

Independent Auditor's Report

To the Shareholders of EXFO Inc.

We have completed an integrated audit of EXFO Inc.'s and its subsidiaries 2012 consolidated financial statements and their internal control over financial reporting as at August 31, 2012 and an audit of their 2011 consolidated financial statements. Our opinions, based on our audits, are presented below.

Report on the consolidated financial statements

We have audited the accompanying consolidated financial statements of EXFO Inc. and its subsidiaries, which comprise the consolidated balance sheets as at August 31, 2012, August 31, 2011 and September 1, 2010 and the consolidated statements of earnings, comprehensive income (loss), changes in shareholders' equity and cash flows for the years ended August 31, 2012 and August 31, 2011, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform an audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement. Canadian generally accepted auditing standards require that we comply with ethical requirements.

An audit involves performing procedures to obtain audit evidence, on a test basis, about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting principles and policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion on the consolidated financial statements.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of EXFO Inc. and its subsidiaries as at August 31, 2012, August 31, 2011 and September 1, 2010 and their financial performance and their cash flows for the years ended August 31, 2012 and August 31, 2011 in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

Report on internal control over financial reporting

We have also audited EXFO Inc's and its subsidiaries' internal control over financial reporting as at August 31, 2012, based on criteria established in Internal Control - Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Management's responsibility for internal control over financial reporting

Management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying managements' report on Internal Control over Financial Reporting.

Auditor's responsibility

Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control, based on the assessed risk, and performing such other procedures as we consider necessary in the circumstances.

We believe that our audit provides a reasonable basis for our audit opinion on the company's internal control over financial reporting.

Definition of internal control over financial reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Inherent limitations

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Opinion

In our opinion, EXFO Inc. and its subsidiaries maintained, in all material respects, effective internal control over financial reporting as at August 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by COSO.

PricewaterhouseCoopers LLP¹

November 7, 2012
Montréal, Quebec, Canada

¹ CPA auditor, CA, public accountancy permit No. A115888

EXFO Inc.

Consolidated Balance Sheets

(in thousands of US dollars)

	As at August 31, 2012	As at August 31, 2011	As at September 1, 2010
Assets			
Current assets			
Cash	\$ 58,868	\$ 22,771	\$ 21,440
Short-term investments (note 7)	8,236	47,091	10,379
Accounts receivable (note 7)			
Trade	37,643	45,151	50,190
Other	4,283	6,329	5,217
Income taxes and tax credits recoverable	9,024	5,414	2,604
Inventories (note 8)	41,212	52,754	40,328
Prepaid expenses	3,800	3,237	2,816
Current assets held for sale (note 4)	—	—	3,769
	163,066	182,747	136,743
Tax credits recoverable (note 22)	38,397	36,627	29,397
Forward exchange contracts (note 7)	—	149	—
Property, plant and equipment (note 9)	49,848	32,076	24,730
Intangible assets (note 10)	14,132	22,901	27,947
Goodwill (note 10)	29,160	30,942	29,355
Deferred income taxes (note 22)	12,080	16,913	18,730
Long-term assets held for sale (note 4)	—	—	7,530
	\$ 306,683	\$ 322,355	\$ 274,432
Liabilities			
Current liabilities			
Bank loan	\$ —	\$ 784	\$ —
Accounts payable and accrued liabilities (note 12)	32,392	30,320	29,943
Provisions (note 12)	952	1,817	927
Income taxes payable	917	876	426
Contingent liability (note 13)	—	338	—
Current portion of long-term debt (note 14)	565	645	568
Deferred revenue	10,583	10,590	10,354
Current liabilities related to assets held for sale (note 4)	—	—	2,531
	45,409	45,370	44,749
Deferred revenue	4,997	5,704	5,775
Long-term debt (note 14)	282	968	1,419
Contingent liability (note 13)	—	—	2,660
Other liabilities	609	723	603
Deferred income taxes (note 22)	2,105	5,079	—
Long-term liabilities related to assets held for sale (note 4)	—	—	537
	53,402	57,844	55,743
Commitments (note 15)			
Shareholders' equity			
Share capital (note 16)	110,965	110,341	106,126
Contributed surplus	17,298	18,017	18,563
Retained earnings	111,511	115,104	92,984
Accumulated other comprehensive income (note 17)	13,507	21,049	1,016
	253,281	264,511	218,689
	\$ 306,683	\$ 322,355	\$ 274,432

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

On behalf of the Board

/s/ Germain Lamonde
GERMAIN LAMONDE
Chairman, President and CEO

/s/ Guy Marier
GUY MARIER
Chairman, Audit Committee

EXFO Inc.

Consolidated Statements of Earnings

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

	Years ended August 31,	
	2012	2011
Sales (note 24)	\$ 249,966	\$ 269,743
Cost of sales ⁽¹⁾ (note 20)	91,792	100,296
Selling and administrative (note 20)	94,139	87,062
Net research and development (note 20)	49,854	47,927
Depreciation of property, plant and equipment (note 20)	6,169	6,655
Amortization of intangible assets (note 20)	7,819	9,183
Changes in fair value of cash contingent consideration (note 13)	(311)	(2,685)
Earnings from operations	504	21,305
Interest and other income	131	511
Foreign exchange loss	(657)	(3,808)
Earnings (loss) before income taxes	(22)	18,008
Income taxes (note 22)	3,571	8,814
Net earnings (loss) from continuing operations	(3,593)	9,194
Net earnings from discontinued operations (note 4)	–	12,926
Net earnings (loss) for the year	\$ (3,593)	\$ 22,120
Basic and diluted net earnings (loss) from continuing operations per share	\$ (0.06)	\$ 0.15
Basic net earnings (loss) per share	\$ (0.06)	\$ 0.37
Diluted net earnings (loss) per share	\$ (0.06)	\$ 0.36
Basic weighted average number of shares outstanding (000's)	60,453	60,000
Diluted weighted average number of shares outstanding (000's) (note 23)	60,453	61,488

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

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

EXFO Inc.
Consolidated Statements of Comprehensive Income (Loss)

(in thousands of US dollars)

	Years ended August 31,	
	2012	2011
Net earnings (loss) for the year	\$ (3,593)	\$ 22,120
Other comprehensive income (loss), net of income taxes		
Foreign currency translation adjustment	(6,875)	19,123
Reclassification of realized losses on short-term investments in net earnings	-	2
Unrealized gains on forward exchange contracts	185	3,413
Reclassification of realized gains on forward exchange contracts in net earnings (loss)	(1,108)	(2,191)
Deferred income tax effect of the components of other comprehensive income (loss)	256	(314)
Other comprehensive income (loss)	(7,542)	20,033
Comprehensive income (loss) for the year	\$ (11,135)	\$ 42,153

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

EXFO Inc.

Consolidated Statements of Changes in Shareholders' Equity

(in thousands of US dollars)

	Year ended August 31, 2011				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Balance as at September 1, 2010	\$ 106,126	\$ 18,563	\$ 92,984	\$ 1,016	\$ 218,689
Exercise of stock options (note 16)	1,452	–	–	–	1,452
Reclassification of stock-based compensation costs (note 16)	2,763	(2,763)	–	–	–
Stock-based compensation costs	–	2,217	–	–	2,217
Net earnings for the year	–	–	22,120	–	22,120
Other comprehensive income					
Foreign currency translation adjustment	–	–	–	19,123	19,123
Changes in unrealized losses on short-term investments	–	–	–	2	2
Changes in unrealized gains on forward exchange contracts, net of deferred income taxes of \$314	–	–	–	908	908
Total comprehensive income for the year	–	–	22,120	20,033	42,153
Balance as at August 31, 2011	<u>\$ 110,341</u>	<u>\$ 18,017</u>	<u>\$ 115,104</u>	<u>\$ 21,049</u>	<u>\$ 264,511</u>

	Year ended August 31, 2012				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Balance as at September 1, 2011	\$ 110,341	\$ 18,017	\$ 115,104	\$ 21,049	\$ 264,511
Exercise of stock options (note 16)	310	–	–	–	310
Redemption of share capital (note 16)	(1,696)	(540)	–	–	(2,236)
Reclassification of stock-based compensation costs (note 16)	2,010	(2,010)	–	–	–
Stock-based compensation costs	–	1,831	–	–	1,831
Net loss for the year	–	–	(3,593)	–	(3,593)
Other comprehensive loss					
Foreign currency translation adjustment	–	–	–	(6,875)	(6,875)
Changes in unrealized gains on forward exchange contracts, net of deferred income taxes of \$256	–	–	–	(667)	(667)
Total comprehensive loss for the year	–	–	(3,593)	(7,542)	(11,135)
Balance as at August 31, 2012	<u>\$ 110,965</u>	<u>\$ 17,298</u>	<u>\$ 111,511</u>	<u>\$ 13,507</u>	<u>\$ 253,281</u>

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

EXFO Inc.

Consolidated Statements of Cash Flows

(in thousands of US dollars)

	Years ended August 31,	
	2012	2011
Cash flows from operating activities		
Net earnings (loss) for the year	\$ (3,593)	\$ 22,120
Add (deduct) items not affecting cash		
Change in discount on short-term investments	45	(42)
Stock-based compensation costs	1,862	2,256
Depreciation and amortization	13,988	15,856
Gain on disposal of discontinued operations (note 4)	–	(13,212)
Gain on disposal of capital assets	–	(568)
Changes in fair value of cash contingent consideration (note 13)	(311)	(2,685)
Deferred revenue	(506)	(1,262)
Deferred income taxes	2,050	7,063
Changes in foreign exchange gain/loss	(1,510)	2,130
	12,025	31,656
Change in non-cash operating items		
Accounts receivable	7,974	10,066
Income taxes and tax credits	(5,570)	(6,714)
Inventories	10,879	(8,751)
Prepaid expenses	(589)	(232)
Accounts payable and accrued liabilities and provisions	643	(2,775)
Other liabilities	(105)	60
	25,257	23,310
Cash flows from investing activities		
Additions to short-term investments	(115,886)	(516,674)
Proceeds from disposal and maturity of short-term investments	152,797	481,945
Additions to capital assets (note 9)	(23,849)	(12,164)
Proceeds from disposal of capital assets	–	568
Net proceeds from disposal of discontinued operations (note 4)	–	22,063
Business combination	–	(1,049)
	13,062	(25,311)
Cash flows from financing activities		
Bank loan	(782)	772
Repayment of long-term debt	(577)	(619)
Exercise of stock options	310	1,452
Redemption of share capital	(2,236)	–
	(3,285)	1,605
Effect of foreign exchange rate changes on cash	1,063	1,058
Change in cash	36,097	662
Cash – Beginning of year	22,771	22,109
Cash – End of year	\$ 58,868	\$ 22,771
Supplementary information		
Interest received	\$ 679	\$ 554
Interest paid	\$ 76	\$ 159
Income taxes paid	\$ 1,494	\$ 1,878

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

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

1 Nature of Activities and Incorporation

EXFO Inc. and its subsidiaries (together “EXFO” or the company) design, manufacture and market test and service assurance solutions for wireless and wireline network operators and equipment manufacturers in the global telecommunications industry. The company offers core-to-edge solutions to assess the performance and reliability of converged Internet protocol (IP) fixed and mobile networks.

EXFO is a company incorporated under the Canada Business Corporations Act and domiciled in Canada. The address of its headquarters is 400 Godin Avenue, Quebec, Province of Quebec, Canada, G1M 2K2.

These consolidated financial statements were authorized for issue by the Board of Directors on October 9, 2012.

2 Basis of Presentation and Adoption of IFRS

For all periods up to and including the year ended August 31, 2011, the company prepared its consolidated financial statements in accordance with Canadian generally accepted accounting principles (Canadian GAAP) as set out in the Handbook of the Canadian Institute of Chartered Accountants (“CICA Handbook”). In 2010, the CICA Handbook was revised to incorporate International Financial Reporting Standards (IFRS) as issued by the “*International Accounting Standards Board*” and requires publicly accountable enterprises to apply such standards effective for years beginning on or after January 1, 2011. Accordingly, the company has commenced reporting on this basis in its condensed interim consolidated financial statements and its annual consolidated financial statements for the year ended August 31, 2012. In these consolidated financial statements, the term “Canadian GAAP” refers to Canadian GAAP applied before the adoption of IFRS.

These consolidated financial statements have been prepared in accordance with IFRS 1, “*First-Time Adoption of International Financial Reporting Standards*”.

Subject to certain transition elections disclosed in note 3, the company has consistently applied the same accounting policies in its consolidated opening IFRS balance sheet as at September 1, 2010 and through all periods presented, as if these accounting policies had always been in effect. Note 3 discloses the impact of the transition to IFRS on the company’s reported consolidated balance sheets, consolidated statements of earnings, comprehensive income and cash flows, including the nature and effect of significant changes in accounting policies from those used in the company’s consolidated financial statements for the year ended August 31, 2011 prepared under Canadian GAAP. Specifically, note 3 presents a reconciliation of the consolidated statements of earnings and comprehensive income for the year ended August 31, 2011, as well as a reconciliation of the consolidated balance sheets and shareholders’ equity as at September 1, 2010 and August 31, 2011.

These IFRS consolidated financial statements have been prepared based on the following accounting policies:

Basis of measurement

These consolidated financial statements have been prepared under the historical cost convention, except for the revaluation of certain financial assets and financial liabilities, including derivative instruments and available-for-sale investments.

Consolidation

These consolidated financial statements include the accounts of the company and its domestic and international subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sales of goods and services in the ordinary course of business.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Sales of goods

Revenue from the sales of goods, which represents the majority of the sales of the company, is recognized when the significant risks and rewards of ownership of the goods have passed to the buyer, usually upon delivery of the goods. Revenue is recorded based on the price specified in the sales arrangement.

Maintenance contracts

Maintenance contracts are usually offered to customers for periods of twelve to thirty-six months. They generally include the right to unspecified upgrades and enhancements on a when-and-if-available basis as well as customer service. Revenue from these contracts is recognized ratably over the terms of the maintenance contracts on a straight-line basis.

Extended warranties

Extended warranties are usually offered to customers for periods of twelve to forty-eight months. Revenue from these extended warranties is recognized ratably over the warranty period on a straight-line basis.

Multiple-component arrangements

When a sales arrangement includes multiple separately identifiable components such as goods, extended warranties, maintenance contracts and installation, the revenue recognition criteria are applied to each separately identifiable component. A component is considered separately identifiable if the delivered item has value to the customer on a stand-alone basis and the fair value associated with the component can be measured reliably. The company allocates the selling price of a multiple-component arrangement to each component based on the fair value of each component in relation to the fair value of the arrangement as a whole.

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

Presentation currency

The functional currency of the company is the Canadian dollar. The company has adopted the US dollar as its presentation currency as it is the most commonly used reporting currency in its industry. The consolidated financial statements are translated into the presentation currency as follows: assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet; revenues and expenses are translated at the monthly average exchange rate. The foreign currency translation adjustment arising from such translation is included in accumulated other comprehensive income in the shareholders' equity.

Foreign currency translation

a) Foreign currency transactions

Transactions denominated in currencies other than the functional currency are translated into the relevant functional currency as follows: monetary assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet, and revenues and expenses are translated at the exchange rate in effect on the date of the transaction. Non-monetary assets and liabilities measured at historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was determined. Foreign exchange gains and losses arising from such translation are included in the consolidated statements of earnings.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

b) Foreign operations

Each foreign operation determines its own functional currency and items included in the financial statements of each foreign operation are measured using that functional currency. The financial statements of each foreign operation that has a functional currency different from the company are translated into Canadian dollars as follows: assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet; revenues and expenses are translated at the monthly average exchange rate. The foreign currency translation adjustment arising from such translation is included in accumulated other comprehensive income in the shareholders' equity.

Financial instruments

The classification of financial instruments depends on the intended purpose when the financial instruments were acquired or issued, as well as on their characteristics and designation by the company.

Classification

Financial assets

Cash	Loans and receivables
Short-term investments	Available for sale
Accounts receivable	Loans and receivables

Financial liabilities

Bank loan	Other financial liabilities
Accounts payable and accrued liabilities	Other financial liabilities
Long-term debt	Other financial liabilities
Contingent liability	Financial liabilities at fair value through profit and loss
Other liabilities	Other financial liabilities

Available-for-sale financial assets

Available-for-sale financial assets are non-derivative financial assets that are designated as available for sale, or are not classified in any of the other categories. They are initially recognized at fair value plus transaction costs and they are subsequently measured at fair value. After their initial recognition, any changes in their fair value are reflected in other comprehensive income.

Interest on available-for-sale financial assets, calculated using the effective interest method, is recognized in the consolidated statements of earnings.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. After their initial measurement at fair value plus transaction costs, they are carried at amortized cost, using the effective interest rate method, which generally corresponds to the nominal amount due to their short-term maturity.

Other financial liabilities

Other financial liabilities are non-derivative financial liabilities initially measured at fair value plus transaction costs and they are subsequently carried at amortized cost, using the effective interest rate method, which generally corresponds to the nominal amount due to their short-term maturity.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Financial liabilities at fair value through profit and loss

Financial liabilities at fair value through profit and loss are non-derivative financial liabilities initially measured at fair value plus transaction costs and they are subsequently measured at fair value. After their initial recognition, any changes in their fair value are reflected in the statements of earnings.

Derivative financial instruments and hedging activities

Forward exchange contracts are utilized by the company to manage its foreign currency exposure. Forward exchange contracts are entered into by the company to hedge anticipated US-dollar-denominated sales and the related accounts receivable. The company's policy is not to utilize those derivative financial instruments for trading or speculative purposes.

The company's forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

They are initially recorded at fair value plus transaction costs and they are subsequently measured at fair value. After initial recognition, the effective portion of changes in their fair value is reflected in other comprehensive income. Any ineffective portion is recognized immediately in the consolidated statements of earnings. Upon the recognition of related hedged sales, accumulated changes in fair value are reclassified in sales in the consolidated statements of earnings.

At the inception of a hedge relationship, the company formally designates and documents the hedge relationship to which the company wishes to apply hedge accounting, the risk management objectives, the hedging instrument, the hedged item and the method used to test effectiveness. The company assesses effectiveness of the hedge relationship at inception and on an ongoing basis using the dollar-offset method.

Fair value hierarchy

The company's short-term investments, forward exchange contracts and the contingent liability are measured at fair value at each balance sheet date. The company's short-term investments are classified within level 1 of the fair value hierarchy because they are valued using quoted market prices in active markets. The company's forward exchange contracts are classified within level 2 of the hierarchy because they are valued using quoted prices and forward foreign exchange rates at the balance sheet dates. The company's contingent liability is classified within level 3 of the fair value hierarchy.

Short-term investments

All investments with original terms to maturity of three months or less and that are not required for the purposes of meeting short-term cash requirements are classified as short-term investments. Short-term investments are classified as available-for-sale financial assets; therefore, they are carried at fair value in the balance sheet, and any changes in their fair value are reflected in other comprehensive income. Upon the disposal or maturity of these assets, accumulated changes in their fair value are reclassified in the consolidated statements of earnings.

Inventories

Inventories are valued on an average cost basis, at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs necessary to make the sale.

The cost of work in progress and finished goods includes material, labor and an allocation of manufacturing overhead.

Property, plant and equipment and depreciation

Property, plant and equipment are recorded at cost, net of accumulated depreciation and accumulated impairment losses. Such cost is reduced by related research and development tax credits.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Depreciation is provided on a straight-line basis over the estimated useful lives of the asset as follows:

	Term
Land improvements	5 years
Buildings	20 to 60 years
Equipment	2 to 10 years
Leasehold improvements	The lesser of useful life and remaining lease term

The assets' residual values and useful lives are reviewed at each financial year-end, and adjusted prospectively, if appropriate.

Intangible assets, goodwill and amortization

Intangible assets

Intangible assets with finite useful lives primarily include the cost of core technology, customer relationships and software. The cost of intangible assets acquired in a business combination is the fair value of the assets as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less accumulated amortization and accumulated impairment losses. Amortization is provided on a straight-line basis over the estimated useful lives of five years for core technology and customer relationships, and four and ten years for software. None of the company's intangible assets was developed internally.

The amortization method and the useful lives of intangible assets are reviewed at each financial year-end, and adjusted prospectively, if appropriate.

Goodwill

Goodwill represents the excess of the purchase price of acquired businesses over the estimated fair value of net identifiable assets acquired, and is allocated to each cash-generating unit (CGU) or group of CGUs that are expected to benefit from the related business combination. A group of CGUs represents the lowest level within the company at which the goodwill is monitored for internal management purposes, which is not higher than an operating segment. Goodwill is not amortized but must be tested for impairment on an annual basis or more frequently if events or circumstances indicate that it might be impaired.

Research and development

All costs related to research are expensed as incurred, net of related tax credits and grants. Development costs are expensed as incurred, net of related tax credits and grants, unless they meet the recognition criteria of intangible assets of IAS 38, "Intangible Assets", in which case they are capitalized, net of related tax credits and grants and amortized on a straight-line basis over the estimated benefit period. Research and development expenses are mainly comprised of salaries and related expenses, material costs as well as fees paid to third-party consultants. As at September 1, 2010, and as at August 31, 2011 and 2012, the company had not capitalized any development costs.

The company elected to account for non-refundable research and development tax credits under IAS 20, "Accounting for Governmental Grants and Disclosures of Governmental Assistance", and as such, these tax credits are presented against gross research and development expenses in the consolidated statements of earnings.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Impairment of non-financial assets

The company assesses at each reporting date whether there is an indication that the carrying value of property, plant and equipment and finite-life intangible assets may not be recoverable. Non-financial assets that are not amortized (such as goodwill) are subject to an annual impairment test. If any indication exists, or when annual impairment testing is required, the company estimates the asset or asset group's recoverable amount. For the purposes of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash flows (CGUs). The recoverable amount is the higher of an asset or CGU's fair value less costs to sell and its value in use. Where the carrying value of an asset or CGU exceeds its recoverable amount, the asset or the CGU is considered impaired and is written down to its recoverable amount. Prior to fiscal 2012, the company performed its annual goodwill impairment test in the third quarter of each fiscal year. In fiscal 2012, the company changed the timing of its annual goodwill impairment for the fourth quarter to align the test with the year end and budget process. Consequently, in fiscal 2012, the company performed its goodwill impairment test in the third quarter and the fourth quarter.

For property, plant and equipment and finite-life intangible assets, the reversal of impairment is limited so that the carrying value of the asset does not exceed its recoverable amount, nor exceed the carrying value that would have been determined, net of depreciation or amortization, had no impairment loss been recognized for the asset in prior periods. Impairment losses on goodwill are not reversed.

Leases

Operating leases are leases where the company does not assume substantially all the risks and rewards of ownership of the asset. Operating lease rentals are charged to the consolidated statements of earnings on a straight-line basis over the lease term.

As at September 1, 2010, and as at August 31, 2011 and 2012, all significant leases of the company were classified as operating leases.

Government grants

Grants related to operating expenses are included in earnings when the related expenses are incurred. Grants related to capital expenditures are deducted from the related assets. Grants are included in earnings or deducted from the related assets, provided there is reasonable assurance that the company has complied and will comply with all the conditions related to the grant and that the grants will be received.

Warranty

The company offers its customers basic warranties of one to three years, depending on the specific products and terms of the purchase agreement. The company's typical warranties require it to repair or replace defective products during the warranty period at no cost to the customer. Costs related to original warranties are accrued at the time of shipment, based upon estimates of expected rework and warranty costs to be incurred. Costs associated with separately priced extended warranties are expensed as incurred.

Income taxes

Income taxes comprise current and deferred income taxes.

Current income taxes

The current income tax assets and liabilities for the current and prior years are measured at the amount expected to be recovered or paid to the taxation authorities. The income tax rates used to calculate the amount are those that are enacted or substantively enacted at the balance sheet dates in the tax jurisdiction where the company generates taxable income/loss.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Deferred income taxes

The company provides for deferred income taxes using the liability method. Under this method, deferred 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 enacted or substantively enacted income tax rates at the balance sheet dates, that are expected to be in effect for the years in which the assets are expected to be realized or the liabilities to be settled.

Deferred income tax assets are recognized only to the extent that it is probable that future taxable income will be available against which the deductible temporary differences, research and development expenses as well as unused tax losses and tax credits can be utilized.

Deferred tax liabilities are recognized for all taxable temporary differences and for taxable temporary differences arising on investments in subsidiaries, except where the reversal of the temporary differences can be controlled and it is probable that the differences will not reverse in the foreseeable future.

Deferred income tax assets and liabilities are presented as non-current in the consolidated balance sheets.

Uncertain tax positions

The company is subject to taxation in numerous jurisdictions. There are many transactions and calculations during the course of business for which the ultimate tax determination is uncertain. The company maintains provisions for uncertain tax positions that it believes appropriately reflect its risk. These provisions are made using the best estimate of the amount expected to be paid based on a qualitative assessment of all relevant factors. The company reviews the adequacy of these provisions at the end of the reporting period. However, it is possible that at some future date, liabilities in excess of the company's provisions could result from audits by, or litigation with, the relevant taxing authorities. Where the final outcome of these tax-related matters is different from the amounts that were initially recorded, such differences will affect the tax provisions in the period in which such determination is made.

Earnings per share

Basic earnings per share are calculated by dividing net earnings attributable to common equity holders of the company by the weighted average number of common shares outstanding during the year.

Diluted earnings per share are calculated by dividing net earnings attributable to common equity holders of the company by the weighted average number of common shares outstanding during the year, plus the effect of dilutive potential common shares outstanding during the year. This method requires that diluted earnings per share be calculated (using the treasury stock method) as if all dilutive potential common shares had been exercised at the latest at the beginning of the year or on the date of issuance, as the case may be, and that the funds obtained thereby (plus an amount equivalent to the unamortized portion of related stock-based compensation costs) be used to purchase common shares of the company at the average market price of the common shares during the year.

Stock-based compensation costs

Equity-settled awards

The company's stock options, restricted share units and deferred share units are equity-settled awards. The company accounts for stock-based compensation costs on equity-settled awards using the Black-Scholes option valuation model. The fair value of equity-settled awards is measured at the date of grant. Stock-based compensation costs are amortized to expense over the vesting periods together with a corresponding change in contributed surplus in the shareholders' equity. For equity-settled awards with graded vesting, each tranche is considered a separate grant with a different vesting date and fair value, and each tranche is accounted for separately.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Cash-settled awards

The company's stock appreciation rights are cash-settled awards. The company accounts for stock-based compensation costs on cash-settled awards using the Black-Scholes option valuation model. The fair value of the cash-settled awards is remeasured at the end of each reporting period, with any changes in the fair value recognized in the consolidated statements of earnings.

Critical accounting judgments and estimates

The preparation of financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses as well as the disclosures of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those judgments, estimates and assumptions.

The judgments, estimates and assumptions that have a significant risk of resulting in a material adjustment to the carrying value of assets and liabilities within the next fiscal year are as follows:

a) Inventories

The company states its inventories at the lower of cost, determined on an average cost basis, and net realizable value, and provides reserves for excess and obsolete inventories. The company determines its reserves for excess and obsolete inventories based on the quantities on hand at the reporting dates compared to foreseeable needs over the next twelve months taking into account changes in demand, technology or market.

b) Income taxes

The company is subject to income tax laws and regulations in several jurisdictions. Under these laws and regulations, uncertainties exist with respect to the interpretation of complex tax regulations and the amount and timing of future taxable income. Management has made reasonable estimates and assumptions to determine the amount of deferred tax assets that can be recognized in the consolidated financial statements, based upon the likely timing and level of anticipated future taxable income together with tax planning strategies. The ultimate realization of the company's deferred 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.

c) Impairment of non-financial assets

Impairment exists when the carrying value of an asset or group of assets (cash generating unit (CGU)) exceeds its recoverable amount, which is the higher of its fair value less costs to sell and its value in use. The fair value less costs to sell calculation is based on available data from a binding sales agreement in an arm's length transaction, available data from observable active market prices less incremental costs for disposing of the asset, or data from recent transactions of similar assets, within the same industry, when available. When such information is not available, or to supplement this information, the company uses discounted cash flows. The establishment of discounted cash flows requires the use of estimates, including management's expectations of future revenue growth, operating costs and profit margins as well as discount rates for each CGU.

i) Growth rates

The assumptions used are based on the company's historical growth, internal budget, expectations of future revenue growth as well as industry and market trends.

ii) Discount rate

The company uses a discount rate to calculate the present value of estimated future cash flows, which represents its weighted average cost of capital (WACC).

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

New IFRS pronouncements and amendments issued but not yet adopted

Financial instruments

IFRS 7, “*Financial Instruments: Disclosures*”, has been amended to enhance disclosure requirements related to offsetting of financial assets and liabilities. The amendments are applicable retrospectively for annual periods beginning on or after January 1, 2013. The company will adopt these amendments on September 1, 2013 and expect their adoption to have no significant impact on its consolidated financial statements.

IFRS 9, “*Financial Instruments*”, was issued in November 2009 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in IAS 39, “*Financial Instruments – Recognition and Measurement*”, for debt instruments with a new mixed measurement model having only two categories: amortized cost and fair value through profit or loss. IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at fair value through profit or loss or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in profit or loss to the extent that they do not clearly represent a return on investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely. Requirements for financial liabilities were added to IFRS 9 in October 2010, and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss are generally recorded in other comprehensive income. This standard is effective for annual periods beginning on or after January 1, 2015. The company has not yet assessed the impact that this new standard is likely to have on its consolidated financial statements.

Financial statement presentation

The IASB amended IAS 1, “*Financial Statement Presentation*”. The amendments to IAS 1 require entities to separate items presented in other comprehensive income into two groups, based on whether or not they may be recycled to the statement of earnings in the future. Items that will not be recycled will be presented separately from items that may be recycled in the future, such as unrealized gains and losses on cash-flow hedges. The amendments are effective for annual periods beginning on or after July 1, 2012. Early adoption is permitted and full retrospective application is required. The company will adopt this new standard on September 1, 2012 and does not expect the amendments to have a significant impact on its consolidated financial statements.

The International Accounting Standard Board (IASB) issued the following standards: IFRS 10, “*Consolidated Financial Statements*”, IFRS 11, “*Joint Arrangements*”, IFRS 12, “*Disclosure of Interests in Other Entities*”, and IFRS 13, “*Fair Value Measurement*”. Each of these new standards is effective for annual periods beginning on or after January 1, 2013, with early adoption permitted. The company has not yet assessed the impact that the new standards may have on its consolidated financial statements or whether or not to early adopt any of these new requirements.

The following is a brief summary of these new standards:

Consolidation

IFRS 10, “*Consolidated Financial Statements*”, requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when a company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces Standing Interpretations Committee (“SIC”) 12, “*Consolidation – Special Purpose Entities*”, and parts of IAS 27, “*Consolidated and Separate Financial Statements*”.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Joint arrangements

IFRS 11, “*Joint Arrangements*”, requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operations. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation, the venturer will recognize its share of the assets, liabilities, revenues and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity-account for interests in joint ventures. IFRS 11 replaces IAS 31, “*Interests in Joint Ventures*” and SIC 13, “*Jointly Controlled Entities–Non-Monetary Contributions by Venturers*”.

Disclosure of interests in other entities

IFRS 12, “*Disclosure of Interests in Other Entities*”, establishes disclosure requirements for interests in other entities, such as subsidiaries, joint arrangements, associates and structured entities. This standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities.

Fair value measurement

IFRS 13, “*Fair Value Measurement*”, is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and, in many cases, does not reflect a clear measurement basis or consistent disclosures.

3 First-Time Adoption of International Financial Reporting Standards (IFRS)

For all periods up to and including the year ended August 31, 2011, the company prepared its consolidated financial statements in accordance with Canadian GAAP. The company's consolidated financial statements for the year ended August 31, 2012 are the first annual consolidated financial statements prepared in accordance with IFRS.

These consolidated financial statements as at and for the year ended August 31, 2012 have been prepared in conformity with the basis of presentation and the accounting policies described in note 2.

In preparing these consolidated financial statements, and in compliance with IFRS 1, “*First-Time Adoption of International Financial Reporting Standards*”, the company's opening IFRS balance sheet has been presented as at September 1, 2010; being the company's date of transition to IFRS. The following section explains the principal adjustments made by the company in transitioning from Canadian GAAP to IFRS and its impact on the opening IFRS balance sheet as at September 1, 2010 as well as the previously published Canadian GAAP consolidated financial statements for the year ended August 31, 2011.

Upon the transition to IFRS on September 1, 2010, the company initially elected to discount the carrying value of its long-term tax credits; this initial election resulted in a decrease of its long-term tax credits of \$2,510,000 and an increase in deferred tax assets of \$678,000 as at September 1, 2010, with a corresponding net decrease of \$1,832,000 in the opening balance of retained earnings. It also resulted in a decrease of \$2,507,000 in its long-term tax credits, an increase in deferred tax assets of \$401,000, a decrease in deferred tax liabilities of 276,000 as at August 31, 2011 as well as interest income of \$227,000 and a related deferred income tax expense of \$61,000 for the year ended August 31, 2011.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

In the fourth quarter of fiscal 2012, prior to issuing its first annual consolidated financial statements under IFRS, the company changed its initial choice of accounting policy for measuring its long-term, non-refundable research and development tax credits and finally opted not to discount these tax credits; it retroactively applied this change in accounting policy at the transition date. Consequently, the carrying value of the previously disclosed long-term tax credits, deferred income tax assets and liabilities and retained earnings as at September 1, 2010 and August 31, 2011, have been adjusted to reflect this change in accounting policy, and the reconciliations from Canadian GAAP to IFRS in the following sections have been adjusted accordingly.

Transition exemptions applied

IFRS 1, "*First-Time Adoption of International Financial Reporting Standards*", allows first-time adopters certain transition exemptions from the general requirement to retrospectively apply all IFRS as effective for the year ended August 31, 2012.

The company has applied the following transition exemptions:

- The company has elected not to apply IFRS 3R, "*Business Combinations*", to business combinations that occurred before the date of transition (September 1, 2010);
- The company elected to deem the cumulative foreign currency translation adjustment from the translation of consolidated financial statements in the reporting currency (US dollars) to be zero as at the transition date to IFRS. Accordingly, the cumulative translation adjustment as at September 1, 2010 was eliminated in the opening balance of retained earnings. Any foreign currency translation adjustment from the translation of consolidated financial statements in the reporting currency arising after the transition date is recorded in accumulated other comprehensive income in the shareholders' equity in the balance sheet.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Reconciliation of the consolidated balance sheet as previously reported under Canadian GAAP to IFRS as at September 1, 2010

Description under Canadian GAAP	Notes	Canadian GAAP	Adjustments	Reclassification	IFRS	Description under IFRS
Assets						
Current assets						
Cash		\$ 21,440	\$ –	\$ –	\$ 21,440	Cash
Short-term investments		10,379	–	–	10,379	Short-term investments
Accounts receivable						Accounts receivable
Trade		50,190	–	–	50,190	Trade
Other		5,217	–	–	5,217	Other
Income taxes and tax credits recoverable		2,604	–	–	2,604	Income taxes and tax credits recoverable
Inventories		40,328	–	–	40,328	Inventories
Prepaid expenses		2,816	–	–	2,816	Prepaid expenses
Future income taxes	a)	6,191	–	(6,191)	–	Deferred income taxes
Current assets held for sale	a)	3,991	–	(222)	3,769	Current assets held for sale
		<u>143,156</u>	<u>–</u>	<u>(6,413)</u>	<u>136,743</u>	
Tax credits recoverable		29,397	–	–	29,397	Tax credits recoverable
Property, plant and equipment	c)	23,455	1,275	–	24,730	Property, plant and equipment
Intangible assets		27,947	–	–	27,947	Intangible assets
Goodwill		29,355	–	–	29,355	Goodwill
Future income taxes	a), c)	12,884	(345)	6,191	18,730	Deferred income taxes
Long-term assets held for sale	a)	7,308	–	222	7,530	Long-term assets held for sale
		<u>\$ 273,502</u>	<u>\$ 930</u>	<u>\$ –</u>	<u>\$ 274,432</u>	
Liabilities						
Current liabilities						
Accounts payable and accrued liabilities	e)	\$ 30,870	\$ –	\$ (927)	\$ 29,943	Accounts payable and accrued liabilities
	e)	–	–	927	927	Provisions
Income taxes payable		426	–	–	426	Income taxes payable
Current portion of long-term debt		568	–	–	568	Current portion of long-term debt
Deferred revenue		10,354	–	–	10,354	Deferred revenue
Current liabilities related to assets held for sale		2,531	–	–	2,531	Current liabilities related to assets held for sale
		<u>44,749</u>	<u>–</u>	<u>–</u>	<u>44,749</u>	
Deferred revenue		5,775	–	–	5,775	Deferred revenue
Long-term debt		1,419	–	–	1,419	Long-term debt
	b)	–	2,660	–	2,660	Contingent liability
Other liabilities		603	–	–	603	Other liabilities
Long-term liabilities related to assets held for sale		537	–	–	537	Long-term liabilities related to assets held for sale
		<u>53,083</u>	<u>2,660</u>	<u>–</u>	<u>55,743</u>	
Shareholders' equity						
Share capital		106,126	–	–	106,126	Share capital
Contributed surplus		18,563	–	–	18,563	Contributed surplus
Retained earnings	b), c), d)	50,528	(1,730)	44,186	92,984	Retained earnings
Accumulated other comprehensive income	c), d)	45,202	–	(44,186)	1,016	Accumulated other comprehensive income
		<u>220,419</u>	<u>(1,730)</u>	<u>–</u>	<u>218,689</u>	
		<u>\$ 273,502</u>	<u>\$ 930</u>	<u>\$ –</u>	<u>\$ 274,432</u>	

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Reconciliation of the consolidated balance sheet as previously reported under Canadian GAAP to IFRS as at August 31, 2011

Notes	Canadian GAAP	Adjustments	Reclassification	IFRS
Assets				
Current assets				
Cash	\$ 22,771	\$ –	\$ –	\$ 22,771
Short-term investments	47,091	–	–	47,091
Accounts receivable				
Trade	45,151	–	–	45,151
Other	6,329	–	–	6,329
Income taxes and tax credits recoverable	5,414	–	–	5,414
Inventories	52,754	–	–	52,754
Prepaid expenses	3,237	–	–	3,237
Deferred income taxes	6,130	–	(6,130)	–
	<u>188,877</u>	<u>–</u>	<u>(6,130)</u>	<u>182,747</u>
Tax credits recoverable	36,627	–	–	36,627
Forward exchange contracts	149	–	–	149
Property, plant and equipment	30,566	1,510	–	32,076
Intangible assets	22,901	–	–	22,901
Goodwill	30,942	–	–	30,942
Deferred income taxes	11,024	(241)	6,130	16,913
	<u>\$ 321,086</u>	<u>\$ 1,269</u>	<u>\$ –</u>	<u>\$ 322,355</u>
Liabilities				
Current liabilities				
Bank loan	\$ 784	\$ –	\$ –	\$ 784
Accounts payable and accrued liabilities	32,137	–	(1,817)	30,320
Provisions	–	–	1,817	1,817
Income taxes payable	876	–	–	876
Contingent liability	–	338	–	338
Current portion of long-term debt	645	–	–	645
Deferred revenue	10,590	–	–	10,590
	<u>45,032</u>	<u>338</u>	<u>–</u>	<u>45,370</u>
Deferred revenue	5,704	–	–	5,704
Long-term debt	968	–	–	968
Other liabilities	723	–	–	723
Deferred income taxes	4,913	166	–	5,079
	<u>57,340</u>	<u>504</u>	<u>–</u>	<u>57,844</u>
Shareholders' equity				
Share capital	110,341	–	–	110,341
Contributed surplus	18,017	–	–	18,017
Retained earnings	69,877	1,041	44,186	115,104
Accumulated other comprehensive income	65,511	(276)	(44,186)	21,049
	<u>263,746</u>	<u>765</u>	<u>–</u>	<u>264,511</u>
	<u>\$ 321,086</u>	<u>\$ 1,269</u>	<u>\$ –</u>	<u>\$ 322,355</u>

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Reconciliation of consolidated shareholders' equity as previously reported under Canadian GAAP to IFRS as at September 1, 2010

	Notes	Share capital	Contributed Surplus	Retained earnings	Accumulated other comprehensive income	Total Shareholders' equity
Canadian GAAP		\$ 106,126	\$ 18,563	\$ 50,528	\$ 45,202	\$ 220,419
Foreign currency translation adjustment	d)	–	–	44,186	(44,186)	–
Adjustment to property, plant and equipment, net of deferred income taxes	c)	–	–	930	–	930
Adjustment to the fair value of the cash contingent consideration	b)	–	–	(2,660)	–	(2,660)
IFRS		<u>\$ 106,126</u>	<u>\$ 18,563</u>	<u>\$ 92,984</u>	<u>\$ 1,016</u>	<u>\$ 218,689</u>

Reconciliation of consolidated shareholders' equity as previously reported under Canadian GAAP to IFRS as at August 31, 2011

	Notes	Share capital	Contributed Surplus	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Canadian GAAP		\$ 110,341	\$ 18,017	\$ 69,877	\$ 65,511	\$ 263,746
Foreign currency translation adjustment	d)	–	–	44,186	(44,186)	–
Adjustment to property, plant and equipment, net of deferred income taxes	c)	–	–	1,016	87	1,103
Adjustment to the fair value of the cash contingent consideration	b)	–	–	25	(363)	(338)
IFRS		<u>\$ 110,341</u>	<u>\$ 18,017</u>	<u>\$ 115,104</u>	<u>\$ 21,049</u>	<u>\$ 264,511</u>

Reconciliation of consolidated net earnings as previously reported under Canadian GAAP to IFRS for the year ended August 31, 2011

	Notes	Canadian GAAP	Adjustments	IFRS
Sales		\$ 269,743	\$ –	\$ 269,743
Cost of sales		100,296	–	100,296
Selling and administrative		87,062	–	87,062
Net research and development		47,927	–	47,927
Depreciation of property, plant and equipment	c)	6,772	(117)	6,655
Amortization of intangible assets		9,183	–	9,183
Changes in fair value of cash contingent consideration	b)	–	(2,685)	(2,685)
Earnings from operations		<u>18,503</u>	<u>2,802</u>	<u>21,305</u>
Interest and other income		511	–	511
Foreign exchange loss		(3,808)	–	(3,808)
Earnings before income taxes		<u>15,206</u>	<u>2,802</u>	<u>18,008</u>
Income taxes	c)	<u>8,783</u>	<u>31</u>	<u>8,814</u>
Net earnings from continuing operations		<u>6,423</u>	<u>2,771</u>	<u>9,194</u>
Net earnings from discontinued operations		<u>12,926</u>	<u>–</u>	<u>12,926</u>
Net earnings for the year		<u>\$ 19,349</u>	<u>\$ 2,771</u>	<u>\$ 22,120</u>

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Reconciliation of consolidated comprehensive income as previously reported under Canadian GAAP to IFRS for the year ended August 31, 2011

	Notes	Canadian GAAP	Adjustments	IFRS
Net earnings for the year		\$ 19,349	\$ 2,771	\$ 22,120
Other comprehensive income				
Foreign currency translation adjustment	b), c)	19,399	(276)	19,123
Reclassification of unrealized losses on short-term investments in net earnings		2	–	2
Unrealized gains on forward exchange contracts		3,413	–	3,413
Reclassification of realized gains on forward exchange contracts in net earnings		(2,191)	–	(2,191)
Deferred income tax effect of the components of other comprehensive income		(314)	–	(314)
Other comprehensive income		20,309	(276)	20,033
Comprehensive income for the year		<u>\$ 39,658</u>	<u>\$ 2,495</u>	<u>\$ 42,153</u>

Statements of cash flows

The adjustments from Canadian GAAP to IFRS had no significant effect on the company's reported consolidated statement of cash flows for the year ended August 31, 2011.

Explanatory notes

a) *Deferred income taxes*

Under IFRS, deferred income tax balances are classified as non-current, irrespective of the classification of the assets or liabilities to which the deferred income tax relates or the expected timing of reversal or utilization. Under Canadian GAAP, deferred income tax relating to current assets, current liabilities and the utilization in the next twelve months of tax losses and deductions must be classified as current. Consequently, deferred tax assets presented as current assets under Canadian GAAP, including those related to the current assets classified as held for sale as at September 1, 2010, were reclassified within long-term deferred tax assets and long-term assets held for sale in the consolidated balance sheets under IFRS.

b) *Business combinations*

As permitted by IFRS 1, "*First-Time Adoption of International Financial Reporting Standards*", the company did not apply IFRS 3R, "*Business Combinations*", to business combinations completed before the transition date, that is, September 1, 2010. However, the cash contingent consideration for the acquisition of NetHawk Oyj (acquisition completed before the transition date) and outstanding as at September 1, 2010, had to be recorded at fair value on that date with a corresponding adjustment to opening retained earnings. Thereafter, the fair value of the cash contingent consideration was reassessed at the end of each reporting period with changes in the fair value being recognized in the statements of earnings.

- As at September 1, 2010, the fair value of the cash contingent consideration was estimated at €2,099,000 (\$2,660,000) based on information available at that time and recorded in long-term liabilities, with a corresponding decrease of the opening balance of retained earnings (shareholders' equity).
- As at August 31, 2011, the fair value of the cash contingent consideration was reassessed to €235,000 (\$338,000), based on revised sales forecasts and presented in current liabilities due to its short-term maturity. The change in the fair value in the amount of \$2,685,000, which includes the effect of a foreign currency translation loss of \$363,000 (shareholders' equity), was recorded in the statement of earnings for the year ended August 31, 2011.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

c) Property, plant and equipment

Under IFRS, depreciation must be based on the allocation of the depreciable amount over the asset's estimated useful life. Depreciable amount is defined as the cost of the asset less its residual value. Residual value is defined as the estimated amount that an entity would currently obtain from the disposal of the asset, after deducting the estimated cost of disposal, if the asset was already of the age and in the condition expected at the end of its useful life. Under Canadian GAAP, the depreciable amount of an asset is the greater of the cost less salvage value over the estimated life of the asset, and the cost less residual value over the estimated useful life of the asset. Salvage value is the estimated net realizable value of the asset at the end of its life. Residual value is the estimated net realizable value of the asset at the end of its useful life to the company.

- As at September 1, 2010, this resulted in an increase of the carrying value of property, plant and equipment of \$1,275,000 and a decrease of deferred income tax assets of \$345,000, for a net increase of the opening balance of retained earnings (shareholders' equity) of \$930,000.
- As at August 31, 2011, this resulted in an increase in the carrying value of property, plant and equipment of \$1,510,000, a decrease of deferred tax assets of \$241,000 and an increase of deferred tax liabilities of \$166,000. For the year ended August, 31, 2011, this resulted in a decrease of depreciation of property, plant and equipment of \$117,000 and a deferred income tax expense of \$31,000. It also resulted in a foreign currency translation gain of \$87,000 recorded in accumulated other comprehensive income in the shareholders' equity.

d) Foreign currency translation adjustment

In accordance with IFRS transitional provisions, the company elected to reset the cumulative foreign currency translation adjustment from the translation of consolidated financial statements in the presentation currency (US dollars) to zero as at the transition date to IFRS. Accordingly, the cumulative foreign currency translation adjustment as at September 1, 2010, in the amount of \$44,186,000, was eliminated in the opening balance of retained earnings as of that date. Any foreign currency translation adjustment from the translation of the consolidated financial statements in the presentation currency arising after the transition date is recorded in accumulated other comprehensive income in the shareholders' equity in the balance sheets.

e) Provisions reclassification

Under IFRS, provisions must be presented separately on the face of the balance sheet. Under Canadian GAAP, provisions were included in accounts payable and accrued liabilities line item in the balance sheets.

4 Discontinued Operations

During the year ended August 31, 2010, the company engaged in a plan to sell its Life Sciences and Industrial Division to focus its activities in the telecom test and service assurance market. On October 1, 2010, the company closed the sale of that Division for total proceeds of \$21,623,000, net of a bank overdraft of \$303,000, selling costs of \$909,000 and deferred income taxes of \$141,000. As such, this Division has been presented as a discontinued operation in these consolidated financial statements. Assets and liabilities as at September 1, 2010 have been presented as assets held for sale and liabilities related to assets held for sale; revenues and expenses have been presented as discontinued operations for the comparative year ended August 31, 2011.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

The results of the discontinued operations are as follows:

	Year ended August 31, 2011 (30 days)
Sales	\$ 1,991
Cost of goods sold and operating expenses	\$ 1,997
Loss from operations	\$ (6)
Gain from disposal of discontinued operations	\$ 13,212
Net earnings from discontinued operations	\$ 12,926
Basic net earnings from discontinued operations per share	\$ 0.22
Diluted net earnings from discontinued operations per share	\$ 0.21

The assets and liabilities of the discontinued operations as at September 1, 2010 have been reclassified and are presented as assets held for sale and liabilities related to assets held for sale as follows:

Assets

Current assets

Cash	\$ 669
Accounts receivable	84
Income taxes and tax credits recoverable	188
Inventories	2,670
Prepaid expenses	158
	3,769

Current assets held for sale

Tax credits recoverable	2,142
Property, plant and equipment	349
Intangible assets	48
Goodwill	4,769
Deferred income taxes	222
	7,530

Long-term assets held for sale

\$ 11,299

Liabilities

Current liabilities related to assets held for sale

\$ 2,531

Long-term liabilities related to assets held for sale

537

\$ 3,068

5 Restructuring charges

In June 2012, the company committed to implement a restructuring plan to align its cost structure to the challenging market environment. This plan will result in one-time severance expenses of approximately \$3,300,000. During the year ended August 31, 2012, the company recorded charges of \$2,329,000 in severance expenses under that plan. The remaining of the expenses will be recorded in the first half of fiscal 2013.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

The following tables summarize changes in restructuring charges payable for the year ended August 31, 2012:

	Balance as at August 31, 2011	Additions	Payments	Balance as at August 31, 2012
Severance expenses	\$ —	\$ 2,329	\$ (2,279)	\$ 50

6 Capital Disclosures

The company is not subject to any external restrictions on its capital.

The company's objectives when managing capital are:

- To maintain a flexible capital structure that optimizes the cost of capital at acceptable risk;
- To sustain future development of the company, including research and development activities, market development, and potential acquisitions of complementary businesses or products; and
- To provide the company's shareholders with an appropriate return on their investment.

No changes were made in the objectives and policies during the years ended 31 August 2011 and 2012.

The company defines its capital as shareholders' equity, excluding accumulated other comprehensive income. The capital of the company amounted to \$217,673,000, \$243,462,000 and \$239,774,000 as at September 1, 2010 and as at August 31, 2011 and 2012 respectively.

7 Financial Instruments

The following tables summarize financial instruments by category:

	As at August 31, 2012				
	Loans and receivable	Derivatives used for hedging	Available for sale	Other financial liabilities	Total
Cash	\$ 58,868	\$ —	\$ —	\$ —	\$ 58,868
Short-term investments	\$ —	\$ —	\$ 8,236	\$ —	\$ 8,236
Accounts receivable	\$ 41,128	\$ —	\$ —	\$ —	\$ 41,128
Forward exchange contracts	\$ —	\$ 798	\$ —	\$ —	\$ 798
Accounts payable and accrued liabilities	\$ —	\$ —	\$ —	\$ 32,392	\$ 32,392
Long-term debt	\$ —	\$ —	\$ —	\$ 847	\$ 847
Other liabilities	\$ —	\$ —	\$ —	\$ 163	\$ 163

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

As at August 31, 2011

	Loans and receivable	Derivatives used for hedging	Available for sale	Other financial liabilities	Financial liabilities at fair value through profit and loss	Total
Cash	\$ 22,771	\$ –	\$ –	\$ –	\$ –	\$ 22,771
Short-term investments	\$ –	\$ –	\$ 47,091	\$ –	\$ –	\$ 47,091
Accounts receivable	\$ 49,779	\$ –	\$ –	\$ –	\$ –	\$ 49,779
Forward exchange contracts	\$ –	\$ 1,850	\$ –	\$ –	\$ –	\$ 1,850
Bank loan	\$ –	\$ –	\$ –	\$ 784	\$ –	\$ 784
Accounts payable and accrued liabilities	\$ –	\$ –	\$ –	\$ 30,320	\$ –	\$ 30,320
Contingent liability	\$ –	\$ –	\$ –	\$ –	\$ 338	\$ 338
Long-term debt	\$ –	\$ –	\$ –	\$ 1,613	\$ –	\$ 1,613
Other liabilities	\$ –	\$ –	\$ –	\$ 201	\$ –	\$ 201

As at September 1, 2010

	Loans and receivable	Derivatives used for hedging	Available for sale	Other financial liabilities	Financial liabilities at fair value through profit and loss	Total
Cash	\$ 21,440	\$ –	\$ –	\$ –	\$ –	\$ 21,440
Short-term investments	\$ –	\$ –	\$ 10,379	\$ –	\$ –	\$ 10,379
Accounts receivable	\$ 54,653	\$ –	\$ –	\$ –	\$ –	\$ 54,653
Forward exchange contracts	\$ –	\$ 522	\$ –	\$ –	\$ –	\$ 522
Accounts payable and accrued liabilities	\$ –	\$ –	\$ –	\$ 29,711	\$ –	\$ 29,711
Contingent liability	\$ –	\$ –	\$ –	\$ –	\$ 2,660	\$ 2,660
Long-term debt	\$ –	\$ –	\$ –	\$ 1,987	\$ –	\$ 1,987
Other liabilities	\$ –	\$ –	\$ –	\$ 295	\$ –	\$ 295

Fair value

Based on market value, the fair value of short-term investments amounted to \$10,379,000, \$47,091,000 and \$8,236,000 as at September 1, 2010 and as at August 31, 2011 and 2012 respectively.

Cash, accounts receivable and accounts payable and accrued liabilities are financial instruments whose carrying values approximate their fair values due to their short-term maturities. The fair value of the long-term debt and other liabilities approximates their carrying value due to their relatively short-term maturities.

The fair value of the contingent liability amounted to \$2,660,000, \$338,000 and nil as at September 1, 2010, and as at August 31, 2011 and 2012 respectively (note 13).

The carrying value of forward exchange contracts is equal to fair value, which represents 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 \$597,000 as at September 1, 2010, \$2,278,000 as at August 31, 2011 and \$932,000 as at August 31, 2012.

Based on the portfolio of forward exchange contracts as at August 31, 2012, the company estimates that the portion of unrealized gains on these contracts as of that date, which will be realized and reclassified from accumulated other comprehensive income to net earnings over the next 12 months, amounts to \$798,000.

As at August 31, 2012, forward exchange contracts, in the amount of \$798,000, are presented as current assets in other receivable in the balance sheet.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

As at August 31, 2011, forward exchange contracts in the amount of \$1,701,000 were presented as current assets in other receivable in the balance sheet, and forward exchange contracts in the amount of \$149,000 were presented as long-term assets in forward exchange contracts in the balance sheet.

As at September 1, 2010, forward exchange contracts in the amount of \$754,000 were presented as current assets in other receivable in the balance sheet, and forward exchange contracts in the amount of \$232,000 were presented as current liabilities in the accounts payable and accrued liabilities in the balance sheet (note 12).

For the years ended August 31, 2011 and 2012, the company recognized within its sales foreign exchange gains on forward exchange contracts of \$2,795,000 and \$1,125,000 respectively.

Market risk

Currency risk

The functional currency of the company is the Canadian dollar. The company is exposed to currency risks as a result of its export sales of products manufactured in Canada, China and Finland, the majority of which are denominated in US dollars and euros. This risk is partially hedged by forward exchange contracts (US dollars) and certain cost of sales and operating expenses (US dollars and euros). Forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

As at September 1, 2010 and as at August 31, 2011 and 2012, the company held contracts to sell US dollars for Canadian 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>
As at September 1, 2010		
September 2010 to August 2011	\$ 29,500	1.0897
September 2011 to August 2012	20,400	1.0802
September 2012 to January 2013	1,500	1.0722
Total	<u>\$ 51,400</u>	<u>1.0854</u>
As at August 31, 2011		
September 2011 to August 2012	\$ 27,500	1.0555
September 2012 to July 2013	11,400	1.0063
Total	<u>\$ 38,900</u>	<u>1.0411</u>
As at August 31, 2012		
September 2012 to August 2013	\$ 23,000	1.0228
September 2013 to August 2014	3,600	1.0439
Total	<u>\$ 26,600</u>	<u>1.0256</u>

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

The following table summarizes significant derivative and non-derivative financial assets and liabilities that are subject to currency risk as at September 1, 2010 and August 31, 2011 and 2012:

	As at August 31, 2012		As at August 31, 2011		As at September 1, 2010	
	Carrying/ nominal amount (in thousands of US dollars)	Carrying/ nominal amount (in thousands of euros)	Carrying/ nominal amount (in thousands of US dollars)	Carrying/ nominal amount (in thousands of euros)	Carrying/ nominal amount (in thousands of US dollars)	Carrying/ nominal amount (in thousands of euros)
Financial assets						
Cash	\$ 9,781	€ 1,555	\$ 10,553	€ 1,502	\$ 6,947	€ 1,287
Accounts receivable	27,996	4,313	25,040	4,332	30,218	3,860
	37,777	5,868	35,593	5,834	37,165	5,147
Financial liabilities						
Accounts payable and accrued liabilities	10,564	71	8,706	37	8,932	438
Forward exchange contracts (nominal value)	4,400	–	5,400	–	5,900	–
	14,964	71	14,106	37	14,832	438
Net exposure	\$ 22,813	€ 5,797	\$ 21,487	€ 5,797	\$ 22,333	€ 4,709

The value of the Canadian dollar compared to the US dollar was CA\$0.9784 = US\$1.00 and CA\$0.9863 = US\$1.00 as at August 31, 2011 and 2012 respectively.

The value of the Canadian dollar compared to the euro was CA\$1.4094 = €1.00 and CA\$1.2438 = €1.00 as at August 31, 2011 and 2012 respectively.

The following sensitivity analysis summarizes the effect that a change in the value of the Canadian dollar (compared to the US dollar and euro) on financial assets and liabilities denominated in US dollars and euros would have on net earnings, net earnings per diluted share and comprehensive income, based on the foreign exchange rates as at August 31, 2011 and 2012:

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would decrease (increase) net earnings by \$1,943,000, or \$0.03 per diluted share, and \$2,053,000, or \$0.03 per diluted share, as at August 31, 2011 and 2012 respectively.
- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the euro would decrease (increase) net earnings by \$831,000, or \$0.01 per diluted share, and \$709,000, or \$0.01 per diluted share, as at August 31, 2011 and 2012 respectively.
- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would increase (decrease) comprehensive income by \$2,404,000 and \$1,575,000 as at August 31, 2011 and 2012 respectively.

The impact of the change in the value of the Canadian dollar compared to the US dollar and the euro on these financial assets and liabilities is recorded in the foreign exchange gain or loss line item in the consolidated statements of earnings, except for outstanding forward contracts, which impact is recorded in other comprehensive income. The change in the value of the Canadian dollar compared to the US dollar and the euro also impacts the company's balances of income tax and tax credits recoverable or payable, as well as deferred income tax assets and liabilities denominated in US dollars and euros; this may result in additional and significant foreign exchange gains or losses. However, these tax-related assets and liabilities are not considered financial instruments and are excluded from the sensitivity analysis above. The foreign exchange rate fluctuations also flow through the statements of earnings line items, as a significant portion of the company's cost of sales and operating expenses is denominated in Canadian dollars, euros and Indian rupees, and the company reports its results in US dollars; that effect is not reflected in the sensitivity analysis above.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Interest rate risk

The company has limited exposure to interest rate risk. The company is mainly exposed to interest rate risks through its cash, short-term investments and long-term debt.

Cash

As at August 31, 2012, the company's cash balances included an amount of \$36,166,000 (nil as at September 1, 2010 and August 31, 2011) that bears interest at a rate of 1.3%.

Short-term investments

Short-term investments consist of the following:

	<u>As at August 31, 2012</u>	<u>As at August 31, 2011</u>	<u>As at September 1, 2010</u>
Commercial paper denominated in Canadian dollars, bearing interest at annual rates of 1.0% to 1.3% in fiscal 2011 and 0.6% to 0.9% in fiscal 2010, maturing between September and November 2011 in fiscal 2011, and in September and October 2010 in 2010	\$ –	\$ 31,765	\$ 6,383
Bankers acceptance denominated in Canadian dollars, bearing interest at annual rates of 1.1% in fiscal 2012, 1.0% and 1.2% in fiscal 2011 and 0.8% in fiscal 2010, maturing in September 2012 in fiscal 2012, in September and November 2011 in 2011, and in September 2010 in 2010	8,236	15,326	3,996
	\$ 8,236	\$ 47,091	\$ 10,379

Due to their short-term maturity of usually three months or less, the company's short-term investments are not subject to a significant fair value interest rate risk. Accordingly, changes in fair value have been nominal to the degree that amortized cost has historically approximated the fair value. Any change in the fair value of the company's short-term investments, all of which are classified as available for sale, is recorded in other comprehensive income.

Long-term debt

As at August 31, 2012, the company's long-term debt, in the amount of \$847,000 (\$1,613,000 as at August 31, 2011 and \$1,987,000 as at September 1, 2010), bears interest at an annual rate of 2.95% and matures in December 2013 (note 14).

Other financial instruments

Accounts receivable, accounts payable and accrued liabilities, other liabilities and the contingent liability, are non-interest-bearing financial assets and liabilities.

Credit risk

Financial instruments that potentially subject the company to credit risk consist of cash, short-term investments, accounts receivable and forward exchange contracts (with a positive fair value). As at August 31, 2012, the company's short-term investments consist of debt instruments issued by two (twelve as at August 31, 2011 and nine as at September 1, 2010) high-credit quality corporations and trusts. None of these debt instruments are expected to be affected by a significant liquidity risk. The company's cash and forward exchange contracts are held with or issued by high-credit quality financial institutions; therefore, the company considers the risk of non-performance on these instruments to be limited.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Generally, the company does not require collateral or other security from customers for trade accounts receivable; however, credit is extended to customers following an evaluation of creditworthiness. In addition, the company performs ongoing credit reviews of all its customers and establishes an allowance for doubtful accounts receivable when accounts are determined to be uncollectible. Allowance for doubtful accounts amounted to \$ 1,243,000 as at September 1, 2010 and \$1,245,000 and \$583,000 as at August 31, 2011 and 2012 respectively.

For the years ended August 31, 2011 and 2012, no customer represented more than 10% of sales.

The following table summarizes the age of trade accounts receivable:

	<u>As at August 31, 2012</u>	<u>As at August 31, 2011</u>	<u>As at September 1, 2010</u>
Current	\$ 31,856	\$ 33,149	\$ 38,663
Past due, 0 to 30 days	3,770	7,299	6,787
Past due, 31 to 60 days	1,048	2,590	1,991
Past due, more than 60 days, less allowance for doubtful accounts of \$1,243, \$1,245 and \$583 as at September 1, 2010 and August 31, 2011 and 2012 respectively	969	2,113	2,749
	<u>\$ 37,643</u>	<u>\$ 45,151</u>	<u>\$ 50,190</u>

Changes in the allowance for doubtful accounts are as follows:

	<u>Years ended August 31,</u>	
	<u>2012</u>	<u>2011</u>
Balance – Beginning of year	\$ 1,245	\$ 1,243
Addition charged to earnings	267	148
Write-off of uncollectible accounts	(873)	(111)
Recovery of uncollectible accounts	(56)	(35)
Balance – End of year	<u>\$ 583</u>	<u>\$ 1,245</u>

Liquidity risk

Liquidity risk is defined as the potential that the company cannot meet its obligations as they become due.

The following tables summarize the contractual maturity of the company's derivative and non-derivative financial liabilities:

	<u>As at August 31, 2012</u>	
	<u>0-12 months</u>	<u>13-24 months</u>
Accounts payable and accrued liabilities	\$ 32,392	\$ –
Long-term debt	565	282
Other liabilities	–	163
Forward exchange contracts		
Outflow	23,000	3,600
Inflow	(23,851)	(3,810)
Total	<u>\$ 32,106</u>	<u>\$ 235</u>

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

	As at August 31, 2011		
	0-12 months	13-24 months	25-36 months
Bank loan	\$ 784	\$ –	\$ –
Accounts payable and accrued liabilities	30,320	–	–
Contingent liability	338	–	–
Long-term debt	645	645	323
Other liabilities	–	201	–
Forward exchange contracts			
Outflow	27,500	11,400	–
Inflow	(29,668)	(11,725)	–
Total	\$ 29,919	\$ 521	\$ 323

	As at September 1, 2010			
	0-12 months	13-24 months	25-36 months	Over 36 months
Accounts payable and accrued liabilities	\$ 29,711	\$ –	\$ –	\$ –
Long-term debt	568	568	568	283
Contingent liability	–	2,660	–	–
Other liabilities	–	295	–	–
Forward exchange contracts				
Outflow	29,500	20,400	1,500	–
Inflow	(30,141)	(20,662)	(1,508)	–
Total	\$ 29,638	\$ 3,261	\$ 560	\$ 283

As at August 31, 2012, the company had \$67,104,000 in cash and short-term investments and \$41,926,000 in accounts receivable. In addition to these financial assets, the company has unused available lines of credit totaling \$15,846,000 for working capital and other general corporate purposes, including potential acquisitions and its share repurchase program as well as unused lines of credit of \$26,256,000 for foreign currency exposure related to its forward exchange contracts (note 11).

8 Inventories

	As at August 31, 2012	As at August 31, 2011	As at September 1, 2010
Raw materials	\$ 19,786	\$ 30,280	\$ 21,505
Work in progress	1,511	2,206	1,975
Finished goods	19,915	20,268	16,848
	\$ 41,212	\$ 52,754	\$ 40,328

The cost of sales comprised almost exclusively the amount of inventory recognized as an expense during the reporting years, except for the related depreciation and amortization, which are shown separately in operating expenses (note 20).

Inventory write-down amounted to \$3,577,000 and \$3,838,000 for the years ended August 31, 2011 and 2012 respectively.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

9 Property, Plant and Equipment

	Land and land improvements	Buildings	Equipment	Leasehold improvements	Asset under construction	Total
Cost as at September 1, 2010	\$ 2,287	\$ 15,670	\$ 39,734	\$ 2,976	\$ –	\$ 60,667
Additions	2,171	1,621	5,551	133	2,888	12,364
Disposals	–	–	(3,193)	(73)	–	(3,266)
Foreign currency translation adjustment	247	1,682	1,942	219	54	4,144
Cost as at August 31, 2011	4,705	18,973	44,034	3,255	2,942	73,909
Reclassification	–	2,942	–	–	(2,942)	–
Additions	918	16,419	6,064	804	–	24,205
Disposals	–	–	(2,255)	(1,745)	–	(4,000)
Foreign currency translation adjustment	(38)	21	119	53	–	155
Cost as at August 31, 2012	<u>\$ 5,585</u>	<u>\$ 38,355</u>	<u>\$ 47,962</u>	<u>\$ 2,367</u>	<u>\$ –</u>	<u>\$ 94,269</u>
Accumulated depreciation as at September 1, 2010	\$ 1,200	\$ 4,987	\$ 28,282	\$ 1,468	\$ –	\$ 35,937
Depreciation for the year	10	302	5,821	522	–	6,655
Disposals	–	–	(2,824)	(73)	–	(2,897)
Foreign currency translation adjustment	107	696	1,191	144	–	2,138
Accumulated depreciation as at August 31, 2011	1,317	5,985	32,470	2,061	–	41,833
Depreciation for the year	10	430	5,411	318	–	6,169
Disposals	–	–	(2,082)	(1,654)	–	(3,736)
Foreign currency translation adjustment	(10)	(173)	372	(34)	–	155
Accumulated depreciation as at August 31, 2012	<u>\$ 1,317</u>	<u>\$ 6,242</u>	<u>\$ 36,171</u>	<u>\$ 691</u>	<u>\$ –</u>	<u>\$ 44,421</u>
Net carrying value as at:						
September 1, 2010	\$ 1,087	\$ 10,683	\$ 11,452	\$ 1,508	\$ –	\$ 24,730
August 31, 2011	\$ 3,388	\$ 12,988	\$ 11,564	\$ 1,194	\$ 2,942	\$ 32,076
August 31, 2012	\$ 4,268	\$ 32,113	\$ 11,791	\$ 1,676	\$ –	\$ 49,848

As at September 1, 2010, and as at August 31, 2011 and 2012, unpaid purchases of property, plant and equipment amounted to \$391,000, \$2,056,000 and \$2,896,000 respectively.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

10 Intangible Assets and Goodwill

Intangible assets

	Core technology	Customer relationships	Brand name	Software	Total
Cost as at September 1, 2010	\$ 34,858	\$ 6,615	\$ 659	\$ 11,557	\$ 53,689
Additions	321	–	–	1,442	1,763
Disposals	(10,187)	–	–	(421)	(10,608)
Foreign currency translation adjustment	2,223	904	90	1,144	4,361
Cost as at August 31, 2011	<u>27,215</u>	<u>7,519</u>	<u>749</u>	<u>13,722</u>	<u>49,205</u>
Additions	128	–	–	653	781
Disposals	–	–	–	(53)	(53)
Foreign currency translation adjustment	(1,266)	(937)	(93)	(253)	(2,549)
Cost as at August 31, 2012	<u>\$ 26,077</u>	<u>\$ 6,582</u>	<u>\$ 656</u>	<u>\$ 14,069</u>	<u>\$ 47,384</u>
Accumulated amortization as at September 1, 2010	\$ 17,496	\$ 622	\$ 62	\$ 7,562	\$ 25,742
Amortization for the year	5,910	1,448	144	1,681	9,183
Disposals	(10,187)	–	–	(410)	(10,597)
Foreign currency translation adjustment	1,236	141	14	585	1,976
Accumulated amortization as at August 31, 2011	<u>14,455</u>	<u>2,211</u>	<u>220</u>	<u>9,418</u>	<u>26,304</u>
Amortization for the year	4,929	1,351	135	1,404	7,819
Disposals	–	–	–	(19)	(19)
Foreign currency translation adjustment	(262)	(310)	(31)	(249)	(852)
Accumulated amortization as at August 31, 2012	<u>\$ 19,122</u>	<u>\$ 3,252</u>	<u>\$ 324</u>	<u>\$ 10,554</u>	<u>\$ 33,252</u>
Net carrying value as at:					
September 1, 2010	\$ 17,362	\$ 5,993	\$ 597	\$ 3,995	\$ 27,947
August 31, 2011	\$ 12,760	\$ 5,308	\$ 529	\$ 4,304	\$ 22,901
August 31, 2012	\$ 6,955	\$ 3,330	\$ 332	\$ 3,515	\$ 14,132
Remaining amortization period as at August 31, 2012	2 years	3 years	3 years	4 years	

Goodwill

	Years ended August 31,	
	2012	2011
Balance – Beginning of year	\$ 30,942	\$ 29,355
Foreign currency translation adjustment	(1,782)	1,587
Balance – End of year	<u>\$ 29,160</u>	<u>\$ 30,942</u>

In the fourth quarter of fiscal 2012, the company performed its annual goodwill impairment test for its two CGUs, NetHawk and Brix. For both CGUs, the company used a combination of a market-based approach (sales multiples), based on recent relevant transactions in its industry, and discounted cash flows.

The sales multiple of recent relevant transactions ranged between 1.2 and 4 times sales. These transactions occurred in calendar 2012.

Discounted cash flows were based on a five-year management projections; the company used five-year sales compound annual growth rate (CAGR) of 20% for the NetHawk CGU, a five-year sales CAGR of 25% for the Brix CGU and a perpetual growth rate of 2% thereafter. For both CGUs, the company used a discount rate of 18%.

Based on the market approach and the discounted cash-flow calculations, the recoverable amount for both CGUs exceeded their carrying value.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

For the purposes of the impairment test, goodwill was allocated as follows to the two CGUs:

	<u>As at August 31, 2012</u>	<u>As at August 31, 2011</u>	<u>As at September 1, 2010</u>
NetHawk CGU	\$ 11,520	\$ 13,160	\$ 11,573
Brix CGU	17,640	17,782	17,782
Total	<u>\$ 29,160</u>	<u>\$ 30,942</u>	<u>\$ 29,355</u>

11 Credit Facilities

The company has lines of credit that provide for advances of up to CA\$15,000,000 (US\$15,208,000) and up to US\$2,000,000. These lines of credit bear interest at the Canadian prime rate. As at August 31, 2012, an amount of CA\$5,289,000 (US\$5,362,000) was drawn from these lines of credit for letters of guarantee in the normal course of the company's operations. From this amount, the company had \$962,000 worth of letters of guarantee for its own selling and purchase requirements, and the remainder of \$4,400,000 was used by the company to secure its line of credit in CNY (Chinese currency). These lines of credit are subject to a negative pledge whereby the company has agreed with the bank not to pledge its assets to any other party without its consent.

The company's line of credit, in CNY (Chinese currency), provides for advances of up to US\$4,000,000. This line of credit bears interest at the Chinese prime rate for advances made in CNY and at LIBOR plus 3.5% for advances made in US dollars. As at August 31, 2012, this line of credit was unused.

Finally, the company has lines of credit of US\$28,110,000 for the foreign currency risk exposure related to its forward exchange contracts (note 7). As at August 31, 2012, an amount of US\$1,854,000 was reserved from these lines of credit. These lines of credit are unsecured.

12 Accounts Payable and Accrued Liabilities and Provisions

Accounts payable and accrued liabilities

	<u>As at August 31, 2012</u>	<u>As at August 31, 2011</u>	<u>As at September 1, 2010</u>
Trade	\$ 16,998	\$ 15,717	\$ 14,244
Salaries and social benefits	13,084	12,649	12,400
Forward exchange contracts (note 7)	-	-	232
Other	2,310	1,954	3,067
	<u>\$ 32,392</u>	<u>\$ 30,320</u>	<u>\$ 29,943</u>

Provisions

	<u>As at August 31, 2012</u>	<u>As at August 31, 2011</u>	<u>As at September 1, 2010</u>
Warranty	\$ 675	\$ 1,402	\$ 579
Other	277	415	348
	<u>\$ 952</u>	<u>\$ 1,817</u>	<u>\$ 927</u>

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Changes in the warranty provision are as follows:

	Years ended August 31,	
	2012	2011
Balance – Beginning of year	\$ 1,402	\$ 579
Provision	861	1,608
Settlements	(1,588)	(785)
Balance – End of year	\$ 675	\$ 1,402

13 Contingent Liability

Under the acquisition agreement of NetHawk Oyj, the company has a cash contingent consideration of up to €8,700,000 (\$10,971,000) based on sales volume of certain NetHawk products over a three-year period ending on December 2012. The company records the cash contingent consideration payable at fair value in each balance sheet date based on actual and forecasted sales over the period of the contingent consideration. Changes in the fair value of the cash contingent consideration payable are recorded in the consolidated statements of earnings.

As at August 31, 2012, the fair value of the cash contingent consideration payable was estimated to nil based on actual and forecasted sales of certain NetHawk products over the period of the contingent consideration; the resulting change in the fair value during the year ended August 31, 2012, in the amount of \$311,000 (€235,000), has been recorded in the consolidated statements of earnings for that year. As at August 31, 2011, the fair value of the cash contingent consideration payable was estimated to \$338,000 (€235,000), which resulted in a change in the fair value of \$2,685,000, recorded in the statement of earnings for the year ended August 31, 2011.

14 Long-Term Debt

	As at August 31, 2012	As at August 31, 2011	As at September 1, 2010
Loan collateralized by assets of NetHawk Oyj denominated in euros (€72), bearing interest at 2.95%, repayable in semi-annual installments of \$282 (€224), maturing in December 2013	\$ 847	\$ 1,613	\$ 1,987
Less: current portion	565	645	568
	\$ 282	\$ 968	\$ 1,419

Capital repayments required in the next two years amount to \$565,000 in 2013 and \$282,000 in 2014.

15 Commitments

The company entered into operating leases for certain of its premises and equipment, which expire at various dates through April 2022. Minimum rentals payable under operating leases are as follows:

	As at August 31, 2012	As at August 31, 2011	As at September 1, 2010
No later than 1 year	\$ 3,628	\$ 4,659	\$ 4,716
Later than 1 year and no later than 5 years	4,711	5,618	6,601
Later than 5 years	676	525	1,181
	\$ 9,015	\$ 10,802	\$ 12,498

For the years ended August 31, 2011 and 2012, rental expenses amounted to \$5,303,000 and \$4,308,000 respectively.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

16 Share Capital

Authorized – unlimited as to number, without par value

Subordinate voting and participating, bearing a non-cumulative dividend to be determined by the Board of Directors, ranking *pari passu* with multiple voting shares

Multiple voting and participating, entitling to 10 votes each, bearing a non-cumulative dividend to be determined by the Board of Directors, convertible at the holder's option into subordinate voting shares on a one-for-one basis, ranking *pari passu* with subordinate voting shares

The following table summarizes the share capital activity:

	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
Balance as at September 1, 2010	36,643,000	\$ 1	22,936,709	\$ 106,125	\$ 106,126
Conversion of multiple voting shares into subordinate voting shares	(5,000,000)	–	5,000,000	–	–
Exercise of stock options (note 18)	–	–	306,825	1,452	1,452
Redemption of restricted share units (note 18)	–	–	340,974	–	–
Redemption of deferred shares units (note 18)	–	–	37,491	–	–
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	2,763	2,763
Balance as at August 31, 2011	31,643,000	1	28,621,999	110,340	110,341
Exercise of stock options (note 18)	–	–	109,700	310	310
Redemption of restricted share units (note 18)	–	–	418,086	–	–
Redemption of share capital	–	–	(438,894)	(1,696)	(1,696)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	2,010	2,010
Balance as at August 31, 2012	31,643,000	\$ 1	28,710,891	\$ 110,964	\$ 110,965

- a) On November 5, 2010, the company announced that its Board of Directors had authorized the renewal of its share repurchase program, by way of a normal course issuer bid on the open market, of up to 10% of its public float (as defined by the Toronto Stock Exchange), or 2,012,562 subordinate voting shares, at the prevailing market price. The period of the normal course issuer bid started on November 10, 2010, and ended on November 9, 2011. All shares repurchased under the bid were cancelled.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

- b) On November 7, 2011, the company announced that its Board of Directors had approved the renewal of its share repurchase program, by way of a normal course issuer bid on the open market of up to 2% of its issued and outstanding subordinate voting shares, representing 575,690 subordinate voting shares at the prevailing market price. The normal course issuer bid started on November 10, 2011, and will end on November 9, 2012. All shares repurchased under the bid will be cancelled.
- c) On November 7, 2012, the company announced that its Board of Directors approved the renewal of its share repurchase program, by way of a normal course issuer bid on the open market of up to 10% of the issued and outstanding subordinate voting shares, representing 2,072,721 subordinate voting shares at the prevailing market price. The company expects 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 12, 2012, and will end on November 11, 2013, or on an earlier date if the company repurchases the maximum number of shares permitted under the bid. The program does not require that the company repurchases 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.

17 Accumulated Other Comprehensive Income

Changes in accumulated other comprehensive incomes are as follows:

	Foreign currency translation adjustment	Cash-flow hedge	Available- for-sale financial instruments	Accumulate other comprehensive income
Balance as at September 1, 2010	\$ –	\$ 1,018	\$ (2)	\$ 1,016
Foreign currency translation adjustment	19,123	–	–	19,123
Changes in unrealized losses on short-term investments	–	–	2	2
Changes in unrealized gains on forward exchange contracts, net of deferred income taxes	–	908	–	908
Balance as at August 31, 2011	19,123	1,926	–	21,049
Foreign currency translation adjustment	(6,875)	–	–	(6,875)
Changes in unrealized gains on forward exchange contracts, net of deferred income taxes	–	(667)	–	(667)
Balance as at August 31, 2012	\$ 12,248	\$ 1,259	\$ –	\$ 13,507

18 Stock-Based Compensation Plans

The following table summarizes the stock-based compensation costs recognized for employee services received during the years ended August 31, 2011 and 2012:

	Years ended August 31,	
	2012	2011
Stock-based compensation costs arising from equity-settled awards	\$ 1,831	\$ 2,217
Stock-based compensation costs arising from cash-settled awards	31	39
	\$ 1,862	\$ 2,256

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

The maximum number of additional subordinate voting shares issuable under the Long-Term Incentive Plan and the Deferred Share Unit Plan cannot exceed 6,306,153 shares. The maximum number of subordinate voting shares that may be granted to any individual on an annual basis cannot exceed 5% of the number of outstanding subordinate voting shares. The company settles stock options and redeems restricted share units and deferred share units through the issuance of common shares from treasury.

Long-Term Incentive Plan

The company established the Long-Term Incentive Plan for directors, executive officers and employees and those of the company's subsidiaries, as determined by the Board of Directors. The plan, which includes stock options and restricted share units, was approved by the shareholders of the company.

Stock Options

The exercise price of stock options granted under the Long-Term Incentive Plan is the market price of the common shares on the date of grant. Stock options granted under the plan generally expire 10 years from the date of grant and generally vest over a four-year period, being the required period of service from employees, generally with 25% vesting on an annual basis commencing on the first anniversary of the date of grant. As at September 1, 2010 and as at August 31, 2011 and 2012, all stock options outstanding were vested.

The following table summarizes stock option activity for the years ended August 31, 2011 and 2012:

	Years ended August 31,			
	2012		2011	
	Number	Weighted average exercise price (CA\$)	Number	Weighted average exercise price (CA\$)
Outstanding – Beginning of year	641,357	\$ 9	1,348,787	\$ 19
Exercised	(109,700)	3	(306,825)	5
Forfeited	(1,500)	5	(43,541)	14
Expired	(285,803)	15	(357,064)	48
Outstanding – End of year	<u>244,354</u>	<u>\$ 5</u>	<u>641,357</u>	<u>\$ 9</u>
Exercisable – End of year	<u>244,354</u>	<u>\$ 5</u>	<u>641,357</u>	<u>\$ 9</u>

The weighted-average market price of the shares at the date of exercise of stock options exercised during fiscal 2011 and 2012 was \$4.90 and \$5.84, respectively.

The following table summarizes information about stock options as at August 31, 2012:

Stock options outstanding and exercisable				
Exercise price (CA\$)	Number	Weighted average exercise price (CA\$)	Intrinsic value (CA\$)	Weighted average remaining contractual life
\$2.50	23,275	\$ 2.50	\$ 55	–
\$4.64 to 6.28	221,079	5.54	–	2 years
	<u>244,354</u>	<u>\$ 5.25</u>	<u>\$ 55</u>	<u>2 years</u>

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Restricted Share Units (RSUs)

RSUs are stock awards that rise and fall in value based on the market price of the company's subordinate voting shares and are redeemable for actual subordinate voting shares or cash at the discretion of the Board of Directors as determined on the date of grant. Vesting dates are also established by the Board of Directors on the date of grant. The vesting dates are subject to a minimum term of three years and a maximum term of 10 years from the award date, being the required period of service from employees. Fair value of RSUs equals the market price of the common shares on the date of grant.

The following table summarizes RSU activity for the years ended August 31, 2011 and 2012:

	Years ended August 31,	
	2012	2011
Outstanding – Beginning of year	1,551,658	1,603,048
Granted	334,878	350,382
Redeemed	(418,086)	(340,974)
Forfeited	(130,720)	(60,798)
Outstanding – End of year	1,337,730	1,551,658

None of the RSUs outstanding, as at September 1, 2010, and as at August 31, 2011 and 2012 were redeemable. The weighted average grant-date fair value of RSUs granted during the years ended August 31, 2011 and 2012 amounted to \$7.26 and \$5.90 respectively.

The weighted-average market price of the shares at the date of redemption of RSUs redeemed during the years ended August 31, 2011 and 2012 was \$7.48 and \$6.07 respectively.

Deferred Share Unit Plan

The company established a Deferred Share Unit (DSU) Plan for the members of the Board of Directors as part of their annual retainer fees. Each DSU entitles the Board members to receive one subordinate voting share. DSUs are acquired on the date of grant and will be redeemed in subordinate voting shares when the Board member will cease to be Director of the company. This plan was approved by the shareholders of the company.

The following table summarizes DSU activity for the years ended August 31, 2011 and 2012:

	Years ended August 31,	
	2012	2011
Outstanding – Beginning of year	110,298	135,003
Granted	22,792	12,786
Redeemed	–	(37,491)
Outstanding – End of year	133,090	110,298

None of the DSUs outstanding as at September 1, 2010, and as at August 31, 2011 and 2012 were redeemable. The weighted average grant-date fair value of DSUs granted during the years ended August 31, 2011 and 2012 amounted to \$7.87 and \$5.86 respectively.

The weighted-average market price of the shares at the date of redemption of DSUs redeemed during the years ended August 31, 2011 was \$8.68.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Stock Appreciation Rights Plan

The company established the Stock Appreciation Rights Plan for certain employees. Under that plan, eligible employees are entitled to receive a cash amount equivalent to the difference between the market price of the common shares on the date of exercise and the exercise price determined on the date of grant. Stock appreciation rights granted under the plan generally expire 10 years from the date of grant and generally vest over a four-year period, being the required period of service from employees, generally with 25% vesting on an annual basis commencing on the first anniversary of the date of grant. This plan was approved by the shareholders of the company.

The following table summarizes stock appreciation rights activity for the years ended August 31, 2011 and 2012:

	Years ended August 31,			
	2012		2011	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding – Beginning of year	29,124	\$ 3	44,374	\$ 8
Granted	4,000	–	4,500	–
Forfeited	–	–	(14,750)	5
Expired	–	–	(5,000)	34
	33,124	\$ 3	29,124	\$ 3
Outstanding – End of year				
Exercisable – End of year	15,787	\$ 4	10,075	\$ 5

The liability arising from stock appreciation rights as at September 1, 2010 and as at August 31, 2011 and 2012 amounted to \$34,000, \$81,000 and \$109,000 respectively and is recorded in accounts payable and accrued liabilities in the balance sheets.

The following table summarizes information about stock appreciation rights as at August 31, 2012:

Exercise price	Stock appreciation rights outstanding		Stock appreciation rights exercisable	
	Number	Weighted average remaining contractual life	Number	
\$ –	8,500	9 years	–	
\$2.36	9,674	6 years	4,837	
\$3.74 to \$4.65	10,500	4 years	6,500	
\$6.28 to \$6.50	4,450	4 years	4,450	
	33,124	6 years	15,787	

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

19 Related Party Disclosures

Compensation of key management personnel

	Years ended August 31,	
	2012	2011
Salaries and short-term employee benefits	\$ 3,398	\$ 3,643
Restructuring charges	177	–
Stock-based compensation costs	793	853
	\$ 4,368	\$ 4,496

Key management personnel includes senior management and Directors.

20 Statements of earnings

Net research and development

Net research and development expenses comprise the following:

	Years ended August 31,	
	2012	2011
Gross research and development expenses	\$ 59,282	\$ 57,226
Research and development tax credits and grants	(9,428)	(9,299)
	\$ 49,854	\$ 47,927

Depreciation and amortization

Depreciation and amortization expenses by functional area are as follows:

	Years ended August 31,	
	2012	2011
Cost of sales		
Depreciation of property, plant and equipment	\$ 2,009	\$ 1,975
Amortization of intangible assets	5,076	6,093
	7,085	8,068
Selling and administrative expenses		
Depreciation of property, plant and equipment	1,037	1,341
Amortization of intangible assets	1,806	2,092
	2,843	3,433
Net research and development expenses		
Depreciation of property, plant and equipment	3,123	3,339
Amortization of intangible assets	937	998
	4,060	4,337
	\$ 13,988	\$ 15,838
Depreciation of property, plant and equipment	\$ 6,169	\$ 6,655
Amortization of intangible assets	7,819	9,183
	\$ 13,988	\$ 15,838

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Employee compensation

Employee compensation comprises the following:

	Years ended August 31,	
	2012	2011
Salaries and benefits	\$ 127,007	\$ 122,828
Restructuring charges	2,329	–
Stock-based compensation costs	1,862	2,256
	\$ 131,198	\$ 125,084

Restructuring charges by functional area are as follows:

	Years ended August 31,	
	2012	2011
Cost of sales	\$ 264	\$ –
Selling and administrative expenses	1,181	–
Net research and development costs	884	–
	\$ 2,329	\$ –

Stock-based compensation costs by functional area are as follows:

	Years ended August 31,	
	2012	2011
Cost of sales	\$ 248	\$ 224
Selling and administrative expenses	1,145	1,281
Net research and development expenses	469	487
Net earnings from discontinued operations	–	264
	\$ 1,862	\$ 2,256

21 Other Disclosures

Government grants

The company is entitled to receive grants on certain eligible research and development projects conducted in Finland from TEKES, a Finnish technology organization, which is funding Finnish companies' high technology, research and innovations. The company's eligible research and development projects must be pre-approved by TEKES and the grant is subject to certain conditions. In the event a condition is not met, TEKES can require reimbursement of a portion or the entire amount of the grant received. A liability to repay the funding is recognized in the period in which conditions arise that will cause the funding to be repayable. As at August 31, 2012, the company was in compliance with the conditions of the funding. This funding is presented as a reduction of gross research and development expenses in the statements of earnings. For the years ended August 31, 2011 and 2012, the company recorded \$2,085,000 and \$1,903,000 respectively, under that program in the statements of earnings.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Defined contribution plans

The company maintains separate defined contribution plans for certain eligible employees. These plans, which are accounted for on an accrual basis, are summarized as follows:

- Deferred profit-sharing plan

The company maintains a plan for certain eligible employees residing in Canada, under which the company may elect to contribute an amount equal to 3% (2% prior to January 2011) of an employee's gross salary, provided that the employee has contributed at least 3% (2% prior to January 2011) of his gross salary to a tax-deferred registered retirement savings plan. Cash contributions to this plan and expenses for the years ended August 31, 2011 and 2012, amounted to \$911,000 and \$1,178,000 respectively.

- 401K plan

The company maintains a 401K plan for eligible employees residing in the U.S. Under this plan, the company must contribute an amount equal to 3% of an employee's current compensation. In addition, eligible employees may contribute up to the lesser of 1% of eligible compensation or the statutorily prescribed annual limit to the 401K plan. The 401K plan permits, but does not require the company to make additional matching contributions to the 401K plan on behalf of the eligible participants, subject to a maximum of 50% of the first 6% of the participant's current compensation subject to certain legislated maximum contribution limits. During the years ended August 31, 2011 and 2012, the company recorded cash contributions and expenses totaling \$680,000 and \$693,000 respectively.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

22 Income Taxes

The reconciliation of the income tax provision calculated using the combined Canadian federal and provincial statutory income tax rate with the income tax provision in the financial statements is as follows:

	Years ended August 31,	
	2012	2011
Income tax provision at combined Canadian federal and provincial statutory tax rate (27% in 2012 and 29% in 2011)	\$ (6)	\$ 5,222
Increase (decrease) due to:		
Foreign income taxed at different rates	285	(402)
Non-taxable (income)/loss	535	(4,102)
Non-deductible expenses	1,028	916
Foreign exchange effect of translation of foreign operations	(2,205)	2,541
Recognition of previously unrecognized deferred income tax assets	(557)	–
Utilization of previously unrecognized deferred income tax assets	(14)	(61)
Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses	4,523	5,111
Other	(18)	(411)
	\$ 3,571	\$ 8,814
The income tax provision consists of the following:		
Current		
Current income taxes	\$ 1,535	\$ 1,986
Benefit arising from previously unrecognized tax losses, tax credits and temporary differences	(14)	(61)
	1,521	1,925
Deferred		
Deferred income taxes relating to the origination and reversal of temporary differences	(1,840)	1,778
Benefit arising from previously unrecognized tax losses and temporary differences	(557)	–
	(2,397)	1,778
Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses	4,447	5,111
	2,050	6,889
	\$ 3,571	\$ 8,814

The income tax provision for the discontinued operations is as follows:

Current	\$ –	\$ 27
Deferred	–	174
	\$ –	\$ 201

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Deferred taxes

	As at August 31, 2012	As at August 31, 2011	As at September 1, 2010
Deferred tax assets			
Deferred tax assets to be recovered within 12 months	\$ 2,121	\$ 4,559	\$ 4,408
Deferred tax assets to be recovered after 12 months	9,959	12,354	14,322
	12,080	16,913	\$ 18,730
Deferred tax liabilities			
Deferred tax liabilities payable within 12 months	108	8	–
Deferred tax liabilities payable after 12 months	1,997	5,071	–
	2,105	5,079	–
Deferred tax assets net	\$ 9,975	\$ 11,834	\$ 18,730

The changes in deferred income tax assets and liabilities for the year ended August 31, 2011 are as follows:

	Balance as at September 1, 2010	Credited (charged) to statement of earnings	Charged to shareholders' equity	Foreign currency translation adjustment	Balance as at August 31, 2011
Deferred tax assets					
Long-lived assets	\$ 5,013	\$ (705)	\$ –	\$ 336	\$ 4,644
Provisions and accruals	3,324	(319)	(314)	234	2,925
Deferred revenue	1,983	(115)	–	115	1,983
Research and development expenses	6,662	(4,602)	–	538	2,598
Losses carried forward	10,172	(558)	–	–	9,614
Deferred tax liabilities					
Long-lived assets	(631)	421	–	(22)	(232)
Research and development tax credits	(7,793)	(1,185)	–	(720)	(9,698)
Total	\$ 18,730	\$ (7,063)	\$ (314)	\$ 481	\$ 11,834
Classified as follows:					
Deferred tax assets	\$ 18,730				\$ 16,913
Deferred tax liabilities	–				(5,079)
	\$ 18,730				\$ 11,834

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

The changes in deferred income tax assets and liabilities for the year ended August 31, 2012 are as follows:

	<u>Balance as at August 31, 2011</u>	<u>Credited (charged) to the statement of earnings</u>	<u>Credited (charged) to shareholders' equity</u>	<u>Foreign currency translation adjustment</u>	<u>Balance as at August 31, 2012</u>
Deferred tax assets					
Long-lived assets	\$ 4,644	\$ (211)	\$ 2	\$ (46)	\$ 4,389
Provisions and accruals	2,925	274	256	(24)	3,431
Deferred revenue	1,983	71		(10)	2,044
Research and development expenses	2,598	(209)	–	(27)	2,362
Losses carried forward	9,614	(412)	–	5	9,207
Deferred tax liabilities					
Long-lived assets	(232)	(254)	(2)	(6)	(494)
Research and development tax credits	(9,698)	(1,309)	–	43	(10,964)
Total	<u>\$ 11,834</u>	<u>\$ (2,050)</u>	<u>\$ 256</u>	<u>\$ (65)</u>	<u>\$ 9,975</u>
Classified as follows:					
Deferred tax assets	\$ 16,913				\$ 12,080
Deferred tax liabilities	(5,079)				(2,105)
	<u>\$ 11,834</u>				<u>\$ 9,975</u>

Unrecognized deferred income tax assets on temporary deductible differences, unused tax losses and research and development expenses are as follows:

	<u>As at August 31, 2012</u>	<u>As at August 31, 2011</u>	<u>As at September 1, 2010</u>
Temporary deductible differences	\$ 270	\$ 615	\$ 332
Losses carried forward	33,135	30,984	17,653
Research and development expenses	2,347	2,917	3,292
	<u>\$ 35,752</u>	<u>\$ 34,516</u>	<u>\$ 21,277</u>

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

As at August 31, 2012, the year of expiry of operating losses and research and development expenses for which no deferred income tax assets were recognized in the balance sheets are as follows by tax jurisdiction:

Year of expiry	Canada		Finland	United States	Other
	Federal	Provincial			
2013	\$ –	\$ –	\$ 1,203	\$ 1,726	\$ –
2014	–	–	4,339	1,404	–
2015	1,182	1,182	2,877	997	–
2016	–	–	–	553	–
2017	–	–	4	–	–
2018	–	–	366	–	–
2020	–	–	8,368	2,145	–
2021	–	–	7,250	10,202	–
2022	–	–	12,699	7,435	–
2023	–	–	–	1,972	–
2024	–	–	–	1,351	–
2025	–	–	–	1,351	–
2026	1,090	1,090	–	1,351	–
2027	1,383	1,383	–	1,351	–
2028	–	–	–	2,447	–
2030	12	12	–	2,713	–
2031	38	38	–	109	–
Indefinite	–	–	–	–	2,109
	\$ 3,705	\$ 3,705	\$ 37,106	\$ 37,107	\$ 2,109

Furthermore, as at August 31, 2012, the company had available capital losses in Canada amounting to \$73,295,000 at the federal level and \$73,655,000 at the provincial level for which no deferred tax assets were recognized. These losses can be carried forward indefinitely against capital gains.

As at August 31, 2012, non-refundable research and development tax credits recognized in the balance sheet amounted to \$41,532,000. In order to realize these non-refundable research and development tax credits, the company needs to generate approximately \$270,000,000 (CA\$267,000,000) in pre-tax earnings at the Canadian federal level and approximately \$11,000,000 at the Canadian provincial level. In addition, as at August 31, 2012, the company had deferred income tax assets in the balance sheet in amount of \$12,080,000 mainly in United States. In order to realize these deferred income tax assets, the company needs to generate \$30,000,000 at the United States level.

As at August 31, 2012, taxable temporary differences of \$13,175,000 were not recognized for taxes that would be payable on the unremitted earnings of certain of the company's subsidiaries, as the company has determined that:

- (1) undistributed profits of its foreign subsidiaries will not be distributed in the foreseeable future; and
- (2) undistributed profits of its domestic subsidiaries will not be taxable when distributed.

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

23 Earnings per Share

The following table summarizes the reconciliation of the basic weighted average number of shares outstanding and the diluted weighted average number of shares outstanding:

	Years ended August 31,	
	2012	2011
Basic weighted average number of shares outstanding (000's)	60,453	60,000
Plus dilutive effect of:		
Stock options (000's)	149	266
Restricted share units (000's)	910	1,106
Deferred share units (000's)	118	116
Diluted weighted average number of shares outstanding (000's)	61,630	61,488
Stock awards excluded from the calculation of the diluted weighted average number of shares outstanding because their exercise price was greater than the average market price of the common shares (000's)	54	381

For the year ended August 31, 2012, the diluted amount per share was the same amount as the basic amount per share since the dilutive effect of stock options, restricted share units and deferred share units was not included in the calculation; otherwise, the effect would have been antidilutive. Accordingly, the diluted amount per share for this year was calculated using the basic weighted average number of shares outstanding.

24 Segment Information

The company has only one reportable segment.

Sales to external customers by geographic region are detailed as follows:

	Years ended August 31,	
	2012	2011
United States	\$ 83,401	\$ 89,240
Canada	29,944	30,986
Other	17,838	17,303
Americas	131,183	137,529
United Kingdom	9,862	15,617
Other	61,449	69,698
Europe, Middle-East and Africa	71,311	85,315
China	18,365	25,799
Other	29,107	21,100
Asia-Pacific	47,472	46,899
	\$ 249,966	\$ 269,743

EXFO Inc.

Notes to Consolidated Financial Statements

(tabular amounts in thousands of US dollars, except share and per share data and as otherwise noted)

Sales were allocated to geographic regions based on the country of residence of the related customers.

Long-lived assets by geographic region are detailed as follows:

	<u>As at August 31, 2012</u>			<u>As at August 31, 2011</u>			<u>As at September 1, 2010</u>		
	<u>Property, plant and equipment</u>	<u>Intangible assets</u>	<u>Goodwill</u>	<u>Property, plant and equipment</u>	<u>Intangible assets</u>	<u>Goodwill</u>	<u>Property, plant and equipment</u>	<u>Intangible assets</u>	<u>Goodwill</u>
Canada	\$ 38,436	\$ 2,858	\$ –	\$ 21,206	\$ 3,164	\$ –	\$ 15,028	\$ 3,316	\$ –
United States	1,335	2,067	17,640	1,402	4,834	17,782	1,829	7,828	17,782
Finland	849	8,265	11,520	1,544	13,324	13,160	1,606	14,906	11,573
India	5,866	16	–	4,709	43	–	3,134	43	–
China	2,094	43	–	2,696	27	–	2,665	33	–
Other	1,268	883	–	519	1,509	–	468	1,821	–
	<u>\$ 49,848</u>	<u>\$ 14,132</u>	<u>\$ 29,160</u>	<u>\$ 32,076</u>	<u>\$ 22,901</u>	<u>\$ 30,942</u>	<u>\$ 24,730</u>	<u>\$ 27,947</u>	<u>\$ 29,355</u>