

TARO PHARMACEUTICAL INDUSTRIES LTD
Form 20-F
June 28, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 20-F

(Mark One)

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

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended _____

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period beginning January 1, 2012 and ending March 31, 2012

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Date of event requiring this shell company report _____

Commission file number 001-35463

TARO PHARMACEUTICAL INDUSTRIES LTD.
(Exact name of Registrant as specified in its charter)

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

Israel
(Jurisdiction of incorporation or organization)

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

Michael Kalb

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

None

(Title of Class)

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

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

(Title of Class)

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

None

(Title of Class)

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

44,476,532 Ordinary Shares, NIS 0.0001 nominal (par) value per share, and 2,600 Founders' Shares NIS 0.00001 nominal (par) value per share were issued and outstanding as of March 31, 2012

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes No

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

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

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

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U.S. GAAP

International Financial Reporting Standards
as issued by the International Accounting
Standards Board

Other

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

Item 17 Item 18

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

Yes No

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INTRODUCTION

We, among other business activities, develop, manufacture and market prescription and over-the-counter (OTC) pharmaceutical products, primarily in the United States (the U.S.), Canada and Israel. We also develop and manufacture active pharmaceutical ingredients (APIs), primarily for use in our finished dosage form products. We were incorporated in 1959 under the laws of the State of Israel. In 1961, we completed the initial public offering of our ordinary shares in the United States. As of March 22, 2012, our ordinary shares are traded on the New York Stock Exchange (the NYSE), under the symbol TARO.

As used in this Transition Report on Form 20-F for the transition period beginning January 1, 2012 and ending March 31, 2012 (the 2012 Transition Report), the terms we, us, our, Taro and the Company mean Taro Pharmaceutical Industries Ltd. (Taro Israel) and its affiliates (excluding Sun Pharmaceutical Industries Ltd. (Reuters: SUN.BO, Bloomberg: SUNP IN, NSE: SUNPHARMA, BSE: 524715) (Sun Pharma) and its other non-Taro affiliates (collectively, Sun)) and subsidiaries, unless otherwise indicated.

Our Board of Directors (the Board) approved a change in our fiscal year end from December 31 to March 31. The new fiscal year end was effectuated to align our fiscal reporting period and our annual budget planning with that of our major shareholder, Sun.

This 2012 Transition Report is being filed in respect of the transition period beginning January 1, 2012 and ending March 31, 2012, and contains the unaudited consolidated financial statements for the three month transition period ended March 31, 2012. To disclose information as of the latest practicable date and to provide material information to shareholders, this 2012 Transition Report discloses events and other information occurring after the three month transition period ended March 31, 2012.

FORWARD-LOOKING STATEMENTS

Except for the historical information contained in this 2012 Transition Report, the statements contained herein are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and Section 21E of the Securities Exchange Act of 1934 in particular with respect to our business, financial condition and results of operations. Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those discussed in Item 5 Operating and Financial Review and Prospectus and elsewhere in this 2012 Transition Report. We urge you to consider that statements which use the terms *believe*, *expect*, *plan*, *intend*, *estimate*, *anticipate*, *should*, *will*, *may*, *hope* and similar expressions are intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and are subject to risks and uncertainties. Except as required by applicable law, including the securities laws of the United States, we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

PRESENTATION OF FINANCIAL INFORMATION

Our consolidated financial statements appearing in this 2012 Transition Report are reported in United States dollars in thousands, unless otherwise indicated, and are prepared in accordance with generally accepted accounting principles in the United States of America (U.S. GAAP). Totals presented in this 2012 Transition Report may not total correctly due to rounding of numbers.

All references in this 2012 Transition Report to dollars, or \$, are to United States dollars and all references in this Transition Report to NIS are to New Israeli Shekels. The published⁽¹⁾ representative exchange rate between the NIS and the dollar for March 31, 2012, was NIS 3.72 per \$1.00. The published⁽²⁾ representative exchange rate between the Canadian dollar and the dollar for March 31, 2012, was \$1.00 Canadian dollar per \$1.00. No representation is made that the NIS amounts or Canadian dollar amounts could have been, or could be, converted into dollars at rates specified herein or any other rate.

⁽¹⁾As published by The Bank of Israel.

⁽²⁾As published by The Bank of Canada.

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The following discussion should be read in conjunction with our unaudited consolidated financial statements and related notes for the transition period beginning January 1, 2012 and ending March 31, 2012, which are included elsewhere in this 2012 Transition 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 Pharmaceuticals Inc. (our Canadian subsidiary) and Taro Pharmaceuticals U.S.A., Inc. (Taro U.S.A.) (our U.S. subsidiary).

The pharmaceutical industry is affected by demographic and socioeconomic trends, such as aging populations and increased demand for pharmaceuticals, as well as broad economic trends, resulting in a corresponding increase in healthcare costs, effects on reimbursement pricing, and spending decisions of healthcare organizations, all of which lead to increased recognition of the importance of generics as providing access to affordable pharmaceuticals. We believe our business model is appropriately structured to take advantage of these trends.

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

| | For the three months ended March 31, 2012 | | 2011 | |
|--------------|--|----------------------------|----------------------------|----------------------------|
| | Sales (in thousands) | % of our total sales | Sales (in thousands) | % of our total sales |
| U.S.A. | \$ 122,472 | 84% | \$ 87,036 | 81% |
| Canada | 13,167 | 9% | 10,394 | 10% |
| Israel | 5,472 | 4% | 5,966 | 5% |
| Other | 4,030 | 3% | 4,331 | 4% |
| Total | \$ 145,141 | 100% | \$ 107,727 | 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 three months ended March 31, 2012 and 2011, three customers in the United States accounted for the following proportion of our total consolidated net sales:

| Customer | For the three months ended March 31, 2012 | | 2011 | |
|------------|--|---------|------------------------|---------|
| | Sales (in millions) | Percent | Sales (in millions) | Percent |
| Customer A | \$ 35.0 | 24.1% | \$ 19.7 | 18.3% |
| Customer B | \$ 18.4 | 12.7% | \$ 11.7 | 10.9% |
| Customer C | \$ 17.3 | 11.9% | \$ 12.2 | 11.3% |

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

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products. These pricing pressures are inherent in the generic pharmaceutical industry.

During the three months ended March 31, 2012, we had no product line with net sales constituting over 10% of our sales on a consolidated basis. During the corresponding three month period in 2011, Desoximetasone constituted 11.6% of our sales on a consolidated basis.

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Our sales of this 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 revenue of this product as well as other products 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.

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 currently 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 (for example, 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)

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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. 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.

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 that 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 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

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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 a specified time period after receipt of invoice. 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.

Transition period summary

The following table summarizes the activities for sales deductions and product returns for the transition period beginning January 1, 2012 and ending March 31, 2012 and the year ended December 31, 2011:

For the Three months ended March 31, 2012 (in thousands)

| | Beginning balance | Provision recorded for current period sales | Credits processed/ Payments | Ending balance |
|-------------------------------------|-------------------|---|-----------------------------|----------------|
| Accounts Receivable Reserves | | | | |
| Chargebacks | \$ (20,145) | \$ (51,711) | \$ 51,067 | \$ (20,789) |
| Rebates and Other | (65,940) | (50,349) | 46,854 | (69,435) |
| Total | \$ (86,085) | \$ (102,060) | \$ 97,921 | \$ (90,224) |
| Current Liabilities | | | | |
| Returns | \$ (30,722) | \$ (6,292) | \$ 3,588 | \$ (33,426) |
| Other (1) | (32,606) | (11,215) | 9,984 | (33,837) |
| Total | \$ (63,328) | \$ (17,507) | \$ 13,572 | \$ (67,263) |

For the Year Ended December 31, 2011 (in thousands)

| | Beginning balance | Provision recorded for current period sales | Credits processed/ Payments | Ending balance |
|-------------------------------------|-------------------|---|-----------------------------|----------------|
| Accounts Receivable Reserves | | | | |
| Chargebacks | \$ (26,559) | \$ (224,112) | \$ 230,526 | \$ (20,145) |
| Rebates and Other | (41,567) | (150,799) | 126,426 | (65,940) |
| Total | \$ (68,126) | \$ (374,911) | \$ 356,952 | \$ (86,085) |
| Current Liabilities | | | | |

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| | | | | | | | | |
|--------------|----|----------|----|----------|----|--------|----|----------|
| Returns | \$ | (21,962) | \$ | (23,242) | \$ | 14,482 | \$ | (30,722) |
| Other (1) | | (13,099) | | (51,462) | | 31,955 | | (32,606) |
| Total | \$ | (35,061) | \$ | (74,704) | \$ | 46,437 | \$ | (63,328) |

(1) Includes indirect rebates and others.

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 use actual data to validate

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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 for goodwill and other indefinite-lived intangible assets at fiscal year end, on March 31 (formerly December 31), 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 U.S. Food and Drug Administration (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 three months ended March 31, 2012 and 2011, we recorded no impairment charges. We may have additional impairments related to our manufacturing facilities in future years.

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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 of goodwill for the three months ended March 31, 2012 and 2011.

Income Taxes. We determine 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 March 31, 2012 and December 31, 2011, our management determined that it was more likely than not that we will not benefit from the deferred tax assets in our Irish facility 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 deferred tax assets, the valuation allowance for such assets may be modified.

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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 our 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 award and the estimated period of time that we expect an employee to hold his or her stock options.

Discontinued Operations. Under ASC Subtopic 205-20, *Presentation of Financial Statements – Discontinued Operations*, when a component of an entity has been disposed of or classified as held for sale, the results of its operations, including the gain or loss on the disclosed component, should be classified as discontinued operations and the assets and liabilities of such component should be classified as assets and liabilities attributed to discontinued operations; that is, provided that the operations, assets and liabilities of the component have been eliminated from the entity's consolidated operations and the entity will no longer have any significant continuing involvement in the operations of the component.

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

In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. ASU No. 2011-03 removes from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion for an agreement to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. This update is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. The adoption of ASU No. 2011-03 did not impact our financial statements as we do not have nor do we anticipate entering into any repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This standard amends Topic 820 by clarifying the following related to fair value measurement: (1) that the application of the highest and best use and valuation premise concepts apply only to nonfinancial assets which might affect entities using the in-use valuation premise to measure the fair value of financial assets, (2) provide additional requirements specific to measuring the fair value of an instrument classified in an entity's shareholders' equity and (3) that a reporting entity should disclose quantitative information about the unobservable inputs used in a level 3 fair value measurement. This update is effective during interim and annual periods beginning after December 15, 2011 on a prospective basis. The adoption of ASU No. 2011-04 did not impact our financial statements as we do not apply the highest and best use and valuation premise concepts, we are not measuring the fair value of an instrument classified in shareholders' equity, nor do we have any level 3 fair value instruments.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. This standard changes the method of presenting comprehensive income. The amendment requires entities to report both the components of net income (i.e.: statement of operations) and the components of other comprehensive income either in a single continuous statement (e.g.: statement of comprehensive income) or in two separate but consecutive statements. ASU No. 2011-05 eliminates the option for an entity to present the components of other comprehensive income as part of the statement of changes in shareholders' equity. The amendments will be applied retrospectively and will effect interim and annual periods beginning after December 15, 2011. Although this standard did not have a material financial impact on our financial statements, it changed how we present the components of other comprehensive income by presenting it with the components of net income and no longer presenting it as part of the statement of changes in shareholders' equity.

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In September 2011, the FASB issued ASU No. 2011-08, *Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. This standard provides the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. ASU No. 2011-08 intends to simplify how entities test goodwill for impairment. Under this update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines through assessing the totality of qualitative factors that it is more likely than not that its fair value is less than its carrying amount. If there is a determination that the fair value is less than its carrying amount, then the entity would perform the two-step goodwill impairment test described in ASC Topic 350, *Intangibles - Goodwill and Other*. The amendments in this update are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted for impairment tests performed as of a date before September 15, 2011, if the entity's financial statements for the most recent period have not been issued. This standard did not have a material financial impact on our financial statements for the transition period for the three months ended March 31, 2012.

In December 2011, the FASB issued ASU No. 2011-11, *Balance Sheet (Topic 210): Testing Disclosures about Offsetting Assets and Liabilities*. This standard requires additional disclosure about financial instruments and derivative instruments that are either (1) offset in accordance with either Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. The amendments in this update are effective for interim and annual reporting periods beginning on or after January 1, 2013. Although this standard will not have a financial impact on our financial statements, it will require additional disclosure in the event we enter into offsetting financial and derivative instruments.

In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. This standard delays implementation of a portion of ASU No. 2011-05 that requires an entity to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. This update is effective for those annual periods beginning after December 15, 2011. This standard delays a portion of ASU No. 2011-05, and although it did not have a financial impact on our financial statements for the transition period for the three months ended March 31, 2012, it will require presentation of reclassification adjustments and their effects to other comprehensive income and the income statement upon implementation.

Table of Contents**RESULTS OF OPERATIONS**

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

| | For the three months ended March 31, | |
|---|---|--------------|
| | 2012 | 2011 |
| Consolidated Statements of Operations | | |
| Sales, net | 100.0% | 100.0% |
| Cost of sales | 31.7% | 41.4% |
| Gross profit | 68.3% | 58.6% |
| Operating expenses: | | |
| Research and development, net | 6.8% | 6.7% |
| Selling, marketing, general and administrative | 15.9% | 20.9% |
| Total operating expenses | 22.7% | 27.6% |
| Operating income | 45.6% | 31.0% |
| Financial expenses, net | 0.6% | 1.1% |
| Other (loss) gain, net | (0.1%) | 0.2% |
| Income before income taxes | 44.9% | 30.1% |
| Tax expense | 12.2% | 5.9% |
| Income from continuing operations | 32.7% | 24.2% |
| Net income (loss) from discontinued operations | * | (0.1%) |
| Net income | 32.7% | 24.1% |
| Net income attributable to non-controlling interest | 0.1% | 0.3% |
| Net income attributable to Taro | 32.6% | 23.8% |

* Less than 0.05%

FOR THE THREE MONTHS ENDED MARCH 31, 2012 COMPARED WITH THE THREE MONTHS ENDED MARCH 31, 2011

Sales. For the three months ended March 31, 2012, sales increased \$37.4 million, or 34.7%, compared to the same period in 2011. Sales in the United States during the three months ended March 31, 2012 increased \$35.4 million, or 40.7%, compared to the same period in 2011, primarily due to price increases on select products, and increased sales volumes on select products, including imiquimod cream, Calcitrene®/calcipotriene ointment, mupirocin ointment, adapalene gel, and ketoconazole cream. Sales in Israel and other international markets decreased \$0.8 million, or 7.7%, and sales in Canada increased \$2.8 million, or 26.7%, compared to the three months ended March 31, 2011.

Cost of Sales. Cost of sales, as a percentage of sales, decreased to 31.7% in the three months ended March 31, 2012, compared to 41.4% in the same period in 2011. This decrease is primarily related to the price increases noted above, which had no impact on costs.

Gross Profit. The Company's gross profit was \$99.2 million, or 68.3% of sales, in the three months ended March 31, 2012, while gross profit was \$63.1 million, or 58.6% of sales, in the same period in 2011. The increase for 2012 was primarily the result of higher sales due to price increases on select products, as noted above.

Research and Development. Net research and development (R&D) expenses increased \$2.6 million, or 35.7%, in the three months ended March 31, 2012 compared to the same period in the previous year. The increase in R&D expenses was primarily the result of an increase in clinical studies.

Selling, Marketing, General and Administrative. In the three months ended March 31, 2012, selling, marketing, general and administrative expenses remained relatively flat from the amount expended in the same period in 2011.

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Operating Income. In the three months ended March 31, 2012, the Company had operating income of \$66.2 million compared to \$33.4 million in the same period in 2011, an increase of \$32.8 million. This increase is primarily attributed to the increase in gross profit. Operating income, as a percentage of sales, increased to 45.6% in the three months ended March 31, 2012 from 31.0% in the same period in 2011.

Financial Expenses. Financial expenses result from interest expense and income and the impact of foreign currency exchange rate fluctuations. Net financial expense remained relatively flat at \$1.0 million in the three months ended March 31, 2012, compared to expense of \$1.2 million in the same period in 2011.

Taxes. Tax expense in the three months ended March 31, 2012 was \$17.8 million, compared to \$6.4 million in the same period in 2011, an increase of \$11.4 million. The increase relates to the increases in operating results. As of March 31, 2012, on an unconsolidated basis, we have available carryforward tax losses of \$1.3 million in the Company and our research institute in Israel, \$10.6 million in the United Kingdom and \$72.1 million in Ireland.

Net Income attributable to Taro. Our net income increased \$21.6 million from net income of \$25.7 million in the three months ended March 31, 2011 to net income of \$47.3 million in the same period in 2012, by reason of the factors noted above.

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 period indicated:

| Period ended | Rate of Inflation | | Rate of Devaluation (Appreciation) Against U.S. Dollar | | Rate of Exchange of U.S. Dollar | |
|--------------|-------------------|------------|--|------------|------------------------------------|------------|
| | Israel (1) | Canada (2) | Israel (1) | Canada (2) | Israel (1) | Canada (2) |
| 12/31/2011 | 2.17% | 2.30% | 7.66% | 2.25% | 3.82 | 1.02 |
| 03/31/2012 | 0.38% | 1.25% | (2.77%) | (1.76%) | 3.72 | 1.00 |

(1) As reported by the Bank of Israel.

(2) As reported by the Bank of Canada.

B. LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents increased \$88.3 million to \$238.3 million at March 31, 2012, principally due to increased income from operations, decreased trade receivables and increased trade and other payables and accrued expenses. Total Shareholders' equity increased from \$571.1 million at December 31, 2011 to \$623.0 million at March 31, 2012, principally due to net income of \$47.4 million.

Net cash provided by operating activities for the three months ended March 31, 2012 was \$78.1 million, compared to net cash provided by operating activities of \$24.4 million in the comparable period in the prior year, an increase of \$53.7 million. For the three months ended March 31, 2012, the Company had net cash provided by investing activities of \$15.6 million compared to net cash used in investing activities of \$11.0 million in the comparable period in 2011. For the three months ended March 31, 2012, the Company had net cash used in financing activities of \$6.6 million compared to net cash provided by financing activities of \$11.0 million in the comparable period in the prior year.

The change in our liquidity for the three months ended March 31, 2012 resulted from a number of factors, including:

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Net cash provided by operating activities consists of an increase in income tax payables of \$12.1 million, a decrease in trade receivables of \$9.9 million, noncash items of depreciation and amortization of \$4.6 million, a change in deferred taxes of \$4.1 million and an increase in accounts payable and accrued expenses of \$3.2 million. These items were offset by a decrease in derivative instruments of \$3.4 million.

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Net cash provided by investing activities consists of the investment in plant, property and equipment, which consumed \$1.6 million and investment in marketable securities of \$4.9 million, offset by proceeds from short-term investments of \$18.0 million and restricted bank deposits of \$4.0 million.

Net cash used in financing activities primarily consists of the repayment of long-term debt of \$6.6 million.

Debt

As of March 31, 2012, we had total debt, including current maturities, of \$38.9 million. *For additional information on our debt obligations, see Notes 12 and 14 to the consolidated financial statements included in this 2012 Transition Report.*

During 2011 and 2012, 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 with all our payment obligations due to our various lenders under their respective indentures and loan agreements.

As of March 31, 2012, we are in compliance with all our debt covenants.

As of March 31, 2012, our total long-term debt obligations (including current maturities) are as follows:

bonds of \$30.6 million with various investors; and

mortgages of \$8.3 million with one lender.

Our currency denominations, interest rates and maturities regarding our long-term debt obligations, including current maturities (excluding mortgages), consist of the following:

| Amount | Linkage | Rate | Maturity |
|--------------|---------------|-------------------|----------|
| \$ 29,333 | Israel CPI(a) | Bonds 11/2003 NIS | 2014 |
| 1,264 | Dollar | Bonds 11/2003 USD | 2014 |
| Total | | | |
| \$ 30,597 | | | |

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

On February 3, 2012, the Company paid \$5.9 million, comprised of \$5.8 million of principal and \$0.1 million of interest, in order to retire one of the mortgage debts. With the payoff of this mortgage, the Company is now in compliance with the terms of its remaining debt agreements.

As of March 31, 2012, we had no lines of credit.

Liquidity

On March 31, 2012, we had total unrestricted cash and cash equivalents and short-term bank deposits of \$310.7 million and total indebtedness to our financial creditors of \$38.9 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 March 31, 2012 and December 31, 2011, we had no commitment for capital expenditures which we consider to be material to our consolidated financial position. The Company had no available and undrawn credit facilities in place at March 31, 2012 and December 31, 2011.

Capital Expenditures

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We invested \$1.6 million in capital equipment and facilities during the three months ended March 31, 2012 and \$6.3 million in the year ended December 31, 2011. 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 current Good Manufacturing Practices. 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 7 to our consolidated financial statements included in this 2012 Transition Report.*

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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.

Recruiting talented scientists is essential to the success of our research and development programs. Approximately 11% of our employees work in our worldwide research and development programs.

We currently conduct research and development in three principal areas:

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

proprietary pharmaceuticals and delivery systems; and

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

Pharmaceutical Products

From January 1, 2012 through March 31, 2012, we did not receive any product approvals in Canada, Israel and the United States. As of March 31, 2012, 22 of our ANDAs and four tentative ANDA approvals were under review by the FDA. Subsequent to March 31, 2012, we withdrew five of the 22 ANDAs. In addition, there are multiple products for which either developmental or internal regulatory work is in process. The applications pending before the FDA are at various stages in the review process, and there can be no assurance that we will be able to successfully complete any remaining testing or that, upon completion of such testing, approvals for any of the applications currently under review at the FDA will be granted. In addition, there can be no assurance that the FDA will not grant approvals for competing products.

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[®] patents granted in July 2009 and 2011 and patents covering Flo-Pred[®], which have been granted between 1999 and 2010, we do not believe that any single patent or license is of material importance to us in relation to our current commercial activities. Our Flo-Pred[®] utilizes our patented NonSpil[®] liquid drug delivery system, which allows liquid medications to pour, but resist spilling, thereby providing accuracy of dosage and ease of use.

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.

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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 a New Drug Application, 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

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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

Other than as disclosed elsewhere in this 2012 Transition Report, we are not aware of any trends, uncertainties, demands, commitments or events for the period beginning January 1, 2012 and ending March 31, 2012 that are reasonably likely to have a material effect on our revenues, income, profitability, liquidity or capital resources, or that caused the disclosed financial information to be not necessarily indicative of future operating results or financial conditions.

E. OFF-BALANCE SHEET ARRANGEMENTS

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

F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table describes the payment schedules of our contractual obligations as of March 31, 2012:

| Type of Contractual Obligation | Payments due by period (in millions of dollars) | | | | |
|---------------------------------|---|---------------------|-----------|-----------|--------------|
| | Total | Less than 1 year | 1-3 years | 3-5 years | Over 5 years |
| Long-term debt obligations | \$ 38.91 | \$ 10.96 | \$ 22.06 | \$ 1.88 | \$ 4.01 |
| Operating lease obligations | 8.24 | 2.69 | 3.49 | 1.30 | 0.76 |
| Other Long-term liabilities (1) | 6.62 | 1.39 | 2.12 | 1.52 | 1.59 |
| Total | \$ 53.77 | \$ 15.04 | \$ 27.67 | \$ 4.70 | \$ 6.36 |

(1) Includes severance commitments and tax accruals.

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 2012 Transition Report, beginning on page F-1.

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 significant effect on our financial position or profitability. Other litigation, as disclosed herein, may have a significant effect on our financial position or profitability.

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.

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On June 15, 2008, the Company brought a lawsuit in the Tel-Aviv 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.

In May 2008, the State of Utah filed a lawsuit against the Company and a number of other pharmaceutical manufacturers. Generally speaking, the lawsuit alleges that the defendants caused the State to overpay pharmacies under the State Medicaid Program by reporting inflated published prices (average wholesale prices or AWP). The trial court dismissed the case with prejudice in February 2010. However, in March 2010, the plaintiff appealed the decision and the Utah Supreme Court issued its decision in June 2012. The ruling generally affirmed that the complaint by the plaintiff is inadequate and the State has been given leave by the court to re-plead its case.

In November 2010, the State of Louisiana filed a lawsuit in state court against the Company and a number of other pharmaceutical manufacturers. This lawsuit, similarly to the lawsuit filed by the State of Utah, also alleges that the defendants caused the State to overpay pharmacies under the State Medicaid Program by reporting inflated AWP's. The parties are currently in the discovery phase of the litigation. We are not in a position to quantify the likely outcome of these AWP cases.

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 originally sought \$6.3 million in fees and expenses and has subsequently amended its pleadings to adjust its claim to \$3.7 million. The parties are currently in the discovery phase of the litigation, and the Company denies liability in the matter.

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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 Company then filed an amended complaint on August 22, 2011 to include a newly issued patent, United States Patent No. 7,977,324. The suit alleges that Suven s ANDA to sell its own malathion lotion infringes Taro s patents.

On February 21, 2012, the Company entered into a License and Settlement Agreement (the Medicis Settlement Agreement) with Medicis Pharmaceutical Corporation. In connection with the Medicis Settlement Agreement, we agreed to settle all legal disputes between the parties relating to Medicis LOPROX Shampoo and Medicis agreed to withdraw its complaint against Taro pending in the U.S. District Court for the Southern District of New York for alleged patent infringement. Subject to the terms and conditions contained in the Medicis Settlement Agreement, Medicis granted Taro a non-exclusive, royalty-bearing license to make and sell limited quantities of our generic version of LOPROX® Shampoo.

B. SIGNIFICANT CHANGES

As of March 31, 2012, Mr. Elisha Sa ar, an independent public accountant, was terminated as the Company s internal auditor and as of that same date, Mrs. Rita Gerson was appointed by the Company s Board of Directors as internal auditor and ceased being an officer of the Company.

On April 18, 2012, Mr. Dilip Shanghvi resigned as Chairman and a member of Taro s Board of Directors and Mr. Kalyanasundaram Subramanian, known in industry circles as Kal Sundaram, has been appointed as Mr. Shanghvi s replacement, serving on the Board as its Chairman until Taro s next Annual General Meeting of Shareholders.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None.

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

Taro maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company s periodic filings under the Securities Exchange Act of 1934 (the Exchange Act), including this transition report, is recorded, processed, summarized and reported on a timely basis. These disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed under the Exchange Act is accumulated and communicated to the Company s management on a timely basis to allow decisions regarding required disclosure. Management, including Taro s Interim Chief Executive Officer (the CEO) and Interim Chief Financial Officer (the CFO), has evaluated the effectiveness of the design and operation of the Corporation s disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as of March 31, 2012.

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Taro carried out the evaluation of the effectiveness of its disclosure controls and procedures, required by paragraph (b) of Exchange Act Rules 13a-15 and 15d-15, under the supervision and with the participation of management, including the CEO and CFO. Based upon this evaluation, the CEO and CFO concluded that the Company's disclosure controls and procedures were effective as of March 31, 2012.

(b) Changes in Internal Control Over Financial Reporting

There were no changes in Taro's internal control over financial reporting during the three months ended March 31, 2012 that materially affected, or are reasonably likely to materially affect, Taro's internal control over financial reporting.

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 2012 Transition 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.

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ITEM 19. EXHIBITS

The exhibits filed with or incorporated into this 2012 Transition Report are listed on the index of exhibits below.

| Exhibit No. | Description |
|------------------------|---|
| 12.1 | Certification of the Interim Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 12.2 | Certification of the 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 |

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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 2012 Transition Report on its behalf.

TARO PHARMACEUTICAL INDUSTRIES LTD.

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

Dated: June 28, 2012

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TARO PHARMACEUTICAL INDUSTRIES LTD.

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TARO PHARMACEUTICAL INDUSTRIES LTD.

TRANSITION CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2012

UNAUDITED

These transition consolidated financial statements have been prepared, without audit, in accordance with United States generally accepted accounting principles (U.S. GAAP) and pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC). The December 31, 2011 consolidated balance sheet presented in this report has been derived from the Company s audited 2011 consolidated financial statements. These unaudited transition consolidated financial statements do not include all disclosures required for annual financial statements and should be read in conjunction with the Company s audited consolidated financial statements and notes thereto for the year ended December 31, 2011 included in the Company s Annual Report filed with the SEC on April 4, 2012. The operating results for transition periods are not necessarily indicative of those that may be expected for any other transition period or for the full fiscal year.

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Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****CONSOLIDATED BALANCE SHEETS**

U.S. dollars in thousands (Unaudited)

| | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 238,266 | \$ 150,001 |
| Short-term bank deposits | 72,440 | 89,814 |
| Restricted short-term bank deposits | 15,780 | 16,080 |
| Marketable securities | 7,835 | 2,901 |
| Accounts receivable and other: | | |
| Trade, net | 111,130 | 120,832 |
| Other receivables and prepaid expenses | 98,501 | 94,344 |
| Inventories | 109,638 | 107,378 |
| Long-term assets held for sale, net | 71 | 81 |
| TOTAL CURRENT ASSETS | 653,661 | 581,431 |
| LONG-TERM RECEIVABLES AND OTHER ASSETS | 19,972 | 23,131 |
| PROPERTY, PLANT AND EQUIPMENT, NET | 150,750 | 152,532 |
| GOODWILL | 7,284 | 7,277 |
| INTANGIBLE ASSETS AND DEFERRED COSTS, NET | 18,308 | 19,172 |
| DEFERRED INCOME TAXES | 6,449 | 12,302 |
| TOTAL ASSETS | \$ 856,424 | \$ 795,845 |

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

Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****CONSOLIDATED BALANCE SHEETS**

U.S. dollars in thousands (Unaudited)

| | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current maturities of long-term debt | \$ 10,957 | \$ 17,073 |
| Accounts payable: | | |
| Trade payables | 22,977 | 23,321 |
| Other current liabilities | 164,965 | 149,989 |
| TOTAL CURRENT LIABILITIES | 198,899 | 190,383 |
| LONG-TERM LIABILITIES: | | |
| Long-term debt, net of current maturities | 27,949 | 27,614 |
| Deferred income taxes | 2,205 | 1,851 |
| Other long-term liabilities | 4,413 | 4,934 |
| TOTAL LONG-TERM LIABILITIES | 34,567 | 34,399 |
| COMMITMENTS AND CONTINGENT LIABILITIES | | |
| TOTAL LIABILITIES | 233,466 | 224,782 |
| SHAREHOLDERS EQUITY: | | |
| Taro shareholders equity: | | |
| Ordinary shares of NIS 0.0001 par value: | | |
| Authorized at March 31, 2012 and December 31, 2011: 200,000,000 shares; Issued at March 31, 2012 and December 31, 2011: 44,800,007 and 44,799,507 shares, respectively | | |
| Outstanding at March 31, 2012 and December 31, 2011: 44,476,532 and 44,476,032 shares, respectively | 679 | 679 |
| Founders shares of NIS 0.00001 par value: | | |
| Authorized, issued and outstanding at March 31, 2012 and December 31, 2011: 2,600 shares | 1 | 1 |
| Additional paid-in capital | 253,584 | 253,577 |
| Accumulated other comprehensive income | 23,034 | 18,549 |
| Treasury stock: 323,475 shares at March 31, 2012 and December 31, 2011 | (1,329) | (1,329) |
| Accumulated earnings | 343,039 | 295,787 |
| Taro shareholders equity | 619,008 | 567,264 |
| Non-controlling interest | 3,950 | 3,799 |
| TOTAL SHAREHOLDERS EQUITY | 622,958 | 571,063 |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | \$ 856,424 | \$ 795,845 |

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

Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****CONSOLIDATED STATEMENTS OF OPERATIONS**

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

| | Three months ended March 31, | |
|---|-------------------------------------|---------------|
| | 2012 | 2011 |
| Sales, net | \$ 145,141 | \$ 107,727 |
| Cost of sales | 45,971 | 44,617 |
| Gross profit | 99,170 | 63,110 |
| Operating expenses: | | |
| Research and development, net | 9,847 | 7,258 |
| Selling, marketing, general and administrative | 23,101 | 22,460 |
| | 32,948 | 29,718 |
| Operating income | 66,222 | 33,392 |
| Financial expenses, net | 1,000 | 1,187 |
| Other (loss) gain, net | (94) | 251 |
| Income before income taxes | 65,128 | 32,456 |
| Tax expense | 17,791 | 6,368 |
| Income from continuing operations | 47,337 | 26,088 |
| Net income (loss) from discontinued operations | 66 | (135) |
| Net income | 47,403 | 25,953 |
| Net income attributable to non-controlling interest | 151 | 295 |
| Net income attributable to Taro | \$ 47,252 | \$ 25,658 |
| Net income from continuing operations attributable to Taro | 47,186 | 25,793 |
| Net income (loss) from discontinued operations attributable to Taro | 66 | (135) |
| Net income attributable to Taro | \$ 47,252 | \$ 25,658 |
| Net income per ordinary share from continuing operations attributable to Taro: | | |
| Basic | \$ 1.06 | \$ 0.58 |
| Diluted | \$ 1.06 | \$ 0.58 |
| Net income (loss) per ordinary share from discontinued operations attributable to Taro: | | |
| Basic | \$ * | \$ ()* |

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| Diluted | \$ | * \$ | ()* |
|--|----|--------|---------|
| Net income per ordinary share attributable to Taro: | | | |
| Basic | \$ | 1.06 | \$ 0.58 |
| Diluted | \$ | 1.06 | \$ 0.58 |
| Weighted-average number of ordinary shares used to compute net income per share: | | | |
| Basic | | 44,476 | 44,285 |
| Diluted | | 44,589 | 44,447 |

* Amount is less than \$0.01

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

Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

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

| | Three months ended March 31, | |
|---|-------------------------------------|--------------|
| | 2012 | 2011 |
| Net income attributable to Taro | \$ 47,252 | \$ 25,658 |
| Other comprehensive income | | |
| Foreign currency translation adjustments | 4,460 | 1,771 |
| Unrealized gain (loss) from marketable securities | 25 | (239) |
| Total other comprehensive income | 4,485 | 1,532 |
| | | |
| Total comprehensive income attributable to Taro | \$ 51,737 | \$ 27,190 |

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

Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY**

U.S. dollars and shares in thousands (Unaudited)

| | Taro Shareholders | | Equity | | Accumulated | | Other | | Total Taro | Non- | Total |
|--|-------------------|---------|------------|---------------|-------------|------------|--------------|-------------|--------------|------|-------|
| | Number of | Share | Additional | Comprehensive | Treasury | Retained | Shareholders | controlling | Shareholders | | |
| | Shares | Capital | Paid-in | Income | Shares | Earnings | Equity | Interest | Equity | | |
| | | | Capital | (Loss) | | | | | | | |
| Balance at January 1, 2011 | 43,018 | \$ 680 | \$ 244,668 | \$ 24,186 | \$ (1,329) | \$ 113,107 | \$ 381,312 | \$ 3,201 | \$ 384,513 | | |
| Exercise of options and issuance of shares of ESPP | 33 | | 300 | | | | 300 | | 300 | | |
| Issuance of shares to Sun and exercise of Sun warrants | 1,425 | | 8,550 | | | | 8,550 | | 8,550 | | |
| Share-based compensation | | | 59 | | | | 59 | | 59 | | |
| Comprehensive loss, net of tax: | | | | (5,637) | | | (5,637) | | (5,637) | | |
| Net income | | | | | | 182,680 | 182,680 | 598 | 183,278 | | |
| Balance at December 31, 2011 | 44,476 | 680 | 253,577 | 18,549 | (1,329) | 295,787 | 567,264 | 3,799 | 571,063 | | |
| Exercise of options and issuance of shares of ESPP | 1 | | 7 | | | | 7 | | 7 | | |
| Comprehensive income, net of tax: | | | | 4,485 | | | 4,485 | | 4,485 | | |
| Net income | | | | | | 47,252 | 47,252 | 151 | 47,403 | | |
| Balance at March 31, 2012 | 44,477 | \$ 680 | \$ 253,584 | \$ 23,034 | \$ (1,329) | \$ 343,039 | \$ 619,008 | \$ 3,950 | \$ 622,958 | | |

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

Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands (Unaudited)

| | Three months ended March 31, | |
|--|-------------------------------------|-------------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income | \$ 47,403 | \$ 25,953 |
| Adjustments required to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,598 | 4,709 |
| Change in deferred charges and other assets | 8 | 5 |
| Share-based compensation expense | | 20 |
| Accrued severance pay and other long-term liabilities, net | (210) | (241) |
| Loss on sale of long-lived assets | 22 | |
| Change in derivative instruments, net | (3,392) | (831) |
| Effect of exchange differences on inter-company balances | 2,104 | (368) |
| Increase in long-term debt due to currency fluctuations | 814 | 1,136 |
| Deferred income taxes, net | 4,075 | 3,917 |
| Decrease (increase) in trade receivables, net | 9,879 | (8,270) |
| Increase in other receivables, prepaid expenses and other | (535) | (2,088) |
| Increase in inventories, net | (1,583) | (1,592) |
| Decrease in long-term receivables and other assets | 53 | 73 |
| Decrease in income tax receivables | | 158 |
| (Decrease) increase in trade payables | (521) | 939 |
| Increase in other accounts payable and accrued expenses | 3,241 | 1,615 |
| Increase (decrease) in income tax payables | 12,138 | (777) |
| Net cash provided by operating activities | 78,094 | 24,358 |

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

Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

U.S. dollars in thousands (Unaudited)

| | Three months ended March 31, | |
|--|-------------------------------------|------------------|
| | 2012 | 2011 |
| Cash flows from investing activities: | | |
| Purchase of property, plant and equipment | (1,610) | (887) |
| Proceeds from (investment in) short-term bank deposits | 18,045 | (10,105) |
| Proceeds from restricted bank deposits | 4,014 | |
| Proceeds from long-term deposits and other assets | 18 | |
| Investment in marketable securities, net | (4,909) | |
| Proceeds from sale of long-lived assets | 28 | |
| Net cash provided by (used in) investing activities | 15,586 | (10,992) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of shares, net | 7 | 8,554 |
| Proceeds from short-term bank debt, net | | 2,428 |
| (Repayment of) proceeds from long-term debt | (6,595) | 9 |
| Net cash (used in) provided by financing activities | (6,588) | 10,991 |
| Effect of exchange rate changes on cash and cash equivalents | 1,173 | 371 |
| Increase in cash and cash equivalents | 88,265 | 24,728 |
| Cash and cash equivalents at the beginning of the period | 150,001 | 54,144 |
| Cash and cash equivalents at the end of the period | \$ 238,266 | \$ 78,872 |
| Supplemental disclosure of cash flow transactions: | | |
| Cash paid during the year for: | | |
| Interest | \$ 216 | \$ 95 |
| Income taxes | \$ 1,039 | \$ 3,140 |
| (a) Non-cash investing and financing transactions: | | |
| Purchase of property, plant and equipment on credit | \$ 633 | \$ 464 |

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

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

U.S. dollars in thousands (Unaudited)

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. As of March 22, 2012, the Company's ordinary shares are traded on the New York Stock Exchange (the NYSE), under the symbol TARO. Prior to the move to the NYSE, the Company's ordinary shares were 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. An application was filed with the Israeli authorities, to merge Taro Research Institute Ltd. with and into Taro Pharmaceutical Industries Ltd. in Israel. Once such merger is completed, the activities of Taro Research Institute Ltd. will be performed by Taro Pharmaceutical Industries Ltd. Taro International Ltd. in Israel and Taro's subsidiary in the United Kingdom 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 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 material actions against the Group or its products have recently occurred. The Group believes that it is in material compliance with all Government Agencies' regulations.

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 or other materials.

Sun Pharmaceutical Industries Ltd. (Reuters: SUN.BO, Bloomberg: SUNP IN, NSE: SUNPHARMA, BSE: 524715) (Sun Pharma) and its affiliates (Sun), the Company's majority shareholder, 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.

On October 18, 2011, the Company received a letter from Sun making a non-binding proposal for the acquisition of all of the issued and outstanding shares of Taro, not currently held by Sun, at a price of \$24.50 per share, in cash. The Company's Board of Directors formed an

independent Special Committee to review and evaluate the offer which it continues to do with its independent financial and legal advisors.

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

U.S. dollars in thousands (Unaudited)

The Company used the market approach in determining the fair value of the group of assets. During the three months ended March 31, 2012 and 2011, there were no impairment charges recorded.

NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements are prepared according to U.S. GAAP.

a. Use of estimates:

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

The Company's most critical estimates are used in its determination of its sales incentives reserves (see Note 5), inventory reserves, income taxes, fixed assets, intangible assets, derivative instruments and contingencies.

b. Financial statements in U.S. dollars:

A majority of the revenue of the Company and certain of its subsidiaries (exclusive of its Canadian, Irish, and U.K. subsidiaries – see below) is generated in U.S. dollars (dollars). In addition, a substantial portion of the costs of the Company and these subsidiaries is incurred in dollars. The Company's management believes that dollars 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 dollars 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 shareholders' equity.

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Sun, through its wholly owned subsidiary, Taro Development Corporation (TDC), owns 3.125% of the shares that have economic rights and has 50% of the voting rights in Taro U.S.A.; with the Company owning the remaining shares and voting rights. In 1993, TDC signed an agreement with the Company to vote all of its shares in Taro U.S.A. in all elections of directors of Taro U.S.A. as the Company shall instruct. In May 2011, TDC renewed its commitment to the Company. TDC may terminate the agreement upon one year written notice. As of March 31, 2012, 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, and as TDC has no obligation to fund such losses, such losses and any further losses applicable to TDC were charged against the Company. Effective January 1, 2009, the Company adopted FASB ASC Section 810-10-65,

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

U.S. dollars in thousands (Unaudited)

Consolidation Overall Transition and Open Effective Date Information Transition Related to FASB Statements No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51, and No. 164, Not-for-Profit Entities: Mergers and Acquisitions. This standard requires that the Company allocate income or loss attributable to the non-controlling interest based on the respective ownership percentages. This aspect of the standard was adopted on a prospective basis.

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.

Short-term bank deposits:

Bank deposits with maturities of more than three months but less than one year are included in short-term deposits. Such deposits are stated at cost which approximates market values.

e. Marketable securities:

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

Realized gains and losses on sale of investments are included in financial (income) expenses, net and are derived using the specific identification method for determining the cost of securities.

The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization together with interest and dividends on securities are included in financial (income) expenses, net.

The Company recognizes an impairment charge when a decline in the fair value of its investments in debt securities is below the cost basis of such securities is judged to be other-than-temporary. Factors considered in making such a determination include the duration and severity of the impairment, the reason for the decline in value, the potential recovery period and the Company's intent to sell, including whether it is more likely than not that the Company will be required to sell the investment before recovery of cost basis. For securities that are deemed other-than-temporarily impaired, the amount of impairment is recognized in financial (income) expenses, net in the Consolidated Statements of Operations and is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income.

During the three months ended March 31, 2012 and the year ended December 31, 2011, the Company did not own nor sell any marketable securities previously impaired.

f. Allowance for doubtful accounts:

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

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Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****Notes to consolidated financial statements****U.S. dollars in thousands (Unaudited)**

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.

h. Deferred income taxes:

Deferred income taxes are determined utilizing the asset and liability method based on the estimated future tax effects of temporary differences between the financial accounting and tax basis of assets and liabilities under the applicable tax laws, and on tax rates anticipated to be in effect when the deferred taxes are expected to be paid or realized. A valuation allowance is provided if, based upon the weight of available evidence, it is more likely than not that a portion of the deferred tax assets will not be realized. Deferred tax liabilities and assets are classified as current or non-current based on the classification of the related asset or liability for financial reporting, or according to the expected reversal dates of the specific temporary differences where appropriate.

i. Property, plant and equipment:

- (1) Property, plant and equipment is stated at cost, net of accumulated depreciation. Payroll and other costs that are direct incremental costs necessary to bring an asset to the condition of its intended use incurred during the construction and validation period of property, plant and equipment are capitalized to the cost of such assets.
- (2) Interest costs are capitalized in accordance with FASB ASC Subtopic 835-20, *Interest Capitalization of Interest*.
- (3) Depreciation is calculated utilizing the straight-line method over the estimated useful lives of the assets, from the date the assets are ready for their intended use, at the following annual rates:

| | % |
|--|--------------------|
| 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) |

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

- (4) The Group accounts for costs of computer software developed or obtained for internal use in accordance with FASB ASC Subtopic 350-40, *Intangibles: Goodwill and Other Internal-Use Software*. FASB ASC Subtopic 350-40 requires the capitalization of certain costs incurred in connection with developing or obtaining internal use software during the application development stage. During the three months ended March 31, 2012 and the year ended December 31, 2011, the Group capitalized \$10 and \$0 of software costs, respectively. Software costs are amortized using the straight-line method over their estimated useful life of three years.

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

U.S. dollars in thousands (Unaudited)

j. Lease of land from Israel Land Administration:
The Company leases land from the Israel Land Administration (ILA), which is accounted for pursuant to FASB ASC Subtopic 840-20, *Leases Operating Leases*. Taro leases several parcels from the ILA. The lease period of the industrial parcels 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.

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

FASB ASC Subtopic 350-20 prescribes that an entity may first assess qualitative factors to determine whether it is necessary to then perform a two-phase process for impairment testing of goodwill. The qualitative factors include macroeconomic conditions, industry and market considerations, cost factors, overall financial performance, any entity specific events, events affecting a reporting unit or a sustained decrease in share price. If upon evaluation of the qualitative factors there is greater than 50% likelihood that the fair value of the reporting unit is less than its carrying amount, then the entity must perform the two-phase process for impairment testing. 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 March 31, 2012 and December 31, 2011, no impairment loss had been identified.

l. 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 FASB ASC Topic 350, *Intangibles-Goodwill and Other*.

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

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

U.S. dollars in thousands (Unaudited)

Long-lived assets:

The Group's long-lived assets, excluding goodwill, are reviewed for impairment in accordance with FASB ASC Topic 360, *Property, Plant and Equipment*, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment exists when the carrying amount of the asset exceeds the aggregate future undiscounted cash flows expected to be generated by the asset. The impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the asset. In the three months ended March 31, 2012 and 2011, the Company recorded no impairment loss.

m. Comprehensive income:

The Company accounts for comprehensive income in accordance with FASB ASC Topic No. 220, *Comprehensive Income*. This statement establishes standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income generally represents all changes in shareholders' equity during the period except those resulting from investments by, or distributions to, shareholders. The Company determined that its items of other comprehensive income relates to gain and loss on hedging derivative instruments and unrealized gains and losses on available for sale securities. In accordance with the changes with the implementation of ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, the Company presents comprehensive income on the consolidated statements of comprehensive income which follows the consolidated statements of operations.

n. 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 may reissue treasury shares, upon exercise of options and upon vesting of restricted stock units. When treasury stock is reissued, the Company accounts for their issuance in accordance with FASB ASC Subtopic 505-30, *Equity Treasury Stock*, and charges the excess of the purchase cost, including related stock-based compensation expenses, over their 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.

o. Revenue recognition:

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

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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.

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Notes to consolidated financial statements

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

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

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

Reserves for returns, Medicaid and indirect rebates are included in current liabilities. All other sales deductions allowances are recorded as accounts receivable reserves. The reserve for returns is included in current liabilities as substantially all of these returns will not be realized until after the year-end accounts receivable balances are settled. Medicaid and indirect rebates are included in current liabilities because the Company does not have direct customer relationships with any of the payees. See Notes 5 and 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*, 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.

p. Research and development:

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

q. 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 three months ended March 31, 2012 and 2011.

r. 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 \$2,166 and \$1,509 for the three months ended March 31, 2012 and 2011, respectively.

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s. Income taxes:

Income taxes are accounted for in accordance with FASB ASC Topic 740, *Income Taxes*. FASB ASC Topic 740 prescribes the use of the liability method, whereby deferred tax asset and liability account balances are determined for temporary differences between the financial reporting and tax basis of assets and liabilities, and for carryforward losses and credits. Deferred taxes are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. As of March 31, 2012 and December 31, 2011, the Company's management

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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.

t. 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.

u. 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*.

v. Freight and distribution costs:

In accordance with FASB ASC Subtopic 605-45, *Revenue Recognition - Principal Agent Considerations*, the Company's accounting policy is to classify shipping and handling costs as a part of sales and marketing expense. Freight and distribution costs and distribution warehousing costs related to shipping and handling to customers, primarily through the use of common carriers or external distribution services amounted to \$2,537 and \$2,051 for the three months ended March 31, 2012 and 2011, respectively.

w. Accounting for stock-based compensation:

The Company recognizes compensation expense in accordance with FASB ASC Topic 718, *Compensation: Stock Compensation* for the value of its awards granted subsequent to January 1, 2006, based on the straight-line method over the requisite service period of each of the awards, net of estimated forfeitures. FASB ASC Topic 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Estimated forfeitures are based on actual historical pre-vesting forfeitures. Upon the adoption of FASB ASC Topic 718 the expected life of the option is estimated using the simplified method as provided in Staff Accounting Bulletin (SAB) 107. Under this method, the expected life equals the arithmetic average of the vesting term and the original contractual term of the option. On December 21, 2007, the SEC issued SAB No. 110 (SAB 110), codified as Topic 14.D.2 which, effective January 1, 2008, amends and replaces SAB 107. The Company currently uses the simplified method as adequate historical experience is not available to provide a reasonable estimate. The Company adopted SAB 110 effective January 1, 2008 and will continue to apply the simplified method until sufficient historical experience is available to provide a reasonable estimate of the expected term for stock option grants.

Stock Options: The Company did not grant any options during the three months ended March 31, 2012 or for the year ended December 31, 2011.

The Company applies FASB ASC Subtopic 505-50, *Equity - Equity-Based Payments to Non-Employees* with respect to options issued to non-employees. FASB ASC Subtopic 505-50 requires the use of option valuation models to measure the fair value of the options granted.

Compensation expense to non-employees was not material.

Estimated forfeitures are based on estimates for the three months ended March 31, 2012 and year ended December 31, 2011.

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x. Concentrations of credit risk:

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

The Group's trade accounts receivables are mainly derived from sales to customers in the United States, Canada, Europe and Israel. At March 31, 2012, three different customers in the United States represented approximately 18.5%, 13.4% and 12.5% 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.

y. 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 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.

z. Accounting for derivatives:

FASB ASC Topic 815, *Derivatives and Hedging*, requires companies to recognize all of their derivative instruments as either assets or liabilities in the statement of financial position at fair value. The accounting for changes (i.e., gains or losses) in the fair value of a derivative instrument depends on whether the instrument has been designated and qualifies as part of a hedging relationship and on the type of hedging relationship. For derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument as a fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation. The designation is based upon the nature of the exposure being hedged. At March 31, 2012 and December 31, 2011, no derivative instruments were designated as hedging instruments.

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

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aa. Fair value measurements:

Effective January 1, 2008, the Company adopted FASB ASC Topic 820, *Fair Value Measurements and Disclosures*. FASB ASC Topic 820 provides a fair value hierarchy that distinguishes between assumptions based on market data obtained from independent sources (observable inputs) and those based on an entity's own assumptions (unobservable inputs). FASB ASC Topic 820 also requires additional disclosure about fair value measurements. The adoption of FASB ASC Topic 820 did not impact the Company's consolidated balance sheet nor consolidated statement of operations.

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bb. Discontinued operations:

Under FASB ASC 205, *Presentation of Financial Statements – Discontinued Operations*, when a component of an entity, as defined in ASC 205, has been disposed of or is classified as held for sale, the results of its operations, including the gain or loss on the disposed component, should be classified as discontinued operations and the assets and liabilities of such component should be classified as assets and liabilities attributed to discontinued operations; that is, provided that the operations, assets and liabilities of the component have been eliminated from the Company's consolidated operations and the Company will no longer have any significant continuing involvement in the operations of the component.

cc. Impact of recently issued accounting standards:

In April 2011, the FASB issued ASU No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. ASU 2011-03 removes from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion for an agreement to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. This update is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. The adoption of ASU 2011-03 did not impact Taro's financial statements as the Company does not have nor is anticipating entering into any repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This standard amends Topic 820 by clarifying the following related to fair value measurement: (1) that the application of the highest and best use and valuation premise concepts apply only to nonfinancial assets which might affect entities using the in-use valuation premise to measure the fair value of financial assets, (2) provide additional requirements specific to measuring the fair value of an instrument classified in an entity's shareholders' equity and (3) that a reporting entity should disclose quantitative information about the unobservable inputs used in a Level 3 fair value measurement. This update is effective during interim and annual periods beginning after December 15, 2011 on a prospective basis. The adoption of ASU-2011 did not impact Taro's financial statements as the Company does not apply the highest and best use and valuation premise concepts, is not measuring the fair value of an instrument classified in shareholders' equity, nor does Taro have any level 3 fair value instruments.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. This standard changes the method of presenting comprehensive income. The amendment requires entities to report both the components of net income (i.e.: statement of operations) and the components of other comprehensive income either in a single continuous statement (e.g.: statement of comprehensive income) or in two separate but consecutive statements. ASU 2011-05 eliminates the option for an entity to present the components of other comprehensive income as part of the statement of changes in shareholders' equity. The amendments will be applied retrospectively and will effect interim and annual periods beginning after December 15, 2011. Although this standard did not have a material financial impact on Taro's financial statements, it changed how Taro presents the components of other comprehensive income by presenting it with the components of net income and no longer presenting it as part of the statement of changes in shareholders' equity.

In September 2011, the FASB issued ASU No. 2011-08, *Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. This standard provides the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. ASU 2011-08 intends to simplify how entities test goodwill for impairment. Under this update, an entity is not required to calculate the fair value of a reporting unit unless the entity determines through

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assessing the totality of qualitative factors that it is more likely than not that its fair value is less than its carrying amount. If there is a determination that the fair value is less than its carrying amount, then the entity would perform the two-step goodwill impairment test described in ASC Topic 350, *Intangibles - Goodwill and Other*. The amendments in this update are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011 with early adoption permitted for impairment tests performed as of a date before September 15, 2011, if the entity's financial statements for the most recent period have not been issued. This standard did not have a material financial impact on Taro's financial statements for the transition period for the three months ended March 31, 2012.

In December 2011, the FASB issued ASU No. 2011-11, *Balance Sheet (Topic 210): Testing Disclosures about Offsetting Assets and Liabilities*. This standard requires additional disclosure about financial instruments and derivative instruments that are either (1) offset in accordance with either Section 210-20-45 or Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. The amendments in this update are effective for interim and annual reporting periods beginning on or after January 1, 2013. Although this standard will not have a financial impact on Taro's financial statements, it will require additional disclosure should Taro enter into offsetting financial and derivative instruments.

In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. This standard delays implementation of a portion of ASU No. 2011-05 that requires an entity to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the Board is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. This update is effective for those annual periods beginning after December 15, 2011. This standard delays a portion of ASU No. 2011-05, and although it did not have a financial impact on Taro's financial statements for the transition period for the three months ended March 31, 2012, it will require presentation of reclassification adjustments and their effects to other comprehensive income and the income statement upon implementation.

NOTE 3: SHORT-TERM INVESTMENTS

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

| | March 31, 2012 | | | December 31, 2011 | | |
|-------------------------------------|-------------------|--------------------|-----------------|----------------------|--------------------|-----------------|
| | Amortized cost | Unrealized gain | Market value | Amortized cost | Unrealized gain | Market value |
| Available-for-sale: | | | | | | |
| Corporate and government debentures | \$ 7,810 | \$ 25 | \$ 7,835 | \$ 2,825 | \$ 76 | \$ 2,901 |

- b. The estimated fair value of available-for-sale investments as of March 31, 2012 and December 31, 2011 by contractual maturity, are as follows:

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| | March 31, 2012 | | December 31, 2011 | |
|---|-------------------|-----------------|----------------------|-----------------|
| | Cost | Market Value | Cost | Market Value |
| Available-for-sale corporate and government debentures: | | | | |
| Matures in one year | \$ 4,913 | \$ 4,913 | | |
| Matures in more than five years | 2,848 | 2,922 | 2,848 | 2,901 |
| | \$ 7,761 | \$ 7,835 | \$ 2,848 | \$ 2,901 |

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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:

| | March 31, 2012 | December 31, 2011 |
|----------------------------------|---------------------------|------------------------------|
| Trade accounts receivable, gross | \$ 201,354 | \$ 206,917 |
| Reserves for sales deductions: | | |
| Chargebacks | (20,789) | (20,145) |
| Customer rebates | (31,774) | (31,898) |
| Other sales deductions | (37,547) | (33,878) |
| Allowance for doubtful accounts | (114) | (164) |
| Trade accounts receivable, net | \$ 111,130 | \$ 120,832 |

b. Other receivables and prepaid expenses:

| | March 31, 2012 | December 31, 2011 |
|------------------------|---------------------------|------------------------------|
| Prepaid expenses | \$ 8,526 | \$ 6,915 |
| Deferred income taxes | 85,020 | 82,885 |
| Government authorities | 1,017 | 1,655 |
| Advances to suppliers | 121 | 367 |
| Derivative instruments | 3,134 | 1,693 |
| Other | 683 | 829 |
| | \$ 98,501 | \$ 94,344 |

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NOTE 5: SALES INCENTIVES

When the Company recognizes and records revenue from the sale of its pharmaceutical products, it records an estimate in the same financial reporting period for product returns, chargebacks, rebates and other sales deductions, which are reflected as reductions of the related gross revenue. 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 all 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 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 and the completeness of their reports, estimates of Taro inventory

held by smaller wholesalers and distributors, processing

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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.

Rebates and other deductions:

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

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.

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.

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The following tables summarize the activities for sales deductions and product returns for the three months ended March 31, 2012 and the year ended December 31, 2011:

For the Three months ended March 31, 2012

| | Beginning balance | Provision recorded for current period sales | Credits processed/ Payments | Ending balance |
|-------------------------------------|-------------------|---|-----------------------------|----------------|
| Accounts Receivable Reserves | | | | |
| Chargebacks | \$ (20,145) | \$ (51,711) | \$ 51,067 | \$ (20,789) |
| Rebates and Other | (65,940) | (50,349) | 46,854 | (69,435) |
| Total | \$ (86,085) | \$ (102,060) | \$ 97,921 | \$ (90,224) |
| Current Liabilities | | | | |
| Returns | \$ (30,722) | \$ (6,292) | \$ 3,588 | \$ (33,426) |
| Other (1) | (32,606) | (11,215) | 9,984 | (33,837) |
| Total | \$ (63,328) | \$ (17,507) | \$ 13,572 | \$ (67,263) |

For the Year Ended December 31, 2011

| | Beginning balance | Provision recorded for current period sales | Credits processed/ Payments | Ending balance |
|-------------------------------------|-------------------|---|-----------------------------|----------------|
| Accounts Receivable Reserves | | | | |
| Chargebacks | \$ (26,559) | \$ (224,112) | \$ 230,526 | \$ (20,145) |
| Rebates and Other | (41,567) | (150,799) | 126,426 | (65,940) |
| Total | \$ (68,126) | \$ (374,911) | \$ 356,952 | \$ (86,085) |
| Current Liabilities | | | | |
| Returns | \$ (21,962) | \$ (23,242) | \$ 14,482 | \$ (30,722) |
| Other (1) | (13,099) | (51,462) | 31,955 | (32,606) |
| Total | \$ (35,061) | \$ (74,704) | \$ 46,437 | \$ (63,328) |

(1) Includes indirect rebates.

NOTE 6: INVENTORIES

| | March 31, 2012 | December 31, 2011 |
|--|---------------------------|------------------------------|
| Raw and packaging materials | \$ 34,678 | \$ 31,810 |
| Finished goods | 51,430 | 51,699 |
| Work in progress | 17,595 | 17,762 |
| Purchased products for commercial purposes and other | 5,935 | 6,107 |
| | \$ 109,638 | \$ 107,378 |

As of March 31, 2012 and December 31, 2011, reserves recorded against inventories for slow-moving, short-dated, excess and obsolete inventory totaled \$17,406 and \$14,285, respectively.

As of March 31, 2012 and December 31, 2011, there were no pledges of inventory.

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

| | March 31, 2012 | December 31, 2011 |
|---|---------------------------|------------------------------|
| Cost: | | |
| Land | \$ 9,607 | \$ 9,521 |
| Buildings | 142,411 | 141,547 |
| Leasehold improvements | 3,270 | 3,259 |
| Machinery and equipment | 151,734 | 150,230 |
| Computer equipment | 33,253 | 32,905 |
| Motor vehicles | 236 | 264 |
| Furniture, fixtures and office equipment | 9,065 | 8,969 |
| Advances for property and equipment | 260 | 501 |
| | 349,836 | 347,196 |
| Accumulated depreciation and impairment charges: | | |
| Buildings | \$ 43,280 | \$ 41,852 |
| Leasehold improvements | 3,214 | 3,186 |
| Machinery and equipment | 113,315 | 110,801 |
| Computer equipment | 31,843 | 31,479 |
| Motor vehicles | 231 | 239 |
| Furniture, fixtures and office equipment | 7,203 | 7,107 |
| | 199,086 | 194,664 |
| Depreciated cost | \$ 150,750 | \$ 152,532 |

Depreciation expenses were \$3,731 and \$3,815 for the three months ended March 31, 2012 and 2011, respectively. For related impairment charges, see Note 2.I.

- b. Cost of property, plant and equipment includes capitalized interest expenses, capitalized direct incremental costs (such as payroll and related expenses) and other internal costs incurred in order to bring the assets to their intended use in the amount of \$16,832 as of March 31, 2012 and December 31, 2011. There was no capitalized interest and other costs for the three months ended March 31, 2012 and the year ended December 31, 2011.

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- c. Cost of computer equipment includes capitalized development costs of computer software developed for internal use in the amount of \$4,699 and \$4,689 as of March 31, 2012 and December 31, 2011, respectively.

- d. As for pledges see Note 14.

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Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****Notes to consolidated financial statements**

U.S. dollars in thousands (Unaudited)

NOTE 8: INTANGIBLE ASSETS AND DEFERRED COSTS

a. Composition:

| | March 31, 2012 | December 31, 2011 |
|---|---------------------------|------------------------------|
| Cost: | | |
| Product and distribution rights | \$ 73,438 | \$ 73,479 |
| Deferred charges in respect of loans and bonds from institutional investors | 194 | 194 |
| Other deferred costs | 1,541 | 1,541 |
| | 75,173 | 75,214 |
| Accumulated amortization and impairment charges: | | |
| Product and distribution rights | 55,168 | 54,353 |
| Deferred charges in respect of loans and bonds from institutional investors | 179 | 177 |
| Other deferred costs | 1,518 | 1,512 |
| | 56,865 | 56,042 |
| Amortized cost | \$ 18,308 | \$ 19,172 |

b. Amortization expenses related to product and distribution rights were \$867 and \$894 for the three months ended March 31, 2012 and 2011, respectively.

c. As of March 31, 2012, the estimated amortization expense of product and distribution rights for March 31, 2013 to 2017 is as follows: 2013 - \$3,444; 2014 - \$3,357; 2015 - \$3,105; 2016 - \$2,970; 2017 - \$2,963.

d. The weighted-average amortization period for product rights is approximately 6 years.

NOTE 9: LONG-TERM RECEIVABLES AND OTHER ASSETS

| | March 31, 2012 | December 31, 2011 |
|---|---------------------------|------------------------------|
| Prepayment of land leased from Israel Land Administration (1) | \$ 13,903 | \$ 13,959 |

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| | | |
|------------------------------|-----------|-----------|
| Restricted bank deposits (2) | | 3,500 |
| Derivative instruments (3) | 2,866 | 2,232 |
| Severance pay fund (4) | 2,939 | 3,159 |
| Long-term security deposit | 218 | 237 |
| Other | 46 | 44 |
| | \$ 19,972 | \$ 23,131 |

- (1) The land is leased for a period of 49 years and is subject to renewal. This amount was prepaid. See Note 2.j.
- (2) Amount represents restricted bank deposits pursuant to an interest rate swap agreement associated with loan agreements in Israel. See Note 10.
- (3) See Note 10.
- (4) Under Israeli law, the Company and its Israeli subsidiaries are required to make severance or pension payments to dismissed employees and to employees terminating employment under certain other circumstances. Deposits are made with a pension fund or other insurance plans to secure pension and severance rights for the employees in Israel. These amounts represent the balance of the deposits in those funds (including profits) that will be used to cover the Company's severance obligations. See Note 12.b.

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Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****Notes to consolidated financial statements****U.S. dollars in thousands (Unaudited)**

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 \$233, and \$861 for the three months ended March 31, 2012 and the year ended December 31, 2011, respectively.

| | Three months ended March 31, | |
|--|-------------------------------------|-------------|
| | 2012 | 2011 |
| Pension, retirement savings and severance expenses | \$ 1,690 | \$ 892 |

NOTE 10: DERIVATIVE INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

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

a. Interest rates:

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

In 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 March 31, 2012 and December 31, 2011, the fair market value of the swap was a liability of \$1,333 and \$1,423, respectively, and was recorded in other long-term liabilities on the consolidated balance sheet. The Company recorded an unrealized gain of \$91 and \$641 within financial expenses, net for the three months ended March 31, 2012 and 2011, respectively. See Note 13.a.4.

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) | Rate of Exchange of U.S. Dollar |
|-------------------|---------------------------------------|------------------------------------|
|-------------------|---------------------------------------|------------------------------------|

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| Period ended | | | Against U.S. Dollar | | | |
|--------------|------------|------------|---------------------|------------|------------|------------|
| | Israel (1) | Canada (2) | Israel (1) | Canada (2) | Israel (1) | Canada (2) |
| 12/31/2011 | 2.17% | 2.30% | 7.66% | 2.25% | 3.82 | 1.02 |
| 03/31/2012 | 0.38% | 1.25% | (2.77%) | (1.76%) | 3.72 | 1.00 |

(1) Per Bank of Israel

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Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****Notes to consolidated financial statements****U.S. dollars in thousands (Unaudited)****(2) Per Bank of Canada**

In November 2003, the Company entered into loan agreements to borrow, in Israel, NIS 210,800 for an eleven-year term at an annual interest rate of 5.8%. At the same time, the Company entered into a USD/NIS, 5-year, CPI-adjusted currency swap in which it will receive at the end of the period the NIS amount linked to the CPI plus interest equal to 5.8% of the outstanding NIS balance, and will pay \$47,190 plus a fixed rate of 5.9%. This swap matured on November 28, 2008, and was replaced on the maturity date by a USD/NIS, CPI-adjusted, 6-year currency swap. In accordance with this swap agreement, the Company receives 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 March 31, 2012, the fair market value of the swap was \$4,163 comprised of a \$1,297 asset (recorded in other receivables and prepaid expenses) and a \$2,866 asset (recorded in long-term receivables and other assets). At December 31, 2011, the fair market value of the swap was \$3,165 comprised of a \$933 asset (recorded in other receivables and prepaid expenses) and a \$2,232 asset (recorded in long-term receivables and other assets). The Company recorded net gains of \$998 and \$641 within financial expenses, net for the three months ended March 31, 2012 and 2011, respectively.

In October 2011, the Company entered into separate forward contracts to purchase the Israeli Shekel and the Canadian dollar on a monthly basis at agreed upon spot rates to hedge the variability of cash flows in U.S. dollars due to changes in the respective exchange rates. The forward contract to purchase the Shekel is for a total amount of \$45,000 which is settled in monthly installments of \$3,958 for six months and \$3,542 for six months. The Company recorded a net gain of \$1,035 and \$0 for the three months ended March 31, 2012 and 2011, respectively, for this contract. The forward contract to purchase the Canadian dollar is for a total amount of \$96,100 which is settled in monthly installments of \$9,300 for five months and \$8,267 for six months. The Company recorded a net gain of \$1,649 and \$0 for the three months ended March 31, 2012 and 2011, respectively, for this contract.

NOTE 11: FAIR VALUE MEASUREMENTS

FASB ASC Topic 820 defines fair value as the price that would be received for an asset or paid to transfer a liability, from a selling party's perspective, in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC Topic 820 requires that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

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

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.

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The fair value of the Company's financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2012 and December 31, 2011 were as follows:

| | March 31, 2012 | | |
|--------------------------|--|--|---|
| | Quoted Market Prices of Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets | | | |
| Marketable securities | \$ 7,835 | \$ | \$ |
| Forward contracts | | | 1,837 |
| Cross-currency swaps | | | 4,163 |
| | \$ 7,835 | \$ 6,000 | \$ |
| Liabilities | | | |
| Interest rate swap | \$ | \$ 1,333 | \$ |
| Forward contracts | | | 237 |
| | \$ | \$ 1,570 | \$ |
| December 31, 2011 | | | |
| | Quoted Market Prices of Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets | | | |
| Marketable securities | \$ 2,901 | \$ | \$ |
| Forward contracts | | | 760 |
| Cross-currency swaps | | | 3,165 |
| | \$ 2,901 | \$ 3,925 | \$ |
| Liabilities | | | |
| Interest rate swap | \$ | \$ 1,423 | \$ |
| Forward contracts | | | 1,483 |
| | \$ | \$ 2,906 | \$ |

NOTE 12: OTHER LIABILITIES

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a. Other current liabilities:

| | March 31, 2012 | December 31, 2011 |
|--------------------------------|---------------------------|------------------------------|
| Returns reserve | \$ 33,426 | \$ 30,722 |
| Due to customers (1) | 459 | 290 |
| Employees and payroll accruals | 15,524 | 12,840 |
| Deferred revenue | | 351 |
| Medicaid and indirect rebates | 33,378 | 32,316 |
| Accrued income taxes | 68,507 | 55,553 |
| Legal and audit fees | 658 | 848 |
| Accrued expenses | 7,091 | 12,424 |
| Interest payable | 639 | 240 |
| Deferred taxes | 302 | 284 |
| Derivative instruments | 237 | 1,483 |
| OCS and other royalties | 2,774 | 1,865 |
| Other | 1,970 | 773 |
| | \$ 164,965 | \$ 149,989 |

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

b. Other long-term liabilities:

| | March 31, 2012 | December 31, 2011 |
|-----------------------|-------------------|----------------------|
| Accrued severance pay | \$ 3,020 | \$ 3,451 |
| Interest rate swap | 1,333 | 1,423 |
| Accrued taxes | 60 | 60 |
| | \$ 4,413 | \$ 4,934 |

NOTE 13: LONG-TERM DEBT

a. Composed as follows:

| | March 31, 2012 | December 31, 2011 |
|--|-------------------|----------------------|
| Loans from institutional investors and bonds (1) | \$ 30,597 | \$ 29,783 |
| Bank loans (2) | | 19 |
| Mortgage for U.S. distribution facility (3) (4) | | 6,393 |
| Mortgage for U.S. headquarters facility (4) | 8,309 | 8,492 |
| | 38,906 | 44,687 |
| Less: current maturities | 10,957 | 17,073 |
| | \$ 27,949 | \$ 27,614 |

(1) In 2003, the Company entered into two series of loan agreements, subsequently amended, with multiple lenders in Israel. At March 31, 2012, the outstanding loans are comprised of \$1,264 (issued in U.S. dollars) at an interest rate of 6.0 - 6.1% with the remaining loans of \$29,333 (issued in NIS) at a rate of Israeli CPI plus 5.8%. The debentures mature in November 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

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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.

- (2) In April 2010, the Company entered into a vehicle financing loan of \$28 at 0.0% interest rate over 5 years for which the bank registered a lien. On March 15, 2012, the Company paid \$18 in order to retire this loan.

- (3) 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 \$0 and \$6,393, as of March 31, 2012 and December 31, 2011, respectively, was for an original term of seven years, bearing interest at the rate of LIBOR plus 1.85% and had 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,

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Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****Notes to consolidated financial statements****U.S. dollars in thousands (Unaudited)**

the principal amount of this mortgage was increased \$4,743 to \$12,993, the interest rate swap was terminated and the maturity extended to October 1, 2012. On February 3, 2012, the Company paid \$5,855 comprised of \$5,843 of principal and \$12 of interest, in order to retire this mortgage.

- (4) 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 mortgage on the New York facility was \$8,309 and \$8,492 as of March 31, 2012 and December 31, 2011, 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 March 31, 2012 and December 31, 2011, the debt service coverage ratio was 2.15. 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. As of March 31, 2012, the Company is in compliance with all of its covenants.

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

| | Weighted-Average Interest Rate | | Amount | |
|--|--------------------------------|----------------------|-------------------|----------------------|
| | March 31, 2012 | December 31, 2011 | March 31, 2012 | December 31, 2011 |
| In, or linked to, U.S. dollars (1) | 2.15% | 2.17% | \$ 9,574 | \$ 16,149 |
| In Canadian dollars (subject to variable interest rates) | 0.00% | 0.00% | | 19 |
| In Israeli currency linked to CPI | 5.80% | 5.80% | 29,332 | 28,519 |
| | | | \$ 38,906 | \$ 44,687 |

- (1) Includes loans in the amount of \$8,309 and \$14,885 as of March 31, 2012 and December 31, 2011, 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:

| | March 31, 2012 |
|-----------|-------------------|
| 3/31/2013 | \$ 10,957 |
| 3/31/2014 | 11,005 |
| 3/31/2015 | 11,056 |
| 3/31/2016 | 912 |
| 3/31/2017 | 969 |

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Thereafter

4,007

\$ 38,906

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

For collateral, see Note 14.

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Balance of liabilities collateralized by pledges is as follows:

| | March 31, 2012 | December 31, 2011 |
|---|---------------------------|------------------------------|
| Long-term debt (including current maturities) (1) | \$ 8,310 | \$ 14,904 |

(1) Long-term debt primarily includes mortgages secured by facilities in the U.S.A. For further discussion of collateralized assets see Note 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 2018. The minimum annual rental payments, under non-cancelable lease agreements, are as follows:

| | March 31, 2012 |
|------------|---------------------------|
| 3/31/2013 | \$ 2,695 |
| 3/31/2014 | 1,979 |
| 3/31/2015 | 1,515 |
| 3/31/2016 | 858 |
| 3/31/2017 | 434 |
| Thereafter | 759 |
| | \$ 8,240 |

Total rent expenses were \$921 and \$886 for the three months ended March 31, 2012 and 2011, respectively.

- b. Royalty commitments:

The Company is committed to pay royalties at the rate of 3.0% to 3.5% 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

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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 March 31, 2012 and December 31, 2011, the aggregate contingent liability to the OCS was approximately \$10,735 and \$10,609, respectively.

Royalty payments to the OCS were \$0 and \$736 for the three months ended March 31, 2012 and the year ended December 31, 2011, respectively.

c. Legal proceedings:

From time to time the Company is subject to litigation arising in the ordinary course of business. 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.

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

U.S. dollars in thousands (Unaudited)

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.

On June 15, 2008, the Company brought a lawsuit in the Tel-Aviv 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.

In May 2008, the State of Utah filed a lawsuit against the Company and a number of other pharmaceutical manufacturers. Generally speaking, the lawsuit alleges that the defendants caused the State to overpay pharmacies under the State Medicaid Program by reporting inflated published prices (average wholesale prices or AWP). The trial court dismissed the case with prejudice in February 2010. However, in March 2010, the plaintiff appealed the decision and the Utah Supreme Court issued its decision in June 2012. The ruling generally affirmed that the complaint by the plaintiff is inadequate and the State has been given leave by the court to re-plead its case.

In November 2010, the State of Louisiana filed a lawsuit in state court against the Company and a number of other pharmaceutical manufacturers. This lawsuit, similarly to the lawsuit filed by the State of Utah, also alleges that the defendants caused the State to overpay pharmacies under the State Medicaid Program by reporting inflated AWP's. The parties are currently in the discovery phase of the litigation. We are not in a position to quantify the likely outcome of these AWP cases.

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 originally sought \$6.3 million in fees and expenses and has subsequently amended its pleadings to adjust its claim to \$3.7 million. The parties are currently in the discovery phase of the litigation, and the Company denies liability in the matter.

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 Company then filed an amended complaint on August 22, 2011 to include a newly issued patent, United States Patent No. 7,977,324. The suit alleges that Suven's ANDA to sell its own malathion lotion infringes Taro's patent.

- d. In 2008, the Company entered into severance agreements tied to a 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 the employment of certain of these executives.
- 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.

f. Licensing Agreements:

1. On February 21, 2012, the Company entered into a License and Settlement Agreement (the "Medicis Settlement Agreement") with Medicis Pharmaceutical Corporation. In connection with the Medicis Settlement Agreement, we agreed to settle all legal disputes between the parties relating to Medicis' LOPROX[®] Shampoo and Medicis agreed to withdraw its complaint against Taro pending in the U.S. District Court for the Southern District of New York for alleged patent infringement. Subject to the terms and conditions contained in the Medicis Settlement Agreement, Medicis granted Taro a non-exclusive, royalty-bearing license to make and sell limited quantities of our generic version of LOPROX[®] Shampoo.

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

U.S. dollars in thousands (Unaudited)

g. Other:

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

NOTE 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, or 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, and none of the options granted include stock appreciation rights. The options were 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 March 31, 2012 and December 31, 2011, an aggregate of 6,425 options in respect of the 1991 plan were outstanding, and no further options in respect of the 1991 plan are available for future grants. The Company issues new shares to employees and associates exercising their stock options.

2. The Company's 1999 Stock Incentive Plan (1999 plan) provides for the issuance of incentive stock options, non-qualified stock options, or 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, and none of the options granted include stock appreciation rights. The options were 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 March 31, 2012 and December 31, 2011, an aggregate of 322,630 and 325,130 options in respect of the 1999 plan were outstanding, respectively, and 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.

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3. A summary of the Company's stock option activity (except options to non-employees) and related information for the three months ended March 31, 2012 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, 2011 | 331,555 | \$ 2.38 - \$68.51 | \$ 26.08 | | |
| Exercised | (500) | \$ 13.64 | \$ 13.64 | | |
| Forfeited | (2,000) | \$ 26.09 - \$68.51 | \$ 43.82 | | |
| Granted | | \$ | \$ | | |
| Outstanding at March 31, 2012 | 329,055 | \$ 2.38 - \$68.51 | \$ 25.99 | 1.87 | \$ 4,800 |
| Exercisable at March 31, 2012 | 329,055 | | \$ 25.99 | 1.87 | \$ 4,800 |
| Vested at March 31, 2012 | 329,055 | | \$ 25.99 | 1.87 | \$ 4,800 |

The shares exercised for the three months ended March 31, 2012 and the year ended December 31, 2011 were 500 and 32,775, respectively, with a total intrinsic value of \$12 and \$378, respectively. As of March 31, 2012, there was \$8 of unrecognized compensation costs related to share-based compensation arrangements granted under the Company's stock option plan. For the three months ended March 31, 2012 and 2011, the Company recognized \$0 and \$20, respectively, in stock-based compensation expense.

The number of options exercisable as of March 31, 2012 and December 31, 2011 were 329,055 and 331,555, respectively. The weighted-average exercise prices for the options exercisable as of March 31, 2012 and December 31, 2011 were \$25.99 and \$26.08, respectively.

The stock options outstanding and exercisable as of March 31, 2012 have been classified into ranges of exercise prices as follows:

| Range of exercise price | Options outstanding | | | Options exercisable | |
|-------------------------|----------------------------------|--|---------------------------------|----------------------------------|---------------------------------|
| | Outstanding as of March 31, 2012 | Weighted-average remaining contractual life (in years) | Weighted-average exercise price | Exercisable as of March 31, 2012 | Weighted-average exercise price |
| \$ 2.38 - \$10.00 | 7,425 | 0.25 | \$ 2.79 | 7,425 | \$ 2.79 |
| \$10.01 - \$20.00 | 118,750 | 2.03 | \$ 13.08 | 118,750 | \$ 13.08 |
| \$20.01 - \$30.00 | 87,500 | 2.26 | \$ 24.09 | 87,500 | \$ 24.09 |
| \$30.01 - \$40.00 | 62,630 | 1.33 | \$ 32.80 | 62,630 | \$ 32.80 |
| \$40.01 - \$68.51 | 52,750 | 1.72 | \$ 53.36 | 52,750 | \$ 53.36 |

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| | | | | |
|---------|------|----------|---------|----------|
| 329,055 | 1.87 | \$ 25.99 | 329,055 | \$ 25.99 |
|---------|------|----------|---------|----------|

4. There was no stock option activity associated with non-employees during the three months ended March 31, 2012. There were 3,000 stock options forfeited by non-employees during the year ended December 31, 2011.

d. Dividends:

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

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Table of Contents**TARO PHARMACEUTICAL INDUSTRIES LTD.****Notes to consolidated financial statements****U.S. dollars in thousands (Unaudited)**

e. Net income per share:

| | Three months ended March 31, 2012 | | | Three months ended March 31, 2011 | | |
|--------------------------------|---|-------------------------|------------------------|---|-------------------------|------------------------|
| | Net income attributable to Taro (numerator) | Shares (denominator) | Per Share Amount | Net income attributable to Taro (numerator) | Shares (denominator) | Per Share Amount |
| Basic EPS: | \$ 47,252 | 44,476,429 | \$ 1.06 | \$ 25,658 | 44,284,556 | \$ 0.58 |
| Effect of dilutive securities: | | | | | | |
| Stock options | | 112,578 | | | 162,737 | |
| Diluted EPS: | \$ 47,252 | 44,589,007 | \$ 1.06 | \$ 25,658 | 44,447,293 | \$ 0.58 |

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 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 2012, 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:

- Generally, Israeli companies are subject to corporate tax on taxable income. On December 6, 2011, the Knesset approved an amendment pursuant to the Law for Change in the Tax Burden (Legislative Amendments) which will apply beginning in 2012. The amendment includes mainly outline stop reduction of corporate tax rates determined in the Economic Efficiency Law, (Legislative Amendments to implement the economic program for 2009 and 2010) and increase the rate of corporation tax, capital gains tax and betterment tax to 25%. Accordingly, the Company adjusted deferred tax assets and liabilities. However; the effective tax rate payable by a company that derives income from an Approved Enterprise, as discussed below, may be considerably less.
- 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

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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.

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TARO PHARMACEUTICAL INDUSTRIES LTD.

Notes to consolidated financial statements

U.S. dollars in thousands (Unaudited)

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

The Company has five Approved Enterprise plans. Under the approved plans, the undistributed income derived from the Approved Enterprise will be exempt from corporate tax for a period of two to four years, and the Company will be eligible for a reduced tax rate of between 10% and 25% for an additional six to eight years. Notwithstanding the foregoing, the Company's undistributed income will be eligible for a reduced tax rate for an additional five years. Under the fourth plan, which was approved in September 2011, the undistributed income was exempted 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 filed a request for an additional five years of reduced tax rates. The fifth plan, is according to the new Approved Enterprise plan, which does not need approval and its benefits start in 2010. The undistributed income will be exempt from corporate tax for a period of two years and another eight years of 10% - 25% tax. The first two plans already finished their benefit periods.

The entitlement to these benefits is conditional upon the Company fulfilling the requirements of the Law, regulations published thereunder and the instruments of approval for the specific investments in Approved Enterprises. In the event of failure to comply with these requirements, the benefits may be canceled and the Company may be required to refund the amount of the benefits, in whole or in part, including interest. As of March 31, 2012, 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 as the undistributed tax exempt income is essentially permanent by reinvestment.

Income from sources other than the Approved and Privileged Enterprise programs is subject to tax at regular Israeli corporate tax rate.

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.

For the three months ended March 31, 2012, income not eligible for Approved Enterprise benefits mentioned above is taxed at the regular rate of 24% (see g below).

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

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upon distribution or liquidation and the Company may be required to record deferred tax liability with respect to such tax-exempt income. 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).

On December 29, 2010, new legislation amending the Investment Law was adopted. Under this new legislation, a uniform corporate tax rate will apply to all qualifying income of certain Industrial Companies, as opposed to the current law's incentives, which are limited to income from Approved Enterprises during their benefits period. Under the new law, the uniform tax rate will be 10% in areas in Israel designated as Development Zone A and 15% elsewhere in Israel during 2011-2012, 7% and 12.5%, respectively, in 2013-2014, and 6% and 12%, respectively thereafter. Certain Special Industrial Companies that meet certain criteria (somewhat equivalent to the criteria for the Strategic Investment Track) will enjoy further reduced tax rates of 5% in Zone A and 8% elsewhere. The profits of these Industrial Companies will be freely distributable as dividends, subject to a 15% withholding tax (or lower, under an applicable tax treaty). The Company did not choose to adopt the new uniform corporate tax rate track.

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

The Company qualifies as an Industrial Company within the meaning of the Law for the Encouragement of Industry (Taxes), 1969 (the Industrial Encouragement Law). The Industrial Encouragement Law defines an Industrial Company as a company that is resident in Israel and that derives at least 90% of its income in any tax year, other than income from defense loans, capital gains, interest and dividends, from an enterprise whose major activity in a given tax year is industrial production. Under the Industrial Encouragement Law the Company is entitled to amortization of the cost of purchased know-how and patents over an eight-year period for tax purposes as well as accelerated depreciation rates on equipment and buildings.

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

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

g. Tax rates applicable to the income of the Company:

The Israeli corporate tax rate is 24% in for the three months ended March 31, 2012 and 24% for the year ended December 31, 2011. However, the Israel Income Tax Authority approved the Israeli companies a special tax year starting January 1, 2011 and ending March 31, 2012 and therefore the applicable tax rate for the 3 months ended March 31, 2012 is 24%.

A company is taxable on its real (non-inflationary) capital gains at the corporate tax rate in the year of sale.

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On December 5, 2011, the Israeli Parliament (the Knesset) passed the Law for Tax Burden Reform (Legislative Amendments), 2011 (the Law) which, among others, cancels effective from 2012, the scheduled progressive reduction in the corporate tax rate. The Law also increases the corporate tax rate to 25% in 2012. In view of this increase in the corporate tax rate to 25% in 2012, the real capital gains tax rate and the real betterment tax rate were also increased accordingly.

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

| | Three months ended March 31, | |
|--|-------------------------------------|------------------|
| | 2012 | 2011 |
| Domestic (Israel) | \$ 26,241 | \$ 18,045 |
| Foreign (North America, the Cayman Islands, Ireland and the U.K.) | 38,953 | 14,276 |
| Income from continuing and discontinued operations before taxes | \$ 65,194 | \$ 32,321 |

- i. Taxes on income are comprised of the following:

| | Three months ended March 31, | |
|-----------------------|-------------------------------------|-----------------|
| | 2012 | 2011 |
| Current taxes | \$ 9,352 | \$ 2,451 |
| Prior years taxes | 4,364 | |
| Deferred income taxes | 4,075 | 3,917 |
| | \$ 17,791 | \$ 6,368 |
| Domestic | \$ 1,730 | \$ 1,554 |
| Foreign | 16,061 | 4,814 |
| | \$ 17,791 | \$ 6,368 |

Included within current and deferred income tax expense are benefits relating to investment tax credits at Taro Canada of \$613 and \$1,954 for the three months ended March 31, 2012 and the year ended December 31, 2011, respectively. Taro Canada uses the flow-through method and therefore records the benefits in earnings in the period the tax credits are utilized.

- j. Reconciliation of the statutory tax rate of the parent company in Israel to the effective consolidated tax rate:

| | Three months ended March 31, | |
|--------------------------------|-------------------------------------|-------------|
| | 2012 | 2011 |
| Statutory tax rate (In Israel) | 24% | 24% |

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(Decrease) increase in effective tax rate due to:

| | | |
|---|------|------|
| Mainly tax benefits from reduced tax rates under benefit programs | (4%) | (9%) |
| Different tax rates applicable to non-Israeli subsidiaries | 1% | 4% |
| Uncertain tax positions, net | (1%) | 1% |
| Taxes from prior years | 7% | 0% |
| Effective consolidated tax rate | 27% | 20% |

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- k. Current taxes are calculated at the following rates:

| | Three months ended March 31, | |
|--|-------------------------------------|-------------|
| | 2012 | 2011 |
| On Israeli operations (not including Approved Enterprise) | 24.0% | 24.0% |
| On U.S. operations * | 35.0% | 35.0% |
| On Canadian operations * | 25.0% | 26.5% |
| On U.K. operations * | 26.5% | 28.0% |
| On Ireland operations * | 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.

- l. 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.

| | March 31, | December 31, |
|---|------------------|---------------------|
| | 2012 | 2011 |
| Deferred tax assets: | | |
| Net operating loss carryforward | \$ 11,844 | \$ 17,316 |
| Deferred revenue | 18,459 | 21,220 |
| Property, plant, and equipment | 1,843 | 2,261 |
| Accrued expenses | 54,087 | 48,851 |
| Bad debt allowance | 37 | 40 |
| Amortization and impairment | 7,222 | 7,326 |
| Other, net | 11,665 | 11,630 |
| Total deferred tax assets | 105,157 | 108,644 |
| Valuation allowance for deferred tax assets | (13,688) | (13,458) |
| Net deferred tax assets | 91,469 | 95,186 |
| Deferred tax liabilities: | | |
| Property, plant, and equipment | (2,205) | (1,897) |
| Amortization | | 46 |
| Other, net | (302) | (283) |

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| | | |
|---------------------------------------|-----------|-----------|
| Total deferred tax liabilities | (2,507) | (2,134) |
| Net deferred tax assets (liabilities) | \$ 88,962 | \$ 93,052 |
| Domestic | \$ 5,655 | \$ 4,354 |
| Foreign | 83,307 | 88,698 |
| | \$ 88,962 | \$ 93,052 |

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

| | March 31, 2012 | December 31, 2011 |
|---|---------------------------|------------------------------|
| Among current assets (other receivables and prepaid expenses) | \$ 85,020 | \$ 82,885 |
| Long-term deferred income tax assets | 6,449 | 12,302 |
| Among short-term liabilities | (302) | (284) |
| Among long-term liabilities | (2,205) | (1,851) |
| | \$ 88,962 | \$ 93,052 |

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U.S. dollars in thousands (Unaudited)

m. Carryforward tax losses:

1. *The Company:*

As of March 31, 2012, one of the Israeli subsidiaries has carryforward tax losses of \$1,287.

2. *Canadian subsidiary:*

As of March 31, 2012, this subsidiary has no carryforward tax losses.

3. *U.K. subsidiary:*

As of March 31, 2012, this subsidiary has carryforward tax losses of \$10,632, which may be carried forward and offset against taxable income for an indefinite period in the future. As discussed in Note 2.s, there is a full valuation allowance provided against these losses.

4. *Irish subsidiary:*

As of March 31, 2012, this subsidiary has carryforward tax losses of \$72,122. Taro Ireland commenced trade in 2006 and therefore has satisfied any expiration deadlines. As discussed in Note 2.s, a full valuation allowance is provided against these losses.

5. *U.S. subsidiary:*

As of March 31, 2012, this subsidiary has no carryforward tax losses. 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 had a past net operating loss carryforward, the U.S. subsidiary remained subject to examination by the U.S. tax authorities from 2002 onward, but only to the extent of the amount of the net operating loss carryforward.

6. *Hungarian subsidiary:*

As of March 31, 2012, this subsidiary has no carryforward tax losses.

- n. 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.

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o. At March 31, 2012, deferred income taxes were not provided for on a cumulative total of \$215,644 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.

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

q. Tax assessments:

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

The Company is now in the process of a tax audit for the years 2004-2008, Taro Research Institute Ltd. is now in the process of a tax audit for the years 2006 - 2008, Taro International Ltd. is now in the process of a tax audit for the years 2004-2008.

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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.

The Company completed its tax assessments with the Canadian tax authorities for the years through 2003. The Company's tax provision was adequate to satisfy these assessments. Taro Canada has the 2004 and 2005 tax years currently under examination and remains subject to examination by the Canadian tax authorities for years after 2005. The Company believes that its tax provision is adequate to satisfy any assessments resulting from examinations related to these years.

r. Uncertain tax positions:

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

| | March 31, 2012 | December 31, 2011 |
|--|---------------------------|------------------------------|
| Unrecognized tax exposure at beginning of year | \$ 14,425 | \$ 21,117 |
| Increases as a result of positions taken in prior period | 92 | 7 |
| Decreases as a result of positions taken in prior period | | (301) |
| Increases as a result of positions taken in current period | 36 | 635 |
| Decreases as a result of positions taken in current period | (725) | |
| Decreases due to settlements with tax authorities | | (6,994) |
| Decreases due to expiration of statute of limitations | | (39) |
| Unrecognized tax exposure at end of year | \$ 13,828 | \$ 14,425 |

The total amount of interest and penalties recognized on the consolidated statement of operations for the three months ended March 31, 2012 and 2011 were \$806 and \$554, respectively. The total amount of interest and penalties recognized on the consolidated balance sheet at March 31, 2012 and December 31, 2011 were \$4,354 and \$3,825, respectively.

The total amount of unrecognized tax benefits, which would impact the effective tax rate if recognized, was \$13,828 and \$14,425 at March 31, 2012 and December 31, 2011, respectively.

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U.S. dollars in thousands (Unaudited)

NOTE 18: SELECTED STATEMENTS OF INCOME DATA

| | Three Months Ended March 31, | |
|---|-------------------------------------|-------------|
| | 2012 | 2011 |
| Sales by location of customers : | | |
| Israel | \$ 5,472 | \$ 5,966 |
| Canada | 13,167 | 10,394 |
| U.S.A. | 122,472 | 87,036 |
| Other | 4,030 | 4,331 |
| | \$ 145,141 | \$ 107,727 |
| Selling, marketing, general and administrative expenses: | | |
| Selling and marketing | \$ 12,192 | \$ 10,614 |
| Advertising | 2,166 | 1,509 |
| General and administrative * | 8,743 | 10,337 |
| | \$ 23,101 | \$ 22,460 |
| * Including provision for doubtful accounts | \$ (50) | \$ 3 |
| Financial (income) expenses: | | |
| Interest and exchange differences on long-term liabilities | \$ 368 | \$ (916) |
| Income in respect of deposits | (510) | (370) |
| Expenses in respect of short-term credit | 35 | 11 |
| Foreign currency transaction losses | 1,107 | 2,462 |
| | \$ 1,000 | \$ 1,187 |

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*.

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| | Israel | Canada* | U.S.A. | Other | Consolidated |
|--|-----------|-----------|------------|----------|--------------|
| Three months ended March 31, 2012 and as of March 31, 2012: | | | | | |
| Sales to unaffiliated customers ** | \$ 5,472 | \$ 13,167 | \$ 122,472 | \$ 4,030 | \$ 145,141 |
| Long-lived assets *** | \$ 91,245 | \$ 40,148 | \$ 42,607 | \$ 2,342 | \$ 176,342 |
| Three months ended March 31, 2011 and as of December 31, 2011: | | | | | |
| Sales to unaffiliated customers ** | \$ 5,966 | \$ 10,394 | \$ 87,036 | \$ 4,331 | \$ 107,727 |
| Long-lived assets *** | \$ 92,547 | \$ 41,010 | \$ 43,133 | \$ 2,291 | \$ 178,981 |

* Includes operations in both Canada and Cayman Islands.

** Based on customer's location.

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

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- b. For the three months ended March 31, 2012, the Company had net sales to three different customers of 24.1%, 12.7% and 11.9% of consolidated net sales. For the three months ended March 31, 2011, the Company had net sales to three different customers of 18.3%, 11.3% and 10.9% of consolidated net sales.
- c. Sales by therapeutic category, as a percentage of total sales for the three months ended March 31, 2012 and 2011:

| Category | Three months ended March 31, | |
|----------------------------|------------------------------|------------|
| | 2012 | 2011 |
| | % | |
| Dermatological and topical | 70 | 61 |
| Neuropsychiatric | 10 | 14 |
| Cardiovascular | 9 | 10 |
| Anti-inflammatory | 4 | 6 |
| Other | 7 | 9 |
| Total | 100 | 100 |

NOTE 20: DISCONTINUED OPERATIONS

- a. During 2010, the Company's management decided to sell its Irish facility. The results of operations of the Irish facility have been classified as discontinued operations in the Consolidated Statements of Operations.
- b. The following is the detail of discontinued operations:

| | Three months ended March 31, | |
|--|------------------------------|--------|
| | 2012 | 2011 |
| Sales, net | \$ (9) | \$ (8) |
| Cost of sales | 72 | 76 |
| Gross loss | 63 | 68 |
| Operating expenses: | | |
| Research and development, net | | 4 |
| Selling, marketing, general and administrative | 34 | 58 |
| Operating loss | 97 | 130 |
| Financial expenses, net | (103) | 10 |
| Other gain, net | (60) | (5) |

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| | | |
|--|---------|--------|
| (Income) loss before income taxes | (66) | 135 |
| Tax expense | | |
| Net (income) loss from discontinued operations | \$ (66) | \$ 135 |

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Notes to consolidated financial statements

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NOTE 21: RELATED PARTY TRANSACTIONS

The Company has substantial relationships with Sun. Certain of Taro's Board members 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.

During 2012 and 2011, Taro entered into various commercial transactions, including product distribution and service agreements with Sun in the ordinary course of our business. The Company does not currently deem any of these material or unusual and believes that terms of these transactions are comparable to those offered by or that could be obtained from unrelated third parties. Additionally, pursuant to Israeli legal requirements, each of the transactions was presented to the Audit Committee, which determined that each such transaction was not considered extraordinary pursuant to Israeli legal requirements and therefore did not require shareholder approval.

On October 18, 2011, the Company received a letter from Sun making a non-binding proposal for the acquisition of all of the issued and outstanding shares of Taro, not currently held by Sun, at a price of \$24.50 per share, in cash. The Company's Board of Directors formed an independent Special Committee, comprised of Professor Dov Pekelman (Chairman of the Special Committee), Ilana Avidov-Mor and Dan Biran, to review and evaluate the offer with its independent financial and legal advisors.

NOTE 22: SUBSEQUENT EVENTS

- a. As of March 31, 2012, Mr. Elisha Saar, an independent public accountant, was terminated as the Company's internal auditor and as of that same date, Mrs. Rita Gerson was appointed by the Company's Board of Directors as internal auditor and ceased being an officer of the Company.
- b. On April 18, 2012, Mr. Dilip Shanghvi resigned as Chairman and a member of Taro's Board of Directors and Mr. Kalyanasundaram Subramanian, known in industry circles as Kal Sundaram, has been appointed as Mr. Shanghvi's replacement, serving on the Board as its Chairman until Taro's next Annual General Meeting of Shareholders.
- c. Stock options:
Between January 1, 2012 and June 28, 2012, no stock options were granted to the Company's directors or employees.

End of consolidated financial statements

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TARO PHARMACEUTICAL INDUSTRIES LTD.

U.S. dollars in thousands (Unaudited)

SCHEDULE II: VALUATION AND QUALIFYING ACCOUNTS

Schedules have been omitted as the required information is provided elsewhere in these financial statements.

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