

	U.S.A.	Canada	Israel	Ireland	Other	Total
Sales and Marketing	116.0	34.0	42.0	1.0	-	193.0
Administration	87.0	31.0	45.5	5.0	1.0	169.5
Research and Development	14.0	42.0	124.0	4.0	2.0	186.0
Production and Quality Control	-	224.0	403.5	22.0	-	649.5
Total	217.0	331.0	615.0	32.0	3.0	1,198.0

The following table sets forth the number of full time equivalents as of December 31, 2008*:

December 31, 2008

	U.S.A.	Canada	Israel	Ireland	Other	Total
Sales and Marketing	115.0	34.0	45.0	1.0	-	195.0
Administration	82.0	27.0	41.5	6.0	1.0	157.5
Research and Development	14.0	39.0	119.0	10.0	2.0	184.0
Production and Quality Control	-	214.0	334.5	45.0	-	593.5
Total	211.0	314.0	540.0	62.0	3.0	1,130.0

The following table sets forth the number of full time equivalents as of December 31, 2007*:

December 31, 2007

	U.S.A.	Canada	Israel	Ireland	Other	Total
Sales and Marketing	110.0	31.0	41.0	1.0	-	183.0
Administration	75.0	26.0	40.5	7.0	1.0	149.5
Research and Development	11.0	39.0	119.0	6.0	2.0	177.0
Production and Quality Control	-	216.0	332.5	36.0	-	584.5
Total	196.0	312.0	533.0	50.0	3.0	1,094.0

* In the U.S.A., distribution employees are included in the Sales and Marketing category.

In general, our relationship with our employees is satisfactory. Since we are members of the Manufacturers Association, certain general collective agreements apply to us. These agreements concern principally the length of the workday, minimum daily wages for professional workers, insurance for work-related accidents, procedures for dismissing employees, pension payments, and other conditions of employment. We generally provide our employees with benefits and working conditions beyond the required minimums.

Additionally, on April 29, 2011, the Board ratified a collective bargaining agreement dated as of April 6, 2011 (the "Collective Bargaining 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 employee-employer relations practices of Taro as well as additional rights relating to job security, compensation and other benefits.

Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment in certain other circumstances. In addition, as of May 2006, under a collective agreement signed by the Manufacturers Association, we are obligated to contribute to a pension plan amounts equal to a certain percentage of the employees' wages, for all employees, and Section 14 of the Severance Pay Law applies to most of our employees. We are complying with these obligations. We fund our ongoing severance obligations by contributing a sum equal to 8.3% of the employee's wages to funds known as Pension Funds or the Managers' Insurance. These funds provide different combinations of savings plan, life insurance and severance pay benefits to our employees, and each employee, according to the fund chosen by them, receives a lump sum payment upon retirement and severance pay, if the employee is legally entitled to it, upon termination of employment. Each employee contributes an amount equal to 5%-7% of their salary. The Company contributes an additional sum of between 5% and 7.5% of the employee's salary. Under Section 14 of the Severance Pay Law, in the event of dismissal, all payments made to pension funds or any other similar funds serve as severance pay and the Company is not obliged to pay the employee any other severance pay. In addition, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute (an agency similar to the United States Social Security Administration), which include payments for national health insurance. The payments to the National Insurance Institute are approximately 17.7% of an employee's wages (up to a specified amount), of which the employee contributes approximately 12.2% and we contribute approximately 5.7%.

E. SHARE OWNERSHIP

The following table sets forth certain information regarding the ownership of our ordinary shares by our directors and officers as of March 31, 2011. The percentage of ownership is based on 44,507,432 ordinary shares outstanding as of March 31, 2011. Ordinary shares subject to options exercisable, or exercisable within 60 days of March 31, 2011, are deemed outstanding for computing the percentage ownership of the person holding such options, but are not deemed outstanding for computing the percentage ownership of any other person.

Name	Number of Ordinary Shares	Percentage of Outstanding Ordinary Shares
Dilip Shanghvi (1)	-	0.00%
Aalok Shanghvi	-	0.00%
Sudhir Valia	-	0.00%
Hasmukh Shah	-	0.00%
Ilan Leviteh	-	0.00%
Ilana Avidov-Mor	-	0.00%
Dan Biran	-	0.00%
James Kedrowski	-	0.00%
Michael Kalb, C.P.A. (New York)	-	0.00%
Zahava Rafalowicz	*	*
Hannah Bayer, C.P.A. (Israel)	*	*
Rami Zajicek, Esq.	-	0.00%
Mariana Bacalu	-	0.00%

Yohanan Dichter	*	*
Rita Gerson, C.P.A. (Israel), CIA	-	0.00%
Roman Kaplan, Ph.D.	-	0.00%
Hagai Reingold	-	0.00%
Yoel Shamir	*	*
Tzvi Tal	*	*
Yael Stein Doukhan	-	0.00%
Itzik Baruch	-	0.00%
Total for all directors and officers (21 persons) listed above, as a group	*	*

* Less than 1%

The following table sets forth certain information regarding the ownership of our founders' shares by our directors and officers as of March 31, 2011. The percentage of ownership is based on 2,600 founders' shares outstanding as of March 31, 2011.

Name	Number of Founders' Shares	Percentage of Outstanding Founders' Shares
Alkaloida (2)	2,600	100.00%

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(1) Dilip Shanghvi, as the chairman of the board of directors of Sun Pharma, controls Sun. As of March 31, 2011, Sun owned 66.3% of Taro's outstanding ordinary shares.

(2) Alkaloida, a subsidiary of Sun, owns all 2,600 of our outstanding founders' shares, whose holders are entitled to exercise one-third of the total voting power in our company regardless of the number of ordinary shares then outstanding.

As of March 31, 2011, the directors and executive officers listed above, as a group, held options to purchase 122,100 of our ordinary shares at exercise prices ranging from $4.63 to $68.51, such options have original expiration dates between May 2010 and May 2016. Because the Company was not current with its SEC filings, such executive officers and directors were ineligible to exercise options, therefore the option exercise date was extended until such time as Taro is current with its filings, at which time, options that would have expired, must be exercised within 90 days.

Stock Option Plans

From time to time, we have granted options to purchase our ordinary shares. As of March 31, 2011, there were 435,705 options outstanding to acquire our ordinary shares.

Compensation Pursuant to Plans

1991 Stock Incentive Plan

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

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

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

The 1991 Stock Incentive Plan is administered by our Board (as required by the Israeli Companies Law) and by a Plan Committee, composed of not less than two members, each of whom must be disinterested persons as defined by the SEC (as required by United States law). Within the limits of the 1991 Stock Incentive Plan, the Board and Plan

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

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

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

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

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

As of March 31, 2011, 11,325 ordinary shares were subject to outstanding options. Of such options, none were held by executive officers; none were held by directors who are not executive officers; and 11,325 (at an average exercise price of $2.47 per share) were held by other persons. None of such options was an SAR. As of December 31, 2009, the Company’s ability to issue additional options under the 1991 Stock Incentive Plan has been terminated. The Company issues new shares to employees and associates exercising their stock options.

1999 Stock Incentive Plan

Our 1999 Stock Incentive Plan was unanimously adopted by our Board on March 10, 1999, and was approved at the annual meeting of shareholders held on July 29, 1999. An amendment that had been previously adopted by our Board was approved at the annual meeting of shareholders held on August 5, 2004. The purpose of the 1999 Stock Incentive Plan is to attract, retain and provide incentives to key employees (including directors and officers who are key employees) and to consultants and directors who are not our employees by enabling them to participate in our long-term growth. The total number of ordinary shares with respect to which options and SARs may be granted under the 1999 Stock Incentive Plan may not exceed 2,100,000 subject to appropriate adjustment in the event of stock dividends, stock splits and similar transactions. As of March 10, 2009, no further options are available for future grants.

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

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

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

The exercise price of an option or base price of a SAR granted under the 1999 Stock Incentive Plan shall be determined by the Administrators, but may not be less than 100% of the fair market value of the ordinary shares on the date of grant (110% of such fair market value in the case of an ISO granted to an optionee who owns or is deemed to own stock possessing more than 10% of the combined voting power of all classes of our stock). The exercise price of an Initial Outside Director Award shall equal the fair market value of the ordinary shares subject to such option on the date of grant.

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

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

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

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

As of March 31, 2011, 424,380 ordinary shares were subject to outstanding options. Of such options, 122,100 (at an average exercise price of $28.61 per share) were held by executive officers; none were held by directors who are not executive officers; and 302,280 (at an average exercise price of $32.66 per share) were held by other persons. None of such options was an SAR. As of December 31, 2009, the Company’s ability to issue additional options under the

1999 Stock Incentive Plan has been terminated. The Company issues new shares to employees and directors exercising their stock options.

2000 Employee Stock Purchase Plan

Our 2000 Employee Stock Purchase Plan was adopted by our Board on May 3, 2000, and was approved at an extraordinary general meeting of our shareholders held on May 2, 2001. The purpose of the 2000 Employee Stock Purchase Plan is to provide our employees and those of certain subsidiaries designated by our Board with an opportunity to purchase our ordinary shares.

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

Under the terms of the 2000 Employee Stock Purchase Plan, participating employees accrue funds in an account through payroll deductions during six-month offering periods. The funds in this account are applied at the end of such offering periods to purchase our ordinary shares at a 15% discount from the closing price of the ordinary shares on (i) the first business day of the offering period or (ii) the last business day of the offering period, whichever closing price shall be less.

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

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

As of March 31, 2011, approximately $4,465 worth of ordinary shares has been purchased through the 2000 Employee Stock Purchase Plan at a weighted-average purchase price of $7.73. The 2000 Employee Stock Purchase Plan was terminated in 2008.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

A. MAJOR SHAREHOLDERS

Ordinary Shares

The following table sets forth certain information as of March 31, 2011, with respect to the ownership of our ordinary shares by all persons who are known to us to beneficially own 5% or more of our outstanding ordinary shares. Beneficial ownership is determined in accordance with rules of the SEC and generally includes voting and investment power with respect to our ordinary shares. Percentage ownership is based on 44,507,432 ordinary shares outstanding as of March 31, 2011.

Name	Ordinary Shares Beneficially Owned	Percent of Ordinary Shares Outstanding
Sun (1)	29,497,933	66.3%

The significant changes in percentage ownership held by the aforementioned major shareholders from March 31, 2008 to March 31, 2011 are as follows:

Name	Change in Percentage Ownership	
Sun	22.0%	Increase

(1) As reported on the Schedule 13D/A filed by Sun on January 19, 2011.

Founders' Shares

At the formation of our company in 1959, two classes of shares were created, founders' shares and ordinary shares. One-third of the voting power of all of our voting shares is allocated to the founders' shares. Alkaloida, which is a subsidiary of Sun Pharma, owns all of the 2,600 outstanding founders' shares.

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Voting Power

As of March 31, 2011, Sun controls approximately 77.5% of the voting power in our Company by reason of their (i) beneficial ownership of an aggregate of approximately 66.3% of our ordinary shares and (ii) ownership of the founders' shares, which constitute one-third of the voting power of our shares.

B. RELATED PARTY TRANSACTIONS

For related party transactions as of March 31, 2011, see Item 5 - "Recent Developments."

C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

ITEM 8. FINANCIAL INFORMATION

A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

The financial statements required by this item are found at the end of this 2009 Annual Report, beginning on page F-1.

Other Financial Information

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

Legal Proceedings

From time to time, we are a party to routine litigation incidental to our business, none of which, individually or in the aggregate, is expected to have a material adverse effect on our financial position. Other litigation, as disclosed herein, may have a material adverse effect on our financial position.

Legal Actions Commenced by the Company

Company's Lawsuit related to Special Tender Offer

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 in the District Court seeking a declaratory judgment that, under the Israeli Companies Law, Sun could not purchase, or offer to purchase, additional ordinary shares representing more than 45% of the total voting power of the Company, other than by means of a "Special Tender Offer" pursuant to the Israeli Companies Law. On June 30, 2008, Sun commenced the Sun Offer, but did not comply with the Special Tender Offer rules. 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 Israeli Supreme Court and requested an injunction barring Sun from acquiring 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 injunction. On September 7, 2010, the Israeli Supreme Court denied the Company's appeal and ordered the revocation of the temporary injunction which had prohibited the closing of the Sun Offer.

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

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.

Company's Lawsuits related to Ovide® (malathion) Lotion

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

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 ANDA seeking approval from the FDA to sell its own malathion lotion infringes Taro's patent.

Legal Actions by Certain Shareholders

Templeton's Lawsuits related to Proposed Merger with Sun

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

Sun's Lawsuit related to Termination of Merger Agreement and Enforcement of the Option Agreement

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

Sun's Lawsuit related to the Issuance of Audited Financial Statements

On May 14, 2009, Sun Pharma 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 Pharma and Alkaloida's motion, the Court dismissed all claims on October 10, 2010.

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

On July 27, 2010, certain affiliates of Sun Pharma 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 engagement of Guggenheim by the Company. Upon Sun Pharma's affiliates' motion, on October 10, 2010, the District Court dismissed all claims against the Company.

Litigation related to Israeli Taxation

The Company has challenged a tax assessment by the 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 million nominal amount of tax and approximately $19 million 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, in June 2008, the Company filed an application with the ITA to have the matter raised with the U.S. Internal Revenue Service under the Israel/U.S. Tax Treaty Mutual Agreement Proceedings ("MAP"). 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 Israeli 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. See Item 5 – "Operating and Financial Review and Prospects – Recent Developments" for an update.

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.

Other Legal Actions

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.

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

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

On March 7, 2011, the Company was sued by 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 $6.3 million in fees and expenses. The proceedings are in the very early stages and the Company denies liability in the matter.

Dividend Policy

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

B. SIGNIFICANT CHANGES

No significant change has occurred since the date of our consolidated financial statements included in this 2009 Annual Report.

ITEM 9. THE OFFER AND LISTING

A. OFFER AND LISTING DETAILS

On December 13, 2006, as a result of our late filing, our ordinary shares were de-listed from the NASDAQ Global Select Market and are now quoted on the Pink Sheets under the symbol “TAROF”. The following table sets forth the high and low closing sale prices of our ordinary shares as quoted on the NASDAQ Global Select Market and the Pink Sheets, as applicable, during the last five most recent full financial years:

	High	Low
2006	$ 16.97	$ 9.64
2007	$ 10.30	$ 5.75
2008	$ 10.80	$ 7.25
2009	$ 9.94	$ 8.10
2010	$ 14.50	$ 9.30

The following table sets forth the high and low closing sale prices of our ordinary shares as quoted on the Pink Sheets, during each fiscal quarter of the most recent two fiscal years and any subsequent period:

	High	Low
First Quarter 2009	$ 9.94	$ 8.10
Second Quarter 2009	$ 9.25	$ 8.43
Third Quarter 2009	$ 9.20	$ 8.50
Fourth Quarter 2009	$ 9.55	$ 8.50
First Quarter 2010	$ 13.50	$ 9.30
Second Quarter 2010	$ 14.15	$ 13.00
Third Quarter 2010	$ 13.00	$ 11.00
Fourth Quarter 2010	$ 14.50	$ 10.72
First Quarter 2011	$ 14.78	$ 14.10
Second Quarter 2011	$ 20.88	$ 14.23

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

	High	Low
Mar-11	$ 14.39	$ 14.11
Apr-11	$ 14.65	$ 14.23
May-11	$ 19.50	$ 14.85
Jun-11	$ 20.88	$ 19.40
Jul-11	$ 22.00	$ 20.69
Aug-11	$ 21.30	$ 18.25

B. PLAN OF DISTRIBUTION

Not applicable.

C. MARKETS

Our ordinary shares have been traded in the over-the-counter market in the United States since 1961. Our ordinary shares were first registered for trading on NASDAQ in 1982. Our ordinary shares first became quoted on the NASDAQ National Market in 1993 under the symbol “TARO.” On July 1, 2006, the NASDAQ National Market was renamed the NASDAQ Global Market and our ordinary shares became quoted on the NASDAQ Global Select Market, a segment of the NASDAQ Global Market. On December 13, 2006, our ordinary shares were de-listed from the NASDAQ Global Select Market and are now quoted on the Pink Sheets under the symbol “TAROF.” There is no non-United States trading market for our ordinary shares.

D. SELLING SHAREHOLDERS

Not applicable.

E. DILUTION

Not applicable.

F. EXPENSES OF THE ISSUE

Not applicable.

ITEM 10. ADDITIONAL INFORMATION

A. SHARE CAPITAL

Not applicable.

B. ISRAELI COMPANIES LAW AND OUR DOCUMENTS OF INCORPORATION

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

Objects and Purposes

Our Memorandum of Association provides that our main objects and purposes include any business connected with the developing, manufacturing, processing, supplying, marketing and distributing of prescription, OTC medical and other health care products.

In February 2000, the Company's Ordinance (New Version — 1983) was replaced with the Israeli Companies Law. Because our Articles of Association were adopted before the enactment of the Israeli Companies Law, they are not always consistent with the provisions of the new law. In all instances in which the Israeli Companies Law changes or amends provisions in the Companies Ordinance, and as a result our Articles of Association are not consistent with the Israeli Companies Law, the provisions of the Israeli Companies Law apply unless specifically stated otherwise in the Israeli Companies Law.

Approval of Specified Related Party Transactions Under Israeli Law and Our Articles of Association

Fiduciary Duties of Office Holders

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

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

Compensation for Office Holders

Under the Israeli Companies Law, arrangements as to compensation of a public company's office holders who are directors require the approval of the audit committee, the board of directors and the shareholders approval, in that order, except where the companies regulations adopted under the Israeli Companies Law provide for certain easements from such requirements. Arrangements as to compensation of a public company's office holders who are not directors require the approval of the audit committee and the board of directors in that order as detailed above in Approval of Interested Party Transactions.

Disclosure of Personal Interest of an Office Holder

The Company's Articles of Association provide that a director must disclose his interest in a contract or arrangement at the meeting of the Board of Directors at which such contract or arrangement is first taken into consideration. The Israeli Companies Law requires that an office holder (including a director) or a controlling shareholder who is aware that he or she has a personal interest in connection with any existing or proposed transaction by the company, promptly disclose to the company the nature of any personal interest that he or she may have, including all related material information or documents known to him or her. "Personal Interest", as defined by the Israeli Companies Law, includes an interest of any person in an act or transaction of the company, including interest of his relative or of a corporate body in which such person or his relative is either a holder of 5% or more of the corporate body shares or voting power, is a director or a general manager, or is entitled to appoint at least one director or the general manager and including the personal interest of a person voting by a proxy granted to him/her by another person, even if the person so granting the proxy does not have a personal interest in the transaction. In addition, the vote of a person who was granted a proxy from another person who has a personal interest shall be deemed the vote of a person having a personal interest, regardless of whether the proxy holder has discretion on how to vote. Personal Interest does not apply to an interest stemming merely from the fact that the person is also a shareholder in the company. In the case of an extraordinary transaction, the office holder's duty to disclose applies also to a personal interest of the office holder's relative. An extraordinary transaction is a transaction other than in the ordinary course of business, other than according to prevailing market terms, or that is likely to have a material impact on the company's profitability, assets or liabilities.

Under the Israeli Companies Law, the office holder must disclose his personal interest without delay and no later than the first meeting of the company's board that discusses the particular transaction. Once disclosure is made in compliance with the above disclosure requirement, the board of directors may approve the transaction between the company and an office holder or a third party in which an office holder has a personal interest, unless the company's articles of association provide otherwise. A transaction that is adverse to the company's interest may not be approved. If the transaction is an extraordinary transaction or if it concerns exemption, indemnification or insurance of an office holder, then it also must be approved by the company's audit committee and board of directors, and, under certain circumstances, by the shareholders of the company, in that order.

A director who has a personal interest in a matter that is considered at a meeting of the board of directors or the audit committee (unless in circumstances of non extraordinary transactions), may not be present at this meeting, unless the chairman of the audit committee or the chairman of the board of directors determined that the participation of such director is required in order to present the transaction. A director who has a personal interest in a matter that is considered at a meeting of the board of directors or the audit committee may not vote on this matter, unless a majority of the members of the board of directors or such committee, as the case may be, has a personal interest in the matter, in which case shareholder approval is also required.

Disclosure of Personal Interests of a Controlling Shareholder

Under the Israeli Companies Law, the disclosure requirements that apply to an office holder also apply to a controlling shareholder of a public company. For these purposes, a controlling shareholder is a shareholder who has the ability to direct the activities of a company (other than solely from his or her position on the board of directors or any other position with the company), including a shareholder who holds 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights. For purposes of attribution, the Israeli Companies Law provides that if two or more persons, holding voting rights in the company, each have a personal interest in the approval of the same transaction, such persons will be deemed to be one holder.

Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, including a private offering in which the controlling shareholder has a personal interest, and the engagement of a controlling shareholder or his or her relative with a public company, as an office holder or employee, require the approval of the audit committee, the board of directors and the shareholders of the company, in that order. The shareholder approval must be by a majority of the votes cast at the meeting, whether in person or by proxy, provided that:

- the majority includes at least the majority of the total votes of the non-controlling shareholders, or anyone voting on their behalf present at the meeting in person or by proxy; or
- the total number of votes of the shareholders mentioned above that are voted against the transaction does not exceed two percent (2%) of the voting rights in the company.

Director Qualifications

Our Articles of Association do not require directors to hold shares in the Company. According to the Articles, the number of directors of the Company should be not less than five or more than twenty-five. Under Israeli Companies Law, we must have at least two statutory external directors on the Board of Directors (see "Qualifications of Statutory External Directors" above).

Voting, Rights Attached to Shares, Shareholders' Meetings and Resolutions

Our directors, other than our statutory external directors, are elected at annual general meetings of our shareholders. A director holds office until the next annual general meeting, unless he or she resigns or is earlier removed from office by an ordinary resolution passed at an extraordinary general meeting of our shareholders.

Our share capital is divided into founders' shares and ordinary shares. Holders of each paid-up share are entitled to participate equally in the payment of dividends and other distributions and, in the event of liquidation, in all distributions after the discharge of liabilities to creditors. In addition, all ordinary shares shall together entitle their holders to two-thirds of the voting power of our Company. All founders' shares shall together entitle their holders to one-third of the voting power of our Company. Under our Articles of Association, an increase to the share capital, creation of preferred shares or shares with special rights, consolidation or division of share capital, cancellation of shares and reduction in share capital, require a "Special Resolution" of the shareholders, i.e. an affirmative vote of 75% of the voting power voting in person or by proxy. The rights attached to any class of shares may be modified with the consent in writing of the holders of three-fourths of the issued shares of that class or by way of a Special Resolution of the shareholders.

According to our Articles of Association, dividends on our ordinary shares may be paid out of profits and other surplus, as defined in the Israeli Companies Law or as otherwise approved by a court of law, provided that there is no reasonable concern that the dividend will prevent us from satisfying our existing and foreseeable obligations as they become due.

Under the Israeli Companies Law and our Articles of Association, an ordinary resolution of the shareholders (for example, with respect to the appointment of auditors) requires the affirmative vote of a majority of the voting power voting in person or by proxy, whereas a special resolution (for example, a resolution amending the Articles of Association or authorizing changes in capitalization or in the rights attached to a class of shares) requires the affirmative vote of at least 75% of the voting power voting in person or by proxy. Rights pertaining to a particular class of shares require the vote of 75% of such class of shares in order to change such rights in addition to the approval of 75% of the voting power of the shareholders voting in person, or by proxy, on such resolution. The quorum required for a meeting of shareholders consists of at least three shareholders present in person, or by proxy, who hold or represent between them at least one-third of the outstanding voting power unless otherwise required by applicable rules. A meeting adjourned for lack of a quorum generally is adjourned to the same day in the following week at the same time and place or any time and place as the board of directors may designate. If at such reconvened meeting the required quorum is not present, any two shareholders present in person, or by proxy, shall constitute a quorum.

Shareholder Meetings

According to our Articles of Association, a general meeting of the shareholders must be held at least once in every calendar year, but not more than fifteen months after the last preceding meeting. All general meetings must be held in Israel. The Board of Directors may call an extraordinary general meeting of the shareholders at any time. The Board shall convene an extraordinary general meeting of the shareholders, at the request of shareholders representing not less than 10% of the voting power in the Company, provided that the request complies with the requirements provided by the Article, including but not limited to statement of the object of the meeting. Any member may appoint by power of attorney a person to act as his representative at a meeting. The original instrument appointing a representative or a notarially certified copy must be deposited at the principal office of the Company at least forty-eight (48) hours before the meeting.

Restriction on Voting

In order to reduce our risk of being classified as a Controlled Foreign Corporation under the Code, we amended our Articles of Association in 1999 to provide that no owner of any of our ordinary shares is entitled to any voting right of any nature whatsoever with respect to such ordinary shares if (a) the ownership or voting power of such ordinary shares was acquired, either directly or indirectly, by the owner after October 21, 1999 and (b) the ownership would result in our being classified as a Controlled Foreign Corporation. This provision has the practical effect of prohibiting each citizen or resident of the United States who acquired or acquires our ordinary shares after October 21, 1999 from exercising more than 9.9% of the voting power in our company, with respect to such ordinary shares, regardless of how many shares the shareholder owns. The provision may therefore discourage United States persons from seeking to acquire, or from accumulating, 15% or more of our ordinary shares (which, due to the voting power of the founders' shares, would represent 10% or more of the voting power of our company).

Duties of Shareholders

Under the Israeli Companies Law, each and every shareholder has a duty to act in good faith and in an acceptable manner in exercising his, her or its rights and fulfilling his, her, or its obligations towards the company and other shareholders and to refrain from abusing his, her or its power, such as in voting in the general meeting of shareholders and/or in a meeting of a different class of shares, on the following matters:

- any amendment to the articles of association;
- an increase of the authorized share capital;
- a merger; or
- the approval of actions of office holders in breach of their duty of loyalty and of interested party transactions.

In addition, each and every shareholder has the general duty to refrain from depriving other shareholders of their rights.

Furthermore, a duty to act in fairness towards the company applies to any controlling shareholder, any shareholder who knows that he possesses the power to determine the outcome of a shareholder vote and any shareholder that, pursuant to the provisions of the Articles of Association, has the power to appoint or to prevent the appointment of an office holder in the company or any other power in regard to the company. The Israeli Companies Law does not describe the substance of this duty to act in fairness.

These various shareholder duties may restrict the ability of a shareholder to act in what the shareholder perceives to be his, her or its own best interests.

Mergers and Acquisitions under Israeli Law

The Israeli Companies Law and the regulations promulgated thereunder include provisions that allow a merger transaction, in general, and require that each company that is a party to a merger has the transaction approved by its board of directors and a vote of the majority of the voting power of its shares at a shareholders' meeting called on at least 35 days' prior notice by each of the merger parties. Under the Articles of Association and the Israeli Companies Law, the required shareholder vote is a supermajority of at least 75% of the shares voting in person or by proxy on the matter. A court may determine that a company duly approved a merger, in certain cases, upon the request of shareholders holding 25% or more of the voting power in the company. A court may not approve a merger unless it is convinced that the merger offer is fair and reasonable, in light of the valuation of the merging companies and the consideration which has been offered to the shareholders. Upon the request of a creditor of either party of the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that as a result of the merger the surviving company will be unable to satisfy the obligations of any of the parties to the merger. In addition, a merger may not be completed unless at least 30 days have passed from the time that the shareholders of each company have approved the merger and 50 days have passed from the time that a merger proposal has been delivered to the Israeli Registrar of Companies.

In general, the Israeli Companies Law also provides that an acquisition of shares of a public company is to be made by means of a special tender offer if, as a result of the acquisition, the purchaser would become a holder of 25% or more of the voting rights in the company if there is no existing holder of 25% or more of the voting rights in the company. If there is no existing holder of more than 45% of the voting rights in the company, in general, the Israeli Companies Law provides that an acquisition of shares of a public company is to be made by means of a special tender offer if as a result of the acquisition the purchaser would become a holder of more than 45% of the voting rights in the company.

These requirements do not apply if, in general, the acquisition (1) was made in a private placement that received shareholders' approval (confirming that the purchaser would become a holder of 25% or more, or 45% or more, of the voting power in the company, unless there is already a holder of 25% or more or 45% or more, respectively, of the voting power in the company), (2) was from a holder of 25% or more of the voting power in the company which resulted in the acquirer becoming a holder of 25% or more of the voting power in the company, or (3) was from a holder of 45% or more of the voting power in the company which resulted in the acquirer becoming a holder of 45% or more of the voting power in the company. The tender offer must be extended to all shareholders, but the offeror is not required to purchase more than 5% of the company's outstanding shares, regardless of how many shares are tendered by shareholders. The tender offer may be consummated only if (i) at least 5% of the company's outstanding shares will be acquired by the offeror and (ii) the number of shares tendered in the offer exceeds the number of shares whose holders objected to the offer.

If as a result of any acquisition of shares, the acquirer will hold more than 90% of the company's issued and outstanding share capital or of a class of shares, the acquisition may not be made other than through a tender offer to acquire all of the shares or all of the shares of such class. If the shares represented by the shareholders who did not tender their shares in the tender offer constitute less than 5% of the issued and outstanding share capital of the company or of a class of shares, and a majority of the shareholders offered such tender who do not have a personal interest in receipt of such tender accepted such tender, all of the shares that the acquirer offered to purchase will be transferred to the acquirer by operation of law. If the dissenting shareholders hold 5% or more of the issued and outstanding share capital of the company or of a class of shares, the acquirer may not acquire additional shares of the company from shareholders who accepted the tender offer to the extent that following such acquisition the acquirer would then own over 90% of the company's issued and outstanding share capital or of a class of shares. Shareholders may petition the court to alter the consideration for the acquisition to reflect a fair value. Such petition may be submitted within 6 months from the date the tender offer has been accepted.

Finally, Israeli tax law may treat stock-for-stock acquisitions between an Israeli company and a foreign company less favorably than does United States tax law. For example, unless the stock-for-stock transaction is considered a tax-deferred merger which relates to a transfer of at least 80% of the shares in the transferred company, Israeli tax law subjects a shareholder who exchanges his ordinary shares for shares in another corporation (which is listed for trading on a stock exchange) to taxation on half the shareholder's shares two years following the exchange and on the balance four years thereafter even if the shareholder has not yet sold the new shares.

Indemnification and Insurance of Office Holders

Insurance of Office Holders

Subject to the provisions of the Israeli Companies Law, our Articles of Association provide that we may enter into an insurance contract that would provide coverage in respect of liability imposed on any of our office holders with respect to an act performed in the capacity of an office holder for:

- a breach of the office holder's duty of care to the company or to another person;
- a breach of the office holder's duty of loyalty to the company, provided that the office holder acted in good faith and had reasonable cause to assume that his or her act would not prejudice the good of the company; or
- a financial liability imposed upon him or her in favor of another person.

We have obtained liability insurance covering our officers and directors.

Indemnification of Office Holders

Subject to the provisions of the Israeli Companies Law, our Articles of Association provide that we may indemnify any of our office holders, in advance and retroactively, against the following liabilities imposed or expenses incurred on the office holder with respect to an act performed in the capacity of an office holder:

- a monetary obligation imposed on him or her in favor of another person by a court judgment, including a compromise judgment or an arbitrator's award approved by the court;
- reasonable litigation expenses, including attorneys' fees, expended by the office holder due to an investigation or a proceeding instituted against him or her by an authority competent to administer such an investigation or proceeding that was either finalized without the filing of an indictment (as defined in the Israeli Companies Law) against him or her and "without any monetary obligation imposed in lieu of criminal proceedings" (as defined in the Israeli

Companies Law) or finalized "without the filing of an indictment" against him or her with a "monetary obligation imposed in lieu of criminal proceedings" relating to an offense that does not require proof of criminal intent; and

- reasonable litigation expenses, including attorneys' fees, expended by the office holder or charged to him or her by a court in connection with proceedings we institute against him or her or that are instituted on our behalf or by another person or a criminal charge from which he or she is acquitted, or a criminal charge in which he or she is convicted of an offense that does not require proof of criminal intent.

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Under the Israeli Companies Law, indemnification in advance in respect to monetary liabilities to third parties are limited to those events which, in the opinion of the board of directors, are to be expected in light of the company's actual activities when the indemnification is granted and to a sum or a standard which the board of directors determines that are reasonable in the circumstances.

Exemption of Office Holders

The Israeli Companies Law provides that a company may exempt an office holder in advance from liability for damages flowing from breach of his duty of care to the company.

Limitations on Exemption, Insurance and Indemnification

The Israeli Companies Law provides that a company may not exempt or indemnify an office holder for, or enter into an insurance contract that would provide coverage for any monetary liability incurred as a result of, any of the following:

- a breach by the office holder of his or her duty of loyalty unless, with respect to indemnification and insurance coverage, the office holder acted in good faith and had a reasonable basis to believe that the act would not prejudice the good of the company;

- a breach by the office holder of his or her duty of care which was committed intentionally or recklessly, except when it was committed solely by negligence;

- any act or omission done with the intent to derive an illegal personal benefit; or

- any fine or forfeiture imposed against the office holder.

In addition, under the Israeli Companies Law, exemption, indemnification, and procurement of insurance coverage (except where the companies regulations provide for certain easements from such requirements with respect to insurance) for office holders must be approved by the Audit Committee and board of directors of a company and, if the beneficiary is a director (as well as to controlling shareholders and their relatives), by the shareholders, in that order.

Following approval by the Audit Committee and Board of Directors and, in the case of directors, shareholders, we have entered into exemption and indemnification agreements with our directors and certain officers.

C. MATERIAL CONTRACTS

During the two years preceding the date of this 2009 Annual Report and subsequent thereto, neither we nor any of our affiliates and subsidiaries entered into any material contracts, other than as set out below and contracts entered into in the ordinary course of business.

Warrant Instrument

The Company issued on May 18, 2007, a warrant instrument, pursuant to the Share Purchase Agreement, under which it granted Sun Pharma, or a permitted transferee of Sun Pharma, the right to purchase up to 7,500,000 ordinary shares of the Company at an exercise price per share of $6.00 (the "Warrant Shares"). The Warrant Shares can be acquired during a period of three years commencing as of May 18, 2007. The warrant instrument contains provisions to adjust the exercise price and the number of Warrant Shares to be acquired under the warrant instrument.

As part of court proceedings initiated against the Company by Templeton, the Company, Sun and Templeton agreed to temporarily decrease the number of Warrant Shares that can be acquired by Sun under the warrant instrument to 6,787,500 ordinary shares.

On August 2, 2007, Sun Pharma exercised a portion of its warrants in favor of Alkaloida, as assignee, and purchased 3,000,000 additional shares at an exercise price of $6.00 per share, or $18,000,000.

On December 1, 2009, Sun provided notice to the Company regarding its exercise of its Warrant. On February 3, 2010, the Israeli Supreme Court ruled that the purpose of the temporary injunction is to maintain the status quo of the Company and that Sun could not exercise the Warrant until the appeal proceedings are over. The Company agreed to extend the expiration date of the Warrant, which the Israeli Supreme Court noted in its decision.

After the litigation between the Company and Sun ceased, Sun Pharma exercised additional portions of its warrant in favor of Alkaloida. Pursuant to the warrant, Alkaloida acquired the following shares at an exercise price of $6.00 per ordinary share, or a total of $31,275,000: (1) 3,712,500 ordinary shares of the Company on September 24, 2010, (2) 75,000 ordinary shares of the Company on September 27, 2010 and (3) 1,425,000 on January 18, 2011.

Quinnova Agreements

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

In May 2010, Taro and Quinnova entered into an agreement to co-promote Taro’s Topicort and desoximetasone products. Under the terms of the arrangement, Taro manufactures and Quinnova co-promotes the products. This agreement has been terminated upon mutual agreement of the parties.

Glenmark Agreement

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

D. EXCHANGE CONTROLS

Israeli law and regulations do not impose any material foreign exchange restrictions on non-Israeli holders of our ordinary shares. In May 1998, a new general permit was issued under the Israeli Currency Control Law, 1978, which removed most of the restrictions that previously existed under the law, and enabled Israeli citizens to freely invest outside of Israel and freely convert Israeli currency into non-Israeli currencies.

Dividends, if any, paid to our ordinary shareholders, and any amounts payable upon our dissolution, liquidation or winding up, as well as the proceeds of any sale in Israel of our ordinary shares to an Israeli resident, may be paid in non-Israeli currency or, if paid in Israeli currency, may be converted into freely repatriable dollars at the rate of exchange prevailing at the time of conversion.

E. TAXATION

General

The following is a summary of the tax structure applicable to companies in Israel with reference to its effect on us. The following also contains a discussion of material Israeli and United States tax consequences to our shareholders and Israeli government programs benefiting us. We cannot assure you that the tax authorities will accept the views expressed in the discussion in question. The discussion is not intended, and should not be construed, as legal or professional tax advice and is not exhaustive of all possible tax considerations. Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of ordinary shares, including, in particular, the effect of any foreign, state or local taxes.

Israeli Tax Considerations and Government Programs

General Corporate Tax Structure

Generally, Israeli companies are subject to Corporate Tax on their taxable income. The corporate tax rate for the tax years 2009, 2010 and 2011 is 26%, 25% and 24%, respectively. Such rate is scheduled to decline to 23% in 2012, 22% in 2013, 21% in 2014, 20% in 2015 and 18% in 2016 and thereafter. Capital gains derived by an Israeli company are subject to the prevailing corporate tax rate. However, the effective tax rate payable by a company that derives income from an Approved Enterprise, as discussed below, may be considerably less.

Tax Benefits under the Law for the Encouragement of Capital Investments, 1959

The Law for the Encouragement of Capital Investments, 5719-1959 (the "Investment Law"), provides certain incentives for capital investments in production facilities (or other eligible assets).

The Investment Law was significantly amended on April 1, 2005 (the "2005 Amendment") and as of January 1, 2011 (the "2011 Amendment"). Pursuant to the 2005 Amendment, tax benefits granted in accordance with the provisions of the Investment Law prior to its revision by the 2005 Amendment remained in force, but any benefits granted subsequently were subject to the provisions of the 2005 Amendment. Similarly, the 2011 Amendment introduces new benefits instead of the benefits granted in accordance with the provisions of the Investment Law prior to the 2011 Amendment. However, companies entitled to benefits under the Investment Law as in effect up to January 1, 2011 may choose to continue to enjoy such benefits, provided that certain conditions are met, or instead may elect to forego such benefits and elect the benefits of the 2011 Amendment.

The following discussion is a summary of the Investment Law prior to the 2005 Amendment and 2011 Amendment as well as the relevant changes contained in such amendments.

Tax Benefits Before the 2005 Amendment

An investment program that is implemented in accordance with the provisions of the Investment Law prior to the 2005 Amendment, referred to as an "Approved Enterprise," is entitled to certain benefits. A company that wished to receive benefits had to receive an approval from the Investment Center of the Israel Ministry of Industry, Trade and Labor (the "Investment Center"). Each certificate of approval for an Approved Enterprise relates to a specific investment program, delineated both by the financial scope of the investment and by the physical characteristics of the facility or the asset. The tax benefits from any certificate of approval relate only to taxable profits attributable to the specific Approved Enterprise. Income derived from activity that is not integral to the activity of the Approved Enterprise will not enjoy tax benefits.

An Approved Enterprise was entitled to receive a grant from the government of Israel. Taxable income derived from an Approved Enterprise under the Investment Law grants program during the benefits period is subject to tax at the maximum rate of 10%-25%, depending on the extent of foreign investment in the company. These tax benefits are granted for a limited period not exceeding seven years, or ten years for a company whose foreign investment level exceeds 25%, from the first year in which the Approved Enterprise has taxable income, after the year in which production commenced (as determined by the Investment Center). However, the period of benefits may in no event exceed the lesser of twelve years from the year in which the production commenced (as determined by the Investment Center) or fourteen years from the year of receipt of Approved Enterprise status, whichever ends earlier. If a company has more than one Approved Enterprise program or if only a portion of its capital investments is approved, the company's effective tax rate reflects a weighted combination of the applicable rates.

A company owning an Approved Enterprise may elect to forego certain government grants extended to Approved Enterprises in return for an alternative package of tax benefits (the “Alternative Benefits Program”). Under the Alternative Benefits Program, a company’s undistributed income derived from an Approved Enterprise is exempt from Corporate Tax for a period of between two and ten years, beginning with the first year the company derives taxable income under the program after the commencement of production, depending on the geographic location of the Approved Enterprise within Israel (the “Exemption Period”). After the Exemption Period the company will be eligible for the reduced tax rates under the Investment Law for the remainder of the benefit period as mentioned above.

The tax benefits under the Investment Law also apply to a company’s income that is generated from (i) the grant of a right of use with respect to know-how developed by the Approved Enterprise, (ii) income generated from royalties and (iii) income derived from a service which is ancillary to such right of use or royalties, provided that such income is generated within the Approved Enterprise’s ordinary course of business. The tax benefits under the Investment Law are generally not available with respect to income derived from products manufactured outside of Israel.

A company that has an Approved Enterprise program is eligible for further tax benefits if it qualifies as a Foreign Investors' Company (FIC). An FIC that is eligible for benefits is essentially a "Foreign Investment Company" that holds an Approved Enterprise. The determination as to whether or not a company qualifies as an FIC is made on an annual basis. An FIC that has an Approved Enterprise program will be eligible for an extension of the period during which it is entitled to tax benefits under its Approved Enterprise status (so that the benefit periods may be up to ten years) and for further tax benefits if the level of foreign investment exceeds 49%. If a company that has an Approved Enterprise program is a wholly-owned subsidiary of another company, then the percentage of foreign investments is determined based on the percentage of foreign investment in the parent company.

The following table sets forth the tax rates and related levels of foreign investments with respect to an FIC that has an Approved Enterprise program.

Percentage of non-Israeli ownership	Tax Rate
Over 25% but less than 49%	25%
49% or more but less than 74%	20%
74% or more but less than 90%	15%
90% or more	10%

Dividends paid out of income generated by an Approved Enterprise (or out of dividends received from a company whose income is generated by an Approved Enterprise) are generally subject to withholding tax at the rate of 15%, or at the lower rate under an applicable tax treaty. This withholding tax is deductible at source by the company. The 15% tax rate is limited to dividends and distributions out of income derived during the benefits period and actually paid at any time up to twelve years thereafter. After such period, the withholding tax is applied at a rate of up to 25%, or at the lower rate under an applicable tax treaty. In the case of an FIC, the 12-year limitation on reduced withholding tax on dividends does not apply. Under the Investment Law, a company that has participated in an Alternative Benefits Program is not obligated to distribute retained profits, and may generally decide from which year's profits to declare dividends. In addition, a company that pays a dividend out of tax-exempt income generated by its Approved Enterprise will be required to recapture the deferred corporate income tax applicable to the amount distributed (grossed up to reflect such tax) at the rate which would have been applicable to such income had such income not been exempted from tax under the Investment Law. This rate generally ranges from 10% to 25%, depending on the extent of non-Israeli shareholdings in the company. We have elected to use the Alternative Benefits Program, but intend to reinvest any income derived from our Approved Enterprise program and not to distribute such income as a dividend.

The Investment Law also provides that an Approved Enterprise is entitled to accelerated depreciation on its property and equipment that are included in an approved investment program.

The entitlement to the above benefits is based upon the fulfillment of the conditions stipulated by the law, the regulations published thereunder and the instruments of approval for the specific investments in the Approved Enterprise. In the event of failure to comply with these conditions, the company is required to refund the amount of tax benefits, plus a Consumer Price Index (CPI) linkage adjustment and interest.

Our facilities in Israel have received Approved Enterprise status which entitles us to receive certain tax benefits. We have received four approvals granting us a package of benefits, subject to compliance with applicable requirements. Under the first approval, our undistributed income derived from one Approved Enterprise was exempt from Corporate Tax for a period of four years from 2001, and was eligible for a reduced tax rate of between 10% and 25% for an additional two years. Under the second approval, our undistributed income derived from another Approved Enterprise was exempt from Corporate Tax for a period of two years from 2001 and we will be eligible for a reduced tax rate of 10% to 25% for an additional eight years. The benefits pursuant to the first two approvals have expired. Under the third approval (benefit period starting 2003), our undistributed income was exempt from Corporate Tax for a period of two years following implementation of the plan and we will be eligible for a reduced tax rate of between 10% and 25% for an additional thirteen years thereafter. All of these programs are subject to the time limits imposed by the Investment Law and based upon the level of foreign ownership in the company in each tax year. To retain the most favorable rates we must maintain a foreign shareholders' level of at least 90%. We exceed this level but there can be no assurance that we will be able to reach or maintain this level of foreign ownership for each subsequent year. Under an additional Approved Enterprise program (benefit period starting 2007), our undistributed income, derived from this approval, will be exempt from Corporate Tax for a period of two years following implementation and is eligible for a reduced tax rate of 10% to 25% for eight additional years thereafter. As a result of these programs, a substantial portion of the profits derived from products manufactured in Israel may benefit from a reduced Israeli Corporate Tax rate.

Tax Benefits Subsequent to the 2005 Amendment

The 2005 Amendment includes revisions to the criteria for investments qualified to receive tax benefits. This amendment applies to new investment programs and investment programs commencing in 2004 and thereafter, but does not apply to investment programs approved prior to March 31, 2005. However, the 2005 Amendment provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the Investment Law as they were on the date of such approval. The tax benefits available under any instrument of approval relate only to taxable profits attributable to the specific program and are contingent upon meeting the criteria set out in the instrument of approval. Furthermore, the Investment Center will continue to grant Approved Enterprise status to qualifying investments. However, the 2005 Amendment limits the scope of enterprises that may be approved by the Investment Center by setting criteria for the approval of a facility as an Approved Enterprise, such as provisions that generally require that at least 25% of the Approved Enterprise's income will be derived from export.

Pursuant to the 2005 Amendment, it is no longer necessary for a company to acquire Approved Enterprise status in order to receive the tax benefits previously available under the Alternative Benefits Program, and therefore such companies need not apply to the Investment Center for this purpose. Rather, a company may claim the tax benefits offered by the Investment Law directly in its tax returns, provided that its facilities meet the criteria for tax benefits set out by the 2005 Amendment (a "Benefited Enterprise"). Companies may, at their discretion, in order to provide greater certainty, elect to apply for a pre-ruling from the ITA regarding their eligibility for benefits under the 2005 Amendment. The Investment Law includes provisions attempting to ensure that a company will not enjoy both government grants and tax benefits for the same investment program.

Tax benefits are available under the 2005 Amendment for production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export to specific markets with a population of at least 12 million people. In order to receive the tax benefits, the amendment states that the company must make an investment in fixed assets in the Benefited Enterprise that meets all the conditions set out in the amendment for tax benefits and that exceeds a minimum amount specified in the Investment Law. Such investment allows the company to receive Benefited Enterprise status and may be made over a period of no more than three years ending at the end of the year in which the company requested to have the tax benefits apply to the Benefited Enterprise (the "Year of Election"). Where the company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Benefited Enterprise and the company's effective tax rate will be the result of a weighted-average of the applicable rates. In the case of an expansion of existing facilities, the minimum investment required in order to qualify as a Benefited Enterprise is required to exceed a minimum amount or certain percentage of the company's production assets, determined as of the end of the year before the expansion.

The duration of tax benefits is subject to a limitation of seven to ten years from the Commencement Year (the Commencement Year being defined as the later of: (i) the first tax year in which the company had derived income for tax purposes from the Benefited Enterprise or (ii) the Year of Election) provided that 12 years have not elapsed from the first day of the Year of Election. The tax benefits granted to a Benefited Enterprise are determined, as applicable to its geographic location within Israel, according to one of the following new tax routes, which may be applicable to the company:

- Similar to the available Alternative Benefits Program, exemption from Corporate Tax on undistributed income for a period of two to ten years, depending on the geographic location of the Benefited Enterprise within Israel, and a reduced Corporate Tax rate of 10% to 25% for the remainder of the benefits period, depending on the level of foreign investment in each year. Benefits may be granted for a term of seven to ten years, depending on the level of foreign investment in the company. If the company pays a dividend out of income derived from the Benefited Enterprise during the tax Exemption Period, such income will be subject to Corporate Tax at the applicable rate (10%-25%) in respect of the gross amount of the dividend that may be distributed. The company is required to withhold tax at the source at a rate of 15% from any dividends distributed from income derived from the Benefited

Enterprise; and

- A special tax route, which enables companies owning facilities in certain geographical locations in Israel to pay Corporate Tax at the rate of 11.5% on income of the Benefited Enterprise. The benefits period is ten years. Upon payment of dividends, the company is required to withhold tax at source at a rate of 15% for Israeli residents and at a rate of 4% for foreign residents.

The Investment Law also provides that a Benefited Enterprise is entitled to accelerated depreciation on its property and equipment.

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The benefits available to a Benefited Enterprise are subject to the fulfillment of conditions stipulated in the Investment Law and its regulations. If a company does not meet these conditions, then it may be required to refund the amount of tax benefits, together with the CPI linkage adjustment and interest, or other monetary penalty.

The Company notified the Israeli Tax Authorities within 12 months of the end of 2010 that its facilities meet the criteria for tax benefits set out by the 2005 Amendment. The Company will be exempt from Corporate Tax for a period of two years following implementation and we will be eligible for a reduced tax rate of 10% to 25% for eight additional years thereafter. There can be no assurance that we will attain approval for additional tax benefits under the 2005 Amendment, or receive approval for any Approved Enterprises in the future.

Tax benefits under the 2011 Amendment

The 2011 Amendment canceled the availability of the benefits granted in accordance with the provisions of the Investment Law prior to 2011 and instead introduced new benefits for income generated by a “Preferred Company” through its Preferred Enterprise (as such term is defined in the Investment Law) effective as of January 1, 2011 and onward. A Preferred Company is defined as either (i) a company incorporated in Israel and not fully owned by a governmental entity or (ii) a limited partnership (a) that was registered under the Israeli Partnerships Ordinance and (b) all limited partners of which are companies incorporated in Israel, but not all of them are governmental entities, which, in the case of the company and limited partnership referenced in clauses (i) and (ii), have, among other things, Preferred Enterprise status and are controlled and managed from Israel. Pursuant to the 2011 Amendment, a Preferred Company is entitled to a reduced corporate tax rate of 15% with respect to its preferred income derived by its Preferred Enterprise in 2011-2012, unless the Preferred Enterprise is located in a specified development zone, in which case the rate will be 10%. Such corporate tax rate will be reduced to 12.5% and 7%, respectively, in 2013-2014 and to 12% and 6% in 2015 and thereafter, respectively. Income derived by a Preferred Company from a “Special Preferred Enterprise” (as such term is defined in the Investment Law) would be entitled, during a benefits period of 10 years, to further reduced tax rates of 8%, or to 5% if the Special Preferred Enterprise is located in a certain development zone.

Dividends paid out of income attributed to a Preferred Enterprise are generally subject to withholding tax at source at the rate of 15% or such lower rate as may be provided in an applicable tax treaty. However, if such dividends are paid to an Israeli company, no tax will be withheld.

Furthermore, the 2011 Amendment provides relief with respect to tax paid on a dividend received by an Israeli company from profits of an Approved or Benefited Enterprise that was accrued during the benefits period according to the Investment Law prior to its amendment, if the company distributing the dividend notifies the Israeli Tax Authority by June 30, 2015 that it is applying the provisions of the 2011 Amendment and the dividend is distributed after the date of the notice.

The 2011 Amendment also provided transitional provisions to address companies already enjoying current benefits. These transitional provisions provide, among other things, that: (i) terms and benefits included in any certificate of approval that was granted to an Approved Enterprise that chose to receive grants before the 2011 Amendment came into effect will remain subject to the provisions of the Investment Law as in effect on the date of such approval, while, provided that certain conditions are met, the 25% tax rate applied to income derived by an Approved Enterprise during the benefit period will be replaced with the regular corporate income tax rate (24% in 2011), unless a request is made to apply the provisions of the Investment Law as amended in 2011 with respect to income to be derived as of January 1, 2011 (such request should be made by way of an application to the Israeli Tax Authority by June 30, 2011 and may not be withdrawn); and (ii) terms and benefits included in any certificate of approval that was granted to an Approved Enterprise, which had participated in an Alternative Benefits Program, before the 2011 Amendment came into effect will remain subject to the provisions of the Investment Law as in effect on the date of such approval, provided that certain conditions are met. However, a company that has such an Approved Enterprise can file a request with the

Israeli Tax Authority, according to which its income derived as of January 1, 2011 will be subject to the provisions of the Investment Law, as amended in 2011; and (iii) a Benefited Enterprise can elect to continue to benefit from the benefits provided to it before the 2011 Amendment came into effect, provided that certain conditions are met, or file a request with the Israeli Tax Authority according to which its income derived as of January 1, 2011 will be subject to the provisions of the Investment Law as amended in 2011. We have evaluated the likely effect of these provisions of the 2011 Amendment and, may file a request to apply the new benefits under the 2011 Amendment.

Tax Benefits under the Law for the Encouragement of Industry (Taxes), 1969

The Law for the Encouragement of Industry (Taxes), 1969 (the "Industry Encouragement Law") provides several tax benefits for Industrial Companies. An Industrial Company is defined as a company resident in Israel, at least 90% of the income of which in a given tax year (exclusive of income from specified government loans), is derived from an Industrial Enterprise owned by it. An Industrial Enterprise is defined as an enterprise whose major activity in a given tax year is industrial production activity.

Under the Industry Encouragement Law, Industrial Companies are entitled to a number of Corporate Tax benefits, including:

- Deduction of the cost of purchase of patents or the right to use a patent or know-how used for the development or promotion of the Industrial Enterprise, over an eight-year period commencing on the year in which such rights were first exercised;
- The right to elect, under specified conditions, to file a consolidated tax return with additional related Israeli industrial companies and an industrial holding company;
- Accelerated depreciation rates on equipment and buildings; and
- A straight-line deduction of expenses related to a public offering over a three-year period.

Under some tax laws and regulations, an Industrial Enterprise may be eligible for special depreciation rates for machinery, equipment and buildings. These rates differ based on various factors, including the date the operations begin and the number of work shifts. An Industrial Company owning an Approved Enterprise may choose between these special depreciation rates and the depreciation rates available to the Approved Enterprise.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority.

We believe that we qualify as an Industrial Company within the definition of the Industry Encouragement Law. We cannot assure you that the ITA will agree that we qualify, or, if we qualify, that we will continue to qualify as an Industrial Company or that the benefits described above will be available to us in the future.

Grants under the Law for the Encouragement of Industrial Research and Development, 1984

Under the Law for the Encouragement of Industrial Research and Development, 1984 (the "Research Law"), research and development programs that meet specified criteria and are approved by a governmental committee of the Office of the Chief Scientist are eligible for grants of up to 50% of the project's expenditures, as determined by the research committee, in exchange for the payment of royalties from the sale of products developed under the program. Regulations under the Research Law generally provide for the payment of royalties to the Chief Scientist of 3-6% on sales of products and services derived from a technology developed using these grants until 100% of the dollar-linked grant is repaid. Our obligation to pay these royalties is contingent on our actual sale of such products and services. In the absence of such sales, no payment is required. Effective for grants received from the Chief Scientist under programs approved after January 1, 1999, the outstanding balance of the grants will be subject to interest at a rate equal to the 12 month LIBOR applicable to dollar deposits that is published on the first business day of each calendar year. Following the full repayment of the grant, there is no further liability for royalties.

The terms of the Israeli government participation also require that the manufacture of products developed with government grants be undertaken in Israel. However, under the regulations of the Research Law, if any of the manufacturing is undertaken outside of Israel, assuming we receive approval from the Chief Scientist for the foreign manufacturing, we may be required to pay increased royalties. The increase in royalties depends upon the extent of the manufacturing volume that is performed outside of Israel as follows:

Extent of manufacturing volume outside of Israel	Royalties to the Chief Scientist as a percentage of grant
Less than 50%	120%
between 50% and 90%	150%
90% and more	300%

A recent amendment to the Research Law has provided that the restriction on manufacturing outside of Israel shall not apply to the extent that plans to so manufacture were declared at the time of application for funding.

In general, the technology developed with Chief Scientist grants may not be transferred to Israeli third parties without the prior approval of a governmental committee under the Research Law and may not be transferred to non-Israeli third parties. A recent amendment to the Research Law has stressed that it is not just transfer of know-how that is prohibited, but also transfer of any rights in such know-how. This approval, however, is not required for the export of any final products developed using the grants. Approval of the transfer of technology may be granted in specific circumstances only if the recipient abides by the provisions of the Research Law and related regulations, including the restrictions on the transfer of know-how and the obligation to pay royalties in an amount that may be increased. We cannot assure you that any consent, if requested, will be granted, or if granted, will be on reasonable commercial terms.

The Israeli authorities have indicated that the government may reduce or abolish grants from the Chief Scientist in the future. Even if these grants are maintained, we cannot assure you that we will receive Chief Scientist grants in the future. In addition, each application to the Chief Scientist is reviewed separately, and grants are based on the program approved by the research committee. Generally, expenditures supported under other incentive programs of the State of Israel are not eligible for grants from the Chief Scientist. We cannot assure you that applications to the Chief Scientist will be approved and, until approved, the amounts of any grants are not determinable.

Tax Benefits and Grants for Research and Development

Israeli tax law allows, under specific conditions, a tax deduction in the year incurred for expenditures, including depreciation, relating to scientific research and development projects, provided that the expenditures are approved by the relevant Israeli government ministry, determined by the field of research, if:

- the research and development is for the promotion or development of the company in one of the fields specified in the Income Tax Ordinance; or

- the research and development is carried out by or on behalf of the company seeking the deduction in such field.

Expenditures not so approved are deductible over a three-year period, from the first year that the expenditures were made. However, the amount of the government grant given will be subtracted from the amount of expenses which may be deducted.

Taxation of Non-Resident Holders of our Ordinary Shares

Taxation of Non-Israeli Shareholders on Receipt of Dividends. Non-residents of Israel (whether individuals or corporations) are generally subject to Israeli income tax on the receipt of dividends paid on our ordinary shares at the rate of 20% (25% if the dividend recipient is a “substantial shareholder” at the time of distribution or at any time during the preceding 12-month period), unless a reduced rate is provided under an applicable tax treaty. A “substantial shareholder” is generally a person who alone or together with such person’s relative or another person who collaborates with such person on a permanent basis, holds, directly or indirectly, at least 10% of any of the “means of control” of the corporation. “Means of control” generally include the right to vote, receive profits, nominate a director or an officer, receive assets upon liquidation, or order someone who holds any of the aforesaid rights how to act, and all regardless of the source of such right. However, distribution of dividends from income attributed to an Approved Enterprise, Benefited Enterprise or Preferred Enterprise is subject to Israeli income tax at a rate of 15%, unless a reduced tax rate is provided under an applicable tax treaty. For example, under the Convention Between the Government of the United States of America and the Government of Israel with Respect to Taxes on Income, as amended (the “U.S.-Israel Tax Treaty”), the maximum rate of tax withheld in Israel on dividends paid to a holder of our ordinary shares who is a U.S. resident (for purposes of the U.S.-Israel Tax Treaty) is 25%. However, generally, the maximum rate of withholding tax on dividends, not generated by an Approved Enterprise, Benefited Enterprise or Preferred Enterprise, that are paid to a U.S. corporation holding 10% or more of the outstanding voting rights throughout the tax year in which the dividend is distributed as well as the previous tax year, is 12.5%, provided that not more than 25% of the gross income for such preceding year consists of certain types of dividends and interest. Furthermore, dividends paid from income derived from an Approved Enterprise, Benefited Enterprise or Preferred Enterprise are subject, under certain conditions, to withholding at the rate of 15%. We cannot assure you that we will designate the profits that are being distributed in a way that will reduce shareholders' tax liability. If the dividend is partly attributable to income derived from an Approved Enterprise, Benefited Enterprise or Preferred Enterprise, and partly to other sources of income, the withholding rate will be a blended rate reflecting the relative portions of the two types of income. U.S. residents who are subject to the Israeli withholding tax on a dividend may be entitled to a credit or deduction for United States federal income tax purposes in the amount of the taxes withheld, subject to detailed rules contained in U.S. tax legislation.

A non-resident of Israel who receives dividends from which tax was duly withheld is generally exempt from the duty to file returns in Israel in respect of such income, provided such income was not derived from a business conducted in Israel by the taxpayer, and the taxpayer has no other taxable sources of income in Israel.

Capital Gains Taxes Applicable to Non-Israeli Resident Shareholders. Israeli law generally imposes a capital gains tax on the sale of any capital assets by residents of Israel, as defined for Israeli tax purposes, and on the sale of assets located in Israel, including shares in Israeli companies, by both residents and non-residents of Israel, unless a specific exemption is available or unless a tax treaty between Israel and the shareholder's country of residence provides otherwise. The law distinguishes between real gain and inflationary surplus. The inflationary surplus is a portion of the total capital gain which is equivalent to the increase of the relevant asset's purchase price which is attributable to the increase in the Israeli CPI or, in certain circumstances, a foreign currency exchange rate, between the date of purchase and the date of sale. The real gain is the excess of the total capital gain over the inflationary surplus.

Non-Israeli residents are generally exempt from Israeli capital gains tax on any gains derived from the sale, exchange or disposition of shares in an Israeli corporation publicly traded on a foreign stock exchange, provided such gains do not derive from a permanent establishment of such shareholders in Israel and provided that such shareholders did not acquire their shares prior to the issuer's initial public offering. However, non-Israeli corporations will not be entitled to such exemption if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary of or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

Additionally, a sale of securities may be exempt from Israeli capital gains tax under the provisions of an applicable tax treaty. For example, under the U.S.-Israel Tax Treaty, the sale, exchange (whether from merger, acquisition or similar transaction) or disposition of our ordinary shares by a shareholder who is both a U.S. resident (for purposes of that treaty) holding the ordinary shares as a capital asset and entitled to claim the benefits afforded to such resident by the U.S.-Israel Tax Treaty (called a "Treaty U.S. Resident") is generally exempt from Israeli capital gains tax unless either (i) such Treaty U.S. Resident is an individual and was present in Israel for more than 183 days during the relevant taxable year; or (ii) such Treaty U.S. Resident holds, directly or indirectly, shares representing 10% or more of our voting power during any part of the 12-month period preceding such sale, exchange or disposition, subject to certain conditions; or (iii) the capital gain arising from such sale, exchange or disposition is attributable to a permanent establishment of the Treaty U.S. Resident located in Israel. In any of these cases, the sale, exchange or disposition of our ordinary shares would be subject to Israeli tax, to the extent applicable; however, under the U.S.-Israel Tax Treaty, such Treaty U.S. Resident would be permitted to claim a credit for the tax against the U.S. federal income tax imposed with respect to the sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits.

Israeli Transfer Pricing Regulations

On November 29, 2006, Income Tax Regulations (Determination of Market Terms), 2006, promulgated under Section 85A of the Tax Ordinance, came into effect ("TP Regulations"). Section 85A of the Tax Ordinance and the TP Regulations generally requires that all cross-border transactions carried out between related parties be conducted on an arm's length principle basis and will be taxed accordingly. The TP Regulations are not expected to have a material effect on us.

United States Federal Income Tax Considerations

Subject to the limitations described in the next paragraph, the following discussion describes the material United States federal income tax consequences to a holder of our ordinary shares (a "U.S. Holder") that is:

- a citizen or resident of the United States;

- a corporation, or other entity taxable as a corporation for United States federal income tax purposes, created or organized in the United States or under the laws of the United States or of any political subdivision thereof;

- an estate, the income of which is includable in gross income for United States federal income tax purposes regardless of its source; or

- a trust, if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust or if the trust has validly elected to be treated as a United States person under applicable Treasury regulations.

In addition, certain material aspects of United States federal income tax relevant to a holder who is not a partnership and is not a U.S. Holder (a "Non-U.S. Holder") are discussed below.

This summary is for general information purposes only. It does not purport to be a comprehensive description of all of the tax considerations that may be relevant to each person's decision to own our ordinary shares.

This discussion is based on provisions of the Code, existing and proposed Treasury regulations promulgated thereunder, and administrative and judicial decisions as of the date hereof, all of which are subject to change, possibly on a retroactive basis. Any such change could materially affect the continued validity of this discussion and the tax consequences described herein. This discussion does not address all aspects of United States federal income taxation that may be relevant to any particular shareholder based on such shareholder's individual circumstances. In particular, this discussion considers only U.S. Holders that will own ordinary shares as capital assets and does not address the potential application of the alternative minimum tax or United States federal income tax consequences to U.S. Holders that are subject to special treatment, including U.S. Holders that:

- are broker-dealers or insurance companies;
- are certain former citizens or long-term residents of the U.S.;
- are persons subject to the alternative minimum tax;
- have elected mark-to-market accounting;
- are tax-exempt organizations;
- are financial institutions or financial services entities;
- hold ordinary shares as part of a straddle, hedge or conversion transaction with other investments;
- own directly, indirectly or by attribution at least 10% of our voting power;
- have a functional currency that is not the United States dollar;
- are carrying on a trade or business in Israel through a permanent establishment; or
- acquire ordinary shares as compensation.

In addition, this discussion does not address any aspect of state, local or non-United States tax laws.

Additionally, the discussion does not consider the tax treatment of persons who hold ordinary shares through a partnership or other pass-through entity or the possible application of United States federal gift or estate tax.

Each holder of ordinary shares is advised to consult such person's own tax advisor with respect to the specific tax consequences to such person of purchasing, holding or disposing of our ordinary shares.

Taxation of Ordinary Shares

Taxation of Distributions Paid On Ordinary Shares

Subject to the discussion below under “Tax Consequences if We Are a Passive Foreign Investment Company,” a U.S. Holder will be required to include in gross income as ordinary income the amount of any distribution paid on our ordinary shares, including any Israeli taxes withheld from the amount paid, on the date the distribution is actually or constructively received to the extent the distribution is paid out of our current or accumulated earnings and profits as determined for United States federal income tax purposes. Distributions in excess of such earnings and profits will be applied against and will reduce the U.S. Holder’s basis in the ordinary shares and, to the extent in excess of such basis, will be treated as gain from the sale or exchange of ordinary shares.

With respect to non-corporate U.S. Holders, including individual U.S. Holders, for taxable years of 2011 and 2012, dividends may constitute qualified dividend income eligible to be taxed at the preferential rate applicable to long-term capital gains (a maximum rate of 15%), provided that (1) (a) our ordinary shares are readily tradable on an established securities market in the United States or (b) we qualify for benefits under an income tax treaty with the United States which includes an information exchange program and such treaty is determined by the United States Internal Revenue Service ("IRS"), to be satisfactory, (2) we are not a passive foreign investment company ("PFIC") (as discussed below) for either our taxable year in which the dividend was paid or the preceding taxable year, and (3) the following holding period requirements are met: (i) the U.S. Holder held the ordinary shares with respect to which the dividend was paid for at least 61 days during the 121-day period beginning on the date that is 60 days before the ex-dividend date with respect to such dividend, excluding for this purpose, under the rules of Code Section 246(c), any period during which the U.S. Holder has an option to sell, is under a contractual obligation to sell, has made (and not closed) a short sale of, is the grantor of a deep-in-the-money or otherwise nonqualified option to buy, or has otherwise diminished its risk of loss by holding other positions with respect to, such ordinary share (or substantially identical securities); and (ii) to the extent that the U.S. Holder is under no obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in property substantially similar or related to the ordinary shares with respect to which the dividend is paid. While the IRS has ruled that shares that are listed on the NASDAQ Stock Market are readily tradable on an established securities market in the United States, as our ordinary shares were until they were delisted effective December 13, 2006, it has ruled that shares traded on the Pink Sheets are not readily tradable on an established securities market in the United States. Even though our shares are traded on the Pink Sheets, we believe the requirements of (1(b) and (2) are met, and therefore dividends on our shares would qualify as qualified dividend income so long as a U.S. Holder met requirement (3). Unless the reduced rate provision is extended or made permanent or other changes are made by subsequent legislation, for tax years beginning on or after January 1, 2013, dividends will be taxed at regular ordinary income rates.

You should consult your tax advisors regarding the availability of the lower rate for dividends paid with respect to our ordinary shares.

U.S. Holders will have the option of claiming the amount of any Israeli income taxes withheld on a dividend distribution either as a deduction from gross income or as a dollar-for-dollar credit against their United States federal income tax liability. Individuals who do not claim itemized deductions, but instead utilize the standard deduction, may not claim a deduction for the amount of the Israeli income taxes withheld, but such amount may be claimed as a credit against the individual's United States federal income tax liability. The amount of foreign income taxes that may be claimed as a credit in any year is subject to complex limitations and restrictions, which must be determined on an individual basis by each shareholder. The limitations set out in the Code include, among others, rules which limit foreign tax credits allowable with respect to specific classes of income to the United States federal income taxes otherwise payable with respect to each such class of income. Distributions by us of our current or accumulated earnings and profits will generally be foreign source passive income for United States foreign tax credit purposes; however, if the dividends are qualified dividend income (as discussed above), the amount of the dividend taken into account for purposes of calculating the United States foreign tax credit limitation will be reduced. In addition, special rules would apply if we were a United States-owned foreign corporation, which we believe we are not. If we were a United States-owned foreign corporation, distributions of our current or accumulated earnings and profits will be treated as United States source and foreign source income in proportion to our earnings and profits in the year of the distribution allocable to United States and foreign sources. We will be treated as a "United States-owned foreign corporation" as long as stock representing 50% or more of the voting power or value of our shares is owned, directly or indirectly, by United States persons. U.S. Holders who are entitled to the benefits of the U.S.–Israel Tax Treaty may elect to credit Israeli withholding taxes allocable to the portion of our distributions treated as from United States sources under these rules against their United States federal income tax liability on such portion.

Generally, the total amount of allowable foreign tax credits in any year cannot exceed regular United States tax liability for the year attributable to foreign source taxable income. A U.S. Holder will be denied a foreign tax credit with respect to Israeli income tax withheld from dividends received on the ordinary shares to the extent such U.S. Holder has not held the ordinary shares for at least 16 days of the 30-day period beginning on the date which is 15 days before the ex-dividend date or to the extent such U.S. Holder is under an obligation to make related payments with respect to positions in substantially similar or related property. Any days during which a U.S. Holder has substantially diminished its risk of loss on the ordinary shares are not counted toward meeting the 16-day holding period required by the statute.

Taxation of the Disposition of Ordinary Shares

Subject to the discussion below under "Tax Consequences if We Are a Passive Foreign Investment Company," upon the sale or exchange of ordinary shares, a U.S. Holder will recognize a capital gain or loss in an amount equal to the difference between such U.S. Holder's basis in the ordinary shares, which is usually the cost of such shares in United States dollars, and the amount realized on the disposition in United States dollars. A capital gain from the sale or exchange of ordinary shares held more than one year is a long-term capital gain, and is eligible for a maximum 15% rate of taxation for individuals and other non-corporate taxpayers for a holding period ending in taxable years beginning before January 1, 2013 and a maximum rate of 20% thereafter. Gains and losses recognized by a U.S. Holder on a sale or exchange of ordinary shares normally will be treated as United States source income or loss for United States foreign tax credit purposes. The deductibility of a capital loss recognized on the sale or exchange of ordinary shares is subject to limitations.

In certain instances, a U.S. Holder who is subject to tax in Israel on the sale of our shares and who is entitled to the benefits of the U.S.–Israel Tax Treaty may treat such gain as Israeli source income and thus could, subject to other United States foreign tax credit limitations, credit the Israeli tax on such sale against such U.S. Holder's United States federal income tax on the gain from that sale.

Tax Consequences if We Are a Passive Foreign Investment Company

We will be a PFIC if 75% or more of our gross income in a taxable year, including the pro rata share of the gross income of any company, United States or foreign, in which we are considered to own, directly or indirectly, 25% or more of the shares by value, is passive income. Alternatively, we will be considered to be a PFIC if at least 50% of our assets in a taxable year, averaged quarterly over the year and ordinarily determined based on fair market value and including the pro rata share of the assets of any company in which we are considered to own, directly or indirectly, 25% or more of the shares by value, are held for the production of, or produce, passive income. Passive income includes, among other amounts, amounts derived by reason of the temporary investment of funds raised in our public offerings. If we were a PFIC, and a U.S. Holder did not make either an election to treat us as a qualified electing fund as defined and described below (a "QEF") or a mark-to-market election:

- Excess distributions by us to a U.S. Holder would be taxed in a special way. Excess distributions are amounts received by a U.S. Holder with respect to our stock in any taxable year that exceed 125% of the average distributions received by such U.S. Holder from us during the shorter of the three preceding taxable years or such U.S. Holder's holding period for the ordinary shares. Excess distributions must be allocated ratably to each day that a U.S. Holder has held our stock. A U.S. Holder must include amounts allocated to the taxable year in its gross income as ordinary income for that year. A U.S. Holder must pay tax on amounts allocated to each prior taxable year (other than the year prior to the first year in which we were a PFIC) at the highest rate in effect for that year on ordinary income and the tax is subject to an interest charge at the rate applicable to deficiencies for income tax.

- The entire amount of gain that was realized by a U.S. Holder upon the sale or other disposition of ordinary shares will also be treated as an excess distribution and will be subject to tax as described above.

- A U.S. Holder's tax basis in shares of our stock that were acquired from a decedent would not receive a step-up to fair market value as of the date of the decedent's death but would instead be equal to the decedent's basis, if lower.

The special PFIC rules described above will not apply to a U.S. Holder if the U.S. Holder makes an election to treat us as a QEF in the first taxable year in which the U.S. Holder owns ordinary shares or in which we are a PFIC, whichever is later, and if we comply with certain reporting requirements. Instead, a shareholder of a QEF is required for each taxable year to include in income a pro rata share of the ordinary earnings of the QEF as ordinary income and a pro rata share of the net capital gain of the QEF as a long-term capital gain, subject to a separate election to defer payment of taxes, which deferral is subject to an interest charge. We have agreed to supply U.S. Holders with the information needed to report income and gains pursuant to a QEF election in the event we are classified as a PFIC. The QEF election is made on a shareholder-by-shareholder basis and can be revoked only with the consent of the IRS. A shareholder makes a QEF election by attaching a completed IRS Form 8621, including the PFIC annual information statement, to a timely filed U.S. federal income tax return or, if no federal income tax return is required to be filed, by filing such form with the IRS Service Center in Ogden, Utah. Even if a QEF election is not made, a shareholder in a PFIC who is a United States person and who recognizes gain on a direct or indirect disposition of PFIC stock or receives direct or indirect distributions from a PFIC must file a completed IRS Form 8621 every year. If a QEF election is made after the first taxable year in which a U.S. Holder holds our ordinary shares and we are a PFIC, then special rules would apply.

Alternatively, a U.S. Holder of PFIC stock which is publicly traded could elect out of the tax treatment discussed above by electing to mark the stock to market annually, recognizing as ordinary income or loss each year an amount equal to the difference as of the close of the taxable year between the holder's fair market value of the PFIC stock and the adjusted basis in the PFIC stock. Losses would be allowed only to the extent of net mark-to-market gain previously included by the U.S. Holder under the election for prior taxable years. If the mark-to-market election were made, then the rules set forth above would not apply for periods covered by the election.

We do not believe that we are a PFIC. However, the tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to this determination. Accordingly, there can be no assurance that we will not become a PFIC. If we determine that we have become a PFIC, we will notify our U.S. Holders and provide them with the information necessary to comply with the QEF rules. U.S. Holders who hold ordinary shares during a period when we are a PFIC will be subject to the foregoing rules, even if we cease to be a PFIC, subject to certain exceptions for U.S. Holders who made a QEF election. U.S. Holders are urged to consult their tax advisors about the PFIC rules, including the consequences to them of making a mark-to-market or QEF election with respect to our ordinary shares in the event that we qualify as a PFIC.

Tax Consequences for Non-U.S. Holders of Ordinary Shares

Except as described in "Information Reporting and Back-up Withholding" below, a Non-U.S. Holder of ordinary shares will not be subject to United States federal income or withholding tax on the payment of dividends on, and the proceeds from the disposition of, ordinary shares, unless:

- such item is effectively connected with the conduct by the Non-U.S. Holder of a trade or business in the United States and, in the case of a resident of a country which has a treaty with the United States, such item is attributable to a permanent establishment or, in the case of an individual, a fixed place of business, in the United States;

- the Non-U.S. Holder is an individual who holds the ordinary shares as a capital asset and is present in the United States for 183 days or more in the taxable year of the disposition and certain other conditions are met; or

- the Non-U.S. Holder is subject to tax pursuant to the provisions of United States tax law applicable to United States expatriates.

Information Reporting and Back-up Withholding

U.S. Holders generally are subject to information reporting requirements with respect to dividends paid in the United States on ordinary shares. U.S. Holders are also generally subject to back-up withholding on dividends paid in the United States on ordinary shares unless the U.S. Holder provides IRS Form W-9 or otherwise establishes an exemption. U.S. Holders are subject to information reporting and back-up withholding (28%) on proceeds paid from the disposition of ordinary shares unless the U.S. Holder provides IRS Form W-9 or otherwise establishes an exemption.

Non-U.S. Holders generally are not subject to information reporting or back-up withholding with respect to dividends paid on, or upon the disposition of, ordinary shares, provided that such Non-U.S. Holder provides a taxpayer identification number, certifies to its foreign status, or otherwise establishes an exemption.

The amount of any back-up withholding may be allowed as a credit against a U.S. or Non-U.S. Holder's United States federal income tax liability and may entitle such holder to a refund, provided that certain required information is furnished to the IRS.

F. DIVIDENDS AND PAYING AGENTS

Not applicable.

G. STATEMENT BY EXPERTS

Not applicable.

H. DOCUMENTS ON DISPLAY

We are subject to the informational requirements of the Exchange Act applicable to foreign private issuers and fulfill the obligation with respect to such requirements by filing reports with the SEC. You may inspect and copy such material at the public reference facilities maintained by the SEC, 100 F Street, N.E., Washington, D.C. 20549. You may also obtain copies of such material from the SEC at prescribed rates by writing to the Public Reference Section of the SEC, 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. The SEC maintains an Internet website at http://www.sec.gov that contains reports, proxy statements, information statements and other material that are filed through the SEC's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system. We began filing through the EDGAR system beginning on December 3, 2002.

As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements, and our officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions contained in Section 16 of the Exchange Act. In addition, we are not required under the Exchange Act to file periodic reports and financial statements with the SEC as frequently or as promptly as United States companies whose securities are registered under the Exchange Act. A copy of each report submitted in accordance with applicable United States law is available for public review at our principal executive offices.

I. SUBSIDIARY INFORMATION

Not applicable.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk, which primarily consists of interest rate and foreign exchange risk. We use derivative instruments to partially mitigate our exposure to these risks. Our objective is to reduce volatility in cash flows due to changes in interest and foreign exchange rates.

Foreign Exchange Rate Risk

We and Taro U.S.A. use the United States dollar as our reporting currency and are exposed to foreign exchange rate risk from transactions conducted in different currencies.

In 2009, 78% of our revenue was generated in United States dollars. However, the remainder of our sales was denominated in the local currencies of the countries in which the sales occurred. As a result, our reported profits and cash flows are exposed to changing exchange rates. If these foreign currencies weaken relative to the United States dollar, the earnings generated in these foreign currencies will, in effect, decrease when converted into United States dollars, and vice versa. Therefore, from time to time we attempt to manage exposures that arise in the normal course of business related to fluctuations in foreign currency exchange rates by entering into offsetting positions through the use of foreign exchange forward contracts.

Due to the relatively low level of non-United States dollar revenues, the effects of currency fluctuations on consolidated net revenues were not significant in 2009.

Intercompany Foreign Exchange Transactions

Our most significant foreign exchange rate risk relates to our Canadian subsidiary's transactions with Taro U.S.A. that are denominated in U.S. dollars. These transactions increase the volatility of our earnings since our Canadian subsidiary records gains or losses on foreign exchange transactions under U.S. GAAP. We do not hedge this risk as it does not impact our net cash flows. A 10% increase in the exchange rate between the U.S. dollar and the Canadian Dollar would reduce pre-tax income by approximately $7.3 million based on the December 31, 2009 U.S. dollar to Canadian Dollar exchange rate.

Debt Denominated in NIS and Related Hedges

We have debt denominated in NIS and Canadian dollar that exposes us to foreign exchange rate risk. We have economically hedged the NIS foreign exchange rate risk by entering into cross-currency swaps, which converts our debt payments into U.S. dollars. We do not account for these derivatives as hedges and are therefore subject to earnings volatility from fluctuations in the fair value of these cross-currency swaps.

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates mainly to our long-term debt incurred to purchase fixed assets. Our interest expenses are primarily sensitive to LIBOR and CPI as most of our long-term debt bears a LIBOR or CPI-linked interest rate. Taro U.S.A. had an interest rate swap in place as of December 31, 2009, which converts a variable rate mortgage to fixed rate. We do not use hedge accounting for this interest rate swap and are therefore subject to earnings volatility due to fluctuations in the fair value of this interest rate swap. We paid $0.3 million to terminate a 2005 swap effective November 28, 2008, and recorded a $0.2 million loss within financial expenses, net for year ended December 31, 2008. As of December 31, 2009, $90.5 million of our outstanding debt bears an average interest rate of 4.65%. Of the $90.5 million, $79.5 million is exposed to interest rate fluctuation. Consequently, each 0.25% increase in interest rates will reduce pretax income by $0.2 million.

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Under conditions as of the date of filing this 2009 Annual Report, we do not believe that our exposure to market risks will have a material impact on future earnings.

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.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

Not applicable.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Not applicable.

ITEM 15. CONTROLS AND PROCEDURES

a. Disclosure Controls and Procedures.

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934, as amended (the “Exchange Act”) is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules, regulations and forms, and that such information is accumulated and communicated to the chief executive officer (“CEO”) and chief financial officer (“CFO”), as appropriate, to allow timely decisions regarding required disclosures. The Company did not perform the evaluation required by paragraph (b) of Exchange Act rule 13a-15 of the effectiveness of our “disclosure controls and procedures” (as defined in Exchange Rule 13a-15(e)) as of December 31, 2009. However, Management has concluded that the Company’s disclosure controls and procedures were ineffective as of December 31, 2009 as a result of the Company’s inability to timely file its Form 20-F for its fiscal year ended December 31, 2009, to perform the required evaluation of its disclosure controls and procedures and the material weaknesses in our internal control over financial reporting that existed as of year-end 2009, as described below.

b. Management’s Annual Report on Internal Control over Financial Reporting.

To address the control weaknesses described below, the Company performed additional analysis, testing and other post-closing procedures in order to prepare its consolidated financial statements in accordance with U.S. GAAP. Accordingly, Management, including the CEO and CFO, believes that the consolidated financial statements in this 2009 Form 20-F fairly present in all material respects, our financial condition, results of operations and cash flows for the periods presented.

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America and includes those that:

- pertain to the maintenance of records that in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP, and that receipts and expenditures of the Company are being made only in accordance with authorizations of Management and directors of the Company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Management, including our CEO and CFO, does not expect that our internal controls will prevent or detect all errors and fraud. A control, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. In addition, any evaluation of the effectiveness of controls is subject to risks that those internal controls may become inadequate in future periods because of changes in business conditions, or that the degree of compliance with the policies or procedures deteriorates.

Management, including our CEO and CFO, has not conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2009, based on the framework set forth in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). However, Management, including our CEO and CFO, believes it has identified a number of material weaknesses in our internal control of financial reporting that existed as of year-end 2009 that are described below. A number of these material weaknesses were identified in Management’s, including our CEO and CFO, evaluations of our internal control over financial reporting as of December 31, 2006 and as of December 31, 2010 which evaluations were conducted using the criteria established in COSO.

Material weakness (within the meaning of PCAOB Auditing Standard No. 5) is defined as a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Management, including our CEO and CFO, cannot conclude that it has identified all material weaknesses but believes that at least the following material weaknesses in internal control over financial reporting existed as of December 31, 2009:

Financial Reporting Closing Process

We did not have the time or resources to fully design, establish and maintain effective documented U.S. GAAP compliant financial accounting policies and procedures, primarily related to those for:

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

Remediation Steps

We have updated or revised the Company’s accounting policies and procedures, and in some cases implemented new policies and procedures. However, we still need to:

- formalize the documentation and fully implement the procedures created on a timely basis; and
- formalize the review of materials, schedules and results in support of the Company’s financial reporting and period-end closing procedures to provide reasonable assurances that our financial reporting is in conformity with U.S. GAAP.

We have expanded, and will continue to expand and reorganize as necessary, our accounting organization by creating and filling new positions with qualified accounting and finance personnel, increasing the number of persons who are CPAs or the CPA international equivalent to assist us with the remediation process.

We are developing a plan to design and implement enhanced information technology systems and user applications commensurate with the complexity of our business and our financial reporting requirements. It is expected that these investments will improve the reliability of our financial reporting by reducing the need for manual processes, reducing the chance for errors and omissions and thereby decreasing our reliance on manual controls to detect and correct accounting and financial reporting inaccuracies.

Certain Revenue Recognition Procedures
Rebates and Other Sales Deductions

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

Remediation Steps

The Company is continuing to develop processes, including increasing, where possible, the use of automated processes to reduce the dependency on manual processes. The Company has also increased the number of qualified personnel assigned to estimating rebates and other sales deductions. The Company will conduct training and continue to incorporate more efficient controls over these estimation processes.

Inventory

While we made significant improvements, we did not fully implement the controls and procedures which were designed to properly account for and report our inventory. These principally related to the valuation of inventory.

The Company primarily maintains inventories for raw materials, work in process, and finished goods. The Company found that adjustments of inventory and cost of goods sold were necessary and mainly relate to errors in the assessment of inventory valuation. Inventory valuation adjustments primarily resulted due to the errors identified in the accounts receivable reserves, which impacted the computation of the Company’s net selling prices which resulted in changes to inventory valuation.

Remediation Steps

The Company will incorporate more efficient controls, including increased use of automated processes and increased review of the schedules used to estimate the inventory valuation.

Taxation

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

Remediation Steps

The Company has individuals in each of its significant locations who are responsible for taxation and is in the process of assessing its specific deficiencies and needs related to taxation and if necessary, will establish a tax position responsible for the global supervision of the Company’s tax compliance and accounting for income taxes for financial reporting purposes. If necessary, the Company will recruit and hire an individual possessing the appropriate expertise to fill such position. In addition, the Company is evaluating whether it needs to engage subject matter experts with specialized international and consolidated income tax knowledge, to assist with the creation, implementation and documentation of a consolidated tax process and formal internal reporting, monitoring and oversight of tax compliance and accounting for income taxes on a global basis. In addition, the Company is in the process of finalizing its tax returns, in all countries, for all prior years, which will minimize the potential for changes to these tax returns.

c. Changes in Internal Control over Financial Reporting.

Other than those changes described above, there was no change in our internal control over financial reporting (as defined in rules 13(a)-15(f) and 15(d)-15(f) under the Exchange Act) that occurred during the period covered by this 2009 Annual Report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. We continue to identify and implement additional best practice solutions regarding efficient data collection, integration and controls, including processes to ensure accounting information is properly evaluated and recorded.

ITEM 16. [RESERVED]

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our Board has determined that Ilana Avidov-Mor, a member of the Audit Committee, is an audit committee financial expert, as defined by applicable SEC regulations, and is independent in accordance with applicable SEC and NASDAQ regulations. See Item 6.A for a summary of Ilana Avidov-Mor's relevant professional experience.

ITEM 16B. CODE OF ETHICS

We have adopted a code of conduct applicable to our directors and all employees. We have also adopted a code of ethics that applies to our chief executive officer, chief financial officer and other senior officers. A copy of the code of conduct or the code of ethics may be obtained, without charge, upon a written request addressed to: Corporate Affairs Department, Taro Pharmaceutical Industries Ltd., c/o Taro Pharmaceuticals U.S.A., Inc., 3 Skyline Drive, Hawthorne, NY 10532. Any waivers of the code of conduct or the code of ethics for executive officers or directors will be disclosed through the filing of a Form 6-K.

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Principal Accountant Fees and Services

We paid the following fees for professional services rendered by Kost Forer Gabbay & Kasierer, Certified Public Accountant, a member firm of Ernst & Young Global, independent registered public accounting firm ("Kost Forer"), during the years ended December 31, 2009, 2008 and 2007, respectively.

	2009	2008	2007
		In millions of U.S. Dollars	
Audit fees	$ 4.54	$ 1.74	$ 2.59
Tax fees	0.02	0.05	0.05
Total	$ 4.56	$ 1.79	$ 2.64

The audit fees for the years ended December 31, 2009, 2008 and 2007, respectively, represent fees for professional services rendered for the audits of our annual consolidated financial statements, statutory or regulatory audits of us and our subsidiaries, consents and assistance with review of documents filed with the SEC. All non-audit services provided by the Company's independent auditors were approved by the Audit Committee.

Tax fees represents fees for professional services related to tax compliance, including the preparation of tax returns and claims for refund, and tax planning and tax advice, including assistance with tax audits and appeals, tax services for employee benefit plans and assistance with respect to requests for rulings from tax authorities.

Policy on Pre-Approval of Audit and Non-Audit Services of Independent Auditors

Our Audit Committee is responsible for the oversight of our independent auditors' work. The Audit Committee's policy is to pre-approve all audit and non-audit services provided by our independent registered public accounting firm, Ziv Haft, a BDO Member Firm ("Ziv Haft"), who replaced Kost Forer as the Company's independent auditors in May 2010. These services may include audit services, audit-related services, tax services and other services, as further described below. The Audit Committee sets forth the basis for its pre-approval in detail, listing the particular services or categories of services that are pre-approved, and setting forth a specific budget for such services. Additional services may be pre-approved by the Audit Committee on an individual basis. Once services have been pre-approved, Ziv Haft and our Management then report to the Audit Committee on a periodic basis regarding the extent of services actually provided in accordance with the applicable pre-approval, and regarding the fees for the services performed.

ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES

Not applicable.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

Not applicable.

ITEM 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT

Not applicable.

ITEM 16G. CORPORATE GOVERNANCE

Not applicable.

PART III

ITEM 17. FINANCIAL STATEMENTS

We have responded to Item 18 in lieu of this item.

ITEM 18. FINANCIAL STATEMENTS

The financial statements required by this item are found at the end of this 2009 Annual Report, beginning on page F-1.

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

ITEM 19. EXHIBITS

The exhibits filed with or incorporated into this 2009 Annual Report are listed on the index of exhibits below.

Exhibit No.	Description
1.1	Memorandum of Association of Taro Pharmaceutical Industries Ltd. (1)
1.2	Articles of Association of Taro Pharmaceutical Industries Ltd., as amended (5)
2.1	Form of ordinary share certificate (1)
4.1	Taro Vit Industries Limited 1991 Stock Incentive Plan (2)
4.2	Taro Pharmaceutical Industries Ltd. 2000 Employee Stock Purchase Plan (3)
4.3	Taro Pharmaceutical Industries 1999 Stock Incentive Plan (4)
4.4	Amendment No. 1 to Taro Pharmaceutical Industries 1999 Stock Incentive Plan (5)
4.5	Amendment No. 2 to Taro Pharmaceutical Industries 1999 Stock Incentive Plan (5)
4.6	Merger Agreement (5)
4.7	Share Purchase Agreement (5)
8	List of Subsidiaries (See "Organizational Structure" in Item 4.C of this Form 20-F) (5)
12.1	Certification of the Interim Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
12.2	Certification of the Interim Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
13	Certification of the Interim Chief Executive Officer and Group Vice President, Interim Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
15(a).2	Debenture and Loan Agreement dated December 19, 2000 (6)
15(a).3	Loan agreements dated May 20, 2003 and November 27, 2003 (7)

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(1) Previously filed as an exhibit to our Registration Statement on Form F-1 (No. 333-63464), as amended, and incorporated herein by reference.

(2) Previously filed as an exhibit to our Registration Statement on Form S-8 (No. 33-80802) and incorporated herein by reference.

(3) Previously filed as an exhibit to our Registration Statement on Form S-8 (No. 333-12388) and incorporated herein by reference.

(4) Previously filed as an exhibit to our Registration Statement on Form S-8 (No. 333-13840) and incorporated herein by reference.

(5) Previously filed as an exhibit to our Annual Report on Form 20-F for the fiscal year ended December 31, 2005, and incorporated herein by reference.

(6) Previously filed as an exhibit to our Annual Report on Form 20-F for the fiscal year ended December 31, 2000 and incorporated herein by reference.

(7) Previously filed as an exhibit to our Annual Report on Form 20-F for the fiscal year ended December 31, 2003 and incorporated herein by reference.

SIGNATURE

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this 2009 Annual Report on its behalf.

TARO PHARMACEUTICAL INDUSTRIES LTD.

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

Dated: September 22, 2011

TARO PHARMACEUTICAL INDUSTRIES LTD.

Report of Independent Registered Public Accounting Firm

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

We have audited the accompanying consolidated balance sheets of Taro Pharmaceutical Industries Ltd. (the "Company") and its subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the years in the three year period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company and its subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2009, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated June 29, 2011 does not express an opinion on the Company's internal control over financial reporting because management was unable to complete all of its testing of internal controls and we were unable to apply other procedures to satisfy ourselves as to the effectiveness of the Company's internal control over financial reporting.

Tel Aviv, Israel

June 29, 2011

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

Report of Independent Registered Public Accounting Firm

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

We were engaged to audit Taro Pharmaceutical Industries Ltd. internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Taro Pharmaceutical Industries Ltd. management is responsible for maintaining effective internal control over financial reporting and for its assessment on the effectiveness of internal control over financial reporting, included in the accompanying Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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

Nevertheless, we draw attention to management conclusion that the Company has at least the following material weaknesses in internal control over financial reporting as of December 31, 2009:

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

Estimating certain accounts receivable reserves and sales deductions including rebates and other sales deductions.

Significant, complex and non-routine transactions, including the area of taxation and certain other accounting items.

Ensuring adequate preparation, timely review and documented approval of account reconciliations, journal entries, both recurring and non-recurring and certain information primarily in the form of spreadsheets that supports our financial reporting process, and consistent communication among the various finance and non-finance organizations across the Company on the terms of our commercial arrangements.

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

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

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

These material weaknesses, identified by management, were considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended December 31, 2009, of the Company and this report does not affect our report dated June 29, 2011, on those financial statements.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) the consolidated balance sheets of Taro Pharmaceutical Industries Ltd. as of December 31, 2009 and 2008, and the related consolidated statements of income and comprehensive income, stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2009 and our report dated June 29, 2011 expressed an unqualified opinion thereon.

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

June 29, 2011

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TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED BALANCE SHEETS

U.S. dollars and shares in thousands

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

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED BALANCE SHEETS

U.S. dollars and shares in thousands

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

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

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

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

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

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

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

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

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

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

TARO PHARMACEUTICAL INDUSTRIES LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

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

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

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NOTE 1: — GENERAL

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

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

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

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

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

While non-compliance with Government Agencies’ regulations can result in refusal to allow entry, seizure, fines or injunctive actions to prevent the sale of products, no such actions against the Group or its products have ever occurred. The Group believes that it is in material compliance with all Government Agencies’ regulations. In February 2009, our Canadian manufacturing facility received a warning letter from the FDA (the “Warning Letter”) expressing concern identified during a July 2008 inspection about certain quality control systems, including failure to complete investigations of quality issues in a timely manner. The Company responded to the Warning Letter on March 17, 2009, submitted and discussed a full compliance work plan with the FDA, provided periodic written updates to the FDA and committed to working with the FDA to resolve all issues. The Company has corrected the specific observations cited during the July 2008 inspection and in the Warning Letter, and, to ensure its products meet all requirements, has improved its ability to adhere to current good manufacturing practices (“cGMPs”) by adding additional qualified personnel, engaging outside experts and adding new procedures to resolve any systemic issues and prevent recurrence. The observations cited in the Warning Letter do not relate to any of the Company's other facilities. Until remedial action is complete and the FDA has confirmed compliance with cGMPs, new applications listing the Canadian facility as a manufacturing location of finished dosage forms may not be approved. However, one new product made at the Company's Canadian facility was approved by the FDA in May 2009 after the issuance of the Warning Letter. Other Federal agencies take the Warning Letter into account when considering the awards of contracts and in some cases may have the right to terminate any agreement they have with us or remove products from their pricing schedule as one agency has done. A formal cGMP re-inspection was conducted by the FDA in February 2011 to evaluate the effectiveness of corrective actions undertaken by Taro. The FDA informed the Company on April 19, 2011 that the site has an acceptable regulatory status. Therefore, the issues noted in the February 5, 2009 warning letter are considered to be resolved. This has not had a material impact on the Company's financial condition.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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 4 for details), inventory reserves, income taxes, fixed assets, intangible assets, derivative instruments and contingencies.

b. Financial statements in U.S. dollars:

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

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

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

c. Principles of consolidation:

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

A private corporation, TDC, owns 3.125% of the shares that have economic rights and has 50% of the voting rights in Taro U.S.A.; with the Company owning the remaining shares and voting rights. In 1993, TDC signed an agreement with the Company to assign its voting rights in Taro U.S.A. in all elections of directors of Taro U.S.A. as the Company may designate. TDC may terminate the agreement upon one year written notice. As of December 31, 2009, no such notice of termination has been provided. TDC is a minority shareholder in the Company by way of its ownership of Taro U.S.A. shares that have economic rights. Since losses applicable to TDC exceeded its interest in Taro U.S.A. equity, such excess and any further losses applicable to TDC were charged against the Company as TDC has no obligation to fund such losses. Effective January 1, 2009, the Company adopted FASB ASC Section 810-10-65, "Consolidation – Overall – Transition and Open Effective Date Information – Transition Related to FASB Statements No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51, and No. 164, Not-for-Profit Entities: Mergers and Acquisitions" (formerly SFAS No. 160). This standard requires that the Company allocate income or loss attributable to the non-controlling interest based on the respective ownership percentages. This aspect of the standard was adopted on a prospective basis. Had the Company continued to follow the accounting standards effective in 2008, the income attributed to Taro would have been higher by $2,728 or $0.07 per share.

d. Cash and cash equivalents:

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

e. Marketable securities:

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

f. Allowance for doubtful accounts:

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

g. Inventories:

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

Raw and packaging materials – average cost basis.

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

Purchased products for commercial purposes – average cost basis.

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

h. Property, plant and equipment:

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

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

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

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

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

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

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

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

i. Lease of land from Israel Land Administration:

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

j. Goodwill:

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

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

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

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

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

Intangible assets and deferred charges:

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

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

Long-lived assets:

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

l. Treasury shares:

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

From time to time the Company reissues treasury shares under the stock purchase plan, upon exercise of options and upon vesting of restricted stock units. When treasury stock is reissued, the Company accounts for the re-issuance in accordance with FASB ASC Subtopic 505-30, “Equity – Treasury Stock” (formerly Accounting Principles Board Opinion (“APB”) No. 6, “Status of Accounting Research Bulletins”) and charges the excess of the purchase cost, including related stock-based compensation expenses, over the re-issuance price (loss) to retained earnings. The purchase cost is calculated based on the specific identification method.

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

m. Revenue recognition:

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

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

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

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

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

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

Reserves for returns, Medicaid and indirect rebates are included in current liabilities. All other sales deductions allowances are recorded as accounts receivable reserves. The reserve for returns is included in current liabilities as substantially all of these returns will not be realized until after the year-end accounts receivable balances are settled. Medicaid and indirect rebates are included in current liabilities because the Company does not have direct customer relationships with any of the payees. See Notes 4 and 12.

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

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

n. Research and development:

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

o. Royalty-bearing grants:

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

p. Advertising expenses:

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

q. Income taxes:

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

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

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

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

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

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

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

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

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

t. Freight and distribution costs:

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

u. Accounting for stock-based compensation:

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

The Company recognizes compensation expense for the value of its awards granted subsequent to January 1, 2006, based on the straight-line method over the requisite service period of each of the awards, net of estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures. For awards granted prior to January 1, 2006, the Company recognizes compensation expense based on the straight line-method over the requisite service period of each of the awards. Forfeitures were previously accounted for as they occurred, but have been estimated with the adoption of SFAS No. 123(R) for those awards not yet vested. Upon the adoption of SFAS No. 123(R) the expected life of the option is estimated using the "simplified" method as provided in SAB 107. Under this method, the expected life equals the arithmetic average of the vesting term and the original contractual term of the option. On December 21, 2007, the SEC issued SAB No. 110 ("SAB 110"), which, effective January 1, 2008, amends and replaces SAB 107. The Company currently uses the simplified method as adequate historical experience is not available to provide a reasonable estimate. The Company adopted SAB 110 effective January 1, 2008 and will continue to apply the simplified method until sufficient historical experience is available to provide a reasonable estimate of the expected term for stock option grants.

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

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

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

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

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

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

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

v. Concentrations of credit risk:

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

The Group's trade accounts receivables are mainly derived from sales to customers in the United States, Canada, Europe and Israel. At December 31, 2009, three different customers in the United States represented approximately 15.4%, 14.9% and 13.7% of the trade accounts receivable, net. The Group has adopted credit policies and standards intended to mitigate inherent risk while accommodating sales growth. The Group performs ongoing credit evaluations of its customers' financial condition when deemed necessary, but does not generally require collateral for its customers' accounts receivable.

w. Fair value of financial instruments:

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

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

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

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

x. Accounting for derivatives:

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

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

y. Fair value measurements:

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

z. Impact of recently issued accounting standards:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 3: — ACCOUNTS RECEIVABLE AND OTHER

a. Trade, net:

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

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

b. Other receivables, prepaid expenses and other:

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

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

(1) See Note 2.q.

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

NOTE 4: — SALES INCENTIVES

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

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

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

Product returns:

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

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

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

Chargebacks:

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

Rebates and other deductions:

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

The Company establishes reserves for rebates and these other various sales deductions based on contractual terms and customer purchasing activity, tracking and analysis of rebate programs, processing time lags, the level of inventory in the distribution channel and other relevant information. Based on the Company's historical experience, substantially all claims for rebates and other sales deductions are received within 24 months. At December 31, 2009 and 2008, and for the years then ended, the Company considered subsequent actual claims submitted by its customers in determining the Company’s reserves and related statements of operations impact for rebates and other sales deductions.

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

Use of estimates in reserves:

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

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

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

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

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

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

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

(1) Includes indirect rebates.

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

NOTE 5: — INVENTORIES

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

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

As for pledges, see Note 14.

NOTE 6: — PROPERTY, PLANT AND EQUIPMENT

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

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

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

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

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

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

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

d. As for pledges – see Note 14.

NOTE 7: —INTANGIBLE ASSETS AND DEFERRED COSTS

a. Composition:

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

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

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

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

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

NOTE 8: — LONG-TERM RECEIVABLES AND OTHER ASSETS

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

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

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

(3) See Note 9.

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

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

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

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

NOTE 9: — DERIVATIVE INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

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

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

a. Interest rates:

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

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

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

b. Currency exchange rates:

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

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

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

(1) Per Bank of Israel

(2) Statistics of Canada

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

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

NOTE 10: — FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 12: — OTHER LIABILITIES

a. Other current liabilities:

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

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

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

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Notes to consolidated financial statements

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b. Other long-term liabilities:

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

NOTE 13: — LONG-TERM DEBT

a. Composed as follows:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

c. The debt matures as follows:

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

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

For collateral, see Note 14.

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

NOTE 14: — LIABILITIES COLLATERALIZED BY PLEDGES

Balance of liabilities collateralized by pledges is as follows:

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

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

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

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

NOTE 15: — COMMITMENTS AND CONTINGENT LIABILITIES

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

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

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

b. Royalty commitments:

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

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

c. Legal proceedings:

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

1. Legal actions commenced by the Company:

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

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

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

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

iii. Company's lawsuit related to Ireland:

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

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

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

2. Legal actions by certain shareholders:

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

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

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

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

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

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

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

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

3. Litigations related to Israeli taxation:

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

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

4. Other Legal Actions:

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

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

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

iv. On March 7, 2011, the Company was sued by The Blackstone Group L.P. ("Blackstone") in the Supreme Court of the State of New York, County of New York. The lawsuit alleges breach of contract relating to fees under an agreement whereby Blackstone would provide certain financial advisory services to the Company. Blackstone seeks approximately $6,300 million in fees and expenses. The proceedings are in the very early stages and the Company denies liability in the matter.

d. In 2003, the Company and its Irish subsidiary entered into an agreement with a government agency in Ireland to receive grants for the development and provision of employment for a manufacturing facility in Ireland. The obligation to repay these grants terminated in 2008 and 2009, subject to the continued operation and control by the Company's Irish subsidiary. The grants, or portions thereof, may be revoked if jobs related to the grants remain vacant for a period in excess of six calendar months. As of December 31, 2009 and 2008, the balance of grants received was $0 and $5, respectively, and is included in other long-term liabilities. Subsequent to the balance sheet date, the Company fulfilled all of its obligations under the terms of the grant agreement and earned the full benefit of the grant. This grant was amortized as earned by the Company.

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

NOTE 16: — SHAREHOLDERS' EQUITY

a. Pertinent rights and privileges of ordinary shares:

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

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

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

b. Founders' shares:

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

c. Stock option plans:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

d. Dividends:

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

e. Net income per share:

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

f. 2000 Employee Stock Purchase Plan:

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

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

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

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

NOTE 17: — INCOME TAXES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

f. Income before income taxes comprises of the following:

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

g. Taxes on income comprise of the following:

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

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

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

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

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

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

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

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

i. Current taxes are calculated at the following rates:

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

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

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

j. Deferred income taxes:

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

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

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

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

k. Carryforward tax losses:

1. The Company:

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

2. Canadian subsidiary:

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

3. U.K. subsidiary:

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

4. Irish subsidiary:

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

5. U.S. subsidiary:

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

6. Hungarian subsidiary:

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

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

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

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

o. Tax assessments:

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

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

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

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

p. Uncertain tax positions:

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

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

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

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

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

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

Notes to consolidated financial statements

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

NOTE 18: — SELECTED STATEMENTS OF INCOME DATA

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

NOTE 19: — SEGMENT INFORMATION

a. Geographic Area Information:

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

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

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

* Includes operations in both Canada and Cayman Islands.

** Based on customer's location.

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

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

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

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

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

NOTE 20: — SUBSEQUENT EVENTS

a. Licensing Agreements:

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

2. In May 2010, Taro and Quinnova 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.

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

b. Major Shareholder Transactions:

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

c. Other:

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

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

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

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

e. 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.

f. Stock options:

Between January 1, 2010 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
2009	$ 15,726	$ 6,762	$ 441	$ (10,923)	$ 12,006
2008	$ 12,435	$ 5,704	$ (614)	$ (1,799)	$ 15,726
2007	$ 14,287	$ 2,403	$ 574	$ (4,829)	$ 12,435

Allowance for Doubtful Accounts

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