EXFO INC.
Form 6-K
January 14, 2011

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

FORM 6-K

Report of Foreign Private Issuer Pursuant to Rule 13a-16 or 15d-16
Under the Securities Exchange Act of 1934

For the month of January 2011

EXFO Inc.
(Translation of registrant's name into English)

400 Godin Avenue, Quebec, Quebec, Canada G1M 2K2
(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.

Form 20-F þForm 40-F o

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes oNo þ

If "Yes" is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-______.

TABLE OF CONTENTS

Table of Contents

On January 12, 2011, EXFO Inc., a Canadian corporation, reported its results of operations for the first fiscal quarter ended November 30, 2010. This report on Form 6-K sets forth the news release relating to EXFO's announcement and certain information relating to EXFO's financial condition and results of operations for the first fiscal quarter of the 2011 fiscal year. This press release and information relating to EXFO's financial condition and results of operations for the first fiscal quarter of the 2011 fiscal year are hereby incorporated as a document by reference to Form F-3 (Registration Statement under the Securities Act of 1933) declared effective as of July 30, 2001 and to Form F-3 (Registration Statement under the Securities Act of 1933) declared effective as of March 11, 2002 and to amend certain material information as set forth in these two Form F-3 documents.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

EXFO INC.

By: /s/ Germain Lamonde
Name: Germain Lamonde
Title: President and Chief Executive Officer

Date: January 14, 2011

Table of Contents

EXFO Reports Record Sales and Bookings in the First Quarter of Fiscal 2011

§ Telecom sales increase 62.9% year-over-year to US$65.7 million
§ Telecom bookings improve 92.0% year-over-year to US$89.8 million (book-to-bill of 1.37)
§ Adjusted EBITDA* amounts to US$8.2 million compared to US$4.4 million in Q1 2010

QUEBEC CITY, CANADA, January 12, 2011 — EXFO Inc. (NASDAQ: EXFO; TSX: EXF) reported today record sales and bookings for its first quarter ended November 30, 2010, with total sales and GAAP net earnings above the company's guidance range.

Total sales, including a one-month revenue contribution from the divested Life Sciences and Industrial Division (referred to as "discontinued operations" in the financial statements), increased 48.5% to US$67.6 million in the first quarter of fiscal 2011 from US$45.6 million in the first quarter of 2010 and 3.7% from US$65.2 million in the fourth quarter of 2010. Management had forecasted total sales between US$61 and US$66 million for the first quarter of 2011.

Telecom sales (referred to as "continuing operations" in the financial statements) increased 62.9% to US$65.7 million in the first quarter of 2011 from US$40.3 million in the first quarter of 2010 and 12.1% from US$58.6 million in the fourth quarter of 2010. NetHawk Oyj, which was acquired in mid-March 2010, contributed US$6.4 million to EXFO's revenues in the first quarter of 2011. Consequently, organic telecom sales increased 47.0% year-over-year.

Telecom bookings improved 92.0% to US$89.8 million in the first quarter of fiscal 2011 from US$46.8 million in the same period last year and 60.9% from US$55.8 million in the fourth quarter of 2010. The company's telecom book-to-bill ratio was 1.37 in the first quarter of 2011.

Telecom gross margin reached 62.2% of sales in the first quarter of fiscal 2011 compared to 65.2% in the first quarter of 2010 and 64.8% in the fourth quarter of 2010.

GAAP net earnings in the first quarter of fiscal 2011 totaled US$14.1 million, or US$0.23 per diluted share, above EXFO's guidance between US$0.17 and US$0.21 per diluted share. In comparison, the company generated US$0.3 million, or US$0.01 per diluted share, in the same period last year and US$5.0 million, or US$0.08 per diluted share, in the fourth quarter of fiscal 2010. It should be noted that EXFO recorded an after-tax gain of US$13.1 million, or US$0.21 per diluted share, from the disposal of discontinued operations (Life Sciences and Industrial Division) in the first quarter of 2011. GAAP net earnings in the first quarter of 2011 also included US$2.6 million in amortization of intangible assets and US$0.7 million in stock-based compensation costs. The former item resulted in an income tax recovery of US$0.2 million. As well, the company reported a foreign exchange loss of US$1.1 million in the first quarter of 2011.

"I am really pleased with our overall performance in the first quarter of 2011 as we posted our fifth consecutive quarter of sales growth and delivered unprecedented telecom bookings of nearly $90 million for a book-to-bill ratio of 1.37," said Germain Lamonde, EXFO's Chairman, President and CEO. "We generated strong sales and bookings growth year-over-year across all our telecom business segments and sales regions, while enjoying expanded traction in the fast-growing wireless market. These outstanding results demonstrate our superior market positioning, continued market-share gains across most businesses and some year-end money from network operators."

“As wireline and wireless operators are escalating investments in broadband deployments and IP convergence in order to increase network performance and lower operating expenses, EXFO is benefiting from ongoing VDSL2 and FTTH rollouts in access networks, upgrades from 10G to 40G and 100G in metro rings and long-haul routes and, on the wireless side, migration from 2G to 3G and 4G/LTE networks,” Mr. Lamonde added. “As a result, I expect EXFO will continue delivering superior revenue growth, while remaining true to its commitment of increasing EBITDA even faster over a three-year horizon from 2010-2012.”

Table of Contents

Selected Financial Information
(In thousands of US dollars)

	Q1 2011	Q4 2010	Q1 2010
Sales:			
Continuing operations (formerly the Telecom Division)	$65,653	$58,583	$40,292
Discontinued operations (formerly the Life Sciences & Industrial Division	1,991	6,653	5,268
Total	$67,644	$65,236	$45,560
Gross margin:			
Continuing operations	$40,868	$37,954	$26,259
	62.2 %	64.8 %	65.2 %
Discontinued operations	$989	$3,488	$2,863
	49.7 %	52.4 %	54.3 %
Total	$41,857	$41,442	$29,122
	61.9 %	63.5 %	63.9 %
Other selected information:			
GAAP net earnings	$14,071	$4,962	$334
Amortization of intangible assets	$2,570	$2,493	$1,469
Stock-based compensation costs	$738	$473	$418
Net income tax effect of the above items	$(192)	$(184)	$(471)
After-tax gain on the disposal of discontinued operations	$(13,071)	$–	$–

Operating Expenses
Telecom selling and administrative expenses totaled US$19.9 million, or 30.3% of sales, in the first quarter of fiscal 2011 compared to US$13.8 million, or 34.3% of sales, in the same period last year and US$18.9 million, or 32.3% of sales, in the fourth quarter of 2010.

Telecom gross research and development expenses amounted to US$13.7 million, or 20.9% of sales, in the first quarter of fiscal 2011 compared to US$9.2 million, or 22.7% of sales, in the first quarter of 2010 and US$12.4 million, or 21.1% of sales, in the fourth quarter of 2010.

Telecom net R&D expenses totaled US$11.6 million, or 17.7% of sales, in the first quarter of fiscal 2011 compared to US$7.8 million, or 19.3% of sales, in the same period last year and US$10.5 million, or 17.9% of sales, in the fourth quarter of 2010.

First-Quarter Business Highlights — Broadband Deployments and IP Fixed-Mobile Network Convergence

§ EXFO generated record telecom orders of US$89.8 million, reflecting strong bookings in all three businesses (Optical, Protocol and Copper Access) and sales regions (Americas, EMEA and Asia-Pacific).

§ Two Tier-1 network operators placed follow-on orders totaling more than US$8 million for EXFO's AXS-200/635 Triple-Play Tester in the first quarter of 2011. EXFO's test solution will support their ongoing deployment of next-generation VDSL2 services over hybrid network access architectures.

§

A Tier-1 US wireless operator selected EXFO's service assurance solution for monitoring Ethernet backhaul networks. The initial contract in excess of US$1 million could reach several millions of dollars.

§ EXFO's wireless and 40G/100G wireline test solutions gained significant traction with customers.

§ EXFO significantly strengthened its "FTB Ecosystem" of modular test platforms, now based on a common Windows operating system, by releasing the second generation of its highly successful FTB-200 platform, launching the entry-level FTB-1 handheld platform with related OTDR and Ethernet test modules, adding ODU0 and ODUflex test capabilities to its industry-leading 10G and 40G test solutions, and introducing the ConnectorMax Pass/Fail Connector Endface Assessment software option.

§ Altogether, EXFO launched seven new products in the first quarter of 2011.

Table of Contents

Profitable Growth Path

EXFO generated adjusted EBITDA* of US$8.2 million, or 12.1% of sales, in the first quarter of fiscal 2011 on total revenue of US$67.9 million. It should be noted the company recorded a pre-tax foreign exchange loss of US$1.1 million in the first quarter of 2011. Foreign exchange losses or gains are included in EBITDA. See the section below entitled "Non-GAAP Financial Measures" for a reconciliation of EBITDA and adjusted EBITDA with GAAP net earnings.

Divestiture

EXFO sold its Life Sciences and Industrial Division in the first quarter of 2011, realizing a gain of US$13.2 million, to become a pure-play supplier in the telecom industry.

Business Outlook

EXFO forecasts sales between US$70.0 million and US$75.0 million for the second quarter of fiscal 2011, while GAAP net earnings are expected to range between US$0.03 and US$0.07 per diluted share. GAAP net earnings include US$0.04 per share in after-tax amortization of intangible assets and stock-based compensation costs. The company also anticipates a pre-tax, foreign exchange loss of US$0.03 per share following the significant increase in the value of the Canadian dollar since November 30, 2010.

This guidance was established by management based on existing backlog as of the date of this press release, seasonality, expected bookings for the remaining of the quarter, as well as exchange rates as of the day of this press release.

Conference Call and Webcast

EXFO will host a conference call today at 5 p.m. (Eastern time) to review its financial results for the first quarter of fiscal 2011. To listen to the conference call and participate in the question period via telephone, dial 1-416-981-9009. Germain Lamonde, Chairman, President and CEO, and Pierre Plamondon, CA, Vice-President of Finance and Chief Financial Officer, will participate in the call. An audio replay of the conference call will be available one hour after the event until 7 p.m. on January 19, 2011. The replay number is 1-402-977-9141 and the reservation number is 21494191. The audio Webcast and replay of the conference call will also be available on EXFO's Website at www.EXFO.com, under the Investors section.

About EXFO

Listed on the NASDAQ and TSX stock exchanges, EXFO is among the leading providers of next-generation test and service assurance solutions for wireless and wireline network operators and equipment manufacturers in the global telecommunications industry. The company offers innovative solutions for the development, installation, management and maintenance of converged, IP fixed and mobile networks — from the core to the edge. Key technologies supported include 3G, 4G/LTE, IMS, Ethernet, OTN, FTTx, and various optical technologies (accounting for an estimated 35% of the portable fiber-optic test market). EXFO has a staff of approximately 1600 people in 25 countries, supporting more than 2000 telecom customers worldwide. For more information, visit www.EXFO.com.

EXFO Brand Name

The corporate name of the company is EXFO Inc. The company requests that all media outlets and publications use the corporate name ("EXFO Inc.") or abbreviated name ("EXFO") in capital letters for branding purposes. EXFO would like to thank all parties in advance for their cooperation.

Table of Contents

Forward-Looking Statements

This press release contains forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995, and we intend that such forward-looking statements be subject to the safe harbors created thereby. Forward-looking statements are statements other than historical information or statements of current condition. Words such as may, will, expect, believe, anticipate, intend, could, estimate, continue, or the negative or comparable terminology are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events and circumstances are considered forward-looking statements. They are not guarantees of future performance and involve risks and uncertainties. Actual results may differ materially from those in forward-looking statements due to various factors including our ability to successfully integrate our acquired and to-be-acquired businesses; fluctuating exchange rates; consolidation in the global telecommunications test, measurement and service assurance industry and increased competition among vendors; capital spending levels in the telecommunications industry; concentration of sales; the effects of the additional actions we have taken in response to economic uncertainty (including our ability to quickly adapt cost structures with anticipated levels of business, ability to manage inventory levels with market demand); market acceptance of our new products and other upcoming products; limited visibility with regards to customer orders and the timing of such orders; our ability to successfully expand international operations; the retention of key technical and management personnel; and future economic, competitive, financial and market condition. Assumptions relating to the foregoing involve judgments and risks, all of which are difficult or impossible to predict and many of which are beyond our control. Other risk factors that may affect our future performance and operations are detailed in our Annual Report, on Form 20-F, and our other filings with the U.S. Securities and Exchange Commission and 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 press release. 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.

Non-GAAP Financial Measures

EXFO provides non-GAAP financial measures (EBITDA* and adjusted EBITDA*) as supplemental information regarding its operational performance. The company uses these measures for the purposes of evaluating its historical and prospective financial performance, as well as its performance relative to competitors. These measures also help the company to plan and forecast for future periods as well as to make operational and strategic decisions. EXFO believes that providing this information to investors, in addition to GAAP measures, allows them to see the company’s results through the eyes of management, and to better understand its historical and future financial performance.

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

*EBITDA is defined as net earnings before interest, income taxes, amortization of property, plant and equipment, amortization of intangible assets. Adjusted EBITDA represents EBITDA excluding the gain from the disposal of discontinued operations.

Table of Contents

The following table summarizes the reconciliation of EBITDA and adjusted EBITDA to GAAP net earnings in thousands of US dollars:

EBITDA and adjusted EBITDA (including discontinued operations)

	Three months ended November 30, 2010	Three months ended August 31, 2010	Three months ended November 30, 2009
GAAP net earnings for the period	$14,071	$4,962	$334
Add (deduct):			
Amortization of property, plant and equipment			
Continuing operations	1,674	1,623	1,258
Discontinued operations	14	42	33
Amortization of intangible assets			
Continuing operations	2,566	2,478	1,460
Discontinued operations	4	15	9
Interest expense			
Continuing operations	64	116	42
Income taxes			
Continuing operations	2,806	1,939	1,122
Discontinued operations	201	291	121
EBITDA for the period	21,400	11,466	4,379
Gain on disposal of discontinued operations	(13,212)	–	–
Adjusted EBITDA for the period	$8,188	$11,466	$4,379
Adjusted EBITDA in percentage of total sales	12.1 %	17.6 %	9.6 %

For more information
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Table of Contents

EXFO INC.
Unaudited Interim Consolidated Balance Sheet

(in thousands of US dollars)

	As at November 30, 2010	As at August 31, 2010
Assets		
Current assets		
Cash	$23,438	$21,440
Short-term investments	27,186	10,379
Accounts receivable (note 5)		
Trade	55,384	50,190
Other	7,190	5,217
Income taxes and tax credits recoverable	3,307	2,604
Inventories (note 6)	43,311	40,328
Prepaid expenses	3,229	2,816
Future income taxes	5,687	6,191
Current assets held for sale (note 3)	–	3,991
	168,732	143,156
Tax credits recoverable	31,549	29,397
Forward exchange contracts (note 5)	415	–
Property, plant and equipment	23,707	23,455
Intangible assets	26,303	27,947
Goodwill	29,690	29,355
Future income taxes	12,669	12,884
Long-term assets held for sale (note 3)	–	7,308
	$293,065	$273,502
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 7)	$31,195	$30,870
Income taxes payable	1,066	426
Current portion of long-term debt (note 8)	584	568
Deferred revenue	8,431	10,354
Current liabilities related to assets held for sale (note 3)	–	2,531
	41,276	44,749
Deferred revenue	5,779	5,775
Long-term debt (note 8)	1,460	1,419
Other liabilities	760	603
Future income taxes	1,258	–

Long-term liabilities related to assets held for sale (note 3)	–	537
	50,533	53,083
Contingency (note 9)		
Shareholders' equity		
Share capital (note 10)	107,048	106,126
Contributed surplus	18,427	18,563
Retained earnings	64,599	50,528
Accumulated other comprehensive income	52,458	45,202
	242,532	220,419
	$293,065	$273,502

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,	
	2010	2009
Sales	$65,653	$40,292
Cost of sales (1,2)	24,785	14,033
Gross margin	40,868	26,259
Operating expenses		
Selling and administrative (1)	19,899	13,804
Net research and development (1) (note 11)	11,601	7,781
Amortization of property, plant and equipment	1,674	1,258
Amortization of intangible assets	2,566	1,460
Total operating expenses	35,740	24,303
Earnings from operations	5,128	1,956
Interest expense	(64)	(42)
Foreign exchange loss	(1,113)	(1,022)
Earnings before income taxes	3,951	892
Income taxes (note 12)		
Current	1,013	87
Future	1,793	1,035
	2,806	1,122
Net earnings (loss) from continuing operations	1,145	(230)
Net earnings from discontinued operations (note 3)	12,926	564
Net earnings for the period	$14,071	$334
Basic and diluted net earnings (loss) from continuing operations per share	$0.02	$(0.00)
Basic net earnings from discontinued operations per share	$0.22	$0.01
Diluted net earnings from discontinued operations per share	$0.21	$0.01
Basic net earnings per share	$0.24	$0.01
Diluted net earnings per share	$0.23	$0.01
Basic weighted average number of shares outstanding (000's)	59,665	59,386
Diluted weighted average number of shares outstanding (000's) (note 13)	61,106	60,122

(1) Stock-based compensation costs included in:		
Cost of sales	$48	$39
Selling and administrative	322	244
Net research and development	104	101
Net earnings from discontinued operations	264	34
	$738	$418

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

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

Table of Contents

EXFO INC.
Unaudited Interim Consolidated Statements of Comprehensive Income
and Accumulated Other Comprehensive Income

(in thousands of US dollars)

Comprehensive income

	Three months ended November 30,	
	2010	2009
Net earnings for the period	$14,071	$334
Foreign currency translation adjustment	6,339	7,813
Unrealized gains on forward exchange contracts	1,444	1,164
Reclassification of realized (gains) losses on forward exchange contracts in net earnings	(189)	77
Future income taxes effect of the above items	(338)	(385)
Comprehensive income	$21,327	$9,003

Accumulated other comprehensive income

	Three months ended November 30,	
	2010	2009
Foreign currency translation adjustment		
Cumulative effect of prior periods	$44,186	$40,458
Current period	6,339	7,813
	50,525	48,271
Unrealized gains on forward exchange contracts		
Cumulative effect of prior periods	1,018	1,076
Current period, net of realized gains and future income taxes	917	856
	1,935	1,932
Unrealized losses on short-term investments		
Cumulative effect of prior periods	(2)	(2)
Accumulated other comprehensive income	$52,458	$50,201

Total retained earnings and accumulated other comprehensive income amounted to $94,444 and $117,057 as at November 30, 2009 and 2010, respectively.

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

Table of Contents

EXFO INC.
Unaudited Interim Consolidated Statements of Retained Earnings
and Contributed Surplus

(in thousands of US dollars)

Retained earnings

	Three months ended November 30,	
	2010	2009
Balance – Beginning of the period	$50,528	$43,909
Add		
Net earnings for the period	14,071	334
Balance – End of the period	$64,599	$44,243

Contributed surplus

	Three months ended November 30,	
	2010	2009
Balance – Beginning of the period	$18,563	$17,758
Add (deduct)		
Stock-based compensation costs	725	413
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	(861)	(86)
Discount on redemption of share capital	–	3
Balance – End of the period	$18,427	$18,088

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

Table of Contents

EXFO INC.
Unaudited Interim Consolidated Statements of Cash Flows

(in thousands of US dollars)

	Three months ended November 30,	
	2010	2009
Cash flows from operating activities		
Net earnings for the period	$14,071	$334
Add (deduct) items not affecting cash		
Change in discount on short-term investments	(18)	2
Stock-based compensation costs	738	418
Amortization	4,258	2,760
Gain on disposal of discontinued operations (note 3)	(13,212)	–
Deferred revenue	(2,571)	(542)
Future income taxes	1,967	1,156
Change in unrealized foreign exchange gain/loss	537	770
	5,770	4,898
Change in non-cash operating items		
Accounts receivable	(4,480)	(4,102)
Income taxes and tax credits	(1,002)	(1,505)
Inventories	(1,362)	(2,351)
Prepaid expenses	(385)	(605)
Accounts payable and accrued liabilities	(1,224)	1,030
Other liabilities	135	–
	(2,548)	(2,635)
Cash flows from investing activities		
Additions to short-term investments	(226,146)	(78,954)
Proceeds from disposal and maturity of short-term investments	209,605	81,336
Additions to capital assets	(1,979)	(1,345)
Net proceeds from disposal of discontinued operations (note 3)	22,124	–
Business combination	(132)	–
	3,472	1,037
Cash flows from financing activities		
Exercise of stock options	61	–
Redemption of share capital	–	(14)
	61	(14)
Effect of foreign exchange rate changes on cash	344	103

Change in cash	1,329	(1,509)
Cash – Beginning of the period	22,109	10,611
Cash – End of the period	$23,438	$9,102
Cash related to:		
Continuing operations	$23,438	$8,347
Discontinued operations	–	755
	$23,438	$9,102

As at November 30, 2009 and 2010, unpaid purchases of capital assets amounted to $147 and $257, respectively.

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

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

1 Interim Financial Information

The financial information as at November 30, 2010, and for the three-month periods ended November 30, 2009 and 2010, is unaudited. In the opinion of management, all adjustments necessary to present fairly the results of these periods in accordance with generally accepted accounting principles (GAAP) in Canada have been included. The adjustments made were of a normal and recurring nature. Interim results may not necessarily be indicative of results anticipated for the entire year.

These interim consolidated financial statements are prepared in accordance with generally accepted accounting principles in Canada and use the same accounting policies and methods used in the preparation of the company's most recent annual consolidated financial statements, except for the changes described in note 2. However, all disclosures required for annual financial statements have not been included in these financial statements. Consequently, these interim consolidated financial statements should be read in conjunction with the company's most recent annual consolidated financial statements.

2 New Accounting Standards and Pronouncements

Adopted in fiscal 2011

In December, 2009, the Canadian Institute of Chartered Accountants' (CICA) Emerging Issues Committee (EIC) issued EIC-175, "Multiple Deliverable Revenue Arrangements", which is applicable prospectively (with retrospective adoption permitted) to revenue arrangements with multiple deliverables entered into or materially modified in the first annual period beginning on January 1, 2011. EIC-175 amends the guidance contained in EIC-142, "Revenue Arrangements with Multiple Deliverables", and establishes additional requirements regarding revenue recognition related to multiple deliverables as well as supplementary disclosures. The company adopted this standard on September 1, 2010 at the same time it adopted similar new U.S. GAAP requirements (note 14), and its adoption had no material effect on its consolidated financial statements.

Update to the accounting policy on revenue recognition

The company's multiple deliverable revenue arrangements may include tangible products (software and/or non software components), extended warranties, maintenance contracts, post-contract customer support (PCS) on software components as well as installation.

Starting September 1, 2010, when a sales arrangement contains multiple elements and software and non software components function together to deliver the tangible products' essential functionality, the company allocates revenue to each element based on the relative selling price of each element. Under this approach, the selling price of a deliverable is determined by using a selling price hierarchy which requires the use of vendor specific objective evidence ("VSOE") of fair value if available, third- party evidence ("TPE") if VSOE is not available, or best estimated selling price ("BESP") if neither VSOE nor TPE are available.

The company establishes VSOE of selling price using the price charged for a deliverable when sold separately and, in some instances, using the price established by management having the relevant authority. TPE of selling price is established by evaluating similar and interchangeable competitor goods or services in sales to similarly situated customers. When VSOE or TPE are not available, the company uses BESP. The company establishes BESP using historical selling price trends if available and considering multiple factors including, but not limited to geographies, market conditions, competitive landscape, internal costs, and pricing practices. When determining BESP, the company's management applies judgment when establishing pricing strategies and evaluating market conditions and product lifecycles. The determination of BESP is made through consultation with and approval by the company's management. The company may modify or develop new pricing practices and strategies in the future. As these pricing strategies evolve, the company may modify its pricing practices in the future, which may result in changes in BESP. The aforementioned factors may result in a different allocation of revenue to the deliverables in multiple-element arrangements from the current period, which may change the pattern and timing of revenue recognition for these elements but will not change the total revenue recognized for the arrangement.

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

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 and customer service. They qualify as a separate unit of accounting. Revenue from these contracts is recognized ratably over the terms of the maintenance contracts on a straight-line basis. The selling price of the maintenance contracts is determined using VSOE.

Extended warranties are usually offered to customers for periods of twelve to forty-eight months. They qualify as a separate unit of accounting. Revenue from these extended warranties is recognized ratably over the warranty period on a straight-line basis. The selling price of the extended warranties is determined using BESP.

When a sales arrangement contains multiple elements and software and non software components do not function together to deliver the tangible products' essential functionality, the company allocates revenue between the tangible products and the PCS, if any, based on VSOE of selling price of each element. PCS revenues are deferred and recognized ratably over the years of the support arrangement. PCS revenues are recognized at the time the product is delivered when provided substantially within one year of delivery, the costs of providing this support are insignificant (and accrued at the time of delivery), and no (or infrequent) software upgrades or enhancements are provided.

To be adopted after fiscal 2011

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

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

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

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

3 Discontinued Operations

During the fourth quarter of 2010, the company engaged in a plan to sell its Life Sciences and Industrial Division to focus its activities in the telecom test and service assurance market. On October 1, 2010, the company closed the sale of that Division for total proceeds of $21,623,000, net of a bank overdraft of $303,000, selling costs of $909,000 and future income taxes of $141,000. As such, this Division has been considered as an operation held for sale and presented as discontinued operations. Assets and liabilities for the comparative period ended August 31, 2010 have been classified as assets held for sale and liabilities related to assets held for sale; revenues and expenses have been classified as discontinued operations for all reporting periods. As a result of the classification of the operations of the Life Sciences and Industrial Division as operation held for sale and as discontinued operations, the company has only one operating segment for all reporting periods. As at November 30, 2010, selling costs in the amount of $57,000 were unpaid and included in accounts payable and accrued liabilities in the balance sheet.

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

The sale of that Division resulted in a gain on disposal of $13,212,000.

The results of the discontinued operations are as follows:

	Three months ended November 30,	
	2010 (30 days)	2009 (91 days)
Sales	$ 1,991	$ 5,268
Gross margin	$ 989	$ 2,863
Earnings (loss) from operations	$ (6)	$ 772
Gain from disposal of discontinued operations	$ 13,212	$ –
Net earnings from discontinued operations	$ 12,926	$ 564
Basic net earnings from discontinued operations per share	$ 0.22	$ 0.01
Diluted net earnings from discontinued operations per share	$ 0.21	$ 0.01

The assets and liabilities of the discontinued operations as at August 31, 2010 are presented as assets held for sale and liabilities related to assets held for sale as follows:

Assets	
Current assets	
Cash	$669
Accounts receivable	84
Income taxes and tax credits recoverable	188
Inventories	2,670
Prepaid expenses	158
Future income taxes	222
Current assets held for sale	3,991
Tax credits recoverable	2,142
Property, plant and equipment	349
Intangible assets	48
Goodwill	4,769
Long-term assets held for sale	7,308
	$11,299
Liabilities	
Current liabilities related to assets held for sale	$2,531

Long-term liabilities related to assets held for sale	537
	$3,068

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

4 Capital Disclosures

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

The company's objectives when managing capital are:

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

The company defines its capital as shareholders' equity, excluding accumulated other comprehensive income. Accumulated other comprehensive income's main components are the cumulative foreign currency translation adjustment, which is the result of the translation of the company's consolidated financial statements into US dollars (the reporting currency), as well as after-tax unrealized gains (losses) on forward exchange contracts.

The capital of the company amounted to $175,217,000 and $190,074,000 as at August 31, 2010 and November 30, 2010, respectively.

5 Financial Instruments

Financial assets and liabilities are initially recognized at fair value and their subsequent measurement depends on their classification, as described below. Their classification 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	Held for trading
Short-term investments	Available for sale
Accounts receivable	Loans and receivables
Forward exchange contracts	Cash flow hedge

Financial liabilities

Accounts payable and accrued liabilities	Other financial liabilities
Long-term debt	Other financial liabilities
Other liabilities	Other financial liabilities
Forward exchange contracts	Cash flow hedge

Held-for-trading, available-for-sale and cash flow hedge financial assets are subsequently measured at fair value. Loans and receivables and other financial liabilities are subsequently measured at amortized cost using the effective interest method.

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.

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

Market risk

Currency risk

The principal measurement 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 and China, 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, 2010, 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 2010 to August 2011	$ 20,800	1.0923
September 2011 to August 2012	20,400	1.0802
September 2012 to January 2013	1,500	1.0722
Total	$ 42,700	1.0858

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 $597,000 as at August 31, 2010 and $2,129,000 as at November 30, 2010.

Based on the portfolio of forward exchange contracts as at November 30, 2010, 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 $1,383,000.

As at November 30, 2010, forward exchange contracts in the amount of $1,383,000 are presented as current assets in other receivable in the balance sheet and forward exchange contracts, in the amount of $415,000, are presented as long-term assets in forward exchange contracts in the balance sheet. These forward exchange contracts are not yet recorded within sales.

During the three months ended November 30, 2009 and 2010, the company recognized within its sales foreign exchange gains on forward exchange contracts of $67,000 and $460,000, respectively.

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

The following table summarizes significant financial assets and liabilities that are subject to currency risk as at November 30, 2009 and 2010:

	As at November 30,			
	2010		2009	
	Carrying/ nominal amount (in thousands of US dollars)	Carrying/ nominal amount (in thousands of euros)	Carrying/ nominal amount (in thousands of US dollars)	Carrying/ nominal amount (in thousands of euros)
Financial assets				
Cash	$8,266	€1,535	$5,144	€577
Accounts receivable	34,173	2,914	20,798	2,980
	42,439	4,449	25,942	3,557
Financial liabilities				
Accounts payable and accrued liabilities	10,447	303	7,431	329
Forward exchange contracts (nominal amount)	4,900	–	5,900	–
	15,347	303	13,331	329
Net exposure	$27,092	€4,146	$12,611	€3,228

The value of the Canadian dollar compared to the US dollar was CA$1.0264 = US$1.00 as at November 30, 2010.

The value of the Canadian dollar compared to the euro was CA$1.3379 = €1.00 as at November 30, 2010.

The following sensitivity analysis summarizes the effect that a change in the value of the Canadian dollar (compared to the US dollar and euro) on financial assets and liabilities denominated in US dollars and euros would have on net earnings, net earnings per diluted share and comprehensive income, based on the foreign exchange rates as at November 30, 2010:

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would decrease (increase) net earnings by $1,210,000 or $0.02 per diluted share and $2,514,000, or $0.04 per diluted share as at November 30, 2009 and 2010, respectively.

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the euro would decrease (increase) net earnings by $490,000 or $0.01 per diluted share and $542,000, or $0.01 per diluted share as at November 30, 2009 and 2010, respectively.

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would increase (decrease) other comprehensive income by $2,773,000 and $2,721,000 as at November 30, 2009 and 2010, respectively.

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

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

Interest rate risk

The company is exposed to interest rate risks through its short-term investments and its long-term debt.

Short-term investments

As at November 30, 2010, the company's short-term investments, in the amount of $27,186,000, bear interest at rates ranging between 1.0% and 1.2% and mature between December 2010 and February 2011.

The fair value of short-term investments based on market value amounted to $58,914,000 and $27,186,000 as at November 30, 2009 and 2010, respectively.

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

Long-term debt

As at November 30, 2010, the company's long-term debt, in the amount of $2,044,000, bears interest at an annual rate of 2.95% and matures in December 2013 (note 8).

Other financial instruments

Cash, accounts receivable and accounts payable and accrued liabilities are non-interest-bearing financial assets and liabilities. Accounts receivable and accounts payable and accrued liabilities are financial instruments whose carrying value approximates their fair value due to their short-term maturity.

Credit risk

Financial instruments that potentially subject the company to credit risk consist primarily of cash, short-term investments, accounts receivable and forward exchange contracts (with a positive fair value). As at November 30, 2010, the company's short-term investments consist of debt instruments issued by nine (nine as at August 31, 2010) high-credit quality corporations and trusts. None of these debt instruments are expected to be affected by a significant liquidity risk. The company's cash and forward exchange contracts are held with or issued by high-credit quality financial institutions; therefore, the company considers the risk of non-performance on these instruments to be limited.

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

$1,318,000 as at August 31, 2010 and November 30, 2010, respectively. Bad debt recovery amounted to $17,000 and $139,000 for the three months ended November 30, 2009 and 2010, respectively.

For the three months ended November 30, 2009 and 2010, no customer represented more than 10% of consolidated sales.

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

The following table summarizes the age of trade accounts receivable:

	As at November 30, 2010	As at August 31, 2010
Current	$45,037	$38,663
Past due, 0 to 30 days	5,604	6,787
Past due, 31 to 60 days	534	1,991
Past due, more than 60 days, less allowance for doubtful accounts of $1,243 and $1,318 as at August 31, 2010 and November 30, 2010, respectively	4,209	2,749
Total accounts receivable	$55,384	$50,190

Liquidity risk

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

The following table summarizes the contractual maturity of the company's derivative and non-derivative financial liabilities as at November 30, 2010:

	As at November 30, 2010			
	0-12 months	13-24 months	25-36 months	Over 36 months
Accounts payable and accrued liabilities	$30,229	$–	$–	$–
Long-term debt	584	584	584	292
Other liabilities	–	343	–	–
Forward exchange contracts				
Outflow	27,100	15,000	600	–
Inflow	(28,773)	(15,772)	(627)	–
Total	$29,140	$155	$557	$292

	As at August 31, 2010			
	0-12 months	13-24 months	25-36 months	Over 36 months
Accounts payable and accrued liabilities	$29,711	$–	$–	$–
Long-term debt	568	568	568	283

Other liabilities	–	295	–	–
Forward exchange contracts				
Outflow	29,500	20,400	1,500	–
Inflow	(30,141)	(20,662)	(1,508)	–
Total	$29,638	$601	$560	$283

As at November 30, 2010, the company had $50,624,000 in cash and short-term investments and $62,574,000 in accounts receivable. In addition to these financial assets, the company has unused available lines of credit totalling $15,508,000 for working capital and other general corporate purposes, including potential acquisitions and its share repurchase program as well as unused lines of credit of $15,223,000 for foreign currency exposure related to its forward exchange contracts.

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

6 Inventories

	As at November 30, 2010	As at August 31, 2010
Raw materials	$ 22,332	$21,505
Work in progress	2,749	1,975
Finished goods	18,230	16,848
	$ 43,311	$40,328

The cost of sales comprised almost exclusively the amount of inventory recognized as an expense during the reporting periods, except for the related amortization, which is shown separately in operating expenses.

Inventory write-down amounted to $590,000 and $711,000 for the three months ended November 30, 2009 and 2010, respectively.

7 Accounts Payable and Accrued Liabilities

	As at November 30, 2010	As at August 31, 2010
Trade	$ 14,292	$14,244
Salaries and social benefits	11,916	12,400
Warranty	603	579
Commissions	1,019	831
Forward exchange contracts	–	232
Other	3,365	2,584
	$ 31,195	$30,870

Changes in the warranty provision are as follows:

	Three months ended November 30,	
	2010	2009
Balance – Beginning of period	$579	$647

Provision	181	137
Settlements	(157)	(135)
Balance – End of period	$603	$649

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

8 Long-Term Debt

	As at November 30, 2010	As at August 31, 2010
Loan collateralized by assets of NetHawk Oyj, denominated in euros (€1,568), bearing interest at 2.95%, repayable in semi-annual installments of $292 (€224), maturing in December 2013	$ 2,044	$ 1,987
Less: current portion	584	568
	$ 1,460	$ 1,419

9 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 pursuant to the terms of Reservation of Rights and Tolling Agreements entered into with the plaintiffs.

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

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 have been filed. Given that the settlement remains subject to appeal as of the date of issuance of these financial statements, the ultimate outcome of the contingency is uncertain. However, based on the settlement approved on October 6, 2009, and the related insurance against such claims, management has determined the impact to its financial position and results of operations as at and for the three months ended November 30, 2010 to be immaterial.

10 Share Capital

On November 5, 2010, the company announced that its Board of Directors had authorized the third renewal of its share repurchase program, by way of a normal course issuer bid on the open market, of up to 10% of its public float (as defined by the Toronto Stock Exchange), or 2,012,562 subordinate voting shares, at the prevailing market price. The company expects to use cash, short-term investments or future cash flows from operations to fund the repurchase of shares. The period of the normal course issuer bid started on November 10, 2010, and will end on November 9, 2011, or at 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.

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

The following tables summarize changes in share capital for the three months ended November 30, 2009 and 2010.

	Three months ended November 30, 2009				
	Multiple voting shares		Subordinate voting shares		
	Number	Amount	Number	Amount	Total amount
Balance as at August 31, 2009	36,643,000	$1	22,736,302	$104,845	$104,846
Redemption of restricted share units	–	–	13,663	–	–
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	86	86
Redemption of share capital	–	–	(3,600)	(17)	(17)
Balance as at November 30, 2009	36,643,000	$1	22,746,365	$104,914	$104,915

	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

11 Net Research and Development Expenses

Net research and development expenses comprise the following:

	Three months ended November 30,	
	2010	2009
Gross research and development expenses	$13,690	$9,153
Research and development tax credits and grants	(2,089)	(1,372)

	$11,601	$7,781

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

12 Income Taxes

For the three months ended November 30, 2009 and 2010, 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,	
	2010	2009
Income tax provision at combined Canadian federal and provincial statutory tax rate (29% in 2010 and 31% in 2009)	$1,146	$277
Increase (decrease) due to:		
Foreign income taxed at different rates	113	(7)
Non-taxable income	(756)	(59)
Non-deductible expenses	260	201
Change in tax rates	–	122
Foreign exchange effect of translation of foreign integrated subsidiaries	492	207
Utilization of previously unrecognized future income tax assets	(70)	(90)
Unrecognized future income tax assets on temporary deductible differences and unused tax losses and deductions	1,497	214
Other	124	257
	$2,806	$1,122

The income tax provision consists of the following:

Current	$1,013	$87
Future	366	911
Valuation allowance	1,427	124
	1,793	1,035
	$2,806	$1,122

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

Current	$27	$–
Future	174	121

	$201	$121

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

13 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,	
	2010	2009
Basic weighted average number of shares outstanding (000's)	59,665	59,386
Plus dilutive effect of:		
Stock options (000's)	273	140
Restricted share units (000's)	1,033	430
Deferred share units (000's)	135	166
Diluted weighted average number of shares outstanding (000's)	61,106	60,122
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)	669	1,297

14 Differences between Canadian and U.S. GAAP

These interim consolidated financial statements are prepared in accordance with Canadian GAAP and significant differences in measurement and disclosure from U.S. GAAP are set out in note 22 to the company's most recent annual consolidated financial statements. This note describes significant changes occurring since the most recent annual consolidated financial statements and provides a quantitative analysis of all significant differences. All disclosures required in annual financial statements under U.S. GAAP and Regulation S-X of the Securities and Exchange Commission (SEC) in the United States are not provided in these interim consolidated financial statements.

Table of Contents

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

Statements of earnings and comprehensive income

Reconciliation of net earnings and comprehensive income to conform to U.S. GAAP

		Three months ended November 30,	
		2010	2009
Net earnings for the period in accordance with Canadian GAAP		$ 14,071	$ 334
Gain on disposal of discontinued operations (note 3)	a)	4,130	–
Net earnings for the period in accordance with U.S. GAAP		18,201	334
Foreign currency translation adjustment		6,488	7,813
Unrealized gains on forward exchange contracts		1,444	1,164
Reclassification of realized (gains) loss on forward exchange contracts in net earnings		(189)	77
Future income taxes effect of the above items		(338)	(385)
Comprehensive income under U.S. GAAP		$ 25,606	$ 9,003
U.S. GAAP net earnings are comprised of:			
Net earnings (loss) from continuing operations		$ 1,145	$ (230)
Net earnings from discontinued operations		$ 17,056	$ 564
Basic and diluted net earnings (loss) from continuing operations per share in accordance with U.S. GAAP		$ 0.02	$ (0.00)
Basic net earnings from discontinued operations per share in accordance with U.S. GAAP		$ 0.29	$ 0.01
Diluted net earnings from discontinued operations per share in accordance with U.S. GAAP		$ 0.28	$ 0.01
Basic net earnings per share in accordance with U.S. GAAP		$ 0.31	$ 0.01
Diluted net earnings per share in accordance with U.S. GAAP		$ 0.30	$ 0.01

Reconciliation of shareholders' equity to conform to U.S. GAAP

The following summary sets out the significant differences in the company's reported shareholders' equity under Canadian GAAP as compared to U.S. GAAP:

	As at	As at August 31,

	November 30, 2010	2010
Shareholders’ equity in accordance with Canadian GAAP	$242,532	$220,419
Goodwill	43	42
Long-term assets held for sale	–	(3,988)
Cash contingent consideration payable	(2,736)	(2,660)
Stock appreciation rights	(73)	(73)
Shareholders’ equity in accordance with U.S. GAAP	$239,766	$213,740

EXFO INC.
Notes to Unaudited Interim Consolidated Financial Statements

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

Research and development tax credits

Under Canadian GAAP, all research and development tax credits are recorded as a reduction of gross research and development expenses in the statements of earnings. Under U.S. GAAP, tax credits that are refundable against taxable income are recorded in the income taxes. These tax credits amounted to $820,000 and $985,000 for the three months ended November 30, 2009 and 2010, respectively. This difference has no impact on the net earnings and the net earnings per share for the reporting periods.

Statements of cash flows

For the three months ended November 30, 2010, cash flows from operating activities under U.S. GAAP were $132,000 lower compared to those established under Canadian GAAP; this difference arose from NetHawk's acquisition-related costs paid during this period and expensed under U.S. GAAP. A corresponding difference also impacted cash flows from investing activities. In addition, under U.S. GAAP, the presentation of subtotal before change in non-cash operating items is not permitted.

For the three months ended November 30, 2009, there were no significant differences between the statements of cash flows under Canadian GAAP as compared to U.S. GAAP, except for the subtotal before change in non-cash operating items, whose presentation is not permitted under U.S. GAAP.

Reconciliation item

a) Gain on disposal of discontinued operations

Under U.S. GAAP, the carrying value of goodwill of the Life Sciences and Industrial Division (discontinued operations) was $4,130,000 lower than the carrying value under Canadian GAAP. As a result, under U.S. GAAP, the gain on the disposal of that Division was higher for the same amount.

New accounting standards and pronouncements

Adopted in fiscal 2011

In October 2009, the FASB issued guidance now codified as ASC Topic 985 “Software”, to change the accounting model for revenue arrangements that include both tangible products and software elements. Under this guidance, tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are excluded from the software revenue guidance. In addition, hardware components of a tangible product containing software components are always excluded from the software revenue guidance. This guidance is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010.

In October 2009, the FASB amended guidance now codified as Topic 605, "Revenue Recognition", to include a consensus relating to multiple-deliverable revenue arrangements. These amendments significantly change certain guidance pertaining to revenue arrangements with multiple deliverables and modify the separation criteria of Topic 605 by eliminating the criterion for objective and reliable evidence of fair value for the undelivered products or services. The amendments also eliminate the use of the residual method of allocation and require, instead, that arrangement consideration be allocated, at the inception of the arrangement, to all deliverables based on their relative selling price. This guidance is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010.

The company adopted Topics 985 and 605 on September 1, 2010, at the same time it adopted similar new requirements under Canadian GAAP (note 2), and their adoption had no significant impact on its consolidated financial statements.

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

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

The following discussion and analysis of financial condition and results of operations is dated January 12, 2011.

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

INDUSTRY OVERVIEW

The fundamental drivers toward broadband deployments and fixed-mobile IP (Internet protocol) network convergence are firmly entrenched in the global telecommunications industry despite a slow recovery in the general economic environment. Although network operators did not significantly increase capital expenditures in calendar 2010, they did 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 updated Visual Networking Index, global IP traffic will quadruple from 2009 to 2014, reaching almost 64 exabytes per month in 2014. (An exabyte is equal to 1 billion gigabytes or 250 million DVDs). Global mobile traffic, a subset of this larger group, is expected to increase 39-fold during the same period. Bandwidth demand is driven by a wide range of applications including various forms of IP video, peer-to-peer file sharing, social networking, Internet gaming as well as increased penetration of media-rich smartphones and notebooks.

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

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

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

On the wireless side, operators are also faced with major investments 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 first quarter of fiscal 2011.

COMPANY OVERVIEW

We reported record-high sales of $65.7 million for our continuing operations (formerly our Telecom Division) in the first quarter of fiscal 2011, which represents an increase of 62.9% compared to the same period last year. Sales for the first quarter of fiscal 2011 included $6.4 million from NetHawk, which was acquired in the third quarter of fiscal 2010. We also reported record-high net accepted orders for our continuing operations of $89.8 million in the first quarter of fiscal 2011, which represents an increase of 92.0% compared to the same period last year, for a book-to-bill ratio of 1.37. During the first quarter of fiscal 2011, in addition to the positive impact of the acquisition of NetHawk on our sales and bookings, we benefited from worldwide capital-intensive deployments and capacity expansion from network operators and we believe we gained market share, especially in the wireline space. Namely, in the first quarter of fiscal 2011, two tier-1 network operators placed follow-on orders totaling more than $8 million for our AXS-200/635 triple-play tester and a tier-1 US wireless operator selected our service assurance solution for monitoring its Ethernet backhaul networks with an initial order in excess of $1 million. A significant portion of these orders were shipped during the quarter. In addition, we benefited from our strong product offering and from larger year-end budget flush-outs compared to the same period last year. These factors contributed to the significant increase of our sales and booking numbers year-over-year.

We generated GAAP net earnings from continuing operations of $1.1 million, or $0.02 per diluted share, in the first quarter of fiscal 2011, compared to a GAAP net loss from continuing operations of $230,000, or $0.00 per share, for the same period last year. Net earnings from continuing operations for the first quarter of fiscal 2011 included $2.4 million in after-tax amortization of intangible assets and $474,000 in stock-based compensation costs. Earnings from operations (from continuing operations) significantly improved year-over-year from $2.0 million, or 4.9% of sales in the first quarter of fiscal 2010 to $5.1 million, or 7.8% of sales for the same period this year. Global net earnings for the first quarter of fiscal 2011, which include the net earnings from the discontinued operations, amounted to $14.1 million, or $0.23 per diluted share, compared to $334,000, or $0.01 per diluted share, for the same period last year.

Table of Contents

Adjusted EBITDA (net earnings before interest, income taxes, depreciation and amortization and gain from disposal of discontinued operations) reached $8.2 million, or 12.1% of global sales in the first quarter of fiscal 2011, compared to $4.4 million, or 9.6% of global sales for the same period last year. Adjusted EBIDTA for the first quarter of fiscal 2011 included a foreign exchange loss of $1.1 million ($1.0 million in 2010). See further in this document for a complete reconciliation of adjusted EBITDA to GAAP net earnings.

On October 1, 2010, we closed the sale of our Life Sciences and Industrial Division for total proceeds of $21.6 million, net of a bank overdraft of $303,000, selling costs of $909,000 and future income taxes of $141,000. As such, this Division has been presented as discontinued operations in our interim consolidated financial statements with revenues and expenses being reclassified from continuing operations to discontinued operations for all reporting periods. The sale of that Division resulted in a gain of $13.2 million.

On November 5, 2010 we announced that our Board of Directors approved the third renewal of our share repurchase program, by way of a normal course issuer bid on the open market of up to 10% of our public float (as defined by the Toronto Stock Exchange), or 2.0 million of subordinate voting shares at the prevailing market price. We expect to use cash, short-term investments or future cash flow from operations to fund the repurchase of shares. The normal course issuer bid started on November 10, 2010, and will end on November 9, 2011, or on an earlier date if we repurchase the maximum number of shares permitted under the bid. The program does not require that we repurchase any specific number of shares, and it may be modified, suspended or terminated at any time and without prior notice. All shares repurchased under the bid will be cancelled.

In terms of new products, we introduced seven innovations in the first quarter of 2011, including several solutions dedicated to strengthening our FTB Ecosystem of Windows XP-based modular test platforms. We launched the FTB-1 handheld platform with related OTDR and Ethernet test modules for field technicians; we enhanced our FTB-200 platform with increased performance and functionality; we added ODU0 and ODUflex test capabilities to our industry-leading 10G and 40G Transport Blazer test solutions; and we released the ConnectorMax pass/fail connector endface assessment software option.

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 2011, please refer to the corresponding sections in our most recent Annual Report, filed with the securities commissions.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

For a complete description of our critical accounting policies and estimates, please refer to the corresponding section in our most recent Annual Report, filed with the securities commissions. The following details the changes in critical accounting policies that were adopted in fiscal 2011 and those to be adopted after 2011.

Adopted in fiscal 2011

In December, 2009, the Canadian Institute of Chartered Accountants' (CICA) Emerging Issues Committee (EIC) issued EIC-175, "Multiple Deliverable Revenue Arrangements", which is applicable prospectively (with retrospective adoption permitted) to revenue arrangements with multiple deliverables entered into or materially modified in the first annual period beginning on January 1, 2011. EIC-175 amends the guidance contained in EIC-142, "Revenue

Arrangements with Multiple Deliverables“, and establishes additional requirements regarding revenue recognition related to multiple deliverables as well as supplementary disclosures. We adopted this standard on September 1, 2010, and its adoption had no material effect on our consolidated financial statements.

Update to the accounting policy on revenue recognition

Our multiple deliverable revenue arrangements may include tangible products (software and/or non software components), extended warranties, maintenance contracts, post-contract customer support (PCS) on software components as well as installation.

Table of Contents

Starting September 1, 2010, when a sales arrangement contains multiple elements and software and non software components function together to deliver the tangible products' essential functionality, we allocate revenue to each element based on the relative selling price of each element. Under this approach, the selling price of a deliverable is determined by using a selling price hierarchy which requires the use of vendor specific objective evidence ("VSOE") of fair value if available, third-party evidence ("TPE") if VSOE is not available, or best estimated selling price ("BESP") if neither VSOE nor TPE are available.

We establish VSOE of selling price using the price charged for a deliverable when sold separately and, in some instances, using the price established by management having the relevant authority. TPE of selling price is established by evaluating similar and interchangeable competitor goods or services in sales to similarly situated customers. When VSOE or TPE are not available, we use BESP. We establish BESP using historical selling price trends if available and considering multiple factors including, but not limited to geographies, market conditions, competitive landscape, internal costs, gross margin objectives, and pricing practices. When determining BESP, management applies judgment when establishing pricing strategies and evaluating market conditions and product lifecycles. The determination of BESP is made through consultation with and approval by management. We may modify or develop new pricing practices and strategies in the future. As these pricing strategies evolve, we may modify our pricing practices in the future, which may result in changes in BESP. The aforementioned factors may result in a different allocation of revenue to the deliverables in multiple-element arrangements from the current period, which may change the pattern and timing of revenue recognition for these elements but will not change the total revenue recognized for the arrangement.

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 and customer service. They qualify as a separate unit of accounting. Revenue from these contracts is recognized ratably over the terms of the maintenance contracts on a straight-line basis. The selling price of the maintenance contracts is determined using VSOE.

Extended warranties are usually offered to customers for periods of twelve to forty-eight months. They qualify as a separate unit of accounting. Revenue from these extended warranties is recognized ratably over the warranty period on a straight-line basis. The selling price of the extended warranties is determined using BESP.

When a sales arrangement contains multiple elements and software and non−software components do not function together to deliver the tangible products' essential functionality, we allocate revenue between the tangible products and the PCS, if any, based on VSOE of selling price of each element. PCS revenues are deferred and recognized ratably over the years of the support arrangement. PCS revenues are recognized at the time the product is delivered when provided substantially within one year of delivery, the costs of providing this support are insignificant (and accrued at the time of delivery), and no (or infrequent) software upgrades or enhancements are provided.

To be adopted after fiscal 2011

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

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

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

Table of Contents

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

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

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

The conversion project consists of four phases.

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

- Design and Solutions Development phase – This phase involves a detailed analysis of identified accounting treatment differences, reviewing and approving accounting policy choices, performing a detailed impact assessment and designing changes to systems and business processes, developing IFRS training material, and drafting IFRS financial statement content.

- Implementation phase – This phase involves embedding changes to systems, business processes and internal controls, determining the opening IFRS transition balance sheet and tax impacts, parallel accounting under Canadian GAAP and IFRS, and preparing detailed reconciliations of Canadian GAAP to IFRS financial statements.

- Post-Implementation phase – This phase involves conversion assessment, evaluating improvements for a sustainable operational IFRS model, and testing the internal controls environment.

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

We have completed the Design and Solutions Development phase to evaluate the overall impact of adopting these new standards on our consolidated financial statements. We have also completed a detailed analysis of the accounting policies affected by the adoption of IFRS.

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

Key accounting areas	Differences with potential impact
Hedge accounting	IAS 39, "Financial Instruments: Recognition and Measurement", does not permit to use the shortcut method to assess hedge effectiveness of hedging relationships. We have elected to use the dollar-offset method, as permitted by IFRS,

to assess the effectiveness of our cash flow hedges and we will recalculate the effectiveness with this new method, which may potentially result into ineffectiveness that did not exist under the previous method. However, we do not anticipate significant reclassification of hedge relationships. The review of our documentation was completed as at September 1, 2010, being the transition date.

Table of Contents

Key accounting areas	Differences with potential impact
Presentation of financial statements	Under IAS 1, “Presentation of Financial Statements”, expenses must be classified by their nature or by their function in the income statement. We elected to present our income statement by function. Accordingly, upon the adoption of IFRS, amortization expenses will be allocated to function rather than being showed as separate lines in the income statement as currently permitted under Canadian GAAP.
Impairment of assets	IAS 36, “Impairment of Assets”, requires a single-step approach for impairment testing of individual assets or a group of assets in cash- generating units (CGUs) on the basis of independent cash inflows whereas Canadian GAAP uses a two-step approach. However, we do not anticipate significant additional impairment due to that one-step approach.
Property, plant and equipment	IAS 16, “Property, Plant and Equipment”, reinforces the requirement under Canadian GAAP that requires that each part of property, plant and equipment that has a cost that is significant in relation to the overall cost of the item should be depreciated separately. Based on the analysis of our property, plant and equipment, we do not expect additional componentization under IFRS.
Leases	Under IAS 17, “Leases”, a lease is classified as either a finance lease or an operating lease. Lease classification depends on whether substantially all the risks and rewards incidental to ownership of the leased assets have been transferred from the lessor to the lessee, and is made at inception of the lease. A number of indicators are used to assist in lease classification; however, quantitative thresholds are not offered as indicators as under current Canadian GAAP. We reviewed all existing significant leases, which are classified as operating leases under Canadian GAAP, and concluded that their classification is in accordance with IAS 17.
Translation of foreign operations	Under IAS 21, “The Effects of Changes in Foreign Exchange Rates”, for foreign entities with the same functional currency as the parent company, the corresponding exchange difference is recognized in the statement of earnings of that entity; and for foreign entities with a functional currency other than the functional currency of the parent company, the corresponding exchange differences should be recognized in a separate component of other comprehensive income. We assessed the functional currency of our foreign operations and concluded that the adoption of IAS 21 will have no impact on our consolidated financial statements.
Business combinations	As permitted by IFRS 1, “First Time Adoption of International Financial Reporting Standards (IFRS)”, we will not apply IFRS 3, “Business Combinations”, to business combinations completed before the transition date, that is, September 1, 2010.

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

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

Table of Contents

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

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

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

Table of Contents

RESULTS OF OPERATIONS

The following discussion and analysis of our consolidated financial condition and results of operations for the three months ended November 30, 2009 and 2010, should be read in conjunction with our interim consolidated financial statements and the related notes thereto. Our interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (Canadian GAAP) and significant differences in measurement and disclosure from United States generally accepted accounting principles (U.S. GAAP) are set out in note 14 to our interim consolidated financial statements. Our principal measurement currency is the Canadian dollar, although we report our financial statements in US dollars. The following table sets forth interim consolidated statements of earnings data in thousands of US dollars, except per share data, and as a percentage of sales for the periods indicated:

	Three months ended November 30,		Three months ended November 30,	
	2010	2009	2010	2009
Consolidated statements of earnings data:				
Sales	$65,653	$40,292	100.0 %	100.0 %
Cost of sales (1)	24,785	14,033	37.8	34.8
Gross margin	40,868	26,259	62.2	65.2
Operating expenses				
Selling and administrative	19,899	13,804	30.3	34.3
Net research and development	11,601	7,781	17.7	19.3
Amortization of property, plant and equipment	1,674	1,258	2.5	3.1
Amortization of intangible assets	2,566	1,460	3.9	3.6
Total operating expenses	35,740	24,303	54.4	60.3
Earnings from operations	5,128	1,956	7.8	4.9
Interest expense	(64)	(42)	(0.1)	(0.1)
Foreign exchange loss	(1,113)	(1,022)	(1.7)	(2.6)
Earnings before income taxes	3,951	892	6.0	2.2
Income taxes	2,806	1,122	4.3	2.8
Net earnings (loss) from continuing operations	1,145	(230)	1.7 %	(0.6)%
Net earnings from discontinued operations	12,926	564		
Net earnings for the period	$14,071	$334		
Basic and diluted net earnings (loss) from continuing operations per share	$0.02	$(0.00)		
Basic net earnings from discontinued operations per share	$0.22	$0.01		
Diluted net earnings from discontinued operations per share	$0.21	$0.01		
Basic net earnings per share	$0.24	$0.01		
Diluted net earnings per share	$0.23	$0.01		

Research and development data:				
Gross research and development	$13,690	$9,153	20.9 %	22.7 %
Net research and development	$11,601	$7,781	17.7 %	19.3 %

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

Table of Contents

RESULTS FROM CONTINUING OPERATIONS (formerly the Telecom Division)

SALES

For the three months ended November 30, 2010, our sales increased 62.9% to a record-high $65.7 million, compared to $40.3 million for the same period last year.

The following table summarizes information about our sales for the three-month periods ended November 30, 2009 and 2010, in thousands of US dollars:

	Three months ended November 30,			
	2010	2009	Change in $	Change in %
Sales	$ 65,653	$ 40,292	$ 25,361	62.9 %
Gains on forward exchange contracts	(460)	(67)	(393)	
Sales, excluding gains on forward exchange contracts (non-GAAP measure)	65,193	40,225	24,968	62.1
Impact of the recent acquisition (NetHawk)	(6,426)	–	(6,426)	
Organic sales (non-GAAP measure)	$ 58,767	$ 40,225	$ 18,542	46.1 %

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

Since the last few months, following the worldwide economic recession in 2009, network operators have been investing in capital-intensive deployments and capacity expansion in order to accommodate bandwidth-intensive applications and to facilitate the migration to more flexible and cost-effective fixed and mobile IP architectures. We believe that our product offering is greatly aligned with the major trend of bandwidth demand, for which network operators are investing. Namely, during the first quarter of fiscal 2011, we received a follow-on order in excess of $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 the quarter. This contributed to the increase of our wireline products sales year-over-year. We did not have such a large order in the first quarter of fiscal 2010; moreover, the size of orders may fluctuate from quarter to quarter. We must also recall that in the first quarter of fiscal 2010, we were at the early stage of the slow recovery from the economic recession.

In addition, during the first quarter of fiscal 2011, NetHawk, which was acquired in the third quarter of 2010, reported sales of $6.4 million, which contributed to the increase in our sales year-over-year. NetHawk's sales for this period were reduced by $0.4 million to account for an adjustment to deferred revenue in the purchase price allocation.

Furthermore, during the first quarter of fiscal 2011, we believe we gained market share, namely in the wireline space, which contributed to the increase of our sales year-over-year.

Finally, during the first quarter of fiscal 2011, we benefited from larger year-end budget flush-outs from some of our customers, compared to the same period last year, which increased our sales year-over-year. The magnitude of customers year-end budget flush outs may fluctuate year-over-year.

Net bookings

For the three months ended November 30, 2010, our net accepted orders increased 92.0% to a record-high $89.8 million, compared to $46.8 million for the same period last year, for a book-to-bill ratio of 1.37.

Table of Contents

During the first quarter of fiscal 2011, in addition to the positive impact of the acquisition of NetHawk on bookings, we benefited from worldwide capital-intensive deployments and capacity expansion from network operators and we believe we gained market share, especially in the wireline space. Namely, in the first quarter of fiscal 2011, two tier-1 network operators placed follow-on orders totaling more than $8 million for our AXS-200/635 triple-play tester and a tier-1 US wireless operator selected our service assurance solution for monitoring its Ethernet backhaul networks with an initial order in excess of $1 million. We did not have such orders in the same period last year. In addition, we benefited from larger year-end budget flush-outs compared to the same period last year. These factors contributed to the significant increase of our bookings year-over-year.

Geographic distribution

In the first quarter of fiscal 2011, sales to the Americas, Europe, Middle-East and Africa (EMEA) and Asia-Pacific (APAC) respectively accounted for 53%, 30% and 17% of sales, compared to 58%, 26% and 16%, respectively for the same period last year.

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 first quarter of fiscal 2011, no customer accounted for more than 10% of our sales, and our top three customers accounted for 24.4% 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 12.4% of our sales.

GROSS MARGIN

Gross margin reached 62.2% of sales for the three months ended November 30, 2010, compared to 65.2% for the same period last year.

The decrease in our gross margin in the first quarter of fiscal 2011, compared to the same period last year, can be explained by the following factors.

In the first quarter of fiscal 2011, our gross margin was negatively affected by the shift in product mix in favor of our copper-access test solutions. In fact, sales of these products, which typically deliver lower margins than our other test solutions, significantly increased year-over-year and we had large orders on which we granted larger volume discounts.

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

However, these negative factors were offset in part by the following elements.

First, the significant sales increase year-over-year (excluding the impact of acquisition of NetHawk) resulted in an increase in our manufacturing activities in Canada and China, allowing us to better absorb our fixed manufacturing costs.

Furthermore, in the first quarter of fiscal 2011, a larger portion of our sales came from products manufactured in our facilities in China compared to the same period last year; those products have a lower cost of goods than those manufactured in our facilities in Canada, thus resulting in an improvement in gross margin year-over-year.

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 first quarter of fiscal 2011; 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.

Table of Contents

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

SELLING AND ADMINISTRATIVE EXPENSES

For the three months ended November 30, 2010, selling and administrative expenses were $19.9 million, or 30.3% of sales, compared to $13.8 million, or 34.3% of sales for the same period last year.

During the first quarter of fiscal 2011, NetHawk, acquired in the third quarter of 2010, contributed for the whole period to our selling and administrative expenses, which caused them to increase year-over-year. In addition, selling expenses for NetHawk tend to be higher in percentage of sales than the rest of our business, as its sales cycle is much longer and complex than most of our other product lines.

In addition, during the first quarter of fiscal 2011, our sales (excluding those of NetHawk) significantly increased compared to the same period last year, causing our selling expenses to increase, namely our commission expenses.

Furthermore, during the first quarter of fiscal 2011, considering our goal of becoming the leading player in the telecom test and service assurance space, we intensified our sales and marketing efforts, both domestic and international, which caused our expenses to increased year-over-year.

Finally, during the first quarter of fiscal 2011, the increase in the average value of the Canadian dollar compared to the US dollar had a negative impact on our selling and administrative expenses, since a certain portion of these expenses are denominated in Canadian dollars and we report our results in US dollars, and since these expenses increased year-over-year as our sales grew.

During the first quarter of fiscal 2011, the significant increase in sales year-over-year caused these expenses to significantly decrease as a percentage of sales, as a portion of these expenses is fixed.

For fiscal 2011, considering the current value of the Canadian dollar compared to the US dollar and the significant impact that the recent acquisition of NetHawk will have on our selling and administrative expenses, we expect our selling and administrative expenses to increase in dollars and range between 31% and 33% of sales. In addition, in fiscal 2011, we expect our commission expenses to increase as the sales volume increases. Furthermore, considering our goal of becoming the leading player in the telecom test and service assurance space and to deliver the synergies expected from our recent acquisition, we plan to continue intensifying our sales and marketing efforts, both domestic and international, which will also cause our expenses to rise. Finally, any increase in the strength of the Canadian dollar and the euro 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 November 30, 2010, gross research and development expenses totaled $13.7 million, or 20.9% of sales, compared to $9.2 million, or 22.7% of sales for the same period last year.

In the first quarter of fiscal 2011, NetHawk, acquired in the third quarter of 2010, contributed for the whole period to our gross research and development expenses, which caused them to increase year-over-year. NetHawk tends to incur higher research and development expenses in percentage of sales, compared to our other product lines, as its products are more software-intensive.

Table of Contents

In addition, during the first quarter of fiscal 2011, we intensified our research and development activities, which resulted in increased gross research and development expenses during that period compared to the same period last year.

Finally, during the first quarter of fiscal 2011, the increase in the average value of the Canadian dollar compared to the US dollar had a negative effect on our gross research and development expenses as a large portion of these expenses are denominated in Canadian dollars and we report our results in US dollars.

The decrease in our gross research and development expenses as a percentage of sales year-over-year is mainly due to the significant increase in sales year-over-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 to grants by a Finnish technology organization on certain research and development projects conducted in Finland.

For the three months ended November 30, 2010, tax credits and grants for research and development activities were $2.1 million, or 15.3% of gross research and development expenses, compared to $1.4 million, or 15.0% of gross research and development expenses for the same period last year.

A significant portion of the year-over-year increase in our tax credits and grants in the first quarter of fiscal 2011, compared to the same period last year, comes from newly acquired NetHawk.

In addition, in the first quarter of fiscal 2011, the year-over-year increase of research and development activities in Canada, where we are entitled to tax credits, resulted in increased tax credits during that period.

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

AMORTIZATION OF PROPERTY, PLANT AND EQUIPMENT

For the three months ended November 30, 2010, amortization of property, plant and equipment was $1.7 million, compared to $1.3 million for the same period last year.

The increase in amortization expense during the first quarter of fiscal 2011, compared to the same period last year mainly comes from the acquisition of NetHawk in the third quarter of fiscal 2010, the increase in the average value of the Canadian dollar versus the US dollar year-over-year as well as the additions to property, plant and equipment over the last few quarters.

AMORTIZATION OF INTANGIBLE ASSETS

For the three months ended November 30, 2010, amortization of intangible assets was $2.6 million, compared to $1.5 million for the same period last year.

The increase in amortization expense during the first quarter of fiscal 2011, compared to the same period last year mainly comes from the acquisition of NetHawk in the third quarter of fiscal 2010, the increase in the average value of the Canadian dollar versus the US dollar year-over-year as well as the additions to intangible assets over the last few quarters.

Table of Contents

FOREIGN EXCHANGE LOSS

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

For the three months ended November 30, 2010, the foreign exchange loss amounted to $1.1 million compared to $1.0 million for the same period last year.

During the first quarter of fiscal 2011, the 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 3.9% to CA$1.0264 = US$1.00 in the first quarter of fiscal 2011, compared to CA$1.0665 = US$1.00 at the end of the previous quarter.

During the first quarter of fiscal 2010, the value of the Canadian dollar also increased versus the US dollar, compared to the previous quarter, which also resulted in a significant foreign exchange loss during that period. The period-end value of the Canadian dollar increased 3.7% to CA$1.0574 = US$1.00 in the first quarter of fiscal 2010, compared to CA$1.0967 = US$1.00 at the end of the previous quarter.

Foreign exchange rate fluctuations also flow through the P&L line items as a significant portion of our operating items are denominated in Canadian dollars, and we report our results in US dollars. Consequently, the significant increase in the average value of the Canadian dollar in the first quarter of fiscal 2011, compared to the same period last year, resulted in a significant and negative impact on our financial results. In fact, the average value of the Canadian dollar in the first quarter of fiscal 2011 was CA$1.0207 = US$1.00 versus CA$1.0643 = US$1.00 for the same period last year, representing an increase of 4.3% in the average value of the Canadian dollar versus the US dollar year-over-year.

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

INCOME TAXES

For the three months ended November 30, 2010, our income tax expense totaled $2.8 million compared to $1.1 million for the same period last year.

For the three months ended November 30, 2010, we reported income tax expenses of $2.8 million on earnings before income taxes of $4.0 million, for an effective income tax rate of 71.0%. Our combined Canadian and provincial statutory tax rate is 29%. This situation mainly results from the fact that a significant portion of our foreign exchange loss is created by the translation of financial statements of our foreign integrated subsidiaries, and is therefore non-deductible. In addition, we continue to maintain a valuation allowance for some of our subsidiaries at loss and we have some non-deductible expenses, such as stock-based compensation costs. Otherwise, the actual tax rate would have been closer to the statutory tax rate.

For the three months ended November 30, 2009, we reported income tax expenses of $1.1 million on earnings before income taxes of $0.9 million, for an effective income tax rate of 125.8%. Our combined Canadian and provincial statutory tax rate is 31%. This situation mainly results from the fact that a significant portion of our foreign exchange loss is created by the translation of financial statements of our foreign integrated subsidiaries, and is therefore non-deductible. In addition, we continue to maintain a valuation allowance for some of our subsidiaries at loss and we have some non-deductible expenses, such as stock-based compensation costs. Otherwise, the actual tax rate would have been closer to the statutory tax rate.

Please refer to note 12 to our interim consolidated financial statements for a full reconciliation of the income tax provision.

Table of Contents

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, compared to the whole quarter during the same period last year. Results from operations for that Division for the first quarter of fiscal 2010 and 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, compared to $5.3 million for the same period last year (three-month contribution).

NET EARNINGS

During the first quarter of fiscal 2011, we reported net earnings from discontinued operations of $12.9 million, compared to $564,000 during the same period last year. Net earnings from discontinued operations in the first quarter of fiscal 2011 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 November 30, 2010, cash and short-term investments totalled $50.6 million, while our working capital was at $127.5 million. Our cash and short-term investments increased $18.8 million in the first quarter of fiscal 2011, compared to the previous quarter, mainly due to the net proceeds of $22.1 million from the disposal of discontinued operations, offset in part by the cash flows used by operating activities of $2.5 million and the cash payments of $2.0 million for the purchase of capital assets. In addition, we recorded an unrealized foreign exchange gain on our cash and short-term investments of $0.5 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.

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

We believe that our cash balances and short-term investments will be sufficient to meet our liquidity and capital requirements for the foreseeable future, including the remaining cash payment for the acquisition of NetHawk, estimated at $0.9 million, the maximum cash contingent consideration of €8.7 million (US$11.3 million) that may become payable in conjunction with this acquisition if sales objectives are met, the payment of our long-term debt, as well as the effect of our normal course issuer bid. In addition to these assets, we have unused available lines of credit totaling $15.5 million for working capital and other general corporate purposes and unused lines of credit of $15.2 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.

Table of Contents

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 used by operating activities were $2.5 million for the three months ended November 30, 2010, compared to $2.6 million for the same period last year.

Cash flows used by operating activities in the first quarter of fiscal 2011 were mainly attributable to the net earnings after items not affecting cash of $5.8 million, offset by the negative net change in non-cash operating items of $8.3 million; this was mainly due to the negative effect on cash of the increase of $4.5 million in our accounts receivable (increase and timing of sales), the increase of $1.0 million in our income taxes and tax credits recoverable (mainly tax credits earned during the quarter and not yet recovered), the increase of $1.4 million in our inventories, to sustain increased sales activities and the decrease of $1.1 million in our accounts payable and accrued liabilities and other liabilities due to timing of purchases and payments during the quarter.

Cash flows used by operating activities in the first quarter of fiscal 2010 were mainly attributable to the net earnings after items not affecting cash of $4.9 million, offset by the negative net change in non-cash operating items of $7.5 million; this was mainly due to the negative effect on cash of the increase of $4.1 million in our accounts receivable (increase and timing of sales), the increase of $1.5 million in our income taxes and tax credits recoverable (mainly tax credits earned during the quarter and not yet recovered), the increase of $2.4 million in our inventories, to sustain increased sales activities and the increase of $605,000 in prepaid expenses (IT maintenance). However, accounts payable and accrued liabilities increased $1.1 million due to timing of purchases and payments during the quarter.

Investing activities (including discontinued operations)

Cash flows provided by investing activities were $3.5 million for the three months ended November 30, 2010, compared to $1.0 million for the same period last year. In the first quarter of fiscal 2010, we received $22.1 million from the disposal of discontinued operations, but we acquired (net of disposal) $16.5 million worth of short-term investments and paid $2.0 million for the purchase of capital assets and $132,000 in relation to the acquisition of NetHawk.

For the corresponding period last year, we disposed (net of acquisitions) of $2.3 million worth of short-term investments but paid $1.3 million for the purchase of capital assets.

Financing activities (including discontinued operations)

During the first quarters of fiscal 2010 and 2011, cash flows provided/used by financing activities were nominal.

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.

Table of Contents

As at November 30, 2010, we held forward exchange contracts to sell US dollars at various forward rates, which are summarized as follows:

Expiry dates	Contractual amounts	Weighted average contractual forward rates
December 2010 to August 2011	$ 20,800	1.0923
September 2011 to August 2012	20,400	1.0802
September 2012 to January 2013	1,500	1.0722
Total	$ 42,700	1.0858

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 $597,000 as at August 31, 2010 and $2.1 million as at November 30, 2010, following the increase in the value of the Canadian dollar compared to the US dollar during the quarter. The period-end exchange rate was CA$1.0264 = US$1.00 as at November 30, 2010.

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

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

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

Table of Contents

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

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

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

On April 2, 2009, a stipulation and agreement of settlement between the plaintiffs, issuer defendants and underwriter defendants was submitted to the Court for preliminary approval. The Court granted the plaintiffs' motion for preliminary approval and preliminarily certified the settlement classes on June 10, 2009. The settlement fairness hearing was held on September 10, 2009. On October 6, 2009, the Court entered an opinion granting final approval to the settlement and directing that the Clerk of the Court close these actions. On August 26, 2010, based on the expiration of the tolling period stated in the Tolling Agreements, the plaintiffs filed a Notice of Termination of Tolling Agreement and Recommencement of Litigation against the two named executive officers. The plaintiffs stated to the Court that they do not intend to take any further action against the named executive officers at this time. Appeals of the opinion granting final approval have been filed. Given that the settlement remains subject to appeal as of the date of issuance of these financial statements, the ultimate outcome of the contingency is uncertain. However, based on the settlement approved on October 6, 2009, and the related insurance against such claims, we have determined the impact to our financial position and results of operations as at and for the three months ended November 30, 2010 to be immaterial.

SHARE CAPITAL AND STOCK-BASED COMPENSATION PLANS

Share capital

As at January 12, 2011, EXFO had 36,643,000 multiple voting shares outstanding, entitling to 10 votes each and 23,136,347 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 November 30, 2010, our off-balance sheet arrangements consisted of letters of guarantee amounting to $5.1 million; these letters of guarantee expire at various dates through fiscal 2017. From this amount, we had $0.7 million worth of letters of guarantee for our own selling and purchasing requirements, which were for the most part reserved from one of our lines of credit. The remainder, in the amount of $4.4 million, was used to secure our line of credit in CNY (Chinese currency). This line of credit was unused as at November 30, 2010.

Table of Contents

VARIABLE INTEREST ENTITY

As of November 30, 2010, we did not have interests in any variable interest entities.

RISKS AND UNCERTAINTIES

Over the past several years, we have managed our business in a difficult environment; focused on research and development programs for new and innovative 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.

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

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

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

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

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

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

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

Table of Contents

NON-GAAP FINANCIAL MEASURES

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

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

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

EBITDA and adjusted EBITDA (including discontinued operations)

	Three months ended November 30,	
	2010	2009
GAAP net earnings for the period	$ 14,071	$ 334
Add (deduct):		
Amortization of property, plant and equipment		
Continuing operations	1,674	1,258
Discontinued operations	14	33
Amortization of intangible assets		
Continuing operations	2,566	1,460
Discontinued operations	4	9
Interest expense		
Continuing operations	64	42
Income taxes		
Continuing operations	2,806	1,122
Discontinued operations	201	121
EBITDA for the period	21,400	4,379
Gain on disposal of discontinued operations	(13,212)	–
Adjusted EBITDA for the period	$ 8,188	$ 4,379
Adjusted EBITDA in percentage of total sales	12.1 %	9.6 %

* EBITDA is defined as net earnings before interest, income taxes, amortization of property, plant and equipment and amortization of intangible assets. Adjusted EBITDA represents EBITDA excluding the gain from the disposal of discontinued operations.

Additional information

	Three months ended November 30, 2010	2009
Sales from continued operations	$ 65,653	$ 40,292
Sales from discontinued operations	1,991	5,268
Total sales	$ 67,644	$ 45,560