

# Consolidated Balance Sheets

(in thousands of US dollars)

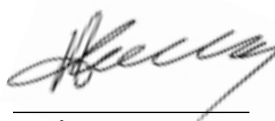
The accompanying notes are an integral part of these consolidated financial statements.

As at August 31,	2003	2002
<b>Assets</b>		
<b>Current assets</b>		
Cash	\$ 5,366	\$ 9,128
Short-term investments (notes 8 and 18)	52,010	40,553
Accounts receivable (notes 8 and 18)		
Trade	9,639	9,881
Other	834	3,267
Income taxes and tax credits recoverable (notes 4 and 8)	6,003	13,473
Inventories (notes 4, 5 and 8)	15,602	23,822
Prepaid expenses	2,041	1,280
Future income taxes (notes 4 and 15)	-	1,272
	<b>91,495</b>	<b>102,676</b>
<b>Income taxes and tax credits recoverable</b> (notes 4 and 8)	<b>1,377</b>	<b>6,234</b>
<b>Property, plant and equipment</b> (notes 6 and 8)	<b>24,931</b>	<b>26,246</b>
<b>Intangible assets</b> (notes 4, 7 and 8)	<b>10,778</b>	<b>16,464</b>
<b>Goodwill</b> (notes 4 and 7)	<b>17,673</b>	<b>17,576</b>
<b>Future income taxes</b> (notes 4 and 15)	<b>-</b>	<b>8,730</b>
	<b>\$ 146,254</b>	<b>\$ 177,926</b>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities (note 9)	\$ 12,026	\$ 10,699
Income taxes payable	2,200	-
Deferred revenue	500	503
Current portion of long-term debt	110	100
	<b>14,836</b>	<b>11,302</b>
<b>Deferred grants</b> (note 14)	<b>1,139</b>	<b>654</b>
<b>Long-term debt</b> (note 10)	<b>453</b>	<b>564</b>
	<b>16,428</b>	<b>12,520</b>
<b>Commitments</b> (note 11)		
<b>Contingencies</b> (note 12)		
<b>Shareholders' equity</b>		
Share capital (note 13)	492,452	489,611
Contributed surplus	1,519	1,487
Cumulative translation adjustment	7,643	(8,854)
Deficit	(371,788)	(316,838)
	<b>129,826</b>	<b>165,406</b>
	<b>\$ 146,254</b>	<b>\$ 177,926</b>



On behalf of the Board:

**Germain Lamonde**  
Chairman, President and CEO



**André Tremblay**  
Chairman, Audit Committee

# Consolidated Statements of Earnings

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

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

Years ended August 31,	2003	2002	2001
<b>Sales</b> (note 16)	\$ 61,930	\$ 68,330 (note 22)	\$ 146,013 (note 22)
<b>Cost of sales*</b>	36,197	52,366	56,207
<b>Gross margin</b>	25,733	15,964	89,806
<b>Operating expenses</b>			
Selling and administrative	26,991	33,881	44,975
Net research and development (notes 4 and 14)	15,879	12,782	13,601
Amortization of property, plant and equipment	6,139	5,932	3,559
Amortization of intangible assets	4,747	11,615	9,876
Write-down of intangible assets (note 4)	2,922	23,657	-
Restructuring and other charges (note 4)	4,134	2,880	3,288
<b>Total operating expenses</b>	60,812	90,747	75,299
<b>Earnings (loss) from operations</b>	(35,079)	(74,783)	14,507
Interest income, net	1,245	1,456	6,098
Foreign exchange gain (loss)	(1,552)	(458)	3,327
<b>Earnings (loss) before income taxes and amortization and write-down of goodwill</b> (note 15)	(35,386)	(73,785)	23,932
<b>Income taxes</b> (note 15)	15,059	(25,451)	8,150
<b>Earnings (loss) before amortization and write-down of goodwill</b>	(50,445)	(48,334)	15,782
<b>Amortization of goodwill</b> (note 2)	-	38,021	31,076
<b>Write-down of goodwill</b> (note 4)	4,505	222,169	-
<b>Net loss for the year</b>	\$ (54,950)	\$ (308,524)	\$ (15,294)
<b>Basic and diluted earnings (loss) per share</b>			
Earnings (loss) before amortization and write-down of goodwill	\$ (0.80)	\$ (0.80)	\$ 0.30
Net loss	\$ (0.87)	\$ (5.09)	\$ (0.29)
<b>Basic weighted average number of shares outstanding (000's)</b>	62,852	60,666	53,014
<b>Diluted weighted average number of shares outstanding (000's)</b> (note 17)	63,317	60,966	53,495

\* Including inventory write-offs of \$4,121, \$18,463 and nil for the years ended August 31, 2003, 2002 and 2001, respectively (note 4).

# Consolidated Statements of Retained Earnings (Deficit) and Contributed Surplus

(in thousands of US dollars)

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

## Retained Earnings (Deficit)

Years ended August 31,	2003	2002	2001
<b>Balance – Beginning of year</b>	<b>\$ (316,838)</b>	\$ (8,314)	\$ 6,980
<b>Add</b>			
Net loss for the year	(54,950)	(308,524)	(15,294)
<b>Balance – End of year</b>	<b>\$ (371,788)</b>	\$ (316,838)	\$ (8,314)

## Contributed Surplus

Years ended August 31,	2003	2002	2001
<b>Balance – Beginning of year</b>	<b>\$ 1,487</b>	\$ 1,457	\$ -
<b>Add</b>			
Premium on resale of share capital	32	30	1,457
<b>Balance – End of year</b>	<b>\$ 1,519</b>	\$ 1,487	\$ 1,457

# Consolidated Statements of Cash Flows

(in thousands of US dollars)

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

Years ended August 31,	2003	2002	2001
<b>Cash flows from operating activities</b>			
Net loss for the year	\$ (54,950)	\$ (308,524)	\$ (15,294)
Add (deduct) items not affecting cash			
Discount on short-term investments	(54)	271	191
Inventory and tax credit write-offs	6,418	18,463	-
Amortization	10,886	55,568	44,511
Foreign exchange gains on disposal of short-term investments	(42)	(74)	(3,437)
Restructuring and other charges	512	741	1,083
Future income taxes	(18,247)	(13,397)	(1,779)
Future income tax assets valuation allowance	28,385	-	-
Write-down of goodwill and intangible assets	7,427	245,826	-
Change in non-cash operating items			
Accounts receivable	3,957	15,406	447
Income taxes and tax credits	13,886	(19,736)	2,237
Inventories	7,925	4,332	(20,308)
Prepaid expenses	(569)	356	(67)
Accounts payable and accrued liabilities	(349)	(7,470)	(3,736)
Deferred revenue	(24)	(106)	100
Deferred grants	420	(335)	(57)
	<b>5,581</b>	<b>(8,679)</b>	<b>3,891</b>
<b>Cash flows from financing activities</b>			
Bank advances	-	-	(2,046)
Repayment of mandatorily redeemable preferred shares	-	-	(354)
Repayment of long-term debt	(133)	(106)	(3,355)
Issuance of share capital	45	-	-
Redemption of share capital	(16)	(6)	(33)
Resale of share capital	48	36	1,490
Share issue expenses	-	(14)	(331)
	<b>(56)</b>	<b>(90)</b>	<b>(4,629)</b>
<b>Cash flows from investing activities</b>			
Additions to short-term investments	(401,105)	(506,228)	(772,808)
Proceeds from disposal of short-term investments	395,699	531,733	865,373
Additions to property, plant and equipment and intangible assets	(2,652)	(5,245)	(15,911)
Business combinations (note 3)	(1,867)	(9,756)	(68,255)
	<b>(9,925)</b>	<b>10,504</b>	<b>8,399</b>
<b>Change in cash</b>	<b>(4,400)</b>	<b>1,735</b>	<b>7,661</b>
<b>Effect of foreign exchange rate changes on cash</b>	<b>638</b>	<b>(336)</b>	<b>(661)</b>
<b>Cash – Beginning of year</b>	<b>9,128</b>	<b>7,729</b>	<b>729</b>
<b>Cash – End of year</b>	<b>\$ 5,366</b>	<b>\$ 9,128</b>	<b>\$ 7,729</b>
<b>Supplementary information</b>			
Interest paid	\$ 417	\$ 269	\$ 377
Income taxes paid (recovered)	\$ (10,351)	\$ 4,172	\$ 8,171

# Notes to Consolidated Financial Statements

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

## 1 • Incorporation and nature of activities

The company, incorporated in 1985 under the Canada Business Corporations Act, designs, manufactures and markets a full line of test, measurement and monitoring solutions for the global telecommunications industry. These solutions characterize the physical, optical and protocol layers of optical fiber and related hardware. The company derives substantially all of its revenue from customers located in the United States, Canada, Europe and Asia. The company's customers consist primarily of telecommunications carriers, network service providers, optical component and system manufacturers, as well as research and development laboratories.

## 2 • Summary of significant accounting policies

### Basis of presentation

These consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada. These principles conform, in all material respects, with accounting principles generally accepted in the United States, except for the significant differences and additional disclosures provided in note 20.

### Accounting estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting years. Actual results could differ from those estimates.

### Consolidation

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

### Reporting currency

The functional currency of the company is the Canadian dollar. However, the company has adopted the US dollar as its reporting currency. The financial statements are translated into the reporting currency using the current rate method. Under this method, the financial statements are translated into the reporting currency as follows: assets and liabilities are translated at the exchange rate in effect at the date of the balance sheet, while revenues and expenses are translated at the monthly average exchange rate. All gains and losses resulting from the translation of the financial statements into the reporting currency are included in the cumulative translation adjustment in shareholders' equity.

In the event that management decides to declare dividends, such dividends would be declared in Canadian dollars.

### Foreign currency translation

#### *Foreign currency transactions*

Transactions denominated in currencies other than the functional currency are translated into the functional currency as follows: monetary assets and liabilities are translated at the exchange rate in effect at the balance sheet date, while revenues and expenses are translated at the exchange rate in effect on the date of the transaction. Non-monetary assets and liabilities are translated at historical rates. Gains and losses arising from such translation are reflected in the statements of earnings.

#### *Foreign subsidiaries*

The financial statements of integrated foreign operations with a functional currency other than the Canadian dollar are remeasured into the functional currency using the temporal method. Under this method, monetary assets and liabilities are remeasured at the exchange rate in effect at the balance sheet date. Non-monetary assets and liabilities are remeasured at historical rates. Revenues and expenses are remeasured at the monthly average exchange rate. Gains and losses resulting from remeasurement are reflected in the statements of earnings.

#### *Forward exchange contracts*

Forward exchange contracts are utilized by the company in the management of its foreign currency exposure. The company's policy is not to utilize those derivative financial instruments for trading or speculative purposes.

Foreign exchange translation gains and losses on forward exchange contracts, used to hedge anticipated US-dollar-denominated sales, are recognized as an adjustment of the revenues when the sale is recorded.

Realized and unrealized gains or losses associated with forward exchange contracts, which have been terminated or cease to be effective prior to maturity, are deferred in the balance sheet and recognized in the earnings of the period in which the underlying hedged transaction is recognized.

### Short-term investments

Short-term investments are valued at the lower of cost and market value. Cost consists of acquisition cost plus amortization of discount or less amortization of premium.

### Inventories

Inventories are valued on an average cost basis at the lower of cost and replacement cost for raw materials and at the lower of cost and net realizable value for work in progress and finished goods.

On September 1, 2002, the company changed its accounting policy for determining the cost of raw materials and work in progress from the first-in, first-out method to the average cost method. This change in accounting policy had no significant impact on the company's financial statements.

## Property, plant and equipment and amortization

Property, plant and equipment are recorded at cost less related government grants and research and development tax credits. Amortization is provided on a straight-line basis over the estimated useful lives as follows:

	<b>Term</b>
Land improvements	5 years
Buildings	15 and 25 years
Equipment	2 to 10 years
Leasehold improvements	Remaining lease term

## Intangible assets, goodwill and amortization

Intangible assets primarily include the cost of acquired in-process research and development and core technology, net of accumulated amortization. Core technology represents the existing technology acquired in business combinations that has reached technological feasibility, while acquired in-process research and development represents the existing technology that has not reached technological feasibility and has no future alternative use. Intangible assets are amortized on a straight-line basis over their estimated useful lives, ranging from five to ten months for in-process research and development, and five years for core technology.

Goodwill represents the excess of the purchase price of acquired businesses over the estimated fair value of net identifiable assets acquired. Goodwill related to business combinations with a date of acquisition prior to July 1, 2001, was amortized on a straight-line basis over the estimated useful life of five years until August 31, 2002. Goodwill related to business combinations with a date of acquisition after June 30, 2001, is not amortized.

Goodwill must be tested for impairment on an annual basis or more frequently if events or circumstances occur that more likely than not reduce the fair value of a reporting unit below its carrying value. Any impairment loss arising from this test will be charged to earnings in the period in which it is incurred. The company elected to perform its annual impairment test in May of each fiscal year for all its existing reporting units (note 4).

## Impairment of long-lived assets

Long-lived assets are reviewed for impairment when events and circumstances indicate that cost may not be recoverable. Impairment exists when the carrying value of the asset is greater than the undiscounted future cash flows expected to be provided by the asset. The amount of impairment loss, if any, is the excess of the carrying value over its fair value. The company has recorded impairment charges for intangible assets in 2002 and 2003 (note 4).

## Revenue recognition

For products in which software is incidental, the company recognizes revenue when persuasive evidence of an arrangement exists, the product has been delivered, the price is fixed and determinable, and collection of the resulting receivable is reasonably assured. In addition, provisions are made for estimated returns, warranties and support obligations.

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

For all sales, the company uses a binding purchase order as evidence that a sales arrangement exists.

Delivery generally occurs when the product is shipped to a transporter.

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

Most sales arrangements do not generally include acceptance clauses. However, if a sales arrangement includes an acceptance provision, acceptance occurs upon the earliest of receipt of a written customer acceptance or expiration of the acceptance period. For these sales arrangements, the sale is recognized when acceptance occurs.

Extended warranties are recognized ratably over the service periods.

## Advertising costs

Advertising costs are expensed as incurred.

## Government grants

Government grants are accrued as a receivable when there is reasonable assurance that the company has complied and will continue to comply with all the conditions related to the grant. Grants related to operating expenses are included in earnings when the related expenses are incurred. Grants related to capital expenditures are deducted from the related assets. Grants related to job creation and training programs for extended periods are deferred and amortized on a straight-line basis over the minimum period for which the created job must be maintained or training provided.

## Research and development expenses

All expenses related to development activities, which do not meet generally accepted criteria for deferral, and research are expensed as incurred, net of related tax credits and government grants. Development expenses that meet generally accepted criteria for deferral are capitalized, net of related tax credits and government grants, and amortized against earnings over the estimated benefit period.

As at August 31, 2003, the company had not deferred any development costs.

## Income taxes

The company provides for income taxes using the liability method of tax allocation. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and liabilities, using enacted income tax rates for the years in which the differences are expected to reverse.

The company establishes a valuation allowance against future income tax assets if, based on available information, it is more likely than not that some or all of the future income tax assets will not be realized. In 2003, the company recorded a valuation allowance for all its future income tax assets (note 4).

## Earnings per share

Basic earnings per share are determined using the weighted average number of common shares outstanding during the year.

Diluted earnings per share are determined using the weighted average number of common shares outstanding during the year, plus the effect of dilutive potential common shares outstanding during the year. This method requires that diluted earnings per share be calculated, using the treasury stock method, as if all dilutive potential common shares had been exercised at the latest at the beginning of the year or on the date of issuance, as the case may be, and that the funds obtained thereby be used to purchase common shares of the company at the average fair value of the common shares during the year.

## New accounting standards

On September 1, 2002, the company prospectively adopted section 3870 of the Canadian Institute of Chartered Accountants (CICA) handbook, "Stock-Based Compensation and Other Stock-Based Payments", which applies to awards granted on or after the date of adoption, and requires that stock-based payments to non-employees and direct awards of stock to employees be accounted for using a fair value-based method. The new section also encourages, but does not require, the use of a fair value-based method to account for stock-based compensation costs arising from awards to employees. The company, to continue with its existing policy, elected not to account for stock-based compensation costs arising from awards to employees using the fair value-based method. The new section requires pro forma disclosures with respect to net earnings and net earnings per share if a fair value-based method of accounting is not adopted for awards granted to employees. The company complied with the standard by providing the required pro forma disclosures (note 13). The adoption of this new standard had no impact on the company's financial results.

On September 1, 2002, the company adopted section 3062 of the CICA handbook, "Goodwill and Other Intangible Assets". This new section changes the accounting for goodwill from an amortization method to an impairment-only approach. Thus, amortization of goodwill, including goodwill recorded in past business combinations ceased upon the adoption of this section. For any acquisitions completed after June 30, 2001, goodwill is not amortized. Until August 31, 2002, goodwill recorded in business combinations completed prior to July 1, 2001, was amortized on a straight-line basis over five years.

Also, under the transitional provisions of the section, the company performed an initial impairment test in September 2002 to identify goodwill impairment using a fair value-based method. Under the new section, goodwill impairment exists when the carrying value of a reporting unit exceeds its fair value. For the purposes of the impairment test, the company allocated its existing goodwill to its reporting units and completed an evaluation of the fair value of such reporting units. Based on the comparison of the fair value of the reporting units to their carrying value, goodwill of the reporting units was not considered impaired.

Furthermore, under this new section, goodwill must be tested for impairment on an annual basis or more frequently if events or circumstances occur that more likely than not reduce the fair value of a reporting unit below its carrying value. Any impairment loss arising from this test will be charged to earnings in the period in which it is incurred. The company elected to perform its annual impairment test in May of each fiscal year for all its existing reporting units (note 4).

This change in accounting policy has been applied prospectively and, consequently, the amounts presented for prior years have not been restated. The consolidated statements of earnings for the years ended August 31, 2001 and 2002, show the net loss and the net loss per share figures before the amortization and write-down of goodwill.

On September 1, 2002, the company prospectively adopted section 3063 of the CICA handbook, "Impairment of Long-Lived Assets". This new section changes existing rules for recognition and measurement of long-lived assets held for use. The section requires that an impairment loss be measured as the excess of the carrying value of a long-lived asset over its fair value. Long-lived assets were tested for impairment in 2003 under these new provisions (note 4).

On March 1, 2003, the company prospectively adopted accounting guideline 14 of the CICA handbook, "Disclosure of Guarantees". This new guideline requires certain disclosure about obligations under guarantees other than product warranties. The adoption of this guideline had no impact on the company's financial statements since the company has no guarantee that falls into the scope of this new guideline.

On May 1, 2003, the company prospectively adopted section 3475 of the CICA handbook, "Disposal of Long-Lived Assets and Discontinued Operations". Under this new section, a long-lived asset to be disposed of other than by sale continues to be classified as held and used until it is disposed of; a long-lived asset classified as held for sale is measured at the lower of its carrying value or fair value less cost to sell; a loss recognized on classification of long-lived assets as held for sale or a group of assets as a discontinued operation does not include future operating losses, other than to the extent to which they are included in the fair value of the asset; and discontinued operations are defined more broadly than under existing rules. The adoption of this new standard had no impact on the company's financial statements since the company did not have such operations.

In July 2003, the CICA issued new handbook section 1100, "Generally Accepted Accounting Principles", which is effective for fiscal years beginning on or after October 1, 2003. This new section defines GAAP, establishes the relative authority of various types of CICA Accounting Standards Board pronouncements, says what to do when the handbook does not cover a particular situation, and clarifies the role of "industry practice" in setting GAAP. The company will adopt this new standard on September 1, 2004, and has not yet determined the impact it will have on its financial statements.

In July 2003, the CICA issued new handbook section 1400, "General Standards of Financial Statements Presentation", which is effective for fiscal years beginning on or after October 1, 2003. This new section confirms that the financial statements of an entity must "present fairly in accordance with Canadian generally accepted accounting principles" its financial position, results of operations and cash flows. The company will adopt this new standard on September 1, 2004, and has not yet determined the impact it will have on its financial statements.

### 3 • Business combinations

The company completed a number of business combinations in 2001, 2002 and 2003. The fair value allocated to significant intangible assets acquired in these business combinations was based upon independent valuations performed in conjunction with the business combinations. Acquired goodwill, except the one from *gnubi communications L.P.*, is not deductible for income tax purposes.

#### Business combination during 2003

##### gnubi communications, L.P.

On October 7, 2002, a newly created wholly-owned subsidiary of the company, EXFO Gnubi Products Group Inc. ("EXFO Gnubi"), acquired substantially all the assets of *gnubi communications, L.P.*, a U.S. company supplying multi-channel telecom and datacom testing solutions for optical transport equipment manufacturers as well as research and development laboratories. This acquisition was made to fully complement the company's offering, to enhance its competitive position with network service providers and system vendors as well as to expand its presence in the data communications test market.

This acquisition was settled for a total consideration valued at \$4,663,000 including acquisition-related costs of \$162,000. The consideration paid consisted of \$1,867,000 in cash, \$2,796,000 by the issuance of 1,479,290 subordinate voting shares and a cash contingent consideration up to a maximum of \$2,900,000, based on sales volume of EXFO Gnubi for the twelve months following the acquisition.

The cash contingent consideration to be paid upon the realization of the defined sales volume is accounted for as an additional acquisition cost and is recognized as an additional cost of acquired core technology as sales occur. Since October 7, 2002, the company recognized \$173,000 as an additional cost of acquired core technology based on realized sales of EXFO Gnubi.

The fair value of the subordinate voting shares issued was determined based on the market price of the shares beginning three days before and ending three days after the number of shares became fixed based on a formula, being September 10, 2002.

This acquisition has been accounted for using the purchase method and, consequently, the results of operations of the acquired business have been included in the consolidated statement of earnings of the company since October 7, 2002, being the date of acquisition.

The purchase price, including acquisition-related costs, has been allocated based on the estimated fair value of net assets at the date of acquisition as follows:

Assets acquired		
Current assets	\$	755
Property, plant and equipment		334
Core technology		750
Current liabilities assumed		(134)
Net identifiable assets acquired		1,705
Goodwill		2,958
Purchase price		4,663
Less: Subordinate voting shares issued		2,796
Cash paid	\$	1,867

#### Business combination during 2002

##### Avantas Networks Corporation (renamed EXFO Protocol Inc.)

On November 2, 2001, the company acquired a 100% interest in EXFO Protocol Inc. ("EXFO Protocol"), a Canadian company specializing in protocol-layer testing, in exchange for a total consideration valued at \$94,952,000 or \$69,381,000 net of \$25,571,000 of cash and cash equivalents acquired. The total consideration includes acquisition-related costs of \$1,272,000.

The consideration paid consisted of \$9,756,000 in cash, net of cash and cash equivalents acquired of \$25,571,000 and the issuance of 4,374,573 subordinate voting shares valued at \$59,625,000. The fair value of the subordinate voting shares issued was determined based on the market price of the shares beginning three days before and ending three days after the terms of the acquisition were agreed upon and announced, being August 20, 2001.

This acquisition has been accounted for using the purchase method and, consequently, the results of operations of EXFO Protocol have been included in the consolidated statement of earnings of the company since November 2, 2001, being the date of acquisition.

The purchase price, including acquisition-related costs, has been allocated based on the estimated fair value of net assets at the date of acquisition as follows:

Assets acquired		
Current assets	\$	6,040
Property, plant and equipment		2,003
In-process research and development		1,400
Core technology		5,050
Future income tax assets (note 4)		476
Current liabilities assumed		(3,575)
Net identifiable assets acquired		11,394
Goodwill (note 4)		57,987
Purchase price		69,381
Less: Subordinate voting shares issued		59,625
Cash paid, net of cash and cash equivalents acquired	\$	9,756

## Business combinations during 2001

### Burleigh Instruments, Inc. (renamed EXFO Burleigh Products Group Inc.)

On December 20, 2000, the company acquired a 100% interest in EXFO Burleigh Products Group Inc. ("EXFO Burleigh"), a U.S. company manufacturing precision scientific instruments used in basic and applied research, engineering and production test applications in a variety of fields, in exchange for a total consideration valued at \$189,270,000, including acquisition-related costs of \$2,461,000.

The consideration paid consisted of \$42,461,000 in cash and the issuance of 6,488,816 subordinate voting shares valued at \$146,809,000.

Furthermore, as part of this acquisition, the company established a restricted stock award plan for employees of EXFO Burleigh (note 13). This plan provides that in the event of an employee's voluntary termination, shares to be issued to this employee under the plan will be issued to EXFO Burleigh's former shareholders. In such circumstances, this issuance of shares will be recorded as additional goodwill. As of August 31, 2003, \$5,000 has been recorded as additional goodwill upon voluntary termination of EXFO Burleigh's employees.

### EFOS Inc. (renamed EXFO Photonic Solutions Inc.)

On March 15, 2001, the company acquired a 100% interest in EXFO Photonic Solutions Inc. ("EXFO Photonic Solutions"), a Canadian company specializing in precision light-based adhesive spot-curing technologies as well as curing process control for the global optical component manufacturing market. This acquisition was settled for a total consideration valued at \$110,146,000, including acquisition-related costs of \$194,000. The consideration paid consisted of \$25,194,000 in cash and the issuance of 3,700,000 subordinate voting shares valued at \$84,952,000.

The 2001 acquisitions have been accounted for using the purchase method and, consequently, the results of operations of EXFO Burleigh and EXFO Photonic Solutions have been included in the consolidated statements of earnings of the company from the date of acquisition of these subsidiaries, being December 20, 2000, for EXFO Burleigh and March 15, 2001, for EXFO Photonic Solutions.

The fair value of subordinate voting shares issued as part of these business combinations was determined based on the market price of the shares beginning three days before and ending three days after the dates of acquisition of the subsidiaries.

The purchase price, including acquisition-related costs, has been allocated based on the estimated fair value of net assets at the dates of acquisition as follows:

	EXFO Burleigh	EXFO Photonic Solutions
Assets acquired		
Current assets	\$ 7,092	\$ 9,195
Property, plant and equipment	4,457	1,054
In-process research and development	1,800	972
Core technology (note 4)	24,000	25,324
Workforce	1,250	907
Trademark	-	421
Liabilities assumed	(9,068)	(7,169)
Future income tax liabilities	(8,342)	(983)
Net identifiable assets acquired	21,189	29,721
Goodwill (note 4)	168,081	80,425
Purchase price	189,270	110,146
Less: Subordinate voting shares issued	146,809	84,952
Cash paid, net of cash acquired	\$ 42,461	\$ 25,194

### Vanguard Technical Solutions, Inc.

On March 16, 2001, the company, through one of its subsidiaries, Burleigh Automation Inc., acquired substantially all the assets of Vanguard Technical Solutions, Inc., a U.S. company specializing in the design and manufacturing of ultra-precision assembly equipment for sensitive process and critical assembly challenges on the production floor. This acquisition, which was settled for a total cash consideration of \$600,000 allocated to property, plant and equipment, has been accounted for using the purchase method.

## 4 • Special charges

### Write-down of goodwill and intangible assets

In May 2003, the company performed its annual impairment test on goodwill for all its reporting units, except for newly acquired EXFO Gnubi. Also, considering market conditions in the telecommunications industry and the persisting unfavorable conditions affecting the subsidiaries' industries, the company reviewed the carrying value of intangible assets related to these reporting units, consisting primarily in acquired core technology.

As a result of this assessment, the company concluded that the carrying value of goodwill related to EXFO Burleigh and the carrying value of intangible assets related to EXFO Burleigh and EXFO Photonic Solutions was impaired and it recorded a charge of \$4,505,000 to write down goodwill and a pre-tax charge of \$2,922,000 to write down acquired core technology. Of the total impairment loss of \$7,427,000, \$6,872,000 is related to EXFO Burleigh for goodwill and acquired core technology, and \$555,000 is related to EXFO Photonic Solutions for acquired core technology.

For the purposes of estimating the fair values, the company used a combination of discounted future cash flows and a market approach (sales multiples). The discounted cash flows were estimated using periods ranging between eight and ten years, discount rates ranging between 15% and 20% and annual growth rates ranging between nil and 35%. The sales multiples used in the market approach ranged between 0.7 and 2.3.

In May 2002, as part of its review of financial results, the company performed an assessment of the carrying value of goodwill and intangible assets recorded in conjunction with the acquisitions of EXFO Burleigh, EXFO Photonic Solutions and EXFO Protocol. The assessment was performed because of the severe and continued downturn in the telecommunications industry, the persisting unfavorable market conditions affecting the subsidiaries' industries and the decline in technology valuations. The growth prospects for those subsidiaries were significantly lower than previously expected and less than those of historical periods, and the decline in market conditions affecting the subsidiaries was significant and other than temporary. As a result, the company concluded that the carrying value of goodwill and certain acquired intangible assets was impaired and it recorded a charge of \$222,169,000 to write down a significant portion of goodwill and a pre-tax charge of \$23,657,000 to write down a significant portion of acquired core technology. Of the total impairment loss of \$245,826,000, \$125,017,000 was related to EXFO Burleigh for goodwill and acquired core technology, \$71,508,000 was related to EXFO Photonic Solutions for goodwill and acquired core technology, and \$49,301,000 was related to EXFO Protocol for goodwill.

The impairment loss was calculated based upon existing accounting rules and represented the excess of the carrying value of the assets over the pre-tax undiscounted future cash flows. The pre-tax undiscounted future cash flows were estimated at the subsidiaries' level since the company had distinct cash flows for each of them and because they were not fully integrated into the company's activities. The cash flow periods used ranged from three to five years, using annual growth rates between 15% and 30%.

The assumptions supporting the estimated fair values and undiscounted future cash flows, including current and future industry conditions, reflect management's best estimates.

### Restructuring and other charges and inventory write-offs

During 2001, the company implemented a structured plan to reduce costs and increase efficiency. Under that plan, the company recorded charges of \$3,288,000, including \$844,000 in severance expenses for the 245 employees who were terminated throughout the company, \$1,476,000 for unused long-lived assets and \$968,000 for future payments on exited leased facilities. These charges are included in the restructuring and other charges in the statement of earnings for the year ended August 31, 2001. As at August 31, 2003, the accrued liabilities related to this restructuring plan amounted to \$124,000 and consisted primarily of future payments on exited leased facilities.

During 2002, the company implemented additional structured plans to further reduce its costs. Under these plans, the company recorded additional charges of \$2,880,000, including \$2,012,000 in severance expenses for the 350 employees who were terminated throughout the company and \$868,000 for unused long-lived assets. These charges are included in the restructuring and other charges in the statement of earnings for the year ended August 31, 2002. Furthermore, the company recorded \$18,463,000 in inventory write-offs for excess and obsolete inventories, which are included in the cost of sales in the statement of earnings for that same year. As at August 31, 2003, the accrued liabilities related to these restructuring plans amounted to \$68,000 and consisted of accrued cost for unused long-lived assets.

During 2003, the company implemented an additional restructuring plan to realign its cost structure to current market conditions. Under that plan, the company recorded additional charges of \$4,134,000, including \$2,767,000 in severance expenses for the 172 employees who were terminated throughout the company, \$512,000 for unused long-lived assets and \$855,000 for future payments on exited leased facilities. Those charges are included in the restructuring and other charges in the statement of earnings for the year ended August 31, 2003. In addition, the company recorded \$4,121,000 in inventory write-offs for excess and obsolete inventories, which are included in the cost of sales in the statement of earnings for that same year. As at August 31, 2003, the accrued liabilities related to the severance expenses and exited leased facilities incurred in 2003 amounted to \$2,276,000.

### Future income tax assets and research and development tax credits

During 2003, the company reviewed the carrying value of its future income tax assets and its research and development tax credits. Considering current market conditions and because the company recorded losses for current and past fiscal years, it concluded that it is more likely than not that its future income tax assets and some of its research and development tax credits will not be recoverable and that a valuation allowance and a write-off were required. Accordingly, the company recorded a valuation allowance of \$28,385,000 to write off all its future income tax assets mainly related to the parent company, EXFO Protocol and EXFO Burleigh and wrote off \$2,297,000 in research and development tax credits related to EXFO Protocol. The valuation allowance has been included in the income taxes in the statement of earnings for the year ended August 31, 2003 (note 15). The write-off of research and development tax credits has been included in the net research and development expenses in the statement of earnings for that same year (note 14).

## 5 • Inventories

As at August 31,	2003		2002	
Raw materials	\$	8,188	\$	13,507
Work in progress		1,022		1,382
Finished goods		6,392		8,933
	\$	15,602	\$	23,822

## 6 • Property, plant and equipment

As at August 31,	2003		2002	
	Cost	Accumulated amortization	Cost	Accumulated amortization
Land and land improvements	\$ 3,323	\$ 350	\$ 2,124	\$ -
Buildings	11,177	1,784	8,043	695
Equipment	33,560	21,790	29,177	14,662
Leasehold improvements	1,837	1,042	4,121	1,862
	49,897	\$ 24,966	43,465	\$ 17,219
Less: Accumulated amortization	24,966		17,219	
	\$ 24,931		\$ 26,246	

## 7 • Intangible assets and goodwill

As at August 31,	2003	2002
Core technology, net of accumulated amortization of \$20,986 (\$15,120 in 2002) (notes 3 and 4)	\$ 10,778	\$ 16,464
In-process research and development, net of accumulated amortization of \$4,496 (\$4,195 in 2002)	-	-
	\$ 10,778	\$ 16,464

Amortization expense for intangible assets in each of the next four years is \$3,932,000 in 2004, \$3,932,000 in 2005, \$2,497,000 in 2006 and \$417,000 in 2007.

The net carrying value of goodwill is comprised of the following:

As at August 31,	2003	2002
Balance – Beginning of year	\$ 17,576	\$ 219,172
Business combination (note 3)	2,958	57,987
Amortization (note 2)	-	(38,021)
Write-down (note 4)	(4,505)	(222,169)
Effect of foreign exchange rate	1,644	607
Balance – End of year	\$ 17,673	\$ 17,576

## 8 • Credit facilities

The company has a line of credit which provides for advances of up to Cdn\$10,000,000 (US\$7,220,000). This line of credit, which is renewable annually, bears interest at prime rate (prime rate in 2002). Short-term investments, accounts receivable, inventories and all tangible and intangible assets of the company have been pledged as collateral against this line of credit. As at August 31, 2003, Cdn\$1,400,000 (US\$1,000,000) has been reserved from this line of credit for letters of guarantee (note 12). As at August 31, 2002, this line of credit was unused.

## 9 • Accounts payable and accrued liabilities

As at August 31,	2003	2002
Trade	\$ 4,227	\$ 4,738
Salaries and social benefits	3,462	2,638
Warranty	687	849
Tax on capital	381	856
Restructuring charges (notes 4 and 19)	2,468	782
Other	801	836
	\$ 12,026	\$ 10,699

## 10 • Long-term debt

As at August 31,	2003	2002
Loans collateralized by equipment, bearing interest at 9.6%, repayable in monthly installments of \$13,000 including principal and interest, maturing in 2008	\$ 563	\$ 664
Less: Current portion	110	100
	\$ 453	\$ 564

As at August 31, 2003, minimum principal repayments required in each of the next five years are \$110,000 in 2004, \$122,000 in 2005, \$135,000 in 2006, \$146,000 in 2007 and \$50,000 in 2008.

## 11 • Commitments

The company has entered into operating leases for certain of its premises and equipment, which expire at various dates through May 2011. As at August 31, 2003, minimum rentals payable under these operating leases in each of the next five years are \$1,078,000 in 2004, \$908,000 in 2005, \$898,000 in 2006, \$764,000 in 2007 and \$448,000 in 2008. As at August 31, 2003, total commitments under these operating leases amounted to \$5,316,000.

For the years ended August 31, 2001, 2002 and 2003, rental expense amounted to \$1,580,000, \$1,936,000 and \$1,718,000, respectively (note 19).

## 12 • Contingencies

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 pre-determined prices.

On April 19, 2002, the plaintiffs filed an amended complaint containing master allegations against all of the underwriters 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 judgment 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.

On June 26, 2003, the Plaintiff's Executive Committee announced that a proposed settlement between the issuers and their directors and officers and the plaintiffs had been structured. A Memorandum of Understanding ("MOU") to settle the plaintiffs' claims against the issuers and their directors and officers has now been approved as to form and the process of obtaining approval by all parties to the MOU is now underway. The parties will be required to prepare many complex documents necessary to consummate the settlement, which will be submitted to the Court for preliminary approval. Final approval will be required by the Court following notice to class members and a fairness hearing. If this tentative settlement is successfully finalized, the company and the individual defendants will be released from the litigation. Any direct financial impact of the proposed settlement is expected to be borne by the company's insurance carriers.

Since the settlement process is subject to a fairness hearing and final court approval, it is possible that it could fail. Therefore, it is not possible to predict the final outcome of the case, nor determine the amount of any possible losses. If the settlement process fails, the company will continue to defend its position in this litigation that the claims against it, and its officers, are without merit. Accordingly, no provision for this case has been made in the consolidated financial statements as of August 31, 2003.

As at August 31, 2003, the company has outstanding letters of guarantee of \$1,232,000, which expire at various dates through 2006. From this amount, \$1,000,000 has been reserved from the line of credit (note 8).

## 13 • Share capital

Authorized – unlimited as to number, without par value

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

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

The following table summarizes the share capital activity since August 31, 2000:

	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
Balance as at August 31, 2000	38,000,000	\$ 1	8,757,264	\$ 198,458	\$ 198,459
Business combinations (note 3)	-	-	10,188,816	231,761	231,761
Conversion of multiple voting shares into subordinate voting shares	(100,000)	-	100,000	-	-
Redemption	-	-	(43,999)	(33)	(33)
Resale	-	-	43,999	33	33
Share issue expenses, net of related income taxes	-	-	-	(225)	(225)
Balance as at August 31, 2001	37,900,000	1	19,046,080	429,994	429,995
Business combination (note 3)	-	-	4,374,573	59,625	59,625
Exercise of stock awards	-	-	144,532	-	-
Redemption	-	-	(7,022)	(6)	(6)
Resale	-	-	7,022	6	6
Share issue expenses, net of related income taxes	-	-	-	(9)	(9)
Balance as at August 31, 2002	37,900,000	1	23,565,185	489,610	489,611
Business combination (note 3)	-	-	1,479,290	2,796	2,796
Exercise of stock options	-	-	25,498	45	45
Exercise of stock awards	-	-	69,935	-	-
Redemption	-	-	(21,515)	(16)	(16)
Resale	-	-	21,515	16	16
Balance as at August 31, 2003	37,900,000	\$ 1	25,139,908	\$ 492,451	\$ 492,452

## Stock purchase plan

The company's stock purchase plan terminated at the time of the initial public offering, being June 29, 2000. In accordance with that plan, officers, directors and key employees could purchase Class F shares up to a maximum of 5% of all participating, issued and outstanding shares of the company. The purchase price of shares under that plan was determined as a multiple of the company's equity as at the end of the preceding fiscal year. Shares issued under that plan are restricted as to sale and transferability for a period of at least five years from the date of acquisition. Prior to its initial public offering, the company issued 707,264 Class F shares in exchange for a weighted average cash consideration of Cdn\$0.98 (US\$0.67) per share. On June 29, 2000, the 707,264 issued and outstanding Class F shares were converted into 707,264 subordinate voting shares on a one-for-one basis.

## Stock option plan

In May 2000, the company established a stock option plan for directors, executive officers, employees and consultants and those of the company's subsidiaries, as determined by the Board of Directors.

The maximum number of subordinate voting shares issuable under the plan cannot exceed 4,470,961 shares. The maximum number of subordinate voting shares that may be granted to any individual cannot exceed 5% of the number of outstanding subordinate voting shares. The exercise price is the market price of the common shares on the date of grant. Options granted under the plan generally expire ten years from the date of grant. Options granted under the plan generally vest over a four-year period, with 25% vesting on an annual basis commencing on the first anniversary of the date of grant. Up to October 10, 2000, the number of options, which ultimately would become exercisable in any given year, and in aggregate, was dependent on the degree to which the company's financial performance objectives were met. Nevertheless, on October 10, 2000, the Board of Directors of the company amended the vesting terms for options granted pursuant to the option plan to remove the financial performance criterion. Accordingly, options granted vest over the four-year period. The Board of Directors may accelerate the vesting of any or all outstanding options upon the occurrence of a change of control.

The following table summarizes stock option activity since August 31, 2000:

Years ended August 31,	2003		2002		2001	
	Number	Weighted average exercise price	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding – Beginning of year	2,597,574	\$ 22	2,414,231	\$ 28	609,734	\$ 26
Granted	1,268,450	2	1,039,805	10	2,153,352	29
Exercised	(25,498)	(2)	-	-	-	-
Forfeited	(663,913)	(17)	(856,462)	(25)	(348,855)	(29)
Outstanding – End of year	3,176,613	\$ 15	2,597,574	\$ 22	2,414,231	\$ 28
Exercisable – End of year	1,068,595	\$ 22	512,161	\$ 28	127,561	\$ 26

The following table summarizes information about stock options as at August 31, 2003:

Exercise price	Options outstanding as at August 31, 2003			Options exercisable as at August 31, 2003		
	Number	Weighted average exercise price	Weighted average remaining contractual life	Number	Weighted average exercise price	Weighted average remaining contractual life
\$1.58 to \$2.16	873,850	\$ 1.59	3.1 years	108,224	\$ 1.58	3.1 years
\$2.59 to \$3.63	224,400	3.39	3.3 years	28,744	3.37	3.3 years
\$5.65	35,479	5.65	2.5 years	8,870	5.65	2.5 years
\$9.13 to \$12.69	676,246	10.12	2.2 years	169,062	10.12	2.2 years
\$19.19 to \$27.80	1,047,812	23.90	1.2 years	594,282	24.15	1.2 years
\$34.07 to \$45.94	269,276	43.58	1.1 years	134,638	43.58	1.1 years
\$56.75	49,550	56.75	1.0 year	24,775	56.75	1.0 year
	3,176,613	\$ 15.36	2.1 years	1,068,595	\$ 22.14	1.6 years

## Restricted stock award plan

On December 20, 2000, the company established a restricted stock award plan for employees of EXFO Burleigh. Each stock award entitles employees to receive one subordinate voting share at a purchase price of nil. Stock awards granted under the plan vest over a four-year period, with 25% vesting on an annual basis commencing on the first anniversary of the date of grant. According to the plan, upon the involuntary termination of a member of the defined management team, all outstanding restricted stock awards granted to such an employee automatically vest. The plan will expire on December 20, 2004.

The following table summarizes restricted stock awards activity since December 2000:

Years ended August 31,	2003	2002	2001
Outstanding – Beginning of year	215,249	359,781	-
Granted	-	-	359,781
Exercised	(69,935)	(144,532)	-
Forfeited	(2,218)	-	-
Outstanding – End of year	143,096	215,249	359,781
Exercisable – End of year	-	-	-

As of August 31, 2003, the weighted average remaining contractual life of the outstanding restricted stock awards was 1.3 years.

## Stock appreciation rights plan

On August 4, 2001, the company established a stock appreciation rights plan for certain employees. Under that plan, eligible employees are entitled to receive a cash amount equivalent to the difference between the market price of the common shares on the date of exercise and the exercise price determined on the date of grant. Stock appreciation rights granted under the plan generally expire ten years from the date of grant. Stock appreciation rights vest over a four-year period, with 25% vesting on an annual basis commencing on the first anniversary of the date of grant.

Considering the market price of the common shares of US\$2.64 as at August 31, 2003, compensation expense for those stock appreciation rights was nominal as at August 31, 2003.

The following table summarizes stock appreciation rights activity since August 2001:

Years ended August 31,	2003		2002		2001	
	Number	Weighted average exercise price	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding – Beginning of year	10,000	\$ 26	22,400	\$ 30	-	\$ -
Granted	5,000	2	1,000	12	22,400	30
Forfeited	(6,000)	(9)	(13,400)	(31)	-	-
Outstanding – End of year	9,000	\$ 24	10,000	\$ 26	22,400	\$ 30
Exercisable – End of year	3,500	\$ 30	2,250	\$ 27	-	\$ -

The following table summarizes information about stock appreciation rights as at August 31, 2003:

	Stock appreciation rights outstanding as at August 31, 2003		Stock appreciation rights exercisable as at August 31, 2003	
Exercise price	Number	Weighted average remaining contractual life	Number	Weighted average remaining contractual life
\$2.10	2,000	3.7 years	-	-
\$19.19 to \$22.25	4,500	1.3 years	2,250	1.3 years
\$45.94	2,500	1.0 year	1,250	1.0 year
	9,000	1.8 years	3,500	1.2 years

## Pro forma information on stock-based compensation plans

The company has elected not to account for stock-based compensation costs arising from awards to employees using the fair value-based method as permitted by the new accounting standard (note 2). However, the company is required to make pro forma disclosures of net loss and net loss per share as if the fair value-based method of accounting had been applied.

Therefore, if the fair value-based method had been used to account for stock-based compensation costs related to stock options granted to employees since the adoption of the new standard on September 1, 2002, the net loss and the related net loss per share figures would be as follows on a pro forma basis:

	Year ended August 31, 2003
Net loss for the year	\$ (54,950)
Pro forma adjustment for stock-based compensation costs	(338)
Pro forma net loss for the year	\$ (55,288)
Basic and diluted net loss per share	\$ (0.87)
Basic and diluted pro forma net loss per share	\$ (0.88)

These options, which have a weighted average fair value of \$0.81, will generate aggregate stock-based compensation costs of \$887,000 over their vesting periods. Those costs will be amortized over their vesting periods using the graded vesting method resulting in annual stock-based compensation costs of \$282,000 in 2004, \$175,000 in 2005, \$84,000 in 2006 and \$8,000 in 2007.

The fair value of options granted was estimated using the Black-Scholes options valuation model with the following weighted average assumptions:

	Year ended August 31, 2003
Risk-free interest rate	4.2%
Expected volatility	80%
Dividend yield	Nil
Expected life	29 months

The Black-Scholes options valuation model was developed for use in estimating the fair value of traded options and awards which have no vesting restrictions, and are fully transferable. In addition, option and award valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

## 14 • Other disclosures

### Net research and development expenses

Net research and development expenses comprise the following:

Years ended August 31,	2003	2002	2001
Gross research and development expenses	\$ 17,133	\$ 17,005	\$ 17,601
Research and development tax credits	(3,506)	(3,890)	(3,369)
Government grants	(45)	(333)	(631)
Write-off of research and development tax credits (note 4)	2,297	-	-
	\$ 15,879	\$ 12,782	\$ 13,601

All tax credits written off can be carried forward against future years' income taxes payable over the next ten years.

### Other grants and tax credits

During 1998, the company entered into an agreement with the Quebec Minister of Industry, Commerce, Science and Technology (the "Minister"). Pursuant to this agreement, the Minister agreed to contribute, in the form of grants, up to a maximum of Cdn\$600,000 (US\$433,000) toward interest costs incurred over the period from January 1, 1998, through December 31, 2002. In addition, the Minister agreed to provide grants up to a maximum of Cdn\$2,220,000 (US\$1,603,000) over the period from January 1, 1998, through December 31, 2002, payable based on the number of full-time jobs created during the period.

The above grants are subject to the condition that jobs created pursuant to the agreement be maintained for a period of at least five years from the date of creation. Should this condition not be met by the company, the Minister may enforce various recourse options, which include suspension or cancellation of the agreement or requiring the repayment of amounts received by the company. Since the beginning of this program, the company recognized the maximum amount of Cdn\$2,820,000 (US\$2,036,000), of which Cdn\$2,003,000 (US\$1,446,000) has been credited to earnings with the balance of Cdn\$817,000 (US\$590,000) having been included in deferred grants in the balance sheet.

Furthermore, in 1999, the company entered into another agreement with the Minister. Pursuant to this agreement, the Minister agreed to provide grants over the period from February 1998 to June 2002, payable based on the number of jobs created and certain specific training expenses related to such jobs. The above grant is subject to the condition that the new employees continue to participate in the specific training program for a period of at least ten consecutive months. Should this condition not be met by the company, the Minister may enforce various recourse options, which include suspension or cancellation of the agreement or requiring the repayment of amounts received by the company. Since 1998, the company has recognized a total of Cdn\$2,965,000 (US\$2,141,000) under this program, which has been credited to earnings.

Should repayments of any amounts received pursuant to these agreements be required, such repayments will be charged to earnings as the amount of any repayment becomes known.

Finally, since 2000, companies operating in the Quebec City area are eligible for a refundable tax credit granted by the Quebec provincial government. This credit is earned on the increase of production and marketing salaries incurred in the Quebec City area at a rate of 40%. Since 2000, the company has recognized a total of Cdn\$5,664,000 (US\$4,089,000) under this program, of which Cdn\$4,905,000 (US\$3,540,000) has been credited to earnings with the balance of Cdn\$759,000 (US\$549,000) having been included in deferred grants in the balance sheet.

The reduction in the company's workforce described in note 4 had no effect on amounts already recognized in the statements of earnings under these programs.

Following is a summary of the classification of these and certain other grants and tax credits (government grants) in the statements of earnings of the reporting years.

Cost of sales for the years ended August 31, 2001, 2002 and 2003, is net of government grants of \$1,742,000, \$546,000 and \$518,000, respectively.

Selling and administrative expenses for the years ended August 31, 2001, 2002 and 2003, are net of government grants of \$260,000, \$213,000 and \$286,000, respectively.

Research and development expenses for the years ended August 31, 2001, 2002 and 2003, are net of government grants of \$631,000, \$333,000 and \$45,000, respectively.

### Defined contribution plans

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

- **Deferred profit-sharing plan**  
The company maintains a plan for certain eligible Canadian resident employees, under which the company may elect to contribute an amount equal to 1% of an employee's gross salary, provided that the employee has contributed at least 2% of his/her gross salary to a tax-deferred registered retirement savings plan. From June 2002 to December 2002, the company suspended its contributions to the plan as part of its cost-reduction efforts. Contributions to this plan during the years ended August 31, 2001, 2002 and 2003, amounted to Cdn\$407,000 (US\$266,000), Cdn\$136,000 (US\$86,000) and Cdn\$93,000 (US\$63,000), respectively.
- **401K plan**  
The company maintains a 401K plan for eligible U.S. resident employees. Under this plan, the company may elect to contribute an amount equal to 3% of an employee's current compensation. During the years ended August 31, 2001, 2002 and 2003, the company recorded contributions totaling \$285,000, \$317,000 and \$253,000, respectively.

## 15 • Income taxes

The reconciliation of the income tax provision calculated using the combined Canadian federal and provincial statutory income tax rate to the provision for income taxes per the financial statements is as follows:

Years ended August 31,	2003	2002	2001
Income taxes at combined Canadian federal and provincial statutory tax rate (34% in 2003, 36% in 2002 and 37% in 2001)	\$ (12,031)	\$ (26,563)	\$ 8,855
Increase (decrease) due to:			
Manufacturing and processing deduction	307	525	(1,201)
Difference between combined Canadian federal and provincial statutory tax rate and foreign subsidiaries statutory tax rates	(999)	(1,101)	60
Non-taxable income	(298)	(143)	(144)
Non-deductible expenses	77	334	274
Reduction of Canadian federal statutory tax rate	92	168	-
Effect of consolidation of subsidiaries	184	1,325	(276)
Tax deductions	(80)	(518)	(136)
Previous year tax recovery upon a tax assessment	(645)	-	-
Other	67	522	356
Change in valuation allowance	28,385	-	362
	\$ 15,059	\$ (25,451)	\$ 8,150

The provision for income taxes consist of the following:

Current			
Canadian	\$ 4,829	\$ (10,816)	\$ 8,416
United States	(247)	(1,232)	1,305
Other	339	(6)	208
	4,921	(12,054)	9,929
Future			
Canadian	(13,553)	(4,475)	578
United States	(4,307)	(8,694)	(2,719)
Other	(387)	(228)	-
	(18,247)	(13,397)	(2,141)
Valuation allowance			
Canadian	20,359	-	-
United States	7,374	-	-
Other	652	-	362
	28,385	-	362
	\$ 15,059	\$ (25,451)	\$ 8,150

Details of the company's income taxes:

Earnings (loss) before income taxes and amortization and write-down of goodwill			
Canadian	\$ (20,449)	\$ (47,431)	\$ 28,202
United States	(8,611)	(28,228)	(5,356)
Other	(6,326)	1,874	1,086
	\$ (35,386)	\$ (73,785)	\$ 23,932

Significant components of the company's future income tax assets and liabilities are as follows:

As at August 31,	2003	2002
Future income tax assets		
Property, plant and equipment and intangible assets	\$ 3,287	\$ 3,725
Provisions and accruals	9,786	1,339
Government grants	185	206
Deferred revenue	140	-
Share issue expenses	1,434	1,069
Restructuring charges	-	715
Research and development expenses	3,621	1,178
Losses carried forward	13,770	6,911
	32,223	15,143
Valuation allowance	(28,846)	(359)
	\$ 3,377	\$ 14,784
Future income tax liabilities		
Property, plant and equipment and intangible assets	\$ (2,848)	\$ (4,566)
Research and development tax credits	(497)	(150)
Provisions and accruals	(32)	(66)
	(3,377)	(4,782)
Future income tax assets, net	\$ -	\$ 10,002

As at August 31, 2003, the company had available operating losses in several tax jurisdictions, for which a valuation allowance was established. The following table summarizes the year of expiry of these operating losses by tax jurisdiction:

Year of expiry	Canada		United States and Other
	Federal	Provincial	
2005	\$ 40,000	\$ 7,000	\$ -
2006	189,000	233,000	-
2007	1,467,000	1,799,000	155,000
2008	4,959,000	5,259,000	1,431,000
2009	2,390,000	2,070,000	-
2010	12,261,000	1,585,000	-
2022	-	-	9,102,000
2023	-	-	11,115,000
Indefinite	-	-	1,267,000
	<b>\$ 21,306,000</b>	<b>\$ 10,953,000</b>	<b>\$ 23,070,000</b>

Also, as at August 31, 2003, the company had available research and development expenses in Canada of \$11,982,000 at the federal level and \$12,330,000 at the provincial level, for which a valuation allowance was established. These expenses can be carried forward indefinitely against future years' taxable income.

## 16 • Segment information

Management has organized the company under one operating segment, being the development, manufacturing and marketing of fiber-optic test, measurement and monitoring solutions. This operating segment is composed of Portable and Monitoring products and Industrial and Scientific products (note 21).

Product sales are detailed as follows:

Years ended August 31,	2003	2002	2001
Portable and Monitoring products	\$ 40,069	\$ 38,887	\$ 69,399
Industrial and Scientific products	21,861	29,443	76,614
	<b>\$ 61,930</b>	<b>\$ 68,330</b>	<b>\$ 146,013</b>

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

Years ended August 31,	2003	2002	2001
United States	\$ 31,561	\$ 35,129	\$ 72,604
Canada	4,806	3,971	12,531
Europe	9,584	9,539	30,568
Asia	10,004	12,971	19,059
Latin America	4,467	2,581	5,838
Other	1,508	4,139	5,413
	<b>\$ 61,930</b>	<b>\$ 68,330</b>	<b>\$ 146,013</b>

Sales have been allocated to geographic regions based on the country of residence of the related customers. In 2003 and 2001, there were no customers from which 10% or more of sales were derived, while in 2002, one customer represented more than 10% of sales with 10.2% of sales (\$6,965,000).

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

As at August 31,	2003	2002
Canada	\$ 43,402	\$ 44,145
United States	9,980	16,141
	<b>\$ 53,382</b>	<b>\$ 60,286</b>

Long-lived assets consist of property, plant and equipment, intangible assets and goodwill.

## 17 • Loss 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 used in the diluted loss per share calculations:

Years ended August 31,	2003	2002	2001
Basic weighted average number of shares outstanding (000's)	<b>62,852</b>	60,666	53,014
Dilutive effect of stock options (000's)	<b>301</b>	31	231
Dilutive effect of restricted stock awards (000's)	<b>164</b>	269	250
<b>Diluted weighted average number of shares outstanding (000's)</b>	<b>63,317</b>	60,966	53,495
Stock options excluded from the calculation of diluted loss per share because the exercise price was greater than the average market price of the common shares (000's)	<b>2,533</b>	2,734	953

The diluted loss per share for the years ended August 31, 2001, 2002 and 2003, was the same as the basic loss per share since the dilutive effect of stock options and restricted stock awards should not be included in the calculation; otherwise, the effect would be anti-dilutive. Accordingly, diluted loss per share for those years was calculated using the basic weighted average number of shares outstanding.

## 18 • Financial instruments

### Short-term investments

Short-term investments consist of the following:

As at August 31,	2003	2002
Commercial paper denominated in Canadian dollars, bearing interest at annual rates of 2.61% to 2.93% in 2002 and 2.65% to 3.10% in 2003, maturing on different dates between September 2002 and November 2002 in 2002, and October 2003 and January 2004 in 2003	<b>\$ 52,010</b>	\$ 40,553

### Fair value

Cash, accounts receivable, accounts payable and accrued liabilities and long-term debt are financial instruments whose fair values approximate their carrying values.

The fair value of short-term investments, based on market value, amounted to \$40,553,000 and \$52,010,000 as at August 31, 2002 and 2003, respectively.

The fair value of forward exchange contracts, based on the current trading value, amounted to Cdn\$13,510,000 and Cdn\$18,550,000 as at August 31, 2002 and 2003, respectively. As at August 31, 2002, these forward exchange contracts generated deferred unrealized losses of US\$39,000, compared to deferred unrealized gains of US\$1,800,000 as at August 31, 2003. Deferred unrealized gains or losses were calculated using year-end exchange rates.

### Credit risk

Financial instruments which potentially subject the company to credit risk consist primarily of cash, short-term investments, accounts receivable and forward exchange contracts. The company's short-term investments consist of debt instruments issued by high-credit quality corporations. 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 remote.

Due to the geographic distribution of the company's customers, there is no particular concentration of credit risk. 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 \$520,000 and \$568,000 as at August 31, 2002 and 2003, respectively.

### Interest rate risk

As at August 31, 2003, the company's exposure to interest rate risk is summarized as follows:

Cash	Non-interest bearing
Short-term investments	As described above
Accounts receivable	Non-interest bearing
Accounts payable and accrued liabilities	Non-interest bearing
Long-term debt	As described in note 10

## Forward exchange contracts

The company is exposed to currency risks as a result of its export sales of products manufactured in Canada, substantially all of which are denominated in US dollars. These risks are partially hedged by forward exchange contracts and certain operating expenses. As at August 31, 2002 and 2003, the company held contracts to sell US dollars at various forward rates, which are summarized as follows:

	Contractual amounts	Weighted average contractual forward rates
As at August 31, 2002		
September 2002 to August 2003	\$ 6,400	1.5464
September 2003 to June 2004	2,200	1.5679
As at August 31, 2003		
September 2003 to August 2004	\$ 6,470	1.5869
September 2004 to August 2005	6,680	1.5647

## 19 • Related party transactions

In 2003, EXFO acquired a building from a company owned by the President of the company for a cash consideration of \$930,000. This transaction was measured at the fair market value since it was not in the normal course of operations, the change in ownership interest in the building was substantive and the fair market value was supported by an independent appraisal.

For the years ended August 31, 2001, 2002 and 2003, EXFO leased facilities from a company owned by the President of the company. The annual rental expense amounted to \$238,000, \$234,000 and \$331,000, respectively. The rental expense for 2003 included \$234,000 for future payments on an exited leased facility; this expense has been recorded in the restructuring and other charges in the statement of earnings (notes 4 and 9). This lease will not be renewed at expiry. These rental expenses were measured at the fair market value since they were made in the normal course of operations.

## 20 • United States generally accepted accounting principles

As a registrant with the Securities and Exchange Commission in the United States, the company is required to reconcile its financial statements for significant differences between generally accepted accounting principles as applied in Canada (Canadian GAAP) and those applied in the United States (U.S. GAAP). Additional significant disclosures required under U.S. GAAP have also been provided in the accompanying financial statements and notes. The following summarizes the significant differences between Canadian and U.S. GAAP and other significant required disclosures under U.S. GAAP not already provided in the accompanying financial statements.

### Reconciliation of net loss to conform with U.S. GAAP

The following summary sets out the significant differences between the company's reported net loss and net loss per share under Canadian GAAP as compared to U.S. GAAP. Please see corresponding explanatory notes in the Reconciliation Items section.

Years ended August 31,	2003	2002	2001
Net loss for the year in accordance with Canadian GAAP	\$ (54,950)	\$ (308,524)	\$ (15,294)
Non-cash stock-based compensation costs related to stock option plan a)	216	49	(954)
Non-cash stock-based compensation costs related to stock purchase plan a)	(61)	(661)	(477)
Non-cash stock-based compensation costs related to restricted stock award plan a)	(987)	(3,038)	(3,481)
Unrealized gains on forward exchange contracts b)	1,645	444	97
Future income taxes on forward exchange contracts b)	(543)	(212)	20
Future income taxes on acquired in-process research and development d)	-	(444)	(936)
Amortization of intangible assets e)	832	239	-
Future income taxes on amortization of intangible assets e)	(279)	(80)	-
Valuation allowance on future income tax assets f)	(252)	-	-
Amortization of goodwill d), e)	-	(9,263)	(8,453)
Write-down of goodwill and intangible assets e)	6,178	(62,557)	-
Future income taxes on write-down of intangible assets e)	-	1,154	-
Net loss for the year in accordance with U.S. GAAP	(48,201)	(382,893)	(29,478)
Other comprehensive income (loss)			
Foreign currency translation adjustments	15,974	(521)	(9,888)
Comprehensive loss	\$ (32,227)	\$ (383,414)	\$ (39,366)
Basic and diluted net loss per share in accordance with U.S. GAAP g)	\$ (0.77)	\$ (6.31)	\$ (0.56)

### Shareholders' equity

As a result of the aforementioned adjustments to net loss, significant differences with respect to shareholders' equity under U.S. GAAP are as follows:

#### Share capital

As at August 31,	2003	2002	2001
Share capital in accordance with Canadian GAAP	\$ 492,452	\$ 489,611	\$ 429,995
Stock-based compensation costs related to stock purchase plan a), h)			
Current year	(75)	(64)	(150)
Cumulative effect of prior years	2,478	2,542	2,692
Reclassification from other capital upon exercise of restricted stock awards			
Current year	1,582	3,270	-
Cumulative effect of prior years	3,270	-	-
Shares issued upon business combinations d)			
Cumulative effect of prior years	65,584	65,584	65,584
Share capital in accordance with U.S. GAAP	\$ 565,291	\$ 560,943	\$ 498,121

**Deferred stock-based compensation costs**

As at August 31,	2003	2002	2001
Deferred stock-based compensation costs in accordance with Canadian GAAP	\$ -	\$ -	\$ -
Stock-based compensation costs related to stock-based compensation plans a), h)			
Current year	-	-	(8,145)
Cumulative effect of prior years	(2,867)	(7,968)	(19,429)
Amortization for the year	1,483	4,698	4,912
Reduction of stock-based compensation costs	106	403	14,694
Deferred stock-based compensation costs in accordance with U.S. GAAP	\$ (1,278)	\$ (2,867)	\$ (7,968)

**Other capital**

As at August 31,	2003	2002	2001
Other capital in accordance with Canadian GAAP	\$ -	\$ -	\$ -
Stock-based compensation costs related to stock-based compensation plans a), h)			
Current year	-	-	8,145
Cumulative effect of prior years	10,963	12,350	18,749
Reduction of stock-based compensation costs	(682)	(1,387)	(14,544)
Reclassification to share capital upon exercise of restricted stock awards			
Current year	(1,582)	(3,270)	-
Cumulative effect of prior years	(3,270)	-	-
Other capital in accordance with U.S. GAAP	\$ 5,429	\$ 7,693	\$ 12,350

**Deficit**

As at August 31,	2003	2002	2001
Deficit in accordance with Canadian GAAP	\$ (371,788)	\$ (316,838)	\$ (8,314)
Stock-based compensation costs related to stock-based compensation plans a)			
Current year	(832)	(3,650)	(4,912)
Cumulative effect of prior years	(10,574)	(6,924)	(2,012)
Unrealized gains on forward exchange contracts, net of related future income taxes b)			
Current year	1,102	232	117
Cumulative effect of prior years	349	117	-
Change in reporting currency c)			
Cumulative effect of prior years	1,016	1,016	1,016
Future income taxes on acquired in-process research and development d)			
Current year	-	(444)	(936)
Cumulative effect of prior years	(1,380)	(936)	-
Amortization of intangible assets e)			
Current year	832	239	-
Cumulative effect of prior years	239	-	-
Future income taxes on amortization of intangible assets e)			
Current year	(279)	(80)	-
Cumulative effect of prior years	(80)	-	-
Write-down of goodwill and intangible assets e)			
Current year	6,178	(62,557)	-
Cumulative effect of prior years	(62,557)	-	-
Future income taxes on write-down of intangible assets e)			
Current year	-	1,154	-
Cumulative effect of prior years	1,154	-	-
Valuation allowance on future income tax assets f)			
Current year	(252)	-	-
Amortization of goodwill d), e)			
Current year	-	(9,263)	(8,453)
Cumulative effect of prior years	(17,716)	(8,453)	-
Deficit in accordance with U.S. GAAP	\$ (454,588)	\$ (406,387)	\$ (23,494)

**Accumulated other comprehensive income (loss)**

As at August 31,	2003	2002	2001
Foreign currency translation adjustments c)			
Balance – Beginning of year	\$ (9,870)	\$ (9,349)	\$ 539
Change during the year	15,974	(521)	(9,888)
Balance – End of year	\$ 6,104	\$ (9,870)	\$ (9,349)

## Balance sheets

The following table summarizes the significant differences in balance sheet items between Canadian GAAP and U.S. GAAP:

		As at August 31, 2003		As at August 31, 2002	
		As reported	U.S. GAAP	As reported	U.S. GAAP
Intangible assets	d), e)				
Cost		\$ 36,260	\$ 32,322	\$ 37,927	\$ 30,301
Accumulated amortization		(25,482)	(21,652)	(21,463)	(17,030)
		\$ 10,778	\$ 10,670	\$ 16,464	\$ 13,271
Goodwill	d), e)				
Cost		\$ 89,721	\$ 99,137	\$ 87,025	\$ 92,747
Accumulated amortization		(72,048)	(90,350)	(69,449)	(87,251)
		\$ 17,673	\$ 8,787	\$ 17,576	\$ 5,496
Shareholders' equity					
Share capital	a), d), h)	\$ 492,452	\$ 565,291	\$ 489,611	\$ 560,943
Contributed surplus		1,519	1,519	1,487	1,487
Cumulative translation adjustment	c)	7,643	-	(8,854)	-
Deferred stock-based compensation costs	a), h)	-	(1,278)	-	(2,867)
Other capital	a)	-	5,429	-	7,693
Deficit	a), b), c), d), e), f)	(371,788)	(454,588)	(316,838)	(406,387)
Accumulated other comprehensive income (loss)	c)	-	6,104	-	(9,870)
		\$ 129,826	\$ 122,477	\$ 165,406	\$ 150,999

## Statements of cash flows

For the years ended August 31, 2001, 2002 and 2003, there are no significant differences between the statements of cash flows under Canadian GAAP as compared to U.S. GAAP.

## Reconciliation items

### a) Accounting for stock-based compensation

To conform with U.S. GAAP, the company measures stock-based compensation costs using the intrinsic value method (APB 25 "Accounting for Stock Issued to Employees").

#### Stock purchase plan

Under APB 25, compensation cost related to the stock purchase plan is measured as the difference between the fair value of the purchased stock and the purchase price paid by plan participants. Compensation cost is amortized to expense over a period of five years, being the restriction period. This plan terminated at the time of the Initial Public Offering on June 29, 2000.

#### Stock option plan

In accordance with APB 25, the company's stock option plan was considered to be a variable plan until October 10, 2000. As a result of the amendment to the stock option plan described in note 13, the performance criterion was removed and the number of shares to be issued under the plan was fixed and the company recorded, in 2001, a net reduction of the compensation cost and deferred compensation cost previously recognized of \$467,000 and \$14,544,000, respectively. Compensation cost under this plan is measured as the difference between the fair value of the underlying stock at the date of grant and the exercise price of the option. Compensation cost is amortized to expense over the estimated vesting period up to a maximum of four years.

#### Restricted stock award plan

Under APB 25, compensation cost related to the restricted stock award plan is measured as the difference between the fair value of the underlying stock at the date of grant and the exercise price, which is nil. Compensation cost is amortized to expense over the estimated vesting period up to a maximum of four years, being the acquisition period.

Under Canadian GAAP, no compensation cost is recognized for these stock-based compensation plans.

### b) Forward exchange contracts

On September 1, 2000, the company prospectively adopted Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) and its amendments (SFAS 138), which require all derivatives to be carried onto the balance sheet at fair value. The forward exchange contracts used by the company have not qualified for hedging accounting treatment during the years ended August 31, 2001, 2002 and 2003 under U.S. GAAP; accordingly, changes in the fair value of the derivatives have been charged to earnings during these years.

Under Canadian GAAP, the company's forward exchange contracts held for the purpose of hedging anticipated sales qualified for hedge accounting and any foreign exchange translation gains or losses on those contracts were recognized as an adjustment of the revenues when the sale was recognized.

### c) Change in reporting currency

On September 1, 1999, the company adopted the US dollar as its reporting currency. Under U.S. GAAP, the financial statements, including prior years, are translated according to the current rate method. Under Canadian GAAP, at the time of change in reporting currency, the historical financial statements are presented using a translation of convenience. This difference between U.S. GAAP and Canadian GAAP created a permanent difference of \$1,016,000 affecting the cumulative translation adjustment and the retained earnings.

### d) Business combinations

Under Canadian GAAP, until June 30, 2001, the value of shares issued upon a business combination was determined based on the market price of the shares over a reasonable period of time before and after the date of acquisition. Under U.S. GAAP, the value of shares was determined based on the market price of the shares over a reasonable period of time before and after the companies had reached an agreement on the purchase price; the significant terms of the agreement were known and the proposed transaction was announced.

Consequently, the measurement dates of the acquisitions of EXFO Burleigh and EXFO Photonic Solutions for U.S. GAAP purposes occurred on December 14, 2000, and on March 6, 2001, respectively; that is, the dates on which all significant terms of the agreements were known. The average market price of the shares a few days before and after those dates was \$31.09 and \$25.84, respectively. Considering the number of shares issued upon those acquisitions, the total consideration for U.S. GAAP purposes amounts to \$244,198,000 (\$189,270,000 under Canadian GAAP) for EXFO Burleigh and \$120,802,000 (\$110,146,000 under Canadian GAAP) for EXFO Photonic Solutions, thus increasing share capital and goodwill under U.S. GAAP.

However, since July 1, 2001, the shares issued upon a business combination are valued under Canadian GAAP using the same method as used under U.S. GAAP.

Furthermore, under U.S. GAAP, in-process research and development acquired in a business combination is written off at the time of acquisition and no future income taxes are recognized on this asset in the purchase price allocation process. Under Canadian GAAP, in-process research and development acquired in a business combination is capitalized and amortized over the estimated useful life. Future income taxes are recognized on the acquisition date on that asset in the purchase price allocation process. As at August 31, 2001, 2002 and 2003, in-process research and development recorded under Canadian GAAP was fully amortized.

#### **e) Write-down of goodwill and intangible assets**

##### **2002**

Under U.S. GAAP, until the adoption of SFAS 142, when assets being tested for recoverability were acquired in business combinations accounted for by the purchase method, the goodwill that arose in that transaction had to be included as part of the assets grouping in determining recoverability. The intangible assets tested for recoverability in 2002 were acquired in business combinations accounted for using the purchase method and, consequently, the company allocated goodwill to those assets on a pro rata basis using the relative fair values of the long-lived assets and identifiable intangible assets acquired as determined at the date of acquisition. The carrying value of goodwill identified with the impaired intangible assets was written down before any reduction was made to the intangible assets. Intangible assets were then written down to their fair value.

The fair value of intangible assets was determined based on discounted future cash flows. The cash flow periods used were ten and eleven years, using annual growth rates ranging between 10% and 30% and discount rates between 15% and 18%. The assumptions supporting discounted cash flows, including the cash flow periods, the annual growth rates and the discount rates, reflect management's best estimates. The discount rates were based upon the company's weighted average cost of capital as adjusted for the risks associated with operations.

The unallocated portion of goodwill was tested for recoverability at the subsidiaries' level based on the related pre-tax undiscounted future cash flows using the same assumptions and methodology as used for Canadian GAAP purposes.

Under U.S. GAAP, the company recorded a charge of \$281,278,000 to write down a significant portion of goodwill and a pre-tax charge of \$27,105,000 to write down a significant portion of acquired core technology. Of the total charge of \$308,383,000, \$170,079,000 was related to EXFO Burleigh for goodwill and acquired core technology, \$83,637,000 was related to EXFO Photonic Solutions for goodwill and acquired core technology and \$54,667,000 was related to EXFO Protocol for goodwill.

Under Canadian GAAP, no allocation of goodwill was required and each asset was tested for recoverability separately based on its pre-tax undiscounted future cash flows over its expected period of use.

Also, under Canadian GAAP, the impairment loss for intangible assets was measured as the difference between the carrying value and the pre-tax undiscounted future cash flows.

Finally, under U.S. GAAP, the carrying value of goodwill reviewed for impairment was \$46,380,000 higher than the carrying value of the same goodwill tested under Canadian GAAP because the measurement dates used to account for the business combinations were different between Canadian GAAP and U.S. GAAP as explained in item d).

##### **2003**

In 2003, Canadian and U.S. GAAP were harmonized to eliminate the existing differences in the assessment and measurement of impairment loss for goodwill and intangible assets. Thus, in 2003, goodwill and intangible assets were tested for impairment using similar methodologies. However, considering that the existing carrying value of goodwill and intangible assets was lower under U.S. GAAP than under Canadian GAAP, the required impairment loss under U.S. GAAP was lower.

Consequently, under U.S. GAAP, the company recorded a charge of \$872,000 to write down goodwill of EXFO Burleigh and a pre-tax charge of \$377,000 to write down acquired core technology of EXFO Burleigh, compared to a write-down of \$4,505,000 for goodwill and a write-down of \$2,922,000 for intangible assets under Canadian GAAP, creating a reconciliation item of \$6,178,000 in the statement of earnings.

Furthermore, considering differences in the carrying value of intangible assets between Canadian GAAP and U.S. GAAP due to impairment losses, adjustments to amortization of such assets and related future income taxes were required as well.

#### **f) Income taxes**

Considering the tax effects of the adjustments discussed in items b), d) and e), the valuation allowance required under U.S. GAAP was \$252,000 higher than under Canadian GAAP.

#### **g) Loss per share**

Under U.S. GAAP, the presentation of per share figures for loss before amortization and write-down of goodwill is not permitted.

#### **h) Share capital**

Under Canadian GAAP, restricted shares reacquired from employees under the stock purchase plan are treated as arm's length repurchases of shares, whereas under U.S. GAAP, the reacquisition of shares would be accounted for as a forfeiture by the employee, which means that any difference between the amount originally credited to share capital and the remaining deferred compensation cost will be credited to compensation expense in the current period. The subsequent resale of the shares would be treated as an issuance of shares for the proceeds received.

#### **i) Research and development tax credits**

Under Canadian GAAP, all research and development tax credits are recorded as a reduction of research and development expenses. Under U.S. GAAP, tax credits that are refundable against taxable income are recorded in the income taxes. This difference had no impact on the net loss and the net loss per share figures for the reporting years.

#### **j) New accounting standards**

On September 1, 2002, the company prospectively adopted SFAS 142, "Goodwill and Other Intangible Assets", which is similar to CICA handbook section 3062 described in note 2.

The following table summarizes the impact of this change in accounting policy on the net loss and the net loss per share for the comparative previous periods on an adjusted basis:

Years ended August 31,	2002	2001
Net loss for the year	\$ (382,893)	\$ (29,478)
Add-back:		
Amortization of goodwill for the year	47,284	39,529
Adjusted net earnings (loss) for the year	\$ (335,609)	\$ 10,051
Basic and diluted net loss per share	\$ (6.31)	\$ (0.56)
Basic and diluted adjusted net earnings (loss) per share	\$ (5.53)	\$ 0.19

### Unaudited pro forma information on business combinations

Under U.S. GAAP, pro forma information must be provided as though the business combinations had occurred at the beginning of the reported periods.

The following unaudited pro forma information reflects the results of operations as if the 2002 acquisition had been completed on September 1, 2001:

	Year ended August 31, 2002 (unaudited)
Sales	\$ 75,282
Net loss	\$ (393,039)
Basic and diluted net loss per share	\$ (6.25)

The acquisition of EXFO Gnubi in 2003 was considered insignificant for the purposes of the pro forma information.

Such information is not necessarily indicative of the actual results which would have been achieved, nor is it necessarily indicative of future consolidated results of the company.

### Accounting for stock-based compensation

Under U.S. GAAP, the company has elected to measure compensation costs related to grants of stock options and stock awards using the intrinsic value method of accounting. In this instance, however, under SFAS 123, "Accounting for Stock-Based Compensation", the company is required to make pro forma disclosures of net loss, basic and diluted net loss per share as if the fair value-based method of accounting had been applied.

The fair value of options or awards granted was estimated using the Black-Scholes options pricing model with the following weighted average assumptions:

Years ended August 31,	2003	2002	2001
Risk-free interest rate	4.83%	4.50%	5.36%
Expected volatility	80%	80%	75%
Dividend yield	Nil	Nil	Nil
Expected life	36 months	40 months	33 months

If the fair value-based method had been used to account for stock-based compensation costs related to stock options and stock awards issued to employees, the net loss and related net loss per share figures under U.S. GAAP would be as follows:

Years ended August 31,	2003	2002	2001
Net loss for the year	\$ (48,201)	\$ (382,893)	\$ (29,478)
Add-back:			
Stock-based compensation costs under APB 25	(216)	(49)	954
Deduction:			
Stock-based compensation costs under SFAS 123	(683)	(4,618)	(10,585)
Pro forma net loss for the year	\$ (49,100)	\$ (387,560)	\$ (39,109)
Basic and diluted net loss per share	\$ (0.77)	\$ (6.31)	\$ (0.56)
Basic and diluted pro forma net loss per share	\$ (0.78)	\$ (6.39)	\$ (0.74)

## 21 • Subsequent event

In September 2003, the company reorganized its business under two reportable segments: Telecom Division and Photonics and Life Sciences Division. The Telecom Division meets the physical-, optical- and protocol-layer test and measurement needs of network service providers, system vendors and component manufacturers throughout the global communications industry. The Photonics and Life Sciences Division mainly leverages developed and acquired technologies for high-tech industrial manufacturing and research markets.

EXFO's President and Chief Executive Officer ("CEO") has been identified as the chief operating decision-maker in assessing the performance of the two segments and the allocation of resources to the segments. Each reportable segment will be managed separately. Earnings from operations represent the primary measure used by the CEO in assessing performance of the reportable segments. Costs associated with shared services and corporate costs will be allocated to segments.

Starting September 1, 2003, the company will provide the required information about each reportable segment. However, the company will not provide comparative information for previous periods about each segment because this information is not available and it is impracticable to do so. The accounting policies of the reportable segments will be the same as those applied in the consolidated financial statements.

Until August 31, 2003, the company was organized under one reportable segment, being the development, manufacturing and marketing of fiber-optic test, measurement and monitoring solutions for the global telecommunications industry (note 16).

## 22 • Comparative figures

Certain comparative figures have been reclassified to conform with the current-year presentation.