EXFO Inc.

Unaudited Interim Consolidated Balance Sheets

(in thousands of US dollars)

	As at November 30, 2011	As at August 31, 2011	As at September 1, 2010
Assets			
Current assets			
Cash	$ 56,170	$ 22,771	$ 21,440
Short-term investments	12,123	47,091	10,379
Accounts receivable			
Trade	46,444	45,151	50,190
Other	5,080	6,329	5,217
Income taxes and tax credits recoverable	5,930	5,414	2,604
Inventories	50,001	52,754	40,328
Prepaid expenses	3,084	3,237	2,816
Current assets held for sale	–	–	3,769
	178,832	182,747	136,743
Tax credits recoverable	31,835	34,120	26,887
Forward exchange contracts (note 4)	–	149	–
Property, plant and equipment	33,523	32,076	24,730
Intangible assets	19,817	22,901	27,947
Goodwill	29,353	30,942	29,355
Deferred income taxes	16,977	17,314	19,408
Long-term assets held for sale	–	–	7,530
	$ 310,337	$ 320,249	$ 272,600
Liabilities			
Current liabilities			
Bank loan	$ –	$ 784	$ –
Accounts payable and accrued liabilities	32,960	30,320	29,943
Provisions	1,829	1,817	927
Income taxes payable	821	876	426
Contingent liability (note 5)	316	338	–
Current portion of long-term debt	603	645	568
Deferred revenue	9,087	10,590	10,354
Current liabilities related to assets held for sale	–	–	2,531
	45,616	45,370	44,749
Deferred revenue	5,409	5,704	5,775
Long-term debt	904	968	1,419
Contingent liability (note 5)	–	–	2,660
Other liabilities	632	723	603
Deferred income taxes	4,856	4,803	–
Long-term liabilities related to assets held for sale	–	–	537
	57,417	57,568	55,743
Contingency (note 6)			
Shareholders' equity			
Share capital (note 7)	110,945	110,341	106,126
Contributed surplus	17,658	18,017	18,563
Retained earnings	116,233	113,438	91,152
Accumulated other comprehensive income	8,084	20,885	1,016
	252,920	262,681	216,857
	$ 310,337	$ 320,249	$ 272,600

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

EXFO Inc.
Unaudited Interim Consolidated Statements of Earnings

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

	Three months ended November 30,	
	2011	**2010**
Sales	$ 66,388	$ 65,653
Cost of sales [1] (note 8)	23,370	24,785
Selling and administrative (note 8)	24,618	19,899
Net research and development (note 8)	12,483	11,601
Depreciation of property, plant and equipment (note 8)	1,568	1,646
Amortization of intangible assets (note 8)	1,921	2,566
Earnings from operations	2,428	5,156
Interest expenses	(27)	(7)
Foreign exchange gain (loss)	1,664	(1,113)
Earnings before income taxes	4,065	4,036
Income taxes (note 9)	1,151	2,829
Net earnings from continuing operations	2,914	1,207
Net earnings from discontinued operations	–	12,926
Net earnings for the period	$ 2,914	$ 14,133
Basic and diluted net earnings from continuing operations per share	$ 0.05	$ 0.02
Basic net earnings from discontinued operations per share	$ –	$ 0.22
Diluted net earnings from discontinued operations per share	$ –	$ 0.21
Basic net earnings per share	$ 0.05	$ 0.24
Diluted net earnings per share	$ 0.05	$ 0.23
Basic weighted average number of shares outstanding (000's)	60,341	59,665
Diluted weighted average number of shares outstanding (000's) (note 10)	61,763	61,106

(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.

Unaudited Interim Consolidated Statements of Comprehensive Income (Loss)

(in thousands of US dollars)

	Three months ended November 30,	
	2011	**2010**
Net earnings for the period	$ 2,914	$ 14,133
Other comprehensive income (loss), net of income taxes		
Foreign currency translation adjustment	(11,752)	6,227
Unrealized gains on forward exchange contracts	(819)	1,444
Reclassification of realized gains on forward exchange contracts in net earnings	(625)	(189)
Deferred income tax effect of the components of other comprehensive income (loss)	395	(338)
Other comprehensive income (loss)	(12,801)	7,144
Comprehensive income (loss) for the period	$ (9,887)	$ 21,277

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

EXFO Inc.
Unaudited Interim Consolidated Statement of Changes in Equity

(in thousands of US dollars)

	Three months ended November 30, 2010				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Balance as at September 1, 2010	$ 106,126	$ 18,563	$ 91,152	$ 1,016	$ 216,857
Exercise of stock options	61	–	–	–	61
Reclassification of stock-based compensation costs	861	(861)	–	–	–
Stock-based compensation costs	–	725	–	–	725
Net earnings for the period	–	–	14,133	–	14,133
Other comprehensive income					
Foreign currency translation adjustment	–	–	–	6,227	6,227
Changes in unrealized gains on forward exchange contracts, net of deferred income taxes of $338	–	–	–	917	917
Total comprehensive income for the period	–	–	–	7,144	7,144
Balance as at November 30, 2010	$ 107,048	$ 18,427	$ 105,285	$ 8,160	$ 238,920

	Three months ended November 30, 2011				
	Share Capital	Contributed Surplus	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Balance as at September 1, 2011	$ 110,341	$ 18,017	$ 113,438	$ 20,885	$ 262,681
Reclassification of stock-based compensation costs	848	(848)	–	–	–
Redemption of share capital (note 7)	(244)	–	(119)	–	(363)
Stock-based compensation costs	–	489	–	–	489
Net earnings for the period	–	–	2,914	–	2,914
Other comprehensive loss					
Foreign currency translation adjustment	–	–	–	(11,752)	(11,752)
Changes in unrealized gains on forward exchange contracts, net of deferred income taxes of $395	–	–	–	(1,049)	(1,049)
Total comprehensive loss for the period	–	–	–	(12,801)	(12,801)
Balance as at November 30, 2011	$ 110,945	$ 17,658	$ 116,233	$ 8,084	$ 252,920

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

EXFO Inc.

Unaudited Interim Consolidated Statements of Cash Flows

(in thousands of US dollars)

	Three months ended November 30,	
	2011	**2010**
Cash flows from operating activities		
Net earnings for the period	$ 2,914	$ 14,133
Add (deduct) items not affecting cash		
Change in discount on short-term investments	31	(18)
Stock-based compensation costs	555	738
Depreciation and amortization	3,489	4,230
Gain on disposal of discontinued operations	–	(13,212)
Deferred revenue	(1,141)	(2,571)
Deferred income taxes	735	1,990
Foreign exchange gain/loss	(1,214)	537
	5,369	5,827
Change in non-cash operating items		
Accounts receivable	(2,897)	(4,480)
Income taxes and tax credits	128	(1,059)
Inventories	593	(1,362)
Prepaid expenses	15	(385)
Accounts payable, accrued liabilities and provisions	3,397	(1,224)
Other liabilities	(61)	135
	6,544	(2,548)
Cash flows from investing activities		
Additions to short-term investments	(57,922)	(226,146)
Proceeds from disposal and maturity of short-term investments	90,779	209,605
Additions to capital assets	(4,486)	(1,979)
Net proceeds from disposal of discontinued operations	–	22,124
Business combination	–	(132)
	28,371	3,472
Cash flows from financing activities		
Bank loan	(785)	–
Exercise of stock options	–	61
Redemption of share capital	(363)	–
	(1,148)	61
Effect of foreign exchange rate changes on cash	(368)	344
Change in cash	33,399	1,329
Cash – Beginning of the period	22,771	22,109
Cash – End of the period	$ 56,170	$ 23,438
Supplementary information		
Interest paid	$ 27	$ 28
Income taxes paid	$ 735	$ 373

As at November 30, 2010 and 2011, unpaid purchases of capital assets amounted to $257 and $1,941 respectively.

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

EXFO Inc.

Notes to Condensed Unaudited Interim 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) designs, manufactures and markets 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 condensed interim consolidated financial statements were authorized for issue by the Board of Directors on January 11, 2012.

2 Basis of Presentation and Adoption of IFRS

The company prepared its consolidated financial statements in accordance with Canadian generally accepted accounting principles 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) 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 these condensed interim consolidated financial statements for the three- month period ended November 30, 2011. In these condensed consolidated financial statements, the term "Canadian GAAP" refers to Canadian GAAP applied before the adoption of IFRS.

These condensed interim consolidated financial statements have been prepared in accordance with the IFRS applicable to the preparation of interim financial statements, including IAS 34, "*Interim Financial Reporting*", and IFRS 1, "*First-Time Adoption of International Financial Reporting Standards*".

These condensed interim consolidated financial statements do not include all disclosures that will normally be found in the company's annual consolidated financial statements. Subject to certain transition elections disclosed in note 3, the company has consistently applied the same accounting policies in its consolidated opening 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 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. Specifically, note 3 presents a reconciliation of the consolidated statements of earnings and cash flows for the three months ended November 30, 2010 and 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, November 30, 2010 and August 31, 2011.

The policies applied in these interim condensed consolidated financial statements are based on IFRS issued as of January 11, 2012, the date the Board of Directors approved the financial statements. Any subsequent changes to IFRS that are given effect in the company's annual consolidated financial statements for the year ending August 31, 2012 could result in restatement of these condensed interim consolidated financial statements, including the transition adjustments recognized on change-over to IFRS.

These condensed interim consolidated financial statements should be read in conjunction with the company's most recent annual consolidated financial statements for the year ended August 31, 2011. These condensed interim consolidated results are not necessarily indicative of the results for the full year.

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

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

Basis of measurement

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

Critical accounting estimates and judgments

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 and the disclosures of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those judgments, assumptions and estimates.

The estimates, assumptions and judgment 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 binding sales transactions in an arm's length transaction of similar assets or observable market prices less incremental costs for disposing of the asset.

In the calculation of recoverable amount of a CGU, the company bases its calculations on discounted cash flows. These calculations require 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.

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.

Sales of goods

Revenue from the sales of goods 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.

Reporting currency

The functional currency of the company is the Canadian dollar. The company has adopted the US dollar as its reporting currency. The consolidated financial statements are translated into the reporting currency as follows: assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet, while revenues and expenses are translated at the monthly average exchange rate. The cumulative foreign currency translation adjustment arising from such translation is included in accumulated other comprehensive income in 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 reflected in the consolidated statements of earnings.

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 have 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. Foreign exchange gains and losses arising from such translation are reflected 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 have been acquired or issued, as well as on their characteristics and their 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 consideration	Other financial liabilities
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-derivatives 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 initially measured at fair value plus transaction costs and they are subsequently carried at amortized cost, using the effective interest rate method. For the company, that value corresponds to the nominal amount for accounts payable and accrued liabilities as a result of their short-term maturity.

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.

The company's forward exchange contracts 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. The company uses the dollar-offset method to assess the effectiveness of its cash flow hedging instruments.

Fair value hierarchy

The company's cash, short-term investments and forward exchange contracts 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 cash and 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 date.

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 securities; 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.

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 25 years
Equipment	2 to 10 years
Leasehold improvements	The lesser of useful life and remaining lease term

The assets' residual values, useful lives and methods of depreciation 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.

Goodwill

Goodwill represents the excess of the consideration transferred of acquired businesses over the estimated fair value of net identifiable assets acquired, and is allocated to each 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 expenses related to research, as well as development activities incurred until the technological feasibility of the product has been established in accordance with the provision of IAS 38, "*Intangible Assets*'', are expensed as incurred, net of related tax credits and grants. After technological feasibility is established, additional costs are capitalized, net of related tax credits and grants, and amortized on a straight-line basis over the estimated benefit period. Technological feasibility occurs when a working model is completed. 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 November 30, 2010 and 2011, the company had not capitalized any development costs.

Long-term research and development tax credits recoverable must be discounted using risk-free interest rates for the periods when tax credits will be recovered. Adjustments to the carrying value related to the passage of time are considered as interest income in the consolidated statements of earnings.

The company elected to present non-refundable research and development tax credits against gross research and development expenses in the consolidated statements of earnings.

Impairment of non-financial assets

The company assesses at each reporting date whether there is an indication that the carrying amount 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 CGUs' 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, which is the higher amount between discounted future cash flows expected to be provided by the asset or group of assets (value in use) or its fair value less costs to sell. The company performs its annual goodwill impairment test in the third quarter of each fiscal year.

For property, plant and equipment and finite-life intangibles, 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, as well as November 30, 2010 and 2011, 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.

Warranty

The company offers its customers 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 periods 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 date in the tax jurisdiction where the company and its subsidiaries generate taxable income/loss.

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 carryforward of unused tax losses and deductions, using enacted or substantively enacted income tax rates 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 they will be recovered.

Deferred tax liabilities are generally 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 sheet.

Income taxes for interim periods are calculated using the tax rates that would be applicable to the annual taxable income.

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 period.

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 period, plus the effect of dilutive potential common shares outstanding during the period. 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 period 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 period.

Share-based payment

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.

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 for the period.

New IFRS pronouncements and amendments not yet adopted

Financial Instruments – Disclosure

IFRS 7, "*Financial Instruments: Disclosures*", has been amended to include additional disclosure requirements in the reporting of transfer transactions and risk exposures relating to transfers of financial assets and the effect of those risks on an entity's financial position, particularly those involving securitization of financial assets. The amendment is applicable for annual periods beginning on or after July 1, 2011, with earlier application permitted. While the company is currently assessing the impact of these amendments, it does not expect the amendments to have a significant impact on its consolidated financial statements.

Financial Instruments

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 of 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.

In May 2011, the 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 the 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 and amended 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*".

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 joint arrangements, associates, special purpose vehicles and off-balance-sheet vehicles. 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.

Financial Statement Presentation

In June 2011, the IASB amended IAS 1, "*Financial Statement Presentation*". The amendments to IAS 1 requires 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 flows hedges. The amendment is effective for annual periods beginning on or after July 1, 2012. Early adoption is permitted and full retrospective application is required. The company does not expect the standard to have a significant impact on its consolidated financial statements.

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 ending August 31, 2012 will be the first annual consolidated financial statements prepared in accordance with IFRS.

These condensed interim consolidated financial statements as at and for the three months ended November 30, 2011 have been prepared in conformity with the accounting policies and the basis of presentation described in note 2.

In preparing these condensed interim 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 three months ended November 30, 2010 and the annual year ended August 31, 2011.

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 ending 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 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 cumulative 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.

(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 GAAP	Notes	Canadian GAAP	Adjustments	Reclassification	IFRS	Description under IFRS
Assets						**Assets**
Current 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
		143,156	–	(6,413)	136,743	
Tax credits recoverable	b)	29,397	(2,510)	–	26,887	Tax credits recoverable
Property, plant and equipment	d)	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), b), d)	12,884	333	6,191	19,408	Deferred income taxes
Long-term assets held for sale	a)	7,308	–	222	7,530	Long-term assets held for sale
		$ 273,502	$ (902)	$ –	$ 272,600	
Liabilities						**Liabilities**
Current liabilities						**Current liabilities**
Accounts payable and accrued liabilities	f)	$ 30,870	$ –	$ (927)	$ 29,943	Accounts payable and accrued liabilities
	f)	–	–	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
		44,749	–	–	44,749	
Deferred revenue		5,775	–	–	5,775	**Deferred revenue**
Long-term debt		1,419	–	–	1,419	**Long-term debt**
	c)	–	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**
		53,083	2,660	–	55,743	
Shareholders' equity						**Shareholders' equity**
Share capital		106,126	–	–	106,126	Share capital
Contributed surplus		18,563	–	–	18,563	Contributed surplus
Retained earnings	b), c), d), e)	50,528	(3,562)	44,186	91,152	Retained earnings
Accumulated other comprehensive income	d), e)	45,202	–	(44,186)	1,016	Accumulated other comprehensive income
		220,419	(3,562)	–	216,857	
		$ 273,502	$ (902)	$ –	$ 272,600	

EXFO Inc.
Notes to Condensed Unaudited Interim 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 November 30, 2010

	Notes	Canadian GAAP	Adjustments	Reclassification	IFRS
Assets					
Current assets					
Cash		$ 23,438	$ –	$ –	$ 23,438
Short-term investments		27,186	–	–	27,186
Accounts receivable					
Trade		55,384	–	–	55,384
Other		7,190	–	–	7,190
Income taxes and tax credits recoverable		3,307	–	–	3,307
Inventories		43,311	–	–	43,311
Prepaid expenses		3,229	–	–	3,229
Deferred income taxes	a)	5,687	–	(5,687)	–
		168,732	–	(5,687)	163,045
Tax credits recoverable	b)	31,549	(2,553)	–	28,996
Forward exchange contracts		415	–	–	415
Property, plant and equipment	d)	23,707	1,353	–	25,060
Intangible assets		26,303	–	–	26,303
Goodwill		29,690	–	–	29,690
Deferred income taxes	a), b), d)	12,669	192	5,687	18,548
		$ 293,065	$ (1,008)	$ –	$ 292,057
Liabilities					
Current liabilities					
Accounts payable and accrued liabilities	f)	$ 31,195	$ –	$ (966)	$ 30,229
Provisions	f)	–	–	966	966
Income taxes payable		1,066	–	–	1,066
Current portion of long-term debt		584	–	–	584
Deferred revenue		8,431	–	–	8,431
		41,276	–	–	41,276
Deferred revenue		5,779	–	–	5,779
Long-term debt		1,460	–	–	1,460
Contingent liability	c)	–	2,736	–	2,736
Other liabilities		760	–	–	760
Deferred income taxes	b), d)	1,258	(132)	–	1,126
		50,533	2,604	–	53,137
Shareholders' equity					
Share capital		107,048	–	–	107,048
Contributed surplus		18,427	–	–	18,427
Retained earnings	b), c), d), e)	64,599	(3,500)	44,186	105,285
Accumulated other comprehensive income	b), c), d), e)	52,458	(112)	(44,186)	8,160
		242,532	(3,612)	–	238,920
		$ 293,065	$ (1,008)	$ –	$ 292,057

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	a)	6,130	–	(6,130)	–
		188,877	–	(6,130)	182,747
Tax credits recoverable	b)	36,627	(2,507)	–	34,120
Forward exchange contracts		149	–	–	149
Property, plant and equipment	d)	30,566	1,510	–	32,076
Intangible assets		22,901	–	–	22,901
Goodwill		30,942	–	–	30,942
Deferred income taxes	a), b), d)	11,024	160	6,130	17,314
		$ 321,086	$ (837)	$ –	$ 320,249
Liabilities					
Current liabilities					
Bank loan		$ 784	$ –	$ –	$ 784
Accounts payable and accrued liabilities	f)	32,137	–	(1,817)	30,320
Provisions	f)	–	–	1,817	1,817
Income taxes payable		876	–	–	876
Contingent liability	c)	–	338	–	338
Current portion of long-term debt		645	–	–	645
Deferred revenue		10,590	–	–	10,590
		45,032	338	–	45,370
Deferred revenue		5,704	–	–	5,704
Long-term debt		968	–	–	968
Other liabilities		723	–	–	723
Deferred income taxes	b), d)	4,913	(110)	–	4,803
		57,340	228	–	57,568
Shareholders' equity					
Share capital		110,341	–	–	110,341
Contributed surplus		18,017	–	–	18,017
Retained earnings	b), c), d), e)	69,877	(625)	44,186	113,438
Accumulated other comprehensive income	b), c), d), e)	65,511	(440)	(44,186)	20,885
		263,746	(1,065)	–	262,681
		$ 321,086	$ (837)	$ –	$ 320,249

EXFO Inc.

Notes to Condensed Unaudited Interim 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	e)	–	–	44,186	(44,186)	–
Adjustment to long-term tax credits recoverable, net of deferred income taxes	b)	–	–	(1,832)	–	(1,832)
Adjustment to the carrying value of property, plant and equipment, net of deferred income taxes	d)	–	–	930	–	930
Adjustment related to the fair value of the cash contingent consideration	c)	–	–	(2,660)	–	(2,660)
IFRS		$ 106,126	$ 18,563	$ 91,152	$ 1,016	$ 216,857

Reconciliation of consolidated shareholders' equity as previously reported under Canadian GAAP to IFRS as at November 30, 2010

	Notes	Share capital	Contributed Surplus	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Canadian GAAP		$ 107,048	$ 18,427	$ 64,599	$ 52,458	$ 242,532
Foreign currency translation adjustment	e)	–		44,186	(44,186)	–
Adjustment to long-term tax credits recoverable, net of deferred income taxes	b)	–	–	(1,792)	(72)	(1,864)
Adjustment to the carrying value of property, plant and equipment, net of deferred income taxes	d)	–	–	952	36	988
Changes in the fair value of the cash contingent consideration	c)	–	–	(2,660)	(76)	(2,736)
IFRS		$ 107,048	$ 18,427	$ 105,285	$ 8,160	$ 238,920

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	e)	–		44,186	(44,186)	–
Adjustment to long-term tax credits recoverable, net of deferred income taxes	b)	–	–	(1,667)	(163)	(1,830)
Adjustment to the carrying value of property, plant and equipment, net of deferred income taxes	d)	–	–	1,017	86	1,103
Changes in the fair value of the cash contingent consideration	c)	–	–	25	(363)	(338)
IFRS		$ 110,341	$ 18,017	$ 113,438	$ 20,885	$ 262,681

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

Reconciliation of consolidated net earnings as previously reported under Canadian GAAP to IFRS for the three months ended November 30, 2010

	Notes	Canadian GAAP	Adjustments	IFRS
Sales		$ 65,653	$ –	$ 65,653
Cost of sales		24,785	–	24,785
Selling and administrative		19,899	–	19,899
Net research and development		11,601	–	11,601
Depreciation of property, plant and equipment	d)	1,674	(28)	1,646
Amortization of intangible assets		2,566	–	2,566
Earnings from operations		5,128	28	5,156
Interest expenses	b)	(64)	57	(7)
Foreign exchange loss		(1,113)	–	(1,113)
Earnings before income taxes		3,951	85	4,036
Income taxes	b), d)	2,806	23	2,829
Net earnings from continuing operations		1,145	62	1,207
Net earnings from discontinued operations		12,926	–	12,926
Net earnings for the period		$ 14,071	$ 62	$ 14,133

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	d)	6,772	(117)	6,655
Amortization of intangible assets		9,183	–	9,183
Changes in fair value of cash contingent consideration	c)	–	(2,685)	(2,685)
Earnings from operations		18,503	2,802	21,305
Interest and other income	b)	511	227	738
Foreign exchange loss		(3,808)	–	(3,808)
Earnings before income taxes		15,206	3,029	18,235
Income taxes	b), d)	8,783	92	8,875
Net earnings from continuing operations		6,423	2,937	9,360
Net earnings from discontinued operations		12,926	–	12,926
Net earnings for the year		$ 19,349	$ 2,937	$ 22,286

Reconciliation of consolidated comprehensive income as previously reported under Canadian GAAP to IFRS for the three months ended November 30, 2010

	Notes	Canadian GAAP	Adjustments	IFRS
Net earnings for the period		$ 14,071	$ 62	$ 14,133
Other comprehensive income				
Foreign currency translation adjustment	b), c), d)	6,339	(112)	6,227
Unrealized gains on forward exchange contracts		1,444	–	1,444
Reclassification of realized gains on forward exchange contracts in net earnings		(189)	–	(189)
Deferred income tax effect of the components of other comprehensive income		(338)	–	(338)
Other comprehensive income		7,256	(112)	7,144
Comprehensive income for the period		$ 21,327	$ (50)	$ 21,277

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	$ 2,937	$ 22,286
Other comprehensive income				
Foreign currency translation adjustment	b), c), d)	19,399	(440)	18,959
Changes in unrealized losses on short-term investments		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	(440)	19,869
Comprehensive income for the year		$ 39,658	$ 2,497	$ 42,155

Statements of cash flows

The adjustments from Canadian GAAP to IFRS had no significant effect on the reported consolidated cash flows of the company for the three months ended November 30, 2010 and 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. Under Canadian GAAP, deferred income tax relating to current assets or current liabilities 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 sheet under IFRS.

b) *Tax credits recoverable*

Under IFRS, long-term tax credits recoverable must be discounted using risk-free interest rates for the periods when the tax credits will be recovered. Under Canadian GAAP, such treatment is not required.

- On September 1, 2010, the discounted value of the company's long-term tax credits recoverable was $2,510,000 lower than the carrying value under Canadian GAAP, and the related deferred income tax assets increased by $678,000. Accordingly, the opening balance of retained earnings (shareholders' equity) was reduced by $1,832,000.

- At as November 30, 2010, the discounted value of the company's long-term tax credits recoverable was $2,553,000 lower than the carrying value under Canadian GAAP, and the related deferred income tax assets increased by $689,000. For the three months ended November 30, 2010, changes in the discounted value of long-term tax credits recoverable resulted in interest income of $57,000 and a related deferred income tax expense of $15,000. It also resulted in a foreign currency translation loss of $72,000 recorded in accumulated other comprehensive income in the shareholders' equity.

- At as August 31, 2011, the discounted value of the company's long-term tax credits recoverable was $2,507,000 lower than the carrying value under Canadian GAAP, and the related deferred income tax assets increased by $401,000 and deferred tax liabilities decreased by $276,000. For the year ended August 31, 2011, changes in the discounted value of long-term tax credits recoverable resulted in interest income of $227,000 and a related deferred income tax expense of $61,000. It also resulted in a foreign currency translation loss of $163,000 recorded in accumulated other comprehensive income in the shareholders' equity.

c) *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, under IAS 37, "*Provisions, Contingent Liabilities and Contingent Assets*", the cash contingent consideration for the acquisition of NetHawk Oyj, 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 re-assessed at the end of each reporting periods and any changes in the fair value were recognized in the statements of earnings.

- As at September 1, 2010, the fair value of the contingent cash 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 November 30, 2010, there was no change in the fair value of the contingent cash consideration compared to the transition date. However, the fair value of the cash contingent consideration was translated into the US dollar (the reporting currency), which resulted in an increase of $76,000 in the carrying value and a corresponding foreign currency translation loss recorded in accumulated other comprehensive income in the shareholders' equity.

- As at August 31, 2011, the fair value of the contingent cash 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 in fiscal 2011.

d) 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 disposal of the asset, after deducting the estimated cost of disposal, if the asset were 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. Residual value is the estimated net realizable value of an item of property, plant and equipment at the end of its useful life to the company. Salvage value is the estimated net realizable value of an item of property, plant and equipment at the end of its life.

- 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 November 30, 2010, this resulted in an increase of the carrying value of property, plant and equipment of $1,353,000 and a decrease of deferred income tax assets of $365,000. For the three months ended November 30, 2010, this resulted in a decrease of depreciation of property, plant and equipment of $28,000 and a deferred income tax expense of $8,000. It also resulted in a foreign exchange translation gain of $36,000 recorded in accumulated other comprehensive income in the shareholders' equity.

- As at August 31, 2011, this resulted in an increase 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 exchange translation gain of $86,000 recorded in accumulated other comprehensive income in the shareholders' equity.

e) Foreign currency translation adjustment

In accordance with IFRS transitional provisions, the company elected to reset the foreign currency translation adjustment from the translation of consolidated financial statements in the reporting currency (US dollars) to zero as at the transition date to IFRS. Accordingly, the 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. Any foreign currency translation adjustment from the translation of the 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.

f) 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 sheet.

4 Derivative Financial Instruments

The principal functional currency of the company is the Canadian dollar. The company is exposed to a currency risk 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 operating expenses (US dollars and euros). Forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

As at November 30, 2011, the company held contracts to sell US dollars for Canadian dollars at various forward rates, which are summarized as follows:

Expiry dates	Contractual amounts	Weighted average contractual forward rates
December 2011 to August 2012	$ 24,500	1.0469
September 2012 to August 2013	19,000	1.0212
September 2013 to August 2014	3,600	1.0439
Total	$ 47,100	1.0363

The carrying amount of forward exchange contracts is equal to fair value, which is based on the amount at which they could be settled based on estimated current market rates.The fair value of forward exchange contracts amounted to net gains of $2,278,000 as at August 31, 2011 and $550,000 as at November 30, 2011.

Based on the portfolio of forward exchange contracts as at November 30, 2011, the company estimates that the portion of the net 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 $331,000.

As at November 30, 2011, forward exchange contracts in the amount of $809,000 are presented as current assets in other receivable in the balance sheet and forward exchange contracts, in the amount of $478,000, are presented as current liabilities in accounts payable and accrued liabilities in the balance sheet. These forward exchange contracts are not yet recorded within sales.

During the three months ended November 30, 2010 and 2011, the company recognized within its sales foreign exchange gains on forward exchange contracts of $460,000 and $433,000 respectively.

5 Contingent Liability

Under the acquisition agreement of NetHawk Oyj, the company has a cash contingent consideration of up to €8,700,000 ($11,000,000) based on a sales volume of certain NetHawk products. The company records the cash contingent consideration 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 are recorded in the consolidated statements of earnings. As at November 30, 2011, the fair value of the cash contingent consideration was estimated to €235,000 ($316,000).

6 Contingency

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

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

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

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

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

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

On April 2, 2009, a stipulation and agreement of settlement between the plaintiffs, issuer defendants and underwriter defendants was submitted to the Court for preliminary approval. The Court granted the plaintiffs' motion for preliminary approval and preliminarily certified the settlement classes on June 10, 2009. The settlement fairness hearing was held on September 10, 2009. On October 6, 2009, the Court entered an opinion granting final approval to the settlement and directing that the Clerk of the Court close these actions. On August 26, 2010, based on the expiration of the tolling period stated in the Tolling Agreements, the plaintiffs filed a Notice of Termination of Tolling Agreement and Recommencement of Litigation against the two named executive officers. The plaintiffs stated to the Court that they do not intend to take any further action against the named executive officers at this time. Appeals of the opinion granting final approval were filed, all of which were disposed of except the appeals filed by one objector were remanded to the district court to determine standing to appeal. On August 25, 2011, the district court issued an order holding that the final objector had no standing to appeal. The objector has appealed that decision. Given that the district court's August 25, 2011 remains subject to appeal, the ultimate outcome of the contingency is uncertain. However, based on the settlement approved on October 6, 2009, and the related insurance against such claims, management has determined the impact to its financial position and results of operations as at and for the three months ended November 30, 2011 to be immaterial.

7 Share Capital

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 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 started on November 10, 2011, and will end on November 9, 2012, 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.

The following tables summarize changes in share capital for the three months ended November 30, 2010 and 2011.

	Three months ended November 30, 2010				
	Multiple voting shares		Subordinate voting shares		
	Number	Amount	Number	Amount	Total amount
Balance as at August 31, 2010	36,643,000	$ 1	22,936,709	$ 106,125	$ 106,126
Exercise of stock options	–	–	11,478	61	61
Redemption of restricted share units	–	–	157,790	–	–
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	861	861
Balance as at November 30, 2010	36,643,000	$ 1	23,105,977	$ 107,047	$ 107,048

	Three months ended November 30, 2011				
	Multiple voting shares		Subordinate voting shares		
	Number	Amount	Number	Amount	Total amount
Balance as at August 31, 2011	31,643,000	$ 1	28,621,999	$ 110,340	$ 110,341
Redemption of restricted share units	–	–	184,167	–	–
Redemption of share capital	–	–	(63,146)	(244)	(244)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	848	848
Balance as at November 30, 2011	31,643,000	$ 1	28,743,020	$ 110,944	$ 110,945

8 Statements of Earnings

Net research and development expenses comprise the following:

	Three months ended November 30,	
	2011	2010
Gross research and development expenses	$ 14,813	$ 13,690
Research and development tax credits and grants	(2,330)	(2,089)
	$ 12,483	$ 11,601

Depreciation and amortization expenses by functional area are as follows:

	Three months ended November 30,	
	2011	2010
Cost of sales		
Depreciation of property, plant and equipment	$ 528	$ 504
Amortization of intangible assets	1,284	1,824
	1,812	2,328
Selling and administrative expenses		
Depreciation of property, plant and equipment	283	324
Amortization of intangible assets	474	504
	757	828
Net research and development expenses		
Depreciation of property, plant and equipment	757	818
Amortization of intangible assets	163	238
	920	1,056
	$ 3,489	$ 4,212
Depreciation of property, plant and equipment for the period	$ 1,568	$ 1,646
Amortization of intangible assets for the period	1,921	2,566
	$ 3,489	$ 4,212

Employee compensation comprises the following:

	Three months ended November 30,	
	2011	**2010**
Salaries and benefits	$ 32,994	$ 29,126
Stock-based compensation costs	555	738
Total employee compensation for the period	$ 33,549	$ 29,864

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

	Three months ended November 30,	
	2011	**2010**
Cost of sales	$ 59	$ 48
Selling and administrative expenses	377	322
Net research and development expenses	119	104
Net earnings from discontinued operations	–	264
	$ 555	$ 738

9 Income taxes

For the three months ended November 30, 2010 and 2011, 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:

	Three months ended November 30,	
	2011	**2010**
Income tax provision at combined Canadian federal and provincial statutory tax rate (28% in 2011 and 29% in 2010)	$ 1,138	$ 1,169
Increase (decrease) due to:		
Foreign income taxed at different rates	105	113
Income/loss from a non-taxable entity	807	(647)
Non-deductible expenses	465	260
Foreign exchange effect of translation of foreign integrated subsidiaries	(1,379)	492
Recognition of previously unrecognized deferred income tax assets	(557)	–
Utilization of previously unrecognized deferred income tax assets	(28)	(70)
Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses and deductions	567	1,497
Other	33	15
	$ 1,151	$ 2,829

The income tax provision consists of the following:

	Three months ended November 30, 2011	Three months ended November 30, 2010
Current	$ 417	$ 1,013
Deferred	734	1,816
	$ 1,151	$ 2,829

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

	2011	2010
Current	$ –	$ 27
Deferred	–	174
	$ –	$ 201

10 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:

	Three months ended November 30, 2011	Three months ended November 30, 2010
Basic weighted average number of shares outstanding (000's)	60,341	59,665
Plus dilutive effect of (000's):		
Stock options	163	273
Restricted share units	1,151	1,033
Deferred share units	108	135
Diluted weighted average number of shares outstanding (000's)	61,763	61,106
Stock awards excluded from the calculation of diluted weighted average number of shares because their exercise price was greater than the average market price of the common shares (000's)	173	669