

**TOWER SEMICONDUCTOR LTD.
AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2009**

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM


To the Board of Directors and Stockholders of Tower Semiconductor Ltd.

We have audited the accompanying consolidated balance sheets of Tower Semiconductors Ltd. and subsidiaries (the "Company") as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Tower Semiconductors Ltd. and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 5 to the financial statements, the Company changed its method of accounting for inventory valuation


Brightman Almagor Zohar & Co.

Certified Public Accountants

A Member Firm of Deloitte Touche Tohmatsu

**Tel Aviv, Israel
February 24, 2010**

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

| | Note | As of December 31, | |
|---|-------------|--------------------|------------|
| | | 2009 | 2008 |
| A S S E T S | | | |
| CURRENT ASSETS | | | |
| Cash and cash equivalents | | \$ 81,795 | \$ 34,905 |
| Trade accounts receivable | 18 | 40,604 | 45,860 |
| Other receivables | 4 | 2,520 | 2,320 |
| Inventories | 5 | 32,250 | 40,899 |
| Other current assets | 20 | 10,304 | 6,777 |
| Total current assets | | 167,473 | 130,761 |
| LONG-TERM INVESTMENTS | 6 | 29,361 | 29,499 |
| PROPERTY AND EQUIPMENT, NET | 7 | 371,400 | 449,697 |
| INTANGIBLE ASSETS, NET | 8 | 67,601 | 81,034 |
| GOODWILL | 3 | 7,000 | 7,000 |
| OTHER ASSETS , NET | 9 | 8,002 | 8,802 |
| TOTAL ASSETS | | \$ 650,837 | \$ 706,793 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | |
| CURRENT LIABILITIES | | | |
| Current maturities of convertible debentures | 13 | \$ -- | \$ 8,330 |
| Short-term bank loan | 10 | 7,000 | 7,000 |
| Trade accounts payable | | 42,012 | 49,462 |
| Deferred revenue and short-term customers' advances | | 24,696 | 6,634 |
| Other current liabilities | 11 | 23,652 | 35,202 |
| Total current liabilities | | 97,360 | 106,628 |
| LONG-TERM LOANS FROM BANKS | 10, 12, 14 | 187,606 | 222,989 |
| DEBENTURES | 13, 14 | 241,207 | 208,512 |
| LONG-TERM CUSTOMERS' ADVANCES | 16A | 8,262 | 11,138 |
| OTHER LONG-TERM LIABILITIES | 15 | 60,388 | 45,959 |
| Total liabilities | | 594,823 | 595,226 |
| SHAREHOLDERS' EQUITY | 13, 16A, 17 | 56,014 | 111,567 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | | \$ 650,837 | \$ 706,793 |

See notes to consolidated financial statements.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

(dollars in thousands, except per share data)

| | <u>Note</u> | Year ended December 31, | | |
|---|-------------|-------------------------|--------------|--------------|
| | | 2009 | 2008 | 2007 |
| REVENUES | 18 | \$ 298,812 | \$ 251,659 | \$ 230,853 |
| COST OF REVENUES | | 325,310 | 296,513 | 284,771 |
| GROSS LOSS | | (26,498) | (44,854) | (53,918) |
| OPERATING COSTS AND EXPENSES | | | | |
| Research and development | | 23,375 | 14,969 | 13,790 |
| Marketing, general and administrative | | 31,943 | 33,223 | 31,604 |
| Write-off of in-process research and development | 3 | -- | 1,800 | -- |
| Merger related costs | | -- | 520 | -- |
| Fixed assets impairment | 7B | -- | 120,538 | -- |
| | | 55,318 | 171,050 | 45,394 |
| OPERATING LOSS | | (81,816) | (215,904) | (99,312) |
| FINANCING EXPENSE, NET | 14, 19 | (45,710) | (17,566) | (34,976) |
| GAIN ON DEBT RESTRUCTURING | 12B | -- | 130,698 | -- |
| OTHER INCOME (EXPENSE), NET | | 2,045 | (918) | 92 |
| LOSS BEFORE INCOME TAX | | (125,481) | (103,690) | (134,196) |
| INCOME TAX BENEFIT (PROVISION) | 20 | 5,022 | (1,455) | -- |
| LOSS FOR THE YEAR | | \$ (120,459) | \$ (105,145) | \$ (134,196) |
| BASIC AND DILUTED LOSS PER ORDINARY SHARE | | | | |
| Loss per share | | \$ (0.71) | \$ (0.78) | \$ (1.13) |
| Weighted average number of ordinary shares outstanding - in thousands | | 170,460 | 134,749 | 118,857 |

See notes to consolidated financial statements.

TOWER SEMICONDUCTOR LTD.
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(dollars in thousands)

| | Ordinary shares | | Additional paid-in capital | Capital notes | Cumulative stock based compensation | Treasury stock | Accumulated Other comprehensive gain (loss) | Accumulated deficit | Comprehensive income (loss) | Total |
|---|---------------------|-----------|----------------------------|---------------|-------------------------------------|----------------|---|---------------------|-----------------------------|------------|
| | Shares-in thousands | Amount | | | | | | | | |
| BALANCE - JANUARY 1, 2007 | 102,053 | \$ 24,187 | \$ 570,984 | \$ 176,401 | \$ 4,870 | \$ (9,072) | \$ (203) | \$ (727,651) | | \$ 39,516 |
| Issuance of shares and warrants | 22,705 | 5,398 | 29,469 | | | | | | | 34,867 |
| Conversion of convertible debentures to shares | 592 | 142 | 674 | | | | | | | 816 |
| Employee stock-based compensation | | | | | 8,731 | | | | | 8,731 |
| Exercise of options | 176 | 44 | 183 | | | | | | | 227 |
| Reclassification of bifurcated conversion option to shareholders' equity | | | 28,377 | | | | | | | 28,377 |
| Stock-based compensation, Note 17B(5) | | | 1,331 | | | | | | | 1,331 |
| Other comprehensive loss | | | | | | | (167) | | (167) | (167) |
| Cumulative effect adjustment of the Facility Agreement to retained earnings | | | | | | | | 65,207 | 65,207 | 65,207 |
| Loss for the year | | | | | | | | (134,196) | (134,196) | (134,196) |
| Comprehensive loss | | | | | | | | | (69,156) | (69,156) |
| BALANCE - DECEMBER 31, 2007 | 125,526 | \$ 29,771 | \$ 631,018 | \$ 176,401 | \$ 13,601 | \$ (9,072) | \$ (370) | \$ (796,640) | | \$ 44,709 |
| Issuance of shares and warrants | 34,257 | 9,699 | 37,045 | | | | | | | 46,744 |
| Conversion of convertible debentures to shares | 1,543 | 459 | 1,692 | | | | | | | 2,151 |
| Employee stock-based compensation | | | | | 6,127 | | | | | 6,127 |
| Exercise of options | | | | | | | | | | - |
| Reclassification of bifurcated conversion option to shareholders' equity | | | 3,907 | | | | | | | 3,907 |
| Capital notes | | | | 115,071 | | | | | | 115,071 |
| Other comprehensive loss | | | | | | | (1,997) | | (1,997) | (1,997) |
| Loss for the year | | | | | | | | (105,145) | (105,145) | (105,145) |
| Comprehensive loss | | | | | | | | | (107,142) | (107,142) |
| BALANCE - DECEMBER 31, 2008 | 161,326 | \$ 39,929 | \$ 673,662 | \$ 291,472 | \$ 19,728 | \$ (9,072) | \$ (2,367) | \$ (901,785) | | \$ 111,567 |
| Issuance of shares and warrants | 36,114 | 9,572 | 24,534 | | | | | | | 34,106 |
| Conversion of convertible debentures to shares | 2,796 | 744 | 3,357 | | | | | | | 4,101 |
| Employee stock-based compensation | | | | | 2,841 | | | | | 2,841 |
| Exercise of options | 25 | 6 | 15 | | | | | | | 21 |
| Stock-based compensation, Note 17B(5) | | | 3,829 | | | | | | | 3,829 |
| Reclassification of options and warrants | | | (13,661) | | | | | 12,800 | | (861) |
| Capital notes | | | | 20,000 | | | | | | 20,000 |
| Other comprehensive loss | | | | | | | 869 | | 869 | 869 |
| Loss for the year | | | | | | | | (120,459) | (120,459) | (120,459) |
| Comprehensive loss | | | | | | | | | (119,590) | (119,590) |
| BALANCE - DECEMBER 31, 2009 | 200,261 | \$ 50,251 | \$ 691,736 | \$ 311,472 | \$ 22,569 | \$ (9,072) | \$ (1,498) | \$ (1,009,444) | | \$ 56,014 |
| BALANCE, NET OF TREASURY STOCK - AS OF DECEMBER 31, 2009, NOTE 17D | | 198,961 | | | | | | | | |

See notes to consolidated financial statements.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

| | Year ended December 31, | | |
|---|-------------------------|--------------|--------------|
| | 2009 | 2008 | 2007 |
| CASH FLOWS - OPERATING ACTIVITIES | | | |
| Loss for the year | \$ (120,459) | \$ (105,145) | \$ (134,196) |
| Adjustments to reconcile loss for the year to net cash provided by operating activities: | | | |
| Income and expense items not involving cash flows: | | | |
| Gain on debt restructuring | -- | (130,698) | -- |
| Depreciation and amortization | 143,404 | 138,808 | 154,343 |
| Effect of indexation, translation and fair value measurement on debt | 3,131 | (6,937) | 6,227 |
| Fixed assets impairment | -- | 120,538 | |
| Other expense (income), net | (2,045) | 918 | (92) |
| Write-off of in-process research and development | -- | 1,800 | -- |
| Changes in assets and liabilities: | | | |
| Trade accounts receivable | 5,256 | 15,666 | (13,479) |
| Other receivables and other current assets | 234 | 6,407 | 333 |
| Inventories | 8,649 | (6,178) | 459 |
| Trade accounts payable | (6,185) | (5,119) | 15,435 |
| Deferred revenue and customers' advances | 15,435 | (13,522) | (11,919) |
| Other current liabilities | (5,595) | (7,224) | (1,363) |
| Other long-term liabilities | (4,576) | 3,247 | 935 |
| Net cash provided by operating activities | 37,249 | 12,561 | 16,683 |
| CASH FLOWS - INVESTING ACTIVITIES | | | |
| Investments in property and equipment | (28,066) | (87,224) | (107,485) |
| Investment grants received | -- | -- | 1,654 |
| Proceeds related to sale and disposal of property and equipment | -- | -- | 108 |
| Acquisition of subsidiary consolidated for the first time (a) | (1,472) | 2,616 | -- |
| Investments in other assets and intangible assets | -- | (1,004) | (1,547) |
| Decrease in short-term interest-bearing deposits | -- | -- | 1,230 |
| Long-term investments | -- | -- | (950) |
| Net cash used in investing activities | (29,538) | (85,612) | (106,990) |
| CASH FLOWS - FINANCING ACTIVITIES | | | |
| Proceeds from long-term loans | -- | 52,000 | 28,000 |
| Proceeds on account of shareholders' equity | 52,922 | 20,000 | 26,761 |
| Proceeds from issuance of debentures and warrants, net | -- | 1,440 | 50,690 |
| Repayment of debenture | (8,254) | (8,179) | (7,088) |
| Debts repayment | (5,416) | (2,000) | (3,230) |
| Net cash provided by financing activities | 39,252 | 63,261 | 95,133 |
| Effect of foreign exchange rate change | (73) | 159 | -- |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 46,890 | (9,631) | 4,826 |
| CASH AND CASH EQUIVALENTS - BEGINNING OF YEAR | 34,905 | 44,536 | 39,710 |
| CASH AND CASH EQUIVALENTS - END OF YEAR | \$ 81,795 | \$ 34,905 | \$ 44,536 |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

| | Year ended December 31, | | |
|---|-------------------------|-----------|-----------|
| | 2009 | 2008 | 2007 |
| NON-CASH ACTIVITIES | | | |
| Investments in property and equipment | \$ 5,703 | \$ 11,667 | \$ 17,982 |
| Stock-based compensation | \$ 3,829 | \$ -- | \$ 1,331 |
| Investments in other assets | \$ -- | \$ -- | \$ -- |
| Conversion of long-term customers' advances to share capital | \$ -- | \$ -- | \$ 6,414 |
| Conversion of long term debt and convertible debentures to capital notes | \$ -- | \$ 95,071 | \$ -- |
| Conversion of convertible debentures to share capital | \$ 4,101 | \$ 2,151 | \$ 816 |
| Cumulative effect adjustment of the Facility Agreement to retained earnings | \$ -- | \$ -- | \$ 65,207 |
| Reclassification of bifurcated conversion option to shareholders' equity | \$ 404 | \$ 3,907 | \$ 28,377 |
| Issuance of shares and warrants relating the merger with Jazz | \$ -- | \$ 46,744 | \$ -- |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | | |
| Cash paid during the year for interest | \$ 25,717 | \$ 18,520 | \$ 28,831 |
| Cash paid during the year for income taxes | \$ 2,010 | \$ 7 | \$ 55 |

(a) **ACQUISITION OF SUBSIDIARY CONSOLIDATED FOR THE FIRST TIME, SEE ALSO NOTE 3 :**

Assets and liabilities of the subsidiary as of September 19, 2008 :

| | |
|---|------------|
| Working capital (excluding cash and cash equivalents) | \$ (1,086) |
| Fixed assets | 95,244 |
| Long-term investments | 17,100 |
| Intangible assets | 59,500 |
| Other assets | 66 |
| Convertible debenture | (108,600) |
| Long-term liabilities | (22,640) |
| Goodwill | 7,000 |
| | 46,584 |
| Less : | |
| Issuance of share capital and warrants | 46,744 |
| Accrued merger related costs | 2,456 |
| | 49,200 |
| | \$ 2,616 |

See notes to consolidated financial statements.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 1 - DESCRIPTION OF BUSINESS AND GENERAL

The consolidated financial statements of Tower Semiconductor Ltd. (“Tower”) include the financial statements of Tower and its wholly-owned subsidiaries, Tower Semiconductor USA, a marketing and sales subsidiary in the United States and Jazz Technologies (“Jazz”), the parent company of its wholly-owned subsidiary, Jazz Semiconductor, Inc., an independent semiconductor foundry focused on specialty process technologies for the manufacture of analog intensive mixed-signal semiconductor devices (Jazz Technologies and Jazz Semiconductor shall collectively be referred to herein as “Jazz”). Tower and its wholly owned subsidiaries are referred to as the “Company”. References to the “Company” for dates prior to the merger of Tower and Jazz on September 19, 2008 (the “Jazz Merger”), shall exclude Jazz.

The Company is a pure-play independent specialty wafer foundry manufacturing integrated circuits with geometries ranging from 1.0 to 0.13-micron. The Company provides industry leading design enablement tools to allow complex designs to be achieved quickly and more accurately and offers a broad range of customizable process technologies including SiGe, BiCMOS, Mixed-Signal and RFCMOS, CMOS Image Sensor, Power Management (BCD), and Non-Volatile Memory (NVM) as well as MEMS capabilities. To provide world-class customer service, the Company maintains two manufacturing facilities in Israel and a one in the U.S. with additional manufacturing capacity available in China.

Tower’s ordinary shares are traded on the NASDAQ Global Market and on the Tel-Aviv Stock Exchange.

During the past years, the Company has experienced significant recurring losses and a substantial accumulated deficit. The Company has been working in various ways to mitigate these financial losses and has been successful in increasing its customer base, increasing its sales, improving its EBITDA and cash flow from operations, increasing its installed capacity level, raising funds, restructuring its debt and modifying its organizational structure to better address its customers’ needs and to improve its market position.

The worldwide economic downturn that commenced in 2008 and its effect on the semiconductor industry resulted in global decreased demand, downward price pressure, excess inventory and unutilized capacity worldwide. While many market analysts and others report signs of recovery, there is no assurance that markets will sufficiently recover from the effect of the downturn. A lack of, or slower than expected, market recovery may adversely affect the future financial results and position of the Company, including its ability to fulfill its debt obligations and other liabilities. Measures that may assist the Company to fulfill its debt obligations and other liabilities include fund-raising, sale of assets, intellectual property licensing, possible sale and lease-back of real estate assets, debt refinancing or restructuring, improving operational efficiencies and sales and the receipt of all or part of pending grants from the Israeli Investment Center. There is no assurance that the Company will be able to obtain sufficient funding from these or other sources to allow it to have sufficient cash to fulfill its debt obligations and other liabilities and support its growth plans. See further details in Notes 7C, 12B, 11, 13, 17F and 17I-J.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Company's consolidated financial statements are presented in accordance with U.S. generally accepted accounting principles ("US GAAP").

A. Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

B. Principles of Consolidation

The Company's consolidated financial statements include the financial statements of Tower and its wholly-owned subsidiaries, which include its marketing and sales subsidiary in the United States and Jazz. The Company's consolidated financial statements include the results of Jazz from September 19, 2008. The Company's consolidated financial statements are presented after elimination of inter-company transactions and balances. For additional data regarding the merger, see also Note 3.

C. Cash and Cash - Equivalents

Cash and cash equivalents consist of banks deposits and short-term investments (primarily time deposits and certificates of deposit) with original maturities of three months or less.

D. Allowance for Doubtful Accounts

The allowance for doubtful accounts is computed mainly on the specific identification basis for accounts whose collectability, in the Company's estimation, is uncertain.

E. Inventories

Inventories are stated at the lower of cost or market. Cost is determined for raw materials and supplies mainly on the basis of the weighted moving average cost per unit. Cost is determined for work in process and finished goods on the basis of actual production costs.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

F. Property and Equipment

- (1) Property and equipment are presented at cost, including financing expenses and other capitalizable costs. Capitalizable costs include only incremental direct costs that are identifiable with, and related to, the property and equipment and are incurred prior to its initial operation. Identifiable incremental direct costs include costs associated with the funding, acquiring, constructing, establishing and installing property and equipment (whether performed internally or by others), and costs directly related to pre-production test runs of property and equipment that are necessary to get it ready for its intended use. Those costs include payroll and payroll-related costs of employees who devote time and are dedicated to the acquiring, constructing, establishing and installing of property and equipment. Allocation, when appropriate, of capitalizable incremental direct costs is based on the Company's estimates and methodologies including time sheet inputs. Maintenance and repairs are charged to expense as incurred.

Cost is presented net of investment grants received, and less accumulated depreciation and amortization.

During 2007, the Company reassessed the estimated useful lives of its machinery and equipment and as a result, machinery and equipment are depreciated over estimated useful lives of 7 years commencing the second quarter of 2007 (as opposed to 5 years prior to such period). The change was based on the Company's best estimate of the useful lives of its equipment, its experience accumulated from Fab 1 and recent trends in industry practices. The Company believes that the change better reflects the economics associated with the ownership of the equipment. This change has been accounted for as a change in estimate and was applied prospectively.

Depreciation is calculated based on the straight-line method over the estimated economic lives commonly used in the industry of the assets or terms of the related leases, as follows:

| | |
|--|-------------|
| Buildings and building improvements (including facility infrastructure). | 10-25 years |
| Machinery and equipment, software and hardware. | 3-7 years |

- (2) Impairment examinations and recognition are performed and determined based on the accounting policy outlined in R below.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

G. Intangible Assets

Technology

The cost of Fab 2 technologies includes the technology process cost and incremental direct costs associated with implementing the technologies until the technologies are ready for their intended use. The costs in relation to Fab 2 technologies are amortized over the expected estimated economic life of the technologies commonly used in the industry. Amortization phases commence on the dates on which each of the Fab2 manufacturing lines is ready for its intended use. Fab 2 technologies are presented net of accumulated amortization as of December 31, 2009 and 2008 in the amounts of \$82,849 and \$73,948, respectively.

Impairment examinations and recognition are performed and determined based on the accounting policy outlined in R below.

H. Other Assets

Prepaid Long-Term Land Lease

Prepaid lease payments to the Israel Land Administration ("ILA") as detailed in Notes 16A(7) and 16C are amortized over the lease period.

I. Convertible Debentures

Under ASC 470-20 Debt with Conversion and Other Options (formerly "APB 14"), the proceeds from the sale of securities are allocated to each security issued based on their relative fair value.

ASC Topic 815 "Derivatives and Hedging" generally provides criteria that, if met, require companies to bifurcate conversion options from their host instruments and account for them as free standing derivative financial instruments. These three criteria are (a) the economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract, (b) the hybrid instrument that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings and (c) a separate instrument with the same terms as the embedded derivative instrument would be considered a derivative instrument subject to the requirements of Topic 815. In determining whether the embedded derivative should be bifurcated, the Company considers all other scope exceptions provided by that topic. One scope exception particularly relevant to convertibles provides that if the embedded conversion feature is both indexed to and classified in the Company's equity.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

I. Convertible Debentures (cont.)

Stock-Based Instruments in Financing Transactions

The Company calculates the fair value of stock-based instruments included in the units issued in its financing transactions. That fair value is recognized in equity, if determined to be eligible for equity classification. The fair value of such stock-based instruments, when included in issuance of debt that is not itself accounted at fair value is considered a discount on the debt and results in an adjustment to the yield of the debt .

J. Income Taxes

The Company accounts for income taxes in accordance with ASC 740, "Income Taxes". This Topic prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities. Deferred taxes are computed based on the tax rates anticipated (under applicable law as of the balance sheet date) to be in effect when the deferred taxes are expected to be paid or realized.

Deferred tax assets are recognized if it is probable that such assets would be realized, for temporary differences, which will result in deductible amounts in future years and for carryforwards. An allowance against such deferred tax assets is recognized if it is probable that some portion or all of the deferred tax assets will not be realized. Due to the material loss carryforward amount of Tower as of December 31, 2009 and uncertainties with regard to its utilization in the future, no such deferred tax assets were recorded in Tower's results of operations, however deferred tax assets were recorded in Jazz, see Note 20C.

The future utilization of Jazz's net operating loss carry forwards to offset future taxable income is subject to an annual limitation as a result of ownership changes that have occurred, see Note 20E.

The Company accounts for its uncertain tax positions in accordance with ASC 740 sections codified from Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" ("FIN 48"). The Company recognizes interest and penalties that would be assessed in relation to the settlement value of unrecognized tax benefits as a component of income tax expense.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

K. Revenue Recognition

The Company's net revenues are generated principally from sales of semiconductor wafers. The Company derives the remaining balance of its net revenues from engineering services and other support services. The majority of the Company's sales are achieved through the efforts of its direct sales force.

In accordance with ASC Topic 605 "Revenue Recognition", the Company recognizes revenues from sale of products when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the price to the customer is fixed or determinable; and (iv) collection of the resulting receivable is reasonably assured. These criteria are usually met at the time of product shipment. Revenues are recognized when the acceptance criteria are satisfied, based on performing electronic, functional and quality tests on the products prior to shipment. Such Company testing reliably demonstrates that the products meet all of the specified criteria prior to formal customer acceptance, hence, collection of payment for services is reasonably assured.

The Company provides for sales returns and allowances relating to specified yield or quality commitments as a reduction of revenues at the time of shipment based on historical experience and specific identification of events necessitating an allowance.

Revenues for engineering and other services are recognized ratably over the contract term or as services are performed. Revenues from contracts with multiple elements are recognized as each element is earned based on the relative fair value of each element and when there are no undelivered elements that are essential to the functionality of the delivered elements and when the amount is not contingent upon delivery of the undelivered elements. Advances received from customers towards future engineering services, product purchases and in some cases capacity reservation are deferred until services are rendered, products are shipped to the customer, or the capacity reservation period ends.

Revenue relating to a turn-key agreement with an Asian entity (as detailed in Note 16D(4)) are recognized based on ASC 605-35 (formerly SOP 81-1 "Accounting for Performance of Construction Type and Certain Production Type Contracts") using contract accounting of the percentage of completion method. Measurement of the percentage toward completion is determined, based on the ratio of actual labor hours incurred to total labor hours estimated to be incurred over the duration of the contract.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

L. Research and Development

Research and development costs are charged to operations as incurred. Amounts received or receivable from the government of Israel and others, as participation in research and development programs, are offset against research and development costs. The accrual for grants receivable is determined based on the terms of the programs, provided that the criteria for entitlement have been met.

M. Loss Per Ordinary Share

Basic earnings per share is calculated, in accordance with ASC Topic 260, "Earnings Per Share", by dividing profit or loss attributable to ordinary equity holders of Tower (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the reported period. Diluted earnings per share is calculated by adjusting profit or loss attributable to ordinary equity holders of Tower, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares.

N. Comprehensive Income (Loss)

In accordance with ASC Topic 220, "Comprehensive Income", comprehensive income (loss) represents the change in shareholders' equity during a reporting period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a reporting period except those resulting from investments by owners and distributions to owners. Other comprehensive income (loss) represents gains and losses that are included in comprehensive income but excluded from net income.

O. Functional Currency and Transaction Gains and Losses

The currency of the primary economic environment in which the Company conducts its operations is the U.S. dollar ("dollar"). Accordingly, the dollar is the functional and reporting currency. Financing expenses, net in 2009 and 2007 include net foreign currency transaction losses of \$4,952 and \$3,526, respectively. Financing expenses, net in 2008 includes net foreign currency transaction gains of \$2,401.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

P. Jazz's Pension Plans

Jazz's liabilities relating its retirement plan for hourly employees and postretirement health and life benefits plans are stated at their fair value.

Jazz adopted ASC Subtopic 715-20 Defined Benefit Plans - General, which requires recognition of the funded status of the defined benefit and other postretirement benefit plans in the balance sheet, with changes in the funded status recognized through comprehensive income, net of tax, in the year in which they occur. This Subtopic requires the amounts recognized in financial statements to be determined on an actuarial basis. To accomplish this, extensive use is made of assumptions about inflation, investment returns, mortality, turnover, medical trend rates and discount rates. A change in these assumptions could cause actual results to differ from those reported.

Q. Stock-Based Compensation

The Company applies the provisions of ASC Topic 718 Compensation - Stock Compensation, under which employee share-based equity awards are accounted for under the fair value method. Accordingly, stock-based compensation to employees and directors is measured at the grant date, based on the fair value of the award. The Company uses the straight-line attribution method to recognize stock-based compensation costs over the service period of the award.

R. Impairment of Assets

Impairment of Property, Equipment and Intangible Assets

The Company reviews long-lived assets and intangible assets on a periodic basis, as well as when such a review is required based upon relevant circumstances, to determine whether events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Application of ASC Subtopic 360-10 Property, Plant, and Equipment, resulted in an impairment charge which was recorded during 2008, see Note 7B.

Impairment of Goodwill

Goodwill is subject to an impairment test on at least an annual basis or upon the occurrence of certain events or circumstances. Goodwill impairment is assessed based on a comparison of the fair value of the unit, to which the goodwill is ascribed, as against the underlying carrying value of its net assets, including goodwill. If the carrying amount of the unit exceeds its fair value, the implied fair value of the goodwill is compared with its carrying amount to measure the amount of impairment loss, if any.

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NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

S. Derivatives

Tower issues derivatives from time to time, whether embedded or freestanding, that are denominated in currency other than its functional currency (generally the NIS in which its shares are also traded). Instruments that are denominated in a currency other than the Company's functional currency are not eligible to be included in equity.

T. Initial Adoption of New Standards

Amendment to Accounting Standards Codification ("ASC") 815 (SFAS No. 161)

Effective January 1, 2009, the Company adopted the disclosure requirements in the amendment to ASC 815 (added by SFAS No. 161), "Disclosures about Derivative Instruments and Hedging Activities", which expands disclosures but does not change accounting for derivative instruments and hedging activities. The adoption of the amendment did not have any impact on the consolidated results of operations or financial position of the Company.

ASC 470-20-15 (FSP APB 14-1)

Effective January 1, 2009, the Company applied the amendment to ASC 470-20-15 (formerly FSP No. APB 14-1), "Accounting for Convertible Debt Instruments that may be Settled in Cash upon Conversion (Including Partial Cash Settlement)". The provision of the amendment applies to any convertible debt instrument that may be wholly or partially settled in cash and requires the separation of the debt and equity components of cash-settleable convertibles at the date of issuance. The amendment is effective for the 8% convertible debt issued by Jazz due in 2011. Following the Jazz Merger, as part of the purchase method, Jazz was required to fair value its convertible debt instrument. As a result, a new basis was determined for the convertible notes of \$108,600. The debt discount was \$19,600. Upon adoption of the amendment, the Company evaluated the equity component as of the date of the Jazz Merger and determined that it is immaterial. As such, the Company expects no impact on the Company's consolidated results of operations or financial position resulting from the adoption of this amendment for periods following the Jazz Merger.

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NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

T. Initial Adoption of New Standards (cont.)

ASC 815-40 (EITF 07-5)

In June 2008, the FASB Emerging Issues Task Force reached a consensus on EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) is Indexed to an Entity's Own Stock". The consensus is an amendment to ASC 815-40 Contract in Entity's Own Equity.

The Company applies this consensus effective January 1, 2009. The Company identified several instruments that are affected by the consensus all of which were, before the adoption of the consensus, classified in equity and upon the adoption were reclassified from equity to liabilities. These instruments include warrants and a previously bifurcated conversion option, with either an anti-dilution feature or with an exercise price denominated in New Israel Shekels ("NIS"). At the date of adoption and in accordance with the transition provisions of the consensus, the Company measured those instruments at fair value. The difference between the fair values and the amount previously recorded in equity was recognized as an adjustment to the opening balance of retained earnings.

The effect of the adoption on equity retained earnings is as follows:

| | January 1, 2009 |
|--------------------------------------|-------------------|
| Additional paid in capital | \$ (14,065) |
| Retained earnings | 12,800 |
| Fair value reclassified to liability | <u>\$ (1,265)</u> |

The effect of the adoption on the Company's consolidated results of operations and net loss for the year ended December 31, 2009 was \$13,723.

ASC 320-10-65 (FSP FAS 115-2 and FAS 124-2)

In April 2009, the FASB issued an amendment to ASC 320-10-65 (Investments - Debt and Equity Securities) through the issuance of FASB staff position 115-2 and 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments" ("OTTI") for investment in debt securities. This amendment applies to all entities and is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009.

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NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

T. Initial Adoption of New Standards (cont.)

ASC 320-10-65 (FSP FAS 115-2 and FAS 124-2) (cont.)

Under the amendment, the primary change to the OTTI model for debt securities is the change in focus from an entity's intent and ability to hold a security until recovery. Instead, an OTTI is triggered if (1) an entity has the intent to sell the security, (2) it is more likely than not that it will be required to sell the security before recovery, or (3) it does not expect to recover the entire amortized cost basis of the security. In addition, the amendment changes the presentation of an OTTI in the income statement if the only reason for recognition is a credit loss (i.e., the entity does not expect to recover its entire amortized cost basis). That is, if the entity has the intent to sell the security or it is more likely than not that it will be required to sell the security, the entire impairment (amortized cost basis over fair value) will be recognized in earnings.

However, if the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security, but the security has suffered a credit loss, then the impairment charge will be separated into the credit loss component, which is recorded in earnings, and the remainder of the impairment charge, which is recorded in other comprehensive income. The adoption of this standard did not have any impact on the consolidated results of operations or financial position of the Company.

Amendment to ASC Topic 820 (FSP FAS 157-4)

In April 2009, the FASB issued an amendment to ASC Topic 820 through the issuance of FASB staff position 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly". This amendment applies to all assets and liabilities within the scope of accounting pronouncements that require or permit fair value measurements, except as discussed in ASC 820-10-15-2. The amendment is effective for interim and annual reporting periods ending after June 15, 2009, and shall be applied prospectively.

ASC 820-35-51 relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. It reaffirms the objective of fair value measurement, as stated in ASC 820, to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. Specifically, it reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive.

The amendment provides guidance on (1) estimating the fair value of an asset or liability (financial and nonfinancial) when the volume and level of activity for the asset or liability have significantly decreased and (2) identifying transactions that are not orderly. The adoption of this standard did not have any impact on the consolidated results of operations or financial position of the Company.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

T. Initial Adoption of New Standards (cont.)

ASC 855 (SFAS 165)

In May 2009, the FASB issued ASC 855 (SFAS No. 165), "Subsequent Events". ASC 855 establishes general standards of accounting for, and disclosure of, events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In particular, this statement sets forth: (1) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and (3) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. ASC 855 is effective for the interim or annual financial periods ending after June 15, 2009. The adoption of this standard did not have any impact on the consolidated results of operations or financial position of the Company.

ASC 105 (SFAS 168)

In June 2009, the FASB issued ASC 105, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles". ASC 105 establishes the "FASB Accounting Standards Codification" ("Codification"), and was officially launched on July 1, 2009, for the purpose of serving as the source of authoritative U.S. generally accepted accounting principles ("GAAP") recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission ("SEC") under the authority of federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. The subsequent issuances of new standards will be in the form of Accounting Standards Updates that will be included in the Codification. In general, the Codification is not expected to change U.S. GAAP. All other accounting literature excluded from the Codification will be considered non-authoritative. ASC 105 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. Effective September 30, 2009, all references made to GAAP in our consolidated financial statements include the new Codification numbering system along with original references.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (cont.)

U. Recently Issued Accounting Standards

ASU 2009-13

In October 2009, the FASB issued “Accounting Standards Update (“ASU”) 2009-13 Multiple Deliverable Revenue Arrangements a consensus of EITF” (formerly topic 08-1) an amendment to ASC 605-25. The update provides amendments to the criteria in Subtopic 605-25 for separating consideration in multiple-deliverable arrangements. The amendments in this update establish a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor-specific objective evidence if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific objective evidence nor third-party evidence is available. The amendments in this update will also replace the term “fair value” in the revenue allocation guidance with the term “selling price” in order to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant.

The amendments will also eliminate the residual method of allocation and require that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. The relative selling price method allocates any discount in the arrangement proportionally to each deliverable on the basis of each deliverable's selling price.

The update will be effective for revenue arrangements entered into or modified in fiscal years beginning on or after June 15, 2010 with earlier adoption permitted. The adoption of this update is not expected to have material impact on the Company's consolidated financial statements.

V. Reclassification

Certain amounts in prior years' financial statements have been reclassified in order to conform to the 2009 presentation.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 3 - MERGER WITH JAZZ

Introduction

In connection with the Jazz Merger described in Note 1 in a stock for stock transaction, upon the closing of the Jazz Merger, each outstanding share of Jazz common stock was converted into 1.8 ordinary shares of Tower and each outstanding warrant, option and convertible debenture to acquire one Jazz common stock became exercisable for 1.8 ordinary shares of Tower. Effective September 19, 2008, Jazz's common stock, warrants and units were no longer traded on the American Stock Exchange (AMEX).

In consideration for the shares, options and warrants of Jazz, Tower issued approximately 34.3 million ordinary shares, 5.4 million options and 59.5 million warrants with a total value of \$46,744 (or \$50,070 including transaction costs). The per share value, as well as the value of the options and warrants, was calculated based on Tower's stock price prevailing around May 19, 2008, the date of signing and announcement of the definitive agreement of the Jazz Merger, in accordance with provisions of EITF 99-12 "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination". The merger was accounted for under the purchase method of accounting. Under this method, Jazz was treated as the "acquired" company. The results of Jazz's operations have been included in the consolidated financial statements as of September 19, 2008.

Estimated Fair Values of Jazz's Assets and Liabilities as of the Date of Merger

The following table summarizes the estimated fair values of Jazz's assets and liabilities at the date of merger:

| | September 19, 2008 |
|-------------------------------------|--------------------|
| Current assets | \$ 42,035 |
| Long-term investments | 17,100 |
| Property, plant, and equipment | 95,244 |
| Intangible assets | 59,500 |
| Other assets | 66 |
| Goodwill | 7,000 |
| Total assets as of merger date | 220,945 |
| Current liabilities | 39,635 |
| Convertible debentures | 108,600 |
| Other long-term liabilities | 22,640 |
| Total liabilities as of merger date | 170,875 |
| Net assets as of merger date | \$ 50,070 |

Of the \$59,500 of intangible assets, \$1,300 were assigned to existing technology, \$15,100 were assigned to patents and other core technology, \$1,800 were assigned to in-process research and development, \$2,600 were assigned to customer relations, \$5,200 were assigned to trade name and \$33,500 were assigned to real estate lease agreements; \$7,000 represent goodwill. The fair values set forth above are based on a valuation of Jazz's assets and liabilities performed by the Company in accordance with SFAS No. 141, "Business Combinations".

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 3 - MERGER WITH JAZZ (cont.)

Pro-Forma Financial Information

The following unaudited pro-forma financial information assumes that the Jazz Merger occurred on January 1, 2007 (and assumes that the acquisition of Jazz Semiconductor by Jazz occurred on January 1, 2007). Such information is presented for illustrative purposes only and is not necessarily indicative of the operating results that would have been achieved if the merger had taken place on the date specified, nor are they indicative of the Company's future operating results.

| | Year ended December 31, | |
|------------------------------------|-------------------------|------------|
| | 2008 | 2007 |
| (Unaudited) | | |
| Revenues | \$ 384,044 | \$ 438,502 |
| Loss | (106,647) | (146,409) |
| Loss per share - basic and diluted | \$ (0.67) | \$ (0.96) |

NOTE 4 - OTHER RECEIVABLES

Other receivables consist of the following:

| | As of December 31, | |
|---------------------|--------------------|-----------------|
| | 2009 | 2008 |
| Government agencies | \$ 2,267 | \$ 2,277 |
| Others | 253 | 43 |
| | <u>\$ 2,520</u> | <u>\$ 2,320</u> |

NOTE 5 - INVENTORIES

Inventories consist of the following:

| | As of December 31, | |
|-----------------|--------------------|------------------|
| | 2009 | 2008 |
| Raw materials | \$ 10,294 | \$ 13,673 |
| Work in process | 17,743 | 13,966 |
| Finished goods | 4,213 | 13,260 |
| | <u>\$ 32,250</u> | <u>\$ 40,899</u> |

Work in process and finished goods are presented net of aggregate write-downs to net realizable value of \$3,107 and \$12,488 as of December 31, 2009 and 2008, respectively.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 5 - INVENTORIES (cont.)

Following the Jazz Merger, Tower and Jazz have been working to align their reporting and information systems. During 2009, the Company completed this process with Jazz adopting in its financial statements the same method of calculating the cost of inventories used by Tower. The primary result of such adoption is the inclusion of depreciation and amortization as part of the cost of inventory. In addition, indirect raw material that had been previously immediately charged in Jazz to earnings, is now being capitalized and presented as part of raw material inventory of Jazz until it is consumed. Comparative financial statements of prior periods (in which Jazz was consolidated) have been adjusted to apply the new method retrospectively. The following financial statement line items for fiscal year 2008 were affected by the change in accounting principles.

As of December 31, 2008:

| | As originally reported | As adjusted | Effect of change |
|---|---------------------------|-------------|---------------------|
| Inventories | \$ 38,729 | \$ 40,899 | \$ 2,170 |
| Other current assets (related to deferred tax asset) | 7,657 | 6,777 | (880) |
| Shareholders' Equity | \$ 110,277 | \$ 111,567 | \$ 1,290 |

For the year ended December 31, 2008:

| | As originally reported | As adjusted | Effect of change |
|----------|---------------------------|--------------|---------------------|
| Net loss | \$ (106,435) | \$ (105,145) | \$ 1,290 |

NOTE 6 - LONG-TERM INVESTMENTS

Long-term investments consist of the following:

| | As of December 31, | |
|---|--------------------|------------------|
| | 2009 | 2008 |
| Severance pay funds (see Note 15B) | \$ 12,078 | \$ 12,193 |
| Investment in HHNEC (see below) | 17,100 | 17,100 |
| Investment in limited partnership (see below) | 183 | 206 |
| | <u>\$ 29,361</u> | <u>\$ 29,499</u> |

Investment in Limited Partnership:

In December 2007, Tower together with CMT Medical Technologies Ltd., a leading provider of advanced digital X-ray imaging systems for medical diagnosis, established a limited partnership to develop and market X-ray detectors for medical applications. Tower owns 38% of the limited partnership and accounts for the investment in the limited partnership using the equity method.

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NOTE 6 - LONG-TERM INVESTMENTS (cont.)

Investment in HHNEC:

Jazz is holding an equity investment in HHNEC (Shanghai Hua Hong NEC Electronics Company, Ltd.). As of December 31, 2009, the investment represented a minority interest of approximately 10% in HHNEC, hence the investment in HHNEC was recorded at fair value as of the date of the Jazz Merger and subsequently carried using the cost method of accounting for investments, as Jazz does not have the ability to exercise significant influence, see Note 3.

As part of the Jazz's acquisition of 10% interest in HHNEC, Jazz was obligated to pay additional amounts to former stockholders of Jazz Semiconductor if it would have realized proceeds in excess of \$10,000 from a liquidity event through February 16, 2010. In that event, Jazz would have been obligated to pay the former Jazz Semiconductor stockholders an amount equal to 50% of the proceeds over \$10,000. No liquidity event occurred on or before February 16, 2010, and accordingly, that obligation has expired. Jazz has no further obligation to pay the former Jazz Semiconductor shareholders any amount realized from a liquidity event relating to its interest in HHNEC.

NOTE 7 - PROPERTY AND EQUIPMENT, NET

A. Composition:

| Cost: | As of December 31, | |
|---|--------------------|------------|
| | 2009 | 2008 |
| Buildings (including facility infrastructure) | \$ 263,506 | \$ 262,332 |
| Machinery and equipment, see B below | 1,033,563 | 1,010,370 |
| | 1,297,069 | 1,272,702 |
| Accumulated depreciation | | |
| Buildings (including facility infrastructure) | 106,363 | 89,914 |
| Machinery and equipment | 819,306 | 733,091 |
| | 925,669 | 823,005 |
| | \$ 371,400 | \$ 449,697 |

Supplemental disclosure relating to cost of property and equipment:

- (1) As of December 31, 2009 and 2008, the cost of buildings, machinery and equipment was reflected net of investment grants in the aggregate of \$265,587 and \$267,922, respectively.
- (2) Depreciation expenses, in relation to Fab 2 property and equipment were \$80,998, \$94,211 and \$113,393 in 2009, 2008 and 2007, respectively.
- (3) Depreciation expenses, in relation to Jazz property and equipment were \$18,808 in 2009 and \$5,513 in the period between the Jazz Merger date and December 31, 2008.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 7 - PROPERTY AND EQUIPMENT, NET (cont.)

B. Fixed Assets Impairment

Machinery and equipment presented above are net of impairment charges. Due to the worldwide economic downturn that commenced in 2008 and its effect on the semiconductor industry that resulted in global decreased demand, downward price pressure and excess inventory (see also Note 1), Tower has determined during 2008 that the events and circumstances indicate that the carrying amount of its machinery and equipment may not be recoverable. In accordance with ASC 360-10 Property, Plant and Equipment, Tower tested the recoverability of its machinery and equipment based, among others, on its business plan and market conditions, and determined that the carrying amounts of its machinery and equipment may not be recoverable. Tower evaluated the fair value of its machinery and equipment and determined that the carrying amounts exceed the fair values by \$120,538. Tower recorded a charge in that amount in a separate line in its 2008 statement of operations.

The fair values of the machinery and equipment were determined using expected cash flows discounted at a discount rate commensurate with the risk involved in generating such cash flows.

C. Investment Grants

In December 2000, the Investment Center approved an investment program in connection with Fab 2 for expansion of Tower's plant. The approval certificate for the program provided for a benefit track entitling Tower to investment grants at a rate of 20% of qualified investments of up to \$1,250,000, or an aggregate of up to \$250,000, of which as of the balance sheet date, an aggregate of approximately \$165,000 has been received from the Investment Center. Under the terms of the program, investments in respect of Fab 2 were to be completed by December 31, 2005, five years from the date the approval certificate was obtained. Due to the later than planned construction of Fab 2, market conditions and slower than planned ramp-up, Tower completed approximately 72% of the investments within the time frame stipulated in the approved enterprise program. In December 2007, Tower submitted the final report in relation to the program. Tower has been holding discussions with the Investment Center to achieve satisfactory arrangements to approve a new expansion program since January 1, 2006.

In May 2008, Tower filed a petition with the Israeli High Court of Justice in which Tower asked the Court to order that its expansion plan (in connection with its Fab 2 Approved Enterprise Program) be brought before the relevant Israeli Governmental bodies for their respective approvals without delay. On August 11, 2008, the Investment Center rejected Tower's expansion plan request. Tower has appealed this decision before the Israeli Minister of Finance and the Israeli Minister of Industry, Trade and Labor. To date, the appeal committee has not yet reviewed Tower's appeal. In February 2010, the Israeli High Court of Justice dismissed the petition and instructed the appeal committee to review this matter as soon as possible and provide its recommendation to the investment center and the Ministers of Finance and Industry.

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NOTE 7 - PROPERTY AND EQUIPMENT, NET (cont.)

C. Investment Grants (cont.)

As of the approval date of the financial statements, Tower cannot estimate when, if at all, Tower will receive approval of its request for a new expansion program or will receive the grants under it.

Entitlement to the above grants and other tax benefits is subject to various conditions stipulated by the Israeli Law for the Encouragement of Capital Investments - 1959 ("Investments Law") and the regulations promulgated thereunder, as well as the criteria set forth in the certificates of approval. In the event Tower fails to comply with such conditions, Tower may be required to repay all or a portion of the grants received plus interest and certain inflation adjustments. In order to secure fulfillment of the conditions related to the receipt of investment grants, floating liens were registered in favor of the State of Israel on substantially all of Tower's assets, see Note 20A.

Any failure by Tower to meet the conditions of the 2000 approval certificate may result in the cancellation of all or a portion of the grants and tax benefits to which Tower is entitled and in the Investment Center requiring Tower to repay all or a portion of grants already received. Under Israeli law, Tower's non-completion of total qualified investments of \$1,250,000 by December 31, 2005 may permit the Investment Center to require Tower to repay all or a portion of grants already received. The Company believes that it is improbable that the Investment Center would demand that Tower repay all or a portion of grants already received, due to its non-completion of such investments by December 31, 2005. See also Note 20A.

D. For liens, see Notes 12D and 16D(2).

NOTE 8 - INTANGIBLE ASSETS, NET

Intangible assets, net consist of the following:

| | Useful Life | As of December 31, | |
|--|-------------|--------------------|------------------|
| | | 2009 | 2008 |
| Real estate lease | 19 | \$ 31,171 | \$ 32,988 |
| Technologies in relation to Fab2 | 4 | 14,897 | 23,799 |
| Patents and other core technology rights | 9 | 12,941 | 14,625 |
| Trade name | 9 | 4,456 | 5,037 |
| Customers relationship | 15 | 2,378 | 2,551 |
| Technology | 9 | 1,083 | 1,259 |
| Others | | 675 | 775 |
| | | <u>\$ 67,601</u> | <u>\$ 81,034</u> |

In process research and development in the amount of \$1,800 was immediately written off and included in a separate line in the statement of operations for 2008.

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NOTE 9 - OTHER ASSETS, NET

Other assets, net consist of the following:

| | As of December 31, | |
|--|--------------------|-----------------|
| | 2009 | 2008 |
| Prepaid long-term land lease, net (see Note 16C) | \$ 4,382 | \$ 4,503 |
| Debentures issuance expenses, net | 2,282 | 2,781 |
| Prepaid expenses - long-term | 1,135 | 1,202 |
| Deferred financing charges, net | 203 | 316 |
| | <u>\$ 8,002</u> | <u>\$ 8,802</u> |

NOTE 10 - ASSET-BASED REVOLVING CREDIT FACILITY

On September 19, 2008, Jazz Technologies entered into a Second Amended and Restated Loan and Security Agreement, as guarantor of its subsidiary Jazz Semiconductor, Inc., with Wachovia Capital Markets, LLC, as lead arranger, bookrunner and syndication agent, and Wachovia Capital Finance Corporation (Western), as administrative agent, and Jazz Semiconductor, Inc. and Newport Fab, LLC, as borrowers (the "Loan Agreement"), with respect to a three-year secured asset-based revolving credit facility in the total amount of up to \$55,000. In December 2008, Wells Fargo acquired Wachovia Corporation, its businesses and obligations and therefore now administers the Loan Agreement as administrative agent.

The borrowing availability varies according to the levels of the borrowers' eligible accounts receivable, eligible equipment and other terms and conditions described in the Loan Agreement. The maturity date of the facility is September 2011, unless terminated earlier. Loans under the facility bear interest at a rate equal to, at the borrowers' option, either the lender's prime rate plus a margin ranging from 0.25% to 0.75% or the USD LIBOR rate plus a margin ranging from 2.0% to 2.5% per annum.

The Loan Agreement contains customary covenants and other terms, including covenants based on Jazz's EBITDA (as defined in the Loan Agreement), as well as customary events of default. The facility is secured by the assets of Jazz and the borrowers. If any event of default occurs, Wachovia may declare due immediately, all borrowings under the facility and foreclose on the collateral. Furthermore, an event of default under the loan agreement would result in an increase in the interest rate on any amounts outstanding. As of December 31, 2009, Jazz was in compliance with all of the covenants under this facility.

Borrowing availability under the facility as of December 31, 2009, was approximately \$100. Outstanding borrowings were \$27,000 and \$1,800 of the facility supporting outstanding letters of credits on that date. Jazz considers borrowings of \$20,000 to be long-term debt as of December 31, 2009.

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NOTE 11 - OTHER CURRENT LIABILITIES

Other current liabilities consist of the following:

| | As of December 31, | |
|--|--------------------|------------------|
| | 2009 | 2008 |
| Accrued compensation and benefits | \$ 10,329 | \$ 10,648 |
| Vacation accrual | 5,426 | 4,652 |
| Interest payable (primarily in relation to convertible debentures) | 1,260 | 5,726 |
| Due to related parties | 2,518 | 11,324 |
| Other (*) | 4,119 | 2,852 |
| | <u>\$ 23,652</u> | <u>\$ 35,202</u> |

(*) As of December 31, 2009 includes \$745 of 5.2 million warrants ("Series 5 Warrants") issued in 2006, exercisable through December 2010, at an exercise price of NIS 9.48 linked to the CPI. Series 5 Warrants were originally presented in shareholders' equity, however following the adoption of EITF 07-5 as codified in ASC 815-40 on January 1, 2009, Series 5 Warrants were classified from equity to liabilities.

NOTE 12 - LONG-TERM LOANS FROM BANKS

A. Composition:

| | As of December 31, 2009 | |
|--|-----------------------------|-------------------|
| | Effective interest rate (*) | |
| In U.S. Dollar (**) | 2.75% | \$ 110,120 |
| In U.S. Dollar | 5.30% | 120,000 |
| Total long-term debt from Banks-principal amount | | 230,120 |
| Fair value adjustments | | (42,514) |
| Total long-term debt from Banks | | <u>\$ 187,606</u> |

| | As of December 31, 2008 | |
|--|-----------------------------|-------------------|
| | Effective interest rate (*) | |
| In U.S. Dollar | 5.30% | \$ 120,000 |
| In U.S. Dollar (**) | 4.00% | 106,087 |
| Total long-term debt from Banks-principal amount | | 226,087 |
| Fair value adjustments | | (3,098) |
| Total long-term debt from Banks | | <u>\$ 222,989</u> |

(*) The effective interest rate as of December 31, 2009 and 2008 of loans in the amounts of \$120,000 and \$200,000, respectively, takes into account the terms of the hedging agreements described in Note 14A.

(**) Including \$20,000 Jazz's Loan Agreement, see Note 10.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 12 - LONG-TERM LOANS FROM BANKS (cont.)

B. Facility Agreement

Introduction

In January 2001, Tower entered into a credit Facility Agreement with the Banks, which was revised several times, to fund the establishment and equipping of Fab 2 (“Facility Agreement”), under which the outstanding debt as of December 31, 2009, is approximately \$210,000, and the annual interest rate is the three-month USD LIBOR plus 2.5%. For details, see below.

September 2006 Amendment

In September 2006, Tower signed definitive agreements with the Banks and TIC. Pursuant to the agreements, among other things:

- (i) \$158,000 of debt under the Facility Agreement was converted into equity equivalent capital notes of Tower, at a conversion ratio of \$3.04 per share, representing twice the average closing price per share during the ten days prior to signing the Memorandum of Understanding (“MOU”) that preceded the final amendment.
- (ii) the interest rate applicable for the quarterly actual interest payment on the loans was decreased from three-month USD LIBOR plus 2.5% per annum to three-month USD LIBOR plus 1.1% per annum, effective from May 17, 2006 (the “Decreased Amount”). As compensation for the Decreased Amount and subject to adjustment, it was agreed that in January 2011, the Banks would be issued such number of shares (or equity equivalent capital notes or convertible debentures) that equals the Decreased Amount divided by the average closing price of Tower's ordinary shares during the fourth quarter of 2010 (the “Fourth Quarter 2010 Price”). If during the second half of 2010, the closing price Tower's ordinary shares on every trading day during this period exceed \$3.49, then the Banks will only be granted such number of shares (or equity equivalent capital notes or convertible debentures) that equals half of the Decreased Amount divided by the Fourth Quarter 2010 Price.
- (iii) TIC invested \$100,000 in Tower in exchange for approximately 65.8 million equity equivalent capital notes exercisable into Tower's ordinary shares, based on the average closing price per share during the ten days prior to signing the MOU that preceded the final agreement.

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NOTE 12 - LONG-TERM LOANS FROM BANKS (cont.)

B. Facility Agreement (cont.)

September 2007 Credit Line Agreements with the Banks and TIC and September 2007 Amendment

In September 2007, Tower signed and closed definitive agreements with the Banks and with TIC, providing for credit lines totaling up to \$60,000, 25% of which was to be provided by each Bank and 50% by TIC, \$28,000 of which had been borrowed during 2007 and the remainder during 2008. Loans under the credit lines carried an interest at an annual rate of three-month USD LIBOR plus 3% and were repayable 2 years from the date any loan was borrowed. The above described loans' terms, including repayment schedule, outstanding amounts and other terms, were later revised to result in postponed schedule, lower amount outstanding and other terms, for details, see "September 2008 definitive agreement with the Banks and TIC" and "September 2009 amendment to the Facility Agreement" below. Tower paid the Banks and TIC customary fees. For details regarding 5.4 million warrants granted to the Banks and TIC in connection with this agreement, see Note 17B(5). Further, in September 2007, the Company signed and closed a definitive amendment to the Facility Agreement mainly to reflect into it the Credit Line Agreements described above and to revise the financial ratios and covenants that Tower was to satisfy.

September 2008 Definitive Agreement with the Banks and TIC

In September 2008, Tower signed and closed definitive agreements with the Banks and TIC. Pursuant to the agreements: (i) \$200,000 of Tower's debt to the Banks was converted into equity equivalent capital notes of Tower at a conversion ratio of \$1.42, exercisable into Tower's ordinary shares, representing two times the average closing price per share on NASDAQ for the ten trading days prior to August 7, 2008 (the date of Tower's public announcement regarding its debt conversion negotiations with the Banks and TIC); (ii) the commencement date for the repayment of the remaining principal of the Banks' loans was postponed from September 2009 to September 2010, such that the outstanding loans shall be repaid in eight equal quarterly installments between September 2010 and June 2012 (which was further revised in the "August 2009 amendment to the Facility Agreement" below; (iii) interest payments owed to the Banks and originally due September 2008 through June 2009 were added to the remaining principal of the Banks' loans and will be paid according to the same schedule; (iv) the interest rate on the remaining principal of the Banks' loans was set to be USD LIBOR plus 2.5% per annum; (v) the compensation for the Decreased Amount agreed to in the September 2006 amendment was revised pro-rata to the decreased loans; (vi) the Banks waived in full Tower's compliance with financial covenants through the end of 2008; (vii) \$50,000 of debt owed by Tower to TIC (consisting of \$30,000 owed under a loan facility and \$20,000 of Tower's convertible debentures series B held by TIC) were converted into equity equivalent capital notes at a conversion ratio of \$1.42 exercisable into Tower's ordinary shares, representing two times the average closing price per share on NASDAQ for the ten trading days prior to August 7, 2008;

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 12 - LONG-TERM LOANS FROM BANKS (cont.)

B. Facility Agreement (cont.)

September 2008 Definitive Agreement with the Banks and TIC (cont.)

and (viii) TIC invested \$20,000 in Tower in exchange for approximately 28.2 million equity equivalent capital notes exercisable into Tower's ordinary shares, based on the average closing price per share on NASDAQ for the ten trading days prior to August 7, 2008.

Furthermore, TIC committed to invest up to an additional \$20,000 under certain conditions. In January 2009, such conditions were satisfied and TIC invested said amount in exchange for approximately 76.9 million equity equivalent capital notes of Tower, exercisable into ordinary shares of Tower.

The debt conversion to equity equivalent capital notes as detailed above resulted in a gain of \$130,698 that was recorded in the Company's statement of operations for 2008.

August 2009 amendment to the Facility Agreement

During 2009, the Banks and Tower entered into an amendment to the Facility Agreement to: (i) postpone the repayment schedule of the outstanding loans, to be repaid in 8 equal quarterly installments from September 2011 until June 2013; (ii) waive the financial covenants stipulated in the Facility Agreement through December 31, 2009; and (iii) upon certain circumstances, as stipulated in the amendment, and following receipt by Tower of significant amounts of proceeds from a certain source, Tower will pay a portion of such proceeds on account of the outstanding loans prior to the due date specified above. As part of the terms of the amendment, Tower agreed to extend the Banks' existing warrants to June 2013, grant the Banks new warrants in three annual tranches of \$1,000 each, at a quantity and price to be calculated based on the market stock price prior to any such grant and pay the Banks fees in the aggregate amount of \$350.

Accounting for the Loans under the Facility Agreement

Loans received under the Facility Agreement, as amended to date, are presented commencing January 1, 2007 at fair value, with changes in value reflected on the statement of operations, following an early adoption by the Company of ASC 825-10 Fair Value Option and Tower's election to apply the fair value option to the Facility Agreement.

The effect of the election of fair value option to the Facility Agreement as of January 1, 2007 was a gain of \$65,207 which has been recorded as a cumulative-effect adjustment to retained loss (no tax effects have been recorded).

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NOTE 12 - LONG-TERM LOANS FROM BANKS (cont.)

B. Facility Agreement (cont.)

Accounting for the Loans under the Facility Agreement (cont.)

The September 2008 amendment was accounted for by calculating the fair value of the remaining outstanding obligation to the Banks. The excess of the fair value of the obligation prior to the amendment over the fair value of the remaining obligation was considered settled (“the Settled Amount”). A gain on conversion of debt was recognized in the amount of the excess of the Settled Amount over the fair value of the equity equivalent capital notes issued. The fair value of the notes was calculated based on the price of the stock of Tower around September 25, 2008, the date of signing and closing of the definitive agreements with the Banks and TIC.

August 2009 amendment to the Facility Agreement - since the loans are carried at fair value, the fair value following the August 2009 amendment includes the effects of the amendment. The cost of the new warrants (all three tranches) granted pursuant to the August 2009 amendment and the additional cost of the existing warrants, which is determined based on the fair value at the date of the amendment, were expensed and recorded in financing expenses, as they relate to an item carried at fair value.

C. Repayment Schedule

The principal amount of the long-term loans as of December 31, 2009 is repayable as follows:

| | | |
|------|----|----------------|
| 2011 | \$ | 72,530 |
| 2012 | | 105,060 |
| 2013 | | 52,530 |
| | \$ | <u>230,120</u> |

According to August 2009 amendment detailed in B above, following receipt by Tower of significant amounts of proceeds from a certain source, Tower will pay a portion of such proceeds on account of the outstanding loans prior to the due date specified above.

D. The Facility Agreement with the Banks restricts Tower’s ability to place liens on its assets (other than to the State of Israel in respect of investment grants - see Note 7C and to SanDisk - see Note 16D(2)), without the prior consent of the Banks. Furthermore, the agreements contain certain restrictive financial ratios and covenants. For further details concerning the Facility Agreement and its amendments, see Note 16A(5).

E. For long term bank loans of Jazz see Note 10.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 13 - DEBENTURES

A. Composition:

| | As of December 31, 2009 | | | |
|---|-------------------------|-----------------|------------|------------|
| | Interest rate | Carrying amount | Fair value | Total |
| 2005 Convertible debentures series B | 5% | \$ 6,976 | \$ -- | \$ 6,976 |
| 2006 Convertible debentures series C | -- (*) | 54,484 | -- | 54,484 |
| 2007 Non-convertible debentures series D | 8% | 31,434 | -- | 31,434 |
| 2007 Convertible debentures series E, see Note 14 | 8% | -- | 37,342 | 37,342 |
| | | 92,894 | 37,342 | 130,236 |
| Jazz's Convertible notes | 8% | 110,971 | -- | 110,971 |
| | | \$ 203,865 | \$ 37,342 | \$ 241,207 |

(*) See D below

| | As of December 31, 2008 | | | |
|---|-------------------------|-----------------|------------|------------|
| | Interest rate | Carrying amount | Fair value | Total |
| 2002 Convertible debentures series A (**) | 4.7% | \$ 8,330 | \$ -- | \$ 8,330 |
| 2005 Convertible debentures series B | 5% | 5,283 | -- | 5,283 |
| 2006 Convertible debentures series C | -- (*) | 46,738 | -- | 46,738 |
| 2007 Non-convertible debentures series D | 8% | 29,614 | -- | 29,614 |
| 2007 Convertible debentures series E, see Note 14 | 8% | -- | 16,825 | 16,825 |
| | | 89,965 | 16,825 | 106,790 |
| Jazz's Convertible notes | 8% | 110,052 | -- | 110,052 |
| Less - current maturities | | 8,330 | -- | 8,330 |
| | | \$ 191,687 | \$ 16,825 | \$ 208,512 |

(*) See D below.

(**) In January 2009, the outstanding amount was fully paid and the debentures were redeemed in full.

If on a payment date of the principal or interest on the debentures (series B-E) there exists an infringement of certain covenants and conditions under the Facility Agreement, the dates for payment of interest and principal on the debentures may be postponed, depending on various scenarios under the Facility Agreement until such covenant or condition is settled. Such debentures and interest thereon are unsecured and subordinated to Tower's existing and future secured indebtedness, including indebtedness to the Banks under the Facility Agreement - see Note 16A(5), to SanDisk - see Note 16D(2) and to the government of Israel - see Note 7C.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 13 - DEBENTURES (cont.)

B. 2002 Convertible Debentures Series A

In 2002, Tower raised approximately \$24,300 in a public offering for the issuance of convertible debentures, the outstanding principal amounts of which as of December 31, 2009 is \$0. The debentures were linked to the Israeli Consumer Price Index ("CPI"), issued at 96% of their par value, and bore annual interest at the rate of 4.7%, payable in January of each year commencing in January 2003. The principal amount was payable in four equal installments in January of each year between 2006 and 2009. The debentures were convertible until December 31, 2008 into ordinary shares, at a conversion rate of one Ordinary Share per each NIS 41.00 principal amount of the debentures. In January 2009, the outstanding amount was fully paid and the debentures were redeemed in full.

C. 2005 Convertible Debentures Series B

In January 2006, Tower raised \$48,169 of convertible debentures by way of a rights offering based on a prospectus which became effective on December 2005, the outstanding principal amounts of which as of December 31, 2009 is \$10,550. The debentures are listed for trade on the Tel-Aviv Stock Exchange and on the NASDAQ Capital Market ("Series B"). The debentures accrue annual interest at the rate of 5% which will be payable, together with the principal of the debentures, in one installment in January 2012.

The debentures are convertible into Tower's ordinary shares at a conversion price of \$1.10 per share. The conversion price was subject to downward adjustment under certain circumstances if Tower had sold securities in future financings at a price per share which was lower than the conversion price, provided that such financings closed, or agreements for such financings were signed, through December 2006. No such adjustment was or will be required and the downward adjustment mechanism has expired.

In analyzing whether the conversion feature requires bifurcation, Tower considered whether the conversion feature would be classified as a liability or within shareholders' equity. To determine classification, the conversion feature must be analyzed under ASC Subtopic 815-40 "Contracts in Entity's Own Equity". The first step in the Subtopic analysis for these features is to determine whether the host contract is a conventional convertible instrument. Since the conversion feature in Series B contained, a reset provision that adjusts the conversion rate through 2006, Tower determined that Series B cannot be considered a "conventional convertible instrument". Since Series B does not qualify as conventional convertible debt, it must be analyzed to determine whether the conversion feature should be accounted for as a liability or as equity.

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NOTE 13 - DEBENTURES (cont.)

C. 2005 Convertible Debentures Series B (cont.)

Tower considered the provisions of Series B and determined that the number of shares issuable upon conversion of the convertible instrument through 2006 is uncapped and thus requires bifurcation and treatment as derivative classified as liability. Such classification remained until the adjustment feature expired in 2006 and the number of shares issuable was fixed. The conversion feature was bifurcated using the “with and without” method and subsequently marked the conversion feature to fair value through profit and loss.

- (i) In December 2006, the downward adjustment to the conversion rate expired resulting in the change to the embedded derivative such that it no longer requires bifurcation and the amount of the liability for the conversion option reclassified to shareholder' equity was \$28,377.
- (ii) The remaining balance of unamortized discount as of December 31, 2009 and 2008 was \$3,573 and 5,398, respectively.

SanDisk Corporation, Alliance Semiconductor Corporation and Macronix International Co. Ltd. (collectively, the “Primary Wafer Partners”) and TIC have invested \$27,811 in the framework of the rights offering.

As part of the September 2008 definitive agreement with the Banks and TIC, \$20,000 in convertible debentures series B were converted into equity equivalent capital notes of Tower, see Note 12B.

The outstanding principal amounts of convertible debentures Series B as of December 31, 2009 and 2008 were \$10,550 and \$10,681, respectively.

D. 2006 Convertible Debentures Series C

In 2006, Tower raised approximately \$31,219 in a public offering of convertible debentures linked to the CPI and issued at 85% of the par value, together with options each exercisable for three months ending on September 27, 2006 for NIS 100 principal amount of convertible debentures at an exercise price equal to 85% of their face amount, linked to the CPI. Such options were exercised fully to convertible debentures. In addition, Tower issued warrants Series 4, exercisable for three years ending on June 28, 2009 for one ordinary share of Tower at a price of NIS 7.40. On January 1, 2009, following the adoption of EITF 07-5 as codified in ASC 815-40, warrants Series 4 were reclassified from equity to liabilities through their expiration in June 2009.

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NOTE 13 - DEBENTURES (cont.)

D. 2006 Convertible Debentures Series C (cont.)

The convertible debentures were convertible into Tower's ordinary shares at a conversion rate of one ordinary share per NIS 8.40 principal amount of convertible debentures. The conversion price was subject to a reduction feature until June 2008, according to which the conversion rate of Series C was reduced in July 2008 from NIS 8.4 to NIS 4.31. The convertible debentures carry a zero coupon with principal payable at maturity in December 2011, at a premium of 37% over principal value, linked to the CPI.

The outstanding principal amounts of the convertible debentures as of December 31, 2009 and 2008 were \$55,439 and \$56,150, respectively.

The net proceeds received were allocated to each of the components in the units sold using the relative fair value method. Tower determined the fair values of each component using the average quoted prices at the first 2 days of trading. The allocation to each component was as follow:

| | <u>Fair Values</u> | <u>Amount allocated</u> |
|--|--------------------|-----------------------------|
| Total net proceeds received for the units issued as of issuance date | | \$ 28,752 |
| Proceeds allocated to convertibles debentures as of issuance date based on relative fair value | \$ 31,402 | \$ 26,735 |
| Proceeds allocated to short term options to purchase additional debentures | 246 | 210 |
| Proceeds allocated to long term warrants | 1,513 | 1,287 |
| Proceeds allocated to short term warrants | 611 | 520 |
| Total allocated | <u>\$ 33,772</u> | <u>\$ 28,752</u> |

Tower further bifurcated the conversion feature from the convertible debt using the "with and without" method. That bifurcation was done, as a next step, after the determination of the allocated proceeds described above. Following the adoption of EITF 07-5 as codified in ASC 815-40, on January 1, 2009, the conversion feature was reclassified from equity to liabilities.

The embedded feature was measured at fair value using a valuation technique that utilizes the discounted cash flows of Black-Scholes and Monte Carlo simulation. The Monte Carlo simulation was used to incorporate the possible adjustment of the conversion rate in different scenarios. The key inputs included were interest rate, the spot price of Tower's share and its volatility.

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NOTE 13 - DEBENTURES (cont.)

E. 2007 Non-Convertible Debentures Series D and Convertible Debentures Series E

In the second half of 2007, Tower consummated a private placement with Israeli institutions of long-term convertible and non-convertible debentures and warrants, by which Tower raised gross proceeds of approximately \$40,000. In the funding, 342 units were sold, each comprised of: (i) long-term non-convertible-debentures, repayable in six equal annual installments between the dates of December 2011 and December 2016, with a face amount of NIS 250,000 (approximately \$59.7) linked to the CPI and carrying an annual interest rate of 8 percent ("series D"); (ii) long-term convertible-debentures repayable in December 2012 with a face amount of NIS 262,500 (approximately \$62.7) linked to the CPI, carrying an annual interest of 8 percent ("series E"). Convertible debentures series E were convertible into Tower's ordinary shares at a conversion rate of one ordinary share per NIS 17.2 principal amount of convertible debentures and (iii) 5,800 warrants series 6, which were exercisable until 2011, for one Tower Ordinary Share at a price of \$2.04. The conversion price of Convertibles debentures series E was subject to adjustments under certain limited circumstances during a two year period. According to such terms, the conversion price was reduced from NIS 17.2 to NIS 4.15. Convertibles debentures series E are carried at fair value through profit and loss and the effect of the reduction in conversion price was reflected in the mark to market of the convertibles. The conversion price of warrants series 6 was subject to adjustments under certain limited circumstances during a two year period. Under such circumstances, the conversion price was reduced from \$2.04 to \$1.06. Warrants series 6 were classified as liabilities and carried at fair value due to the existence of the ratchet described above. After the exercise price was adjusted and the ratchet expired, the warrants were adjusted to fair value through earnings and reclassified to equity.

In September 2007, Tower expanded its series of long-term debentures and warrants by selling 12,118 units, each comprised of long-term non-convertible debentures, with a face amount of NIS 2,500 (approximately \$0.62), long-term convertible debentures, with a face amount of NIS 2,625 (approximately \$0.65), and 58 warrants. The debentures were issued at 90% of par value and with the other same terms as the debentures and the warrants issued in the private placement. In this expansion, Tower raised gross proceeds of approximately \$14,000.

The outstanding principal amounts of series D as of December 31, 2009 and 2008 were \$34,121 and \$32,632, respectively.

The outstanding principal amounts of series E as of December 31, 2009 and 2008 were \$37,659 and \$36,095, respectively.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 13 - DEBENTURES (cont.)

F. Convertible Notes Issued By Jazz

In 2006, Jazz completed private placements of convertible notes. The convertible notes bear interest at a rate of 8% per annum payable semi-annually and mature in December 2011. The convertible notes may be redeemed for cash at a redemption price equal to par plus accrued and unpaid interest plus a redemption premium equal to 2% in the year beginning December 31, 2009 until December 31, 2010 and 0% thereafter.

As of December 31, 2009, the holders of the convertible notes have the option to convert the convertible notes into Tower's ordinary shares based on an implied conversion price of \$4.07 per Tower ordinary share. Jazz's obligations under the convertible debentures are not being guaranteed by Tower.

As of December 31, 2009 and 2008, \$123,334 and \$128,200, respectively in principal amount of convertible notes were outstanding.

According to the terms of the notes, Tower has the right to deliver, in lieu of shares, cash or a combination of cash and Tower ordinary shares to satisfy the conversion obligation. The amount of such cash and Tower ordinary shares, if any, will be based on the trading price of Tower's ordinary shares during the 20 consecutive trading days beginning on the third trading day after proper delivery of a conversion notice.

Jazz's obligations under the convertible debentures are guaranteed by Jazz's wholly owned domestic subsidiaries.

Upon the occurrence of certain specified fundamental changes, the holders of the convertible debentures will have the right, subject to various conditions and restrictions, to require Jazz to repurchase the convertible debentures, in whole or in part, at par plus accrued and unpaid interest to, but not including, the repurchase date.

NOTE 14 - FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

The Company makes certain disclosures with regard to financial instruments, including derivatives. These disclosures include, among other matters, the nature and terms of derivative transactions, information about significant concentrations of credit risk and the fair value of financial assets and liabilities.

A. Interest Rate Derivatives

A derivative is typically defined as an instrument whose value is derived from an underlying instrument, index or rate, has a notional amount, requires no or little initial investment and can be net settled.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 14 - FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (cont.)

A. Interest Rate Derivatives (cont.)

ASC Topic 815 “Derivatives and Hedging” requires that all derivatives be recorded in the financial statements at their fair value at the date of the financial statements. The changes in the fair value of the derivatives are charged to the statement of operations unless designated as a hedging item in a cash flows hedge at which time changes are classified in other comprehensive income, to the extent effective.

Tower, from time to time, enters into agreements to hedge variable interest rate exposure on long-term loans. Tower uses interest rate collar agreements, some with knock-out and knock-in features to hedge its LIBOR-based variable long-term debt cash flow exposure. The knock-out feature was set above the cap level and the knock-in feature was set below the floor level. The derivatives, although used as economic hedges, are not treated as hedges for accounting purposes. The changes in fair value are recorded immediately in earnings.

As of December 31, 2009 and 2008, Tower had outstanding agreements to economically hedge interest rate exposure on loans drawn down under the Facility Agreement, the aggregate amount of \$120,000 and \$200,000, respectively. These agreements resulted in a loss of \$1,552 and \$2,097 for the years ended December 31, 2009 and 2008, respectively and resulted in a gain of \$1,074 for the year ended December 31, 2007.

The Company does not hold or issue derivative financial instruments for non-hedging purposes.

B. Concentration of Credit Risks

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, short-term bank deposits, trade receivables and government agencies receivables. The Company's cash and cash equivalents are maintained with large and reputable banks, and the composition and maturities of investments are regularly monitored by the Company. Generally, these securities may be redeemed upon demand and bear minimal risk.

The Company generally does not require collateral insurance, however, in certain circumstances the Company maintains a credit insurance policy or may require letters of credit. An allowance for doubtful accounts is determined with respect to those amounts that were determined to be doubtful of collection. The Company performs ongoing credit evaluations of its customers, see Note 18.

The Company is exposed to credit-related losses in respect of derivative financial instruments in a manner similar to the credit risk involved in the realization or collection of other types of assets. The Company believes that its exposure to credit risk is immaterial considering its overall position with the Banks that are the counterparty to the derivatives.

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NOTE 14 - FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (cont.)

C. Fair Value of Financial Instruments

The estimated fair values of the Company's financial instruments, excluding long-term debentures and long-term Banks loans, do not materially differ from their respective carrying amounts as of December 31, 2009 and 2008. The fair values of Tower and Jazz's debentures, based on quoted market prices as of December 31, 2009 and 2008, were \$240,272 and \$60,264, respectively compared to carrying amounts of \$241,207 and \$208,512, for the above dates, respectively.

D. Fair Value Measurements

Fair values were determined, as follows:

- For Tower's loans based on the income approach using a present value technique - the cash flows used in the technique reflect the cash stream expected to be used to satisfy the obligation over its economic life. The Company discounted expected cash flows as forecasted each quarter using the appropriate discount rate for the applicable maturity.
- For Embedded Derivatives and Warrants - the Company utilized the Black Scholes Merton formula.
- For Over the Counter derivatives - the Company used the market approach using quotation from independent brokers and dealers.
- For Tower's convertible debentures series E - the market approach using quoted market prices was used.

Recurring Fair Value Measurements Using the Indicated Inputs:

| | December 31, 2009 | Quoted prices in active market for identical liability (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
|---|----------------------|---|--|---|
| Convertible debentures series E | \$ 37,342 | \$ 37,342 | \$ -- | \$ -- |
| Tower's long-term debt | 167,606 | -- | -- | 167,606 |
| Derivatives | 3,502 | -- | 3,502 | -- |
| Warrants and previously bifurcated conversion option | 12,779 | 745 | -- | 12,034 |
| | <u>\$ 221,229</u> | <u>\$ 38,087</u> | <u>\$ 3,502</u> | <u>\$ 179,640</u> |

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NOTE 14 - FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (cont.)

D. Fair Value Measurements

Liabilities measured on a recurring basis using significant unobservable inputs (Level 3):

| | Long-term debt | Convertible debentures series E | Warrants and previously bifurcated conversion option |
|---|--------------------|---------------------------------------|--|
| As of January 1, 2009 - at fair value | \$ 202,989 | \$ 16,825 | \$ -- |
| Reclassification of warrants and previously bifurcated conversion option from equity to liability - see Note 2T - Initial Adoption of New Standards - ASC 815-40-15 | -- | -- | 89 |
| Warrants exercise | -- | -- | (1,325) |
| Decrease in bifurcated conversion option due to conversions | -- | -- | (477) |
| Total losses (gains) unrealized in earnings | (35,383) | 5,922 | 13,747 |
| Transfer out of level 3 | -- | (22,747) | -- |
| As of December 31, 2009 - at fair value | <u>\$ 167,606</u> | <u>\$ --</u> | <u>\$ 12,034</u> |
| Unrealized losses (gains) recognized in earnings from liabilities held at period end | <u>\$ (35,383)</u> | <u>\$ 5,922</u> | <u>\$ 13,747</u> |

Recurring Fair Value Measurements Using the Indicated Inputs:

| | December 31, 2008 | Quoted prices in active market for identical liability (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
|---------------------------------|----------------------|---|--|---|
| Convertible debentures series E | \$ 16,825 | \$ -- | \$ -- | \$ 16,825 |
| Long-term debt | 202,989 | -- | -- | 202,989 |
| Derivatives | 3,236 | -- | 3,236 | -- |
| | <u>\$ 223,050</u> | <u>\$ --</u> | <u>\$ 3,236</u> | <u>\$ 219,814</u> |

Liabilities measured on a recurring basis using significant unobservable inputs (Level 3):

| | Long-term debt | Convertible debentures series E | Derivatives |
|---|-------------------|---------------------------------------|-------------------|
| As of January 1, 2008 - at fair value | \$ 365,563 | \$ 28,484 | \$ 7,313 |
| Total losses (gains) recognized in earnings | 2,670 | (11,659) | (3,406) |
| Conversion of Bank loans under the Definitive Agreements with the Banks and TIC, see Note 12B | (165,244) | -- | -- |
| Reclassification of previously bifurcated conversion option to shareholders' equity | -- | -- | (3,907) |
| As of December 31, 2008 - at fair value | <u>\$ 202,989</u> | <u>\$ 16,825</u> | <u>\$ --</u> |
| Unrealized losses (gains) recognized in earnings from liabilities held at period end | <u>\$ 6,301</u> | <u>\$ (11,659)</u> | <u>\$ (3,406)</u> |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 15 - OTHER LONG-TERM LIABILITIES

A. Other long-term liabilities consist of the following:

| | As of December 31, | |
|---|--------------------|------------------|
| | 2009 | 2008 |
| Accrued severance pay and other employee benefit plans, see B and C below | \$ 26,770 | \$ 27,880 |
| Long-term liability to a Primary Wafer Partner net of current maturity, see Notes 16A(4) and 16D(2) | 4,929 | 710 |
| Deferred tax liability | 11,195 | 11,749 |
| Warrants and previously bifurcated conversion option | 12,034 | -- |
| Others (*) | 5,460 | 5,620 |
| | <u>\$ 60,388</u> | <u>\$ 45,959</u> |

(*) Includes \$1,370 and \$718 as of December 31, 2009 and 2008, respectively, of interest payable to related parties in regard to convertible debentures Series B, see also Note 13C.

B. Employee Termination Benefits

Israeli law and labor agreements determine the obligations of Tower to make severance payments to dismissed employees and to employees leaving employment under certain circumstances. Generally, the liability for severance pay benefits, as determined by Israeli Law, is based upon length of service and the employee's monthly salary. This liability is primarily covered by regular deposits made each month by Tower into recognized severance and pension funds and by insurance policies purchased by Tower, based on the employee's salary for the relevant month. The amounts so funded and the liability are reflected separately on the balance sheets in long-term investments and other long-term liabilities, respectively. Commencing January 1, 2005, Tower started implementing a labor agreement with regard to most of its employees, according to which monthly deposits into recognized severance and pension funds or insurance policies release it from any additional severance obligation to its employees and therefore Tower incurs no liability or asset, since that date. Any net severance pay amount as of such date will be released on the employee's termination date. Payments relating to Israeli employee termination benefits were approximately \$2,496, \$4,018 and \$3,323 for 2009, 2008 and 2007, respectively.

C. Employee Benefit Plans

The following information recognizes the periodic expenses and changes in benefit obligations in the years ended December 31, 2009 and 2008 due to the new bargaining agreement effective May 2, 2008 entered into by Jazz with its collective bargaining unit employees.

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NOTE 15 - OTHER LONG-TERM LIABILITIES (cont.)

C. Employee Benefit Plans (cont.)

Postretirement Medical Plan

The components of the net periodic benefit cost and other amounts recognized in other comprehensive income (loss) for postretirement medical plan expense are as follows:

| | Year ended December 31, 2009 | Year ended December 31, 2008 |
|--|---------------------------------|---------------------------------|
| Net periodic benefit cost | | |
| Service cost | \$ 178 | \$ 46 |
| Interest cost | 463 | 126 |
| Expected return on the plan's assets | -- | -- |
| Amortization of transition obligation (asset) | -- | -- |
| Amortization of prior service costs | -- | -- |
| Amortization of net (gain) or loss | 57 | -- |
| Total net periodic benefit cost | <u>\$ 698</u> | <u>\$ 172</u> |
| Other changes in plan assets and benefits obligations recognized in other comprehensive income | | |
| Prior service cost for the period | \$ -- | \$ -- |
| Net (gain) or loss for the period | 19 | 1,338 |
| Amortization of transition obligation (asset) | -- | -- |
| Amortization of prior service costs | -- | -- |
| Amortization of net (gain) or loss | (57) | -- |
| Total recognized in other comprehensive income | <u>\$ (38)</u> | <u>\$ 1,338</u> |
| Total recognized in net periodic benefit cost and other comprehensive income | <u>\$ 660</u> | <u>\$ 1,510</u> |

| | Year ended December 31, 2009 | Year ended December 31, 2008 |
|--|---------------------------------|---------------------------------|
| Weighted average assumptions used: | | |
| Discount rate | 6.10% | 7.00% |
| Expected return on plan assets | N/A | N/A |
| Rate of compensation increases | N/A | N/A |
| Assumed health care cost trend rates: | | |
| Health care cost trend rate assumed for current year | 9.00% | 9.00% |
| Ultimate rate | 5.00% | 5.00% |
| Year the ultimate rate is reached | 2015 | 2014 |
| Measurement date | December 31, 2009 | December 31, 2008 |

Impact of one-percentage point change in assumed health care cost trend rates as of December 31, 2009:

| | Increase | Decrease |
|---|----------|------------|
| Effect on service cost and interest cost | \$ 121 | \$ (104) |
| Effect on postretirement benefit obligation | \$ 1,340 | \$ (1,083) |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 15 - OTHER LONG-TERM LIABILITIES (cont.)

C. Employee Benefit Plans (cont.)

The components of the change in benefit obligation; change in plan assets and funded status for postretirement medical plan are as follows:

| | Year ended December 31, 2009 | Year ended December 31, 2008 |
|--|---------------------------------|---------------------------------|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of period | \$ 7,688 | \$ 6,226 |
| Service cost | 178 | 46 |
| Interest cost | 463 | 126 |
| Benefits paid | (116) | (48) |
| Change in plan provisions | -- | -- |
| Actuarial loss | 19 | 1,338 |
| Benefit obligation end of period | <u>\$ 8,232</u> | <u>\$ 7,688</u> |
| Change in plan assets: | | |
| Fair value of plan assets at beginning of period | \$ -- | \$ -- |
| Actual return on plan assets | -- | -- |
| Employer contribution | 116 | 48 |
| Benefits paid | (116) | (48) |
| Fair value of plan assets at end of period | <u>\$ --</u> | <u>\$ --</u> |
| Funded status | <u>\$ (8,232)</u> | <u>\$ (7,688)</u> |

| | As of December 31, 2009 | As of December 31, 2008 |
|---|----------------------------|----------------------------|
| Amounts recognized in statement of financial position: | | |
| Non-current assets | \$ -- | \$ -- |
| Current liabilities | (199) | (180) |
| Non-current liabilities | (8,033) | (7,508) |
| Net amount recognized | <u>\$ (8,232)</u> | <u>\$ (7,688)</u> |
| Weighted average assumptions used: | | |
| Discount rate | 6.30% | 6.10% |
| Rate of compensation increases | N/A | N/A |
| Assumed health care cost trend rates: | | |
| Health care cost trend rate assumed for next year | 10.00% | 9.00% |
| Ultimate rate | 5.00% | 5.00% |
| Year the ultimate rate is reached | 2017 | 2015 |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 15 - OTHER LONG-TERM LIABILITIES (cont.)

C. Employee Benefit Plans (cont.)

The following benefit payments are expected to be paid in each of the next five fiscal years and in the aggregate for the five fiscal years thereafter:

| Fiscal Year | Other Benefits (\$) |
|-------------|---------------------|
| 2010 | 199 |
| 2011 | 224 |
| 2012 | 251 |
| 2013 | 275 |
| 2014 | 328 |
| 2015 - 2019 | 2,298 |

Pension Plan

Jazz has a pension plan that provides for monthly pension payments to eligible employees upon retirement. The pension benefits are based on years of service and specified benefit amounts. Jazz uses a December 31 measurement date. Jazz makes quarterly contributions in accordance with the minimum actuarially determined amounts.

The components of the change in benefit obligation, the change in plan assets and funded status for Jazz's pension plan are as follows:

| | Year ended December 31, 2009 | Year ended December 31, 2008 |
|--|---------------------------------|---------------------------------|
| Net periodic benefit cost | | |
| Service cost | \$ 306 | \$ 101 |
| Interest cost | 679 | 203 |
| Expected return on plan assets | (537) | (189) |
| Amortization of transition obligation/(asset) | -- | -- |
| Amortization of prior service costs | -- | -- |
| Amortization of net (gain) or loss | 192 | -- |
| Total net periodic benefit cost | <u>\$ 640</u> | <u>\$ 115</u> |
| Other changes in plan assets and benefits obligations recognized in other comprehensive income | | |
| Prior service cost for the period | \$ -- | \$ -- |
| Net (gain) or loss for the period | (1,415) | 2,804 |
| Amortization of transition obligation (asset) | -- | -- |
| Amortization of prior service costs | -- | -- |
| Amortization of net (gain) or loss | (192) | -- |
| Total recognized in other comprehensive income | <u>\$ (1,607)</u> | <u>\$ 2,804</u> |
| Total recognized in net periodic benefit cost and other comprehensive income | <u>\$ (967)</u> | <u>\$ 2,919</u> |
| Weighted average assumptions used: | | |
| Discount rate | 6.20% | 7.00% |
| Expected return on plan assets | 7.50% | 7.50% |
| Rate of compensation increases | N/A | N/A |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 15 - OTHER LONG-TERM LIABILITIES (cont.)

C. Employee Benefit Plans (cont.)

| | Year ended December 31, 2009 | Year ended December 31, 2008 |
|--|---------------------------------|---------------------------------|
| Estimated amounts that will be amortized from accumulated other comprehensive income in the next fiscal year ending: | | |
| Transition obligation (asset) | \$ -- | \$ -- |
| Prior service cost | -- | -- |
| Net actuarial (gain) or loss | \$ -- | \$ 192 |

The components of the change in benefit obligation; change in plan assets and funded status for Jazz's postretirement medical plan are as follows:

| | Year ended December 31, 2009 | Year ended December 31, 2008 |
|---|---------------------------------|---------------------------------|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of period | \$ 11,101 | \$ 9,961 |
| Service cost | 306 | 101 |
| Interest cost | 679 | 203 |
| Benefits paid | (241) | (47) |
| Change in plan provisions | -- | -- |
| Actuarial loss (gain) | 94 | 883 |
| Benefit obligation end of period | <u>\$ 11,939</u> | <u>\$ 11,101</u> |
| Change in plan assets | | |
| Fair value of plan assets at beginning of period | \$ 6,995 | \$ 8,560 |
| Actual return on plan assets | 2,046 | (1,732) |
| Employer contribution | 453 | 214 |
| Benefits paid | (241) | (47) |
| Fair value of plan assets at end of period | <u>\$ 9,253</u> | <u>\$ 6,995</u> |
| Funded status | <u>\$ (2,686)</u> | <u>\$ (4,106)</u> |
| Accumulated benefit obligation | <u>\$ (11,939)</u> | <u>\$ (11,101)</u> |
| Amounts recognized in statement of financial position | | |
| Non-current assets | \$ -- | \$ -- |
| Current liabilities | -- | -- |
| Non-current liabilities | (2,686) | (4,106) |
| Net amount recognized | <u>\$ (2,686)</u> | <u>\$ (4,106)</u> |
| Weighted average assumptions used | | |
| Discount rate | 6.20% | 6.20% |
| Expected return on plan assets | 7.50% | 7.50% |
| Rate of compensation increases | N/A | N/A |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 15 - OTHER LONG-TERM LIABILITIES (cont.)

C. Employee Benefit Plans (cont.)

The following benefit payments are expected to be paid in each of the next five fiscal years and in the aggregate for the five fiscal years thereafter:

| Fiscal Year | Other Benefits |
|-------------|----------------|
| 2010 | \$ 366 |
| 2011 | 401 |
| 2012 | 454 |
| 2013 | 512 |
| 2014 | 585 |
| 2015 - 2019 | \$ 3,862 |

Jazz has estimated the expected return on assets of the plan of 7.5% based on assumptions derived from, among other things, the historical return on assets of the plan, the current and expected investment allocation of assets held by the plan and the current and expected future rates of return in the debt and equity markets for investments held by the plan. The obligations under the plan could differ from the obligation currently recorded if Jazz's estimates are not consistent with actual investment performance.

Jazz's pension plan weighted average asset allocations at December 31, 2009 by asset category are as follows:

| Asset Category: | December 31, 2009 | Target allocation 2010 |
|-------------------|-------------------|------------------------|
| Equity securities | 71% | 65 - 75% |
| Debt securities | 29% | 25 - 35% |
| Real estate | --% | --% |
| Other | --% | --% |
| Total | 100% | 100% |

Jazz's primary policy goals regarding the plan's assets are cost-effective diversification of plan assets, competitive returns on investment, and preservation of capital. Plan assets are currently invested in mutual funds with various debt and equity investment objectives. The target asset allocation for the plan assets is 25-35% debt, or fixed income securities, and 65-75% equity securities. Individual funds are evaluated periodically based on comparisons to benchmark indices and peer group funds and necessary investment decisions are made by the Company in accordance with the policy goals.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 16 - COMMITMENTS AND CONTINGENCIES

A. Commitments and Contingencies Relating to Fab 2

(1) Overview

In 2001, the Company's Board of Directors approved the establishment of the Company's second wafer fabrication facility in Israel ("Fab 2"). In Fab 2, the Company manufactures semiconductor integrated circuits on silicon wafers in geometries of 0.18 to 0.13 micron on 200-millimeter wafers. In connection with the establishment, equipping and financing of Fab 2, the Company has entered into several related agreements and other arrangements and has completed several public and private financing transactions. The agreements and arrangements include those with technology partners, with SanDisk Corporation, Alliance Semiconductor Corporation, Macronix International Co., Ltd. and QuickLogic Corporation (collectively, the "Wafer Partners"), TIC, Banks, the Government of Israel through the Investment Center and others.

(2) Wafer Partner Agreements

Through December 31, 2004, the Wafer Partners invested under the Wafer Partner agreements an aggregate of \$246,823. Of such amount, \$201,059, was credited as paid in capital and \$45,764, was established as long-term customers' advances which may be, subject to the terms and conditions stipulated in the Wafer Partner agreements, as amended to date, utilized as credit against purchases to be made by the Wafer Partners, primarily through December 2010, or converted into paid-in-capital for a limited term.

Due to the termination by one of the Wafer Partners of its semiconductor business, the Company believed that no future utilization of the wafer credits will be made by such Wafer Partner, hence a full write-down of its outstanding wafer credits in the amount of \$9,747 was recorded during 2007. In 2009, an additional amount of \$2,342 was recorded as a write-down due to low utilization of the wafer credits expected from another Wafer Partner based on past history and future forecasts received from the Wafer Partner.

As of December 31, 2009 and 2008, the outstanding long-term customers' advances were \$8,262 and \$11,138, respectively.

In August 2006, Tower signed an agreement with SanDisk, one of the Wafer Partners, to invest in the expansion of its 0.13 micron manufacturing capacity. For the agreement with SanDisk, as amended, see Note D(2) below.

For amendments to the Wafer Partner agreements, see (4) below.

(3) TIC Agreements

For agreements during the years 2007-2009, see Note 12B.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 16 - COMMITMENTS AND CONTINGENCIES (cont.)

A. Commitments and Contingencies Relating to Fab 2 (cont.)

(4) Amendments to the Primary Wafer Partner Agreements

Pursuant to the Primary Wafer Partner Agreements, as amended to date, each of the Primary Wafer Partners had an option to convert, at the end of each calendar quarter commencing 2004, that portion of the long-term customers' advances which it is entitled to utilize, based upon payments made by such Primary Wafer Partner and purchase orders received from the Wafer Partners through December 31, 2006 (subject to the below amendment with one of the Wafer Partners), into fully-paid ordinary shares of Tower. The number of shares was determined based on the average closing sale price of Tower's ordinary shares for the 15 trading days preceding the end of the relevant quarter. Accordingly, through December 31, 2007, two of the Primary Wafer Partners had elected to convert an aggregate of \$12,487 of long-term customer advances into 7.9 million fully-paid ordinary shares of Tower, at an average share price of \$1.58 per share. Any quarterly amount, which the Primary Wafer Partners did not so convert, was to be repaid in December 2007. The amounts bore interest, payable at the end of each quarter, at an annual rate equal to three-month USD LIBOR plus 2.5% through December 31, 2007, subject to the amendment described below with respect to one of the Wafer Partners.

In 2006, Tower and one of the Primary Wafer Partners entered into an agreement to extend the date until which the credits could be utilized and would be subject to repayment if not so utilized in December 2009. Further, according to the agreement, with respect to certain orders placed until July 2006, and all orders placed thereafter through December 2009, such utilized advances bear interest at an annual rate equal to three-month USD LIBOR plus 1.1%, payable at the end of each quarter, through December 2009. During 2009, it has been agreed to extend the repayment schedule of the utilized advances and amend the terms of credits utilization, and the parties are currently working on formalizing an amendment to this effect.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 16 - COMMITMENTS AND CONTINGENCIES (cont.)

A. Commitments and Contingencies Relating to Fab 2 (cont.)

(5) Facility Agreement

Compliance with Financial Ratios and Covenants

As of the balance sheet date, Tower was in full compliance with all of the financial ratios and covenants under the Facility Agreement, as amended to date, see also Note 12B regarding the Banks' waiver of Tower's compliance with financial covenants through the end of 2009 as part of the August 2009 amendment to the Facility Agreement. According to the Facility Agreement, satisfying the financial ratios and covenants is a material provision. The amended Facility Agreement provides that if, as a result of any default, the Banks were to accelerate Tower's obligations, Tower would be obligated, among other matters, to immediately repay all loans made by the Banks (which as of the approval date of the financial statements amounted to approximately \$210,120) plus penalties, and the Banks would be entitled to exercise the remedies available to them under the Facility Agreement, including enforcement of their liens against all of Tower's assets.

Liens

Under the Facility Agreement, Tower agreed to register liens in favor of the Banks on substantially all its present and future assets.

Offeror by the Banks

If one or more certain bankruptcy related events occur, the Banks are entitled to bring a firm offer made by a potential investor to purchase Tower's ordinary shares ("the Offer") at a price provided in the Offer. In such case, Tower shall be required thereafter to procure a rights offering to invest up to 60% of the amount of the Offer on the same terms. If the Offer is conditioned on the offeror purchasing a majority of Tower's outstanding share capital, the rights offering will be limited to allow for this, unless TIC and the Primary Wafer Partners agree to exercise in a rights offering rights applicable to their shareholdings and agree to purchase in a private placement enough shares to ensure that the full amount of the Offer is invested.

For further details in regard to the Facility Agreement, see Note 12B.

For interest rate derivatives agreements in connection with the loans under the Facility Agreement, see Note 14.

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NOTE 16 - COMMITMENTS AND CONTINGENCIES (cont.)

A. Commitments and Contingencies Relating to Fab 2 (cont.)

(6) Approved Enterprise Status

For details regarding Approved Enterprise Status relating to Fab2, see Note 7C.

(7) Agreement with the ILA

In November 2000, Tower entered into a development agreement with the Israel Land Administration (“ILA”) with respect to a parcel of land on which Fab 2 was constructed. Following the completion of the construction of Fab 2 on the land, in June 2003, Tower entered into a long-term lease agreement with the ILA for a period ending in 2049. The lease payments through 2049 relating to this lease have been paid in advance and are expensed through the operational lease period.

B. License Agreements

(1) In June 2000, Tower entered into a cross license agreement with a major technology company. According to the agreement, each party acquired a non-exclusive license to certain of the other’s patents. Tower agreed to pay an annual license fee through July 2005. In July 2006, Tower extended its cross license agreement with the major technology company until December 2010 in consideration for an annual license fee through 2010.

(2) The Company enters into intellectual property and licensing agreements with third parties from time to time. The effect of each of them on the Company’s total assets and results of operations is immaterial. Certain of these agreements call for royalties to be paid by the Company to these third parties.

C. Leases

(1) Tower’s offices and engineering and manufacturing operations are located in a building complex situated in an industrial park in Migdal Ha’emek, in the northern part of Israel. These premises are currently occupied under a long-term lease from the ILA, which expires in 2032. Tower has no obligation for lease payments related to this lease through the year 2032.

(2) With respect to a long-term lease agreement of land on which Fab 2 was constructed, see A(7) above.

(3) Tower occupies certain other premises under various operating leases. The obligations under such leases were not material as of December 31, 2009.

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NOTE 16 - COMMITMENTS AND CONTINGENCIES (cont.)

C. Leases (cont.)

- (4) Jazz leases its fabrication facilities, land and headquarters from Conexant Systems, Inc. (“Conexant”) under non-cancelable operating leases through 2017. Jazz has the unilateral option to extend the terms of each of these leases for two consecutive five-year periods ending in 2027. Jazz’s rental payments under these leases consist solely of its pro rata share of the expenses incurred by Conexant in the ownership of these buildings and applicable adjustments for increases in the consumer price index. These expenses include property taxes, building insurance, depreciation and common area maintenance and are included in operating expenses in the accompanying consolidated statements of operations. Jazz is not permitted to sublease space that is subject to the leases with Conexant without Conexant’s prior approval. Jazz also leases office and warehouse facilities from third parties. In connection with the acquisition of Jazz Semiconductor, Jazz and Conexant executed amendments to the leases. Under the lease amendments, Jazz’s headquarters may be relocated one time no earlier than 12 months from the completion of the acquisition of Jazz Semiconductor to another building within one mile of Jazz’s current location at Conexant’s option and expense subject to certain conditions. The amount allocated to facilities leases represents the fair value of acquired leases calculated as the difference between market rates for similar facilities in the same geographical area and the rent Jazz is estimated to pay over the life of the leases, discounted back over the life of the lease. The future minimum costs under these leases have been estimated based on costs incurred during 2009.

As of December 31, 2009, future minimum payments under operating leases are primarily due to Conexant and these costs have been estimated based on the actual costs incurred during 2009 and when applicable have been adjusted for increases in the consumer price index.

On January 2010, Conexant sold the fabrication facilities, land and headquarters to City Ventures LLC, a leading residential and mixed-use developer of urban projects throughout California. Jazz expects no impact of this sale on its operations and business.

Future minimum payments under non-cancelable operating leases are as follows:

| | Payment Obligations by Year | | | | | | |
|------------------|------------------------------------|----------|----------|----------|---------|-----------|-----------|
| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015-2018 | Total |
| Operating leases | \$ 2,300 | \$ 2,300 | \$ 2,300 | \$ 2,300 | \$2,300 | \$ 5,053 | \$ 16,553 |

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NOTE 16 - COMMITMENTS AND CONTINGENCIES (cont.)

D. Other Principal Agreements

The Company, from time to time in the ordinary course of business, enters into long-term agreements with various entities for the joint development of products and processes utilizing technologies owned separately by either the other entity or the Company, or owned jointly by both parties, as applicable.

(1) Siliconix

In 2004, Tower and Siliconix incorporated (“Siliconix”), a subsidiary of Vishay Intertechnology Inc., entered into a definitive long-term foundry agreement for semiconductor manufacturing in the Company’s Fab 1. During recent years, the parties amended the agreement several times to revise the terms of the purchase of wafers, and transfer additional product platforms to Tower for the manufacturing of new products in Fab 1.

(2) SanDisk Corporation

In 2006, Tower and SanDisk Corporation (“SanDisk”), one of its Primary Wafer Partners, signed a Loan Agreement under which Tower borrowed approximately \$10,000 from SanDisk for the purpose of financing the purchase of a portion of the equipment needed for 0.13 micron production and SanDisk was granted a first ranking charge on the equipment purchased therewith. The loan bears interest on the amounts outstanding at three-month USD LIBOR plus 1.1%. In recent years, the parties amended the agreement mainly to revise the terms of the loan repayments schedule.

(3) Agreement with Crocus Technology

In June 2009, Tower and Crocus Technology, a developer of Magnetic Random Access Memory (MRAM), entered into an exclusive agreement to port Crocus’ MRAM process technology into Tower’s manufacturing environment. As part of this agreement, Tower will perform all manufacturing steps required for Crocus’ next-generation MRAM technology in Fab 2. In addition to collaborating on the process port, Tower will receive an equity position in Crocus valued at \$1,250, as agreed between the parties to reflect the fair market value of the shares as of agreement date.

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NOTE 16 - COMMITMENTS AND CONTINGENCIES (cont.)

D. Other Principal Agreements (cont.)

(4) An agreement with an Asian entity

In November 2009, Tower entered into a definitive agreement with an Asian entity. Under the agreement, Tower will provide turnkey manufacturing solutions and will arrange for the required manufacturing know-how, training and certain assets required for the capacity ramp-up of the Asian entity.

For revenue recognition policy in that regard, see Note 2K. During the year ended December 31, 2009, Tower recorded \$8,079 revenues and \$5,167 expenses in the statement of operation relating to this agreement.

E. Environmental Affairs

The Company's operations are subject to a variety of laws and governmental regulations in Israel relating to the use, discharge and disposal of toxic or otherwise hazardous materials used in the production processes. Operating permits and licenses are required for the operation of The Company's facilities and these permits and licenses are subject to revocation, modification and renewal. Government authorities have the power to enforce compliance with these regulations, permits and licenses. As of the approval date of the financial statements, the Company was in compliance with the terms of said permits and licenses.

F. International Trade Commission Action

During 2008, an International Trade Commission ("ITC") action was filed by Agere/LSI Corporation ("LSI"), which alleged infringement by 17 corporations of LSI's patent No. 5227335. Following the initial filing, in October 2008, LSI amended the ITC complaint to add Tower, Jazz and three other corporations as additional respondents. The case was tried before an administrative law judge ("Judge") in July 2009. In September 2009, the Judge ruled against LSI and in favor of the respondents, determining that the patent claims asserted by LSI are invalid. In November 2009, in response to a Petition for Review filed by LSI, the ITC determined that it would review the Judge's determination on patent invalidity. To date, no further ruling has been issued by the ITC on any claims asserted against Tower or Jazz.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 16 - COMMITMENTS AND CONTINGENCIES (cont.)

G. In connection with Jazz's aerospace and defense business, its facility security clearance and trusted foundry status, Tower and Jazz are working with the Defense Security Service of the United States Department of Defense ("DSS") to develop an appropriate structure to mitigate any concern of foreign ownership, control or influence over the operations of Jazz specifically relating to protection of classified information and prevention of potential unauthorized access thereto. In order to safeguard classified information, it is expected that the DSS will require adoption of a Special Security Agreement ("SSA"). The SSA may include certain security related restrictions, including restrictions on the composition of the board of directors, the separation of certain employees and operations, as well as restrictions on disclosure of classified information to Tower. The provisions contained in the SSA may also limit the projected synergies and other benefits to be realized from the Jazz Merger. There is no assurance when, if at all, an SSA will be reached.

H. Jazz's Supply Agreement

Jazz has a guaranteed supply agreement for certain gases used in Jazz's manufacturing process that expires in 2014. The agreement specifies minimum purchase commitments and contains a termination fee that is adjusted downward on each of the agreement's anniversary dates. The initial minimum purchase commitment of approximately \$1,000 annually is adjusted based on supplemental gas purchases, wage increases for the labor portion of the minimum purchase commitment and price increases for supplemental product. If Jazz were to terminate the supply agreement prior to 2014, the termination fee would be approximately \$3,000.

I. Other Commitments

Receipt of certain research and development grants from the government of Israel is subject to various conditions. In the event Tower fails to comply with such conditions, Tower may be required to repay all or a portion of the grants received. In Tower's opinion, Tower has been in full compliance with the conditions through December 31, 2009. In regard to Investment Center grants, see Note 7C.

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NOTE 17 - SHAREHOLDERS' EQUITY

A. Description of Ordinary Shares

As of December 31, 2009 and 2008, Tower had 1.1 billion authorized ordinary shares, par value NIS 1.00 each, of which approximately 199 million and 160 million, respectively, were issued and outstanding (net of 1.3 million ordinary shares held by Tower as of such dates). As of December 31, 2009, there were additional ordinary shares of Tower contingently issuable under various agreements according to their provisions, as detailed below: (i) the possible exercise of TIC warrants, see B(5)(b) below; (ii) the possible exercise of outstanding warrants, see notes 11, 13E and F and J below; (iii) the possible exercise of options granted to employees of the Company and non-employees, see B(1) below; (iv) the possible conversion of outstanding convertible debentures, see Note 13; (v) the possible exercise of equity equivalent capital notes, see C below; (vi) the possible exercise of Banks warrants, see B(5) below; and (vii) the conversion of Jazz's convertible debentures and the exercise of Jazz's outstanding warrants into Tower's ordinary shares, see H below. Holders of ordinary shares are entitled to participate equally in the payment of cash dividends and bonus share (stock dividend) distributions and, in the event of the liquidation of Tower, in the distribution of assets after satisfaction of liabilities to creditors. Each Ordinary Share is entitled to one vote on all matters to be voted on by shareholders.

B. Share Option Plans

(1) Employee, Chairman of the Board of Directors, Chief Executive Officer and Director Share Options

(a) General

The Company has granted to its employees options to purchase ordinary shares under several option plans adopted by the Company since 1995. The particular provisions of each plan and grant vary as to vesting period, exercise price, exercise period and other terms. Generally, the options are granted at an exercise price which equals the closing market price of the ordinary shares immediately prior to the date of grant, vest over a one to four-year period according to various vesting schedules, and are not exercisable beyond ten years from the grant date.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

B. Share Option Plans (cont.)

(1) Employee, Chairman of the Board of Directors, Chief Executive Officer and Director Share Options (Cont.)

(b) *Share Incentive Plan for the Former Chairman of the Company's Board of Directors*

The former chairman served as the chairman of the Company's Board of Directors ("Board") until January 5, 2009. Pursuant to his appointment as chairman, in December 2006, the Audit Committee of the Board ("Audit Committee") and the Board approved granting him options to purchase 3.2 million ordinary shares of the Company, which constituted 1% of the Company's issued and outstanding share capital on a fully diluted basis as of December 2006, the date the Board approved the grant. The options vest over 4 years, 25% on the 12 month anniversary of the shareholders approval date and 6.25% on each 3 month anniversary of the first vesting date until fully vested. The options grant to the former chairman of the Board was approved by the shareholders of the Company in January 2007. Upon termination of the Company's chairman, all unvested options immediately expired and the 1.4 million vested options are exercisable until January 2011. The exercise price is \$1.88, which was the closing price of the Company's ordinary shares on the NASDAQ Global Market on the trading day immediately prior to the date of approval of the grant by the Shareholders of the Company.

(c) *Share Incentive Plan for the Chairman of Board*

In June 2009, the Audit Committee and the Board approved a grant to the Chairman of the Board of options to purchase 11.5 million Tower ordinary shares, which was further approved by Tower's shareholders in November 2009 (the "Date of Grant"). The exercise price is \$0.29 (but not lower than the nominal value of Tower's ordinary shares), which was the closing price of Tower's ordinary shares on the NASDAQ Global Market on the trading day immediately prior to the date of approval of the grant by the Board. The options vest over three years as follows: 50% of the options shall vest on the second anniversary of the Date of Grant and an additional 50% on the third anniversary of the Date of Grant. The options are exercisable for a period of seven years from the Date of Grant. The compensation cost of the options granted was determined based on the fair value at the Date of Grant and amounted to \$9,711. Such amount is expensed on an accelerated basis over the vesting periods of the options.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

B. Share Option Plans (cont.)

(1) Employee, Chairman of the Board of Directors, Chief Executive Officer and Director Share Options (cont.)

(d) *Share Incentive Plan for the Company's Employees and CEO*

In April 2005, the Board approved the grant of options to purchase up to 1.3 million ordinary shares to the Chief Executive Officer ("CEO"), who also serves as a director, which was further approved by Tower's shareholders in October 2005. These options are exercisable at an exercise price of \$1.56, which was the closing market price of Tower's shares on the last trading day prior to the Board approval of the grant. These options will vest over a four-year period, with 25% vesting over each year of employment. The options granted are exercisable for a period of ten years from the date of grant.

In May 2006, the Audit Committee and Board approved the grant of options to the CEO, in addition to the options granted to him in 2005, such that in total, the CEO will hold options to purchase shares that represent 4% of Tower's shares on a fully diluted basis during the two-year period from the approval of the Audit Committee. The exercise price of the initial grant of the additional options was \$1.45, the 90-day average closing price of Tower's shares prior to the Board's approval. Dilutive events following May 2006 and until May 2008 also entitled him to additional option grants with an exercise price equal to the price per share of the newly issued securities. The additional options granted during the two-year period will vest in equal amounts over 4 years of employment commencing from May 2006. The options are exercisable for a period of 10 years from the date of grant. Such grant of options and its terms were approved by Tower's shareholders in September 2006.

In May 2006, the Board approved that if the total number of employee options, including the options to the CEO, during the two-year period from May 2006 will represent less than 8% of Tower's shares on a fully diluted basis, additional options will be allocated for grants to Tower's employees.

In November 2008, the Audit Committee and Board approved Tower's 2009 Employee Share Incentive Plan (the "Plan") to grant options and/or restricted share units ("RSU's") to the Company's employees (including its CEO), which plan was approved by Tower's shareholders in April 2009. Up to approximately 28 million options are reserved for grant to the Company's employees (excluding its CEO), and approximately 28 million additional options under the Plan are reserved for grant to the CEO. However, the amount of available options for grant at any time will be reduced by the aggregate number of outstanding options available for grant under previous employee option plans and under the previous CEO Share Option Plan.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

B. Share Option Plans (cont.)

(1) Employee, Chairman of the Board of Directors, Chief Executive Officer and Director Share Options (cont.)

(d) *Share Incentive Plan for the Company's Employees and CEO*

In June 2009, the Board approved a grant to the CEO under the Plan to purchase up to 8.5 million ordinary shares. These options are exercisable at an exercise price of \$0.29 (but not lower than the nominal value of Tower's ordinary shares), which was the closing price of Tower's shares on the NASDAQ Global Market on the trading day immediately prior to the date of approval of the grant by the Board. These options will vest over a three-year period as follows: 50% of the options shall vest on the second anniversary of the date of grant and an additional 50% on the third anniversary of the date of grant. The options granted are exercisable for a period of seven years from the date of grant.

In June 2009, the Board approved a grant to the employees of the Company under the Plan to purchase up to 9 million ordinary shares. These options are exercisable at an exercise price of \$0.29 (but not lower than the nominal value of Tower's ordinary shares), which was the closing price of Tower's shares on the NASDAQ Global Market on the trading day immediately prior to the date of approval of the grant by the Board. These options will vest over a three-year period as follows: 50% of the options shall vest on the second anniversary of the date of grant and an additional 50% on the third anniversary of the date of grant. The options granted are exercisable for a period of seven years from the date of grant.

As of the balance sheet date, a total of 23.4 million options were outstanding to the CEO. The compensation cost of the total options granted to the CEO was determined based on the fair value on the grant dates and amounted to \$13,139. Such amount is expensed on an accelerated basis over the vesting periods of the options.

As of the balance sheet date, approximately 6.5 million options are available for future grant of options to Company employees.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

B. Share Option Plans (cont.)

(1) Employee, Chairman of the Board of Directors, Chief Executive Officer and Director Share Options (cont.)

(e) *Options Granted to Directors*

During 2001, the Audit Committee, the Board and the shareholders approved a stock option plan pursuant to which certain of Tower's directors will be granted options to purchase up to 400,000 Tower ordinary shares (40,000 to each eligible director appointed to the Board of Directors) at an exercise price equal to the closing market price of the ordinary shares immediately prior to the date of grant. As of December 31, 2009, 120,000 options were outstanding under the plan with a weighted average exercise price of \$1.58.

Options granted under the plan vest over a four-year period according to various vesting schedules, and generally may not be exercised beyond five years from the date they first become exercisable. So long as the Independent Directors' Option Plan described below remains in effect, no new independent director, appointed after January 2007 will be entitled to receive options under the 2001 director options plan.

(f) *Independent Directors' Option Plan*

In November 2006, the Board approved, following the approval by the Audit Committee, the grant to each independent director options to purchase ordinary shares ("Initial Options") that shall equal 150,000 less the number of options to purchase ordinary shares held by such independent director as of January 31, 2007, the date the shareholders approved the grant (the "Initial Grant Date") and which, as of the Initial Grant Date, have not vested. The Initial Options shall vest over 3 years: one third will vest on the 12 month anniversary of the Initial Grant Date, and thereafter, the remaining two thirds will vest on a monthly basis until fully vested. The exercise price of the Initial Options is \$1.88, which was the closing price of Tower's ordinary shares on NASDAQ on the trading day immediately prior to the Initial Grant Date. Each new independent director appointed after the Initial Grant Date shall be granted 150,000 options to purchase ordinary shares ("Subsequent Options"), which, shall vest over 3 years: one third on the 12 month anniversary of the date on which such independent director shall have served on the Board, the remaining two thirds will vest on a monthly basis until fully vested. The exercise price per Subsequent Option shall be the closing price of Tower's ordinary shares on NASDAQ on the trading day immediately prior to the relevant date of appointment.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

B. Share Option Plans (cont.)

(1) Employee, Chairman of the Board of Directors, Chief Executive Officer and Director Share Options (cont.)

(f) Independent Directors Option Plan (cont.)

Upon each 36 month anniversary of a previous grant of options to an independent director (each a "Tenure Grant Date"), each such independent director shall be granted an additional 150,000 options to purchase ordinary shares ("Tenure Options"), which will vest over 3 years on a monthly basis until fully vested. The exercise price per Tenure Option shall be the closing price of Tower's ordinary shares on NASDAQ on the trading day immediately prior to the relevant Tenure Grant Date. Subject to certain conditions, the Initial Options, Subsequent Options and Tenure Options that have vested shall be exercisable by an independent director for a period of ten years following the date on which the Initial Options, Subsequent Options or Tenure Options, as the case may be, first vested. So long as this option plan remains in effect, no future grants will be made to independent directors under the plan described in (e) above.

During 2009, under the Independent Director Share Option Plan, 0.3 million options were granted to new directors appointed to the Board in 2009 at an average exercise price of \$0.20 (but not lower than the nominal value of Tower's ordinary shares).

As of December 31, 2009 0.86 million options were outstanding under the plan with a weighted average exercise price of \$0.83.

The compensation cost of the total options granted to the directors and to independent directors under the plans described in (e) and (f) above was determined based on the fair value on the grant dates and amounted to \$474. Such amount is expensed on an accelerated basis over the vesting periods of the options.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

B. Share Option Plans (cont.)

(2) Summary of the Status of all the Company's Employee and Director Share Options

A summary of the status of all employee and director share option plans as of December 31, 2009, 2008 and 2007, as well as changes during each of the years then ended, is presented below (for options granted to the Banks, a related party and a consultant, see B(5) below):

| | 2009 | | 2008 | | 2007 | |
|---------------------------------------|-------------------------|---------------------------------|-------------------------|---------------------------------|-------------------------|---------------------------------|
| | Number of share options | Weighted average exercise price | Number of share options | Weighted average exercise price | Number of share options | Weighted average exercise price |
| Outstanding as of beginning of year | 35,118,153 | \$ 1.62 | 29,595,535 | \$ 1.79 | 23,514,042 | \$ 1.87 |
| Granted | 29,292,482 | 0.29 | 10,847,825 | 1.23 | 9,127,384 | 1.88 |
| Exercised | (24,725) | 0.85 | (5) | 1.45 | (176,231) | 1.30 |
| Terminated | -- | -- | (32,712) | 6.83 | (525,000) | 7.07 |
| Forfeited | (2,861,361) | 1.59 | (5,292,490) | 1.77 | (2,344,660) | 1.81 |
| Outstanding as of end of year | <u>61,524,549</u> | 0.99 | <u>35,118,153</u> | 1.62 | <u>29,595,535</u> | 1.79 |
| Options exercisable as of end of year | <u>22,815,612</u> | \$ 1.74 | <u>15,585,571</u> | \$ 1.87 | <u>7,827,743</u> | \$ 2.15 |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

B. Share Option Plans (cont.)

(3) Summary of Information about Employee Share Options Outstanding

The following table summarizes information about employee share options outstanding as of December 31, 2009:

| Outstanding as of December 31, 2009 | | | | Exercisable as of December 31, 2009 | |
|-------------------------------------|-----------------------|--|--|--|--|
| Range of exercise Prices | Number outstanding | Weighted average remaining contractual life (in years) | Weighted average exercise price | Number exercisable | Weighted average exercise price |
| \$ 0.18-\$ 0.29 | 29,143,232 | 6.74 | \$ 0.29 | -- | \$ 0.00 |
| 0.32-0.69 | 1,984,861 | 8.60 | 0.54 | 660,242 | 0.59 |
| 0.84-0.95 | 720,812 | 8.39 | 0.87 | 170,508 | 0.87 |
| 1.06 | 2,809,400 | 8.10 | 1.06 | 714,050 | 1.06 |
| 1.18-1.40 | 1,407,934 | 6.32 | 1.36 | 1,148,634 | 1.35 |
| 1.45 | 7,116,033 | 6.35 | 1.45 | 5,348,436 | 1.45 |
| 1.50-1.59 | 8,855,546 | 6.13 | 1.54 | 7,309,982 | 1.54 |
| 1.6-1.78 | 2,444,803 | 7.04 | 1.73 | 1,389,127 | 1.73 |
| 1.8-1.83 | 1,502,343 | 7.28 | 1.81 | 1,233,985 | 1.81 |
| 1.88-1.96 | 2,862,075 | 3.64 | 1.88 | 2,554,184 | 1.88 |
| 2.02-2.28 | 1,832,662 | 6.44 | 2.12 | 1,522,564 | 2.13 |
| \$3.25-\$25.00 | 844,848 | 4.46 | \$ 6.53 | 763,900 | \$ 6.78 |
| | <u>61,524,549</u> | | | <u>22,815,612</u> | |

(4) Weighted Average Grant-Date Fair Value of Options Granted to Employees

The weighted average grant-date fair value of the options granted during 2009, 2008 and 2007 to employees and directors amounted to \$0.52, \$0.43 and \$0.87 per option, respectively. Tower utilizes the Binomial lattice model. Jazz utilizes the Black-Scholes model. The Company estimated the fair value, utilizing the following assumptions for the years 2009, 2008 and 2007 (all in weighted averages):

| | 2009 | 2008 | 2007 |
|----------------------------|-------------|-------------|-------------|
| Risk-free interest rate | 2.51%-3.83% | 2.61%-4.27% | 3.61%-6.09% |
| Expected life of options | 7 years(*) | 10 years(*) | 10 years |
| Expected annual volatility | 63%-78.5% | 51%-72% | 55%-65% |
| Expected dividend yield | None | None | None |

(*) Expected life of options granted to Jazz employees was 4.7 and 6 years for the years ended December 31, 2009 and 2008, respectively.

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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

B. Share Option Plans (cont.)

(5) Non-Employee Warrants

(a) Banks Warrants

As of December 31, 2009, 12.8 million warrants to purchase ordinary shares of Tower, at terms described below, were outstanding and exercisable, at a weighted average exercise price of \$1.69 per share, of which 11.7 million warrants are exercisable until 2013 and 1.1 million exercisable through 2012.

The cost of 9.2 million of the warrants issued to the Banks, exercisable until 2013, was determined based on the fair value at the grant and amendment dates and amounted to a total of \$10,886.

In September 2007, as part of Tower's credit line agreement with the Banks described in Note 12B, the Banks received an aggregate of 2.5 million warrants to purchase ordinary shares of Tower at an exercise price of \$2.04 per share. All the warrants were exercisable until March 2010 and following the August 2009 amendment to the Facility Agreement are exercisable until June 2013. The cost of the warrants, determined based on the fair value at the grant and amendment dates, amounted to a total of \$608.

In August 2009, as part of the terms of the August 2009 amendment to the Facility Agreement, Tower agreed to issue the Banks 1.1 million new warrants in three annual tranches of \$1,000 each, at a quantity and price to be determined based on the future stock price (the first tranche of which was issued for an exercise price of \$0.89). See Note 12B for the accounting treatment of these warrants.

In lieu of paying the exercise price in cash, the Banks are entitled to exercise their warrants on a "cashless" basis, i.e. by forfeiting part of the warrants in exchange for ordinary shares equal to the aggregate fair market value of the shares underlying the warrants forfeited less the aggregate exercise price.

(b) Warrants Granted to TIC

Tower issued TIC warrants for the purchase of 58,906 of Tower's ordinary shares. The exercise price for the warrants was \$6.17 per share, the 15-day average closing price of Tower's ordinary shares prior to the date the November 2003 amendment with the Banks was signed. The warrants were exercisable for a five-year period ending December 2008, none of which were exercised. The cost of the warrants award granted to TIC, determined based on the fair value at the grant date, amounted to a total of \$259.

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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

B. Share Option Plans (cont.)

(5) Non-Employee Warrants (cont.)

(b) Warrants Granted to TIC (cont.)

In September 2007, as part of Tower's credit line agreement with TIC described in Note 12B, TIC received an aggregate of 2.9 million warrants to purchase ordinary shares of Tower at an exercise price of \$2.04 per share. All the warrants are exercisable until March 2010. The cost of the warrants, determined based on the fair value at the grant and amendment dates, amounted to a total of \$723.

C. Equity-Equivalent Capital Notes

(1) Equity-Equivalent Capital Notes

All issued equity equivalent capital notes described in these financial statements have no voting rights, no maturity date, no dividend rights, are not tradable, are not registered, do not carry interest, are not linked to any index and are not redeemable. In January 2007, at the request of the Banks and Israel Corp. (the holders of the capital notes) pursuant to their right to request registration, the Company filed a registration statement with the SEC on Form F-3 for the registration of the shares underlying the capital notes. The SEC, among other comments, required that the Banks and Israel Corp be named as underwriters for purposes of this registration statement. The Banks and Israel Corp. did not agree to be named as underwriters and in 2008 asked the Company to withdraw the registration statement. The shares underlying the capital notes remain unregistered under the US Securities Act of 1933. The equity equivalent capital notes are classified in shareholders' equity. For further information regarding the equity equivalent capital notes, see Note 12B.

For further information regarding the equity equivalent capital notes, see Note 12B.

D. Treasury Stock

During 1998, the Board authorized, subject to certain conditions, the purchase of up to 1.4 million of Tower ordinary shares to facilitate the exercise of employee stock options under Tower's share option plans. During 1999 and 1998, the Company funded the purchase by a trustee of 0.1 million and 1.2 million, respectively, of Tower's ordinary shares.

E. Dividend Distributions

According to the Facility Agreement, as amended to date, Tower undertook not to distribute any dividends prior to the date that all amounts payable under the Facility Agreement have been paid in full.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

F. Private Placement in the US - March 2007

In March 2007, Tower completed a private placement of its securities in which it sold ordinary shares and warrants for the purchase of ordinary shares, raising a total of approximately \$29,000 in gross proceeds. In the private placement, Tower issued approximately 18.8 million shares and warrants exercisable into approximately 9.4 million shares exercisable until March 2012 at an exercise price of \$2.04 ("Series I Warrants"). This exercise price is subject to an adjustment mechanism under certain limited circumstances during a five year period. Under such circumstances, the exercise price was adjusted during 2009 to be \$0.74.

Following exercises done by several investors, the Series I Warrants outstanding is approximately 6.9 million as of December 31, 2009. Following the adoption of EITF 07-5 as codified in ASC 815-40, on January 1, 2009, Series I Warrants were classified from equity to liabilities. Since Series I Warrants are carried at fair value, the changes in fair value reflect the decreased exercise price. Series I Warrants will continue to be carried at fair value due to potential exercise price adjustment.

G. Shelf Prospectus - 2008

In January 2008, Tower filed a shelf registration statement on Form F-3 with the U.S. Securities and Exchange Commission, registering the possible offer and sale from time to time of up to \$40,000 of securities which Tower may elect to so offer and sell during the three years following the effective date of the registration statement. The registration form was declared effective in February 2008. As of December 31, 2009, this registration statement was fully utilized following the investments detailed in I and J below.

H. Securities Issuance Pursuant to the Jazz Merger

On September 19, 2008, pursuant to the terms of the Jazz Merger signed on May 19, 2008, Tower acquired all of Jazz's outstanding capital in a stock-for-stock transaction. See Note 3.

For accounting purposes, the purchase price for the acquisition of Jazz's stock was reconciled against all consideration made to date as follows:

| | |
|-------------------------------------|------------------|
| Stock consideration | \$ 39,189 |
| Other equity consideration | 7,555 |
| Total merger consideration | 46,744 |
| Transaction costs | 3,326 |
| Total revised purchase price | \$ 50,070 |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

H. Securities Issuance Pursuant to the Jazz Merger (cont.)

Pursuant to the merger, Jazz's outstanding stock options immediately prior to September 19, 2008, whether vested or unvested, were converted to options to purchase Tower's ordinary shares on the same terms and conditions as were applicable to such options, with adjusted exercise prices and numbers of shares to reflect the exchange ratio of the common stock. This conversion was accounted for as a modification in accordance with ASC 718 Compensation—Stock Compensation, with the fair value of the outstanding options of \$1,290 being included as part of the purchase price.

Pursuant to the Jazz Merger, all outstanding warrants to purchase the shares of Jazz's common stock that were outstanding immediately prior to September 19, 2008, became exercisable for Tower's ordinary shares. The fair value of the outstanding warrants of \$6,265 was included as part of the purchase price.

Tower's transaction costs of \$3,326 primarily consist of fees for financial advisors, attorneys, accountants and other advisors incurred in connection with the Jazz Merger.

I. Definitive Agreement with Yorkville

In August 2009, Tower entered into a definitive agreement with YA Global Master SPV Ltd. ("Yorkville"), according to which Yorkville committed to invest in Tower, upon Tower's request, up to \$25,000 over the next 24 months by way of a stand-by equity-line, in consideration for ordinary shares of Tower to be issued at a 3% discount on the market price of the ordinary shares as determined in accordance with the agreement. Investments made by Yorkville will be made such that Yorkville will not hold more than 4.99% of Tower's ordinary shares during the period of the agreement. As of December 31, 2009, draw downs in the amount of approximately \$13,000 have been made under this agreement. No warrants or any debt or derivative instruments were issued by Tower under this agreement.

J. Investment by Israeli Institutional Investors

In September 2009, Tower raised approximately \$21,000 of gross proceeds from certain Israeli institutional investors invested in Tower's shareholders' equity. In consideration for such investment, Tower sold approximately 22 million ordinary shares and approximately 5.3 million Warrants Series 6. Warrants Series 6 are exercisable through August 2011, are traded on the Tel Aviv Stock Exchange, and are classified as shareholders' equity.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 17 - SHAREHOLDERS' EQUITY (cont.)

K. Shelf Prospectus - 2009

In November 2009, Tower filed a shelf registration statement on Form F-3 with the U.S. Securities and Exchange Commission, registering the possible offer and sale from time to time of up to \$50,000 of securities which Tower may elect to so offer and sell during the three years following the effective date of the registration statement. The registration form was declared effective in December 2009. As of December 31, 2009, the registration statement was not utilized.

NOTE 18 - INFORMATION ON GEOGRAPHIC AREAS AND MAJOR CUSTOMERS

A. Revenues by Geographic Area - as percentage of total sales

| | Year ended December 31, | | |
|---------------|-------------------------|-------------|-------------|
| | 2009 | 2008 | 2007 |
| United States | 79% | 77% | 75% |
| Israel | 3 | 5 | 7 |
| Asia Pacific | 13 | 11 | 10 |
| Europe | 5 | 7 | 8 |
| Total | 100% | 100% | 100% |

B. Long-Lived Assets by Geographic Area - Substantially all of Tower's long-lived assets are located in Israel and substantially all of Jazz's long-lived assets are located in the United States.

C. Major Customers - as percentage of net accounts receivable balance

Accounts receivable from significant customers representing 10% or more of the net accounts receivable balance as of December 31, 2009 and December 31, 2008 consist of the following customers:

| | As of December 31, | |
|------------|--------------------|------|
| | 2009 | 2008 |
| Customer 1 | 20% | 19% |
| Customer 2 | 5 | 14 |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 18 - INFORMATION ON GEOGRAPHIC AREAS AND MAJOR CUSTOMERS (cont.)

D. Major Customers - as percentage of total sales

| | Year ended December 31, | | |
|----------------------|-------------------------|------|------|
| | 2009 | 2008 | 2007 |
| Customer A | 17% | 8% | --% |
| Customer B | 11 | 17 | 13 |
| Customer C | 4 | 13 | 11 |
| Customer D (*) | -- | 9 | 29 |
| Other customers (**) | 7 | 8 | 23 |

(*) Related party.

(**) Represents sales to one customer who accounted for 7% of sales during 2009; and to two different customers each of whom accounted for between 3% and 5% of sales during 2008 and to four different customers each of whom accounted for between 5% and 7% of sales during 2007.

NOTE 19 - FINANCING EXPENSES, NET

Financing expenses, net consist mainly of Banks' loans expenses (see Note 12), and interest and other financing expenses in connection with debentures (see Note 13).

NOTE 20 - INCOME TAXES

A. Approved Enterprise Status

Substantially all of Tower's existing facilities and other capital investments through December 31, 2005 have been granted approved enterprise status, as provided by the Investments Law. See also Note 7C.

The tax benefits derived from approved enterprise status relate only to taxable income attributable to each approved enterprise investments program. Pursuant to the Investments Law and the approval certificates, Tower's income attributable to its various approved enterprise investments is taxed at a rate of up to 25% through 2012. Taxable income attributable to the Fab 2 approved program shall be tax-exempt for the first two profitable years for tax purposes. The portion of Tower's taxable income that is not attributable to approved enterprise investments is taxed at a rate of 26% in 2009 ("regular Company Tax"). The regular Company Tax rate is to be reduced to 25% in 2010.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 20 - INCOME TAXES (cont.)

A. Approved Enterprise Status (cont.)

The tax benefits are also conditioned upon fulfillment of the requirements stipulated by the Investments Law and the regulations promulgated thereunder, as well as the criteria set forth in the certificates of approval. In the event of a failure by Tower to comply with these conditions, the tax benefits could be canceled, in whole or in part, and Tower would be required to refund the amount of the canceled benefits, plus interest and certain inflation adjustments. In the Company's opinion, Tower has been in compliance with the conditions through the approval date of the financial statements. See Note 7C.

B. Income Tax provision is as follows:

| | Year Ended | |
|--------------------------------|-------------------|-------------------|
| | December 31, 2009 | December 31, 2008 |
| Current tax expense: | | |
| Federal | \$ 4 | \$ 2 |
| State | 43 | 17 |
| Foreign | 3 | 14 |
| Total current | 50 | 33 |
| Deferred tax expense: | | |
| Federal | 464 | 1,125 |
| State | (5,536) | 297 |
| Total deferred | (5,072) | 1,422 |
| Income tax provision (benefit) | \$ (5,022) | \$ 1,455 |

C. Components of Deferred Tax Asset/Liability

The following is a summary of the components of the deferred tax benefit and liability reflected on the balance sheets as of the respective dates:

| | As of December 31, | |
|---|--------------------|-----------------|
| | 2009 | 2008 |
| Deferred tax benefit – current | | |
| Net operating loss carryforwards | \$ 1,737 | \$ -- |
| Employees benefits and compensation | 2,783 | 2,282 |
| Accruals, reserves and others | 3,691 | 1,716 |
| | 8,211 | 3,998 |
| Valuation allowance | (1,034) | (783) |
| Total current deferred tax benefit | \$ 7,177 | \$ 3,215 |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 20 - INCOME TAXES (cont.)

C. Components of Deferred Tax Asset/Liability (cont.)

| | As of December 31, | |
|--|--------------------|--------------------|
| | 2009 | 2008 |
| Net deferred tax benefit - long-term | | |
| Deferred tax assets - | | |
| Net operating loss carryforwards | \$ 242,421 | \$ 210,907 |
| Employees benefits and compensation | 4,051 | 5,757 |
| Research and development | 1,523 | 1,923 |
| | <u>247,995</u> | <u>218,587</u> |
| Valuation allowance | (201,853) | (176,251) |
| | <u>46,142</u> | <u>42,336</u> |
| Deferred tax liability - depreciation and amortization | (34,873) | (26,527) |
| Intangible assets | (15,915) | (18,508) |
| Investment basis difference | (2,922) | (3,142) |
| Others | (3,627) | (5,908) |
| Total net long-term deferred tax benefit | \$ (11,195) | \$ (11,749) |

Deferred tax asset in the amounts of \$7,177 and \$3,215 as of December 31, 2009 and 2008, respectively are presented in Other Current Assets.

Deferred tax liability in the amounts of \$11,195 and \$11,749 as of December 31, 2009 and 2008, respectively are presented in other Long-Term Liabilities.

Jazz establishes a valuation allowance for deferred tax assets when it is unable to conclude that it is more likely than not that such deferred tax assets will be realized. In making this determination, Jazz evaluates both positive and negative evidence. The state deferred tax assets exceed the reversal of taxable temporary differences. Without other significant positive evidence, the Company has determined that the state deferred tax assets are not more likely than not to be realized. At December 31, 2009 Jazz recorded a valuation allowance against its deferred tax assets in the amount of \$2,236.

Tower recorded a valuation allowance of \$200,651 on December 31, 2009 and \$177,034 as of December 31, 2008 to offset the related net deferred tax assets as Tower is unable to conclude that it is more likely than not that such deferred tax assets will be realized.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| | Unrecognized tax benefits |
|--|---------------------------|
| Balance at January 1, 2009 | \$ 1,871 |
| Additions for tax positions of prior year | 9,641 |
| Reductions for tax positions of prior year | (583) |
| Balance at December 31, 2009 | \$ 10,929 |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 20 - INCOME TAXES (cont.)

C. Components of Deferred Tax Asset/Liability (cont.)

| | <u>Unrecognized tax benefits</u> |
|--|----------------------------------|
| Balance at January 1, 2008 | \$ -- |
| Addition due to the Merger | 1,222 |
| Additions based on tax positions related to the current year | 649 |
| Balance at December 31, 2008 | <u>\$ 1,871</u> |

The \$9,641 increase in the gross unrecognized tax benefit in 2009 has been recorded as a change to a prior year unrecognized tax benefit see “additions for tax positions of prior year” in the tabular presented above.

At December 31, 2009, it is reasonably likely that \$1,300 of Jazz's unrecognized tax benefits will reverse during the next twelve months. The reversal of uncertain tax benefits is primarily related to net operating losses that will be abandoned when Jazz liquidates its Chinese subsidiary in 2010.

D. Effective Income Tax Rates

The reconciliation of the statutory tax rate to the effective tax rate is as follows:

| | <u>Year ended December 31,</u> | | |
|---|--------------------------------|-----------------|--------------|
| | 2009 | 2008 | 2007 |
| Tax benefit computed at statutory rates | \$ (32,886) | \$ (28,020) | \$ (38,917) |
| Reduced tax rate for approved enterprise | 7,228 | 7,410 | 12,078 |
| Tax benefits for which deferred taxes were not recorded | 23,617 | 23,955 | 22,540 |
| State tax, net of federal benefit | (3,686) | 197 | -- |
| In-process research and development | -- | 630 | -- |
| Permanent differences and other, net | 705 | (2,717) | 4,299 |
| Income tax provision (benefit) | <u>\$ (5,022)</u> | <u>\$ 1,455</u> | <u>\$ --</u> |

Jazz’s effective tax rate for the year ended December 31, 2009 differs from the statutory rate primarily due to the establishment of a valuation allowance mainly due to state tax benefit due to unitary filing of Tower and Jazz tax reports with the state of California.

E. Net Operating Loss Carry forward

As of December 31, 2009, Tower had net operating loss carry forwards for tax purposes of approximately \$1 billion which may be carried forward for an unlimited period of time.

At December 31, 2009, Jazz had state net operating loss carry- forwards of approximately \$94,400. The state tax loss carry forwards will begin to expire in 2014, unless previously utilized.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
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NOTE 20 - INCOME TAXES (cont.)

E. Net Operating Loss Carry forward (cont.)

The future utilization of Jazz's net operating loss carry forwards to offset future taxable income is subject to an annual limitation as a result of ownership changes that have occurred. Additional limitations could apply if ownership changes occur in the future. Jazz has had two "change in ownership" events that limit the utilization of net operating loss carry forwards. The first "change in ownership" event occurred in February 2007 upon the acquisition of Jazz Semiconductor. The second "change in ownership" event occurred on September 19, 2008, the date of the merger with Tower. Jazz concluded that the net operating loss limitation for the change in ownership which occurred in September 2008 will be an annual utilization of approximately \$2,100 for the use in its tax return. Accordingly Jazz had at December 31, 2009 federal net operating loss carry forwards of approximately \$46,900 that will begin to expire in 2021 unless previously utilized.

At December 31, 2009, Jazz had combined federal and state alternative minimum tax credits of \$100. The alternative minimum tax credits do not expire.

F. Final Tax Assessments

Tower possesses final tax assessments through the year 1998. In addition, the tax assessments for the years 1999-2005 are deemed final.

Jazz and its subsidiaries are subject to U.S. federal income tax as well as income tax in multiple state and foreign jurisdictions. With few exceptions, Jazz is no longer subject to U.S. federal income tax examinations for the years before 2006; state and local income tax examinations before 2005; and foreign income tax examinations before 2006. However, to the extent allowed by law, the tax authorities may have the right to examine prior periods where net operating losses were generated and carried forward, and make adjustments up to the amount of the net operating loss carry forward amount. Jazz is not currently under Internal Revenue Service ("IRS"), state or local tax examination. In connection with the pending liquidation of Jazz's Chinese subsidiary, the Chinese tax authorities completed a review of the historic income tax filings and accepted all of the historic income tax filings

The Company and its subsidiaries account for uncertain tax positions in accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109" as codified into 740-10 Income Taxes and recognize interest and penalties that would be assessed in relation to the settlement value of unrecognized tax benefits as a component of income tax expense. At December 31, 2009, Jazz had unrecognized tax benefits of \$10,900. The amount of unrecognized tax benefit that, if recognized and realized, that would affect the effective tax rate is \$10,500 as of December 31, 2009.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(dollars in thousands, except share data and per share data)

NOTE 20 - INCOME TAXES (cont.)

F. Final Tax Assessments (cont.)

During the fourth quarter of 2009, Jazz completed an analysis on its ability to utilize net operating losses under Section 382 of the Internal Revenue Code. The conclusion reached in the analysis was based on authority that did not meet recognition threshold as provided for in ASC 740. This position relates to net operating losses that were incurred prior to September 19, 2008.

NOTE 21 - RELATED PARTIES BALANCES AND TRANSACTIONS

A. Balances

| | <u>The nature of the relationships involved</u> | As of December 31, | |
|---|--|--------------------|-----------|
| | | 2009 | 2008 |
| Trade accounts receivable | Customers who are Primary Wafer Partners and a limited partnership | \$ 83 | \$ 2,379 |
| Long-term investment | Equity investment in HHNEC and in a limited partnership | \$ 17,284 | \$ 17,306 |
| Trade accounts payable | HHNEC and related parties of TIC | \$ 2,469 | \$ 387 |
| Current liabilities- Due to related parties | Mainly loans from Primary Wafer Partners | \$ 2,518 | \$ 11,324 |
| Debentures | Debenture Series B held by Primary Wafer Partners and TIC | \$ 6,318 | \$ 7,318 |
| Long-term customers' advances | Up-front payments for product from Primary Wafer Partner to be credited against future sales | \$ -- | \$ 8,183 |
| Other long-term liabilities | Long term liability to a Primary Wafer Partner and Debenture B accrued interest related to Primary Wafer Partners and TIC. | \$ 2,080 | \$ 1,428 |

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 21 - RELATED PARTIES BALANCES AND TRANSACTIONS (cont.)

B. Transactions

| | <u>Description of the transactions</u> | As of December 31, | | |
|--|--|--------------------|------------------|------------------|
| | | 2009 | 2008 | 2007 |
| Revenues | Mainly from customers who are Primary Wafer Partners | <u>\$ 1,911</u> | <u>\$ 31,314</u> | <u>\$ 78,870</u> |
| Cost of revenues | Purchase of services and goods from HHNEC and related parties of TIC | <u>\$ 4,371</u> | <u>\$ 1,270</u> | <u>\$ 840</u> |
| Financing expenses | Interest on loans received from Primary Wafer Partners and Series B held by Primary Wafer Partners and TIC | <u>\$ 198</u> | <u>\$ 1,543</u> | <u>\$ 2,252</u> |
| General and Administrative expenses | Mainly directors fees and reimbursement to directors | <u>\$ 118</u> | <u>\$ 120</u> | <u>\$ 289</u> |
| Other income (expense), net | Equity losses in a limited partnership | <u>\$ 23</u> | <u>\$ 744</u> | <u>\$ --</u> |
| Customers' advance and shareholders' equity - see Note 16A(4) | Customers' advance conversion into ordinary shares by Primary Wafers Partners | <u>\$ --</u> | <u>\$ --</u> | <u>\$ 6,414</u> |
| Customers' advance and other long-term liabilities - see Note 16A(4) | Customer's advance conversion into long term loans by a Primary Wafer Partner | <u>\$ --</u> | <u>\$ 1,738</u> | <u>\$ 1,258</u> |
| Loans and liabilities | Loan repayment to a Primary Wafer Partner | <u>\$ 3,000</u> | <u>\$ 2,000</u> | <u>\$ 2,974</u> |

C. For commitments, contingencies and other transaction relating to Fab 2 Wafer Partner and TIC agreements, see Note 16A.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS**

The information contained in this section should be read in conjunction with our consolidated financial statements as of December 31, 2009 and related notes for the year then ended. Our financial statements have been prepared in accordance with generally accepted accounting principles in United States ("US GAAP").

Following the Company's merger with Jazz Technologies Inc. ("Jazz") on September 19, 2008, (the "Jazz Merger"), the Company's results of operations include Jazz results commencing September 19, 2008. The Company's consolidated statement of operations for the year ended December 31, 2008 includes Jazz's results for the period from September 19, 2008 through December 31, 2008; the Company's consolidated statement of operations for the year ended December 31, 2009 includes Jazz's results for the twelve months ended December 31, 2009. The balance sheets as of December 31, 2009 and December 31, 2008 include Jazz's balances as of such dates.

Results of Operations

The following table sets forth certain statement of operations data as a percentage of total revenues for the periods indicated.

| | Year Ended December 31, | |
|--|------------------------------------|-------------|
| | 2009 | 2008 |
| Statement of Operations Data: | | |
| Revenues | 100% | 100% |
| Cost of revenues..... | 108.9 | 117.8 |
| Gross loss | (8.9) | (17.8) |
| Research and development expenses, net | 7.8 | 5.9 |
| Marketing, general and administrative expenses | 10.7 | 13.2 |
| Write-off of in-process research and development | -- | 0.7 |
| Merger related costs | -- | 0.2 |
| Fixed assets impairment..... | -- | 47.9 |
| Operating loss | (27.4) | (85.8) |
| Financing expense, net..... | (15.3) | (7.0) |
| Gain on debt restructuring..... | -- | 51.9 |
| Other income (expenses), net..... | 0.7 | (0.4) |
| Income tax benefit (provision) | 1.7 | (0.6) |
| Loss | (40.3)% | (41.8)% |

Year Ended December 31, 2009 compared to Year Ended December 31, 2008

Revenue. Revenue for the year ended December 31, 2009 increased by 18.7% to \$298.8 million from \$251.7 million for the year ended December 31, 2008.

Due to the worldwide economic downturn that commenced in 2008 and its effect on the semiconductor industry and us, including global decreased demand, downward price pressure, excess inventory and unutilized capacity worldwide, revenues in all our manufacturing facilities had a decline, consistent with the worldwide semiconductor decline. Total revenues were increased by \$47.1 million, of which \$102.9 million from Jazz less \$55.8 from Tower stand alone, excluding Jazz. The inclusion of Jazz's revenue as from the merger date in 2008 resulted in revenues of \$56.3 million in 2008 and revenues of \$159.2 million in 2009. The decrease of \$55.8 million from Tower stand alone, excluding Jazz was comprised of reduction of product shipments while average selling price remained stable

Cost of Total Revenues. Cost of total revenues for the year ended December 31, 2009 amounted to \$325.3 million, as compared to \$296.5 million for the year ended December 31, 2008. This 9.7% increase in cost of revenues resulted from the inclusion of the costs of Jazz for the full year ended December 31, 2009 (as compared to including the costs of Jazz in the cost of revenues only as of the date of the Jazz Merger in 2008), which was partially offset by the cost reduction plan executed by the Company and synergies captured through the integration of Jazz.

Gross Loss. Gross loss for the year ended December 31, 2009 was \$26.5 million compared to a gross loss of \$44.9 million for the year ended December 31, 2008. The decrease in gross loss was mainly attributable to the 18.7% increase in revenues which was partly offset by the 9.7% increase in cost of total revenues as described above.

Research and Development. Research and development expenses for the year ended December 31, 2009 amounted to \$23.4 million as compared to \$15.0 million for the year ended December 31, 2008. This increase in research and development costs resulted from the inclusion of the costs of Jazz for the year ended December 31, 2009 (as compared to including the costs of Jazz only as of the date of the Jazz Merger in 2008), which was partially offset by the cost reduction plan executed by the Company and synergies captured through the integration of Jazz.

Marketing, General and Administrative Expenses. Marketing, general and administrative expenses for the year ended December 31, 2009 amounted to \$31.9 million as compared to \$33.2 million for the year ended December 31, 2008. The decrease in marketing, general and administrative expenses is mainly attributed to the cost reduction plan executed by the Company and synergies captured through the integration of Jazz, which was partially offset by the inclusion of the costs of Jazz for the year ended December 31, 2009 (as compared to including the costs of Jazz only as of the date of the Jazz Merger in 2008).

Fixed Assets Impairment. Fixed assets impairment amounted to \$120.5 million in the year ended December 31, 2008. The worldwide economic downturn and the adverse market conditions in the semiconductor industry that commenced in 2008, resulted in global decreased demand, downward price pressure, excess inventory and unutilized capacity worldwide. As a result, we determined in 2008 that the circumstances indicate that the carrying amount may not be recoverable. In accordance with ASC Subtopic 360-10 Property, Plant and Equipment, we tested the recoverability of our plant and equipment based, among others, on our business plan and market prevailing conditions and determined that the carrying amounts of our plant and equipment may not be recoverable. We evaluated the fair value of our plant and equipment and determined that the carrying amounts exceeded the fair values by \$120.5 million and recorded a charge in that amount in the year ended December 31, 2008. For year ended December 31, 2009 similar evaluation was done which resulted in carrying value in excess of recoverable amounts and hence no impairment charge required.

Operating Loss. Operating loss for the year ended December 31, 2009 was \$81.8 million, compared to \$215.9 million for the year ended December 31, 2008. The decrease in the operating loss was mainly due to the one-time fixed assets impairment (as described above) in the year ended December 31, 2008. The amount of operating loss, excluding any one-time items in 2008, (which are comprised of \$120.5 fixed assets impairment and \$2.3 million write off of in process research and development and merger related costs), decreased by \$11.2 million as compared to the year ended December 31, 2008. Such decrease, despite including the costs of Jazz for the year ended December 31, 2009 (as compared to including the costs of Jazz only as of the date of the Jazz Merger in 2008) was mainly attributable to the cost reduction plan executed by the Company and synergies captured through the integration of Jazz.

Financing Expenses, Net. Financing expenses, net for the year ended December 31, 2009 were \$45.7 million compared to financing expenses, net of \$17.6 million for the year ended December 31, 2008. Such increase was mainly due to the inclusion of financing expenses of Jazz, mainly related to convertible notes, for the year ended December 31, 2009 (as compared to including the costs of Jazz only as of the date of the Jazz Merger in 2008) and due to measuring at fair value part of our convertible debentures, options, warrants and loans.

Gain On Debt Restructuring. Gain on debt restructuring in the year ended December 31, 2008 resulted from the definitive agreements with the Banks and TIC executed in September 2008, amounting to \$130.7 million in the year ended December 31, 2008.

Income Tax Benefit (Provision). Income Tax Benefit in relation to Jazz amounted to \$5.0 million in the year ended December 31, 2009, \$6.5 million higher as compared to \$1.5 million income tax provision in the year ended December 31, 2008, mainly due to state tax benefit due to unitary filing of Tower and Jazz tax reports with the state of California.

Loss. Loss for the year ended December 31, 2009 was \$120.5 million as compared to \$105.1 million for the year ended December 31, 2008. This increase was mainly attributed to the \$130.7 million of gain on debt restructuring in the year ended December 31, 2008 and the \$28.1 million increase in financing expense, net, which was partially offset by the \$134.1 million of lower operating loss in the year ended December 31, 2009 and \$6.5 million higher income tax benefit.

Impact of Inflation and Currency Fluctuations

The US Dollar costs of our operations in Israel are influenced by changes in the rate of inflation in Israel and the extent to which such changes are not offset by changes in the valuation of the NIS in relation

to the US Dollar. During the year ended December 31, 2009, the exchange rate of the US Dollar in relation to the NIS decreased by 0.7% and the Israeli Consumer Price Index ("CPI") increased by 3.9% (during the year ended December 31, 2008 there was a decrease of 1.1% in the exchange rate of the US Dollar in relation to the NIS and an increase of 3.8% in the CPI). The rate of inflation in Israel did not have a material effect on our business to date. However, our US Dollar costs will increase if inflation in Israel exceeds the devaluation of the NIS against the US Dollar.

Nearly the entire cash generated from our operations and from our financing and investing activities is denominated in US Dollar and NIS. Our expenses and costs are denominated in NIS, US Dollar, Japanese Yen and Euros. We are, therefore, exposed to the risk of currency exchange rate fluctuations.

Liquidity and Capital Resources

As of December 31, 2009, we had an aggregate amount of \$81.8 million in cash and cash equivalents, as compared to \$34.9 million as of December 31, 2008.

During the year ended December 31, 2009, we raised \$52.9 million on account of shareholders' equity (for further details see Notes 12B and 17I-J to the consolidated financial statements as of December 31, 2009), and generated a net amount of \$37.2 million from our operating activities. These liquidity resources financed the capital investments we made during the year ended December 31, 2009, which aggregated to an amount of \$29.5 million and the repayment of debentures and other debt in the total amount of \$13.7 million.

As of December 31, 2009, loans from banks were presented under GAAP in the amount of \$194.6 million, of which \$7.0 million are presented as short-term. As of such date, we presented an aggregate of \$241.2 million of debentures on our balance sheet (under GAAP). See also Note 1 to the consolidated financial statements As of December 31, 2009.