

Management's Discussion and Analysis of Financial Condition and Results of Operations

This discussion and analysis contains forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995, and we intend that such forward-looking statements be subject to the safe harbors created thereby. Forward-looking statements are statements other than historical information or statements of current condition. Words such as may, will, expect, believe, anticipate, intend, could, estimate, continue, or the negative or comparable terminology are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events and circumstances are considered forward-looking statements. They are not guarantees of future performance and involve risks and uncertainties. Actual results may differ materially from those in forward-looking statements due to various factors including our ability to successfully integrate our acquired and to-be-acquired businesses; fluctuating exchange rates; consolidation in the global telecommunications test, measurement and service assurance industry and increased competition among vendors; capital spending levels in the telecommunications industry; concentration of sales; the effects of the additional actions we have taken in response to economic uncertainty (including our ability to quickly adapt cost structures with anticipated levels of business, ability to manage inventory levels with market demand); market acceptance of our new products and other upcoming products; limited visibility with regards to customer orders and the timing of such orders; our ability to successfully expand international operations; the retention of key technical and management personnel; and future economic, competitive, financial and market condition. Assumptions relating to the foregoing involve judgments and risks, all of which are difficult or impossible to predict and many of which are beyond our control. Other risk factors that may affect our future performance and operations are detailed in our Annual Report, on Form 20-F, and our other filings with the U.S. Securities and Exchange Commission and the Canadian securities commissions. We believe that the expectations reflected in the forward-looking statements are reasonable based on information currently available to us, but we cannot assure you that the expectations will prove to have been correct. Accordingly, you should not place undue reliance on these forward-looking statements. These statements speak only as of the date of this document. Unless required by law or applicable regulations, we undertake no obligation to revise or update any of them to reflect events or circumstances that occur after the date of this document.

The following discussion and analysis of the consolidated financial condition and results of operations is dated November 5, 2010.

All dollar amounts are expressed in US dollars, except as otherwise noted.

INDUSTRY OVERVIEW

The fundamental drivers toward broadband deployments and fixed-mobile IP (Internet protocol) network convergence are firmly entrenched in the global telecommunications industry despite a slow recovery in the general economic environment. Although network operators are not significantly increasing capital expenditures in calendar 2010, they are spending more in select, high-growth areas to accommodate bandwidth-intensive broadband applications and to facilitate the migration to more flexible and cost-effective fixed and mobile IP networks.

According to Cisco's updated Visual Networking Index, global IP traffic will quadruple from 2009 to 2014, reaching almost 64 exabytes per month in 2014. (An exabyte is equal to 1 billion gigabytes or 250 million DVDs). Global mobile traffic, a subset of this larger group, is expected to increase 39-fold during the same period. Bandwidth demand is driven by a wide range of applications including various forms of IP video, peer-to-peer file sharing, social networking, Internet gaming as well as increased penetration of media-rich smartphones and notebooks.

To support such explosive bandwidth growth, wireline networks are being transformed into next-generation IP-based infrastructures. Legacy SONET/SDH networks, which were established in the mid-1980s, do not have the flexibility to seamlessly mix and transport voice, data and video services. Such networks are not capable of efficiently carrying triple-play services because they were designed for point-to-point voice communication. As a result, new optical transport network (OTN) standards, which are at the very heart of what the industry is labeling next-generation IP networks, have been defined to carry IP applications over Ethernet. Network operators are increasingly turning to such next-generation, IP-based networks in order to offer customers higher-margin triple-play services while lowering their operating costs.

Fiber-to-the-home (FTTH) has also become the access network architecture of choice for wireline operators wishing to provide a superior user experience for a combined voice, data and video offering. This architecture allows operators to meet heightened bandwidth requirements and future-proof their access networks as residential bandwidth demands grow from 1 to 5 Mbit/s (megabits per second) to 30 to 100 Mbit/s required for the long term. Hybrid architectures, combining copper and fiber (fiber-to-the-curb, or FTTC, and fiber-to-the-node, or FTTN), will also increase in the short term, since they are less expensive methods to increase bandwidth and can be mass-deployed quickly.

As bandwidth growth in access networks continues to increase, it has begun placing a strain on metro rings and core networks. It is also driving the need for higher-speed technologies. For example, 43 Gbit/s (gigabits per second) SONET/SDH is becoming mainstream, while a few network operators have already begun 100 Gbit/s Ethernet field trials. In the long run, these solutions will offer a more economical way to add capacity to saturated network links, especially if trenches need to be dug in order to deploy new fiber in metro and long-distance routes.

On the wireless side, operators are also faced with major investments in upcoming years to meet soaring bandwidth demand. Wireless operators are accelerating deployments of 3G networks, fast-tracking 4G/LTE (long-term evolution) adoption, and investing in mobile backhaul networks in order to increase transmission rates for bandwidth-hungry consumers to approach wireline speeds. Furthermore, as these consumers expect wireline and wireless networks to transport any content to any device at any time, both fixed and mobile networks are converging to a common IP-based infrastructure supported by IMS (IP multimedia subsystem) for seamless network interoperability.

These market dynamics affected telecom test and service assurance suppliers in fiscal 2010.

COMPANY OVERVIEW

We are a leading provider of test and service assurance solutions for wireless and wireline network operators and network equipment manufacturers in the global telecommunications industry. We offer core-to-edge solutions to assess the performance and reliability of converged IP (Internet protocol) fixed and mobile networks. Our products are sold in approximately 100 countries around the world.

We were founded in 1985 in Quebec City, Canada. Our original products were focused on the needs of installers and operators of fiber-optic networks. Customers use these field-portable testing products for the installation, maintenance, monitoring and troubleshooting of optical networks. In 1996, we supplemented our product portfolio with an extensive line of high-end products that are mainly dedicated to research and development as well as manufacturing activities of optical component manufacturers and system vendors. Over the past several years, we have enhanced our competitive position through acquisitions of protocol, copper/xDSL and service assurance test businesses for the wireless and wireline telecommunications industry.

In the fourth quarter of 2010, we engaged in a plan to sell our Life Sciences and Industrial Division to focus our activities in the telecom test and service assurance market. We announced and closed the sale of that Division on October 1, 2010 for a selling price of \$24.3 million. Consequently, this Division has been considered as an operation held for sale and presented as discontinued operations in our consolidated financial statements. Related assets and liabilities have been reclassified as assets held for sale and liabilities related to assets held for sale and revenues and expenses have been reclassified from continuing operations to discontinued operations for all reporting years. The Life Sciences and Industrial Division included the operations of EFOS Inc. (renamed EXFO Photonic Solutions Inc.), acquired in March 2001 for its precision light-based, adhesive spot-curing technology as well as most of the operations of Burleigh Instruments, Inc. (renamed EXFO Burleigh Products Group Inc.), acquired in December 2000 for its wavelength measurement instruments and nanopositioning alignment systems, which were consolidated since then with those of EXFO Photonic Solutions Inc. The operations of that Division are located in Toronto, Canada.

On March 12, 2010, we acquired 91% of the issued and outstanding common shares of NetHawk Oyj (NetHawk). Headquartered in Oulu, Finland, NetHawk was a privately owned company providing 2G, 3G and 4G/LTE protocol analyzers and simulators aimed mostly at network equipment manufacturers and wireless network operators. On March 15, 2010, we made a voluntary offer to purchase the remaining issued and outstanding shares; this offer expired on April 30, 2010. Simultaneously, we entered into a statutory procedure under the Finnish Companies Act by which we acquired the remaining of the issued and outstanding common shares that were not tendered under the voluntary offer. Total consideration was comprised of a cash consideration of €37.3 million (US\$51.1 million), including acquisition-related costs of \$2.8 million, or €25.1 million (US\$34.4 million), excluding NetHawk's cash of €2.1 million (US\$16.7 million) at the acquisition date, plus a cash contingent consideration of up to €8.7 million (US\$11.0 million) based on a certain sales volume of NetHawk products over the three years following the acquisition. The cash contingent consideration will be accounted for as additional goodwill when the amounts of any contingent consideration can be reasonably estimated and the outcome of the contingency is resolved. Acquisition-related costs include an amount of \$780,000 for a statutory transfer tax payable in Finland based on the purchase price of shares.

In February 2009, we closed the acquisition of Sweden-based PicoSolve Inc., a supplier of ultra-high-speed optical sampling oscilloscopes for 40G and 100G research and development, manufacturing and deployment applications.

In April 2008, we acquired all issued and outstanding shares of Brix Networks Inc. (renamed EXFO Service Assurance Inc.), for a cash consideration of \$32.1 million. Brix Networks, a privately held company located in the Boston, MA area, offers VoIP and IPTV service assurance solutions across the three areas most affecting the success of a real-time service: signaling quality (signaling path performance), delivery quality (media transport performance) and content quality (overall quality of experience). Brix Networks' service assurance solutions are mainly designed for network service providers (NSPs) and large enterprises.

In March 2008, we acquired all issued and outstanding shares of Navtel Communications Inc., for a cash consideration of \$11.3 million. Navtel Communications, a privately held company in Toronto, Canada, is a leading provider of Internet protocol multimedia subsystem (IMS) and VoIP test solutions for network equipment manufacturers (NEMs) and NSP labs. Navtel Communications specializes in testing next-generation IP networks that are increasingly combining wireline and wireless technologies. Subsequent to the acquisition, Navtel Communications was merged into the parent company.

In fiscal 2008, we opened our own manufacturing facilities in Shenzhen, China. With the recent acquisition of NetHawk, which has manufacturing activities in Oulu, Finland, we now have three main manufacturing sites, including our plant in Quebec City. In addition, since fiscal 2008, we have been accelerating the deployment of a software development center in Pune, India. With the recent acquisition of NetHawk, which has a software development center in Bhubaneswar, India, we now have two development centers in India. This enables us to benefit from the wealth of IP expertise in India, to accelerate product development—especially for our wireless and wireline software-intensive protocol test and service assurance solutions—to take advantage of a lower cost structure. These two R&D centers also supplement the research and development capabilities of our labs in Boston, Toronto, Montreal and Quebec City, as well as in Oulu, Lappeenranta and Dallas from NetHawk.

In January 2006, we acquired substantially all the assets of Consultronics Limited (now merged with the parent company), a leading supplier of test equipment for copper-based broadband access networks, for a total cash consideration of \$19.1 million. Above and beyond copper/xDSL test solutions, Consultronics had a rich product portfolio for testing next-generation technologies, such as IPTV and VoIP, which are critical for NSPs in their deployment of triple-play services (voice, data, video) over optical and copper links in access networks.

In November 2001, we acquired Avantas Networks Corporation (renamed EXFO Protocol Inc. and now merged with the parent company), a supplier of protocol-testing and optical-network performance management equipment for NSPs. This transaction enabled us to combine optical and protocol test modules inside a single field-portable test platform in order to help our customers increase revenues and reduce operating costs. In October 2002, our wholly-owned subsidiary, EXFO Gnubi, purchased substantially all the assets of *gnubi communications, L.P.*, a supplier of multichannel telecom and datacom testing solutions for the system manufacturer market. EXFO Protocol and EXFO Gnubi were consolidated in Montreal, Canada, in fiscal 2004.

We launched 20 new products in fiscal 2010, including four in the fourth quarter, compared to 26 in fiscal 2009. Key product introductions in fiscal 2010 included among others a new service assurance solution for 4G/LTE mobile networks; an end-to-end IP video service assurance solution; a new standards-based test methodology (EtherSAM) across EXFO's Ethernet product offering for Carrier Ethernet and mobile backhaul service deployments; a high-resolution optical spectrum analyzer (OSA) for in-depth characterization of optical networks with narrow channel spacing; and an optical modulation analyzer for complete characterization of signals up to 100G. Following the year-end, we released the new FTB-1 platform, a handheld unit optimized for fiber-to-the-home (FTTH) and Ethernet test applications.

We reported record-high sales of \$202.8 million for our continuing operations (formerly our Telecom Division) in fiscal 2010, which represented an increase of 32.4% year-over-year. Sales for fiscal 2010 included \$14.5 million from newly acquired NetHawk since its acquisition on March 12, 2010. NetHawk's sales for the period were reduced by \$1.3 million to account for an adjustment to deferred revenue in the purchase price allocation. In addition, in fiscal 2010, we believe that we gained market share and we benefited from improving economic and market conditions that mainly contributed to the increase of our sales of optical and copper-access test solutions year-over-year. Also, in fiscal 2010, we recorded in our sales foreign exchange gains on our forward exchange contracts of \$1.5 million, compared to foreign exchange losses of \$3.2 million in 2009, which contributed to the increase of our sales of \$4.7 million year-over-year. Finally, our strong product offering contributed to the increase of our sales year-over-year. In fact, our sales of fiscal 2010 were positively impacted by the recent launches of certain key new products such as the portable test solution for characterizing 100 Gbit/s Ethernet and 40/43 Gbit/s SONET/OTN networks, the FTB-5600 Distributed PMD Analyzer, the new software releases for the IMS InterWatch platform and Packet Blazer product lines that support the migration of voice and video applications to the IPv6 (Internet protocol, version 6), the next-generation FTB-500 multilayer platform, the AXS-200/635 triple-play tester and the optical modulation analyzer for complete characterization of signals up to 100 GBd. Excluding the positive impact of the acquisition of NetHawk and the foreign exchange gains on our forward exchange contracts, our sales would have increased 19.5% year-over-year organically.

Looking at the bottom line, we reported GAAP earnings from continuing operations before extraordinary gain of \$3.6 million, or \$0.06 per diluted share, in fiscal 2010, compared to a loss of \$20.9 million, or \$0.34 per share, in 2009. Earnings from continuing operations before extraordinary gain for fiscal 2010 included \$6.5 million in after-tax amortization of intangible assets and \$1.7 million in stock-based compensation costs. Loss from continuing operations before extraordinary gain for fiscal 2009 included a pre-tax impairment of goodwill of \$21.7 million and a pre-tax charge of \$1.0 million in severance expenses for the 58 employees who were terminated throughout the company. It also included \$3.0 million in after-tax amortization of intangible assets and \$1.3 million in stock-based compensation costs.

EBITDA (including continuing and discontinued operations) were at \$27.3 million, or 12.0% of sales in fiscal 2010, compared to \$14.5 million, or 8.4% of sales in 2009. EBITDA for fiscal 2009 included pre-tax charges of \$1.2 million in severance expenses for the 65 employees who were terminated throughout the company and stock-based compensation costs of \$1.4 million (\$1.8 million in 2010). However, EBITDA for 2009 included a pre-tax research and development tax credits recovery of \$1.9 million. EBITDA represent net earnings (loss) before interest, income taxes, amortization of property, plant and equipment, amortization of intangible assets, impairment of goodwill and extraordinary gain; see further in this document for a comprehensive reconciliation of EBITDA to GAAP net earnings (loss).

In fiscal 2010, we faced a substantial increase in the value of the Canadian dollar versus the US dollar, the euro and the British pound compared to 2009; this had a two-fold negative impact on our financial results. Firstly, the average value of the Canadian dollar versus the US dollar increased 12.8% in fiscal 2010, compared to 2009. Given that most of our sales are denominated in US dollars but a significant portion of our expenses are denominated in Canadian dollars, our financial results were negatively affected as these expenses (denominated in Canadian dollars) increased when translated in US dollars for reporting purposes in fiscal 2010.

Secondly, we recorded a foreign exchange loss of \$1.5 million in fiscal 2010, which mainly represents the effect of the increase in the period-end value of the Canadian dollar versus the US dollar, the euro and the British pound on our balance sheet items during that year. In comparison, in fiscal 2009, we reported a foreign exchange gain of \$1.1 million following the decrease in the value of the Canadian dollar compared to the US dollar during that year.

On November 6, 2009, we announced that our Board of Directors had authorized the second renewal of our share repurchase program, by way of a normal course issuer bid on the open market, of up to 10% of our public float (as defined by the Toronto Stock Exchange), or 2.3 million subordinate voting shares, at the prevailing market price. The period of the normal course issuer bid started on November 10, 2009, and ended on November 9, 2010. All shares repurchased under the bid were cancelled. In fiscal 2010, we have repurchased 3,600 shares for a total redemption price of \$14,000.

On November 5, 2010 we announced that our Board of Directors approved the third renewal of our share repurchase program, by way of a normal course issuer bid on the open market of up to 10% of our public float (as defined by the Toronto Stock Exchange), or 2.0 million of subordinate voting shares at the prevailing market price. We expect to use cash, short-term investments or future cash flow from operations to fund the repurchase of shares. The normal course issuer bid will start on November 10, 2010, and will end on November 9, 2011, or on an earlier date if we repurchase the maximum number of shares permitted under the bid. The program does not require that we repurchase any specific number of shares, and it may be modified, suspended or terminated at any time and without prior notice. All shares repurchased under the bid will be cancelled. We shall provide to any person or company, upon request to our Secretary, at 400 Godin Avenue, Quebec, Province of Quebec, Canada, G1M 2K2, phone number (418) 683-0913 ext. 3704 or fax number (418) 683-9839 a copy of the notice sent to the Toronto Stock Exchange (TSX) according to our normal course issuer bid.

Sales

We sell our products to a diversified customer base in approximately 100 countries through our direct sales force and channel partners like sales representatives and distributors. Most of our sales are denominated in US dollars and euros.

In fiscal 2008 and 2010, no customer accounted for more than 10% of our sales, with our top customer representing 8.4% and 4.9% of our sales, respectively. In fiscal 2009, our top customer accounted for 13.1% of sales.

We believe that we have a vast array of products, a diversified customer base, and a good spread across geographical areas, which provides us with reasonable protection against the concentration of sales and credit risk.

Cost of Sales

The cost of sales includes raw materials, salaries and related expenses for direct and indirect manufacturing personnel (net of government grants), as well as overhead costs. Excess, obsolete and scrapped materials are also included in the cost of sales. However, the cost of sales is exclusive of amortization, which is shown separately in the statements of earnings.

Operating Expenses

We classify our operating expenses into three main categories: selling and administrative expenses, research and development expenses, and amortization expenses.

Selling and administrative expenses consist primarily of salaries and related expenses for personnel, sales commissions, travel expenses, marketing programs, professional services, information systems, human resources and other corporate expenses.

Gross research and development expenses consist primarily of salaries and related expenses for engineers and other technical personnel, material component costs as well as fees paid to third-party consultants. We are eligible to receive research and development tax credits and grants on research and development activities carried out in Canada and Finland. All related research and development tax credits and grants are recorded as a reduction of gross research and development expenses.

OUR STRATEGY, KEY PERFORMANCE INDICATORS AND CAPABILITY TO DELIVER RESULTS

Three-Year Strategic Objectives

Our goal is to become the market leader in the global telecom test and service assurance industry. Given the emergence of IP video, social networking and media-rich smartphones, wireless and wireline network operators and equipment manufacturers are faced with a major spending cycle to meet soaring bandwidth demand on their converged, IP fixed and mobile networks.

To achieve our long-term vision, we plan to:

- Capitalize on bandwidth explosion in the telecom industry with the introduction of innovative, market-driven test and service assurance solutions;
- Focus on the convergence of IP fixed and mobile networks, including emerging technologies like 4G/LTE and high-speed Ethernet;
- Leverage our leadership in optical testing for new opportunities like wireless backhaul, fiber- to-the-home, and 40G and 100G network upgrades;
- Move up the IP networks value chain by leveraging the intelligence, or computing capacities, of our modular test platforms with our service assurance systems to develop a series of value-added solutions; and
- Accelerate profitability through globalization and execution.

In our fiscal 2009 Annual Report, we established three corporate performance objectives to gauge the success of our overall plan over the next three years (2010-2012):

- Increase sales by a CAGR* of 20% or more
- Raise gross margin to 64%
- Double EBITDA** in dollars

* Compound annual growth rate

** EBITDA is defined as net earnings (loss) before interest, income taxes, amortization of property, plant and equipment, amortization of intangible assets, impairment of goodwill and extraordinary gain.

However, in fiscal 2010, following the recent acquisition of NetHawk and the divestiture of our Life Sciences and Industrial Division following the year-end, we updated our corporate performance objectives for the same three-year period extending from fiscal 2010 to 2012:

- Increase sales by a CAGR of at least 25%
- Raise gross margin to 65%
- Increase EBITDA in dollars by a CAGR of at least 30%

These three-year objectives were established based on results achieved in the past few years as well as on our strategic plan for the next three years. We are witnessing a period of significant investments in the telecom industry and we believe we are well-positioned to take advantage of the wealth of growth opportunities—from the network core to the edge. Namely, we expect to benefit from high-growth sectors like 4G/LTE applications, wireless backhaul, fiber-to-the-home, Carrier Ethernet, as well as 40G and 100G network upgrades to bolster sales and earnings. These objectives will guide our actions in upcoming years as we are committed to maximizing shareholder value.

Results Achieved in Fiscal 2010

Our corporate performance objectives were established and updated taking into account the sales and operating results of our Life Sciences and Industrial Division, which are now presented as discontinued operations in our GAAP figures for fiscal 2008, 2009 and 2010. As such, sales and operating results of that Division were included in the results achieved in fiscal 2010.

In fiscal 2010, sales including those of the discontinued operations increased 32.0% compared to 2009. Our gross margin, including the effect of the discontinued operations, reached 62.4%, 1.1% higher compared to 61.3% in 2009. Finally, EBITDA, including the results of the discontinued operations, amounted to \$27.3 million, or 12.0 % of sales in fiscal 2010, representing an increase of 88.8% compared to 2009. See further in this document for a reconciliation of the GAAP sales and GAAP gross margin to the global sales and global gross margin, including the effect of the discontinued operations and a reconciliation of GAAP net earnings (loss) to EBITDA.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's discussion and analysis of financial conditions and results of operations is based on our consolidated financial statements. As previously mentioned, they have been prepared in accordance with Canadian GAAP. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting years. On an ongoing basis, we evaluate these estimates and assumptions, including those related to the fair value of financial instruments, the allowance for doubtful accounts receivable, the amount of tax credits recoverable, the provision for excess and obsolete inventories, the estimated useful lives of capital assets, the valuation of long-lived assets, the impairment of goodwill, the valuation allowance of future income tax assets, the amount of certain accrued liabilities and deferred revenue as well as stock-based compensation costs. We base our estimates and assumptions on historical experience and on other factors that we believe to be reasonable under the circumstances, the result of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates.

The following summarizes our critical accounting policies as well as other policies that require the most significant judgment and estimates in the preparation of our consolidated financial statements.

Revenue recognition. For products in which software is incidental, we recognize revenue when persuasive evidence of an arrangement exists, the product has been delivered, the price is fixed or determinable, and collection of the resulting receivable is reasonably assured. Provisions are made for estimated returns, warranties and support obligations.

For products in which software is not incidental, revenues are separated into two categories: product and post-contract customer support (PCS) revenues, based upon vendor-specific objective evidence of fair value. Product revenues for these sales are recognized as described above. PCS revenues are deferred and recognized ratably over the years of the support arrangement. PCS revenues are recognized at the time the product is delivered when provided substantially within one year of delivery, the costs of providing this support are insignificant (and accrued at the time of delivery) and no (or infrequent) software upgrades or enhancements are provided.

Maintenance contracts generally include the right to unspecified upgrades and enhancements on a when-and-if-available basis and ongoing customer support. Revenue from these contracts is recognized ratably over the terms of the maintenance contracts on a straight-line basis.

Revenue for extended warranties is recognized on a straight-line basis over the warranty period.

For all sales, we use a binding purchase order as evidence that a sales arrangement exists.

Delivery generally occurs when the product is handed over to a transporter for shipment.

At the time of the transaction, we assess whether the price associated with our revenue transaction is fixed or determinable, and whether or not collection is reasonably assured. We assess whether the price is fixed or determinable based on the payment terms associated with the transaction. We assess collection based on a number of factors, including past transaction history and the creditworthiness of the customer. Generally, collateral or other security is not requested from customers.

Sales arrangements may include acceptance clauses. When a sales arrangement does include an acceptance provision, acceptance occurs upon the earliest of the receipt of a written customer acceptance or the expiration of the acceptance period. For these sales arrangements, the sale is recognized when acceptance occurs.

Allowance for doubtful accounts. We estimate collectability of accounts receivable on an ongoing basis by reviewing balances outstanding over a certain period of time. We determine our allowance for doubtful accounts receivable based on our historical accounts receivable collection experience and on the information that we have about the status of our accounts receivable balances. If the financial conditions of our customers deteriorate, resulting in an impairment of their ability to make required payments, additional allowance may be required, which could adversely affect our future results.

Reserve for excess and obsolete inventories. We state our inventories at the lower of cost, determined on an average cost basis, and net realizable value, and we provide reserves for excess and obsolete inventories. We determine our reserves for excess and obsolete inventories based on the quantities we have on hand versus expected needs for these inventories, so as to support future sales of our products. Expected needs are usually estimated over a twelve-month period. It is possible that additional inventory reserves may occur if future sales are less than our forecasts or if there is a significant shift in product mix compared to our forecasts, which could adversely affect our future results.

Research and development tax credits and government grants. We record research and development tax credits and government grants based on our interpretation of tax laws and grant programs, especially regarding related eligible projects and expenses, and when there is reasonable assurance that we have complied and will continue to comply with all conditions and laws. Also, our judgment and estimates are based on historical experience. It is possible, however, that the tax authorities or the sponsors of the grant programs have a different interpretation of laws and application of conditions related to the programs or that we do not comply with all conditions related to grants in the future, which could adversely affect our future results. Furthermore, a significant part of our research and development tax credits are refundable against income taxes payable, causing their ultimate realization to be dependent upon the generation of taxable income. If we obtain information that causes our forecast of future taxable income to change or if actual taxable income differs from our forecast, we may have to revise the carrying value of these tax credits, which would affect our results in the period in which the change was made.

Impairment of long-lived assets and goodwill. Long-lived assets are reviewed for impairment when events or circumstances indicate that cost may not be recoverable. Impairment exists when the carrying amount of an asset, or a group of assets is greater than the undiscounted future cash flows expected to be provided by the asset or the group of assets. The amount of impairment loss, if any, is the excess of the carrying value over the fair value. We assess fair value of long-lived assets based on discounted future cash flows.

We assess impairment of goodwill on an annual basis, or more frequently, if events or circumstances indicate that it might be impaired. Recoverability of goodwill is determined at the reporting unit level, using a two-step approach. First, the carrying value of a reporting unit is compared to its fair value, which is usually determined based on a combination of discounted future cash flows and a market approach. If the carrying value of a reporting unit exceeds its fair value, the second step is performed. In this step, the amount of impairment loss, if any, represents the excess of the carrying value of goodwill over its fair value, and the loss is charged to earnings in the period in which it is incurred. For the purposes of this impairment test, the fair value of goodwill is estimated in the same way as goodwill is determined in business combinations; that is, the excess of the fair value of a reporting unit over the fair value of its net identifiable assets. Future discounted cash flows may be lower than expected and our stock price may decrease to a level that would cause the fair value of our reporting units to be lower than their carrying value. This may lead to goodwill impairment loss in the future.

Future income taxes. We provide for income taxes using the liability method of tax allocation. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and liabilities as well as the carry-forward of unused tax losses and deductions, using substantively enacted income tax rates expected for the years in which the assets are expected to be realized or the liabilities to be settled. In assessing the recoverability of our future income tax assets, we consider whether it is more likely than not that some or all of the future income tax assets will not be realized. The ultimate realization of our future income tax assets is dependent upon the generation of sufficient future taxable income during the periods in which those assets are expected to be realized.

Stock-based compensation costs. We account for all forms of employee stock-based compensation using the fair value-based method. This method requires that we make estimates about the expected volatility of our shares, the expected life of the awards and the forfeiture rate.

New accounting standards and pronouncements

Adopted in fiscal 2010

In February 2008, the Canadian Institute of Chartered Accountants (CICA) issued Section 3064, “Goodwill and Intangible Assets”, which supersedes Section 3062, “Goodwill and Other Intangible Assets”, and Section 3450, “Research and Development Costs”. Various changes have been made to other sections of the CICA Handbook for consistency purposes. Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill remain unchanged from the standards included in Section 3062. This new section applies to fiscal years beginning on or after October 1, 2008. We adopted this new standard on September 1, 2009, and its adoption had no material effect on our consolidated financial statements.

In June 2009, the CICA amended section 3862, “Financial Instruments – Disclosures”, to include enhanced disclosures on liquidity risk of financial instruments and new disclosures on fair value measurements of financial instruments. The amendments apply to fiscal years ending after September 30, 2009, with early adoption permitted. Section 3862 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under Section 3862 are described below:

- Level 1 – Unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets or liabilities;

- Level 2 – Quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 – Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (supported by little or no market activity).

We adopted these amendments on September 1, 2009, and their adoption had no measurement impact on our consolidated financial statements.

To be adopted after fiscal 2010

In January 2009, the CICA issued Section 1582, “Business Combinations”, which replaces Section 1581, “Business Combinations”. This new section establishes the standards for the accounting of business combinations and states that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent consideration and contingencies will also be recorded at fair value at the acquisition date. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date. This standard applies prospectively to business combinations with acquisition dates on or after September 1, 2011; earlier adoption is permitted.

In January 2009, the CICA issued Section 1601, “Consolidated Financial Statements”, which replaces Section 1600, “Consolidated Financial Statements”, and establishes the standards for preparing consolidated financial statements. This new section applies to fiscal years beginning on or after January 1, 2011; earlier adoption is permitted. We have not yet determined the impact that adopting this standard will have on our consolidated financial statements.

In January 2009, the CICA issued Section 1602, “Non-controlling Interests”, which establishes standards for the accounting of non-controlling interests of a subsidiary in the preparation of consolidated financial statements subsequent to a business combination. This new section applies to fiscal years beginning on or after January 1, 2011; earlier adoption is permitted as of the beginning of a fiscal year.

Should we decide to adopt one of these three new sections earlier, we must adopt all three at the same date.

In December 2009, the CICA’s Emerging Issues Committee (EIC) issued EIC-175, “Multiple Deliverable Revenue Arrangements”, which will be applicable prospectively (with retrospective adoption permitted) to revenue arrangements with multiple deliverables entered into or materially modified in the first annual period beginning on January 1, 2011. EIC-175 amends the guidance contained in EIC-142, “Revenue Arrangements with Multiple Deliverables”, and establishes additional requirements regarding revenue recognition related to multiple deliverables as well as supplementary disclosures. We will adopt this standard on September 1, 2010 and we are currently evaluating the impact that EIC-175 will have on our consolidated financial statements.

In February 2008, the Canadian Accounting Standards Board announced that Canadian GAAP, as used by publicly accountable enterprises, will be converged with the International Financial Reporting Standards (IFRS) as issued by the International Accounting Standard Board (IASB). Accordingly, we will adopt these standards during our fiscal year beginning on September 1, 2011 and we will be required to report under IFRS and to provide IFRS comparative information for the fiscal year ending on August 31, 2011. Although the conceptual framework of IFRS is similar to Canadian GAAP, there are significant differences on recognition, measurement and disclosures.

As part of the IFRS conversion project, we have set up an IFRS-dedicated team at different levels of the organization and have also retained the service of an external expert advisor to assist us. A process for reporting regular progress to senior management and to the Audit Committee on the status of the IFRS conversion project has been established.

The conversion project consists of four phases.

- Diagnostic phase – This phase involves an initial scoping of significant accounting differences between Canadian GAAP and IFRS, a preliminary evaluation of IFRS 1 exemptions for first-time IFRS adopters, and a high-level assessment of potential consequences on financial reporting, business processes, internal controls and information systems.

- Design and Solutions Development phase – This phase involves a detailed analysis of identified accounting treatment differences, reviewing and approving accounting policy choices, performing a detailed impact assessment and designing changes to systems and business processes, developing IFRS training material, and drafting IFRS financial statement content.
- Implementation phase – This phase involves embedding changes to systems, business processes and internal controls, determining the opening IFRS transition balance sheet and tax impacts, parallel accounting under Canadian GAAP and IFRS, and preparing detailed reconciliations of Canadian GAAP to IFRS financial statements.
- Post-Implementation phase – This phase involves conversion assessment, evaluating improvements for a sustainable operational IFRS model, and testing the internal controls environment.

We have completed the Diagnostic phase to assess and scope the significant differences between existing Canadian GAAP and IFRS as well as the impact on our consolidated financial statements.

We are currently completing the Design and Solutions Development phase to evaluate the overall impact of adopting these new standards on our consolidated financial statements. Following the Diagnostic phase, we have initiated a detailed analysis of the accounting policies affected by the adoption of IFRS, which is expected to be completed throughout calendar 2010.

Significant differences with respect to recognition, measurement, presentation and disclosure of financial information are expected to be in the following key accounting areas:

Key accounting areas	Differences with potential impact
Hedge accounting	<ul style="list-style-type: none"> • IAS 39, “Financial Instruments: Recognition and Measurement”, does not permit to use the shortcut method to assess hedge effectiveness of hedging relationships. We have elected to use the dollar-offset method, as permitted by IFRS, to assess the effectiveness of our cash flow hedges and we will recalculate the effectiveness with this new method, which may potentially result into ineffectiveness that did not exist under the previous method. However, we do not anticipate significant reclassification of hedge relationships. The review of our documentation was completed as at September 1, 2010, being the transition date.
Presentation of financial statements	<ul style="list-style-type: none"> • Under IAS 1, “Presentation of Financial Statements”, expenses must be classified by their nature or by their function in the income statement. We elected to present our income statement by function. Accordingly, upon the adoption of IFRS, amortization expenses will be allocated to function rather than being showed as separate lines in the income statement as currently permitted under Canadian GAAP.
Impairment of assets	<ul style="list-style-type: none"> • IAS 36, “Impairment of Assets”, requires a single-step approach for impairment testing of individual assets or a group of assets in cash generating units (CGUs) on the basis of independent cash inflows whereas Canadian GAAP uses a two-step approach. However, we do not anticipate significant additional impairment due to that one-step approach.
Property, plant and equipment	<ul style="list-style-type: none"> • IAS 16, “Property, Plant and Equipment”, reinforces the requirement under Canadian GAAP that requires that each part of property, plant and equipment that has a cost that is significant in relation to the overall cost of the item should be depreciated separately. Based on the analysis of our property, plant and equipment, we do not expect additional componentization under IFRS.

Key accounting areas	Differences with potential impact
Leases	<ul style="list-style-type: none"> Under IAS 17, "Leases", a lease is classified as either a finance lease or an operating lease. Lease classification depends on whether substantially all the risks and rewards incidental to ownership of the leased assets have been transferred from the lessor to the lessee, and is made at inception of the lease. A number of indicators are used to assist in lease classification; however, quantitative thresholds are not offered as indicators as under current Canadian GAAP. We reviewed all existing significant leases, which are classified as operating leases under Canadian GAAP, and concluded that their classification is in accordance with IAS 17.
Translation of foreign operations	<ul style="list-style-type: none"> Under IAS 21, "The Effects of Changes in Foreign Exchange Rates", for foreign entities with the same functional currency as the parent company, the corresponding exchange difference is recognized in the statement of earnings of that entity; and for foreign entities with a functional currency other than the functional currency of the parent company, the corresponding exchange differences should be recognized in a separate component of other comprehensive income. We assessed the functional currency of our foreign operations and concluded that the adoption of IAS 21 will have no impact on our consolidated financial statements.
Business combinations	<ul style="list-style-type: none"> As permitted by IFRS 1, "First Time Adoption of International Financial Reporting Standards (IFRS)", we will not apply IFRS 3, "Business Combinations", to business combinations completed before the transition date, that is, September 1, 2010.

This is not an exhaustive list of all the impacts that could occur during the conversion to IFRS. Additionally, we are completing an IFRS financial statement in accordance with IAS 1, "Presentation of Financial Statements". In addition, we analyzed the effects on information technology and internal controls and we do not foresee any significant modifications to our information technology and data systems and internal controls.

In addition, some transitional options permitted under IFRS were analyzed. In most cases, we will opt for a prospective application when the choice is available, namely for business combinations as described above.

We have provided training for key employees and stakeholders. Additional training will be ongoing as necessary until full adoption in fiscal 2012.

As IASB work plan anticipates the completion of several significant projects in calendar years 2010 and 2011, we continue to track the progress of these projects. However, it is difficult to predict the IFRS that will be effective at the end of our first IFRS reporting period. Our decisions may change if previously unconsidered new standards or amendments are introduced before our changeover date.

Our IFRS project is progressing according to plan, and we will provide updates as further progress is achieved and conclusions are reached.

RESULTS OF OPERATIONS

The following table sets forth Canadian GAAP consolidated financial statements data in thousands of US dollars, except per-share data, and as a percentage of sales for the years indicated:

Consolidated statements of earnings data:						
	2010	2009	2008	2010	2009	2008
Sales.....	\$ 202,757	\$ 153,082	\$ 160,981	100.0 %	100.0 %	100.0 %
Cost of sales ⁽¹⁾	73,901	57,897	64,364	36.4	37.8	40.0
Gross margin.....	128,856	95,185	96,617	63.6	62.2	60.0
Operating expenses						
Selling and administrative.....	66,612	58,067	54,869	32.9	37.9	34.1
Net research and development	37,847	27,213	24,580	18.7	17.8	15.3
Amortization of property, plant and equipment	5,757	4,453	4,137	2.8	2.9	2.6
Amortization of intangible assets	7,773	5,033	3,862	3.8	3.3	2.3
Restructuring charges.....	—	963	—	—	0.6	—
Impairment of goodwill	—	21,713	—	—	14.2	—
Total operating expenses.....	117,989	117,442	87,448	58.2	76.7	54.3
Earnings (loss) from operations	10,867	(22,257)	9,169	5.4	(14.5)	5.7
Interest income (expense), net.....	(292)	592	4,381	(0.1)	0.4	2.7
Foreign exchange gain (loss)	(1,496)	1,074	404	(0.8)	0.7	0.3
Earnings (loss) before income taxes	9,079	(20,591)	13,954	4.5	(13.4)	8.7
Income taxes						
Current.....	715	587	(7,154)	0.4	0.4	(4.5)
Future.....	4,814	(321)	12,815	2.3	(0.2)	8.0
Recognition of previously unrecognized future income tax assets.....	—	—	(5,324)	—	—	(3.3)
	5,529	266	337	2.7	0.2	0.2
Earnings (loss) from continuing operations before extraordinary gain.....	3,550	(20,857)	13,617	1.8 %	(13.6) %	8.5 %
Net earnings from discontinued operations	3,069	4,272	1,771			
Earnings (loss) before extraordinary gain ..	6,619	(16,585)	15,388			
Extraordinary gain	—	—	3,036			
Net earnings (loss) for the year	\$ 6,619	\$ (16,585)	\$ 18,424			
Basic and diluted earnings (loss) from continuing operations before extraordinary gain per share.....	\$ 0.06	\$ (0.34)	\$ 0.20			
Basic and diluted net earnings (loss) per share.....	\$ 0.11	\$ (0.27)	\$ 0.27			
Research and development data:						
Gross research and development.....	\$ 44,551	\$ 33,584	\$ 30,167	22.0 %	21.9 %	18.7 %
Net research and development	\$ 37,847	\$ 27,213	\$ 24,580	18.7 %	17.8 %	15.3 %
Consolidated balance sheets data:						
Total assets	\$ 273,502	\$ 240,371	\$ 293,066			

(1) The cost of sales is exclusive of amortization, shown separately.

RESULTS FROM CONTINUING OPERATIONS (formerly the Telecom Division)

SALES

Fiscal 2010 vs. 2009

In fiscal 2010, our sales increased 32.4% to a record-high \$202.8 million, compared to \$153.1 million in 2009.

The following table summarizes information about our sales for the years ended August 31, 2009 and 2010, in thousands of US dollars:

	<u>Year ended August 31, 2010</u>	<u>Year ended August 31, 2009</u>	<u>Change in \$</u>	<u>Change in %</u>
Sales	\$ 202,757	\$ 153,082	\$ 49,675	32.4 %
(Gains) losses on forward exchange contracts	<u>(1,517)</u>	<u>3,178</u>	<u>(4,695)</u>	
Sales, excluding gains/losses on forward exchange contracts (non-GAAP measure)	201,240	156,260	44,980	28.8
Impact of the recent acquisition (NetHawk)	<u>(14,483)</u>	<u>–</u>	<u>(14,483)</u>	
Organic sales (non-GAAP measure)	<u>\$ 186,757</u>	<u>\$ 156,260</u>	<u>\$ 30,497</u>	<u>19.5 %</u>

See further in this document for information about non-GAAP financial measures.

First, in fiscal 2010, we believe we gained market share, namely in the optical and copper-access space, which contributed to the increase of our sales year-over-year.

In addition, in fiscal 2010, NetHawk, which was acquired on March 12, 2010, contributed about five and a half months to our sales, which caused them to increase \$14.5 million year-over-year. NetHawk's sales for this period were reduced by \$1.3 million to account for an adjustment to deferred revenue in the purchase price allocation. NetHawk contributed to the increase of our sales of protocol test solutions year-over-year.

Furthermore, in fiscal 2010, we benefited from improving economic and market conditions following the global economic recession that negatively affected our sales in fiscal 2009, allowing customers to invest in their networks in order to accommodate bandwidth-intensive applications and to facilitate the migration to more flexible and cost-effective fixed and mobile IP architectures. In 2009, many network operators delayed capital-intensive deployment decisions on FTTx rollouts and capacity expansion, opting to increase speed rather than digging trenches to add new fiber-optic cables. However, in fiscal 2010, network operators restarted investing worldwide in capital-intensive deployments and capacity expansion on the basis of the current recovery in the telecom market. These improved market conditions mainly contributed to the increase of our sales of optical and copper-access test solutions.

Finally, in fiscal 2010, we recorded in our sales foreign exchange gains of \$1.5 million on our forward exchange contracts, compared to foreign exchange losses of \$3.2 million in 2009, which contributed to the increase of our sales of \$4.7 million year-over-year.

In terms of product lines, we reported a sales increase of 43.3% for our protocol test solutions, as they reached a record-high \$78.7 million, compared to \$54.9 million in 2009. Sales of protocol test solutions in fiscal 2010 included the \$14.5 million contribution of newly acquired NetHawk. Excluding sales of newly acquired NetHawk, our sales of protocol test solutions would have increased 16.9% in fiscal 2010 compared to 2009 on the strength of improved market and economic conditions year-over-year. On the other hand, sales of fiscal 2009 included \$6.7 million worth of orders shipped to a Tier-1 North American wireless operator for our service assurance solutions. In fiscal 2010, we did not have such a large single order from that customer.

Sales of our optical test solutions increased 14.2% to \$109.1 million in fiscal 2010 compared to \$95.5 million in 2009. Improved market and economic conditions year-over-year resulted in higher sales in fiscal 2010 as we almost came back to the pre-recession level of 2008. In addition, we believe we gained market share in fiscal 2010. Furthermore, year-end budget flush-outs from some of our customers caused our sales to increase in fiscal 2010, compared to the same period last year. In fiscal 2009, we did not have such level of year-end budget flush-outs as they may vary significantly from year to year. Finally, our sales of fiscal 2010 were positively impacted by the recent launch of significant new products such as our patent-pending distributed PMD analyzer, our next-generation FTB-500 multilayer platform and our optical modulation analyzer for complete characterization of signals up to 100 GBd. These major products contributed to the increase of our sales year-over-year.

Sales of our copper-access test solutions increased 131.2% to \$13.4 million compared to \$5.8 million in 2009. In fiscal 2010, we reached a multimillion-dollar deal with a Tier-1 European operator for our AXS-200/635 triple-play tester, and recognized \$5.3 million of sales to this customer during the year, which contributed for the most part to the year-over-year increase in sales. In addition, this product family benefited from improved market conditions year-over-year as the access segment was severely impacted by the recession in 2009. Finally, in fiscal 2010, our AXS-200/635 triple-play tester was approved by three Tier-1 North American network operators to support their deployment of next-generation VDSL2 services and applications. We believe the combined deals could reach several millions of dollars over the next two or three years or over a mid-term horizon.

Fiscal 2009 vs. 2008

In fiscal 2009, our sales decreased 4.9% to \$153.1 million from \$161.0 million in 2008.

The following table summarizes information about our sales for the years ended August 31, 2008 and 2009, in thousands of US dollars:

	<u>Year ended August 31, 2009</u>	<u>Year ended August 31, 2008</u>	<u>Change in \$</u>	<u>Change in %</u>
Sales	\$ 153,082	\$ 160,981	\$ (7,899)	(4.9) %
(Gains) losses on forward exchange contracts	<u>3,178</u>	<u>(4,171)</u>	<u>7,349</u>	
Sales, excluding gains/losses on forward exchange contracts (non-GAAP measure)	156,260	156,810	(550)	(0.4)
Impact of the recent acquisitions ⁽¹⁾	<u>(25,327)</u>	<u>(5,423)</u>	<u>(19,904)</u>	
Organic sales (non-GAAP measure)	<u>\$ 130,933</u>	<u>\$ 151,387</u>	<u>\$ (20,454)</u>	<u>(13.5) %</u>

(1) Includes Brix Networks and Navtel Communications.

In fiscal 2009, we reported a year-over-year decrease in sales mainly due to the impact of the worldwide economic recession that affected most of our product lines during that period. In addition, as a portion of our sales are denominated in Canadian dollars, euros or British pounds, the increased strength of the US dollar against these currencies in fiscal 2009, compared to 2008, also had a negative impact on our sales expressed in US dollars, which contributed to the decrease in sales compared to the corresponding period last year. This was amplified by foreign exchange losses on our forward exchange contracts, which are recorded in reduction of sales. In fact, in fiscal 2009, foreign exchange losses on our forward exchange contracts amounted to \$3.2 million and accordingly reduced our sales, compared to foreign exchange gains of \$4.2 million in 2008, which increased our sales; this represents a decrease in sales of \$7.3 million year-over-year. Excluding the impact of gains and losses on forward exchange contracts, our sales would have been relatively flat year-over-year.

However, the decrease in sales in fiscal 2009, compared to the same period last year, was offset in part by the inclusion of the sales of newly acquired Brix Networks and Navtel Communications products. In fact, sales of Brix Network and Navtel Communications amounted to \$25.3 million in 2009, compared to \$5.4 million in 2008. Brix Networks and Navtel Communications were acquired two months and one month into the third quarter of fiscal 2008, respectively. Excluding sales of Brix Networks and Navtel Communications and the impact of the foreign exchange gains or losses on our forward exchange contracts, our sales would have decreased 13.5% organically year-over-year in 2009, reflecting the impact of the global economic recession and the decrease of the Canadian dollar, euro and British pound compared to the US dollar.

In fiscal 2009, we posted record-high sales and bookings of protocol test solutions, including next-generation IP test solutions and product lines of newly acquired Brix Networks and Navtel Communications. Protocol test solutions sales, buoyed by network capacity upgrades on wireline and wireless networks, increased 63.1% year-over-year (organic growth of 4.8% excluding sales of our new acquisitions of fiscal year 2008) as they reached \$54.9 million in 2009, compared to \$33.7 million in 2008. During fiscal 2009, we shipped \$6.7 million worth of orders to a Tier-1 wireless operator in North America for our service assurance test solutions, which increased our protocol sales year-over-year. However, sales of our optical test solutions decreased 17.5% to \$95.5 million, from \$115.7 million in 2008. Also, in fiscal 2009, we posted a year-over-year sales decrease of 21.8% (\$5.8 million in fiscal 2009, compared to \$7.4 million in 2008) for our copper-access test solutions. Our optical business was more affected by difficult market conditions, as many network operators deferred capital-intensive deployment decisions on FTTx rollouts and capacity expansion, opting to increase speed rather than digging trenches to add new fiber-optic cables. We believe that we still gained market share in the optical segment despite our year-on-year revenue decline. The access segment was also severely impacted by the recession, but we believe in this case that we have likely lost some market share from a small overall market presence, as our new products have not yet created a significant impact in the market.

Net bookings

Net accepted orders increased 31.1% year-over-year to a record-high \$211.4 million in fiscal 2010 from \$161.2 million in 2009, for a book-to-bill ratio of 1.04 in fiscal 2010. In fiscal 2010, as mentioned earlier, we benefited from improving economic and market conditions as well as from our strong product offering. In addition, NetHawk, acquired on March 12, 2010, contributed about five and a half months to our bookings. In fiscal 2009, we were affected by the global economic recession, which had a negative impact on our bookings during that period.

Geographic distribution

Fiscal 2010 vs. 2009

In fiscal 2010, sales to the Americas, Europe, Middle East and Africa (EMEA) and Asia-Pacific (APAC) accounted for 52%, 30% and 18% of sales, respectively, compared to 57%, 28% and 15%, respectively in 2009.

In fiscal 2010, we reported sales increases (in dollars) in every geographic area. In fact, sales to the Americas, EMEA and APAC increased (in dollars) 22.6%, 41.2% and 53.0%, respectively.

In the Americas, the increase in sales in fiscal 2010, compared to 2009, mainly comes from the United States and Latin America. In fact, we posted year-over-year sales growth of 24.1% and 48.2% in the United States and Latin America, respectively, in fiscal 2010. In Canada, sales slightly increased 5.5% in fiscal 2010, compared to the same period last year. In fiscal 2010, in the United States, we benefited from improving economic and market conditions as well as from year-end budget flush-outs from some of our customers. Also, in fiscal 2010, we recorded foreign exchange gains on our forward exchange contracts, which are included in our sales to the Americas for the most part, compared to significant forward exchange losses for the same periods last year. This contributed to the increase in our sales to this region year-over-year. Excluding the impact of gains and losses on our forward exchange contracts, sales to the United States would have increased 13.8% year-over-year. Furthermore, sales to the United States in fiscal 2010 were positively impacted by the contribution of newly acquired NetHawk. Finally, it should be remembered that in fiscal 2009, we shipped \$6.7 million worth of orders to a Tier-1 US-based wireless operator for our service assurance solutions. Excluding this significant order, the increase in sales to the United States would have been even larger year-over-year. In Latin America, we also benefited from an improving economic environment as we won several deals during the year. Sales to this region depend on the timing and scope of our customers' projects. In Canada, sales slightly increased in fiscal 2010 compared to the same period last year. In fact, the increase in sales in Canada comes from the increase in the average value of the Canadian dollar compared to the US dollar year-over-year. In Canadian dollars, sales to Canada decreased 6% year-over-year. In fiscal 2009, we shipped large orders to two Canadian Tier-1 network operators, namely for our protocol and copper-access test solutions. Such large orders did not occur in 2010 in Canada.

The increase in sales in the EMEA market, in dollars, in fiscal 2010, compared to 2009, is due in part to the contribution of Finland-based NetHawk to our sales in this region since its acquisition in mid-March 2010. A large portion of NetHawk's sales are made to the EMEA market. In addition, in fiscal 2010, we shipped \$5.3 million worth of orders for our copper-access test solutions to a Tier-1 European operator, which contributed to the increase in sales to this end market year-over-year. Finally, improved economic and market conditions in this region contributed to the increase in our sales year-over-year as carriers are starting to invest in next-generation access and transport networks after several months of delay and spending reductions due to the global economic recession of 2009.

In the APAC market, sales significantly increased in fiscal 2010, compared to 2009. As explained above, we benefited from improving market conditions worldwide in fiscal 2010, which had a positive impact on sales to the APAC market during this period. We are committed to carrying out our strategy to increase our market share with products and solutions developed and targeted for this important market, as well as to expand our market presence. In addition, in fiscal 2010, we benefited from the contribution of newly acquired NetHawk in this region since its acquisition in mid-March 2010.

Fiscal 2009 vs. 2008

In fiscal 2009, sales to the Americas, Europe, Middle East and Africa (EMEA) and Asia-Pacific (APAC) accounted for 57%, 28% and 15% of global sales, respectively, compared to 55%, 30% and 15%, respectively in 2008.

In fiscal 2009, we reported sales decreases (in dollars) in every geographic area. In fact, sales to the Americas, EMEA and APAC decreased (in dollars) 1.7%, 10.5% and 5.5%, respectively.

In the Americas, the decrease in sales in fiscal 2009, compared to 2008, mostly came from the United States where we posted a year-over-year decrease in sales of 7.6%. The global economic recession in 2009 forced NSPs and NEMs to reduce their capital and operating expenses and several customers announced significant reductions in capital expenditures and staffing levels for calendar year 2009 in anticipation of lower revenues; this directly affected our sales in the United States in fiscal 2009, compared to 2008. Also, in fiscal 2009, we recorded significant foreign exchange losses on our forward exchange contracts, which are included in our sales to the Americas for the most part, compared to forward exchange gains in 2008. Excluding the impact of gains and losses on our forward exchange contracts, sales to the United States would have increased 3.6% year-over-year. The decrease in sales to the United States in fiscal 2009 was offset in part by an increase of 32.3% of sales made in Canada, despite the negative impact of a weaker Canadian dollar versus the US dollar year-over-year on our Canadian-dollar-denominated sales. The recession also affected Latin America, where sales decreased 7.8% year-over-year. Finally, the contribution of Brix Networks and Navtel Communications in fiscal 2009 also mitigated the effect of the recession and the currencies on our sales in the United States, as a significant portion of Brix and Navtel sales are made in the United States and Canada.

The decrease in sales in the EMEA market, in dollars, in fiscal 2009, compared to 2008, was also due to the impact of the global recession as we witnessed caution from many of our customers with their fiscal year budgets (calendar 2009). In fact, due to the recession, many Tier-1 carriers in EMEA have postponed or significantly reduced the speed of the migration of their traditional circuit-switched core networks to higher-speed, dense wavelength-division multiplexing (DWDM) and next-generation packet-based architectures, which negatively impacted the sales of our products. Also, as a portion of the orders in this region are denominated in euros or British pounds, the strength of the US dollar against these currencies in fiscal 2009 had a negative impact on our sales expressed in US dollars for this region, which contributed to the decrease in sales compared to 2008.

In the APAC market, sales to China slightly increased year-over-year, despite the recession and the negative impact of currency fluctuations. In fact, the recession in China has been less severe than in the rest of the world, and we were able to mitigate its impact on our sales in that region. However, the rest of Asia has been affected by the general economic conditions and the currency fluctuations, and our sales to the rest of Asia have decreased 24.2% in fiscal 2009 compared to 2008.

We sell our products to a broad range of customers, including network service providers, network equipment manufacturers, wireless operators and cable TV operators. In fiscal 2010, no customer accounted for more than 10% of our sales, and our top three customers accounted for 12.2% of our sales. In fiscal 2009, our top customer accounted for 13.1% (\$20.0 million) of our sales, and our top three customers accounted for 20.1% of our sales. With record-high sales in fiscal 2010, the fact that no customer accounted for more than 10% of our sales and that our top three customers accounted for just over 10% of our sales shows that we have a well-diversified customer base.

GROSS MARGIN

Gross margin amounted to 63.6%, 62.2% and 60.0% of sales in fiscal 2010, 2009 and 2008, respectively.

Fiscal 2010 vs. 2009

In fiscal 2010, we recorded in our sales foreign exchange gains totaling \$1.5 million on our forward exchange contracts, compared to foreign exchange losses of \$3.2 million in 2009. This contributed to a 1% increase in our gross margin year-over-year.

In addition, the acquisition of NetHawk had a positive impact on our gross margin in fiscal 2010 as its products deliver margins well above our average typical gross margin.

Furthermore, in fiscal 2010, a larger portion of our sales came from products manufactured in our facilities in China compared to 2009; those products have a lower cost of goods than those manufactured in our facilities in Canada, thus resulting in an improvement in gross margin year-over-year.

Also, an increased sales volume year-over-year resulted in an increase in manufacturing activities, allowing us to better absorb our fixed manufacturing costs.

Finally, the increase in the value of the Canadian dollar in 2010 compared to 2009 had a positive impact on our gross margin in 2010; in fact, our procurement costs decreased as the Canadian dollar strengthened compared to the US dollar, since a significant portion of our raw material purchases are denominated in US dollars. This allowed us to improve our gross margin continually over the last few quarters, as our raw material costs of parts purchased in US dollars are measured in Canadian dollars in our financial statements.

On the other hand, in fiscal 2010, our gross margin was negatively affected by the shift in product mix in favor of our copper-access test solutions, as these products deliver lower margins than our other test solutions and we had large orders on which we granted larger discounts.

In addition, the shift in the geographic distribution of our sales in favor of the EMEA and APAC markets in fiscal 2010, compared to 2009, resulted in a lower margin year-over-year. Sales to these markets tend to deliver lower margins than those made in the Americas, as they are made through distribution channels instead of being made directly with the end customers.

Finally, in fiscal 2010, the significant year-over-year increase in the average value of the Canadian dollar versus the US dollar resulted in a higher cost of goods sold expressed in US dollars in the statement of earnings, as a portion of these costs are incurred in Canadian dollars and we report our results in US dollars.

Fiscal 2009 vs. 2008

Despite the negative impact on the gross margin of foreign exchange losses on our forward exchange contracts in fiscal 2009 compared to 2008, which have reduced our sales, we were able to significantly increase our gross margin by 2.2% year-over-year.

The increase in our gross margin in fiscal 2009, compared to 2008, can be explained by the following factors.

First, in fiscal 2009, our gross margin was positively affected by the significant increase in sales of our protocol test solutions year-over-year, including those of newly acquired Brix Networks and Navtel Communications, as these products have better margins than our other test solutions.

Second, during fiscal 2009, the value of the Canadian dollar significantly fluctuated compared to the US dollar, which impacted our gross margin for this period, compared to the same period last year. In fact, since the beginning of fiscal 2009, the value of the Canadian dollar significantly decreased compared to the US dollar; this resulted in a lower cost of goods sold expressed in US dollars in the statement of earnings, thus increasing our gross margin year-over-year. However, the increase in the procurement costs of our raw materials purchased in US dollars, as a result of the recent and significant decrease in the value of the Canadian dollar compared to the US dollar, materialized in fiscal 2009, in line with the inventory turnover rate, as these raw materials are included in the cost of goods sold of products manufactured with these parts.

Furthermore, the operation of our manufacturing facilities in China resulted in a larger portion of our sales coming from products manufactured in China; those products have a lower cost than those manufactured in our facilities in Canada, thus resulting in an improvement in gross margin in fiscal 2009 compared to 2008.

However, foreign exchange losses on our forward exchange contracts recorded in fiscal 2009 (\$3.2 million), which are included in our sales, had a negative impact of 0.7% on our gross margin during this period, compared to the positive impact of our foreign exchange gains of \$4.2 million, or 1.0% on the gross margin in 2008, for a year-over-year negative impact of 1.7% on our gross margin.

In addition, a lower sales volume in fiscal 2009 compared to 2008 resulted in decreased manufacturing activities and in lower absorption of our fixed manufacturing costs, thus negatively impacting our gross margin year-over-year.

Finally, in fiscal 2008, we were able to reuse excess inventories that were written off in previous years in the amount of \$1.2 million (nominal amount in 2009). This had a one-time positive impact of 0.7% of sales on our gross margin in 2008.

Outlook for fiscal 2011

Considering the expected sales growth in fiscal 2011, the full contribution of newly acquired NetHawk (which delivers higher margins), the expected increase in sales of protocol products, the cost-effective design of our products, our increased manufacturing activities in China and our tight control on operating costs, we expect our gross margin to continue to improve in the future. However, our gross margin may fluctuate quarter-over-quarter as our sales may fluctuate. Furthermore, our gross margin can be negatively affected by increased competitive pricing pressure, customer concentration and/or consolidation, increased obsolescence costs, shifts in customer and product mix, under-absorption of fixed manufacturing costs and increases in product offerings by other suppliers in our industry. Finally, any increase in the strength of the Canadian dollar, compared to the US dollar, may have a negative impact on our gross margin in fiscal 2011 and beyond.

SELLING AND ADMINISTRATIVE

Selling and administrative expenses were \$66.6 million, \$58.1 million and \$54.9 million for fiscal 2010, 2009 and 2008, respectively. As a percentage of sales, selling and administrative expenses amounted to 32.9%, 37.9% and 34.1% for fiscal 2010, 2009 and 2008, respectively.

Fiscal 2010 vs. 2009

In fiscal 2010, NetHawk, acquired on March 12, 2010, contributed about five and half months to our selling and administrative expenses, which caused them to increase year-over-year. In addition, selling expenses for NetHawk tend to be higher in percentage of sales than the rest of our business, as its sales cycle is much longer and complex than our other product lines.

Furthermore, in fiscal 2010, the significant increase (12.8%) in the average value of the Canadian dollar compared to the US dollar, year-over-year, had a negative impact on our selling and administrative expenses, since a certain portion of these expenses is denominated in Canadian dollars and since these expenses increased year-over-year as our sales grew.

Finally, in fiscal 2010, our sales (excluding those of NetHawk) significantly increased compared to 2009, causing our selling expenses to increase, namely our commission expenses.

However, given the restructuring actions taken in the end of fiscal 2009 to reduce our costs, we have been able to reduce some of our selling and administrative expenses in fiscal 2010 compared to 2009.

In fiscal 2010, the significant increase in sales year-over-year caused these expenses to significantly decrease as a percentage of sales, as a portion of these expenses is fixed.

Fiscal 2009 vs. 2008

Brix Networks and Navtel Communications, which were respectively acquired two months and one month into the third quarter of fiscal 2008, contributed for the whole year to our selling and administrative expenses in fiscal 2009, which caused these expenses to increase compared to 2008. In addition, selling expenses for Brix Networks and Navtel Communications tend to be higher in percentage of sales than the rest of our business, as their sales cycle is much longer and more complex than our other product lines.

In addition, during fiscal 2009, despite the challenging market conditions and currency fluctuations, we maintained our sales and marketing activities for most of the year to develop our markets and to support the launches of several products.

However, in fiscal 2009, the substantial and sudden decrease in the average value of the Canadian dollar, compared to the US dollar year-over-year, had a significant positive impact on our selling and administrative expenses, since a large portion of these expenses is denominated in Canadian dollars and since these expenses increased year-over-year. Also, the restructuring plan implemented in the fourth quarter of fiscal 2009 has, to some extent, decreased our selling and administrative expenses.

Furthermore, in fiscal 2008, we discontinued certain product lines, which led to the layoff of some of our sales and marketing personnel, resulting in severance expenses in 2008.

In fiscal 2009, our selling and administrative expenses increased in percentage of sales compared to 2008. This increase is explained by the impact of the acquisitions of Brix Networks and Navtel Communications—whose selling expenses tend to be higher and whose products deliver better margins than the rest of our product lines—and by the reduction of our sales levels due to the worldwide recession, despite the significant decrease in the average value of the Canadian dollar compared to the US dollar year-over-year.

Outlook for fiscal 2011

For fiscal 2011, considering the current value of the Canadian dollar compared to the US dollar and the significant impact that the recent acquisition of NetHawk will have on our selling and administrative expenses, we expect our selling and administrative expenses to increase in dollars and range between 32% and 34% of sales. In addition, in fiscal 2010, we expect our commission expenses to increase as the sales volume increases. Furthermore, considering our goal of becoming the leading player in the telecom test and service assurance space and to deliver the synergies expected from our recent acquisition, we plan to continue intensifying our sales and marketing efforts, both domestic and international, which will also cause our expenses to rise. Finally, any increase in the strength of the Canadian dollar and the euro would also cause our selling and administrative expenses to increase, as a portion of these expenses are incurred in Canadian dollars and euros.

RESEARCH AND DEVELOPMENT

Gross research and development expenses

Gross research and development expenses totaled \$44.6 million, \$33.6 million and \$30.2 million for fiscal 2010, 2009 and 2008, respectively. As a percentage of sales, gross research and development expenses amounted to 22.0%, 21.9% and 18.7% for fiscal 2010, 2009 and 2008, respectively, while net research and development expenses accounted for 18.7%, 17.8% and 15.3% of sales for these respective years.

Fiscal 2010 vs. 2009

In fiscal 2010, NetHawk, acquired on March 12, 2010, contributed about five and a half months to our gross research and development expenses, which caused them to increase year-over-year. NetHawk tends to incur higher research and development expenses in percentage of sales, compared to our other product lines, as its products are more software-intensive, although they deliver higher margins than most of our other product lines.

In addition, the significant increase (12.8%) in the average value of the Canadian dollar compared to the US dollar year-over-year is also responsible for the significant increase of our gross research and development expenses year-over-year, as a large portion of these expenses are denominated in Canadian dollars and we report our results in US dollars and as these expenses increased year-over-year.

Finally, we intensified our research and development activities, namely in our software development center in Pune, India, and in our service assurance development center, which resulted in increased gross research and development expenses in fiscal 2010, compared to 2009.

Fiscal 2009 vs. 2008

Brix Networks and Navtel Communications, which were acquired two months and one month into the third quarter of fiscal 2008, respectively, contributed to our gross research and development expenses during the entire year in fiscal 2009; this caused these expenses to increase both in dollars and in percentage of sales, compared to 2008. Brix Networks and Navtel Communications tend to incur higher research and development expenses in percentage of sales, compared to our other product lines, as their products are more software-intensive, although they deliver higher margins than most of our other product lines.

In addition, we intensified our research and development activities by hiring additional employees, namely in our software development center in Pune, India, which resulted in increased gross research and development expenses in fiscal 2009, compared to 2008.

However, during fiscal 2009, the significant and rapid decrease in the average value of the Canadian dollar, compared to the US dollar year-over-year, had a substantial positive effect on our gross research and development expenses, as a significant portion of these expenses are denominated in Canadian dollars and also because these expenses increased year-over-year.

Also, in fiscal 2008, we closed down our research and development operations in Budapest, Hungary, and certain research and development projects, which resulted in severance expenses during fiscal 2008.

The increase in our gross research and development expenses as a percentage of sales year-over-year is mainly due to a lower sales volume and the impact of the acquisitions of Brix Networks and Navtel Communications.

Tax credits and grants

We are entitled to tax credits from the Canadian federal and provincial governments for eligible research and development activities conducted in Canada. We are also eligible to grants by a Finnish technology organization on certain research and development projects conducted in Finland by NetHawk.

Tax credits and grants for research and development activities were \$6.7 million, \$6.4 million and \$5.6 million for fiscal 2010, 2009 and 2008, respectively. As a percentage of gross research and development expenses, tax credits reached 15.0%, 19.0% and 18.5% for fiscal 2010, 2009 and 2008, respectively.

Fiscal 2010 vs. 2009

A significant portion of the increase in our tax credits and grants in fiscal 2010, compared to 2009, comes from newly acquired NetHawk, which contributed about five and a half months to our grants. In addition, our research and development tax credits are denominated in Canadian dollars. The significant increase in the average value of the Canadian dollar, compared to the US dollar, in fiscal 2010 compared to 2009 had a positive impact on these tax credits expressed in US dollars.

The decrease in research and development tax credits and grants as a percentage of gross research and development expenses in fiscal 2010, compared to 2009, is mainly due to the fact that the portion of gross research and development incurred in Canada, where we are entitled to tax credits, was lower than last year because we continued intensifying our activities in our software development center in India as well as in our service assurance development center, which is located in the United States. In addition, a significant portion of NetHawk's research and development activities are conducted in India and in the United States. Research and development activities conducted in India and in the United States do not entitle us to tax credits and grants.

Fiscal 2009 vs. 2008

Increased research and development activities in Canada in fiscal 2009 compared to 2008, where we are eligible to tax credits, resulted in increased tax credits year-over-year. However, our research and development tax credits are denominated in Canadian dollars. The significant decrease in the average value of the Canadian dollar, compared to the US dollar, in fiscal 2009, compared to 2008, had a negative impact on these tax credits once expressed in US dollars.

Outlook for fiscal 2011

For fiscal 2011, considering the current value of the Canadian dollar compared to the US dollar and the significant impact that the recent acquisition of NetHawk will have on our research and development expenses, we expect our net research and development expenses to increase in dollars, and range between 17% and 19% of sales, given our focus on innovation, the addition of software features in our products, our desire to gain market share and our goal to exceed customer needs and expectations. Also, we are increasingly taking advantage of talent pools around the world, namely through our software development centers in Pune and Bhubaneswar, India. Finally, any increase in the strength of the Canadian dollar and euro versus the US dollar in the upcoming quarters would also cause our net research and development expenses to increase, as a significant portion of these expenses are incurred in Canadian dollars and euros.

AMORTIZATION OF PROPERTY, PLANT AND EQUIPMENT

In fiscal 2010, amortization of property, plant and equipment was \$5.8 million, compared to \$4.5 million in 2009 and \$4.1 million in 2008.

Fiscal 2010 vs. 2009

The increase in amortization expenses in fiscal 2010, compared to 2009, mainly comes from the acquisition of NetHawk in mid-March 2010, the increase in the average value of the Canadian dollar versus the US dollar year-over-year as well as the additions to property, plant and equipment over the last few quarters.

Fiscal 2009 vs. 2008

The increased activities of our own manufacturing facility in China, the upgrade of our IT systems and the impact of the acquisitions of Brix Networks and Navtel Communications (acquired in the third quarter of fiscal 2008) resulted in an increase in our amortization expenses in fiscal 2009, compared to 2008. However, the significant decrease in the average value of the Canadian dollar versus the US dollar in fiscal 2009, compared to 2008, limited the increase in our amortization expenses year-over-year as a significant portion of these expenses are denominated in Canadian dollars.

Outlook for fiscal 2011

For fiscal 2011, considering the current value of the Canadian dollar compared to the US dollar, the impact that the recent acquisition of NetHawk and the expected additions to property, plant and equipment will have on our amortization expenses, we expect our amortization expenses to increase in dollars in 2011.

AMORTIZATION OF INTANGIBLE ASSETS

In conjunction with the business combinations we completed over the past several years, we recorded intangible assets, primarily consisting of core technology and customer relationships. These intangible assets resulted in amortization expenses of \$7.8 million, \$5.0 million and \$3.9 million for fiscal 2010, 2009 and 2008, respectively.

Fiscal 2010 vs. 2009

The increase in amortization expenses in fiscal 2010, compared to 2009, is mainly due to the acquisition of NetHawk in mid-March 2010 as well as to the increase in the average value of the Canadian dollar versus the US dollar year-over-year.

Fiscal 2009 vs. 2008

The increase in amortization expenses in fiscal 2009, compared to 2008, is mainly due to the acquisition of Brix Networks core technology in the third quarter of 2008. However, the significant decrease in the average value of the Canadian dollar versus the US dollar in fiscal 2009, compared to 2008, limited the increase in our amortization expenses year-over-year as a portion of these expenses are denominated in Canadian dollars.

Outlook for fiscal 2011

For fiscal 2010, considering the current value of the Canadian dollar compared to the US dollar and the impact that the recent acquisition of NetHawk will have on our amortization expenses, we expect our amortization expenses to increase in 2011.

RESTRUCTURING CHARGES

During fiscal 2009, we implemented a restructuring plan to align our cost structure to the difficult economic and market conditions. Under that plan, we recorded charges of \$1.0 million in severance expenses for the 58 employees who were terminated throughout the company. These charges are included in the restructuring charges in the statement of earnings for the year ended August 31, 2009.

IMPAIRMENT OF GOODWILL

Recoverability of goodwill is determined at the reporting unit level, using a two-step approach. First, the carrying value of the reporting units is compared to their fair value. If the carrying value of a reporting unit exceeds its fair value, the second step is performed to determine the amount of the impairment loss. In the third quarter of fiscal 2009, we performed our annual impairment test for goodwill for all reporting units. Following the decrease in our stock price in June, 2009, we came to the conclusion that the carrying value of one of our reporting units exceeded its fair value. We recorded an impairment charge of \$21.7 million in fiscal 2009 to bring the goodwill of this reporting unit to its fair value. The fair value of the reporting unit was determined based on a combination of our market capitalization and discounted cash flows. Discounted cash flows were estimated using periods ranging between 5 to 7 years and a discount rate of 18%. This impairment resulted in a future income tax recovery of \$2.1 million.

We performed our annual impairment test for goodwill in May 2010 based on a methodology and assumptions consistent with the previous year, and we determined that goodwill was not impaired.

INTEREST INCOME (EXPENSE), NET

Our interest income mainly resulted from our short-term investments, less interests and bank charges. Our net interest expense amounted to \$292,000 in fiscal 2010 compared to net interest income of \$592,000 and \$4.4 million in fiscal 2009 and 2008, respectively.

Fiscal 2010 vs. 2009

The decrease in our interest income in fiscal 2010 compared to 2009 is mainly due to the decrease of our cash and short-term investments following the cash payment of \$26.9 million for the redemption of share capital in fiscal 2009, in accordance with our share buy-back programs and the cash payment of \$33.0 million for the acquisition of NetHawk in fiscal 2010.

Fiscal 2009 vs. 2008

The decrease in interest income in fiscal 2009, compared to 2008, is mainly due to the decrease in our cash and short-term investments following the cash payment of \$41.0 million for the acquisitions of Brix Networks and Navtel Communications in the third quarter of fiscal 2008, the redemption of share capital amounting to \$34.9 million over the last two years, in accordance with our share buy-back programs, as well as the significant reduction in interest rates year-over-year. In addition, the significant decrease in the average value of the Canadian dollar, compared to the US dollar year-over-year, contributed to the decrease in our interest income in fiscal 2009, compared to 2008, as it is denominated in Canadian dollars.

FOREIGN EXCHANGE GAIN (LOSS)

Foreign exchange gains and losses are mainly the result of the translation of operating activities denominated in currencies other than the measurement currency (mainly the Canadian dollar).

We reported a foreign exchange loss of \$1.5 million in fiscal 2010, compared to foreign exchange gains of \$ 1.1 million and \$404,000 in fiscal 2009 and 2008, respectively.

Fiscal 2010 vs. 2009

In fiscal 2010, the value of the Canadian dollar increased versus the US dollar, the euro and the British pound, compared to August 31, 2009, which resulted in a foreign exchange loss of \$1.5 million during the year. In fact, the period-end value of the Canadian dollar increased 2.8% versus the US dollar to CA\$1.0665 = US\$1.00 at the end of fiscal 2010, compared to CA\$1.0967 = US\$1.00 at the end of 2009. It increased 16.5% versus the euro to CA\$1.3515 = €1.00, compared to CA\$1.5741 = €1.00 at the end of fiscal 2009. Finally, it increased 9.5% versus the British pound to CA\$1.6337 = £1.00 at the end of fiscal 2010 compared to CA\$1.7888 = £1.00 at the end of 2009. In addition, the volume of operations denominated in foreign currencies (including balance sheet items) increased year-over-year, further increasing the exchange loss compared to the same period last year.

It should be noted that foreign exchange rate fluctuations also flow through the P&L line items as a significant portion of our operating items are denominated in Canadian dollars, and we report our results in US dollars. Consequently, the significant increase in the average value of the Canadian dollar in fiscal 2010, compared to 2009, resulted in a significant and negative impact on our financial results of 2010. This was amplified by the fact that our operating activities incurred in Canadian dollars increased year-over-year. In fact, the average value of the Canadian dollar in fiscal 2010 was CA\$1.0446 = US\$1.00 compared to CA\$1.1782 = US\$1.00 in 2009, representing an increase of 12.8% in the average value of the Canadian dollar year-over-year. In fiscal 2009, the average value of the Canadian dollar was CA\$1.1782 = US\$1.00 compared to CA\$1.0071 = US\$1.00 in 2008, representing a decrease of 14.5% in the average value of the Canadian dollar year-over-year. This had a significant and positive impact on our financial results of 2009.

Fiscal 2009 vs. 2008

During fiscal 2009, we witnessed huge volatility in the value of the Canadian dollar as it fluctuated compared to the US dollar, which overall resulted in a foreign exchange gain of \$1.1 million. In fact, the period-end value of the Canadian dollar decreased 3.1% to CA\$1.0967 = US\$1.00 at the end of fiscal 2009, compared to CA\$1.0626 = US\$1.00 at the end of 2008.

We manage our exposure to currency risks with forward exchange contracts. In addition, some of our entities' operating activities are denominated in US dollars or other currencies, which further hedges these risks. However, any increase in the value of the Canadian dollar, compared to the US dollar, the euro and the British pound, would have a negative impact on our operating results.

INCOME TAXES

We recorded income tax expenses of \$5.5 million, \$266,000 and \$337,000 in fiscal 2010, 2009 and 2008, respectively.

Fiscal 2010

In fiscal 2010, we reported an income tax expense of \$5.5 million on earnings before income taxes of \$9.1 million, for an effective income tax rate of 60.9%. This situation mainly results from the fact that we continue to maintain a valuation allowance for some of our subsidiaries at loss and we have some non-deductible expenses, such as stock-based compensation costs. In addition, a portion of our foreign exchange loss is created by the translation of financial statements of our foreign integrated subsidiaries, and is therefore non-deductible. Otherwise, the actual tax rate would have been closer to the statutory tax rate of 30% for that year.

Fiscal 2009

In fiscal 2009, we reported an income tax expense of \$266,000 on a loss before income taxes of \$20.6 million, for a nominal effective tax rate. This situation mainly results from the fact that a significant portion of the impairment of goodwill of \$21.7 million was not deductible for tax purposes. In addition, we continued to maintain a valuation allowance for some of our subsidiaries at loss and we had some non-deductible expenses, such as stock-based compensation costs. On the other hand, a significant portion of our foreign exchange gain was created by the translation of financial statements of our foreign integrated subsidiaries, and was therefore non-taxable. Otherwise, the actual tax rate would have been closer to the statutory tax rate of 31% for that year.

Fiscal 2008

During fiscal 2008, reductions to the Canadian federal statutory tax rate were substantively enacted. Therefore, Canadian federal future income tax assets decreased by \$1.5 million and generated a future income tax expense in the same amount during the year.

In addition, during fiscal 2008, taking into account these new Canadian federal substantively enacted tax rates, we reviewed our tax strategy for the future use of our Canadian federal operating losses, research and development expenses, certain timing differences and research and development tax credits to minimize income taxes payable on future years' taxable income. Consequently, we amended our prior year's income tax returns to generate a net operating loss to be carried back to prior years, which reinstated previously used research and development tax credits. This resulted in an increase of \$2.7 million in both our tax-related assets in the balance sheet and future income tax recovery in the statement of earnings for the year ended August 31, 2008.

Finally, during fiscal 2008, considering the expected positive impact that the acquisitions of Brix Networks and Navtel Communications would have on future years' taxable income at the United States federal level, and because actual taxable income in the United States was greater than initially expected, we concluded that it was more likely than not that all future income tax assets of our existing consolidated U.S. group would be recovered. Consequently, we reversed our valuation allowance against future income tax assets in the amount of \$7.6 million. The portions of the valuation allowance that were reversed, and that were attributable to the effects of the Brix Networks and Navtel Communications acquisitions—in the amount of \$652,000 and \$1.6 million, respectively—were included in the purchase price allocation of the related acquired businesses. The remainder of the reversal, in the amount of \$5.3 million, has been recorded in income taxes in the statement of earnings for the year ended August 31, 2008.

Altogether, these elements generated an income tax recovery of \$6.5 million. Excluding these items, the income tax expense would have amount to \$6.9 million, on earnings before income taxes of \$14.0 million for an effective income tax rate of 47%. In 2008, we maintained a valuation allowance for some of our subsidiaries at loss and we had some non-deductible expenses, such as stock-based compensation costs. Otherwise, the actual tax rate would have been closer to the statutory tax rate of 31% for that year.

Future income tax assets

As at August 31, 2010, our net future income tax assets recognized in the balance sheet amounted to \$19.1 million, and our non-refundable research and development tax credits amounted to \$29.4 million. In order to realize these future income tax assets and non-refundable research and development tax credits, we need to generate approximately \$216 million in pretax earnings at the Canadian federal level, approximately \$36 million at the Canadian provincial levels, and approximately \$34 million at the United States federal level.

Valuation allowance

As at August 31, 2009 and 2010, we were in a cumulative loss position in certain of our subsidiaries and negative evidence outweighed positive evidence. For these subsidiaries, we maintained a valuation allowance against our net future income tax assets. As at August 31, 2010, the valuation allowance for these subsidiaries amounted to \$19.3 million and mainly related to operating losses and research and development expenses carried forward. Of the valuation allowance of \$19.3 million, \$11.3 million related to Brix Networks and NetHawk at the acquisition date. In the event that we reverse a portion of or all the valuation allowance related to Brix Networks and NetHawk, the amount of such reversal would reduce the amount of goodwill recognized for these acquisitions.

Please refer to note 19 of our consolidated financial statements for more details on income taxes and a full reconciliation of the income tax provision.

EXTRAORDINARY GAIN

In conjunction with the acquisition of Navtel Communications, we recorded negative goodwill in the amount of \$3.0 million. This negative goodwill has been recorded as an extraordinary gain in the statement of earnings for fiscal 2008.

RESULTS OF DISCONTINUED OPERATIONS (formerly the Life Sciences and Industrial Division)

SALES

Fiscal 2010 vs. 2009

In fiscal 2010, sales of discontinued operations increased 28.1% to \$25.4 million, compared to \$19.8 million in 2009.

In fiscal 2010, this Division benefited from improving market conditions as a significant part of its product offering is related to manufacturing applications of consumer goods, which have been more affected by the global economic recession in fiscal 2009.

In addition, a significant portion of sales of that division are conducted through original equipment manufacturer (OEM) agreements. Consequently, we are dependent, to some extent, on the buying pattern of our customers.

Fiscal 2009 vs. 2008

In fiscal 2009, sales of that Division decreased 13.2% to \$19.8 million, compared to \$22.8 million in 2008.

As previously mentioned, a significant portion of that Division's sales activities are conducted through original equipment manufacturer (OEM) agreements. Consequently, we are dependent, to some extent, on the buying pattern of our customers. Moreover, a significant part of our product offering is related to manufacturing applications of consumer goods, which have been affected by the current state of the global economy. Finally, the decrease in the value of the Canadian dollar and the euro versus the US dollar year-over-year had a negative impact on sales of this Division, since a portion of these are denominated in currencies other than the US dollar and since we report our results in US dollars.

EARNINGS FROM OPERATIONS

Fiscal 2010 vs. 2009

In fiscal 2010, earnings from operations of that Division increased 2.4% to \$4.3 million, or 16.9% of sales, compared to \$4.2 million, or 21.1% of sales in 2009. Earnings from operations in 2009 included a gain of \$1.9 million for the one-time recognition of previously unrecognized non-refundable research and development tax credits. These tax credits were recognized after reviewing both available positive and negative evidence, and because we were in a cumulative profit position in this Division, and also because we expected to generate sufficient taxable income in future years at the Division level. In addition, as a significant portion of the operating items of that Division are denominated in Canadian dollars, and we report our results in US dollars, the significant increase in the average value of the Canadian dollar in fiscal 2010, compared to 2009, resulted in a significant and negative impact on the financial results of that Division year-over-year. On the other hand, in fiscal 2009, we implemented a restructuring plan to align our cost structure to the current economic and market conditions, and we recorded charges of \$208,000 in severance expenses for the employees who were terminated. We did not have such expenses in 2010 in this Division. Finally, increased sales activities in fiscal 2010 compared to 2009 resulted in increased earnings from operations year-over-year, as a portion of operating expenses of this Division are fixed.

Fiscal 2009 vs. 2008

In fiscal 2009, earnings from operations increased 48.5% to \$4.2 million, or 21.1% of sales, compared to \$2.8 million, or 12.3% of sales in 2008. As mentioned above, earnings from operations in 2009 included \$1.9 million for the one-time recognition of previously unrecognized non-refundable research and development tax credits. In addition, the significant decrease in the average value of the Canadian dollar in fiscal 2009, compared to 2008, resulted in a significant and positive impact on the financial results of that Division year-over-year. On the other hand, in fiscal 2009, we recorded charges of \$208,000 in severance expenses for the employees who were terminated under our restructuring plan. We did not have such expenses in 2008 in this Division. Finally, decreased sales activities had a negative impact year-over-year as a portion of operating expenses are fixed.

LIQUIDITY AND CAPITAL RESOURCES

Cash requirements and capital resources (from continuing operations)

As at August 31, 2010, cash and short-term investments totaled \$31.8 million, while our working capital was at \$98.4 million. Our cash and short-term investments decreased \$37.1 million in fiscal 2010, compared to 2009, mainly due to the cash payments of \$33.0 million and \$9.0 million for the acquisition of NetHawk and the purchase of capital assets, respectively. On the other hand, we recorded an unrealized foreign exchange gain on our cash and short-term investments of \$3.0 million. This unrealized foreign exchange gain resulted from the translation, in US dollars, of our Canadian-dollar- and euro-denominated cash and short-term investments, and was included in the accumulated other comprehensive income in the balance sheet. In addition, operating activities generated cash flows of \$1.8 million.

Our short-term investments consist of commercial paper issued by nine (eleven as at August 31, 2009) high-credit quality corporations and trusts; therefore, we consider the risk of non-performance of these financial instruments to be limited. None of these debt instruments are expected to be affected by a significant liquidity risk. For the purposes of managing our cash position, we have established a cash management policy, which we follow and monitor on a regular basis. Our short-term investments will be used for working capital and other general corporate purposes, including the remaining cash payment and any payment for the cash contingent consideration related to the recent acquisition of NetHawk, any other potential acquisition, as well as our share repurchase program.

Newly acquired NetHawk has a long-term debt denominated in euros amounting to \$2.0 million (€1.6 million) as at August 31, 2010. This debt, which matures in 2013, is collateralized by assets of NetHawk, bears interest at an annual rate of 2.95% and is repayable in bi-annual installments of \$284,000 (€224,000).

We believe that our cash balances and short-term investments will be sufficient to meet our liquidity and capital requirements for the foreseeable future, including the remaining cash payment for the acquisition of NetHawk, estimated at \$1.4 million, the maximum cash contingent consideration of €8.7 million (US\$11.0 million) that may become payable in conjunction with this acquisition if sales objectives are met, the payment of our long-term debt, as well as the effect of our normal course issuer bid. In addition to these assets, we have unused available lines of credit totaling \$14.7 million for working capital and other general corporate purposes and unused lines of credit of \$16.5 million for foreign currency exposure related to forward exchange contracts. In addition, following the sale of our Life Sciences and Industrial Division on October 1, 2010, we received approximately \$22 million in cash. However, possible operating losses and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms.

As at August 31, 2010, our commitments under operating leases for continuing operations amount to \$4.7 million in 2011, \$3.0 million in 2012, \$1.8 million in 2013, \$1.0 million in 2014 and \$2.0 million in 2015 and after, for total commitments of \$12.5 million.

Sources and uses of cash

We finance our operations and meet our capital expenditure requirements mainly through cash flows from operating activities, the use of our cash and short-term investments as well as the issuance of subordinate voting shares.

Operating activities (including discontinued operations)

Cash flows provided by operating activities were \$1.8 million in fiscal 2010, compared to \$22.6 million in 2009 and \$12.7 million in 2008.

Fiscal 2010 vs. 2009

Cash flows provided by operating activities in fiscal 2010 were attributable to the net earnings after items not affecting cash of \$32.1 million, largely offset by the negative net change in non-cash operating items of \$30.3 million. The negative net change in non-cash operating items was mainly due to the negative effect on cash of the increase of \$22.5 million of our accounts receivable, the negative effect on cash of the increase of \$9.3 million of our inventories and the negative effect on cash of the increase of \$4.1 million of our income taxes and tax credits recoverable. These were offset in part by the positive effect on cash of the increase of \$5.5 million of our accounts payable and accrued liabilities and other liabilities. The increase of our accounts receivable is directly attributable to the significant increase in sales year-over-year and the timing of sales during the year. The increase in our inventories is mainly due to increased activity levels year-over-year. The increase in our income taxes and tax credits is mainly due to the increase in our tax credits recoverable that were earned during the year but not yet recovered. The increase in our accounts payable and accrued liabilities and other liabilities is due to increased activities year-over-year and the timing of purchases and payments in fiscal 2010.

Fiscal 2009 vs. 2008

Cash flows provided by operating activities in fiscal 2009 were attributable to the net earnings after items not affecting cash of \$16.5 million, and to the positive net change in non-cash operating items of \$6.1 million. The positive net change in non-cash operating items was mainly due to the positive effect on cash of the decrease of \$9.7 million of our accounts receivable, the positive effect on cash of the decrease of \$2.6 million of our inventories, offset in part by the negative effect on cash of the increase of \$3.4 million of our income taxes and tax credits recoverable, as well as the negative effect on cash of the decrease of \$2.4 million of our accounts payable and accrued liabilities. The decrease of our accounts receivable is directly attributable to the decrease in sales year-over-year and the timing of sales during the year. The decrease in our inventories is mainly due to lower activity levels year-over-year and a shift in product mix in favor of software-intensive products requiring less material and parts than our traditional ones. The increase in our income taxes and tax credits is mainly due to the increase in our tax credits recoverable that were earned during the year but not yet recovered, as well as the fact that we recognized at the end of the year previously unrecognized research and development tax credits. The decrease in our accounts payable and accrued liabilities is due to the timing of purchases and payments.

Investing activities (including discontinued operations)

Cash flows provided by investing activities amounted to \$10.4 million in fiscal 2010, compared to \$8.8 million in 2009 and cash flows used of \$4.2 million in 2008.

Fiscal 2010

In fiscal 2010, we disposed (net of acquisitions) of \$52.4 million worth of short-term investments but paid \$33.0 million for the acquisition of NetHawk and \$9.0 million for the purchase of capital assets.

Fiscal 2009

In fiscal 2009, we disposed (net of acquisitions) of \$18.1 million worth of short-term investments but paid \$6.9 million for the purchase of capital assets and \$2.4 million for a contingent consideration on a business combination.

Financing activities (including discontinued operations)

Cash flows provided by financing activities amounted to \$55,000 in fiscal 2010, compared to cash flows used of \$26.8 million in 2009 and \$8.0 million in 2008.

Fiscal 2010

In fiscal 2010, we made a repayment of our long-term debt of \$274,000 and redeemed share capital for a cash consideration of \$14,000. On the other hand, we received \$343,000 from the exercise of stock options.

Fiscal 2009

In fiscal 2009, we redeemed share capital for a cash consideration of \$26.9 million. However, during that year, exercise of stock options generated \$56,000.

FORWARD EXCHANGE CONTRACTS

We utilize forward exchange contracts to manage our foreign currency exposure. Our policy is not to utilize those derivative financial instruments for trading or speculative purposes.

Our forward exchange contracts, which are used to hedge anticipated US-dollar-denominated sales, qualify for hedge accounting; therefore, foreign exchange translation gains and losses on these contracts are recognized as an adjustment of the revenues when the corresponding sales are recorded.

As at August 31, 2010, we held forward exchange contracts to sell US dollars at various forward rates, which are summarized as follows:

<u>Expiry dates</u>	<u>Contractual amounts</u>	<u>Weighted average contractual forward rates</u>
September 2010 to August 2011	\$ 29,500,000	1.0897
September 2011 to August 2012	20,400,000	1.0802
September 2012 to January 2013	1,500,000	1.0722
Total	<u>\$ 51,400,000</u>	<u>1.0854</u>

The carrying amount of forward exchange contracts is equal to fair value, which is based on the amount at which they could be settled based on estimated current market rates. The fair value of forward exchange contracts amounted to net gains of \$530,000 and \$597,000 as at August 31, 2009 and 2010, respectively. The year-end exchange rate was CA\$1.0665 = US\$1.00 as at August 31, 2010.

CONTINGENCY

Class action

On November 27, 2001, a class action suit was filed in the United States District Court for the Southern District of New York against EXFO, four of the underwriters of our Initial Public Offering and some of our executive officers pursuant to the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder and Sections 11, 12 and 16 of the Securities Act of 1933. This class action alleges that EXFO's registration statement and prospectus filed with the Securities and Exchange Commission on June 29, 2000, contained material misrepresentations and/or omissions resulting from (i) the underwriters allegedly soliciting and receiving additional, excessive and undisclosed commissions from certain investors in exchange for which they allocated material portions of the shares issued in connection with EXFO's Initial Public Offering; and (ii) the underwriters allegedly entering into agreements with customers whereby shares issued in connection with EXFO's Initial Public Offering would be allocated to those customers in exchange for which customers agreed to purchase additional amounts of shares in the after-market at predetermined prices.

On April 19, 2002, the plaintiffs filed an amended complaint containing master allegations against all of the defendants in all of the 310 cases included in this class action and also filed an amended complaint containing allegations specific to four of EXFO's underwriters, EXFO and two of our executive officers. In addition to the allegations mentioned above, the amended complaint alleges that the underwriters (i) used their analysts to manipulate the stock market; and (ii) implemented schemes that allowed issuer insiders to sell their shares rapidly after an initial public offering and benefit from high market prices. As concerns EXFO and our two executive officers in particular, the amended complaint alleges that (i) EXFO's registration statement was materially false and misleading because it failed to disclose the additional commissions and compensation to be received by underwriters; (ii) the two named executive officers learned of or recklessly disregarded the alleged misconduct of the underwriters; (iii) the two named executive officers had motive and opportunity to engage in alleged wrongful conduct due to personal holdings of EXFO's stock and the fact that an alleged artificially inflated stock price could be used as currency for acquisitions; and (iv) the two named executive officers, by virtue of their positions with EXFO, controlled it and the contents of the registration statement and had the ability to prevent its issuance or cause it to be corrected. The plaintiffs in this suit seek an unspecified amount for damages suffered.

In July 2002, the issuers filed a motion to dismiss the plaintiffs' amended complaint and a decision was rendered on February 19, 2003. Only one of the claims against EXFO was dismissed. On October 8, 2002, the claims against its officers were dismissed, without prejudice, pursuant to the terms of Reservation of Rights and Tolling Agreements entered into with the plaintiffs (the "Tolling Agreements"). Subsequent addenda to the Tolling Agreements extended the tolling period through August 27, 2010.

In June 2004, an agreement of partial settlement was submitted to the court for preliminary approval. The proposed partial settlement was between the plaintiffs, the issuer defendants in the consolidated actions, the issuer officers and directors named as defendants, and the issuers' insurance companies. The court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005, the court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The court also appointed the notice administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members by January 15, 2006. The settlement fairness hearing occurred on April 24, 2006, and the court reserved decision at that time.

While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The district court directed that the litigation proceed within a number of "focus cases" rather than in all of the 310 cases that have been consolidated. EXFO's case is not one of these focus cases. On October 13, 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision.

On April 6, 2007, the Second Circuit denied the plaintiffs' petition for rehearing of that decision and, on May 18, 2007, the Second Circuit denied the plaintiffs' petition for rehearing *en banc*. In light of the Second Circuit's opinion, liaison counsel for all issuer defendants, including EXFO, informed the court that this settlement cannot be approved, because the defined settlement class, like the litigation class, cannot be certified. On June 25, 2007, the district court entered an order terminating the settlement agreement. On August 14, 2007, the plaintiffs filed their second consolidated amended class action complaints against the focus cases and, on September 27, 2007, again moved for class certification. On November 12, 2007, certain defendants in the focus cases moved to dismiss the second consolidated amended class action complaints. On March 26, 2008, the district court denied the motions to dismiss, except as to Section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside of the previously certified class period. Briefing on the class certification motion was completed in May 2008. That motion was withdrawn without prejudice on October 10, 2008.

On April 2, 2009, a stipulation and agreement of settlement between the plaintiffs, issuer defendants and underwriter defendants was submitted to the Court for preliminary approval. The Court granted the plaintiffs' motion for preliminary approval and preliminarily certified the settlement classes on June 10, 2009. The settlement fairness hearing was held on September 10, 2009. On October 6, 2009, the Court entered an opinion granting final approval to the settlement and directing that the Clerk of the Court close these actions. On August 26, 2010, based on the expiration of the tolling period stated in the Tolling Agreements, the plaintiffs filed a Notice of Termination of Tolling Agreement and Recommencement of Litigation against the two named executive officers. The plaintiffs stated to the Court that they do not intend to take any further action against the named executive officers at this time. Notices of appeal of the opinion granting final approval have been filed. Given that the settlement remains subject to appeal as of the date of issuance of these financial statements, the ultimate outcome of the contingency is uncertain. However, based on the settlement approved on October 6, 2009, and the related insurance against such claims, we have determined the impact to our financial position and results of operations as at and for the year ended August 31, 2010 to be immaterial.

Cash contingent consideration

Following the purchase of assets in fiscal 2009, we have a cash contingent consideration of up to \$825,000 payable based upon the achievement of a certain booking volume in the next six months.

SHARE CAPITAL AND STOCK-BASED COMPENSATION PLANS

Share capital

As at November 5, 2010, EXFO had 36,643,000 multiple voting shares outstanding, entitling to 10 votes each and 23 114 482 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

Long-Term Incentive Plan and Deferred Share Unit Plan

The aggregate number of subordinate voting shares covered by stock options, restricted share units (RSUs) and deferred share units (DSUs) granted under the Long-Term Incentive Plan and the Deferred Share Unit Plan was 3,086,838 as at August 31, 2010. The maximum number of subordinate voting shares issuable under these two plans cannot exceed 6,306,153 shares. The following tables summarize information about stock options, RSUs and DSUs granted to the members of the Board of Directors and to Management and Corporate Officers of the company and its subsidiaries as at August 31, 2010:

Stock Options	Number	% of issued and outstanding	Weighted average exercise price
Chairman of the Board, President and CEO (one individual)	154,240	11 %	\$6.26
Board of Directors (four individuals)	117,807	9	5.95
Management and Corporate Officers (eight individuals)	187,039	14	14.79
	<u>459,086</u>	<u>34 %</u>	<u>\$9.66</u>

Restricted Share Units (RSUs)	Number	% of issued and outstanding
Chairman of the Board, President and CEO (one individual)	197,533	12 %
Management and Corporate Officers (thirteen individuals)	589,093	37
	<u>786,626</u>	<u>49 %</u>

Deferred Share Units (DSUs)	Number	% of issued and outstanding
Board of Directors (five individuals)	135,003	100 %

OFF-BALANCE SHEET ARRANGEMENTS

As at August 31, 2010, our off-balance sheet arrangements consisted of letters of guarantee amounting to \$5.4 million; these letters of guarantee expire at various dates through fiscal 2016. From this amount, we had \$1.0 million worth of letters of guarantee for our own selling and purchasing requirements, which were for the most part reserved from one of our lines of credit. The remainder, in the amount of \$4.4 million, was used to secure our line of credit in CNY (Chinese currency). This line of credit was unused as at August 31, 2010.

VARIABLE INTEREST ENTITY

As of August 31, 2010, we did not have interests in any variable interest entities.

RISKS AND UNCERTAINTIES

Over the past several years, we have managed our business in a difficult environment; focused on research and development programs for new and innovative products aimed at expected growth pockets in our sector; continued the development of our domestic and international markets; and made strategic acquisitions. However, we operate in a highly competitive and complex sector that is in constant evolution and, as a result, we encounter various risks and uncertainties that must be given appropriate consideration in our strategic management plans and policies.

While strategic acquisitions, like the recent acquisition of NetHawk, those we have made in the past and possibly others in the future, are essential to our long-term growth, they also expose us to certain risks and uncertainties related to the rapid and effective integration of these businesses, their products, technologies and personnel as well as key personnel retention. Finally, integration of NetHawk will require the dedication of management resources, which may detract their attention from our day-to-day business and operations.

In addition, we are exposed to currency risks due to the export of our products manufactured in Canada and China; the large majority of these sales are denominated in US dollars and euros. These risks are partially hedged by operating expenses denominated in US dollars and euros, the purchase of raw materials in US dollars as well as forward exchange contracts. Any decrease in the value of the US dollar compared to the Canadian dollar and the euro in the coming months would negatively affect our results of operations.

Also, our business is subject to the effects of general economic conditions in North America and throughout the world and, more particularly, market conditions in the telecommunications industry. In the past, our operating results were adversely affected by reduced telecom capital spending in North America, Europe and Asia and by unfavorable general economic conditions. In particular, sales to network service providers in North America were significantly and adversely affected by a downturn in 2001 in the telecommunications industry and by the global economic recession in 2009. These recession and downturn affected our key geographic regions or markets. In the event of another recession or slowdown in key geographic regions or markets, we may experience a material adverse impact on our business, operating results and financial conditions.

Furthermore, risks and uncertainties related to the telecommunications test and service assurance industry involve the rapid development of new products that may have short life cycles and require extensive research and development; the difficulty of adequately predicting market size and trends; the difficulty of retaining highly skilled employees; and the ability to quickly adapt our cost structure to changing market conditions in order to achieve profitability.

Also, given our strategic goals for growth and competitive positioning in our industry, we are continuously expanding into international markets, which requires certain actions, such as the operation of our manufacturing facilities in China and software development centers in India. This exposes us to certain risks and uncertainties, namely changes in local laws and regulations, multiple technological standards, protective legislation, pricing pressure, cultural differences and the management of operations in China and India.

The economic environment of our industry could also result in some of our customers experiencing difficulties, which, consequently, could have a negative effect on our results, especially in terms of future sales and recoverability of accounts receivable. However, the sectorial and geographic diversity of our customer base provides us with a reasonable level of protection in this area. Finally, other financial instruments, which potentially subject us to credit risks, consist mainly of cash, short-term investments and forward exchange contracts. Our short-term investments consist of debt instruments issued by high-credit quality corporations and trusts. Our cash and forward exchange contracts are held with or issued by high-credit quality financial institutions; therefore, we consider the risk of non-performance on these instruments to be limited.

For a more complete understanding of risk factors that may affect us, please refer to the risk factors set forth in our disclosure documents published with securities commissions at www.EXFO.com, or at www.sedar.com in Canada or www.sec.gov/edgar.shtml in the U.S.

Non-GAAP financial measures

We provide non-GAAP financial measures (EBITDA* and sales, excluding gains/losses on forward exchange contracts and sales of recently acquired businesses) as supplemental information regarding our operational performance. We use these measures for the purposes of evaluating our historical and prospective financial performance, as well as our performance relative to our competitors. These measures also help us to plan and forecast future periods as well as to make operational and strategic decisions. We believe that providing this information to our investors, in addition to the GAAP measures, allows them to see the company's results through the eyes of management, and to better understand our historical and future financial performance.

The presentation of this additional information is not prepared in accordance with GAAP. Therefore, the information may not necessarily be comparable to that of other companies and should be considered as a supplement to, not a substitute for, the corresponding measures calculated in accordance with GAAP.

* EBITDA is defined as net earnings (loss) before interest, income taxes, amortization of property, plant and equipment, amortization of intangible assets, impairment of goodwill and extraordinary gain.

The following tables summarize the reconciliation of EBITDA to GAAP net earnings (loss) and additional information, in thousands of US dollars:

EBITDA (including discontinued operations)

	<u>Year ended August 31, 2010</u>	<u>Year ended August 31, 2009</u>	<u>Year ended August 31, 2008</u>
GAAP net earnings (loss) for the year	\$ 6,619	\$ (16,585)	\$ 18,424
Add (deduct):			
Amortization of property, plant and equipment			
Continuing operations	5,757	4,453	4,137
Discontinued operations	154	154	155
Amortization of intangible assets			
Continuing operations	7,773	5,033	3,862
Discontinued operations	45	34	9
Interest (income) expense, net			
Continuing operations	292	(592)	(4,381)
Discontinued operations	1	(5)	(258)
Income taxes			
Continuing operations	5,529	266	337
Discontinued operations	1,136	(5)	1,339
Impairment of goodwill (continuing operations)	-	21,713	-
Extraordinary gain (continuing operations)	-	-	(3,036)
EBITDA for the year	<u>\$ 27,306</u>	<u>\$ 14,466</u>	<u>\$ 20,588</u>
EDITDA in percentage of total sales	<u>12.0%</u>	<u>8.4%</u>	<u>11.2%</u>

Additional information

	<u>Year ended August 31, 2010</u>	<u>Year ended August 31, 2009</u>	<u>Year ended August 31, 2008</u>
Sales from continued operations	\$ 202,757	\$ 153,082	\$ 160,981
Sales from discontinued operations	<u>25,359</u>	<u>19,796</u>	<u>22,809</u>
Total sales	<u>\$ 228,116</u>	<u>\$ 172,878</u>	<u>\$ 183,790</u>

	<u>Year ended August 31, 2010</u>	<u>Year ended August 31, 2009</u>	<u>Year ended August 31, 2008</u>
Gross margin from continued operations	\$ 128,856	\$ 95,185	\$ 96,617
Gross margin from discontinued operations	<u>13,563</u>	<u>10,801</u>	<u>11,549</u>
Total gross margin	<u>\$ 142,419</u>	<u>\$ 105,986</u>	<u>\$ 108,166</u>

QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)

(tabular amounts in thousands of US dollars, except per share data)

	1st quarter	2nd quarter	3rd quarter	4th quarter	Year ended August 31
2010					
Sales	\$ 40,292	\$ 47,951	\$ 55,930	\$ 58,584	\$ 202,757
Cost of sales	\$ 14,033	\$ 18,818	\$ 20,421	\$ 20,629	\$ 73,901
Gross margin	\$ 26,259	\$ 29,133	\$ 35,509	\$ 37,955	\$ 128,856
Earnings from operations	\$ 1,956	\$ 2,657	\$ 1,840	\$ 4,414	\$ 10,867
Earnings (loss) from continuing operations before extraordinary gain	\$ (230)	\$ 256	\$ (600)	\$ 4,124	\$ 3,550
Net earnings	\$ 334	\$ 1,154	\$ 169	\$ 4,962	\$ 6,619
Basic and diluted earnings (loss) from continuing operations before extraordinary gain per share	\$ (0.00)	\$ 0.00	\$ (0.01)	\$ 0.07	\$ 0.06
Basic and diluted net earnings per share	\$ 0.01	\$ 0.02	\$ 0.00	\$ 0.08	\$ 0.11
2009					
Sales	\$ 41,159	\$ 41,367	\$ 39,047	\$ 31,509	\$ 153,082
Cost of sales	\$ 15,276	\$ 16,089	\$ 14,333	\$ 12,199	\$ 57,897
Gross margin	\$ 25,883	\$ 25,278	\$ 24,714	\$ 19,310	\$ 95,185
Earnings (loss) from operations	\$ 1,266	\$ 2,044	\$ (22,066)	\$ (3,501)	\$ (22,257)
Earnings (loss) from continuing operations before extraordinary gain	\$ 4,564	\$ 2,319	\$ (23,994)	\$ (3,746)	\$ (20,857)
Net earnings (loss)	\$ 5,287	\$ 2,655	\$ (23,346)	\$ (1,181)	\$ (16,585)
Basic and diluted earnings (loss) from continuing operations before extraordinary gain per share ⁽¹⁾	\$ 0.07	\$ 0.04	\$ (0.40)	\$ (0.06)	\$ (0.34)
Basic and diluted net earnings (loss) per share ⁽¹⁾	\$ 0.08	\$ 0.04	\$ (0.39)	\$ (0.02)	\$ (0.27)

(1) Per share data is calculated independently for each of the quarters presented. Therefore, the sum of this quarterly information does not equal the corresponding annual information.

Fourth-quarter results

In the fourth quarter of fiscal 2010, sales were \$58.6 million, compared to \$31.5 million in 2009.

In the fourth quarter of fiscal 2010, we reported a year-over-year increase in sales for the following reasons.

First, in the fourth quarter of fiscal 2010, we benefited from improving economic and market conditions following the global economic recession that negatively and significantly affected our sales in the corresponding period of 2009. In fact, we witnessed a significant drop in our bookings in the last part of the third quarter of fiscal 2009 and the beginning of the fourth quarter, reflecting the significant reduction of spending in our end-markets. In addition, in the fourth quarter of fiscal 2010, NetHawk, which was acquired on March 12, 2010, contributed to our sales in the amount of \$8.5 million in the fourth quarter of 2010. NetHawk's sales for this period were reduced by \$0.5 million to account for an adjustment to deferred revenue in the purchase price allocation. Finally, we believe we gained market share in the fourth quarter of fiscal 2010 compared to the same period last year.

In the fourth quarter of fiscal 2010, gross margin reached 64.8% of global sales compared to 61.3% for the same period last year. First, the acquisition of NetHawk had a positive impact on our gross margin in the fourth quarter of fiscal 2010 as its products deliver margins well above our average typical gross margin. In addition, in the fourth quarter of fiscal 2010, a larger portion of our sales came from products manufactured in our facilities in China compared to the same period in 2009; those products have a lower cost of goods than those manufactured in our facilities in Canada, thus resulting in an improvement in gross margin year-over-year. Furthermore, increased sales volume in the fourth quarter of fiscal 2010 compared to the same period last year resulted in an increase in manufacturing activities, allowing us to better absorb our fixed manufacturing costs. Also, in the fourth quarter of fiscal 2010, we recorded in our sales foreign exchange gains totaling \$285,000 on our forward exchange contracts, compared to foreign exchange losses of \$218,000 in 2009, contributing to the increase in our gross margin 0.5% year-over-year. Finally, the increase in the value of the Canadian dollar in 2010 compared to 2009 had a positive impact on our gross margin in the fourth quarter of 2010; in fact, our procurement costs decreased as the Canadian dollar strengthened, compared to the US dollar, since a significant portion of our raw material purchases are denominated in US dollars. This allowed us to improve our gross margin continually over the last few quarters, as our raw material costs of parts purchased in US dollar are measured in Canadian dollars in our financial statements.

In the fourth quarter of fiscal 2010, earnings from operations amounted to \$4.4 million, compared to a loss from operations of \$3.5 million for the same period last year. The significant increase in our sales, which resulted in a better absorption of our fixed costs as well as our the increase in our gross margin contributed to increase our earnings from operations in the fourth quarter of fiscal 2010 compared to the same period last year. Results from operations in the fourth quarter of fiscal 2009 were negatively impacted by the worldwide recession as well as by restructuring charges of \$1.0 million in severance expenses for the employees who were terminated throughout the organization during the quarter.

Net earnings amounted to \$5.0 million, or \$0.08 per diluted share, in the fourth quarter of fiscal 2010, compared to a net loss of \$1.2 million, or \$0.02 per share, for the same period last year. The significant increase in global sales and gross margin in the fourth quarter of fiscal 2010 contributed to the increase of our net earnings compared to the same period last year. In addition, in the fourth quarter of fiscal 2010, we recorded a significant pre-tax foreign exchange gain of \$1.8 million compared to \$144,000 for the same period last year. Also, the net loss recorded in the fourth quarter of 2009 included pre-tax restructuring charges of \$1.0 million. However, the net loss in the fourth quarter of fiscal 2009 included \$1.9 million for the recognition of prior years' non-refundable research and development tax credits as well as \$372,000 worth of future income tax assets for which a valuation allowance was previously established; these two items related to our discontinued operations. Finally, in the fourth quarter of fiscal 2010, the average value of the Canadian dollar, compared to the US dollar, increase compared to the same period last year, which had a negative impact on net earnings in the fourth quarter of 2010 compared to 2009, as a portion of our operating expenses are denominated in Canadian dollars and we report our results in US dollars.