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

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

The following discussion and analysis of financial condition and results of operations is dated March 27, 2012.

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

TRANSITION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

On September 1, 2011, we adopted International Financial Reporting Standards (IFRS). Our condensed interim consolidated financial statements for the three months and the six months ended February 29, 2012, have been prepared in accordance with IFRS 1, "*First-Time Adoption of International Financial Reporting Standards*", and with IAS 34, "*Interim Financial Reporting*", as issued by the International Accounting Standard Board (IASB). Previously, we prepared our consolidated financial statements in accordance with Canadian generally accepted accounting principles, in effect prior to September 1, 2011 (previous GAAP). Comparative information as at August 31, 2011 and for the three months and the six months ended February 28, 2011, has been restated to comply with IFRS. Note 3 to our condensed interim consolidated financial statements details the most significant adjustments to our reported statement of change in shareholders' equity, statements of earnings, comprehensive income and cash flows for comparative periods.

INDUSTRY OVERVIEW

Market conditions in the telecommunications industry remain tenuous due to weak global economic growth and unresolved sovereign debt issues in Europe. This economic uncertainty was exacerbated in the second quarter of fiscal 2012 by the late approval of annual capital spending budgets among certain Tier-1 network operators.

Nevertheless, the fundamental drivers toward broadband deployments and fixed-mobile Internet protocol (IP) network convergence are firmly entrenched in the telecommunications industry. Although we do not expect that network operators will significantly increase their capital expenditures in calendar 2012, we believe they will spend more in select, high-growth areas to accommodate bandwidth-intensive broadband applications and to facilitate the migration to more flexible and cost-effective fixed and mobile IP networks.

According to Cisco's Visual Networking Index, global IP traffic will quadruple from 2010 to 2015, reaching 966 exabytes per year in 2015. (An exabyte is equal to 1 billion gigabytes or 250 million DVDs). Global mobile traffic, a subset of this larger group, is expected to increase 18-fold from 2011 to 2016. This explosive growth is being driven by a proliferation of media-rich communication devices (smartphones and tablets), a growing number of Internet users, faster broadband speeds and increased video usage.

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

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

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

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

These market dynamics affected telecom test and service assurance suppliers in the second quarter of fiscal 2012.

COMPANY OVERVIEW

We reported sales of $66.9 million in the second quarter of fiscal 2012, which represents a decrease of 7.1% compared to the same period last year. We also reported bookings of $60.6 million in the second quarter of fiscal 2012, for a book-to-bill ratio of 0.91; this represents an increase of 5.3% compared to $57.6 million for the same period last year.

We generated net earnings of $1.0 million, or $0.02 per diluted share, in the second quarter of fiscal 2012, compared to $1.7 million, or $0.03 per diluted share, for the same period last year. Net earnings for the second quarter of fiscal 2012 included $1.9 million in after-tax amortization of intangible assets and $508,000 in stock-based compensation costs. Earnings from operations amounted to $4.1 million, or 6.1% of sales in the second quarter of fiscal 2012 compared to $6.8 million, or 9.4% of sales for the same period last year.

Adjusted EBITDA (net earnings before interest, income taxes, depreciation of property, plant and equipment, amortization of intangible assets and changes in fair value of cash contingent consideration) reached $5.8 million, or 8.7% of sales in the second quarter of fiscal 2012, compared to $8.4 million, or 11.6% of sales for the same period last year. Adjusted EBIDTA for the second quarter of fiscal 2012 included a foreign exchange loss of $1.5 million, compared to $2.4 million for the same period last year. See further in this document for a complete reconciliation of adjusted EBITDA and IFRS net earnings.

On November 7, 2011, we announced that our Board of Directors had approved the renewal of our share repurchase program, by way of a normal course issuer bid on the open market of up to 2% of the issued and outstanding subordinate voting shares, representing 575,690 subordinate voting shares at the prevailing market price. We expect to use cash, short-term investments or future cash flow from operations to fund the repurchase of shares. The normal course issuer bid started on November 10, 2011, and will end on November 9, 2012, or on an earlier date if we repurchase the maximum number of shares permitted under the bid. The program does not require that we repurchase any specific number of shares, and it may be modified, suspended or terminated at any time and without prior notice. All shares repurchased under the bid will be cancelled.

EXFO launched seven new products in the second quarter, including amongst others, the QA-805/QA-813 QualityAssurer, the industry’s most scalable platform (simulates more than 12 million active subscribers) for load simulation and only one supporting converged 3G, LTE and IMS; EXFO Apps, a portal offering software applications that boost the capabilities and productivity of the FTB Ecosystem of smart platforms and test modules; a fully featured optical spectrum analyzer (IQS-5240S/B-P) for lab and manufacturing in 40G/100G coherent communication environments; and the MaxTester 630, a handheld tester that can characterize advanced capabilities like bonding and vectoring in VDSL2 technologies.

OUR STRATEGY, KEY PERFORMANCE INDICATORS AND CAPABILITY TO DELIVER RESULTS

For a complete description of our strategy and the related key performance indicators, as well as our capability to deliver results in fiscal 2012, please refer to the corresponding sections in our most recent Annual Report, filed with the securities commissions.

However, given the sales level reached in the first half of fiscal 2012 of $133.3 million, the sales forecast for the third quarter of 2012 and the ongoing difficult macro-economic environment, we no longer believe that we can organically achieve our corporate objective to increase our sales by a compound annual growth rate (CAGR) of at least 25% for fiscal 2010 to 2012. Nevertheless, we remain confident that we will grow faster than our end-markets during this period.

RESULTS OF OPERATIONS

(in thousands of US dollars, except per share data, and as a percentage of sales for the periods indicated)

	Three months ended February 29, 2012	Three months ended February 28, 2011	Six months ended February 29, 2012	Six months ended February 28, 2011
Sales	**$ 66,917**	$ 72,046	**$ 133,305**	$ 137,699
Cost of sales [1]	**23,616**	27,821	**46,986**	52,606
Selling and administrative	**23,676**	22,235	**48,294**	42,134
Net research and development	**12,307**	11,244	**24,790**	22,845
Depreciation of property, plant and equipment	**1,546**	1,597	**3,114**	3,243
Amortization of intangible assets	**1,974**	2,367	**3,895**	4,933
Changes in fair value of cash contingent consideration	**(311)**	–	**(311)**	–
Earnings from operations	**4,109**	6,782	**6,537**	11,938
Interest income	**171**	49	**144**	42
Foreign exchange gain (loss)	**(1,471)**	(2,395)	**193**	(3,508)
Earnings before income taxes	**2,809**	4,436	**6,874**	8,472
Income taxes	**1,769**	2,720	**2,920**	5,549
Net earnings from continuing operations	**1,040**	1,716	**3,954**	2,923
Net earnings from discontinued operations	–	–	–	12,926
Net earnings for the period	**$ 1,040**	$ 1,716	**$ 3,954**	$ 15,849
Basic net earnings from continuing operations per share	**$ 0.02**	$ 0.03	**$ 0.07**	$ 0.05
Diluted net earnings from continuing operations per share	**$ 0.02**	$ 0.03	**$ 0.06**	$ 0.05
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	**$ 0.02**	$ 0.03	**$ 0.07**	$ 0.27
Diluted net earnings per share	**$ 0.02**	$ 0.03	**$ 0.06**	$ 0.26
Other selected information:				
Gross margin [2]	**$ 43,301**	$ 44,225	**$ 86,319**	$ 85,093
Research and development data:				
Gross research and development	**$ 14,800**	$ 13,824	**$ 29,613**	$ 27,514
Net research and development	**$ 12,307**	$ 11,244	**$ 24,790**	$ 22,845
Adjusted EBITDA [2]	**$ 5,847**	$ 8,351	**$ 13,428**	$ 16,539

(1) The cost of sales is exclusive of depreciation and amortization, shown separately.
(2) Refer to page 20 for non-IFRS measures.

	Three months ended February 29, 2012	Three months ended February 28, 2011	Six months ended February 29, 2012	Six months ended February 28, 2011
Sales	**100.0 %**	100.0 %	**100.0 %**	100.0 %
Cost of sales [1]	**35.3**	38.6	**35.2**	38.2
Selling and administrative	**35.4**	30.9	**36.3**	30.6
Net research and development	**18.4**	15.6	**18.6**	16.6
Depreciation of property, plant and equipment	**2.3**	2.2	**2.3**	2.3
Amortization of intangible assets	**3.0**	3.3	**2.9**	3.6
Changes in fair value of cash contingent consideration	**(0.5)**	–	**(0.2)**	–
Earnings from operations	**6.1**	9.4	**4.9**	8.7
Interest income	**0.3**	0.1	**0.1**	–
Foreign exchange gain (loss)	**(2.2)**	(3.4)	**0.1**	(2.5)
Earnings before income taxes	**4.2**	6.1	**5.1**	6.2
Income taxes	**2.6**	3.7	**2.1**	4.1
Net earnings from continuing operations	**1.6**	2.4	**3.0**	2.1
Net earnings from discontinued operations	–	–	–	9.4
Net earnings for the period	**1.6 %**	2.4 %	**3.0 %**	11.5 %
Other selected information:				
Gross margin [2]	**64.7 %**	61.4 %	**64.8 %**	61.8 %
Research and development data:				
Gross research and development	**22.1 %**	19.2 %	**22.2 %**	20.0 %
Net research and development	**18.4 %**	15.6 %	**18.6 %**	16.6 %
Adjusted EBITDA [2]	**8.7 %**	11.6 %	**10.1 %**	11.8 %

(1) The cost of sales is exclusive of amortization, shown separately.
(2) Refer to page 20 for non-IFRS measures.

RESULTS FROM CONTINUING OPERATIONS (formerly the Telecom Division)

SALES

For the three months ended February 29, 2012, our sales decreased 7.1% to $66.9 million, compared to $72.0 million for the same period last year.

For the six months ended February 29, 2012, our sales decreased 3.1% to $133.3 million, compared to $137.7 million for the same period last year.

In the second quarter and the first half of fiscal 2012, we reported a decrease in sales compared to the same periods last year. Network operators and equipment manufacturers are increasingly scrutinizing their capital expenditures and even delaying some purchasing decisions considering global economic conditions. Namely, in the first and second quarters of fiscal 2012, we did not benefit from the same level of calendar year-end budget spending from some of our customers compared to the same periods last year. In addition, we believe that our sales in the second quarter and the first half of fiscal 2012 were affected by the late approval of annual capital spending budgets of certain Tier-1 network operators.

Furthermore, during the first quarter of fiscal 2011 (included in the first half of fiscal 2011), we received a follow-on order worth over $6 million from a Tier-1 European operator for our AXS-200/635 triple-play tester, and recognized $5.7 million from that order during that quarter and the remaining portion in the second quarter. We did not recognize such large single order in fiscal 2012.

Finally, in the first quarter of fiscal 2011, we reported record-high bookings of $89.8 million, which positively affected our sales during the first and the second quarters of fiscal 2011. In fact, a portion of our sales in the second quarter of fiscal 2011 was generated by exceptionally large bookings as bookings of the second quarter of 2011 significantly decreased sequentially.

Despite current challenging market conditions on a global basis and the general decrease in our sales year-over-year in the second quarter and the first half of fiscal 2012, we delivered double-digit sales growth for our protocol products year-over-year, which were positively affected by the increased sales of our SONET/SDH and Ethernet test equipment and the increased traction gained in the high-growth wireless market.

Bookings

For the three months ended February 29, 2012, our bookings increased 5.3% to $60.6 million, compared to $57.6 million for the same period last year, for a book-to-bill ratio of 0.91.

Our second quarter is typically lower in terms of bookings due to seasonality, especially in North America, because of holidays and annual budget approvals from large customers. Also, in fiscal 2011, bookings were significantly front-end- loaded (first quarter) due to timing of orders, including maintenance-contract renewal, and the magnitude of calendar year-end budget spending from some of our customers, which resulted in significant bookings in the first quarter and much lower bookings in the second quarter of that year. In fiscal 2012, they were closer to our normal pattern, although we did not reach the same level of calendar year-end budget spending compared to last year.

Although we reported a year-over-year increase in bookings in the second quarter of fiscal 2012, market conditions in the telecommunications industry remain tenuous based on weak global economic growth. In addition, as mentioned earlier, network operators and equipment manufacturers are increasingly scrutinizing their capital expenditures and even delaying some purchasing decisions, and some Tier-1 network operators were late to approve their annual capital spending budgets, which affected our bookings in fiscal 2012.

Geographic distribution

In the second quarter of fiscal 2012, sales to the Americas, Europe, Middle-East and Africa (EMEA) and Asia-Pacific (APAC) accounted for 49%, 31% and 20% of sales respectively, compared to 52%, 29% and 19% for the same period last year respectively. In the first half of fiscal 2012, sales to the Americas, EMEA and APAC accounted for 52%, 29% and 19% of sales, respectively, compared to 52%, 30% and 18%, respectively, for the same period last year respectively.

Customer concentration

We sell our products to a broad range of customers, including network service providers, network equipment manufacturers, wireless operators and cable TV operators. In the second quarter of fiscal 2012, no customer accounted for more than 10% of our sales, and our top three customers accounted for 13.7% of our sales. In the corresponding period last year, no customer accounted for more than 10% of our sales, and our top three customers accounted for 17.9% of our sales. For the six months ended February 29, 2012, no customer accounted for more than 10% of our sales, and our top three customers accounted for 11.1% of our sales. In the corresponding period last year, no customer accounted for more than 10% of our sales, and our top three customers accounted for 18.5% of our sales.

GROSS MARGIN (non-IFRS measure – refer to page 20 of this document)

Gross margin reached 64.7% of sales for the three months ended February 29, 2012, compared to 61.4% for the same period last year.

Gross margin amounted to 64.8% of sales for the six months ended February 29, 2012, compared to 61.8% for the same period last year.

The increase in our gross margin in the second quarter of fiscal 2012, compared to the same period last year, can be explained by the following factors.

First, in the second quarter of fiscal 2012, there has been a more favorable product mix in favor of our protocol products compared to the same period last year, which resulted in a higher gross margin year-over-year. Protocol products deliver higher gross margin than our other product lines. In addition, during the second quarter of fiscal 2012, there was a more favorable wireless product mix within our protocol products compared to the same period last year, which further increased our gross margin year-over-year. In contrast, in the second quarter of fiscal 2011, we reported larger orders for copper-access test solutions, which typically deliver lower margins than our other test solutions, and we granted larger volume discounts on a significant part of these sales.

Furthermore, in the second quarter of fiscal 2012, our warranty provision decreased compared to the same period last year; this resulted in a positive impact on our gross margin year-over-year.

The increase in our gross margin in the first half of fiscal 2012, compared to the same period last year, can be explained by the following factors.

To begin with, during the first half of fiscal 2012, the product mix was more favorable as we sold more protocol products compared to the same period last year, which resulted in a higher gross margin year-over-year. Protocol products deliver higher gross margin than our other product lines. In addition, during the first half of fiscal 2012, there was a more favorable wireless product mix within our protocol products compared to the same period last year, which further increased our gross margin year-over-year. In contrast, in the first half of fiscal 2011, we reported larger orders for copper-access test solutions, which typically deliver lower margins than our other test solutions, and we granted larger volume discounts on a significant part of these sales.

Furthermore, in the first half of fiscal 2012, our warranty provision decreased compared to the same period last year; this resulted in a positive impact on our gross margin year-over-year.

In the second quarter and the first half of fiscal 2012, a larger portion of our sales came from products manufactured in our facilities in China compared to the same periods last year; those products have a lower cost of goods than those manufactured in our facilities in Canada, thus resulting in an improvement in our gross margin year-over-year.

Finally, the increase in the value of the Canadian dollar, compared to the US dollar over the last few months had a positive impact on our gross margin in the second quarter and the first half of fiscal 2012 compared to the same periods last year; in fact, our procurement costs decreased as the Canadian dollar strengthened compared to the US dollar, as a significant portion of our raw material purchases are denominated in US dollars. This allowed us to improve our gross margin continually over the last few quarters, as our raw material costs of parts purchased in US dollars are measured in Canadian dollars in our financial statements.

On the other hand, a lower sales volume in the second quarter and the first half of fiscal 2012 compared to the same periods last year resulted in a lower absorption of our fixed manufacturing costs, which prevented us from further improving our gross margin year-over-year.

Considering the expected sales growth in fiscal 2012, the expected increase in sales of protocol products as well as software-intensive products and services, the cost-effective design of our products, our increased manufacturing activities in China and our tight control on operating costs, we expect our gross margin to continue to improve in the future. However, our gross margin may fluctuate quarter-over-quarter due to the mix of our products and as our sales may fluctuate. Furthermore, our gross margin can be negatively affected by increased competitive pricing pressure, customer concentration and/or consolidation, increased obsolescence and warranty costs, shifts in customer and product mix, under-absorption of fixed manufacturing costs and increases in product offerings by other suppliers in our industry. Finally, any increase in the strength of the Canadian dollar, compared to the US dollar, may have a negative impact on our gross margin in fiscal 2012 and beyond.

SELLING AND ADMINISTRATIVE EXPENSES

For the three months ended February 29, 2012, selling and administrative expenses were $23.7 million, or 35.4% of sales, compared to $22.2 million, or 30.9% of sales for the same period last year.

For the six months ended February 29, 2012, selling and administrative expenses were $48.3 million, or 36.3% of sales, compared to $42.1 million, or 30.6% of sales for the same period last year.

In the second quarter of fiscal 2012, considering our goal of becoming the leading player in the telecom test and service assurance space, we continued intensifying our sales and marketing efforts, including additional domestic and international headcounts, which caused our expenses to increase year-over-year.

However, in the second quarter of fiscal 2012, commission expenses to our sales channels were lower compared to the same period last year mainly due to lower sales volume.

In the first half of fiscal 2012, we continued intensifying our sales and marketing efforts, including additional headcounts, both domestically and internationally, which caused our expenses to increase year-over-year.

In addition, in the first half of fiscal 2012, despite lower sales volume year-over-year, we had larger commission expenses to our sales channels compared to the same period last year due to the shift in product and territory mix.

For fiscal 2012, we expect our selling and administrative expenses to increase in dollars and range between 33% and 35% of sales. In addition, in fiscal 2012, we expect our commission expenses to increase as the sales volume increases. Furthermore, considering our goal of becoming the leading player in the telecom test and service assurance space and to deliver the synergies expected from our recent acquisition, we plan to continue intensifying our sales and marketing efforts, both domestically and internationally, which will also cause our expenses to rise. Finally, any increase in the strength of the Canadian dollar and the euro versus the US dollar would also cause our selling and administrative expenses to increase, as a portion of these expenses are incurred in Canadian dollars and euros.

RESEARCH AND DEVELOPMENT EXPENSES

Gross research and development expenses

For the three months ended February 29, 2012, gross research and development expenses totaled $14.8 million, or 22.1% of sales, compared to $13.8 million, or 19.2% of sales for the same period last year.

For the six months ended February 29, 2012, gross research and development expenses amounted to $29.6 million, or 22.2% of sales, compared to $27.5 million, or 20.0% of sales for the same period last year.

During the second quarter and the first half of fiscal 2012, we intensified our research and development activities, including additional headcounts, which resulted in increased gross research and development expenses during these periods compared to the same periods last year.

In addition, in the second quarter and the first half of fiscal 2012, a shift in the mix of research and development projects resulted in increased gross research and development expenses compared to the same periods last year.

Tax credits and grants

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

For the three months ended February 29, 2012, tax credits and grants for research and development activities were $2.5 million, or 16.8% of gross research and development expenses, compared to $2.6 million, or 18.7% of gross research and development expenses for the same period last year.

For the six months ended February 29, 2012, tax credits and grants for research and development activities amounted to $4.8 million, or 16.3% of gross research and development expenses, compared to $4.7 million, or 17.0% of gross research and development expenses for the same period last year.

For fiscal 2012, we expect our net research and development expenses to increase in dollars, and range between 17% and 19% of sales, given our focus on innovation, the addition of software features in our products, our desire to gain market share and our goal to exceed customer needs and expectations. Finally, any increase in the strength of the Canadian dollar, the euro and the Indian Rupee versus the US dollar in the upcoming quarters would also cause our net research and development expenses to increase, as a significant portion of these expenses are incurred in Canadian dollars, euros and Indian Rupees.

AMORTIZATION OF INTANGIBLE ASSETS

For the three months ended February 29, 2012, amortization of intangible assets was $2.0 million, compared to $2.4 million for the same period last year. For the six months ended February 29, 2012, amortization of intangible assets amounted $3.9 million, compared to $4.9 million for the same period last year.

The decrease in amortization expenses during the second quarter and the first half of fiscal 2012, compared to the same periods last year comes from the fact that core technologies related to the acquisition of Consultronics Limited became fully amortized during the second quarter of fiscal 2011.

FOREIGN EXCHANGE GAIN (LOSS)

Foreign exchange gains and losses are mainly the result of the translation of operating activities denominated in currencies other than our functional currency, which is the Canadian dollar. A large portion of our foreign exchange gains or losses results from the translation of cash balances and deferred income taxes denominated in US dollars. We manage our exposure to currency risks in part with forward exchange contracts. In addition, some of our entities' operating activities are denominated in US dollars, euros, or other currencies, which further hedges these risks. However, we remain exposed to currency risks and any increase in the value of the Canadian dollar, compared to the US dollar and euro, would have a negative impact on our operating results.

For the three months ended February 29, 2012, we recorded a significant foreign exchange loss of $1.5 million, compared to $2.4 million for the same period last year.

For the six months ended February 29, 2012, we recorded a foreign exchange gain of $193,000, compared to significant a foreign exchange loss of $3.5 million for the same period last year.

During the second quarter of fiscal 2012, the period-end value of the Canadian dollar increased versus the US dollar, compared to the previous quarter, which resulted in a significant foreign exchange loss during that period. In fact, the period-end value of the Canadian dollar increased 3.0% to CA$0.9895 = US$1.00 in the second quarter of fiscal 2012, compared to CA$1.0197 = US$1.00 at the end of the previous quarter.

During the second quarter of fiscal 2011, the period-end value of the Canadian dollar increased versus the US dollar, compared to the previous quarter, which resulted in a significant foreign exchange loss during that period. In fact, the period-end value of the Canadian dollar increased 5.7% to CA$0.9714 = US$1.00 in the second quarter of fiscal 2011, compared to CA$1.0264 = US$1.00 at the end of the previous quarter.

During the first half of fiscal 2012, the period-end value of the Canadian dollar slightly decreased versus the US dollar, compared to August 31, 2011, which resulted in a small foreign exchange gain during that period. In fact, the period-end value of the Canadian dollar decreased 1.1% to CA$0.9895 = US$1.00 in the first half of fiscal 2012, compared to CA$0.9784 = US$1.00 as at August 31, 2011.

During the first half of fiscal 2011, the period-end value of the Canadian dollar increased versus the US dollar, compared to August 31, 2010, which resulted in a significant foreign exchange during that period. In fact, the period-end value of the Canadian dollar increased 9.8% to CA$0.9714 = US$1.00 in the first half of fiscal 2011, compared to CA$1.0665 = US$1.00 as at August 31, 2010.

INCOME TAXES

For the three months ended February 29, 2012, our income tax expenses totaled $1.8 million, compared to $2.7 million for the same period last year.

For the six months ended February 29, 2012, our income tax expenses amounted to $2.9 million, compared to $5.5 million for the same period last year.

For the three months ended February 29, 2012, we reported income tax expenses of $1.8 million on earnings before income taxes of $2.8 million, for an effective income tax rate of 63.0%; this compares to our combined Canadian and provincial statutory tax rate of 28%. This situation mainly results from the fact that we did not recognize deferred income taxes for some of our subsidiaries at loss and we have some non-deductible expenses, such as stock-based compensation costs.

For the three months ended February 28, 2011, we reported income tax expenses of $2.7 million on earnings before income taxes of $4.4 million, for an effective income tax rate of 61.3%. Our combined Canadian and provincial statutory tax rate was 29%. This situation mainly results from the fact that a significant portion of our foreign exchange loss was created by the translation of financial statements of our foreign operations, and was therefore non-deductible. In addition, we did not recognize deferred income taxes for some of our subsidiaries at loss and we had some non-deductible expenses, such as stock-based compensation costs. On the other hand, we had some non-taxable income.

For the six months ended February 29, 2012, we reported income tax expenses of $2.9 million on earnings before income taxes of $6.9 million, for an effective income tax rate of 42.5%; this compares to our combined Canadian and provincial statutory tax rate of 28%. This situation mainly resulted from the fact that we did not recognize deferred income taxes for some of our subsidiaries at loss and we have some non-deductible loss and expenses, such as stock-based compensation costs. However, a significant portion of our foreign exchange gain is created by the translation of financial statements of our foreign operations, and is therefore non-taxable. In addition, during the first quarter, we recognized previously unrecognized deferred income tax assets of one of our subsidiaries, which resulted in a one-time income tax recovery of $557,000. In fact, during the first quarter of fiscal 2012, based on available positive and negative evidence, as well as on the level and the nature of cumulative and expected profits of one of our subsidiaries located in Asia, we concluded that it was probable that deferred income tax assets of that subsidiary would be realizable. Consequently, we recognized deferred income tax assets in the amount of $557,000 during the first quarter of fiscal 2012. These deferred income tax assets are mainly comprised of operating losses carried forward.

For the six months ended February 28, 2011, we reported income tax expenses of $5.5 million on earnings before income taxes of $8.5 million, for an effective income tax rate of 65.5%. Our combined Canadian and provincial statutory tax rate was 29%. This situation mainly results from the fact that a significant portion of our foreign exchange loss was created by the translation of financial statements of our foreign operations and was therefore non-deductible. In addition, we did not recognize deferred income taxes for some of our subsidiaries at loss and we had some non-deductible expenses, such as stock-based compensation costs. On the other hand, we had some non-taxable income.

Please refer to note 9 to our condensed interim consolidated financial statements for a full reconciliation of our income tax provision.

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

On October 1, 2010, we completed the sale of our Life Sciences and Industrial Division and that Division contributed one month to our results of the first quarter of fiscal 2011. Results from operations for that Division for the first quarter of fiscal 2011 were included in net earnings from discontinued operations along with the gain on the sale of the Division.

SALES

For the first quarter of fiscal 2011, sales of the discontinued operations (one-month contribution) amounted to $2.0 million.

NET EARNINGS

During the first quarter of fiscal 2011, we reported net earnings from discontinued operations of $12.9 million, which included a gain on disposal of discontinued operations of $13.2 million and $264,000 in stock-based compensation costs.

LIQUIDITY AND CAPITAL RESOURCES

Cash requirements and capital resources (from continuing operations)

As at February 29, 2012, cash and short-term investments totaled $76.4 million, while our working capital was at $134.9 million. Our cash and short-term investments increased $8.1 million in the second quarter of fiscal 2012, compared to the previous quarter. During the second quarter of fiscal 2012, operating activities generated $13.6 million in cash. In addition, we recorded an unrealized foreign exchange gain on our cash and short-term investments of $1.7 million. This unrealized foreign exchange gain resulted from the translation, in US dollars, of our Canadian-dollar-denominated cash and short-term investments and was included in the accumulated other comprehensive income in the balance sheet. However, we made cash payments of $6.7 million for the purchase of capital assets, mainly for our new building in Montreal, Canada, as well as cash payments of $296,000 and $263,000 for the repayment of our long-term debt and the redemption of share capital pursuant to our share repurchase program respectively.

Our short-term investments consist of a banker acceptance issued by a high-credit quality corporation; therefore, we consider the risk of non-performance of this financial instrument to be limited. This debt instrument is not expected to be affected by a significant liquidity risk. For the purpose of managing our cash position, we have established a cash management policy, which we follow and monitor on a regular basis. Our cash and short-term investments will be used for working capital and other general corporate purposes, potential acquisitions, the construction of our new building in Montreal, Canada, as well as our share repurchase program. As at February 29, 2012, cash balances included an amount of $43.4 million that bears interest at a rate of 1.3%.

We believe that our cash balances and short-term investments will be sufficient to meet our liquidity and capital requirements for the foreseeable future, including the remaining construction costs, over the next quarter, of our new building in Montreal, Canada, as well as the effect of our normal course issuer bid. In addition to these assets, we have unused available lines of credit totaling $16.7 million for working capital and other general corporate purposes and unused lines of credit of $15.9 million for foreign currency exposure related to forward exchange contracts. However, possible operating losses and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms.

Sources and uses of cash

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

Operating activities (including discontinued operations)

Cash flows provided by operating activities were $13.6 million for the three months ended February 29, 2012, compared to $20.7 million for the same period last year.

Cash flows provided by operating activities were $20.1 million for the six months ended February 29, 2012, compared to $18.2 million for the same period last year.

Cash flows provided by operating activities in the second quarter of fiscal 2012 were mainly attributable to the net earnings after items not affecting cash of $6.3 million and the positive net change in non-cash operating items of $7.3 million; this was mainly due to the positive effect on cash of the decrease of $5.5 million in our accounts receivable due to timing of sales during the quarter, and the positive effect on cash of the decrease of $7.1 million in our inventories due to timing of purchases and improved inventory turn. These positive effects on cash were offset in part by the negative effect of the increase of $1.5 million in our income taxes and tax credits recoverable due to tax credits earned during the quarter not yet recovered, the decrease of $3.5 million in our accounts payable, accrued liabilities, provisions and other liabilities due to timing of purchases and payments during the quarter, as well as the decrease of $311,000 in our contingent liability payable (changes in fair value).

Cash flows provided by operating activities in the second quarter of fiscal 2011 were attributable to the net earnings after items not affecting cash of $13.2 million, and the positive net change in non-cash operating items of $7.5 million; this was mainly due to the positive effect on cash of the decrease of $9.1 million in our accounts receivable (timing of sales) and the increase of $3.1 million in our accounts payable, accrued liabilities, provisions, and other liabilities due to timing of purchases and payments during the quarter. These positive effects on cash were offset in part by the increase of $2.2 million in our income taxes and tax credits recoverable (mainly tax credits earned during the quarter and not yet recovered) and the increase of $2.1 million in our inventories, to sustain increased sales activities.

Cash flows provided by operating activities in the first half of fiscal 2012 were mainly attributable to the net earnings after items not affecting cash of $12.0 million and the positive net change in non-cash operating items of $8.1 million; this was mainly due to the positive effect on cash of the decrease of $2.6 million in our accounts receivable due to timing of sales during the period, and the positive effect on cash of the decrease of $7.6 million in our inventories due to timing of purchases and improved inventory turn. These positive effects on cash were offset in part by the negative effect on cash of the increase of $1.4 million in our income taxes and tax credits recoverable due to tax credits earned during the period not yet recovered, the decrease of $187,000 in our accounts payable, accrued liabilities, provisions and other liabilities due to timing of purchases and payments as well as the decrease of $311,000 in our contingent liability payable (changes in fair value).

Cash flows provided by operating activities in the first half of fiscal 2011 were mainly attributable to the net earnings after items not affecting cash of $19.0 million, offset in part by the negative net change in non-cash operating items of $881,000; this was mainly due to the negative effect on cash of the increase of $3.3 million in our income taxes and tax credits recoverable (mainly tax credits earned during the period and not yet recovered) and the increase of $3.5 million in our inventories, to sustain increased sales activities. These negative effects on cash were offset in part by the decrease of $4.6 million in our accounts receivable (timing of sales) and the increase of $2.0 million in our accounts payable, accrued liabilities, provisions, and other liabilities, due to timing of purchases and payments during the period.

Investing activities (including discontinued operations)

Cash flows provided by investing activities were $420,000 for the three months ended February 29, 2012, compared to cash flows used of $20.0 million for the same period last year.

Cash flows provided by investing activities were $28.8 million for the six months ended February 29, 2012, compared to cash flows used of $16.5 million for the same period last year.

In the second quarter of fiscal 2012, we disposed (net of acquisitions) of $7.1 million worth of short-term investments, but we paid $6.7 million for the purchase of capital assets, mainly for our new building in Montreal, Canada.

For the corresponding period last year, we acquired (net of disposal) $18.5 million worth of short-term investments, and we paid $1.3 million for the purchase of capital assets as well as $111,000 in relation to the acquisition of NetHawk.

In the first half of fiscal 2012, we disposed (net of acquisitions) of $40.0 million worth of short-term investments, but we paid $11.2 million for the purchase of capital assets, mainly for our new building in Montreal, Canada.

For the corresponding period last year, we acquired (net of disposal) $35.0 million worth of short-term investments, and we paid $3.3 million for the purchase of capital assets as well as $243,000 in relation to the acquisition of NetHawk. However, we received $22.1 million from the disposal of discontinued operations.

Financing activities (including discontinued operations)

Cash flows used by financing activities were $481,000 for the three months ended February 29, 2012, compared to cash flows provided of $923,000 for the same period last year.

Cash flows used by financing activities were $1.6 million for the six months ended February 29, 2012, compared to cash flows provided of $984,000 for the same period last year.

In the second quarter of fiscal 2012, we made a repayment of $296,000 of our long-term debt and redeemed share capital for a cash consideration of $263,000. However, we received $78,000 from the exercise of stock options.

For the corresponding period last year, we received $1.2 million from the exercise of stock options but made a repayment of $296,000 of our long-term debt.

In the first half of fiscal 2012, we reimbursed our bank loan of $785,000, we made a repayment of $296,000 of our long-term debt and redeemed share capital for a cash consideration of $626,000. However, we received $78,000 from the exercise of stock options.

For the corresponding period last year, we received $1.3 million from the exercise of stock options but made a repayment of $296,000 of our long-term debt.

FORWARD EXCHANGE CONTRACTS

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

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

As at February 29, 2012, we held forward exchange contracts to sell US dollars at various forward rates, which

Expiry dates	**Contractual amounts**	**Weighted average contractual forward rates**
March 2012 to August 2012	$ 15,500,000	1.0401
September 2012 to August 2013	19,000,000	1.0212
September 2013 to August 2014	3,600,000	1.0439
Total	$ 38,100,000	1.0310

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 $2.3 million as at August 31, 2011, and $1.4 million as at February 29, 2012. The quarter-end exchange rate was CA$0.9895 = US$1.00 as at February 29, 2012.

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 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. Appeals of the opinion granting final approval were filed, all of which have been dismissed or settled as of January 9, 2012. The settlement payment on behalf of EXFO has been made by the insurers, the settlement among the parties is final, and the case is concluded.

SHARE CAPITAL

Share capital

As at March 27, 2012, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 28,857,826 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

OFF-BALANCE SHEET ARRANGEMENTS

As at February 29, 2012, our off-balance sheet arrangements consisted of letters of guarantee amounting to $5.2 million; these letters of guarantee expire at various dates through fiscal 2017. From this amount, we had $0.8 million worth of letters of guarantee for our own selling and purchasing requirements, which were for the most part reserved from one of our lines of credit. The remainder, in the amount of $4.4 million, was used to secure our line of credit in CNY (Chinese currency) of $4.0 million plus any accrued interests. This line of credit was unused as at February 29, 2012.

SPECIAL PURPOSES ENTITIES

As at February 29, 2012, we did not have interests in any special purposes entities.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our condensed interim consolidated financial statements have been prepared in accordance with IFRS 1, "*First-Time Adoption of International Financial Reporting Standards (IFRS)*", and IFRS applicable to the preparation of interim financial statements, IAS 34, "*Interim Financial Reporting*". Note 2 of our condensed interim consolidated financial statements for the three months ended November 30, 2011, details accounting policies that we adopted under IFRS. In addition, note 3 to our condensed interim consolidated financial statements for the three months ended November 30, 2011, as well as for the three months and the six months ended February 29, 2012, discloses the impact of the transition to IFRS on our reported financial position, financial performance and cash flows, including the nature and effect of significant changes in accounting policies from those used in our consolidated financial statements for the year ended August 31, 2011, under Canadian GAAP (previous GAAP).

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. On an ongoing basis, we evaluate these estimates and assumptions, including those related to the fair value of financial instruments, the allowance for doubtful accounts receivable, the amount, timing and discounted value of recovery of tax credits recoverable, the provision for excess and obsolete inventories, the estimated useful lives of capital assets, the valuation of long-lived assets, the impairment of goodwill, the recoverable amount of deferred income tax assets, the amount of certain accrued liabilities, provisions and deferred revenue as well as stock-based compensation costs. We base our estimates and assumptions on historical experience and on other factors that we believe to be reasonable under the circumstances, the result of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates and assumptions.

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

(a) Long-term tax credits

Our long-term tax credits must be discounted under IFRS. The discounted value is influenced by interest rates used and the expected recovery period of the tax credits. The higher the interest rates are and the longer the recovery period is, the lower the discounted value of the tax credits will be. We use Canadian government bond yield rates as risk-free interest rates for the periods when the tax credits are expected to be recovered. In addition, we make reasonable estimates of future taxable income to determine the recovery period of our long-term tax credits. As at February 29, 2012, risk-free interest rates ranged between 1.00% and 2.88% and the estimated recovery period was six years. Any increase in interest rates or the recovery period would adversely affect our future results. As at February 29, 2012, the discounted value of our tax credits was $35.6 million.

(b) Inventories

We state our inventories at the lower of cost, determined on an average cost basis and net realizable value, and we provide reserves for excess and obsolete inventories. We determine our reserves for excess and obsolete inventories based on the quantities on hand at the reporting dates compared to foreseeable needs over the next twelve months, taking into account changes in demand, technology or market. It is possible that additional inventory reserves may occur if future sales are less than our forecasts or if there is a significant shift in product mix compared to our forecasts, which could adversely affect our future results.

(c) Income taxes

We are 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. We maintain provisions for uncertain tax positions that we believe appropriately reflect our risk based on our interpretation of laws and regulations. In addition, we make reasonable estimates and assumptions to determine the amount of deferred tax assets that can be recognized in our consolidated financial statements, based upon the likely timing and level of anticipated future taxable income together with tax planning strategies. The ultimate realization of our 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.

As at February 29, 2012, our net deferred income tax assets recognized in the balance sheet amounted to $11.1 million, and our non-refundable research and development tax credits amounted to $38.8 million. In order to realize these deferred income tax assets and non-refundable research and development tax credits, we need to generate approximately $258 million (CA$255 million) in pre-tax earnings at the Canadian federal level, approximately $10 million at the Canadian provincial levels, approximately $31 million at the United States federal level, and approximately $3 million in Singapore.

(d) 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, when available. When such information is not available, we base our 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.

i) Growth rates

The assumptions used are based on historical growth, our internal budget, expectations of future revenue growth as well as industry and market trends. We projected revenues, operating margins and cash flows for periods of five years, and applied a perpetual long-term growth rate thereafter.

ii) Discount rate

We use a discount rate to calculate the present value of estimated future cash flows, which represents our weighted average cost of capital (WACC).

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 impact 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 we are currently assessing the effect of this new standard, we do not expect the standard to have a significant impact on our 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. We have not yet assessed the impact that this new standard is likely to have on our 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. We have not yet assessed the impact that the new and amended standards may have on our 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 disclosures 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. We do not expect the standard to have a significant impact on our consolidated financial statements.

RISKS AND UNCERTAINTIES

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

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

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

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

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

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

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

We depend on a limited number of suppliers for some of the parts used to manufacture our products for which alternative sources may not be readily available. In addition, all our orders are placed through individual purchase orders and, therefore, our suppliers may experience difficulties, suffer from natural disasters, delays or stop supplying parts to us at any time. The reliance on a single source or limited number of suppliers could result in increased costs, delivery problems and reduced control over product pricing and quality. Any interruption or delay in the supply of any of these parts could significantly harm our ability to meet scheduled product deliveries to our customers and cause us to lose sales. Furthermore, the process of qualifying a new manufacturer for complex parts designed to our specifications, such as our optical, electronic or mechanical parts, is lengthy and would consume a substantial amount of time for our technical personnel and management. If we were required to change a supplier in a short period of time, our business would be disrupted. In addition, we may be unsuccessful in identifying a new supplier capable of meeting and willing to meet our needs on terms that we would find acceptable.

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

NON-IFRS FINANCIAL MEASURES

We provide non-IFRS financial measures (gross margin*, EBITDA** and adjusted EBITDA**) as supplemental information regarding our operational performance. We use these measures for the purposes of evaluating our historical and prospective financial performance, as well as our performance relative to our competitors. These measures also help us to plan and forecast future periods as well as to make operational and strategic decisions. We believe that providing this information to our investors, in addition to the IFRS measures, allows them to see the company's results through the eyes of management, and to better understand our historical and future financial performance.

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

* Gross margin represents sales less cost of sales, excluding depreciation and amortization.

** EBITDA is defined as net earnings before interest, income taxes, depreciation of property, plant and equipment and amortization of intangible assets. Adjusted EBITDA represents EBITDA excluding changes in the fair value of the cash contingent consideration and the gain from the disposal of discontinued operations.

The following tables summarize the reconciliation of EBITDA and adjusted EBITDA to IFRS net earnings and additional information, in thousands of US dollars:

EBITDA and adjusted EBITDA *(including discontinued operations)*

	Three months ended February 29, 2012	Six months ended February 29, 2012	Three months ended February 28, 2011	Six months ended February 28, 2011
IFRS net earnings for the period	$ 1,040	$ 3,954	$ 1,716	$ 15,849
Add (deduct):				
Depreciation of property, plant and equipment				
Continuing operations	1,546	3,114	1,597	3,243
Discontinued operations	–	–	–	14
Amortization of intangible assets				
Continuing operations	1,974	3,895	2,367	4,933
Discontinued operations	–	–	–	4
Interest income				
Continuing operations	(171)	(144)	(49)	(42)
Income taxes				
Continuing operations	1,769	2,920	2,720	5,549
Discontinued operations	–	–	–	201
EBITDA for the period	6,158	13,739	8,351	29,751
Changes in fair value of cash contingent consideration	(311)	(311)	–	–
Gain on disposal of discontinued operations	–	–	–	(13,212)
Adjusted EBITDA for the period	$ 5,847	$ 13,428	$ 8,351	$ 16,539
EBITDA in percentage of total sales	9.2 %	10.3 %	11.6 %	21.3 %
Adjusted EBITDA in percentage of total sales	8.7 %	10.1 %	11.6 %	11.8 %

Additional information

	Three months ended February 29, 2012	Six months ended February 29, 2012	Three months ended February 28, 2011	Six months ended February 28, 2011
Sales from continued operations	$ 66,917	$ 133,305	$ 72,046	$ 137,699
Sales from discontinued operations	–	–	–	1,991
Total sales	$ 66,917	$ 133,305	$ 72,046	$ 139,690

QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)
(tabular amounts in thousands of US dollars, except per share data)

	Quarters ended			
	February 29, 2012	November 30, 2011	August 31, 2011	May 31, 2011
Sales	$ 66,917	$ 66,388	$ 64,414	$ 67,630
Cost of sales (1)	$ 23,616	$ 23,370	$ 23,447	$ 24,243
Earnings from operations	$ 4,109	$ 2,428	$ 5,878	$ 3,489
Net earnings	$ 1,040	$ 2,914	$ 4,638	$ 1,798
Basic and diluted net earnings per share	$ 0.02	$ 0.05	$ 0.08	$ 0.03

	Quarters ended			
	February 28, 2011	November 30, 2010	August 31, 2010 (2)	May 31, 2010 (2)
Sales	$ 72,046	$ 65,653	$ 58,583	$ 55,930
Cost of sales (1)	$ 27,821	$ 24,785	$ 20,629	$ 20,421
Earnings from operations	$ 6,782	$ 5,156	$ 4,414	$ 1,840
Net earnings (loss) from continuing operations	$ 1,716	$ 1,208	$ 4,124	$ (600)
Net earnings	$ 1,716	$ 14,133	$ 4,962	$ 169
Basic and diluted net earnings (loss) from continuing operations per share	$ 0.03	$ 0.02	$ 0.07	$ (0.01)
Basic net earnings per share	$ 0.03	$ 0.24	$ 0.08	$ 0.00
Diluted net earnings per share	$ 0.03	$ 0.23	$ 0.08	$ 0.00

(1) The cost of sales is exclusive of depreciation and amortization.
(2) Quarterly data for fiscal 2010 has not been adjusted to reflect new standards under IFRS.