TOWER SEMICONDUCTOR LTD
Form 20-F
July 13, 2006

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

FORM 20-F

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005 Commission File number: 0-24790

TOWER SEMICONDUCTOR LTD.
(Exact name of registrant as specified in its charter and translation of registrant's name into English)

ISRAEL
(Jurisdiction of incorporation or organization)

RAMAT GAVRIEL INDUSTRIAL PARK
P.O. BOX 619, MIGDAL HAEMEK, ISRAEL 23105
(Address of principal executive offices)

SECURITIES REGISTERED OR TO BE REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:
None
SECURITIES REGISTERED OR TO BE REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:
Ordinary Shares, par value New Israeli Shekels 1.00 per share

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(Title of Class)

Warrants

(Title of Class)

Convertible Debentures

(Title of Class)

SECURITIES FOR WHICH THERE IS A REPORTING OBLIGATION PURSUANT TO
SECTION 15(D) OF THE ACT: None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: 66,932,056 Ordinary Shares

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

Yes [_] No [X]

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

Yes [_] No [X]

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

Yes [X] No [_]

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

Large accelerated filer [_] Accelerated filer [_] Non-accelerated filer [X]

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 [_] Item 18 [X]

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

Yes [_] No [X]

This annual report on Form 20-F includes certain "forward-looking" statements within the meaning of Section 21E of the Securities Exchange Act of 1934. The use of the words "projects," "expects," "may," "plans" or "intends," or words of similar import, identifies a statement as "forward-looking." There can be no assurance, however, that actual results will not differ materially from our expectations or projections. Factors that could cause actual results to differ from our expectations or projections include the risks and uncertainties relating to our business described in this annual report at "Item 3. Risk Factors."

We have prepared our consolidated financial statements in United States dollars and in accordance with accounting principles generally accepted in Israel ("Israeli GAAP"). Israeli GAAP varies in certain significant respects from accounting principles generally accepted in the United States of America ("U.S. GAAP"). The effect of the application of the latter on the financial position and results of operations as of the dates and for the years presented herein is summarized in Note 20 to our consolidated financial statements included herein. All references herein to "dollars" or "$" are to United States dollars, and all references to "Shekels" or "NIS" are to New Israeli Shekels.

Manufacturing or production capacity refers to installed equipment capacity in our facilities and is a function of the process technology and product mix being manufactured because certain processes require more processing steps than others. All information herein with respect to the wafer capacity of our manufacturing facilities is based upon our estimate of the effectiveness of the

manufacturing equipment and processes in use or expected to be in use during a period and the actual or expected process technology mix for such period. Unless otherwise specifically stated, all references herein to "wafers" in the context of capacity in Fab 1 are to 150-mm wafers and in Fab 2 are to 200-mm wafers.

MICROFLASH(R) is a registered trademark of Tower and N-ROM(TM) is a trademark of Saifun Semiconductor Ltd.

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PART I.

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

SELECTED FINANCIAL DATA

This section presents our selected historical financial data. You should carefully read the financial statements included in this annual report, including the notes to the financial statements. The selected data in this section is not intended to replace the financial statements.

We derived the selected statement of operations data and other financial data for the years ended December 31, 2005, 2004 and 2003, and selected balance sheet data as of December 31, 2005 and 2004 from the audited financial statements in this annual report. Those financial statements were prepared in accordance with Israeli GAAP and audited by Brightman Almagor & Co., a member firm of Deloitte Touche Tohmatsu, independent registered public accounting firm. We derived the selected statement of operations data and other financial data for the years ended December 31, 2002 and 2001 and the selected balance sheet data as of December 31, 2003, 2002 and 2001 from our audited financial statements that are not included in this annual report, which were prepared in accordance with Israeli GAAP. The differences between statements of operations and balance sheet data in accordance with US GAAP and the respective data in accordance with Israeli GAAP are presented below. See also note 20 to our audited financial statements in this annual report. Our management believes that the financial statements contain all adjustments needed to present fairly the information included therein.

	YEAR ENDED DECEMBER 31,				
	2005	2004	2003	2002	2001
STATEMENT OF OPERATIONS DATA IN ACCORDANCE WITH ISRAELI GAAP:	(in thousands, except share data)				
Revenues	$ 101,991	$ 126,055	$ 61,368	$ 51,801	$ 52,372
Cost of Sales	238,358	228,410	122,395	67,022	76,733
Gross loss	(136,367)	(102,355)	(61,027)	(15,221)	(24,361)
Research and development	16,029	17,053	20,709	17,031	9,556
Marketing, general and administrative	17,418	21,297	22,615	17,091	14,489
Operating loss	(169,814)	(140,705)	(104,351)	(49,343)	(48,406)
Financing income (expense), net	(35,651)	(29,745)	(9,826)	(2,104)	1,465
Other income (expense), net	2,383	32,682	(84)	45	8,419
Loss for the period	$(203,082)	$(137,768)	$(114,261)	$ (51,402)	$ (38,522)
Basic loss per ordinary share	$ (3.06)	$ (2.13)	$ (2.45)	$ (1.63)	$ (1.92)
OTHER FINANCIAL DATA:					
Depreciation and amortization	$ 144,852	$ 121,067	$ 54,611	$ 18,821	$ 21,721
Capital expenditures excluding Investment Center grants	$ 30,239	$ 172,617	$ 164,187	$ 243,431	$ 364,347

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	AS OF DECEMBER 31,				
	2005	2004	2003	2002	2001
	(in thousands)				
SELECTED BALANCE SHEET DATA IN ACCORDANCE WITH ISRAELI GAAP:					
Cash and cash equivalents, including short-term deposits and designated cash	$ 38,998	$ 81,457	$ 56,490	$ 69,695	$ 33,202
Working capital	(6,028)	63,591	50,492	21,927	(16,335)

Total assets	678,686	847,508	788,335	716,261	472,054
Current maturities of long-term debt and other short-term debt	21,103	--	--	4,000	14,000
Current maturities of convertible debentures	6,453	--	--	--	--
Long-term debt from banks	497,000	497,000	431,000	253,000	115,000
2002 convertible debentures and 2005 convertible debentures	44,851	26,651	25,783	24,121	--
Long-term liabilities in respect of customers' advances	59,621	64,428	46,347	47,246	17,910
Shareholders' equity (deficit)	(30,067)	167,980	229,457	298,334	252,805
Weighted average number of ordinary shares outstanding (*)	66,371	64,717	46,710	31,523	20,020
Number of shares issued and outstanding (*)	66,932	65,700	51,696	43,436	24,997

(*) Net of 1,300,000 Ordinary Shares held by us through a trustee as of each date presented.

	AS OF DECEMBER 31,				
	2005	2004	2003	2002	2001
	(in thousands)				
RECONCILIATION TO US GAAP:					
TOTAL ASSETS					
According to Israel GAAP	$ 678,686	$ 847,508	$ 788,335	$ 716,261	$ 472,054
The effect of:					
Presentation of long-term liabilities in respect of employees	13,658	16,350	14,607	12,368	10,334
Hedging activities	(1,524)	(4,619)	(5,947)	(5,727)	(4,564)
Sale of convertible debentures	(196)	(196)	(196)	(196)	--
According to US GAAP	$ 690,624	$ 859,043	$ 796,799	$ 722,706	$ 477,824
SHAREHOLDERS' EQUITY (DEFICIT)					
According to Israel GAAP	$ (30,067)	$ 167,980	$ 229,457	$ 298,334	$ 252,805
The effect of:					
Hedging activities	(1,524)	(7,025)	(15,867)	(17,807)	(8,169)
Proceeds on account of share capital	--	--	(16,428)	--	--

Sale of convertible debentures(*)	2,363	2,363	2,363	2,363	--
According to US GAAP	$ (29,228)	$ 163,318	$ 199,525	$ 282,890	$ 244,636

(*) Including mainly the allocation of a portion of the total proceeds from the sale of securities issued in January 2002.

RISK FACTORS

This annual report and statements that we may make from time to time may contain forward-looking information. There can be no assurance that actual results will not differ materially from our expectations, statements or projections. Factors that could cause actual results to differ from our expectations, statements or projections include the risks and uncertainties relating to our business described below.

RISKS AFFECTING OUR BUSINESS

IF WE DO NOT CLOSE THE $100 MILLION INVESTMENT OF ISRAEL CORP. AND A DEFINITIVE AMENDMENT TO OUR FACILITY AGREEMENT BASED ON THE TERMS OF THE MAY 2006 MOU WITH OUR BANKS, WE MAY HAVE TO SUSPEND OUR PLAN TO RAMP-UP FAB 2 PRODUCTION CAPACITY, WHICH WOULD MATERIALLY ADVERSELY AFFECT OUR COMPANY.

We currently expect to have sufficient liquidity at least until the end of 2006 to meet our short-term activities and liabilities. However, if we fail to close in a timely manner the $100 million investment by Israel Corp. and a definitive amendment to our facility agreement with our banks based on the May 2006 MOU, we may be required to suspend the implementation of our current plan to ramp-up Fab 2 production capacity to approximately 24,000 wafers per month (See "Item 4 - Information on the Company - A. History and Development of the Company - Recent Developments"), which would materially adversely affect our company and may cause us to cease our operations.

IF WE DO NOT COMPLETE THE EQUIPMENT INSTALLATION, TECHNOLOGY TRANSFER AND RAMP-UP OF PRODUCTION IN FAB 2, OUR BUSINESS WILL BE MATERIALLY ADVERSELY AFFECTED.

Fab 2 production capacity as of May 31, 2006 was approximately 15,000 200-mm wafers per month. In March 2006, our board of directors approved a plan to ramp-up Fab 2 production capacity to a capacity of approximately 24,000 wafers per month. Depending on the process technology and product mix, when fully ramped-up, we estimate that Fab 2 will be able to achieve capacity levels of approximately 40,000 wafers per month. We have not completed the acquisition, installation, equipping and financing necessary in order for production at our Fab 2 facility to reach such levels. Our determination as to the timing of the implementation of the ramp-up plan recently approved by our board of directors and the increase in Fab 2's production levels is dependent on prevailing and forecasted market conditions and our ability to fund these increases. We need to continue to develop new process technologies for Fab 2 in order to suit our customers' needs. The ramp-up of Fab 2 is a substantial and complex project. We have and may in the future experience difficulties that are customary in the installation, functionality and operation of equipment during manufacturing.

Failures or delays in obtaining and installing the necessary equipment, technology and other resources may delay the completion of the ramp-up of Fab 2 and add to its cost, which would have a material adverse effect on our business and results of operations.

IF WE DO NOT HAVE SUFFICIENT FUNDS TO FULLY EQUIP FAB 2, OUR BUSINESS WILL BE MATERIALLY ADVERSELY AFFECTED.

Fab 2's cost is estimated to be approximately $1.5 billion, including costs of construction, equipment, installation, libraries, intellectual property, technology transfers and other related ramp-up and pre-operation costs. However, the actual total cost of Fab 2 may exceed our estimates. If we cannot successfully raise sufficient funding to complete the ramp-up and to fund other related costs, we may be unable to meet our customers' production demands and as a result we may lose customers and may not attract new ones. In addition, we will be required to scale back our equipment purchases and capacity forecasts, and, as a result, we will not fully utilize the substantial investment made in constructing Fab 2, which will adversely affect our financial results.

IF THE INVESTMENT CENTER WILL NOT APPROVE OUR REQUEST FOR A NEW EXPANSION PROGRAM, WE WOULD BE REQUIRED TO SEEK ALTERNATIVE FINANCING SOURCES TO COMPLETE THE RAMP-UP OF FAB 2, WHICH MAY NOT BE AVAILABLE. OUR NOT COMPLETING INVESTMENTS IN THE AMOUNT OF $1.25 BILLION BY THE END OF 2005 MAY RESULT IN THE INVESTMENT CENTER REQUIRING US TO REPAY ALL OR A PORTION OF THE GRANTS ALREADY RECEIVED, AND IF WE ARE UNABLE TO REFUND SUCH GRANTS, WE MAY HAVE TO CLOSE OUR OPERATIONS.

In connection with Fab 2, we received approval for grants and tax benefits from the Investment Center of the Israeli Ministry of Industry, Trade and Labor (Investment Center) under its Approved Enterprise Program. Under the terms of the approval, we were eligible to receive grants of 20% of up to $1.25 billion invested in Fab 2 plant and equipment, or an aggregate of up to $250 million. As of May 31, 2006, we received approximately $161 million in grants from the Investment Center. Our eligibility to receive grants is with respect to investments in Fab 2 plant and equipment made by the end of 2005. Any failure by us to meet the conditions of our grants may result in the cancellation of all or a portion of our grants to be received and tax benefits and in the Investment Center requiring us to repay all or a portion of grants already received. We did not complete investments in the amount of $1.25 billion by the end of 2005, mainly since we reduced our rate of annual investments as a result of our decision to slow-down the ramp-up of our Fab 2 facility in order to align our capital investments with market conditions in the semiconductor industry. Israeli law limits the ability of the Investment Center to extend this time limitation, unless approved through an expansion plan. Under Israeli law, our not completing investments in an amount of $1.25 billion by the end of 2005 may permit the Investment Center to require us to repay all or a portion of grants already received. We have been holding discussions with the Investment Center to achieve satisfactory arrangements to approve a new expansion program to commence as of January 1, 2006. In 2005, at the Investment Center's request, we submitted a revised business plan to the Investment Center for the period commencing January 1, 2006. Currently, we cannot estimate when we will receive a formal response to our request for a new expansion program to commence as of January 1, 2006 or if the Investment Center will approve our request. If the Investment Center will not approve our request for a new expansion program, we would be required to seek alternative financing sources to finance the ramp-up of Fab 2 and if we do not succeed in finding such alternative financing sources, we may have to close our operations. While there can be no assurance that we will

obtain the Investment Center's approval for the new expansion program, we believe that it is improbable that the Investment Center would demand that we repay all or a portion of grants already received due to our not completing investments in an amount of $1.25 billion by the end of 2005. If we would have to repay the Investment Center all or a portion of grants already received, we would need to seek alternative financing sources to refund the grants we received and if we do not succeed in finding such alternative financing sources, we may have to close our operations.

IF OUR FUTURE OPERATIONS DO NOT INCREASE OR IF WE FAIL TO RAISE ADDITIONAL FUNDING, WE MAY BE UNABLE TO REPAY OUR DEBT ON A TIMELY BASIS.

There is no assurance that our future operations will increase or that we will succeed in raising the additional funding required for the completion of the ramp up of Fab 2 and the repayment of our short-term and long-term debt, which consists mainly of bank debt, trade accounts payable and convertible debentures and also includes moneys we may owe to Israel Corp. in connection with the agreement we signed with it according to which Israel Corp. will order up to approximately $100 million worth of equipment. As a result, our ramp-up of Fab 2 may be delayed and we may be unable to repay on time or repay at all our short-term and long-term debt, which may significantly harm our financial results or cause us to cease our operations. In accordance with our amended facility agreement with our banks, under which we have drawn down approximately $526.7 million as of June 30, 2006, we are required to repay principal in the amount of approximately $100 million in July 2007 and begin repaying the balance of the principal amount on a quarterly basis commencing September 2007. We anticipate that we will not be in compliance with the repayment schedule set forth in our amended facility agreement. In the event that (i) a definitive amendment to our facility agreement based on the May 2006 MOU with our banks will not be signed and closed, (ii) we are otherwise unsuccessful in negotiating a revised repayment schedule or (iii) our banks do not waive our non-compliance, pursuant to the terms of our amended facility agreement, our banks may require us to immediately repay all loans made by them to us, plus penalties, and they would be entitled to exercise the remedies available to them under our credit amended facility, including enforcement of their lien against all our assets. This would have a material adverse effect on our company. In addition, we cannot assure you we will be successful at negotiating price reductions and arrangements to slow down or postpone payments to our suppliers and service providers, or negotiating revised repayment schedules of our other debt, when we have liquidity problems.

THE CYCLICAL NATURE OF THE SEMICONDUCTOR INDUSTRY AND THE RESULTING PERIODIC OVERCAPACITY HAVE ADVERSELY AFFECTED OUR BUSINESS IN THE PAST, RESULTING IN A HISTORY OF LOSSES; DOWNWARD PRICE PRESSURE MAY SERIOUSLY HARM OUR BUSINESS.

The semiconductor industry has historically been highly cyclical. Historically, companies in the semiconductor industry have expanded aggressively during periods of increased demand. This expansion has frequently resulted in overcapacity and excess inventories, leading to rapid erosion of average sale prices. We expect this pattern to repeat itself in the future. The overcapacity and downward price pressures characteristic of a prolonged downturn in the semiconductor market may not allow us to operate at a profit, even at full utilization, and could seriously harm our financial results and business.

WE HAVE A HISTORY OF OPERATING LOSSES AND EXPECT TO OPERATE AT A LOSS FOR THE FORESEEABLE FUTURE; OUR FACILITIES MUST OPERATE AT HIGH UTILIZATION RATES FOR US TO BE PROFITABLE.

We have operated at a loss for the last number of years. Because fixed costs represent a substantial portion of the operating costs of semiconductor manufacturing operations, we must operate our facilities at high utilization rates for us to be profitable. We began construction of Fab 2 in 2001 and Fab 2 operations began in 2003. Our losses since 2003 are due primarily to significant depreciation and amortization expenses related mainly to Fab 2, as well as financing and operating expenses which have not yet been offset by a sufficient increase in the level of our sales. If we do not succeed in operating our facilities at high utilization rates, we expect to operate at a loss for the foreseeable future, which may adversely affect our business and company.

OUR OPERATING RESULTS FLUCTUATE FROM QUARTER TO QUARTER WHICH MAKES IT DIFFICULT TO PREDICT OUR FUTURE PERFORMANCE.

Our revenues, expenses and operating results have varied significantly in the past and may fluctuate significantly from quarter to quarter in the future due to a number of factors, many of which are beyond our control. These factors include, among others:

- The cyclical nature of both the semiconductor industry and the markets served by our customers;
- Changes in the economic conditions of geographical regions where our customers and their markets are located;
- Shifts by integrated device manufacturers (IDMs) and customers between internal and outsourced production;
- Inventory and supply chain management of our customers;
- The loss of a key customer, postponement of an order from a key customer, failure of a key customer to pay accounts receivables in a timely manner or the financial condition of our customers;
- The occurrence of accounts receivables write-offs;
- The rescheduling or cancellation of large orders or planned capital expenditures;
- Our ability to satisfy our customers' demand for quality and timely production;
- The timing and volume of orders relative to our available production capacity;
- Our ability to obtain raw materials and equipment on a timely and cost-effective basis;
- Environmental events or industrial accidents such as fires or explosions;
- Our susceptibility to intellectual property rights disputes;
- Our ability to continue with existing and to enter into new partnerships and technology and supply alliances on mutually

beneficial terms;

- Actual capital expenditures exceeding planned capital expenditures;

- Interest and currency rate fluctuations that may not be adequately hedged;
- Technological changes and short product life cycles; and
- Timing for designing and the qualification of new products.

Due to the factors noted above and other risks discussed in this section, many of which are beyond our control, you should not rely on quarter to quarter comparisons to predict our future performance. Unfavorable changes in any of the above factors may seriously harm our company.

THE LACK OF A SIGNIFICANT BACKLOG RESULTING FROM OUR CUSTOMERS NOT PLACING PURCHASE ORDERS FAR IN ADVANCE MAKES IT DIFFICULT FOR US TO FORECAST OUR REVENUES IN FUTURE PERIODS.

Our customers generally do not place purchase orders far in advance, partly due to the cyclical nature of the semiconductor industry. As a result, we do not typically operate with any significant backlog. The lack of a significant backlog makes it difficult for us to forecast our revenues in future periods. Moreover, since our expense levels are based in part on our expectations of future revenues, we may be unable to adjust costs in a timely manner to compensate for revenue shortfalls. We expect that in the future our revenues in any quarter will continue to be substantially dependent upon purchase orders received in that quarter and in the immediately preceding quarter. We cannot assure you that any of our customers will continue to place orders with us in the future at the same levels as in prior periods.

OUR SALES CYCLES MAY BE LONG AND, AS A RESULT, ORDERS RECEIVED MAY NOT MEET OUR EXPECTATIONS WHICH MAY ADVERSELY AFFECT OUR OPERATING RESULTS.

Our sales cycles, which measure the time between our first contact with a customer and the first shipment of product orders to the customer, vary substantially and may last as long as two years or more, particularly for new technologies. In addition, even after we make initial shipments of prototype products, it may take several more months to reach full production of the product. As a result of these long sales cycles, we may be required to invest substantial time and incur significant expenses in advance of the receipt of any product order and related revenue. If orders ultimately received differ from our expectations with respect to the product, volume, price or other items, our operating results may be adversely affected.

DEMAND FOR OUR FOUNDRY SERVICES IS DEPENDENT ON THE DEMAND IN OUR CUSTOMERS' END MARKETS.

We are ramping-up Fab 2 based on our expectations of customer demand and our financial resources. In order for demand for our wafer fabrication services to increase, the markets for the end products using these services must develop and expand. For example, the success of our imaging process technologies will depend, in part, on the growth of markets for certain image sensor product applications. Because our services may be used in many new applications, it is difficult to forecast demand. If demand is lower than expected, we may have

excess capacity, which may adversely affect our financial results. If demand is higher than expected, we may be unable to fill all of the orders we receive, which may result in the loss of customers and revenues.

IF WE DO NOT ATTRACT ADDITIONAL CUSTOMERS, OUR BUSINESS MAY BE ADVERSELY AFFECTED.

During the three months ended March 31, 2006, approximately 55% of our business was generated by four significant customers that contributed 18%, 14%, 12%, and 11% of our revenues, respectively. We expect to continue to receive a significant portion of our revenue from a limited number of customers in 2006. Loss or cancellation of business from, or decreases in, the sales volume or sales prices to our significant customers, could seriously harm our financial results, revenues and business. Since the sales cycle for our services typically exceeds one year, if our customers order significantly fewer wafers than forecasted, we will have excess capacity that we may not be able to sell in a short period of time, resulting in lower utilization of our facilities. We may have to reduce prices in order to try to sell the excess capacity. In addition to the revenue loss that could result from unused capacity or lower sales prices, we might have difficulty adjusting our costs to reflect the lower revenues in a timely manner, which could harm our financial results.

WE DEPEND ON A RELATIVELY SMALL NUMBER OF PRODUCTS FOR A SIGNIFICANT PORTION OF OUR REVENUES.

From time to time, a significant portion of our revenue is generated from a small number of very high volume products that are shipped to volatile consumer-oriented markets. The volume of orders of such products may adversely change or demand for such products may be abruptly discontinued. We expect that in the foreseeable future we will continue to be dependent upon a relatively limited number of products for a significant portion of our revenue due to the nature of our business. We cannot assure you that revenue generated from these products, individually or in the aggregate, will reach or exceed historical levels in any future period. A decrease in the price of, or demand for, any of these products could negatively impact our financial results.

IF WE DO NOT RECEIVE ORDERS FROM OUR WAFER PARTNERS WE MAY HAVE EXCESS CAPACITY.

We have committed a portion of our Fab 2 capacity for future orders. During the ramp-up of Fab 2, our capacity commitments to our wafer partners, which are SanDisk Corporation, Alliance Semiconductor Corporation, Macronix International Co. Ltd. and Quicklogic Corporation, are limited to approximately 50% of our Fab 2 capacity. Parties to whom we have committed capacity are generally not obligated to utilize or pay for all or any portion of their allocated capacity, and generally provide and confirm their orders to us less than one month before the production start date. If these parties do not place orders with us, and if we are unable to fill such unutilized capacity, our financial results may be adversely affected.

IF WE DO NOT MAINTAIN AND DEVELOP OUR TECHNOLOGY PROCESSES AND SERVICES, WE WILL LOSE CUSTOMERS AND MAY NOT BE ABLE TO ATTRACT NEW ONES.

The semiconductor market is characterized by rapid change, including the following:

- rapid technological developments;

- evolving industry standards;
- changes in customer and product end user requirements;

- frequent new product introductions and enhancements; and
- short product life cycles with declining prices as products mature.

In order to maintain our current customer base and attract new customers, we must continue to advance our manufacturing process technologies. We are developing and introducing to production specialized process technologies. Our ability to achieve and maintain profitable operations depends on the successful development and introduction to production of these processes, which we may not achieve in a timely manner or at all.

IF WE DO NOT COMPETE EFFECTIVELY, WE WILL LOSE BUSINESS TO OUR COMPETITORS.

The semiconductor foundry industry is highly competitive. We compete with more than ten independent dedicated foundries, the majority of which are located in Asia-Pacific, including new foundries based in Taiwan, China, Korea and Malaysia, and with over twenty integrated semiconductor and end-product manufacturers that allocate a portion of their manufacturing capacity to foundry operations. The foundries with which we compete benefit from their close proximity to other companies involved in the design and manufacture of integrated circuits, or ICs. If we do not compete effectively, our business and results of operations may be adversely affected. Many of our competitors may have one or more of the following competitive advantages over us:

- greater manufacturing capacity;
- multiple and more advanced manufacturing facilities;
- more advanced technological capabilities;
- a more diverse and established customer base;
- greater financial, marketing, distribution and other resources;
- a better cost structure; and/or
- better operational performance in cycle time and yields.

WE HAVE A LARGE AMOUNT OF DEBT WHICH COULD HAVE SIGNIFICANT NEGATIVE CONSEQUENCES.

We have a large amount of long-term debt, which could have significant negative consequences. As of June 30, 2006, we had approximately $526.7 million of bank debt and approximately $90 million of convertible debt (including approximately $37 million of convertible debt issued on June 29, 2006). Our current and future indebtedness could have significant negative consequences, including:

- requiring the dedication of a substantial portion of our expected cash flow from operations to service our indebtedness;

- increasing our vulnerability to general adverse economic and industry conditions;

- limiting our ability to obtain additional financing;

- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we compete;

- placing us at a competitive disadvantage to less leveraged competitors and competitors that have better access to capital resources; and/or

- affecting our ability to make interest payments and other required debt service on our indebtedness.

IF WE FAIL TO SATISFY THE COVENANTS SET FORTH IN OUR AMENDED CREDIT FACILITY, OUR BANKS WILL BE ABLE TO CALL OUR LOANS.

Our credit facility, under which we have drawn down approximately $526.7 million as of June 30, 2006, requires that we comply with certain financial, capital raising and production milestone covenants. In the July 2005 amendment to our credit facility agreement, our banks agreed to amend our financial ratios and covenants through the third quarter of 2006. We anticipate that we will not be in compliance with all of the financial ratios and covenants under the amended facility agreement commencing in the fourth quarter of 2006. In the event that (i) a definitive amendment to our facility agreement based on the May 2006 MOU with our banks will not be signed and closed, (ii) we are otherwise unsuccessful in negotiating revised financial, capital raising and production milestone covenants or (iii) our banks do not waive our non-compliance, pursuant to the terms of our amended facility agreement our banks may require us to immediately repay all loans made by them to us, plus penalties, and they would be entitled to exercise the remedies available to them under the credit facility, including enforcement of their lien against all our assets. This would have a material adverse effect on our company.

ISRAELI BANKING LAWS MAY IMPOSE RESTRICTIONS ON THE TOTAL DEBT THAT WE MAY BORROW FROM OUR BANKS.

Pursuant to an amendment to a directive published by the Israel Supervisor of Banks, effective March 31, 2004, we may be deemed part of a group of borrowers comprised of the Ofer Brothers Group, Israel Corp., and other companies which are also included in such group of borrowers pursuant to the directive, including companies under the control or deemed control of these entities. The directive imposes limitations on amounts that banks may lend to borrowers or groups of borrowers. Should our banks exceed these limitations, they may limit our ability to borrow other money in the future and may require us to return some or all of our outstanding borrowings (which were approximately $526.7 million as of June 30, 2006), which may have a material adverse effect on our business, financial condition and results of operations.

IF WE EXPERIENCE DIFFICULTY IN ACHIEVING ACCEPTABLE DEVICE YIELDS, PRODUCT

PERFORMANCE AND DELIVERY TIMES AS A RESULT OF MANUFACTURING PROBLEMS, OUR BUSINESS WILL BE ADVERSELY AFFECTED.

The process technology for the manufacture of semiconductor wafers is highly complex, requires advanced and costly equipment and is constantly being modified in an effort to improve device yields, product performance and delivery times. Microscopic impurities such as dust and other contaminants, difficulties in the production process, defects in the key materials and tools used to manufacture a wafer and other factors can cause wafers to be rejected or individual semiconductors on specific wafers to be non-functional. We have from time to time experienced production difficulties that have caused delivery delays or returns and lower than expected device yields. We may also experience difficulty achieving acceptable device yields, product performance and product delivery times in the future as a result of manufacturing problems. Any of these problems could seriously harm our financial results and business.

IF WE ARE UNABLE TO PURCHASE EQUIPMENT AND RAW MATERIALS, WE MAY NOT BE ABLE TO MANUFACTURE OUR PRODUCTS IN A TIMELY FASHION, WHICH MAY RESULT IN A LOSS OF EXISTING AND POTENTIAL NEW CUSTOMERS.

To complete the ramp-up of our Fab 2 facility and to maintain the quality of production in our facilities, we must procure new equipment. In periods of high market demand, the lead times from order to delivery of manufacturing equipment could be as long as 12 to 18 months. In addition, our manufacturing processes use many raw materials, including silicon wafers, chemicals, gases and various metals, and require large amounts of fresh water and electricity. Manufacturing equipment and raw materials generally are available from several suppliers. In many instances, however, we purchase equipment and raw materials from a single source. Shortages in supplies of manufacturing equipment and raw materials could occur due to an interruption of supply or increased industry demand. Any such shortages could result in production delays that could have a material adverse effect on our business and financial condition.

OUR EXPOSURE TO CURRENCY EXCHANGE AND INTEREST RATE FLUCTUATIONS MAY INCREASE OUR COST OF OPERATIONS.

Almost all of our cash generated from operations and from our financing and investing activities is denominated in U.S. dollars and New Israeli Shekels, or NIS. Our expenses and costs are denominated in NIS, U.S. dollars, Japanese Yen and Euros. We are, therefore, exposed to the risk of currency exchange rate fluctuations.

Our borrowings under our Fab 2 credit facility provide for interest based on a floating LIBOR rate, thereby exposing us to interest rate fluctuations. Furthermore, if our banks incur increased costs in financing our Fab 2 credit facility due to changes in law or the unavailability of foreign currency, our banks may exercise their right to increase the interest rate on our Fab 2 credit facility as provided for in the credit facility agreement.

We regularly engage in various hedging strategies to reduce our exposure to some, but not all, of these risks and intend to continue to do so in the future. However, despite any such hedging activity, we are likely to remain exposed to interest rate and exchange rate fluctuations, which may increase the cost of our operating and financing activities.

WE DEPEND ON INTELLECTUAL PROPERTY RIGHTS OF THIRD PARTIES AND FAILURE TO

MAINTAIN OR ACQUIRE LICENSES COULD HARM OUR BUSINESS.

We depend on third party intellectual property in order for us to provide foundry and design services to our clients. If problems or delays arise with respect to the timely development, quality and provision of such intellectual property to us, our customers' design and production could be delayed, resulting in underutilization of our capacity. If any of our third party intellectual property right vendors go out of business, liquidate, merge with, or are acquired by, another company that discontinues the vendor's previous line of business, or if we fail to maintain or acquire licenses to such intellectual property for any other reason, our business may be adversely affected. In addition, license fees and royalties payable under these agreements may impact our margins and operating results.

FAILURE TO COMPLY WITH THE INTELLECTUAL PROPERTY RIGHTS OF THIRD PARTIES OR DEFEND OUR INTELLECTUAL PROPERTY RIGHTS COULD HARM OUR BUSINESS.

Our ability to compete successfully depends on our ability to operate without infringing on the proprietary rights of others and defend our intellectual property rights. Because of the complexity of the technologies used and the multitude of patents, copyrights and other overlapping intellectual property rights, it is often difficult for semiconductor companies to determine infringement. Therefore, the semiconductor industry is characterized by frequent litigation regarding patent, trade secret and other intellectual property rights. There are no lawsuits currently pending against us regarding the infringement of patents or intellectual property rights of others nor are we currently a plaintiff in any such action against other parties. However, we have been subject to such claims in the past, all of which have been resolved through license agreements, the terms of which have not had a material effect on our business. One of these agreements expired at the end of 2005, and we are currently negotiating its renewal. If we are unable to renew it on similar terms, we may have to agree to less favorable terms or consider other alternatives, including designing around certain processes.

Because of the nature of the industry, we may continue to be a party to infringement claims in the future. In the event any third party were to assert infringement claims against us or our customers, we may have to consider alternatives including, but not limited to:

- negotiating cross-license agreements;
- seeking to acquire licenses to the allegedly infringed patents, which may not be available on commercially reasonable terms, if at all;
- discontinuing use of certain process technologies, architectures, or designs, which could cause us to stop manufacturing certain integrated circuits if we were unable to design around the allegedly infringed patents;
- fighting the matter in court and paying substantial monetary damages in the event we lose; or
- seeking to develop non-infringing technologies, which may not be feasible.

Any one or several of these developments could place substantial financial and administrative burdens on us and hinder our business. Litigation, which could result in substantial costs to us and diversion of our resources, may also be necessary to enforce our patents or other intellectual property rights or to defend us or our customers against claimed infringement of the rights of others. If we fail to obtain certain licenses and if litigation relating to alleged patent infringement or other intellectual property matters occurs, it could

prevent us from manufacturing particular products or applying particular technologies, which could reduce our opportunities to generate revenues.

As of March 31, 2006, we held 58 patents worldwide. We intend to continue to file patent applications when appropriate. The process of seeking patent protection may take a long time and be expensive. We cannot assure you that patents will be issued from pending or future applications or that, if patents are issued, they will not be challenged, invalidated or circumvented or that the rights granted under the patents will provide us with meaningful protection or any commercial advantage. In addition, we cannot assure you that other countries in which we market our services and products will protect our intellectual property rights to the same extent as the United States. Further, we cannot assure you that we will at all times enforce our patents or other intellectual property rights or that courts will uphold our intellectual property rights, or enforce the contractual arrangements that we have entered into to protect our proprietary technology, which could reduce our opportunities to generate revenues.

WE COULD BE SERIOUSLY HARMED BY FAILURE TO COMPLY WITH ENVIRONMENTAL REGULATIONS.

Our business is 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 our production processes. If we fail to use, discharge or dispose of hazardous materials appropriately, or if applicable environmental laws or regulations change in the future, we could be subject to substantial liability or could be required to suspend or adversely modify our manufacturing operations.

WE ARE SUBJECT TO THE RISK OF LOSS DUE TO FIRE BECAUSE THE MATERIALS WE USE IN OUR MANUFACTURING PROCESSES ARE HIGHLY FLAMMABLE.

We use highly flammable materials such as silane and hydrogen in our manufacturing processes and are therefore subject to the risk of loss arising from fires. The risk of fire associated with these materials cannot be completely eliminated. We maintain insurance policies to reduce losses caused by fire, including business interruption insurance. If any of our fabs were to be damaged or cease operations as a result of a fire, or if our insurance proves to be inadequate, it would reduce our manufacturing capacity and revenues.

POSSIBLE PRODUCT RETURNS COULD HARM OUR BUSINESS.

Products manufactured by us may be returned within specified periods if they are defective or otherwise fail to meet customers' prior agreed upon specifications. Product returns in excess of established provisions may have an adverse effect on our business and financial condition.

WE MAY BE REQUIRED TO REPAY GRANTS TO THE INVESTMENT CENTER THAT WE RECEIVED IN CONNECTION WITH FAB 1.

We received grants and tax benefits for Fab 1 under the government of Israel Approved Enterprise program. As of December 31, 2001, we completed our investments under our Fab 1 program and are no longer entitled to any further investment grants for future capital investments in Fab 1. We have agreed that if we do not achieve Fab 1 revenues of $90 million for 2003 and $100 million for 2004 and maintain at Fab 1 at least 600 employees for 2003 and 625 employees for

2004, subject to prevailing market conditions, we will, if demanded by the Investment Center, be required to repay the Investment Center up to approximately $2.5 million. Since our actual level of Fab 1 revenues and employees for 2003 and 2004 were not in compliance with the above mentioned levels, we may be required to repay the Investment Center up to approximately $2.5 million.

WE ARE SUBJECT TO RISKS RELATED TO OUR INTERNATIONAL OPERATIONS.

Since 2003, we have made substantial sales to customers located in Asia-Pacific and in Europe. Because of our international operations, we are vulnerable to the following risks:

- we price our products primarily in U.S. dollars; if the Euro, Yen or other currencies weaken relative to the U.S. dollar, our products may be relatively more expensive in these regions, which could result in a decrease in our sales;
- the need to comply with foreign government regulation;
- general geopolitical risks such as political and economic instability, potential hostilities and changes in diplomatic and trade relationships;
- natural disasters affecting the countries in which we conduct our business, such as the earthquakes experienced in China, Japan and Taiwan;
- reduced sales to our customers or interruption in our manufacturing processes in Asia Pacific that may arise from regional issues in Asia;
- imposition of regulatory requirements, tariffs, import and export restrictions and other barriers and restrictions;
- adverse tax rules and regulations;
- weak protection of our intellectual property rights; and
- delays in product shipments due to local customs restrictions.

OUR BUSINESS COULD SUFFER IF WE ARE UNABLE TO RETAIN AND RECRUIT QUALIFIED PERSONNEL.

We depend on the continued services of our executive officers, senior managers and skilled technical and other personnel. Our business could suffer if we lose the services of some of these personnel and we cannot find and adequately integrate replacement personnel into our operations in a timely manner. We seek to recruit highly qualified personnel and there is intense competition for the services of these personnel in the semiconductor industry. Competition for personnel may increase significantly in the future as new fabless semiconductor companies as well as new semiconductor manufacturing facilities are established. We may need to review employee compensation competitiveness with the purpose of retaining our existing officers and employees and attracting and retaining additional personnel, including granting large packages of options to purchase our ordinary shares.

RISKS RELATED TO OUR SECURITIES

OUR STOCK PRICE MAY BE VOLATILE IN THE FUTURE.

The stock market, in general, has experienced extreme volatility that often has been unrelated to the operating performance of particular companies. In particular, the stock prices for many companies in the semiconductor industry have experienced wide fluctuations, which have often been unrelated to the operating performance of such companies. These broad market and industry fluctuations may adversely affect the market price of our ordinary shares, regardless of our actual operating performance.

In addition, it is possible that in some future periods our operating results may be below the expectations of public market analysts and investors. In this event, the price of our securities may under perform or fall.

ISSUANCE OF ADDITIONAL SHARES PURSUANT TO OUR FAB 2 FINANCING ARRANGEMENTS AND OPTIONS GRANTED TO OUR FAB 2 BUILDING CONTRACTOR, EMPLOYEES AND DIRECTORS MAY DILUTE THE INTEREST OF OUR SHAREHOLDERS.

In connection with Fab 2, we have issued as of May 19, 2006, approximately 65.3 million ordinary shares to our wafer and equity partners and other shareholders. In December 2003, we issued to our banks and to one of our shareholders warrants exercisable into 896,596 and 58,906 ordinary shares, respectively, with an exercise price of $6.17. In addition, in connection with the July 2005 amendment to our credit facility agreement, we issued warrants to our banks exercisable into an aggregate 8,264,464 ordinary shares with an exercise price of $1.21, one-half of which shall only be exercisable if our banks agree to reschedule the repayment dates of the loans made to us under the July 2005 amendment. As of May 19, 2006, up to approximately 51.4 million additional ordinary shares may be issued upon the conversion of our 2002 outstanding convertible debentures, 2005 outstanding convertible debentures and upon exercise of warrants held by some of our shareholders and others. With the completion of the TASE offering described below, securities convertible into and/or exercisable for the purchase of an additional approximately 41 million ordinary shares have also been issued.

In addition, as of April 30, 2006, we had outstanding employee and directors options to purchase up to approximately 13 million shares at a weighted average exercise price of $4.15. We have also entered into a number of agreements which may result in our issuing large numbers of shares, particularly if we complete the transactions contemplated by these agreements at a time when our share price is low. For example, we have agreed that our three major wafer partners may elect to convert, on a quarterly basis through 2006, wafer credits we have issued to them into our ordinary shares rather than use these credits to reduce their cash payments for wafers manufactured in Fab 2, based on the average trading price of our ordinary shares during the 15 consecutive trading days preceding the relevant quarter. As of May 19, 2006, we had issued approximately 2.2 million of our ordinary shares to SanDisk Corporation and approximately 2.6 million ordinary shares to Alliance Semiconductor upon conversion of approximately $7.6 million of wafer credits. Following such conversions, an aggregate of approximately $30 million of credits issued to our three major wafer partners were outstanding as of May 19, 2006.

The MOU we signed with our banks contemplates the issuance of 51,973,684 of our ordinary shares and, in connection thereto, Israel Corp. committed to our banks to invest $100 million in consideration for 65,789,474 of our ordinary shares. Our audit committee and board of directors approved, subject to shareholder approval, the grant of options to our CEO, in addition to the options granted to him in April 2005, such that the CEO will hold options to purchase shares that represent 4% of our shares on a fully diluted basis. Our board of directors further approved a plan to offer our current employees the opportunity to exchange their existing options to purchase our ordinary shares for new options and approved the allocation of additional options to be made to our employees if the total number of employee options, including the options to our CEO, during a 24 month period will represent less than 8% of the our shares on a fully diluted basis.

In addition to the proceeds we may raise in the contemplated investment by Israel Corp., we will need to raise significant additional funds from other sources to finance (i) the ramp-up of Fab 2, which we currently estimate to be up to an additional approximately $150 million, and (ii) our payments on the long-term loans from our banks and other debt. We are engaged in discussions with potential investors in order to attract them to make investments in our company. However, no understandings have been reached with respect to the amount of any investment or the terms of any investment and there can be no assurance that any investment will be made. These investments may be for shares or for securities convertible into shares, which would materially dilute the holdings of our current shareholders.

MARKET SALES OF LARGE AMOUNTS OF OUR SHARES ELIGIBLE FOR FUTURE SALE MAY LOWER THE PRICE OF OUR ORDINARY SHARES.

Of our 77,561,979 outstanding ordinary shares as of May 19, 2006, approximately 33.3 million are freely tradable and held by non-affiliates under U.S. securities laws. In addition, certain of our affiliates (Israel Corp., SanDisk Corporation, Alliance Semiconductor, and Macronix International) hold approximately 44.3 million of our shares, of which approximately 4.1 million are registered for resale and are therefore freely tradable under U.S. securities laws and approximately 35.5 million are currently eligible for sale subject to the time, volume and manner of sale limitations of Rule 144 promulgated under the U.S. Securities Act of 1933, as amended. An additional approximately 2.6 million shares held by Alliance Semiconductor and 2 million shares held by SanDisk Corporation, will become eligible for sale subject to the time, volume and manner of sale limitations of Rule 144 through 2007. Shares held by these affiliates are subject to the share transfer restrictions set forth in the shareholders agreement to which they are a party and which remain in effect through January 2008. As of May 19, 2006, up to 36,598,425 additional shares issuable upon the conversion of our 2005 convertible debentures are held by non-affiliates or are registered for resale and are therefore freely tradable under U.S. securities laws. In addition, 9,161,060 shares issuable upon the exercise of warrants we granted to our banks are registered for resale and are therefore freely tradable under U.S. securities laws. The additional up to approximately 41 million shares issuable upon the conversion and/or exercise of the securities sold in our recently completed TASE offering, would be freely tradeable in normal trading transactions in the United States. The sales of large amounts of our ordinary shares (or the potential for those sales even if they do not actually occur) may depress the market price of our ordinary shares. This could also impair our ability to raise capital through the sale of our equity securities.

OUR PRINCIPAL SHAREHOLDERS COLLECTIVELY OWN A CONTROLLING INTEREST IN US AND WILL BE ABLE TO EXERCISE THEIR VOTING RIGHTS IN WAYS WHICH MAY BE ADVERSE TO THE INTERESTS OF OUR SHAREHOLDERS.

As of May 19, 2006, our wafer partners and Israel Corp. collectively owned approximately 57% of our outstanding shares. Under our articles of association, two shareholders holding together 33% of our outstanding shares constitute a quorum for conducting a shareholders meeting. Our wafer partners and Israel Corp. could constitute a quorum for purposes of conducting a shareholders meeting. While we have always solicited proxies from our shareholders prior to our shareholders meetings, we would have a sufficient quorum with two large shareholders even if none of our other shareholders were to participate in our shareholders meetings. If only two large shareholders, owning collectively at least 33% of our shares, were to participate in one of our shareholders meetings, these shareholders would determine the outcome of our shareholders meeting without the benefit of the participation of our other shareholders. In addition, even if our other shareholders were to participate in our shareholders meetings in person or by proxy, our wafer partners and Israel Corp. collectively control our company and may exercise this control in a manner adverse to the interests of our other shareholders.

THE PAYMENT OF THE REDEMPTION AMOUNT ON ACCOUNT OF OUR OUTSTANDING DEBENTURES IS SUBORDINATED TO OUR INDEBTEDNESS TO OUR BANKS AND OBLIGATIONS TO SECURED CREDITORS.

The payment of the redemption amount on account of our outstanding debentures is subordinated to the prior payment of all amounts payable by us to Bank Hapoalim B.M and Bank Leumi Le-Israel Ltd. under our credit facility agreement with them, to any obligations to the Investment Center of the Israeli Ministry of Industry, Trade and Labor related to $161 million in grants received through May 31, 2006 under the Investment Center's "Approved Enterprise" program, and to a first ranking charge in favor of Siliconix Technology C.V., on approximately $20 million of equipment purchased in connection with the performance of our obligations under our agreement with Siliconix. As a result, upon any distribution to our creditors in liquidation or reorganization or similar proceedings, these secured creditors will be entitled to be paid in full before any payment may be made with respect to any of our outstanding debentures. In any of these circumstances, we may not have sufficient assets remaining to pay amounts due on any or all of the debentures then outstanding. In addition, we are not permitted under the terms of our facility agreement to make a payment on account of our outstanding debentures if on the date of such payment an "Event of Default" exists under our facility agreement.

WE MAY INCUR ADDITIONAL INDEBTEDNESS, INCLUDING INDEBTEDNESS THAT WOULD BE SENIOR TO OUR OUTSTANDING DEBENTURES.

Although we are limited by the covenants in the facility agreement, we could enter into certain transactions that would increase the amount of our outstanding senior indebtedness. It is possible that all or part of these borrowings would be senior to our outstanding debentures. If new indebtedness is added to our current indebtedness levels, the related risks that we now face could intensify.

RISKS RELATED TO OUR OPERATIONS IN ISRAEL

INSTABILITY IN ISRAEL MAY HARM OUR BUSINESS.

All of our manufacturing facilities and our corporate and some of our sales offices are located in Israel. Accordingly, political, economic and military conditions in Israel may directly affect our business.

Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, as well as incidents of civil unrest. In addition, Israel and companies doing business with Israel have, in the past, been the subject of an economic boycott. Although Israel has entered into various agreements with Egypt, Jordan and the Palestinian Authority, Israel has been and is subject to civil unrest and terrorist activity, with varying levels of severity. Parties with whom we do business have sometimes declined to travel to Israel during periods of heightened unrest or tension, forcing us to make alternative arrangements where necessary. In addition, the political and security situation in Israel may result in parties with whom we have agreements claiming that they are not obligated to perform their commitments under those agreements pursuant to force majeure provisions. We can give no assurance that security and political conditions will have no impact on our business in the future. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could adversely affect our operations and could make it more difficult for us to raise capital. Furthermore, our manufacturing facilities are located exclusively in Israel, which has been experiencing civil unrest, terrorist activity and military action. We could experience serious disruption of our manufacturing if acts associated with this conflict result in any serious damage to our manufacturing facilities. In addition, our business interruption insurance may not adequately compensate us for losses that may occur, and any losses or damages incurred by us could have a material adverse effect on our business.

OUR OPERATIONS MAY BE NEGATIVELY AFFECTED BY THE OBLIGATIONS OF OUR PERSONNEL TO PERFORM MILITARY SERVICE.

In the event of severe unrest or other conflict, individuals could be required to serve in the military for extended periods of time. In response to increases in terrorist activity, there have been periods of significant call-ups of military reservists, and it is possible that there will be additional call-ups in the future. A large part of male Israeli citizens, including our employees, are subject to compulsory military reserve service through middle age. Our operations could be disrupted by the absence for a significant period of time of one or more of our key employees or a significant number of our other employees due to military service. Such disruption could harm our operations.

OUR OPERATIONS MAY BE AFFECTED BY NEGATIVE ECONOMIC CONDITIONS IN ISRAEL.

In recent years, Israel has experienced periods of recession in economic activity, resulting in low growth rates and growing unemployment. Our operations could be adversely affected if the economic conditions in Israel deteriorate. In addition, Israel has experienced several general strikes and other work stoppages, affecting banks, government offices, airports and ports. These strikes have had an adverse effect on the Israeli economy and on business, including our ability to deliver products to our customers or to receive raw materials from our suppliers in a timely manner. From time to time, the Israeli trade unions threaten strikes or work-stoppages, which may, if carried out, have a material adverse effect on the Israeli economy and our business.

IF THE EXEMPTION ALLOWING US TO OPERATE OUR MANUFACTURING FACILITIES SEVEN DAYS A WEEK IS NOT RENEWED, OUR BUSINESS WILL BE ADVERSELY AFFECTED.

We operate our manufacturing facilities seven days a week pursuant to an exemption from the law that requires businesses in Israel to be closed from sundown on Friday through sundown on Saturday. This exemption expires by its terms on December 31, 2006. In addition, a significant increase in the number of employees permitted to work under this exemption will be needed as we ramp-up production at Fab 2. If the exemption is not renewed and we are forced to close any or all of the facilities for this period each week, our financial results and business will be harmed.

ITEM 4. INFORMATION ON THE COMPANY

A. History and Development of the Company

We are a pure-play independent specialty foundry dedicated to the manufacture of semiconductors. Typically, pure-play foundries do not offer products of their own, but focus on producing integrated circuits, or ICs, based on the design specifications of their customers. We manufacture semiconductors using advanced production processes for our customers primarily based on third party designs and our own proprietary designs. We currently offer the manufacture of ICs with geometries ranging from 1.0 to 0.13-micron. We also provide complementary technical services and design support. ICs manufactured by us are incorporated into a wide range of products in diverse markets, including consumer electronics, personal computers, communications, automotive, industrial and medical device products.

We are focused on establishing leading market share in high-growth specialized markets by providing our customers with high-value wafer foundry services. Our historical focus has been standard digital complementary metal oxide semiconductor ("CMOS") process technology, which is the most widely used method of producing ICs. We currently are focused on the emerging opportunities surrounding CMOS image sensors, embedded flash, mixed-signal and radio frequency CMOS (RFCMOS) technologies. In addition, we have commenced development of a new technology that targets the radio frequency identification, or RFID, tags market. Through our expertise and experience gained over a decade of operations, we differentiate ourselves in these areas by creating a high level of value for our clients through innovative technological processes, design support and services, competitive manufacturing indices, such as cycle times and yields, and dedicated customer service.

Our company was founded in 1993, when we acquired National Semiconductor's 150-mm wafer fabrication facility, or Fab 1, and commenced operations as an independent foundry with a production capacity of approximately 5,000 wafers per month. Since then, we have significantly modernized our Fab 1 facility and equipment, which has improved our process geometries to range from 1.0-micron to 0.35-micron and enhanced our process technologies to include CMOS image sensors, embedded flash and mixed-signal technologies. Production capacity in Fab 1 as of June 30, 2006 was approximately 16,000 wafers per month, depending on process technology and product mix.

We have completed the construction of the building and infrastructure and

are in the course of ramping our second manufacturing facility, or Fab 2. Fab 2 is designed to operate in geometries of 0.18-micron and below, using advanced materials and advanced CMOS technology licensed from Freescale and Toshiba and other technologies that we might acquire or develop independently or with development partners. Production capacity as of June 30, 2006 was approximately 15,000 wafers per month. When fully ramped-up, we estimate that Fab 2 will be able to achieve capacity of approximately 40,000 wafers per month.

Our capital expenditures net of Investment Center grants for 2005, 2004 and 2003 of $24 million, $142 million and $137 million, respectively, were made principally in connection with the construction of, and purchase of equipment and technology for, Fab 2.

Our legal and commercial name is Tower Semiconductor Ltd. We were incorporated under the laws of Israel. Our manufacturing facilities and executive offices are located in the Ramat Gavriel Industrial Park, Post Office Box 619, Migdal Haemek, 23105 Israel, and our telephone number is 972-4-650-6611. Our worldwide web site is located at http://www.towersemi.com. Information on our web site is not incorporated by reference in this annual report.

RECENT DEVELOPMENTS

COMPLETION OF $31 MILLION TASE OFFERING

On June 29, 2006 we successfully completed an underwritten public offering of our securities on the Tel-Aviv Stock Exchange (TASE) in Israel resulting in gross proceeds of approximately NIS 140 million (approximately $31 million). In the offering, 78,000 Units were sold at a price per Unit of NIS 1,785 (approximately $400). Each Unit consists of (i) convertible debentures in the face amount of NIS 2,100 (approximately $470), (ii) five options each exercisable for three months for NIS 100 principal amount of convertible debentures at an exercise price equal to 85% of their face amount, (iii) 140 warrants each exercisable for three months for one Tower ordinary share at a price of NIS 6.75 (approximately $1.51) and (iv) 70 warrants each exercisable for three years for one Tower ordinary share at a price of NIS 7.40 (approximately $1.66). The convertible debentures are convertible into Tower's ordinary shares at a conversion rate of one ordinary share per NIS 8.40 (approximately $1.89) principal amount of convertible debentures. The convertible debentures carry a zero coupon with principal payable at maturity in December 2011, at a premium of 37% over face value, linked to the Israeli Consumer Price Index (CPI). The conversion price is subject to reduction in certain limited circumstances.

The offering was made in Israel to Israeli residents only. The securities offered were not registered under the Securities Act and may not be sold in the U.S. or to U.S. persons absent registration or an applicable exemption.

AMENDMENT TO OUR FACILITY AGREEMENT

In May 2006, we signed amendments to the facility agreement with our banks, according to which: (i) repayments of long-term loans in the amount of approximately $100 million scheduled to be paid between October 2006 and June 2007, were deferred to July 2007; and (ii) the date on which we were required to raise approximately $8 million was deferred from June 30, 2006 to September 30, 2006, which amount was raised with the completion of the TASE offering described

above.

RAMP-UP OF FAB 2

In March 2006, our board of directors approved a plan to ramp up Fab 2 in order to meet our customer and product qualification needs, based on our customer pipeline and reinforced by forecasted market conditions. According to this plan, we will need to raise approximately $130 million during 2006, which will take the current Fab 2 capacity to approximately 24,000 wafers per month. We plan to raise this amount by way of (i) $30 million public offering (this amount was raised with the completion of the TASE offering described above) and (ii) $100 million investment by Israel Corp. (described below). In addition to the aforementioned amount, in order to fully ramp-up the capacity of Fab 2 to approximately 40,000 wafers per month, we currently estimate that we will require the raising of an additional up to approximately $150 million.

As part of the financing efforts for the ramp-up plan, in May 2006, we signed a Memorandum of Understanding (MOU) with our banks for the refinancing of the approximately $526.7 million of long-term debt under our facility agreement, according to which: (i) $158 million, representing 30% of such debt, will be converted to equity for 51,973,684 of our ordinary shares, at a price per share of $3.04, which is equal to twice the average closing price of our ordinary shares during the 10 consecutive trading days prior to signing the MOU; (ii) the interest rate of the long-term loans will be decreased from LIBOR plus 2.5% per annum to LIBOR plus 1.1% per annum; and (iii) the commencement date for the repayment of principal shall be postponed from July 2007 to no earlier than September 2009. The terms of the MOU are subject to a commitment of Israel Corporation Ltd. (Israel Corp.) to invest $100 million in our capacity expansion as described below. The MOU is further subject to our reaching a definitive amendment to the facility agreement based on the terms of the MOU which is expected to also include arrangements to compensate the banks, under certain conditions, for the reduction in the interest on the amount borrowed from the banks (such compensation may include the issuance of our securities and/or the extension of the exercise period of the banks' warrants), and revised financial ratios and covenants based on our updated working plan. In this regard, Israel Corp. has committed to invest $100 million in consideration for 65,789,474 of our ordinary shares, at a price per share of $1.52, which equals the average closing price during the 10 consecutive trading days prior to signing the MOU. Such amount may include amounts that may be payable by us to Israel Corp. in connection with the agreement for the ordering of equipment described below. Israel Corp.'s investment is subject to the signing of a definitive investment agreement, the approvals of our audit committee, board of directors and shareholders and the closing of a definitive amendment to the facility agreement with our banks based on the terms of the MOU.

In order to implement the ramp-up plan in a timely manner, we entered into an agreement with Israel Corp. according to which Israel Corp. will order up to approximately $100 million worth of equipment for Fab 2. Under the terms of the agreement: (i) Israel Corp. has the right to sell us the equipment at cost, plus related expenses; (ii) we have the right to purchase the equipment from Israel Corp. at cost, plus related expenses, subject to us having raised $100 million; (iii) upon our purchase of the equipment from Israel Corp., we will assume Israel Corp.'s obligations to the equipment suppliers; and (iv) if after 5 months from the signing of the agreement, the equipment has not been sold to us by Israel Corp., Israel Corp. may sell the equipment to a third party and we will pay Israel Corp. the difference between the cost, plus related expenses, of

the purchase of the equipment by Israel Corp. and the net sale price.

OPTIONS GRANTED TO THE CHIEF EXECUTIVE OFFICER (CEO)

In May 2006, our audit committee and board of directors approved the grant of options to our CEO, who also serves as a director, in addition to the options granted to him in April 2005, such that in total, the CEO will hold options to purchase shares that represent 4% of our 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 additional options will be $1.45, the average closing price of our shares on the Nasdaq during the 90 consecutive trading days prior to the board of directors' approval. In the event of a future equity financing, additional options will be granted to the CEO as described above with an exercise price equal to the price per share of such investment. The vesting period of the new options will be identical to the vesting period of the existing options. The new grant of options and its terms are subject to the approval of our shareholders. If the new grant of options is approved by our shareholders, no additional options will be granted under the CEO's current option agreement, which was approved by our shareholders in October 2005.

RE-PRICING OF EMPLOYEE OPTIONS

Our board of directors approved a plan to offer each of our current employees the opportunity to exchange their existing options to purchase our ordinary shares for new options with an exercise price of $1.45, which is the average closing price of our shares on the Nasdaq during the 90 consecutive trading days prior to the board of directors' approval. The new options will be granted based on terms similar to our existing employee option plan with new vesting periods. As of May 19, 2006, options to purchase approximately 9 million ordinary shares held by our current employees, with exercise prices ranging from $1.46 to $25, were outstanding. Our board of directors further approved that if the total number of employee options, including the options to our CEO, during the coming 24 months will represent less than 8% of the our shares on a fully diluted basis, additional options will be allocated for grants to be made to our employees. No options have been granted under such plan.

DISMISSAL OF CLASS ACTION

In June 2006, the United States Court of Appeals for the Second Circuit affirmed the August 2004 decision of the United States District Court for the Southern District of New York to dismiss the class action suit filed in July 2003 against us and certain of our directors and shareholders. The District Court accepted the motion to dismiss filed on behalf of the defendants and noted that our status as a foreign private issuer exempts us, our directors and controlling shareholders, from liability under the proxy rules of Section 14(a) of the Securities Exchange Act.

B. Business Overview

INDUSTRY OVERVIEW

Semiconductor devices are responsible for the rapid growth of the electronics industry over the past fifty years. They are critical components in a variety of applications, from computers, consumer electronics and communications, to industrial, military, medical and automotive applications. The semiconductor industry is characterized by rapid changes in technology,

frequently resulting in the obsolescence of recently introduced products. As performance has increased and size and cost have decreased, the use of semiconductors and the number of their applications have grown significantly.

Historically, the semiconductor industry was composed primarily of companies that designed and manufactured ICs in their own fabrication facilities. These companies, such as Intel and IBM, are known as integrated device manufacturers, or IDMs. In the mid-1980s, fabless IC companies, which focused on IC design and used external manufacturing capacity, began to emerge. Fabless companies initially outsourced production to IDMs, which filled this need through their excess capacity. As the semiconductor industry continued to grow, increasing competition forced fabless companies and IDMs to seek reliable and dedicated sources of IC manufacturing services. This need has been met by the development of independent companies, known as foundries, which focus primarily on providing IC manufacturing services to semiconductor suppliers. Foundry services are now used by nearly every major semiconductor company in the world, including IDMs as part of a dual-source, risk-diversification and cost effectiveness strategy.

Semiconductor suppliers face increasing demands for new products that provide higher performance, greater functionality and smaller form factors at lower prices, which require increasingly complex ICs. In addition to the increased complexity of designs, there has also been a dramatic increase in the number of applications for semiconductors. To compete successfully, semiconductor suppliers must also minimize the time it takes to bring a product to market. As a result, fabless companies and IDMs are focusing more on their core competencies -- design and intellectual property -- and outsourcing manufacturing to foundries.

The consumer sector is expanding worldwide with new applications and multi-functional devices, including those that incorporate CMOS image sensors, embedded flash and mixed-signal ICs. Increasingly, emerging applications, such as camera-equipped cell phones, digital still cameras and flat panel displays, are enabled by ICs manufactured using advanced process technologies.

The enormous costs associated with modern fabs, combined with the increasing demand for complex ICs, has created an expanding market for outsourced manufacturing offered by foundries. Foundries can cost-effectively supply the technologies involved in manufacturing advanced ICs to even the smallest fabless companies by creating economies of scale through pooling the demand of numerous customers. In addition, customers whose IC designs require process technologies other than standard digital CMOS have created a market for independent foundries that focus on providing specialized process technologies, such as CMOS image sensors, embedded flash and mixed-signal technologies. Foundries also offer competitive customer service through design, testing, and information services, often at a level previously found only at an IDM's internal facilities.

These trends have led to the rapid growth in demand in recent years for advanced semiconductor manufacturing services provided by independent foundries.

SPECIALIZED TECHNOLOGIES

We provide wafer fabrication services and technologies to fabless IC companies and IDMs and enable smooth integration of the semiconductor design and manufacturing processes. By doing so, we enable our customers to bring

high-performance, highly integrated ICs to market rapidly and cost effectively. We believe that our technological strengths and emphasis on customer service have allowed us to develop unique positions in large, high-growth specialized markets for CMOS image sensors, embedded flash memory, mixed signal and RF CMOS ICs. We serve as a sole source or alternative provider of foundry services.

We believe that we are a trusted, customer-oriented service provider that has built a solid reputation in the foundry industry over the last thirteen years. We have built strong relationships with customers, who continue to use our services, even as their demands evolve to smaller form factors and new applications. Our consistent focus on providing high-quality, value added services, including engineering and design support, has allowed us to attract customers for both our Fab 1 and Fab 2 facilities who seek to work with a proven provider of foundry services. As a result, we have a high customer retention rate and an increase in new customers and new products for production.

In August 2005, we implemented changes in our organizational structure focusing on establishing three product line units. The re-structuring reflects our emphasis on working closely with customers and accelerating the time-to-market of their next-generation products. The three distinct product line units are: CMOS Image Sensors and embedded Non-Volatile Memory products (CIS/NVM), Radio Frequency (RF)/Mixed Signal, and CMOS.

We derived approximately 45% of our revenues for the year ended December 31, 2005 from our target specialized markets: CMOS image sensors, embedded flash, mixed-signal, RF and power ICs. We are highly experienced in these markets, being an early entrant and having developed unique proprietary technologies, primarily through licensing and joint development efforts with our customers and other technology companies.

CMOS IMAGE SENSORS

CMOS image sensors are ICs used to capture an image in a wide variety of consumer, communications, medical, automotive and industrial market applications, including camera-equipped cell phones, digital still and video cameras, security and surveillance cameras and video game consoles. We are currently actively involved in this mass market as well as the high-end sensor and applications specific markets, which include applications such as industrial machine vision, medical equipment and automotive sensors. While CMOS image sensors for advanced optical applications are an emerging technology, we believe that they are becoming the preferred technology to traditional charge coupled devices, or CCDs. CCDs have historically provided superior image quality; however, advances in semiconductor manufacturing processes and design techniques have led to significant improvements in CMOS image sensor performance and image quality. These advances have resulted in smaller size circuits and better current control, making it possible to design CMOS image sensors that provide high image quality at a significantly lower cost.

As early as 1997, we recognized the market potential of using CMOS process technology for a digital camera-on-a-chip, which would integrate a CMOS image sensor, filters and digital circuitry. In entering the CMOS image sensor foundry business, we utilized research and development work that had been ongoing since 1993. Our services include a broad range of turnkey solutions and services, including sensor design services, optical characterization of a CMOS process, innovative stitching manufacturing technique and optical testing and packaging. CMOS image sensors manufactured by us deliver outstanding image quality for a

broad spectrum of digital imaging applications. As the market for these products becomes more main stream, we expect that more competition will enter this high growth market and some of those products will become commodities.

In the end of 2005, we began production of new products in Fab 2. For example, in November 2005, we began manufacturing 2.0 and 1.3-megapixel CMOS image sensors for Biomorphic Microsystems Corporation (Biomorphic) designed for cellular phone applications. These image sensors are produced in 0.18-micron process at Fab2, utilizing our pixel IP and our optically-optimized-multilayer metallization, which achieves dramatically better optical sensitivity by reducing stack height from silicon to micro-lens.

EMBEDDED FLASH

Flash memory is a constantly powered nonvolatile memory that can be erased and reprogrammed in units of memory called blocks. The IC of flash memory is organized so that a section of memory cells may be erased in a single action, or "flash". Applications for flash memory products range from most types of portable electronic equipment devices to high volume mass storage of data. Flash is particularly suitable for applications such as handheld devices, combining the need for portability, high density, ruggedness and lower power requirements. Flash memory products are also well-suited for audio products such as digital answering machines and MP3 players, as well as other applications including networking devices, digital cameras, personal computer motherboards and portable memory devices.

Embedded flash is the combination of flash memory with other components, such as other memory, logic and analog, on a single IC to provide speed, functionality and form factor advantages and reduce system cost. Embedded flash memory products are used in communications, consumer, industrial, military and automotive applications. End products include networks, base stations, servers, microcontrollers, toys, set-top boxes, DVD players, cell phones and smart cards.

In 1997, we entered into a strategic investment and technology agreement with Saifun Semiconductors Ltd., pursuant to which we obtained approximately a 10% equity stake in Saifun. Together we brought to market a new non-volatile memory technology based on 0.5-micron, microFlash(TM)/NROM(TM). NROM technology enables the implementation of ultra high-density flash arrays using CMOS processes, and is particularly suitable for embedding flash arrays with standard CMOS logic, as well as for commodity memories. Our microFLASH technology, based on Saifun's patented NROM technology, provides greater memory cell density than other currently available flash architectures for given design rule generation, permitting an approximately four-fold reduction in the size of the memory cell for stand-alone memories and embedded applications in a given geometry.

In December 2004, we sold our entire equity stake in Saifun for approximately $39 million. This sale had no effect on our technology rights under our agreement with Saifun.

MIXED SIGNAL AND RF CMOS

Mixed-signal ICs are an essential part of any electronic system that interacts with the real world. Analog ICs monitor and manipulate real world signals such as sound, light, pressure, motion, temperature and electrical current and are used in a wide variety of electronic products such as PCs, cell phones, DVD players, automotive electronics and medical imaging equipment.

Digital ICs perform arithmetic functions on data represented by a series of ones and zeroes, provide critical processing power and have enabled many of the computing and communication advances of recent years. Mixed-signal ICs combine analog and digital semiconductor functionality on a single IC to enable digital systems to interface with the real world. As these digital systems proliferate, there is a growing need for analog functionality to enable them to interface with the real world.

We focus on providing high-quality mixed-signal capabilities, as this technology is a cornerstone to both CMOS image sensor and embedded flash applications. For example, in May 2006, we began production of metro Wi-Fi baseband controller for Wavion Ltd. for the communications industry, utilizing our 0.18-micron mixed-signal technology. In addition, in June 2006, we began production of a notebook embedded controller developed by Winbond Israel using our 0.18-micron technology.

In recent years, more and more designers opt to develop high frequency products based on RF CMOS technologies as opposed to exotic process technologies, such as SiGe or GaAs. The superior cost structure of CMOS technologies enables high volume, low cost production of such high frequency products. We use our mixed signal expertise to leverage and develop processes and provide services for customers utilizing CMOS technologies. We further enhanced our mixed signal 0.18-micron platform technology offering by developing RF CMOS product design kits. This allowed us to increase our customer base and obtain new products for production as well as develop special capabilities with RFID applications. For example, in February 2006, we began producing wireless LAN products for Atheros Communications.

CONVERGENCE OF TECHNOLOGIES

In response to the growing demand for a single chip to offer a wide array of functions, we are leveraging a combination of some of the abovementioned technologies by developing a single chip with multiple functions. The successful development of this chip will allow us to provide additional value to our customers and obtain a unique market position by offering our customers a unique technology platform. We engage in projects merging CMOS, NVM and CIS for unique solutions to customers' needs, as well as in a project targeting RFID tags applications merging RF CMOS, mixed signal and NVM technologies onto a single chip.

CUSTOMERS, MARKETING AND SALES

Our marketing and sales strategy seeks to aggressively expand our global customer base. To achieve this objective, we match our standard digital CMOS technology to the industry benchmark and differentiate ourselves based on customer service, design support and expertise in specialized technologies, such as CMOS image sensors, embedded flash and mixed signal. We have marketing, sales and engineering support personnel in the United States, Taiwan and Israel. Our marketing and sales staff is supported by independent sales representatives, located throughout the world, who have been selected based on their understanding of the semiconductor marketplace.

Our sales cycle is generally 12-24 months or longer for new customers and can be as short as 9-12 months for existing customers. The typical stages in the sales cycle process from initial contact until production are:

- technical evaluation;
- product design to our specifications including integration of third party intellectual property;
- photomask design and third party manufacturing;
- silicon prototyping;
- assembly and test;
- validation and qualification; and
- production.

The primary customers of our foundry services are fabless semiconductor companies and IDMs. A substantial portion of our product sales are made pursuant to long-term contracts with our customers, under which we have agreed to reserve manufacturing capacity at our production facilities for such customers. Our customers include many industry leaders, some of our shareholders and a number of Taiwanese companies who preferred our solution to the solutions that were offered locally. During the year ended December 31, 2005, we had five significant customers who contributed 22%, 14%, 8%, 7% and 5% of our revenues, respectively. In 2004, we had five significant customers who contributed 24%, 17%, 8%, 8% and 6% of our revenues, respectively.

In addition to further developing our customer base, we have also made a concentrated effort to expand the geographical diversity of our sales. The percentage of our sales from customers located outside the United States was 27%, 40% and 36% in the years ended December 31, 2003, 2004 and 2005, respectively. We believe that a substantial portion of our sales will continue to come from customers located outside the United States. The following table sets forth the geographical distribution, by percentage, of our net sales for the periods indicated:

	Year ended December 31,		
	2005	2004	2003
United States	64%	60%	73%
Israel	7%	20%	2%
Asia-Pacific (in 2005 and 2004 - primarily Taiwan, in 2003 - only Taiwan)	20% (*)	11% (*)	10%
Europe	9%	9%	15%
Total	100%	100%	100%

(*) Including payments made to us in connection with our May 2002 joint development agreement for 0.18-micron embedded MICROFLASH technology.

COMPETITION

The global semiconductor foundry industry is highly competitive. The major independent dedicated foundries include Taiwan Semiconductor Manufacturing

Corporation, United Microelectronics and Chartered Semiconductor Manufacturing; emerging and existing Chinese, Korean, Malaysian and Taiwanese foundries, including Semiconductor Manufacturing International Corp., DongBu, He Jien Technology, ASMC, MagnaChip, CSMC Grace, HHNEC, and Silterra; and other specialized foundries, such as AMI Semiconductor, Jazz Semiconductor and X-Fab. In addition, there are IDMs and end-product manufacturers that produce ICs for their own use and/or allocate a portion of their manufacturing capacity to foundry operations. Most of the foundries with which we compete are located in Asia-Pacific and benefit from their close proximity to other companies involved in the design and manufacture of ICs. We believe that the principal elements of competition in the wafer foundry market are:

- technical competence;
- production quality;
- time-to-market;
- device and end-product price;
- available capacity;
- device yields;
- design and customer support services;
- access to intellectual property; and
- research and development capabilities.

Many of our competitors have greater manufacturing capacity, multiple manufacturing facilities, more advanced technological capabilities, a more diverse and established customer base, greater financial, marketing, distribution and other resources and a better cost structure than ours.

We seek to compete primarily on the basis of technology, production quality, device yields and services involving design, support and manufacturing. We believe we have a differentiated service offering and track record in specialized markets, which enables us to effectively compete with larger IC manufacturers.

WAFER FABRICATION SERVICES

Wafer fabrication is an intricate process that consists of constructing layers of conducting and insulating materials on raw wafers in intricate patterns that give the IC its function. IC manufacturing requires hundreds of interrelated steps performed on different types of equipment, and each step must be completed with extreme accuracy for finished ICs to work properly. The process can be summarized as follows:

CIRCUIT DESIGN. IC production begins when a fabless IC company or IDM designs the layout of a device's components and designates the interconnections between each component. The result is a pattern of components and connections that defines the function of the IC. In highly complex circuits, there may be more than 35 layers of electronic patterns. After the IC design is complete, we provide these companies with IC manufacturing services.

MASK MAKING. The design for each layer of a semiconductor wafer is imprinted on a photographic negative, called a reticle or mask. The mask is the blueprint for each specific layer of the semiconductor wafer.

IC MANUFACTURING. Transistors and other circuit elements comprising an IC are formed by repeating a series of processes in which photosensitive material is deposited on the wafer and exposed to light through a mask. Advanced IC manufacturing processes consist of hundreds of steps, including photolithography, oxidation, etching and stripping of different layers and materials, ion implantation, deposition of thin film layers, chemical mechanical polishing and thermal processing. The final step in the IC manufacturing process is wafer probe, which involves electronically inspecting each individual IC in order to identify those that are operable for assembly.

ASSEMBLY AND TEST. After IC manufacture, the wafers are transferred to assembly and test facilities. In the assembly process, each wafer is cut into dies, or individual semiconductors, and tested. Defective dies are discarded, while good dies are packaged and assembled. Assembly protects the IC, facilitates its integration into electronic systems and enables the dissipation of heat or cold. Following assembly, the functionality, voltage, current and timing of each IC is tested. After testing, the completed IC is shipped to the IC supplier or directly to its final destination.

MANUFACTURING PROCESSES

We manufacture ICs on silicon wafers, generally using the customer's proprietary circuit designs. In some cases, we use third-party or our own proprietary design elements. The end product of our manufacturing process is a silicon wafer containing multiple identical ICs. In most cases, our customer assumes responsibility for dicing, assembly and testing. Although we are an independent foundry specializing in wafer fabrication, we offer our customers the option to purchase from us finished semiconductor products that have been assembled and tested. In these cases, we take responsibility for the production and delivery of finished IC products to our customer on a turnkey basis and subcontract some or all of the dicing, assembly and testing functions to third parties. We also maintain limited assembly capabilities for manufacturing prototype units to facilitate customer evaluation and thereby accelerate new product introduction.

We manufacture ICs using CMOS process technology. CMOS is currently the dominant semiconductor manufacturing process because it requires lower power than other technologies and allows dense placement of components onto a single IC. The low power consumption and high-density characteristics of the CMOS process allow the continued development of high performance ICs that are smaller and faster. We believe that our specialized process technology distinguishes our IC manufacturing services and attracts industry-leading customers. The specific process technologies that we currently focus on include:

CMOS IMAGE SENSORS. Our advanced CMOS image sensor process is intended to meet the established growing demand for optical sensors used in consumer, industrial, medical and automotive applications. Our dedicated manufacturing and testing processes assure consistently high electro-optical performance of the integrated sensor through wafer-level characterization. Our CMOS image sensor processes have demonstrated superior optical characteristics, excellent spectral response and high resolution and sensitivity. The ultra-low dark current, high

efficiency and accurate spectral response to our photodiode enable faithful color reproduction and acute detail definition.

In addition, our innovative "stitching" technology enables semiconductor exposure tools to manufacture single ultra high-resolution CMOS image sensors containing millions of pixels at sizes far larger than their existing field. Our 0.5, 0.35-micron and 0.18-micron CMOS image sensor processes are designed to permit the customer to create high-quality solutions and integrate a product's CMOS analog and logic circuitry together with the sensor pixel array all on one chip, thereby facilitating miniaturization, reducing power consumption and increasing performance.

We have commenced volume production of CMOS Image Sensors for the cellular phone camera market in its 0.18 micron process in the last quarter of 2005, using its own developed 3.6um pixel. During the past two years, we have developed an advanced pixel that allows very low temporal noise levels in a variety of pixel sizes, from 3.6um to 2.7um. These pixels shall be ready for production in the last quarter of 2006.

EMBEDDED FLASH. Our microFLASH technology, based on Saifun NROM patented technology, provides greater memory cell density than other currently available flash architectures for given design rule generation, permitting an approximately four-fold reduction in the size of the memory cell for stand-alone memories and embedded applications in a given geometry. The relative simplicity of our microFLASH manufacturing process offers cost advantages over competing flash technologies for high density memories. Using our 0.5-micron technology, we have introduced the first of our microFLASH processes into production with the manufacture of a 2 megabit stand-alone memory device and embedded multi-time programming modules, with a limited number of rewrite cycles. Our 0.18-micron embedded flash technology was mutually developed with a Japanese semiconductor manufacturer during 2004, with multiple Flash modules ranging in sizes from 0.5 megabit to 8 megabit, and is currently in production with a few customers.

MIXED SIGNAL. We have developed the Tower 0.18-micron Mixed-Signal Design and RFCMOS Kits, which contains a comprehensive characterization of a wide range of analog and RF devices, some of which are specifically developed to provide our customers with the ability to design mixed-signal and RF ICs for their specific needs.

RFID. In 2004, we started a joint development program with Alien Technology Corporation that targets the RFID tag market and utilizes a platform technology of mixed signal, RF and non volatile memory function. In June 2006, we announced that we are the manufacturing supplier for Alien Technology's internally-designed Gen 2 RFID ICs.

PROCUREMENT AND SOURCING

Our manufacturing processes use many raw materials, including silicon wafers, chemicals, gases and various metals. These raw materials generally are available from several suppliers. In many instances, we purchase raw materials from a single source. In connection with our technology advancement plans, we expect to continue to make purchases of semiconductor manufacturing equipment, mainly for Fab 2.

RESEARCH AND DEVELOPMENT

Our future success depends, to a large degree, on our ability to continue to successfully develop and introduce to production advanced process technologies that meet our customers' needs. Our process development strategy relies on CMOS process technologies that we primarily license and transfer from third parties. We also develop these technologies on our own, at our own initiative, our customers' request or in cooperation with our customers.

From time to time, at a customer's request, we develop a specialty process module, which we use for such customer on an exclusive basis, and, if permitted under our agreements with our customers, we then add it to our process offering. Such developments are very common in all of our value added process technologies noted above. In 2004, in response to market demand, we introduced a 0.16-micron optical shrink solution which represents a 10% linear shrink from our existing 0.18-micron offering while utilizing virtually the same 0.18-micron libraries and IP. The shrink allows a 15 to 20 percent die size reduction and a potentially higher wafer ASP and lower die cost. Applications include industry standard CMOS logic and some mixed-signal technologies. This 0.16-micron technology is ready for production.

Our research and development activities have related primarily to our process development efforts and have been sponsored and funded by us with some participation by the Israeli Office of the Chief Scientist, or OCS. Accordingly, we are subject to restrictions set forth in Israeli law which limit the ability of a company to manufacture products or to transfer technologies outside of Israel, if such products or technologies were developed with OCS funding. Research and development expenses for the years ended December 31, 2003, 2004 and 2005 were $20.7 million, $17.1 million and $16 million, net of government participation of $1.1 million, $1.5 million and $1 million, respectively.

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As of June 30, 2006, we employed 164 professionals in our research and development department, 30 of whom have PhDs. In addition to our research and development department located at our facilities in Migdal Haemek, we maintain a design center in Netanya, Israel.

PROPRIETARY RIGHTS

INTELLECTUAL PROPERTY AND LICENSING AGREEMENTS

Our success depends in part on our ability to obtain patents, licenses and other intellectual property rights covering our production processes. To that end, we have acquired certain patents and patent licenses and intend to continue to seek patents on our production processes. As of March 2006, we held 58 patents. We have entered into various patent licenses and cross-licenses with technology companies including Toshiba, Freescale, Synopsys, ARM, Chipidea Microelectronics, Virage Logic, and others. We may choose to renew our present licenses or obtain additional technology licenses in the future. There can be no assurance that any such licenses could be obtained on commercially reasonable terms. In addition, we cannot assure you that other countries in which we market our services will protect our intellectual property rights to the same extent as the United States or Israel.

We constantly seek to strengthen our technological expertise through relationships with technology companies and silicon suppliers. We seek to expand our core strengths in CMOS image sensors, embedded flash and mixed-signal technologies by combining our proprietary technology with those of other technology companies. A main component of our process development strategy is to

acquire licenses to standard CMOS technologies and cell libraries from leading designers, such as Freescale and Toshiba, and further develop specialized processes through our internal design teams. The licensing of these technologies has enormously reduced our internal development costs.

CMOS PROCESS TECHNOLOGY PLATFORM

We have licensed an array of process technologies through the following arrangements:

o TOSHIBA. In April 2000, we entered into a technology transfer agreement with Toshiba, pursuant to which Toshiba has transferred to us certain advanced CMOS technologies for use in Fab 2. In exchange for certain license and technology transfer fees and royalties, Toshiba has provided us with recipes, know-how and patent licenses and has trained a group of our engineers and managers. Subject to prior termination for cause by Toshiba, our licenses under the agreement with Toshiba are perpetual. Based on Toshiba's 0.18-micron CMOS process technology, we have internally developed an enhanced industry compatible version of the process technology.

o MOTOROLA (NOW FREESCALE). In September 2002, we entered into a technology transfer and development agreement with Motorola, pursuant to which Motorola transferred to us its 0.13-micron HiPerMOS7 CMOS process technology for Fab 2 as well as co-developed with us an industry-standard compatible version of the process technology. Subject to prior termination for cause by Motorola, our licenses under the technology transfer agreement with Motorola are perpetual. In August 2004, Motorola assigned all of its rights and obligations under the aforementioned agreement to Freescale.

FOUNDATION IP BLOCKS

To better serve our customers design needs using advanced CMOS processes and mixed-signal, we have entered into a series of agreements with leading providers of physical design libraries, mixed-signal and non volatile memory design components. These components are basic design building blocks, such as standard cells, interface input-output (I/O) cells, software compilers for the generation of on-chip embedded memories arrays, mixed-signal and non-volatile memory design blocks. To achieve optimal performance, all of these components must be customized to work with our manufacturing process and are used in most of our customers' chip designs.

o SYNOPSYS. In June 2001, we entered into an agreement with Synopsys (formerly, Avant!) under which Synopsys has developed libraries for our 0.18-micron process technology. Multiple customers use the Synopsys libraries in producing their ICs at our company. In 2004, we entered into a set of comprehensive technology transfer and license agreements with Synopsys that provide us with broad rights to use Synopsys' library technology in multiple process technology generations including 0.18 micron and 0.13 micron. Under these agreements, we were given the right to develop, customize, validate and characterize libraries, based on Synopsys' library technology and to distribute such libraries through and have them supported by Synopsys. These agreements place us in a superior position of having in-house capability to serve our customers' needs. Certain parts of the 2004 license agreements, relating to elements of distribution and support by Synopsys, expire in October 2006, and we may be unable to extend or renew them on similar terms.

o ARM (INCLUDING ITS WHOLLY-OWNED SUBSIDIARY, ARM PHYSICAL IP). In 2002 and subsequently in 2004, we entered into license agreements with ARM (formerly, Artisan Components) under which we received a license to a suite of library products for our 0.18-micron and 0.13-micron process technologies, respectively. ARM is licensing its libraries to our customers free of charge. Multiple customers are using the ARM libraries in their chip design for manufacturing at our company. The ARM libraries include, among others, standard cells, general purpose and specialty input-output cells and memory generators.

o VIRAGE LOGIC. In 2002 and subsequently in 2004, we entered into license agreements with Virage Logic under which we received a license to a suite of library products for our 0.18-micron and 0.13-micron process technologies, respectively. These library products are available for licensing by our customers, and with respect to most of the 0.13-micron library products, free of a license charge. Virage offers a variety of SRAM and ROM memory compilers on both process technologies, and also offers standard cells, general purpose and specialty input-output cells libraries in the 0.13-micron technology. Presently, multiple customers' products that use Virage Logic's memory products are in production at Fab 2. In addition, our license agreement with Virage Logic from 2002 has also introduced Virage Logic's patented Nonvolatile Electrically Alterable embedded memories for production on our 0.18-micron CMOS logic process. Currently customers' products that use Virage Logic's non-volatile memory products are in production at Fab 2. We have selected and qualified these memories for our process to help our customers meet their application requirements for cost-effective embedded non-volatile memory for security, encryption, unique device identification, analog trimming, silicon repair and flexible program store.

o IMPINJ INC. In 2005, we entered into a development and license agreement with Impinj Inc. under which Impinj is developing its AEON(R) non-volatile memory (NVM), in parallel architecture, based on its patented Self-Adaptive Silicon(R) technology, for production on our 0.13-micron CMOS logic process. We chose Impinj's cost-effective NVM to help our customers' products meet their application requirements for embedded non-volatile memories. Primary applications for Impinj's AEON parallel architecture include analog trimming, digital rights management and wireless controllers.

o CHIPIDEA MICROELECTRONICS. In 2003 and subsequently in 2005, we entered into a non-exclusive, perpetual, royalty-free license and design agreement with Chipidea Microelectronics. Further to this agreement, Chipidea has customized several of its mixed-signal design blocks for manufacturing on our 0.18-micron and 0.13-micron process technologies, such asUSB 2.0 (Universal Serial Bus 2.0) and USB2.0 OTG (On The Go), which are currently being utilized by several of our customers.

IMAGE SENSOR TECHNOLOGIES

We developed, both independently and together with our customers, basic pixel intellectual property to be used by those customers in the manufacturing of our CMOS image sensor products.

C. ORGANIZATIONAL STRUCTURE

The legal and commercial name of our company is Tower Semiconductor Ltd. We were incorporated under the laws of the State of Israel in 1993. We have one subsidiary, incorporated in the United States under the name Tower Semiconductor USA, Inc. Our subsidiary is wholly-owned by us.

D. PROPERTY, PLANTS AND EQUIPMENT

MANUFACTURING FACILITIES

FAB 1

We acquired our Fab 1 facility from National Semiconductor in 1993, which had operated the facility since 1986. We occupy the facility pursuant to a long-term lease from the Israel Lands Authority that expires in 2032.

Due to the sensitivity and complexity of the semiconductor manufacturing process, a semiconductor manufacturing facility requires a special "clean room" in which most of the manufacturing functions are performed. Our Fab 1 facility includes an approximately 51,900 square foot clean room.

Since we commenced manufacturing at Fab 1, we increased its manufacturing capacity from 5,000 wafers per month, using 1.25-micron and 1.0-micron processes, to approximately 16,000 wafers per month as of May 31, 2006 depending on process technology and product mix, using our 1.0 micron to 0.35-micron processes, including specialized processes.

Our exact capacity is variable and depends on the combination of the processes being used and may be significantly lower at certain times as a result of certain of our combinations. In general, our ability to increase our manufacturing capacity has been achieved through the addition of equipment, improvement in equipment utilization, the reconfiguration and expansion of the existing clean room area and the construction of an additional clean room area within the building shell of Fab 1.

We have completed the transfer of Siliconix technology to Fab 1 and started wafer production for Siliconix in the second quarter of 2005.

FAB 2

In January 2001, we commenced construction of Fab 2, our new advanced wafer fab adjacent to Fab 1 in Migdal Haemek. The land on which Fab 2 is located is subject to a long-term lease from the Israel Lands Authority that expires in 2049.

Fab 2 offers integrated circuits manufacturing services utilizing advanced materials and a 0.18-micron process technology we licensed from Toshiba, as well as 0.13-micron process technology we licensed from Freescale.

The overall clean room area in Fab 2 is approximately 100,000 square feet. We began volume production at Fab 2 during the third quarter of 2003. . Production capacity as of May 31, 2006 was approximately 15,000 wafers per month. Depending on the process technology and product mix, when fully ramped-up, we estimate that Fab 2 will be able to achieve capacity levels of approximately 40,000 wafers per month.

Since 2000, we have invested significantly in the purchase of fixed assets, primarily in connection with the construction of Fab 2, technology advancement and capacity expansion. Capital expenditures in 2005, 2004 and 2003 were approximately $30million, $172 million and $164 million, respectively, before related Investment Center grants of $6 million, $30 million and $27 million, respectively.

We have registered liens in favor of the State of Israel and our banks on substantially all of our present and future assets, including Fab 1 and Fab 2 (see "Item 5 - Operating and Financial Review and Prospects - B. Liquidity and Capital Resources - Fab 2 Agreements - Credit Facility").

ENVIRONMENTAL MATTERS AND CERTIFICATIONS

Our operations are subject to a variety of laws and governmental regulations relating to the use, discharge and disposal of toxic or otherwise hazardous materials used in our production processes. Failure to comply with these laws and regulations could subject us to material costs and liabilities, including costs to clean up contamination caused by our operations.

We believe that we are currently in compliance in all material respects with applicable environmental laws and regulations.

In November 2004, we received ISO 14001 certification from The Standards Institution of Israel. A series of international standards on environmental management, ISO 14000 provides a framework for the development of an environmental management system and the supporting audit program. ISO 14001 is the cornerstone standard of the ISO 14000 series. It specifies a framework of control for an environmental management system pursuant to which an organization can be certified by a third party. The ISO 14001 certification applies to all of our manufacturing facilities. Our authorized design center in Netanya, Israel also received certification.

In November 2005, we achieved ISO/TS 16949 certification from the UK-based National Quality Association pertaining to the manufacturing processes, work procedures and product performance meeting the requirements of the automotive industry. This quality management system standard certification covers all our departments and activities.

In March 2006, we achieved ISO 17799 certification from The Standards Institution of Israel for the high quality of our security technology and implementations, covering all our departments and activities.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not Applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

A. OPERATING RESULTS

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 FOR THE YEAR ENDED DECEMBER 31, 2005 AND

RELATED NOTES AND THE INFORMATION CONTAINED ELSEWHERE IN THIS ANNUAL REPORT. OUR FINANCIAL STATEMENTS HAVE BEEN PREPARED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ("GAAP") IN ISRAEL. DIFFERENCES BETWEEN ISRAELI GAAP AND US GAAP AS THEY RELATE TO OUR FINANCIAL STATEMENTS ARE DESCRIBED IN NOTE 20 TO OUR AUDITED ANNUAL CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEAR ENDED DECEMBER 31, 2005.

OVERVIEW

We are a pure-play independent specialty foundry dedicated to the manufacture of semiconductors. Pure-play foundries do not offer any products of their own, but focus on producing integrated circuits based on the design specifications of their customers. We manufacture semiconductors using advanced production processes for our customers primarily based on third party designs and our own proprietary designs. We currently offer the manufacture of ICs with geometries ranging from 1.0 to 0.13-micron.

Our primary source of revenue is from the fabrication of ICs using CMOS process technology. We are currently focused on the emerging opportunities involving CMOS image sensors, embedded flash, mixed-signal and RFID technologies. ICs manufactured by us are incorporated into a wide range of products in diverse markets, including consumer electronics, personal computer and office equipment, communications, automotive, professional photography and medical device products.

The primary customers for our products are fabless IC companies and IDMs. A substantial portion of our product sales are made pursuant to long-term contracts with our customers, under which we have agreed to reserve manufacturing capacity at our production facilities. Our sales cycle is generally 12-24 months for new customers and can be as short as 9-12 months for existing customers. The typical stages in the sales process, from initial contact until production are: technical evaluation; photomask design specification; silicon prototyping; assembly and testing; validation and qualification; and production.

During the year ended December 31, 2005, we had five significant customers who contributed between 5% to 22% of our revenues. In 2004, we had five significant customers who contributed between 6% to 24% of our revenues. In 2003, we had five significant customers who contributed between 6% and 24% of our revenues. In 2004 and 2005, SanDisk was instrumental in ramping up our business. While we currently expect that SanDisk will continue to be a significant customer of Fab 2, additional customers are expected to commence or increase their purchase orders following the qualification of their products in Fab 2 during 2006.

In addition to further developing our customer base, we have also made a concentrated effort to expand the geographical diversity of our sales. The percentage of our sales from customers located outside the United States was 36%, 40% and 27% in the years ended December 31, 2005, 2004 and 2003, respectively. We believe that a substantial portion of our sales will continue to come from customers located outside the United States.

Our company was founded in 1993, when we acquired National Semiconductor's 150-mm wafer fabrication facility, or Fab 1, and commenced operations as an independent foundry. Since then, we have significantly modernized our Fab 1 facility, which has improved its process geometries from 1.0-micron to

0.35-micron and enhanced its process technologies to include CMOS image sensors, embedded flash and mixed-signal technologies. We have also expanded our production capacity in Fab 1 to approximately 16,000 wafers per month as of June 30, 2006, depending on process technology and product mix, to meet additional customer demand. Fab 1 has been cash flow positive from operations since the second quarter of 2002. We completed the transfer of Siliconix technology to Fab 1 and started wafer production for Siliconix in the second quarter of 2005.

During the third quarter of 2003, we completed the construction of the building and infrastructure of our second manufacturing facility, or Fab 2. Fab 2 is designed to operate in geometries of 0.18-micron and below, using advanced materials and advanced CMOS technology licensed from Freescale and Toshiba, as well as other technologies that we might acquire or develop independently. We began volume production at Fab 2 during the third quarter of 2003. Production capacity of Fab 2 as of June 30, 2006 was approximately 15,000 wafers per month.

CRITICAL ACCOUNTING POLICIES

REVENUE RECOGNITION. In accordance with generally accepted accounting principles, our revenues are recognized upon shipment or as services are rendered when title has been transferred, collectibility is reasonably assured and acceptance criteria are satisfied, based on tests performed prior to customer on-site testing. Prior to commencement of our production, both our customers and our personnel test and pre-approve the prototype, on the basis of which specifications and features the ordered products will be produced. Electronic, functional and quality tests are performed on the products prior to shipment and customer on-site testing. Such testing reliably demonstrates that the products meet all of the specified criteria prior to formal customer acceptance and that product performance upon customer on-site testing can reasonably be expected to conform to the specified acceptance provisions. Our revenue recognition policy is significant because our revenues are a key component of our results of operations. We follow very specific and detailed guidelines in measuring revenue; however an accrual for estimated returns, which is computed primarily on the basis of historical experience, is recorded. Any changes in assumptions for determining the accrual for returns may affect mainly the timing of our revenue recognition and cause our operating results to vary from quarter to quarter.

Accordingly, our financial position and results of operations may be affected. That effect, if any, under Israel GAAP and US GAAP would be similar.

DEPRECIATION AND AMORTIZATION OF FAB 2 ASSETS. Depreciation and amortization expense in 2005 amounted to $144.9 million. During the third quarter of 2003, we commenced depreciating the Fab 2 property and equipment and amortizing the 0.18-micron technology, based on the straight-line method. Currently, we estimate that the expected economic life of the Fab 2 assets will be as follows: (i) prepaid perpetual land lease and buildings (including facility infrastructure) - 14 to 25 years; (ii) machinery and equipment - 5 years; and (iii) the 0.18-micron and 0.13 micron technology - 4 years, while amortization phases in commencing on the dates on which each of the Fab 2 manufacturing lines is ready for its intended use. We expect that the depreciation and amortization expenses relating to Fab 2 facilities will be approximately $138 million in 2006. Changes in our estimates regarding the expected economic life of Fab 2 assets, or a change in the dates on which each of the Fab 2 manufacturing lines is ready for its intended use, might affect our depreciation and amortization expenses. That effect, if any, under Israel GAAP

and US GAAP would be similar.

IMPAIRMENT OF ASSETS. Standard No. 15, "Impairment of Assets," of the Israeli Accounting Standards Board addresses the accounting treatment and presentation of impairment of assets, and establishes procedures to be implemented in order to ensure that assets are not presented in amounts exceeding their recoverable value. The review of possible impairment charges was performed based on our business plan, as was approved by our board of directors. The business plan is based, among other things, on the future completion of the construction and equipping of Fab 2 to reach full capacity. Application of Standard 15 resulted in no impairment charges. According to US GAAP, e.g. FASB 144 and FASB 142, recoverability tests are performed based on undiscounted expected cash flows, Standard No. 15 indicates that an asset's recoverable value is the higher of the asset's net selling price and the asset's value in use, the latter being equal to the asset's discounted expected cash flows. While applying the provisions of Standard No. 15 had no effect on our financial position and results of operations, the use of different assumptions with respect to the expected cash flows from our assets and with respect to other economic variables, primarily the discount rate, may lead to different conclusions regarding the recoverability of our assets' carrying values and to the potential need to record an impairment loss for our long-lived assets.

CONVERTIBLE DEBENTURES

As of December 31, 2005, convertible debentures the future conversion of which is not probable as of the balance-sheet date are presented as long-term liabilities and current liabilities (with respect to the current maturities) based on their terms as of such date, net of discount.

As of December 31, 2005, under Israeli GAAP, convertible debentures denominated in dollar the future conversion of which is probable as of the balance-sheet date, are presented as a separate line-item between total liabilities and shareholders equity.

Commencing January 1, 2006, we adopted Standard No. 22 of the Israeli Accounting Standard Board "Financial Instruments: Disclosure and Presentation". Under Standard No. 22, the three series of our convertible debentures are considered compound instruments, therefore, are to be separated to its components, the equity component and the liability component. The amount attributed to the equity component is calculated as the excess in value of (i) the carrying amount net of issuance costs and (ii) discounting the same cash flows using the rate commensurate for non-convertible debt. The equity component as calculated above is classified in equity. In applying the provisions of Standard No. 22, the use of different assumptions with respect to the discount rate may lead to different amounts allocated to the equity component.

Under US GAAP the Company is required to determine the conversion option embedded in the convertible debt should be bifurcated and accounted for separately. Such determination is based on the determination whether on a stand alone such conversion option would be classified in equity. If the option can be classified as equity no bifurcation is required.

NON-CAPITALIZABLE COSTS. In accordance with generally accepted accounting principles, we capitalized through the third quarter of 2003 most of our costs relating to the establishment of Fab 2, primarily for property and equipment and other assets. Capitalizable Fab 2 costs were only incremental direct costs that

related to the establishment and equipping of Fab 2 and to the integration and transfer of technology to be implemented in Fab 2. Following initial commencement of operations of Fab 2 in the third quarter of 2003(equipping of Fab 2 towards full capacity is still to be completed, most of the direct costs related to the construction and equipping of Fab 2 and to the transfer of the Fab 2 technologies that were capitalizable until Fab 2 came into production, are no longer capitalizable.

Direct internal costs which were capitalized to Fab 2 consisted primarily of payroll-related costs, and allocated payroll costs, on the basis of management's estimates and assumptions and methodologies, including timesheet inputs. Most of the capitalized payroll-related costs consisted of wages to employees dedicated solely to the establishment of Fab 2. In addition, other direct related expenses such as import costs, transportation, installation and consulting fees were also capitalized. Under different assumptions relating to these costs and their being attributable to Fab 2, the classification and accounting recognition of these costs may have been different, which may significantly affect our financial position and results of operations. The effect, if any, under Israel GAAP and US GAAP would be similar.

RECENT ACCOUNTING PRONOUNCEMENTS UNDER US GAAP AS THEY APPLY TO US

SFAS No. 151 - Inventory Costs, an Amendment of ARB No. 43, Chapter 4 - In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an Amendment of ARB No. 43, Chapter 4". SFAS No. 151 amends the guidance in ARB 43, Chapter 4, "Inventory Pricing", which provides guidance on the allocation of certain costs to inventory. SFAS 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this statement are effective for inventory costs incurred during fiscal years beginning after June 2005. The provisions of this statement shall be applied prospectively. This Standard is not expected to have a material effect on our financial position or results of operations.

SFAS No. 123 (revised 2004) "Share Based Payments". In December 2004, the FASB issued SFAS No. 123 (revised 2004) "Share Based Payments" ("SFAS 123(R)"). This Statement is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation", which supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees" and its authoritative interpretations.

SFAS 123(R) eliminates the alternative to use APB 25's intrinsic value method of accounting that was allowed in SFAS 123 as originally issued and requires to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The fair-value-based method in this Statement is similar to the fair-value-based method in SFAS 123 in most respects. The costs associated with the awards will be recognized over the period during which an employee is required to provide service in exchange for the award - the requisite service period (usually the vesting period).

The provisions of SFAS 123(R) apply to all awards granted by us on or after January 1, 2006 and to awards modified, repurchased, or cancelled after that date. When initially applied the provisions of SFAS 123(R), in the first quarter of 2006, we were required to elect between using either the "modified

prospective method" or the "modified retrospective method". Under the modified prospective method, we were required to recognize compensation cost for all awards granted after the adoption of SFAS 123(R) and for the unvested portion of previously granted awards that are outstanding on that date. Under the modified retrospective method, we were required to restate its previously issued financial statements to recognize the amounts previously calculated and reported on a pro forma basis, as if the original provisions of SFAS 123(R) had been adopted. Under both methods, it is permitted to use either a straight line or an accelerated method to amortize the cost as an expense for awards with graded vesting.

Management has commenced identifying the potential future impact of applying the provisions of SFAS 123(R), including each of its proposed transition methods. Based on the outstanding options as of December 31, 2005, the total compensation to be amortized in the years 2006-2009 is expected to be approximately $4.2 million.

On March 29, 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107"). This Staff Accounting Bulletin expresses views of the staff regarding the interaction between SFAS 123(R) and certain SEC rules and regulations and provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies.

On April 14, 2005, the SEC adopted a new rule amending the compliance dates for SFAS 123(R). Under the SEC rule, the provisions of SFAS 123(R) apply to all awards to be granted after January 1, 2006 and to awards modified, repurchased, or cancelled after that date.

SFAS 153, Exchange of Non-Monetary Assets - In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets an amendment of APB No. 29". This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Statement specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Retroactive application is not permitted. The adoption of this Standard does not affect our financial position or results of operations.

SFAS No. 154, Accounting Changes and Error Corrections - This Statement, published in May 2005, replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principles. This Statement applies to all voluntary changes in accounting principles, and to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions.

Opinion 20 previously required that most voluntary changes in accounting principles be recognized by including the cumulative effect of changing to the new accounting principles in the net income of the period of the change. This Statement requires retrospective application to prior periods' financial statements of changes in accounting principles, unless it is impracticable to determine the specific effects or the cumulative effect of the change. The Statement also provides guidance for cases in which it is impracticable to

determine the period-specific effects of an accounting change on one or more individual prior periods presented, and/or for cases in which it is impracticable to determine the cumulative effect of applying a change in accounting principles to all prior periods.

This Statement defines retrospective application as (i) the application of a different accounting principle to prior accounting periods as if that principle had always been used, or (ii) as the adjustment of previously issued financial statements to reflect a change in the reporting entity. This Statement also redefines restatement as the revisiting of previously issued financial statements to reflect the correction of an error.

This Statement also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets, be accounted for as a change in accounting estimate effected by a change in accounting principles. This Statement carries forward without change the guidance in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. This Statement also carries forward the guidance in Opinion 20 requiring justification of a change in accounting principles on the basis of preferability.

The provisions of this Statement are effective for accounting changes and corrections of errors made during fiscal years beginning after December 15, 2005. The adoption of this Standard is not expected to have a material effect on our financial position or results of operations. SFAS No. 155. Accounting for Certain Hybrid Financial Instruments -In February 2006, the FASB issued SFAS 155, "Accounting for Certain HybridFinancial Instruments". Key provisions of SFAS 155 include: (1) a broad fair value measurement option for certain hybrid financial instruments that contain an embedded derivative that would otherwise require bifurcation; (2) clarification that only the simplest separations of interest payments and principal payments qualify for the exception afforded to interest-only strips and principal-only strips from derivative accounting under paragraph 14 of FAS 133 (thereby narrowing such exception); (3) a requirement that beneficial interests in securitized financial assets be analyzed to determine whether they are freestanding derivatives or whether they are hybrid instruments that contain embedded derivatives requiring bifurcation; (4) clarification that concentrations of credit risk in the form of subordination are not embedded derivatives; and (5) elimination of the prohibition on a QSPE holding passive derivative financial instruments that pertain to beneficial interests that are or contain a derivative financial instrument. In general, these changes will reduce the operational complexity associated with bifurcating embedded derivatives, and increase the number of beneficial interests in securitization transactions, including interest-only strips and principal-only strips, required to be accounted for in accordance with FAS 133. Management does not believe that SFAS 155 will have a material effect on our financial condition, results of operations, or liquidity.

RECENT ACCOUNTING PRONOUNCEMENTS UNDER ISRAELI GAAP AS THEY APPLY TO US

Accounting Standard No. 24 "Share-Based Payments" - In September 2005, the Israeli Accounting Standards Board published Accounting Standard No. 24 "Share-Based Compensation" (the "Standard"), which calls for the recognition in the financial statements of share-based payments, including transactions with employees, which are to be settled by the payment of cash, by other assets, or by equity instruments. Under Standard No. 24, amongst other matters, costs associated with grants of shares and options to employees will be expensed over

the vesting period of each grant. Said costs will be determined based on the fair value of the grants at each grant date. The Standard establishes guidelines for measuring the fair value of each grant based on the settlement terms (either by cash or equity instrument), and disclosure provisions.

The Standard is effective for financial statements for periods commencing January 1, 2006 or thereafter. The Standard provides that with respect to Share-based payments to be settled by equity instruments, its provisions should be applied to all grants made after March 15, 2005, that are unvested as of December 31, 2005. The Standard further provides that its provisions should be applied to modifications that were made after March 15, 2005, even if the underlying grants are not in the scope of the Standard.

As of December 31, 2005, the award cost with respect to outstanding employee and director options on which the Standard will be applied amounts to approximately $2.0 million, to be amortized over 2006-2009.

Accounting Standard No. 22 "Financial Instruments: Disclosure and Presentation" - In July 2005, the Israeli Accounting Standards Board approved for publication Accounting Standard No. 22 "Financial Instruments: Disclosure and Presentation" ("Standard No. 22"). A financial instrument under Standard No. 22 is defined, in general, as any contract that establishes a financial asset of an entity, or a financial liability or equity instrument of another entity. Standard No. 22 establishes the requirements for presentation of financial instruments in the financial statements and indicates the information that should be disclosed in relation thereto, and, in certain cases, the method to measure their impact on the entity's financial statements. The presentation requirements relate to the classification of financial instruments as financial assets, financial liabilities or equity instruments. It also deals with the classification of related interest, dividends, losses and gains and to the circumstances under which financial assets and financial liabilities are to be offset. Standard No. 22 establishes requirements for disclosure of information relating to factors affecting the amount, timing and certainty of the entity's future cash flows relating to financial instruments and accounting policy implemented in respect of these instruments. Standard No. 22 also establishes requirements for disclosure of information about the nature and the extent of an entity's use of financial instruments, the business purposes they serve, the risks associated with them and management's policies for the oversight of those risks.

Standard No. 22 is effective for financial statements for periods commencing January 1, 2006 or thereafter. Financial instruments issued before the effective date of Standard No. 22 will be classified and presented in accordance with its provisions commencing from the effective date. Comparative financial statements for prior periods are not to be adjusted. We issued three series of convertible debentures that are considered compound instruments under Standard No. 22. A compound instrument has to be separated to its components, the equity component and the liability component. The equity component is classified as shareholders' equity and is determined as the excess of the total value over the fair value of the liability component.

The initial adoption of the Standard commencing 2006, affected primarily the presentation of our convertible debentures (the bifurcation of the convertible debentures into debt component and equity component, as these terms are defined by the Standard). Consequently, on January 1, 2006, our shareholders equity was recorded with a one-time increase of approximately $22.0 million,

while its total convertible debentures decreased by same amount. Commencing from that date, said amount will be amortized as financing expenses through 2011.

Accounting Standard No. 21 "Earnings Per Share" - In February 2006, the Israeli Accounting Standards Board approved for publication Accounting Standard No. 21, "Earnings Per Share" ("Standard No. 21").

With the initial adoption of Standard No. 21, Opinion No. 55 of the Institute of Certified Public Accountants in Israel - Earnings per share is cancelled.

Standard No. 21 prescribes that an entity shall calculate basic earnings per share amounts for profit or loss attributable to ordinary equity holders of the entity. The basic earnings per share shall be calculated by dividing profit or loss attributable to ordinary equity holders of the entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the reported period. For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the entity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares.

Standard No. 21 is effective for financial statements for periods commencing January 1, 2006 or thereafter. The adoption of Standard No. 21 is accounted for retrospectively and a comparative earnings per share data for prior periods is adjusted. Accordingly, in the unaudited condensed interim consolidated financial statements for the three months ended March 31, 2006, the loss per share presented for the 12 months ended December 31, 2005 was adjusted from $2.55 to $3.06.

Accounting Standard No. 25 "Revenues" - In February 2006, the Israeli Accounting Standards Board approved for publication Accounting Standard No. 25, "Revenues" ("Standard No. 25").

Standard No. 25 establishes the requirements for recognition criteria, measurement, disclosure and presentation of revenues arising from sale of goods, rendering of services and from the use by others of entity assets yielding interest, royalties and dividends. Standard No. 25 prescribes that revenue shall be measured at the fair value of the consideration received or receivable.

Standard No. 25 is effective for financial statements for periods commencing January 1, 2006 or thereafter. The adoption of the standard had no material effect on the unaudited condensed interim consolidated financial statements for the three months ended March 31, 2006.

RESULTS OF OPERATIONS

You should read the following discussion and analysis of our financial condition and results of operations in conjunction with the financial statements and the related notes thereto included in this annual report. The following table sets forth certain statement of operations data as a percentage of total revenues for the years indicated.

	Year Ended December (31,)		
	2005	2004	2003
STATEMENT OF OPERATIONS DATA:			
Cost of sales	100.0%	100.0%	100.0%
Cost of total revenues	233.7	181.2	199.4
Gross loss	(133.7)	(81.2)	(99.4)
Research and development	15.7	13.5	33.7
Marketing, general and administrative	17.1	16.9	36.9
Operating loss	(166.5)	(111.6)	(170.0)
Financing expense, net	(35.0)	(23.6)	(16.1)
Other income (expense), net	2.34	25.9	(0.1)
Loss	(199.1)%	(109.3)%	(186.2)%

YEAR ENDED DECEMBER 31, 2005 COMPARED TO YEAR ENDED DECEMBER 31, 2004

TOTAL REVENUES. Total revenues for the year ended December 31, 2005 decreased by 19.1% to $102.0 million from $126.1 million for the year ended December 31, 2004. This $24.1 million decrease was mainly attributable to lower volume of wafer shipments, which was partly offset by increased revenues from a joint development agreement for certain technology with a Japanese semiconductor manufacturer.

During the year ended December 31, 2005, we had five significant customers who contributed between 5% and 22% of our revenues.

COST OF TOTAL REVENUES. Cost of total revenues in the year ended December 31, 2005 amounted to $238.4 million, compared with $228.4 million for the year ended December 31, 2004. This increase was mainly due to an increase in depreciation and amortization expenses which was partly offset by cost reductions and efficiency measures taken by us.

GROSS LOSS. Gross loss in the year ended December 31, 2005 was $136.4 million compared to a gross loss of $102.4 million for the year ended December 31, 2004. The increase in gross loss was mainly attributable to the decrease in total revenues and to the increased cost of total revenues.

RESEARCH AND DEVELOPMENT. Research and development expenses for the year ended December 31, 2005 decreased to $16.0 million from $17.1 million for the year ended December 31, 2004. The decrease was mainly attributable to cost reductions and efficiency measures taken by us. Research and development expenses are reflected net of participation grants received from the Israeli government ($1.0 million and $1.5 million, for the years ended December 31, 2005 and 2004, respectively).

MARKETING, GENERAL AND ADMINISTRATION. Marketing, general and administrative expenses in the year ended December 31, 2005 decreased to $17.4 million from $21.3 million for the year ended December 31, 2004, primarily due to cost reductions and efficiency measures taken by us.

OPERATING LOSS. Operating loss in the year ended December 31, 2005 was $169.8 million, compared to $140.7 million for the year ended December 31, 2004. The increase in the operating loss is attributable mainly to the increase in the gross loss.

FINANCING EXPENSES, NET. Financing expenses, net in the year ended December 31, 2005 were $35.7 million compared to financing expenses, net of $29.8 million for the year ended December 31, 2004. This increase is mainly due to an increase of $7.6 million in connection with our Fab 2 credit facility agreement attributable to (i) a higher amount of long-term loans which financed the construction and equipping of Fab 2 during the year ended December 31, 2005 as compared to the amount of such long-term loans during the year ended December 31, 2004, and (ii) an increase in the LIBOR rate from an average of approximately 1.5% per annum for the year ended December 31, 2004 to an average of approximately 3.3% per annum for the year ended December 31, 2005 (our long-term loans bear interest at a rate of LIBOR + 2.5% per annum).

OTHER INCOME (EXPENSE), NET. Other income, net for the year ended December 31, 2005 was $2.4 million compared to $32.7 million for the year ended December 31, 2004. This decrease was mainly attributable to the $32.4 million gain from the sale of the Saifun Semiconductor shares in 2004.

LOSS. Our loss in the year ended December 31, 2005 was $203.1 million, compared to $137.8 million for the year ended December 31, 2004. This increase is primarily attributable to the increase in the operating loss of $29.1 million, the increase in financing expenses, net of $5.9 million, and the decrease in other income, net of $30.3 million.

YEAR ENDED DECEMBER 31, 2004 COMPARED TO YEAR ENDED DECEMBER 31, 2003

TOTAL REVENUES. Total revenues in the year ended December 31, 2004 increased by 105.4% to $126.1 million from $61.4 million in 2003. This $64.7 million increase was attributable to the ramp up of capacity of our Fab 2 wafer fabrication and the increase in production levels.

COST OF TOTAL REVENUES. Cost of total revenues in the year ended December 31, 2004 totaled $228.4 million, compared with $122.4 million in 2003. This increase was due mainly to Fab 2 operations, which in 2003 operated only for half a year while in 2004 operated for a full year, resulting in an increase of $61.6 million in depreciation and amortization expenses and an increase of $23.9 million in materials usage mainly related to Fab 2.

GROSS LOSS. Gross loss in the year ended December 31, 2004 was $102.4 million compared to a gross loss of $61.0 million in 2003. The increase in gross loss was primarily attributable to the increased cost of total sales, which was partially offset by the increase in revenues.

RESEARCH AND DEVELOPMENT. Research and development expenses in the year ended December 31, 2004 decreased to $17.1 million from $20.7 million in 2003. The decrease was primarily due to decreased expenses related to the Fab 2 0.13-micron technology agreement signed with Freescale in 2002. Research and development expenses are reflected net of participation grants received from the Israeli government ($1.5 million and $1.1 million, in 2004 and 2003, respectively).

MARKETING, GENERAL AND ADMINISTRATION. Marketing, general and administrative expenses in the year ended December 31, 2004 decreased to $21.3 million from $22.6 million in 2003, primarily due to decreased use of outsourcing services.

OPERATING LOSS. Operating loss in the year ended December 31, 2004 was $140.7 million, compared to $104.4 million in 2003, attributable primarily to the ramp-up of Fab 2. This increase in the operating loss reflects an increase in gross loss of $41.4 million, a decrease in research and development expenses of $3.6 million and a decrease in marketing and sales, general and administrative expenses of $1.3 million.

FINANCING EXPENSES, NET. Financing expenses, net in the year ended December 31, 2004 were $29.7 million compared to financing expenses, net of $9.8 million in 2003. This increase is mainly due to an increase of $19.5 million in connection with our Fab 2 facility agreement attributable to (i) an increase during 2004 in the total amount of long-term loans which financed the construction and equipping of Fab 2, (ii) the discontinuation of capitalization of financing costs that had been capitalized prior to the commencement of operations of Fab 2 in the third quarter of 2003 and (iii) the increase in the interest rate from LIBOR plus 1.5% in 2003 to LIBOR plus 2.5% commencing from January 2004 pursuant to the November 2003 amendment to our credit facility agreement with our banks.

OTHER INCOME (EXPENSE), NET. Other income, net in 2004 was $32.7 million compared to other expense, net of $0.1 million in 2003 due to the sale in 2004 of our shareholdings in Saifun Semiconductors Ltd. for a net capital gain of $32.4 million.

LOSS. Our loss in the year ended December 31, 2004 was $137.8 million, compared to $114.3 million in 2003. This increase is primarily attributable to the increased operating loss of $36.3 million and the increase in financing expenses, net, of $19.9 million offset by increased other income, net of $32.8.

IMPACT OF INFLATION AND CURRENCY FLUCTUATIONS

The dollar cost of our operations in Israel is influenced by the timing of any change in the rate of inflation in Israel and the extent to which such change is not offset by the change in valuation of the NIS in relation to the dollar. During 2005, the dollar strengthened against the NIS by 6.8% and the Israeli Consumer Price Index, or CPI increased by 2.4%. During 2004, the dollar was devalued against the NIS by 1.6%, and the CPI increased by 1.2%. We believe that the rate of inflation in Israel has had a non-material effect on our business to date. However, our dollar costs will increase if inflation in Israel exceeds the devaluation of the NIS against the dollar, or if the timing of such devaluation lags behind inflation in Israel.

Almost all of our cash generated from operations and from our financing and investing activities is denominated in U.S. dollars and NIS. Our expenses and costs are denominated in NIS, U.S. dollars, Japanese Yen and Euros. We are, therefore, exposed to the risk of currency exchange rate fluctuations.

Our borrowings under our Fab 2 credit facility, which comprise the majority of our long-term liabilities, provide for interest based on a floating Libor rate, and we are therefore exposed to interest rate fluctuations. From time to time, we engage in various hedging strategies to reduce our exposure to some,

but not all, of these risks and intend to continue to do so in the future. However, despite any such hedging activity, we are likely to remain exposed to interest rate and currency exchange rate fluctuations, which may increase the cost of our business activities, particularly our financing expenses.

Our 2002 and 2006 convertible debentures are denominated in NIS linked to the Israeli CPI and therefore we are exposed to fluctuation in the NIS/dollar exchange rate. The dollar amount of our financing costs (interest and currency adjustments) related to the 2002 and 2006 convertible debentures will increase if the rate of inflation in Israel is not offset (or is offset on a lagging basis) by the devaluation of the NIS in relation to the dollar. In addition, the dollar amount of any repayment on account of the principal of the 2002 and 2006 convertible debentures will increase as well.

The quantitative and qualitative disclosures about market risk are in Item 11 of this annual report.

B. LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2005, we had an aggregate of $39.0 million in cash, cash equivalents, and short-term interest-bearing deposits, of which $22.0 million was contractually restricted for Fab 2 use only and $9.6 million was contractually restricted for use in the Siliconix project only. This compares to $81.5 million in cash, cash equivalents, and short-term interest-bearing deposits, of which $39.7 million was contractually restricted for Fab 2 use only and $14.1 million was contractually restricted for use in the Siliconix project only, as of December 31, 2004. In addition, as of December 31, 2004, we had $5.1 million (none as of December 31, 2005) in long-term interest-bearing deposits, which were contractually serving as a security for our convertible debentures.

During the year ended December 31, 2005, we generated cash from the following sources: $22.1 million from bank loans; $25.1 million in proceeds from the issuance of convertible debentures, net; $7.5 million from Investment Center grants and $2.2 million in proceeds from disposal of property. These liquidity resources partially financed our operating activities (net amount of $60.7 million) and our investments made during the year ended December 31, 2005, which aggregated $42.7 million mainly in connection with the construction, and purchase and installation of equipment and other assets, for Fab 2.

As of December 31, 2005, we had loans in the amount of $518.1 million in connection with the establishment of Fab 2. Of that amount, $21.1 million are presented as current maturities as of December 31, 2005 in the financial statements included in this annual report. In addition, as of such date, we had convertible debentures in the aggregate of $51.3 million, of which $6.5 million are presented as current maturities in the financial statements included in this annual report.

During the third quarter of 2003, Fab 2, our new advanced wafer facility adjacent to Fab 1 in Migdal Haemek, Israel had initially commenced operations. Production capacity of Fab 2 as of May 31, 2006 was approximately 15,000 wafers per month. The Fab 2 ramp up financing may be funded by additional grants from the Investment Center, sales of our securities, wafer prepayments from our customers and cash flow from operations or from other sources.

In recent years, we have experienced significant recurring losses from operations and recurring negative cash flows from operating activities and an

increasing accumulated deficit and a deficit in shareholders equity. In order to have adequate liquidity for our activities in 2005 and thereafter, we have taken measures to reduce our short-term liabilities. We have implemented cost reduction measures, including measures to reduce expenses, cost structure and cash burn, and in March 2005, we completed a workforce cutback, as part of an across-the-board savings plan focused on operational efficiencies. In addition, in July 2005 we entered into a definitive amendment to our facility agreement with our banks. The amendment provided, among other things, for our banks to provide additional financing of up to approximately $30 million, subject to us raising through the issuance of shares or convertible debentures $23.5 million by October 31, 2005 (which was subsequently extended to December 31, 2005) and an additional $6.5 million by March 31, 2006. In January 2006 we completed a rights offering of convertible debentures in which we raised approximately $48.2 million, thereby satisfying the abovementioned obligation to raise additional funds. For a description of the July 2005 amendment and the rights offering of convertible debentures see "Fab 2 Agreements" below.

In May 2006 we signed an amendment to the Facility Agreement with its Banks, according to which repayments of long-terms loans in the amount of approximately $100 million, formerly scheduled to be paid between October 2006 and June 2007, were deferred to July 2007.

In March 2006, our Board of Directors approved the plan to ramp up Fab 2 in order to meet our customer and product qualification needs, based on its customer pipeline, reinforced by forecasted market conditions. According to this plan, we will need to raise approximately $130 million during 2006 (of which approximately $31 million was raised with the completion of the TASE offering in June 2006 and additional $100 million is expected to be raised from Israel Corp as described under "Item 4 - Information on the Company - A. History and Development of the Company - Recent Developments), which will increase the current Fab 2 capacity to approximately 24,000 wafers per month.

As part of the financing efforts for that expansion plan, in May 2006, we signed a Memorandum of Understanding (MOU) with our banks for the refinancing of the $526.7 million in long term debt, which is described above under "Item 4 - Information on the Company - A. History and Development of the Company - Recent Developments.

In June 2006 we successfully completed an underwritten public offering of our securities on the TASE in Israel resulting in gross proceeds of approximately NIS 140 million (approximately $31 million). See "Item 4 - Information on the Company - A. History and Development of the Company - Recent Developments".

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We currently expect to have sufficient liquidity at least until the end of 2006 to meet our short-term activities and liabilities. However, if we fail to close in a timely manner the $100 million investment by Israel Corp. and a definitive amendment to our facility agreement with our banks based on the May 2006 MOU, we may be required to suspend the implementation of our current plan to ramp-up Fab 2 production capacity to approximately 24,000 wafers per month (See "Item 4 - Information on the Company - A. History and Development of the Company - Recent Developments"), which would materially adversely affect our company and may cause us to cease our operations.

In order to fully ramp-up the capacity of Fab 2 to approximately 40,000 wafers per month, we currently estimate that we will require the raising of up

to an approximately $150 million, in addition to funds already raised and the $100 million committed by Israel Corp.

The following chart illustrates the various financial sources available to us to fund the construction and ramp-up of Fab 2, the amounts received as of March 31, 2006 and the amounts expected or required to be received from various sources as of March 31, 2006. We cannot assure you that we will be able to obtain funds from these sources as expected due to poor conditions in capital markets, poor conditions in the semiconductor market, failure to benefit from upswings in the semiconductor market or other factors, any or all of which may affect our ability to raise funds. If we do not satisfy our need for funds for Fab 2 or if the timing of the receipt of financing lags behind the timing of expenses, we may from time to time experience lack of liquidity for our activities.

Financial Sources based on agreements and arrangements completed through March 31, 2006	RECEIVED AS OF MARCH 31, 2006	AMOUNTS EXPECTED OR REQUIRED TO BE RECEIVED AFTER MARCH 31, 2006	TOTAL (3
		(IN MILLIONS)	
Major shareholders	$323.7	$100	$423.7
Investment Center	$159 (1)	$ 91	$250
Credit facility	$526.7(2)	-	$526.7
Other financing sources	$243.4	-	$243.4

(1) Under the requirements of Israeli Law, we were required to complete our approved investment program for Fab 2 by the end of 2005 (see "-- Investment Center Grants" below). Our not completing such investment program by the end of 2005 may result in the Investment Center requiring us to repay all or a portion of the grants already received. See "Risk Factors -- If the Investment Center of the Israeli Ministry of Industry, Trade and Labor, or Investment Center, will not approve our request for a new expansion program, we would be required to seek alternative financing sources to complete the ramp-up of Fab 2, which may not be available. Our not completing investments in the amount of $1.25 billion by the end of 2005 may result in the Investment Center requiring us to repay all or a portion of the grants already received, and if we are unable to refund such grants, we may have to close our operations".

(2) Under the amended credit facility agreement, we are required to comply with minimum production capacity milestones and maintain certain financial ratios and additional conditions and covenants. For a description of these ratios and covenants, see below "Fab 2 Agreements-Credit Facility".

(3) We will be required to make capital investments and acquire and implement advanced technologies in order to complete the ramp-up Fab 2. We will also require additional cash to complete the full ramp-up of Fab 2.

FAB 2 AGREEMENTS

WAFER PARTNER AGREEMENTS. During 2000, we entered into a series of agreements with four wafer partners: SanDisk Corporation, Alliance Semiconductor, Macronix International and QuickLogic Corporation. The wafer partners agreed to invest $250 million in us; SanDisk, Alliance and Macronix

each committed to invest $75 million, and QuickLogic committed to invest $25 million in exchange for our ordinary shares and credits towards the purchase of wafers from Fab 2 under the terms set forth in the agreements. We also agreed to reserve approximately 50% of Fab 2's capacity for our wafer partners for a 10-year period ending in January 2011, including during the ramp-up of Fab 2. In addition, these agreements generally provide for a five percent discount on wafer purchases made by the wafer partners of up to 80% of the maximum Fab 2 wafer fabrication capacity committed to the wafer partners, subject to minimum holdings of our ordinary shares. These agreements (and the agreements with our financial investors) were amended in April 2002, May 2003, and November 2003.

As of June 30, 2006, we have received an aggregate of approximately $245 million from our wafer partners, of which approximately $202 million was invested in consideration for approximately 31.4 million of our ordinary shares, approximately $8 million was invested in our 2005 rights offering (described below), and the remaining approximately $35 million was established as wafer credits.. Our wafer partners are not obligated to invest any more money in us. See Note 11A(3) to our audited annual consolidated financial statements.

INVESTMENT BY ISRAEL CORPORATION AND OTHER FINANCIAL INVESTORS. In December 2000, Israel Corp., our current principal shareholder and one of Israel's major holding companies, agreed to invest $50 million contemporaneous with the investments by the wafer partners. In consideration of Israel Corp.'s investment, we issued its wholly-owned subsidiary, Israel Corporation Technologies (ICTech) Ltd., or ICTech, a total of 6,749,669 of our ordinary shares through January 2004. In 2005, ICTech transferred these shares to Israel Corp. TIC invested, in the aggregate, an additional approximately $29million in connection with our 2002 and 2005 rights offerings (described below).

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In February 2001, the Challenge Fund-Etgar II agreed to invest $5 million in our company on substantially the same terms as Israel Corp. In consideration of Challenge's investment, we issued Challenge a total of 670,166 of our ordinary shares through January 2004.

See Note 11A(4) to our audited annual consolidated financial statements.

WAFER CREDITS. In connection with their investments in Fab 2, we issued to our wafer partners non-transferable credits that may be used to reduce the cash amounts to be paid by them when paying for wafers manufactured in Fab 2. These credits could generally be used at a rate of 7.5% for purchases made through June 2005 and 15% for purchases made thereafter. Our major wafer partners, SanDisk, Alliance and Macronix, have agreed that they will not utilize any of their credits, which amounted to approximately $36 million as of December 31, 2005, for purchase orders of our wafer products until December 31, 2006. From January 1, 2004 to December 31, 2006, each major wafer partner is entitled, every quarter, to convert into our ordinary shares its wafer credits that could have been utilized by such wafer partner against the actual payment of wafers manufactured at Fab 2 during such quarter; otherwise, these credits will bear interest payable every quarter at three-month LIBOR plus 2.5% through December 31, 2007. On December 31, 2007, the remaining wafer credits that could have been utilized during this period that have not been converted into shares will be repaid to all our major wafer partners. Should the wafer partners elect to convert their wafer credits into our ordinary shares, they will be issued ordinary shares at the average trading price of our ordinary shares during the 15 consecutive trading days preceding the last day of the relevant quarter. For example, if our major wafer partners purchase an amount of wafers which would

otherwise result in their using the full amount of credits available to them as of March 31, 2006, and they elect to convert all of these credits into ordinary shares, we will issue them an aggregate of 22.4 million shares, assuming the average trading price of our ordinary shares during the 15 consecutive trading days preceding the last relevant quarter is $1.38.

In February 2006, one of our wafer partners converted approximately $3.9 million of its advances into paid-in equity entitling it for 2,455,905 of our ordinary shares. The number of shares was determined based on $1.58 per share, which was the average closing sale price of our ordinary shares for the 15 trading days prior to December 31, 2005.

All the ordinary shares issued to our wafer partners and Israel Corp. in connection with their committed investments are subject to (i) restrictions on transfer and (ii) registration rights.

See Note 11A(5) to our audited annual consolidated financial statements.

JOINT DEVELOPMENT AGREEMENT. In May 2002, we entered into an agreement for the joint development of 0.18-micron embedded microFLASH technology with a Japanese manufacturer. The Japanese manufacturer granted to us the non-exclusive right to utilize, on a royalty-free basis, our jointly developed technology, which is based on its 0.18-micron process technology, for foundry services and for the manufacture and sale of our own proprietary products. We granted the Japanese manufacturer a royalty-free, non-exclusive license with respect to our microFLASH technology for manufacturing semiconductor devices that utilize our jointly developed technology for its own semiconductor business.

In April 2005, the Japanese manufacturer elected, and we agreed, to cease the joint development of certain technology and to terminate the agreement. According to the terms of the termination agreement, the Japanese manufacturer paid us, net of deducted tax, $2.25 million. Revenues for 2005 include $8 million generated by the termination of the agreement. In addition, each party expressly released the other party from any obligations or liabilities of any nature in connection with the joint development agreement. The license rights granted to the parties continue pursuant to the terms of the original agreement.

CREDIT FACILITY. In January 2001, we entered into a credit facility with two leading Israeli banks, Bank Hapoalim and Bank Leumi, pursuant to which the banks committed to make available to us up to $550 million in loans for Fab 2. As a result of our reduction of the total project cost of Fab 2 through the renegotiation of equipment prices and a change of equipment suppliers, in January 2002, we and our banks agreed to amend the credit facility such that the total amount of loans committed by the banks was reduced to $500 million. In July 2005, we entered into a definitive amendment to our facility agreement with our banks. The amendment provided, among other things, for our banks to provide additional financing of up to approximately $30 million, subject to us raising through the issuance of shares or convertible debentures $23.5 million by October 31, 2005 (which was subsequently extended to December 31, 2005) and an additional $6.5 million by March 31, 2006. The banks provided us with the entire amount we were entitled to borrow under the amendment following the consummation of the rights offering in January 2006 in which we raised approximately $48.2 million (described below).

Loans drawn down through December 2004 were repayable as of December 31, 2005, prior to the May 2006 amendment to the facility agreement (described

below), as follows: (i) with respect to loans received by us through December 31, 2003, we repaid our banks on December 31, 2003 all payments due by such date, amounting to $431 million and, concurrently, drew down an equivalent amount from our banks on such date to be repaid in 12 quarterly installments commencing on March 31, 2007 and bearing interest, payable quarterly, at LIBOR plus 2.5%, and (ii) with respect to loans received in 2004 (amounting to $66.0 million), we will repay our banks, in 12 quarterly installments, or before the maturity date of the facility, commencing three years from the drawdown date of each loan and bearing interest, payable quarterly, at LIBOR plus 2.5%. Loans drawn down under the July 2005 amendment (amounting to $29.7 million as of January 31, 2006) were repayable as of December 31, 2005, prior to the May 2006 amendment to the facility agreement, twelve to fifteen months from the drawdown date of each loan and bear interest, payable quarterly, at LIBOR plus 2.5%.

In May 2006, we signed amendments to the facility agreement with our banks, according to which: (i) repayments of long-terms loans in the amount of approximately $100 million scheduled to be paid between October 2006 and June 2007, were deferred to July 2007; and (ii) the date on which we were required to raise approximately $8 million was deferred from June 30, 2006 to September 30, 2006, which amount was raised with the completion of the recent TASE offering described below.

As of June 30, 2006, we have drawn, in the aggregate, $526.7 million in loans. We paid the banks an annual commitment fee of 0.25% on any unused portion of the facility.

Under the terms of the amended facility agreement, (i) Fab 2 must have full manufacturing capacity of 33,000 wafer starts per month by December 31, 2007; (ii) there are limitations on changes of ownership which generally required that, through January 2006, (a) our three largest wafer partners not sell the shares they purchased in connection with each of their $75 million investments in our shares other than a portion of their holdings which may be sold prior to this date and (b) Israel Corp. hold during this period at least the higher of (i) eight million of our ordinary shares or (ii) 16.5% of our issued share capital less two million ordinary shares, with portions of the shares held by our wafer partners being released from these restrictions through January 2008 and January 2009 with respect to Israel Corp.; and (iii) additional conditions and covenants, including restrictions on debt and a prohibition on the distribution of dividends prior to 2008.

Under the terms of the amended facility agreement, we must also meet certain financial ratios. For any quarter, the "life of loan coverage ratio" (which is the ratio of our Fab 2 net cash flow to our total debt related to Fab 2 in any quarter) is not permitted to be less than 1.3 at any time. In addition, our ratio of equity to assets is not permitted to be less than 0% until the end of 2006, 20% during 2007 and 30% thereafter, until the termination of the facility agreement. The facility agreement also provides that we must comply with additional financial covenants relating to quarterly sales and quarterly earnings before interest, taxes, depreciation and amortization (quarterly EBITDA). We anticipate that we will not be in compliance with all of the financial ratios and covenants under the facility agreement commencing in the fourth quarter of 2006. Under the terms of the amended facility agreement, satisfying these financial ratios and covenants is a material provision.

Our amended credit facility further provides that upon certain triggering events (such as the commencement of bankruptcy or receivership, proceedings

against us ordered by a court of competent jurisdiction or the prior determination of an arbitrator that bankruptcy or receivership proceedings would be issued by a court against us were a petition to be filed with a court seeking reorganization or arrangement under applicable bankruptcy law or our requesting creditor protection), our banks will be able to bring a firm offer made by a potential investor to purchase our shares at the price provided in the offer. In such case, we shall be required thereafter to procure a rights offering to invest up to 60% of the amount of this offer on the same terms. If the offeror intends to purchase a majority of our outstanding share capital, the rights offering will be limited to allow for this, unless Israel Corp. and the wafer partners (excluding QuickLogic) 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.

If, as a result of any default, our banks were to accelerate our obligations, we would be obligated to immediately repay all loans made by the banks, plus penalties, and the banks would be entitled to exercise the remedies available to them under the credit facility, including enforcement of their lien against all our assets. An event of default under the credit facility and the subsequent enforcement by the banks of their remedies under the credit facility may result in the cancellation of all or a portion of our Fab 2 Investment Center grants and tax benefits and in the Investment Center requiring us to repay all or a portion of grants already received (approximately $161 million as of May 31, 2006).

In January 2001, we also issued the banks warrants to purchase an aggregate of 400,000 ordinary shares at a purchase price of $6.20 per share, which expired in January 2006. In December 2003, pursuant to the November 11, 2003 amendment to the credit facility, we issued our banks additional five year warrants to purchase an aggregate of 896,596 ordinary shares at a purchase price of $6.17 per share, exercisable until December 2008. Moreover, in connection with the July 2005 amendment to the credit facility, we issued our banks five year warrants to purchase an aggregate of 8,264,464 ordinary shares at a purchase price of $1.21 per share, one-half of which or 4,132,232 are exercisable until August 2010 and one half shall only be exercisable when a definitive amendment to our facility agreement based on the May 2006 MOU with our banks closes.

We have registered liens in favor of our banks on substantially all of our present and future assets. The agreements with our banks restrict our ability to place liens on our assets (other than to the State of Israel in respect of investment grants and to Siliconix in respect of assets purchased under our agreement with it) without the prior consent of the banks.

In May 2006, we signed an MOU with our banks for the refinancing of the $526.7 million in long term debt, which is described above under "Item 4 - Information on the Company - A. History and Development of the Company - Recent Developments.

For more information on our credit facility, see Note 11A(6) to our audited annual consolidated financial statements.

INVESTMENT CENTER GRANTS. In December 2000, the Israeli government's Investment Center approved an investment program in connection with Fab 2. The approval certificate provides for government grants equal to 20% of qualified investments up to $1.25 billion (i.e., up to $250 million), subject to customary conditions and other conditions, including a requirement that approximately 30%

of our Fab 2 funding consist of paid-in-capital and that $550 million of our Fab 2 funding be obtained by way of a credit facility from commercial banks (which amount was subsequently reduced to $500 million with the consent of the Investment Center). We have registered a lien on our assets for the benefit of the Investment Center which ranks subordinate to that of our banks. The approval certificate also provides for a tax holiday on all taxable income related to Fab 2 for the first two years of undistributed profitable operations. As of May 31, 2006, we had received $161 million in grants from the Investment Center, and satisfied in full the 30% requirement described above. As long as we comply with the terms of our approval certificate, we are not required to make royalty payments or any other payments under the terms of our Investment Center grants.

To be eligible to receive grants, we are required to invest minimum amounts on an annual basis. We notified the Investment Center of our reduced rate of annual investments and in July 2004, we received approval of our revised investment schedule from the Investment Center. In addition, we were required, but were unable to complete our Fab 2 investments by the end of 2005. Israeli law limits the ability of the Investment Center to extend this time limitation, unless approved through an expansion plan. We have been holding discussions with the Investment Center to achieve satisfactory arrangements to approve our request for a new expansion program to commence as of January 1, 2006. In 2005, at the Investment Center's request, we submitted a revised business plan to the Investment Center for the period commencing on January 1, 2006. There can be no assurance that we will obtain the Investment Center's approval for the new expansion program and we cannot estimate the outcome of our efforts to obtain such approval. See "Risk Factors -- If the Investment Center of the Israeli Ministry of Industry, Trade and Labor, or Investment Center, will not approve our request for a new expansion program, we would be required to seek alternative financing sources to complete the ramp-up of Fab 2, which may not be available. Our not completing investments in the amount of $1.25 billion by the end of 2005 may result in the Investment Center requiring us to repay all or a portion of the grants already received, and if we are unable to refund such grants, we may have to close our operations".

Since the inception of our financing activity for Fab 2, we have completed the following public offerings:

SALE OF UNITS 2002. In January 2002, we completed a sale of units in Israel, composed of NIS 110,579,800 principal amount of convertible unsecured subordinated debentures and 2,211,596 options, resulting in net proceeds of approximately $21.5 million. Each debenture is NIS 1 in principal amount, and is adjusted to reflect increases in the Israeli Consumer Price Index and bears interest at a rate of 4.7% per annum, payable yearly commencing January 20, 2003. Principal is payable in four installments beginning in January of 2006 through 2009. Prior to December 31, 2008, the debentures are convertible into ordinary shares at a conversion rate of one ordinary share per NIS 41 principal amount of debentures linked to the Israel Consumer Price Index. Each option was exercisable into one ordinary share until January 20, 2006 at an exercise price of NIS 39, linked to the Israel Consumer Price Index. To date, all options expired and none were exercised.

RIGHTS OFFERING 2002. In September 2002, we distributed to our shareholders and certain of our employees in Israel and the United States rights to purchase ordinary shares and warrants to purchase our ordinary shares. Substantially all of the rights exercised in connection with the rights offering were exercised by Israel Corp. and our major wafer partners. The rights offering resulted in net

proceeds of approximately $19.7 million.

UNDERWRITTEN PUBLIC OFFERING. In January 2004, we completed an underwritten public offering in the United States of 11.44 million of our ordinary shares at a price to the public of $7.00 per share. The underwritten public offering resulted in net proceeds of approximately $75.1 million.

RIGHTS OFFERING 2005. In December 2005, we filed in Israel and the United States a prospectus for the distribution of transferable rights to purchase up to $50 million U.S. dollar denominated debentures that are convertible into up to approximately 45.5 million of our ordinary shares. In connection with the exercise of these rights, through January 2006, we issued, in the aggregate, 48.2 million convertible debentures, with each debenture of $1.00 in principal amount, or a total of $48.2 million principal amount of debentures, which bear annual interest at the rate of 5%. The principal of the debentures, together with accrued interest, is payable in one installment on January 12, 2012. The debentures are convertible into our ordinary shares at a rate of one ordinary share per $1.10 aggregate principal amount of debentures. The conversion price is subject to downward adjustment under certain circumstances in which we sell securities in future financings at a price per share which is lower than the conversion price, provided that such financings close through December 2006 (or under certain conditions, through June 2007). Subject to the terms of our facility agreement, we may at our option announce the early redemption of the debentures, provided that the outstanding aggregate balance of principal on account of the debentures is equal to or less than $500,000. The debentures and interest thereon are unsecured and rank behind our existing and future secured indebtedness, including indebtedness to our banks, as well as to the government of Israel in connection with grants we received under its approved enterprise programs and to Siliconix. For more information, see Note 13H to our audited annual consolidated financial statements.

SALE OF UNITS 2006. In June 2006, we completed an underwritten public offering of our securities on the TASE in Israel resulting in gross proceeds of approximately NIS 140 million (approximately $31 million). In the offering, 78,000 Units were sold at a price per Unit of NIS 1,785 (approximately $400). Each Unit consists of (i) convertible debentures in the face amount of NIS 2,100 (approximately $470), (ii) five options each exercisable for three months for NIS 100 principal amount of convertible debentures at an exercise price equal to 85% of their face amount, (iii) 140 warrants each exercisable for three months for one Tower ordinary share at a price of NIS 6.75 (approximately $1.51) and (iv) 70 warrants each exercisable for three years for one Tower ordinary share at a price of NIS 7.40 (approximately $1.66). The convertible debentures are convertible into Tower's ordinary shares at a conversion rate of one ordinary share per NIS 8.40 (approximately $1.89) principal amount of convertible debentures. The convertible debentures carry a zero coupon with principal payable at maturity in December 2011, at a premium of 37% over face value, linked to the Israeli Consumer Price Index (CPI). The conversion price is subject to reduction in certain limited circumstances. The offering was made in Israel to Israeli residents only. The securities offered were not registered under the Securities Act and may not be sold in the U.S. or to U.S. persons absent registration or an applicable exemption.

C. RESEARCH AND DEVELOPMENT, PATENTS AND LICENSES

Our research and development activities have related primarily to our process development and microFLASH module design efforts, and have been

sponsored and funded by us with some participation by the Israeli government. Research and development expenses for the years ended December 31, 2005, 2004 and 2003 were $16.0 million, $17.1 million and $20.7 million net of government participation of $1.0 million, $1.5 million and $1.1 million, respectively. We have also incurred costs in connection with the transfer of Toshiba and Freescale technology for use in Fab 2, some of which have been amortized over the estimated economic life of the technology following the commencement of production in Fab 2 during the third quarter of 2003 (see also in this Item "Critical Accounting Policies - Depreciation and Amortization of Fab 2 Assets"). For a description of our research & development policies and our patents and licenses, see "Item 4. Information on the Company--4.B. Business Overview".

D. TREND INFORMATION

The semiconductor industry has historically been highly cyclical on a seasonal and long-term basis. On a long-term basis, the market has fluctuated, cycling through periods of weak demand, production overcapacity, excess inventory and lower sales prices and periods of strong demand, full capacity utilization, product shortages and higher sales prices.

There is a trend within the semiconductor industry toward ever-smaller features and ever-growing wafer sizes. State-of-the-art fabs are currently using process geometries of 90-nanometer and below and wafer sizes of 300-mm. As demand for smaller geometries increases, there is downward pressure on the pricing of larger geometry products and increasing underutilization of fabs that are limited to manufacturing larger geometry products, which results in less profitability for manufacturers of larger geometry products. Fab 1 is limited to geometries of 0.35-micron and above on 150-mm wafers and Fab 2 currently offers process geometries of 0.18 and 0.13-micron and produces 200-mm wafers.

E. OFF-BALANCE SHEET ARRANGEMENTS

We are not a party to any material off-balance sheet arrangements. In addition, we have no unconsolidated special purpose financing or partnership entities that are likely to create material contingent obligations.

F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table summarizes our contractual obligations and commercial commitments as of December 31, 2005:

	PAYMENT DUE					
CONTRACTUAL OBLIGATIONS	TOTAL	LESS THAN 1 YEAR	2 YEARS	3 YEARS	4 YEARS	5 Y
			(IN THOUSANDS)			
Short-term debt and other current liabilities (1)	$ 65,533	$ 65,533	-	-	-	
Long-term debt (2)	615,307	57,711	183,272	185,744	174,115	1
Convertible Debentures (3)	63,287	7,740	7,434	7,128	6,822	

Operating leases (4)	4,822	2,293	1,817	712	0	
Construction and equipment purchase agreements	15,018	10,218	4,800	0	0	
Siliconix advance	19,615	1,593	2,585	2,168	2,123	
Other long-term liabilities	14,418	1,414	7,516	561	140	
purchase obligations (5)	31,695	3,239	2,688	2,688	2,688	
TOTAL CONTRACTUAL OBLIGATIONS	829,695	149,741	210,112	199,001	185,888	1

(1) Short-term debt and other current liabilities include our trade accounts payable for equipment and services that have already been supplied.

(2) Long-term debt includes principal and interest payments in accordance with the terms of the credit facility, amended in November 2003, as well as the impact of our hedging transactions.

(3) Total amounts include expected principal and interest payments for the presented periods.

(4) These amounts primarily consist of ordered equipment that has not yet been received. In addition to these contractual obligations, we have committed approximately $1.1 million in standby letters of credit and guarantees to secure our Fab 2 construction and equipment obligations.

The above table does not include other contractual obligations or commitments we have, such as undertakings pursuant to royalty agreements, commissions and service agreements. We are unable to reasonably estimate the total amounts or the time table for such payments to be paid under the terms of these agreements, as the royalties, commissions and required services are a function of future sales revenues, the volume of business and hourly-based fees. In addition, the above table does not include our long-term liability with respect to our wafer partner advances, which as of December 31, 2005, amounted to approximately 41.0 million that may be utilized by them against future purchases of Fab 2 products. We are unable to reasonably estimate the total amounts that may be utilized by our wafer partners since we can not reasonably estimate their future orders in the periods set forth in the above chart; and even if we could reasonably estimate our wafer partners' future orders, we are unable to determine which portion of the advances they are entitled to utilize against purchases will be chosen by them to be converted into our fully paid ordinary shares, as provided under the amendments to our agreements with our wafer partners (see "Fab 2 Agreements").

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

A. DIRECTORS AND SENIOR MANAGEMENT

Set forth below is information regarding the members of our administrative, supervisory or management bodies and our directors.

	AGE	TITLE
Russell C. Ellwanger	51	Chief Executive Officer
Oren Shirazi	36	Acting Chief Financial Officer
Dudu Vidan	45	Vice President and Fab 1 Manager
Dr. Itzhak Edrei	46	Senior Vice President of Product Lines and Sales
Rafi Nave	56	Chief Technology Officer
Ephie Koltin	44	Vice President of Business Development
Dalit Dahan	38	Vice President of Human Resources
Shimon Dahan	43	Vice President of Manufacturing Services
Nati Somekh Gilboa	31	Corporate Secretary and General Counsel
Rafi Mor	42	Vice President and Fab 2 Manager
DIRECTORS		
Udi Hillman	53	Chairman of the Board
Russell C. Ellwanger	51	Director
Yossi Rosen	66	Director
Dr. Eli Harari	61	Director
Miin Wu	57	Director
N. Damodar Reddy	67	Director
Kalman Kaufman	61	Independent Director
Hans Rohrer	56	Independent and External Director
Tal Yaron-Eldar	42	Independent and External Director

RUSSELL C. ELLWANGER has served as our Chief Executive Officer since May 2005. From 1998 to 2005, Mr. Ellwanger served in various executive positions for Applied Materials Corporation, including Group Vice President, General Manager of the Applied Global Services (AGS), from 2004 to 2005, Group Vice President, General Manager of the CMP and Electroplating Business Group, from 2002 to 2004. Mr. Ellwanger also served as Corporate Vice President, General Manager of the Metrology and Inspection Business Group, from 2000 to 2002, during which he was based in Israel. From 1998 to 2000, Mr. Ellwanger served as Vice President of

Applied Materials' 300-mm Program Office, USA. Mr. Ellwanger served as General Manager of Applied Materials' Metal CVD Division from 1997 to 1998 and from 1996 to 1997, Mr. Ellwanger served as Managing Director of CVD Business Development, during which he was based in Singapore. In addition, Mr. Ellwanger held various managerial positions in Novellus System from 1992 to 1996 and in Philips Semiconductors from 1980 to 1992.

OREN SHIRAZI was appointed as our acting Chief Financial Officer in November 2004. Mr. Shirazi joined us in October 1998 and served as our controller since July 2000, after serving as vice controller since October 1998. Prior to joining us, Mr. Shirazi was employed as an Audit Manager in the accounting firm of Ratzkovski-Fried & Co., which merged into Ernst & Young (Israel). Mr. Shirazi is a Certified Public Accountant in Israel (CPA). He has an MBA from the Graduate School of Business of Haifa University with honors and a BA in economics and accounting from the Haifa University.

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DUDU VIDAN was appointed Vice President and Fab 1 Manager in August 2005, having served previously as FAB2 production manager since March 2003 and as FAB2 tool installation manager from March 2001. Previously, Mr. Vidan was employed by MDF, serving as plant manager, and Carcom Aviation Products serving as production manager. Mr Vidan served as a Naval Reserve Lt. Colonel in the Israel Defense Forces. Mr. Vidan holds a B.Sc. in Industrial and Management Engineering from the Technion - Israel Institute of Technology.

DR. Itzhak Edrei was appointed Senior Vice President of Product Lines and Sales in August 2005 after serving as Vice President of Research and Development since August 2001, having served as Director of Research and Development since 1996. From 1994 to 1996, Dr. Edrei served as our Device and Yield Department Manager. Prior to joining Tower, Dr. Edrei was employed by National Semiconductor as Device Section Head. Dr. Edrei earned his Ph.D. in physics from Bar Ilan University and his post-doctorate from Rutgers University.

RAFI NAVE was appointed Chief Technology Officer in August 2005 after serving as Vice President of Customer Services since August 2003. From 1996 to 2003, Mr. Nave served as Vice President of Research and Development for NDS Group. From 1974 to 1995, Mr. Nave was employed by Intel Corporation in a variety of positions of increasing responsibility, among them chip design engineer and General Manager of Intel's design center in Israel. Mr. Nave earned master and bachelor degrees in electrical engineering from the Technion - Israel Institute of Technology.

EPHIE KOLTIN was appointed Vice President of Business Development in August 2005, having served as Vice President, General Foundry and Mixed Signal Technology from 2003 and as Senior Director, FAB2 Process Engineering since 2000. From 1996-1999, Mr. Koltin served in several senior positions as Director, NVM Technology, CIS technology and ERS manager, FAB1. Prior to joining Tower, Mr. Koltin was employed at National Semiconductor and the Technion - Israel Institute of Technology. Mr. Koltin holds a B.Sc. in Mechanical Engineering and M.Sc. in Materials Engineering from the Technion - Israel Institute of Technology.

DALIT DAHAN was appointed Vice President of Human Resources in April 2004. Ms. Dahan joined us in November 1993 and served as Personnel Manager since April 2000, after having served as Compensation & Benefits Manager and in various other positions in the Human Resources Department. Prior to joining us, Ms. Dahan served as Manager of the North Branch of O.R.S - Manpower Company for 3

years. Ms. Dahan holds a bachelor's degree in social science from Haifa University and an MBA from the University of Derby.

SHIMON DAHAN was appointed Vice President of Manufacturing Services in January 2006, having served previously as Test & MTG manager since August 2005 and prior to that as Research and Development Operation Manager from November 2000. Prior to that, Mr. Dahan was employed by National Semiconductor in various capacities. Mr. Dahan holds a bachelors degree in Political Science from Haifa University, and an MBA from the University of Derby.

NATI SOMEKH GILBOA was appointed as Corporate Secretary and General Counsel in March 2005, has served as our Associate General Counsel since May 2004. From 2001 to 2004, Ms. Somekh Gilboa was employed by Goldsobel & Kirshen, Adv. Ms. Somekh Gilboa holds an LL.M. and J.D. from Boston University and a B.A. from Johns Hopkins University. She is a member of the Israeli Bar Association and the New York bar.

RAFI MOR was appointed Vice President and Fab 2 Manager in August 2005, having served as Fab 1 Manager since August 2003 and Senior Director and Fab 1 Manager since March 2003. From November 2000 to March 2003, Mr. Mor served as Senior Director of Process Device & Yield of Fab 1. From 1998 to 2000, Mr. Mor served as Director of Equipment Reliability & Support of Fab 1. Previously, Mr. Mor was employed by National Semiconductor in various engineering and management capacities. Mr. Mor earned master and bachelor degrees in chemical engineering from Ben Gurion University.

UDI HILLMAN has served as Chairman of the Board since May 2005. Mr. Hillman served as Acting Chief Executive Officer from February 2005 to April 2005. Mr. Hillman has served as a director from October 1996 through August 1999 and was reappointed to the Board in January 2000. In January 2001, Mr. Hillman was appointed Vice Chairman of the Board and resigned as Vice Chairman in March 2005. Mr. Hillman serves on the Tender Committee. Since March 2001, Mr. Hillman has served as President and Chief Executive Officer of ICTech, a subsidiary of Israel Corp., which is one of our current principal shareholders. Since February 2004, Mr. Hillman has served as a member of the Board of Directors of ZIM Integrated Shipping Services. Mr. Hillman served as Chief Financial Officer of Israel Corp. from September 1996 to 1997 and as Executive Vice President and Chief Financial Officer of Israel Corp. from May 1997 to 2001. Mr. Hillman served as a director of several subsidiaries of Israel Corp., including Israel Chemicals Ltd., ZIM Integrated Shipping Services and others. Prior thereto, Mr. Hillman was Vice President and Controller of Clal Industries Ltd. and a director of several companies in the Clal Group.

YOSSI ROSEN has served as a director and Chairman of the Stock Option and Compensation Committee since February 2005. Since November 30, 1998, Mr. Rosen has served as the President and CEO of The Israel Corporation. Mr. Rosen is also Chairman of the Board of Directors of Israel Chemicals Ltd. and a director of its subsidiaries, a member of the Board of Directors and Executive Committee of ZIM Integrated Shipping Services, Chairman of the Board of Dead Sea Magnesium Ltd. and a director of Oil Refineries Ltd. Mr. Rosen was previously President of Mashav Initiating & Development Ltd. and Chairman of the Board of various industrial companies, such as Nesher cement. Mr. Rosen holds a BA in Economics from the Hebrew University of Jerusalem and an MA in Business Management from the Hebrew University of Jerusalem.

DR. ELI HARARI has served as a director since January 2001. Dr. Harari

serves on the Stock Option and Compensation Committee. Dr. Harari served as President and Chief Executive Officer and as a Director of SanDisk Corporation from its inception in 1988 until May 2006, and currently serves as Chief Executive Officer and Chairman of the Board of SanDisk. Dr. Harari is a pioneer in non-volatile semiconductor storage with more than 100 U.S. and foreign patents and numerous technical articles and has more than 30 years of experience in the electronics industry. His extensive operational and technological development experiences include co-founding Waferscale Integration, overseeing the development and transfer into production of Intel Corporation's first-generation stepper and dry etch technology, and technical management positions at Hughes Aircraft and Honeywell, Inc. He holds an M.A. and Ph.D. in Solid State Sciences from Princeton University and a B.S. (Honors) degree in Physics from Manchester University.

MIIN WU has served as a director since January 2001. Mr. Wu serves as President, Chief Executive Officer and an Executive Director of Macronix International and has been an executive officer of Macronix since its formation in 1989. Mr. Wu received both a B.S. and an M.S. in Electrical Engineering from National Cheng-Kung University in Taiwan as well as an M.S. in Material Science & Engineering from Stanford University.

N. DAMODAR REDDY has served as a director since January 2001. Mr. Reddy serves on the Audit Committee. Mr. Reddy is the co-founder of Alliance Semiconductor Corporation and has served as its Chairman of the Board since its inception in February 1985. Mr. Reddy also served as President and Chief Executive Officer since its inception and until December 2005. In addition, Mr. Reddy served as Chief Financial Officer of Alliance Semiconductor from June 1998 to January 1999 and from May 2001 until April 2002. From September 1983 to February 1985, Mr. Reddy served as President and Chief Executive Officer of Modular Semiconductor, Inc., and from 1980 to 1983, he served as manager of Advanced CMOS Technology Development at Synertek, Inc., a subsidiary of Honeywell, Inc. Prior to that time, Mr. Reddy held various research and development and management positions at Four Phase Systems, a subsidiary of Motorola, Inc., Fairchild Semiconductor and RCA Technology Center. He holds an MS degree in Electrical Engineering from North Dakota State University and an MBA from Santa Clara University.

KALMAN KAUFMAN has served as a director and as a member of our Audit Committee since August 2005. Mr. Kaufman also served as Corporate Vice President at Applied Materials from 1994 to 2005. Between 1985 and 1994, Mr. Kaufman served as President of KLA Instruments Israel, a company he founded, and General Manager of Kulicke and Soffa Israel. Mr. Kaufman is currently the Chairman of Solgel Nanotechnology and is a member of several boards of directors. He holds engineering degrees from the Technion - Israel Institute of Technology.

HANS ROHRER has been a director and member of the Audit Committee since April 2002. Since May 2002, Mr. Rohrer serves as President and Chief Executive Officer of Acuid Corporation. From 1999 to 2002, Mr. Rohrer served as President of Taiwan Semiconductor Manufacturing Company -- Europe (TSMC - Europe). Mr. Rohrer has held various engineering, marketing, sales and general management positions, including Vice President and General Manager, Europe, with National Semiconductor between 1980 and 1998. Mr. Rohrer started his career in the semiconductor industry with Texas Instruments.

TAL YARON-ELDAR has been a director and member of the Audit Committee and the Stock Option and Compensation Committee since January 2005. Since September

2004, Ms. Yaron-Eldar serves as Chief Executive Officer of Arazim Investment Ltd. and she is a partner in Cohen, Cohen, Yaron-Eldar & Co. law offices. Ms. Yaron-Eldar served as Israel's Income Tax and Real Property Tax Commissioner from 2002 to 2004. Between 1998 and 2001, Ms. Yaron-Eldar served as the Chief Legal Advisor to the Customs and V.A.T. Authority. During the preceding ten years, Ms. Yaron-Eldar served in various positions with Israel's Income Tax and Real Property Tax Commission, including Senior Head of its legislation department and Deputy Chief Legal Advisor. Ms. Yaron-Eldar holds a master's degree in business and a bachelor's degree in law from Tel-Aviv University and is a member of the Israeli Bar Association.

Pursuant to a shareholders agreement dated January 18, 2001, SanDisk, Alliance Semiconductor and Macronix have agreed to vote all their respective shares for nominees designated by each shareholder and for the election of a nominee of Israel Corp. as Chairman of the Board.

B. COMPENSATION

For the years ended December 31, 2005 and 2004, we paid to all our directors and senior management, as a group, an aggregate of $1.2 and $1.2 million, respectively, in salaries, fees and bonuses, excluding management fees paid to Israel Corp. The total amount set aside or accrued in the year ended December 31, 2005 to provide for severance, retirement and similar benefits for such persons was $0.2 million. No directors received cash compensation other than the annual and meeting fees described below.

During 2005, three of our directors were granted options to purchase an aggregate of 120,000 ordinary shares at a weighted average exercise price of $1.67 per share. These options will become exercisable according to various vesting schedules over four years and generally remain exercisable for five years following the vesting date. During the year ended December 31, 2005, we granted a total of 1,420,000 options to purchase ordinary shares to our senior managers as a group. These options have a weighted average exercise price of $1.545 per share with vesting periods over four years and expire in 2015.

In April 2005, our Board of Directors approved the grant of options to purchase up to 1,325,724 of our ordinary shares to our Chief Executive Officer ("CEO"), who was also appointed as a director, which was further approved by our shareholders in October 2005. These options are exercisable at an exercise price of $1.56, which was the closing market price of our 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 addition, in May 2006, our Audit Committee and Board of Directors approved the grant of options to the CEO in addition to the options granted to him in April 2005, such that in total, the CEO will hold options to purchase shares that represent 4% of our 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 additional options will be $1.45, the 90 day average closing price of our shares prior to the Board of Directors' approval. In the event of a future equity financing, additional options will be granted to the CEO as described above with an exercise price equal to the price per share of such investment. The vesting period of the new options will be identical to the vesting period of the existing options. No additional options will be granted under the CEO's employment agreement, which was approved by our shareholders in

October 2005. The new grant of options and its terms are subject to the approval of our shareholders.

Since October 2001, our directors have foregone their directors' fees, except for fees required by law to be paid to our external directors, consisting of a NIS 26,000 (approximately $5,650) annual fee plus NIS 915 (approximately $200) per meeting. The aggregate amount payable to our external directors with respect to the year ended December 31, 2005 was approximately $21,000. The annual and meeting fees paid to our external directors are adjusted semiannually to reflect changes to the published guidelines in Israel for external directors.

C. BOARD PRACTICES

Our Articles of Association provide that the Board of Directors shall consist of at least five and no more than 11 members. All directors, except for external directors, hold office until their successors are elected at the next annual general meeting of shareholders. Our officers are appointed by the Board of Directors and (subject, in certain cases, to employment agreement provisions that require 270 days notice of termination) continue to serve at the discretion of the Board of Directors. The Board of Directors may grant the CEO the power to appoint officers.

Our Articles of Association provide that any director may, by written notice to us, appoint another person to serve as an alternate director, and may cancel such appointment. Any person who is not already a director may act as an alternate, and the same person may not act as the alternate for more than one director at a time. The term of appointment of an alternate director may be for one meeting of the Board of Directors or for a specified period or until notice is given of the cancellation of the appointment.

None of the members of the Board are entitled to receive any severance or similar benefits upon termination of service with the Board of Directors.

The Companies Law requires Israeli companies with shares that have been offered to the public in or outside of Israel to appoint no less than two external directors. No person may be appointed as an external director if the person or the person's relative, partner, employer or any entity under the person's control, has or had, on or within the two years preceding the date of the person's appointment to serve as external director, any affiliation with the company or any entity controlling, controlled by or under common control with the company. The term "affiliation" includes:

- an employment relationship;
- a business or professional relationship maintained on a regular basis;
- control; and
- service as an office holder.

A person shall be qualified to serve as an external director only if he or she possesses accounting and financial expertise or professional qualifications. At least one external director must posses accounting and financial expertise. The conditions and criteria for possessing accounting and financial expertise or professional qualifications were recently determined in regulations promulgated by the Israeli Minister of Justice in consultation with the Israeli Securities

Authority. These regulations do not appear to relate to external directors currently serving. The regulations mandate that a person is deemed to have "expertise in finance and accounting" if his or her education, experience and qualifications provide him or her with expertise and understanding in business matters - accounting and financial statements, in a way that allows him or her to understand, in depth, the company's financial statements and to encourage discussion about the manner in which the financial data is presented.

The company's board of directors must evaluate the proposed external director's expertise in finance and accounting, by considering, among other things, his or her education, experience and knowledge in the following: (i) accounting and auditing issues typical to the field in which the company operates and to companies of a size and complexity similar to such company; (ii) a company's external public accountant's duties and obligations; (iii) preparing company financial statements and their approval in accordance with the Companies Law and the Israeli Securities Law.

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A director is deemed to be "professionally qualified" if he or she meets any of the following criteria: (i) has an academic degree in any of the following professions: economics, business administration, accounting, law or public administration; (ii) has a different academic degree or has completed higher education in a field that is the company's main field of operations, or a field relevant to his or her position; or (iii) has at least five years experience in any of the following, or has a total of five years experience in at least two of the following: (A) a senior position in the business management of a corporation with significant operations, (B) a senior public position or a senior position in public service, or (C) a senior position in the company's main field of operations. The board of directors here too must evaluate the proposed external director's "professional qualification" in accordance with the criteria set forth above.

The affidavit required by law to be signed by a candidate to serve as an external director must include a statement by such candidate concerning his or her education and experience, if relevant, in order that the board of directors may properly evaluate whether such candidate meets the requirements set forth in the regulations. Additionally, the candidate should submit documents and certificates that support the statements set forth in the affidavit.

No person may serve as an external director if the person's position or other business activities create, or may create, a conflict of interest with the person's responsibilities as an external director or may otherwise interfere with the person's ability to serve as an external director. If, at the time external directors are to be appointed, all current members of the board of directors are of the same gender, then at least one external director must be of the other gender.

External directors are to be elected by a majority vote at a shareholders' meeting, provided that either:

- the majority of shares voted at the meeting, including at least one-third of the shares held by non-controlling shareholders voted at the meeting, vote in favor of election of the director; or

- the total number of shares held by non-controlling shareholders voted against the election of the director does not exceed one percent of the aggregate voting rights in the company.

The initial term of an external director is three years and may be extended for an additional three years. External directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the external directors cease to meet the statutory qualifications for their appointment or if they violate their duty of loyalty to the company. Each committee of a company's board of directors must include at least one external director.

Mr. Rohrer and Ms. Yaron-Eldar currently serve as our external directors. Mr. Rohrer was appointed for an initial three-year term that expired in April 2005 and was reappointed for a subsequent three-year term expiring in April 2008. Ms. Yaron-Eldar was appointed for an initial three-year term expiring in December 2007

An external director is entitled to compensation, as provided in regulations adopted under the Israeli Companies Law, and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an external director.

The Companies Law requires public companies to appoint an audit committee. The responsibilities of the audit committee include reviewing the company's financial statements, monitoring the company's independent auditors, identifying irregularities in the management of the company's business and approving related party transactions as required by law. An audit committee must consist of at least three directors, including the external directors of the company. The chairman of the board of directors, any director employed by or otherwise providing services to the company, and a controlling shareholder or any relative of a controlling shareholder, may not be a member of the audit committee. An employee, executive officer or director of a controlling shareholder of an Israeli company may serve as a member of an audit committee under Israeli law, unless such individual controls more than 50% of the controlling shareholder. Each of our external directors are members of our audit committee.

Under the Companies Law, the board of directors must appoint an internal auditor, who is recommended by the audit committee. The role of the internal auditor is to examine, among other matters, whether the company's actions comply with the law and orderly business procedure. Under the Companies Law, the internal auditor may be an employee of the company but not an office holder, an affiliate, or a relative of an office holder or affiliate, and he may not be the company's independent auditor or its representative.

Mr. Rosen, Dr. Harari and Ms. Yaron-Eldar serve on the stock option and compensation committee. The committee meets at least once a year. The primary function of this committee is to approve our employee compensation policy and determine remuneration and other terms of employment for our officers. In setting our remuneration policy, the committee considers a number of factors including:

- the overall employment market environment;
- the basic salaries and benefits available to comparable officers at comparable companies;
- the need to attract and retain officers of an appropriate caliber;

- o the need to ensure such executives' commitment to the future success of our company by means of incentive schemes;
- o the performance of the officer; and
- o financial and operating results of our company.

D. EMPLOYEES

The following table sets forth for the last three fiscal years, the number of our employees engaged in the specified activities.

	As of December 31,		
	2005	2004	2003
Process and Product Engineering, R&D, Design	293	360	405
Manufacturing, Operations (*)	734	780	670
Manufacturing Support	123	124	134
Administration, Marketing, Finance	88	100	117
Fab 2 Construction and Technology Transfer (*)	--	5	45
Total	1,238	1,369	1,371

(*) Following the commencement of operations of Fab 2 during the third quarter of 2003, most of the employees that prior to that date were classified under Fab 2 construction and technology transfer activities are classified under manufacturing operations activities.

Except for an arrangement regarding pension contributions, we have no collective bargaining agreements with any of our employees. However, by administrative order, certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations, relating primarily to the length of the work day, minimum wages, pension contributions, insurance for work-related accidents, procedures for dismissing employees, determination of severance pay and other conditions of employment are applicable to our employees. In accordance with these provisions, the salaries of our employees are partially indexed to the Consumer Price Index in Israel.

We generally provide our employees with benefits and working conditions beyond the minimum requirements. For example, a general practice in Israel, which we follow, despite not being legally obligated to do so, is the contribution of funds to an employee's "Manager's Insurance" fund and/or pension fund. Such funds generally provide a combination of savings plans, insurance and severance pay benefits to the employee, giving the employee a lump sum payment upon retirement and securing his or her right to receive severance pay, if legally entitled, upon termination of employment. To the Manager's Insurance fund, the employee usually contributes an amount equal to 5% of his or her wages and the employer usually contributes an additional 13.3% to 15.8%. To the pension fund the employee usually contributes an amount equal to between 5% and 6% of his or her wages and the employer usually contributes an additional 13.7% to 17.3%. Israeli law generally requires severance pay upon the retirement or death of an employee or termination of employment without due cause.

Furthermore, Israeli employees and employers are required to make payments to the National Insurance Institute. We consider our relationship with our employees to be good, and we have never experienced a labor dispute, strike or work stoppage.

E. SHARE OWNERSHIP

All of the persons listed above under the caption "Directors and Senior Management" own ordinary shares and/or options to purchase ordinary shares. Except as described below, none of such persons own shares and/or options amounting to 1% or more of the outstanding ordinary shares. Information regarding our share option plans and warrants presented in Note 13B to our consolidated financial statements is incorporated herein by reference.

In April 2005, our Board of Directors approved the grants of options to purchase up to 1,325,724 ordinary shares (which represent 1.6% of our outstanding share capital as of June 30, 2006) to our Chief Executive Officer, who was also appointed as a director. These options are exercisable at an exercise price of $1.56, the opening market price of our shares on the date of the board approval of the grants. The options vest over a four-year period, 25% over each year of employment. The options granted are exercisable for a period of ten years from the date of grant. If as a result of future equity financings (excluding the exercise or conversion of existing warrants, options or other rights to acquire our securities), the number of total options granted to our CEO through April 30, 2007 would represent less than 1.2% of our total number of issued and outstanding shares as of such date, additional options will be granted to the CEO to represent a 1.2% holding of the total number of our issued and outstanding shares as of April 30, 2007. These grants were approved by our shareholders in October 2005.

In May 2006, our audit committee and board of directors approved the grant of options to our CEO, who also serves as a director, in addition to the options granted to him in April 2005, such that in total, the CEO will hold options to purchase shares that represent 4% of our 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 additional options will be $1.45, the average closing price of our shares on the Nasdaq during the 90 consecutive trading days prior to the board of directors' approval. In the event of a future equity financing, additional options will be granted to the CEO as described above with an exercise price equal to the price per share of such investment. The vesting period of the new options will be identical to the vesting period of the existing options. The new grant of options and its terms are subject to the approval of our shareholders. If the new grant of options is approved by our shareholders, no additional options will be granted under the CEO's current option agreement, which was approved by our shareholders in October 2005.

Our board of directors approved a plan to offer each of our current employees the opportunity to exchange their existing options to purchase our ordinary shares for new options with an exercise price $1.45, which is the average closing price of our shares on the Nasdaq during the 90 consecutive trading days prior to the board of directors' approval. The new options will be granted based on terms similar to our existing employee option plan with new vesting periods. As of May 19, 2006, options to purchase approximately 9 million ordinary shares held by our current employees, with exercise prices ranging from $1.46 to $25, were outstanding. Our board of directors further approved that if the total number of employee options, including the options to our CEO, during

the coming 24 months will represent less than 8% of the our shares on a fully diluted basis, additional options will be allocated for grants to be made to our employees. As of May 31, 2006, no options have been granted under such plan.

During 2001, the Audit Committee, Board of Directors and shareholders approved a stock option plan pursuant to which our Board members will be granted options to purchase up to 400,000 ordinary shares. In accordance with this option plan, 120,000 options were granted in 2005 to three directors (40,000 options each) at exercise prices of $1.87, $1.87 and $1.26 280,000 options to purchase ordinary shares were outstanding under this plan, with a weighted average exercise price of $5.39. These options vest over a four-year period, according to various vesting schedules and are generally not exercisable following the fifth anniversary of their vesting date.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

The following table and notes thereto set forth information, as of May 19, 2006, concerning the beneficial ownership (as defined in Rule 13d-3 under the Securities Exchange Act of 1934, as amended), and on a diluted basis, of ordinary shares by any person who is known to own at least 5% of our issued and outstanding ordinary shares. On such date, 77,561,979 ordinary shares were issued and outstanding. The voting rights of our major shareholders do not differ from the voting rights of other holders of our ordinary shares. However, certain of our shareholders have entered into a shareholders agreement pursuant to which they may be able to exercise control over matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions.

IDENTITY OF PERSON OR GROUP	AMOUNT OWNED (1)	PERCENT OF CLASS(1)	PERCENT OF CLASS (DILUTED)(2)
Israel Corporation Ltd. (3)	33,324,887(4)	34.49%	23.50%
SanDisk Corporation(3)	14,650,132(5)	18.06%	10.33%
Alliance Semiconductor Corporation (3)	13,492,975(6)	16.67%	9.52%
Macronix International Co. Ltd.(3)	9,979,485(7)	12.67%	7.04%

(1) Assumes the holder's beneficial ownership of all Ordinary Shares and all securities that the holder has a right to purchase within 60 days.

(2) Assumes that all currently outstanding securities to purchase Ordinary Shares, other than those which cannot be calculated as of the date of this annual report, have been exercised by all holders.

(3) Pursuant to a shareholders agreement among Israel Corp., Alliance Semiconductor Corporation, SanDisk Corporation and Macronix Co. Ltd., each of Israel Corp., Alliance Semiconductor Corporation, SanDisk Corporation and Macronix Co. Ltd. may be said to have shared voting and dispositive control over approximately 57% of the outstanding shares of Tower.

(4) Based on information provided by Israel Corp., represents 14,260,504 shares currently owned by Israel Corp., 882,560 shares issuable upon

the exercise of currently exercisable warrants and 18,181,823 shares issuable upon conversion of debentures.

(5) Based on information provided by SanDisk, represents 11,108,002 shares currently owned by SanDisk, 360,312 shares issuable upon the exercise of currently exercisable warrants and 3,181,818 shares issuable upon conversion of debentures.

(6) Based upon information provided by Alliance, represents 10,125,410 shares currently owned by Alliance, 357,747 shares issuable upon the exercise of currently exercisable warrants and 3,009,818 shares issuable upon conversion of debentures.

(7) Based on information provided by Macronix, represents 8,773,395 shares currently owned by Macronix, 297,000 shares issuable upon the exercise of currently exercisable warrants and 909,090 shares issuable upon conversion of debentures.

This information does not take into account the following potential dilutive issuances of securities pursuant to our credit facility agreement and agreements with our major wafer partners and with Israel Corp. which cannot be calculated as of the date of this annual report since the number of shares issuable will depend upon future transactions in which we may engage: (i) ordinary shares issuable upon conversion of up to $30 million in wafer prepayment credits (as of May 19, 2006) which we have issued to our major wafer partners; and (ii) ordinary shares issuable upon conversion of securities we may be required to issue in connection with a rights offering and outside investor provisions agreed to in the November 2003 amendment to our facility agreement.

Pursuant to a shareholders agreement dated January 18, 2001, among Israel Corp., Alliance Semiconductor, SanDisk and Macronix, such parties have agreed, among other things, to vote or cause to be voted all their respective shares for the election to the Board of Directors of nominees designated by each party, nominees recommended by the Board, the election of a designee of the Israel Corp. to serve as Chairman of the Board, and against the election of any other persons to the Board of Directors. In addition, subject to certain exceptions, each shareholder agreed to restrictions on the transfer of its shares, including certain rights of first refusal, and through January 2008, to maintain minimum shareholdings.

As of July 10, 2006, there were a total of 34 holders of record of our ordinary shares, of which 21 were registered with addresses in the United States. Such United States holders were, as of such date, the holders of record of approximately 62% of our outstanding ordinary shares.

B. RELATED PARTY TRANSACTIONS

EXEMPTION AND INDEMNIFICATION AGREEMENTS WITH DIRECTORS. In December 2001, we entered into exemption and indemnification agreements with the members of our Board of Directors, pursuant to which, subject to the limitations set forth in the Israeli Companies Law and our Articles of Association, they will be exempt from liability for breaches of the duty of care owed by them to the Company or indemnified for certain costs, expenses and liabilities with respect to events specified in the exemption and indemnification agreements. In September 2005, we entered into amended exemption and indemnification agreements with the members of our Board of Directors to reflect certain amendments to the Companies Law

that came into effect in March 2005. Our shareholders approved these amended exemption and indemnification agreements in October 2005.

AGREEMENTS WITH CERTAIN OF OUR WAFER PARTNERS AND ISRAEL CORP. We are party to several agreements with our wafer partners, including SanDisk and Alliance, and Israel Corp related to the financing of Fab 2 and manufacture of products as described under the caption "Fab 2 Agreements" in "Item 5. Operating and Financial Review and Prospects" of this annual report and Note 11A to the consolidated financial statements included in this annual report, which discussions are incorporated by reference herein

AGREEMENTS WITH ISRAEL CORP. Discussed under "Item 4 - Information on the Company - A. History and Development of the Company - Recent Developments", which discussion is incorporated by reference herein.

GRANT OF OPTIONS TO OUR CEO AND DIRECTOR. Discussed under "Item 6 - Directors, Senior Management and Employees - E. Share Ownership", which discussion is incorporated by reference herein.

C. INTERESTS OF EXPERTS AND COUNSEL

Not applicable.

ITEM 8. FINANCIAL INFORMATION

A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION

Our consolidated financial statements are incorporated herein by reference to pages following the signature page of this Annual Report.

LEGAL PROCEEDINGS

In June 2006, the United States Court of Appeals for the Second Circuit affirmed the August 2004 decision of the United States District Court for the Southern District of New York to dismiss the class action suit filed in July 2003 by certain of our shareholders in the United States against us and certain of our directors, wafer partners and equity investors (the "Defendants"). The plaintiffs had asserted claims arising under the Securities Exchange Act of 1934, alleging misstatements and omissions made by the Defendants in materials sent to our shareholders in April 2002 with respect to the approval of an amendment to the investment agreements with our Fab 2 investors. The decision of the Court of Appeals may be subject to motions for appeal/or rehearing by the plaintiff within 90 days of said decision and there is therefore no assurance that the decision of the Court of Appeals is a final disposition of the action.

From time to time we are a party to various litigation matters incidental to the conduct of our business. There is no pending or threatened legal proceeding to which we are a party, that, in the opinion of management, is likely to have a material adverse effect on our future financial results or financial condition.

B. SIGNIFICANT CHANGES

Not applicable.

ITEM 9. THE OFFER AND LISTING

Our ordinary shares are listed and traded on the NASDAQ National Market under the symbol "TSEM." In addition, in January 2001, our ordinary shares commenced trading on the Tel Aviv Stock Exchange (TASE) under the symbol "TSEM."

The following table sets forth, for the periods indicated, the high and low reported sales prices of the ordinary shares on the Nasdaq National Market and Tel Aviv Stock Exchange:

PERIOD	NASDAQ NATIONAL MARKET		TEL AVIV STOCK EXCHANGE	
	HIGH ($)	LOW ($)	HIGH (NIS)	LOW (NIS)
June 2006	1.70	1.35	7.65	6.00
May 2006	1.75	1.22	7.91	6.37
April 2006	1.41	1.25	6.90	6.00
March 2006	1.45	1.28	6.73	6.11
February 2006	1.73	1.22	8.10	6.03
January 2006	1.93	1.52	8.54	6.57
Second quarter 2006	1.75	1.22	7.91	6.00
First quarter 2006	1.93	1.22	8.54	6.03
Fourth quarter 2005	1.80	1.02	8.30	5.20
Third quarter 2005	1.40	0.92	6.04	5.10
Second quarter 2005	1.90	1.08	8.00	5.15
First quarter 2005	2.38	1.36	10.30	6.36
Fourth quarter 2004	3.66	1.62	15.55	7.70
Third quarter 2004	5.96	2.95	26.95	13.03
Second quarter 2004	7.20	4.87	32.70	21.80
First quarter 2004	10.80	6.22	46.39	29.30
2005	2.38	0.92	10.30	5.10
2004	10.80	1.62	46.39	7.70
2003	7.90	2.16	35.00	10.12
2002	8.50	3.11	37.99	15.30
2001	17.12	3.80	71.90	16.80

ITEM 10. ADDITIONAL INFORMATION

ARTICLES OF ASSOCIATION; ISRAELI COMPANIES LAW

ARTICLES OF ASSOCIATION

Our Articles of Association ("Articles") were adopted in November 2000, and amended on October 27, 2005 in order to increase our authorized capital toNIS 500 million. The objective stated in the Articles is to engage in any lawful activity.

We have currently outstanding only one class of equity securities, our ordinary shares, par value NIS 1.00 per share. Holders of ordinary shares have one vote per share, and are entitled to participate equally in the payment of dividends and share distributions and, in the event of liquidation of the Company, in the distribution of assets after satisfaction of liabilities to creditors. No preferred shares are currently authorized.

Our Articles require that we hold our annual general meeting of shareholders each year no later than 15 months from the last annual meeting, at a time and place determined by the Board of Directors, upon at least 21 days' prior notice to our shareholders. No business may be commenced until a quorum of two or more shareholders holding at least 33% of the voting rights are present in person or by proxy. Shareholders may vote in person or by proxy, and are required to prove title to their shares as required by the Israeli Companies Law - 1999 (or the "Companies Law") pursuant to procedures established by the Board of Directors. Resolutions regarding the following matters must be passed by an ordinary majority of those voting at the general meeting:

- amendments to our Articles;
- appointment and termination of our independent auditors;
- appointment and dismissal of directors;
- approval of acts and transactions requiring general meeting approval under the Companies Law;
- increase or reduction of authorized share capital or the rights of shareholders or a class of shareholders;
- any merger as provided in section 320 of the Companies Law; and
- the exercise of the Board of Directors' powers by the general meeting, if the Board of Directors is unable to exercise its powers and the exercise of any of its powers is essential for Tower's proper management, as provided in section 52(a) of the Companies Law.

A special meeting may be convened by the request of two directors or by written request of one or more shareholders holding at least 5% of our issued share capital and 1% of the voting rights or one or more shareholders holding at least 5% of the voting rights. Shareholders requesting a special meeting must submit their proposed resolution with their request. Within 21 days of receipt of the request, the Board must convene a special meeting and send out notices setting forth the date, time and place of the meeting. Such notice must be given

at least 21 days but not more than 35 days prior to the special meeting.

EXEMPTION AND INDEMNIFICATION AGREEMENTS WITH DIRECTORS

In December 2001, we entered into exemption and indemnification agreements with the members of our Board of Directors, pursuant to which, subject to the limitations set forth in the Israeli Companies Law and our Articles of Association, they will be exempt from liability for breaches of the duty of care owed by them to the Company or indemnified for certain costs, expenses and liabilities with respect to events specified in the exemption and indemnification agreements. In September 2005, we entered into amended exemption and indemnification agreements with the members of our Board of Directors to reflect certain amendments to the Companies Law that came into effect in March 2005. Our shareholders approved these amended exemption and indemnification agreements in October 2005.

THE COMPANIES LAW

We are subject to the provisions of the Israeli Companies Law - 1999. The Companies Law codifies the fiduciary duties that "office holders," including directors and executive officers, owe to a company. An office holder, as defined in the Companies Law, is a director, general manager, chief business manager, deputy general manager, vice general manager, executive vice president, vice president, another manager directly subordinate to the managing director or any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title. Each person listed in the table in "Item 6. Directors, Senior Management and Employees" above is an office holder. Under the Companies Law, all arrangements as to compensation of office holders who are not directors require approval of the board of directors. With the exception of compensation of external directors in an amount specified in the regulations adopted under the Companies Law, arrangements regarding the compensation of directors also require audit committee and shareholder approval.

The Companies Law requires an office holder to promptly disclose any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. In addition, if the transaction is an extraordinary transaction, the office holder must also disclose any personal interest held by the office holder's spouse, siblings, parents, grandparents, descendants, spouse's descendants and the spouse of any of the foregoing, or any corporation in which the office holder is a 5% or greater shareholder, holder of 5% or more of the voting power, director or general manager or in which he or she has the right to appoint at least one director or the general manager. An extraordinary transaction is defined as a transaction not in the ordinary course of business, not on market terms, or that is likely to have a material impact on the company's profitability, assets or liabilities.

The Companies Law requires that specific types of transactions, actions and arrangements be approved as provided for in a company's articles of association and in some circumstances by the company's audit committee, board of directors and shareholders. In the case of a transaction that is not an extraordinary transaction, after the office holder complies with the above disclosure requirements, only board approval is required, unless the Articles provide otherwise. If the transaction is an extraordinary transaction, then, in addition to any approval required by the Articles it must be approved first by the audit committee and then by the board of directors, and, in specific circumstances, by

a meeting of the shareholders. Subject to exceptions set forth in the Companies Law, an office holder who has a personal interest in a matter that is considered at a meeting of the board of directors or the audit committee may not be present at such meeting or vote on such matter.

The Companies Law applies the same disclosure requirements to a controlling shareholder of a public company, which is defined as a shareholder who has the ability to direct the activities of a company, other than if this power derives solely from the shareholder's position on the board of directors or any other position with the company and includes a shareholder that holds 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company. Extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest, and agreements relating to employment and compensation terms of controlling shareholders require the approval of the audit committee, the board of directors and the shareholders of the company. The shareholder approval must either include at least one-third of the shares held by disinterested shareholders who are present, in person or by proxy, at the meeting, or, alternatively, the total shareholdings of the disinterested shareholders who vote against the transaction must not represent more than one percent of the voting rights in the company.

In addition to approval by a company's board of directors, a private placement in a public company requires approval by a company's shareholders in the following cases:

- A private placement that meets all of the following conditions:
  - 20 percent or more of the voting rights in the company prior to such issuance are being offered.
  - The private placement will increase the relative holdings of a shareholder that holds five percent or more of the company's outstanding share capital (assuming the exercise of all of the securities convertible into shares held by that person), or that will cause any person to become, as a result of the issuance, a holder of five percent or more of the company's outstanding share capital.
  - All or part of the consideration for the offering is not cash or registered securities, or the private placement is not being offered at market terms.
- A private placement which results in anyone becoming a controlling shareholder.

The above transactions must not be adverse to the company's interest.

Under the Companies Law, a shareholder has a duty to act in good faith towards the company and other shareholders and refrain from abusing his power in the company, including, among other things, vote in the general meeting of shareholders on the following matters:

- any amendment to the Articles;
- an increase of the company's authorized share capital;

- a merger; or
- approval of interested party transactions that require shareholder approval.

In addition, any controlling shareholder, any shareholder who knows that it possesses power to determine the outcome of a shareholder vote and any shareholder who has the power to appoint or prevent the appointment of an office holder in the company is under a duty to act with fairness towards the company. The Companies Law does not describe the substance of this duty.

Tender Offer. A person wishing to acquire shares or any class of shares of a publicly traded Israeli company and who would as a result hold over 90% of the company's issued and outstanding share capital or of a class of shares which are listed, is required by the Companies Law to make a tender offer to all of the company's shareholders for the purchase of all of the issued and outstanding shares of the company. If the shareholders who do not respond to the offer hold less than 5% of the issued share capital of the company, all of the shares that the acquirer offered to purchase will be transferred to the acquirer by operation of law. The Companies Law provides for an exception regarding the threshold requirement for a shareholder that prior to and following February 2000 holds over 90% of a company's issued and outstanding share capital. However, the shareholders may petition the court to alter the consideration for the acquisition. If the dissenting shareholders hold more than 5% of the issued and outstanding share capital of the company, the acquirer may not acquire additional shares of the company from shareholders who accepted the tender offer if following such acquisition the acquirer would then own over 90% of the company's issued and outstanding share capital.

The Companies Law provides that an acquisition of shares of a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 25% or greater shareholder of the company. This rule does not apply if there is already another 25% shareholder of the company. Similarly, the Companies Law provides that an acquisition of shares in a public company must be made by means of a tender offer if as a result of the acquisition the purchaser would become a 45% or greater shareholder of the company, if there is no 45% or greater shareholder of the company.

Merger. The Companies Law permits merger transactions if approved by each party's board of directors and the majority of each party's shares voted on the proposed merger at a shareholders' meeting called on at least 21 days' prior notice. Under the Companies Law, merger transactions may be approved by holders of a simple majority of our shares present, in person or by proxy, at a general meeting and voting on the transaction. In determining whether the required majority has approved the merger, if shares of a company are held by the other party to the merger, or by any person holding at least 25% of the outstanding voting shares or 25% of the means of appointing directors of the other party to the merger, then a vote against the merger by holders of the majority of the shares present and voting, excluding shares held by the other party or by such person, or anyone acting on behalf of either of them, is sufficient to reject the merger transaction. If the transaction would have been approved but for the exclusion of the votes of certain shareholders as provided above, a court may still approve the merger upon the request of holders of at least 25% of the voting rights of a company, if the court holds that the merger is fair and reasonable, taking into account the value of the parties to the merger and the consideration offered to the shareholders. Upon the request of a creditor of

either party to the proposed merger, the court may delay or prevent the merger if it concludes that there exists a reasonable concern that, as a result of the merger, the surviving company will be unable to satisfy the obligations of any of the parties to the merger. In addition, a merger may not be executed unless at least 30 days have passed from the receipt of the shareholders' approval and 50 days have passed from the time that a proposal for approval of the merger has been filed with the Israeli Registrar of Companies.

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NASDAQ MARKETPLACE RULES AND HOME COUNTRY PRACTICES

Nasdaq's Marketplace Rule 4350 ("Rule 4350") was amended to permit foreign private issuers to follow certain home country corporate governance practices without the need to seek an individual exemption from Nasdaq. Instead, a foreign private issuer must provide Nasdaq with a letter from outside counsel in its home country certifying that the issuer's corporate governance practices are not prohibited by home country law.

In July 2005, pursuant to this new exception, we provided a notice to Nasdaq required by Rule 4350, with a letter from our outside Israeli counsel informing it that in keeping with Rule 4350(a)(1) we had elected to follow the practices of our home country in lieu of those set forth in Rule 4350, to the extent permitted thereby, and provided a letter from our outside Israeli counsel certifying that our the practices being followed of amending employee share option plans that do not permit the grant of options to directors upon the approval of our board of directors, and without seeking shareholder approval (which approval is required for Nasdaq-listed companies under Marketplace Rule 4350(i)), is in place thereof were not prohibited by Israeli law.

As provided by Rule 4350(a)(1), in lieu of the requirements of Rule 4350 we have chosen to follow the practices of our home country with respect to the following:

(a) We do not supply an annual report as required by Rule 4350(b)(1)(A), but makes our audited financial statements available to our shareholders prior to our annual general meeting.

(b) The majority of our Board of Directors is not comprised of directors who meet the definition of independence contained in Nasdaq Marketplace Rule 4200(a)(15), as required by Rule 4350(c)(1). Under the Companies Law a majority of the Board of Directors is not required to be comprised of independent directors. In keeping with the requirements of the Companies Law two of the members of our Board of Directors are external directors, and are independent as defined under Rule 10A-3 of the Securities Act.

(c) Our Board has not adopted a policy of conducting regularly scheduled meetings at which only our independent directors are present, as required by Rule 4350(c)(2). The Companies Law does not require our external directors to conduct regularly scheduled meetings at which only they are present.

(d) The compensation of our chief executive officer and all other executive officers is not determined, or recommended to the Board for determination, in the manner required by Rule 4350(c)(3). In accord with the Companies Law the compensation of the chief executive officer and all other officers requires the approval of our Board of Directors, however the compensation of our chief executive officer, who also serves as a director, requires also the approval of our shareholders.

(e) Director nominees are not selected, or recommended for the Board's selection, as required by Rules 4350(c)(4)(A) and 4350(c)(4)(C).

(f) Our Board of Directors has not adopted a formal written charter or board resolution addressing the nomination process and such related matters as may be required under United States federal securities laws, as required by Rule 4350(c)(4)(B).

(g) Although we have adopted a formal written audit committee charter, there is no requirement under the Companies Law to do so and the charter as adopted may not specify all the items enumerated in Rule 4350(d)(1).

(h) Our audit committee does not meet with all of the requirements of Rules 4350(d)(2)(A)(i), 4350(d)(2)(A)(iii) and 4350(d)(2)(A)(iv). Though all members are independent as such term is defined under Rule 10A-3 of the Exchange Act, the audit committee does not comply with the foregoing Rule 4350 requirements, as permitted by the Companies Law.

(i) Our articles of association do not provide for a quorum of not less than 33 1/3% of the outstanding shares of our voting ordinary shares for meetings of our ordinary shareholders, as required by Rule 4350(f). Our articles of association presently require a quorum consisting of two shareholders holding a combined 33% of our ordinary shares. Under the Companies Law a quorum consisting of two shareholders holding a combined 25% of the company's voting shares is required.

(j) We review and approve all related party transactions in accordance with the requirements and procedures for approval of interested party acts and transactions, set forth in the Companies Law, which do not fully reflect the requirements of Rule 4350(h).

(k) We seek shareholder approval for all corporate action requiring such approval, in accordance with the requirements of the Companies Law, which does not fully reflect the requirements of Rule 4350(i).

We may in the future provide Nasdaq with an additional such letter or letters notifying Nasdaq that we are following our own practices, consistent with the Companies Law and practices in Israel in lieu of other requirements of Marketplace Rule 4350.

MATERIAL CONTRACTS. Discussions of these agreements are incorporated herein by reference to the discussion under the caption "Intellectual Property and Licensing Agreements" in "Item 4."Information on the Company" and under the caption "Fab 2 Agreements" in "Item 5. Operating and Financial Review and Prospects" of this annual report.

FAB 2 AGREEMENTS. Since 2000, we have entered into several important Fab 2 agreements and arrangements with a key technology partner, wafer and equity financing partners, the Israeli Investment Center and two leading Israeli banks. Discussions of these agreements are incorporated herein by reference to the discussion under the caption "Fab 2 Agreements" in "Item 5. Operating and Financial Review and Prospects" of this annual report and to Note 11A to the consolidated financial statements included in this annual report.

INTELLECTUAL PROPERTY AND LICENSING AGREEMENTS. Discussions of these

agreements are incorporated herein by reference to the discussion under the caption "Intellectual Property and Licensing Agreements" in "Item 4."Information on the Company" of this annual report.

EXCHANGE CONTROLS

Under Israeli law, non-residents of Israel who purchase ordinary shares with certain non-Israeli currencies (including U.S. dollars) may freely repatriate in such non-Israeli currencies all amounts received in Israeli currency in respect of the ordinary shares, whether as a dividend, as a liquidating distribution, or as proceeds from any sale in Israel of the ordinary shares, provided in each case that any applicable Israeli income tax is paid or withheld on such amounts. The conversion into the non-Israeli currency must be made at the rate of exchange prevailing at the time of conversion.

Under Israeli law and our company's Articles, both residents and non-residents of Israel may freely hold, vote and trade our ordinary shares.

TAXATION

The below discussion does not purport to be an official interpretation of the tax law provisions mentioned therein or to be a comprehensive description of all tax law provisions which might apply to our securities or to reflect the views of the relevant tax authorities, and it is not meant to replace professional advice in these matters. The below discussion is based on current, applicable tax law, which may be changed by future legislation or reforms. Non-residents should obtain professional tax advice with respect to the tax consequences under the laws of their countries of residence of holding or selling our securities.

A. Israeli Capital Gains Tax

Until the end of the year 2002 and provided we maintained our status as an "Industrial Corporation", capital gains from the sale of our securities were generally exempt from Israeli Capital Gains Tax. This exemption did not apply to a shareholder whose taxable income was determined pursuant to the Israeli Income Tax Law (Inflationary Adjustments) 1985, or to a person whose gains from selling or otherwise disposing of our securities were deemed to be business income.

On January 1, 2006 an amendment to the Israeli tax regime became effective (the "2006 Tax Reform"). The 2006 Tax Reform significantly changed the tax rates applicable to income derived from shares.

According to the 2006 Tax Reform, an individual is subject to a 20% tax rate on real capital gains derived from the sale of shares, as long as the individual is not a "substantial shareholder" (generally a shareholder with 10% or more of the right to profits, right to nominate a director and voting rights) in the company issuing the shares. The rate on the gains from publicly traded shares applicable to gains that were realized between January 1, 2003 and January 1, 2006 was 15%.

A substantial shareholder will be subject to tax at a rate of 25% in respect of real capital gains derived from the sale of shares issued by the company in which he or she is a substantial shareholder. The determination of whether the individual is a substantial shareholder will be made on the date that the securities are sold. In addition, the individual will be deemed to be a

substantial shareholder if at any time during the 12 months preceding this date he had been a substantial shareholder.

Corporations will be subject to corporate tax rates in respect of total income, including capital gains, with the corporate tax rate reduced gradually from 34% in 2005 to 25% in 2010. However, between 2006 and 2009, corporations whose taxable income was not determined, immediately before the 2006 Tax Reform was published, pursuant to part B of the Israeli Income Tax Law (Inflationary Adjustments), 1985 or pursuant to the Income Tax Regulations (Rules on Bookkeeping by Foreign Invested Companies and Certain Partnership and Determination of their Chargeable Income), 1984 will generally be taxed at a rate of 25% on their capital gains from the sale of their securities.

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

In some instances where our shareholders may be liable to Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

Pursuant to the treaty between the Governments of the United States and Israel with respect to taxes on income, or the U.S.-Israel tax treaty, the sale, exchange or disposition of our ordinary shares by a person who qualifies as a resident of the United States under the treaty and who is entitled to claim the benefits afforded to him by the treaty, will generally not be subject to Israeli capital gains tax. This exemption shall not apply to a person who held, directly or indirectly, shares representing 10% or more of the voting power in our company during any part of the 12-month period preceding the sale, exchange or disposition, subject to certain conditions. A sale, exchange or disposition of our shares by a U.S. resident qualified under the treaty, who held, directly or indirectly, shares representing 10% or more of the voting power in our company at any time during the preceding 12-month period would be subject to Israeli tax, to the extent applicable; however, under the treaty, this U.S. resident would be permitted to claim a credit for these taxes against the U.S. income tax with respect to the sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits.

B. Israeli Tax on Interest Income and on Original Issuance Discount

Interest and Original Issuance Discount (OID) on our convertible debentures will, in general, be subject to Israeli tax of up to 20% if received by an individual. This reduced rate of tax will not apply if the interest and OID are business income in the hands of the recipient, if the interest is recorded or should be recorded in the individual's accounting books, if the recipient is a substantial shareholder of our company, if financing expenses related to the purchase of the debentures were deducted by the individual in the calculation of the individual's Israeli taxable income, or if the individual is an employee, supplier, or service provider of the company and the tax authorities have not

been persuaded that the payment of interest was not affected by the relationship between the parties. In such cases the regular rate of tax on Interest and OID of up to 49% will apply to the individual. Interest and OID paid to corporations will be subject to corporate tax at the regular rates of 34% in 2005, 31% in 2006, 29% in 2007, 27% in 2008, 26% in 2009 and 25% in 2010 and thereafter. As a result of the provisions related to tax withholding, as explained below, foreign resident individuals and corporations will be subject to tax of 25% or less, according to the relevant treaty relating to their domicile country.

Under regulations promulgated as part of the 2006 Tax Reform, withholding tax at source from debenture interest and OID paid to resident individuals will, in general, be at a rate of 20%. However, if the individual receiving the interest and OID is a substantial shareholder, an employee, supplier or service provider of the company, tax will be withheld at the marginal rates applicable to individuals. Corporations will be subject to withholding tax at the applicable rate of corporate tax as set out above. Withholding tax at source from debenture interest and OID paid to non-resident individuals or corporations will be at a rate of 25% or less, according to the relevant treaty relating to their domicile country. In any event, under the US-Israel Tax Treaty, the maximum Israeli tax withheld on interest and OID paid on our convertible debentures due 2006 to a US treaty resident (other than a US bank, savings institution or company) is 17.5%.

C. Israeli Tax on Dividend Income

On distributions of dividends other than bonus shares, or stock dividends, to Israeli individuals and foreign resident individuals and corporations we would be required to withhold income tax at the rate of 20%. If the income out of which the dividend is being paid is attributable to an Approved Enterprise under the Law for the Encouragement of Capital Investments, 1959, the rate is 15%. A different rate may be provided for in a treaty between Israel and the shareholder's country of residence.

Under the US-Israel Tax Treaty, Israeli withholding tax on dividends paid to a US treaty resident may not, in general, exceed 25%, or 15% in the case of dividends paid out of the profits of an Approved Enterprise. Where the recipient is a US corporation owning 10% or more of the voting stock of the paying corporation and the dividend is not paid from the profits of an Approved Enterprise, the Israeli tax withheld may not exceed 12.5%, subject to certain conditions.

D. PFIC Rules

A non-U.S. corporation will be classified as a passive foreign investment company, or a PFIC, for U.S. federal income tax purposes if either (i) 75% or more of its gross income for the taxable year is passive income, or (ii) on a quarterly average for the taxable year by value (or, if it is not a publicly traded corporation and so elects, by adjusted basis), 50% or more of its gross assets produce or are held for the production of passive income.

We do not believe that we satisfied either of the tests for PFIC status in 2005 or in any prior year. However, there can be no assurance that we will not be a PFIC in 2006 or a later year. If, for example, the "passive income" earned by us exceeds 75% or more of our "gross income", we will be a PFIC under the "income test". Passive income for PFIC purposes includes, among other things, gross interest, dividends, royalties, rent and annuities. For manufacturing

businesses, gross income for PFIC purposes should be determined by reducing total sales by the cost of goods sold. Although not free from doubt, if our cost of goods sold exceeds our total sales by an amount greater than our passive income, such that we are treated as if we had no gross income for PFIC purposes, we believe that we would not be a PFIC as a result of the income test. However, the tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to the determination of PFIC status.

If we were to be a PFIC at any time during a U.S. holder's holding period, such U.S. holder would be required to either: (i) pay an interest charge together with tax calculated at maximum ordinary income tax rates on "excess distributions," which is defined to include gain on a sale or other disposition of ordinary shares, or (ii) so long as the ordinary shares are "regularly traded" on a qualifying exchange, elect to recognize as ordinary income each year the excess in the fair market value, if any, of its ordinary shares at the end of the taxable year over such holder's adjusted basis in such ordinary shares and, to the extent of prior inclusions of ordinary income, recognize ordinary loss for the decrease in value of such ordinary shares (the "mark to market" election). For this purpose, the Nasdaq National Market is a qualifying exchange. U.S. holders are strongly urged to consult their own tax advisers regarding the possible application and consequences of the PFIC rules.

DOCUMENTS ON DISPLAY

We are required to file reports and other information with the SEC under the Securities Exchange Act of 1934 and the regulations thereunder applicable to foreign private issuers. Reports and other information filed by us with the SEC may be inspected and copied at the SEC's public reference facilities described below. Although as a foreign private issuer we are not required to file periodic information as frequently or as promptly as United States companies, we generally do publicly announce our quarterly and year-end results promptly and file periodic information with the SEC under cover of Form 6-K. As a foreign private issuer, we are also exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements and our officers, directors and principal shareholders are exempt from the reporting and other provisions in Section 16 of the Exchange Act.

You may review and copy our filings with the SEC, including any exhibits and schedules, at the SEC's public reference room at 100 F Street N.E., Washington, D.C. 20549. You may call the SEC at 1-800-SEC-0330 for further information on this public reference room. As a foreign private issuer, all documents which were filed after November 4, 2002 on the SEC's EDGAR system will be available for retrieval on the SEC's website at www.sec.gov. These SEC filings are also available to the public on the Israel Securities Authority's Magna website at www.magna.isa.gov.il and from commercial document retrieval services. We also generally make available on our own web site (www.towersemi.com) our quarterly and year-end financial statements as well as other information.

Any statement in this annual report about any of our contracts or other documents is not necessarily complete. If the contract or document is filed as an exhibit to a registration statement, the contract or document is deemed to modify the description contained in this annual report. We urge you to review the exhibits themselves for a complete description of the contract or document.

ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss related to changes in market prices, including interest rates and foreign exchange rates, of financial instruments and derivatives that may adversely impact our consolidated financial position, results of operations or cash flows.

Our primary market risk exposures relate to interest rate movements on borrowings, fluctuations of the exchange rate of the US dollar, which is the primary currency in which we conduct our operations, against the NIS, the Japanese Yen and the Euro. To manage those risks and mitigate our exposure to them, we from time to time use financial instruments, primarily, interest rate collar agreements with a knock-out and knock-in features, and foreign currency forward contracts and options (including zero-cost cylinders).

All financial instruments are managed and controlled under a program of risk management in accordance with established policies. These policies are reviewed and approved by our board of directors. Our treasury operations are subject to an internal audit on a regular basis. We do not hold derivative financial instruments for speculative purposes, and we do not issue any derivative financial instruments for trading or speculative purposes.

RISK OF INTEREST RATE FLUCTUATION

We have market risk exposure to changes in interest rates on our long-term debt obligations with floating interest rates. We have entered into debt obligations to support our capital expenditures and needs. From time to time we enter into interest rate collar agreements with knock-out and knock-in features to modify our exposure to interest rate movements and to reduce our borrowing costs. These agreements limit our exposure to the risks of fluctuating interest rates by allowing us to convert a portion of the interest on our borrowings from a variable rate to a limited variable rate. A knock-out LIBOR-based interest rate collar is a combination of a purchased knock-out cap with a cap level, floor level and a knock out level (and a knock in level for some of the agreements).

We are subject to interest rate exposure in connection with $518 million long-term debt outstanding as of December 31, 2005 under the Fab 2 facility agreement, as such debt bears interest at a rate of LIBOR plus 2.5% per annum. The interest rate as of December 31, 2005 on $226 million of the Fab 2 loans, not subject to the results of our collar agreements, was 7.06%. Our remaining loans of $292 million are covered by the collar agreements and bore annual interest rate as of December 31, 2005, including the results of our hedging activities described below, as follows: $212 million - 7.06%, $80 million - 6.5%, As of December 31,2005 loans in the amount of $21 million drawn down during 2005 following the July 2005 Amendment of the Facility Agreement were repayable through December 31,2006, loans in the amount of $431 million were repayable in 12 equal consecutive quarterly installments commencing March 31, 2007, and loans in the amount of $66 million drawn down during 2004 were repayable in 12 equal consecutive quarterly installments, commencing three years from the end of the quarter of each draw down. Following the May 2006 Amendment to the Facility Agreement, the repayments of long-term loans in the amount of approximately $100 million (including $8 million drawn down in 2006 following the July 2005 Amendment to the Facility Agreement) formerly scheduled to be paid between October 2006 and June 2007, were deferred to July 2007.

All our collar agreements, which gradually expire in 2006-2009, were effective as of December 31, 2005. These agreements provide for combinations as described below. Under the knock-out provision in these agreements, in the event that the LIBOR rate exceeds the knock-out LIBOR rate level during a particular quarter, the protection provided under the interest collar agreements will not apply with respect to that entire quarter. If the LIBOR rate decreases thereafter and remains below the knock-out LIBOR rate level in any successive quarter for the duration of the entire quarter, the protection provided under the interest rate collar will again be effective.

With respect to the $172 million of our Fab 2 credit facility debt, under the terms of the collar agreements, if the LIBOR is below the floor rate of 4.28% we will pay total interest at the fixed rate of 6.78% (the 4.28% floor rate plus 2.5%); if the LIBOR is between 4.28% and 5.56%, we will pay total interest at the actual LIBOR plus 2.5%; if the LIBOR is between 5.56% and 7.50% we will pay total interest at a fixed rate of 8.06% (the 5.56% cap rate plus 2.5%); and if the LIBOR is higher than 7.50%, we will pay the actual LIBOR rate plus 2.5%. On December 31, 2005, the LIBOR rate was 4.56%. Accordingly, as of such date the interest rate on these long-term loans was 7.06% (the Libor rate of 4.56% plus 2.5%).

With respect to the $40 million of our Fab 2 credit facility debt, under the terms of the collar agreements, if the LIBOR is below the floor rate of 2.80% we will pay total interest at the fixed rate of 5.30% (the 2.80% floor rate plus 2.5%); if the LIBOR is between 2.80% and 5.50%, we will pay total interest at actual LIBOR plus 2.5%; if the LIBOR is between 5.50% and 7.50% we will pay total interest at a fixed rate of 8.00% (the 5.50% cap rate plus 2.5%); and if the LIBOR is higher than 7.50%, we will pay the actual LIBOR rate plus 2.5%. At December 31, 2005, the LIBOR rate was 4.56%. Accordingly, as of such date, the interest rate on these long-term loans was 7.06% (the Libor rate of 4.56% plus 2.5%).

With respect to the $80 million of our Fab 2 credit facility debt, under the terms of the collar agreements, if the LIBOR is below the knock-in of 0.70% we will pay total interest at the fixed rate of 5.25% (the 2.75% floor rate plus 2.5%); if the LIBOR is between 0.70% and 4.00%, we will pay total interest at the actual LIBOR plus 2.5%; if the LIBOR is between 4.00% and 7.00% we will pay total interest at a fixed rate of 6.50% (the 4.00% cap level plus 2.5%); and if the LIBOR is higher than 7.00%, we will pay the actual LIBOR rate plus 2.5%. At December 31, 2005, the LIBOR rate was 4.56%. Accordingly, as of such date, the interest rate on these long-term loans was 6.5% (the cap level of 4.0% plus 2.5%).

All our collar agreements resulted in a loss of $1.8 million in the year ended December 31, 2005. The fair value of these agreements, as of December 31, 2005 was a $1.8 million gain.

Our cash equivalents and interest-bearing deposits are exposed to market risk due to fluctuation in interest rates, which may affect our interest income and the fair market value of our investments. We manage this exposure by performing ongoing evaluations of our investments in those deposits. Due to the short maturities of our investments, their carrying value approximates their fair value.

CONVERTIBLE DEBENTURES AND OPTIONS - FOREIGN EXCHANGE RISK

We are exposed to the risk of fluctuation in the NIS/dollar exchange rate with respect to our 2002 convertible debentures. As of December 31, 2005, we were exposed to the risk of fluctuation in the NIS/dollar exchange rate with respect to our exercise price of our Options (Series 1) issued in 2002, which are both denominated in NIS linked to the Consumer Price Index in Israel (CPI). As of December 31, 2005 the adjusted outstanding principal amount of the 2002 convertible debentures was $26.1 million and the adjusted exercise price of the options (Series 1) was $9.2(all of which expired on January 2006). The dollar amount of our finance costs (interest and currency adjustments) related to the 2002 convertible debentures will be increased if the rate of inflation in Israel is not offset (or is offset on a lagging basis) by the devaluation of the NIS in relation to the dollar. In addition, the dollar amount of any repayment on account of the principal of the 2002 convertible debentures will be increased as well. If the devaluation of the NIS against the dollar is greater than the rate of inflation in Israel, the dollar amounts we may raise on the date of exercising our NIS denominated options linked to the CPI will be decreased (all our options (Series 1) expired in January 2006). From the date of the issuance of the 2002 convertible debentures and Options (Series 1) in January 2002 until December 31, 2005, the Israel consumer price index increased by 8.5% while the US dollar/NIS exchange rate increased by 0.4%.

Following the completion of the TASE offering in June 2006, we will also be exposed to foreign exchange risk with respect to our 2006 convertible debentures and our Options (Series C3, 3 and 4), which are denominated in NIS and linked to the CPI.

We are not exposed to foreign exchange risk with respect to our 2005 convertible debentures since these debentures are denominated in USD.

CONVERTIBLE DEBENTURES - RISK OF INTEREST RATE FLUCTUATION

The 2002 convertible debentures bear annual interest at a fixed rate of 4.7%. The debentures are payable in four annual installments commencing in January 2006. The 2005 convertible debentures are denominated in USD and bear annual interest at the rate of 5%. The principle of the debentures, together with accrued interest, will be payable in one installment on January 12, 2012. Therefore, we are not subject to exposure to interest rate fluctuations with respect to the debentures. However, in case the actual market interest rates are lower than the interest rate provided on the convertible debentures, our actual finance costs would be higher than in case our convertible debentures bear floating interest rate.

Assuming a 10% upward shift in the LIBOR rate at December 31, 2005 (from 4.56% to 5.02%), the effective fair value of $438 million debt would have increased and the effective fair value of the convertible debentures would have decreased resulting in a total increase in the fair value of our debts in the amount of approximately $2.9 million. The amount of $438 is comprised of $226 million debt not hedged by the collar agreements and $212 million debt hedged by the collar agreements with a cap level of 5.5% and a knock out level of 7.5%. With regard to the remaining $80 million debt hedged by the collar agreements, as of December 31, 2005 such assumed increase in the LIBOR rate presents no change in the interest rate exposure since as of such date the collar agreements would still result in a fixed rate interest of the cap level plus 2.5%.

We are not exposed to the risk of interest rate fluctuation with respect to our 2006 convertible debentures since these debentures do not bear interest.

FOREIGN EXCHANGE RISK

Our main foreign currency exposures give rise to market risk associated with exchange rate movements of the US dollar, our functional and reporting currency, against the Japanese Yen, the Euro and the NIS. To protect against reductions in value and the volatility of future cash flows caused by changes in foreign exchange rates, we utilize foreign currency forward contracts and options (including zero-cost cylinder options) in order to minimize part of the impact of foreign currency fluctuations on our financial position and results of operations. A cylinder option is a combination of a purchased call option and a written put option. The exercise prices of the options may not be identical and this effectively creates a synthetic range forward. The maturity dates of the options coincide with the scheduled payments to suppliers.

Accordingly, we enter, from time to time, into foreign currency agreements to hedge exposure to equipment purchase commitments and other firm commitments. Most of our agreements to hedge equipment purchase commitments are designated to eliminate exposure changes in the Japanese Yen and the Euro vis-a-vis the US dollar. During the year ended December 31, 2005, we did not have any such transactions.

We enter from time to time into foreign exchange agreements to hedge exposure relating to Value Added Tax (VAT), grants receivables and payroll payments denominated in NIS. During the year ended December 31, 2005, we did not have any such transaction.

We are exposed to currency risk in the event of default by the other parties of the exchange transaction. We estimate the likelihood of such default to occur is remote, as the other parties are widely recognized and reputable Israeli banks.

Assuming a 10% revaluation of the NIS against the US dollar on December 31, 2005 (from 4.603 to 4.143), the effective fair value of our liabilities net of assets denominated in NIS (mainly vendors, convertible debentures and liabilities in regard to employees) would have increased in approximately $4.6 million.

IMPACT OF INFLATION

We believe that the rate of inflation in Israel has had a minor effect on our business to date. However, our dollar costs in Israel will increase if inflation in Israel exceeds the devaluation of the NIS against the dollar or if the timing of such devaluation lags behind inflation in Israel.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

Not applicable.

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

In December of 2005 we filed a registration statement on Form F-1 (Registration No. 333-126909) covering the registration of rights to purchase $50 million worth of $1 denominated convertible debentures, $50 million in aggregate principal amount of convertible debentures issuable upon the exercise of the rights, and 45,454,454 Ordinary Shares issuable upon conversion of the convertible debentures at a conversion price of $1.10 per share. The effective date of the registration statement was December 15, 2005. The rights were distributed to all holders of record of our Ordinary Shares as of December 20, 2005. The rights were exercisable for a 23-day period beginning on December 20, 2005 and ending on January 12, 2006. The offering, which terminated on January 20, 2005, resulted in gross proceeds to us from rights exercises of approximately $48.2 million. After issuing expenses of approximately $1.6, the net proceeds received by us were approximately $46.4 million. None of the net proceeds were paid directly or indirectly to any of our directors or officers, or their associates, any persons owning 10% or more of any class of our equity securities, or any of our affiliates. From January 20, 2005 to the date of this annual report, the net offering proceeds were used to finance our on going operations, including the cash needed to support our production ramp-up in both fabs to support our increased customers demand in the first half of 2006.

ITEM 15. CONTROLS AND PROCEDURES

We carried out an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and the acting Chief Financial Officer, of the design and operation of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and acting Chief Financial Officer concluded that as of December 31, 2005, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms and to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as required to allow timely decisions regarding required disclosure.

There have been no significant changes in our internal controls or in other factors that could significantly affect disclosure controls and procedures subsequent to the date of our most recent evaluation.

ITEM 16. [RESERVED]

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our board of directors has determined that a member of our audit committee, Ms. Tal Yaron-Eldar, is an audit committee financial expert and is independent as defined by Nasdaq Marketplace Rule 4350.

ITEM 16B. CODE OF ETHICS

We adopted a code of ethics that applies to all of our directors, officers and employees, including our chief executive officer, acting chief financial officer, controller, and persons performing similar functions. We have posted our code of ethics on our website, www.towersemi.com under "About Tower".

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The following table presents fees for professional services rendered by our independent registered public accounting firm for audit services, audit-related services and for tax services:

	2005 (US DOLLARS)	2004 (US DOLLARS)
Audit Fees(1)	325,000	362,000
Audit-Related Fees(2)	3,000	12,000
Tax Fees(3)	9,000	14,000
Other(4)	-	-
Total	337,000	388,000

(1) Audit fees consist of fees for professional services rendered for the audit of our consolidated financial statements, services in connection with statutory and regulatory filings and engagements (including review of Forms 20-F, F-1, F-3 and S-8), and reviews of our unaudited interim consolidated financial statements included in our quarterly reports.

(2) Audit related fees consist of accounting consultation and consultation on financial accounting standards, not arising as part of the audit.

(3) Tax fees consist of fees for tax compliance services, tax planning and tax advice.

Our audit committee's charter states that the audit committee is responsible for receiving specific information on the independent auditor's proposed services and for pre-approving all audit services annually and separately approving any other permitted non-audit related services.

ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FROM AUDIT COMMITTEES.

Not Applicable.

ITEM 16E.PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PARTIES.

Not Applicable.

PART III

ITEM 17. FINANCIAL STATEMENTS

Not applicable.

ITEM 18. FINANCIAL STATEMENTS

See Index to Financial Statements following the signature page.

ITEM 19. EXHIBITS

1.1 Articles of Association of the Registrant, approved by shareholders on November 14, 2000, as amended (incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form F-1, File No. 333-126909,"Form F-1 No. 333-126909").

2.1 Bank Warrants, dated January 18, 2001, between the Registrant and Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M. (incorporated by reference to the correspondingly-numbered exhibit to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2000 (the "2000 Form 20-F")).

2.2 Registration Rights Agreement, dated January 18, 2001, by and between SanDisk Corporation, Israel Corporation, Alliance Semiconductor Ltd. and Macronix International Co., Ltd. (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

2.3 Terms of the Registrant's Convertible Debentures issued under an Indenture, dated January 22, 2002, (incorporated by reference to the summary of terms included under the caption "Description of the Debentures" in Exhibit C to the Registrant's Report on Form 6-K for January 2002 (No. 2), filed January 16, 2002 ("January 2002 Form 6-K")).

2.4 Terms of the Registrant's Options (Series 1) (incorporated by reference to the summary of terms included under the caption "Description of the Options" in Exhibit C to the January 2002 Form 6-K).

2.5 Form of Indenture (incorporated by reference to Exhibit 4.2 to Form F-1 No. 333-126909).

2.6 Form of Note for the Debentures (included as Exhibit A to the Indenture filed as Exhibit No. 4.2 to Form F-1 No. 333-126909 and incorporated herein by reference).

3.1 Consolidated Shareholders Agreement, dated January 18, 2001, by and between SanDisk Corporation, Israel Corporation, Alliance Semiconductor Ltd. and Macronix International Co., Ltd. (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.1 Share Purchase Agreement, dated July 4, 2000, by and between SanDisk Corporation and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.2 Additional Purchase Obligation Agreement, dated July 4, 2000, by and between SanDisk Corporation ("SanDisk") and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.3 Share Purchase Agreement, dated August 29, 2000, by and between Alliance Semiconductor Corporation ("Alliance") and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.4 Share Purchase Agreement, dated December 11, 2000, by and between QuickLogic Corporation ("QuickLogic") and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.5 Share Purchase Agreement, dated December 12, 2000, by and between Macronix International Co., Ltd. ("Macronix") and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.6 Share Purchase Agreement, dated December 12, 2000, between Israel Corporation and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.7 Additional Purchase Obligation Agreement, dated December 12, 2000, between Israel Corporation and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.8 Share Purchase Agreement, dated February 11, 2001, between The Challenge Fund - Etgar II and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.9 Facility Agreement, dated January 18, 2001, among the Registrant, Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M. (the "Facility Agreement") (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.10 Design and Construction/Turn-Key Contract, dated August 20, 2000, among the Registrant, M+W Zander Holding GmbH, Meissner-Baran Ltd. and Baran Group Ltd. (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.11 Approval, dated December 31, 2000, of the Israeli Investment Center (Hebrew language document; a summary of the terms is included in the 2000 Form 20-F under the caption "Fab 2 Agreements" in "Item 5. Operating and Financial Review and Prospects") (incorporated by reference to the correspondingly-numbered exhibit to the 2000 Form 20-F).

4.12 Agreement between the Registrant and Saifun, dated October 9, 1997 (incorporated by reference to exhibit 1.1 to the Registrant's Annual Report on Form 20-F for the year ended December 31, 1997).

4.13 Registrant's Non-Employee Director Share Option Plan 2000/3 (incorporated by reference to exhibit 4.5 to the Registrant's Registration Statement on Form S-8 No. 333-83204 ("Form S-8 No. 333-83204")).

4.14 Form of Grant Letter for Non-Employee Directors Share Option Plan 2001/4 (incorporated by reference to exhibit 4.9 to the Form S-8 No. 333-83204).

4.15 Form of Grant Letter for Non-Employee Directors Share Option Plan 2001/5 (incorporated by reference to exhibit 4.10 to the Form S-8 No. 333-83204).

4.16 Wafer Partner Conversion Agreements, dated September 2001, between the Registrant and each of SanDisk, Alliance and Macronix (incorporated by reference to the correspondingly-numbered exhibit to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2001 (the "2001 Form 20-F)).

4.17 Letter Agreement, dated November 29, 2001, among SanDisk, Alliance, Macronix, QuickLogic and the Registrant regarding the Utilization of Prepayments (incorporated by reference to the correspondingly-numbered

exhibit to the 2001 Form 20-F).

4.18 Letter Agreements among Alliance, Macronix, QuickLogic, Israel Corp. and the Registrant and between SanDisk and the Registrant regarding Additional Wafer Partner Financing Date (incorporated by reference to the correspondingly-numbered exhibit to the 2001 Form 20-F).

4.19 Letter Agreement, dated November 15, 2001, among SanDisk, Alliance, Macronix, QuickLogic, ICTech and the Registrant regarding Amendment to Financing Plan (incorporated by reference to the correspondingly-numbered exhibit to the 2001 Form 20-F).

4.20 First Amendment, dated January 29, 2001, to the Facility Agreement (incorporated by reference to the correspondingly-numbered exhibit to the 2001 Form 20-F).

4.21 Second Amendment, dated January 10, 2002, to Facility Agreement (incorporated by reference to the correspondingly-numbered exhibit to the 2001 Form 20-F).

4.22 Third Amendment, dated March 7, 2002, to the Facility Agreement (incorporated by reference to the correspondingly-numbered exhibit to the 2001 Form 20-F).

4.23 Joint Development and Transfer and Cross License Agreement, dated May 2002, between the Registrant and a Japanese manufacturer (incorporated by reference to exhibit 10.3 to the Registrant's Registration Statement on Form F-2, No. 333-97043).

4.24 Technology License Agreement, dated April 7, 2000, between the Registrant and Toshiba Corporation (incorporated by reference to exhibit 10.4 to the Registrant's Registration Statement on Form F-2, No. 333-97043).

4.25 Technology Transfer License Agreement, dated September 2002, between Registrant and Motorola, Inc. (incorporated by reference to exhibit 10.5 to the Registrant's Registration Statement on Form F-2, No. 333-97043).

4.26 Fourth Amendment, dated April 29, 2002, to the Facility Agreement (incorporated by reference to the correspondingly-numbered exhibit to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2002 (the "2002 Form 20-F)).

4.27 Fifth Amendment dated September 18, 2002 to the Facility Agreement (incorporated by reference to the correspondingly-numbered exhibit to the 2002 Form 20-F).

4.28 Amendment to Fifth Amendment to the Facility Agreement, dated October 22, 2002, to the Facility Agreement (incorporated by reference to the correspondingly-numbered exhibit to the2002 Form 20-F).

4.29 Letter Agreement, dated March 2002, among SanDisk, Alliance, Macronix, ICTech and Challenge Fund to advance Third and Fourth Milestone Payments (incorporated by reference to the correspondingly-numbered exhibit to the 2002 Form 20-F).

4.30 Letter Agreement, dated July 2002, among SanDisk, Alliance, Macronix, and

ICTech to exercise rights distributed in rights offering (incorporated by reference to the correspondingly-numbered exhibit to the 2002 Form 20-F).

4.31 Letter Agreement, dated March 2003, among SanDisk, Alliance, Macronix, ICTech, and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2002 Form 20-F).

4.32 Form of Rights Agent Agreement between the Registrant and American Stock Transfer & Trust Company (including form of Rights Certificate) (incorporated by reference to exhibit 4.1 to the Registrant's Registration Statement on Form F-2, No. 333-97043).

4.33 Form of Warrant Agreement between the Registrant and American Stock Transfer & Trust Company (including form of Warrant Certificate) (incorporated by reference to exhibit 4.2 to the Registrant's Registration Statement on Form F-2, No. 333-97043).

4.34 Reserved.

4.35 Investment Center Agreement related to Fab 1, dated November 13, 2001 (English translation of Hebrew original) (incorporated by reference to exhibit 10.2 to the Registrant's Registration Statement on Form F-2, No. 333-97043).

4.36 Development and License Agreement, dated March 31, 2002, between Virage Logic Corporation and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2002 Form 20-F).

4.37 Master Services and License Agreement, dated June 2002, between Artisan Components, Inc. and the Registrant (incorporated by reference to the correspondingly-numbered exhibit to the 2002 Form 20-F).

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4.38 Seventh Amendment to the Facility Agreement, dated November 11, 2003, (incorporated by reference to Exhibit 99.1 of the Registrant's Report on Form 6-K filed on December 17, 2003).

4.39 Undertaking of the Registrant, dated November 11, 2003 (incorporated by reference to Exhibit 99.3 of the Registrant's Report on Form 6-K filed on December 17, 2003).

4.40 Letter Agreement, dated November 11, 2003, by and among the Registrant, Israel Corporation Technologies, SanDisk Corporation, Alliance Semiconductor Corporation and Macronix International Co., Ltd. (incorporated by reference to Exhibit 99.4 of the Registrant's Report on Form 6-K filed on December 17, 2003).

4.41 Foundry Agreement, dated May 12, 2004, between the Registrant and Siliconix incorporated (incorporated by reference to correspondingly-numbered exhibit to the Registrant's Annual Report on Form 20-F for the year ended December 31, 2004 (the " 2004 Form 20-F)).

4.42 Share Purchase Agreement, dated December 8, 2004, between the Registrant and the Purchasers named therein (incorporated by reference to correspondingly-numbered exhibit to the 2004 Form 20-F).

4.43 Agreement, dated December 31, 2004, by and among the Registrant and the

Purchasers named therein (incorporated by reference to correspondingly-numbered exhibit to the 2004 Form 20-F).

4.44 Employee Share Option Plan 2004 (incorporated by reference to Exhibit 4.3 to the Registrant's Registration Statement on Form S-8 No. 333-117565 ("Form S-8 No. 333-117565").

4.45 Form of Grant Letter to Israeli Employees (incorporated by reference to Exhibit 4.4 to Form S-8 No. 333-117565).

4.46 Form of Grant Letter to U.S. Employees (incorporated by reference to Exhibit 4.5 to Form S-8 No. 333-117565).

4.47 Bank Warrants, dated August 2005, between the Registrant and Bank Hapoalim B.M. and Bank Leumi Le-Israel B.M.

4.48 Ninth Amendment to the Facility Agreement, dated July 2005, dated July 24, 2005 (incorporated by reference to Form F-1 No. 333-126909).

4.49 Tenth Amendment to the Facility Agreement, dated September 2005incorporated by reference to Exhibit 4.4 to Form F-1 No. 333-126909).

4.50 Eleventh Amendment to the Facility Agreement, dated October 2005 (incorporated by reference to Exhibit 4.3 to Form F-1 No. 333-126909).

4.51 Twelfth Amendment to the Facility Agreement, dated November 2005 (incorporated by reference to Exhibit 4.6 to Form F-1 No. 333-126909).

4.52 Thirteenth Amendment to the Facility Agreement, dated May 2006.

4.53 Fourteenth Amendment to the Facility Agreement, dated May 2006.

4.54 Fifteenth Amendment to the Facility Agreement, dated June 2006.

4.55 Form of Indenture (incorporated by reference to Exhibit 4.2 to Form F-1 No. 333-126909).

4.56 Form of Rights Agent Agreement with Rights Certificate Attached (incorporated by reference to Exhibit 4.1 to Form F-1 No. 333-126909).

4.57 Development and License Agreement, dated July 2005, between Impinj, Inc. and the Registrant.

4.58 License and Design Agreement, dated January 10, 2003 between Chipidea Microelectronics S.A. and the Registrant.

4.59 Amendment to Design Agreement of January 2003 between Chipidea Microelectronics S.A. and the Registrant, dated June 2005.

4.60 License Agreement, dated April 29, 2004, between Synopsys, Inc. and the Registrant.

4.61 Equipment Purchase Agreement, dated May 17, 2006, between the Israel Corporation Ltd. and the Registrant.

12.1 Certification by Chief Executive Officer pursuant to Section 302 of the

Sarbanes-Oxley Act of 2002.

12.2 Certification by Acting Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

13.1 Certification by Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

13.2 Certification by Acting Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

14.1 Consent of Brightman Almagor & Co.

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TOWER SEMICONDUCTOR LTD.
AND SUBSIDIARY
CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2005

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARY

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE SHAREHOLDERS OF

TOWER SEMICONDUCTOR LTD.

We have audited the accompanying consolidated balance sheets of Tower Semiconductor Ltd. and subsidiary ("the Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and subsidiary as of December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in accordance with accounting principles generally accepted in Israel.

Accounting principles generally accepted in Israel vary in certain significant respects from accounting principles generally accepted in the United States of America. The effect of the application of the latter on the financial position, results of operations and cash flows as of the dates and for the years presented is summarized in Note 20.

BRIGHTMAN ALMAGOR & CO.
CERTIFIED PUBLIC ACCOUNTANTS
A MEMBER FIRM OF DELOITTE TOUCHE TOHMATSU

Tel Aviv, Israel
February 1, 2006

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
(DOLLARS IN THOUSANDS, EXCEPT SHARE DATA AND PER SHARE DATA)

	NOTE	AS 20
A S S E T S		

CURRENT ASSETS		
CASH AND CASH EQUIVALENTS		$ 7
DESIGNATED CASH AND SHORT-TERM INTEREST-BEARING DEPOSITS		31
TRADE ACCOUNTS RECEIVABLE:	14	
RELATED PARTIES		5
OTHERS		11
OTHER RECEIVABLES	3	9
INVENTORIES	4	24
OTHER CURRENT ASSETS		1
TOTAL CURRENT ASSETS		90
LONG-TERM INVESTMENTS		
LONG-TERM INTEREST-BEARING DEPOSITS DESIGNATED FOR FAB 2 OPERATIONS		
PROPERTY AND EQUIPMENT, NET	5	510
OTHER ASSETS, NET:	6	
TECHNOLOGY		61
OTHER		16
		77
TOTAL ASSETS		$ 678
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
CURRENT MATURITIES OF LONG-TERM DEBT	8	$ 21
CURRENT MATURITIES OF CONVERTIBLE DEBENTURES	9	6
TRADE ACCOUNTS PAYABLE		59
OTHER CURRENT LIABILITIES	7	8
TOTAL CURRENT LIABILITIES		96
LONG-TERM DEBT	8	497
CONVERTIBLE DEBENTURES	9	19
LONG-TERM LIABILITY IN RESPECT OF CUSTOMERS' ADVANCES	11A	59
OTHER LONG-TERM LIABILITIES	10	11
COMMITMENTS AND CONTINGENCIES	11	
TOTAL LIABILITIES		683
CONVERTIBLE DEBENTURES	12	25
SHAREHOLDERS' EQUITY (DEFICIT)		
ORDINARY SHARES, NIS 1.00 PAR VALUE - AUTHORIZED 500,000,000 AND 250,000,000 SHARES, RESPECTIVELY; ISSUED 68,232,056 AND 66,999,796 SHARES, RESPECTIVELY	11A, 13	16
ADDITIONAL PAID-IN CAPITAL	11A	522

SHAREHOLDER RECEIVABLES		
ACCUMULATED DEFICIT		(559
		(20
TREASURY STOCK, AT COST - 1,300,000 SHARES	13C	(9
TOTAL SHAREHOLDERS' EQUITY (DEFICIT)		(30
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY		$ 678

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

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TOWER SEMICONDUCTOR LTD. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF OPERATIONS
(dollars in thousands, except share data and per share data)

		Year en
	Note	2005
REVENUES	14	
SALES		$ 93,991
REVENUES RELATED TO A JOINT DEVELOPMENT AGREEMENT	11B(3)	8,000
		101,991
COST OF SALES	11A(1)	238,358
GROSS LOSS		(136,367)
OPERATING COSTS AND EXPENSES		
RESEARCH AND DEVELOPMENT		16,029
MARKETING, GENERAL AND ADMINISTRATIVE		17,418
		33,447
OPERATING LOSS		(169,814)
FINANCING EXPENSE, NET	15	(35,651)
OTHER INCOME (EXPENSE), NET	16	2,383
LOSS FOR THE YEAR		$(203,082)
BASIC LOSS PER ORDINARY SHARE		
LOSS PER SHARE		$ (2.55)

LOSS USED TO COMPUTE BASIC LOSS PER SHARE	$(203,082)	$
WEIGHTED AVERAGE NUMBER OF ORDINARY SHARES OUTSTANDING - IN THOUSANDS	79,675	

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

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TOWER SEMICONDUCTOR LTD.
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (DEFICIT)
(dollars in thousands, except share data and per share data)

	ORDINARY SHARES		ADDITIONAL PAID-IN CAPITAL
	SHARES	AMOUNT	
BALANCE - JANUARY 1, 2003	44,735,532	$ 11,294	$ 400,808
STOCK-BASED COMPENSATION RELATED TO THE FAB 2 CONSTRUCTOR			145
STOCK-BASED COMPENSATION RELATED TO THE FACILITY AGREEMENT WITH THE BANKS, NOTE 13B(5)			4,205
ISSUANCE OF SHARES, NET OF RELATED COSTS	8,260,565	1,856	22,723
PROCEEDS ON ACCOUNT OF SHARE CAPITAL			
AMORTIZATION OF UNEARNED COMPENSATION			
LOSS FOR THE YEAR			
BALANCE - DECEMBER 31, 2003	52,996,097	$ 13,150	$ 427,881
ISSUANCE OF SHARES	2,463,949	553	16,414
ISSUANCE OF SHARES, NET OF RELATED COSTS - PUBLIC OFFERING	11,444,500	2,550	72,536
EXERCISE OF SHARE OPTIONS	95,250	21	645
LOSS FOR THE YEAR			
BALANCE - DECEMBER 31, 2004	66,999,796	$ 16,274	$ 517,476
ISSUANCE OF SHARES	1,232,260	274	1,520
STOCK-BASED COMPENSATION RELATED TO THE FACILITY AGREEMENT WITH THE BANKS, NOTE 13B(5)			2,793
STOCK-BASED COMPENSATION RELATED TO RIGHTS OFFERED TO EMPLOYEES, NOTE 13H			448
LOSS FOR THE YEAR			
BALANCE - DECEMBER 31, 2005	68,232,056	$ 16,548	$ 522,237

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands, except share data and per share data)

	YEAR ENDED	
	2005	2
CASH FLOWS - OPERATING ACTIVITIES		
LOSS FOR THE YEAR	$(203,082)	$(1
ADJUSTMENTS TO RECONCILE LOSS FOR THE YEAR TO NET CASH USED IN OPERATING ACTIVITIES:		
INCOME AND EXPENSE ITEMS NOT INVOLVING CASH FLOWS:		
DEPRECIATION AND AMORTIZATION	144,852	1
EFFECT OF INDEXATION AND TRANSLATION ON CONVERTIBLE DEBENTURES	(1,031)	
OTHER EXPENSE (INCOME), NET	(2,383)	(
CHANGES IN ASSETS AND LIABILITIES:		
DECREASE (INCREASE) IN TRADE ACCOUNTS RECEIVABLE	2,510	
DECREASE (INCREASE) IN OTHER RECEIVABLES AND OTHER CURRENT ASSETS	1,988	
DECREASE (INCREASE) IN INVENTORIES	1,293	
INCREASE IN TRADE ACCOUNTS PAYABLE	3,082	
INCREASE (DECREASE) IN OTHER CURRENT LIABILITIES	(1,839)	
INCREASE (DECREASE) IN OTHER LONG-TERM LIABILITIES	(5,368)	
	(59,978)	(
INCREASE (DECREASE) IN LONG-TERM LIABILITY IN RESPECT OF CUSTOMERS' ADVANCES, NET	(760)	
NET CASH USED IN OPERATING ACTIVITIES	(60,738)	(
CASH FLOWS - INVESTING ACTIVITIES		
DECREASE (INCREASE) IN DESIGNATED CASH, SHORT-TERM AND LONG-TERM INTEREST-BEARING DEPOSITS, NET	27,266	(
INVESTMENTS IN PROPERTY AND EQUIPMENT	(38,878)	(1
INVESTMENT GRANTS RECEIVED	7,496	
PROCEEDS RELATED TO SALE AND DISPOSAL OF PROPERTY AND EQUIPMENT	2,179	
INVESTMENTS IN OTHER ASSETS	(3,841)	
DECREASE IN DEPOSITS, NET	--	
PROCEEDS FROM SALE OF LONG-TERM INVESTMENT	--	
NET CASH USED IN INVESTING ACTIVITIES	(5,778)	(
CASH FLOWS - FINANCING ACTIVITIES		
PROCEEDS FROM ISSUANCE OF CONVERTIBLE DEBENTURES, NET	25,086	
PROCEEDS FROM LONG-TERM DEBT	21,103	
PROCEEDS FROM ISSUANCE OF SHARES, NET	--	
PROCEEDS FROM EXERCISE OF SHARE OPTIONS	--	
PROCEEDS ON ACCOUNT OF SHARE CAPITAL	--	
REPAYMENT OF LONG-TERM DEBT	--	
PROCEEDS FROM LONG-TERM DEBT, NET IN CONNECTION WITH RE-BORROWING, NOTE 11A(6)	--	

NET CASH PROVIDED BY FINANCING ACTIVITIES	46,189	1
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(20,327)	
CASH AND CASH EQUIVALENTS - BEGINNING OF YEAR	27,664	
CASH AND CASH EQUIVALENTS - END OF YEAR	$ 7,337	$
NON-CASH ACTIVITIES		
INVESTMENTS IN PROPERTY AND EQUIPMENT	$ 12,999	$
STOCK-BASED COMPENSATION RELATED TO THE FACILITY AGREEMENT WITH THE BANKS	$ 2,793	$
STOCK-BASED COMPENSATION RELATED TO RIGHTS OFFERED TO EMPLOYEES, NOTE 13H	$ 448	$
INVESTMENTS IN OTHER ASSETS	$ 442	$
CONVERSION OF LONG-TERM LIABILITY IN RESPECT OF CUSTOMERS' ADVANCES TO SHARE CAPITAL	$ 1,794	$
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
CASH PAID DURING THE YEAR FOR CAPITALIZED AND EXPENSED INTEREST	$ 32,805	$
CASH PAID DURING THE YEAR FOR INCOME TAXES	$ 86	$

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

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

NOTE 1 - DESCRIPTION OF BUSINESS AND GENERAL

A. DESCRIPTION OF BUSINESS

Tower Semiconductor Ltd. ("the Company"), incorporated in Israel, commenced operations in March 1993. The Company is an independent wafer foundry dedicated to the manufacture of semiconductor integrated circuits on silicon wafers. The Company manufactures integrated circuits in geometries from 1.0 to 0.35 microns at its 150-millimeter fabrication facility ("Fab 1"), and in 0.18 microns and below at its 200-millimeter fabrication facility ("Fab 2"). As a foundry, the Company manufactures wafers using its advanced technological capabilities and the proprietary integrated circuit designs of its customers.

The industry in which the Company operates is characterized by wide fluctuations in supply and demand. Such industry is also characterized

by the complexity and sensitivity of the manufacturing process, by high levels of fixed costs, and by the need for constant improvements in production technology.

The Company's Ordinary Shares are traded on the Nasdaq National Market and on the Tel-Aviv Stock Exchange.

B. ESTABLISHMENT AND OPERATIONS OF NEW FABRICATION FACILITY (FAB 2)

In January 2001, the Company's Board of Directors approved the establishment of a new wafer fabrication facility in Israel ("Fab 2"), at an expected cost of approximately $1,500,000. Fab 2 is designed to manufacture semiconductor integrated circuits on silicon wafers in geometries of 0.18 micron and below on 200-millimeter wafers. The Company has entered into several related agreements and other arrangements and has completed public and private financing deals, which, as of the approval date of the financial statements, have provided an aggregate of approximately $1,260,000 of financing for Fab 2.

The Fab 2 project is a complex undertaking, which entails substantial risks and uncertainties. For further details concerning the Fab 2 project and related agreements, some of which were amended several times, see Note 11A.

During the third quarter of 2003, in which Fab 2's construction was substantially completed, the Company began commercial production and shipment of wafers to its customers utilizing the 0.18 micron process technology. With the commencement of Fab 2 operations, the Company began to depreciate and amortize Fab 2 assets, and to expense most of the ongoing direct costs related to the construction and equipping of Fab 2 and to the transfer of the Fab 2 technology that had been previously capitalized. For further details concerning the depreciation and amortization of Fab 2 assets, see Note 11A.

NOTE 1 - DESCRIPTION OF BUSINESS AND GENERAL (cont.)

C. FINANCING OF THE COMPANY'S ONGOING OPERATIONS

In the year ended December 31, 2005 and in recent years, the Company has experienced significant recurring losses from operations, recurring negative cash flows from operating activities, an increasing accumulated deficit and a deficit in shareholders equity. According to the Company's approved short-term working plan, based on the current prevailing semiconductor market conditions, the Company needs to raise funds in order to finance its short-term activities and liabilities in 2006, including repayment of long-term loans to the extent to be required (see the following paragraph). In addition, according to the Facility Agreement with the Banks, in the fourth quarter of 2006 and in 2007, the Company is to repay on account of long-term loans $21,103 and $160,257, respectively. For details concerning an amendment to the Company's financial ratios and covenants through the third quarter of

2006 under the amended Facility Agreement with the Banks, which was obtained subsequent to a waiver letter agreement signed between the Company and the Banks in January 2005 following non-compliance of the Company with certain of the financial ratios and covenants that were applicable as of December 31, 2004, see Note 11A(6).

In light of the described above, the Company has been taking comprehensive measures to obtain the needed funds for its near-term ongoing operations, as well as to reduce its short-term liabilities. The Company has also implemented cost reduction measures, including measures to reduce expenses, cost structure and cash burn, and in March 2005, the Company completed a workforce cutback, as part of an across-the-board savings plan focused on operational efficiencies. In this regard, the Company has held discussions with its Equity Investors, Wafer Partners and its Banks to provide additional funding for the Company of an aggregate amount of approximately $60,000. Following an amendment to the Facility Agreement signed between the Company and its Banks in July 2005, and the completion of a rights offering in which in December 2005 and January 2006 the Company raised $48,169 (of which $27,811 was received from certain of the Company's Equity Investors and Wafer Partners), the Company was provided with additional $29,693 from the Banks.

Further, the Company is currently examining alternatives for additional funding sources, including raising funds in the capital markets, private placements and other sources. In addition, as provided in the July 2005 amendment, subsequent to the balance sheet date the Company and the Banks commenced and are holding discussions for rescheduling of the repayment dates of the $29,693 provided by the Banks under this amendment, currently to be repaid through March 31, 2007 ($21,103 of which in the fourth quarter of 2006 and the reminder in March 31, 2007). Management also intends to discuss with the Banks the rescheduling of the repayment dates of all the remaining loans obtained from the Banks.

The Company's management estimates that it is probable that additional funds the Company will need in 2006 from the additional funding sources the Company is currently examining, as described above, will be achieved. Management also estimates, based on the discussions held with the Banks subsequent to the balance sheet date, that reaching satisfactory agreement with the Banks regarding the rescheduling of the repayment dates of the $29,693 obtained under the July 2005 amendment is probable. Management further estimates that obtaining satisfactory agreement with the Banks regarding the rescheduling of all the remaining loans obtained from them is achievable, subject that the discussions management intends to hold with the Banks are concluded.

NOTE 1 - DESCRIPTION OF BUSINESS AND GENERAL (cont.)

D. USE OF ESTIMATES IN PREPARATION OF FINANCIAL STATEMENTS

The preparation of financial statements in conformity with generally accepted accounting principles requires management 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.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Company's consolidated financial statements are presented in accordance with generally accepted accounting principles ("GAAP") in Israel. See Note 20 for the reconciliation of material differences between GAAP in Israel and in the United States of America.

A. PRINCIPLES OF CONSOLIDATION

The Company's consolidated financial statements include the financial statements of the Company and its wholly-owned marketing subsidiary in the United States, after elimination of material inter-company transactions and balances. The effect of the subsidiary's operations on the Company's revenues, net loss and total assets was immaterial for the dates and periods presented.

B. CASH AND CASH EQUIVALENTS

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

C. ALLOWANCE FOR DOUBTFUL ACCOUNTS

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

D. INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined for raw materials, spare parts and supplies 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.

E. PROPERTY AND EQUIPMENT

(1) Property and equipment are presented at cost, including interest 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 acquiring, constructing, establishing and installing property and equipment (whether performed by others or by the Company), and costs directly related to preproduction 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 solely to the acquiring, constructing, establishing and installing property and equipment. Allocation, when appropriate, of capitalizable incremental direct costs is based on management's estimates and methodologies including time sheet inputs.

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

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

E. PROPERTY AND EQUIPMENT (cont.)

(1) (cont.)

Cost is presented net of investment grants received or receivable, and less accumulated depreciation and amortization. The accrual for grants receivable is determined based on qualified investments made during the reporting period, provided that the primary criteria for entitlement have been met.

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

Prepaid long-term land lease and buildings (including facility infrastructure)	14-25 years
Machinery and equipment	5 years
Transportation vehicles	7 years

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

F. OTHER ASSETS

(1) TECHNOLOGY

The cost of Fab 2 technologies includes the technology process cost, internal incremental direct costs, mainly payroll-related costs of employees designated for integrating the technologies in the Company's facilities, 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. Amortization phases in commencing on the dates on which each of the Fab 2 manufacturing lines is ready for its intended use, and is based on the straight-line method over a four-year period.

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

(2) DEFERRED FINANCING CHARGES

Deferred financing charges included in other assets in relation to funding the establishment of Fab 2 are being amortized over the lives of the borrowings based on the repayment schedule of such funding (in general, 6 years). During the establishment period of Fab 2, amortized deferred financing charges were capitalized to property and equipment. Commencing the third

quarter of 2003, in which the building and infrastructures of Fab 2 were substantially completed and became ready for their intended use, and in which the initial ramp-up commenced, the deferred financing charges are being amortized to financing expenses, net.

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

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

G. CONVERTIBLE DEBENTURES

Convertible debentures the future conversion of which is not probable as of the balance-sheet date are presented as long-term liabilities and current liabilities (with respect to the current maturities) based on their terms as of such date, net of discount.

Convertible debentures denominated in dollar the future conversion of which is probable as of the balance-sheet date, are presented as a separate line-item between total liabilities and shareholders equity.

See P(1) below for the effect of the initial adoption of Standard No. 22 of the Israeli Accounting Standards Board "FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION". See Notes 20F and 20G for presentation of convertible debentures in accordance with U.S. GAAP.

H. INCOME TAXES

The Company records deferred income taxes in accordance with Standard No. 19 "INCOME TAXES" of the Israeli Accounting Standards Board, to reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and for tax purposes. 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 liabilities and assets are classified as current or noncurrent based on the classification of the related asset or liability for financial reporting, or according to the expected reversal dates of the specific temporary differences, if not related to an asset or liability for financial reporting. Deferred tax liabilities are recognized for temporary differences that will result in taxable amounts in future years. Deferred tax assets are recognized for temporary differences, which will result in deductible amounts in future years and for carryforwards. An allowance against such deferred tax asset 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 of the Company as of December 31, 2005 and uncertainties with regard to its utilization in the future, no deferred taxes were recorded in the Company's results of operations.

I. REVENUE RECOGNITION

Revenues are recognized upon shipment or as services are rendered when title has been transferred, collectibility is reasonably assured and acceptance provisions criteria are satisfied, based on performing electronic, functional and quality tests on the products prior to shipment and customer on-site testing. Such testing reliably demonstrates that the products meet all of the specified criteria prior to formal customer acceptance, and that product performance upon customer on-site testing can reasonably be expected to conform to the specified acceptance provisions. An accrual for estimated returns, computed primarily on the basis of historical experience, is recorded at the time when revenues are recognized.

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

J. 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.

K. LOSS PER ORDINARY SHARE

Basic loss per ordinary share is calculated based on the weighted average number of ordinary shares outstanding during each year presented, adjusted retroactively to include the beneficial feature contemplated in a rights offering. The calculation includes retroactive effect from the beginning of each year (or the issuance date, which is the earlier) of shares issued upon exercise of options and warrants and upon conversion of convertible debentures outstanding at the beginning of each year (or that were issued during the year). The calculation further includes shares issuable from probable exercise and from probable conversion. Basic loss per ordinary share is calculated based on loss for the period with the inclusion of imputed interest income on the exercise price of options and warrants exercised or whose exercise is probable, and of financing expenses in relation to conversion of convertible debentures or probable conversion, as required under Israeli GAAP. See Note 20K for disclosure of loss per share data in accordance with U.S. GAAP.

L. DERIVATIVE FINANCIAL INSTRUMENTS

The Company, from time to time, enters into foreign exchange agreements (primarily forward contracts and options) to hedge non-dollar equipment purchase and other firm commitments. Gains and losses on such agreements through the date that the equipment is received or the commitment is realized are deferred and capitalized to the cost of equipment or the commitment, while gains and losses subsequent thereto, through the date of expiration of the foreign exchange agreement, are included in financing expense, net.

In addition, the Company, from time to time, enters into agreements to hedge interest rate exposure on long-term loans. Gains and losses on such agreements are recognized on a current basis in accordance with the terms of these agreements, and expensed or capitalized in the same manner as the corresponding interest costs.

See Note 20D for disclosure of the derivative financial instruments in accordance with U.S. GAAP.

M. 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 Company uses the dollar as its functional and reporting currency. Financing expenses, net in 2005 include net foreign currency transaction gains of $1,398. Financing expenses, net in 2004 and 2003 include net foreign currency transaction losses of $760 and $232, respectively.

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

N. STOCK-BASED COMPENSATION

The Company accounts for employee and director stock-based compensation in accordance with Accounting Principles Board Opinion No. 25, "ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES" ("APB 25") and authoritative interpretations thereof. Accordingly, the Company accounts for share options granted to employees and directors based on the intrinsic value of the options on the measurement date. The compensation cost of options without a fixed measurement date is remeasured at each balance sheet date. Deferred compensation in respect of awards with graded vesting terms is amortized to compensation expense over the relevant vesting periods. In a manner consistent with FIN 28, the vesting period over which compensation is expensed is determined, based on the straight-line method, separately for each portion of the award as if the grant were a series of awards. See P(2) below for the effect of the initial adoption of Standard No. 24 of the Israeli Accounting Standards Board "SHARE-BASED PAYMENTS". See Note 13B(6) for pro forma disclosures required by SFAS 123 and SFAS 148.

The Company accounts for stock-based compensation of non-employees using the fair value method in accordance with Financial Accounting Standards Board Statement No. 123, "ACCOUNTING FOR STOCK-BASED COMPENSATION" ("SFAS 123") and EITF 96-18: Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services. The award cost of warrants granted in connection with bank financing is amortized as deferred financing charges over the terms of the loans, in a manner described in paragraph F(2) above. The award cost of warrants granted in connection with the construction of Fab 2, is recorded as

depreciation expense over the life of the prepaid perpetual land lease and buildings. The award cost of warrants granted to consultants and a related party in connection with equity transactions is offset against paid-in-capital.

O. IMPAIRMENT OF LONG-LIVED ASSETS

Management reviews long-lived 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. According to the Israeli Accounting Standards Board No.15, "IMPAIRMENT OF ASSETS", an asset's recoverable value is the higher of the asset's net selling price and the asset's value in use, the latter being equal to the asset's discounted expected cash flows. Prior to issuing Standard No. 15 in January 2003, the Company tested the recoverability of its assets based on undiscounted expected cash flows, as applicable by U.S. GAAP, a method that under Standard No. 15 is no longer acceptable.

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

P. RECENT ACCOUNTING PRONOUNCEMENTS BY THE ISRAELI ACCOUNTING STANDARDS BOARD

(1) ACCOUNTING STANDARD NO. 22 "FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION" - In July 2005, the Israeli Accounting Standards Board approved for publication Accounting Standard No. 22 "FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION" (the "Standard"). A FINANCIAL INSTRUMENT under this Standard is defined, in general, as any contract that establishes a financial asset of an entity, or a financial liability or equity instrument of another entity. This Standard establishes the requirements for presentation of financial instruments in the financial statements and indicates the information that should be disclosed in relation thereto, and, in certain cases, the method to measure their impact on the entity's financial statements. The presentation requirements relate to the classification of financial instruments as financial assets, financial liabilities or equity instruments. It also deals with the classification of related interest, dividends, losses and gains and to the circumstances under which financial assets and financial liabilities derived from financial instruments are to be offset. The Standard establishes requirements for disclosure of information relating to factors affecting the amount, timing and certainty of the entity's future cash flows relating to financial instruments and accounting policy implemented in respect of these instruments. The Standard also establishes requirements for disclosure of information about the nature and the extent of an entity's use of financial instruments, the business purposes they serve, the risks associated with them and management's policies for the oversight of those risks.

The Standard is effective for financial statements for periods commencing January 1, 2006 or thereafter. The initial adoption of the Standard will be accounted for by the "prospective method", i.e. financial instruments issued before the effective date of the Standard will be classified and presented in accordance with its provisions commencing from the effective date. Comparative financial statements for prior periods are not to be adjusted. The new Standard supersedes Opinion No.53 "ACCOUNTING FOR CONVERTIBLE LIABILITIES" and Opinion No.48 "ACCOUNTING FOR OPTIONS".

The initial adoption of the Standard is expected to affect primarily the presentation of the Company's convertible debentures (the bifurcation of the convertible debentures into debt component and equity component, as these terms are defined by the Standard). Consequently, on January 1, 2006, the Company's shareholders equity will be recorded with a one-time increase of approximately $17,000, while its total convertible debentures will be decreased by same amount. Commencing from that date, said amount will be amortized as financing expenses through 2011.

(2) ACCOUNTING STANDARD NO. 24 "SHARE-BASED PAYMENTS" - In September 2005, the Israeli Accounting Standards Board published Accounting Standard No. 24 "SHARE-BASED COMPENSATION" (the "Standard"), which calls for the recognition in the financial statements of share-based payments, including transactions with employees, which are to be settled by the payment of cash, by other assets, or by equity instruments. Under Standard No. 24, amongst other matters, costs associated with grants of shares and options to employees will be expensed over the vesting period of each grant. Said costs will be determined based on the fair value of the grants at each grant date. The Standard establishes guidelines for measuring the fair value of each grant based on the settlement terms (either by cash or equity instrument), and disclosure provisions.

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

P. RECENT ACCOUNTING PRONOUNCEMENTS BY THE ISRAELI ACCOUNTING STANDARDS BOARD (CONT.)

(2) ACCOUNTING STANDARD NO. 24 "SHARE-BASED PAYMENTS" (cont.)

The Standard is effective for financial statements for periods commencing January 1, 2006 or thereafter. The Standard provides that with respect to Share-based payments to be settled by equity instruments, its provisions should be applied to all grants made after March 15, 2005, that are unvested as of December 31, 2005. The Standard further provides that its provisions should be applied to modifications that were made after March 15, 2005, even if the underlying grants are not in the scope of the

Standard.

As of December 31, 2005, the award cost with respect to outstanding employee and director options on which the Standard will be applied amounts to approximately $2,000, to be amortized over 2006-2009.

Q. RECLASSIFICATION

Certain amounts in prior years financial statements have been reclassified in order to conform to the 2005 presentation.

NOTE 3 - OTHER RECEIVABLES

Other receivables consist of the following:

	As of December 31, 2005	As of December 31, 2004
Government of Israel - investment grants receivable	$ 7,276	$ 8,400
Other government agencies	1,706	2,382
Others	61	583
	$ 9,043	$11,365

NOTE 4 - INVENTORIES

Inventories consist of the following (*):

	As of December 31, 2005	As of December 31, 2004
Raw materials	$ 6,777	$ 9,260
Spare parts and supplies	3,738	3,950
Work in process	11,502	10,085
Finished goods	2,359	2,374
	$24,376	$25,669

(*) Net of aggregate write-downs to net realizable value of $3,259 and $2,665 as of December 31, 2005 and 2004, respectively.

NOTE 5 - PROPERTY AND EQUIPMENT, NET

A. COMPOSITION

As of December 31,

	2005	2004
COST:		
Prepaid perpetual land lease and buildings (including facility infrastructure)	$237,401	$235,632
Machinery and equipment	709,862	688,691
Transportation vehicles	425	2,989
	947,688	927,312
ACCUMULATED DEPRECIATION AND AMORTIZATION:		
Prepaid perpetual land lease and buildings (including facility infrastructure)	47,841	33,960
Machinery and equipment	388,867	282,092
Transportation vehicles	335	1,964
	437,043	318,016
	$510,645	$609,296

SUPPLEMENTAL DISCLOSURE RELATING TO COST OF PROPERTY AND EQUIPMENT:

(1) As of December 31, 2005 and 2004, the cost of property and equipment included costs relating to Fab 2 in the amount of $713,837 and $701,982, respectively. Said amounts are net of investment grants of $165,222 and $158,830, respectively.

(2) As of December 31, 2005, the cost of buildings, machinery and equipment was reflected net of investment grants in the aggregate of $268,688 (as of December 31, 2004 - $262,320).

(3) Cost of property and equipment as of December 31, 2005 and 2004 includes capitalized interest costs in the aggregate of $18,480.

(4) Following the commencement of Fab 2 operations in the third quarter of 2003, in which the building and infrastructures of Fab 2 were substantially completed and became ready for their intended use, the Company began to depreciate Fab 2 property and equipment, resulting in depreciation expenses of $109,283, $93,457 and $35,582 in 2005, 2004 and 2003, respectively.

NOTE 5 - PROPERTY AND EQUIPMENT, NET (cont.)

B. INVESTMENT GRANTS

In connection with the formation of the Company, the Investment Center of the Ministry of Industry and Trade of the State of Israel ("Investment Center"), under its "approved enterprise" program, approved an investment program for expenditures on buildings and equipment in Fab 1 in the aggregate amount (as amended) of approximately $96,850. The Company completed its investments under

this program, and received final approval from the Investment Center in November 1997.

In January 1996, an investment program ("1996 program") for expansion of Fab 1 in the aggregate amount (as amended in December 1999 and 2001) of $228,680, entitling the Company to investment grants, was approved by the Investment Center. The Company completed its investments under the 1996 program in December 2001 and invested through such date approximately $207,000. In May 2002, the Company submitted the final report in relation to the 1996 program. As of December 31, 2005, the report has not yet received final approval from the Investment Center.

See Note 11A(8) with respect to the Fab 2 program approved by the Investment Center in December 2000.

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 the Company fails to comply with such conditions, the Company 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 the Company's assets. See also Note 17A.

C. For liens see Note 11A(6).

NOTE 6 - OTHER ASSETS, NET

Other assets, net consist of the following:

	As of December 31, 2005	As of December 31, 2004
TECHNOLOGIES (in relation to Fab 2) - Note 11A(2)		
Cost	$94,247	$90,747
Accumulated amortization (*)	32,806	13,797
	$61,441	$76,950
OTHER ASSETS (in relation to Fab 2)		
COST - Deferred financing charges	$24,049	$20,915
Other	4,448	3,217
	28,497	24,132
ACCUMULATED AMORTIZATION (**):		
Deferred financing charges	10,812	6,606
Other	1,326	993
	12,138	7,599
	$16,359	$16,533

(*) For amortization policy, see Note 2F(1).

(**) For amortization policy, see Note 2F(2).

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NOTE 7 - OTHER CURRENT LIABILITIES

Other current liabilities consist of the following:

	As of December 31,	
	2005	2004
Accrued salaries	$ 3,162	$ 3,902
Vacation accrual	2,322	3,509
Interest payable (primarily in relation to convertible debentures)	1,263	1,208
Other	2,225	2,059
	$ 8,972	$10,678

NOTE 8 - LONG-TERM DEBT

A. COMPOSITION:

	Effective interest rate as of December 31, 2005	As of December 31, 2005	2004
In U.S. Dollar	7.06%	$438,103	$417,000
In U.S. Dollar	6.5%	80,000	80,000
Total long-term debt		518,103	497,000
Less - current maturities	7.06%	21,103	--
		$497,000	$497,000

B. All loans received under the Facility Agreement bear interest based on the three-month USD Libor rate plus 2.5%, as revised under the amendment to the Facility Agreement described in detail in Note 11A(6). Prior to the closing of this amendment in December 2003, the loans bore interest based on the three-month USD Libor rate plus 1.55%. The effective interest rate as of December 31, 2005 of loans, the amount of which as of such date was $292,000, includes the terms of collar agreements with knock-out and knock-in features described in Note 18A. Interest is payable at the end of each quarter.

C. For additional information regarding the Facility Agreement, as amended, between the Company and the Banks for financing the construction and equipping of Fab 2, including re-borrowing terms and including loans withdrawn under the July 2005 amendment to the Facility Agreement, see Note 11A(6).

D. REPAYMENT SCHEDULE

The balance of the long-term debt as of December 31, 2005 is repayable as follows:

2006 - current maturities	$ 21,103
2007	151,667
2008	165,667
2009	165,666
2010	14,000
	$518,103

NOTE 8 - LONG-TERM DEBT (cont.)

E. The agreement with the Company's Banks restricts the Company's ability to place liens on its assets (other than to the State of Israel in respect of investment grants - see Note 11A(8), and to Siliconix - see Note 11E(3)) without the prior consent of the Banks. Furthermore, the agreements contain certain restrictive financial covenants (see also Note 11A(6)). For further details concerning amendments to the Facility Agreement for revised financial ratios and covenants for 2005 and 2006, see Note 11A(6).

NOTE 9 - CONVERTIBLE DEBENTURES

A. COMPOSITION:

	Interest rate as of December 31, 2005	As of December 31, 2005	As of December 31, 2004
Convertible debentures	4.7%	$25,811	$26,651
Less - current maturities		6,453	--
		$19,358	$26,651

B. In January 2002, the Company issued on the Tel-Aviv Stock Exchange, NIS 110,579,800 principal amount of convertible debentures, linked to the Israeli Consumer Price Index ("CPI") (adjusted to the CPI as of December 31, 2005 - NIS 119,960,426, $26,061). The debentures were issued at 96% of their par value, and bear annual interest at the rate of 4.7%, payable in January of each year commencing in January 2003. The principal amount is payable in four equal installments in January of each year between 2006 and 2009. The debentures may be converted 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, linked to the CPI (subject to customary adjustments) (adjusted to the CPI as of December 31, 2005 - NIS 44.48, $9.66). The effective rate of interest on the convertible debentures, taking into account the initial proceeds, net of the discount and the related

costs of issuance, is 7.26%. For U.S. GAAP purposes, which require taking into account, in addition to the discount and the related issuance costs, amounts attributed to the options described in Note 13E, the effective rate of interest on the convertible debentures is 9.88%.

Subject to certain conditions and the Company's Facility Agreement, the Company may announce the early redemption of the debentures or part thereof, provided that the sum of the last payment on account of the principal shall be no less than approximately $700.

If on a payment date of the principal or interest on the debentures 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.

The debentures and interest thereon are unsecured and rank behind the Company's existing and future secured indebtedness, including indebtedness to the Banks under the Facility Agreement, as well as to the government of Israel in connection with grants the Company received under its approved enterprise programs and to Siliconix.

See Note 20F for disclosure of the accounting treatment of the convertible debentures in accordance with U.S. GAAP.

NOTE 9 - CONVERTIBLE DEBENTURES (cont.)

C. Following the initial adoption of Accounting Standard No. 22 "FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION" of the Israeli Accounting Standards Board (see Note 2P(1)) in the first quarter of 2006, the Company's convertible debentures would be bifurcated in a manner by which the Company's shareholders' equity would increase by approximately $500 and the convertible debentures will be reduced by the same amount. Said amount will be expensed as financing expenses through 2009.

NOTE 10 - OTHER LONG-TERM LIABILITIES

A. COMPOSITION

	As of December 31,	
	2005	2004
Net liability for employee termination benefits (see B below):		
Gross obligation	$ 18,445	$ 20,938
Amounts funded through deposits to severance pay funds and purchase of insurance policies	(13,658)	(16,350)

	4,787	4,588
Long-term advances (see Note 11B(3))	-	5,500
Long-term liabilities in respect of license agreements	5,123	5,191
Other	1,102	166
	$ 11,012	$ 15,445

B. EMPLOYEE TERMINATION BENEFITS

Israeli law and labor agreements determine the obligations of the Company to make severance payments to dismissed employees and to employees leaving employment under certain other circumstances. The liability for severance pay benefits, as determined by Israeli Law, is generally based upon length of service and the employee's monthly salary. This liability is primarily covered by regular deposits made each month by the Company into recognized severance and pension funds and by insurance policies purchased by the Company, based on the employee's salary for the relevant month. The amounts so funded are not reflected separately on the balance sheets, since they are controlled by the fund trustees and insurance companies and are not under the control and management of the Company. For presentation of employee termination benefits in accordance with U.S GAAP, see Note 20C.

Costs relating to employee termination benefits were approximately $2,631, $3,836 and $2,828 for 2005, 2004 and 2003, respectively.

NOTE 11 - COMMITMENTS AND CONTINGENCIES

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2

(1) OVERVIEW

In January 2001, the Company's Board of Directors approved the establishment of a new wafer fabrication facility in Israel ("Fab 2"), at an expected cost of approximately $1,500,000. Fab 2 is designed to manufacture semiconductor integrated circuits on silicon wafers in geometries of 0.18 micron and below on 200-millimeter wafers. The Company has entered into several related agreements and other arrangements, and has completed public and private financing transactions, to provide an aggregate, as of the approval date of the financial statements, of approximately $1,260,000 of financing for Fab 2. The agreements and arrangements include those with technology partners, Wafer Partners, Equity Investors, the Company's Banks, the Government of Israel through the Investment Center and others. The agreements with the Banks and the Investment Center are subject to certain conditions, including the achievement of performance and financing milestones, and the securing of additional required financing. The Company has also entered into agreements for the design and construction of Fab 2, for

equipping Fab 2 and for the transfer to the Company of process technologies to produce wafers in Fab 2.

As of December 31, 2005, the Company had incurred costs associated with the establishment of Fab 2 project of an aggregate of approximately $1,000,000. As of the approval date of the financial statements, the major shareholders of the Company have invested an aggregate of $323,730; the Banks have made long-term loans in the aggregate of $526,693; the Investment Center grants at an aggregate of $165,419; the Company has raised $243,370 from other financial sources.

During the third quarter of 2003, in which Fab 2's construction was substantially completed, the Company began commercial production and shipment of wafers to its customers utilizing the 0.18 micron process technology. With the commencement of Fab 2 operations, the majority of the ongoing direct costs related to the construction and equipping of Fab 2 and to the transfer of the Fab 2 technologies that previously had been capitalized, are no longer capitalizable. Depreciation and amortization of Fab 2 assets in 2005, 2004 and 2003 amounted to $133,021, $108,542 and $39,625, respectively (see also Note 5A), the majority of which is included in cost of goods sold.

The construction and equipping of Fab 2 is a substantial project, which requires extensive management involvement as well as timely coordination of the activities of many participants. In addition, this project is a complex undertaking which entails substantial risks and uncertainties, including but not limited to those associated with the following: obtaining additional commitments to finance the construction and equipping of Fab 2 and its ongoing operations (see also Note 1C); achieving certain operational milestones and complying with various significant conditions and financial ratios and covenants provided by the Facility Agreement with the Banks; compliance with the conditions under the Approval Certificate for Fab 2 provided by the Investment Center; and completing the complex processes of transferring from Freescale the manufacturing technologies to be used at Fab 2 and development of new technologies.

NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2 (cont.)

(1) OVERVIEW (cont.)

According to the Facility Agreement with the Banks, raising certain required additional funding by the dates specified, achieving the milestones as scheduled, as well as complying with all the conditions and financial ratios and covenants stipulated in that agreement and in the Approval Certificate from the Investment Center, are material provisions for financing provided

and to be further obtained. For details concerning revising certain of the financial ratios and covenants under the Facility Agreement for 2005 and 2006, as were amended in the July 2005 amendment to the Facility Agreement, see paragraph A(6) below.

(2) TECHNOLOGY TRANSFER AGREEMENTS

TOSHIBA - In April 2000, the Company entered into a technology transfer agreement with Toshiba Corporation ("Toshiba"), a Japanese corporation. This agreement provided for the transfer by Toshiba to the Company of advanced semiconductor manufacturing process technologies installed in Fab 2 including related technology transfer assistance in exchange for certain fees for patent licenses, technology transfer and technical assistance. The transfer of the technology was substantially completed during the first half of 2003. The Company's commitment under the Toshiba agreement to reserve for Toshiba a certain portion of Fab 2 wafer manufacturing capacity expired in December 2005.

FREESCALE - In September 2002, the Company entered into a non-exclusive technology transfer, development and licensing agreement with Freescale. This agreement provides for the transfer by Freescale to the Company of existing and newly developed versions of advanced semiconductor manufacturing process technologies to be installed in Fab 2, and for the provision by Freescale of related technology transfer assistance, in exchange for certain fees for patent and other intellectual property licenses, technology transfer and development, technical assistance and ongoing royalties based on sales of products to be manufactured in Fab 2 with the transferred technology. Subject to prior termination for cause by Freescale, the licenses under the agreement are perpetual.

(3) WAFER PARTNER AGREEMENTS

During 2000, the Company entered into various share purchase agreements ("Wafer Partner Agreements") with SanDisk Corporation, Alliance Semiconductor Corporation, Macronix International Co., Ltd. and QuickLogic Corporation (collectively, the "Wafer Partners"; excluding QuickLogic, the "primary Wafer Partners") to partially finance the construction and equipping of Fab 2. Pursuant to the Wafer Partner Agreements, the Wafer Partners agreed to invest an aggregate of $250,000 to purchase Ordinary Shares of the Company. According to the Wafer Partner Agreements, the Company agreed, subject to certain conditions, to reserve for each Wafer Partner a certain portion, and collectively approximately 50%, of Fab 2 wafer manufacturing capacity for a period of 10 years ending January 2011.

NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2 (cont.)

(3) WAFER PARTNER AGREEMENTS (cont.)

Through December 31, 2005, the Wafer Partners invested in the Company, based on the Wafer Partner Agreements, an aggregate of $246,823, of which as of such date $201,909, was credited as paid in capital and $44,914, was established as long-term customers' advances which may be, subject to the terms and conditions stipulated in the Wafer Partner Agreements utilized as credit against purchases to be made by the Wafer Partners, or converted into paid-in-capital. Through December 31, 2005, the Wafer Partners were issued an aggregate of 27,475,135 Ordinary Shares at an average price per share of $7.35, which was determined based on the average closing sale price of the Company's Ordinary Shares for the 15-30 trading days prior to making any investment.

For additional investments made by the primary Wafer Partners in the aggregate amount of $19,089 in connection with the 2002 and 2005 rights offerings, see Notes 13F and 13H, respectively, and paragraph (6) below.

(4) EQUITY INVESTOR AGREEMENTS

Through December 31, 2005, The Israel Corporation ("TIC"), the principal shareholder of the Company, and Challenge Fund-Edgar II LP, a Delaware limited partnership ("Challenge") (together, "Equity Investors") invested in the Company, an aggregate of $55,000 for the purchase of an aggregate of 7,419,835 Ordinary Shares of the Company at an average price per share of $7.41, which was determined based on the average closing sale price of the Company's Ordinary Shares for the 15-30 trading days prior to making any investment. The investments of TIC and Challenge were made in accordance with share purchase agreements the Company entered into with them in December 2000 and February 2001, respectively.

For additional investments made by TIC in the aggregate amount of $29,152 in connection with the 2002 and 2005 rights offerings, see Notes 13F and 13H, respectively, and paragraph (6) below.

In 2002, a Canadian pension fund invested in the Company's equity $15,000 in consideration for 3,000,000 Ordinary Shares of the Company for $5.00 per share, and a warrant to purchase an additional 1,350,000 Ordinary Shares of the Company. The warrant is exercisable for a four-year period ending in October 2006, at an exercise price of $7.50 per share (subject to customary adjustments).

(5) AMENDMENTS TO THE PRIMARY WAFER PARTNER AND EQUITY INVESTOR AGREEMENTS

Pursuant to the primary Wafer Partner Agreements, as amended, the primary Wafer Partners were entitled to convert an aggregate of up to $7,507 of the unutilized long-term customers' advances, which they had as of December 31, 2005, into fully-paid Ordinary Shares of the Company. In January 2006, one of the primary Wafer Partners notified the Company of its election to convert $3,880 of its advances into paid-in equity entitling it for 2,455,905 Ordinary Shares of the Company, constituting approximately 3.67% of the Company's outstanding Ordinary Shares as of December 31, 2005. The number of shares was determined based on $1.58 per share, which was the average closing sale price of the Company's

Ordinary Shares for the 15 trading days prior to December 31, 2005.

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NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2 (cont.)

(5) AMENDMENTS TO THE PRIMARY WAFER PARTNER AND EQUITY INVESTOR AGREEMENTS (cont.)

Pursuant to the primary Wafer Partner Agreements, as amended, each of the primary Wafer Partners has an option to convert, at the end of each calendar quarter in 2004-2006, that portion of the long-term customers' advances which it is entitled to utilize, based upon payments made by such primary Wafer Partner during that quarter, into fully-paid Ordinary Shares of the Company. The number of shares is to be determined based on the average closing sale price of the Company's Ordinary Shares for the 15 trading days preceding the end of each quarter. Accordingly, through December 31, 2005, two of the primary Wafer Partners had converted an aggregate of $2,332 of long-term customer advances into 1,349,423 fully paid Ordinary Shares of the Company, at an average share price of $1.73 per share.

Any quarterly amount, which the primary Wafer Partners have elected not to so convert, will not be utilizable against purchases made subsequent to that quarter, and shall bear interest, payable at the end of each quarter, at an annual rate equal to three-month LIBOR plus 2.5% through December 31, 2007. The aggregate principal of the unconverted long-term customers' advances, which could have been utilized against purchases and which the primary Wafer Partners elected not to convert into fully-paid Ordinary Shares of the Company (as of December 31, 2005 - $1,102), shall be fully repaid on December 31, 2007. Other than as described above in this paragraph and the preceding paragraph, each of the primary Wafer Partners agreed that long-term customer's advances could not be utilized before December 31, 2006. Following December 31, 2006, the remaining long-term customer advances may be utilized as credits against purchases to be made.

(6) FACILITY AGREEMENT

OVERVIEW - In January 2001, the Company entered into a credit facility agreement with two leading Israeli banks ("Banks") entitling the Company to borrow an aggregate, as amended in January 2002, of $500,000 to finance the construction and equipping of Fab 2 ("Facility Agreement"). Of that amount, as of December 31, 2005, the Company withdrew an aggregate of $497,000. These loans bear interest at a rate of Libor plus 2.5% per annum payable at the end of each quarter (prior to the November 2003 amendment, described below, the loans bore interest at a rate of

Libor plus 1.55% per annum). The loans are subject to certain prepayment provisions. Unused amounts under the Facility Agreement were subject to a quarterly commitment fee of 0.25% per annum.

In July 2005, the Company and its Banks entered into a definitive amendment to the Facility Agreement. The amendment provides, among other things, for Bank financing of up to approximately $30,000, subject to the Company raising a similar amount by March 31, 2006. Through the approval date of the financial statements, the Banks provided the Company with the entire amount it was entitled to borrow under the July 2005 amendment following the consummation of a rights offering in January 2006 by the Company (for additional details, see below).

NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2 (cont.)

(6) FACILITY AGREEMENT (cont.)

REPAYMENT SCHEDULE - Loans in the amount of $431,000 received by the Company through December 31, 2003, were repaid on December 31, 2003 and, concurrently, an equivalent amount was drawn down on such date to be repaid in 12 equal consecutive quarterly installments commencing March 31, 2007 (the net amount of long-term loans the Company received in 2003 in connection with the abovementioned re-borrowing was $187,000). Loans in the amount of $66,000 drawn down during 2004 are repayable in 12 equal consecutive quarterly installments, commencing three years from the draw down date of each loan, which in no case shall be after the maturity date of the Facility Agreement. Loans drawn down under the July 2005 amendment are repayable in a period between twelve to fifteen months from each date any amount is received by the Company.

The July 2005 amendment further provides that a rescheduling of the repayment dates of the loans drawn down under it shall be discussed following the closing date of the amendment. Subsequent to the balance sheet date, the Company and the Banks commenced and are holding discussions for rescheduling of the repayment dates of the $29,693 provided by the Banks under this amendment. For further details regarding loans drawn down under the Facility Agreement see Note 8.

NOVEMBER 2003 AMENDMENT - In November 2003, the Company and its Banks entered into an amendment to the Facility Agreement. The amendment was based, among other things, on an updated plan for the construction and equipping Fab 2 submitted to the Banks, and was approved by the Company's shareholders' meeting held in December 2003. Pursuant to the amendment, the Banks waived all noncompliance or breach of covenants by the Company prior to the

date of amendment. The amendment further revised and updated the covenants under the Facility Agreement according to which the Company is obligated to comply with certain operational and financial ratios, primarily total shareholders' equity to total assets, quarterly and annual EBITDA, sales and production capacity milestones.

During 2005, the Company and the Banks entered into the following amendments to the Facility Agreement:

- JANUARY 2005 AMENDMENT - In January 2005, the Company and its Banks signed a waiver letter agreement according to which the Banks waived the Company's non-compliance with certain financial ratios and covenants for the fourth quarter of 2004. The agreement also amended certain of the financial ratios and covenants with which the Company was to comply with during 2005, and which were further revised in the framework of the July 2005 amendment to the Facility Agreement described below.

NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2 (cont.)

(6) FACILITY AGREEMENT (cont.)

- JULY 2005 AMENDMENT - In July 2005, the Company and its Banks entered into a definitive amendment to the Facility Agreement, which closed in August 2005. The amendment provides, among other things, for the Banks to provide additional financing of up to approximately $30,000, subject to the Company raising through the issuance of shares or convertible debentures $23,500 by October 31, 2005 (which was subsequently extended to December 31, 2005) and an additional $6,500 by March 31, 2006. In connection with the amendment, certain of the Company's Equity Investors, Wafer Partners and other investors committed to invest an aggregate of $23,500 towards such funding in the context of a rights offering. Following the closing of the amendment to the Facility Agreement described above and complying with the above commitments, the Banks provided the Company with the full amount of loans to which it was entitled to borrow under the July 2005 amendment.

  Under the July 2005 amendment, the $29,693 provided by the Banks through January 2006 bear annual interest based on the three-month LIBOR plus 2.5% and are repayable in a period between twelve to fifteen months from each date any amount was received by the Company. The amendment further provides that a rescheduling of said repayment dates shall be discussed following the closing date of the amendment. Such discussions have been commenced subsequent to the balance

sheet date.

The July 2005 amendment further provides that: (i) The Israel Corp. ("TIC") undertaking, as detailed below, shall be extended from June 30, 2006 to December 31, 2006; (ii) such undertaking will be deemed to have been fulfilled if TIC invests at least $14,000 in the context of a rights offering; (iii) any amounts raised in equity or in convertible debentures through March 31, 2006, up to $30,000, shall not constitute financing from other sources towards the $152,000 fundraising milestone, as detailed below; and (iv) the last date in which the Company is to comply with the $152,000 fundraising milestone is postponed from December 31, 2005 to June 30, 2006.

The amendment also revised certain of the financial ratios and covenants through the third quarter of 2006 (primarily quarterly EBITDA and sales).

As described in Note 13H, the Company raised $48,169 in the form of a rights offering, thereby satisfying its obligations to raise $23,500 and $6,500 by December 31, 2005 and March 31, 2006, respectively. In the context of such rights offering, TIC invested $20,000, thereby terminating its undertaking detailed below. In addition, the commitment by one of the Company's Wafer Partners to invest an aggregate of $3,500 in the rights offering was fulfilled.

Following the satisfaction of all the Company's commitments under the July 2005 amendment, as of December 31, 2005, $21,103 was drawn down in two installments and in January 2006, an additional $8,590 was drawn down.

NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2 (cont.)

(6) FACILITY AGREEMENT (cont.)

FUNDRAISING MILESTONE - According to the amended Facility Agreement with the Banks, the Company is to raise from specified financial sources an aggregate of $152,000 by June 30, 2006. As of the approval date of the financial statements, the Company had raised $144,124 towards said amount. Accordingly, the Company's remaining obligation to raise financings from specified financial sources is $7,876 to be raised by June 30, 2006.

The Facility Agreement provided that should the Company fail to meet its fundraising obligation towards the aggregate of $152,000 by June 30, 2006, the Banks will have the option to demand that the Company consummate within three months from the failing raising date a rights offering of convertible debentures and

warrants to purchase the Company's Ordinary Shares to raise the missing amount towards the required funding, all in accordance with the terms prescribed in the Facility Agreement.

TIC'S UNDERTAKING - In connection with the November 2003 amendment to the Facility Agreement, TIC undertook to the Banks to exercise all of the rights it received in the above mentioned rights offering. In addition, as part of TIC's undertaking, it agreed to purchase from the Company additional securities in a private placement on the same terms as the rights offering, in an amount equal to 50/93 of the difference between the amount the Company was to raise in the rights offering and the amount raised from shareholders other than TIC, less any amounts actually invested in the rights offering by TIC in connection with the exercise of its own rights. Following TIC's investment in the Company of $20,000 in the context of the 2005 rights offering (see Note 13H), according to the July 2005 amendment, TIC's undertaking has been fulfilled.

For further details regarding 58,906 warrants issued to TIC in connection with its undertaking described above, see Note 13B(5)(b).

The Company has agreed to indemnify TIC for any liabilities it incurs with respect to these arrangements, up to a maximum of $100,000 as follows: up to $25,000 in cash and any amount exceeding such $25,000 limit will earn interest at LIBOR plus 2.5% and will be paid on the same terms that the Company repays its loans to the Banks.

WARRANTS ISSUED TO THE BANKS - For further details regarding 9,561,060 warrants issued to the Banks in connection with the Facility Agreement, see Note 13B(5)(a).

COMPLIANCE WITH FINANCIAL RATIOS AND COVENANTS - As of the balance sheet date, the Company was in full compliance with all of the financial ratios and covenants under the amended Facility Agreement. As of the approval date of the financial statements, the Company anticipates that it will not be in compliance with all of the financial ratios and covenants under the amended Facility Agreement applicable for the fourth quarter of 2006. According to the Facility Agreement, satisfying the financial ratios and covenants is a material provision.

NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2 (cont.)

(6) FACILITY AGREEMENT (cont.)

LIENS - Under the Facility Agreement, the Company agreed to register liens in favor of the Banks on substantially all its

present and future assets. If, as a result of any default under the Facility Agreement, the Banks were to accelerate the Company's obligations, the Company would be obligated to immediately repay all loans made by the Banks (which as of the approval date of the financial statements amounted to $526,693), plus penalties, and the Banks would be entitled to exercise the remedies available to them under the Facility Agreement, including enforcement of the liens against the Company's 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 the Company's ordinary shares ("the Offer") at a price provided in the Offer. In such case, the Company 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 offeror offers a majority of the Company'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.

(7) FAB 2 CONSTRUCTION AGREEMENT

In August 2000, the Company entered into a fixed price turn-key agreement with a contractor for the design and construction of Fab 2 in consideration of approximately $200,000 to be paid according to certain performance milestones stipulated in the agreement. As of December 31, 2005, approximately $192,000 of that amount had already been paid by the Company.

(8) APPROVED ENTERPRISE STATUS

In December 2000, the Investment Center approved an investment program in connection with Fab 2 for expansion of the Company's plant. The approval certificate for the program provided for a benefit track entitling the Company 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 $158,143 has been received from the Investment Center. Since the Company's eligibility to receive grants is with respect to investments in Fab 2 plant and equipment made by December 31, 2005, five years from the date the approval certificate was obtained, the Company is not to receive grants under this program for investments made after that date.

Due to the later than planned commencement of construction of Fab 2, prevailing market conditions and slower than planned ramp-up, as of December 31, 2005, the Company did not complete the program and made investments constituting approximately 72% of the eligible investments under the approved enterprise program.

NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2 (cont.)

(8) APPROVED ENTERPRISE STATUS (cont.)

As a result of the Company's actual investments lagging behind the original terms of the program, the Company notified the Investment Center of its revised investment schedule contemplated in an updated plan for the construction and equipping Fab 2. Such plan includes, among other matters, a reduced rate of annual investments and lower than projected expectations for Fab 2 sales. In July 2004, the Company received from the Investment Center an approval to the revised investment schedule.

Since the approved investment period of five years ended on December 31, 2005, the Company has been holding discussions with the Investment Center to achieve satisfactory arrangements to approve a new expansion program to commence on January 1, 2006. During the first half of 2005, the Company received letters from the Israeli Minister of Industry, Trade and Employment and from the General Manager of the Investment Center stating that they will act under Israeli law to support such expansion. In April 2005, at the Investment Center's request, the Company submitted a revised business plan to the Investment Center for the period commencing on January 1, 2006. As of the approval date of the financial statements, although the Investment Center has concluded its review of the revised business plan, the Company has not received, and the Company's management cannot estimate when the Company will receive, a formal response to its request for a new expansion program to commence on January 1, 2006, or if the Investment Center will approve the Company's request.

Any failure by the Company to meet the conditions of the 2000 approval certificate may result in the cancellation of all or a portion of the grants to be received and tax benefits and in the Investment Center requiring the Company to repay all or a portion of grants already received. Under Israeli law, the Company's non-completion of investments in an amount of $1,250,000 by December 31, 2005 may permit the Investment Center to require the Company to repay all or a portion of grants already received. Management believes that it is improbable that the Investment Center would demand the Company to repay all or a portion of grants already received, or deny investment grants receivable as of December 31, 2005, due to its non-completion of investments in the amount of $1,250,000 by December 31, 2005 - see also Note 17A.

(9) AGREEMENT WITH THE ILA

In November 2000, the Company 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, the Company 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.

(10) HEDGING ACTIVITIES

For hedging transactions and agreements the Company has entered

into, see Note 18C.

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NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

A. COMMITMENTS AND CONTINGENCIES RELATING TO FAB 2 (cont.)

(11) OTHER AGREEMENTS

Through December 31, 2005, the Company had entered into several additional agreements related mainly to the construction, equipping and transfer of technology for Fab 2. The Company's aggregate commitment in connection with these agreements which were not supplied or rendered as of such date, including the Fab 2 construction agreement described in paragraph (7) above, amounted to $14,715.

B. LICENSE AGREEMENTS

(1) In June 2000, the Company 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. The Company agreed to pay an annual royalty through July 2005. Though the licenses terminated on December 31, 2005, the parties are currently negotiating the renewal of said agreement.

(2) In December 2001, the Company and DSP Group Ltd. ("DSPG") entered into a license agreement, pursuant to which DSPG granted the Company a personal, non-exclusive, nontransferable license to use certain technology in the Company's products, in exchange for license fee and ongoing royalties to be paid by either the Company or its customers based on sales of products manufactured in Fab 2 based on the technology. In addition, the agreement provides for technical support by DSPG in connection with using the technology. The license terminates on December 31, 2007.

(3) In May 2002, the Company entered into a joint development and royalty-free, non-exclusive cross-license agreement with a Japanese semiconductor manufacturer corporation, for the joint development of certain technology to be used by the Company in its Fab 2 and by the Japanese manufacturer in its facilities. In April 2005, the Japanese semiconductor manufacturer corporation elected, and the Company agreed, to cease the joint development of certain technology and to terminate the agreement. However, the license rights granted to the parties continue pursuant to the terms of the May 2002 original agreement. According to the terms of the termination agreement, the Japanese manufacturer paid the Company an amount of $2,500 in April 2005. In addition, each party expressly released the other party from any obligations or liabilities of any nature in connection with the original agreement. Revenues for 2005 and 2004 include $8,000 and $1,944, respectively, in relation to this agreement, with the $8,000 of 2005 received subsequent to the termination of the

agreement, and as a result of its termination. See also Note 10A.

(4) The Company from time to time enters into intellectual property and licensing agreements with third parties, 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. See also Note 10A and paragraph E(2) below.

NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

C. LEASES

(1) The Company'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 Israel Lands Authority, which expires in 2032. The Company 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 paragraph A(9) above.

(3) The Company occupies certain other premises under various operating leases. The obligations under such leases were not material as of December 31, 2005.

D. PROFIT SHARING PLAN

The Company maintains an employee profit sharing plan. No amounts were provided for under this plan for periods presented in these financial statements, since the Company did not record profits for these periods.

E. OTHER PRINCIPAL AGREEMENTS

(1) MACRONIX - In December 2000, the Company and Macronix entered into an agreement according to which the Company waived in favor of Macronix certain exclusive semiconductor manufacturing rights it received from Saifun.

(2) SAIFUN - Pursuant to an agreement between the Company and Saifun signed in October 1997, the Company has certain exclusive semiconductor manufacturing rights for certain licensed technology. The agreement also sets certain limitations on Saifun regarding future licensing of such technology (see (1) above). Pursuant to certain provisions of the agreement, the Company and Saifun are obligated, under certain circumstances, to pay each other royalties. For royalty amounts received and payable by the Company under the agreement, see Note 19B. The agreement terminates in October 2007, unless terminated earlier for cause.

(3) SILICONIX - In May 2004, the Company and chip maker Siliconix incorporated ("Siliconix"), a wholly-owned subsidiary of Vishay Intertechnology Inc., entered into a definitive long-term foundry agreement for semiconductor manufacturing. Pursuant to the agreement, Siliconix will place with the Company orders valued at approximately $200,000 for the purchase of wafers to be manufactured in the Company's Fab 1 over a seven to ten year period. Approximately $53,000 of that amount will be delivered over an initial three-year period commencing the second quarter of 2005 (the date in which the transfer of Siliconix's technology to Fab 1 was completed). According to the agreement, in August 2004 Siliconix advanced the Company $20,000 to be used primarily for the purchase of additional equipment required to satisfy Siliconix's orders. The advanced amount is credited towards the purchase price of wafers. The unused remaining balance of the $20,000 ($9,631 as of December 31, 2005) is included in designated cash and short-term interest-bearing deposits in the balance sheet. The Company registered liens in favor of Siliconix on the bank account in which the $20,000 was deposited and over the equipment purchased in connection with the transaction.

NOTE 11 - COMMITMENTS AND CONTINGENCIES (cont.)

E. OTHER PRINCIPAL AGREEMENTS (cont.)

(4) OTHER - 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 by both the other entities and the Company.

F. 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 operations 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 the permits and licenses.

G. CLASS ACTION

In August 2004, the United States District Court dismissed the class action filed in July 2003 by certain of the Company's shareholders in the United States against the Company and certain of its directors, Wafer Partners and Equity Investors ("the Defendants"). The plaintiffs had asserted claims arising under the Securities Exchange Act of 1934, alleging misstatements and omissions made by the Defendants in

materials sent to the Company's shareholders in April 2002 with respect to the approval of an amendment to the Company's investment agreements with its Fab 2 investors. In December 2004, one of the lead plaintiffs filed an appeal of the decision dismissing the complaint. The Company believes that the complaint is without merit and is vigorously contesting it.

H. AMENDMENT TO ISRAELI BANKING REGULATIONS

Pursuant to an amendment to a directive published by the Israel Supervisor of Banks, effective March 31, 2004, the Company may be deemed part of a group of borrowers comprised of the Ofer Brothers Group, Israel Corp., and other companies which are also included in such group of borrowers pursuant to the directive, including companies under the control or deemed control of these entities. The directive provides for limits on amounts that banks may lend to borrowers or groups of borrowers. Should the Company's Banks exceed these limitations, they may limit the Company's ability to borrow other money in the future and may require the Company to return some or all of the outstanding borrowings (which were $526,693 as of the approval date of the financial statements). As of the approval date of the financial statements, the Company had received no such request.

I. OTHER COMMITMENTS

Receipt of certain research and development grants from the government of Israel is subject to various conditions. In the event the Company fails to comply with such conditions, the Company may be required to repay all or a portion of the grants received. In management's opinion, the Company has been in full compliance with the conditions through December 31, 2005.

NOTE 12 - CONVERTIBLE DEBENTURE

A. In connection with the rights offering described in Note 13H, the Company issued $48,169 principal amount of convertible debentures of which $25,493 was fully paid as of December 31, 2005. The rights were distributed to the Company's shareholders and eligible employees holding options to purchase Ordinary Shares of the Company under share option plans that entitle option holders to participate in a rights offering. The debentures are listed for trade on the Tel-Aviv Stock Exchange and on the NASDAQ Capital Market. The debentures bear annual interest at the rate of 5% and are convertible into up to 43,790,272 of the Company's Ordinary Shares. The principal of the debentures, together with accrued interest, will be payable in one installment on January 12, 2012. The effective interest rate on the convertible debentures, taking into account the proceeds and related costs of issuance of approximately $1,300, is 5.48%.

The debentures are convertible into the Company's Ordinary Shares at a conversion price of $1.10 per share. The conversion price is subject to downward adjustment under certain circumstances in which the

Company sells securities in future financings at a price per share which is lower than the conversion price, provided that such financings close through December 2006 (or under certain conditions, through June 2007).

Subject to the Facility Agreement, the Company may at its option announce the early redemption of the debentures, provided that the outstanding aggregate balance of principal on account of the debentures is equal to or less than $500.

Certain of the Company's Equity Investors and Wafer Partners invested $27,811 in the framework of the rights offering.

The debentures and interest thereon are unsecured and rank behind the Company's existing and future secured indebtedness, including indebtedness to the Banks under the Facility Agreement, as well as to the government of Israel in connection with grants the Company received under its approved enterprise programs and to Siliconix.

B. Subsequent to the balance sheet date and through the approval date of the financial statements the nominee company acting on behalf of the Tel Aviv Stock Exchange Clearing House has requested to convert, 3,351,854 of the convertible debentures, issued in connection with the Company's recent rights offering, into 3,047,140 Ordinary Shares of the Company.

C. The beneficial feature according to the provisions of Opinion No. 55 "EARNINGS PER SHARE" of the Institute of Certified Public Accountants in Israel, determined based on the theoretical ex-price derived from the Company's share price immediately prior to the issuance date of the rights, was 19 %. According to Opinion No. 55, the number of shares used in the computation of loss per share for the periods presented has been adjusted retroactively according to that beneficial feature.

D. Following the initial adoption of Accounting Standard No. 22 "FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION" of the Israeli Accounting Standards Board (see Note 2P(1)) in the first quarter of 2006, the Company's convertible debentures would be bifurcated in a manner by which the Company's shareholders' equity would increase by approximately $16,500 and the convertible debentures will be reduced by the same amount. Said amount will be expensed as financing expenses through 2011.

NOTE 13 - SHAREHOLDERS' EQUITY

A. DESCRIPTION OF ORDINARY SHARES

As of December 31, 2005 and 2004, the Company had 500,000,000 and 250,000,000 authorized Ordinary Shares, respectively, par value NIS 1.00 each, of which 66,932,056 and 65,699,796, respectively, were issued and outstanding (net of 1,300,000 Ordinary Shares held by the

Company as of such dates). As of the approval date of the financial statements, there were 67,189,547 Ordinary Shares issued and outstanding and 58,627,109 Ordinary Shares of the Company contingently issuable. This amount includes Ordinary Shares to be issued under various agreements according to their provisions related to Fab 2 Wafer Partners and Equity Investors warrants, the exercise of all options granted and issued to non-employees and the conversion of all convertible debentures. Subsequent to the balance sheet date and through the approval date of the financial statements, the nominee company acting on behalf of the Tel Aviv Stock Exchange Clearing House has requested to convert 3,351,854 of convertible debentures, issued in connection with the Company's recent rights offering, into 3,047,140 Ordinary Shares of the Company, which as of the approval date of the financial statements have not yet been issued. 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 the Company, 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, CHIEF EXECUTIVE OFFICER AND DIRECTOR SHARE OPTIONS

(A) GENERAL - The Company has granted to its employees options to purchase its 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 to not less than 85% of the market value of the Ordinary Shares at the date of grant (in mostly all cases, at an exercise price equal to the market value of the underlying shares at the date of grant); vest over a three to four-year period according to various vesting schedules; and are not exercisable beyond ten years from the grant date under each plan.

(B) OPTIONS TO THE COMPANY'S NEW CHIEF EXECUTIVE OFFICER AND DIRECTOR - In April 2005, the Company's Board of Directors approved the grant of options to purchase up to 1,325,724 Ordinary Shares to the Company's new appointed Chief Executive Officer ("CEO"), who was also appointed as a director, which was further approved by the Company's shareholders in October 2005. These options are exercisable at an exercise price of $1.56, which was the closing market price of the Company'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.

NOTE 13 - SHAREHOLDERS' EQUITY (cont.)

B. SHARE OPTION PLANS (cont.)

(1) EMPLOYEE, CHIEF EXECUTIVE OFFICER AND DIRECTOR SHARE OPTIONS (cont.)

(B) OPTIONS TO THE COMPANY'S NEW CHIEF EXECUTIVE OFFICER AND DIRECTOR (CONT.)

If as a result of equity financings consummated after April 30, 2005 (excluding the exercise or conversion of warrants, options, convertible debentures or other rights to acquire the Company's securities outstanding on such date), the CEO's total number of options granted to him through April 30, 2007 would represent less than 1.2% of the total number of issued and outstanding shares of the Company as of April 30, 2007, additional options will be granted to the CEO to result in a 1.2% holding of the total number of issued and outstanding shares of the Company as of April 30, 2007.

(C) OPTIONS GRANTED TO DIRECTORS - During 2001, the Audit Committee, the Board of Directors of the Company and the general meeting of the Company's shareholders approved a stock option plan pursuant to which the Company's directors will be granted options to purchase up to 400,000 Ordinary Shares of the Company (40,000 to each eligible director appointed to the Board of Directors) at an exercise price equal to the market price of the Company's shares on the grant dates. In accordance with this option plan, 120,000 options were granted in 2005 to three directors who were appointed in 2005 (40,000 options each) at exercise prices of $1.87, $1.87 and $1.26, which equal the market price of the Company's shares on the grant dates. As of December 31, 2005 and 2004, 280,000 and 240,000 options were outstanding under the plan, respectively, with a weighted average exercise price of $5.39 and $8.41, respectively.

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.

In addition, during 2000 and 2001, the Audit Committee, the Board of Directors of the Company and the general meeting of the Company's shareholders approved the grant to a director of the Company options to purchase up to 50,000 and 21,500 Ordinary Shares, respectively, of the Company at an exercise price of $20.00 and $10.75, respectively, per share, the market price of the Company's shares on the dates of grant. The options may be exercised for a period of three years from the date on which they have become vested. As of December 31, 2005, 16,666 and 14,334 options, respectively, were expired.

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NOTE 13 - SHAREHOLDERS' EQUITY (cont.)

B. SHARE OPTION PLANS (cont.)

(1) EMPLOYEE, CHIEF EXECUTIVE OFFICER AND DIRECTOR SHARE OPTIONS (cont.)

(D) EXPIRATION OF OPTIONS GRANTED TO THE COMPANY'S FORMER CHAIRMAN OF THE BOARD OF DIRECTORS AND CHIEF EXECUTIVE OFFICER - In March 2003, the Board of Directors of the Company approved a share option plan, which was approved by the Company's shareholders in May 2003, pursuant to which the Company's former Chairman of the Board of Directors and CEO was granted options to purchase up to 1,043,000 Ordinary Shares of the Company at an exercise price of $2.983, an exercise price which is higher than the Company's share price at the date of the approval by the Board of Directors, and is equivalent to the average closing trading price for the Company's Ordinary Shares during the 30 consecutive trading days preceding the date of board approval of an amendment to the Fab 2 investment agreements. Options granted under the plan vest over a five-year period according to various vesting schedules. Due to the resignation of the Company's former Chairman of the Board of Directors and Chief Executive Officer in May 2005, 625,800 options granted to him were fully forfeited and 417,200 options were exercisable until May 2006.

(E) OPTIONS GRANTED TO FORMER CO-CEOS IN OCTOBER 1998 AND MAY 2001 - In October 1998 and May 2001, the Board of Directors of the Company approved share option plans pursuant to which each of the Company's two former Co-Chief Executive Officers was granted options to purchase up to 300,000 and 100,000 Ordinary Shares of the Company, respectively, at an exercise price of $7.00 and $11.81, respectively, the market price of the Company's shares on the dates of grant. In the framework of the retirement of the former Co-Chief Executive Officers in May 2003, based on their retirement provisions as stipulated in the agreements, the 300,000 options are available for exercise through April 2007. As of December 31, 2005, there were 705,000 options exercisable by the former Co-Chief Executive Officers.

(F) OPTIONS AVAILABLE FOR GRANT - Under a provision approved in September 2000, as amended in December 2003, by the Company's Board of Directors, on January 1 of each year commencing 2001 and ending 2003 and on each year commencing November 1, 2003 and November 1, 2004, the total number of options available for grant under all the Company's employee share option plans is to be increased by an amount equal to a certain percentage of the outstanding Ordinary Shares of the Company on each such dates, provided that the maximum number of options available for grant at any time shall not exceed 12% of the outstanding Ordinary Shares of the Company, and that additional options may not be granted if the total number of unvested options outstanding under all the Company's share option plans exceeds 12% of the outstanding Ordinary Shares of the Company. The percentage

of the outstanding Ordinary Shares of the Company added for the years 2001, 2002 and 2003 was 4%, and for the years 2004 and 2005 - 3.6%. As of December 31, 2005, an aggregate of 1,973,025 options had not yet been granted, and are accordingly available for grant under the general terms described in paragraph (a) above.

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

NOTE 13 - 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 the Company's employee and director share option plans as of December 31, 2005, 2004 and 2003, 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 paragraph B(5) below):

	2005		2004		2
	Number of share options	Weighted average exercise price	Number of share options	Weighted average exercise price	Number of share options
Outstanding as of beginning of year	10,212,920	$ 5.71	6,842,442	$ 7.93	4,247,89
Granted	5,000,224	1.54	4,364,954	2.69	3,118,74
Exercised	--		(95,250)	7.00	-
Terminated	(77,214)	12.45	--		-
Forfeited	(2,124,355)	4.99	(899,226)	7.89	(524,19
Outstanding as of end of year	13,011,575	4.19	10,212,920	5.71	6,842,44
Options exercisable as of end of year	4,602,447	7.77	3,010,870	10.78	2,008,67

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 13 - 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, 2005:

Outstanding as of December 31, 2005				Exercisabl December 3
Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable
		(in years)		
1.00-1.99	4,860,017	9.29	1.54	--
2.00-2.99	2,723,059	7.64	2.33	991,621
3.00-3.99	1,317,600	8.59	3.26	344,220
4.42-4.92	1,051,350	7.55	4.43	530,396
5.00-5.96	118,000	7.11	5.23	72,412
6.00-6.99	714,889	6.50	6.13	437,138
7.00-7.99	579,750	1.17	7.01	579,750
8.00-8.99	344,887	2.36	8.51	344,887
9.063-9.812	8,250	1.09	9.37	8,250
10.00-10.89	612,109	5.23	10.41	612,109
11.81-11.81	200,000	5.41	11.81	200,000
12.00-13.00	38,350	4.67	12.40	38,350
14.25-17.1875	18,500	4.85	16.16	18,500
18.75-18.75	44,500	4.26	18.75	44,500
20.00-25.00	380,314	4.30	24.48	380,314
	13,011,575			4,602,447

(4) WEIGHTED AVERAGE GRANT-DATE FAIR VALUE OF OPTIONS GRANTED TO EMPLOYEES

The weighted average grant-date fair value of the options granted during 2005, 2004 and 2003 to employees and directors amounted to $0.83, $1.53 and $2.18 per option, respectively. The Company utilized the Black-Scholes option-pricing model to estimate fair value, utilizing the following assumptions for the years 2005, 2004 and 2003 (all in weighted averages):

	2005	2004	2003
Risk-free interest rate	3.69%-4.34%	2.84%-3.88%	2.88%-3.22%
Expected life of options	4.49 years	4.5 years	4.75 years
Expected annual volatility	54%-69%	65%-82%	55%-74%
Expected dividend yield	None	None	None

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARY
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(dollars in thousands, except share data and per share data)

NOTE 13 - SHAREHOLDERS' EQUITY (cont.)

B. SHARE OPTION PLANS (cont.)

(5) NON-EMPLOYEE WARRANTS

(A) BANKS - As of December 31, 2005, the Company had granted the Banks an aggregate of 9,561,060 warrants to purchase Ordinary Shares of the Company, at an average exercise price of $1.88 per share, at terms described below, of which 9,161,060 were outstanding and 5,028,828 were exercisable as of the approval date of the financial statements.

WARRANTS ISSUED IN JANUARY 2001 - In January 2001, as part of the Facility Agreement described in Note 11A(6), the Banks received an aggregate of 400,000 warrants to purchase Ordinary Shares of the Company (200,000 each) at an exercise price, as amended in December 2001, of $6.20 per share. As of December 31, 2005, all of these warrants were fully vested. The warrants expired in January 2006.

The cost of the warrants issued to the Banks, determined based on the fair value at the grant and amendment dates in accordance with SFAS 123, amounted to a total of $5,466. Such amount is amortized as deferred financing charges over the terms of the loans under the Facility Agreement.

WARRANTS GRANTED IN DECEMBER 2003 - In December 2003, as part of an amendment to the Facility Agreement, the Banks received an aggregate of 896,596 warrants to purchase Ordinary Shares of the Company (448,298 each) at an exercise price of $6.17 per share, the 15 day average closing price of the Company's Ordinary Shares prior to the date the amendment with the Banks was signed. As of December 31, 2005, all of the warrants are fully vested. The warrants are exercisable for a five-year period ending December 2008.

The cost of the warrants issued to the Banks, determined based on the fair value at the grant and amendment dates in accordance with SFAS 123, amounted to a total of $3,946. Such amount is amortized as deferred financing charges over the terms of the loans under the Facility Agreement.

WARRANTS ISSUED IN JULY 2005 - In connection with the July 2005 amendment to the Facility Agreement detailed in Note 11A(6) above, the Company agreed to issue warrants to the Banks exercisable into an aggregate of 8,264,464 ordinary shares of the Company, with an exercise price of $1.21. One-half, or 4,132,232, of the warrants are exercisable for five years ending in August 2010, and one-half, or 4,132,232, of the warrants shall be exercisable for a five-year period commencing on the date on which the Company and its Banks will agree, if at all, upon the rescheduled repayment dates of the new loans of $29,693, as described in Note 11A(6) above.

The cost of the currently exercisable 4,132,232 warrants, determined based on the fair value at the grant date in accordance with SFAS 123, amounted to a total of $2,793. Such amount is amortized as deferred financing charges over the term of the new loans of $29,693.

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

NOTE 13 - SHAREHOLDERS' EQUITY (cont.)

B. SHARE OPTION PLANS (cont.)

(5) NON-EMPLOYEE WARRANTS (cont.)

(A) BANKS (cont.)

In lieu of paying the exercise price in cash, the Banks are entitled to exercise all 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 A RELATED PARTY - In consideration for TIC's undertaking described in Note 11A(6), the Company issued TIC warrants for the purchase of 58,906 of the Company's Ordinary Shares. The exercise price for the warrants is $6.17 per share, the 15-day average closing price of the Company's Ordinary Shares prior to the date the November 2003 amendment with the Banks described in Note 11A(6) was signed. As of December 31, 2005, all of the warrants are fully vested and none of them was exercised. The warrants are exercisable for a five-year period ending December 2008.

The cost of the warrants award granted to TIC, determined based on the fair value at the grant date in accordance with SFAS 123, amounted to a total of $259. Such amount was allocated to other assets as deferred financing charges and is amortized as financing expense over the terms of the loans under the Facility Agreement with the Banks.

(C) WARRANTS ISSUED TO A CANADIAN PENSION FUND - See Note 11A(4).

The Company utilized the Black-Scholes option pricing model to estimate fair values of options and warrants granted to non-employees, utilizing the assumptions similar to those presented in paragraph B(4) above.

(6) PRO FORMA LOSS PER SHARE ACCORDING TO SFAS 123 AND SFAS 148

Had compensation cost for the Company's share option plans been determined based on the fair value at the grant dates for all awards made through December 31, 2005 in accordance with SFAS 123, as amended by SFAS 148, the Company's pro forma loss per share would have been as follows:

For the year ended December 31,

	2005	2004	2003
PRO FORMA LOSS			
Loss for the year, as reported	$(203,082)	$(137,768)	$(114,261)
Less - stock-based compensation determined under APB 25	--	--	27
Add - stock-based compensation determined under SFAS 123	(4,229)	(3,980)	(8,437)
Pro forma loss	$(207,311)	$(141,748)	$(122,671)
BASIC LOSS PER SHARE			
As reported	$ (2.55)	$ (1.79)	$ (2.01)
Pro forma	$ (2.60)	$ (1.84)	$ (2.16)

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 13 - SHAREHOLDERS' EQUITY (cont.)

C. TREASURY STOCK

During 1998, the Board of Directors of the Company authorized, subject to certain conditions, the purchase of up to 1,400,000 Ordinary Shares of the Company to facilitate the exercise of employee stock options under the Company's share option plans. During 1999 and 1998, the Company funded the purchase by a trustee of 142,500 and 1,157,500, respectively, of the Company's Ordinary Shares.

D. DIVIDEND DISTRIBUTIONS

According to the Facility Agreement, as amended (Note 11A(6)), the Company undertook not to distribute any dividends prior to January 1, 2008. Any dividend distributions after that date shall be subject to provisions stipulated in such agreement, mainly the prior approval of the Banks.

E. SALE OF SECURITIES - JANUARY 2002

In January 2002, the Company issued on the Tel Aviv Stock Exchange, Israel NIS 110,579,800 principal amount of convertible debentures, under terms described in Note 9. Together with the convertible debentures the Company issued for no consideration an aggregate of 552,899 options and 2,211,596 Options (Series 1). As of the approval date of the financial statements, all said options were expired and none were exercised.

The total initial proceeds raised were $23,200, and costs related to the issuance of the securities and the prospectus were approximately $1,750. See Note 20F for the presentation and the accounting treatment of the sale of these securities under U.S. GAAP.

F. RIGHTS OFFERING - OCTOBER 2002

In October 2002, the Company issued in connection with a rights offering done on the Nasdaq and on the Tel-Aviv Stock Exchange in Israel 4,097,964 Ordinary Shares of the Company and 1,844,070 warrants, all of which were outstanding as of December 31, 2005, to purchase Ordinary Shares of the Company, in consideration for aggregate gross proceeds of $20,490. Of these amounts, 4,086,037 Ordinary Shares and 1,838,715 warrants were issued to Wafer Partners and Equity Investors in consideration for an aggregate of $20,430. Each warrant may be exercised for the purchase of one Ordinary Share at an exercise price of $7.50 for a period ending on October 31, 2006. Costs in relation to the prospectus and the issuance of the securities were approximately $800.

G. PUBLIC OFFERING - JANUARY 2004

In January 2004, the Company completed a public offering of its Ordinary Shares at a price of $7.00 per share. Following the offering, and including the partial exercise in February 2004 of an over-allotment option the Company granted the underwriters, the Company issued 11,444,500 of its Ordinary Shares, in consideration for gross proceeds of $80,112 (net of related costs - $75,086).

NOTE 13 - SHAREHOLDERS' EQUITY (cont.)

H. RIGHTS OFFERING - DECEMBER 2005

In December 2005, the Company filed in Israel and the U.S. a prospectus for the distribution of transferable rights to purchase up to $50,000 U.S. dollar denominated debentures that are convertible into up to 45,454,545 of the Company's Ordinary Shares. The rights were distributed to the shareholders of record of the Company on December 20, 2005 (the record date), and to certain employees who on the record date held options to purchase the Company's Ordinary Shares under share option plans that entitle the option holders to participate in a rights offering. Each 138.98 Ordinary Shares and/or eligible employee options held on the record date entitled their holder to one right. The rights were exercisable until January 12, 2006. Each right entitled its holder to purchase, at a subscription price of $100.00, 100 U.S. dollar denominated convertible debentures.

In connection with the exercise of the rights, the Company issued 48,169,300 convertible debentures, with each debenture of $1.00 in principal amount, or total of $48,169 principal amount of debentures, which bear annual interest at the rate of 5%. The principal of the debentures, together with accrued interest, is payable in one installment on January 12, 2012.

The debentures are convertible into the Company's Ordinary Shares at a rate of one ordinary share per $1.10 aggregate principal amount of debentures. The conversion price is subject to downward adjustment

under certain circumstances in which the Company sells securities in future financings at a price per share which is lower than the conversion price, provided that such financings close through December 2006 (or under certain conditions, through June 2007).

Subject to the Facility Agreement, the Company may at its option announce the early redemption of the debentures, provided that the outstanding aggregate balance of principal on account of the debentures is equal to or less than $500.

The debentures are listed and quoted on the NASDAQ Capital Market and the Tel Aviv Stock Exchange.

Certain of the Company's Equity Investors and Wafer Partners invested $27,811 in the framework of the rights offering.

The debentures and interest thereon are unsecured and rank behind the Company's existing and future secured indebtedness, including indebtedness to the Banks under the Facility Agreement, as well as to the government of Israel in connection with grants the Company received under its approved enterprise programs and to Siliconix.

If on the payment date of the principal and interest on the debentures, there exists an infringement of certain covenants and conditions under the Facility Agreement, the date for payment of the interest and principal on the debentures may be postponed, depending on various scenarios under the Facility Agreement until such covenant or condition is settled. See Note 20G for the presentation of the rights offering in accordance with U.S. GAAP.

NOTE 14 - INFORMATION ON GEOGRAPHIC AREAS AND MAJOR CUSTOMERS

A. REVENUES BY GEOGRAPHIC AREA (as percentage of total sales)

	Year ended December 31,		
	2005	2004	2003
United States	64%	60%	73%
Israel	7	20	2
Asia Pacific - in 2005 and 2004 - primarily Taiwan; in 2003 - only Taiwan	20	11	10
Europe	9	9	15
Total	100%	100%	100%

B. LONG-LIVED ASSETS BY GEOGRAPHIC AREA - Substantially all of the Company's long-lived assets are located in Israel.

C. MAJOR CUSTOMERS (as percentage of total sales)

	Year ended December 31,		
	2005	2004	2003
Customer A	22%	24%	20%
Customer B	14	5	1
Customer C	2	17	1
Customer D	4	8	24
Customer E	3	6	11
Other customers (*)	27	17	20

(*) Represent sales to six different customers each of whom accounted for between 1% and 8% of sales during 2005; to four customers (1% -8%) of sales during 2004; and to six customers (0%-9%) during 2003.

As of December 31, 2005 and 2004, the above major customers constituted the majority of the trade accounts receivable reflected on the balance sheets.

NOTE 15 - FINANCING EXPENSES, NET

Financing expenses, net consist of the following:

	Year ended December 31,		
	2005	2004	2003
Financial expenses (primarily bank loan interest)	$(35,595)	$(29,709)	$(16,073)
Interest expenses in relation to convertible debentures	(1,249)	(1,233)	(1,198)
Less capitalized interest - Note 5A(3)	--	--	6,892
	(36,844)	(30,942)	(10,379)
Financing income (primarily bank deposit interest)	1,193	1,197	553
Financing expense, net	$(35,651)	$(29,745)	$ (9,826)

NOTE 16 - OTHER INCOME

In December 2004, the Company entered into a definitive agreement to sell all of its holdings in Saifun Semiconductors Ltd. ("Saifun"), an Israeli company which designs and develops memory designs, to a U.S. based private equity investor in consideration for $38,677. In December 2004, shareholders of Saifun exercised their right of first refusal, and accordingly purchased the shares from the Company for said amount. The net gain from the sale of Saifun's shares amounted to $32,377.

NOTE 17 - INCOME TAXES

A. APPROVED ENTERPRISE STATUS

Substantially all of the Company's existing facilities as of December 31, 2005 have been granted approved enterprise status, as provided by the Israeli Law for the Encouragement of Capital Investments - 1959 ("Investments Law") (see Note 5B).

The tax benefits derived from approved enterprise status relate only to taxable income attributable to each approved enterprise investments programs. Pursuant to the Investments Law and the approval certificates, the Company's income attributable to its various approved enterprise investments is taxed at a rate of up to 25% through 2012. Taxable income attributable to Fab 2 approved program shall be tax-exempt for the first two years it arises. The portion of the Company's taxable income that is not attributable to approved enterprise investments is taxed at a rate of 34% in 2005 (regular "Company Tax"). The regular Company Tax rate is to be gradually reduced to 25% until 2010.

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 the Company to comply with these conditions, the tax benefits could be canceled, in whole or in part, and the Company would be required to refund the amount of the canceled benefits, plus interest and certain inflation adjustments. In management's opinion, the Company has been in compliance with the conditions through the approval date of the financial statements. See also Notes 5B and 11A(8).

NOTE 17 - INCOME TAXES (cont.)

B. 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,	
	2005	2004
DEFERRED TAX BENEFIT - CURRENT		
Accrued vacation pay	$ 464	$ 702
Other	109	68
	573	770
Valuation allowance	(573)	(770)
Total current deferred tax benefit	$ --	$ --

NET DEFERRED TAX BENEFIT - LONG-TERM		
Deferred tax assets -		
Net operating loss carryforwards	$ 165,000	$ 112,147
Research and development	2,427	3,213
Liability for employee rights upon severance	957	918
	168,384	116,278
Valuation allowance	(118,321)	(75,613)
	50,063	40,665
Deferred tax liability - depreciation and amortization	(50,063)	(40,665)
Total net long-term deferred tax benefit	$ --	$ --

C. EFFECTIVE INCOME TAX RATES

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

	Year ended December 31,		
	2005	2004	2003
Israeli statutory rate	(34)%	(35)%	(36)%
Reduced tax rate for approved enterprise	14	15	16
Tax benefits for which deferred taxes were not recorded	21	23	23
Permanent differences and other, net	(1)	(3)	(3)
	--%	--%	--%

D. NET OPERATING LOSS CARRYFORWARD

As of December 31, 2005, the Company had net operating loss carryforwards for tax purposes of approximately $825,000, which may be carried forward for an unlimited period of time.

E. FINAL TAX ASSESSMENTS

The Company possesses final tax assessments under agreement through the year 1998. In addition, the tax assessments for the years 1999-2001 are deemed final.

NOTE 18 - FINANCIAL INSTRUMENTS

A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that imposes on one entity a contractual obligation either to deliver or receive cash or another

financial instrument to or from a second entity. Examples of financial instruments include cash and cash equivalents, trade accounts receivable, loans, investments, trade accounts payable, accrued expenses, options and forward contracts.

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.

See Note 20D for disclosure related to the Company's derivatives financial instruments in accordance with U.S. GAAP.

A. HEDGING ACTIVITIES

The Company, from time to time, enters into foreign currency derivatives to hedge its foreign currency exposure to equipment purchase commitments and other firm commitments denominated in foreign currency (primarily Japanese Yen and Euro). In that regard, the Company generally uses foreign currency forward contracts and options (zero-cost cylinder) as hedging instruments for foreign currency exposure. Accordingly, if the hedge is determined to be effective all changes in value attributed to spot rate fluctuations as well as the premium of forward contracts and the time value of options at inception are deferred until the hedged item is recognized (i.e., receipt of the equipment). The time value of options at inception is amortized on a straight-line basis.

In addition, the Company, from time to time, enters into agreements to hedge variable interest rate exposure on long-term loans (see Note 8). In order to hedge the cash flow related to this exposure, the Company uses various types of derivative contracts, consisting primarily of interest rate caps, floors and collars. If the hedge is determined to be effective, the changes in the intrinsic value of the derivative contracts are deferred and recognized in results of operations as interest payments become due. The time value of options at inception is recognized in the results of operations on a straight-line basis. When the related debt is issued in connection with the acquisition of assets not yet placed into operations, interest costs and gains and losses on the derivative contracts are capitalized to the related asset.

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

NOTE 18 - FINANCIAL INSTRUMENTS (cont.)

B. CREDIT RISK OF FINANCIAL INSTRUMENTS, INCLUDING DERIVATIVES

The face or contract amounts of derivatives do not represent amounts exchanged by the parties and, accordingly, are not a measure of the

exposure of the Company through its use of derivatives.

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. In management's estimation, due to the fact that derivative financial instrument transactions are entered into solely with financial institution counterparties, it is not expected that such counterparties will fail to meet their obligations. Substantially all remaining financial instruments held by the Company are due from governmental entities and, accordingly, the Company's credit risk in respect thereof is negligible.

C. PRESENTATION OF HEDGING ACTIVITIES IN THE FINANCIAL STATEMENTS

(1) As of December 31, 2005 and 2004, there were no outstanding foreign exchange agreements (options) to hedge exposure related to the purchase of machinery and equipment. During 2005, the Company did not enter into foreign exchange agreements (options) and accordingly there were no results of such agreements during that year. The loss resulted from these agreements in 2004 was immaterial. The agreements resulted in 2003 in a gain of $2,357 of which $1,663 was capitalized to fixed assets.

(2) As of December 31, 2005 and 2004, the Company had outstanding agreements to hedge interest rate exposure on loans drawn down under the Facility Agreement, the aggregate amount of which was $292,000, all of which is attributable to Fab 2. These agreements resulted in 2005 and 2004 in a loss of $1,756 and $5,629, respectively, and in 2003 in a loss of $5,335, out of which $2,547 was capitalized to property and equipment.

D. FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair values of the Company's financial instruments, excluding the Company's agreements to hedge interest rate exposure on long-term loans, did not materially differ from their respective carrying amounts as of December 31, 2005 and 2004. The fair value of the interest rate hedging transactions as of December 31, 2005 would have resulted in an unrealized capitalizable gain of $1,767 (as of December 31, 2004 - an unrealized capitalizable loss of $2,406).

NOTE 19 - RELATED PARTIES BALANCES AND TRANSACTIONS

A. BALANCES

	As of December 31,	
	2005	2004
Trade accounts receivable	$ 5,309	$ 9,054

Current liabilities	$ 188	$ 12
Convertible debenture	$25,493	$ --
Long-term liability in respect of customers' advances	$37,785	$40,514
Other long-term liabilities	$ 1,102	$ 166

B. TRANSACTIONS

	Year ended December 31,		
	2005	2004	2003
Sales	$ 33,456	$ 37,521	$13,282
Management fees	$ 120	$ 120	$ 240
Expenses paid	$ 47	$ 60	$ 99
Royalties received - Note 11E(2)	$ --	$ 875	$ 225
Application of customer advances towards purchases	$ --	$ 445	$ 870
Equity conversion of customer advances - Note 11A(5)	$ 1,794	$ 539	$ --
Expense reimbursements received	$ --	$ --	$ 282
Conversion of customer advances into Long-term loans - Note 11A(5)	$ 936	$ 166	$ --

C. For commitments, contingencies and other transactions relating to Fab 2 Wafer Partner and Equity Investor agreements - see Note 11A.

NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP

With regard to the Company's financial statements, the material differences between GAAP in Israel and in the U.S. relate to the following. See H below for the presentation of the Company's balance sheets as of December 31, 2005 and 2004 in accordance with U.S. GAAP.

A. RECENT ACCOUNTING PRONOUNCEMENTS BY THE FASB

(1) SFAS NO. 151 - INVENTORY COSTS, AN AMENDMENT OF ARB NO. 43, CHAPTER 4 - In November 2004, the FASB issued SFAS No. 151, "INVENTORY COSTS, AN AMENDMENT OF ARB NO. 43, CHAPTER 4". SFAS No. 151 amends the guidance in ARB 43, Chapter 4, "Inventory Pricing", which provides guidance on the allocation of certain

costs to inventory. SFAS 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this statement are effective for inventory costs incurred during fiscal years beginning after June 2005. The provisions of this statement shall be applied prospectively. This Standard is not expected to have a material effect on the Company's financial position or results of operations.

(2) SFAS NO. 123 (REVISED 2004) "SHARE BASED PAYMENTS" - In December 2004, the FASB issued SFAS No. 123 (revised 2004) "SHARE BASED PAYMENTS" ("SFAS 123(R)"). This Statement is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation", which supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees" and its authoritative interpretations.

SFAS 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services; focuses primarily on accounting for transactions in which an entity obtains employee and directors services in share-based payment transactions; and does not change the accounting guidance for share-based payment transactions with parties other than employees.

SFAS 123(R) eliminates the alternative to use APB 25's intrinsic value method of accounting that was provided in SFAS 123 as originally issued and requires to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The fair-value-based method in this Statement is similar to the fair-value-based method in SFAS 123 in most respects. The costs associated with the awards will be recognized over the period during which an employee is required to provide service in exchange for the award - the requisite service period (usually the vesting period).

The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments (unless observable market prices for the same or similar instruments are available). If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

A. RECENT ACCOUNTING PRONOUNCEMENTS BY THE FASB (cont.)

(2) SFAS NO. 123 (REVISED 2004) "SHARE BASED PAYMENTS" (cont.)

In The provisions of SFAS 123(R) apply to all awards to be granted by the Company on or after January 1, 2006 and to awards modified, repurchased, or cancelled after that date. When initially applying the provisions of SFAS 123(R), in the first quarter of 2006, the Company will be required to elect between using either the "modified prospective method" or the "modified retrospective method". Under the modified prospective method, the Company is required to recognize compensation cost for all awards granted after the adoption of SFAS 123(R) and for the unvested portion of previously granted awards that are outstanding on that date. Under the modified retrospective method, the Company is required to restate its previously issued financial statements to recognize the amounts previously calculated and reported on a pro forma basis, as if the original provisions of SFAS 123(R) had been adopted. Under both methods, it is permitted to use either a straight line or an accelerated method to amortize the cost as an expense for awards with graded vesting.

Management has commenced identifying the potential future impact of applying the provisions of SFAS 123(R), including each of its proposed transition methods. Based on the outstanding options as of December 31, 2005, the total compensation to be amortized in the years 2006-2009 is expected to be approximately $4,200.

(3) SFAS 153, EXCHANGE OF NON-MONETARY ASSETS - In December 2004, the FASB issued SFAS No. 153, "EXCHANGES OF NONMONETARY ASSETS AN AMENDMENT OF APB NO. 29". This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Statement specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This Statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Retroactive application is not permitted. The adoption of this Standard does not affect the Company's financial position or results of operations.

(4) SFAS NO. 154, ACCOUNTING CHANGES AND ERROR CORRECTIONS - This Statement, published in May 2005, replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principles. This Statement applies to all voluntary changes in accounting principles, and to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions.

NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

A. RECENT ACCOUNTING PRONOUNCEMENTS BY THE FASB (cont.)

(4) SFAS NO. 154, ACCOUNTING CHANGES AND ERROR CORRECTIONS (cont.)

Opinion 20 previously required that most voluntary changes in accounting principles be recognized by including the cumulative effect of changing to the new accounting principles in the net income of the period of the change. This Statement requires retrospective application to prior periods' financial statements of changes in accounting principles, unless it is impracticable to determine the specific effects or the cumulative effect of the change. The Statement also provides guidance for cases in which it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, and/or for cases in which it is impracticable to determine the cumulative effect of applying a change in accounting principles to all prior periods.

This Statement defines RETROSPECTIVE APPLICATION as (i) the application of a different accounting principle to prior accounting periods as if that principle had always been used, or (ii) as the adjustment of previously issued financial statements to reflect a change in the reporting entity. This Statement also redefines RESTATEMENT as the revisiting of previously issued financial statements to reflect the correction of an error.

This Statement also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets, be accounted for as a change in accounting estimate effected by a change in accounting principles. This Statement carries forward without change the guidance in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. This Statement also carries forward the guidance in Opinion 20 requiring justification of a change in accounting principles on the basis of preferability.

The provisions of this Statement are effective for accounting changes and corrections of errors made during fiscal years beginning after December 15, 2005. The adoption of this Standard is not expected to have a material effect on the Company's financial position or results of operations.

B. PRESENTATION OF DESIGNATED CASH AND SHORT-TERM AND LONG-TERM INTEREST-BEARING DEPOSITS

In accordance with U.S. GAAP, the Company's designated cash, short-term and long-term interest-bearing deposits should be excluded from current assets and long-term investments and presented separately as a non-current asset. Accordingly, as of December 31, 2005, $31,661 was reclassified from current assets to a long-term asset (as of December 31, 2004, $53,793 and $5,134 were reclassified, respectively, from current assets and long-term investments to a long-term asset).

C. PRESENTATION OF NET LONG-TERM LIABILITIES IN RESPECT OF EMPLOYEES

Under U.S. GAAP, assets and liabilities relating to severance arrangements are to be presented separately and are not to be offset, while according to Israeli GAAP such an offset is required. Accordingly, as of December 31, 2005 an amount of $13,658 was

reclassified from other long-term liabilities to long-term investments (as of December 31, 2004 - $16,350).

NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

D. HEDGING ACTIVITIES IN ACCORDANCE WITH U.S. GAAP (SFAS 133)

(1) In 2001, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" and the related statements and interpretations thereon (collectively, "SFAS 133"). 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.

SFAS 133 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 or to other comprehensive income, as appropriate in the circumstances. The Company's derivatives consist mainly of foreign currency forward transactions and options and interest rate instruments (collars).

(2) The Company uses foreign exchange agreements (forward contracts and options) to hedge its foreign currency exposure in anticipated equipment purchases denominated in foreign currency. All foreign exchange agreements are with underlying terms that match or approximate the hedged transactions and thus are highly effective. The Company measures the effectiveness of the forward contracts hedges based on forward rates. The Company assesses and measures the effectiveness of the options hedge, at inception and throughout the hedge, based on total changes in cash flows. All changes in fair value are reported in other comprehensive income. The amounts accumulated in other comprehensive income are expensed to results of operations concurrent with the recognition of depreciation expenses on the equipment. As of December 31, 2005 and 2004, the Company had no outstanding foreign exchange agreements.

The Company uses interest rate collars with a 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 Company determined that the probability that the cap will be knocked-out is remote and thus expected that the hedge will be highly effective. The Company assessed and measured the effectiveness of the hedge, at inception and throughout the hedge, based on total changes in cash flows of the collar, and reported all changes in fair value in other comprehensive income. Amounts presented in other comprehensive income are reclassified to operations or capitalized to property and equipment, as

applicable (see Note 2L), as interest payment become due. For outstanding contracts as of December 31, 2005 and 2004, see Note 18C(2).

(3) Following the commencement of operations of Fab 2 during the third quarter of 2003, $6,641 of the aggregate comprehensive loss as of June 30, 2003, which is attributable to property and equipment, is amortized on a straight-line method over five years, in correspondence to the economic useful lives of the machinery and equipment.

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

D. HEDGING ACTIVITIES IN ACCORDANCE WITH U.S. GAAP (SFAS 133) (cont.)

(4) Complying with SFAS 133 with respect to the Company's hedging transactions as of December 31, 2005 would have resulted in: an increase in other long-term investments in the amount of $1,767; a decrease (for U.S. GAAP purposes only) in other comprehensive loss for the year ended December 31, 2005 in the net amount of $5,501; an accumulated other comprehensive loss component of equity balance as of such date in the amount of $1,554; and in a decrease of $3,291 in property and equipment, net as of December 31, 2005.

E. IMPLEMENTATION OF SFAS 123 AND SFAS 148

Had compensation cost for the Company's share option plans been determined based on fair value at the grant dates for awards made through December 31, 2005 in accordance with SFAS 123, as amended by SFAS 148, the Company's pro forma loss and loss per share would have been as follows (for further information with regard to the Company's share option plans and the assumptions for utilizing the Black-Scholes pricing model, see Note 13B(4)):

	Year ended December 31,		
	2005	2004	2003
PRO FORMA LOSS			
Loss for the year, as reported according to U.S. GAAP (see I below)	$(203,082)	$(137,768)	$(114,261)
Less - stock-based compensation determined under APB 25	--	--	27
Add - stock-based compensation determined under SFAS 123	(4,229)	(3,980)	(8,437)
Pro forma loss	$(207,311)	$(141,748)	$(122,671)

BASIC LOSS PER SHARE			
As reported according to U.S. GAAP (see K below)	$ (3.06)	$ (2.13)	$ (2.45)
Pro forma	$ (3.12)	$ (2.19)	$ (2.63)

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NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

F. SALE OF SECURITIES

Under Accounting Principles Board Opinion No. 14 ("APB 14"), the proceeds from the sale of the securities described in Note 9 are to be allocated to each of the securities issued based on their relative fair value, while according to Israeli GAAP such treatment is not required. Complying with APB 14, based on the average market value of each of the securities issued in the first three days following their issuance, would have resulted in an increase in shareholders' equity as of December 31, 2005 and 2004 in the amount of $2,363 (net of $196 related issuance expenses), and a decrease in convertible debentures as of such dates in the amount of $2,559. The effect of amortization of the discount on the convertible debentures under U.S. GAAP for each of the years ended December 31, 2005, 2004 and 2003 would have been immaterial.

G. CONVERTIBLE DEBENTURES

Under U.S. GAAP (SFAS No. 133), an embedded conversion option should be bifurcated and accounted for separately as a derivative instrument, unless the specific requirements for equity classification of the embedded conversion option, as stated in EITF 00-19, are met. EITF 00-19 provides that an equity classification is appropriate if the settlement criteria set forth therein for such classification are met and that the additional conditions necessary for equity classification, set forth therein, are also met. EITF 00-19 also allows for the equity classification of the embedded conversion option in case the necessary additional conditions are not met, only if the contract is a conventional convertible debt instrument. In accordance with EITFs 00-19 and 05-2, a conventional convertible debt instrument is an instrument that provides the holder with an option to convert into a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer), and the ability to exercise that option is based on the passage of time or a contingent event. Convertible debt is not considered conventional when the number of shares the holder converts into is not fixed and can vary based on a contingent future event (other than "standard" antidilution provisions).

As detailed in Note 13H, the conversion price of the convertible debenture issued by the Company in December 2005 is subject to downward adjustment under certain circumstances; i.e. the number of shares to be issued is not fixed. In addition, the criteria set forth

in EITF 00-19 for classification as equity are not met. Accordingly, for purposes of U.S. GAAP, these convertible debentures are to be accounted for under SFAS No. 133 and to be bifurcated with the embedded conversion option treated as a liability.

Under Israeli GAAP, convertible debentures the future conversion of which is probable as of the balance-sheet date, are presented as a separate line-item between total liabilities and shareholders equity, while according to U.S. GAAP such presentation is not allowed as detailed above.

Accordingly, as of December 31, 2005 an amount of $25,493 was reclassified from that separate line-item to convertible debentures (under total long-term liabilities).

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NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

H. Balance Sheets in Accordance with U.S. GAAP

		AS OF DECEMBER	
	U.S. GAAP REMARK	AS PER ISRAELI GAAP	ADJUST MENTS
A S S E T S			
CURRENT ASSETS			
CASH AND CASH EQUIVALENTS		$ 7,337	$
DESIGNATED CASH AND SHORT-TERM INTEREST-BEARING DEPOSITS	B	31,661	(31,66
TRADE ACCOUNTS RECEIVABLE:			
RELATED PARTIES		5,309	
OTHERS		11,467	
OTHER RECEIVABLES		9,043	
INVENTORIES		24,376	
OTHER CURRENT ASSETS		1,048	
TOTAL CURRENT ASSETS		90,241	(31,66
LONG-TERM INVESTMENTS			
LONG-TERM INTEREST-BEARING DEPOSITS DESIGNATED FOR FAB 2 OPERATIONS	B	--	
OTHER LONG-TERM INVESTMENT	C, D	--	15,42
		--	15,42
PROPERTY AND EQUIPMENT, NET	D	510,645	(3,29

DESIGNATED CASH AND SHORT-TERM AND LONG-TERM INTEREST-BEARING DEPOSITS	B	--	31,66
OTHER ASSETS, NET:			
TECHNOLOGY		61,441	
OTHER	F	16,359	(19
		77,800	(19
TOTAL ASSETS		$ 678,686	$ 11,93
LIABILITIES AND SHAREHOLDERS' EQUITY		0	
CURRENT LIABILITIES			
CURRENT MATURITIES OF LONG-TERM DEBT		$ 21,103	$
CURRENT MATURITIES OF CONVERTIBLE DEBENTURES	F	6,453	(64
TRADE ACCOUNTS PAYABLE		59,741	
OTHER CURRENT LIABILITIES		8,972	
TOTAL CURRENT LIABILITIES		96,269	(64
LONG-TERM DEBT		497,000	
CONVERTIBLE DEBENTURES	F, G	19,358	23,57
LONG-TERM LIABILITY IN RESPECT OF CUSTOMERS' ADVANCES		59,621	
OTHER LONG-TERM LIABILITIES	C, D	11,012	13,65
TOTAL LIABILITIES		683,260	36,59
CONVERTIBLE DEBENTURES	G	25,493	(25,49
SHAREHOLDERS' EQUITY (DEFICIT)			
ORDINARY SHARES, NIS 1.00 PAR VALUE - AUTHORIZED 500,000,000 AND 250,000,000 SHARES, RESPECTIVELY; ISSUED 68,232,056 AND 66,999,796 SHARES, RESPECTIVELY		16,548	
ADDITIONAL PAID-IN CAPITAL	F	522,237	2,36
SHAREHOLDER RECEIVABLES		(26)	
ACCUMULATED OTHER COMPREHENSIVE LOSS	D	--	(1,55
ACCUMULATED DEFICIT		(559,754)	3
		(20,995)	83
TREASURY STOCK, AT COST - 1,300,000 SHARES		(9,072)	
TOTAL SHAREHOLDERS' EQUITY (DEFICIT)		(30,067)	83
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY		$ 678,686	$ 11,93

TOWER SEMICONDUCTOR LTD. AND SUBSIDIARY
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NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

I. STATEMENTS OF OPERATIONS IN ACCORDANCE WITH U.S. GAAP

Complying with SFAS 133 and SFAS 138 (D above) and APB 14 (F above) would not have materially affected the results of operations for the years ended December 31, 2005, 2004 and 2003.

J. COMPREHENSIVE INCOME (LOSS) IN ACCORDANCE WITH U.S. GAAP (SFAS 130)

Comprehensive income (loss) represents the change in shareholder's 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 under U.S. GAAP are included in comprehensive income but excluded from net income. Following are statements of comprehensive loss in accordance with U.S. GAAP:

	Year ended December 31,		
	2005	2004	2003
Loss for the year according to U.S. GAAP	$(203,082)	$(137,768)	$(114,261)
Other comprehensive loss:			
Amortization of unrealized losses on derivatives	1,328	1,328	664
Unrealized gains on derivatives	4,173	7,514	1,276
Net comprehensive loss for the year	$(197,581)	$(128,926)	$(112,321)

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NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

K. LOSS PER SHARE DATA IN ACCORDANCE WITH U.S. GAAP (SFAS 128)

In accordance with U.S. GAAP (SFAS 128, including the implementation of SFAS 133 and SFAS 138, and APB 14 as described above), the basic and diluted loss per share would be:

	Year ended December 31,		
	2005	2004	2003
Basic loss per share	$(3.06)	$(2.13)	$(2.45)

Diluted loss per share	$(3.06)	$(2.13)	$(2.45)
	======	======	======

For the purpose of U.S. GAAP, the beneficial feature attributed to the rights offering that retroactively adjusted loss per share under Israeli GAAP, as described in Note 12C, was eliminated since such accounting treatment is not allowed by U.S. GAAP.

The following tables provide a reconciliation of the numerators and denominators of the basic and diluted per share computations for 2005, 2004 and 2003 in accordance with U.S. GAAP. The loss per share for each year presented according to U.S. GAAP may differ from the corresponding amount under Israeli GAAP due to different methods for determining the weighted average number of ordinary shares outstanding and the loss used to compute loss per share. According to Israeli GAAP, the weighted average number of ordinary shares outstanding for each year presented include retroactive effect from the beginning of each year of shares issued upon exercise of share options and warrants ("Exercise") and upon conversion of convertible debentures ("Conversion"), outstanding at the beginning of each year and giving effect to shares issuable from probable Exercise and from probable Conversion. Israeli GAAP further provide that loss per ordinary share is to be calculated based on loss for the year with the inclusion of imputed interest income on the exercise price of options and warrants exercised or of probable Exercise, and of financial expenses in relation to converted debentures or on probable Conversion. According to U.S. GAAP, the amount of shares underlying the options and warrants is accounted for according to the treasury method, regardless of the probability of the exercise of the options and warrants, and the amount of shares underlying convertible debentures is accounted for by application of the if-converted method. According to Israeli GAAP, the loss to compute basic loss per share should include imputed interest income on the exercise price of options and warrants exercised during the year and of probable Exercise and probable Conversion, an inclusion which is not allowed under U.S. GAAP.

NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

K. LOSS PER SHARE DATA IN ACCORDANCE WITH U.S. GAAP (SFAS 128) (cont.)

RECONCILIATION FOR 2005:

	Year ended December 31, 2005		
	Loss (numerator)	Shares (in thousands) (denominator)	Per-share amount
BASIC LOSS PER SHARE			
Loss available to ordinary shareholders	$(203,082)	66,371	$(3.06)
			======

EFFECT OF DILUTIVE SECURITIES			
Convertible debentures	-	-	
Options and warrants	-	-	
DILUTED LOSS PER SHARE			
Loss available to ordinary shareholders after assumed conversions	$(203,082)	66,371	$(3.06)

Options and warrants to purchase 28,437,207 Ordinary Shares at an average exercise price of $4.23 per share were outstanding as of December 31, 2005 but were not included in the computation of diluted loss per share because their effect was anti-dilutive. The options and warrants, which as of December 31, 2005 expire between January 2006 and November 2015 (weighted average remaining contractual life of 5.02 years), were still outstanding as of such date. Convertible debentures, convertible into 25,872,523 Ordinary Shares, were outstanding as of December 31, 2005 but were not included in the computation of diluted loss per share since their effect is anti-dilutive. Of that amount, 2,697,068 convertible debentures may be converted into Ordinary Shares until December 31, 2008, and the remaining 23,175,455 convertible debentures may be converted into Ordinary Shares until December 2011.

RECONCILIATION FOR 2004:

	Year ended December 31, 2004		
	Loss (numerator)	Shares (in thousands) (denominator)	Per-share amount
BASIC LOSS PER SHARE			
Loss available to ordinary shareholders	$(137,768)	64,633	$(2.13)
EFFECT OF DILUTIVE SECURITIES			
Convertible debentures	--	--	
Options and warrants	--	--	
DILUTED LOSS PER SHARE			
Loss available to ordinary shareholders after assumed conversions	$(137,768)	64,633	$(2.13)

Options and warrants to purchase 17,374,088 Ordinary Shares at an average exercise price of $6.61 per share were outstanding as of December 31, 2004 but were not included in the computation of diluted loss per share because their effect was anti-dilutive. The options and warrants, which as of December 31, 2004 expire between January 2005 and December 2014 (weighted average remaining contractual life of 5.26 years), were still outstanding as of such date. Convertible debentures, convertible into 2,697,068 Ordinary Shares, were outstanding as of December 31, 2004 but were not included in the computation of diluted loss per share since their effect is anti-dilutive. The convertible debentures may be converted until December 31, 2008 into Ordinary Shares.

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NOTE 20 - MATERIAL DIFFERENCES BETWEEN ISRAEL AND U.S. GAAP (cont.)

K. LOSS PER SHARE DATA IN ACCORDANCE WITH U.S. GAAP (SFAS 128) (cont.)

RECONCILIATION FOR 2003:

	Year ended December 31, 2003		
	Loss (numerator)	Shares (in thousands) (denominator)	Per-share amount
BASIC LOSS PER SHARE			
Loss available to ordinary shareholders	$(114,261)	46,710	$(2.45)
EFFECT OF DILUTIVE SECURITIES			
Convertible debentures	--	--	
Options and warrants	--	--	
DILUTED LOSS PER SHARE			
Loss available to ordinary shareholders after assumed conversions	$(114,261)	46,710	$(2.45)

Options and warrants to purchase 14,003,621 Ordinary Shares at an average exercise price of $7.87 per share were outstanding as of December 31, 2003 but were not included in the computation of diluted loss per share because their effect was anti-dilutive. The options and warrants, which as of December 31, 2003 expire between April 2005 and December 2013 (weighted average remaining contractual life of 5.02 years), were still outstanding as of such date. Convertible debentures, convertible into 2,697,068 Ordinary Shares, were outstanding as of December 31, 2003 but were not included in the computation of diluted loss per share since their effect is anti-dilutive. The convertible debentures may be converted until December 31, 2008 into Ordinary Shares.

L. STATEMENTS OF CASH FLOWS IN ACCORDANCE WITH U.S. GAAP (SFAS 95)

Complying with SFAS 95 would not have materially affected the cash flows of the Company for each of the years ended December 31, 2005, 2004 and 2003.

SIGNATURES

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all the requirements for filing on Form 20-F and has duly caused this Annual Report to be signed on its behalf by the undersigned, thereunto duly authorized on this 13 day of July, 2006.

TOWER SEMICONDUCTOR LTD.

BY: /s/ Russell C. Ellwanger

Russell C. Ellwanger
Chief Executive Officer